Domestic Revenue Mobilization and Debt Relief: The Lack of Any Link

Mark Plant and Nancy Lee

Abstract

As the global financial community considers how to extend debt relief accompanied by IMF adjustment programs to vulnerable low-income countries, the issue of policy conditions for fiscal adjustment will inevitably arise. This paper considers the effectiveness of conditions related to domestic revenue mobilization (DRM) in the last systematic round of debt relief in the early 2000s Highly Indebted Poor Countries Initiative and the Multilateral Debt Relief Initiative (HIPC/MDRI). We find that debt relief had no impact on low-income countries' DRM. Countries benefitting from debt relief had roughly the same DRM as those that did not. And DRM grew only slightly over time for both sets of countries.

In the months to come there will be pressure to use debt restructuring and leverage to accelerate fiscal reforms and boost domestic revenue mobilization so that LICs can be seen to be contributing "their fair share" to economic recovery and transformation. Experience with the HIPC/MDRI tells us that we must be realistic in our expectations: external forces have limited impact unless combined with strong internal will and implementation capacity.

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Contents

List of figures

Introduction

As the global community struggles with the economic impact of the COVID-19 pandemic, the issue of debt sustainability, particular in vulnerable low-income countries (LICs) has re-emerged. As of the end of June 2021, 7 LICs are in debt distress, 29 are at high risk of debt distress, and only 9 are scored by the International Monetary Fund and the World Bank as being at low risk. With no immediate end in sight to the economic devastation caused by the pandemic, debt prospects in LICs are not expected to improve. There have been increased calls for debt relief, beyond the G20 Debt Service Suspension Initiative (DSSI) which expired at the end of 2021.

The Common Framework for Debt Treatments beyond the DSSI, which was agreed by the G20 in 2021, seeks to strengthen the process but fundamental uncertainties remain that will slow debt resolution, especially how to bridge differences regarding comparable treatment for public and private creditors.

Nevertheless, we know that the sine qua non of any formal debt restructuring is a definition, by the IMF, of the needed financing envelope for the recipient country in the context of a macroeconomic reform program that seeks to bring the country back into a position of debt sustainability over the medium term. The IMF is likely to support such programs financially, with disbursements from the Poverty Reduction and Growth Trust (PRGT) through the Enhanced Credit Facility (ECF).

A key element of any such program will be a fiscal framework for the government that allows sufficient room for essential government expenditure and the rebuilding of the economy after the crisis. This will be no easy task, as health needs will continue to be at high levels for most LICs while domestic revenue collections will continue to be difficult given the significant tax breaks granted during the COVID crisis. Slowly over time, domestic revenues will have to be rebuilt to their pre-COVID levels and expanded further. Expenditure growth will have to decelerate while protecting critical social and infrastructure needs. (see, for example, this analysis by CGD experts).

An important question in the design of the economic reform program and the support from the IMF will be to what extent the program should depend on enhanced revenue mobilization: how much should the fiscal consolidation rely on increasing revenues versus decreasing expenditures?

Debt relief given under the Highly Indebted Poor Countries Initiative and the Multilateral Debt Relief Initiative (HIPC/MDRI), in the early 2000s, gives some precedent to consider. While HIPC/MDRI took place in much more benign global economic conditions than now, LICs receiving this relief faced similar problems: economies weighed down by a heavy debt burden and an imperative to address poverty and transform their economies to a more inclusive growth path. At the time, many viewed HIPC/MDRI as the final offer of debt relief by the international community, that would lessen the burden of debt service and help set LICs on a long-term sustainable trajectory.

The economic programs that supported HIPC/MDRI focused primarily on using the fiscal space freed up by debt relief to enhance poverty-reducing government expenditure. Increasing revenues, both through economic growth and increased tax rates, were usually part of the package, but not at center stage.

Ex-post, the social spending and growth impact of HIPC/MDRI appears to have been limited. Studies on the expenditure generally show some increase in spending at least in the out years. An early World Bank study concludes that the HIPC initiative positively contributed to augmenting resources for health and education.[1] However, Hepp (2005) finds that debt relief had no major improvement in health expenditure per capita in HIPC countries.[2] Knoll (2013) argued that the HIPC and MDRI initiatives, while contributed to increasing private investment, failed to stimulate sound public investment and found out no major improvement in total factor productivity, calling into question the hypothesis of significant growth due to debt relief.[3]

Empirical evidence of the impact of the HIPC initiative on domestic resource mobilization is mixed. Dömeland and Kharas (2009) find that debt relief seemed to not have had an impact on fiscal space for HIPC-initiative countries.[4] A World Bank report (2006) assessing the HIPC initiative suggests that weak improvements in domestic revenue mobilization are present in post-completion-point countries.[5] Ferry (2015) argues that the tax effort of HIPC-initiative countries is not consistent over time, as these countries report having greater revenue collection levels before debt relief is granted.[6] However, Cassimon et al. (2013) find that the HIPC initiative has had a positive impact on domestic revenue.[7]

Unlike most of the research conducted on this topic, our analysis focuses on assessing the possible effects of HIPC and MDRI debt relief on domestic revenue mobilization by comparing two groups of countries: HIPC low-income countries and non-HIPC low-income countries over the period 2003–2013; our research examines the evolution of domestic revenue by type of tax, explores main revenue sources, and assesses the relationship between domestic revenues and IMF conditionality.

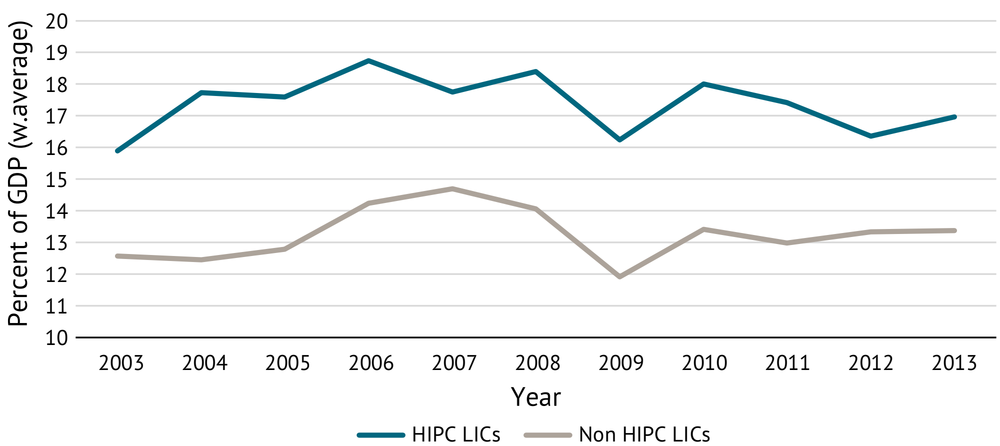
We find that HIPC debt relief and associated policy reform objectives had no differential impact on domestic resource mobilization in LICs. There is an inertia in country domestic resource mobilization systems that is difficult to overcome. Increasing domestic resource mobilization is a long-term effort requiring political and technical perseverance. This makes the prospects for a swift recovery from LIC debt distress even more daunting and warns against relying on short-term IMF programs to effect the needed change.

Revenue trends

We considered the revenue performance of low-income countries (LICs) that benefitted from HIPC/MDRI debt relief and LICs that did not over the period 2002–14, when data were available. Here we summarize graphically the key results from our study. (The details of data sources, data definitions, research questions, and regressions are available from the authors upon request.)

Throughout the period, HIPCs had considerably higher total revenue/GDP ratios than non-HIPCs (Figure 1). The differences in ratios for the two country groups averaged 4 percentage points over the period 2003 to 2013. But the pattern over time was similar for both HIPCs and non-HIPCs, with a steep drop during the Global Financial Crisis and a slight overall upward trend.

Figure 1. Total revenue to GDP ratios, by HIPC status



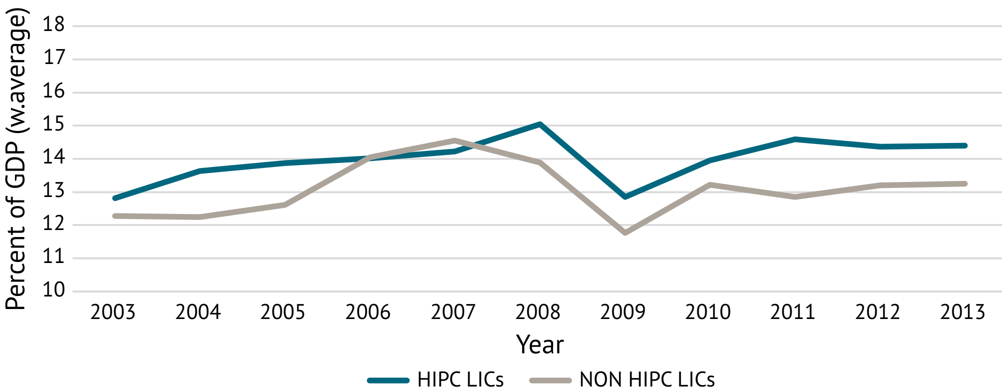
Notes: Data sample: 15 observations (HIPCs LICs), 14 observations (Non HIPC LICs). Total revenue comprises tax revenue, grants including ODA, other revenue including rents and royalties, and social contributions in the form of employee, employer, self-employed, unemployed, unallocable and imputed contributions.

Sources:

1) IMF Government Finance Statistics—Revenue
2) World Bank WDI
3) World Bank GNI per capita operational and analyitical classifications
4) IMF policy paper, heavily indebted poor countries (HIPC) initiative and multilateral debt relief initiative (MDRI)—statistical update, August 2019.

The difference in overall revenues was in part due to higher overall grants received by HIPCs, both because they were more likely to receive grant aid from development partners and because that debt relief was in part counted as grants in revenue calculations. Removing grants significantly reduces the revenue/GDP gap between the two sets of countries, but we nonetheless see a similar pattern: a small increase in non-grant revenues over time for both country groups, with HIPCs at a somewhat higher level (Figure 2).

Figure 2. Total non-grant revenue* to GDP ratios, by HIPC status



Notes: Data sample: 15 observations (HIPCs LICs), 14 observations (Non HIPC LICs). *Non-grant revenue comprises tax revenue, other revenue including rents and royalties, and social contributions in the form of employee, employer, self-employed, unemployed, unallocable and imputed contributions.

Sources:

1) IMF Government Finance Statistics—Revenue
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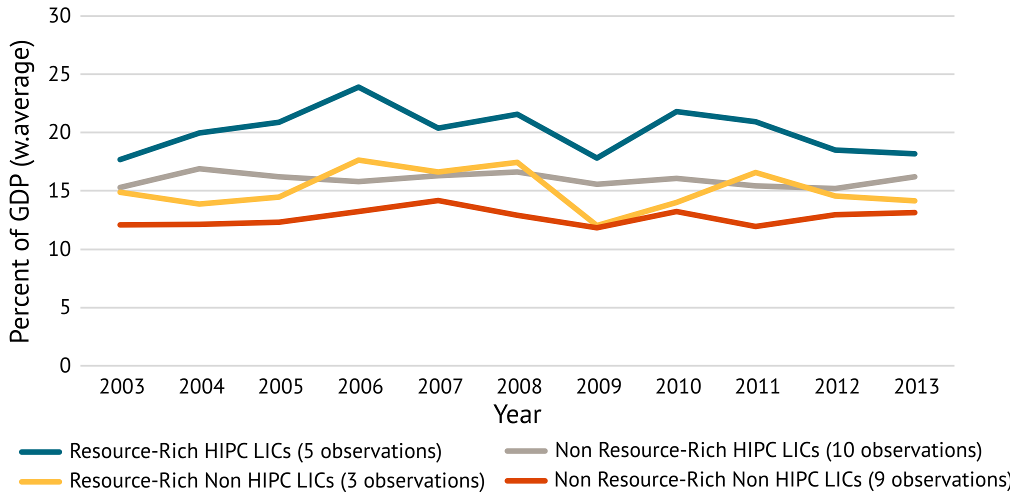
4) IMF policy paper, heavily indebted poor countries (HIPC) initiative and multilateral debt relief initiative (MDRI)—statistical update, August 2019.

One important distinction that emerged was the difference between resource-rich and non-resource rich LICs. Resource-rich HIPCs have much higher revenue ratios, while resource-rich non-HIPCs appear to have about the same revenue ratios as LICs without substantial revenues from resource rents and royalties. Higher HIPC LIC reliance on indirect and trade taxes (see below) could help explain this to the extent that such taxes capture part of the domestic and international sale of resources. Both resource-rich HIPCs and non-HIPCs experienced considerable revenue volatility, though such volatility was higher in resource-rich HIPCs (Figure 3).

Figure 3. Total revenue to GDP ratios, by natural resources endowment and HIPC status



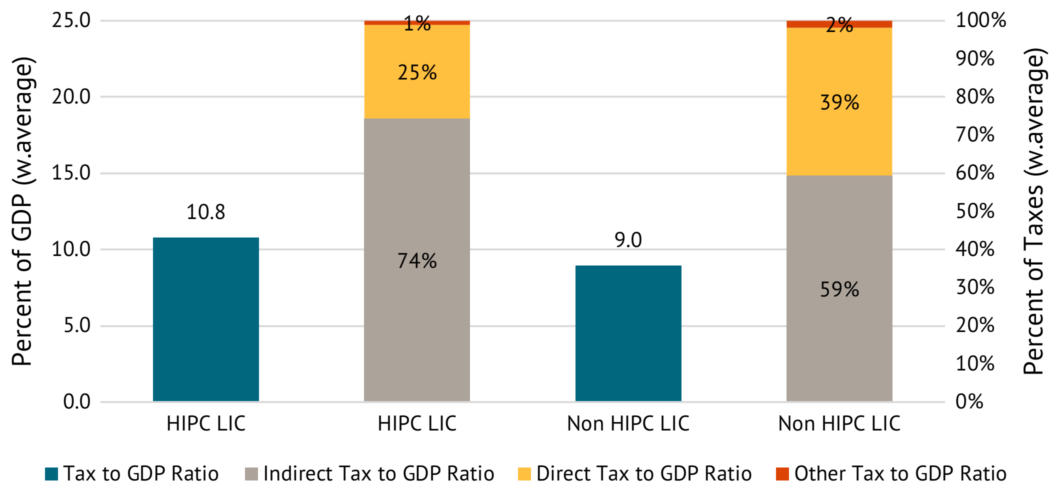
Sources:

1) IMF Government Finance Statistics—Revenue
2) World Bank WDI
3) World Bank GNI per capita operational and analyitical classifications
4) IMF policy paper, heavily indebted poor countries (HIPC) initiative and multilateral debt relief initiative (MDRI)—statistical update, August 2019.

Tax revenue performance composition and performance

At the beginning of the period (2003) the tax revenue/GDP ratio was somewhat higher for HIPCs: nearly 11 percent versus 9 percent for non-HIPCs (Figure 4). But the tax revenue composition was much different. The share of indirect taxes (those levied on goods and services, rather than income and profit) was 15 percentage points higher for HIPCs than for non-HIPCs, indicating a heavy reliance on potentially regressive taxes in HIPCs. Non-HIPCs relied more heavily on income taxes, generally viewed as less regressive, especially in poorer countries with less scope for progressive expenditure programs to offset tax regressivity.

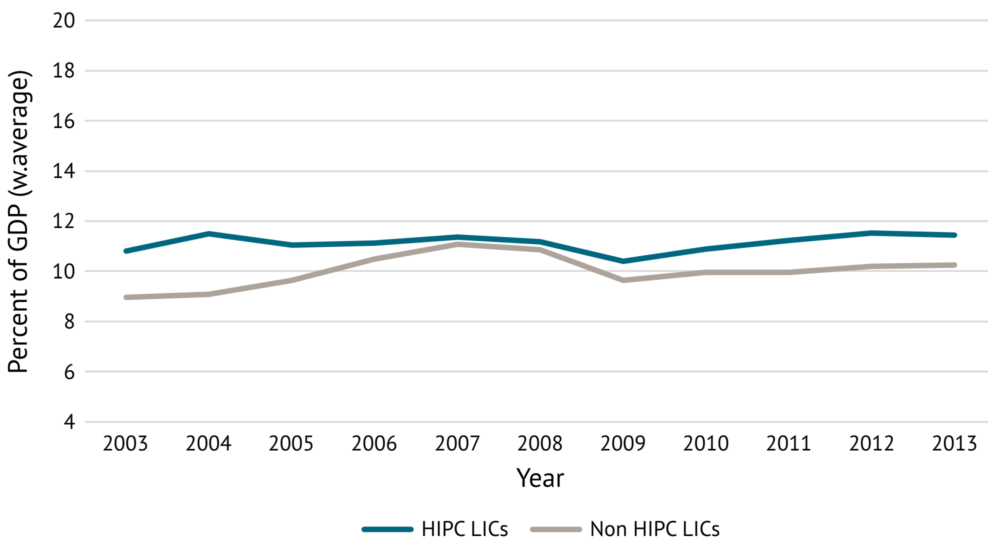
Figure 4. Tax revenue to GDP and shares of tax revenue ratios, by HIPC status and type of tax, in 2003



Note: Number of observations: 29 Countries (15 HIPCs, 14 Non-HIPC LICs).
Source: IMF Government Finance Statistics—revenue.

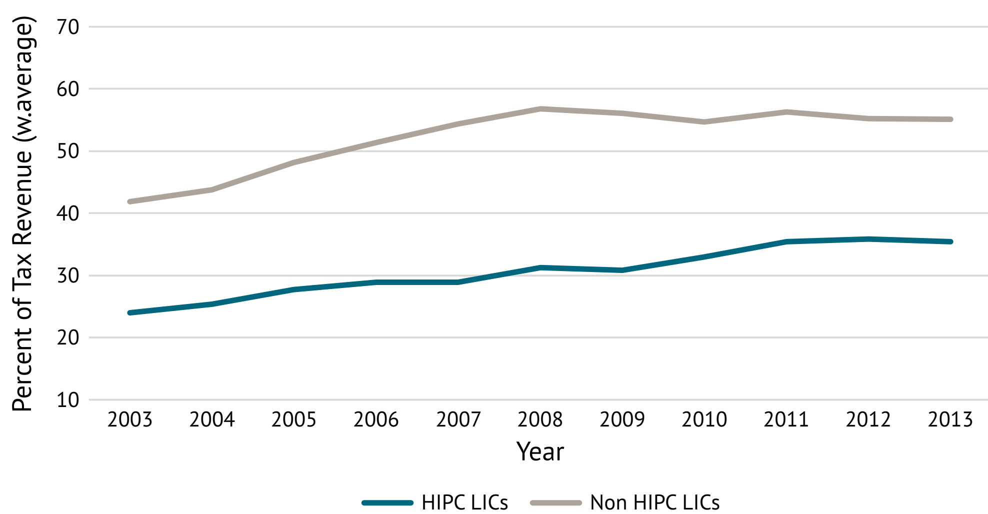
Over time, non-HIPCs slightly narrowed, but did not close, the tax revenue/GDP difference (Figure 5). For both HIPCs and non-HIPCs, the share of direct taxes in total tax revenue increased, but non-HIPCs relied much more than HIPCs on direct taxes (Figure 6). The largest tax revenue source for HIPCs was taxes on goods and services throughout the period, whereas the largest source for non-HIPCs was consistently taxes on income, profits, and capital gains. In both country groups, the share of international trade taxes dropped steadily over the period (Figures 7 and 8), with non-HIPCs maintaining a greater reliance on direct taxes throughout the period. Over this period HIPCs were in different stages of the debt relief initiative, but we failed to find any correlation between initiative stage and revenue composition or performance.

Figure 5. Tax revenue to GDP ratios, by HIPC status



Note: Data sample: 15 observations (HIPCs LICs), 14 observations (Non HIPC LICs).
Sources:
1) IMF Government Finance Statistics—Revenue
2) World Bank WDI
3) World Bank GNI per capita operational and analyitical classifications
4) IMF policy paper, heavily indebted poor countries (HIPC) initiative and multilateral debt relief initiative (MDRI)—statistical update, August 2019.

Figure 6. Direct tax to total tax revenue ratios, by HIPC status



Note: Data sample: 15 observations (HIPCs LICs), 14 observations (Non HIPC LICs).
Sources:
1) IMF Government Finance Statistics—Revenue
2) World Bank WDI
3) World Bank GNI per capita operational and analyitical classifications
4) IMF policy paper, heavily indebted poor countries (HIPC) initiative and multilateral debt relief initiative (MDRI)—statistical update, August 2019.

Figure 7. Shares of total tax revenue, by type of tax, for HIPC LICs

Note: Data sample: 15 observations.

Figure 8. Shares of total tax revenue, by type of tax, for non HIPC LICs

Note: Data sample: 14 observations.

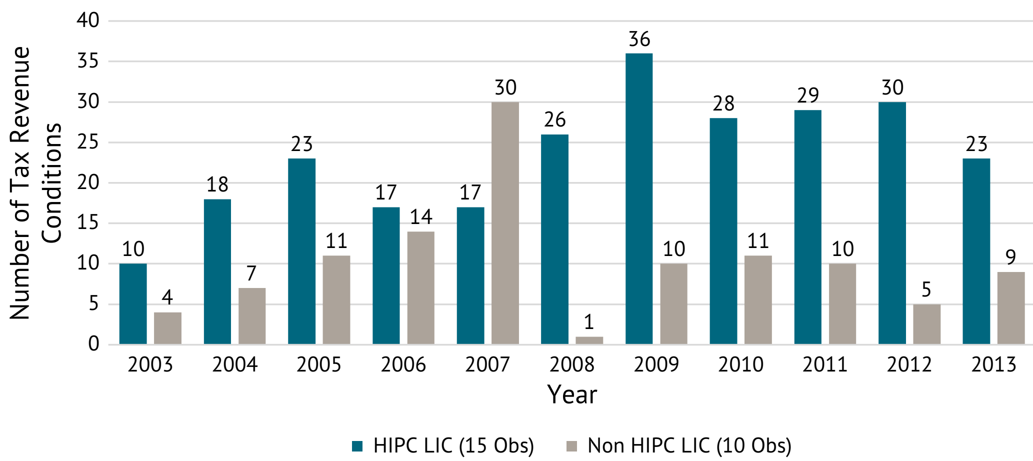
Tax conditionality: HIPCs vs. non-HIPCs

A key question is whether there was a focus on tax revenue conditionality in IMF programs associated with the HIPC program, and, if so, was there an observable effect of that focus. Although we do not see a sizable increase in tax revenues/GDP for HIPCs overall over the period, such conditionality might have driven greater increases in some countries.

There are two types of conditions in IMF-supported programs, either as prior conditions or conditions to be fulfilled under an IMF-supported program after debt relief was given. First, the IMF uses quantitative performance criteria (QPCs) to track the evolution of various macroeconomic aggregates. For example, fiscal QPCs can include ceilings on government borrowing or targets for the central government's primary balance. Second, structural conditions are measures that are not necessarily quantifiable, but advance policy reforms that are deemed essential to achieving objectives and are used for program evaluation. In the fiscal area, these include such things as amending income tax legislation, strengthening tax administration, adopting strategies to tackle tax evasion, removing tax exemptions and concessions, among others.

Looking at tax revenue conditionality in terms of numbers of IMF program conditions for HIPCs versus non-HIPCs, we do see a significant difference (Figure 9). HIPCs had many more structural revenue conditions than non-HIPCs, particularly after 2007, even accounting for the fact that there were more HIPCs than non-HIPCs.

Figure 9. Tax revenue conditionality, by HIPC status, structural

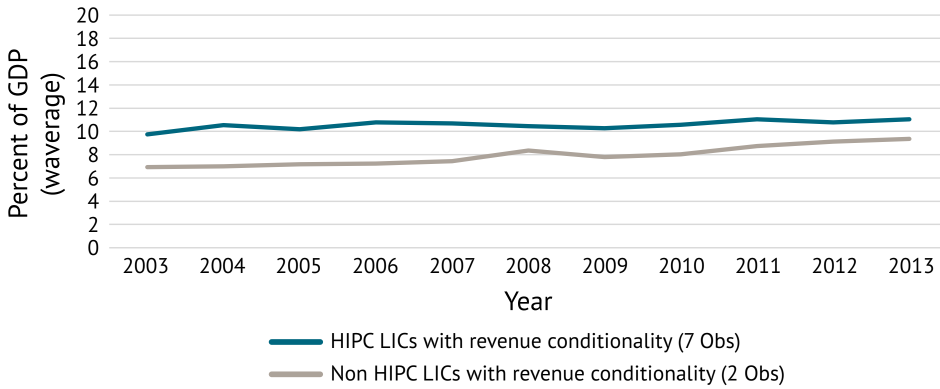


Sources:

1) IMF Government Finance Statistics—Revenue
2) World Bank WDI
3) World Bank GNI per capita operational and analyitical classifications
4) IMF policy paper, heavily indebted poor countries (HIPC) initiative and multilateral debt relief initiative (MDRI)—statistical update, August 2019.
5) IMF MONA database.

Looking just at HIPCs and non-HIPCs with revenue conditionality, we see a slight upward trend in tax/GDP ratios for both, with the increase for the two non-HIPCs being slightly larger (Figure 10). One question for future research is whether the content of the conditionality influenced tax composition, including the higher HIPC reliance over the period on indirect taxes, given anecdotal evidence that the IMF favored the relative administrative ease of relying on value added taxes. Not too much should be read into these findings given the small sample sizes, but there does not appear to be evidence of a large effect of policy conditionality for either HIPCs or non-HIPCs.

Figure 10. Tax revenue to GDP ratios for HIPC and non HIPC LICs, by structural conditionality

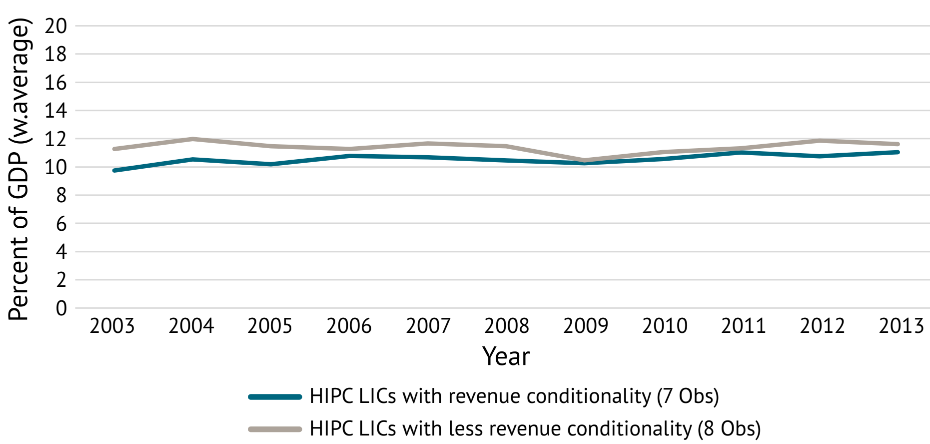


Sources:

1) IMF Government Finance Statistics—Revenue
2) World Bank WDI
3) World Bank GNI per capita operational and analyitical classifications
4) IMF policy paper, heavily indebted poor countries (HIPC) initiative and multilateral debt relief initiative (MDRI)—statistical update, August 2019.
5) IMF MONA database.

Comparing tax/GDP ratios for HIPCs with more revenue conditionality to those HIPCs with less (six or more years with no revenue conditionality) reveals higher tax revenue/GDP ratios through the period for HIPCs *with less conditionality* (although there was a small upward trend for the HIPCs with conditionality) but no significant changes over the period (Figure 11).

Figure 11. Tax revenue to GDP ratios for HIPC LICs, by structural conditionality



Sources:

1) IMF Government Finance Statistics—Revenue
2) World Bank WDI
3) World Bank GNI per capita operational and analyitical classifications
4) IMF policy paper, heavily indebted poor countries (HIPC) initiative and multilateral debt relief initiative (MDRI)—statistical update, August 2019.
5) IMF MONA database.

Further analysis, overall conclusions, and some policy implications

As noted above, this graphical analysis was confirmed by panel regression analysis of the data, where the data sets were sufficiently rich to support such analysis. The bottom line is that there was so little variation over time in revenue trends for the LICs in the sample, that it was impossible to detect any difference between HIPCs and non-HIPCs. In particular:

- HIPC status did not appear to be a significant factor in shaping total revenue performance or tax composition.
- Both HIPC and non-HIPC LICs increased the share of direct taxes (and reduced the share of indirect and trade taxes) in total tax revenues, potentially contributing to less regressive tax systems and more open economies. Non-HIPCs started the sample period with a larger share of direct tax revenues and HIPCs did not catch up.
- IMF tax conditionality associated with programs under HIPC did not appear to result in significantly higher tax revenue/GDP ratios in HIPCs than non-HIPCs.
- It is possible that IMF tax conditionality associated with the programs supported under HIPC may have influenced the shift toward direct taxes, but progress was no faster than in non-HIPC LICs, so the evidence of causality is weak.

As the international community sets about the design and implementation of the macroeconomic programs to support future debt relief in LICs, it should take this evidence as a cautionary tale. There will be pressure to use debt restructuring and associated IMF programs as leverage to accelerate fiscal reforms and boost domestic revenue mobilization so that LICs can be seen to be contributing "their fair share" to economic recovery and transformation. Experience with the HIPC initiative tells us that we must be modest in our expectations. Domestic revenues are a result of a complex set of economic, institutional, and political influence,[8] and they are not easily levered by external incentives. External forces have limited impact unless combined with strong internal will and implementation capacity.

Notes

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