How dependence on external development finance is affecting fiscal policies

CHAPTER 4

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A. Introduction

Critical to achieving the Sustainable Development Goals in LDCs are the domestic public resources needed for public investments and services, as well as enabling policies, to sustain economic transformation, eradicate poverty and end hunger (UNCTAD, 2014b). Private investments are drivers of economic activities, yet a substantial increase in domestic and external public resources is also required for LDCs to boost productive capacities, accelerate growth and build economic resilience. However, resource constraints in LDCs suggest a greater need for external financing, including ODA, to supplement domestic public resources.

The development cooperation landscape is changing rapidly, with the emergence of new financial vehicles and additional actors, including the private sector (see chapter 3). In LDCs, dependence on external finance is driven by persistent structural deficits and balance of payments problems (see chapter 1). Even LDCs with relatively higher tax revenues require substantial amounts of ODA to finance the growing demand for infrastructure and public services, to attain the Goals (UNCTAD, 2014b). The pace of achievement of the Goals and the quality of results also depends on the synergy between domestic and external public resources in the development process. The Addis Ababa Action Agenda highlights the complementary role that international public finance plays in the poorest and most vulnerable countries, and signatory countries committed to further strengthening the mobilization and effective use of domestic resources (United Nations, 2015b).

Strengthening domestic public resource mobilization is critical to closing development financing gaps in LDCs. With domestic public resources failing to keep pace with the increased demand for public goods and services, tax revenue should be ramped up to avert the risk of increasingly unsustainable public debt. ODA is expected to continue to play a catalytic role in LDCs, including in helping to strengthen the management of public finances and develop administrative and institutional capacities. However, misalignments between sectoral allocations of ODA and national priorities place a further constraint on already overstretched public budgets. This is shown partially by the divergent trend between public capital investment expenditure and ODA and an uptick in public debt. The growth in the number of partners with diverse interests bears the risk that LDC development agendas may be rendered alternative and additional. For LDCs to benefit from increased partnerships, specific attention should be paid to aid predictability and accountability and a better alignment with LDC priorities, consistent with the principle of national ownership, an overarching principle of the Goals.[1]

Strengthening domestic public resource mobilization is critical to closing development financing gaps

This chapter seeks to explain the link between fiscal imbalances in LDCs and dependence on external public development finance, and how domestic resource mobilization is already playing a critical role in development financing. It discusses the implications of the slowing inflows of external resources on LDC capacity to close structural fiscal gaps, and how LDCs manage and coordinate development partnerships given the increased number of actors in financing for development. In addition, it provides insights on how misalignment between sectoral allocations of ODA and the national priorities of LDCs impacts on their capacity to accelerate structural transformation, further potential to mobilize additional domestic resources and chance of graduating from the LDC category. Section B discusses recent progress in LDCs in raising domestic resources through taxation, assesses both the capacity and efficiency of tax systems and discusses the scope for mobilizing additional domestic tax revenues from various tax components. In addition, an analysis of the expenditure side provides insights on whether synergy is being achieved through aid. Section C discusses the alignment of international support for development in LDCs. It takes the view that safeguarding the policy space of LDCs and strengthening their institutional capacities are critical in accelerating structural transformation (UNCTAD, 2006a; UNCTAD, 2009). In addition, it provides insights on how divergence between national and partner priorities may negatively impact LDC fiscal policies and slow down structural transformation.

B. The state of fiscal policies in the least developed countries

The link between fiscal policy and ODA and its implications for aid effectiveness have been studied extensively (Morrissey, 2015; Mosley, 2015). The substitutability (additionality) of domestic and external

[1] The term “alignment of aid” is used in this chapter in terms of the extent to which partners use beneficiary country systems and policy frameworks in their aid disbursement, implementation and results frameworks.

LDCs have increased tax collection efforts, but structural constraints limit further growth in revenue

resources can give rise to a trade-off or complementarity between policies oriented towards growth or structural transformation (for example, public investment in energy and transport infrastructure) and social policies such as social transfers and primary health-care expenditure. The impact of aid on government expenditures in recipient countries depends on the composition of aid, but the effect of aid on government revenue is country specific (Chatterjee et al., 2012). To break aid dependence, it is important to reverse on a case-by-case basis the tendency for ODA to promote increased public spending and reduced tax collection efforts and to rather promote a better alignment between ODA allocation and national priorities; aid can also lead to reduced spending in some sectors in favour of others, while maintaining or raising the overall budgetary outlay (Mascagni and Timmis, 2017; Morrissey, 2015; Mosley, 2015; Ouattara, 2006). The complementarity between ODA and domestic resources is presumed in the Addis Ababa Action Agenda because both flows are expected to rise during the period of implementation of the 2030 Agenda. However, concern remains that, in developing countries, ODA dampens incremental tax efforts or the degree to which tax-based revenue rises as a share of government revenue over time (Mosley, 2015; Thornton, 2014).

Strengthening public administration systems in LDCs is crucial in implementing the 2030 Agenda. The capacity of the State to collect taxes can be understood in two ways. First, it refers to technical capacity, which is influenced by the level of economic development and the structure of the economy. Second, tax revenues, as with ODA disbursements, are not outcomes of neutral policies; both have complex incentive structures that have feedback impacts on the amount of tax collected by the State. The starting point of a country on the tax revenue curve matters because tax receipts are sensitive to tax rate increments, depending on the level of economic activity, tax regulatory framework and level of tax compliance (Akgun et al., 2017). Tax policy reforms can positively or negatively impact aggregate demand components, including capital accumulation, and have wider macroeconomic consequences depending on how budget deficits are financed. Under the 2030 Agenda, domestic capacity for tax and other revenue collection is assessed under the indicators for target 17.1, on total government revenue as a proportion of GDP and on the proportion of the domestic budget funded by domestic taxes.[2] Data with regard to the first indicator are covered in the World Development Indicators database of the World Bank but, with regard to the second, several countries are not covered in the government finance statistics of the International Monetary Fund. Tax revenue-to-GDP ratio is an insufficient indicator of capacity to collect tax, yet it provides a reasonable estimate of the fiscal resources that a country can mobilize relative to its economy (Sindzingre, 2007).

1. Recent progress in raising tax revenue

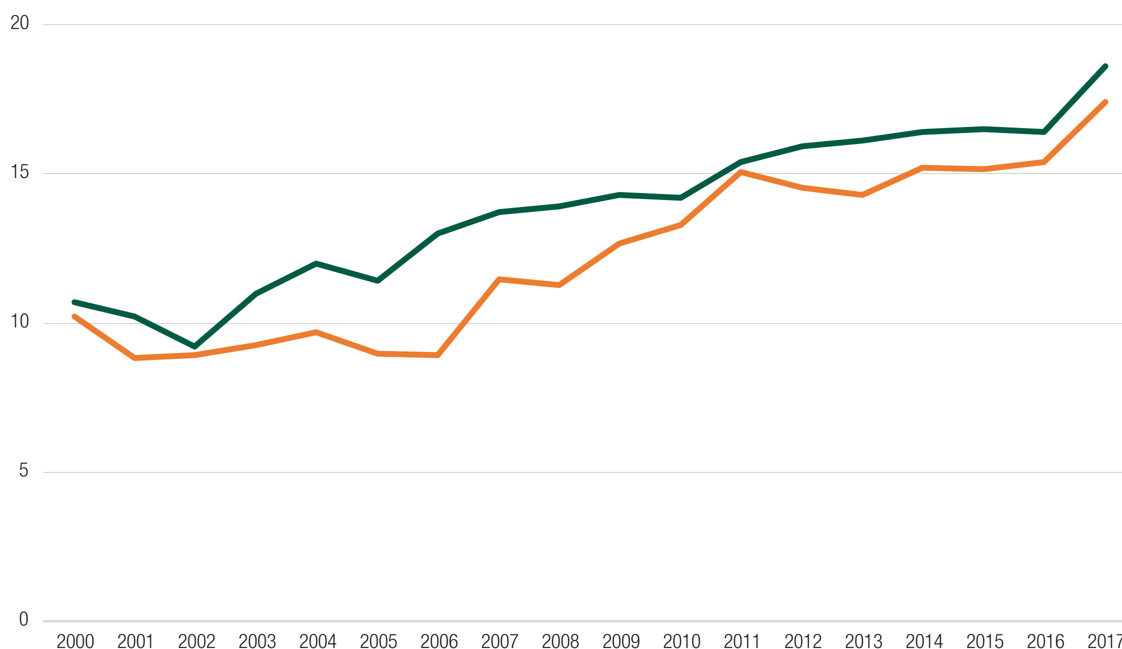
Among LDCs, tax revenue has increased, from an average of 11 per cent of GDP in 2000 to 19 per cent in 2017 (figure 4.1). Despite heterogeneity between countries, the median and average tax revenue-to-GDP ratios have remained close. The trend reveals a slow upward movement in both statistics, yet the number of countries with low ratios has remained relatively matched with those with higher values, implying no radical improvement or deterioration at either extreme. Significantly, in 2011, both reached 15 per cent, which is widely regarded as the minimum threshold necessary to support sustainable growth and development (International Monetary Fund, 2016). However, the tax revenue-to-GDP ratio remains less than 10 per cent in several LDCs. Since 2015, for example, Bangladesh and Myanmar, which are relatively large economies with GDPs of $250 billion and $67 billion, respectively, had ratios averaging only 9 and 6 per cent, respectively. Afghanistan, Angola, Bhutan, the Lao People's Democratic Republic, Rwanda, Timor-Leste and Uganda have also recorded tax revenue-to-GDP ratios averaging less than 15 per cent since 2015. In the last three years, Angola, Bhutan, the Lao People's Democratic Republic, Lesotho, Senegal, Solomon Islands, Togo, Vanuatu and Zambia have experienced sharp declines in tax revenue-to-GDP ratios. Kiribati, at 23 per cent, Lesotho, at 37 per cent, Mozambique, at 22 per cent, and Solomon Islands, at 28 per cent, perform relatively well in such ratios, yet closer analysis is needed to ascertain the strength of their tax systems. For example, the tax base of Kiribati is narrow, with taxes on goods and services, on income and on international trade contributing a combined total of 22 per cent to revenue in 2017. In 2015, fisheries licence fees contributed 78 per cent of total government revenue, and this reliance on a single

[2] The metadata repositories for the related indicators are available at https://unstats.un.org/sdgs/metadata/.

Figure 4.1

Tax revenue-to-gross domestic product ratios in the least developed countries

(Percentage)



Source: UNCTAD calculations, based on data from the World Development Indicators database.

natural resource exposes the country to vagaries in weather, the international price of tuna and fish stocks (Kiribati, 2015). In contrast, the tax revenue of Lesotho is fairly diversified, with value added tax, at 39 per cent, and personal income tax, at 36 per cent, contributing large shares, and corporate income tax, at 15 per cent, and other taxes, at 10 per cent, completing the basket in the 2017/18 fiscal year (Lesotho Revenue Authority, 2018).

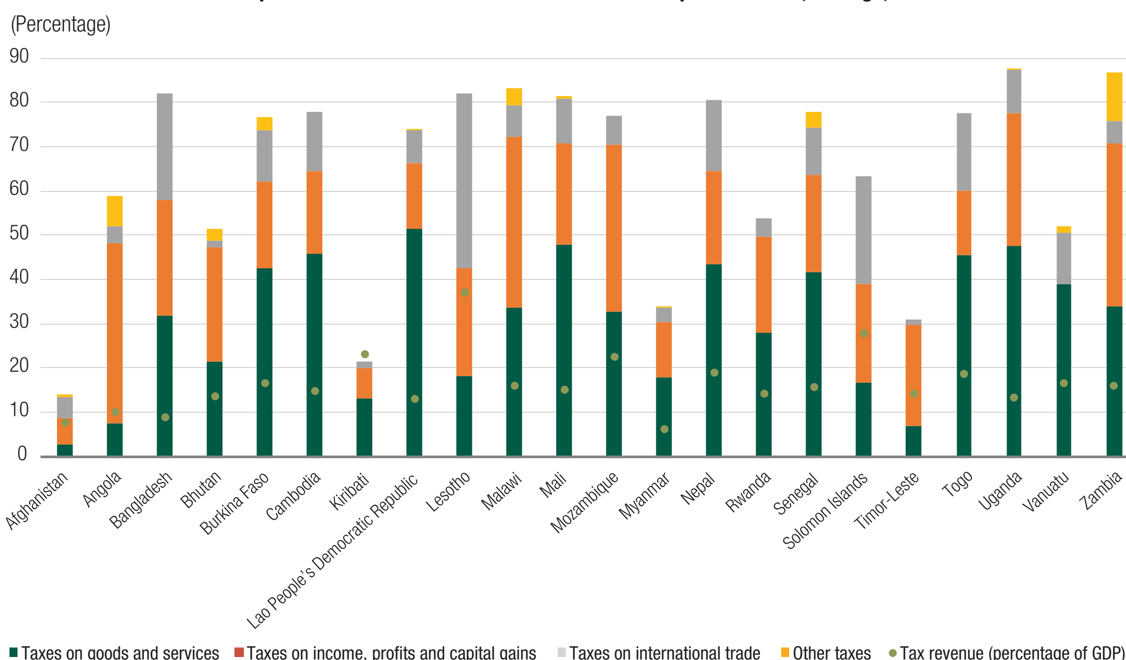
The structure of taxation in some LDCs is also diverse, with taxes on goods and services and on income playing significant roles (figure 4.2). Generally, there has been a significant shift in the composition of taxes among LDCs over the years, from predominantly taxes on international trade to broadly defined consumer and income taxes. Taxes on international trade include import and export duties and taxes on the profits of export or import monopolies, exchange profits and foreign exchange. In 1990–2000, taxes on international trade averaged 25 per cent of total revenue, receding to 13 per cent in the last decade. Since 2011, a few countries, including Bangladesh, Cambodia, Lesotho, Nepal, Solomon Islands and Togo have still earned significant shares of tax revenue from international trade. However, among LDCs, taxes on goods and services are beginning to dominate, rising from an average of 24.5 per cent in 2010 to 32.4 per cent of total revenue in 2017. In the same period, taxes on income, profits and capital gains also increased in significance, from 18.6 to 23.5 per cent of total revenue. However, low levels of diversification of economies limit the extent to which LDCs can increase net revenue from taxes on income and profits. Also, due to the positive correlation with the level of economic activity or GDP, net revenue from taxes on goods and services and on income is bounded by the weak growth potential of these economies. Macroeconomic shocks and structural vulnerabilities in LDCs also contribute to the underperformance in tax revenue collection, in particular in countries with weak institutions.

Economic growth is a key determinant of the accuracy of fiscal revenue forecasts. However, global conditions affect the economic growth of this group of vulnerable countries, as 39 of the 47 LDCs are commodity dependent and have relatively less capacity to absorb negative commodity price shocks (UNCTAD, 2019e). Their fiscal space grows when the global economy is in an upswing and contracts during a slump. In 2009–2017, LDCs experienced relatively strong economic growth averaging 5.2 per cent, and projections for 2018 remained within the

Figure 4.2

Contribution of various components to tax revenue in selected least developed countries, average, 2015–2017

(Percentage)



Source: UNCTAD calculations, based on data from the World Development Indicators database.

Note: Only LDCs for which recent data are available are included in the analysis.

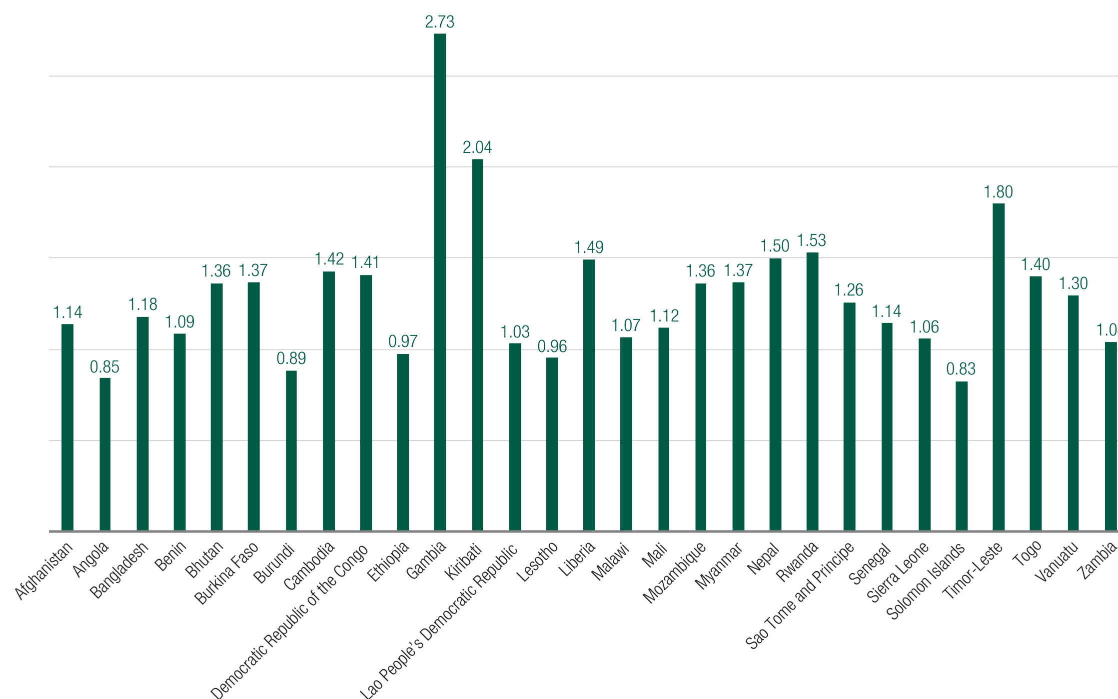
same range. Medium-term economic projections are optimistic, as conditions are improving in many parts of the world, yet the prospects for many commodity exports remain challenging (United Nations, 2019c). Moreover, most LDCs have low tax buoyancy, that is, the responsiveness of tax revenue to changes in GDP, averaging 1.2 in 2002–2017 (figure 4.3). Although tax revenues in LDCs grew by an annual average of 18 per cent in 2002–2017, the tax revenue-to-GDP ratio grew slowly, by 2.1 percentage points in 2015–2017. The tax revenue-to-GDP ratio grew by 0.6 percentage points in 2002–2017 and recorded growth of more than 1 percentage point only five times in the 16-year period. This may suggest that the tax systems in most LDCs operate at inefficient levels, and periods of fast economic growth such as commodity booms do not necessarily translate into proportionate increases in tax revenue or sizeable reductions in government deficits. Implicitly, in periods of economic slump, the tax systems may hinder economic recovery due to inbuilt inefficiencies. Tax buoyancy is robust in only a few countries, in particular in the Gambia, Kiribati, Liberia, Nepal, Rwanda and Timor-Leste.

The countries in this analysis, except for Liberia, Nepal and Rwanda, have small populations, which makes the identification of taxpayers and tax collection relatively less costly. In addition, improvements in tax administration, including compliance, have helped to better link tax revenue to economic activities. For example, in Nepal, which has a population of 29.9 million, the number of taxpayers increased from 1.5 million in the 2015/16 fiscal year to 1.8 million in 2017/18 (German Corporation for Development Cooperation, 2019; United Nations Population Fund, 2019). Similarly, Rwanda intensified registration and added 20,450 new taxpayers in 2017/18, to reach a total of 172,988 registered taxpayers (Rwanda Revenue Authority, 2018). The analysis of tax revenue potential also shows that in LDCs, tax efficiency could be improved, with the average tax effort across countries stable at 0.82 in the last 10 years.[3] Only nine countries, namely, Lesotho, Kiribati, Togo, the Gambia, Nepal, Malawi, Benin, Burkina Faso and Mali, consistently operate at close to full tax capacity or average at least 0.9, implying high tax efforts (figure 4.4). Another seven LDCs have tax efforts of

[3] Tax effort is measured as the ratio of actual tax collected to the predicted tax value from a stochastic regression relationship that controls for individual country characteristics. A ratio of close to 1 shows that a country has made a high level of effort, above 1 shows that a country has exceeded capacity and below 1 implies that a country has made a low level of effort. For a discussion of estimation methods see Fenochietto and Pessino (2013) and Khwaja and Iyer (2014).

Figure 4.3

Estimates of tax buoyancy in selected least developed countries, 2002–2017



Source: UNCTAD calculations, based on data from the World Development Indicators database.

Note: Estimates are based on a regression of the log of tax revenue on the log of GDP, not including those countries for which there are insufficient observations and/or insignificant regressions.

between 0.8 and 0.9. The Democratic Republic of the Congo, Zambia, Afghanistan, Bhutan, Timor-Leste, Bangladesh and Angola have relatively lower tax efforts of 0.75 or less, with Myanmar scoring lowest at 0.56.

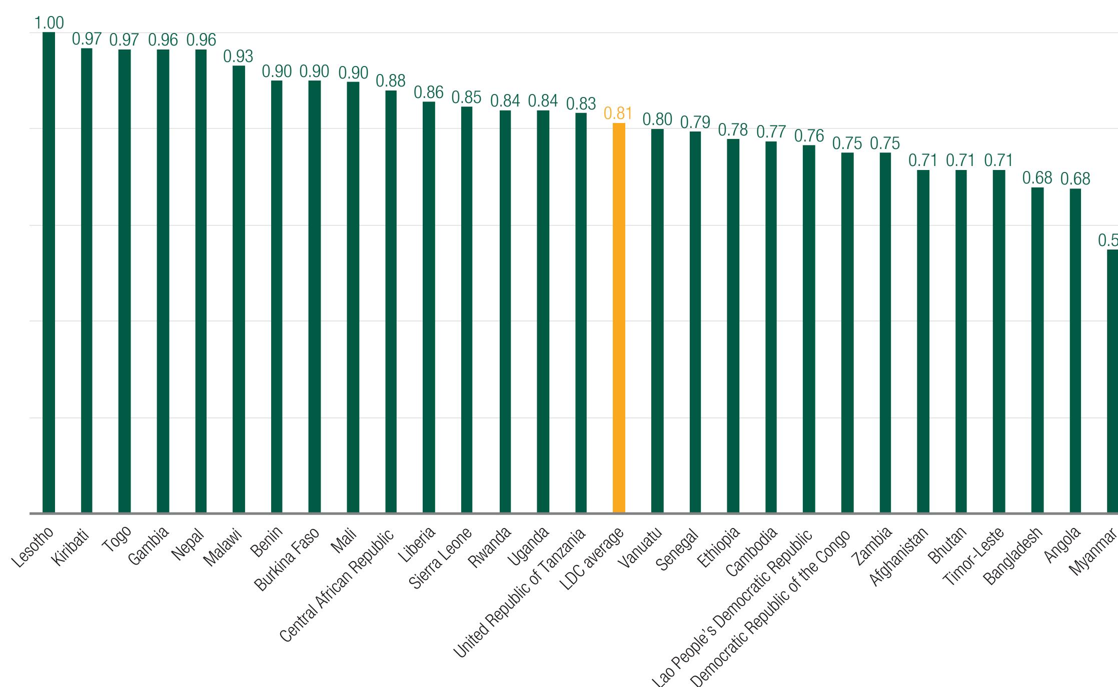
LDCs need to improve tax efficiency to enhance domestic revenue mobilization. Tax components can be seamlessly substituted through changes in tax regulations or policies in some LDCs, but in many LDCs, there are structural limitations and capacity challenges when it comes to tax policy changes. For example, the net addition to tax revenue from tax policy changes, such as by substituting one tax for another, increasing or reducing the tax rate or removing tax exemptions, is marginal, in particular among already high performing small economies such as Kiribati, Lesotho and Malawi. In these countries, the coherence of fiscal policies with structural transformation and long-term economic growth objectives is more relevant. Tax collection inefficiencies in larger LDCs, including commodity-dependent economies, may be reduced through a rigorous review of fiscal policies to promote the broad-based growth of tax bases and diversify and rationalize the contribution of various tax components to the total tax collected. The short-term trade-offs in the tax system may be minimized only through a series of budget reforms aimed at lessening the negative impacts of changes to the relative size of various fiscal aggregates, including the expenditure side. It may also be necessary for countries to assess how the various tax components (that is, the fiscal policy options) affect the total tax effort, in addition to addressing the macroeconomic and institutional impacts of increased tax collection (Fenochietto and Pessino, 2013).

The buoyancy of various tax components provides further empirical evidence for countries exploring net tax revenue gains from consumer taxes (figure 4.5).[4]

[4] These elasticities are indicative and should be interpreted with caution, as the assumption that tax rates remained stable over the estimation period is unrealistic for most countries. The elasticities are with regard to the change in final consumption for taxes on goods and services; the change in disposable income for taxes on income and profits and the change in imports and exports for taxes on international trade. For a discussion of methodological issues, see Haughton (1998).

Figure 4.4

Tax effort in selected least developed countries, average, 2007–2016



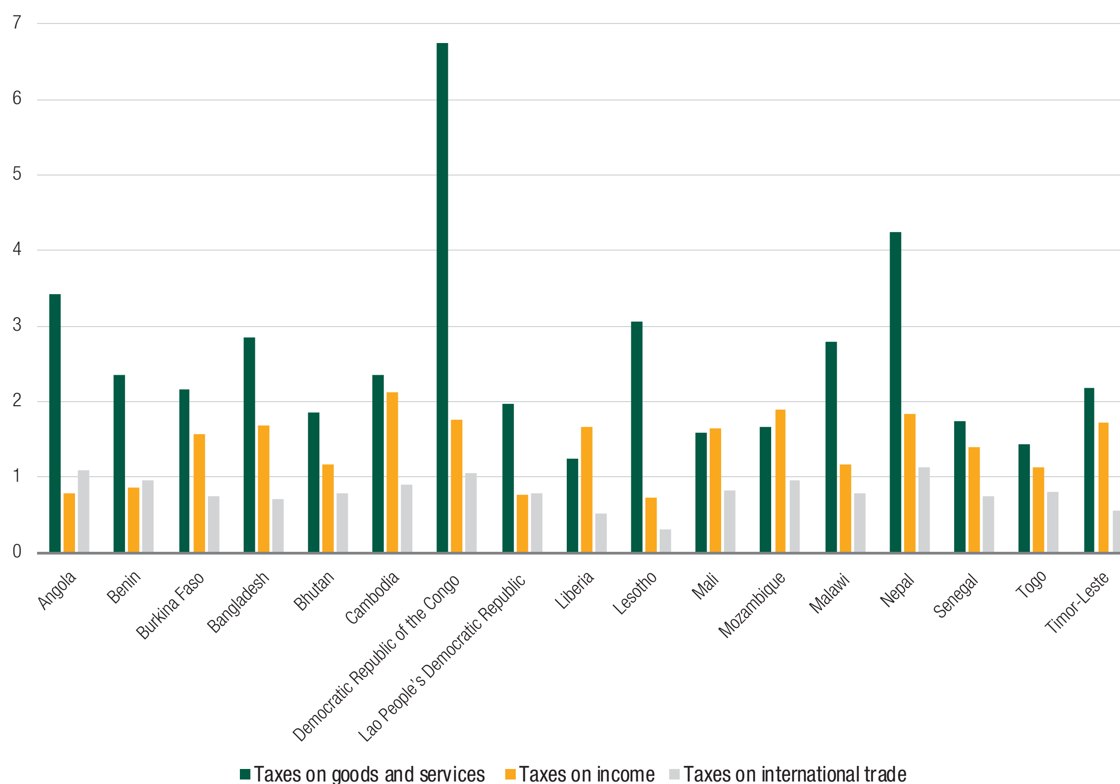
Source: UNCTAD calculations, based on data from the World Development Indicators database.

However, indirect taxes and value added taxes tend to have greater welfare implications for the poor and may therefore conflict with poverty eradication goals if not accompanied by other, offsetting public policies. Taxes on international trade are the least responsive, with an average elasticity of 0.81. This confirms the insignificant level, as well as the slow growth, of international trade from individual LDCs and LDCs as a group. The elasticity of taxes on goods and services or value added tax ranges from a minimum of 1.24 in Liberia to a maximum of 6.5 in the Democratic Republic of the Congo and the elasticity of taxes on income and profits ranges from 0.74 in Lesotho to 2.12 in Cambodia. However, countries apply different tax rates from one fiscal year to another, and it is therefore generally ineffective to focus on a few tax components instead of comprehensively reviewing the tax base and improving the tax administration system on a continuous basis. In addition, taxes are non-neutral and distortionary in nature, and raising tax rates or introducing new taxes does not always lead to greater tax revenue. In the context of fiscal policy, neutrality occurs when a change in tax or expenditure policy does not affect aggregate demand and distortions occur when a change in policy impacts production or consumption patterns (Weil, 2019). The impact of new or broadened taxes on the economy depends on design and implementation, economic structure, consumer preferences and the social contract ramifications of the fiscal policy (Freire-González, 2018).

There are other factors that reduce the tax potential in LDCs, including tax evasion, the relative size of the informal economy compared with the formal economy, weak tax administration systems, corruption, illicit financial flows and underperforming public policies and institutions. Fiscal reforms necessitated by the related challenges can either reinforce or break the momentum of structural transformation by shifting production and consumption patterns away from or towards intended policy objectives. Other challenges include the high cost of tax administration, due in part to high levels of informality, non-compliance with tax procedures, ineffective processes and political patronage (Gupta and Plant, 2019). Tax policy reforms should therefore aim to close loopholes in tax administration systems; remove ill-designed tax incentives, in particular exemptions in natural resource sectors that do not correspond to the value of the underlying resource and tax holidays that fail to balance foreign interests and local enterprise development requirements; curb illicit financial flows

Figure 4.5

Buoyancy (elasticity) of various tax components in selected least developed countries, 2002–2017



Source: UNCTAD calculations, based on data from the World Development Indicators database.

that directly reduce the tax revenue potential; simplify the tax system and provide adequate information to improve willingness to pay; and improve the capacity and efficiency of public institutions.

Building fiscal space requires a series of budget cycles to incrementally and cumulatively develop the efficiency of the Government to meet its fiscal projections based on national priorities (Schick, 2009). This may be done through a clearly articulated fiscal reform agenda through removing non-performing subsidies, reviewing malfunctioning taxes, rationalizing social protection measures to safeguard vulnerable segments of society and reduce inequality, deepening the tax base, improving coherence between fiscal policy and broader structural transformation policies, incentivizing the formalization of businesses and reducing the cost of tax compliance among small-scale businesses and responding to public feedback about their value assessments of the quality of public goods and services (World Bank and Pricewaterhouse Coopers, 2015). Curbing illicit financial flows, which averaged 5 per cent of GDP in 2015, has the potential to boost revenue. Such flows were on average equivalent to 36 per cent of tax revenue in LDCs, with certain countries facing particularly high outflows relative to tax revenue, as follows: Bangladesh, 36 per cent; Malawi, 36 per cent; Burkina Faso, 40 per cent; Zambia, 43 per cent; Timor-Leste, 52 per cent; Kiribati, 58 per cent; Mozambique, 58 per cent; Vanuatu, 64 per cent; Myanmar; 68 per cent; and Cambodia, 115 per cent (figure 4.6).

Developing countries are significantly more exposed to tax avoidance by multinational firms. Dealing with illicit financial flows is complicated because of the illegal nature of the transactions and the systematic steps that those conducting them take to hide the trails (African Union Commission and United Nations Economic Commission for Africa, 2015). Beyond the difficulties in defining the illicit component, illicit financial flows also include different categories that have tax implications. Further, specific sectors such as extractives are more prone to such flows than others (Moore et al., 2018). However, in general, countries should target trade-related activities such as tax evasion, trade and services misinvoicing, base

erosion and transfer pricing abuses, which are the predominant contributors to illicit financial flows, as well as the natural resource sectors that are particularly vulnerable to abuse by multinational companies and organized criminals (Global Financial Integrity, 2019).

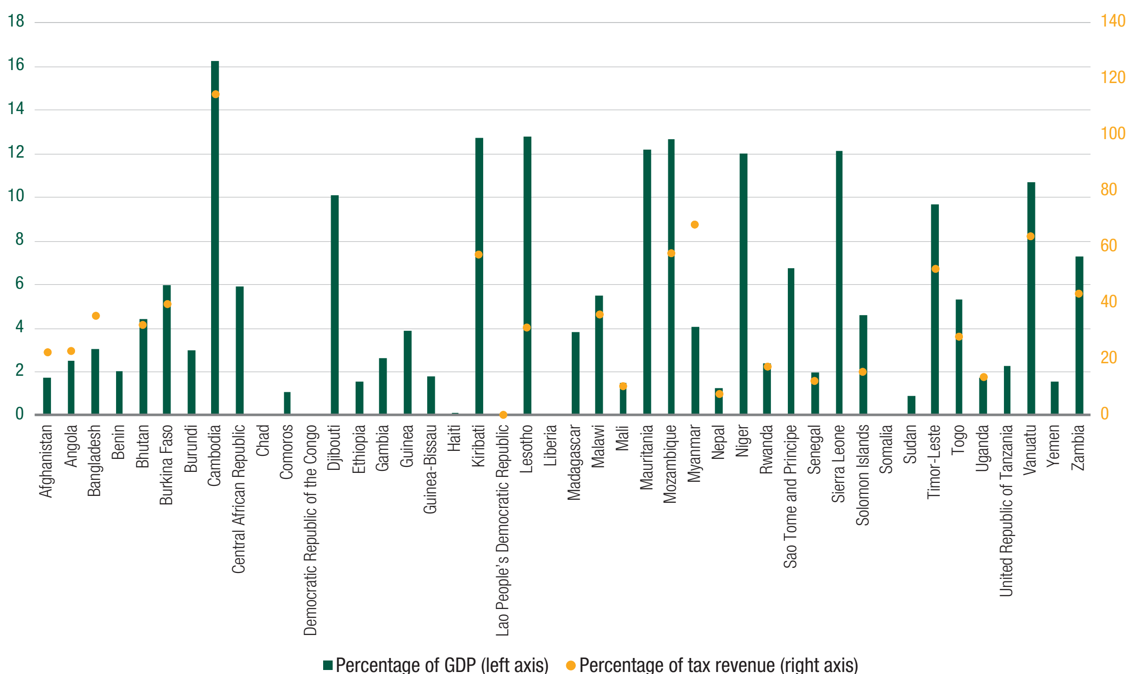
At the policy level, lack of transparency, discretionarily awarded incentives and corruption are some of the factors that facilitate illicit financial flows and worsen the loss of tax revenue in LDCs. Closing the gaps in national and international tax systems requires concerted efforts by countries. Stylized facts also show a small number of destination countries of illicit financial flows, which primarily include developed countries and emerging economies that are the major trade partners of developing countries (United Nations, Economic Commission for Africa, 2015b). LDCs therefore require the cooperation of these countries in setting minimum standards to close tax loopholes, including on exchanges of information on the true beneficiary owners of entities and their tax transactions and in enforcing regulations that have been flouted. There is also a need for enhanced national capacities among regulatory and tax administration bodies to track, stop and prevent illicit activities that drain resources and reduce tax revenue collected by LDCs.

2. Public expenditures and external resource dependence

National budgets are critical for mobilizing and allocating public resources towards key priorities in national development plans. An efficient and

Figure 4.6

Illicit financial flows from selected least developed countries, 2015



Source: UNCTAD calculations, based on data from the World Development Indicators database, the direction of trade statistics of the International Monetary Fund and Global Financial Integrity, 2019.

Note: Estimates do not cover all possible illicit flows, and data are not available for Eritrea, South Sudan and Tuvalu.

effective allocation of public resources may assist countries to lower their financing deficits (Bhushan et al., 2013). Aligning public expenditure with structural transformation and national development plans is therefore as strategic as mobilizing domestic and external resources to finance the Sustainable Development Goals. Public expenditure instruments can be used to bolster the tax revenue potential of future budget cycles in addition to stabilizing the economy. Each national budget cycle reveals the public resource envelope within which capital and social development expenditures are available to deliver public goods and services, as well as the fiscal deficit projections against which domestic and external financing decisions are made. The growth of tax revenue would contribute to reducing dependence on ODA and external debt, while an increase in the domestic resource gap increases the risk of external indebtedness.

Most LDCs face long-term fiscal imbalances indicative of consistently low revenue but increasing expenditure on public goods and services. Government budget deficits steadily widened from an average of 1.8 per cent of GDP in 2013 to 4.8 per cent in 2016, before contracting slightly to 3.6 per cent in 2018. The five-year average in 2014–2018 shows that only Kiribati and Tuvalu posted budget surpluses and Bhutan balanced its budget (figure 4.7). Tax revenues linked to natural resources in commodity-dependent LDCs are volatile and impact both the revenue and

Figure 4.7

Government budget primary deficit, average, 2014–2018

(Percentage of gross domestic product)

Source: UNCTAD calculations, based on the government finance statistics of the International Monetary Fund.
Note: Data are not available for Somalia.

Public debt stocks of LDCs generally track fluctuations of foreign aid

expenditure sides of the fiscal relationship. In addition, despite having relatively high tax efforts, some developing countries have a high concentration of tax revenue from one tax base, either a natural resources sector, income taxes or consumer taxes, but low effective tax rates and exemptions that contribute to fiscal imbalances (Fenochietto and Pessino, 2013). Since 2007, there has been an uptick in domestic debt, as demand for development financing has increased while ODA has slowed. The public debt stocks of LDCs have generally tracked fluctuations in foreign aid, with a rapid fall in ODA mirrored by a significant increase in external debt stocks in subsequent years. Experiences vary by country; for example, in the last five years, both domestic and external public debt have increased in Bangladesh, Benin, Burkina Faso, the Gambia, Guinea, Guinea-Bissau, Haiti, the Lao People's Democratic Republic, Malawi, Myanmar, Senegal, Uganda, the United Republic of Tanzania and Vanuatu. In Chad, domestic debt rose sharply from 18 per cent of GDP in 2015 to 25.2 per cent of GDP in 2018. Some countries experienced only slight increases in both domestic and external debt, for example Afghanistan and Yemen, and others in external debt only, for example Cambodia, Kiribati, Lesotho, Madagascar, Mali, Mauritania, Mozambique and the Sudan. In other countries, external debt levels are falling, while domestic debt levels have stabilized, for example in the Central African Republic, Djibouti, Liberia, Rwanda, and Solomon Islands. Togo has stable external debt but rising levels of domestic liabilities.

As domestic tax resources fall short of development financing requirements, ODA and other sources of financing are required to fill the gap. The link between external financing and various categories of public sector expenditure is critical, in particular in the impact on the quality of public financial management institutions and their ability to generate domestic revenue for government priorities (Feeny and McGillivray, 2010). The willingness of a Government to finance its expenditures through taxation is seen through the growth of tax revenue as a share of public revenue, yet external financing, in particular concessional aid, may reduce incremental tax efforts and is therefore detrimental to development (Mosley, 2015; Thornton, 2014). In LDCs, tax revenues are low due to a combination of low income levels, narrow tax bases and weak tax administration systems. There is therefore a need to strike a balance in mobilizing additional tax revenue in a manner that recognizes the dynamic impacts of tax-financed public investments (UNCTAD, 2016a). In 2012–2016, in LDCs for which budget data is available, capital expenditure averaged 21 per cent of total government expenditure and public expenditure on recurrent consumption and wages averaged 25 and 31 per cent of total expenditure, respectively (figure 4.8). Some countries spent proportionately more on the use of goods and services, such as Benin, at 41 per cent, Liberia, at 31 per cent, and the Niger, at 62 per cent, while in other countries, wages accounted for the largest share of expenditure, such as in Afghanistan, at 49 per cent.

a. *Tax revenue and official development assistance fall short of desired public expenditures*

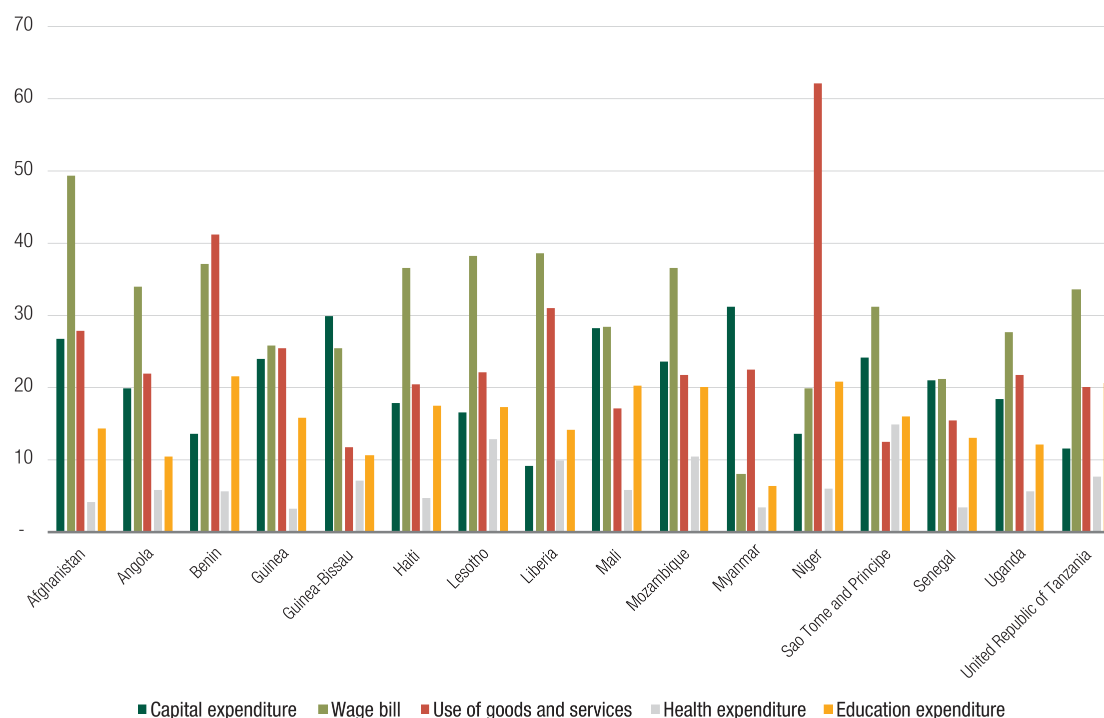
The effect of aid on the fiscal behaviour of developing countries has been studied extensively (Feeny and McGillivray, 2009; Morrissey, 2015; Ouattara, 2006; Remmer, 2004). The impacts are country specific depending on the type and channel of aid received and the domestic environment, including the quality of public policies and institutions (Feeny and McGillivray, 2010). The risk of a misalignment of priorities between LDCs and aid providers escalates if tax revenue decreases absolutely or marginally with concessional support, including ODA. The risk is less pronounced when non-concessional debts replace grants and concessionary loans contracted to cover structural deficits in recurrent budgets but may increase if grants and concessional loans are used to cover temporary shortfalls in recurrent budgets.

LDCs can aim to achieve the Goals if both domestic public resources and external financing, including aid, are scaled up substantially. A positive relationship between public investment and economic growth defies the general view that LDCs have low absorptive capacities. Declining marginal returns of public investment have been used to justify low levels of foreign aid to productive sectors, although such investments have better potential to stimulate structural transformation, in particular in LDCs. Overcoming structural bottlenecks, particularly to the real economy, is critical to sustaining economic growth and effectively removing structurally imposed limits on domestic resource mobilization. However, this requires better policies and a better alignment of donor aims with national priorities through a substantial shift away from projects in favour of

Figure 4.8

Government expenditure categories, selected least developed countries, average, 2012–2016

(Percentage of total expenditure)



Source: UNCTAD calculations, based on data from the open budgets database of the World Bank.

more programmatic forms of aid, using national systems and reducing donor overlaps (Foster and Keith, 2003).

ODA and government investments were closely matched from 1980 to 2004. Public expenditure on social services increased after 2000, as countries embarked on strategies to deliver on the Millennium Development Goals. However, since 2005, public investment and ODA have diverged significantly, with public capital formation rising sharply as ODA growth has faltered; the divergence rose from $3.5 billion in 2006 to $92.6 billion in 2017, in a period during which LDCs experienced higher output gains, with combined GDP rising from $384 billion to $1,070 billion (figure 4.9). This trend is consistent with the conclusion that domestic policies have a more positive impact on economic growth than aid, which may undermine the tax structures and key institutions of recipient countries (Presbitero, 2016). Although some aid is specifically earmarked for public administration, aid has also been found to have a negative impact on some dimensions of governance, particularly when transactions between donors and recipients are not transparent. It has also been argued that aid delivered through the State, that is, budget support, may trigger increased corruption and decreased accountability (Cheng and Zaum, 2013; Salifu and Abdulai, 2018). However, aid withdrawn from budget support also slows the development of the financial management capacity of the public sector (Salifu and Abdulai, 2018).

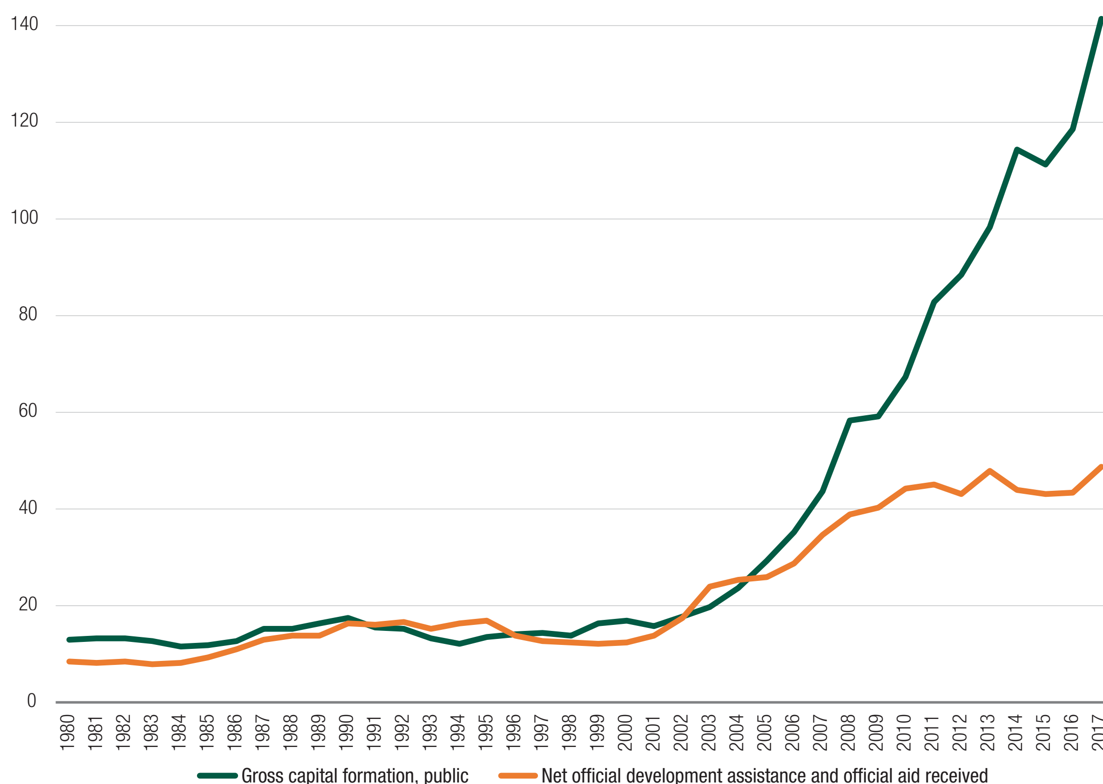
Fragmented modalities of aid also create and sustain independent bureaucracies in both source and beneficiary countries. Many donors operate more than one aid agency or contribute to several multilateral agencies with clearly defined thematic, sectoral or regional focuses, which further refragments support into projects or other arrangements. Research suggests that developing countries receiving aid that is broken up into projects exhibit worse outcomes than recipients with streamlined aid (Carcelli, 2019). As outcomes worsen, the implication is that beneficiary Governments either need to step up the mobilization of domestic resources through tax revenue or scale down public expenditures, to maintain a balanced budget.

Whether ODA has a direct impact on the level and composition of government expenditure, that is, the

Figure 4.9

Public capital formation and official development assistance in the least developed countries

(Billions of dollars)



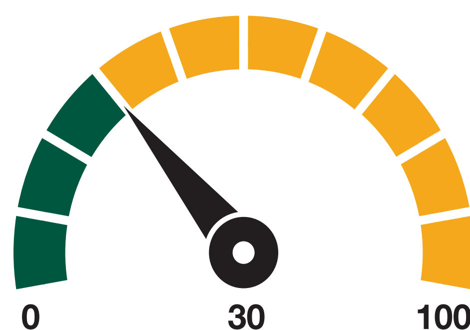
Source: UNCTAD calculations, based on data from the World Development Indicators database.

additionality of aid, and whether aid is allocated to sectors intended by donors or recipients, that is, the fungibility of aid, have been the focus of many studies on aid effectiveness (Feeny and McGillivray, 2010; Mascagni and Timmis, 2017; Morrissey, 2012; Ouattara, 2006; Remmer, 2004). Frequent episodes of unexpected shortfalls in tax revenue should sound alarm bells for aid recipient countries because of the enhanced risk posed by non-performing public sector expenditures that drain public resources. Persistent shortfalls of tax revenue in a country with low growth potential could be a result of institutional capacity weaknesses in planning and managing economic development. In such a situation, the volatility of foreign aid and the allocation of volatile aid between different uses have negative impacts on economic growth in recipient countries. In LDCs, the concern is that not all sources of financing contribute significantly to productive capacities, and ODA has been shown to have a significant impact on composition or allocations to various sectors, and the level of government spending, particularly in social sectors such as health, education, water and sanitation.

Building productive capacities in LDCs requires scaling up capital accumulation through both public and private investment. In this regard, and despite concerns about the volatility of allocations, ODA could have a positive impact on economic growth when used directly in productive activities, for example, through aid earmarked for improving public services and the physical and social infrastructure in the recipient country, namely, with regard to transport, communications, energy, water, banking, industry, health and education, while negative economic growth effects of foreign aid occur when aid is purely humanitarian, that is, used for food aid or reconstruction after a natural disaster, and involving transfers to cover emergencies (Neanidis and Varvarigos, 2009). LDCs have considerably increased the role of domestic policies in driving their development agendas, including fiscal policies that positively contribute to the proportion of development financing from domestic resources. Tax revenue as

a share of GDP increased from 9 per cent in 2002 to 19 per cent in 2017, while ODA as a share of GDP gradually declined, from about 16 per cent in 2002 to 11 per cent in 2017 (figure 4.10). This suggests that tax efforts have not been negatively affected by ODA and that, in particular, as tax revenue was twice the value of ODA received in 2017, the bulk of development financing in LDCs is being met by domestic resources. The analysis in section B.1 also shows a stable trend in tax efforts among LDCs. In addition, based on individual LDC indicators, several countries have relatively higher tax revenue-to-GDP ratios compared with ODA-to-GDP ratios, including Bangladesh, the Lao People's Democratic Republic, Lesotho, Myanmar, Senegal, Timor-Leste, Togo and Zambia.

There was a sharp rise in government expenditures among LDCs in Africa, from $88 billion in 2009

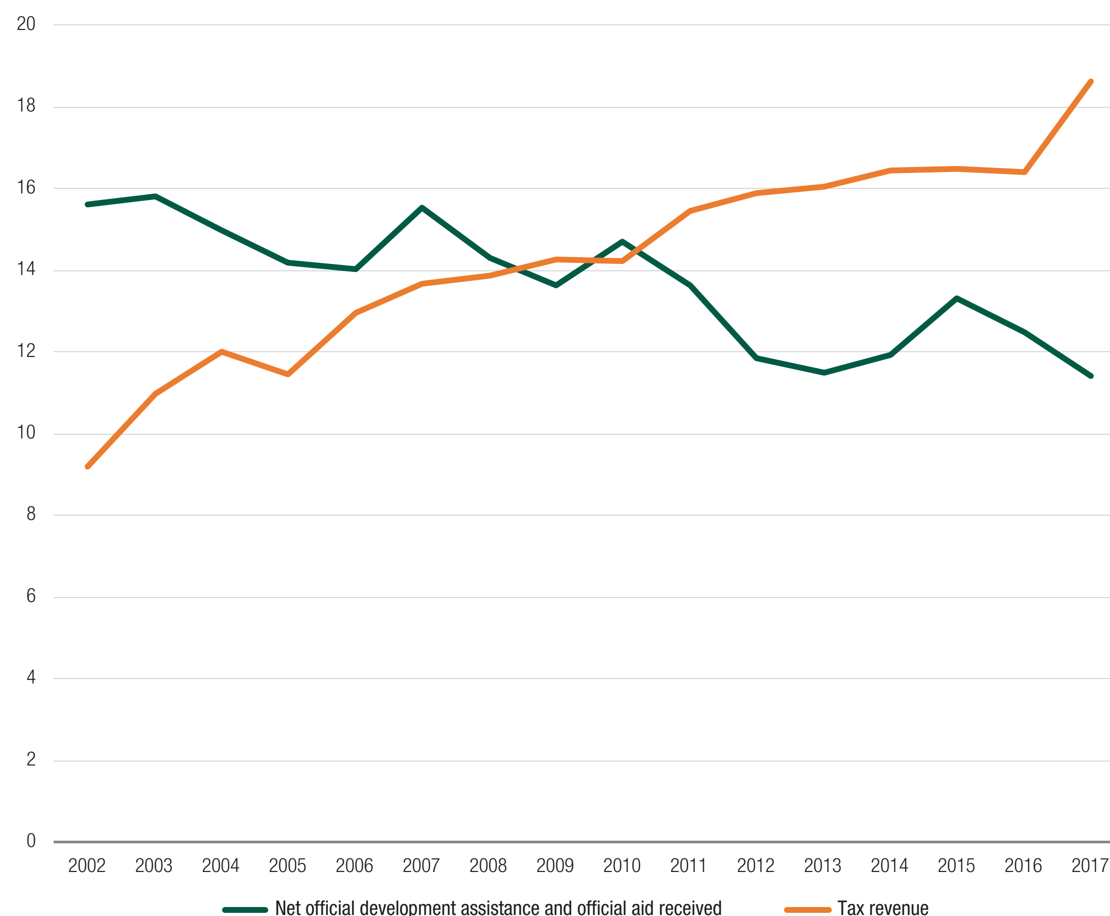


to $146 billion in 2014, as countries sustained government spending in the wake of the global financial crisis of 2008/09 (figure 4.11). However,

Figure 4.10

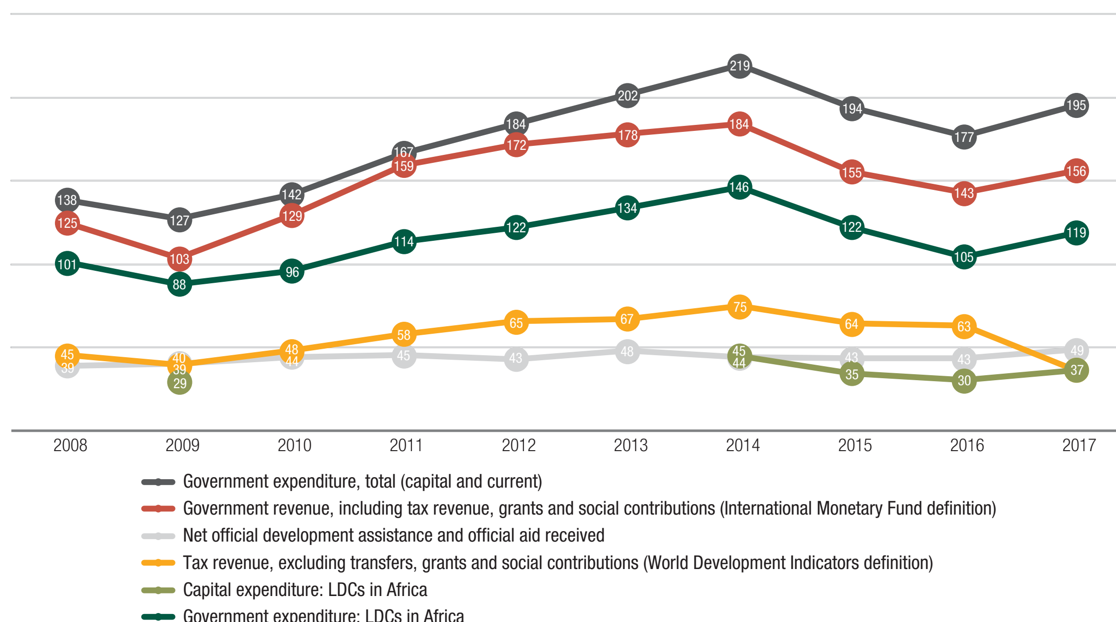
Tax revenue and official development assistance, least developed country average

(Percentage of gross domestic product)



Source: UNCTAD calculations, based on data from the World Development Indicators database.

Figure 4.11
Fiscal aggregates and official development assistance in relation to total government expenditure
(Billions of dollars)



Source: UNCTAD calculations, based on data from the World Development Indicators database and the African Economic Outlook database of the African Development Bank (available at http://dataportal.opendataforafrica.org/tovgvsb/african-economic-outlook-2018).

Notes: Capital expenditure data is only available for LDCs in Africa from the African Economic Outlook database. The fiscal aggregate figures are indicative, and caution must be exercised in interpretation. Consistently full tax revenue data is only available for 20 LDCs in the World Development Indicators database, namely, Afghanistan, Angola, Bangladesh, Bhutan, Burkina Faso, Cambodia, Kiribati, the Lao People's Democratic Republic, Lesotho, Malawi, Mali, Mozambique, Myanmar, Nepal, Senegal, Solomon Islands, Timor-Leste, Togo, Vanuatu and Zambia.

there has been a significant cutback since 2015, with slight recovery at the end of 2017, as countries emerged from underperforming commodity trade. This analysis shows that both capital expenditure and current expenditure have increased at a rapid pace. However, as evident in the short trend in 2014–2017, capital expenditures decline faster during a recession than current expenditures and recover sluggishly during economic recovery. There is thus a limit to growth based on expansion through government spending, in particular focused on physical and social infrastructures, if there are no measures to complement domestic resources, including strategies to better align external development support such as ODA with LDC priorities and domestic policies to crowd in the private sector to offset the negative impact of an expanded government. Even LDCs with relatively higher tax revenue-to-GDP ratios, including Guinea-Bissau, Haiti, Lesotho, Mozambique, the Niger and Sao Tome and Principe, need to manage fiscal imbalances as government expenditures rise. The growing gap between tax revenue and public expenditure is of concern, whereas ODA levels have remained relatively unchanged over the years.

b. Foreign aid eased out of fiscal relationships

In comparing the relative contributions of domestic tax revenue and ODA to government expenditure, the ratios of tax revenue-to-government expenditure and ODA-to-government expenditure provide two key insights, namely, the fiscal position of a Government is considered healthy when the share of government priorities financed by tax-based resources is high; and the relative importance of aid in financing government expenditure, although the ODA-to-government expenditure ratio does not accurately account for the actual amount of aid spent on government programmes, or additionality and fungibility. In this regard, when both the tax revenue-to-government expenditure ratio and the ODA-to-government expenditure ratio are equivalent to at least two thirds, parallel donor structures divert resources and avoid national systems (Morrissey, 2015). The tax revenue-to-government expenditure ratio remained relatively high among LDCs in 2002–2017, implying that most government priorities were financed through

domestic resources (table 4.1). Only Eritrea posted revenue of less than 70 per cent in 2002–2008, and in 2009–2017, none of the countries dropped below this level. In comparison, in 2002–2008, aid was less than 30 per cent of government expenditure in Angola, Bangladesh, Bhutan, the Comoros, Kiribati, Lesotho, Myanmar, the Sudan and Yemen, but increased in the Comoros and Kiribati in 2009–2017.

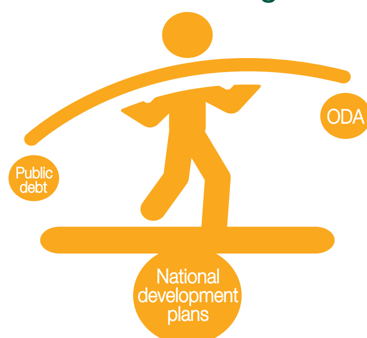
Table 4.1

Government revenue and foreign aid as percentage of government expenditure

Country	2002–2008		2009–2017		
	Revenue ratio	Aid ratio	Revenue ratio	Aid ratio	Domestic debt ratio
Afghanistan	90	239	98	127	1
Angola	102	6	95	1	..
Bangladesh	77	19	76	13	137
Benin	95	59	85	36	106
Bhutan	92	23	99	20	6
Burkina Faso	90	70	85	41	43
Burundi	74	88	82	82	40
Cambodia	79	49	86	26	0
Central African Republic	98	..	91	..	160
Chad	87	43	90	29	135
Comoros	89	22	111	32	..
Democratic Republic of the Congo	78	257	100	82	..
Djibouti	88	30	84	30	16
Eritrea	60	36	51	19	..
Ethiopia	80	81	88	46	..
Gambia	88	125	79	68	295
Guinea	86	57	81	34	115
Guinea-Bissau	73	85	90	73	158
Haiti	87	60	87	90	10
Kiribati	90	22	101	32	..
Lao People’s Democratic Republic	81	54	85	20	63
Lesotho	102	17	95	16	6
Liberia	102	249	90	117	1
Madagascar	82	103	84	39	79
Malawi	88	92	86	58	72
Mali	103	75	87	47	21
Mauritania	92	66	96	30	17
Mozambique	88	108	83	48	20
Myanmar	74	8	84	14	122
Nepal	94	39	97	28	62
Niger	106	98	83	48	30
Rwanda	96	117	93	58	32
Sao Tome and Principe	193	106	84	46	..
Senegal	96	53	83	25	59
Sierra Leone	101	152	74	83	61
Solomon Islands	107	101	103	54	1
South Sudan	..	..	90	43	..
Sudan	95	23	76	14	82
Timor-Leste	96	54	71	19	..
Togo	91	31	81	40	181
Tuvalu	80	49	101	78	..
Uganda	94	101	78	43	84
United Republic of Tanzania	91	86	82	38	50
Vanuatu	94	52	88	53	29
Yemen	96	6	67	27	10
Zambia	101	87	78	22	..
LDC average	**92**	**75**	**86**	**45**	**54**

Source: UNCTAD calculations, based on data from the International Monetary Fund and OECD.
Note: Domestic debt data are not readily available, and most countries have few data points.

Greater LDC domestic public debt
correlated with **misaligned ODA**



Domestic public debt > ODA
in **40%** of **LDCs** (2000–2017)

In 2009–2017, aid was also less than 30 per cent of government expenditure in Cambodia, Chad, Eritrea, the Lao People's Democratic Republic, Nepal, Senegal, Timor-Leste and Zambia. Critically, LDCs that received aid equivalent to at least 50 per cent of government expenditure but with a similarly high tax revenue-to-government expenditure ratio faced significant aid diversion problems. Most aid is delivered through parallel donor structures that do not report using the public financial management systems of recipients. There is therefore no clear mapping of ODA receipts to fiscal aggregates on either the revenue or the expenditure side of Governments' financial statements. This explains the findings of fiscal response models that aid has a direct impact on budget deficits mainly because the dominant mode of delivery defies the logical expectation that it should be spent through the Government, thereby complementing tax efforts and reducing the need for domestic debt. The extent to which aid increases government expenditure additionality and fungibility is also overstated; it is therefore not possible to generalize the effect of aid on fiscal policy as the effects tend to be country specific (Morrissey, 2015; Mosley, 2015). In 2009–2017, domestic debt exceeded aid in 17 of the 34 LDCs for which data were available. In eight economies, namely, Afghanistan, Bhutan, Djibouti, Haiti, Lesotho, Liberia, Mozambique and Solomon Islands, domestic debt is closely matched with fiscal deficit; Mali and Mauritania have slightly overestimated budget deficits. In fiscal policy contexts, excessive deficits and a procyclical bias in government budgets may suggest suboptimal institutional or political choices (Lledo et al., 2018).

Aid disbursement is weakly associated with national development priorities in LDCs mainly because aid is delivered in a manner that is outside the policy frameworks of recipient countries. A non-stochastic analysis of aid and government revenue cannot adequately explain the budgeting behaviour of recipients, yet pairwise correlations confirm that aid flows are not correlated with fiscal imbalances in recipients. A negative and significant correlation between revenue and aid, and between aid and domestic borrowing, for example in the United Republic of Tanzania, may be indicative of a need for better forecasting of tax targets as the tax administration system continues to mature. Significantly, however, the impact of donor withdrawal has been felt in the United Republic of Tanzania, as both revenue and aid declined relative to government expenditure in 2002–2017, with aid receding heavily in 2009–2017. By contrast, in Rwanda, although aid has decreased significantly, from 117 to 58 per cent of government expenditure since 2009, a positive correlation between revenue and aid, and between aid and domestic debt, shows the positive complementary impact of aid when it is fully supportive of national priorities.

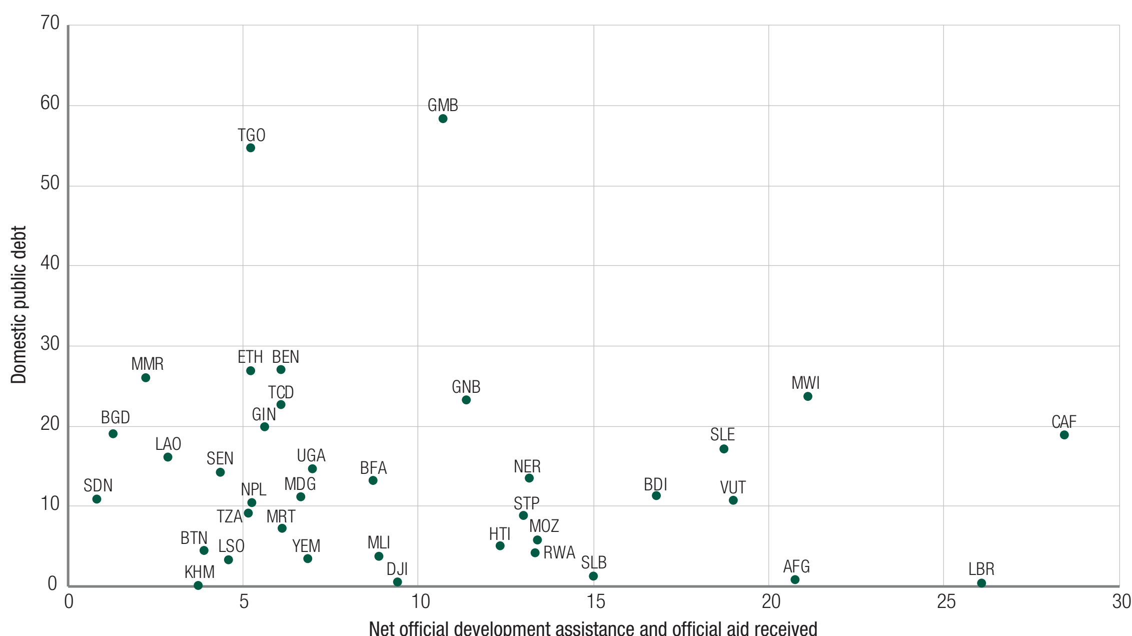
In Afghanistan, Djibouti, Haiti, Lesotho, Mozambique and Solomon Islands, domestic debt is closely associated with short-term discrepancies between tax revenue and government expenditure, which give rise to fiscal deficits. In these countries, aid can facilitate improved fiscal outcomes and reduced public debt when it is earmarked for specific sectors that contribute to increasing the fiscal deficit. Although the share of aid delivered through public sector channels is high, averaging 52 per cent among LDCs in 2014–2017 as reported in the common reporting standard database of OECD, in most countries aid is not fully reflected in the regular budgets of the central government or the sectoral budgets of the recipients. In such cases, the impact of aid on fiscal aggregates is subdued or not direct. In 2014–2017, LDCs that received at least 60 per cent of aid through the public sector included Bhutan, Burkina Faso, the Comoros, the Lao People's Democratic Republic, Mauritania, Sao Tome and Principe, Senegal and Togo.

Aid supporting a country-owned strategy can lead to growth and poverty reduction, in contrast to imposed reforms (Remmer, 2004). However, low levels of tax revenue and ODA have increased the exposure of LDCs to the risk of debt. With tightening global economic conditions, external debt and domestic liabilities have also been pushed up to unsustainable levels in some countries, and domestic debt threatens to slow economic growth even further. For example, Bangladesh, Myanmar, the Sudan and Togo have double digit domestic debt-to-aid ratios, and Benin, Chad, Ethiopia, Guinea, the Gambia, Guinea-Bissau, the Lao People's Democratic Republic, Madagascar,

Figure 4.12

Domestic public debt and official development assistance, 2015–2017

(Percentage of gross domestic product)



Source: UNCTAD calculations, based on the government finance statistics of the International Monetary Fund and data from the World Development Indicators database.

Notes: Country names in figure abbreviated using ISO codes. Data are not available for the Comoros, the Democratic Republic of the Congo, Eritrea, Kiribati, Somalia, South Sudan, Timor-Leste and Zambia. To enhance readability, Tuvalu is not included, as it is a clear outlier, with a value of net ODA and official aid received at 91 per cent of GDP.

Nepal, Senegal, the United Republic of Tanzania and Uganda have a ratio of at least 2 (figure 4.12). The diversion between donor priorities and national priorities is therefore critical in these countries because of the high fiscal imbalance and the low level of external support relative to deficits. An increase in government expenditure would have significant positive spinoffs initially but might also pose challenges if the additional expenditure resulted in higher current consumption and inflation. High levels of domestic public debt are also associated with low growth due to the crowding out effect on private investment. Such imbalances may increase in the absence of complementarity between ODA and domestic public resources.

C. Aligning international support for development in the least developed countries

Global economic trends point to the emergence of a multipolar world defined by a shift in the balance of power from traditional donors with historical ties to developing countries to emerging developing partners. This is evident from shifts in world trade, capital flows, exchange reserves, commercial interests and sovereign assets (World Bank, 2011). Flows and cooperation to developing countries worldwide from China have grown significantly, ranging from $3 billion to $18 billion per year, with some higher estimates (Dreher et al., 2017; see chapter 2). South–South trade also accounts for more than half of the increase in exports in developing and transition economies (UNCTAD, 2018e).

Brazil, India and the Russian Federation have also emerged as important partners to LDCs. According to UNCTAD statistics, merchandise exports from LDCs to Brazil, China, India, the Russian Federation and South Africa increased from $44 billion in 2015 to $52 billion in 2017 and imports from these countries to LDCs grew from $88 billion to $95 billion in the same period. Exports from LDCs to China alone grew from $30 billion in 2015 to $37 billion in 2017 and imports from China averaged $51 billion per year in the same period. Exports from LDCs to India also increased slightly in the same period, from $10 billion to $11 billion, and imports from India rose sharply, from $21 billion to $27 billion. FDI from China to

Donor coordination policies in LDCs back up national development strategies and institutions

developing countries fell from $458 billion in 2014 to $381 billion in 2017, but the stock of FDI from China in developing countries has been on a steady rise, from $5.2 trillion in 2014 to $6.9 trillion in 2017 (UNCTAD, 2018d).

The increased trade and development financing options from emerging South–South cooperation are an opportunity for LDCs to close financing gaps for sustainable development, but there are concerns about the increased complexity of development cooperation and aid coordination challenges posed by multiple partnerships. Developing countries are not necessarily seeking low-cost financing alternatives but rather filling the gaps left by unfulfilled aid pledges and fragmented aid and to leverage support for national development agendas. In some LDCs, ODA is a source of financing for much needed services, particularly in the social sector, which is currently difficult to replace, and critical for building productive capacities (United Nations, 2015d). However, the diverse and fragmented delivery system is well documented in most LDCs in Africa and Asia, in which bilateral and multilateral official aid projects in each country number in the hundreds (UNCTAD, 2006a). The number of instruments and mechanisms has increased and international private flows to developing countries have also grown significantly in relation to external public funding (Alonso, 2015). This has meant that there are more financing options available to developing countries, yet the challenges of managing the various sources of financing have also multiplied.

1. Aid coordination policies

The purpose of donor coordination is threefold, namely, to ensure the integration of external development assistance with the priorities of recipients; assert the responsibility of recipients for their development agendas as recognized in the Addis Ababa Action Agenda, the Istanbul Programme of Action and the 2030 Agenda; and ensure that external support adheres to the strategic objectives of national development agendas, as emphasized in the Monterrey Consensus and the Paris Declaration on Aid Effectiveness. Coordinating donor aid has a number of advantages, including lowering transaction costs, reducing the fragmentation of donor activities and eliminating parallel structures and inconsistencies in donor approaches (Fengler and Kharas, 2011).

Aid coordination and aid effectiveness have re-emerged as topical issues in development financing because the number of players has increased significantly, while the level of direct financing to individual countries, in particular LDCs, has not significantly improved (Bickenbach et al., 2019; Dornan, 2017). Bilateral and multilateral aid is no longer mobilized only by State actors, but also by private actors (see chapter 3). The need for coordination increases when bilateral donors multiply, bringing unharmonized procedures and conditionalities. For example, Bangladesh has over 1,000 active donor-funded projects being implemented by at least 60 donor or partner groups.[5] The coordination of aid is expected to reduce duplication among donors, but also involves a burden on scarce labour resources in recipient countries and high turnover due to excessive recruitment levels among donors (Bourguignon and Platteau, 2015).

Donor and recipient perspectives on aid coordination have not changed much over the years. In 1967, the notion of a common aid effort was floated, whereby the purpose of coordination was to eliminate overlaps and differences between bilateral and multilateral aid givers (Overseas Development Institute, 1967). The notion remains relevant as the modalities of aid to developing countries, in particular programmed aid and project-type aid, usually involve a small group of partners pooling resources, using common procedures and delivering results that satisfy all parties. However, recipient perspectives of aid coordination depend on who manages aid, the disbursement process and how integrated the aid process is to national development priorities.

In the Paris Declaration on Aid Effectiveness, in the context of external support, alignment refers to the fact that donors base their overall support on partner countries' national development strategies, institutions and procedures; and commit to respecting partner country leadership and helping strengthen their capacity to exercise it (OECD, 2005). There is an assumed joint commitment between donors and partners to developing a relationship that ensures that donor inputs are effectively integrated into national processes at both the policy and systems levels (Welle et al., 2008). National planning and budget frameworks are tools for policy coherence and in improving the quality of results across sectors and different levels of government. Since budget support to LDCs remains fragmented, and less inclined towards

[5] See http://aims.erd.gov.bd/AIMS/Home.

developing productive capacities, there is a need to improve the coordination of aid to avoid selective focus, misalignment and the wasteful allocation of donor support to non-performing sectors.

The Paris Declaration on Aid Effectiveness and the Accra Agenda for Action strongly advocate for the use of national systems, including public financial systems, institutions and procedures, to achieve alignment with national priorities. However, in most project-type interventions, the role of recipient governments is reduced to tracking the number of projects approved, with donors deciding on strategy and implementation. With less than 10 per cent of the total aid receipts in LDCs going through budget support, the aid process remains donor-centric despite the target in the Paris Declaration on Aid Effectiveness to increase this type of aid. According to creditor reporting system data from OECD, over two thirds of aid to LDCs – 69 per cent in 2017 – is delivered through project-type interventions. Developing countries must therefore coordinate fragmented efforts that are effectively under the control of external partners rather than directly integrated into their national systems. This has given rise to ad hoc systems whereby LDCs urge cooperating partners to pool resources instead of channelling support through unrelated projects managed by donors or their proxies (Klingebiel et al., 2017). In the implementation of the 2030 Agenda, Goal 17 on partnerships for the Goals is shaping conversation and practice on the means of implementation for the Goals, with recognition of the need for better cooperation among actors, including Governments, the private sector, civil society and communities.[6] A number of United Nations-led multi-stakeholder partnerships have been set up to achieve the Goals, such as the high-level political forum on sustainable development and the partnership forum of the Economic and Social Council, which were established following General Assembly resolution 67/290 and subsequent resolutions, including resolution 68/234 on global partnerships.[7] However, greater efforts are needed to translate global partnership interests into country-level interventions and to improve the alignment of development cooperation with national priorities in the most vulnerable countries and integrate efforts into government systems.

a. Thematic coordination

Following the Monterrey Consensus, sectoral approaches became popular among donors seeking

Global partnerships need translation into country-level interventions aligned with national priorities

to align their priorities in developing countries. However, the geographic and thematic distribution of aid continued to reveal the non-neutrality of aid disbursement (Sraieb, 2016). The focus on narrow sectoral themes is common among bilateral donors and proves useful for countries facing non-binding commitments of official aid flows (Bourguignon and Platteau, 2015). It is also important to note that bilateral relations are constantly evolving, not just from the recipient perspective but also from the perspective of donors, with diverse policy and organizational changes in DAC members and emerging South–South partners contributing to the trend.

i Sector-wide coordination mechanisms

Although recipient countries are often assumed to be in control of national development strategies, sector-themed support does not eliminate donor influence on sectoral agenda setting. Whether coordinated by donors or recipients, sector-themed coalitions only bring together the main actors according to their priorities, by sector. A national aid coordination mechanism is deemed successful when it brings together donors into one sectoral programme rather than aggregating separately conceived donor projects in a sector. Bilateral and multilateral donors use sector-themed support for various reasons, including alignment with their own policies, priorities or strategic visions; for engagement with recipients; and to maintain control over implementation and results (Boesen and Dietvorst, 2007; OECD, 2009).

Several LDCs have developed sectoral aid coordination protocols due to the large volumes received through project-type interventions. Some countries have interministerial and sectoral processes for coordinating aid, for example, Angola, Burundi, Ethiopia, the Lao People's Democratic Republic, Senegal, Tuvalu, Uganda and Vanuatu, and others have international cooperation policies that detail how sectoral support should be treated, such as Afghanistan, Kiribati, Malawi, Nepal, Sierra Leone and Rwanda. In arrangements such as these, joint consultation or programming is used to eliminate fragmented approaches, and common reporting and the use of country systems have been useful in aligning donor approaches to the financial cycles of recipients (Hart et al., 2015). For

6 See https://unstats.un.org/sdgs/report/2018/goal-17/.

7 For a goal by goal breakdown of registered partnerships at the global level, see https://sustainabledevelopment.un.org/partnership/browse/.

Box 4.1 **Eritrea: Development cooperation**

Eritrea receives aid mainly through project-type interventions, which accounted for 90.7 per cent of the aid received since 2013, and virtually no interventions through public budget processes. The United Nations Security Council, in its resolution 2444, decided to lift targeted sanctions on Eritrea, and this assists the ongoing normalization of relations between the nations in the region and external partners, in particular those that already support programmes in Eritrea through the Strategic Partnership Cooperation Framework 2017–2021. In the immediate past, only a few donors had bilateral agreements with Eritrea due to challenges in securing effective dialogue and maintaining relations. Eritrea relied on bilateral aid that was loosely aligned with its sectoral policies, yet failed to mobilize resources at the level required. A review of four donors that had close ties with Eritrea in the 1990s until about 2000 showed that the country favoured loan facilities over grants, and equipment and supplies over consultancies, as the funding situation became tight. The Strategic Partnership Cooperation Framework assists Eritrea in gaining control over key sectoral priorities through alignment with the National Indicative Development Plan 2014–2020 and other sectoral plans. In addition, support has been secured for at least 25.4 per cent of the required funding through eight United Nations funds, programmes and specialized agencies.

Aid coordination facilitated by the United Nations is critical in a country that is emerging from a situation of conflict or in the absence of institutional set-ups for coordinating support. However, caution must be exercised so that over the long term, the sectoral approach is not overplayed by donors to maintain control over support programmes in the recipient country. Sectoral aid allocation patterns show a lack of consistency in linking aid volume with the needs and constraints of developing countries, leading to unbalanced and ineffective support. Thematically linked donor support is low in Eritrea, and this example contrasts with the general trend in LDCs, whereby countries negotiate with donors based on thematic orientation rather than integrated national development plans. For example, the European Union has pledged €200 million for energy development and enhancing government and public finances in Eritrea. Without strong aid coordination strategies, project-type support remains the main vehicle for aid delivery, at the risk of achieving tangential alignment with broader national priorities. This also increases the fragmentation of aid and feeds aid dependency through uneven support for sectoral programmes. LDCs need strong human and institutional capacities for aid coordination, as well as proactive foreign policy directions that cement the role of national systems in national development. In addition, donors should streamline aid delivery processes to strengthen national systems, to ensure the effectiveness and alignment of donor support with national priorities.

Sources: Alonso, 2015; Dijkstra, 2013; European Commission, 2015; Haider, 2018; Michael et al., 2008; United Nations and Eritrea, 2017.

example, in the Lao People's Democratic Republic, several sectoral working groups led by the Government have been established, including on education, health, governance, infrastructure, agriculture and rural development and natural resources and the environment. The groups usually include development partners as co-chairs, as well as civil society and private sector representatives. Two-layer forums are used to coordinate with development partners, namely, a round table process of consultations held every five years according to the cycles of national development plans and annual coordination meetings to review progress on the implementation of the plans (Lao People's Democratic Republic, 2019). Box 4.1 provides an example of development cooperation in Eritrea.

ii Multi-partner trust funds

Multi-partner trust funds have been used in various contexts to coordinate donor efforts to mobilize support for specific global, regional and national-level agendas, including humanitarian agendas and those related to governance, gender equality, the environment and development. This approach works well in coordinating aid with regard to humanitarian crisis situations, when decisions must be made quickly and the needs and priorities of recipients are not in doubt. For example, about 80 per cent of United Nations multi-partner trust fund transfers to humanitarian funds take less than 36 hours to effect and most transactions, at 98 per cent, are concluded within five working days (United Nations Multi-Partner Trust Fund Office, 2017). Trust fund management is at the national level through the lead United Nations agency or a national coordination unit, such as the ministry of finance, and typically involves diverse partners with clearly defined roles and agreed governance structures, operations and implementation (United Nations, 2018e). The administrator holds and manages the funds in trust, providing tools for ensuring transparency, tracking results and reporting. Trust funds managed at the national level allow beneficiary countries to provide inputs into the planning and implementation process.

The multi-partner trust funds administered by the United Nations Development Programme are meant to support specific national plans, yet their global donor inputs also imply commitment to global-level strategic priorities. For example, the United Nations Sustainable Development Cooperation Framework

and "Delivering as one" have been critical in translating national priorities into traceable actions that respond to global frameworks such as the Sustainable Development Goals and the Paris Agreement. However, most of the trust funds are allocated to countries in humanitarian crisis as originally intended, and Afghanistan, the Central African Republic, the Democratic Republic of the Congo, Somalia and South Sudan are among the top five recipients (United Nations Development Programme, 2019).

Despite its institutional strength, turning the trust fund process into viable support for national development strategies has generally proven difficult, either because resources are too low or a fund's thematic focus is too narrow to trigger such a shift (Dag Hammarskjöld Foundation and United Nations Multi-Partner Trust Fund Office, 2017; Downs, 2011). A brief review of trust funds and joint programmes that are ongoing or were completed in 2015–2019 shows that only the Climate Resilient Green Economy Facility in Ethiopia is supporting a national development programme and a few countries are implementing sectoral programmes, namely, the Democratic Republic of the Congo, on reducing emissions from deforestation and forest degradation in developing countries-plus; Mali, on agropastoral products and climate change; and Yemen, on rural resilience. The rest of the funds are typically for humanitarian needs or for narrowly defined projects. A few funds have a broadly defined goal to accelerate the implementation of global agendas such as the 2030 Agenda, such as in Kenya, Malawi and Rwanda. In Ethiopia, the Climate Resilient Green Economy Facility is a funding vehicle managed by the United Nations Development Programme for the transition towards an inclusive green economy based on four pillars, namely, agriculture; forests; energy; and transport, industrial sectors and infrastructure. The national development plan for 2015–2020, the Second Growth and Transformation Plan, fully integrates the climate resilient green economy strategy. However, based on approved trust fund budgets, the funding level in Ethiopia falls short of the required resources to implement the strategy, let alone the broad aims of the Second Growth and Transformation Plan.

b. Strengthening national systems

Lack of coherence between external support and public budget processes for the implementation of national development may be the main reason for the weak link between aid and structural transformation. Well-coordinated donor support is important in strengthening synergies and tracking complementarities among sectoral programmes and eliminating mismatches between donor-supported programmes when they are not jointly planned or delivered within national planning and budgeting processes. However, for solid transformative results, investments, whether funded from domestic resources or through external support, should be implemented in the context of national systems. Developing countries have stressed the need for well-functioning multilateral arrangements to align donor support and harmonize aid processes with national priorities. In the Paris Declaration on Aid Effectiveness and the Accra Agenda for Action, countries affirmed their commitment to supporting the national ownership of development processes, helping to strengthen capacities and reforming and simplifying donor policies and procedures to encourage collaborative behaviour and progressive alignment with partner country priorities, systems and procedures. However, low levels of funding for investments in public budgets and sectoral plans do not support these commitments, as many LDCs receive less than a quarter of external support, including aid, through public budget processes (figure 4.13).

National systems that lead policy formulation and resource deployment yield alignment and effectiveness

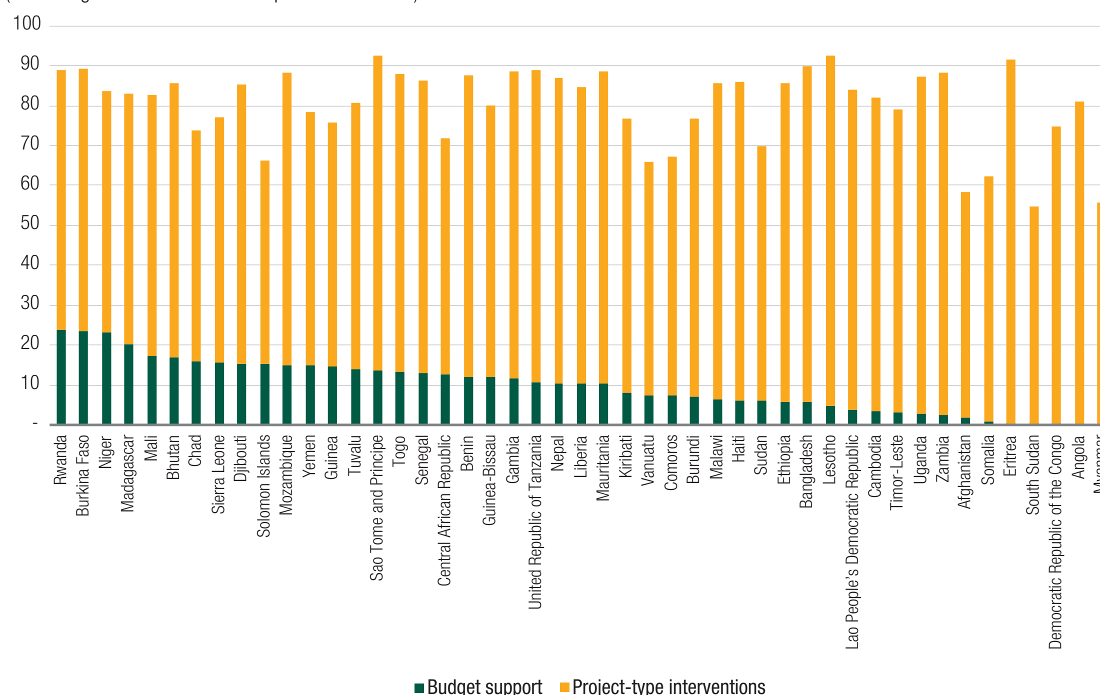
Rwanda has taken an institutional approach to aid coordination, shifting from a donor-dominated development agenda to a State-led development framework that places a high value on national ownership (box 4.2). Post-conflict reconstruction after 1994 involved many donor-supported programmes, including for rebuilding institutions, and policy reforms encompassing social and infrastructure sectors (World Bank, 2009). Human capital development, agriculture, transport, information and communications technologies, energy, housing and urban development were the main priorities. The Economic Development and Poverty Reduction Strategy 2007–2012 aimed to achieve high levels of human development, economic growth, rural development and good governance. In this period, the Government focused on building institutions and strengthening its planning, monitoring and evaluation systems, including financing and donor coordination mechanisms (Watson-Grant et al., 2016).

Where aid coordination is institutionalized through policy on international cooperation or donor coordination mechanisms, clear mapping exists between national development strategies,

Figure 4.13

Project-type interventions and budget support, average, 2013–2017

(Percentage of total official development assistance)



Source: UNCTAD calculations, based on creditor reporting system data from OECD.

external support received and national budget aggregates. However, the national ownership of development will remain a lofty objective if donors do not align themselves with national processes. A country-owned development process is one in which there is a significantly reduced role for project-type funding or core contributions and, critically, one in which national systems play a significant role in policy formulation and the deployment of resources. This is a radical shift from donor-centric definitions of the national ownership of development aid, which emphasize power, legitimacy, commitment, capacity and accountability (Watson-Grant et al., 2016).

i A social sector bias among donors

Aid allocation to LDCs shows that donors have a strong preference for the social infrastructure and services sector, which accounted for 59 per cent of aid to LDCs in 2014–2017. Aid to productive sectors and to economic infrastructure and services in LDCs remained low, at 8 and 12 per cent, respectively, and humanitarian assistance accounted for 10 per cent of aid in the same period. It is implicit that non-neutral processes determine bilateral and multilateral aid allocation to individual LDCs. Aid neutrality is the idea that aid takes a normative structural identity, as in the humanitarian field, rather than a positive or political stance that distorts its intended purpose (Drążkiewicz, 2017). Aid selectivity strategies have been part of the decision-making processes of both international financial institutions and bilateral donors. Donors need to justify and account for public resources to taxpayers in their countries and it has therefore been argued that there is a politicization of every amount spent abroad, reflected in the spread of preferred partner countries, themes and sectors that match the political and economic considerations of donors (Gulrajani, 2016). In addition, the initial and subsequent aid-related decisions in donor countries or among agencies depend on non-neutral considerations such as procurement rules that favour the source country or other factors that may facilitate or impede aid coordination and alignment efforts to achieve development (Williamson, 2010). A social sector bias may be justified if aid helps to increase human capital development, resulting in positive impacts on economic development and FDI performance. However, a focus on basic skills development, primary health care and basic education means that recipient countries cannot achieve balanced transformative development as intended under the 2030 Agenda.

Box 4.2 **Rwanda: Aid coordination framework**

Under structural adjustment programmes, most developing countries implemented reforms as a precondition for funding from the International Monetary Fund and World Bank under HIPC. As part of reforms, Rwanda began to install measures to promote accountability and the alignment of donor funding with national priorities. Vision 2020 provided a long-term strategy and was used as the basis for mobilizing foreign aid, setting targets for 2010 and 2020, with 2000 as the baseline year.

The Rwanda Aid Policy was approved by the Government in 2006 and sought to provide clear structures and guidelines for the mobilization and management of external assistance. By 2007, when the first poverty reduction strategy was launched, the Rwanda Aid Policy also provided the basis for monitoring progress and the medium-term expenditure framework guided donor monitoring of budgets (input and output) and strengthened relations. The Rwanda Aid Policy sets the boundaries for mobilizing external assistance in a form that does not undermine government autonomy and in a manner that strengthens the ownership and capacities of the Government and its ability to manage all of its resources effectively, further enhancing service delivery to citizens. Earmarked budget support is the preferred aid modality. However, the Policy stipulates conditions under which project-type support may be accepted. In such cases, preference is given to sectoral budget support, followed by stand-alone projects, which must be reflected in the government budget and demonstrate alignment with national plans. Further, pooled funding is strongly encouraged, rather than individual project support. The Policy mandates the Ministry of Finance and Economic Planning to perform aid coordination functions and, in this regard, the External Finance Unit was established with the primary responsibility to mobilize external financing from traditional partners and non-traditional partners through ODA, commercial loans to finance government priorities (sovereign bonds) and private sector finance from international financial institutions. The Unit also coordinates development partners through various forums, including sectoral working groups and joint sectoral reviews. In the implementation of the Economic Development and Poverty Reduction Strategy 2007–2012, joint sectoral reviews were held between the Government and development partners, at which individual ministries reported on key indicators and at which national results and outcomes were monitored, and the reviews were used as a basis for seeking greater donor harmonization and support. In this context, under the Strategy, resources were mobilized through high-level dialogues with strategic partners. Sectoral consultations were key entry points for donors, as they co-chaired the 19 sectoral working groups. Other actions taken by the Government included the strengthening of public financial management institutions and setting up of supportive infrastructures and systems.

At about this time, it became global practice, for mutual accountability, to hold partnership meetings to agree on priorities, such as in the Rome Declaration on Harmonization, the Paris Declaration on Aid Effectiveness and the Accra Agenda for Action, which emphasized the domestication of policies and the building of ownership. In Rwanda, further refinement to the coordination framework as a result of the interest of both the Government and its development partners in continuing to accelerate efforts to further streamline effective ways in which aid could be provided, and to enhance the utilization of aid for maximum development impacts, led to the launch in 2011 of single project implementation units in ministries, including the Ministry of Finance and Economic Planning. The mandate of the External Finance Unit was broadened and now encompasses the mobilization of other sources of external finance, including private finance.

In the implementation of the Economic Development and Poverty Reduction Strategy 2013–2018, an annual leadership retreat provided a forum for the official reporting of sectoral performance to the President and to peers. In addition, donor harmonization provided benefits in the form of lowering the Government's data and transaction costs and paved the way for further alignment of government and donor systems. The mobilization of external financing in Rwanda is designed to support State-building priorities and national strategies, to ensure the relevance of donor funds and, generally, coordination has yielded positive support in some sectors, for example, business development services, in which the Government has leveraged support for small and medium-sized enterprises. However, challenges remain in aligning donor support in other sectors such health, and the bulk of donor support remains skewed towards sectoral support rather than purely national budget support.

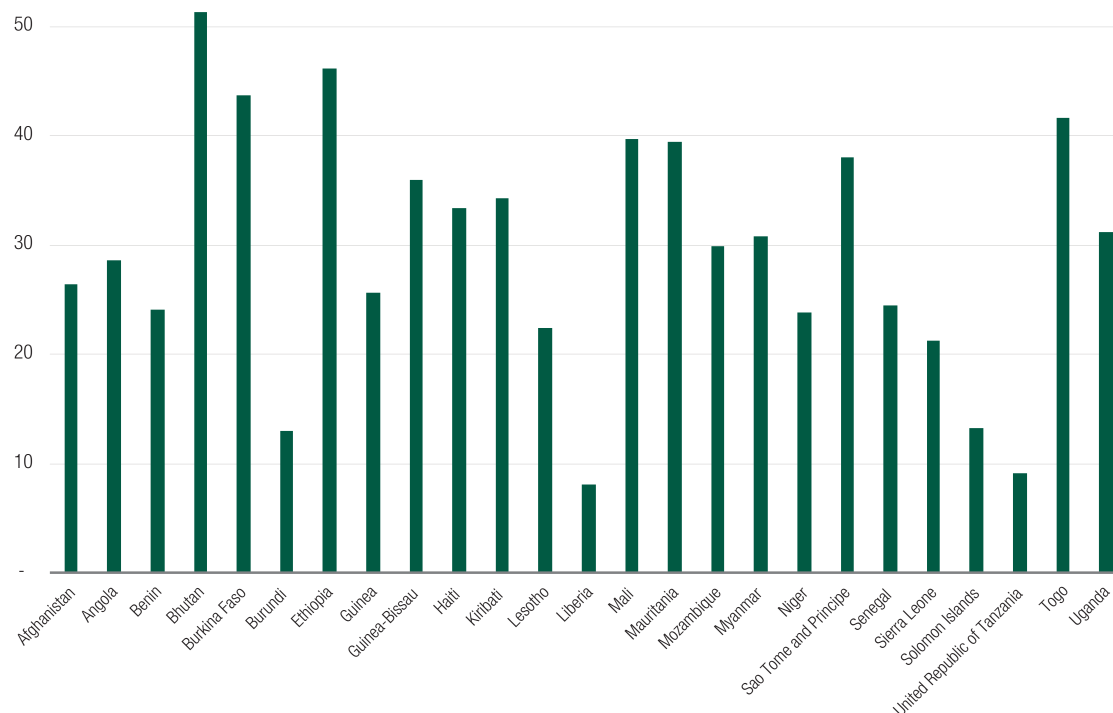
Sources: Rwanda, 2006; Rwanda, Ministry of Finance and Economic Planning, 2013; Rwanda, Ministry of Finance and Economic Planning, 2015; Rwanda, 2017; Rwanda, Ministry of Finance and Economic Planning, 2019.

One threat to the achievement of the Goals in LDCs is path dependency in the pattern of aid allocation. Donors have not shifted from a concentration in the social sector since the period of the Millennium Development Goals; for example, in 2006, the largest share of aid, at 53 per cent, was allocated to the social infrastructure sector, followed by economic infrastructure, at 19 per cent, and productive sectors, at 10 per cent (Anderson, 2008). These shares have significantly shifted in favour of the social sector and the fragmented bilateral channels of aid delivery have intensified this concentration. Institutions, governance and public administration are considered significant in the decisions of bilateral and multilateral donors,

Figure 4.14

Capital expenditure, selected least developed countries, average, 2013–2017

(Percentage of total expenditure)



Source: UNCTAD calculations, based on data from the open budgets database of the World Bank.

yet a critical component of the inefficiency in aid allocation arises from the static manner in which aid is structured vis-à-vis national priorities that change over time (Whitfield and Fraser, 2010).

ii Inadequate support for building productive capacities

Productive capacities in LDCs remain weak due to poor infrastructure and a lack of financial resources, entrepreneurship development and technological innovation and adaptation, among others (UNCTAD, 2006a; UNCTAD, 2011b). However, external support targeted towards economic infrastructure and productive sectors remains low.

Significant investments are needed in LDCs to trigger sustained, broad-based economic growth and poverty reduction and to increase resilience. Scaling up infrastructure investment is a key priority in developing countries and, in LDCs, the gap in economic infrastructure is considerable (Gurara et al., 2017). The national budgets in various LDCs indicate the importance of capital investments relative to other sectoral allocations and, in particular, with the exception of Burundi, Liberia, Solomon Islands and the United Republic of Tanzania, the common element among LDCs for which data is available is the high share of spending on capital investment; at least one fifth of total government appropriation, rising to at least 30 per cent of the budget in most of the LDCs considered (figure 4.14). Capital expenditures generally involve physical assets that have a life cycle of at least one year. There may be overlaps in capital and current expense records, yet the former usually consist of physical assets such as office buildings and vehicles, public goods such as roads and water and sanitation systems and intangibles such as education and research, which are generally considered investments (Jacobs, 2009). For example, Bhutan, with more than half of its total outlay directed to capital expenditure in 2013–2017, continues to place a high value on infrastructure development, and the preliminary fiscal projections in its twelfth five-year plan, for 2019–2023, provide for 38.3 per cent of the total outlay to be directed to capital expenditure (Bhutan, 2016). Burkina Faso, in its National Plan for Economic and Social Development 2016–2020 provides for 54.6 per cent of the total outlay to be directed to capital expenditure (Burkina Faso, 2016). Togo envisages raising about 35 per cent from public resources to deliver its National Development Plan 2018–2022 and, according

to the estimates, will spend between $80 million and $120 million on an industrial park, $300 million on rural electrification and $620 million on improving the competitiveness of the corridor from the autonomous port of Lomé to Cinkassé (Togo, 2016). These examples demonstrate not only the commitment of the countries to developing productive capacities through meaningful capital investments but also the need for a shift in the way external resources are allocated to sectors. By contrast, in 2013–2017, inclusive of capital expenditure, expenditure on health ranged from 2 per cent of the total outlay in Guinea to 14 per cent in Solomon Islands, and on education, ranged from 8 per cent in Myanmar to 30 per cent in Burundi.

iii Misalignment of priorities deepening fiscal imbalances

The mismatch in resource allocations by donors and partners to the social infrastructure and services sectors and the economic infrastructure and productive sectors may be interpreted as complementary, yet a deeper analysis of the fiscal implications of the divergence between areas of domestic resource allocation in LDCs and the external support bias towards selective social sectors suggests that the alignment of country priorities is not being achieved and that the effectiveness of donor support is therefore debatable (Morrissey, 2015; Mosley, 2015). The inefficiency cost of such a misalignment imposes significant costs on LDCs that are only partially reflected by an increase in domestic and external borrowing and higher administrative overheads in aid management and undue wastage imposed on recipients coordinating fragmented donor support.

Even assuming that most aid is channelled through government spending, the impact on government tax efforts depends on how easily aid can substitute for domestic tax revenue. Monitoring and review is an important feedback mechanism for assessing how donor aid is aligned with national priorities. However, a key issue with DAC evaluations is the self-evaluation bias that donors may have when assessing their impacts.

The Global Partnership for Effective Development Cooperation supports mutual accountability efforts through the provision of data and evidence. In 2016, a survey conducted to assess the alignment of new interventions with national priorities showed that 86 per cent of interventions in LDCs stated that they were so aligned (table 4.2). However, closer analysis shows that only 32 per cent of the interventions drew their objectives from national development plans and that the proportion of those that drew from sectoral plans and strategies, at 22 per cent, and from development partner strategies, at 19 per cent, were close. This puts into perspective the risk of misalignment brought about by sector-themed support and project-type interventions. The data also show that, on average, aid allocated to each project ranged from $2.3 million to $53.7 million, with a median of $13 million, and the number of interventions ranged from 3 to 131.

Misaligned external support – mixed with fragmented donor delivery – creates unnecessary costs for LDCs

D. Conclusions

Domestic resource mobilization has a significant role in the achievement of the Sustainable Development Goals, yet the expectation placed on LDCs to mobilize adequate domestic resources for development should be tempered by reality. The domestic imbalances faced by LDCs are not going to diminish unless the fundamentals constraining their economic development are addressed. The analysis in this chapter and the literature on tax capacity and efficiency in LDCs suggest that they have limited scope for increasing public resources through taxation. Those countries with fiscal space, such as Angola, Bangladesh, Bhutan, Myanmar and Timor-Leste, are typically those that are close to graduation or technically eligible for graduation, having had consistently better performances in terms of per capita income, human assets and economic vulnerability scores. The lack of fiscal space affects the most economically vulnerable, such as Benin, Lesotho, Malawi, Nepal and Togo, which are already collecting more revenue compared with their capacity. In addition, small economies and a low share of world trade further limit the capacity of LDCs to generate domestic resources through savings, investments and the private sector.

At the current level of development, LDCs are not able to raise adequate resources to finance development. LDCs need to enhance capacity to mobilize domestic resources and this extends beyond tax-based resources. Key priority areas include strengthening tax administration systems and governance structures that impact on the independence of tax collection bodies. Natural resource-rich countries, for example, need to ensure fair and transparent taxation and an improved distribution of natural resource rents. Growing the tax base, which is the main component of domestic resources, hinges on fostering sustained economic growth in LDCs, building resilience and creating a macroeconomic environment for broader, sound taxation. Fiscal policies also play a key role

Table 4.2

The extent to which donors align new interventions with national priorities

	Number of interventions assessed	Amount	The objective of the development intervention is drawn from country and/or Government-led results framework(s)					
			Yes	From national development plans	From sectoral plans and strategies	From institutional or ministry plans	From other government planning tools	From development partner strategies agreed with the Government
		(Millions of dollars)	*(Percentage)*					
Afghanistan	39	1 659.8	77	10	18	18	13	18
Angola	17	867.6	94	35	–	59	–	–
Bangladesh	74	3 706.3	89	54	12	4	1	18
Benin	62	356.6	84	18	29	13	2	23
Bhutan	10	83.4	90	20	10	20	–	40
Burkina Faso	22	410.1	100	36	14	5	9	36
Burundi	15	195	27	20	–	–	7	–
Cambodia	67	873.3	100	100	–	–	–	–
Central African Republic	5	62.7	100	–	–	–	–	100
Chad	18	294.4	89	6	6	33	–	44
Comoros	10	40.2	90	50	20	–	10	10
Democratic Rep. of the Congo	81	1 366.7	100	47	27	4	5	17
Ethiopia	103	4 121.3	94	40	33	6	1	14
Gambia	11	41.5	82	36	36	–	9	–
Guinea	8	124.5	100	13	25	50	13	–
Kiribati	9	20.7	100	67	–	–	–	33
Lao People's Democratic Rep.	63	552.2	95	41	16	10	2	27
Liberia	17	913	100	94	6	–	–	–
Madagascar	57	517.6	81	40	26	4	5	5
Malawi	38	573.9	92	32	26	11	3	21
Mali	47	535.4	62	28	6	13	–	15
Mauritania	19	181.1	89	–	21	–	–	68
Mozambique	62	1 647.3	95	18	48	13	5	11
Myanmar	63	2 944.5	57	17	25	6	–	8
Nepal	51	1 633.1	84	47	6	2	14	16
Niger	10	144	50	10	10	–	20	10
Rwanda	47	962.4	89	30	38	2	2	17
Sao Tome and Principe	3	27.2	100	–	67	–	–	33
Senegal	53	747	94	8	60	4	4	19
Sierra Leone	30	135.3	90	27	–	30	27	7
Solomon Islands	13	64.7	38	15	15	–	–	8
Somalia	131	1 367.2	76	8	20	1	11	36
South Sudan	21	530.1	71	5	67	–	–	–
Sudan	57	220	88	19	61	2	5	–
United Republic of Tanzania	74	1 166.7	89	26	31	15	1	16
Timor-Leste	23	217.6	96	65	9	9	–	13
Togo	27	255.7	96	52	26	4	4	11
Tuvalu	7	19.7	100	86	–	14	–	–
Uganda	53	1 134.1	92	30	34	6	–	23
Vanuatu	14	111.6	86	43	14	–	–	29
Yemen	7	126.1	100	14	57	–	14	14
LDC total (or average shares)	**1 538**	**30 952**	**86**	**32**	**22**	**9**	**5**	**19**

Source: UNCTAD calculations, based on data from the Global Partnership for Effective Development Cooperation (available at http://dashboard.effectivecooperation.org/viewer).

in ensuring that public expenditure addresses other social development challenges, including inequality. In LDCs, the dynamic role of fiscal policies in stimulating growth is critical, but this requires continuous improvement to ensure that tax policies are supportive of the productive capacities of the countries, structural transformation, economic diversification and accelerated industrialization.

LDCs should also address limitations arising from external sources, to generate adequate domestic resources to finance their development agendas. Private investment flows to LDCs, predominantly in the natural resource sectors, have not been fully useful in building the conditions and capacities needed to support domestic resource mobilization. LDCs have also been affected by significant levels of illicit financial flows, which further erode the taxable base, and requires strengthened international cooperation on tax matters and the closing of loopholes, to contribute to domestic resource mobilization efforts in developing countries. This extends to special tax exemptions for contractors and procurement policies that controversially reduce domestic resource mobilization and undermine the growth of the domestic private sector excluded from donor transactions (Steel, 2018). The work of the Committee of Experts on International Cooperation in Tax Matters under the Economic and Social Council is particularly relevant in LDCs in enhancing and promoting international tax cooperation and providing recommendations on new and emerging issues of relevance to developing countries (United Nations, 2014; United Nations, 2019f).

The emergence of South–South partners has created more challenges. In this regard, several basics remain relevant in LDCs, including the need for better institutions, policy coherence and harmonization with donors and partners. LDCs face limitations in terms of institutional capacity for implementing projects and coordinating international support. The transaction costs of dealing with multiple development partners have risen with the increased number of actors and bilateral partners. It is likely that aid has been used to impose the narrow interest-driven external agendas of donors and partners rather than the agendas of recipient countries. New forms of cooperation may not represent additional financing but rather a mere trade-off between scanty official aid and costly private financial flows, such that additionality benefits are immediately wiped out by increased indebtedness, greater private liabilities and low-quality outcomes due to inappropriate disbursement modalities that are inconsistent with the long-term development agendas of recipient countries. Strong institutions are therefore needed to implement national development agendas and manage external relations with partners.

As shown by the experience of Rwanda, States that have insisted on country-coordinated aid processes have generally reduced the number of ad hoc donor projects that have no correspondence with national development priorities. Ownership over development agendas and benefiting from increased choice

New forms of cooperation should complement ODA, not worsen ODA fragmentation and debt burden

among development partners also requires human capacities for aid coordination, strong policies and proactive foreign policy positions that cement national control and creativity with regard to external support. There is a need for better policy coherence and the alignment of donor priorities with the national plans of LDCs and the greater use of budget support rather than project-type aid, as intended under the Paris Declaration on Aid Effectiveness. The rapidly growing divergence between ODA and public capital investment shows the need to boost productive capacities and accelerate structural transformation in LDCs. In Rwanda, the National Strategy for Transformation 2017–2024 exemplifies a departure from donor dependence, as aid receipts by sector have not directly enabled the country to directly achieve the transformative goals in its previous development plans, and the focus has shifted to private sector development, economic diversification and human capital and skills development that will reinforce its competitiveness in the global economy. External support will continue to play a role through sectoral working groups and joint reviews, yet domestic public resources will contribute 59 per cent of the cost of the plan and the rest will be mobilized from the private sector (Rwanda, 2017).

The misalignment cost of divergence between the priorities of LDCs and those of development partners will escalate if domestic resource mobilization continues to fall short of the rising demand for development financing. Non-concessional borrowing, both domestic and external, has increased sharply compared with both ODA and domestic resource mobilization, despite rapid output gains in LDCs over the years. It is therefore critical to carefully assess whether the new forms of cooperation and emerging donor relations are complementing ODA or are merely costly private financial flows and additional public liabilities. Targeted aid earmarked for specific sectors, in particular infrastructure investments, can facilitate improved fiscal outcomes in LDCs and reduce debt burdens. Finally, there is a need for the greater integration of aid into various categories of government budget aggregates, to achieve positive impacts from aid on fiscal policy.