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The paradox of tax exemptions of Official Development Assistance in developing countries

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Tax exemptions for foreign aid-funded projects have been the subject of international debate since the mid-2000s, their elimination being frequently discussed but never implemented. This issue has now returned to the fore. First, many developing countries have embarked on reforms in the areas of tax policy and administration with a view to improving the efficiency of their general tax system. These efforts have made tax systems more acceptable, eliminating one of the main justifications for aid-related tax exemptions. Second, the International Conference on Financing for Development held in Addis Ababa in August 2015 emphasised domestic resource mobilisation as the high-priority source of development finance.

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• • • / • • • However, the broadening of tax base, which is synonymous with a more evenly spread tax burden, faces the proliferation of special tax arrangements, fuelled in part by the tax-exempt status of Official Development Assistance (ODA). Exemptions for project aid could represent as much as 2 percent to 3 percent of gross domestic product (GDP) in countries where tax revenues barely surpass 15 percent of GDP or, in the case of failed states, 10 percent of GDP or less. In addition to loss of tax revenue, tax exemptions for project aid have particularly damaging effects on the formalisation of the economies of recipient countries and on the efficiency of their tax and customs institutions. Moreover, systematic exemption reduces the credibility of the policies of donor countries and the consistency of their aid policy, which can directly support the budget of a developing country while demanding that its project aid be exempt from taxation. Last, the taxation of aid meets the commitment made by donors in the Paris Declaration on Aid Effectiveness (2005) to use recipient countries' national public financial management systems.

The conference on development finance held in 2015 in Addis Ababa emphasised domestic resource mobilisation as the largest source of development finance[1]. While ODA efforts have stagnated in most Development Assistance Committee (DAC) countries,[2] domestic resource mobilisation remains insufficient (Keen et al., 2010). The tax reforms undertaken in developing countries since the 1980s have paved the way for a first-generation tax transition, consisting in offsetting the fall in external revenues from international trade under the effect of the dismantling of tariff barriers. However, volume targets for domestic resource mobilisation have not been met (Op de Beke, 2014). Despite an upward trend, Sub-Saharan African countries mobilised on average barely 15 percent of their GDP in tax revenue (excluding natural resources) in 2014. The corresponding figure for OECD member states was 33 percent[3]. Developing countries have continued to make efforts to improve their tax systems via tax legislation and capacity building among tax and customs authorities. These reforms have generally sought to broaden the tax base, lower tax rates, and restructure and modernise tax and customs administrations. However, special tax arrangements – tax exemptions, reduced rates, tax relief – have proliferated in developing countries, where tax exemptions have often seemed a necessary condition to attract foreign direct investment in light of infrastructure deficiencies and skilled labour shortages[4]. Like the informal sector, these special tax arrangements help to explain why developing countries are characterised by high tax rates, narrow bases, and low tax revenue to GDP ratios.

Some developing countries have therefore made significant efforts to better identify and control these tax exemptions, which are sometimes granted outside of any legal framework (IMF, 2011)[5]. Tax expenditures assessments and their publication in the appendices of finance laws have contributed to their rationalisation and have improved governments' fiscal transparency. The elimination of some tax exemptions clearly helps improve domestic resource mobilisation (Geourjon and Rota-Graziosi, 2014). Against this backdrop, tax expenditures related to project aid are paradoxical since they directly hamper developing countries' capacity to mobilise tax revenue[6]. For instance, a massive in-

1. This tax revenue does not include external tax revenue in the form of tariff receipts or any levies raised on countries' foreign trade, which have declined.
2. In 2014, ODA represented only 23% of finance provided by developed countries (OECD data).

3. Authors' calculation based on ICTD data.
4. For example, Mansour and Rota-Graziosi (2012) show that WAEMU member states compete mainly via special tax arrangements offered to firms as most member states' taxes and duties are regulated by widely-followed community directives.
5. Notable sources of tax expenditure are sectoral codes (mining, oil), investment codes, ministerial decrees, and even establishment agreements and ad hoc decisions.
6. Broadly speaking, there are two types of aid: Project aid, which consists in financing certain public goods or services, in particular infrastructure (roads, bridges, ports), and budget support, which consists of transfers to the government of a developing country. Project aid represents around 70% of all ODA (see Chart 1).

flow of aid in the form of foreign-funded projects in a failed state will help improve its growth and therefore GDP but will have no positive effect on the country's tax revenue. Its tax revenue to GDP ratio will even decrease. In addition to the simple accounting effect, tax exemptions for public aid from institutions such as Non-Governmental Organizations (NGOs) sustain informality in recipient countries and therefore their inability to mobilise more tax revenue[7]. Indeed, tax exemptions are particularly harmful regarding value added tax (VAT) as they break the payment-deduction chain of this tax and favour imports at the expense of locally supplied goods and services. A local supplier for a tax-exempt project can entirely bypass the tax authorities since their client (donor or NGO) does not carry over deductible VAT when purchasing of goods and services. Last, the proliferation of special tax arrangements significantly complicates the work of tax and customs administrations (or authorities) and significantly increases the risk of fraud and corruption[8].

Historical Justification for Tax Exemption of Project Aid

The practice of exempting ODA-financed projects from tax is as old as foreign aid itself (1950–1960). Wary of the quality of recipient countries' financial and other institutions, donors preferred to circumvent national systems by setting up their own agencies or institutions[9]. Tax and customs exemptions for these aid programs naturally followed. Donors justified their demands for exemptions by citing the "unreasonable" nature of the tax systems of most developing countries (ITD, 2006) with regard to both tax policy and administration: high rates, myriad taxes or rates, tax law lacking transparency, abusive interpretation of legislation, and risk of discrimination and corruption (Geourjon, 2013). In particular, before the reforms undertaken as part of structural adjustment programs, customs tariffs were characterised by a large number of taxes and different rates for similar products[10]. Moreover, the use of non-tariff instruments was widespread.

In addition, donors preferred – and continue to prefer – project aid, which is more visible and comes with targets, over general budget support because of common perceptions of inefficient public spending management (see Firgure 1). In cases of recipient countries considered to be poorly governed or corrupt, donor countries would seek to avoid directly feeding their budgets. Last, as ODA replaces actions the failed state should have financed by mobilising its own resources, donors have had difficulty justifying paying taxes or duties on these activities. On the contrary, exemptions came to be seen either implicitly or explicitly as recipient countries' contribution to project financing (MAEE, 2010). This understanding of exemptions has encouraged some beneficiary countries to record these contributions as expenditure on the projects in question and therefore to simultaneously collect fictitious tax revenues as "balancing transactions" equal to the exemptions granted as the national contribution to aid programs. Such behaviour has a macroeconomic impact on the ratio of tax revenue to GDP and leads to significant and damaging overestimates of countries' capacity to mobilise domestic tax revenue.

7. These exemptions even create the need for further aid, leading to the Samaritan dilemma described by Buchanan (1975).
8. For example, with the complicity of a customs officer, a merchant could claim a tax exemption granted to a donor and import goods free of any tax or duty without the donor knowing.
9. Knack (2013) studied decisions to bypass recipient country institutions. The author highlighted the role of donors' trust in these institutions, their quality, and risk aversion on the part of donor countries.
10. These rates could vary very significantly depending on whether or not the product imported was produced locally.

Warming towards Taxation of Project Aid

The 2005 Paris Declaration on Aid Effectiveness called on donors to use or strengthen existing national systems with a view to improving recipient countries' appropriation of aid. Despite their commitments, donors' use of recipient countries' Public Finance Management (PFM) systems is still far from systematic (see Figure 2). Although not mentioned explicitly in the Paris declaration, tax and customs systems are an important part of PFM systems. Since 2005, the World Bank officially announced first its willingness to pay taxes if the recipient country's taxes are "reasonable"[11]. Following this approach, other donors decided to review their position within the framework of the International Tax Dialogue (ITD)[12].

ITD published several documents, including draft guidelines for the tax treatment of aid-funded projects prepared by the secretariats of the member organisations (ITD, 2006, 2007). These guidelines were supposed to give rise to a recommendation by the United Nations Economic and Social Council (ECOSOC). However, the draft guidelines were never validated, and no other document resulting from a global and organised approach to taxing project aid has been made public since 2007. The issue of exemptions for aid-funded projects continues to be raised frequently in discussions on aid funding (for example, at the OECD's annual meeting in Kampala in 2009), without this leading to concrete initiatives (OECD, 2009)[13].

Today, the major donors say they are ready to forgo aid exemptions, many of them expressing a desire for this to take place as part of a joint initiative, in particular under the aegis of the European Union (see Map 1). Officially, they accept the idea of tax-inclusive project finance, sometimes with some conditions, notably the application of "reasonable" or "efficient" taxation. Broadly speaking, the countries that have honoured the Paris Declaration's commitments by using national PFM systems are generally those that favour the taxation of project aid (see Figure 2)[14]. Despite this change of discourse, the commitments made and a relative consensus on the benefits of a move towards taxing project aid, the status quo remains and foreign aid-funded projects still enjoy taxes and duties exemption[15].

Further, recipient countries had not previously demonstrated any concerted initiative to take part in the debate. Competition between developing countries to attract donors is a potential explanation. For instance, in the CFA currency area, neither of the two Commissions (WAEMU or CEMAC) has taken the initiative to address the matter.

While recipient countries continue to exempt foreign aid-funded projects, the management and monitoring of tax expenditure have greatly improved, highlighting the importance of this issue. The debate has thus been revived, as evidenced, for example, by a note entitled "Tax exemptions for aid-funded projects: Reasons for change" published in March 2013 in the "Commentary & Debate" section of the website of the ICTD (Diallo, 2013).

11. "To eliminate these inconsistencies and distortions and reduce transaction costs in the administration of Bank-financed projects, Bank policy would be changed to provide Bank financing for the reasonable costs of taxes and duties associated with project expenditures." (World Bank, 2004, p. 11).
12. The ITD is a joint initiative of the European Union Commission, the Inter-American Development Bank, the IMF, the OECD, the World Bank, and the Inter-American Center of Tax Administrations.
13. In 2010, France considered establishing a working task force to study this issue. This working group would have measured the impact of aid taxation and discussed the issue with the various stakeholders before presenting a proposal to the DAC to set in motion a fresh round of discussion.
14. There are a few exceptions: Romania is opposed but uses national procedures for 90% of its aid; Belgium and Luxembourg are in favor but have done little to meet the commitments of the Paris Declaration. The use of national systems is a signal of confidence among donors in the systems of recipient countries, which may explain donors' stance on the taxation of project aid.
15. Some countries are beginning to forgo exemptions. France has embarked on this process through "debt reduction and development contracts" (C2D), which finance tax-inclusive development projects and programs.

Status Quo and Current Reluctance to Tax Aid

Despite most donors being in favour in principle, concerns remain. Some donors remain opposed to the taxation of aid, thus contributing to the status quo. There are at least four explanations:

(1) Taxing aid reduces the amount of aid allocated directly to projects (in the order of 10 percent to 20 percent of the total amount allocated);

(2) It runs the risk that collected taxes and duties might be poorly used or even have a negative long-term impact on governance (MAEE, 2009). The second argument is especially apposite in cases where recipient countries publish governance indicators as if they did not receive budget support. Project aid also gives greater visibility to donors' actions than general budget support;

(3) As the sums paid already stem from taxes in donor countries, some decry the double taxation that would result;

(4) There is also consideration of the risk of unequal treatment between the 30 DAC donors and non-member countries – China, in particular–, if the former opt for the taxation of aid.

Numerous Perverse Effects of Tax Exemptions for Aid on Recipient Countries

Tax exemptions for aid lead to a loss of tax revenue for recipient countries

The proliferation of tax exemptions erode tax bases and deteriorates domestic resource mobilisation in developing countries. The non-taxation of aid is one component of this problem and can hardly be addressed in isolation.

As ODA accounts for a sizeable share of GDP in most developing countries – especially in weak states – exempting it from tax leads to a significant loss of tax revenue for these countries. Although low-income countries' reliance on ODA has tended to decline over the past 20 years, in 2015 ODA still represented on average 8.7 percent of gross national income (GNI). This figure was as high as 30 percent of GNI in the Central African Republic, 21 percent in Afghanistan, and 12 percent in Burundi and Gambia[16]. Further, project aid has increased in recent years, rising from 61 to 82 billion dollars between 2007 and 2015 at an annual average growth rate of 3.7 percent (see Figure 1).

Tax exemptions for project aid could represent a tax revenue shortfall in the order of 2 percent to 3 percent of GDP depending on the country (MAEE, 2010). In 2009, the OECD's Task Team on Taxation and Accountability and ATAF (OECD, 2009) estimated that revenue losses represented 18 percent of funded projects and 10 percent of overall tax revenue in Niger. In Tanzania, exemptions on customs duties for donors amounted to 17 percent of the gross value of imports. In Madagascar, taxation of aid is included in the benchmark tax system and the cost of exemptions has been estimated (Ministry of Finance and the Budget, 2017). Among the 243 tax expenditures, which the Malagasy tax administration identified, 34 percent of these concerns foreign aid, ahead of the mining (11 percent) and healthcare (5 percent) sectors[17]. In Burkina Faso, exemptions for donor-financed projects (excluding NGOs) resulted in a loss of revenue of CFAF 13 billion in 2016. Between January and October 2017, the loss of revenue reached CFAF 19 billion, or 20 percent of total customs revenue losses (all taxes and duties combined) related to exempt imports (all categories) and 4 percent of the total amount of taxes and duties paid over the same period for imports[18].

16. Authors' calculation based on World Bank data.
17. As in many developing countries, it is impossible to estimate the cost of customs exemptions granted in Madagascar to project aid from customs data, for two reasons: 1) the codes used for exemptions in the computer system do not make it possible to separate them; and 2) they are sometimes considered fully taxed imports if taxes and duties are collected as "balancing transactions."
18. Authors' calculation.

The purpose of taxing project aid – an essential element in rationalising tax expenditure in general – is to broaden the tax base. This would lead to an improvement in recipient countries' tax revenue to GDP ratio, easing tax on the "modern formal" sector and even help with the formalisation of developing economies, as tax authorities would then have better knowledge of the turnover of donors' local suppliers, mainly via the simple calculation of VAT deductibility.

Exempting aid fuels a culture of exemptions

Beyond the resulting loss of revenue, non-taxation of project aid encourages the development of a governance culture of exemptions. It incentivises claims for exemptions, resulting in a multiplication of legal texts, a lack of transparency over tax law, and reduced effectiveness in tax auditing. It also runs counter to the main objective of the tax system reforms encouraged by donors, namely the widespread application of ordinary law.

In particular, emerging countries – especially China – seek to benefit from the same treatment, while it can be difficult in practice to distinguish between what is and is not ODA. NGOs, which are often involved in implementing externally funded projects, enjoy the same exemptions. Given their number and diversity, the risk of fraud is considerable[19]. Taxing project aid would ensure equal treatment for all technical and financial partners and would prevent such pitfalls.

Exempting aid leads to distortions in favour imports at the expense of locally provided goods and services.

Non-taxation of aid mechanically modifies the structure of incentives and gives rise to distortions. As products imported under such aid are not subject to the same tax regime as comparable products in the national market outside the scope of the aid, it is less attractive to buy locally[20]. Moreover, as mentioned in the previous point, some firms may try to take advantage of the exemptions granted to foreign aid activities for other ends, giving rise to unfair competition with other local or foreign firms (MAEE, 2010).

Exempting aid increases the risk of fraud and constitutes a burden for the state.

Non-taxation of project aid encourages tax fraud and corruption by offering a path for circumventing the rules. Like any exemption, it breaks the tax chain – especially for VAT – complicating the task of tax auditing. Maintaining the system of exemptions amounts to encouraging the growth of the informal sector.

For tax and customs authorities in recipient countries, managing, monitoring, and auditing exemptions for project aid against the backdrop of a significant risk of fraud constitutes a considerable additional workload (Orlowski, 2007, MAEE, 2011). In addition to the loss of revenue, tax exemptions for aid hamper already-limited human and financial capacities (ITD, 2005, 2006). For instance, it is difficult to trace exempt goods. Authorities must ensure that exempt goods are indeed intended for the projects for which they have been allocated and not sold in the domestic market in competition with firms subject to the ordinary tax code. In developing countries, moreover, the categorisation and codification of customs exemptions are not conducive to rigorous monitoring or to estimations of their budgetary impact.

The payment of taxes and duties on ODA would help strengthen tax systems by eliminating high management costs, simplifying logistics from the management of exemptions to the collection of taxes, redeploying human resources, and improving the transparency of tax systems.

19. For example, apart from frequent and practically uncontrollable misappropriations, exemptions create opportunities for customs evasion through the fraudulent use of the tax identification number of the development partner without its knowledge.

20. For example, a local supplier will not be able to collect VAT and therefore deduct VAT from its inputs. Instead, it will be forced to carry over some of this VAT in the price of its service or reduce its profit margin. Exemptions for the suppliers of the donor's supplier could also be considered. This solution, which has been adopted in the agricultural, mining, and oil sectors, is particularly costly in terms of tax revenue.

Transaction Costs and Donor Credibility Are Hampered by Continued Exemptions for Aid.

Exempting aid increases transaction costs for donors.

In addition to these widely recognised economic efficiency arguments for recipient countries, exemptions for project aid represent a significant transaction cost for donor countries. Understanding texts and procedures can be a sizeable administrative burden, especially in the presence of a large number of bilateral agreements. Procedures for granting exemptions are generally time-consuming, requiring many cumbersome and repetitive processes that involve different departments and delay clearance times. The mechanisms introduced by recipient countries in recent years to better monitor and control exemptions (treasury cheques, lists, quotas) make these procedures even more cumbersome.

Exempting aid erodes donors' credibility and consistency between statements and actions.

All donors and financial partners – with the IMF at the fore – encourage the fight against the proliferation of exemptions. Recognised as a barrier to domestic resource mobilisation, their economic efficiency in attracting FDI or reducing inequality is also questionable. In the interests of consistency and exemplarity, these same donors can hardly seek special tax arrangements for their foreign aid activities. There are no obvious reasons why tax arrangements regarding aid-funded goods and services should not be debated like the rest of tax expenditure. It seems problematic for donors to both make domestic resource mobilisation in developing countries a priority and continue to benefit from tax exemptions on their project aid.

Furthermore, the maintenance of this system runs counter to donors' discourse on strengthening the capacities of tax authorities and the commitments made in the Paris Declaration on Aid Effectiveness (2005) and the Monterrey Consensus (2002) on Financing for Development. Indeed, donor countries have committed to "reducing transaction costs" and to "increasing alignment of aid with partner countries' priorities, systems, and procedures and helping to strengthen their capacities" (United Nations, 2002). Keeping the taxation of ODA outside the scope of ordinary law runs counter to these commitments. It increases the workload of tax and customs administrations and diverts resources from their tax collection objectives. An end to project aid exemptions would show respect for the commitments made and would contribute to reinforcing donors' legitimacy and the credibility of their discourse.

Arguments for exemptions are less robust in the current climate.

If donor countries initially justified exemptions by citing the inefficiency of recipient countries' tax systems and administrations, this argument has now lost its potency following the numerous reforms that have been implemented to improve tax systems (such as rate cuts and simplification) and to modernise tax departments in most recipient countries.

Some donor countries have programs in place to provide tax-exempt project aid and budget support for the same country. This can be explained by the variety of institutions, agencies, and ministries involved in donor countries' ODA policy, but it does underline inconsistency in ODA at the level of the recipient country. Since the discussion began on the taxation of aid, the DAC has ensured that if project aid were to be taxed, it would be accounted for as tax-inclusive. Taxation of ODA-financed projects would then have no impact on the total amount of aid allocated by donors. The loss of resources for each project due to taxation would be offset by the payment of the tax, amounting to general budget support. Thus, the amount of aid allocated to projects would be reduced by the amount of tax paid, but the volume of total aid would remain unchanged since the recipient country would receive the income from these taxes. If donor countries wished to continue to provide project aid and budget support, they would simply have to offset the automatic allocation of a portion of project aid to budget support by rebalancing the two instruments so that the share of project aid is increased in the total volume of aid. However, when the country in question does not provide budget support, the issue remains unsolved. This is the case for most DAC member countries, where budget support represented less than 1 percent of total ODA in 2015 compared with 3.23 percent in 2007 (see Figure 1). For the majority of countries that do provide it, it has largely been on a downward trend. Nevertheless, some countries, such as Portugal, which opposes the taxation of aid precisely because it would result in a reduction in available funds for project aid, provide significant levels of budget support, or 12.81 percent, compared with 9.57 percent for New Zealand, 8.5 percent for Russia, and 7.54 percent for Ireland on average between 2000 and 2015 (see Figure 3). Yet Ireland is already beginning to forgo tax exemptions on project aid. Great Britain, which does not have an official position, allocated on average 5.3 percent of its aid to budget support between 2000 and 2015.

The economic literature has endeavoured to study the relationship between ODA and domestic resource mobilisation. Several studies have shown a negative effect of ODA on domestic resource mobilisation, in particular in low-income countries with weak institutions (Benedek et al., 2012). These studies have also underlined the importance of the composition of aid. Gupta et al. (2004) concluded that general budget support has a disincentive effect on domestic resource mobilisation. In the long term, this reduces the accountability of governments in developing countries and affects governance in these countries. Nevertheless, this work has recently been the subject of debate, and new studies have showed that the negative relationship put forward is not in fact robust [21].

An increase in general budget support would offer vital fiscal leeway to recipient countries to pursue their own development policies in accordance with the principle of appropriation. As donors become taxpayers, it would also strengthen political dialogue with recipient countries over their tax policies within a framework of mutual responsibility and appropriation.

Going Further

Today, donors are increasingly open to the taxation of project aid. Discussion has led to the recognition of changes in the international aid environment, resulting in a (theoretical) warming to the taxation of aid. It has also led to a recommendation for dialogue between donors and recipient countries to tax foreign aid-funded projects.

Nevertheless, in practice, little change has taken place. No international guidelines on the taxation of aid projects have been issued, and no organised discussions between donors and recipient countries have been initiated. The coordination of tax policies within the framework of regional integration should nevertheless encourage both donors and recipients to revive dialogue at the regional level. The condition of "reasonable taxation" frequently associated with a favourable position on the part of donors should be defined and given specific indicators [22].

21. Clist and Morrissey (2011) and Carter (2013) showed that this relationship is not robust relative to sample or specification changes and that it results from an endogeneity bias. Responding to the work of Benedek et al. (2012), Clist (2014) also concluded that these studies were not robust and attributed the supposed disincentivising effect of aid to poor econometric specifications and failure to take into account the obvious presence of endogeneity bias. Yohou et al. (2016) also showed that heterogeneity between countries and the influence of parameters such as political stability and the quality of institutions should also be factored into such analyses.
22. Studies should be carried out to define the most suitable indicators for this purpose.

There is also too little information on ODA-related exemptions and on their potential impact on current tax systems (Prichard et al., 2012).

Numerous questions remain unresolved and deserve more in-depth discussion and study, including (but not limited to): What impact would the taxation of project aid by donors have on tax revenue in beneficiary countries? What is the administrative cost (in time and resources) of keeping such a system in place for both donors and recipient countries? Beyond the direct (revenue) and indirect (administrative cost) financial impact of tax exemptions, what policy implications do they entail for both donors and recipients? What initiatives can beneficiary countries undertake to curb the exemptions they grant? How can the reluctance to pay tax be lifted? What would the cost of change be for donor administrations, and does this explain the status quo?

Figure 1. ODA by sector, DAC data

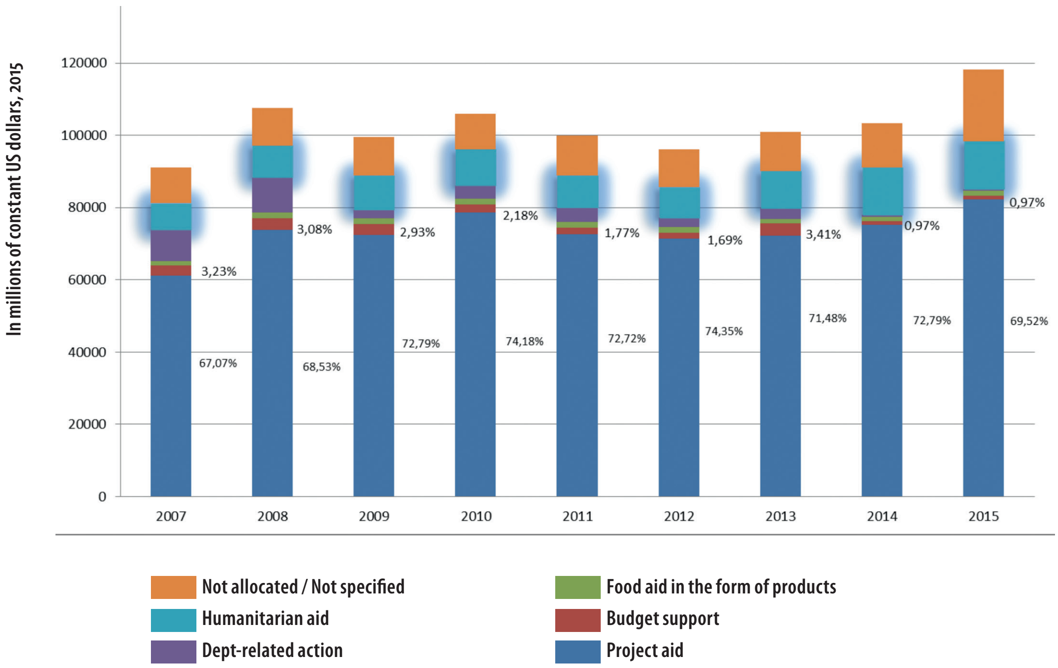


Figure 2. Donors' position regarding the taxation of project aid and their use of recipient countries' public financial management (PFM) systems

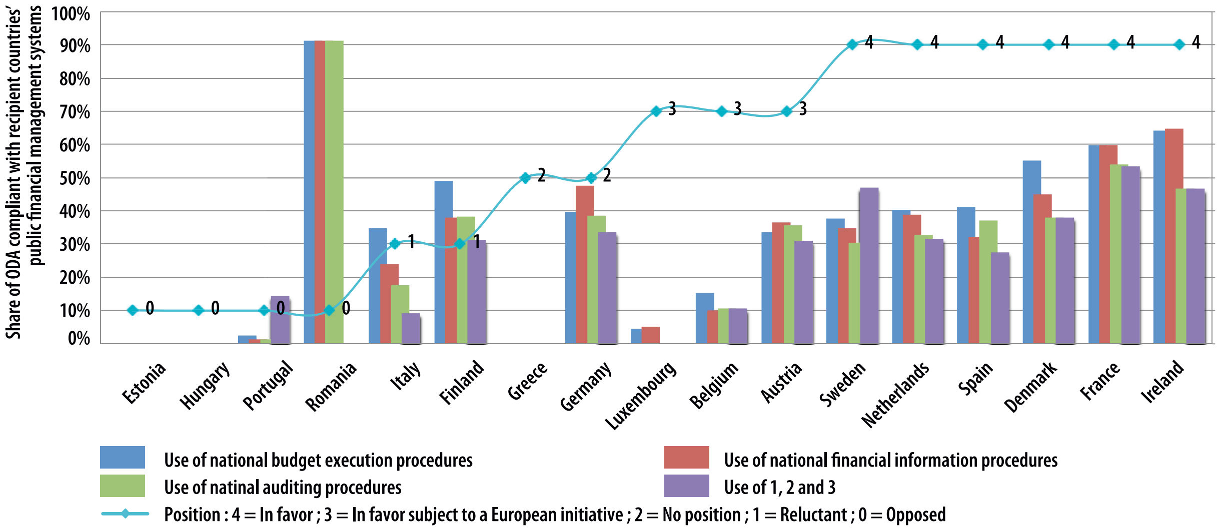
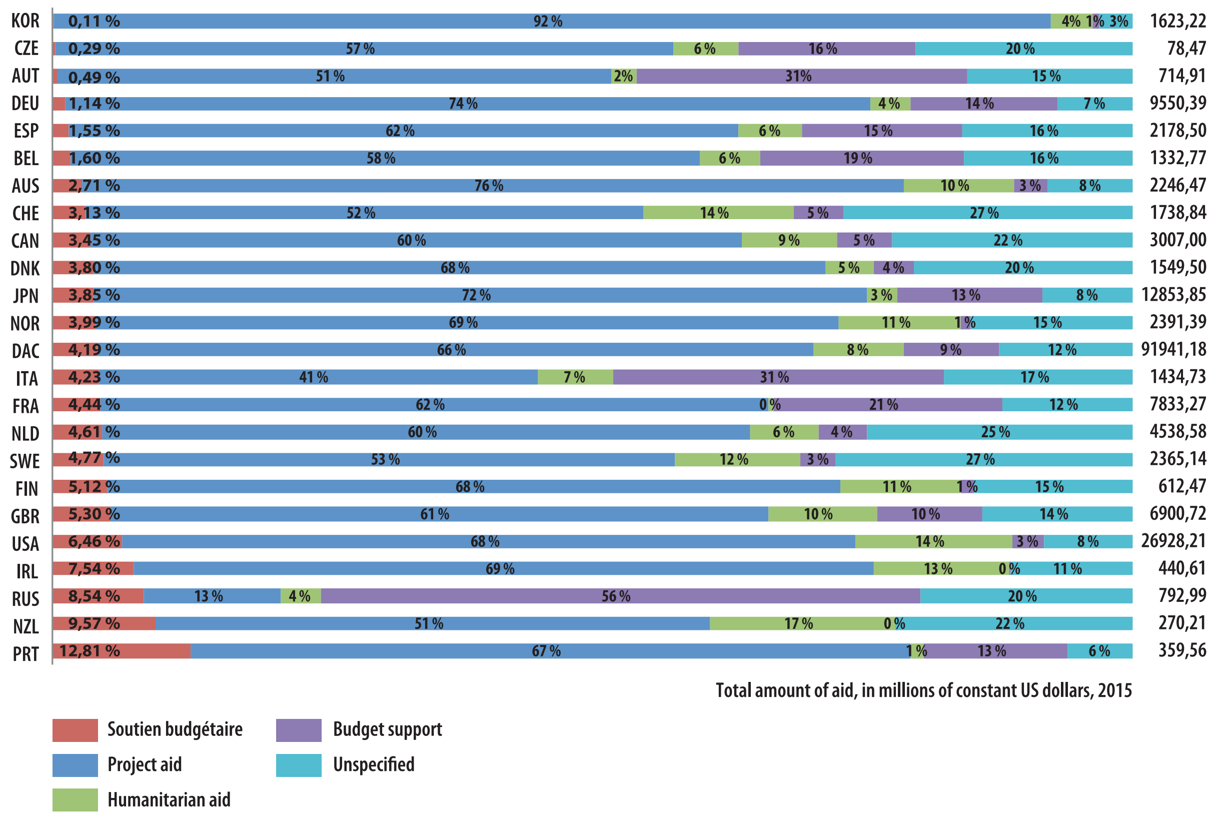
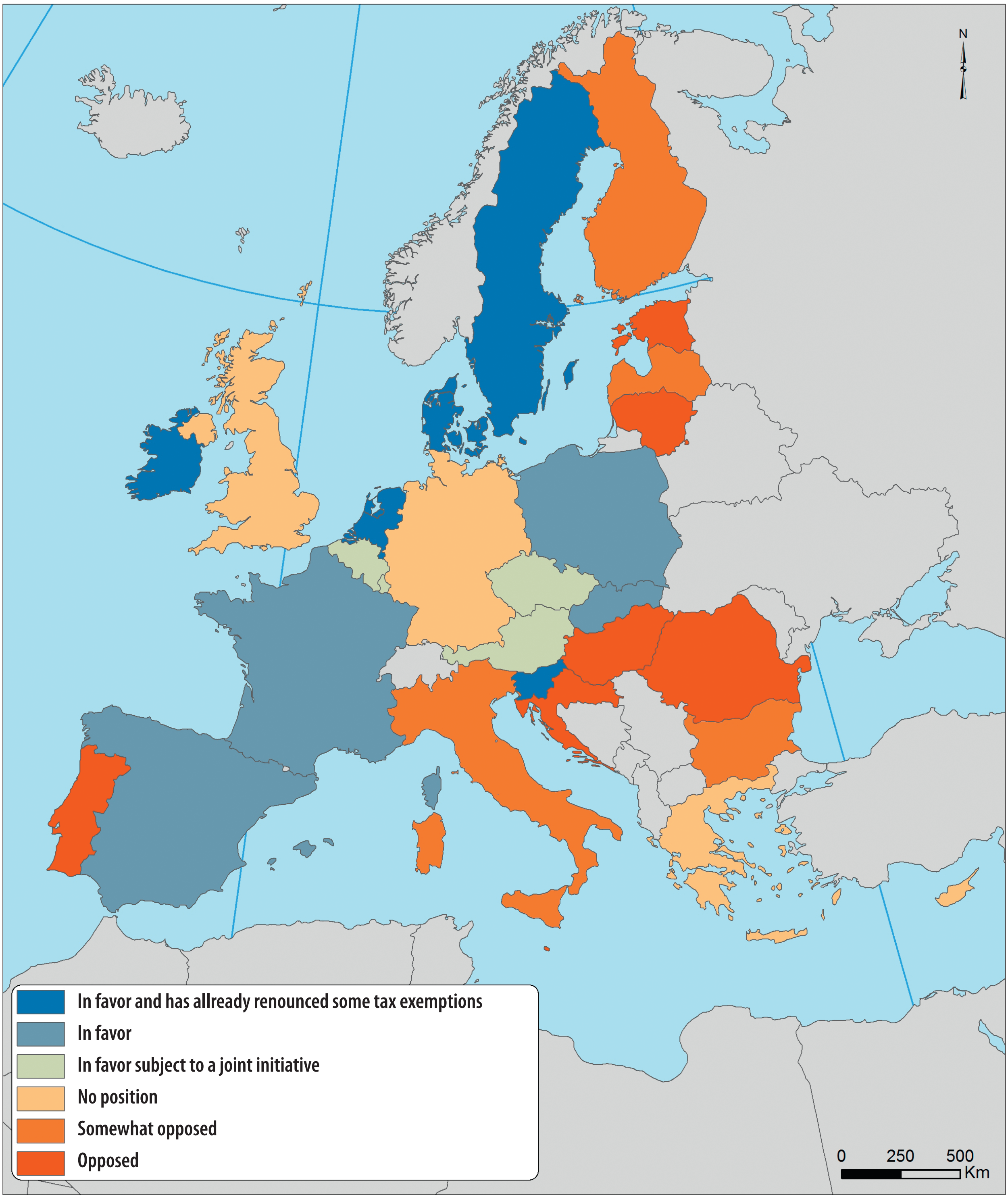


Figure 3. Share of different types of ODA by country, 2000-2015



Map 1. Positions of various donors on the taxation of project aid



Other donors	Position
European Union	In favor
World Bank, African Development Bank, Asian Development Bank, Inter-American Development Bank	In favor, provided costs are reasonable
USAID	Opposed to a global initiative; for bilateral negotiations

Based on the "Summary Table of the Positions of Various Donors Concerning the Taxation of Aid," Working Paper, FERDI, 2017.

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