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# Taxing aid: The end of a Paradox?

Émilie Caldeira, Anne-Marie Geourjon, and Grégoire Rota-Graziosi,

*Université Clermont Auvergne, CNRS, IRD, CERDI. FERDI, France.*

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# Introduction

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- Domestic Revenue Mobilization (Addis, 2015) to finance development
  - Developing countries: Tax revenue to GDP ratio around 15. (around 33 percent for OECD members).
  - Recent tax reforms in a lot of developing countries.
- However, tax expenditures:
  - One serious limit to DRM.
  - What is the role of ODA in tax exemptions?

# Why aid tax exemptions?

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- “ Unreasonable ” tax system in developing countries => risk of discrimination
- Higher visibility of project aid
  - Taxing aid => reduces project aid (-10 to 20%).
  - Collected tax would be poorly used.
  - Risk of unequal treatment between DAC members and other donors (China).
- Passive role of recipient countries

# Aid effectiveness

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- Academic literature on aid effectiveness
  - Nothing on the tax exemption of foreign aid.
  - Burnside and Dollar (2000): the role of institutional quality as a condition for aid effectiveness.
- Some (robust?) empirical studies:
  - Negative effect of ODA on domestic resource mobilization (Benedek et al. 2012).
  - Negative effect on governance (Djankov et al. 2008) => Aid curse // Resource curse.
  - Importance of the composition of aid (budget vs. project)..

# The cost of aid tax exemption: Not so negligible

| Country | Total tax revenue losses (% GDP) | Indirect tax revenue losses (% GDP) | Aid (USD, const, Millions) | GDP (USD, const, Millions) | Aid (%GDP) | Tax revenue to GDP | Indirect tax revenue to GDP |
|---|---|---|---|---|---|---|---|
| Malawi | 3,27 | 1,33 | 1 520 | 9 059 | 16,72 | 19,53 | 7,95 |
| Togo | 1,80 | 1,26 | 345 | 5 058 | 6,81 | 26,45 | 18,56 |
| Mozambique | 3,04 | 1,25 | 1 790 | 15 401 | 11,63 | 26,13 | 10,77 |
| Rwanda | 2,97 | 1,17 | 1 230 | 9 354 | 13,10 | 22,69 | 8,95 |
| Lesotho | 2,13 | 1,13 | 147 | 2 912 | 5,04 | 42,18 | 22,33 |
| Jordan | 2,37 | 1,08 | 2 920 | 31 614 | 9,24 | 25,70 | 11,64 |
| Mali | 1,76 | 1,00 | 1 360 | 14 147 | 9,59 | 18,29 | 10,47 |
| Nepal | 1,38 | 0,80 | 1 270 | 21 464 | 5,91 | 23,32 | 13,51 |
| Mongolia | 1,18 | 0,72 | 764 | 12 443 | 6,14 | 19,26 | 11,71 |
| Dominica | 1,26 | 0,70 | 19 | 457 | 4,15 | 30,27 | 16,80 |
| Madagascar | 1,07 | 0,58 | 771 | 10 802 | 7,13 | 14,99 | 8,17 |
| Bolivia | 1,13 | 0,58 | 949 | 27 881 | 3,40 | 33,22 | 16,99 |
| Uganda | 1,03 | 0,57 | 2 010 | 28 579 | 7,03 | 14,61 | 8,04 |
| Senegal | 1,06 | 0,56 | 910 | 22 965 | 3,96 | 26,77 | 14,09 |
| Ethiopia | 1,13 | 0,55 | 4 120 | 58 320 | 7,07 | 16,02 | 7,77 |

# Other evidences

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- French Ministry of Foreign Affairs (2010): tax exemptions for project aid around 2 to 3% of GDP.
- OECD (2009): 10% of overall tax revenue in Niger.
- Madagascar: 243 tax expenditures,
  - 34 percent = foreign aid, ahead of the mining sector (11 percent).
- Tresory cheques in Togo or Guinea (1 to 2% of GDP).

# Indirect costs

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- Favor imports instead of locally provided goods and services
  - The Bellmon amendment (1977) to the US Public Law 480 (1954), American Food Aid program.
- Complexity of the management of tax exemptions:
  - Tax fraud and corruption.
  - More work for the tax and customs administrations.
- Treasury cheques => Fictitious tax revenue.

# Towards the end of a paradox?

- DRM = a high priority.
- The jeopardized credibility of donors:
  - Not taxpayers.
  - Budget support and Project aid for the same donor in the same recipient country.
  - Paris Declaration on Aid Effectiveness (2005)
    - Use recipient countries' national Public Finance Management systems (tax system?).
- At least, pay VAT.
  - VAT => Chain effect => Formalization of the economy.

# Share of types of ODA by country (2000-2015)

| Country | Budget support | Project aid | Humaniatrian aid | Debt-related aid | Unspecified |
|---|---|---|---|---|---|
| KOR | 0,00 | 0,92 | 0,04 | 0,01 | 0,03 |
| CZE | 0,00 | 0,57 | 0,06 | 0,16 | 0,20 |
| AUT | 0,00 | 0,51 | 0,02 | 0,31 | 0,15 |
| DEU | 0,01 | 0,74 | 0,04 | 0,14 | 0,07 |
| ESP | 0,02 | 0,62 | 0,06 | 0,15 | 0,16 |
| BEL | 0,02 | 0,58 | 0,06 | 0,19 | 0,16 |
| AUS | 0,03 | 0,76 | 0,10 | 0,03 | 0,08 |
| CHE | 0,03 | 0,52 | 0,14 | 0,05 | 0,27 |
| CAN | 0,03 | 0,60 | 0,09 | 0,05 | 0,22 |
| DNK | 0,04 | 0,68 | 0,05 | 0,04 | 0,20 |
| JPN | 0,04 | 0,72 | 0,03 | 0,13 | 0,08 |
| NOR | 0,04 | 0,69 | 0,11 | 0,01 | 0,15 |
| DAC | 0,04 | 0,66 | 0,08 | 0,09 | 0,12 |
| ITA | 0,04 | 0,41 | 0,07 | 0,31 | 0,17 |
| FRA | 0,04 | 0,62 | 0,00 | 0,21 | 0,12 |
| NLD | 0,05 | 0,60 | 0,06 | 0,04 | 0,25 |
| SWE | 0,05 | 0,53 | 0,12 | 0,03 | 0,27 |
| FIN | 0,05 | 0,68 | 0,11 | 0,01 | 0,15 |
| GBR | 0,05 | 0,61 | 0,10 | 0,10 | 0,14 |
| USA | 0,06 | 0,68 | 0,14 | 0,03 | 0,08 |
| IRL | 0,08 | 0,69 | 0,13 | 0,00 | 0,11 |
| RUS | 0,09 | 0,13 | 0,04 | 0,56 | 0,20 |
| NZL | 0,10 | 0,51 | 0,17 | 0,00 | 0,22 |
| PRT | 0,13 | 0,67 | 0,01 | 0,13 | 0,06 |

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- Thank you for your attention

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POLICY WATCH

# Taxing aid: the end of a paradox?

Émilie Caldeira[1] · Anne-Marie Geourjon[2] · Grégoire Rota-Graziosi[1,2]

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**Abstract**
Taxing aid was often discussed, but never implemented. This issue has now returned to the fore. First, many developing countries reform their tax system becoming more "reasonable" and 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 revenue mobilisation as the main source of development finance. However, the broadening of tax base faces the proliferation of special tax arrangements, fuelled in part by the tax-exempt status of Official Development Assistance. Exemptions for project aid could represent as much as 3 per cent of Gross Domestic Product (GDP) in countries where tax revenues barely surpass 15 per cent of GDP. 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. Moreover, systematic exemption reduces the credibility of the policies of donor countries and the consistency of their aid policy. 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 Finance Management systems. This note reviews tax exemptions of foreign aid-funded projects: their consequences in terms of domestic revenue mobilisation in recipient countries, the induced inconsistency of foreign aid policy, their main historical justifications, and recent moves from some donor countries towards the taxation of their aid.

**Keywords** Tax · Exemption · Tax expenditure · Official Development Assistance · Domestic revenue mobilisation · Developing countries

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✉ Grégoire Rota-Graziosi
gregoire.rota-graziosi@uca.fr

1 CNRS, IRD, CERDI, Université Clermont Auvergne, 63000 Clermont-Ferrand, France

2 Fondation pour les Etudes et Recherches sur le Développement International, FERDI, Clermont-Ferrand, France

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