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Should donors cooperate with developing countries with a persistently low tax ratio?

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Bonn, 7 September 2009. For countries with low tax rates or lax enforcement of tax laws, the air is growing increasingly thin. Against the background of the present global financial and economic crisis, so-called tax havens are finding themselves faced with growing pressure to improve the transparency of their tax systems and discontinue unfair practices. Also, developing countries are being called upon to do more to mobilise resources of their own. The European Commission, for instance, proposes to cut development funds for countries that fail to meet their commitments to establish good governance in tax matters. There are even some, sporadic, calls for discontinuation of development cooperation (DC) with countries whose tax ratio (that is, the share of taxes and levies as a percentage of GDP) is below a threshold value of e.g. 20 percent.

In the international discussion there are mainly three reasons advanced for cutting DC funds for countries with low tax ratios.

Legitimacy of development policy

It injures our sense of justice when we see donor countries using their tax resources to support developing countries whose governments do too little to mobilise resources of their own. What this means in effect is: The middle classes in donor countries compensate for the unwillingness of elites in developing countries to contribute to financing public goods and services.

Bad governance

The inability of political regimes to induce their elites to pay taxes may be read as an indication of poor governance in other areas. In such cases DC provides a contribution to further stabilising political regimes with bad governance.

Rent-seeking

In many developing countries DC amounts to a rent that tends more to impair development than to further it. Governments may see no need to shoulder the burden of mobilising resources of their own as long as they are able to fall back on external resources.

In such cases it is certainly not wrong to at least think about cutting DC funding. But what countries are we talking about here, actually?

Cross-country comparison

Is it possible to identify low-revenue countries on the basis of a fixed tax ratio threshold value? Not really. If, for example, we used the 20 percent GDP figure mentioned above as a basis, we would find that a clear-cut majority of the partner countries of German DC fall below the threshold. True, there are exceptions, including e.g. Ghana (21.3 percent) or Jordan 24.3 percent), but the trend still remains clear.

Furthermore, any attempt to set a rigid threshold value would be tantamount to overlooking the fact that a country's tax ratio tends to correlate closely with its per capita income. In other words, DC needs to take account of a given country's stage of development. A trend line indicating the relation between tax ratio and income could be used for purposes of guidance. Countries with a tax ratio at or above the trend line would then be seen as making better use of their taxation capacity than countries with a tax ratio below the trend line. Generally speaking, a good number of countries in Subsaharan Africa are either at, or indeed above, the trend line. On the other hand, numerous countries in Latin America have poorer performance records, some of them significantly poorer.

Compared with a rigid threshold value, the trend line proves to be a better indicator of the ability or willingness of countries to collect taxes. However, it takes observation over a protracted period of time to identify trends, and an analysis of this kind often proves impossible for lack of proper data.

Moreover, aside from per capita income, there are other factors that influence tax ratios: (1) Countries involved in an armed conflict or caught up in a post-conflict situation, or whose tax structures are fragile for other reasons, tend to have especially low taxation capacities. (2) The economic structure also plays a role here. For example, a country in which the agricultural sector accounts for a high share of overall economic output will tend, on average, to fall short of the trend, while countries with a high foreign-trade volume will tend to perform better.

Conclusions for development cooperation

In dealing with partner countries with a weak performance record on taxes, development policy needs to adopt a case-by-case approach. When countries are found to lie persistently and significantly below the trend line, it would be advisable to further analyse the reasons for their low tax ratios. A close look should be taken in particular at the composition of their tax regimes: Low *direct* taxes tend to be a signal for bad governance in this area.

Tax system reform should be placed on the agenda of DC with countries with low tax revenues, stagnant or deteriorating indicators, and a “bad” tax regime composition. According to the OECD, in 2007 less than one tenth of a percent of public DC funds was spent for tax-related tasks. That is certainly not enough to have any appreciable impact on existing incentive structures.

Instead of being cut off from DC, highly fragile countries or countries in a conflict or post-conflict situation should be provided targeted support in their efforts to strengthen their tax systems. Governments should be encouraged to boost their tax revenues, e.g. by conditioning budget support or other financial aid on improvements of their tax systems.

If, however, successes fail to materialise, and decision-makers in partner countries clearly lack the will needed for the purpose, donors will be forced to ask themselves how they can continue to justify, or explain to their constituencies at home, development cooperation with the governments concerned.

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