THE IMPACT OF ODA ON DOMESTIC FISCAL REVENUE MOBILIZATION OF RECIPIENT COUNTRIES: A CASE STUDY OF RWANDA

By

KABANDA EMMANUEL

THESIS

Submitted to
KDI School of Public Policy and Management
in partial fullfilment of the requirements
for the degree of

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Committee in charge:

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ABSTRACT

THE IMPACT OF ODA ON DOMESTIC FISCAL REVENUE MOBILIZATION OF RECIPIENT COUNTRIES; A CASE STUDY OF RWANDA

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ODA (Official Development Assistance) finances government expenditure is crucial in raising the living standards of the poor in the developing world. There is a debate, however, regarding the impact of ODA on recipient countries with proponents emphasizing that foreign aid, in addition to filling the government budgetary gaps of developing countries to meet their obligations to their citizenry, it increases the imperative on the recipients' efforts to develop their own capacity with the hope that this will enable them to wean off aid; opponents argue that it stifles the capacity of recipient governments to create, support and tax their domestic sources and instead perpetuates their dependence on aid, promotes rent-seeking, corruption and civil strife. This study examines the impact of ODA on Rwanda's efforts and capacity to generate domestic fiscal revenue and draws on the findings to reach a conclusion.

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Finally, I would like to recognize the support and camaraderie we shared as students of KDI School Class of 2011.

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1. AfDB- African Development Bank
2. BBC-British Broadcasting Corporation
3. BNR- Banque Nationale du Rwanda /National Bank of Rwanda
4. DR Congo -Democratic Republic of Congo
5. CPI- Corruption Perception Index
6. DAC-Development Assistance Committee
7. DFID-Department for International and Overseas Development
8. DRM-Domestic Revenue Mobilization
9. EAC-East African Community
10. FDI-Foreign Direct Investments
11. GDP-Gross Domestic Product.
12. GNI-Gross National Index
13. HDI-Human Development Index
14. ICT-Information and Communication Technology
15. IMF-International Monetary Fund
16. ODA-Official Development Assistance.
17. OECD-Organization for Economic Cooperation and Development.
18. NEPAD-New Partnership for Africa's Development
19. RDB-Rwanda Development Board
20. RRA-Rwanda Revenue Authority.
21. RwF- Rwanda Franc
22. SSA-Sub-Saharan Africa
23. TFP-Total Factor Productivity
24. UN-United Nations
25. UNDP- United National Development Program
26. UNECA-United Nations Economic Commission for Africa
27. USD-United States Dollar
28. UShs-Uganda Shillings

29. VAT-Value Added Tax

30. WEF -World Economic Forum

Chapter 1: Introduction

Governments have a duty to extend services to nationals, which services are funded by resources mobilized majorly in form of taxes levied on economic activities carried out in a country, particularly exchange of goods, services and labour in an economy and the activities of citizens carried outside of the country. Many developing countries are unable raise enough resources locally to meet their budgetary demands because of the existing narrow tax base and in a bid to fill their countries' budgetary deficits, they resort to borrowing through loans which are repaid in future with or without interest from bilateral and multilateral sources and aid in form of grants. Indeed foreign aid funds a big portion of the fiscal budgets of many developing countries which face shortfalls in their domestic revenue mobilization.

There are studies that showed that ODA has a positive impact on recipient countries by reducing corruption, and that it shapes the "relationship between taxation and improved governance in much broader ways". Other studies reported that continued receipts of ODA lowers the impetus on the part of recipient countries' governments to build relations and representation of local economic actors as taxpayers from domestic sources by improving the efficiency and effective use of their tax administration systems and processes, widening their tax base, optimizing their domestic tax and the general management of the economy in terms of economic growth and development. There are studies that reported that aid in large quantities may increase corruption, rent-seeking and civil strife which are detrimental to increased domestic fiscal revenue collection. Moss et al (2006) warned that foreign aid may undermine the strengthening of governance structures and that "aid-dependent countries may be inclined to underuse their available sources of tax revenues." It is argued that because those who run governments in developing countries can access ODA, they neglect building systems which might otherwise help them overcome their dependency. There are studies that found that ODA has neither positive nor negative impact on growth of economies of recipient countries.

There is need to investigate the relationship between ODA and domestic fiscal revenue collection of recipient countries. I believe ODA contributes to increased domestic fiscal revenue generation of recipient countries and it is my belief that this study will add to more understanding the subject of ODA in the context of developing countries' revenue collection and development.

Using Rwanda as a case study for the study of the impact of ODA on the domestic fiscal revenue generation of recipient countries is pertinent given the history of the country, the amount of aid (in terms of ODA as a percentage of total fiscal budget not in absolute and comperative terms) that was received by the country during its rehabilitation and reconstruction stage and the steady increase in the amount of domestic taxes as a percentage of GDP, gross taxes, and the comparison between potential and actual tax over the period under review. If any country and its government could fail to build institutional structures because of ODA, Rwanda would be the perfect example, because until recently a sizable portion of the national budget was funded through ODA sources. After the 1994 Genocide in Rwanda institutions were rebuilt anew in terms of skilled personnel, systems and practices.

1.1 Statement of the problem

There is need to understand the impact of ODA on the capacity of recipient countries to generate their own fiscal revenue for two major reasons:

(1) Aid and donations cannot be sustained forever and at one point donation recipients must be responsible for their own consumption and expenditures, and;

(2) Donor governments cannot be expected to have the means and the political will to continue funding the expenditure and consumption of others at the expense of their electorates.

ODA that stifles the ability of developing countries to generate their domestic fiscal revenue, therefore, should be re-viewed.

1.2 Objectives of the study

The objective of this study is to examine the impact ODA, has had on the ability and capacity of Rwanda to generate domestic fiscal revenue given the amount of aid (modest in absolute amounts, though, when compared with other countries) the country received. The study will highlight the country's economic growth, revenue volumes and tax-base widening given the prevailing circumstances and efforts to increase domestic fiscal revenue.

1.3 Significance of the study

The study is significant for several reasons: no country has ever developed using ODA; all countries need to and must build institutions that support their development, hence, use of ODA should have an end game to wean them of external dependence. Donors, on the other hand, should be concerned that their tax resources are used to keep the poor countries poorer, with no effort to build their domestic institutional capacity.

The study will contribute; it is hoped, to more understanding of the efficacy and efficiency of aid which has become a major subject of discussion in both the academic and policy arenas.

1.4 Research questions/hypotheses

To find out the impact of ODA on Rwanda's domestic revenue mobilization efforts, I intend to use two hypothesis questions. The hypotheses are constructed with a view to generating empirical evidence both in quantitative and qualitative form to better understand the impact of ODA on the fiscal revenue mobilization efforts of Rwanda as a recipient country. To examine the impact of ODA on recipients' revenue generation another country, Uganda, is subjected to the same examination with a view to examining the interplay of the country's GDP, Domestic Tax revenue and amount of ODA received during the same period. Two hypotheses are therefore developed to guide this study;

(1) Hypothesis one:

Ha1: "There is a significant positive relationship between ODA and domestic fiscal revenue collected.

(2) Hypothesis 2:

Ha2: There is significant positive relationship between ODA and economic growth"

1.5 Research instrument

This thesis uses quantitative methods to test the two hypotheses using statistical data from different sources to test the relationship between ODA and GDP and the relationship between ODA and domestic revenue volumes collected over the period under review. Different data from the period 1995 to 2009 when ODA formed the bulwark of government fiscal budget in Rwanda are used. Available literature from related studies use models which may be broad and complex to comprehend. It is hoped that this study will highlight the impact of ODA on the ability of recipient countries to generate and collect their domestic revenues using simple and easy to apply methods.

Chapter 2: Literature review

ODA (Official Development Assistance) refers to transfer of "official financing administered with the promotion of the economic development and welfare of developing countries as the main objective, and which are concessional in character with a grant element of at least 25 percent"[1]. Much of the developing world can hardly run their governments without foreign aid particularly ODA which funds part of their fiscal budget on social, administrative and governance budgets.

Kim and Kim (2011) argue that, "If the ability to tax (and to govern) is a measure of a state's capacity, then the capacity of a state can be defined as the power to tax and regulate the economy and to withstand political and social challenges from non-state actors." Gurría (2009) states that, "Taxation is a core pillar of a country's regulatory framework for investment and growth. It features prominently in investment decision-making motivated by profit maximisation, while also spurring local enterprise development if properly designed". The director of OECD development centre, Pezzini summed up the importance of domestic fiscal revenue vis-a-vis foreign aid when he wrote in The Guardian (2010) that, "Unlike aid money, which will likely to remain painfully limited, tax revenue can make an enormous difference to achieving development goals. In 2008, the combined fiscal revenue in Africa reached over $400bn - 10 times the total amount of aid money flowing to the continent" and warned that "With aid money limited, African governments must evolve more efficient taxation systems in order to fund development policies."

The impact of ODA on recipient countries has been studied and different conclusions drawn though consensus has not been reached. Existing literature on the subject of

[1] OECD, http://stats.oecd.org/glossary/detail.asp?ID=6043

ODA may be divided into three categories; the positive view that supports the positive impact of ODA on recipient countries; the negative view that sees the impact on recipient as negative and the neutral view that found neither positive nor negative impact of ODA on recipient countries.

2.1 The positive view

There are studies that were carried out and produced results that favour continued and even increased aid to developing countries. Brun et al (2010) reported that, for both donors and recipients "technical assistance associated programs" is important as it reinforces capability of institutions that plan and implement the reforms and encouraged assistance to tax administrations which should be made stronger in countries with "low quality bureaucracies". An OECD report (2010) concluded that, "The preceding discussion suggests that the impact of aid on taxation is relatively ambiguous, and that blanket claims about the negative impact of aid on domestic taxation are unjustified. However, the equally important message for development partners is that aid may shape the relationship between taxation and improved governance in much broader ways".

Ouattara (2006) reported that, foreign aid has a positive influence on public investment; it is associated with higher expenditure on development, reduces non-developmental expenditures and does not affect tax collection in recipient countries. Hansen and Tarp (2001) studied the interaction between foreign aid and growth on per capita real GDP and reported that aid increases the rate of growth that is not conditional on good policies. They reported decreasing returns to aid; estimating aid effectiveness is sensitive to the estimator chosen and the set of control variables applied. They concluded that, "We find a consistent pattern of results. Aid increases aggregate savings; aid increases investment; and there is a positive relationship between aid and growth in reduced form models. The positive aid-growth link is a robust result from all three generations of work".

Tavares (2002) concluded that, "In this paper we ask whether foreign aid corrupts by using data on a cross-section of developing countries and instrumenting for total aid inflows. We find that foreign aid decreases corruption. Our results are statistically and economically significant and robust to the use of different controls." Bulíř and Lane (2002) asserted that "As a starting point, from a fiscal perspective, aid can be used to increase expenditure, lower taxes, reduce debt, or a combination of all three". Burnside and Dollar (2000) after their study emphasized policy rather than political institutions as a factor for the effectiveness of aid. They showed that foreign aid had good results in favourable environments such as fiscal, trade and monetary policies. The conclusion by Burnside and Dollar seem to imply that conditions tied to aid and better policies could improve its effectiveness. Burnside and Dollar (June, 1997) reported that, "Our primary question concerned the effect of aid on growth. Consistent with other authors, we found that on average aid has had little impact on growth. However, a robust finding was that aid has a positive impact on growth in a good policy environment." Pack and Pack (1990) analyzed data for Indonesia and found that aid had not been diverted from development purposes, but in accordance with the way donors intended, and that aid had not reduced domestic revenue collection efforts.

2.2 The negative view

There are other studies that produced results that show negative impact of ODA on recipient countries:

African Economic Outlook, 2010 (a collaboration among AfDB, OECD, UNDP and UNECA) reports that, in developing countries, "Obviously, tax administrations are genuine in their desire to raise revenue, but the availability of large foreign aid flows may reduce the urgency with which revenue collection is pursued". In addition, the report cautioned that there is a risk that aid-recipient governments that depend on ODA "may shy away from politically demanding income, property and local tax reforms, while these are precisely the areas that are likely to be most important to tax-governance linkages". Moyo (*The Independent*, 2009), argues that, "I have long believed that far from being a catalyst, foreign aid has been the biggest single inhibitor of Africa's growth. Among its shortcomings, aid is correlated with corruption, fosters dependency, and invariably instils bureaucracy that hinders the emergence of an essential entrepreneurial class. For Africa to grow in a sustained way, foreign aid will have to be dramatically reduced."

Kim and Kim (2011) while acknowledging the important role ODA played in the aftermath of the end of Japanese colonization, division of the country and the fratricidal Korean war, showed that the percieved and real reduction underway in foreign aid to the Republic of Korea was a major factor behind the reforms and anti-corruption measures in the tax administration body that led to increased domestic revenues. They showed that the increase in domestic fiscal revenue thanks to the reforms and anti-corruption measures by the government of President Park Chung-Hee allowed the country to wean itself off foreign aid and therefore "taking ownership of its development process". They reported that "Korea's capacity to mobilize tax revenue, often taken for granted, was crucial in providing sufficient fiscal resources - government savings - to maintain an economic environment conducive to growth, not to mention allow the government to take an active role in economic development. Fiscal soundness allowed Korea not only to manage inflation and induce foreign capital but also to make huge investments in education and infrastructure."(pp2)

Moss et al (2006) concluded that, "We have reviewed different bodies of literature that suggest that the current aid system may have undercut incentives for revenue collection and negatively affected public governance in Africa. In addition, we have examined a political science literature that finds both anti-development governance patterns across most of sub-Saharan Africa …Combined, they suggest that aid may undermine the development of effective state structures" and that "Aid may also reduce tax receipts directly, contributing to a cycle of low revenues and rising fiscal deficits… aid-dependent countries may be inclined to underuse their available sources of tax revenues."

Ekanayake and Dasha (undated) from their study reported that "the major point emerging from this work is that foreign aid has a mixed impact on economic growth of developing countries… However, this variable is negative for low-middle income countries indicating that foreign aid has a negative effect on economic growth in these countries". Acharya, et al (2004) after their study reported 'transaction costs' accruing to recipient governments which they classified as indirect and direct. One of the costs is the variety of donors, requiring 'energies and attentions of senior government officials.

The findings by Acharya et al (2004) were corroborated by Knack and Rahman (2004) who found that foreign aid undermined the efficiency of bureaucracy in poor countries as long as donors are fragmented. Reinikka and Svensson (2004) after their study in Uganda found that for the period 1991–95, schools received only an average of 13% of the grants and that surveys in similar African countries were not different. McGillivray and Morrissey (2001) reported that "Fiscal response models identify how aid may induce government behaviour that undermines or enhances the positive impact of aid. Aid may be diverted to non-productive uses, it may discourage tax effort or encourage increased borrowing."

Morss (1984) reported that, "This donor and project build-up, which continues into the 1980s, is having a negative impact on the major government institutions of developing nations. Instead of working to establish comprehensive and consistent development objectives and policies, government officials are forced to focus on pleasing donors by approving projects that mirror the current development enthusiasm of each donor. The results may be interpreted as the consequence of the transacting derived from donor fragmentation."

Djankov et al (2005) reported that, "we find that foreign aid has a negative impact …. In particular, if the foreign aid over GDP that a country receives over a period of five years reaches the 75th percentile in the sample, then a 10-point index of democracy is reduced between 0.6 and one point, a large effect. For comparison, we also measure the effect of oil rents on political institutions. The fall in democracy if oil revenues reach the 75th percentile is smaller, (0.02). Aid is a bigger curse than oil".

Cordella and Dell'Ariccia (2003) found out that the effectiveness of foreign aid is dependent on whether the aid is received through project financing or budget support. Boone (1996) showed that non-fungible aid may be more effective as opposed to fungible aid. Tirmizi (The Express Tribune), argues that "As a result of this semi-constant flow of aid (to Pakistan), the government never faced enough fiscal pressure to fully tax the economy, inculcating a culture of tax evasion that plagues the country today. The government collects only a little more than nine per cent of the Gross

Domestic Product (GDP) in taxes and faces an annual fiscal deficit of about six per cent of GDP."

Others see aid as a deterrent to development; *Reuters* News Agency (2009) in an interview reported that for Africa, "…the global financial crisis is a chance to break a dependence on development aid that has kept it in poverty, argues Zambian economist Dambisa Moyo… believes more than $1 trillion in development aid over the past 50 years has only entrenched Africa's poverty, distorted economies and fuelled bureaucracy and corruption".

Mosley et al (1987) observed that, "…the apparent inability of development aid over more than twenty years to provide a net increment to overall growth in the Third World must give the donor community, as it gives us, cause for grave concern"

2.3 The Neutral view

There are other studies whose results are neither positive nor negative on the issue; Carter (2010) observed that, "Donors want to discover the extent to which aid tends to fund tax cuts rather than expenditure, but this paper has argued they are unlikely to learn much of use from statistical associations among aggregate data, gathered over the last few decades, particularly those based on the relationship between ratios like aid/GDP and tax/GDP" while Djankov et al (2006) concluded thus, "Making aid effective is difficult. The conditionality principle does not seem to work because of the lack of credibility of the punishment. Empirical studies show that loans may help to induce some discipline and a more effective use of the funds, since they have to be returned. … Finally, the increasing access to the aid market of new participants and the potential conflict of the goals of donors contribute to the ineffectiveness of aid.

Therefore, increasing the responsibility of recipient countries (by providing loans instead of grants in a credible policy environment), reducing the cost of remittances to developing countries, and improving the coordination of donors seem to be reasonable goals to improve the effectiveness of foreign aid".

Sachs et al. (2004) after their study recommended public investment instead of consumption ODA that is disbursed as grants because money received in form loans and has to be repaid and will be more efficiently utilised than grants. Barro and Lee (2002) analyzed IMF aid and its effectiveness and reported that foreign "loan participation rates reduce economic growth and investment, although they increase openness". Brautigam (1992) after her study advised that donors should empower societies to "push" governments for accountability, openness and predictability that foster development.

From the discussion above, there is no agreed position on the impact of foreign aid /ODA on recipient countries. The fact that aid may be detrimental to the recipients' efforts to generate their own fiscal revenue resources leading to their governments to continuously expect others to fund their budgets should certainly worry both donors and recipients. The consequences of failure by ODA recipient countries to generate their own revenue is unfortunately evident, in the weak institutions, instability, poor governance, poverty and underdevelopment of countries and people in the developing world and if aid is the cause of such a state, its continued flow should be revised as indeed some have proposed. Specific research to study the impact of ODA on the domestic fiscal revenue mobilization efforts is needed because the whole issue of ODA and aid stems from some countries' failure to generate enough domestic fiscal revenue resources.

Chapter 3: Background to the study

3.1 History of Rwanda's Political economy and fiscal legacy

Prior to 1994, Rwanda's was a small economy which for more than 30 years was controlled by a dictatorship that thrived on ethnic division to stay in power. During the 1960s and 1970s, Rwanda received foreign development aid because it was, as Andersen (2000) reported, "known and admired by international donors as a successful non-communist Entwicklungsdiktatur (development dictatorship)."

Rwanda government's vision for the country was elaborated on May 1, 1974 by the then President who emphasized peasantry and glorified subsistence agriculture. Verwimp quoted President Habyarimana thus, "Some societies have, in the past, opposed (juxtaposed[2]) manual and intellectual labour with the latter giving in general more prestige to its performer. Such a concept not only seems outdated but also unacceptable because it is not realistic. In fact, manual labour, especially agricultural labour is the basis of our economy. We want to repeat that agriculture will stay the essential base of our economic system for the years to come…Remember that this is the way we want to fight this form of intellectual bourgeoisie and give all kinds of physical labour its value back." Kalamogo et al (2008,) reported that, "From 1961 to 1990, Rwanda had an administered economy characterized by the imposition of severe restrictions on trade and foreign exchange transactions, as well as a fixed exchange rate."

Coffee as the major export funded much of the state budget, for example, in 1986 coffee exports comprised 82% of Rwanda's exports. The government made popular the

[2] Added by the Author

expression “real work is to till the land, the rest is good luck” emphasizing the importance of rural peasantry agriculture. Rwanda’s population density was one of the highest in Africa in 1980s but the president of the country was defending those who had large families; for example, in July, 1980, President Habyarimana was quoted as saying he had learned a lot from his parents and his time on the farm and he himself had eight children.

In 1992, Rwanda's population was 7.5 million, and had recorded an annual growth rate of 3.3 % from 1985 to 1990 (UN Data 1993). When the government partially liberalised land purchase policy in late 1970s the rich and elite bought land from desperate small-holder farmers and by the mid-1980s, 26% of Rwandans were landless. Desforges (1999) reports that, “According to a government study done in 1991, the richest 16% of landowners held 43% of the land, while the poorest households tried to eke out a living on holdings that ranged from one quarter to three-quarters of a hectare, or less than an acre of land.”

Moise (undated) reported that “85% of the Rwandan population [were] living well below the poverty line in the late 1980s and early 1990s”. The ruling elite enforced movement restrictions and rules set up during the colonial period to prevent landless citizens from migrating to urban centres. Rwandans intending to move from one location to another sought permission from the local administrators stating the motive, duration and people to see in another locality. In other words rural-urban-migration in Rwanda was prevented by laws that required peasants to seek permission for their travel from one district to another.

UN Environmental Program (1993-94) reported that “Only 6 percent of Rwanda's population lived in urban areas in 1990, and the annual urban growth rate decreased from 5.6 percent in the period 1955-60 to 4.9 percent in the years 1985-90." Verwimp (undated) reports about the government policy to keep the people of Rwanda rural peasants thus; "Habyarimana followed a consistent policy to make the peasants stay in the rural areas. They had to remain in an agricultural setting. Of course, this anti-urban policy benefited people already living in the cities, the so-called 'elite'. It also explains why in 1973, 95% of the population lived in the rural areas and in 1993, 95% still lived in the rural areas. The dictator considered cities places of immorality, theft and prostitution."

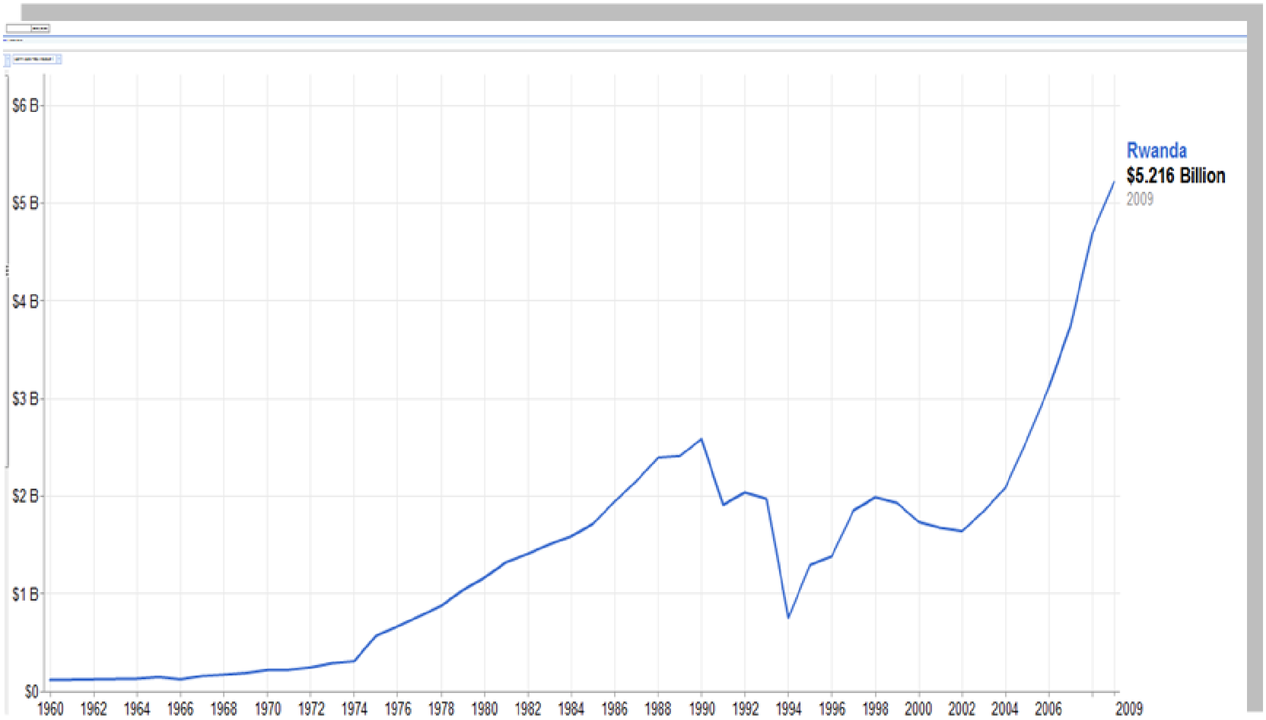

Figure 1: Rwanda's GDP growth from 1960-2009 (source: World Bank website)

In a bid to control and use the country's economic resources, Kalamogo et al (March 2008) reported that "every exporter and every importer was subjected to a quota, and all import operations were subject to a license authorizing external currency disbursement … Exporters were to repatriate currency generated by the sale of exports, and export licenses were authorized only by the Banque Nationale du Rwanda (BNR).

More importantly, all export earnings were transferred to and managed by the BNR which had to give prior approval for certain invisible transactions including medical care, tourist trips and study abroad”.

By the late 1980s coffee contributing “75 percent of Rwanda’s foreign exchange” earnings (Desforges 1999) had reduced both in volume and prices. In 1989 under threat of collapse of the International Coffee Agreement (ICA), international coffee sell-offs began leading to collapse of international coffee prices by $.80/pound. The yearly GDP growth rate from 1973 to 1980 recorded at 6.5% reduced from 1980 to 1985 on average to 2.9%, and remained stagnant from 1986 to 1990. The country’s real per capita GDP averaged 0.10 % per annum for the period from 1980-1989. For the period 1986-1987, the country’s coffee export receipts reduced from 14 billion to 05 billion RwF. In 1990, when the first measures of an IMF structural adjustment program were carried out there was a crisis in the country as the government agreed to structural adjustment recommendations by the IMF program in 1990 under economic pressure, leading to currency devaluation of up to 40%.

The economic hardships caused by the currency devaluation led to internal dissent among the population many of whom could not find enough food, increased demands for political pluralism and more freedoms. In 1990, refugees who had been denied the right to return from 1959 militarily attacked the country leading to a four year civil war, adding pressure to the economy. The combination of all these factors; defeat in the war, an economy in reverse, with annual GDP growth of -10% and -49% in 1993 and 1994 respectively and with international pressure mounting for an inclusive government, came to bear on the regime that it planned and implemented the genocide against the

Tutsi minority in 1994 before looting the country and fleeing to Democratic Republic of the Congo (then known as Zaire).

The genocide in which over 1.000.000 people were killed left the economy shattered and the country more impoverished. Moreover, because many of the people who organized the genocide before fleeing were government officials at different levels, the country was left with no manpower and Human resources to run the government bureaucracy. Rwanda was not only destroyed with no resources but there were no skilled personnel to run the country. The country needed aid particularly ODA to run the government and offer basic services. GDP per capita had plummeted to more than US$200, while poverty levels had become worse.

In a nutshell by 1994, Rwanda was an overpopulated and impoverished small country after years of dictatorships that kept its citizens rural peasants, controlled the small economy majorly based on exports of tea and coffee in the hands of a few individuals, whose population was divided by years of ethnic divisions by government campaigns and an eighth of whose population had been killed while half was in refugee camps in the neighbouring countries. What impact did ODA that went into the country after 1994 have on Rwanda's efforts to generate domestic fiscal revenue?

3.2 Importance of ODA on Rwanda's GDP and domestic Fiscal Revenue after 1994

Domestic Resource Mobilization (DRM) is the ability by governments to generate revenue within their territories, which become the resources for allocation to public goods and services. In this study, I am concerned with the government's ability to collect domestic resources for fiscal purposes in relation to ODA from bilateral, multilateral and multilateral institutional sources. The government carries out DRM through tax and nontax sources, domestic borrowing such as issuance of bonds and other forms of public revenue generation.

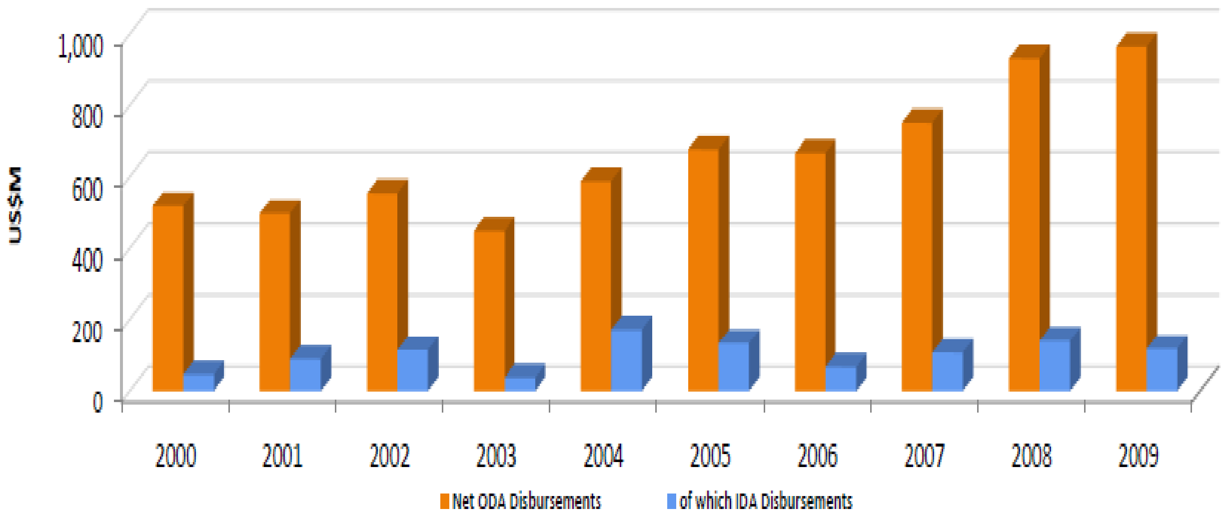

Figure 2: Rwanda - Total Net ODA Disbursements (in US$M) Source: OECD/DAC Database

DRM is important to Rwanda and other developing countries because; it forms the source of sustainable financing for development and is the cornerstone of governance especially through provision of public goods and services. DRM helps in strengthening fiscal institutions for stable collection of revenue that facilitate long term planning which to ensure that resources are allocated to priority sectors and that outcomes are in line with plans and goals. DRM that is accompanied by sustained economic growth may work as an antidote to the effects of aid dependency and allows countries to have an increased sense of ownership and the policy independency to implement programmes that reflect their development priorities. DRM also ensures accountability on part governments in provision of goods and services to those governed.

Year	1995	1996	1997	1998	1999	2000	2001	2002	2003
Tot. domestic rev. as %ge of GDP	6.9	9.2	10.3	10.5	10	10.1	11.8	12.4	13
Grants as percentage of GDP	11.4	7.4	6.7	5.3	6.1	9.4	8.7	7.2	7.8
Total domestic revenue (Billions RwF)	23.1	39.4	58.1	66	63.6	68.7	86.2	101.2	122.3

Table 1: Rwanda's domestic fiscal revenue, grants as percentages of GDP and domestic total revenue collected for the period 1995-2003 (Source: BNR Annual Report, 2003).

One of the biggest challenges that faced the government of Rwanda in 1994 in its reconstruction efforts was that there was no economy to tax. The inability to mobilize domestic fiscal revenues was not only because the economy had been destroyed but there were no skilled people to manage the tax department because former employees had been murdered or in exile. The economy which had been severely destroyed however regained and was growing by 80% for the period 1994 and 1998.

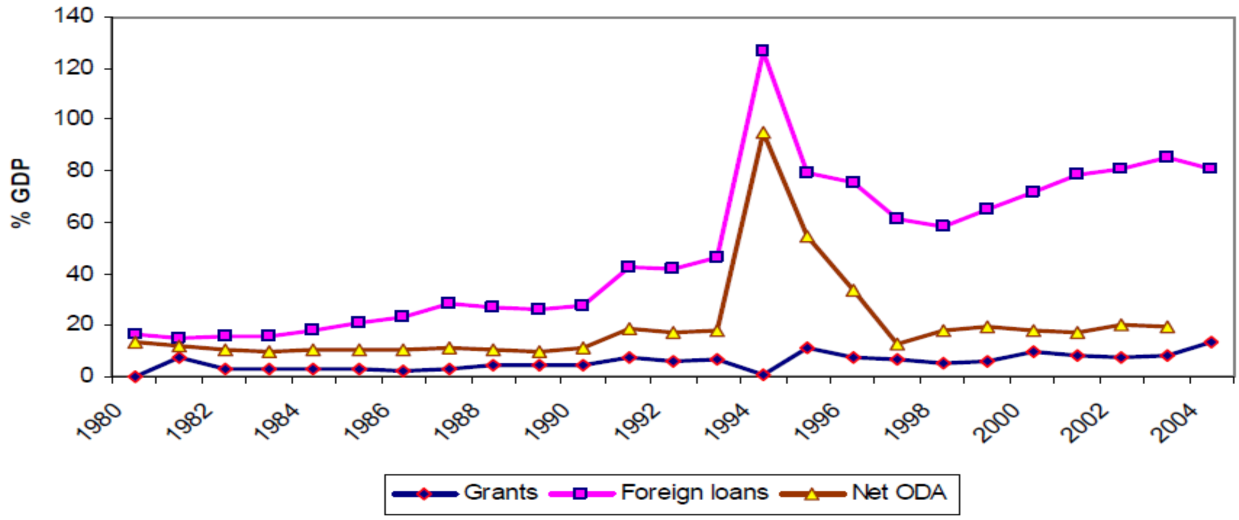

Figure 3: Rwanda's Foreign Aid (including Grants and Loans), foreign loans and net ODA (Source: Ezemeneri et al, 2008)

Rwanda was able to increase its domestic fiscal revenue at a time its ODA was at its highest compared to the GDP because in part it was able to receive support to build its institutions and capacity. The ODA in form of technical and monetary support was used to train employees and build systems that allowed the country to increasingly surpass its revenue targets. One of the first steps the government undertook was to set up the Rwanda Revenue Authority which was later supported by the British Department For International Development (DFID).

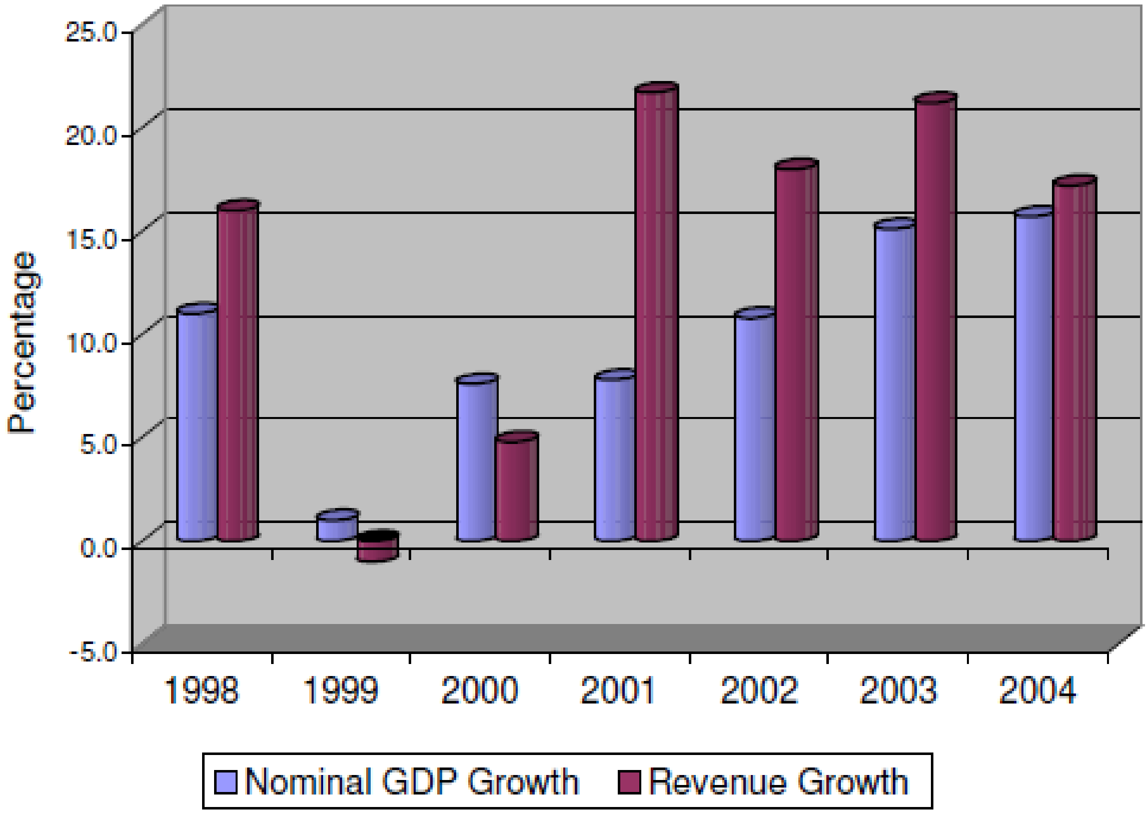

Figure 4: Comparison between Nominal GDP growth and Revenue growth 1998-2004 (RRA Report 2004 pp12)

Ezemenari et al (2008) after their study reported that, “The result was that government revenue, estimated at about 13 percent of GDP in 1992, and which had fallen to below 4 percent in 1994, began to increase gradually to reach an average of around 10 percent per annum between 1996 and 2001. By 2002, revenues stood at 12.2 percent of GDP, reflecting the increase in the VAT rate from 15 to 18 percent, and the substantial strengthening of revenue administration. Revenue as a share of GDP rose further in the following years and is now just under 15 percent.”

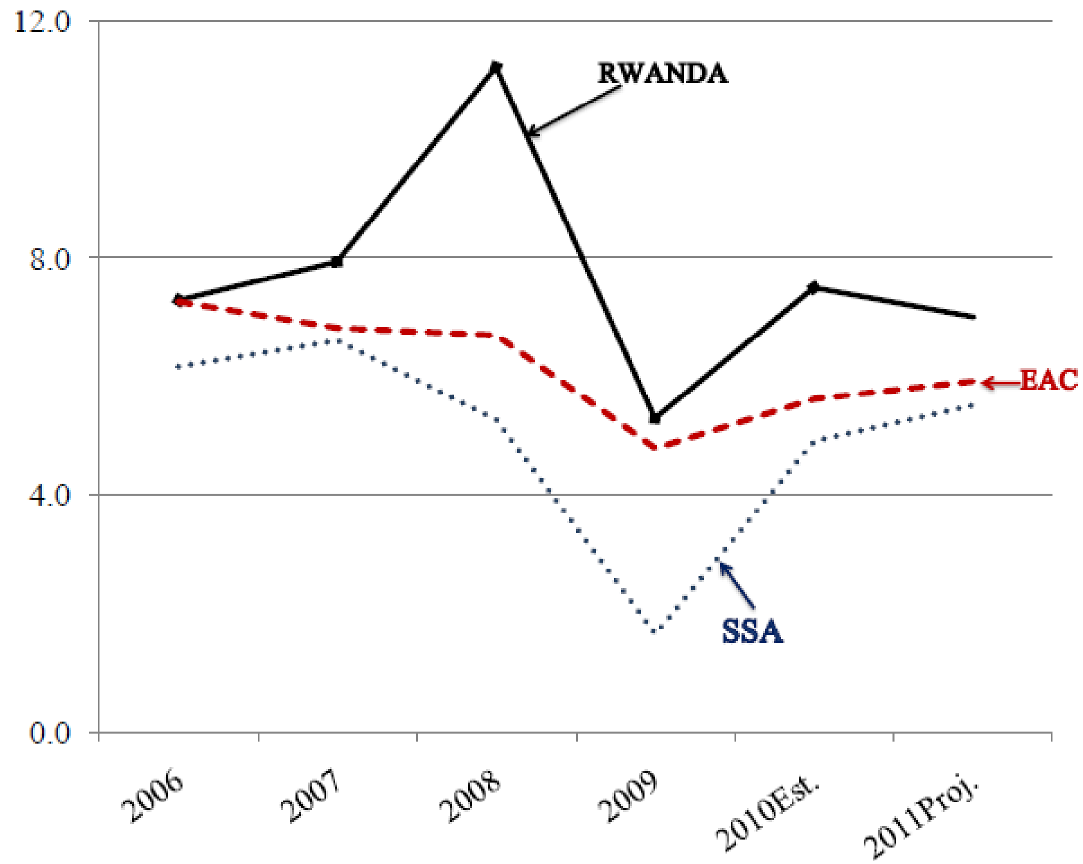

Figure 5: Rwanda's real growth compared to East African Community and Sub-Sharan Africa (SSA) % (Source: World Bank, April 2011)

Owens (Tax Justice Focus) summarized the ODA support to Rwanda Revenue Authority thus, "The Governance Dimension in Rwanda DFID's support to the Rwandan Revenue Authority (RRA) has resulted in a significant increase in domestic revenue (from 9% of GDP in 1998 to 14.7% in 2005). Costs of collection have also been reduced. This success is the result of strengthening internal organisational structures and processes and of building accountable relationships with external partners, such as central and local government, a growing tax profession and taxpayers themselves. The RRA now plays an important role in strengthening relationships between citizens and the state, helping to build a [social contract] based on trust and co-operation".

Period	1998	1999	2000	2001	2002	2003	2004	2005
Rwf Bn								
Nominal GDP	629.4	649.7	708.9	766.3	838.5	905.3	1032.1	1184.7
Total Tax Revenue	67.9	66.6	67.9	80.7	95.0	118.7	136.0	173.4
Nominal GDP Growth	10.8%	3.2%	9.1%	8.1%	9.4%	8.0%	14.0%	14.8%
Tax Revenue Growth	15.2%	98.1%	2.0%	18.9%	17.7%	24.9%	14.6%	27.5%

Table 2: Composition of Rwanda's GDP and tax revenue growth in billions RwF (RRA 2006)

As Gurría (2009 pp15) points out, "On a more positive note, the Rwandan Revenue Authority, with strong international support, carried out changes to strengthen internal organisational structures and training, as well as improve relationships with local government. The result was a sharp increase in domestic revenue from 9% of GDP in 1998 to nearly 15% in 2005." Indeed the increase was both in both volume and percentage of GDP as shown above.

Description	1995	1996	1997	1998	1999	2000	2001	2002	2003(est.)
Africa	3.0	5.6	3.0	3.2	2.7	3.0	3.7	3.1	3.7
Angola	10.4	11.2	7.9	6.8	3.3	3.0	3.2	15.3	4.4
Burundi	-7.9	-8.0	-	4.7	-0.9	-1.1	2.2	4.5	-0.5
Comoros	8.9	-1.3	4.2	1.2	1.9	-1.1	1.9	2.5	2.5
Djibouti	-3.5	-4.1	-0.7	0.1	2.2	0.7	1.9	2.6	3.0
Eritrea	2.9	9.3	7.9	1.8	-	-13.2	10.2	1.8	5.0
Ethiopia	6.2	10.6	4.7	-1.4	6.0	5.4	7.7	1.2	-3.8
Kenya	4.4	4.2	2.1	1.6	1.3	-0.1	1.2	1.0	1.3
Madagascar	1.7	2.1	3.7	3.9	4.7	4.8	6.0	-12.7	6.0
Malawi	16.7	7.3	3.8	3.3	4.0	1.1	-4.2	1.8	6.5
Mauritius	3.5	5.2	6.0	6.0	5.3	2.6	7.2	4.0	3.3
Namibia	4.1	3.2	4.2	3.3	3.3	3.3	2.4	2.7	3.7
DR Congo	0.7	-1.0	-5.6	-.,6	-4.3	-6.2	-2.1	3.0	5.0
Rwanda	**35.2**	**12.7**	**13.8**	**8.9**	**7.6**	**6.0**	**6.7**	**9.4**	**3.4**
Seychelles	0.5	10.0	12.2	5.7	-1.3	4.8	-2.2	0.3	-5.1
Sudan	3.0	6.3	9.3	5.7	6.9	6.9	5.3	5.0	5.8
Swaziland	3.8	3.9	3.8	3.3	3.5	2.0	1.8	1.6	1.5
Tanzania	3.6	4.5	3.5	3.7	3.7	5.6	6.1	6.3	5.5
Uganda	11.9	8.6	5.1	4.7	7.9	5.3	5.5	6.6	5.4
Zambia	-2.5	6.5	3.4	-1.9	2.2	3.6	4.9	3.0	4.5
Zimbabwe	0.2	9.7	1.4	0.8	-4.1	-6.8	-8.8	-12.8	-11.0

Table 3: Rwanda's economic growth compared to some African countries in percentages (BNR 2003)

Rwanda tax policy from a macroeconomic point aimed at raising domestic fiscal revenues, measured by tax/GDP ratios. RRA had as one of its objective to raise the 2009/2010 tax/GDP ratio from 14 % to 15% of GDP, an increase from 9.2 % of GDP in 1996. Indeed since 1995, RRA has surpassed its targeted revenue collection as shown in the table below.

As Addison et al (2006) report, "There is also a balance to be struck in mobilizing more revenue and doing so in ways that do not discourage innovation, and growth through punitive tax rates. Therefore while countries take action to broaden the existing narrow tax base, aid inflows must continue at high levels and, indeed, donors need to step up aid if governments are to meet the ambitious Millennium Development Goals."

Country	Year	Tax revenue (A)	Estimated potential tax revenue (B)	Tax gap (B) – (A)	Tax effort (A)/(B) as a %
		As a % of GDP			
Kenya	2001	17.8	20.8	3.0	85.5
	2005	18.6	20.6	2.0	90.5
South Africa	2001	24.8	26.7	1.9	92.9
	2005	27.4	27.0	-0.4	101.4
Rwanda	2001	10.7	20.9	10.2	51.2
	2005	12.2	21.4	9.9	57.0
	2008	13.5	22.0	8.5	61.4
Tanzania	2001	9.7	20.0	10.3	48.5
	2005	11.2	20.5	9.3	54.4
	2008	15.0	20.9	5.9	71.6
Uganda	2001	10.4	19.2	8.8	54.3
	2005	11.8	19.5	7.8	60.3

Table 4: Tax gap and tax effort for selected EAC countries and South Africa for selected years,
(Ezemenari et al 2008 pp44)

The support to Rwanda's tax body, partly from ODA, has enabled it to compare favourably with other countries in the region, their history and resources notwithstanding. At a time when ODA accounted for half of Rwanda's fiscal revenue, it is inconceivable, that the country would have had the resources and other means to achieve continued success.

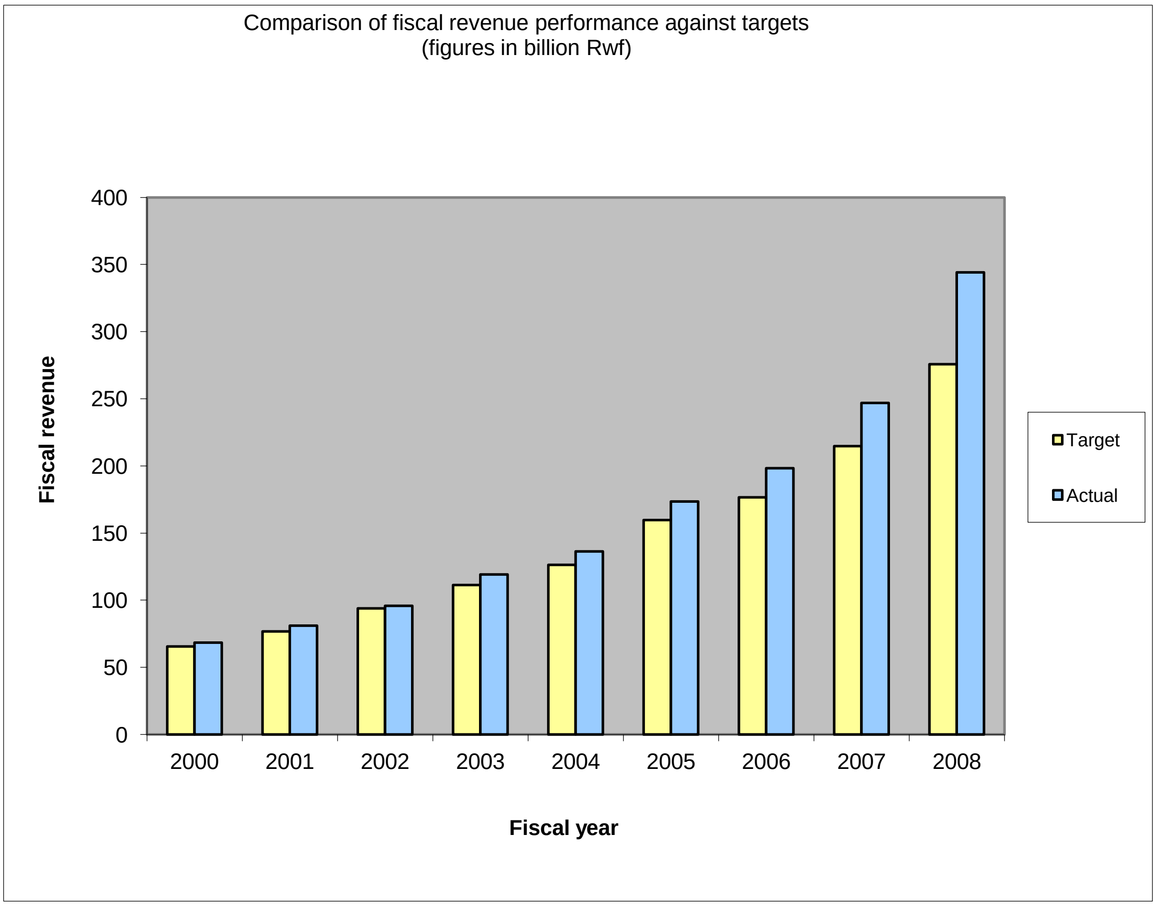

Figure 6: Comparison of RRA performance against targets figures in billions RwF (RRA2008, Pp9). See table below.

Year	1998	1999	2000	2001	2002	2003	2004	2005
Target	62,8	63,2	62,3	76,8	93,9	112,4	126,3	150,3
Actual	68,2	60,7	65,3	79,5	94,6	118,1	136,2	173,4

Table 5: Rwanda Actual revenue performance compared to targets 1998-2005 in billions (RRA 2008)

From the discussion above, in accordance with the stated Hypothesis, ODA has a positive impact on domestic revenue mobilization. From the evidence, the ODA as a percentage of GDP and the achievements, there is a very strong positive relationship between ODA and the domestic fiscal revenue generation by Rwanda as a recipient.

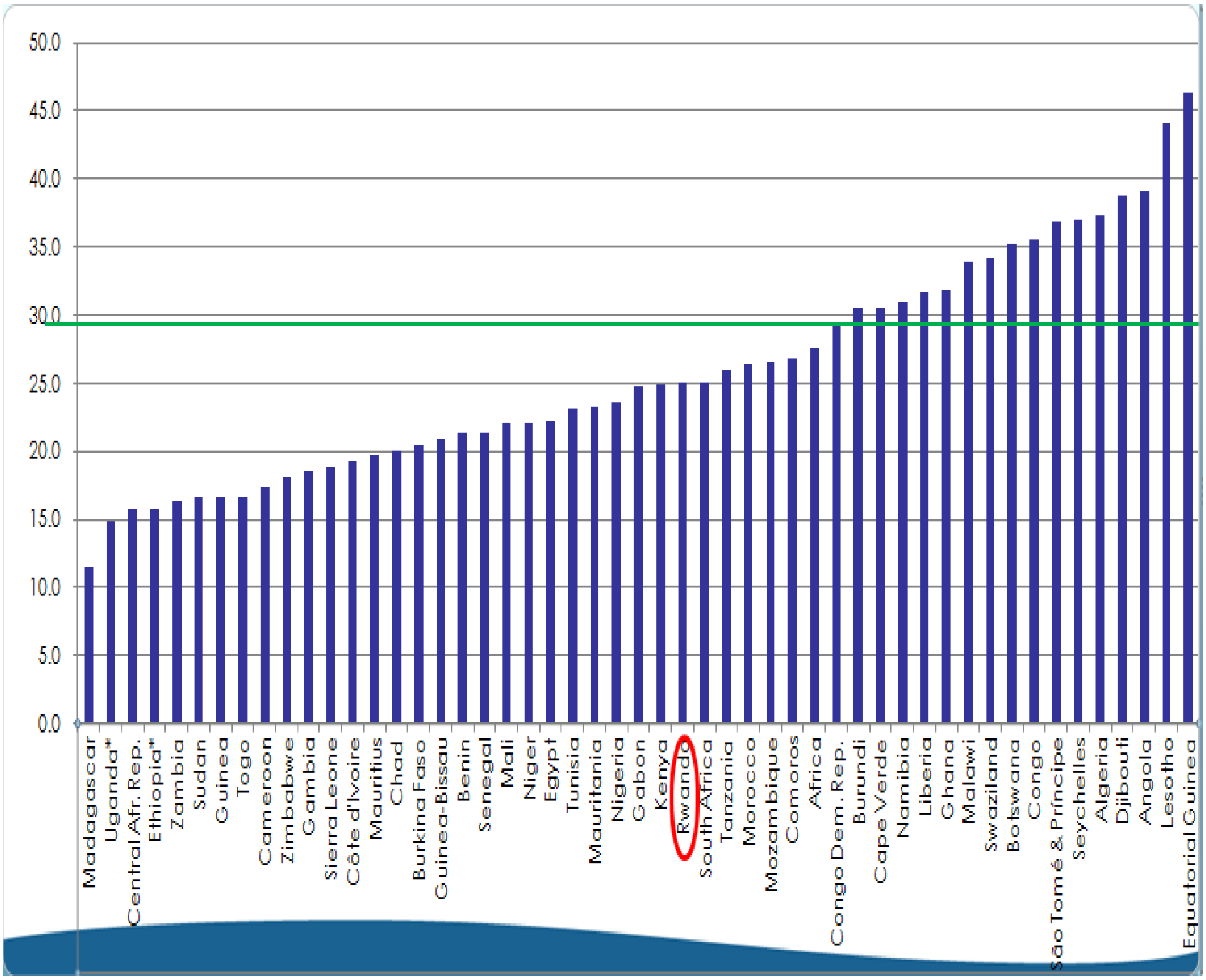

Figure 7: Comparison of Rwanda and other African countries' Tax revenues as percentage of GDP 2010 (Pezzini 2011).

It is important to note that out of the total ODA extended to many aid recipient countries the fraction of it going to tax administration is smaller. It is reported that, "of the US$7.1 billion spent in 2005 on bilateral aid for government administration, economic policy and public sector financial management, only 1.7% was directed at tax-related assistance" (Pretoria Communiqué, 2008).

No one should over look the importance of leadership in Rwanda's utilization of ODA and attempts to improve the economy of the country. President Kagame's anti-corruption stand is exemplified by the fact that prior to the elections in 2010 two cabinet ministers from his own party, three Directors Generals and other high ranking government officials were in prison on corruption related charges. The fact that there are low levels of corruption is a result of empowering institutions like the Ombudsman, Auditor General, the Police, Prosecution office and the Judiciary which investigate and prosecute corruption related cases which were empowered to carry out their duties which may not be the case in other countries where politics and public administration are intertwined.

Rwanda government has made improvements in many sectors governance with decentralization and built institution to fight corruption which has increased its nationals' confidence in the authority for example; in a study by Transparency International in 2011, it was reported that, "the likelihood of encountering bribe demand occurrences is 3.9%, the prevalence of bribery is 2.15% and the impact of bribery on service delivery is 1.98%, while more than 80% of Rwandans have neither encountered nor witnessed corruption". Indeed Rwanda was ranked at world No. 66 in world rankings ahead of Italy and Brazil according to Transparency International (2010) corruption indices. The globally recognized Transparency International's Corruption Perception Index (CPI) and East African Bribery Index (EABI) have in the recent past revealed that Rwanda is the best performing country in the East African region and is ranked 9th in the African continent when it comes to corruption control.

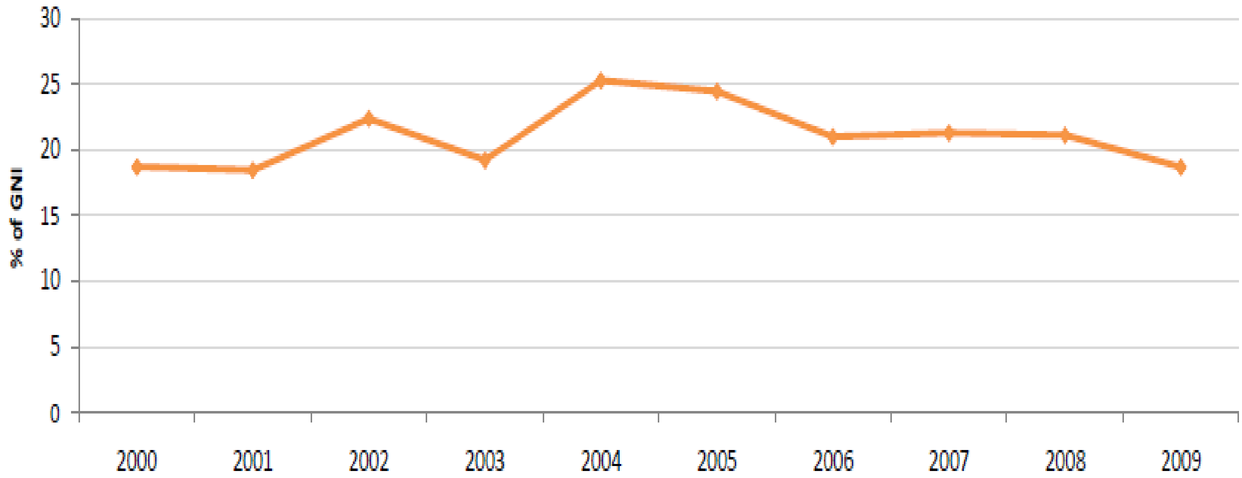

Figure 8: Rwanda - Total Net ODA as a Percentage of GNI (OECD/DAC Database)

Tax policies in Rwanda did not only increase domestic revenue in terms of volumes and as a percentage of GDP, the efficiency and effectiveness of Rwanda Revenue authority increased thanks in part to ODA through technical and advisory support. Rwanda may have attained the tax mobilization the country did; but no one can doubt that the time would have been longer and the achievements less without ODA particularly in the crucial area of personnel training and capacity building. RRA continually surpassed its revenue target as shown in graph above and table below. The support of ODA in the performance of GDP and revenue mobilization cannot be overemphasized.

Fiscal year	Operating cost (RwF)	Operating cost as a % of tax revenue
2003/04	4,343,432,497	3.2%
2004/05	4,919,010,000	2.8%
2005/06	6,996,670,000	3.4%
2006/07	7,575,300,000	3.0%
2007/08	9,418,400,000	2.7%

Table 6: Rwanda Tax administration costs and cost as percentage of total taxes

(Emezenari et al, 2008)

The importance of ODA on the capacity building of RRA as the national tax body in Rwanda is best captured in the study carried out by Land (2004) who reported that, “ Without DFID support, it would not have been possible to finance a substantial part of the organisational development process that the RRA has undertaken. Whilst the organisation's running costs have been met from the state budget, it did not have adequate means to invest in its own organisational development, whether in terms of covering the costs of training, bursaries, hiring experts or purchasing equipment. By providing all of these inputs in a timely and flexible manner, DFID has considerably accelerated the pace of change within the RRA”.

Registered for	Total number			Percentage increase (2006 to 2008)
	2006	2007	2008	
VAT	2,637	3,741	4,644	76%
PAYE	4,495	9,285	8,929	99%
Profit taxes	4,205	11,842	20,676	392%
Large taxpayers	284	289	311	10%

Table 7: Increase of registered tax payers in Rwanda for selected years (RRA Report)

The support extended to RRA has allowed it not only to collect more revenue but improve its efficiency and relationship with tax payers thereby improving its long term relationship with nationals and build its capacity to serve its core mission (see table below). Since its inception, RRA has surpassed it annual targets every year and its efficiency has improved over the period of its existence.

Country	Average Cost - revenue ratio
Sudan	5.7%
Ethiopia	5.3%
Congo RDC	5.2%
Rwanda	3.2%
Tanzania	3.2%
South Africa	1.2%
Argentina	*1.8%*
Ecuador	*1.0%*
Costa Rica	*0.8%*

Figure 9: Collection costs as a percentage of collected tax revenues for some countries (Stijns, 2011)

From the above, there is a strong case that ODA helps recipient countries to strengthen their capacity to collect and increase their domestic revenues as was the case in Rwanda. There is no doubt that RRA might have attained some of the results it did, but the duration, achievements and pace may have been different without ODA which supported the institution and the country in general.

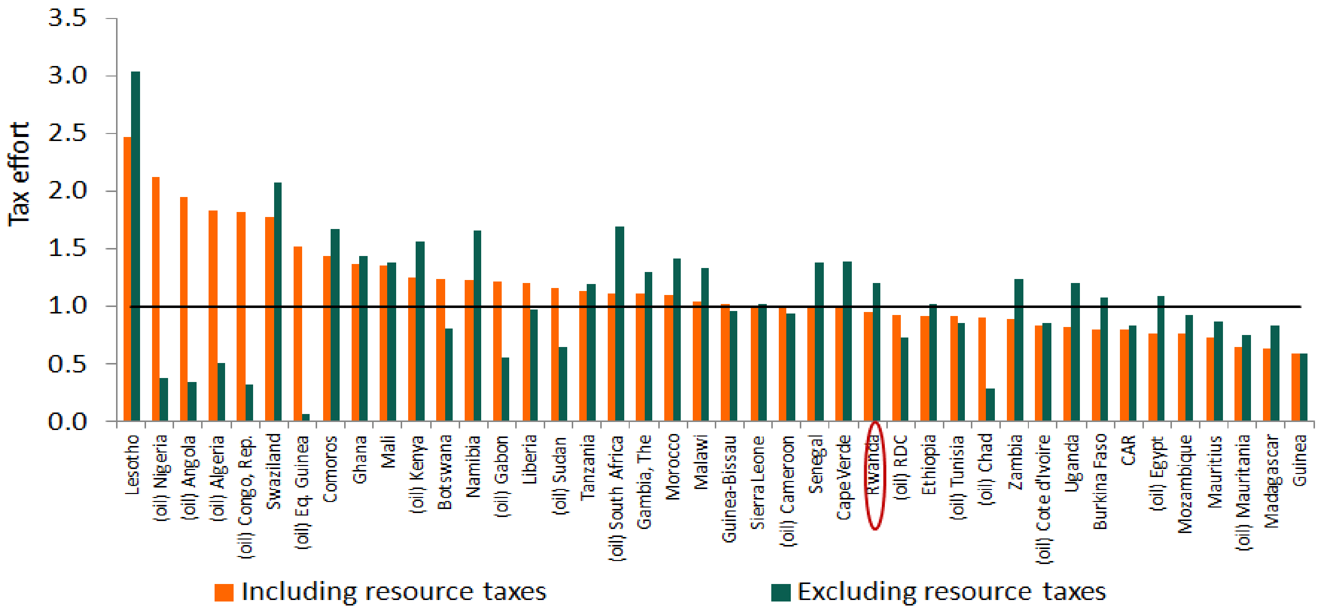

Figure 10: Comparison of some African economies' actual against potential tax revenue (Stijns)

Tax effort "is an index measure of how well a country is doing in terms of tax collection, relative to what could be reasonably expected given its economic potential. It is a ratio that, by construction, is always positive. Tax effort is calculated by dividing its actual tax share by an estimate of how much tax the country should be able to collect given the structural characteristics of its economy"[3].This calls for a delicate balance between increased tax volumes and optimal rates that do not distort the opportunities to economic agents for example higher tax rates may drive some agents

[3] Source: ***African Outlook*** available at http://www.africaneconomicoutlook.org/en/in-depth/public-resource-mobilisation-and-aid-2010/the-state-of-public-resource-mobilisation-in-africa/tax-effort/

out of business. Countries that are naturally endowed with natural resources such as oil may apply less than optimal effort compared to those without resources as shown in the graph above.

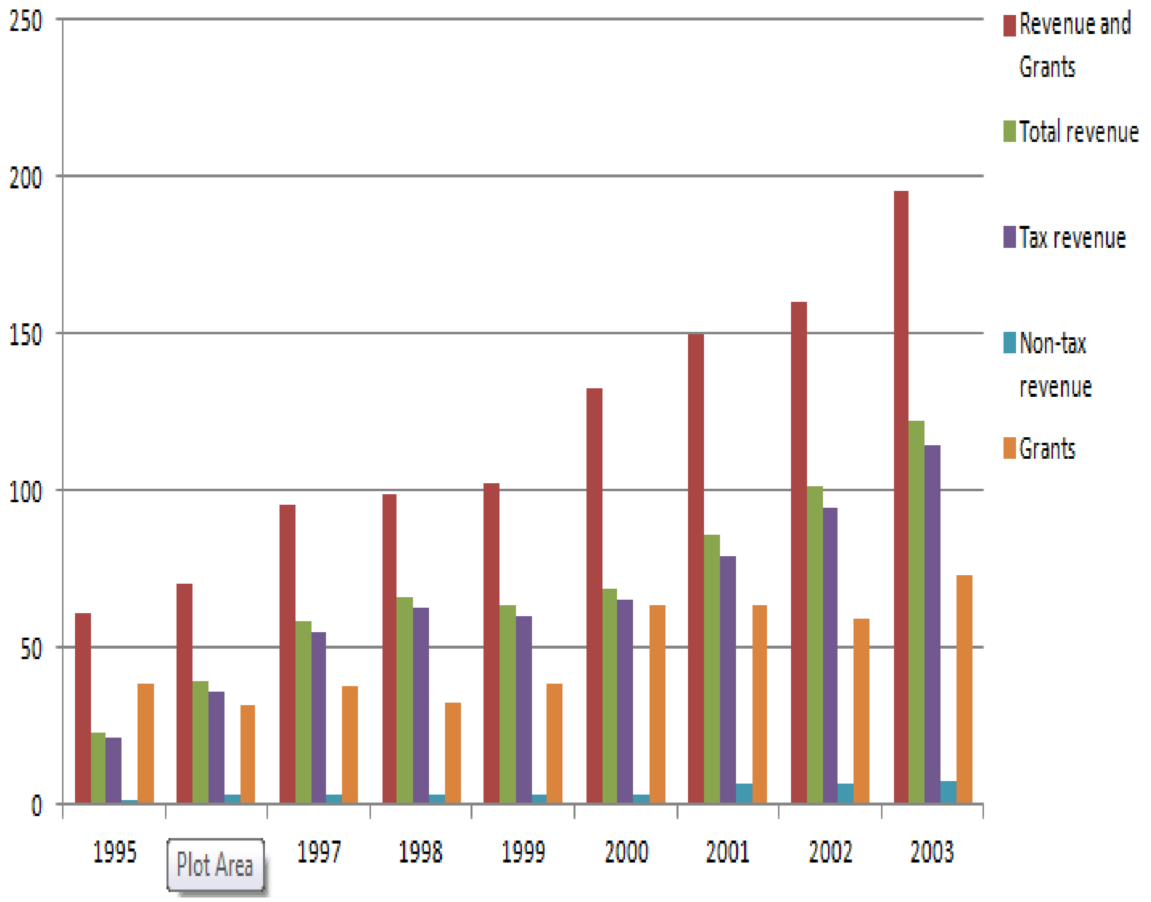

Figure 11: Rwanda fiscal operations 1995-2003 in RWF billions (source: BNR 2003)

The country in an effort to overcome "its small market status" joined together with Uganda, Tanzania, Kenya and Burundi in the East African Community (EAC) creating a common market of 150 million people with a stated object of forming a political federation. The country has also won international recognition in several areas for example its efforts to finding better living conditions for its citizens was awarded with "what is currently the most prestigious human settlements accolade in the world - the Habitat Scroll of Honour Award" (RDB, March 2011). Rwanda has also protected its environment and was the first country in the region to put in place stringent environmental policies as Leahy (September, 2011) reported, "Government policies are seldom lauded, yet Rwanda's forest policy has resulted in a 37-percent increase in forest cover on a continent better known for deforestation and desertification… Rwanda's National Forest Policy has also resulted in reduced erosion, improved local water supplies and livelihoods… Rwanda was the winner of the prestigious Future Policy Award for 2011"

Year	**Time release**
2007	3 days, 11 hours and 16 minutes
2008	2 days, 19 hours and 32 minutes
2009	1 day, 5 hours and 49 minutes
2010	1 day, 2 hours and 3 minutes

Table 8: Release time of goods from Customs (RRA report 2009-2010)

Rwanda embarked on a drive to make tourism as a major economic factor and source of income for the country. For several years after the 1994 genocide tourism in Rwanda remained a distant possibility with little interest from tourists and security concerns over instability caused by former government soldiers and killers who raided the country from neighbouring Zaire later renamed Democratic Republic of Congo (DRC). Rwanda was declared "the only country to take away the Best African Exhibitor award for the fourth time in a row at the world's premier tourism trade fair, Internationale Tourismus Börse (ITB-Berlin) 2010" (The Rwanda Focus, 2010). From merely 417 tourists in 1999, Rwanda hosted 666,000 tourists in 2010, a 10% over the previous year, generating 200 million USD compared to 175 Million generated the previous year. Rwanda was ranked one of the top 5 emerging destinations by the 2011 Wanderlust Travel Awards committee. As a sign of improving tourism, the industry earned Rwf 33 billion (US$56 million) in revenues in the 1st quarter of 2011, compared to the same period the previous year when US$43 million was realized. 201,088 visitors visited the country during the same period representing an increase of 32 % (Daily Monitor online, 2011).

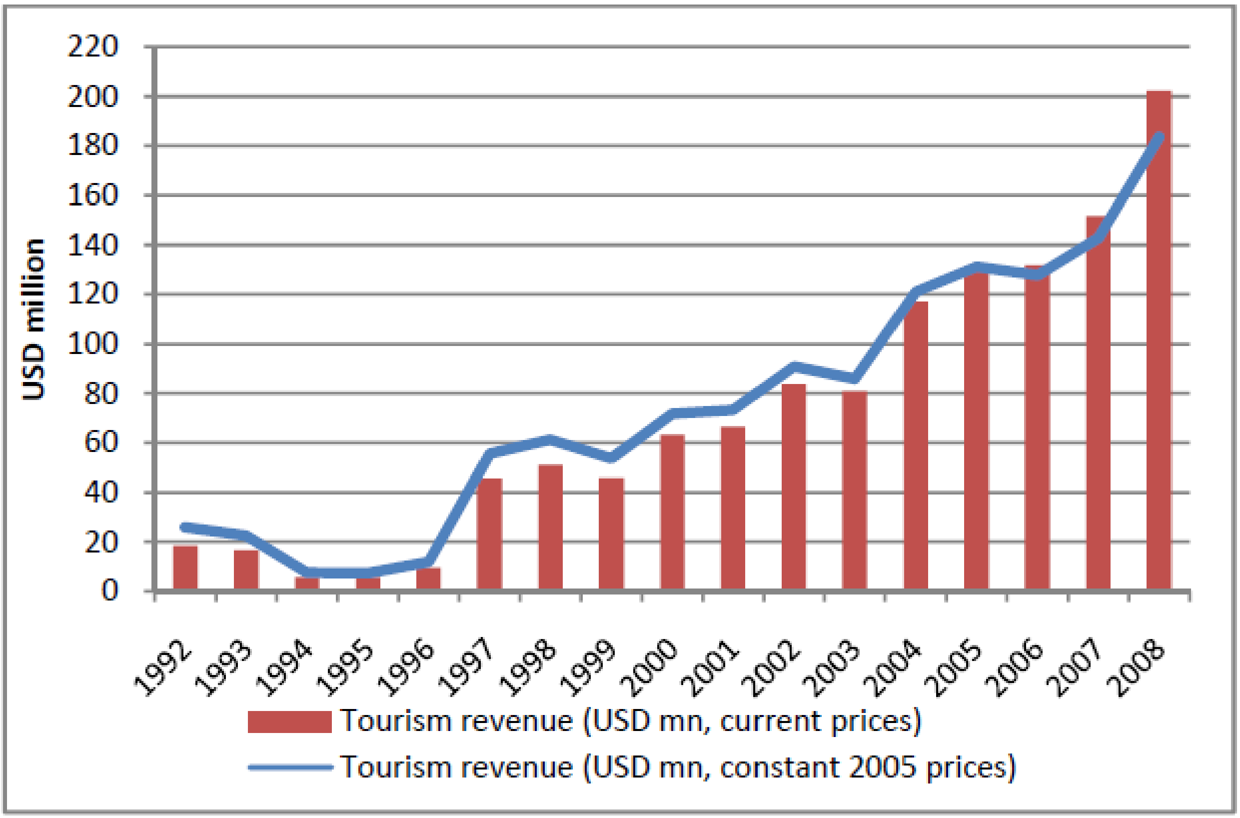

Figure 12: Rwanda Tourism revenue (US$ million), 1992-2008 (Nielsen and Spenceley April 2010)

According to the World Bank's 'Doing Business 2010', "the small East African country reformed in 7 areas propelling its rankings an unprecedented 76 places from 143 in the Doing Business 2009 survey to 67 out of the 183 countries surveyed." Rwanda emerged among the top performing countries on the competitiveness index for the year 2011-2012 for the second year in a row according to the World Economic Forum (WEF) in which the country emerged third in Africa behind Mauritius and

South Africa jumping ten positions from number 80 in the 2010-2011 to 70 in the 2011-2012 overall world rankings.

As a result, the country's dependence on, "Aid as a percentage of government spending dropped from 85% in 2000 to 45% in 2010" according to ACTIONAID citing reforms such as the country's tax administration that improved and was able to quadruple the country's own taxes between 1998 and 2006 (ACTIONAID, 2011). RDB reported that in the year 2010, "105 Investment projects were registered and will generate 381M US$ in 2010 of which FDI is estimated at 173M US$, while local investments are estimated at 208M US$. These will create 12,736 jobs".

In its Doing Business Report 2011, the World Bank commended Rwanda for easing the doing business environment, "The 10 economies that made the largest strides in making their regulatory environment more favorable to business are Georgia, Rwanda, Belarus, Burkina … In 2005 starting a business in Rwanda took 9 procedures and cost 223% of income per capita. Today entrepreneurs can register a new business in 3 days, paying official fees that amount to 8.9% of income per capita. More than 3,000 entrepreneurs took advantage of the efficient process in 2008, up from an average of 700 annually in previous years. Registering property in 2005 took more than a year (371 days), and the transfer fees amounted to 9.8% of the property value. Today the process takes 2 days and costs 0.4% of the value". In an interview 'Narrow Minds', reported that, "Rwanda is now one of Africa's major success stories and is growing in leaps and bounds. The government has shown it is serious and determined about rebuilding its economy …Who does not want to be associated with success"?

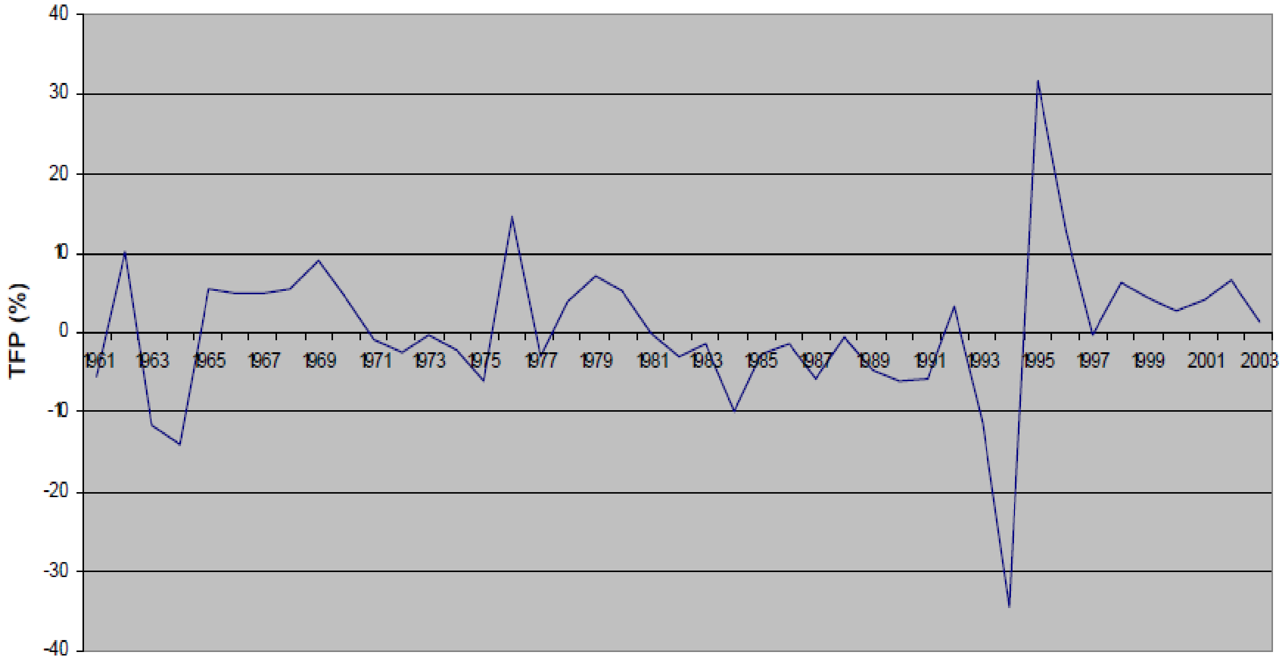

Figure 13: Annual TFP growth rate (%) in Rwanda, 1960-2003 (Kalamogo et al, 2008)

Rwanda's case may be different because of its history and leadership; in fact the country has defied many predictions and studies. As an example, Knack (World Bank) reported that, "Analyses of cross-country data in this paper provide evidence that higher aid levels erode the quality of governance, as measured by indexes of bureaucratic quality, corruption, and the rule of law" and yet Rwanda with high levels of ODA as a percentage of fiscal budget, Rwanda is the first country where women outnumber men in parliament with 56% members of Parliament (BBC 2008). Moreover under the provisions of the constitution, a 30% quota in all government appointments and positions are reserved for women; 92% of the population of Rwanda have medical insurance (McNail 2010) while the budgetary allocation to health services particularly in the utilization of ICT and Telemedicine as a proportion of total budget is relatively higher given the country's resources, for example, it was reported that Rwanda had invested $2 million in telemedicine.

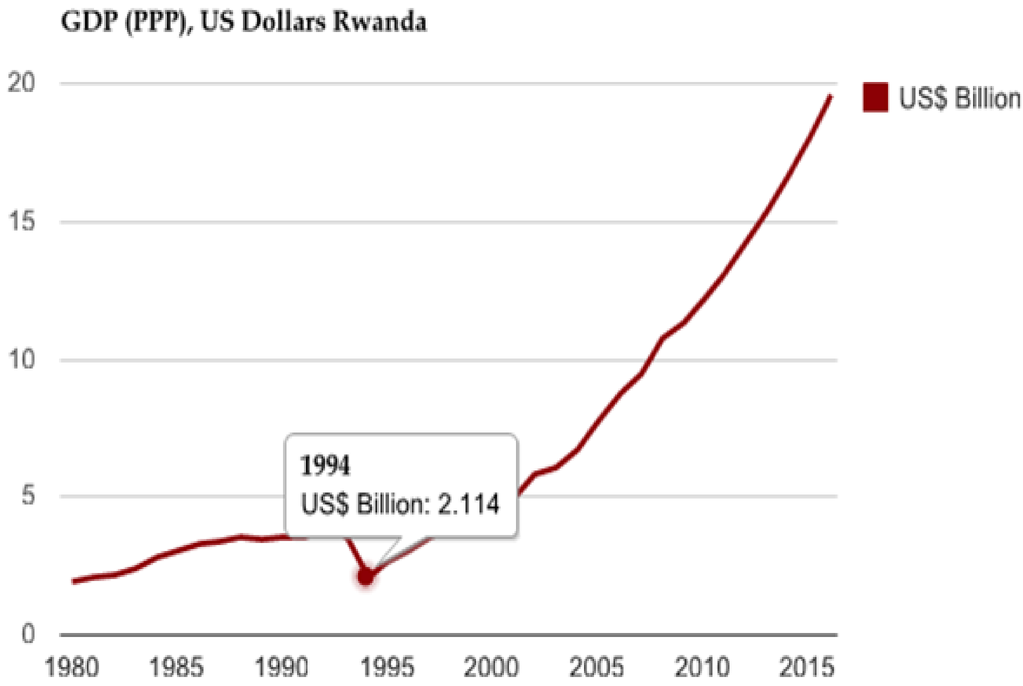

Figure 14: Rwanda's GDP growth from 1980-2011
(http://www.economywatch.com/economic-statistics/country/Rwanda)/

Cunningham (IPS 2007) reported that the country's "current ICT sector budget is on par with nations of the Organisation of Economic Cooperation and Development (OECD), a grouping of 30 rich nations, at 1.6 percent, far above the African average… One billion dollars was committed in 2006… to building nationwide tele-centres with Internet and telephone access points, allowing for increased connectivity and mobility in rural areas."

Dr Anna Thomas, ActionAid's Head of Economic & Social Development, put it better, "Not all aid is the same. Real aid is effective and has few strings attached. It puts developing countries where they should be - in the driving seat of their own development. It makes governments answerable to their own citizens, rather than to the donors. And real aid can help countries do things like raising tax revenues more effectively, so they can generate more of their own funds for development" (Real aid Report).

The Rwanda freedom indices shown below may be normal or even average by some countries' standards; however to many social, political and economic observers of Rwanda, they represent a major transformation for a country that was devastated by civil war, genocide and years of dictatorships. As Amartya (1999) argues, "If freedom is what development advances, then there is a major argument for concentrating on that overarching objective, rather than on some particular means, or some chosen list of instruments. Viewing development in terms of expanding substantive freedoms directs attention to the ends that make development important, rather than merely to some of the means that, inter alia, play a prominent part in the process." The change in Rwanda can be better represented by the improved freedoms enjoyed by its nationals as shown in the graph below.

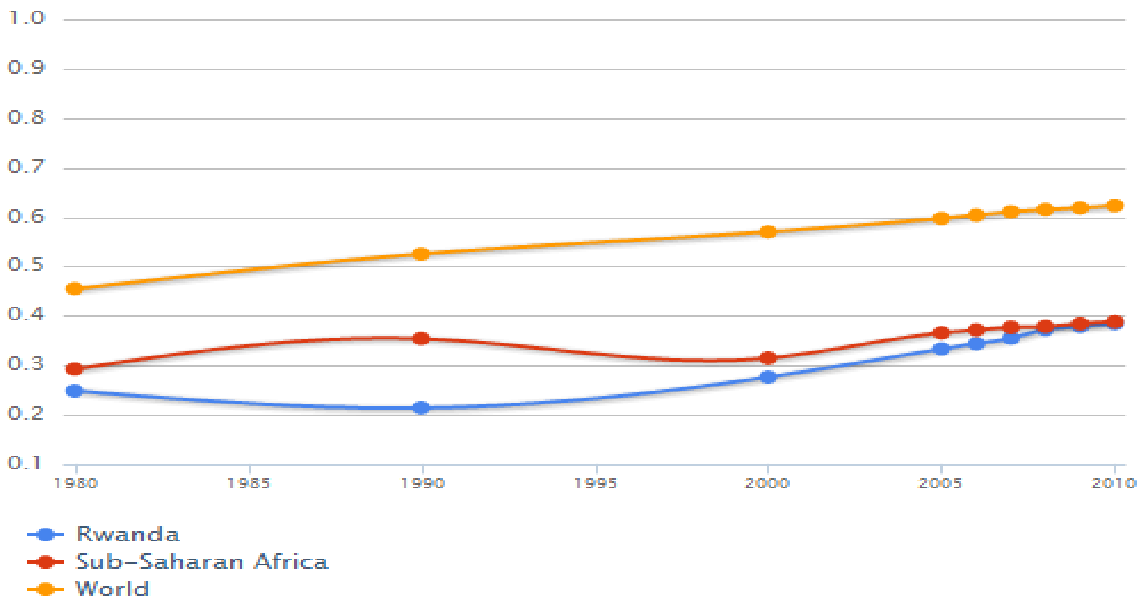

Figure 15: Comparison of Rwanda, Africa and World Human Development Index trends from 1980 to 2010 **http://hdrstats.undp.org/en/countries/profiles/RWA.html**

The discussion above shows how Rwanda was able to transition from a country destroyed by years of autocracy and poor economic management using ODA. This will be proven in analytical terms using empirical evidence in the next chapters.

Chapter 4: Research Design

4.0 Overview

This study uses a simple and easy to understand statistical calculation of the relationship and correlation between three variables: ODA, GDP and Domestic Fiscal Revenue (Domestic Taxes) while other factors are considered given. The data analyzed covers the period 1995- 2009 excluding 2005 for which data could not be found. By observing the correlation and significance of the interplay among the three different sets of variables, we can reach a conclusion.

Whereas the study uses Rwanda as a case study, the impact of ODA on Uganda's GDP and tax revenues is considered for comparative purposes. Using Uganda for the study purpose is appropriate because; both countries received large amounts of ODA during the period under review; both countries are located in the same geographical location (though Uganda is comparatively larger in land size); both had low intensity insurgency for the period under review which may have had similar effects on their economies, both are land locked, both are agricultural economies and both have similar exports and imports, the volumes notwithstanding. The results may be applied to other countries in similar development stages receiving ODA. At the end of the exercise results will show the impact of ODA on their domestic fiscal revenue mobilization efforts in terms of volumes and GDP growth.

4.1 Conceptual Model

The conceptual model used by this study is that Rwanda and Uganda receive ODA whose two governments use to finance both development and recurrent expenditures. Because the governments receive this "free windfall" less effort is put in collecting local revenue from domestic sources. Over a given period, local revenue collections will deteriorate as policy makers wait for more “windfalls.” Specifically, as more ODA is received by Rwanda and Uganda, domestic revenue collected should increase at a slower pace and over time will stagnate or even decline. The same applies to the GDP of the countries; as more ODA is received, people have less incentive to work harder, production slumps and instead emphasis is put on rent seeking and sharing the windfall that ODA is. Simply put, the relationship among ODA, GDP and domestic revenue should be inverse.

Scope of the study

This study will examine the relationship among three variables: ODA, GDP and Domestic Tax revenue figures for the period 1995-2009 excluding the year 2005 for which figures could not be obtained of the Republics of Rwanda and Uganda. The discussion part, however, will focus on the impact of ODA on Rwanda’s Domestic Tax revenues and tax revenue collection.

Sources and validity of Data

This study uses secondary data from three different sources; ODA figures were found at OECD/DAC website (http://stats.oecd.org/qwids/) at USD current prices, GDP in USD Constant at 2005 rate for Rwanda and USD constant 2000 for Uganda respectively. Revenue figures in local currency calculated at 2005 rate for Rwanda are from annual RRA Reports and USD 2000 constant for Uganda were got from World Bank Website (http://databank.worldbank.org). Other sources of information and data are books, published reports, professional and academic research journals and news media.

Data used

For the purpose of this study government revenue is the total sum of tax and nontax revenue to the government treasury (excluding loans and grants) generated within the country. Revenue in its different forms; corporate, excise, VAT, income, withholding and other types of taxes are combined with other sources such as profits from government businesses, royalties, and rent proceeds to the national treasury.

4.2 Empirical Model

The empirical model is based an economy where government fiscal revenue is made up of tax and Non-tax revenue to which ODA is introduced

$$\boldsymbol{GR = f\,(TR,\ \mathrm{NTR})} \qquad (1)$$

Where

- GR refers to the Initial government fiscal revenue
- TR refers Tax revenue,
- NTR refers Non Tax revenue

$$\boldsymbol{GR = f\,(TR,\ \mathrm{NTR},\ \mathrm{ODA})} \qquad (2)$$

- ODA is stock of externally generated ODA.

I assume (1) above to be linear in logs and below are the determinants of the growth rate of government revenue,

$$GR = \alpha + \beta_t + \delta_{nt} + \phi_{oda} \qquad (3)$$

Where $_{t}$, $_{nt}$ and $_{oda}$ denote the determinants of the growth rate of each variable individually.

The function of government revenue, therefore, should be as follows;

$$\mathbf{GR}_{it} = \beta_0 + \beta_1(\mathbf{TR/GDP})_{it} + \beta_2(\mathbf{NTR/GDP})_{it} + \beta_3(\mathbf{ODA/GDP})^2_{it} \ldots \mu \qquad (4)$$

GR_{it} is the growth rate of government fiscal revenue in the country $_i$ (Rwanda) in year $_t$

For the hypotheses to be rejected, the model should be as follows implying that as more ODA is received into the country, both tax and nontax revenue decline.

$$\mathbf{GR}_{it2} = \beta_4 + \beta_5 \ (\Delta \mathrm{ODA/GDP})^2_{it} + \beta_6 \ (\triangledown \mathrm{T/GDP})_{it} + \beta_7 (\triangledown \ \mathrm{NT/GDP})_{it} \ldots \ \mu \quad (5)$$

The purpose of this study is to test statistical significance of the marginal impact of ODA on government fiscal revenue and economic growth. For the hypothesis to be rejected the expected signs of the coefficients should over time be negative meaning that the more ODA received in the country the less tax revenue will be collected. The same model is applied to the country's GDP against ODA where GDP is a function of Labour (L) and capital (K) in an economy to which externally generated ODA is added.

Empirical analysis of impact of ODA on domestic taxes in Rwanda

Year	GDP($ Const'05)	ODA in USD	Tot. Rev. (05$Const)
1995	1,293,447,630	694,700,000	41,717,836
1996	1,382,334,846	465,310,000	71,155,096
1997	1,851,557,081	229,600,000	104,926,678
1998	1,989,343,579	350,070,000	119,193,816
1999	1,931,185,216	373,080,000	114,859,496
2000	1,734,921,293	321,460,000	124,069,927
2001	1,674,685,046	304,850,000	155,674,348
2002	1,640,603,017	362,890,000	182,763,852
2003	1,846,148,216	335,180,000	220,869,754
2004	2,088,892,750	489,600,000	245,792,097
2006	3,111,203,756	588,950,000	370,042,621
2007	3,741,050,578	722,210,000	456,187,243
2008	4,712,306,077	933,150,000	688,615,185
2009	5,261,963,315	934,380,000	714,801,705

Table 9: Rwanda's, total ODA, total GDP, and total revenue 1995-2009

① ODA figures were obtained from OECD/DAC website (http://stats.oecd.org/qwids/)

② GDP were from the World Bank Website (http://databank.worldbank.org/ddp/home.do?Step=2&id=4&hActiveDimensionId=WDI_Series)

③ Revenue figures for Rwanda were collected from different RRA reports and calculated at the 2005 USD constant exchange rate from Local Currency (RwF). http://www.rra.gov.rw/IMG/pdf/RRA_ANNUAL_REPORT_

④ Domestic Tax figures for Uganda were obtained from the World Bank website and calculated at 2000 USD Constant rate from Local Currency (UShs).

⑤ Exchange rates were obtained from Center for International Comparisons, University of Pennsylvania *http://pwt.econ.upenn.edu/php*

4.3 Hypothesis testing

(1) Hypothesis one: Ho1: **"There is a significant positive relationship between ODA and domestic Revenue collected.**

Correlations

		Revenue	ODA
Pearson Correlation	Revenue	1.000	.822
	ODA	.822	1.000
Sig. (1-tailed)	Revenue	.	.000
	ODA	.000	.
N	Revenue	14	14
	ODA	14	14

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-1.368E8	8.628E7		-1.586	.139
	ODA	.778	.156	.822	4.999	.000

a. Dependent Variable: Revenue

The Sig. (1-tailed) of .000 of the regression between ODA and domestic Revenue figures shows how significantly correlated the two variables are in case of Rwanda. With R Square at .676 and Std. Error of the Estimate of $1.301E8 the significance is robust at .000 as proven by the coefficients above; implying a strong and robust relationship between the two variables.

(2) Hypothesis 2:

Ha2: **“There is significant positive relationship between ODA and economic growth”**

Model Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Square Change	F Change	df1	df2	Sig. F Change
1	.827[a]	.684	.658	$7.379E8	.684	26.034	1	12	.000

a. Predictors: (Constant), ODA

b. Dependent Variable: GDP

Similar results are observed when ODA and GDP figures for Rwanda are put to the same test: the regressions show a high and significant correlation as confirmed by the significance of the coefficients at .000 which support the hypothesis that there is a highly significant positive relationship among the three variables under review.

Comparative analysis of impact of ODA on domestic taxes in Uganda

Country: Uganda

Year	Exch Rate	Net ODA (cur.US$)	GDP (constant 2000 US$)	Rev. US$ 2000 Const	Tax Rev. Const USD 2000
1995	969	832,870,000	4,620,924,068		
1996	1,046	673,670,000	5,040,139,594		
1997	1,083	812,850,000	5,297,186,807		
1998	1,240	655,150,000	5,557,027,883	489,639,451	461,484,575
1999	1,455	604,980,000	6,004,588,040	578,092,270	568,909,811
2000	1,644	853,000,000	6,193,246,632	614,334,813	594,721,542
2001	1,756	822,190,000	6,514,283,550	658,698,642	653,641,835
2002	1,798	725,280,000	7,083,155,463	762,196,299	737,003,902
2003	1,964	997,480,000	7,541,666,438	867,111,824	852,113,183
2004	1,810	1,215,640,000	8,055,045,270	1,015,069,018	998,528,788
2006	1,831	1,553,680,000	9,488,864,309	1,406,533,081	1,356,669,152
2007	1,723	1,737,020,000	10,287,107,994	1,655,460,443	1,596,753,533
2008		1,641,250,000	11,182,997,488	1,974,385,586	1,922,255,018
2009		1,785,880,000	11,993,479,808	2,302,625,579	2,227,043,637

Table 10: Uganda’s exchange rates, ODA, GDP and Tax Revenue 1995-2003

Regression of ODA against GDP in Uganda 1995-2009 excluding 2005

Coefficients[a]

Model		Unstandardized Coefficients B	Unstandardized Coefficients Std. Error	Standardized Coefficients Beta	t	Sig.
1	(Constant)	-2.146E8	1.401E8		-1.531	.152
	GDP	.171	.018	.940	9.551	.000

a. Dependent Variable: ODA

Correlations

		GDP	ODA
GDP	Pearson Correlation	1	.940**
	Sig. (2-tailed)		.000
	Sum of Squares and Cross-products	7.384E19	1.262E19
	Covariance	5.680E18	9.705E17
	N	14	14
ODA	Pearson Correlation	.940**	1
	Sig. (2-tailed)	.000	
	Sum of Squares and Cross-products	1.262E19	2.439E18
	Covariance	9.705E17	1.876E17
	N	14	14

**. Correlation is significant at the 0.01 level (2-tailed).

Regression of data for Uganda show a statistically significant relationship of Sig. (2-tailed) of .000 with a Pearson Correlation.940 between GDP against ODA and domestic revenue figures against ODA with Sig. (2-tailed) of .000 at Pearson Correlation.

Correlation between ODA and Taxes-Uganda

Correlations

		TAX	ODA
TAX	Pearson Correlation	1	.900**
	Sig. (2-tailed)		.000
	Sum of Squares and Cross-products	6.396E18	3.555E18
	Covariance	4.920E17	2.735E17
	N	14	14
ODA	Pearson Correlation	.900**	1
	Sig. (2-tailed)	.000	
	Sum of Squares and Cross-products	3.555E18	2.439E18
	Covariance	2.735E17	1.876E17
	N	14	14

**. Correlation is significant at the 0.01 level (2-tailed).

Regression of ODA against Taxes

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	5.898E8	8.462E7		6.970	.000
	TAX	.556	.078	.900	7.159	.000

a. Dependent Variable: ODA

The **time lag** between ODA disbursements, economic growth and/or domestic revenue receipts is not considered in the case of Rwanda. As mentioned earlier, the country began from a low level because the government prior to 1994 had expended much of the national resources on the war effort, organized the murder of a million of its citizens and looted the country of all valuables before stampeding a quarter of the population into exile in Zaire (DR Congo). The new government lacked the resources both material and human to manage the existing economy and collect taxes which amounted to a mere 41,717,836 USD for the year 1995. This meant that every resource was immediately put to use and there was no time spent between receipts and implementation.

The **disturbance** in the regression may be explained by several factors:

1. The defeated former government troops raided Rwanda from Zaire/DR Congo, which prompted the Rwandan government to attack the latter and overthrew the government there but the war dragged on for six years as former government troops with the support of Congo government attacked Rwanda. The war, therefore, diverted national resources and affected ODA receipts too.
2. The country relied on exports of coffee and tea in the 1990s whose prices fluctuated effecting the economy, ODA receipts notwithstanding; for example in the year 2003 the economy grew by 0.9 compared to 6.7 and 9.4 in 2001 and 20002 respectively and 4.0 in 2004. In 2003 value of coffee and tea exports, with value added (1995 constant prices) earned the country 6.14 billion RWF compared to 8.23 billion for 2002, a significant reduction of 25.4%.

4.4 Discussion of the results

1. The testing of the hypothesis was meant to understand the relationship between ODA and total fiscal revenue generated and, ODA and GDP growth for the period under review in both Rwanda and Uganda. The regression of the correlation among Domestic fiscal Revenue, ODA and GDP is robust and positively in favour of both hypotheses for the two countries Rwanda and Uganda. In case of Rwanda’s domestic

revenue against ODA, the Pearson Correlation is 1.000 with Sig. (1-tailed) of .000 with R Square at .676 at a Std. Error of the estimate of $1.301E8 while for the coefficients with a Std. Error of 8.628E7 it was .156 with robust significance of .000. The same results are observed when the country's GDP figures are regressed and correlated against ODA. Similar results are obtained when figures for Uganda's GDP, ODA and domestic revenue are put to the same test for the period under review which also show a highly positive correlation which leads to the hypotheses to be accepted. In brief, there is a high and positive correlation among ODA, domestic fiscal revenue and ODA received by both Rwanda and Uganda for the period under review.

2. In the post-war period in Rwanda of 1995, capital flows and financing for the fiscal budget was mainly in form of ODA because there were meagre foreign direct investments. This however led to increase in liquidity in the country which necessitated efforts to maintain macroeconomic stability leading to prudent financial and monetary management of the economy as a whole ensuring stability and controlled inflation in the wake of the sudden increase of ODA. This may be the reason the country did not face the phenomenon highlighted by Djankov et al (2005) where a sudden increase in aid money leads to instability and rent seeking.

3. In the year 1995, only 6.9% of Rwanda's GDP was taxed, two years later 10% of GDP was collected as fiscal revenue and by 2003, 13% of GDP was collected as domestic revenue. Much of the improvement can be attributed to government efforts to increase domestic revenue although during the same period under review, the country received ODA with a maximum of 11.4% and minimum of 5.3% of GDP. The effort was directed through the creation and support of RRA in 1997 which was empowered and strengthened for domestic revenue collection. Domestic fiscal revenue in Rwanda

which had been 13% of GDP in 1992 and 4 % in 1994 increased to 10% from 1996 to 2001 and 12.2% of GDP by 2002. Revenue as a share of GDP rose to 14% by 2004. This contrasts with the findings of McGillivray and Morrissey (2001) and indeed proves wrong the argument that more ODA leads to lower domestic fiscal revenue. Rwanda consistently increased domestic revenue even as more ODA went into the country.

4. In Rwanda, ODA as a percentage of GDP reduced from 95% as per the year 1994 to merely 19.2 % in 2004. ODA also played an important role in macroeconomic stability particularly balance of payments where capital inflows were mainly grants and loans as the major source of budget finance. Government was able to extend medical, educational and agricultural extension services partly because of the ODA that was received in the country. This is in line with the findings of Bulíř and Lane (2002) and Burnside and Dollar (2000).

5. In a bid to harmonise the external financing that came into the country from the different bilateral, multilateral and institutional sources, the government of Rwanda established the Central Public Investments and External Finance Bureau (CEPEX) as an agency within the Ministry of Finance and economic planning. Instead of donors and their representatives meeting and undertaking collaborations at different ministerial and departmental levels, all such dealings were assigned to CEPEX. This helped the country to avoid the problems such as the “transaction costs” highlighted by Acharya, et al (2004), the findings by Knack and Rahman (2004), Reinikka and Svensson (2004), Cordella and Dell’Ariccia (2003) and Morss (1984) .

6. The government of Rwanda has promoted zero tolerance to corruption which may explain the level efficiency and efficacy of ODA and the continued support from

donors who are satisfied with the way funds are utilized. The investigation and prosecution of culprits in abuse of public funds particularly during the procurement process ensures proper utilisation of funds and in a timely and coordinated manner.

7. Much of the efficiency and effectiveness of RRA can be attributed to ODA from the British government through DFID which went into training and modernisation of the Authority. This is in tandem with the views of Brun et al (2010), Ouattara (2006), Burnside and Dollar (2000), and Pack and Pack (1990). In particular, the support given to RRA and the achievements it was able to attain augurs well with the findings of Brun et al (2010) who advocated for technical assistance related programs ODA because they “reinforce administrations that define and implement the reform” and assistance for tax bodies which should be strengthened in “countries with low quality bureaucracies”.

Chapter 5: Conclusion and recommendation for further studies

This thesis aimed at studying the impact ODA on the fiscal revenue effort of recipient countries. Rwanda was chosen because it received large amounts of ODA (as a percentage of GDP and not in absolute amounts compared to other recipients), its economy was among the poorest and its institutions were destroyed before the period under review and had to be rebuilt anew after 1994. In a way Rwanda started from a very low level in her development effort particularly human resources and institutional capacity building.

Results have shown that contrary to some studies and findings that ODA retards domestic fiscal revenue collection efforts, increases rent-seeking and weaker institutions, Rwanda used it to increase the volumes of fiscal revenue year after year and increased the efficiency of the country's revenue agency, the Rwanda Revenue Authority. Drawing on inferences from the test carried out, ODA had a positive and healthy relationship for the increase and strengthening of GDP, fiscal revenue and institutional growth in Rwanda.

Whereas the results of the hypothesis testing are true for Rwanda, whether they are applicable to another country is beyond the scope of this study and this is due several reasons. What is proven however is that ODA had a positive impact on the country's GDP and domestic fiscal revenue mobilization efforts because: it reduced the constraint on budget, availed the scarce foreign exchange, supported areas which might have been considered non-priority in the allocation of the scarce resources and helped build local capacity in selected areas.

The role of ODA in Rwanda cannot be over emphasised because it enabled the government to allocate scarce resources to sectors that may not be otherwise allocated funds considering the pressing demand on the available domestically raised revenue. ODA also allowed the government to find an optimal tax rate for the economy which might have been higher and possibly "punitive" without it. If there were no ODA available, the tax rates would increase exorbitantly and in a globalized world, capital flight may take place from those countries where the tax rates may be higher and head for tax havens, which is detrimental to many developing countries.

Recipient countries must have the willingness and ability to harness the received ODA and put it to national priorities in a transparent way and on programs it is intended. This may explain the success and significant relationship between ODA and GDP and ODA and domestic fiscal revenue mobilization efforts in Rwanda as discussed earlier. The importance of ODA to fiscal revenues and GDP of Rwanda was important, especially technical assistance to the revenue administration agency like RRA. ODA is important for revenue administration because it strengthens the capacity of revenue collection Institutions in recipient countries which may explain the positive relationship among ODA, GDP and domestic revenue mobilization efforts in case of Rwanda. There is no doubt that the positive relationship and coefficients among the three variables studied in this thesis were a result of deliberate policies and efforts of the Rwanda government and ODA received.

Areas for further research

Rwanda received grants for the most of its aid. However, it is not clear whether Rwanda would have achieved the same success in mobilizing domestic resources for development as it did with the loan form of aid. This may require further research.

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