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Fiscal Composition and Aid Effectiveness: A Political Economy Model☆

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Summary. — In the long run tax effort, we argue, determines the effectiveness of aid, and this relationship operates simultaneously with the negative link in the opposite direction observed by Bräutigam and Knack (2004) and others. Tax effort and the ability of the state to diversify its taxation structure, we find, are significantly linked to growth and poverty indicators. The key message for policy is that a broadening of the tax structure in low-income countries is crucial in order to enable those countries to escape from the "weak-state–low-tax trap," and to make aid effective.
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Key words — overseas aid, aid effectiveness, political economy, fiscal policy, tax policy

1. INTRODUCTION

For all the idealism, and increased aid levels, aroused by the Millennium Goals and Make Poverty History campaigns, the literature on the effectiveness of aid flows has entered a gloomy phase. The most up-to-date and comprehensive recent study of aid effectiveness, the paper by Rajan and Subramaniam (2008) finds no significant association between aid and growth in any region, whatever the lag-structure that is used. This finding casts a shadow over the more optimistic results achieved by, for example, Hansen and Tarp (2001), Mosley et al. (2004) and Clemens et al. (2004, 2012), all of which suggest that long-term aid flows, at least since the 1990s, had a positive impact on the performance of developing economies. Explanations of this poor performance contain two major strands. One, favored by Rajan and Subramaniam (2009), invokes the purely economic mechanism of "Dutch disease": aid flows buoy up the exchange rates of recipient developing countries, in a manner which blunts their competitiveness and their growth. Another, associated with Bräutigam and Knack (2004) draws a contrast between short-term and long-term impacts, and suggests that the long-term institutional impact is a negative one, which over time cancels out any positive short-term impact. The reasons for this negative institutional impact are multiple, and include a tendency for aid flows to be used corruptly in some recipient countries (Knack & Rahman, 2007) and a tendency for aid flows to undermine tax effort (Gupta, Clemens, Pivovarsky, & Tiongson 2003; Moore, 1998), leading in turn to lower public expenditures and lower growth possibilities.

In this paper, we pursue the second of these two explanatory strands—i.e., the hypothesis that aid damages institutions—with particular reference to fiscal institutions. Initially, we return to the so-called "fiscal response" literature of the 1980s, which linked aid effectiveness to fiscal performance. We then build on this by showing that the composition of public expenditure and taxation, as well as their level, is an important determinant of aid effectiveness. Finally, we seek to understand the political economy underlying the state's choice of an inclusionary, rather than an exclusionary, fiscal strategy—which, we argue, plays an important part in determining the composition of taxation and expenditure. Throughout, our concern is to improve aid effectiveness if that is possible—with a focus on fiscal approaches to that objective—and only secondarily to measure the size and significance of the aid effectiveness coefficient.

2. THE ARGUMENT: FISCAL DETERMINANTS OF AID EFFECTIVENESS

Three decades ago, in Mosley (1980), we showed that fiscal performance was a key element in determining aid effectiveness over the previous two decades. We defined fiscal performance not only in terms of the level and productivity of public expenditure, but also in terms of the willingness of governments to finance that expenditure out of taxes rather than simply out of aid flows, on the grounds that this is a key determinant of the stability and effectiveness of public expenditure. In that paper, we defined willingness to finance public expenditure out of taxes as "incremental tax effort," or the degree to which public revenue as a share of taxation rises over time, and argued that it was a key element in making public expenditure and thence aid more effective. Incremental tax effort is not an easy thing to generate in a poor country with a weak state, as politically it is in the short term much less costly to finance additional expenditure by asking donors for more aid than by raising taxes. This poses the obvious risk of "bottom billion" countries being caught in a low-tax, weak-governance vicious circle, a dilemma explored in particular by Moore (1998).

However, for those states who manage to escape this vicious circle—including the countries of the Far East in the 1970s and 1980s, Russia and many countries of Eastern Europe in the 1990s and now the "proto-developmental states" of Africa, such as Uganda and Ghana, in the 2000s—there are important rewards to increasing public revenues in terms of state-building. One of them is that one source of potential political instability, which is volatility in aid disbursements [1] (Bulir & Hamann, 2008; Fielding & Mavrotas, 2005; Hudson & Mosley, 2008) is diminished in proportion as the ratio of tax revenue to aid revenue can be increased. However, a second

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Table 1. *Tax Ratio Dynamics (1990 to Present). Numbers in Each Cell Represent the Absolute Number of Countries in Each Category*

	Low-income (average tax ratio = 13.2%)	Middle-income (average tax ratio = 19.3%)
Numbers with static or falling tax ratios	11 (Burundi, Cote d'Ivoire, DRC, Kyrgyz Republic, Madagascar, Nicaragua, Nigeria, Pakistan, Sri Lanka, Yemen, Zambia, Zimbabwe)	6 (Czech Republic, Hungary, Jordan, Indonesia, Panama, Venezuela)
Numbers with rising tax ratios	9 (Bangladesh, Cambodia, Ghana, Kenya, Nepal, Rwanda, Sierra Leone, Uganda, Vietnam)	35 (Argentina, Bolivia, Botswana, Brazil, Bulgaria, Chile, Colombia, China, Dominican Republic, Ecuador, Egypt, Fiji, Guatemala, India, Iran, Jamaica, Kazakhstan, Lesotho, Malaysia, Mexico, Morocco, Papua New Guinea, Papua New Guinea, Paraguay, Philippines, Poland, Romania, Russia, Senegal, South Africa, South Korea, Swaziland, Thailand, Tunisia, Uruguay)
Trade taxes share of tax revenue (average 1980–2009; %)	22.1	11.5
Aid/GDP% (average 1980–2009)	11.1	4.0

Source: International Monetary Fund (IMF), *Government Expenditure Statistics*, various issues; 61 observations, as listed. "Rising tax ratios" denotes that the regression coefficient of tax effort (tax revenue/GDP) on time is significantly positive over the period 1990–2008. For 13 countries in our sample, no significant trend is observable. A "middle-income" country is defined as a per capita income in excess of $1000 in current dollars in 2009, and a "low-income" country is defined as a country with a per capita income below that level.

and more fundamental advantage of building up the tax base to finance public expenditures is that, in proportion as citizens are free to express their wishes, governments are put under pressure to improve public services—a pressure which is absent in the case of aid-financed expenditures since taxpayers, unlike aid recipients, only get what they pay for (Bräutigam, Fjeldstad and Moore, 2008; Haggard & Kaufman, 2008, p. 356 [2]). Thus, our main story is that, because expenditure financed out of taxation is in the long run more effective than expenditure financed out of aid flows, aid becomes more effective in proportion as it incentivises, rather than substituting for, the creation of tax revenue, and if we can understand the political process by which this happens, we will better understand the macro-effectiveness of aid.

A first step in explaining this political economy is to see that achieving a long-term increase in tax revenue requires an evolution of tax structures. Many of the poorest countries have inherited, almost unaltered from colonial times, a structure of taxation which is highly dependent on foreign trade in primary commodities, and this is inhibitive of development, both because this category of expenditure does not grow so fast as world trade or expenditure as a whole, and because commodity trade is more subject to violent and unexpected fluctuation than other tax bases (Greenaway & Milner, 1991). Therefore, development of tax revenue, and of the economy as a whole, may depend on the elite being motivated to diversify the tax base. Uganda is a notable example. In 1986 85% of its public revenue was derived, not just from trade taxes, but from export taxes on coffee alone (Uganda, *Statistical Abstract*, 1987). As a consequence, most other commodity exports were wiped out, the ratio of taxation to income was only 5%, and public expenditure was heavily constrained and aid-reliant. By 1995, the export tax had been eliminated in favor of import duties, a value added tax (VAT) and various user charges had been brought in to augment revenue, the ratio of taxation to gross domestic product (GDP) had increased to 12%, and Uganda had become one of the fastest-growing economies in Africa. Table 1, which describes the dynamics of developing-country tax ratios between 1990 and the present, illustrates both the fundamental problem and the possibility of escape from it. As illustrated by Moore in the 1990s, a majority of low-income countries have been unable to raise their tax ratios over this period—and have thereby been tightly constrained in terms of the volume and the effectiveness of their expenditure—whereas a majority of middle-income countries have been successful in escaping from this constraint. However, nine low-income countries—the "off-diagonal" cases listed in the bottom left-hand corner of Table 1—have managed to spring the trap. Since, on our hypothesis, being able to do this holds the key to aid effectiveness, it is of obvious interest to understand what distinguishes the political economy of the countries which have been able to escape from those who have not.

Thus, we see the likelihood of escape from the "low state capacity, low growth" trap as crucial to aid effectiveness, and this likelihood as being determined by the balance, within the recipient elite, between narrowly patrimonial (rent-seeking) elements whose focus is on short-term survival, and elements whose focus is on the long term and on the putting together of a broad-based, inclusive "developmental coalition." What determines the likelihood of the latter outcome? On this issue, our understanding consists more of case-studies and improvisations rather than a rigorous body of knowledge. However, basing ourselves mainly on case-study material such as that contained in Besley and Cord (2007) and Mosley (2012), we offer four hypotheses:

(1) Inclusiveness (specifically in the allocation of fiscal resources) often comes about because exclusiveness has repeatedly failed to deliver growth or political stability, and the fundamental institutional changes associated with its advent are often associated with a learning experience such as a period of chronic political instability which convinces the elite that "we cannot carry on like this if we are going to progress." We can return again to the example of Uganda, whose National Resistance Movement, from the early 1990s onward, decided that fundamental fiscal reforms were required to establish the state on a stable and inclusive basis, which it saw as a precondition for

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