CHAPTER

2 Establishing a Medium-Term Resource Envelope

The first step in establishing a medium-term resource envelope is to collect information on the intentions of official and private donors. Governments typically lack information on private aid flows, and a part of the aid from official sources is also provided outside the budget. The increase in the average number of donors per country, as well as an increase in the number of aid channels, has complicated the task of gathering accurate information on external flows. The average number of donors per country has increased from about 12 in the 1960s to more than 30 during 2001–05 (World Bank, 2007a). In some sectors, such as health, aid channels have also proliferated, stretching the already weak capacity of low-income countries. Governments should encourage private aid organizations to strengthen their representation in recipient countries, while official donors should reach out to key private donors and invite them to participate in existing donor coordination structures.

Aid characteristics have implications for budget planning and formulation. Earmarking by donors limits flexibility in the use of budgetary resources. When aid resources are earmarked, governments cannot readily reallocate these resources in response to changing macroeconomic conditions and priorities, which hampers the implementation of expenditure plans. Similarly, the requirement for counterpart funds reduces the budgetary resources available for other purposes. The terms of financing also have implications for budget planning and debt sustainability. Grants do not require any budgetary allocation for debt service payments, whereas loans do, thereby establishing a claim on future resources.

Medium-term aid flow projections should reflect the IMF staff's best estimates. Aid flows (both loans and grants) should be projected based on all relevant and available information, including donor commitments and indications. Aid forecasts in IMF-supported programs also need to reflect debt sustainability concerns. Overly optimistic or pessimistic projections should be explicitly justified, because they may complicate fiscal management by creating mismatches between spending and available resources (IMF, 2007a). The costs of overly optimistic aid forecasts are likely to be higher than the costs of overly pessimistic ones, because aid shortfalls might entail fiscal adjustment. To mitigate such costs, spending should be anchored in a medium-term perspective, as outlined below. Aid shortfalls could then be smoothed out over time, as could fiscal adjustment.

Sustaining and increasing the domestic revenue effort is critical to achieving the MDGs. Strengthening revenue-raising capacity is essential to guarding against aid volatility and preparing for an orderly exit from long-term reliance on aid. Moreover, projects financed by scaled-up aid flows will give rise to future recurrent spending, which will need to be financed by domestic resources. Insufficient growth in domestic revenues will either constrain other spending or lower the productivity of existing programs and assets through inadequate provision for operations and maintenance outlays. Care has to be taken to ensure that scaled-up aid does not weaken the incentive to mobilize domestic revenues by relaxing the budget constraint, particularly when institutions are weak (Gupta and others, 2004). However, lowering distortionary tax rates may be part of the strategy of some low-income countries to promote private sector–led development.

Trade liberalization is another important reason to strengthen the domestic revenue base. When trade is liberalized, aid absorption is facilitated and pressures on the real exchange rate are mitigated. However, this liberalization would lower overall revenues, because these countries on average derive one-third of their total revenue from trade taxes (Keen and Simone, 2004). Therefore, trade liberalization would need to be accompanied by a strengthening of indirect taxes. International competition in tax incentives (including those offered to investors in free trade zones) has reduced both the corporate tax revenue and its base in many low-income countries, making it more difficult to recover revenue lost because of trade liberalization. Governments can adapt to this new reality by improving the efficiency of value-added taxes (VATs), which can raise significant revenues in many low-income countries (Selassie and others, 2006). This will require reducing exemptions and broadening the tax base for VATs.

Policies for broadening the tax base and strengthening revenue administration are critical to raising additional revenues in low-income countries. Low revenues are not, in most cases, a reflection of low tax rates—in fact, tax rates are high in many of these countries—rather, they reflect narrow tax bases and weak administrative capacity.[5] A tax-to-GDP ratio of at least 15 percent is considered a reasonable target for most low-income countries (Selassie and others, 2006). The United Nations Millennium Project (2005) estimated that low-income countries could mobilize additional domestic revenues equivalent to 4 percent of GDP. Improved organizational structure of revenue administration, strengthened audit capacity, and fair tax enforcement all contribute to the expansion of the tax base. Revenue administration reforms are a particularly high priority in many countries in sub-Saharan Africa.

[5]See IMF (2007b) for details.