



## Donors, Aid and Taxation in Developing Countries: An overview

There is growing interest among development policymakers in taxation, both as a crucial source of revenue for development and because taxation is central to economic growth, redistribution and broader state-building and governance goals. This paper explores the direct impact of donor supported tax reform efforts; the indirect impact of aid and related donor policies on domestic tax effort; the potentially perverse effects of tax-related conditionality; and the impact of broader donor policies including global tax arrangements. It makes detailed recommendations about future donor support for tax reform.

### Strengthening the impact of tax reform

The last few decades have seen the emergence of a global tax reform agenda, supported by donors and local tax professionals, and resulting in significant convergence of tax policy and administration across a range of developing countries. However, formal changes in tax regimes have led to relatively modest gains in terms of revenue mobilisation and improved practice, and they have been hard to sustain. Tax reform is politically difficult: it encounters strong resistance from vested interests, but mobilising potential winners is hard. Policymakers need to do more to foster local ownership and be opportunistic in engaging with sources of local political support for reform. They should look for ways to build support and weaken likely resistance by emphasising equity, transparency and inclusive process. They could do more to foster links between

taxation and broader governance objectives. For example greater equity in enforcement, and transparency about tax-expenditure linkages could encourage collective action and bargaining, in place of fragmented rent seeking. There should be more focus on visible taxes on income and property, and on informal sector and subnational taxation, which have a direct impact on large numbers of people. Encouraging inclusive reform processes and civil society engagement could be important as well as fostering administrative cooperation across government departments, with the aim of enhancing performance and potentially providing a catalyst for broader improvements in state capacity.

### Linkages between aid, incentives and tax collection

There is growing concern about the indirect, unintended impact of aid on tax systems, including the risk that aid may reduce

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incentives for domestic tax collection. However research has produced divergent results, suggesting that while aid may contribute to lower tax efforts in some contexts, this relationship is neither simple nor universal. For example, donor assistance can have positive impacts on tax collection through effective technical support or the pressures that result from conditionality. More nuanced, context specific investigation is needed, recognising that much aid is not an effective substitute for tax; that the quality of institutions will influence aid/tax relationships; and that aid is only one factor in shaping tax effort, alongside domestic politics. Recognising that the relationship between aid and tax effort is likely to be context specific, policymakers should be alert to the risks of undermining local tax effort, especially in aid dependent countries with weak institutions; but they should avoid assuming that the impact of aid is necessarily negative.

### **The impact of tax-related conditionality**

Conditionality is one of the few tools available to donors to generate pressure for reform and manage risk. However, highly intrusive and detailed conditionality risks undermining local ownership and policy processes. While there is some evidence that conditionality can have positive impacts, its effectiveness is heavily dependent on domestic political support for reform. Where this is lacking, change may be superficial, with variable, sometimes negative, longer term outcomes. Conditionality will only be effective if desired outcomes can be monitored, if donor demands are coordinated, and if sanctions are applied when conditions are not met. There is scope to improve the design and implementation of tax conditionality, based on realistic and appropriate performance targets and indicators. These should be compatible with longer term goals of building trust and strengthening voluntary tax compliance, focusing on equitable enforcement and broader principles of transparency and accountability. Donors need to beware of creating perverse incentives, for example by focusing too narrowly on total revenue collection which can generate incentives for

short-term and coercive forms of collection. They should invest in understanding local context, work with local reformers, and seek to engage where possible with local political priorities. Incremental reform may be the best strategy, especially in difficult environments.

### **Tax systems are shaped by the external environment**

There are three main ways in which donors could improve the external environment for tax reform in developing countries. They should reduce proliferation of uncoordinated, potentially conflicting interventions that create high transaction costs and undermine local policy and institutions. They should reduce or eliminate tax exemptions for aid funded goods and services which reduce revenue, are costly to administer and open to abuse, and may undermine the norm of tax compliance if exemptions are perceived as evidence of donors operating double standards. Finally they should advocate for more ambitious reform of offshore financial centres (or tax havens) which allow elite individuals and multinational corporations to evade tax. Evasion reduces overall levels of tax collection; increases inequality, thus undermining voluntary compliance; fragments taxpayer interests thus reducing the potential for effective tax bargaining; and facilitates corruption.

### **Implications for policymakers**

In summary, the paper suggests seven guiding principles for design of donor support to tax reform:

- support local leadership of reform efforts;
- incorporate political economy analysis into the design and implementation of programmes;
- design tax reform programmes to foster broader linkages between taxation, state building and governance;
- pay attention to the complexity of the relationship between aid and tax effort;
- improve design of tax-related conditionality and performance indicators;
- coordinate donor interventions more effectively;
- pay greater attention to the international policy context and its impact on local tax systems.

### **Further reading**

Prichard, W., Brun, J-F., & Morrissey, O., (2012) *Donors, Aid and Taxation in Developing Countries: An Overview* ICTD Working Paper 6, Brighton: IDS, September

### **Credits**

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