



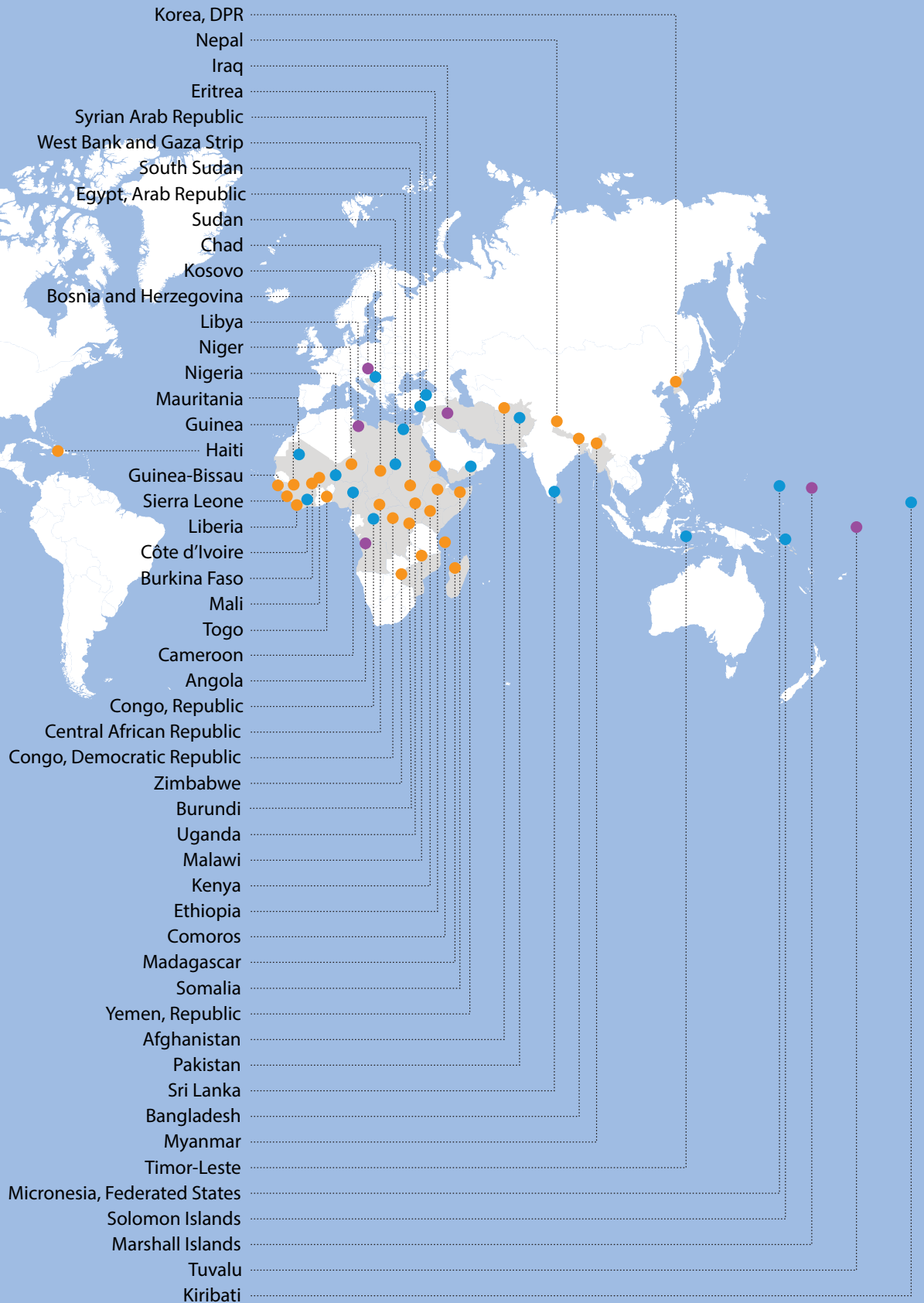
Fragile States 2014

Domestic Revenue Mobilisation in Fragile States



THE LIST OF 51 FRAGILE STATES USED IN THIS REPORT

● Low income ● Lower middle income ● Upper middle income



FOREWORD

THIS IS A CRUCIAL TIME FOR FRAGILE STATES. They are the ones furthest away from the Millennium Development Goals. They will be home to more than half of the world's poor after 2018. Yet the aid they receive is shrinking, and they have limited access to alternatives for financing development such as remittances and foreign direct investment. The domestic revenues they raise are not enough. Evidence in this report suggests that fragile states mobilise less than 14% of their GDP in tax revenues – a level the United Nations deems to be inadequate to achieve the Millennium Development Goals. Yet accountable tax systems are perhaps more crucial in fragile states than anywhere else. Domestic revenues are not only a way out of aid dependency – they are important for building mutual accountability between citizens and states.

The 2014 Fragile States report is a wake-up call for development co-operation providers: it is time to invest more in the capacity of fragile states to mobilise their own revenue to support statebuilding and peace. In international fora held at Monterrey and Busan as well as at the G20 Summit in St. Petersburg, donors affirmed that support for domestic revenue mobilisation is a priority, but this commitment has not been translated into reality. In fact a very small sum – only 0.07% of all aid – is targeted toward building accountable tax systems in fragile states, despite the fact that investments in this sector can yield impressive returns.

Domestic resource mobilisation is a top priority of both the Global Partnership for Effective Development Co-operation and the New Deal for Engagement in Fragile States. We trust the evidence in this report will assist them and many other actors to address the challenges. We are convinced that by working together solutions can and will be found that finance development, including by drawing on the wealth in fragile states. We hope this work can also be taken into account by Member States as the turn their attention to the post-2015 development agenda. Fragile states and the many poor who will live within their borders deserve no less.



Erik Solheim

A handwritten signature in black ink that reads "Erik Solheim".

Chair, Development Assistance Committee (DAC), Organisation for Economic Co-operation and Development (OECD)



Tobias Nussbaum

A handwritten signature in black ink that reads "Tobias Nussbaum".

Director General, Development Policy, Department of Foreign Affairs, Trade and Development, Co-Chair of the DAC International Network on Conflict and Fragility (INCAF)



Jordan Ryan

A handwritten signature in black ink that reads "Jordan D. Ryan".

Assistant Administrator and Director, Bureau for Crisis Prevention and Recovery, United Nations Development Programme (UNDP) Co-Chair of the DAC INCAF

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ACKNOWLEDGEMENTS

The OECD is grateful to the team that has worked on the 2014 report. Emmanuel Letouzé was contracted as lead author and led the development phase of this work and produced the original drafts. Jolanda Profos was co-author and project manager, and their co-author was Sarah L. Cramer.

Ana Vidales, Elena Bernaldo, Fredrik Ericsson, Cecilia Piemonte, and Andrzej Suchodolski (OECD) provided DAC statistics and analysis; Emilie Kothe (OECD) provided figures and advice on foreign direct investment, Eugenia Suarez Moran provided MDG statistics (World Bank), and Gabriel Pestre, Maia Sieverding and Fredrik Sjöberg helped with the quantitative analysis. Lee Corrick, Lena Diesing, Sara Fyson, Donata Garrasi, Kjetil Hansen, Yannick Hingorani, Diana Koester, Caroline Malcolm, Miriam Möller, Nariné Nersesyan, Keith Patterson, Jocelyn Pierre, Giovanni Maria Semeraro and Jean-Philippe Stijns (OECD) provided further substantive advice. Jolanda Profos co-ordinated the team effort, providing oversight and bringing together the final report.

We would like to thank several contributors for providing inputs to this report, including the g7+ Secretariat, Sakher AlAhmad of UNDP Programme of Assistance to the Palestinian People (PAPP), Nicolas Garrigue and Eugenia Piza-Lopez of the Bureau for Crisis Prevention and Recovery at UNDP, Matthew Genasci from the Mining Policy Group, Jörn Grävingsholt from the German Institute for Development (DIE), Paul Harvey from the Secure Livelihoods Research Consortium, Antoine Heuty from Ulula, and Amanda di Lorenzo from the UN Office for the Coordination of Humanitarian Affairs (OCHA). We are grateful to Laurence Chandy from Brookings Institution for permission to use the graphic on poverty trends.

The overall project was completed under the responsibility of Alan Whaites and Brenda Killen (OECD). The report was edited by Fiona Hinchcliffe and proofread by Susan Sachs. Peggy Ford-Fyffe King designed the report and visualised the data. The report has benefitted from input from the members of the reference group who provided valuable reviews of the drafts of the report: Habib Ur Rehman Mayar (g7+ Secretariat); Gary Milante (World Bank/SIPRI); Henk-Jan Brinkman (United Nations Peacebuilding Support Office); Kristoffer Nilaus Tarp (Independent Consultant); Antoine Heuty (Ulula); and Fredrik Ericsson, Gregory de Paepe, Ben Dickinson and Keith Patterson (OECD). However, any errors or omissions remain the authors' responsibility.

ACRONYMS AND ABBREVIATIONS

AFD	<i>Agence Française de Développement</i>	IDS	International Development Statistics (OECD)
AfDB	African Development Bank	IFC	International Finance Corporation (World Bank Group)
AfDF	African Development Fund	IMF	International Monetary Fund
APG	Asia/Pacific Group on Money Laundering	INCAF	International Network for Conflict and Fragility (OECD DAC)
BIF	Burundian franc	JICA	Japan International Cooperation Agency
CFATF	Caribbean Financial Action Task Force	LDC	least developed country
CPA	country programmable aid	MDG	Millennium Development Goal
CPIA	Country Performance and Institutional Assessment	MENA	Middle East and North Africa
CRS	Creditor Reporting System	MENAFATF	Middle East and North Africa Financial Action Task Force
CTP	International Centre for Tax and Development	MIC	middle-income country
DAC	Development Assistance Committee (OECD)	MNE	multinational enterprise
Danida	Danish International Development Agency	MONEYVAL	Council of Europe Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism
DfID	Department for International Development (UK government)	NGO	non-governmental organisation
DRC	Democratic Republic of the Congo	OCHA	UN Office for the Coordination of Humanitarian Affairs
ECHO	European Community Humanitarian Office	ODA	official development assistance
EITI	Extractive Industries Transparency Initiative	OECD	Organisation for Economic Co-operation and Development
ESAAMLG	Eastern and Southern Africa Anti-Money Laundering Group	PFM	public financial management
FATF	Financial Action Task Force	PSG	peacebuilding and statebuilding goal
FDI	foreign direct investment	SBS	sector budget support
FSI	Failed States Index	SIPRI	Stockholm International Peace Research Institute
GAVI	Global Alliance for Vaccines and Immunisation	UN	United Nations
GBS	General Budget Support	UNDP	United Nations Development Programme
GDP	gross domestic product	UNPBF	United Nations Peacebuilding Fund
GIABA	Inter Governmental Action Group against Money Laundering in West Africa	USD	United States Dollar
GNI	gross national income	VAT	value-added tax
HDI	Human Development Index	WDI	World Development Indicator
IBRD	International Bank for Reconstruction and Development		
IDA	International Development Association		
IDP	internally displaced person		

EXECUTIVE SUMMARY

WHAT FINANCIAL RESOURCES are available to fragile states – internationally and domestically – to fund their development? What role does aid play? What can be done to close the gaps in resources for development? This report looks at these questions, highlighting the need to focus more on domestic revenue generation as a source of state revenue, and also as a cornerstone of statebuilding. While the focus on tax as is not new in the development community, the report finds that much more can be done.

Ending extreme poverty means supporting fragile states.

Of the seven countries that are unlikely to meet any MDG by the 2015 deadline, six are fragile states. Today, more than one-third of the people living below the USD 1.25-a-day poverty line live in fragile states; by 2018, most of the world's extremely poor will be in fragile states.

Yet aid to fragile states is falling.

Aid has been the largest and most reliable source of development finance for the least developed fragile states over the past decade. It is, however, showing a worrying downward trend: official development assistance (ODA) to fragile states fell by 2.4% in 2011 and is expected to shrink further. The least developed fragile states with the highest needs are losing out the most.

Many fragile states are under-aided.

The poorest fragile states often depend on ODA. In some of them it can constitute up to 55% of their GDP. Others, however, are neglected: in 2011, 44 fragile states – among them some of the poorest in the world – each received on average less than half a percentage of global ODA.

The least developed fragile states have few other sources of finance.

Fragile states tap into sources of external finance other than aid, in particular middle-income fragile countries, where remittances have outpaced aid. Foreign direct investment (FDI) is another – albeit volatile – source of external finance. Yet the least-developed fragile states have little access to FDI, as they are often considered less credit-worthy than middle-income countries.

Greater domestic revenue is needed to plug the development finance gap.

Domestic revenue offers fragile states a promising and sustainable source of home-grown development finance. The UN estimates that to achieve the MDGs, domestic revenue should represent at least 20% of GDP. Yet only two fragile states have reached that target; on average, domestic revenue represents only 14% of the GDP of fragile states.

Mobilising revenue matters for generating public income – and for statebuilding.

Building capacity to raise revenue through taxes is particularly crucial in fragile states, as it reduces dependence on aid and helps finance human development and recovery. At the same time, it strengthens the contract between the state and its citizens, and can fortify intra-society relationships.

Fragile states face several challenges in raising domestic revenue.

- Many fragile states rely heavily on only one source of domestic revenue: non-renewable natural resources. Ensuring robust and transparent systems to capture, manage and distribute these resources fairly is a challenge.
- Another challenge lies in growing the tax base to foster sustainability and strengthen state-society relations.

- Over-generous tax exemptions awarded to multinational enterprises often deprive fragile states of potential revenues that could be used to fund their most pressing needs. At the same time, this undermines citizens' tax morale and their confidence in the state.
- Weak technical and institutional capacity can make it challenging to introduce direct taxation; it also fuels tax evasion and avoidance, capital flight, and criminal activities such as smuggling – with disastrous effects far beyond lost revenue.

Action is needed to stem revenue lost through illicit activities.

- Vast sums of potential domestic revenue are lost through illicit activities in fragile states. OECD countries and fragile states alike must take steps to comply with global standards on money laundering, tax evasion and bribery.
- Donor agencies can help fragile states build their capacity to combat illicit flows, and other parts of donor governments can also play an important role.

Support for domestic revenue mobilisation in fragile states is essential.

Donors have made strong political commitments to helping developing countries raise revenue – in Monterrey, Busan and at the G20. Yet despite evidence that this support pays dividends, only 0.07% of ODA to fragile states actually supports their tax systems. Prioritising this support means using countries' own systems and at the same time, managing the risks involved.

How to encourage broad-based, simple and transparent revenue systems:

Development actors should encourage broad-based, simple and transparent revenue systems:

- Encourage a broader tax base by focusing on approaches that give citizens a voice.
- Support fragile states in designing frameworks to secure fairer deals with multinational enterprises, in particular on proceeds from their natural resources; providers of development co-operation can lead by example by being transparent about the tax exemptions that benefit them.
- Boost citizens' tax morale by establishing clear links between tax revenue and local benefits.

INTRODUCTION

FRAGILE STATES are lagging behind in achieving the Millennium Development Goals. Without urgent action they will be home to more than half of the world's poor after 2018. Declining foreign aid and other external resources are not enough to drive development and stability in these countries. The development community is turning its attention to taxation as a potential source of development finance and a means of strengthening state-citizen relationships. Domestic revenue mobilisation was recognised as a top priority by the Monterrey Consensus on Financing for Development in 2002, and gained significant attention on the G20 agenda in 2013.

This 2014 Fragile States Report zooms in on domestic revenue (in particular taxation) as a key nexus between the state and citizens and within society. The report is the seventh publication in a series on resource flows in fragile and conflict-affected states. Since 2005, the series has been filling an important knowledge gap by providing information about the scale, impact and interaction of resource flows in fragile states. It is produced for the OECD Development Assistance Committee (DAC) by the Secretariat of the International Network on Conflict and Fragility (INCAF) but also aims at a wider audience of policy makers.

The considerable and growing attention given to domestic revenue mobilisation by the international community has not yet been backed up by sufficient financial support. This is despite the fact that the evidence shows that for every dollar of aid spent in this sector, many more dollars can be earned for the country concerned. Such support is not just about *how much* domestic revenue a country mobilises (ideally 15% or 20% of GDP). Just as important is *how* it is mobilised and harnessed. The political and institutional processes required, moreover, are essential for enhancing state and social resilience. This is why domestic revenue is a key dimension of the five Peacebuilding and Statebuilding Goals (PSGs) set out in the New Deal for Engagement in Fragile States, endorsed by 41 countries and organisations in 2011.

This report asks, and answers, ten key questions concerning development finance and other sources of revenue for fragile states and the role of the international community.¹ A pertinent question is what is holding donors back from helping fragile states mobilise their own revenue. The report sheds light on some of the key debates around domestic resource mobilisation and explores fundamental questions donors need to address to support this vital statebuilding goal. How to deal with risk and corruption? How to use country systems in fragile states? How to support domestic resource mobilisation in a way that strengthens statebuilding, enhances government credibility and engages citizens? The report concludes by listing some steps donors can take, illustrated by examples of how they, and fragile states themselves, are putting some of these principles into practice.

INTRODUCTION

NOTES

1. This report draws on 2011 official development assistance (ODA) data, the latest available at the time of writing. All amounts are denoted in US dollars, unless specified otherwise. Figures reflect OECD statistics unless indicated otherwise.

QUESTION 1

What are the key trends in fragile states today?



TODAY, ABOUT 1.4 BILLION PEOPLE LIVE IN FRAGILE STATES.

Fragile and transitional situations comprise a broad spectrum of contexts – from the one-party state of North Korea to war-torn Syria and relatively stable Bosnia and Herzegovina. Close to half – 23 of 51 – are middle-income states and economies, and many of them are rich in natural resources.

Poverty remains highly prevalent in most fragile states. Today, one-third of the world's poor live in fragile countries; by 2018 that share is likely to grow to one-half, and in 2030 to nearly two-thirds. The proportion of young people in those states is approximately twice that in non-fragile countries, and the populations of these states are growing roughly twice as fast. Although 35 fragile states have made significant progress towards the Millennium Development Goals (MDGs) and will be able to meet at least one by the 2015 deadline, progress towards the MDGs has been much slower than in other developing countries. Of the seven countries that are unlikely to be able to meet any MDG by 2015, six are fragile. As a consequence, in five years extreme poverty is expected to be concentrated mainly in fragile states. ■

QUESTION 1

Fragility affects a wide range of countries and economies. Fragile states include countries that are recovering from conflict and embarking on peace and statebuilding processes (e.g. Liberia, Myanmar and Timor-Leste). They also include countries that are experiencing long-term insecurity, recurrent crises or localised conflict (e.g. the Central African Republic, Guinea-Bissau and Yemen), or high levels of criminality and violence (e.g. Pakistan). They encompass a range of situations where governments have strong administrative structures but where political exclusion combined with lack of economic opportunities are fuelling tension and violence. This is the situation in countries such as Egypt, Libya and North Korea, as well as across entire regions such as the Maghreb and the Sahel. In Zimbabwe these characteristics are compounded by weak institutions, and in Mali by an armed rebellion. Fragility can be found at the sub-national level; can affect some people, institutions and services and not others; and can have a regional dimension.

According to the OECD, “a fragile region or state has weak capacity to carry out basic governance functions, and lacks the ability to develop mutually constructive relations with society. Fragile regions or states are also more vulnerable to internal or external shocks such as economic crises or natural disasters. More resilient states exhibit the capacity and legitimacy for governing a population and its territory. They can manage and adapt to changing social needs and expectations, shifts in elite and other political agreements, and growing institutional complexity. Fragility and resilience should be seen as shifting points along a spectrum” (OECD, 2012a). The g7+, a voluntary association of countries that are or have been affected by conflict, is refining the way fragility is assessed. It has deepened work on the fragility spectrum along key dimensions of peacebuilding and statebuilding (see Box 1.1).

Every year the OECD compiles a list of countries and economies considered to be fragile (Table 1.1). It uses this list to monitor both financial flows to fragile states and progress towards peacebuilding, statebuilding and development objectives. The list is assembled by combining the latest harmonised list of fragile situations published by the World Bank, African Development Bank and Asian Development Bank¹ with those countries that have a Failed State Index above 90 on the Failed States list developed by the Fund for Peace (see also Table A.1).^{2,3} The OECD uses the fragile states list to monitor

BOX 1.1 A new way to assess fragility: the fragility spectrum

The concept of fragility assessments conceived by the g7+ and framed in the New Deal for Engagement in Fragile States aims to enable national stakeholders to identify the drivers of fragility from their own perspective. The fragility assessment includes a fragility spectrum which has been developed by the g7+ as a tool for states to assess their own fragility. It allows fragility to be measured across the New Deal Peace and Statebuilding Goals (PSGs; see Annex B, Figure B.1) along five stages. Rather than relying on an absolute value of fragility, the spectrum shows where the country stands across each dimension of the PSGs. This helps develop a targeted development plan, giving clear directions for the country. .

Source: g7+ Secretariat

the flows of official development assistance (ODA) and other sources of finance available to fragile states. Annex B outlines the current discussion of the merits and limitations of lists and indicators of state fragility. Substantive work is now needed to ensure that country-level analysis of fragility is strengthened.

Since the 2013 Fragile States Report (OECD, 2012b), eight countries have been added to this list (Burkina Faso, Egypt, Libya, Syria, Mali, Mauritania, Madagascar and Tuvalu), while four countries no longer feature (Georgia,⁴ Iran, the Kyrgyz Republic and Rwanda).

These changes reflect several important evolutions in the fragile state landscape:

- The **Arab Spring**, which began in Tunisia in late 2010, has since affected Egypt, Libya, Syria, and Yemen, with repercussions for Mali, Mauritania and Chad. Madagascar's political crisis also caused its Country Performance and Institutional Assessment (CPIA) scores to slip markedly.⁵
- Two-thirds of fragile states are now found in **sub-Saharan Africa, the Middle East and North Africa**. The number of fragile sub-Saharan countries (now 29) and fragile Arab states and economies (now 6) has increased. In contrast, the Caucasus and Central Asian region is no longer represented on the list.

TABLE 1.1 List of fragile states and economies used in the 2014 Fragile States Report

Region	Income level		
	Low income	Middle Income	
		Lower middle	Upper middle
East Asia and Pacific (8)	Korea, DPR + Myanmar*	Kiribati* Micronesia, Fed. States Solomon Islands* Timor-Leste*	Tuvalu* + Marshall Is.
Europe and Central Asia (2)		Kosovo	Bosnia and Herzegovina
Latin America and Caribbean (1)	Haiti*		
MENA (6)		Egypt, Arab Rep. + Syrian Arab Rep. + West Bank and Gaza Strip Yemen, Rep.*	Libya Iraq
South Asia (5)	Afghanistan* Bangladesh* Nepal*	Pakistan Sri Lanka	
Sub-Saharan Africa (29)	Burundi* CAR* Chad* Comoros* Burkina Faso *+ DRC* Madagascar*+ Malawi* Eritrea* Ethiopia* Guinea* Guinea-Bissau*	Kenya Liberia* Mali*+ Niger* Sierra Leone* South Sudan* Somalia* Togo* Uganda* Zimbabwe	Cameroon Congo, Rep. Côte d'Ivoire Nigeria Sudan* Mauritania*+
Angola*			
Income Level: Totals (and %)	28 (55%)	17 (33%)	6 (12%)

* denotes a fragile state that is also defined as a least developed country (LDC).

+ Eight countries that are new on this year's list.

(For the country classification, see <http://data.worldbank.org/about/country-classifications/country-and-lending-groups>)

Sources: 2013 harmonised list of fragile states put together by the World Bank, Asian Development Bank and African Development Bank, available at: <http://siteresources.worldbank.org/EXTLICUS/Resources/511777-1269623894864/HarmonizedlistoffragilestatesFY14.pdf>; Failed States Index 2013, available at: <http://ffp.statesindex.org/rankings-2013-sortable>.

- The **number of people** living in fragile states has increased. Partly as a result of the inclusion in the list of some large middle-income countries, more people now live in countries considered fragile – roughly 1.4 billion, up from 1.3 billion last year, out of a global population of 7 billion.
- Close to half of fragile states (23 countries out of 51) are **middle-income countries**, and many are resource-rich; the inclusion of Arab countries such as Libya, Syria and Egypt has contributed to this trend.

SLOW PROGRESS TOWARDS THE MDGs

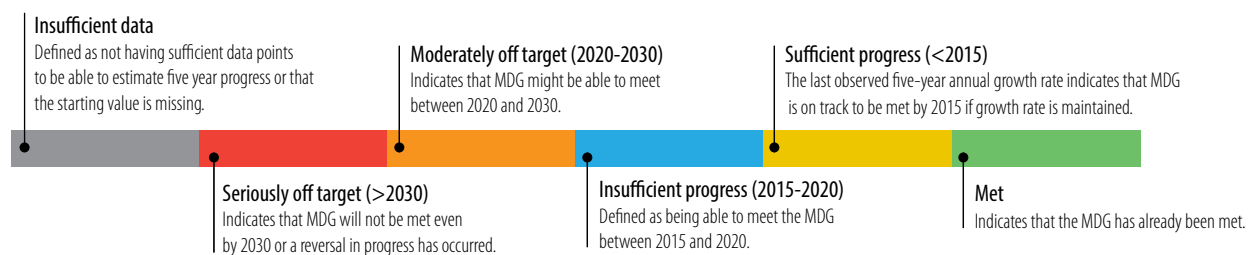
Since the last fragile states report, fragile states have been making greater progress than expected towards the Millennium Development Goals. According to World Bank data, 35 of the countries considered fragile in this report have recently met one or more MDG targets. An additional five are on track to meet individual MDG targets ahead of the 2015 deadline (World Bank, WDI and GMR team estimations, 2013). The strongest progress has been on the gender equality goal (MDG3, Target 3A), access to safe drinking water (MDG7, Target 7C), and eradicating extreme poverty (MDG1, Target 1A). Twenty-one fragile countries are expected to achieve the gender equality target by 2015 (Target 3A), 17 are likely to have improved access to safe drinking water for their population, and 16 are expected to meet the target on eradicating extreme poverty.

Nonetheless, overall progress towards the MDGs has been uneven and slow compared to that of non-fragile states. Of the seven countries that are unlikely to meet any MDG by the 2015 deadline and for which data are available, six are fragile:

DRC, Côte d'Ivoire, Haiti, Somalia, South Sudan and Kosovo.⁶ The seventh country, Papua New Guinea, has a history of conflict as well.

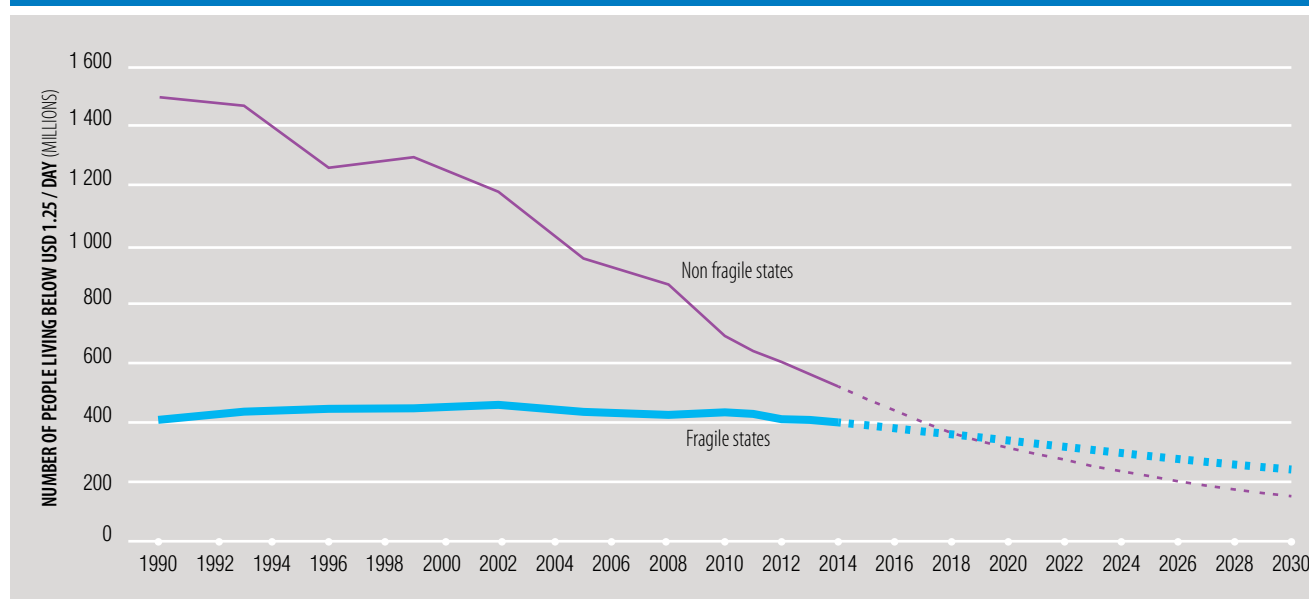
Only two fragile states (or 4% of the total) are expected to meet the target for reducing infant mortality (MDG4, Target A) by 2015. Six non-fragile developing countries, on the other hand, have already met it and seven more have made sufficient progress to meet

FIGURE 1.1 Fragile countries lag behind on the MDGs
Progress on MDG indicators by fragile and non-fragile states, 2013



MILLENNIUM DEVELOPMENT GOAL		No. of countries is shown inside bars.	2015		% of countries expected to reach target
MDG 1 Eradicate extreme poverty and hunger	1.A Halve, between 1990 and 2015, the proportion of people living on less than \$1.25 a day	FRAGILE	14 (Insufficient data), 16 (Seriously off target), 5 (Moderately off target), 3 (Insufficient progress), 13 (Sufficient progress)	FRAGILE	31%
		NON FRAGILE	17 (Insufficient data), 8 (Seriously off target), 4 (Moderately off target), 2 (Insufficient progress), 9 (Sufficient progress), 53 (Met)	NON FRAGILE	67%
	1.C Halve, between 1990 and 2015, the proportion of people who suffer from hunger.	FRAGILE	10 (Insufficient data), 25 (Seriously off target), 4 (Moderately off target), 3 (Insufficient progress), 2 (Sufficient progress), 9 (Met)	FRAGILE	22%
		NON FRAGILE	7 (Insufficient data), 47 (Seriously off target), 3 (Moderately off target), 6 (Insufficient progress), 5 (Sufficient progress), 25 (Met)	NON FRAGILE	32%
MDG 2 Achieve universal primary education	2.A Ensure that, by 2015, all children will be able to complete primary schooling	FRAGILE	18 (Insufficient data), 12 (Seriously off target), 5 (Moderately off target), 7 (Insufficient progress), 4 (Sufficient progress), 5 (Met)	FRAGILE	18%
		NON FRAGILE	10 (Insufficient data), 32 (Seriously off target), 4 (Moderately off target), 3 (Insufficient progress), 5 (Sufficient progress), 39 (Met)	NON FRAGILE	47%
MDG 3 Promote gender equality and empower women	3.A Eliminate gender disparity education no later than 2015	FRAGILE	13 (Insufficient data), 7 (Seriously off target), 6 (Moderately off target), 4 (Insufficient progress), 9 (Sufficient progress), 12 (Met)	FRAGILE	33%
		NON FRAGILE	10 (Insufficient data), 25 (Seriously off target), 2 (Moderately off target), 4 (Insufficient progress), 3 (Sufficient progress), 49 (Met)	NON FRAGILE	56%
MDG 4 Reduce child mortality:	4.A (Indicator 4.1) Reduce by two thirds, between 1990 and 2015, the under-five mortality rate	FRAGILE	1 (Insufficient data), 21 (Seriously off target), 11 (Moderately off target), 5 (Insufficient progress), 4 (Sufficient progress), 9 (Met)	FRAGILE	25%
		NON FRAGILE	1 (Insufficient data), 18 (Seriously off target), 23 (Moderately off target), 15 (Insufficient progress), 10 (Sufficient progress), 26 (Met)	NON FRAGILE	39%
	4.A (Indicator 4.2) Reduce infant mortality rate	FRAGILE	1 (Insufficient data), 33 (Seriously off target), 8 (Moderately off target), 7 (Insufficient progress), 2 (Sufficient progress)	FRAGILE	4%
		NON FRAGILE	1 (Insufficient data), 44 (Seriously off target), 24 (Moderately off target), 11 (Insufficient progress), 7 (Sufficient progress), 6 (Met)	NON FRAGILE	14%
MDG 5 Improve maternal health	5.A Reduce by three quarters, between 1990 and 2015, the maternal mortality ratio	FRAGILE	6 (Insufficient data), 21 (Seriously off target), 10 (Moderately off target), 3 (Insufficient progress), 10 (Sufficient progress), 1 (Met)	FRAGILE	22%
		NON FRAGILE	5 (Insufficient data), 53 (Seriously off target), 16 (Moderately off target), 4 (Insufficient progress), 8 (Sufficient progress), 7 (Met)	NON FRAGILE	16%
MDG 7 Ensure environmental sustainability:	7.C (Indicator 7.8) Increase proportion of population using an improved drinking water source	FRAGILE	8 (Insufficient data), 18 (Seriously off target), 7 (Moderately off target), 1 (Insufficient progress), 3 (Sufficient progress), 14 (Met)	FRAGILE	33%
		NON FRAGILE	11 (Insufficient data), 22 (Seriously off target), 4 (Moderately off target), 3 (Insufficient progress), 3 (Sufficient progress), 50 (Met)	NON FRAGILE	57%
	7.C (Indicator 7.9) Increase proportion of population using an improved sanitation facility	FRAGILE	9 (Insufficient data), 29 (Seriously off target), 4 (Moderately off target), 3 (Insufficient progress), 6 (Sufficient progress)	FRAGILE	18%
		NON FRAGILE	17 (Insufficient data), 31 (Seriously off target), 4 (Moderately off target), 8 (Insufficient progress), 7 (Sufficient progress), 26 (Met)	NON FRAGILE	35%

Source: World Bank, Global Monitoring Report estimates, 2013.

FIGURE 1.2 Number of people in poverty: Fragile states vs. stable developing countries, 1990-2030

Notes: The classification of countries (fragile / not fragile) is based on the list used in the 2013 Fragile States Report; classifications across years are held constant.

Source: Chandy, L., N. Ledlie and V. Pencikova (2013), *The Final Countdown: Prospects for Ending Extreme Poverty by 2030* (interactive), April 24, 2013 Brookings Institution, Washington DC, available at www.brookings.edu/research/interactives/2013/ending-extreme-poverty

the target by 2015. When compared to other developing countries, progress by fragile states on eradicating poverty has been especially slow. Around one-third of fragile states have reportedly made progress towards halving the proportion of people with an income below USD 1.25 a day (MDG1, Target A), compared to two-thirds of non-fragile developing countries. Undernourishment and poor sanitation have also proven difficult to overcome in fragile states (Figure 1.1).

It is important to note that data for all the MDG indicators are not available for many countries, most of them fragile states. On average, MDG data are incomplete for one in six fragile states, compared to one in 12 non-fragile developing countries. This reflects a much broader data problem typical of many fragile states, and has been referred to as a “statistical tragedy” (Giugale, 2012).

AN INCREASING CONCENTRATION OF POVERTY

Although poverty and fragility are not synonymous, poverty is increasingly concentrated in fragile states (Figure 1.2). In these states, “the record of and prospects for poverty reduction are weakest” (Chandy *et al.*, 2013). Today, 37% of

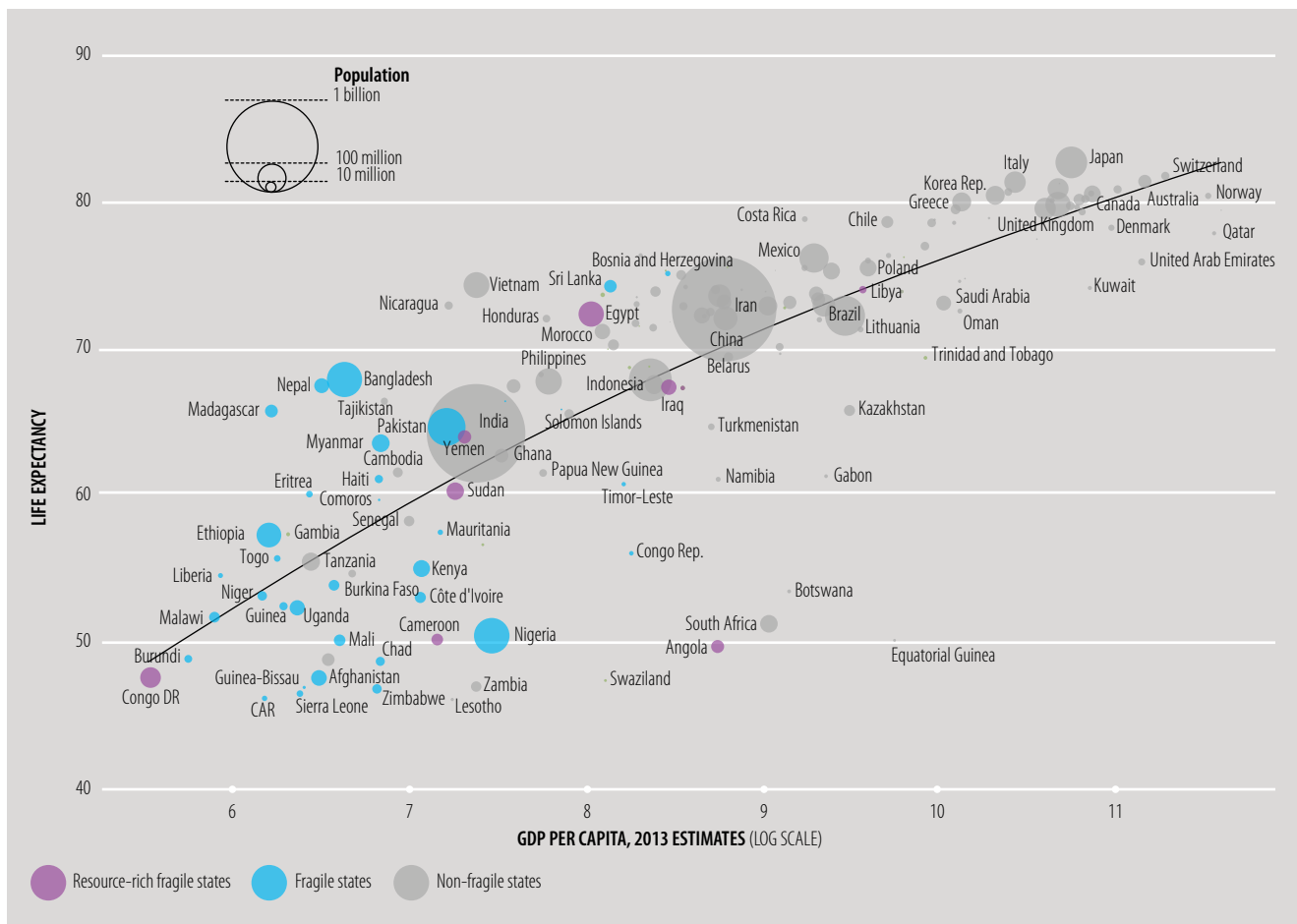
In fragile states, the record of and prospects for poverty reduction are weakest.

the world’s extreme poor (i.e. those living on less than USD 1.25 a day) live in fragile states.⁷ With no new action, their share is set to reach 50% in 2018 and nearly 75% in 2030

(Chandy *et al.*, 2013). In addition, the projections for economic growth and aid are not promising for fragile states in the coming years (see Question 2 below).

QUESTION 1

FIGURE 1.3 Lower life expectancy relative to income in fragile states



Notes: This graph shows GDP per capita (x), life expectancy (y), and population size. The trend line shows the life expectancy at birth in a given country in relation to its gross domestic product (expressed in logarithmic terms). The blue and purple dots stand for fragile states; purple ones represent resource-rich fragile states; the grey dots represent countries that are not fragile (both developing countries and others).

Source: World Development Indicators for GDP data (estimates for 2013), UN Population Division for demographic data

YOUNG POPULATIONS AND LOW LIFE EXPECTANCY

Populations in fragile states are young, and are growing rapidly. On average, close to 40% of people living in fragile states are below the age of 15. The average for the rest of the world is 25%.⁸ Population growth is more than double that of non-fragile states.⁹ What is more significant, however, is that income levels suggest average life expectancy should be higher than it

is in fragile states. Figure 1.3 contrasts all countries in the world for which data are available against three dimensions: GDP per capita, life expectancy at birth for 2005-2010 and population size. Fragile states – and in particular sub-Saharan ones – tend to be clustered in the lower-left corner of the plot, and most are below the trend line.

NOTES

1. The list for 2014 is available at: <http://siteresources.worldbank.org/EXTLICUS/Resources/511777-1269623894864/HarmonizedlistoffragilestatesFY14.pdf>.
2. The full FSI for 2013 is available at: <http://ffp.statesindex.org/rankings-2013-sortable>.
3. Of the 51 states on the OECD list, 22 countries are common to both the World Bank and the FSI lists, and 29 (14 and 15) are on one but not the other (see Annex A, Table A.1). Contrasting the characteristics of countries in these three groups shows the different underlying assumptions and real-world experiences and challenges. Of the countries that figure on both lists, most are found in sub-Saharan Africa and/or have low income. Many countries listed only on the World Bank's harmonised list are small island states. Many that are found on the FSI list only are populous countries of Africa and South Asia, several of which are middle-income countries.
4. The end of the United Nations Observer Mission in Georgia (UNOMIG) in 2009 means Georgia is no longer included on the list, because the World Bank's lists include all countries where there has been a UN and/or regional peacekeeping or peacebuilding mission during the past three years.
5. The Harmonised List of fragile states by the World Bank and the Asian and African Development Bank is partially based on the CPIA.
- 6; Data on Kosovo are however incomplete.
7. This is based on the 51 fragile states monitored in this report. Data are not available for DPR Korea.
8. This figure includes both developing countries and others.
9. According to analysis by the UN Population Division, the 0-15 age group makes up 39.5% of the population of fragile states for which data are available; it accounts for more than one-third of the population of 40 fragile countries. The average estimated rate of population growth over 2011-2013 is 0.9%, compared with 0.43% for non-fragile states.

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QUESTION 2

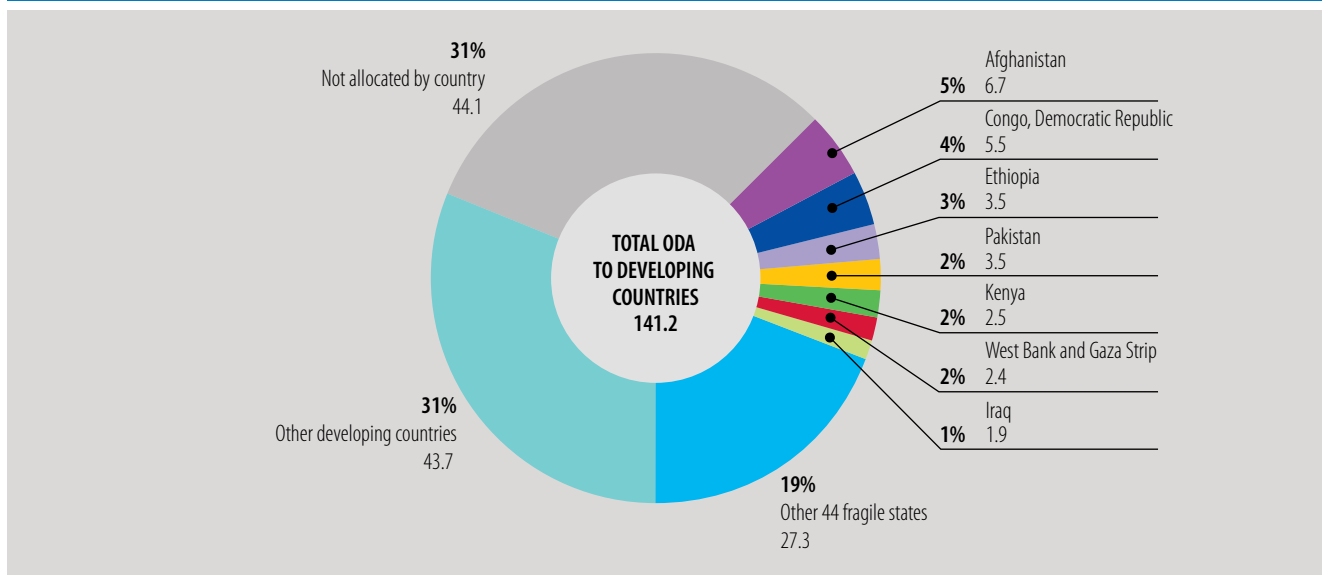
How has aid to fragile states changed?



SINCE PEAKING IN 2005, the volume of aid to fragile states has followed an erratic but downward trend. This is worrying, given that some fragile states are highly dependent on aid. In line with the fact that poverty is becoming more concentrated in fragile states, this group received the greatest share of official development assistance (ODA) of all country allocations in 2011. The amount received by individual fragile states, however, varies greatly. Half of ODA to fragile states is directed at just seven countries, and aid per capita ranges from USD 4 300 in the small island state Tuvalu to just USD 5 in Egypt and North Korea. Multilateral agencies deliver half of aid to fragile states. ■

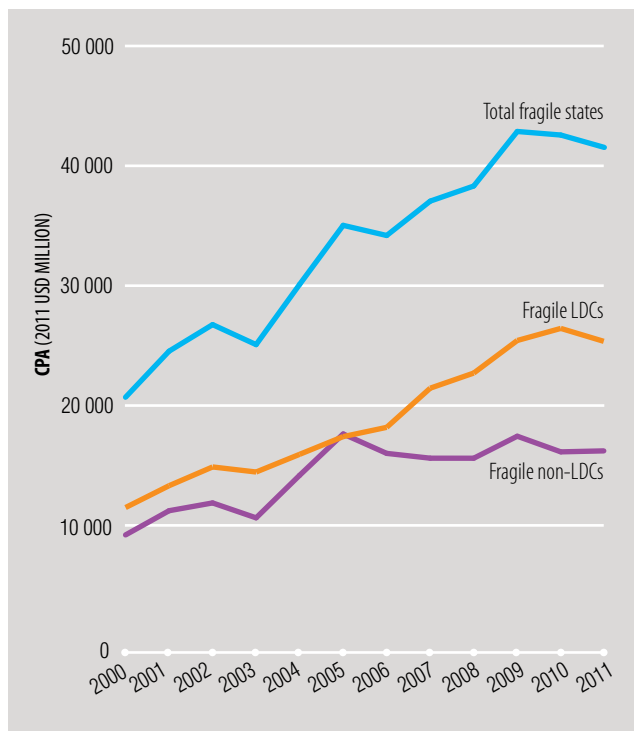
QUESTION 2

FIGURE 2.1 ODA recipients, 2011
(current USD billions and % share of total net ODA)



Notes: This graphic reflects total net ODA; it includes the aid outflows (disbursements) of both bilateral and multilateral donors to fragile states.
Source: OECD International Development Statistics online databases on aid and other resource flows, available at www.oecd.org/dac/stats/idsonline.

FIGURE 2.2 After increasing for many years, aid to fragile states has begun to fall
(Country Programmable Aid to fragile states, 2000-2011)



Source: OECD International Development Statistics online databases on aid and other resource flows, available at www.oecd.org/dac/stats/idsonline.

In 2011, fragile states received USD 53.4 billion in ODA.¹ The fact that 38% of ODA is devoted to fragile states reflects the reality that poverty, and efforts to alleviate it, are increasingly concentrated in these countries (see Question 1). Thirty-one percent was earmarked for all other developing countries. The remaining 31% of ODA was not allocated to specific countries (Figure 2.1).

OFFICIAL DEVELOPMENT ASSISTANCE TO FRAGILE STATES HAS FALLEN

After a peak in 2005, aid from all donors to the 51 fragile states on the current list has continued its erratic but generally downward trend; it fell by 2.4% in 2011. ODA from DAC donors to fragile states diminished by 0.7% (Table 2.1 and Annex A, Table A.2).²

Aid to fragile states fell by 2.4% in 2011, marking a downward trend that is expected to continue.

While ODA volatility can often be ascribed to debt relief or humanitarian aid, the decrease

in aid to fragile states is confirmed even when those amounts are excluded. Figures reflecting country programmable aid (CPA) confirm a downward turn since 2010 (Figure 2.2).³

TABLE 2.1 Aid to fragile states and economies fell between 2010 and 2011
(total net ODA disbursements, in 2011 USD billion)

	2010	2011		% change*
ALL DONORS				
Total ODA to all developing countries	140.0	141.2	▲	+ 0.8%
ODA earmarked for FS** (allocations)	54.7	53.4	▼	- 2.4%
ODA earmarked for other developing countries (allocations)	42.9	43.7	▲	+ 1.8%
ODA not allocated to any country	42.4	44.1	▲	+3.9%
DAC DONORS				
Total ODA to all developing countries	96.6	94.2	▼	-2.5%
ODA earmarked for FS** (allocations)	36.1	35.9	▼	-0.7%
ODA earmarked for other developing countries (allocations)	27.6	25.6	▼	-7.4%
ODA not allocated to any country	32.9	32.7	▼	-0.5%

Notes: *% change is adjusted for inflation and exchange rate movements in each case

**To ensure comparability, the calculations use the same list of countries for both years (Table 1.1).

Source: OECD IDS online databases on aid and other resource flows, available at www.oecd.org/dac/stats/idsonline.

This is the first decrease since 2000, the year when CPA was first measured. This fall came after bilateral aid to the same fragile states had more than doubled in real terms between 2000 and 2009. Aid to fragile least developed countries (LDCs) showed the greatest growth over this period. According to the OECD Forward Spending Survey, ODA growth looks to be slowing down for fragile states – including those which are LDCs (OECD, 2013). The largest future increases are expected to benefit mainly middle-income countries in the Far East and South and Central Asia, primarily China, India, Indonesia, Pakistan, Sri Lanka, Uzbekistan and Vietnam.

The poorest countries with the furthest to go to achieve the MDGs will see aid decline.

It is worrying that the poorest countries with the furthest to go to achieve the Millennium Development Goals are the ones which will see aid decline. With less than two years to go to the 2015 deadline set by the international development community to achieve the MDGs, this trend needs to be reversed if aid is to play its part in helping achieve them.

BOX 2.1 The shift from grants to loans brings losses to fragile LDCs

Like most other developing countries, fragile states receive the greatest part of their ODA in the form of grants. According to a recent OECD study, aid from the DAC to developing countries is made up of 70% grants and 30% concessional loans, while the grant share to fragile LDCs can be as high as 88% (and 68% in other fragile states). Over the past three years, however, DAC donors have reduced the share of grants and increased the share of loans in their aid portfolios. This is partly because current low interest rates make it easier to raise funds through the market. However, loans target mostly creditworthy middle-income countries (MICs). This is one reason why LDCs, including fragile ones, are expected to receive less aid in the future and MICs more. For fragile LDCs this trend is of particular concern, as their ability to attract other external flows is limited (OECD, forthcoming).

QUESTION 2

TABLE 2.2 Changing bilateral aid allocations to fragile states, 2011

Top 10 donors to fragile states and economies		ODA to fragile states and economies (USD million)	% change in ODA to all developing countries, 2010-2011		% change in ODA to fragile states and economies, 2010-2011	
1	United States	13 291	▼	-0.3	▲	+1.1
2	EU institutions	5 041	▲	+29.1	▼	-9.1
3	IDA	4 613	▼	-15.6	▼	-5.6
4	United Kingdom	3 804	▼	-0.8	▲	+16.4
5	Japan	3 150	▼	-12.2	▲	+8.8
6	France	2 935	▲	+2.5	▲	+3.1
7	Germany	2 573	▲	+2.7	▲	+11.5
8	Canada	1 359	▼	-2.6	▼	-24.3
9	AfDF	1 283	▲	+14.5	▲	+33.0
10	Australia	1 229	▲	+13.6	▲	+5.3

Notes IDA: International Development Association; AfDF: African Development Fund

Source: OECD International Development Statistics online databases on aid and other resource flows, available at www.oecd.org/dac/stats/idsonline. Figures represent outflows and do not include imputed multilateral aid.

What lies behind this trend? There are several factors. The first is that the continuing financial crisis and euro area turmoil have led several governments to tighten their budgets, including for development. The second is that a trend to favour loans over grants is driving a noticeable shift in aid allocations away from the poorest countries and towards middle-income countries (MICs, Box 2.1). The third is a tailing off in disaster relief related to some major disasters, such as the 2010 Haiti earthquake.

Three of the ten largest DAC donors to fragile states and economies – the EU institutions, the World Bank’s IDA and Canada – scaled back their allocations in 2010/11 (Table 2.2). EU institutions reduced their aid to Malawi, Sudan, Haiti, Egypt, DRC, and the West Bank and Gaza Strip.⁴ IDA reduced its loans to Nigeria, Uganda and Yemen, and also received loan repayments from Yemen. Canadian aid fell mainly because of a reduction in grants to Haiti, Afghanistan, Sudan, Niger and Sierra Leone.

Other donors, however, increased their aid to fragile states. The UK provided substantial grants to Ethiopia, Afghanistan, DRC, Bangladesh and Somalia. Germany increased its grants to the Republic of Congo, Kenya, Afghanistan, Egypt and Liberia. The African Development Fund (AfDF) stepped up its grants and loans to Côte d’Ivoire, and its loans to Ethiopia and Kenya.

BOX 2.2 Which are the “forgotten crises” among the fragile states?

The spotlight on some “mega crises” has overshadowed a number of “forgotten” emergencies. They have faded from the media and the public eye, and sometimes lack consistent international support in solving long-term problems. These countries receive comparatively little aid per capita (Annex A, Figure A.3).

Several organisations are making efforts to identify and draw attention to countries and economies that are potentially under-aided, and to crises that are forgotten: the OECD in its report on potentially under-aided countries (OECD, 2012); the Global Public Policy Institute (GPPI, 2013); ECHO in its Forgotten Crisis Assessment (ECHO, 2013); and OCHA with its support to underfunded emergencies through the Central Emergency Response Fund.⁵

Fragile states that figure most consistently on such lists are Bangladesh, Myanmar, Madagascar, Niger and Pakistan. These five countries alone are home to 430 million people. The Central African Republic, Chad, DPR Korea, Eritrea, Ethiopia, Guinea, Nepal, Sri Lanka, Somalia and Yemen are also highlighted in some of these frameworks as forgotten crises.

ODA TO FRAGILE STATES IS UNEVEN

More than half of ODA to fragile states in 2011 went to just seven recipients. Afghanistan tops the list with USD 6.7 billion, followed by DRC with USD 5.5 billion. The next five were Ethiopia, Pakistan, Kenya, West Bank and Gaza, and Iraq (Figure 2.1). This means that in 2011, 44 fragile states – including some of the poorest countries in the world – each received on average less than half a percentage of global ODA.

Average ODA per capita for fragile states stood at about USD 240, but levels differ by a factor of close to 1 000 across individual countries. They range from Tuvalu (USD 4 300 per person per year) at one extreme, to populous Bangladesh

Among the fragile states that receive the least aid per capita are some of the worst HDI performers, such as Bangladesh, Chad, Eritrea, Madagascar and Myanmar.

(USD 10), DPR Korea and Egypt at the other (USD 5). Small island states and territories – Tuvalu, the Marshall Islands, Micronesia, Kiribati and the Solomon Islands – receive the highest amounts per person along with West Bank and Gaza. Among those that receive the least aid per capita are some of the countries with the worst human development indicators, such as Bangladesh, Chad, Eritrea, Madagascar and Myanmar (Box 2.2 and Annex A Figure A.3).

QUESTION 2

NOTES

1. This total also includes aid that is not allocated to any specific country.
2. Providers of development co-operation that were not DAC members at the time the data was collected, but also reported to the OECD/DAC, include Bulgaria, Chinese Taipei, Cyprus*, the Czech Republic, Estonia, Hungary, Iceland, Israel, Kuwait, Latvia, Lichtenstein, Lithuania, Malta, Poland, Romania, Russia, Saudi Arabia, Slovak Republic, Slovenia, Thailand, Turkey, and the United Arab Emirates. (The Czech Republic, Iceland, Poland, Slovak Republic and Slovenia have since joined the DAC.) Aid from all providers also includes outflows from multilateral agencies.

* a. The information in this document with reference to "Cyprus" relates to the southern part of the Island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. Turkey recognises the Turkish Republic of Northern Cyprus (TRNC). Until a lasting and equitable solution is found within the context of the United Nations, Turkey shall preserve its position concerning the "Cyprus issue".

b. The Republic of Cyprus is recognised by all members of the United Nations with the exception of Turkey. The information in this document relates to the area under the effective control of the Government of the Republic of Cyprus.

3. 2012 data are not yet available at the time of writing.
4. While previous Fragile States Reports used ODA figures to track aid, this year's edition also uses the concept of country programmable aid (CPA), a subset of gross bilateral ODA, when aid is looked at as an "inflow" and compared with other such inflows like FDI. CPA tracks the proportion of ODA over which recipient countries have, or could have, significant say. It measures gross bilateral ODA but excludes activities that: (1) are inherently unpredictable (humanitarian aid and debt relief); (2) entail no cross-border flows (administrative costs, imputed student costs, promotion of development awareness, and costs related to research and refugees in donor countries); (3) do not form part of co-operation agreements between governments (food aid, aid from local governments, core funding to NGOs, ODA equity investments, aid through secondary agencies, and aid which is not allocable by country or region).
5. Economies in this and the next paragraph are listed in descending order of magnitude of aid volumes.
6. See the CERF webpage on Applying for Underfunded Emergencies Grants, www.unocha.org/cerf/resources/how-apply/underfunded-emergencies-0, accessed 17 November 2013.

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QUESTION 3

How aid-dependent are fragile states?



THE DOWNWARD TREND in aid to fragile states is worrying given that the poorest fragile states often depend on development assistance, which can constitute up to 55% of their GDP. Aid has become increasingly predictable and remained faithful to traditional sectors in fragile states. It is to a great extent delivered by multilateral agencies. ■

QUESTION 3

SEVERAL LEAST DEVELOPED FRAGILE STATES ARE HEAVILY DEPENDENT ON AID

Several fragile states are among the most aid-dependent countries in the world (measured as the ratio of CPA to gross national income). All are least developed countries, and in 2011 all but one of the top seven most aid-dependent countries were fragile states (Table 3.1). Aid is the largest inflow of external finance in least developed fragile states, ahead of remittances, as the following section will show. As they find it difficult to access other external resources such as foreign direct investment, aid remains the key resource for development in those countries (see Question 4).

TABLE 3.1 The world's most aid-dependent countries, 2007 and 2011

Country		Rank 2011	Rank 2007	CPA / GNI 2011
Tuvalu	●	1	4	55.6%
Solomon Islands	●	2	2	44.7%
Afghanistan	●	3	3	31.1%
Liberia	●	4	1	30.1%
Sao Tome and Principe	■	5	8	25.1%
Kiribati	●	6	13	24.7%
Burundi	●	7	5	20.4%
Tonga	■	8	21	19.2%
Rwanda	■	9	9	18.7%
Sierra Leone	●	10	10	16.4%
Samoa	■	11	25	16.0%
Gambia	■	12	12	15.3%
Mozambique	■	13	6	14.4%
Haiti	●	14	28	13.4%
Malawi	●	15	7	13.4%
Cape Verde	■	16	19	13.0%
Mali	●	17	18	12.1%
Congo DR	●	18	38	11.6%
Vanuatu	■	19	16	11.5%
Guinea-Bissau	●	20	11	10.8%

● Fragile state or economy ■ Other developing economies

Source: OECD International Development Statistics online databases on aid and other resource flows, available at www.oecd.org/dac/stats/idsonline.

ODA TO FRAGILE STATES HAS BECOME MORE STABLE

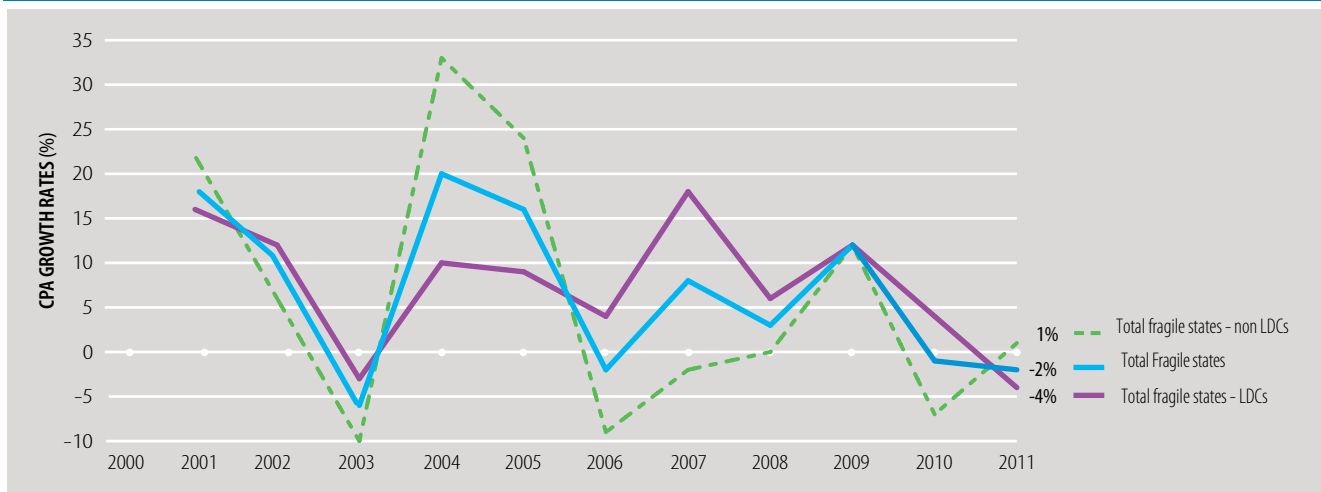
Aid to fragile states has become less volatile over the past decade. Aid – measured in terms of country programmable aid – has been most reliable to fragile LDCs, where fluctuations averaged between -4% and +18% (Figure 3.1, for country-specific data, see Table A.4 in Annex A). In non-LDC fragile states, fluctuations tended to be higher: between -10% and 33%. But for both country groups, fluctuations have flattened over time. This seems to mark a positive trend, as predictable aid is more useful for planning.

Aid to fragile states is becoming more predictable.

ODA REMAINS FAITHFUL TO TRADITIONAL SECTORS

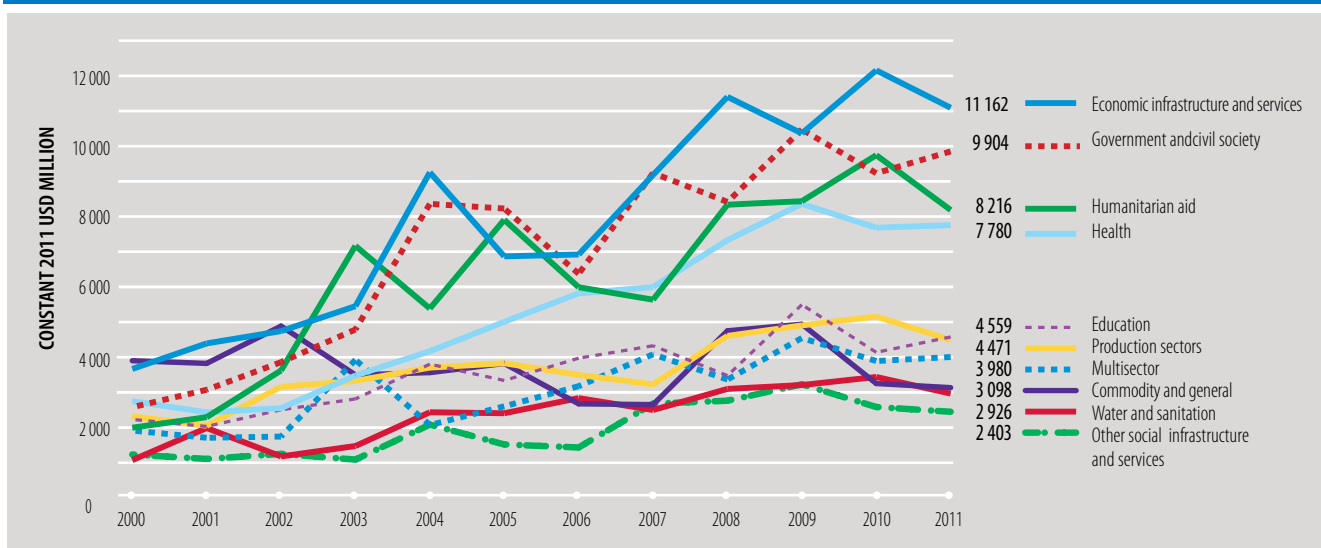
A new development framework is being debated in the run-up to 2015, the target date for the Millennium Development Goals. Some fear that the new framework might see donors start to divert aid away from traditional sectors such as health and education towards investments in peace, security, rule of law and governance. However, trends in fragile states where peace and security needs are highest show no evidence of such a shift. Countries that have seen their share of funding in these sectors increase drastically, such as Afghanistan, remain exceptions. On average, ODA distribution across sectors has stayed much the same over the last decade. Every year since 2008, the economic infrastructure and services sector in fragile states has attracted the largest share of ODA (Figure 3.2). The government and civil society sector – which includes support to conflict prevention and resolution – received the second highest share, followed by humanitarian aid and then health. The share of ODA spent on health and education has remained stable. In short, there is no evidence that ODA is moving away from traditional development areas towards security-related expenditure in fragile states.

FIGURE 3.1 Aid to fragile states is becoming less volatile
(CPA growth rates from previous year, all donors)



Source: OECD International Development Statistics online databases on aid and other resource flows, available at www.oecd.org/dac/stats/idsonline.

FIGURE 3.2 Which sectors get the most ODA in fragile states?
(Commitments, bi-annual average, 2011 prices)



Source: OECD International Development Statistics online databases on aid and other resource flows, available at www.oecd.org/dac/stats/idsonline.

GENDER EQUALITY IN FRAGILE STATES IS A FOCUS FOR SUPPORT TO THE SECURITY SECTOR

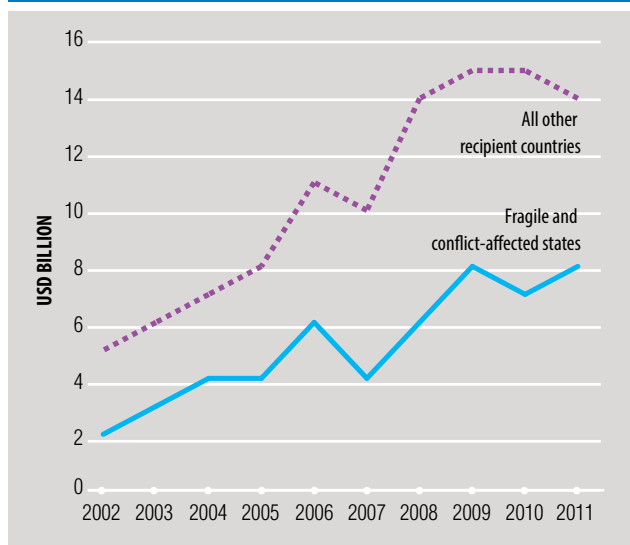
To build peaceful and effective states, women must be included and their specific experiences and priorities taken into account. Yet DAC donors do not appear to target gender equality more in fragile states than in other developing countries. Over the past decade, aid for gender equality grew at the same pace in fragile countries as in other countries (Figure 3.3). Donor support to the security sector in fragile

states, however, shows an increasing focus on gender equality (Figure 3.4). This is in line with the assertion made by 17 DAC institutions in a recent survey that “women, peace and security” are key policy priorities.²

Building peaceful and effective states, however, requires the full participation of women at every stage of the process. This means seizing opportunities to support gender equality across the board, not just in the security sector. The OECD INCAF policy paper on *Gender and*

QUESTION 3

FIGURE 3.3 Total gender-focused aid
(Total sector allocable aid, commitments, bi-annual average, 2011 prices)



Source: OECD (IDS)

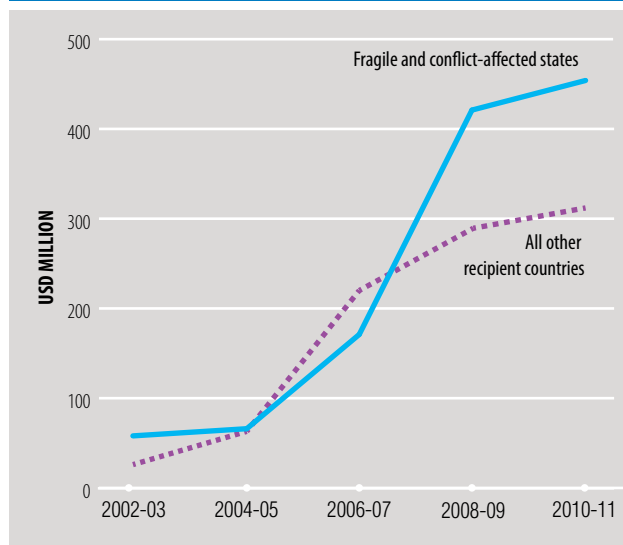
Statebuilding in Fragile and Conflict-Affected States (OECD, 2013b) provides guidance on how to achieve this goal. It argues for a more politically informed approach in the post-2015 framework for development – one that is more realistic about how long change takes and recognises that women’s ability to participate in statebuilding depends on wider issues of power. Among its concrete recommendations are to take steps to build the evidence base on gender-sensitive statebuilding; integrate a gender perspective into New Deal pilots and the post-2015 framework; and make use of international fora, such as the INCAF and the International Dialogue on Peacebuilding and Statebuilding, for exchanging innovative practices.

MULTILATERAL AGENCIES PLAY AN IMPORTANT ROLE IN FRAGILE STATES

In fragile states, 50% of ODA is channelled through multilateral organisations, compared to 37% in other developing countries. In 2011, 83% of DAC members’ non-core aid to multilateral organisations was earmarked for conflict-affected low-income countries (OECD, 2012a).¹

While the share of aid delivered by multilaterals has remained relatively stable over the last five years, there does appear to be a correlation between a country’s fragility and the share

FIGURE 3.4 Gender-focused aid in the peace and security sector
(Commitments, bi-annual average, 2011 prices)



Source: OECD (IDS)

of aid it receives multilaterally. Libya, for instance, which has become markedly more unstable since its 2011 revolution, saw its multilaterally delivered aid jump from 69% in 2010 to 91% in 2011. A similar, if slightly less drastic, change can be seen in the Central African Republic, Chad and North Korea. Inversely, countries which have become more stable have seen their bilateral share grow and their multilateral share shrink. In Liberia multilaterally delivered aid fell from 85% in 2007 to 57% in 2011. The only exceptions are fragile small island states – the Marshall Islands, Micronesia and the Solomon Islands. In those countries aid is delivered almost exclusively through bilateral agencies. Only 1% of aid is delivered multilaterally in the Marshall Islands, 5% in Micronesia and 16% in the Solomon Islands.

Why are multilateral agencies used more in fragile contexts? One explanation may be that bilateral donors who lack a presence or specific expertise in fragile states may prefer financing multilateral organisations to working in fragile contexts. Multilateral agencies can channel large sums of money and achieve economies of scale; they may benefit from greater political neutrality and legitimacy in the host country; and they can draw on abundant capital and expertise (OECD, 2012b).

NOTES

1. This type of earmarked ODA is also called multi-bi aid.
2. Source: unpublished survey among DAC members conducted by the OECD in early 2013.

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QUESTION 4

What are the other external sources of finance for fragile states?



WHILE AID IS ONLY ONE SOURCE of finance for fragile states, it remains an important one. In fragile LDCs, it is the largest inflow; several fragile states depend heavily upon it. In fragile middle-income countries, remittances and foreign direct investment have outpaced aid as a source of development finance. Yet these flows have their own shortcomings and are unreliable resources for development. Fragile LDCs have little access to FDI, and investment is volatile. There are opportunities to harness remittances, a largely untapped resource for fragile states, as a source of development. ■

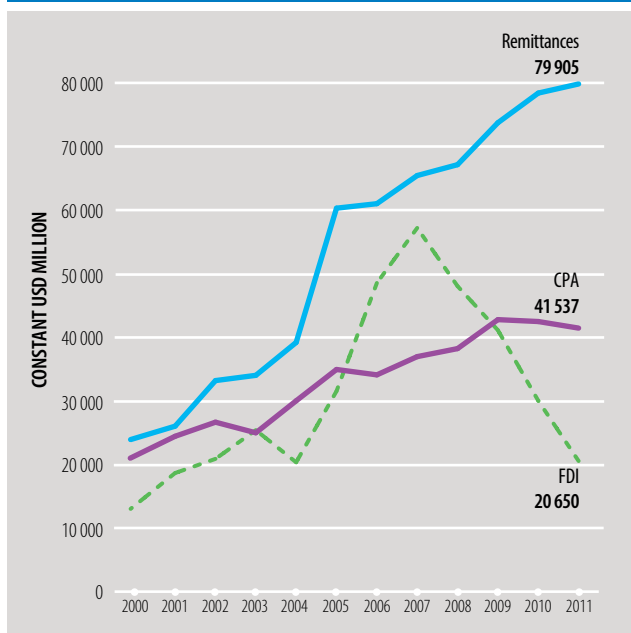
QUESTION 4

REMITTANCES HAVE OUTPACED AID IN FRAGILE STATES AS A GROUP

Aid is only one part of a bigger picture. Figures for other key sources of finance for all fragile states show that, in total, remittances from overseas migrants outpace aid (Figure 4.1). Remittances overtook aid in 2004 to become the largest

inflow. In 2011 they reached 56% of all inflows to fragile states, nearly double the share of country programmable aid, which accounted for 29%. At 15%, foreign direct investment still represents a small part of inflows to fragile states; investment has yet to recover from the financial and economic crisis.¹ These three are the largest inflows. Others – including bonds, export credits, securities and private grants – are not included but represent a comparatively smaller share of external resources. All these inflows complement domestic revenue, which has grown slowly but steadily.

FIGURE 4.1 The major inflows in fragile states: remittances, aid and foreign direct investment
(in constant 2011 USD million)



Source: Compiled from OECD CPA data, FDI data from IMF through eLibrary, <http://elibrary-data.imf.org/>, and Remittances from World Development Indicators, <http://data.worldbank.org/data-catalog/world-development-indicators>.

This picture contrasts with that of non-fragile developing countries, where foreign direct investment accounts for the lion's share – 67% – of inflows. Remittances account for 28% of inflows, and aid for only 5%. Figure 4.2 compares the mixture of aid, remittances and FDI in fragile LDCs with that in fragile non-LDCs. It also shows the respective weight of those three flows in developing countries' financing portfolio as a whole.

AID IS THE LARGEST INFLOW IN FRAGILE LDCS

For low-income fragile states aid continues to be important. A snapshot of 2011 data shows that in fragile LDCs aid accounts for 45% of development finance and remains the

At 45%, aid remains the largest source of external financing for fragile LDCs.

largest inflow, closely followed by remittances at 42%. Fragile LDCs have little access to foreign direct investment, which represents 13% of inflows. ODA inflows to fragile

LDCs were more stable than other external financial flows between 2000 and 2011. What is more, aid flows increased when other external financial flows fell steeply. This means that in fragile LDCs aid is possibly helping to fill the gap.

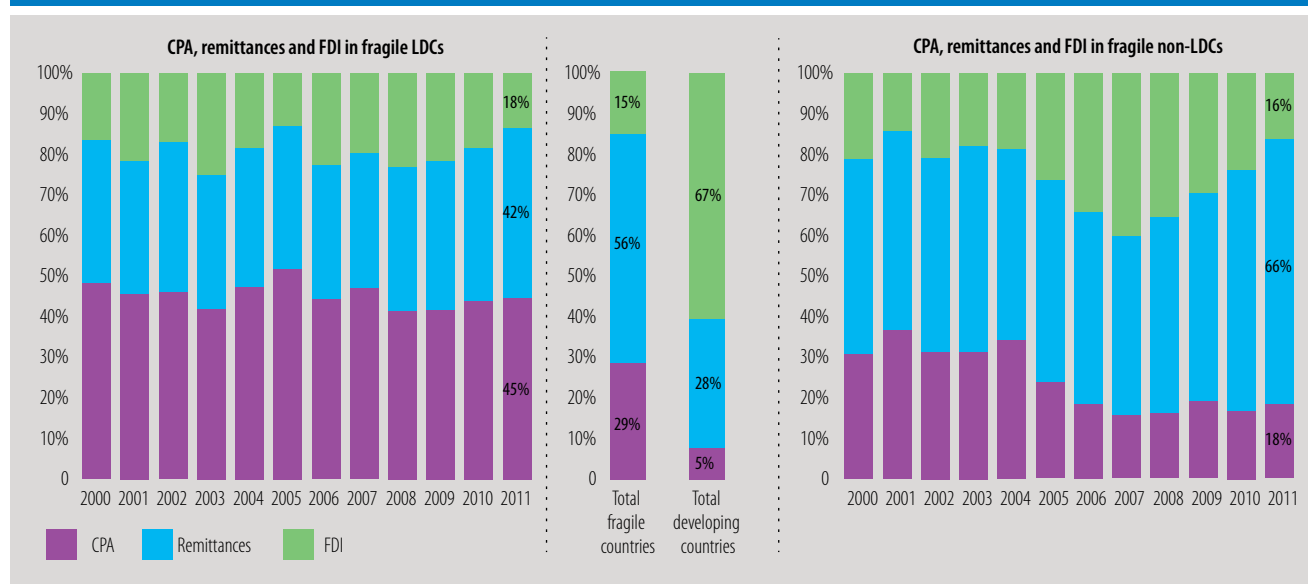
At 18%, aid is the second largest inflow in fragile middle-income countries after remittances.

In other, non-LDC fragile states, remittances account for 66% of inflows, followed by aid (18%) and foreign direct investment (16%).

FDI, REMITTANCES AND TRADE HAVE THEIR SHORTCOMINGS AS SOURCES OF DEVELOPMENT FINANCE

Each of the flows examined in this report has different characteristics. Aid is an official flow, FDI is a private sector flow, while remittances count towards household income. Trade adds to the picture by indicating the balance between exports and imports. Each of these flows has its advantages, but also its shortcomings, as resources for development.

Net FDI inflows in fragile states have followed a continuous downward slide since the start of the global economic crisis. They are volatile and extremely unequally distributed,

FIGURE 4.2 Aid inflows dominate in fragile LDCs; remittances in fragile non-LDCs


Note: CPA: country programmable aid; FDI: foreign direct investment

Source: Compiled from OECD CPA data, FDI data from IMF through eLibrary, <http://elibrary-data.imf.org/>, and Remittances from World Development Indicators, <http://data.worldbank.org/data-catalog/world-development-indicators>.

TABLE 4.1 FDI is unevenly distributed
 (net inflows, 2007-2011 average, in USD billion and distribution)

Rank	Fragile States	FDI average 2007-2011	In % of FDI to all fragile states
1	Nigeria	7 535	19%
2	Egypt	6 737	17%
3	Sudan*	3 864	10%
4	Pakistan	3 339	9%
5	Congo, Rep.	2 638	7%
6	Libya	2 431	6%
7	Iraq	1 581	4%
8	Congo, Dem. Rep.*	1 516	4%
9	Syria	1 349	3%
10	Myanmar*	911	2%

* denotes LDCs

Source: IMF

both among countries and among sectors. Almost half of all FDI to fragile states goes to just three countries: Nigeria, Egypt and Sudan (Table 4.1). It benefits mostly resource-rich middle-income countries; the only low-income countries among the top ten recipients are Sudan, DRC and Myanmar. This implies that for most fragile states, especially African countries that are not resource-rich, FDI is simply not part of the resource equation. FDI is also unevenly spread among sectors in fragile states. It is concentrated in the extractive industries (oil, gas and mining) and in mobile telecommunications, reflecting and fostering impressive uptakes in cell phone penetration and use in these countries.

Trade balances have rebounded since their 2009 historical low, but remain negative for most fragile states with the exception of Iraq, Nigeria and Angola, which are rich in non-renewable natural resources. Long-term trade deficits typically represent borrowing to finance current consumption rather than long-term investment. It is therefore questionable whether net flows resulting from trade can be a resource for development.

QUESTION 4

The extent to which **remittances** contribute to development is not clear. Remittances do constitute an important source of finance for many developing countries because of their countercyclical nature. They increase during downturns in the recipient economy, unlike capital flows such as FDI, and so play an important role in mitigating economic shocks. Yet their current development impact is disputed. Remittances are often spent on meeting the daily needs of families, including health care and education, and to a lesser extent on construction and productive investment. A study of Egypt showed that about 80% of remittances went into essential expenses and consumption and the remaining 20% was invested in small businesses, agriculture and the stock market (IOM, 2010). In addition, remittances disproportionately benefit citizens in middle-income countries, especially those with large populations. Those countries tend to receive much larger amounts per capita than low-income fragile states (Figure 4.3).

The decline of aid to fragile states, combined with the need to fight poverty, make it urgent to mobilise other resources for development. Remittances could be a resource with great potential for fragile states.

REMITTANCES COULD BE PUT TO WORK FOR DEVELOPMENT

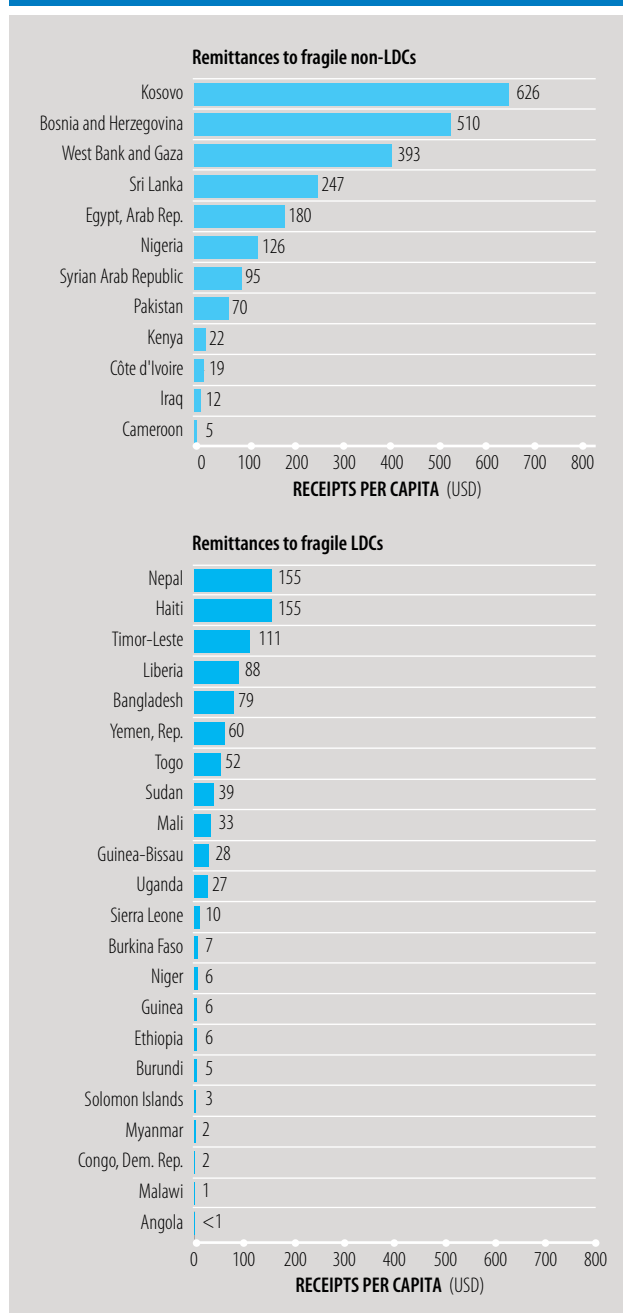
Remittances sent by migrants are a major financial resource for many fragile states and other developing countries. In 2011 remittances worldwide amounted to around USD 480 billion. Remittances to developing countries³ were USD 343 billion; fragile states alone received USD 85 billion.⁴ The true magnitude of remittances, including unrecorded flows through informal channels, is believed to be even greater.

Could remittances fill the gap in fragile LDCs if aid becomes more scarce? Perhaps, since they represent a large part of external finance and are on the rise (see above). Yet among

There is great potential to use remittances to finance development in fragile states, even in LDCs.

the least developed fragile countries, only Nepal, Haiti, Liberia and Bangladesh currently receive significant amounts (from USD 80 to USD 150 per capita per year).

FIGURE 4.3 Remittances benefit mainly middle-income countries
(per capita annual remittances, 2011)



Source: World Development Indicators, drawing on IMF figures. These figures include flows from OECD and non-OECD countries.

Meanwhile citizens in countries such as Malawi, DRC, Myanmar or Burundi receive on average fewer than USD 5 in remittances. One explanation for this may be that their émigrés are mainly low-skilled workers with small salaries. But it is also probable that considerable amounts of remittances are sent through informal channels and go unreported. Therefore, it is assumed that there is great potential to use remittances to finance development in fragile countries, even in LDCs.

How can remittances become a source for development?

Over the last decade several countries have taken steps to offset the negative effects on growth and fiscal revenue incurred when workers emigrate. They have tapped into remittances as an additional source of state revenue. The main debate today is around whether to facilitate, leverage and complement them, or whether to tax them.

■ **Facilitating financial inclusion:** The development community can play an important role by making financial services for remittances cheaper and easier to access, both for sending and receiving countries. This means improving access to formal financial services such as banks, money transfer companies, saving banks, credit unions and microfinance institutions, even in rural areas, so that recipients do not have to rely on intermediaries. The G8 in 2009, followed by the G20 in 2011, pledged to reduce the global average costs of transferring remittances from 10% to 5% by 2014.

■ **Leveraging remittances for capital market access of financial institutions or countries.** Some banks “securitise” future remittance receipts, i.e. they transform them into securities to raise financing for infrastructure and development projects. Leveraging their future remittance receipts allows them to raise lower-cost and longer-term financing in international capital markets. Brazil, Jamaica, Kazakhstan, Mexico, Peru and Turkey are among the countries that have such schemes. The United States has struck an agreement to assist Ecuador and Honduras to securitise remittances under the Building Remittance Investment for Development Growth and Entrepreneurship (BRIDGE) initiative (Mohapatra, 2010a).

■ **Subsidising or matching remittances.** A number of governments, including Mexico and Albania, provide matching funds for remittance-backed projects. Several aid agencies support hometown associations to promote community financing of infrastructure. For example, Switzerland has pooled aid with remittances from Albanian emigrants and with budgetary resources from the Albanian government to finance public service investments in communes (OECD, 2009).

■ **Taxing remittances.** Several countries are currently looking into taxing remittances. Some already have hidden taxes by imposing overvalued official exchange rates for such transfers (Cuba, for instance, levied a 10% penalty exchange fee from 2006 to 2010). However, most experts today advise against a tax on remittances as it could affect recipient countries negatively in several ways. Such a tax would be additional to any income and sales taxes emigrants already pay in their host country. It would lessen their incentive to send remittances home or could drive these flows underground. A shift to informal channels could also hurt efforts to achieve financial inclusion of migrants and their dependents and to leverage remittances (Mohapatra, 2010b). Besides, such taxes are difficult to impose and require extensive information sharing among governments.

Many of the current efforts to facilitate, leverage or subsidise remittances are taking place in non-fragile middle-income countries and target skilled emigrants. Yet many fragile

There are also powerful arguments for donors to strengthen the development impact of remittances in low-income fragile states.

middle-income countries would benefit greatly from applying some of the same tools. There are also powerful arguments for donors to strengthen the development impact of remittances in low-income fragile states. For instance, evidence suggests that remittances from unskilled workers tend to reduce inequality, while remittances from skilled workers tend to exacerbate income divides (Portes, 2009; Wilson, 2012).

QUESTION 4

DAC members are currently exploring ways to facilitate monitoring of the G20 commitment to reduce the cost of remittance services and to improve the tracking of donors' efforts in support of remittances. To date, project data in the Creditor Reporting System of the OECD show that between 2006 and 2011, more than USD 400 million were committed to this purpose (including statistical capacity building and awareness campaigns). The top recipients were Iraq, Afghanistan, Bangladesh and Haiti; the top donors were the US, United Kingdom, Spain, and the Bill and Melinda Gates Foundation (OECD, 2013).

INCOME FROM PROVIDING PEACEKEEPING TROOPS: A GROWING SOURCE

Although this Fragile States Report does not look into non-aid inflows related to the security sector, it is important to mention that the provision of peacekeepers by fragile states is on the increase. The contribution of troops is becoming a *de facto* source of income and the attendant implications need to be considered (Box 4.1).

In conclusion, all the sources of development finance to which fragile states have access have drawbacks. Aid is on the decline, foreign direct investment is not easily accessible

All the sources of development finance accessible to fragile states have their weaknesses. The most promising source is domestic revenue.

and has been volatile, remittances remain a largely untapped resource, and the provision of peacekeeping troops offers a relatively small income. There may be other opportunities to access additional financial inflows and turn them into sources of development. But will these suffice to fill the gap in development finance? The most promising and sustainable source is domestic revenue, as the next question will explore.

BOX 4.1 The provision of peacekeeping troops – a growing source of income

With the establishment of a new UN peacekeeping mission in Mali and an expanded force in the DRC, there will soon be more UN peacekeepers deployed around the world than ever before. Potential future missions in Syria, Somalia or the Central African Republic – all of which are considered fragile states – would accentuate this trend. The International Peace Institute (IPI) recently compiled the IPI Peacekeeping Database whose purpose is to facilitate and improve the monitoring and analysis of both trends and patterns in the provision of resources for peacekeeping, such as troops, police and funding. This publically available dataset has particular relevance to fragile states. The data confirm that many fragile states, even ones recently emerging from conflict, have increasingly acted as providers of peacekeepers to neighbouring fragile states. For example, Burundi, Chad, Côte d'Ivoire, DRC, Sierra Leone and Timor-Leste are all current peacekeeping contributors. In January 2013, 27 fragile states were providing a total of 43 806 UN peacekeepers. Ten years earlier, only 16 of those 27 states provided peacekeepers. For many fragile states, providing peacekeepers can serve as a significant source of income. For instance, a country contributing 100 troops for one year would receive at least USD 1.3 million in reimbursement from the UN, not including extra allowances for specialists or equipment. The provision of such security personnel – from fragile state to fragile state – has both geopolitical and financial implications for fragile states that should receive greater attention in coming years.

Source: Personal communication, Adam C. Smith, International Peace Institute. For the Annual Review of Global Peace Operations, see <http://cic.nyu.edu/content/annual-review-global-peace-operations-2012-0>

NOTES

1. Some of the decline in FDI shown in Figure 4.1 is also due to missing data in several fragile states in 2010 and/or 2011.
2. Afghanistan, for example, received over USD 1.5 billion in FDI in the sector between 2000 and 2011 (Kenny, 2013).
3. This reflects the DAC list of ODA eligible countries.
4. According to the World Bank's World Development Indicators.

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QUESTION 5

Why do fragile states need to mobilise their own revenue?



MOBILISING DOMESTIC REVENUE has great potential for development. It is a crucial avenue to finance human development and recovery and an eventual exit from aid dependency. Moreover, reinforcing the tax system in order to raise this revenue is central to strengthening the state and fostering good governance. A transparent and efficient tax system simultaneously bolsters intra-societal relationships and the relationship between citizens and the state. Mobilising revenue in fragile states is a key element of a functioning civil service and a robust state-society relation. It should be seen as a vital process whose positive side effects for society and stability are at least as important as the financial outcome itself. ■

QUESTION 5

Since the Monterrey Consensus in 2002¹ there has been growing recognition of the importance of mobilising domestic resources for development, a process generally defined as

Donors have made a strong political commitment to helping partner countries raise revenue - in Monterrey, Busan and at the G20.

“the generation of savings from domestic resources and their allocation to socially productive investments” (Culpeper, 2008).²

The New Deal for Engagement in Fragile States lists “to manage revenue and build capacity for accountable and

fair service delivery” as one of the five Peacebuilding and Statebuilding Goals (International Dialogue on Peacebuilding and Statebuilding, 2011). Most recently world leaders at the G20 in St. Petersburg emphasised that “developing countries should be able to reap the benefits of a more transparent international tax system, and to enhance their revenue capacity, as mobilising domestic resources is critical to financing development.”³ Why is this so critical?

■ To finance human development and recovery

As recognised in the New Deal, accountable and fair service delivery is a crucial foundation for progress in fragile states (Annex B, Figure B.1). The claim that governments should be able to cover expenditures that spur and sustain human development is not new (Musgrave, 1959; Roy *et al.*, 2007). For fragile states, though, it is especially relevant, given that they are further away from achieving the MDGs than other developing countries (Question 1). Fragile states may also see a further decline in aid (Question 2) and can rely little on other types of development finance (Questions 3 and 4). The UN estimates that a 20% tax-to-GDP ratio is necessary to achieve the MDGs (UNDP, 2010), and it is generally accepted that ensuring basic public service provision requires a revenue-to-GDP ratio of at least 15% (OECD, 2012). Countries emerging from conflict may have an even greater need (Boyce, 2008).

■ To reduce dependence on aid

For many fragile states, generating domestic revenue will pave the way for an eventual exit from aid dependency. Today, seven out of the ten most aid-dependent countries are fragile and suffer particularly from the volatility and uncertainty of external finance. Given that aid to fragile states dropped for the second year in a row in 2012, and given the projected impact of the fiscal crisis and euro area turmoil (Question 3), a stable domestic resource base is becoming increasingly important.

■ To build a contract between state and people

Being more fiscally reliant is not only an economic or budgetary issue. Resource mobilisation through taxation is one of the key elements of a functioning civil service. It forms the basis of bargaining between citizens and political leaders over their mutual duties and obligations. Through taxation, the population has a stake in supporting the state, and the state has

an interest in being responsive because it relies on taxation to raise the revenues it needs to function and survive (OECD, 2011). In other words, “[t]axation is the main nexus that binds state officials with interest groups and citizens” (Di John, 2010). Where a visibly positive link between taxation

The ability to generate their own income gives “a sense of increased pride and ownership to the people in the country for their own development investments.”

*H.E. Ngozi Okonjo-Iweala,
Finance Minister of Nigeria*

and service delivery is missing, state legitimacy is likely to suffer (OECD, 2008; Clements, 2008). Rwanda and Burundi illustrate these deeper implications of revenue mobilisation well. By drawing clear links between paying taxes and public benefits, Rwanda’s One Cow per Poor Family Programme, funded partly through taxes, has helped to overcome people’s reluctance to pay taxes and is building a sense of communal responsibility (Box 5.1).⁴ In Burundi, higher tax revenues allowed the country to build its first hospital and to plan the construction of a 10-megawatt hydroelectric dam (Chonghaile, 2012) – both public services that benefit society at large, rather than a small minority.

BOX 5.1 Rwanda's one cow per poor family programme: how taxes provide state resources to invest in development

The Rwanda Revenue Authority (RRA) was established in 1997 as a semi-autonomous agency to rebuild revenue-collecting capacity in the aftermath of the devastating genocide of 1994. Under the slogan "Taxes for Growth and Development," the RRA undertook a series of initiatives to inform and engage Rwandans on the importance of taxes for national development. The authority highlighted the government's development-related investments to show how taxes provide the resources for public services and infrastructure that benefit the public. One of the most visible efforts was Rwanda's One Cow per Poor Family Programme. Through this programme the government has used tax revenues to distribute more than 130 000 dairy cows to the rural poor since 2006. The cow not only supplies milk – an important source of nutrition and income – but also manure, which serves as a fertiliser and as biogas for cooking. The first female calf is given to a neighbour. A forthcoming comparative study by an academic team commissioned by the European Union supports the hypothesis that the credibility of Rwanda's commitment to spending on development is helping to overcome potential reluctance on the part of citizens to pay taxes (Garcimartin *et al.*, forthcoming).

Source: UNICEF (2012); OECD/EUROsociAL (forthcoming 2013).

■ To strengthen the state

The ability of the state to monopolise the collection of taxes is essential to establish government presence and legitimacy, in particular in new or re-emerging states, and improves their resilience. Reforms in tax and revenue administration have been shown to catalyse reforms in other public sector institutions. They create capacity and tools, such as digital property databases, that benefit other state activities, such as civil registration, land registration or urban planning (Fjeldstad and Moore, 2007). Tax collection capacity is "a useful (but neglected) indicator of state performance and provides important clues as to where polities lie on the spectrum between fragility and resilience" (Di John, 2010).

One issue rarely mentioned in much of the policy discourse and literature on taxation is informal and local level taxation. Yet informal payments, protection rackets, violence, and local-level coercion often rival formal tax systems and are among the key issues that distinguish fragile states from other developing countries (see Box 5.2).

Outside of the formal, national-level taxation systems and policies, people often have to pay simply to engage in trade and business, travel, educate their children, and get health care. In eastern DRC, an unpublished Oxfam report in 2009 looked at such informal taxes in palm oil production.⁵ For every 20-litre bottle (which could be sold for around USD 10) state actors took seven litres and USD 0.12, the military took seven litres and USD 0.25; USD 10 a year had to be paid

to access the trees, and a tax was levied on the machine to extract the oil. In Nepal, farmers wanting to transport milk and vegetables to urban markets have to pay taxes to different levels of local government such as municipalities, village development and district development committees – and they often must make multiple payments whenever they cross administrative boundaries.

Whether these payments are legal or illegal, or corrupt or not, it is important to develop a better understanding of these local level and informal processes and their relationship to

States may be raising more revenue at the local level than official statistics show. It is necessary to appreciate the existing social contracts before assuming that new forms of formal taxation will build stronger state-citizen contracts.

formal taxation. Without it, debates about how to mobilise greater domestic revenue miss an important part of the picture. States may already be raising much more revenue at the local level than official statistics and calculations of tax-to-GDP ratios show. Simply adding higher levels of formal taxation risks not only overburdening individual livelihoods and businesses. It may also undermine prospects for growth. It is necessary to appreciate the existing social contracts between citizens and local governance (both formal and informal) before assuming that new forms of formal taxation will necessarily build stronger social contracts between a state and its citizens (Lough *et al.*, 2013).

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QUESTION 5

■ To strengthen intra-society relationships

Domestic revenue mobilisation is not only relevant for the relationships between the state and its citizens, but also for intra-society relationships and dynamics. Empirical studies have shown that in countries with high taxation, economic resources are distributed more equally, leading to greater social cohesion (Haldenwang, 2008). These countries also had much greater success in achieving gender equality, and citizens were more likely to have a higher degree of trust in one another (Brooks and Hwong, 2006).

For the reasons mentioned above, the process, rather than the volume of domestic revenue raised, should be seen as the end in itself. Making a tax system more just, fair, accountable and

The process of raising domestic revenue, rather than the volume raised, should be seen as the end in itself.

responsive addresses some of the root causes of fragility and can contribute to greater societal resilience. The OECD report *Citizen-State Relations: Improving Governance through Tax Reform* has looked in detail at the statebuilding role of taxation and how taxation can become a catalyst for more responsive and accountable governments (OECD, 2010).

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BOX 5.2 Rival tax collection in the DRC

Despite years of reconstruction efforts, parts of the eastern provinces of the Democratic Republic of the Congo until recently remained under the control of national and foreign non-state armed groups. According to the latest report by the UN Group of Experts on the DRC, armed groups and brigades of the Congolese army (FARDC) continued to control important mining sites and the main trading routes in the North and South Kivu provinces. They imposed illegal tax systems as their key source of revenue. Local rebel groups such as the M23 movement – which signed a peace agreement with the DRC Government in Nairobi in December 2013 – and the Mai Mai Sheka, were reported to illegally tax nearly 100 mining sites in Walikale territory and to levy taxes in North Kivu at checkpoints near the Rwandan border. The M23 had reportedly been taxing commercial trucks between USD 200 and USD 1 000 each, which added up to an average monthly income of USD 180 000. Failure to pay resulted in attacks on diggers' homes and families. This illegal taxation was eroding state authority in mine sites and fuelling conflict (Global Witness, 2013). The surrender of the M23 has meant that such coercive informal tax payments in the territory previously occupied by the rebel group have been suspended. Yet the fragile condition of the Congolese security sector remains among the greatest obstacles to extending the reach of the state.

Source: UN Security Council (2013); Global Witness (2013).

NOTES

1. The Monterrey Consensus was the outcome of the 2002 United Nations International Conference on Financing for Development in Monterrey, Mexico. The document embraces six areas of financing for development, the first of which is mobilising domestic financial resources for development. The commitments of the Monterrey Consensus were reiterated at the Doha Financing for Development Conference in 2008.
2. What is the difference between domestic revenue and domestic resources? Much of the literature and debates actually focus on a subset of domestic resources, namely public sector revenues, although the distinction is not always clearly made. “Revenue” includes state income that stems mainly from taxes and tariffs, while “resources” can include natural resources, personnel and other assets. In this report, the term “domestic revenue” (or simply “revenue”) is consistently used to refer to public sector revenues.
3. G20 leaders’ declaration, Saint Petersburg Summit, 5-6 September 2013, paragraph 54, available at www.g20.org/news/20130906/782776427.html.
4. The example of Rwanda was chosen for Box 5.1 and Question 8 even though the country is not on this year’s list of Fragile States, since it provides a positive illustration of these issues.
5. See [http://www.securelivelihoods.org/blogpost/31/taxed-to-death-\(really\)](http://www.securelivelihoods.org/blogpost/31/taxed-to-death-(really)) and Oxfam (2009, unpublished).

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QUESTION 6

How are fragile states doing at raising their own revenue?



REVENUE AND TAX-TO-GDP RATIOS in fragile states remain well below the 20% target set by the international community. Also, many of them rely on only one or two types of resources, rather than on a diverse and balanced mix. Grants and trade tax are typically the most important sources of domestic income, while direct tax – with the greatest potential for statebuilding – plays a smaller role. ■

QUESTION 6

DOMESTIC REVENUE IS INSUFFICIENT TO SUPPORT DEVELOPMENT

Fragile states should raise more domestic revenue to fuel development and reduce their reliance on external sources of finance. With an average tax-to-GDP ratio of less than

According to the UN, countries need to raise at least 20% of their GDP through taxes to achieve the MDGs – but only two fragile states reach this target.

14% in 2011, their capacity to mobilise revenue stands in stark contrast to other developing countries, where the average was 17%, and to OECD countries, with an average of 34%. It is also below the minimum targets mentioned in Question 5 to supply basic services (15%) or reach the MDGs (20%).

As of 2011, only two of the 14 fragile states for which data are available – Bosnia and Herzegovina and Kenya – were raising 20% of their GDP through taxes. Only five were meeting the 15% minimum target (Table 6.1).

TABLE 6.1 Tax and revenue to GDP ratio in fragile states, 2011

	Tax revenue as % of GDP	Revenue as % of GDP (excluding grants)
Bosnia and Herzegovina	20.7%	39.7%
Kenya	19.9%	20.7%
Liberia	17.4%	21.6%
Togo	16.8%	18.2%
Uganda	16.1%	16.4%
Burkina Faso	14.2%	16.2%
Egypt, Arab Republic	14.0%	22.0%
Nepal	13.2%	14.8%
Sri Lanka	12.4%	14.3%
Sierra Leone	10.9%	11.4%
Bangladesh	10.0%	12.0%
Ethiopia	9.4%	11.1%
Pakistan	9.2%	12.2%
Afghanistan	8.6%	11.4%
Average	13.8%	17.3%

Source: World Development Indicators, available at <http://databank.worldbank.org>

SOME FRAGILE STATES ARE MAKING PROGRESS

In fragile states on average, shares of domestic revenue and tax in GDP have grown by 6% annually since 2007,¹ while revenue generation in non-fragile countries fell 1% over the same period (for both indicators). Uganda, Niger and Mali have made especially impressive progress. Their ratio of direct taxes to GDP has grown at an annual compound rate of more than 7% since 2000. In the Democratic Republic of Congo and Comoros indirect taxes as a share of GDP have grown by more than 10% a year (AfDB/OECD/UNDP/ECA, 2013). In Burundi tax revenue is reported to have grown from BIF 300 billion (USD 240 million) in 2009 to BIF 545 billion in 2012 (USD 430 million) and is expected to climb to BIF 1.2 trillion (around USD 770 million) by 2017 (McGregor, 2012).

FRAGILE STATES TEND TO RELY ON A FEW REVENUE SOURCES

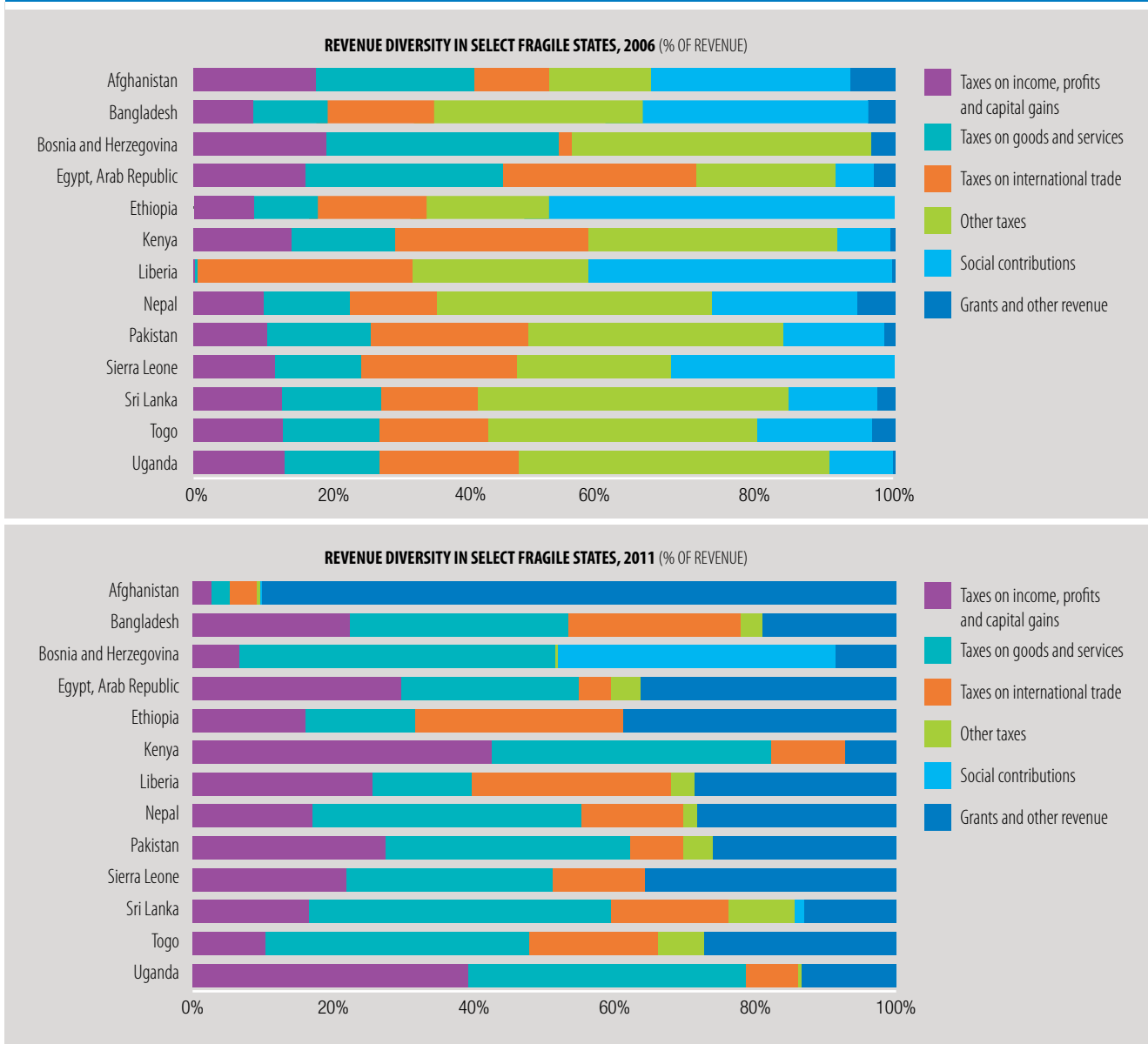
State revenues are usually divided into three major groups: taxes,² social contributions,³ and grants and other revenues,⁴ which include credits and loans.

A diversity of revenue sources matters for state resilience. Yet many fragile states rely heavily on only one or two types of resources, rather than on a balanced mix. In fragile states, grants and other revenues and taxes on trade typically account for a much larger proportion of revenue than in other

Grants and trade tax – the main sources of domestic revenue in fragile states – are not suited for building a social contract.

countries. For instance, foreign grants make up over 90% of Afghanistan's revenue (Figure 6.1 and Annex A, Table A.7). On the other hand, taxes on income, profits and capital gains and social contributions account for smaller shares. This is significant for two reasons. First, it means that fragile states suffer more from the progressive trade liberalisation and the resulting loss in customs revenues. This is because a shift to other tax instruments, such as value-added or direct tax, is harder to implement when capacity is limited (see Question 7). Second, the two main sources of domestic revenue in fragile states – grants and trade tax – do less to build a social contract than direct tax, which is used less frequently.

FIGURE 6.1 Revenue diversity in select fragile states, 2006 and 2011



Source: World Development Indicators, available at <http://data.worldbank.org/data-catalog/world-development-indicators>. For exact figures see Annex A, Table A.7

AID MAKES UP A LARGE SHARE OF REVENUE IN SOME FRAGILE STATES

How do aid and domestic revenue compare in fragile states? Many fragile states are highly aid-dependent, as seen in terms of aid-to-GNI ratio (Table 6.1). A recent study by the OECD, based on flows from DAC member countries, showed that ODA in fragile LDCs is especially high compared to government revenue (28%) (OECD, forthcoming). In Côte d'Ivoire, Kenya and

Kosovo aid represents over 30% of government revenues. In non-LDC fragile states ODA is relatively small (7%) compared to government revenue, and it is even less in other lower middle-income (4%) and in upper middle-income countries (0.6%). The figures are all the more stark when ODA is measured against government tax revenues: aid was equal to 43% of the amount raised in taxes by governments in fragile LDCs, and 13% in other fragile countries.

QUESTION 6

NOTES

1. Two consecutive years of data are only available for 19 countries.
2. Taxes range from direct taxes (such as income tax, capital or property taxes) to indirect taxes (such as value-added tax, or VAT) or trade taxes on imports.
3. Social contributions include social security contributions by employees, employers and self-employed individuals, and other contributions whose source cannot be determined. They also include actual or imputed contributions to social insurance schemes operated by governments.
4. According to the World Bank's definition, "grants and other revenue" include grants from foreign governments, international organisations and other government units; interest; dividends; rent; required, nonrepayable receipts for public purposes (such as fines, administrative fees and entrepreneurial income from government ownership of property); and voluntary, unrequited, nonrepayable receipts other than grants.

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QUESTION 7

Why are fragile states struggling to raise their own revenue?



FOR STATEBUILDING, the tax-to-GDP ratio is only part of the story. What matters more is a well-balanced, inclusive tax base. This is where fragile states face particular challenges: they often rely on one or two types of resources for their revenue – typically natural resources or customs revenues. Weak technical, technological and statistical capacities; a real or perceived lack of legitimacy; and their large informal and agricultural sectors mean it is hard to broaden their tax base. At the same time, the progressive liberalisation of trade and loss of trade tax and tariff revenue, the pressure to offer competitive tax conditions to attract multinational enterprises, and illicit financial flows all mean that huge potential revenue is lost. ■

QUESTION 7

The share of domestic revenue and tax in GDP has grown impressively in fragile states in recent years, and indeed more than in other developing countries. Their capacity to generate revenue, however, remains low (Question 6).

Why is this? Fragile states face many specific constraints and challenges in mobilising domestic revenues. In many, political unrest, war, and years of economic turmoil have caused the collapse of their revenue collection mechanisms. There are also a number of internal and external challenges with which they must contend.

OVER-RELIANCE ON TAXING NATURAL RESOURCES

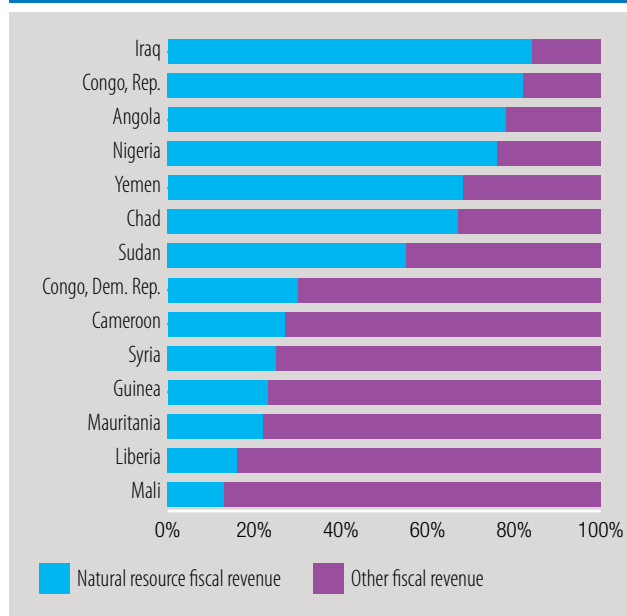
As seen in the previous question, many fragile states rely heavily on only one or two types of resources, rather than on a well-balanced mix (Figure 6.1). They also do not have the same policy choices between different models of taxation as other countries. As a consequence, fragile states rich in non-renewable natural resources often rely on taxing them (both profits and capital gains). Non-renewable natural resources deliver a large share of total fiscal revenue in those states – 84% in Iraq, 82% in the DRC, 78% in Angola, 76% in Nigeria, 68% in Yemen, 67% in Chad and 55% in Sudan (Figure 7.1;

Fragile states often do not have the same policy choices between different models of taxation as other countries.

IMF, 2012). In South Sudan, as much as 98% of fiscal revenue came from oil in 2011 (World Bank, 2013). An analysis of tax effort¹ shows that at the same time fragile states rich in non-renewable natural resources “have made little effort to broaden their tax base” (OECD/AfDB/ECA, 2010). The dependency on income from natural resources leaves fragile states vulnerable. It exposes them to shocks in commodity prices – as demonstrated by the sudden fall in commodity prices in 2009 following the 2002-2008 boom. Neither is it a sustainable source of income. South Sudan’s oil production, for instance, is projected to decrease steadily in future years and become negligible by 2035 (World Bank, 2013). The specific challenge for fragile states that derive much of their revenue from natural resources is

to have robust and transparent systems in place to capture, manage and distribute that wealth fairly, while at the same time levying other types of taxes that have a beneficial impact on state-society relations.

FIGURE 7.1 The importance of natural resources for state revenue in fragile states
Natural resource fiscal revenue
(in % of total revenue, average, 2006-10)

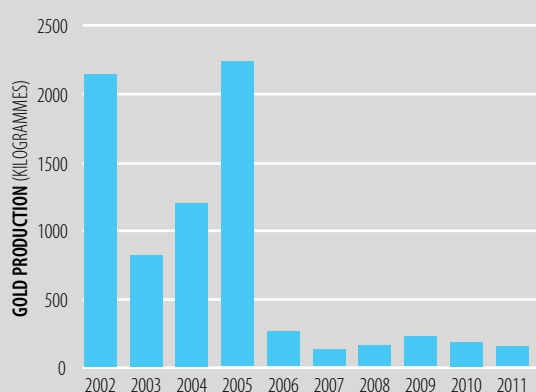


Source: IMF (2012), Macroeconomic Policy Frameworks for Resource-Rich Developing Countries, Washington DC, available at www.imf.org/external/np/pp/eng/2012/082412.pdf

Many fragile states rely on economies with large informal and agricultural sectors. The benefit of taxing these sectors is debatable. It is often not cost-effective, as the financial revenue produced for the state may not justify the cost of taxing subsistence farmers or fishermen. This tends to lead to narrow tax bases and policies that disproportionately affect the much smaller formal sector of the economy. In Burundi, close to 20% of taxes are estimated to be collected from one single company (North-South Institute, 2010). Even in cases where commercial and for-export niche farming has contributed to growth (e.g. Uganda and Ethiopia), taxation has not had a significant impact on domestic revenue mobilisation (North-South Institute, 2010).

BOX 7.1 Gold smuggling in the DRC

According to the DRC Central Bank, gold production in the DRC reached 2.2 tonnes in 2005. Between 2006 and 2011, however, the country recorded only between 120 and 245 kg gold every year (Figure 7.2). It is estimated that 95% of gold produced is smuggled out of the country, amounting to up to 12 tonnes, worth roughly USD 500 million, every year.² As it was not recorded by the Central Bank, it was not taxed.

FIGURE 7.2. RECORDED GOLD PRODUCTION IN DRC, 2001-2011

Source: Banque Centrale du Congo, 2011

LOW TAX MORALE AMONG CITIZENS

Tax morale is people's motivation to pay their taxes, beyond their legal obligation to do so (OECD, 2013b). Lack of state legitimacy can discourage citizens and corporations from paying taxes. In some cases, unwillingness to pay tax reflects "an often accurate perception that officials themselves may be corrupt, that governments consistently misuse public funds and that expenditure patterns may not reflect their wishes." (OECD, 2010). A 2010 report on the DRC found "substantial evidence that high level state officials themselves have appropriated substantial amounts from secretive mining contracts with multinationals", creating nothing less than a rival tax collection system (Tax Justice Network, 2010). The issue of informal and illegal tax collection, and of wealth creation for private interest – for the pockets of rulers and their cronies – goes to the core of state authority and capacity. It needs to be tackled through multiple approaches ranging from capacity development to law enforcement and the creation of transparent institutions.

BOX 7.2 Public revenue statistics in Africa: An instrument for fiscal analysis and reform

Transparency over public revenue is key for economic analysis, building accountability for taxes paid and public services delivered, and strengthening the legitimacy of the state and the revenue authority. This requires government revenue statistics to be available, in particular on tax revenues. The OECD's Development Centre and Centre for Tax Policy and Administration are collaborating on a forthcoming publication that will publish tax statistics for interested African countries as a tool for fiscal policy makers in these countries. The publication sheds light on fiscal reform and the capacity to mobilise domestic revenue. It adopts a standard methodology so that African countries participating in the project can compare their revenue data with OECD countries and others. These statistics enable comparisons of the relative importance of various sources of government revenue and provide a basis for analysing and designing tax policy.

An increasing number of countries have volunteered to participate in this project to collect data; the African Development Bank has expressed its interest in collaborating on this initiative, and others are expected to join as well. No fragile state has officially expressed interest yet in participating, but experience from Latin America shows that the revenue statistics methodology can accommodate a wide range of statistical and administrative capacity.

Source: OECD/CTP, OECD/DEV .

WEAK INSTITUTIONAL CAPACITY

Weak technical, technological and institutional capacities in many fragile states also make it harder to levy taxes. Developing the necessary skills and retaining personnel qualified in fiscal matters are key challenges for developing countries. Lack of such capacities facilitates or perpetuates not only capital flight and tax evasion and avoidance, but also criminal activities such as smuggling (Box 7.1, Figure 7.2). As we will see in Question 8, the effects can be disastrous quite apart from the lost revenue.

QUESTION 7

Weak national tax laws also leave gaps that can be exploited by multinational companies. They do so to avoid taxation and to shift profits to locations where there is little or no real activity but where tax jurisdictions are weak. This undermines the revenue of many fragile countries. These issues are being addressed by the Base Erosion and Profit Shifting project of the G20/OECD, known as BEPS.³

Accurate revenue statistics are an important part of an administration's capacity to collect and manage revenue. However, roughly two-thirds of fragile states lack revenue data, double the proportion for other developing countries. Efforts to overcome the "statistical tragedy" and improve public revenue statistics are therefore particularly important in fragile states (Box 7.2).

TOO MANY TAX EXEMPTIONS

Some fragile states are engaged in a "race to the bottom" to out-do each other in attracting foreign firms with special tax conditions and incentives. While tax incentives for investments are a challenge for most developing countries, fragile states are particularly vulnerable to agreeing unfavourable terms.

This is because in fragile states the need to generate any revenue quickly is often coupled with particularly low tax policy and administrative capacity. As a consequence, they grant excessive tax exemptions to powerful multinational corporations, often in the natural resources sector (OECD/AfDB/UN ECA, 2010) and potentially in violation of their own domestic laws (OECD, 2013b).

Fragile states need to strike "the right balance between an attractive tax regime for investment and growth, and securing the necessary revenues for public spending."

OECD, 2010

Such incentives erode resources for the real drivers of investment decisions – infrastructure, education and security. Recent studies have shown there is very little empirical evidence that tax incentives in developing countries are effective, or that the benefits outweigh the costs (Bhushan and Samy, 2012).⁴ What is more, country case studies by the North-South Institute show that the lost potential revenue can be a significant drain on domestic revenue mobilisation; this is backed up by other research (Parys, 2012).⁵ Another significant drain on revenue in fragile states are illicit flows – the subject of the next question.

NOTES

1. Looking at the level of tax effort provides a more accurate picture of revenue mobilisation than a sole focus on tax and revenue against GDP, because tax effort reflects the ratio of actual to potential tax revenue in a given country, and controls for country characteristics such as income level, economic structures, institutional arrangements and demographic trends.
2. There are various different estimates. This estimate was made by De Koning, Ruben and the Enough Team (2013) in "Striking Gold - How M23 and its Allies are Infiltrating Congo's Gold Trade". The Enough Project, Washington, DC.
3. More information on BEPS can be found at <http://www.oecd.org/ctp/beps.htm>
4. More on this topic can be found in Klemm, A. and S. Van Parys (2009), "Empirical Evidence on the Effects of Tax Incentives", IMF Working Paper, IMF, Washington, DC; and Nathan Associates (2004), *Effectiveness and Economic Impact of Tax Incentives in the SADC Region*, Nathan Associates, Washington, DC.

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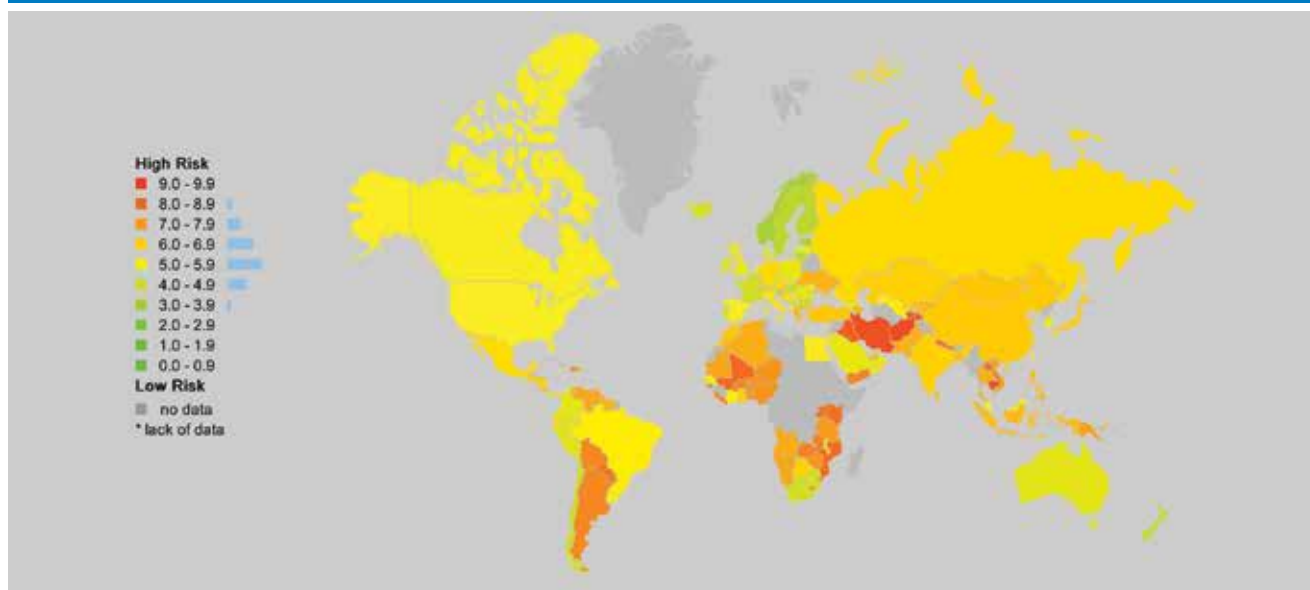
QUESTION 8

What can be done to stem the revenue loss from corruption and illicit financial flows?



FRAGILE STATES LOSE significant amounts of revenue through illicit financial flows. These flows exceed aid and foreign investment. Fragile states are particularly affected by illicit flows and activities, since they are more at risk from being targeted by such illegal activity, and low state legitimacy can prevent authorities from combatting the economic and financial crimes that contribute to such losses. Seven fragile states or economies are rated high-risk jurisdictions, and 15 are yet to engage in international efforts to stem illicit flows. OECD countries can and should help build the capacity of fragile states by building relevant capacities on the ground, and through coherent global action on illicit flows, money laundering and anti-bribery. ■

FIGURE 7.1 What countries are at risk of illicit financial flows?



Notes: The Basel AML Index scores countries on a scale from 0 (low risk) to 10 (high risk). High scores indicate a country is more vulnerable to money laundering/terrorist financing based on its anti-money laundering (AML) and counter-terrorist financing (CTF) framework and other risk categories such as rule of law, corruption, and financial and public transparency. The Index is based on external public sources including indices from the World Bank, the World Economic Forum and Financial Action Task Force (FATF).

Source: The 2013 Basel AML Index, available at www.index.baselgovernance.org.

Fragile states lose vast sums of potential domestic revenue through illicit financial flows. These flows have numerous origins including corruption, money laundering and tax evasion. While the figures and measurement methodology are still disputed, these outflows may greatly exceed the inflows of

Fragile states are more at risk from being targeted by illicit financial activity and corruption.

aid and net FDI (OECD, 2013; Reed and Fontana, 2011). They strip public institutions of resources necessary to ensure the provision of public goods and services to the population, including healthcare, education and basic security. The socio-economic and political impact of illicit financial flows and corruption is especially detrimental to fragile states. The inherent weaknesses of fragile states mean that they are more at risk from being targeted by such illegal activity (Figure 8.1). Public corruption, elite capture, weak institutions and low state legitimacy prevent authorities from combatting the economic and financial crimes that contribute to such losses. Criminal networks can undermine democratic institutions and take control of mechanisms and bodies charged with detecting, investigating

and prosecuting illicit flows (e.g. the central banks, financial intelligence units, police, prosecutors and courts) (Reed and Fontana, 2011). Corruption also seriously undermines citizens' tax morale.

SOME FRAGILE STATES ARE MAKING EFFORTS TO STEM ILLICIT FLOWS

Several fragile states have made an effort to prevent the loss of potential state revenue by stemming illicit flows. Of the 51 fragile states examined in this report, 36 are involved in either

To stem revenue loss from corruption and illicit flows, donors should support fragile states engagement in FATF or its global network.

the Financial Action Task Force (FATF), have FATF Associate Membership through a regional group, or are members of the Global Forum of Transparency and Exchange of Information for Tax Purposes. Yet seven of these members (Ethiopia, Kenya, Democratic Republic of Korea, Myanmar, Pakistan, Syria and Yemen) are rated "high-risk, non-cooperative jurisdictions" by the FATF.

BOX 8.1 Global action is slow to deal with bribery

The OECD Anti-Bribery Convention came into force in 1999. It is the first and only legally binding instrument to tackle and prevent the payment of bribes (the supply side) in international business transactions carried out by companies based in member countries. Countries that have signed the convention are required to put in place legislation that criminalises the act of bribing a foreign public official. As of October 2013, 40 countries had ratified or acceded to the convention. However, OECD members have made mixed progress in implementing the convention. By December 2011, 210 individuals and 90 companies had been sanctioned under criminal proceedings for foreign bribery in 14 OECD countries, while more than half of all OECD countries – including some key donors to fragile states such as Australia, Denmark, Belgium, Spain and Ireland – had made no prosecutions at all (OECD, 2012).¹ This lack of judicial activity, though, says little about the actual likelihood of those countries to engage in bribery in foreign markets. Transparency International's Bribe Payers Index, on the other hand, ranks the likelihood of companies from 28 leading economies to win business abroad by paying bribes (Transparency International, 2011). While some of the smaller donors to fragile states such as the Netherlands, Switzerland and Belgium rank comparatively well in this index, some of the largest bilateral donors to fragile states – France, the US and the United Kingdom – still have considerable progress to make.

Source: OECD/CTP, OECD/DEV.

Also, 15 fragile states or economies are yet to become members of these international groups (Burundi, the Central African Republic, Chad, DRC, Congo, Côte d'Ivoire, Eritrea, Kiribati, North Korea, Kosovo, Madagascar, Somalia, South Sudan, Tuvalu, and the West Bank and the Gaza Strip) (Annex A, Table A.8). OECD countries can and should

15 fragile states are not yet members of international groups combatting illicit flows.

help build the capacity of developing countries to sign up to and comply with these standards.

There are several regional bodies which help implement standards on money laundering and tax: the Inter-Governmental Action Group Against Money Laundering in West Africa, the Eastern and Southern Africa Anti-Money Laundering Group and the African Tax Administration Forum. These also have an important role to play in supporting fragile states, yet many of these bodies themselves may need support.

Given the scarce resources and limited expertise for combatting economic and financial crimes in fragile states, it is important to analyse the specific types of illicit financial flows that constitute the greatest threat in each particular country and then design policy responses accordingly. Depending on the structure of the economy, the socio-economic and even geographic conditions, the threats from illicit flows will vary.

A comprehensive risk assessment, involving all relevant institutions, must be conducted to determine the most effective point of action. OECD countries could have a role in supporting the development of such risk assessments and in building the capacity of the institutions responsible for implementing the priority actions identified.

TARGETED DONOR ACTION

Donor agencies can play an important role in helping fragile states to stem the illegal outflow of revenue. A new report – *Measuring OECD Responses to Illicit Financial Flows from Developing Countries* (OECD, 2013) – makes recommendations for donors. Among those relevant to donors in fragile states are:

- Building up relevant capacities in development agencies
- Building investigative capacities of partner country administrations to tackle economic crime in developing countries
- Building political commitment to combat economic and financial crimes in developing countries
- Supporting research on illicit financial flows, especially at the country level
- Maintaining political momentum within OECD countries by supporting advocacy efforts

QUESTION 8

- Ensuring a development dimension in current efforts
- Undertaking proper risk assessments in developing countries.

In 2011 donors at the Fourth High Level Forum on Aid Effectiveness Busan pledged to intensify their joint efforts to fight corruption. Fighting bribery can take several avenues, tackling both “supply” (Box 8.1) and “demand”.

One avenue used in recent years to tackle the demand side of bribery in fragile states has been to establish independent revenue authorities – typically with significant donor support. The aim is to increase transparency and create institutions that are sufficiently independent to resist political pressure. Burundi set up a semi-autonomous revenue authority in July 2010, at a time when the country’s tax and customs services topped the list of East Africa’s most corrupt organisations in Transparency International’s East African Bribery Index. Since then, the country’s culture of tax collection has been thoroughly changed. Burundi has redrafted its related legislation, broadened the tax base (keeping the rates as low as possible), brought in advisers in income tax and customs, updated or installed computer systems, and reformed human resources in revenue matters. All of this has led to better transparency. In 2012 tax revenues were 75% higher than in 2009 – a 25% increase in real terms. The contribution of tax to GDP had risen from 13.8% in 2009 to 16.7% (Holmes *et al.*, 2013).

Similarly, Rwanda opted to set up an independent revenue authority to prepare and implement reforms in the legal and regulatory frameworks and management systems. In 2010 the management procedures of the authority were awarded ISO 9001 2008 accreditation, making it the first Rwandan institution to attain this international standard for quality management systems. Rwanda’s strong tax performance is believed to have been a factor in the country’s significant development progress in recent years.

COHERENT GLOBAL ACTION

Supporting fragile states’ ability to combat illicit flows and corruption is not only a matter of providing aid. Given that OECD countries are the main haven for illicit financial flows from developing countries, they must ensure they have the necessary firewalls in place to block illicit funds from coming in and can freeze, seize and return stolen assets. At the same time developing countries must work to strengthen their systems and institutions.

Both OECD and developing countries – in particular fragile states – must take steps to comply with global standards on money laundering (Financial Action Task Force, or FATF, standards), tax evasion (Global Forum Standards on Exchange of Information, the Multilateral Convention), and bribery (Anti-Bribery Convention; Box 8.1).

NOTES

1. While Belgium has reported several convictions, data on domestic and foreign bribery cases have not, to date, been counted separately.

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QUESTION 9

What issues do donors need to consider in supporting domestic revenue mobilisation in fragile states?



DOMESTIC REVENUE MOBILISATION has drawn a great deal of high-level political interest from donors in recent years. A growing body of evidence shows that this is an area in which the concerted action of international donors can have an important impact. Yet surprisingly little aid is being spent on improving revenue generation in fragile states.

What is holding back donors in helping fragile states mobilise their own revenue? This section sheds light on some of the key debates around domestic resource mobilisation and on fundamental questions donors need to address to support revenue mobilisation in fragile states. For example, does aid help or hinder the process of revenue collection? How to deal with risk? How to use country systems in fragile states when supporting domestic revenue mobilisation? ■

QUESTION 9

LEVELS OF AID TO DOMESTIC REVENUE MOBILISATION

Despite donors' strong political and rhetorical commitment to revenue mobilisation in developing countries, only 0.08% of ODA to developing countries in 2010/11 supported public

In fragile states, only 0.07% of donors' aid supports public financial management and taxation.

financial management and related areas. In fragile states and economies, the share was even lower – only 0.07%.¹

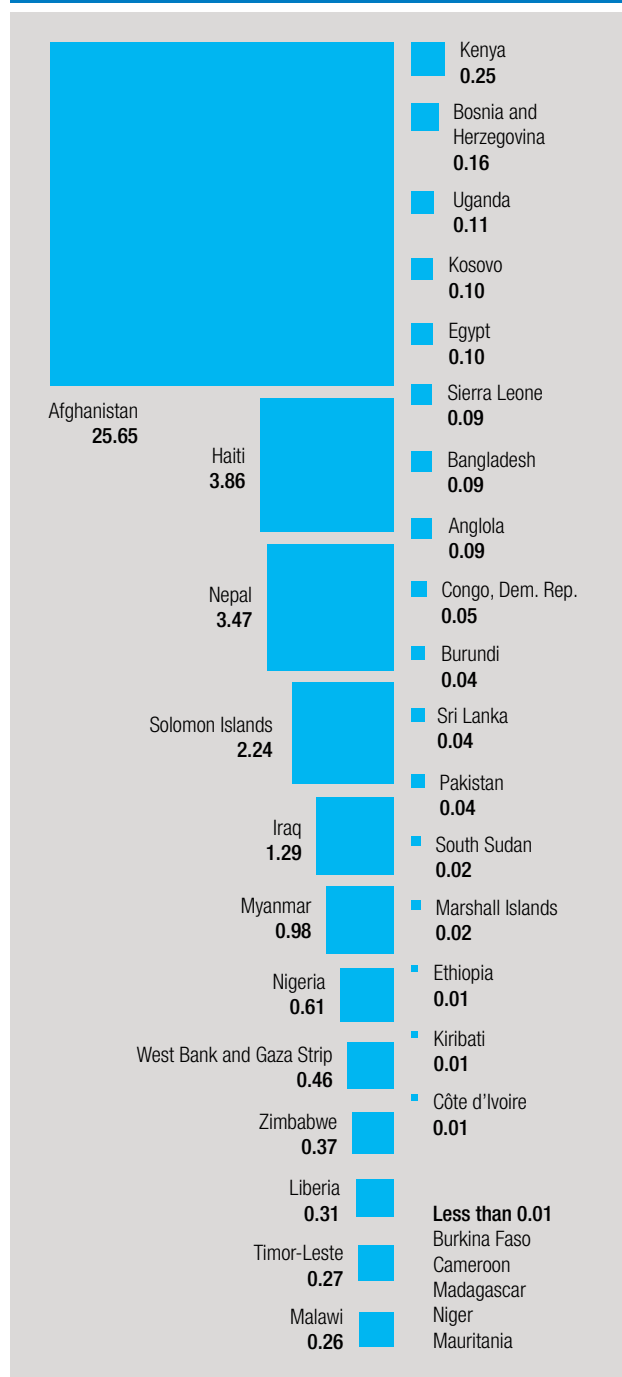
Afghanistan has received by far the most support in this area (Figure 9.1). Notable support

has come from the International Development Association (IDA) for trade facilitation and from the US for public financial management. Haiti and Nepal received the next largest amounts. Haiti mainly benefitted from US technical assistance for public financial management, while Korean aid in Nepal helped modernise the customs system, and Germany and Denmark supported its revenue and tax administration. Other fragile states, on the other hand, received very little aid in this sector (e.g. Mauritania, Niger or Madagascar). Still others received none at all (e.g. CAR, Chad and Mali). CAR and Chad in particular could benefit hugely from support to build their public financial management systems. These countries are not yet part of any international efforts to stem illicit flows either (Annex A, Table A.8).

FLEXIBILITY IN THE APPROACH TO TAKE

There is much debate – specifically among tax experts and statebuilding experts – around the best approach to take to help fragile states strengthen their own revenue (Box 9.1). This shows that there is no one-size-fits-all blueprint approach for supporting tax administrations. Weak governments in particular have little choice in what they tax and how. The key role of donors in such circumstances is to respect sovereign decision-making while encouraging good practice. It is often the context that dictates the different elements that can be combined to break the cycle of fragile states' dependency on external resources.

FIGURE 9.1 Which fragile countries receive most support for domestic revenue mobilisation?
2010-2011 averages (in USD million)



Notes: based on data from the OECD Creditor Reporting System, 2013. Figures represent the sum of ODA dedicated to public financial management, anti-corruption measures, trade facilitation, public sector policy and administration management, legal and judicial management, and similar issues captured in the corresponding CRS purpose codes.

BOX 9.1 Policy questions in strengthening tax regimes: a debate

There is no model for strengthening tax systems that would simultaneously satisfy the needs of tax experts and statebuilding advocates. Many issues remain contentious, and each argument has its merits and weaknesses, and proponents and critics:

(1) Should tax reform start with the big fish or with the small fry?

- **It should start with the big fish.** Tax experts often see the benefits in focusing on the large taxpayers first – mostly companies – until fiscal self-reliance is reached, and as a second step establishing tax systems for small taxpayers. The argument is that this lets the state secure the funds and capacity necessary to undertake the more costly and labour-intensive reforms to reach small taxpayers and introduce direct taxes.
- **It should include the small fry from the outset.** Statebuilding experts tend to argue that taxation is part of the process of building a social contract, the mutual expectation between state and society that there is a reciprocal relationship built on entitlements and duties. Taxation in fragile states should therefore involve small taxpayers from the outset, despite their small incomes. The rationale of these experts is that revenue and tax reforms aimed at small taxpayers drive reforms in other public sector institutions (see below) which are essential for development and statebuilding. Also, they argue that including large companies and small taxpayers simultaneously ensures that neither of them feels unjustly penalised, and that political difficulties of introducing direct tax later on are avoided.

(2) Should tax reform in fragile states use country systems or take an assertive approach?

- **Use country systems:** Development practitioners tend to argue that donors should strengthen existing country systems rather than establish new ones. The 2011 Busan Partnership for Effective Development Co-operation committed developing countries to strengthen their country systems as much as possible and donor countries to using these systems as the default option.
- **Be more assertive:** Other experts argue that fragile states sometimes require radical solutions, and that taxation cannot be reformed if business continues as usual. A recent example of donors taking a more assertive approach is Burundi, where an Irish Commissioner General was chosen to head the tax office. He started out by dismissing over 400 staff and recruiting qualified replacements, then radically redesigning the system from scratch. In 2012 tax revenues were 75% higher than in 2009 – a 25% increase in real terms (see Question 7).

ACCEPT THAT DOMESTIC REVENUE MOBILISATION CAN YIELD SIGNIFICANT RETURNS EVEN IN CHALLENGING CONTEXTS

Does the availability of aid undermine governance and reduce the incentive for governments to tax their citizens? As 12 of the top 20 aid recipients are fragile, this question is particularly relevant for fragile states. However, several studies, including a recent OECD report, find no compelling evidence that ODA has a consistent disincentive effect on tax collection in recipient countries (Di John, 2010a; OECD, 2010a). On the contrary, several recent and well-founded studies found a negligible or even positive impact of aid on tax revenue (Gupta, 2007; Clist and Morrissey, 2011; Brun *et al.*, 2008).

Experience confirms this, showing that support to domestic revenue mobilisation can pay dividends. Each dollar spent on tax systems can generate several dollars in tax collected; some claim it can have up to a tenfold multiplier effect (OECD/AfDB/UN ECA, 2010; Box 9.2).

Some fear that the presence of many development agencies in a fragile state who employ some of the most competent local professionals, can lead to a “dual public sector” (Di John, 2010b), distort accountability¹ and send a signal to citizens that their governments cannot be trusted. Ultimately this is said to create a “negative feedback effect on domestic revenue mobilisation” (Boyce, 2008). However, a recent World Bank study finds that the provision of public services by donors and non-state actors can strengthen rather than undermine the relationship between citizens and the state (Sacks, 2012; and see the Burundi example in Box 9.1).

Box 9.2 Support to tax administrations – an investment that pays off

Compelling evidence shows that investments in domestic resource mobilisation can yield significant returns, even in challenging contexts.

- In Ethiopia, the UK Department for International Development (DFID), alongside other donors, supports the Public Sector Capacity Building Programme, which includes capacity building support to the tax system. One objective is to increase tax revenue by 87% from 43.3 billion birr in 2010 to 81.1 billion birr in 2013. Every GBP 1 of DFID support to tax system reform is estimated to produce additional revenue of about GBP 20 a year.
- USAID support worth USD 5.3 million between 2004 and 2010 to improve tax collection in El Salvador allowed the country to increase its revenue collected by USD 350 million a year.
- DFID support to the Rwanda Revenue Authority reached a point where it was collecting the full GBP 24 million value of the DFID support programme every three weeks.
- In the West Bank, a joint programme by UNDP, Danida, World Bank, GIZ and JICA aimed at strengthening property tax allowed the 60 participating municipalities to almost double their property tax collection from USD 16.8 million in 2008 to USD 33 million in 2012. The 2012-14 phase of the programme has a total budget of USD 2.6 million.

Source: OECD (2013), *Tax Inspectors Without Borders, Final Report on the Feasibility Study into the Tax Inspectors Without Borders Initiative*, Paris: OECD, available at www.oecd.org/ctp/tax-global/TIWB_feasibility_study.pdf. Information on West Bank programme provided by Sakher AlAhmad, Nicolas Garrigue and Eugenia Piza-Lopez (UNDP).

UNDERSTAND AND MANAGE RISK FOR GREATER USE OF COUNTRIES' OWN SYSTEMS

There is also a wider debate around using partner countries' own structures or "country systems". The 2005 Paris Declaration on Aid Effectiveness saw providers of development co-operation agree that aid should be channelled through country systems. The New Deal reinforces this emphasis. It commits donors and partner countries even more firmly to building country systems and using them (Annex B, Figure B.1). Despite international commitments, however, progress on the use of country systems remains mixed, especially in fragile and conflict-affected states. Results from the Paris Declaration

Survey in 2011 show that for the 32 countries for which data were available, only 55% of aid for the government sector used country public financial management (PFM) systems. The use of country systems in fragile states was even lower, and donors also made less use of existing structures and programme-based approaches (OECD, 2011a).

Why is this? The report *Aid Effectiveness 2005-2010: Progress in Implementing the Paris Declaration* (OECD, 2011b) issued prior to the Busan High Level Forum found little evidence that donors' use of country systems was correlated to the quality of those systems. Rather, the answer revolves around several fears and tendencies to risk aversion on the part of development co-operation providers:

- Risk of failing: fear that country systems are not able to deliver expected results;
- Risk of wasting money: fear of losing track of aid money spent (follow each dollar) and resulting focus on fiduciary risk rather than longer-term objectives;
- Risk of working within a complex political economy;
- Risk of being inappropriately equipped: fear that donors lack the specific resources and skills required to use country systems well.

Another constraint are donors' operational policies or laws that preclude the use of country systems and may be difficult to reconcile with partner countries' requirements and legislative frameworks.

The New Deal for Engagement in Fragile States recognises these fears, but emphasises that the risk of not engaging in fragile states outweighs the risks of getting involved. By endorsing the TRUST principles of the New Deal (Annex B, Figure B.1), donors

and partner countries have recognised the importance of better risk management and have agreed to make progress in this area. While appropriate risk-taking is essential to delivering results during transition, international support is often not properly tailored to managing risks in fragile and conflict-affected states.

Donors often wrongly assume that using country systems entails adopting general budget support. In fact, the use of country systems is not limited to a particular aid modality.

The risk of not engaging in fragile states outweighs the risks of getting involved.

TABLE 9.1 What type of aid works best for supporting tax systems in fragile states?

Aid instrument	Allows government discretion?	Uses national systems and institutions?	How can it work?
General budget support (GBS)	Yes	Yes	Well suited to addressing interactions between taxation and governance, given its accompanying high-level policy review. Use variable tranche mechanisms linked to revenue targets to ensure GBS does not weaken incentives for revenue mobilisation.
Sector budget support	Yes, within earmarked sectors	Yes	Can create a direct link between budget funding and PFM performance. Sector-wide approaches are a good vehicle for donor co-ordination on revenue issues. Use variable tranche mechanisms linked to revenue targets, such as “cash-on-delivery”.
Government-managed pooled funds (basket financing)	Some, but development partners can earmark to the level of projects	To varying degrees	Well suited for co-ordinating multi-donor funding, given its unified arrangement for planning, implementation, monitoring. At least 3 donors recommended. Programme should include governance and state-building elements.
Other multi-donor instruments (including trust funds managed jointly by donors and partner country)	Some	To varying degrees	Especially suited for countries whose government systems lack the capacity needed for budget support. Pursue tax-related activities either through targeted joint projects, or joint projects designed for other purposes (e.g. strengthening Parliament and civil society).
“Stand-alone” bilateral projects or programmes	Only indirectly and relying on good donor behaviour	Most often not	Danger of being donor-driven. Requires strong leadership by host country, and strong donor co-ordination for a coherent division of labour in the support to taxation.
Funding South-South co-operation	Depends on good donor behaviour	Most often not	Can be a low-cost, high-value modality. Often limited by Southern partners’ absorptive capacity.
In-kind support	Only indirectly and relying on good donor behaviour	No	Twinning arrangements or secondment of experienced tax officials can be highly responsive to the needs of host countries. Peer to peer learning has proven most effective.
Support to and through non-state actors	Only indirectly and relying on good donor behaviour	No	

Sources: Drawing on information in OECD (2013), Tax and Development: Aid Modalities for Strengthening Tax Systems, OECD Publishing, available at <http://dx.doi.org/10.1787/9789264177581-en>

Personal Communication, Kristoffer Nilas Tarp, United Nations Peacebuilding Support Office (PBSO)

BOX 9.3 Dealing with risk

Donor Approaches to Risk in Fragile and Conflict-Affected States brings together concrete examples of risk taking and risk management from Afghanistan, DRC, Haiti, Myanmar, Nepal, Somalia and South-Sudan. The work provides a wealth of examples with a series of practical implications for donors:

- **Using pooled funds to share risks:** Pooled funds can enable donors to share institutional and programmatic risk, and to transfer fiduciary risk management functions to specialised management agents better equipped to control them. An example widely regarded as effective is the Capacity Building Trust Fund (CBTF) in South Sudan, focused on building the capacity of public financial management (PFM) systems (notably pensions and payroll management) and institutions of public accountability. A clear and focused strategy, a strong organisational setup with strong government ownership, and a short – two-year – planning cycle are seen as factors of success.
- **Incremental arrangements for using country systems:** The UNDP Harmonised Approach to Cash Transfers (HACT) is a method for moving gradually towards the use of country systems, and was piloted in DRC. It has enabled donor funds to be advanced to national entities subject to previous accreditation, spot checks during project implementation and *ex-post* auditing.
- **More robust remote management systems** become necessary where security concerns prevent donors and NGOs from accessing the area, such as in eastern DRC and Somalia. Remote management methods were used by Médecins Sans Frontières in Somalia after three MSF employees were killed in 2008 and staff withdrawn. A rigorous and transparent control system, the competence of national staff in Somalia, and their familiarity with MSF principles and protocols seem to have been decisive in the programme's success.

The report further recommends using joint risk assessments and fast disbursing instruments; better co-operation between development, humanitarian and peacekeeping missions; and learning from the implementation of New Deal compacts as a basis for increasing the use of country systems.

Source: OECD / The Policy Practice (forthcoming)

In line with this, domestic resource mobilisation and accountability can be strengthened through many types of aid approaches – from stand-alone bilateral aid, South-South regional programmes, pooled financing and other joint donor approaches right through to sector or general budget support. Recent in-depth research on the topic through a joint project involving the International Tax Compact, Germany's Federal Ministry of Economic Cooperation and Development (BMZ) and the OECD found that there is no "best" aid instrument to support effective resource mobilisation (OECD, 2013). Instead each type of support has a distinct role to play in promoting tax-governance linkages. Table 9.1 summarises the strengths and weaknesses of each approach for supporting tax systems and underlines that one size does not fit all when it comes to fragile states. This is the message which also emerges from the debates over the best approach to take outlined in Box 9.1 above.

Sector-wide approaches have been particularly effective for statebuilding in Afghanistan, Bolivia, DRC, Nepal, Rwanda and Sierra Leone. They maintain decision-making processes within the state and often promote new channels of interaction between social groups and the state (OECD, 2010b). At the same time, unlike full-blown budget support, they clearly target certain interventions.

To translate principles into practical solutions, more work is needed to understand how donors can and do manage risks in fragile states. To address some of these challenges, and help guide donors and partners in their decisions to use country systems, the OECD-DAC has produced a number of tools. These include *Transition Financing: Building a Better Response* (2010); *Practitioner's Guide to Using Country Systems* (2011); *Managing Risks in Fragile and Transitional Contexts: the Price of Success* (2011); and *Donor Approaches to Risk in Fragile and Conflict-Affected States* (forthcoming). The latter will feature some innovative approaches developed by donors to provide transition financing, and which help strengthen country systems and make aid more transparent and predictable (Box 9.3). Partner countries and donor agencies have committed to work with civil society and other stakeholders to make further progress in this area, including through the New Deal and Effective Institutions Platform.

Although there is still much to learn, a substantial body of knowledge is emerging on the ways in which donors can support revenue systems that also encourage statebuilding. This is the subject of the final question in this report.

NOTES

1. These figures are based on an analysis of project-level data from the OECD Creditor Reporting System.

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QUESTION 10

What approaches should donors follow when supporting tax reform in fragile states?



WHAT ARE SOME OF THE CONCRETE STEPS donors can take to support tax reform in fragile contexts? This section offers some possible approaches for donors in supporting revenue mobilisation in fragile states. It also gives some examples of how donors, and fragile states themselves, have been putting those into practice.

These approaches are grouped around five areas: (1) donors should encourage fragile states to *broaden their tax base* by focusing on direct taxation (often through simplified tax rates); (2) they should help fragile states design frameworks to *manage natural resource revenues* better; (3) they should strengthen fragile states in their *interaction with multinational enterprises* – enhancing the transparency and governance of tax incentives, transfer pricing regimes (as done in Rwanda), and supply chains; (4) they can set an example by being transparent about development co-operation (and exemptions around it); and (5) they can help fragile states *boost tax morale* among citizens by strengthening the link between revenue collection and responsible expenditure management. ■

BOX 10.1 Key guiding principles for revenue mobilisation in fragile states

- **Leadership and political will** for reform by the host country is crucial – aid alone cannot “buy” effective and lasting reforms.
- **How revenue gets collected** is just as important as how much gets collected. In fragile states, tax reform should put emphasis on being equitable and fostering accountability and transparency.
- Reforming the tax system only works when done in conjunction with **anti-corruption** measures. Otherwise corruption continues to undermine new tax administrations and policies (OECD, 2013b).
- Strengthening linkages between taxation and governance also involves supporting institutions and **organisations outside the revenue system** such as the justice system, parliament and civil society.

Sources: OECD (2013b), and OECD/AfDB/UN ECA (2010)

Several recent studies have attempted to identify good practice and provide guidance on supporting revenue mobilisation in developing countries. They include the OECD's *Draft Principles for International Engagement in Supporting Developing Countries in Revenue Matters* (OECD, 2013a) and the report on *Taxation, Statebuilding and Aid* (OECD, 2008).¹

Donors can also draw on guiding principles from the joint ITC/BMZ/OECD report, *Tax and Development: Aid Modalities for Strengthening Tax Systems* (OECD, 2013b). The report makes 50 recommendations for best practice for donors (Box 10.1).

But what issues are particularly pertinent for fragile states, given their characteristics? As noted in Question 9, fragile states with weak governments have few options to generate tax revenue, given their limited resources and systems in place. Under these circumstances, it is important for donors

BOX 10.2 Making it easier for small business to comply

Presumptive taxes are used to tax income for small businesses in Timor-Leste and Kosovo. They are calculated based on factors such as the type of product sold, the size of the enterprise and a rough estimate of turnover. It was not anticipated that the revenue yield from these taxes would be high, at least initially. However, introducing a tax system to encourage a culture of compliance from the start was seen as imperative – especially in sectors expected to grow.

Sources: Carnahan (2007)

to encourage good practice while respecting sovereign decision-making. This section aims at providing examples of good practice, without however being prescriptive. Approaches that have showed positive results in fragile states include encouraging broad-based, simple and transparent revenue systems; strengthening capacity to interact with multinational enterprises, in particular in the natural resources sector; and improving tax morale by demonstrating how tax income can be turned into a resource to finance development.

1. BROADEN THE TAX BASE

A broader, more diverse tax base does not only bring additional resources. It can also increase state resilience, as it reduces vulnerability to economic volatility and minimises the tax burden by spreading it across a larger base of taxpayers (OECD/AfDB/UN ECA, 2010). It also makes government accountable to a larger constituency. Ways to broaden the tax base that have been shown to work in fragile states include:

- **Focusing on direct taxation.** Direct taxes, such as income or property tax, are thought to be the most effective kind of taxation for statebuilding as they give citizens a voice (Di John, 2010). Indirect taxes, such as VAT, are less powerful, while customs taxes and those levied on companies have the least effect on statebuilding. Even though direct taxation is difficult to levy due to the high cost of pursuing self-employed individuals who typically earn low salaries (Solignac-Lecomte, 2010), and because of the low returns it may yield, it is considered essential to foster a culture of compliance (Fjeldstad and Moore, 2007; see Box 10.2).

BOX 10.3 Guinea: Getting more from its ores

Despite its very large mineral reserves, Guinea has not mobilised much revenue from their exploitation over the past 50 years. What revenue it did collect it did not manage effectively. In 2011, the government of Guinea started to craft a new mining code reflecting international good practices. Various provisions in the new code – e.g. higher royalties on iron ore – have the potential to add more than USD 1 billion in annual domestic revenues from 2017 onwards (for comparison, Guinea received about USD 200 million in ODA annually in recent years). The government has set up a Technical Review Committee to oversee and support the renegotiation of existing agreements with international mining companies. The mining code review drew support from a range of donors and agencies, including the IMF, Agence Française de Développement, the World Bank, Revenue Watch and the Africa Governance Initiative set up by former British Prime Minister Tony Blair. Guinea’s ability to sign new deals consistent with the revised mining code – particularly major ones such as Simandou, an iron ore mining project by Rio Tinto — will be a critical test of the process. The new regime also incorporates strong principles for transparency and accountability, such as contract transparency, to reduce opportunities for corruption while increasing the legitimacy of the reform process. Improving administrative capacity to effectively collect the revenues will be crucial if Guinea is to realise the potential of its riches. The government of Guinea is now receiving specific targeted support for the review of its contracts from Revenue Watch and the AfDB via the Africa Legal Support Facility,² which was created recently to help countries get a better deal for their resources.

Source: personal communication, Antoine Heuty, Ulula

■ **Simplifying tax rates.** Simplified tax rates, such as presumptive direct taxes, can be a pragmatic solution where taxing effective income is impossible, for instance where the government faces capacity constraints or taxpayers lack financial transparency. The term “presumptive taxation” generally means that the tax rate is not directly measured on the basis of the actual tax base (e.g., income), but estimated based on indicators that are easier to measure. Such user-friendly procedures have been shown to help improve voluntary compliance (Box 10.2), and can later be phased out and replaced by actual income-based taxation.

■ **Strengthening customs systems.** A top priority in post-conflict countries is to strengthen customs systems and regulations. Customs posts at borders and ports are often the targets of corruption and the place where illicit taxation thrives. Well-connected business leaders and top politicians often control networks involving police, customs and immigration officials (Gastrow, 2011). It is widely recognised that strengthening the capacity of customs posts, systematic scanning and audit, and the reform of customs revenue systems are effective ways to broaden the resource base.

2. MANAGE NATURAL RESOURCE REVENUES BETTER³

As noted in Question 7, many fragile states rely on income derived from non-renewable natural resources. Several of them – Afghanistan, DRC, Guinea (Box 10.3), Liberia, Niger and Sierra Leone – have recently undertaken major reviews and reforms of their extractive regulatory framework and practices to boost domestic revenues, mitigate socio-environmental impact, and foster employment and other socio-economic benefits. Mali has also announced its intention to undertake a similar review. In Liberia, successful negotiation of natural resource concessions has been a major factor in its rapid increase in revenues. Also notable is Liberia’s early entry into

Good management of natural resource revenues hinges on robust frameworks to share revenues and risks, the timing of revenue, and effective administration.

the Extractive Industries Transparency Initiative (EITI) to ensure full disclosure of revenues from mining, petroleum and forestry (Box 10.4).

Three factors matter most for good management of natural resource revenues: robust frameworks to share revenues and risks, the timing of revenue, and effective administration.

BOX 10.4 Promising revenue reforms in Liberia

Since 2003, when a peace accord ended 14 years of devastating civil war, Liberia has achieved great progress in the face of serious difficulties and risks. Under strong government leadership, Liberia started the lengthy process of re-establishing public financial management systems, delivering essential public services and laying the foundations for local government systems.

Despite extreme capacity constraints and a large share of non-monetised economic activity, revenue performance has been remarkable. In 2010 total revenues (excluding grants) reached nearly 30% of estimated GDP. In its initial fiscal recovery effort, the government focused on overcoming corruption in customs and gaining quick wins by re-negotiating concessions for forestry, flagships, mining (mainly iron ore), and more recently, palm oil. In 2010, concession revenue yielded 11% of GDP. The government has also sold offshore oil exploration rights to a major company. To ensure transparency, the government enacted the Liberia Extractive Industries Transparency Initiative (LEITI) Act in 2009. It encompassed forestry and agriculture as well as the extractive industries. The EITI Board commended Liberia as the “Best EITI Implementing Country” in 2009.

Revenue reforms have been driven by the government itself, with only moderate donor support. Support for revenue mobilisation has been growing, though, including assistance from the AfDB, ECOWAS, the EU, France, the US Treasury Department, the World Bank and the International Finance Corporation. Despite its progress, Liberia’s revenue modernisation will need extensive financial and nonfinancial support over the next decade. The government has developed a strategic plan for revenue and customs, and will be seeking donor support in the range of USD 35-40 million.

Sources: OECD (2013b)

First, it is important that fiscal regimes in fragile states share revenues and risks equitably between the investor and the government – even when economic circumstances change. Resource tax regimes typically include a royalty or other charge based on output, some mechanism for capturing a share of profits and “rents” (i.e., returns beyond an investor’s minimum threshold return), and other charges such as license fees or import duties. In fragile states, investors typically seek contractual protections against changes to the fiscal regime. These “stabilisation clauses” may exempt an investor from future changes in law or provide for compensation or a rebalancing of contract terms where a change in law affects an investor’s expected benefits. Stabilisation clauses can hinder the host country’s policy agility if their scope and duration are not adequately circumscribed.

Fiscal regimes that are made “robust” to changing circumstances by means of progressive parameters may provide a desirable alternative. A number of such parameters can be seen in both petroleum and mining regimes, such as variable income taxes, variable royalties, resource rent taxes and variable production sharing formulas. Fragile state examples include the following:

- Angola imposes a profit-sharing mechanism for petroleum that is based on the rate of return.
- Malawi’s tax legislation provides for a 10% resource rent tax on mining when cumulative cash flows exceed a 20% internal rate of return.
- Liberia imposes a 20% surtax on mining when the internal rate of return exceeds 22.5%.
- Timor-Leste imposes an additional profit tax on oil once the internal rate of return exceeds a specified threshold level.
- Cameroon and Chad both increase the state’s share of oil production as the ratio of total project revenues to costs increases.

The level of overall revenues generated by a fiscal system is important, but a second issue that matters is timing. Profit or rent-based charges capture a greater share of future windfalls and may therefore be perceived as fairer, but they may take years to materialise while investors recoup heavy up-front investments. In comparison, royalties or front-loaded charges like signature bonuses ensure immediate revenue flows to the state.

Because of these differences, fragile states will typically use a combination of fiscal tools, but the devil is in the detail. Besides headline rates (e.g., a 35% income tax or a 5% royalty), calculating the tax base is key in determining future domestic revenues. Details such as the rules governing interest payment deductions, or procedures for valuing minerals, must be clear.

Finally, effective administration – facilitated by reliance on straightforward and uniform rules rather than a patchwork of bespoke fiscal arrangements – is key if fragile states are to realize the benefits of robust fiscal systems for their natural resource revenues.

3. MINIMISE TAX INCENTIVES

As noted in Question 6, there is clear evidence today that the costs of tax incentives for investment, especially tax-free zones and tax holidays, outweigh their benefits and may actually damage a developing country's revenue base. The

Tax incentives damage a developing country's revenue base.

OECD Task Force on Tax and Development (Box 10.5) has produced draft *Principles to Enhance the Transparency and Governance of Tax Incentives for Developing*

Countries (OECD, 2013c). Several developing countries have requested OECD support to analyse their tax incentives based on these principles. In-depth studies provide developing countries with practical recommendations to improve the efficiency of their tax system in mobilising revenue and attracting the right kind of investment. Although the first countries to be reviewed – Tunisia, Ghana and Senegal – are not fragile states, OECD support is open to all interested countries.

4. ENCOURAGE TRANSPARENCY BY MULTINATIONAL ENTERPRISES

Effective transfer pricing rules can enable developing countries to collect the right amount of tax from multinational enterprises, counter cross-border profit shifting and create a predictable investment climate. The OECD Task Force on Tax and Development gives support to regional organisations such as the Africa Tax Administration Forum. The task force also has programmes underway in Colombia, Ghana, Honduras, Kenya, Rwanda (Box 10.6), Tanzania and Vietnam to build capacity for creating effective transfer pricing rules.

BOX 10.5 A Tax and Development Task Force at the OECD

Every year the OECD's Task Force on Tax and Development brings together OECD and developing countries, international and regional organisations, civil society, and business. It advises the OECD Committee on Fiscal Affairs and the Development Assistance Committee (DAC) on the delivery of a Tax and Development Programme to improve the conditions for developing countries to collect taxes fairly and effectively. The Task Force has identified four key areas for developing countries' efforts to mobilise domestic resources:

- 1) Statebuilding, accountability and effective capacity development
- 2) Strengthened and more effective transfer pricing regimes in developing countries
- 3) Increased transparency in the reporting of financial data by multinational enterprises
- 4) Countering international tax evasion and avoidance and improving transparency and information exchange.

For more information see: www.oecd.org/tax/tax-global/taxanddevelopment.htm

These country initiatives are delivered in partnership with the EU, the World Bank and other international partners. New tools are helping all stakeholders do their work more effectively, such as the forthcoming *Country Transfer Pricing Needs Assessment Tool* and *Tax Inspectors without Borders*, to be launched in 2014 (Box 10.7).

Another crucial aspect of transparency for multinational enterprises working in or with fragile states is to ensure responsible supply chains. The OECD *Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas* provides recommendations to help companies respect human rights and avoid contributing to conflict through their mineral purchasing decisions and practices (OECD, 2013d). Over 100 companies and industry associations have volunteered to implement the guidance. The broadening of these efforts beyond Africa's Great Lakes region is a positive development as it will allow a growing number of fragile and conflict-affected states to benefit from the guidance.

BOX 10.6 Designing an effective transfer pricing regime in Rwanda

The OECD's Task Force on Tax and Development has provided assistance to the Rwanda Revenue Authority (RRA) to assess the potential risk from transfer pricing. Its initial results found significant risk to Rwanda's overall tax revenues. Over 50% of Rwanda's tax is raised from Rwandan companies that are members of a multinational enterprise. In 2010 alone these companies paid over EUR 60 million to foreign related parties in interest charges, royalties and service fees. This suggests that there is a risk that Rwanda may be losing some of its potential revenue to foreign related parties. The programme is now working with the RRA to design an effective transfer pricing regime to address this risk. This includes revising Rwanda's legislation and guidelines for transfer pricing to align them with international standards – the guidelines are expected to enter into force in 2014. It has also designed the processes of the RRA for identifying and addressing the risk in transfer pricing, and building audit skills for RRA transfer pricing auditors.

Source: OECD/Tax and Development Programme. For further information see www.oecd.org/ctp/tax-global/taxanddevelopment.htm.

BOX 10.7 Tax inspectors without borders

Tax Inspectors Without borders (TIWB) is a new OECD initiative to help tax administrations in developing countries improve their tax audit knowledge and skills. TIWB will transfer experts from OECD tax administrations to developing countries, as well as between developing countries, to work on audits and audit-related issues. The experts work in joint teams with local tax experts on international tax matters and to share general audit practices under the leadership of each country's tax administration.

TIWB assistance is aimed at improving the quality and consistency of audits by transferring knowledge through practice. Broader benefits are also anticipated including the potential for increased revenues, greater certainty for taxpayers and encouraging a culture of compliance through more effective enforcement. Among fragile states, TIWB assistance will be particularly relevant where there is a danger of multinational profit shifting, for example in the natural resources and extractive industries.

The TIWB initiative is starting with pilot projects in Africa, South America and the Asia-Pacific. The project will be formally launched in early 2014.

For more information see www.oecd.org/tax/taxinspectors.htm

Set an example by being transparent about development co-operation. Promoting transparency in revenue matters helps foster mutual accountability. After a conflict, development assistance is often the biggest component of the formal economy. Yet income of local and international staff is often exempt from taxes, as are services provided to expatriates (e.g. hotels, restaurants) and goods imported for aid projects. Several sources stress that this reinforces a culture of exemptions and favouritism. It can be seen as a lack of coherence on the side of donor governments to preach one approach but do another; it can send a signal to local taxpayers that their national government cannot be trusted with tax revenues, undermining the legitimacy (Boyce, 2008). Furthermore, such exemptions deny partner governments important revenue that could “prime the pump of domestic revenue-collection capacity” (Boyce, 2008). Donors could set an example by being fully transparent about the technical assistance they provide to developing countries on revenue matters. They should also be fully transparent about the exemptions they claim on aid-funded goods and services, in line with the Busan Partnership for Effective Development Co-operation.⁴

5. BUILD TAX MORALE

Taxpayer education can help build tax morale. It is not simply a strategy to collect more money. Rather, it tries to foster attitudes of commitment to the common good. Its goal is to create a “culture of compliance” based on rights and responsibilities, in which citizens see paying taxes as an integral aspect of their relationship with their government and recognise the social value of tax and its link to public expenditures.

BOX 10.8 “Binding duty” – soap operas build tax morale in Nigeria

Governments are using many different ways to inform and engage today’s – and future – taxpayers. A multitude of innovative approaches to tax education are springing up. In Nigeria, a television soap opera – “Binding Duty” – is a relaxed, enjoyable and non-confrontational way of reminding citizens of their responsibility to pay taxes. With a weekly audience of 50 million, the programme has been very successful in raising awareness of the importance of taxation among ordinary citizens. The series has been watched by a total of 80 million citizens across Nigeria.

Source: OECD/EUROsociAL, forthcoming 2013

This includes highlighting how public money is used (OECD/EUROsociAL, forthcoming 2013), and working to reduce confusion between formal and informal taxation. Research – including the ITC/OECD study, *Tax and Development: Aid Modalities for Strengthening Tax Systems* (OECD, 2013b) – notes that such taxpayer education campaigns can be an efficient and effective way of building trust and increasing public engagement (Box 10.8).

Efforts to build tax morale are closely linked with responsible management of expenditure. Several fragile states provide examples of increasing accountability in the use of revenue, including from natural resources. Timor-Leste, Libya, Angola and Nigeria all have established sovereign wealth funds, though with varying degrees of transparency. Several countries – mainly non-fragile ones – have built cash handout programmes to distribute windfalls from their natural resources to the population. The US state of Alaska’s Permanent Fund dividend programme is the best known, but there are also others, including Bolivia’s *Renta Dignidad* and Mongolia’s “Motherland Endowment”. Such schemes have also been shown to work in fragile states – as Timor-Leste’s post-conflict, veteran and social protection transfers illustrate (Box 10.9).

Efforts to build tax morale and compliance are also linked to the design of transfers between national and sub-national governments. Questions of resource transfer are currently

BOX 10.9 Timor-Leste’s oil revenues fuel a return to stability

Since 2004, Timor-Leste has earned oil revenues which are enormous relative to its small population and non-oil economy. Revenues now exceed USD 2 billion, and state spending increased from USD 70 million in 2004 to a projected USD 1.7 bn in 2012. The government has implemented several cash transfer programmes as one mechanism for allocating this newfound wealth. Beneficiaries include:

- Internally displaced persons (IDPs) from the security crisis in 2006 and 2007 received transfers as part of resettlement packages. These transfers helped to close large IDP camps and advanced a return to stability.
- Veterans of the 24-year struggle for independence from Indonesia, and their survivors.
- Vulnerable groups, such as the elderly, the disabled and low income female-headed households.

Since the introduction of the transfers in 2008, their value and the number of recipients have grown. These transfer programmes now consume a large portion of the annual budget (22% in 2010; 17% in 2011), and constitute a significant channel of interaction between the state and its citizens. While providing a practical democracy/peace dividend to a poor population, there is however also a risk they could be used for political rather than developmental aims. For example, several groups, including a group of former soldiers, have demanded and received payments by threatening violence.

Source: Gillies (2012); Timor-Leste State Budget (2012)

high on the agenda in Nigeria and DRC. In Nigeria, oil-rich states in the south generate very low levels of revenue from resources other than oil. Only Lagos State collects more revenues from taxes than from derivation transfer. In DRC there are major problems with the redistribution from Kinshasa to the provinces. As a result, incentives are so low for the provincial administration to collect revenue for the centre that they have sometimes created their own provincial parallel tax system.⁵

QUESTION 10

NOTES

1. Further reports are available at: <http://www.oecd.org/tax/tax-global/taxanddevelopment.htm>.
2. For more see www.afdb.org/en/topics-and-sectors/initiatives-partnerships/african-legal-support-facility.
3. This section is based on information provided by Matthew Genasci, Mining Policy Institute (personal communication).
4. Norway has recently stopped claiming exemptions on goods and services funded by bilateral aid.
5. Personal communication, Antoine Heuty, Ulula.

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Table A.1 List of 51 fragile states and economies used in the 2014 Fragile States Report and how it was assembled

COUNTRIES	World Bank/AfDB/ADB Harmonised List of Fragile States 2014	Fund for Peace Fragile States Index 2013	COUNTRIES	World Bank/AfDB/ADB Harmonised List of Fragile States 2014	Fund for Peace Fragile States Index 2013
Afghanistan	●	●	Madagascar	●	
Angola	●		Malawi	●	
Bangladesh		●	Mali	●	
Bosnia and Herzegovina	●		Marshall Islands	●	
Burkina Faso		●	Mauritania		●
Burundi	●	●	Micronesia, Federated States	●	
Cameroon		●	Myanmar	●	●
Central African Republic	●	●	Nepal	●	●
Chad	●	●	Niger		●
Comoros	●		Nigeria		●
Congo, Democratic Republic	●	●	Pakistan		●
Congo, Republic	●		Sierra Leone	●	●
Côte d'Ivoire	●	●	Solomon Islands	●	
Egypt, Arab Republic		●	Somalia	●	●
Eritrea	●	●	South Sudan	●	●
Ethiopia		●	Sri Lanka		●
Guinea		●	Sudan	●	●
Guinea-Bissau	●	●	Syrian Arab Republic	●	●
Haiti	●	●	Timor-Leste	●	●
Iraq	●	●	Togo	●	
Kenya		●	Tuvalu	●	
Kiribati	●		Uganda		●
Korea, DPR		●	West Bank and Gaza Strip	●	
Kosovo	●		Yemen, Republic	●	●
Liberia	●	●	Zimbabwe	●	●
Libya	●				

Sources: 2014 World Bank / AfDB, ADB Harmonised List, available at <http://siteresources.worldbank.org/EXTLICUS/Resources/511777-1269623894864/HarmonizedlistoffragilestatesFY14.pdf>, and 2013 Failed States Index, <http://ffp.statesindex.org/rankings-2013-sortable>

TABLE A.2 How much aid did Fragile States receive?
Net ODA by recipient country, 2000–2011 (constant 2011 USD million)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Afghanistan	243	764	2 032	2 164	2 849	3 360	3 409	5 413	5 103	6 644	6 743	6 711
Angola	508	493	650	670	1 443	508	196	275	382	259	253	200
Bangladesh	1 830	1 710	1 428	1 888	1 753	1 589	1 435	1 626	2 154	1 339	1 512	1 498
Bosnia-Herzegovina	1 283	1 090	912	756	867	681	644	658	477	445	545	624
Burkina Faso	344	704	731	760	814	860	1 086	1 046	1 033	1 154	1 134	996
Burundi	162	254	283	316	458	443	511	523	541	597	673	579
Cameroon	638	802	1 019	1 217	988	507	2 044	2 070	561	684	575	611
Central African Republic	117	128	96	71	137	108	158	191	268	255	280	272
Chad	222	329	373	352	420	472	346	393	431	589	514	468
Comoros	33	48	45	34	33	28	38	49	42	53	72	52
Congo, Dem. Rep.	307	426	1 865	7 358	2 344	2 304	2 529	1 462	1 813	2 523	3 772	5 532
Congo, Rep.	56	121	95	95	145	1 770	309	130	488	294	1 397	260
Côte d'Ivoire	598	350	1 800	346	202	114	296	193	647	2 503	897	1 436
Egypt	2 064	1 977	1 814	1 335	1 873	1 232	1 054	12 17	1 792	1 042	628	412
Eritrea	293	487	359	435	334	420	153	175	151	155	172	135
Ethiopia	1 105	1 809	2 063	2 158	2 246	2 306	2 374	2 728	3 426	4 077	3 723	3 532
Guinea	240	472	393	346	347	241	202	250	338	223	231	201
Guinea-Bissau	145	111	100	211	96	81	103	132	136	153	148	119
Haiti	314	262	232	284	382	525	687	773	957	1 194	3 231	1 712
Iraq	182	220	195	2 953	5 566	25 986	10 400	10 202	10 529	2 928	2 269	1 904
Kenya	779	772	590	696	813	907	1 102	1 433	1 406	1 890	1 714	2 484
Kiribati	32	28	40	32	25	39	37	36	33	35	26	64
Korea, DPR	136	216	388	181	204	112	69	112	217	73	85	118
Kosovo										821	662	657
Liberia	105	61	85	147	262	267	305	772	1 284	547	1 511	765
Libya						29	42	21	75	43	9	642
Madagascar	510	614	593	753	1 589	1 119	937	1 007	872	469	499	441
Malawi	684	675	587	703	618	691	833	800	948	836	1 090	804
Mali	488	605	688	779	752	894	1 039	11 16	1 005	1 059	1 157	1 270
Marshall Islands	77	96	81	70	61	66	62	57	56	62	94	82
Mauritania	367	485	595	357	243	231	270	383	468	395	398	381
Micronesia, Fed. States	131	175	142	141	103	123	122	126	100	127	129	134
Myanmar	150	191	182	174	161	183	179	226	571	392	384	374
Nepal	595	639	530	642	533	519	629	665	726	927	880	892
Niger	349	448	487	670	690	645	653	603	631	498	792	646
Nigeria	261	280	443	405	691	7 396	13 164	2 073	1 340	1 768	2 178	1 777
Pakistan	998	2 839	3 183	1 432	1 785	1 984	2 574	2 460	1 598	2 982	3 171	3 509
Sierra Leone	288	558	588	450	458	402	444	590	384	477	496	424
Solomon Islands	137	134	67	144	219	318	321	347	302	293	391	334
Somalia	188	265	253	260	264	299	461	430	788	707	532	1 096
South Sudan												1 087
Sri Lanka	392	531	545	931	656	1 476	986	692	786	786	629	611
Sudan	383	335	463	845	1 232	2 175	2 373	2 289	2 663	2 517	2 195	1 123
Syria	232	271	101	172	134	85	17	76	146	214	142	335
Timor-Leste	476	394	400	268	225	248	275	334	315	255	324	284
Togo	116	79	83	69	83	102	96	132	334	554	446	557
Tuvalu	9	17	20	10	12	13	21	15	20	21	15	43
Uganda	1 374	1 365	1 135	1 347	1 499	1 437	1 833	1 866	1 689	1 907	1 827	1 582
West Bank and Gaza Strip	1 109	1 670	1 562	1 439	1 463	1 257	1 635	1 888	2 540	29 93	2 667	2 442
Yemen	484	606	340	329	325	352	334	259	440	594	706	476
Zimbabwe	278	274	305	248	228	450	319	503	635	799	782	716
GRAND TOTAL	21 810	27 179	30 963	37 447	38 627	67 355	59 104	50 816	53 640	52 147	54 701	53 403

Source: OECD IDS online databases on aid and other resource flows, available at www.oecd.org/dac/stats/idsonline. This table reflects net ODA receipts in constant 2011 USD million.

TABLE A.3 How much country programmable aid did fragile states receive – and what is the outlook?
Country programmable aid to fragile states, by recipient country, 2000-2016, in 2011 USD million

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Total CPA																	
All developing countries	64 236	70 635	74 664	70 993	76 066	79 489	80 356	85 549	93 149	102 572	99 884	96 220	95 408	104 145	104 334	104 544	104 429
Fragile States	20 371	23 958	26 689	25 010	30 018	34 906	33 999	36 931	38 190	42 780	42 410	41 397	42 028	45 116	44 559	43 890	43 791
Afghanistan	50	126	1 049	1 525	2 236	2 890	2 925	4 679	3 978	5 769	5 729	5 763	5 188	5 202	5 277	5 021	5 016
Angola	288	291	312	292	265	347	389	360	348	296	269	234	266	303	323	312	310
Bangladesh	2 103	1 936	1 639	2 153	2 008	1 983	1 909	1 928	2 458	1 840	1 958	2 046	2 738	2 981	2 916	2 903	2 909
Bosnia and Herzegovina	878	854	802	652	746	540	567	588	427	410	502	385	371	453	384	392	388
Burkina Faso	577	673	697	730	768	809	955	967	949	1 060	1 034	930	1 010	912	979	936	918
Burundi	121	185	187	167	278	262	318	392	411	450	558	479	431	401	428	410	400
Cameron	540	381	508	363	479	347	531	598	545	664	562	561	562	557	556	560	553
Central African Rep.	114	127	83	53	118	94	189	170	165	195	170	190	141	113	150	146	148
Chad	219	271	377	333	319	346	254	207	252	275	269	257	225	265	255	246	235
Comoros	33	46	48	28	27	22	29	40	38	46	64	43	41	39	44	41	41
Congo, Dem. Rep.	183	204	1 908	715	966	1 202	917	751	1 186	1 796	1 642	1 739	1 653	1 741	1 775	1 729	1 753
Congo, Rep.	47	105	65	70	153	127	125	108	130	85	119	165	117	136	145	136	134
Côte d'Ivoire	602	380	990	208	174	113	228	197	681	893	638	1 225	715	608	584	603	604
Egypt	2 078	2 027	2 151	1 597	2 158	1 603	1 391	1 685	2 299	1 613	1 366	1 005	1 189	1 496	1 325	1 385	1 376
Eritrea	153	375	240	222	189	219	104	134	105	101	129	117	83	68	98	94	94
Ethiopia	763	1 409	1 612	1 099	1 489	1 364	1 598	2 142	2 134	3 125	2 650	2 659	2 731	2 830	2 995	2 878	2 873
Guinea	259	401	335	295	274	237	218	246	249	181	224	303	317	213	228	218	217
Guinea-Bissau	134	94	89	99	89	68	86	118	116	140	121	101	64	48	91	83	83
Haiti	270	228	185	236	234	460	543	588	680	928	1 313	1 050	973	1 029	1 016	999	1 021
Iraq	24	28	27	1 665	4 218	8 500	5 565	4 273	2 978	2 369	1 978	1 579	1 245	1 247	1 212	1 219	1 219
Kenya	873	812	665	785	745	880	891	1 304	1 221	1 658	1 615	2 191	2 474	2 581	2 651	2 657	2 654
Kiribati	32	28	40	32	25	38	37	35	31	35	18	61	70	78	76	77	77
Korea, DPR	46	91	184	51	51	43	29	55	91	27	47	59	58	66	66	65	65
Kosovo										770	599	599	478	388	419	412	406
Liberia	58	39	28	37	85	111	142	655	625	361	469	466	462	468	468	465	463
Libya					21	35	15	80	44	39	59	82	64	62	65	66	66
Madagascar	531	560	582	609	913	715	771	805	807	404	451	355	325	396	415	386	380
Malawi	672	649	509	595	581	606	618	695	860	758	984	707	1 086	977	961	937	938
Mali	643	644	714	754	732	848	890	924	943	1 006	1 073	1 219	729	1 082	1 055	996	935
Marshall Islands	76	96	81	70	60	66	59	57	56	62	96	82	84	84	83	83	83
Mauritania	366	457	475	260	234	201	214	328	410	356	384	357	360	258	257	253	261
Micronesia, Fed. States	131	176	142	141	103	123	121	126	99	126	130	133	120	119	122	122	122
Myanmar	107	125	134	140	115	138	132	153	177	198	289	278	424	1 337	590	606	612
Nepal	627	661	558	654	552	526	613	687	717	946	951	903	811	1 045	995	1 005	1 008
Niger	341	414	465	485	452	489	487	498	510	397	457	446	580	598	559	543	540
Nigeria	268	308	401	416	690	918	1 104	1 128	1 333	1 831	2 129	1 910	2 029	2 628	2 677	2 587	2 580
Pakistan	1 218	2 896	3 120	1 648	2 094	1 871	2 630	2 676	1 972	3 074	2 407	2 526	2 781	3 102	3 243	3 315	3 326
Sierra Leone	269	439	346	267	356	331	301	297	337	428	432	380	403	364	390	381	378
Solomon Islands	140	140	70	172	210	311	321	346	292	291	372	331	336	287	201	204	201
Somalia	88	130	96	98	82	85	116	118	177	189	246	274	462	400	386	391	391
South Sudan												-	582	731	785	790	772
Sri Lanka	687	853	844	1 219	899	1 072	1 144	940	1 040	1 095	937	972	928	948	1 026	1 049	1 055
Sudan	147	135	163	477	308	627	842	778	1 150	1 111	1 183	615	686	647	659	620	618
Syria	341	287	262	303	261	206	187	218	303	269	256	396	432	493	508	504	511
Timor-Leste	289	357	360	249	213	232	244	271	274	233	282	252	264	280	238	244	244
Togo	134	119	88	65	72	81	81	109	322	229	227	259	148	159	181	187	178
Tuvalu	9	17	19	10	11	10	21	15	19	21	13	31	25	26	32	31	30
Uganda	1 193	1 283	1 076	1 202	1 326	1 235	1 423	1 542	1 347	1 668	1 670	1 466	1 600	1 795	1 831	1 742	1 726
West Bank and Gaza Strip	892	1 179	1 395	1 282	1 148	997	1 118	1 368	2 089	2 067	2 140	1 764	1 646	1 765	1 626	1 665	1 670
Yemen	398	621	337	340	344	410	408	366	543	528	709	376	615	631	618	608	607
Zimbabwe	357	302	229	149	167	184	185	250	236	362	510	519	740	626	588	605	602

Source: OECD IDS online databases on aid and other resource flows, available at www.oecd.org/dac/stats/idsonline, for 2000-2011 data; Survey on Donors' Forward Spending Plans, 2013, for 2012-2016 forecasts, available at <http://www.oecd.org/development/effectiveness/aidpredictability.htm>

TABLE A.4 Aid fluctuations in fragile states
Changes in country programmable aid (CPA) over previous year, 2000-2011

	2000-2001	2001-2002	2002-2003	2003-2004	2004-2005	2005-2006	2006-2007	2007-2008	2008-2009	2009-2010	2010-2011
Changes in total CPA											
All developing countries	10%	6%	-5%	7%	4%	1%	6%	9%	10%	-3%	-4%
Fragile States	18%	11%	-6%	20%	16%	-3%	9%	3%	12%	-1%	-2%
Afghanistan	154%	735%	45%	47%	29%	1%	60%	-15%	45%	-1%	1%
Angola	1%	7%	-6%	-9%	31%	12%	-7%	-3%	-15%	-9%	-13%
Bangladesh	-8%	-15%	31%	-7%	-1%	-4%	1%	27%	-25%	6%	4%
Bosnia-Herzegovina	-3%	-6%	-19%	14%	-28%	5%	4%	-27%	-4%	23%	-23%
Burkina Faso	17%	4%	5%	5%	5%	18%	1%	-2%	12%	-2%	-10%
Burundi	53%	1%	-11%	66%	-6%	21%	23%	5%	10%	24%	-14%
Cameroon	-29%	33%	-29%	32%	-28%	53%	13%	-9%	22%	-15%	0%
Central African Rep.	12%	-35%	-36%	124%	-21%	102%	-10%	-2%	18%	-13%	12%
Chad	24%	39%	-12%	-4%	8%	-27%	-18%	21%	9%	-2%	-5%
Comoros	38%	4%	-41%	-6%	-20%	32%	40%	-4%	21%	39%	-33%
Congo, Dem. Rep.	12%	834%	-63%	35%	24%	-24%	-18%	58%	51%	-9%	6%
Congo, Rep.	123%	-38%	8%	120%	-17%	-1%	-14%	21%	-35%	40%	39%
Côte d'Ivoire	-37%	160%	-79%	-16%	-35%	102%	-14%	246%	31%	-29%	92%
Egypt	-2%	6%	-26%	35%	-26%	-13%	21%	36%	-30%	-15%	-26%
Eritrea	145%	-36%	-8%	-15%	16%	-53%	29%	-22%	-3%	28%	-10%
Ethiopia	85%	14%	-32%	36%	-8%	17%	34%	0%	46%	-15%	0%
Guinea	55%	-16%	-12%	-7%	-13%	-8%	13%	1%	-27%	24%	35%
Guinea-Bissau	-30%	-5%	11%	-10%	-24%	26%	38%	-2%	21%	-14%	-16%
Haiti	-16%	-19%	28%	-1%	96%	18%	8%	16%	36%	42%	-20%
Iraq	19%	-2%	5961%	153%	102%	-35%	-23%	-30%	-20%	-17%	-20%
Kenya	-7%	-18%	18%	-5%	18%	1%	46%	-6%	36%	-3%	36%
Kiribati	-14%	45%	-21%	-22%	53%	-2%	-4%	-12%	11%	-48%	238%
Korea, DPR	98%	102%	-72%	1%	-17%	-32%	92%	64%	-70%	75%	26%
Kosovo										-22%	0%
Liberia	-33%	-29%	35%	127%	30%	28%	362%	-5%	-42%	30%	-1%
Libya						67%	-56%	417%	-44%	-12%	52%
Madagascar	5%	4%	5%	50%	-22%	8%	4%	0%	-50%	12%	-21%
Malawi	-3%	-22%	17%	-2%	4%	2%	13%	24%	-12%	30%	-28%
Mali	0%	11%	6%	-3%	16%	5%	4%	2%	7%	7%	14%
Marshall Islands	26%	-15%	-15%	-14%	9%	-11%	-3%	-2%	11%	53%	-14%
Mauritania	25%	4%	-45%	-10%	-14%	6%	53%	25%	-13%	8%	-7%
Micronesia, Fed. States	34%	-19%	0%	-27%	20%	-2%	4%	-21%	27%	3%	2%
Myanmar	17%	7%	5%	-18%	20%	-5%	16%	16%	12%	46%	-4%
Nepal	5%	-16%	17%	-16%	-5%	17%	12%	4%	32%	1%	-5%
Niger	22%	12%	4%	-7%	8%	-1%	2%	3%	-22%	15%	-2%
Nigeria	15%	30%	4%	66%	33%	20%	2%	18%	37%	16%	-10%
Pakistan	138%	8%	-47%	27%	-11%	41%	2%	-26%	56%	-22%	5%
Sierra Leone	64%	-21%	-23%	33%	-7%	-9%	-1%	14%	27%	1%	-12%
Solomon Islands	0%	-50%	145%	22%	48%	3%	8%	-16%	0%	28%	-11%
Somalia	48%	-26%	2%	-16%	3%	36%	2%	50%	7%	30%	11%
South Sudan											
Sri Lanka	24%	-1%	44%	-26%	19%	7%	-18%	11%	5%	-14%	4%
Sudan	-9%	21%	193%	-36%	104%	34%	-8%	48%	-3%	6%	-48%
Syria	-16%	-9%	16%	-14%	-21%	-9%	16%	39%	-11%	-5%	55%
Timor-Leste	23%	1%	-31%	-15%	9%	5%	11%	1%	-15%	21%	-11%
Togo	-11%	-26%	-27%	11%	12%	0%	35%	196%	-29%	-1%	14%
Tuvalu	90%	13%	-47%	10%	-12%	115%	-30%	31%	6%	-38%	141%
Uganda	8%	-16%	12%	10%	-7%	15%	8%	-13%	24%	0%	-12%
West Bank and Gaza Strip	32%	18%	-8%	-10%	-13%	12%	22%	53%	-1%	4%	-18%
Yemen	56%	-46%	1%	1%	19%	-1%	-10%	48%	-3%	34%	-47%
Zimbabwe	-15%	-24%	-35%	12%	10%	0%	36%	-6%	53%	41%	2%

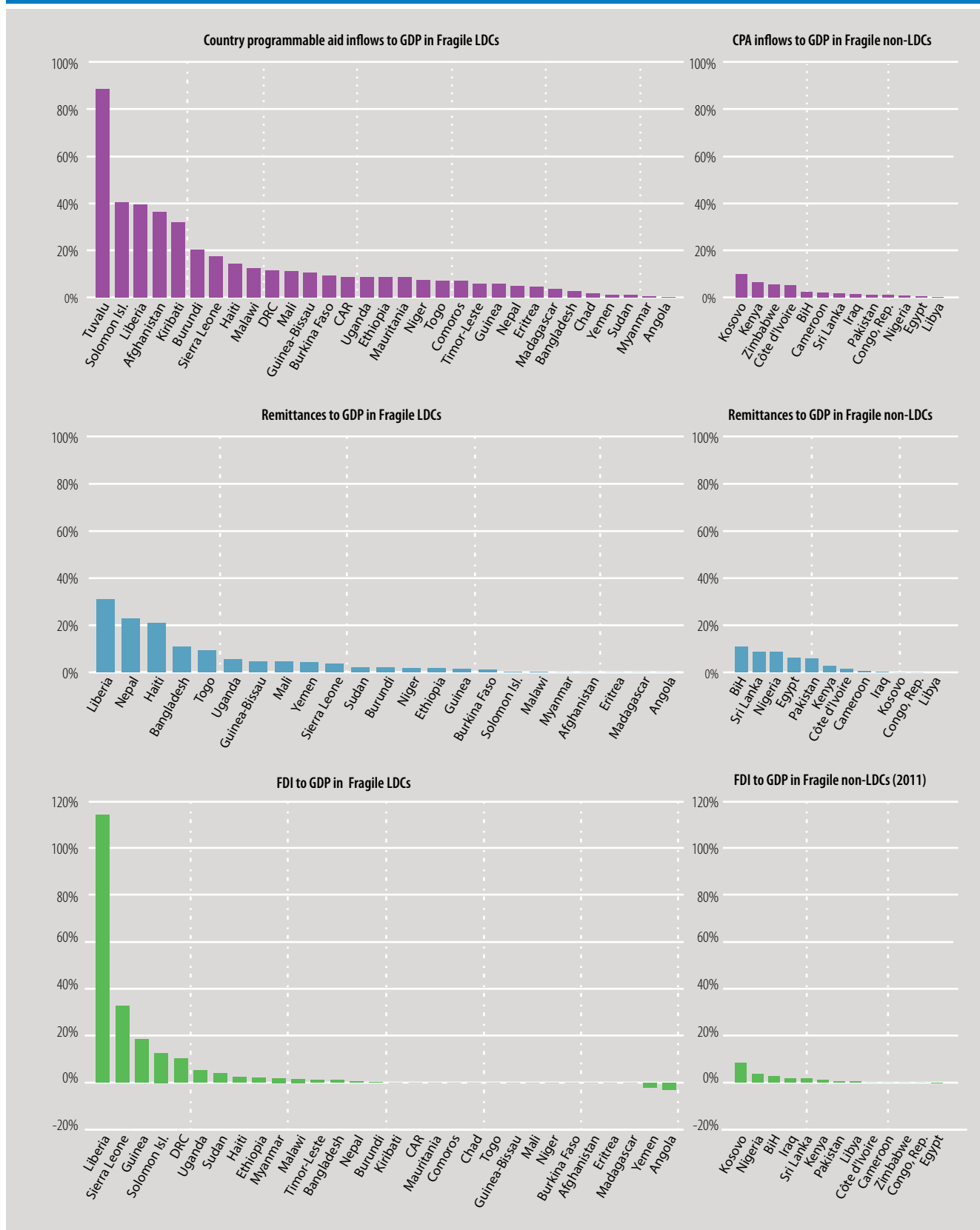
Source: OECD IDS online databases on aid and other resource flows, available at www.oecd.org/dac/stats/idsonline

TABLE A.5 Multilateral agencies deliver a higher share of aid in fragile states than in others

	2007	2008	2009	2010	2011
Total share, fragile states	44%	44%	45%	43%	42%
Total share, non-fragile states	33%	32%	36%	34%	35%
Total share, developing countries	38%	37%	40%	38%	38%
Afghanistan	25%	13%	17%	14%	14%
Angola	41%	45%	38%	38%	35%
Bangladesh	67%	66%	53%	53%	45%
Bosnia and Herzegovina	37%	32%	32%	55%	42%
Burkina Faso	60%	56%	62%	61%	57%
Burundi	70%	60%	63%	61%	62%
Cameroon	39%	43%	59%	51%	53%
Central African Rep.	63%	76%	78%	85%	77%
Chad	66%	72%	72%	75%	83%
Comoros	78%	66%	66%	70%	65%
Congo, Rep.	72%	81%	77%	83%	47%
Congo, Dem. Rep.	64%	63%	71%	63%	61%
Côte d'Ivoire	55%	78%	87%	76%	53%
Egypt	21%	26%	34%	30%	26%
Eritrea	81%	74%	75%	84%	89%
Ethiopia	59%	63%	65%	60%	56%
Guinea	67%	68%	52%	72%	81%
Guinea-Bissau	73%	70%	72%	67%	67%
Haiti	47%	46%	44%	49%	42%
Iraq	2%	1%	4%	7%	15%
Kenya	44%	36%	39%	35%	47%
Kiribati	14%	23%	15%	11%	6%
Korea, DPR	28%	13%	50%	81%	77%
Kosovo	-	-	43%	54%	57%
Liberia	81%	67%	37%	41%	46%
Libya	20%	39%	37%	69%	90%
Madagascar	66%	71%	51%	60%	51%
Malawi	51%	56%	46%	53%	50%
Mali	55%	48%	45%	42%	41%
Marshall Islands	3%	5%	1%	12%	0%
Mauritania	68%	78%	72%	75%	70%
Micronesia, Fed. States	4%	8%	2%	1%	5%
Myanmar	36%	40%	34%	37%	29%
Nepal	43%	47%	49%	49%	52%
Niger	65%	65%	54%	64%	71%
Nigeria	57%	52%	60%	62%	57%
Pakistan	68%	56%	66%	47%	37%
Sierra Leone	57%	60%	60%	67%	65%
Solomon Islands	4%	3%	3%	13%	11%
Somalia	53%	35%	35%	54%	53%
South Sudan	-	-	-	-	38%
Sri Lanka	39%	36%	46%	37%	38%
Sudan	24%	41%	22%	34%	56%
Syrian Arab Republic	-	74%	70%	64%	76%
Timor-Leste	10%	15%	14%	11%	14%
Togo	63%	88%	76%	83%	84%
Tuvalu	20%	5%	13%	5%	41%
Uganda	50%	44%	47%	43%	41%
West Bank and Gaza Strip	54%	41%	34%	31%	38%
Yemen, Republic	-	67%	60%	67%	55%
Zimbabwe	31%	21%	22%	36%	29%

Source: OECD. This table reflects country programmable aid (CPA), whereby multi-bi aid has been reallocated from bilateral to multilateral agencies.

FIGURE A.2 Aid, remittances and FDI in fragile LDCs and non-LDCs
(% of GDP, 2011)



Source: Compiled from OECD CPA data (country programmable aid), FDI data from IMF through eLibrary, <http://elibrary-data.imf.org/>, and Remittances from World Development Indicators, <http://data.worldbank.org/data-catalog/world-development-indicators>.

TABLE A.6 Revenue and tax against GDP in fragile states (2007-2011)

	Average revenue (% of GDP) 2007-2011	Revenue - Annual growth rate 2007-2011	Average tax revenue (% of GDP) 2007-2011	Tax revenue - Annual growth rate 2007-2011	Available years for annual growth rate calculations
Average, Fragile States (2007-2011)*	16.1	4.8	12.3	5.3	
Afghanistan	9.6	10.5	7.5	11.1	2007-2011
Bangladesh	11.1	3.2	8.9	4.4	2007-2011
Bosnia and Herzegovina	39.3	-0.1	20.7	-1.3	2007-2011
Burkina Faso	14.3	3.2	12.7	2.2	2007-2011
Congo, Democratic Republic	20.4	11.2	13.4	4.1	2007-2010
Egypt, Arab Republic.	25.7	-4.2	14.9	-1.8	2007-2011
Ethiopia	10.1	5.6	8.1	3.3	2007-2011
Kenya	19.8	2.0	19.0	2.3	2007-2011
Liberia	21.5	1.7	18.4	-1.7	2007-2011
Madagascar	13.0	19.3	12.2	13.8	2007-2008
Mali	16.8	0.2	14.4	-0.5	2007-2010
Nepal	13.6	4.5	11.7	6.2	2007-2011
Niger	13.5		11.3		2007
Nigeria	8.9	20.1	0.2	42.6	2007-2008
Pakistan	13.2	-2.1	9.4	-0.1	2007-2011
Sierra Leone	9.5	6.5	8.9	6.7	2007-2011
Sri Lanka	14.8	-2.0	13.1	-2.7	2007-2011
Togo	17.0	1.6	15.8	0.7	2007-2011
Uganda	13.5	5.0	13.1	5.4	2007-2011

* Includes all countries with at least two data points.

Source: World Development Indicators

TABLE A.7 Revenue diversity in select fragile states, 2011

	% OF TOTAL REVENUE												Grants and other revenue					
	Taxes on income, profits and capital gains		Taxes on goods and services		Taxes on international trade		Other taxes		Social contributions									
	2006	2011	2006	2011	2006	2011	2006	2011	2006	2011	2006	2011						
Afghanistan	6.9	2.7	▼	8.9	2.6	▼	4.2	3.8	▼	5.7	0.4	▼	11.2	0.3	▼	2.4	90.2	▲
Bangladesh	8.2	22.4	▲	10.2	30.9	▲	14.6	24.6	▲	28.6	3.1	▼	30.9			3.3	19.1	▲
Bosnia and Herzegovina	22.5	6.6	▼	39.4	44.9	▲	2.2			50.6	0.5	▼	0.0	39.4	▲	4.0	8.7	▲
Egypt, Arab Republic	15.8	29.7	▲	28.1	25.2	▼	27.4	4.6	▼	19.7	4.2	▼	5.5			2.9	36.4	▲
Ethiopia	8.3	16.0	▲	8.9	15.6	▲	15.1	29.7	▲	17.0	-		48.1			-	38.8	
Kenya	17.4	42.5	▲	18.4	39.8	▲	34.3	10.4	▼	44.2	0.1	▼	9.4			0.8	7.3	▲
Liberia	0.2	25.5	▲	0.2	14.1	▲	29.3	28.5	▼	23.8	3.2	▼	41.4			0.3	28.7	▲
Nepal	8.8	17.1	▲	10.7	38.2	▲	10.9	14.5	▲	34.4	1.9	▼	18.2			4.7	28.3	▲
Pakistan	9.4	27.4	▲	13.4	34.7	▲	20.2	7.6	▼	32.8	4.2	▼	13.0			1.4	26.1	▲
Sierra Leone	8.5	21.8	▲	9.0	29.4	▲	16.3	13.0	▼	16.1	-		23.5			-	35.8	
Sri Lanka	14.6	16.6	▲	16.2	42.9	▲	15.9	16.6	▲	51.1	9.4	▼	14.6	1.3	▼	2.9	13.1	▲
Togo	14.8	10.3		15.9	37.5	▲	18.2	18.3	▲	44.5	6.5	▼	19.2			3.8	27.4	▲
Uganda	12.3	39.1	▲	12.7	39.5	▲	18.8	7.4	▼	41.9	0.4	▼	8.6			0.3	13.5	▲

Source: WDI available at <http://databank.worldbank.org>.

TABLE A.8 Top 20 fragile ODA recipients, 2011

	Fragile state or economy	ODA (USD million)	ODA PER CAPITA (USD)
1	Afghanistan	6 711	..
2	Congo, Democratic Republic	5 532	38
3	Ethiopia	3 532	11
4	Pakistan	3 509	2
5	Kenya	2 484	7
6	West Bank and Gaza Strip	2 442	..
7	Iraq	1 904	2
8	Nigeria	1 777	1
9	Haiti	1 712	23
10	Uganda	1 582	10
11	Bangladesh	1 498	1
12	Côte d'Ivoire	1 436	6
13	Mali	1 270	13
14	Sudan	1 123	..
15	Somalia	1 096	..
16	South Sudan	1 087	..
17	Burkina Faso	996	10
18	Nepal	892	5
19	Malawi	804	15
20	Liberia	765	73

Sources: OECD IDS online databases on aid and other resource flows, available at www.oecd.org/dac/stats/idsonline.

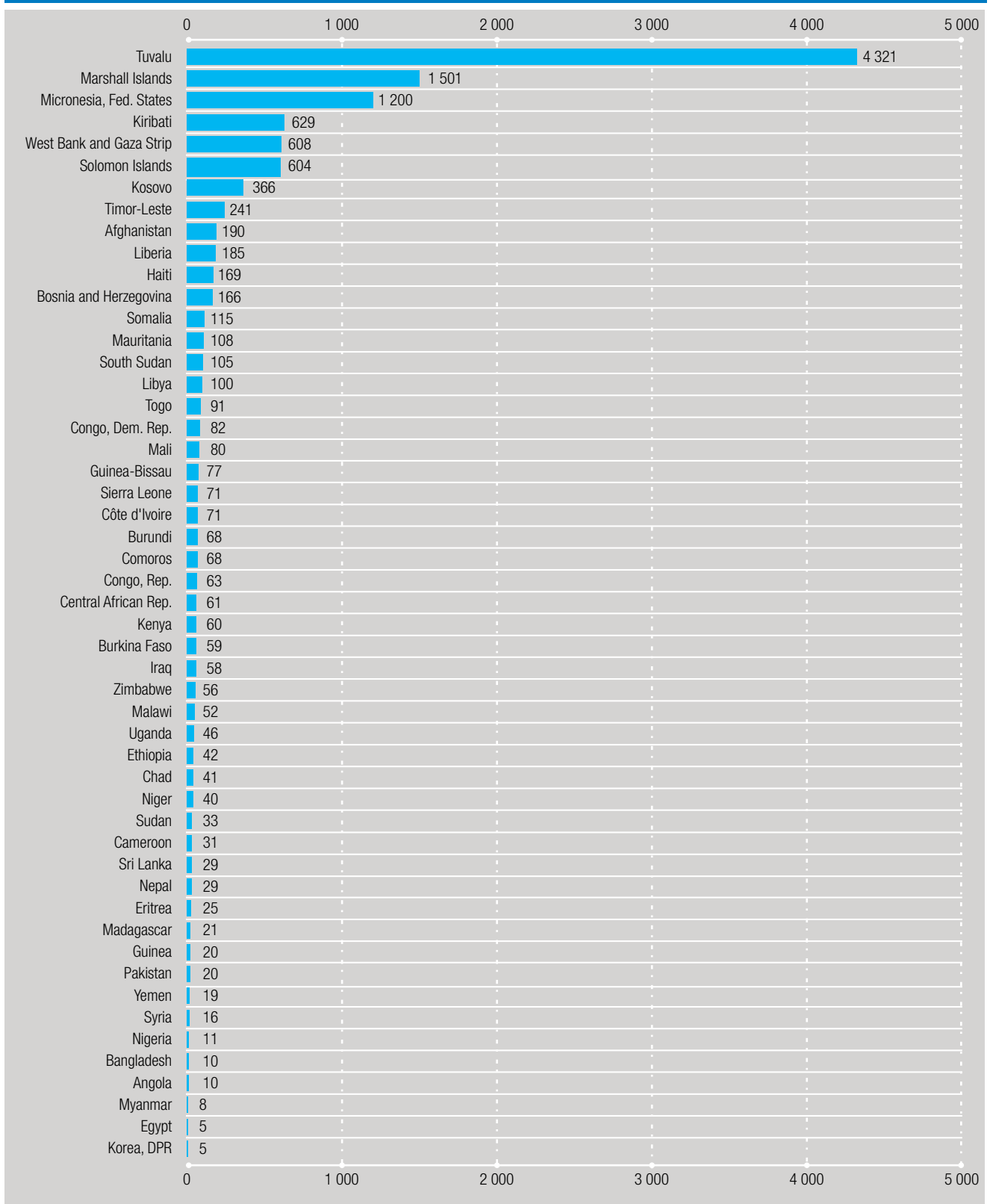
TABLE A.9 What are fragile states doing to combat illicit flows?

Rank	Country	Financial Action Task Force (FATF) status	FATF Associate Membership through Regional group	Membership Global Forum of Transparency and Exchange of Information for Tax Purposes
1	Afghanistan	● Improving compliance	● APG	
2	Angola	● Improving compliance	● ESSAAMLG	
3	Bangladesh	● Improving compliance	● APG	
4	Bosnia and Herzegovina		● MONEYVAL	
5	Burkina Faso		● GIABA	● Member
6	Burundi			
7	Cameroon			● Member
8	Central African Republic			
9	Chad			
10	Comoros		● ESAAMLG, GIABA observer	
11	Congo, Democratic Republic			
12	Congo, Republic			
13	Côte d'Ivoire			
14	Egypt, Arab Republic		● MENAFATF	
15	Eritrea			
16	Ethiopia	● High-risk, non-cooperative jurisdiction	● ESAAMLG observer	
17	Guinea		● GIABA	
18	Guinea-Bissau		● GIABA	
19	Haiti		● CFATF	
20	Iraq		● MENAFATF	
21	Kenya	● High-risk, non-cooperative jurisdiction	● ESAAMLG	● Member
22	Kiribati			
23	Korea, DPR	● High-risk, non-cooperative jurisdiction		
24	Kosovo			
25	Liberia		● GIABA	● Member
26	Libya		● MENAFATF	
27	Madagascar			
28	Malawi		● ESAAMLG	
29	Mali		● GIABA	
30	Marshall Islands		● APG	● Member
31	Mauritania		● MENAFATF	● Member
32	Micronesia, Federated States			
33	Myanmar	● High-risk, non-cooperative jurisdiction	● APG	
34	Nepal	● Improving compliance	● APG	
35	Niger		● GIABA	
36	Nigeria	● Improving compliance	● GIABA	● Member
37	Pakistan	● High-risk, non-cooperative jurisdiction	● APG	● Member
38	Sierra Leone		● GIABA	
39	Solomon Islands		● APG	
40	Somalia			
41	South Sudan			
42	Sri Lanka		● APG	
43	Sudan	● Improving compliance	● MENAFATF	
44	Syrian Arab Republic	● High-risk, non-cooperative jurisdiction	● MENAFATF	
45	Timor-Leste		● APG	
46	Togo		● GIABA	
47	Tuvalu			
48	Uganda		● ESAAMLG	● Member
49	West Bank and Gaza Strip			
50	Yemen	● High-risk, non-cooperative jurisdiction	● MENAFATF	
51	Zimbabwe	● Improving compliance	● ESAAMLG	

APG: Asia/Pacific Group on Money Laundering; CFATF: Caribbean Financial Action Task Force; ESAAMLG: Eastern and Southern Africa Anti-Money Laundering Group; FATF: Financial Action Task Force; GIABA: Inter Governmental Action Group against Money Laundering in West Africa; MENAFATF: Middle East and North Africa Financial Action Task Force; MONEYVAL: Council of Europe Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism

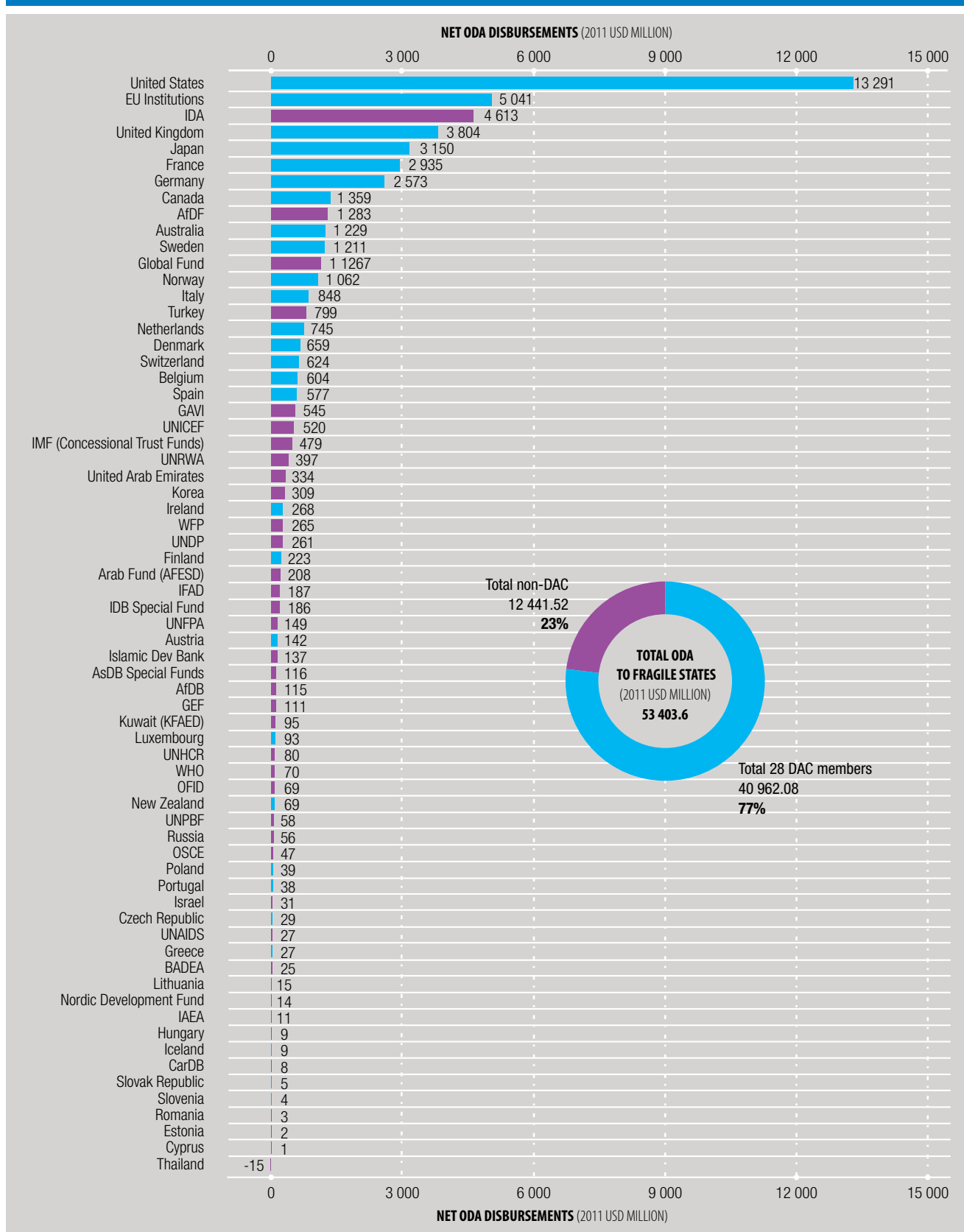
Source: Financial Action Task Force (FATF) status (2013): <http://www.fatf-gafi.org/>

FIGURE A.3 ODA per capita to fragile states and economies, 2011 (in USD)



Source: OECD IDS online databases on aid and other resource flows, available at www.oecd.org/dac/stats/idsonline.

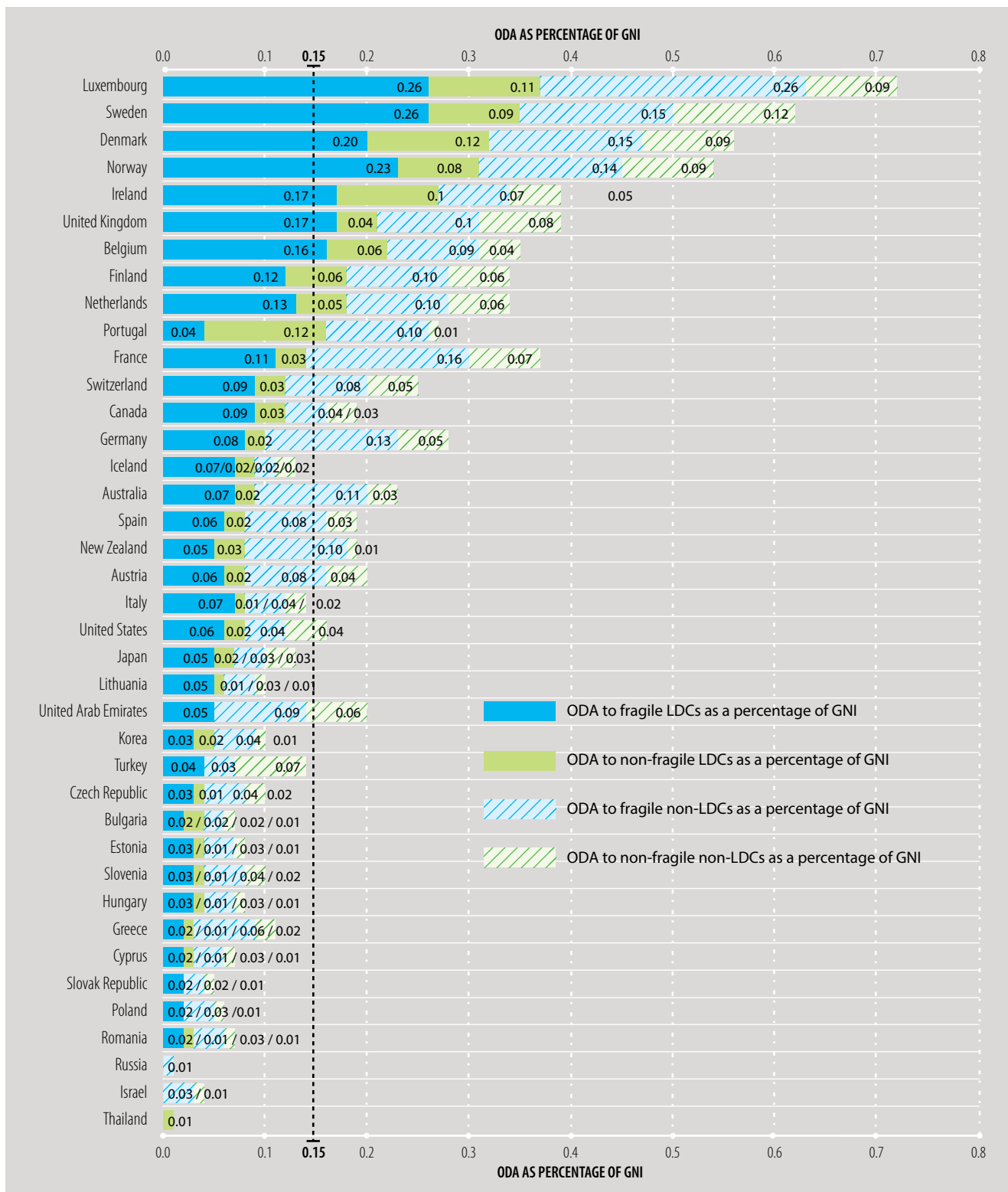
FIGURE A.4 Providers of ODA to fragile states and economies, 2011



Source: OECD IDS online databases on aid and other resource flows, available at www.oecd.org/dac/stats/idsonline.

The figures reflect disbursements.

FIGURE A.5 How are donors performing against the goal to spend 0.15%-0.20% of donor GNI as aid to LDCs? (Istanbul commitment) - and how much of that aid goes to fragile LDCs?
(Breakdown by fragile LDCs, non-fragile LDCs; fragile non-LDCs and non-fragile non-LDCs - ODA as a percentage of donor GNI, 2011)



Source: OECD IDS online databases on aid and other resource flows, available at www.oecd.org/dac/stats/idsonline.

These numbers include imputed multilateral ODA.

WHY DOES FRAGILITY MATTER?

There is increasing consensus that fragility matters. It matters because fragile states face specific challenges which, if left unaddressed, can pose a threat to their own people, their neighbours and those beyond, with costly consequences. They also present great opportunities, including human, socio-economic and natural capital, which could contribute to national, regional and global progress and prosperity.

In general terms, the fragility of a state affects the ability of national, regional and international actors to ensure security, combat poverty and make progress toward other development goals. Today, a third of the world's poor live in fragile states but this share could rise to half by 2018 and nearly two-thirds of the by 2030 (Chandy et al., 2013), and it is there that the most intractable forms of extreme poverty are likely to be concentrated. Fragility is a driver of national, regional and global instability. It discourages investment, economic

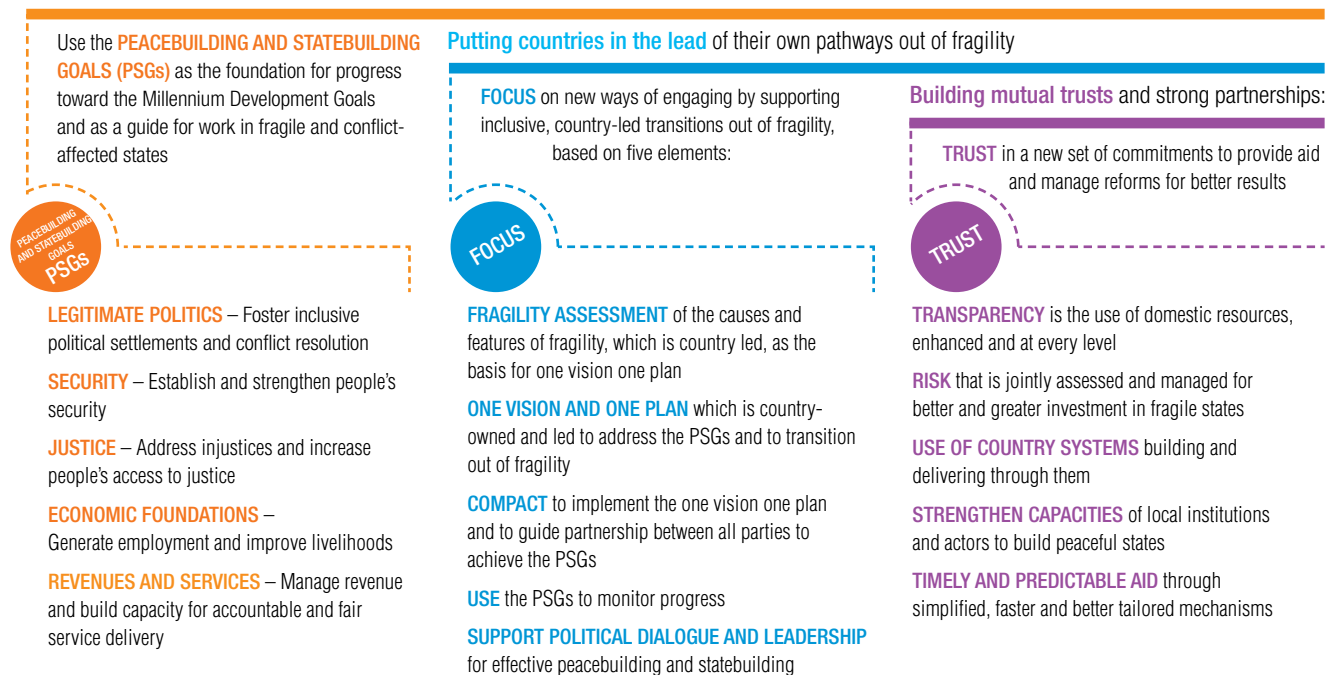
growth, and job creation. It affects peoples' resilience and the environment. Two of the visible consequences of fragility that spill over borders are uncontrolled migratory flows, including displacement of people, and the spread of violence through terrorism and illicit trade.

Fragility also matters because of its economic cost. It has been estimated that a civil conflict costs the average developing country roughly 30 years of GDP growth, and that countries in protracted crisis can fall more than 20 percentage points behind in overcoming poverty. Similarly, trade levels after major episodes of violence have been shown to take 20 years to recover to pre-conflict levels (World Bank, 2011). Also, a country that is making progress in its own development is estimated to lose about 0.7% of GDP for each of its neighbours in conflict (World Bank, 2011).

FIGURE B.1 The New Deal snapshot

THE NEW DEAL CREATES CHANGE BY...

Addressing what matters most for the 1.5 billion people affected by conflict and fragility



Source: www.newdeal4peace.org/new-deal-snapshot

National and global ambitions to eradicate extreme poverty, achieve the other Millennium Development Goals, and ensure peace and security will not be met unless fragility is addressed and reversed.

(HOW) SHOULD COUNTRIES BE CATEGORISED?

Finding ways to identify fragile states is essential. This helps to draw attention to countries that face specific and common challenges. It makes it easier to observe global and regional trends, and monitor progress or lapses against peace, state-building and development objectives.

The first step is to identify what countries are affected by fragility, and identify their key dimensions and degree of fragility. This step is vital for monitoring progress through national and international action such as funding, policies and programmes.

In the OECD, the fragile states list is used to monitor the flows of official development assistance (ODA) and other sources of finance available to fragile states. This can help determine whether aid is targeting the trends and needs of these countries, and give a more comprehensive picture of resources available to fragile countries and the interaction of those resources. This information can also enable actors within fragile countries, development partners, and international groups to identify gaps or opportunities for support.

The endorsement of the new deal for engagement with fragile states and its five peace and statebuilding goals in 2011 are shifting the debate about how fragility should be assessed and countries categorised as fragile.

capture political sensitivities and the realities of the diverse contexts faced by fragile states. However, key actors in fragile states, faced with many competing priorities, often struggle to find the time and means to analyse their own situation, from their own perspective.

However, lists or indices of state fragility have their limitations (Box B.1). Also, they are often compiled without input from a state's leadership or involvement of governmental actors and civil society. When done by external actors, ranking and categorisation can fail to

BOX B.1 The advantages and limitations of lists

Lists of fragile states are helpful tools:

- They allow monitoring a pool of countries selected on the basis of specific indicators,
- They provide a snapshot in time,
- They allow comparison among countries,
- They help in identifying similarities and differences,
- They can point to issues that merit further research.

On the other hand, aggregate lists of fragile states have their limitations:

- They change every year, which limits comparison across time.¹
- They may not reflect the fact that fragility comes in a variety of forms. Projecting indicators onto one linear scale means losing crucial information.²
- They do not reflect the complex and dynamic situation of countries.
- Given their underlying data sources, they cannot capture in a timely and accurate manner important changes that have occurred within countries over time.³
- They do not capture the dynamic nature and spatial dimension of fragility.⁴
- They can miss countries where long-standing deterioration of institutions and latent political and social tensions have contributed to new forms of fragility.⁵

For further reading, see DIE/UNDP (2009)

One way of categorising fragility could be to look at the way in which countries are fragile and to group them according to certain variables. The German Development Institute (DIE), for example, has recently proposed a multi-dimensional typology of state fragility (Box B.2)

Substantive work is now needed to ensure that country-level analysis of fragility is strengthened. For example, indicators are currently being developed for assessing progress towards the five PSGs. These indicators could provide a framework against which fragility can be assessed and progress towards the building of peaceful states and societies can be monitored.

New developments in this area are provided by the New Deal and the related fragility assessments piloted by the g7+ group of fragile states (see Box 1.2 – “A new way to assess fragility – the fragility spectrum”).

Five g7+ New Deal pilot countries – the Democratic Republic of Congo, Liberia, Sierra Leone, South Sudan, and Timor-Leste – have already undertaken country-led self-assessments of fragility in line with the New Deal principles. These assessments are being used to align country level actors and partners around a common understanding of the causes of fragility and sources of resilience, so as to better inform national transition strategies and development plans. In South Sudan, for instance, the findings of the fragility assessment are being used to better prioritise peacebuilding measures and to align partners behind these priorities, through a compact – a key mechanism to implement country-owned visions and planning in critical areas where joint effort is required.

Liberia, Sierra Leone and Timor-Leste, among others, are looking at using the PSGs and the outcomes of the assessments to enhance country plans and eventually to monitor progress against the priorities that had been identified.

BOX B.2 State fragility: a multidimensional empirical typology

The Multidimensional Empirical Typology (MET) of state fragility, developed at the German Development Institute (DIE), is a novel method to provide an aggregate picture of multidimensional fragility. Rather than applying a linear scale, the MET categorises state fragility into four main types, using empirical data for more than 160 countries. These groups face substantially different problem constellations: a capacity gap (weak states), a legitimacy gap (repressive autocracies), a security gap (violence-ridden societies), or a fatal combination of all three gaps (“failing” often war-torn states). Grouping countries according to their characteristics allows for more context-sensitive policy formulation and better planning in development co-operation. DIE is currently investigating the policy implications for different types of fragility in case studies.

Source: Grävingholt, J., S. Ziaja and M. Kreibaum (2012), “State Fragility: Towards a multi-dimensional empirical typology”, DIE Discussion Paper 3/2012, DIE, Bonn, available at <http://tinyurl.com/DP-FragileStatesTypology>.

NOTES

1. When comparisons over time are made in this report, they are always done on the basis of the fragile states list used in this report (Table 1.1). Lists from previous years are not taken into account.
2. For instance, countries as diverse as East Timor and North Korea end up in close neighbourhood to each other although they face very different challenges.
3. Somalia, for instance, tops the Failed States Index for the sixth consecutive year, despite its significant progress on key dimensions of fragility. It has sworn in a new government after years of anarchy, and launched a New Deal Compact .
4. Countries may experience moments of fragility as opposed to “being fragile”; for example, Rwanda and Iran move in and out of lists of fragile states. Stable countries may have pockets of fragility, such as the Philippines or India. Entire regions can be affected by fragility – none of these circumstances are captured in lists.
5. Countries such as Mali, Egypt and Syria have only been added to the lists this year. Mali has only been added on the basis of the presence of a peacekeeping mission, rather than on a thorough understanding of the characteristics of fragility in the country and the wider region of which it is a part.

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In April 2013, the Development Assistance Committee (DAC) agreed on a proposal on concessionality which recognises that there are different views on the interpretation of concessionality in character among DAC members. All information pertaining to this concept, and related practice of ODA reporting, can be found on the OECD website.¹

¹ <http://www.oecd.org/dac/stats/concessionality-note.htm>



Fragile States 2014: Domestic Revenue Mobilisation in Fragile States

By 2018, half of the world's people living on less than USD 1.25 a day will be in fragile states. While poverty has decreased globally, progress on the Millennium Development Goals has been much slower in fragile states than in other developing countries. Out of the seven countries that are unlikely to meet a single MDG, six are fragile.

At the same time, aid to fragile states is falling. This should be a wake-up call for the international community as it shapes the global development agenda for post-2015.

What other flows can fill the gap to finance progress in fragile states? The answers, and the challenges, depend on whether we look at middle-income countries or least developed ones. Middle-income countries have access to multiple sources of development finance, notably remittances and foreign direct investment, though these flows are often volatile and their development impact is unclear. Many of the least developed fragile states, however, continue to depend on aid, and have little access to other external sources of development finance.

This publication therefore zooms in on domestic resources. How can fragile states mobilise domestic revenue to finance their recovery and development? How can they do so in a way that strengthens statebuilding, enhances government credibility and engages citizens?

This report takes stock of the efforts of fragile states to raise domestic revenue. It analyses the specific challenges fragile countries face in doing so and asks what policy makers and the international community can do to support domestic revenue generation in fragile states.



**Organisation for Economic Co-operation
and Development**

2, rue André-Pascal

75775 Paris Cedex 16 France

WWW.OECD.ORG