



The taxation of foreign aid

Don't ask, don't tell, don't know

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Key messages

- Official development assistance (ODA) has generally been exempt from taxation in developing countries since the 1940s. Despite the longevity of this practice, justified primarily on the basis of maximising the quantity of aid, there is relatively little evidence on how much tax is exempted and the impact on development outcomes.
- The practice is coming under scrutiny as ODA providers increase support for domestic resource mobilisation (DRM) to meet the Addis Tax Initiative (ATI) commitments. The policy incoherence between tax exemptions for ODA and efforts to support DRM has become more apparent. The Platform for Collaboration on Tax (PCT) has pledged to review ODA tax exemptions and issue guidelines.
- The PCT should focus first on increasing transparency and improving the evidence base before issuing guidance on what specific ODA tax exemptions should or should not apply. At the same time, the most harmful practices should be ended, including the 'don't ask, don't tell' practice of contracting that facilitates income tax avoidance for aid workers and private contractors.

Acknowledgements

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Acronyms

ATAF	African Tax Administration Forum
ATI	Addis Tax Initiative
CATA	Commonwealth Association of Tax Administrators
DAC	Development Assistance Committee (OECD)
DOA	Development Objective Agreement
DRM	Domestic resource mobilisation
DTA	Double taxation agreement
ERP	European Recovery Program
EU	European Union
IATI	International Aid Transparency Initiative
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IMF	International Monetary Fund
LRD	Liberian Dollars
NGO	Non-governmental organisation
ODA	Official development assistance
ODI	Overseas Development Institute
OECD	Organisation for Economic Co-operation and Development
PCT	Platform for Collaboration on Tax
US	United States
USAID	United States Agency for International Development
VAT	Value-added tax

About ATAF

The African Tax Administration Forum (ATAF) is an international organisation that acts as a platform for promoting cooperation, knowledge sharing and capacity building among African revenue administrations (RAs). It seeks to build capacity, ensure greater synergy and cooperation amongst relevant stakeholders by reducing duplication of work in support to African Tax Administrations. From its inception in 2009, when it was formally launched in Kampala, Uganda, ATAF has grown in stature and in influence. Today ATAF is an important voice in taxation globally with its membership at 38 African tax administrations. For more information please visit ATAF website: <https://www.ataftax.org>

1. Purpose of this paper

Foreign aid is often exempt from taxation in recipient countries. Research on the topic is sparse and debate infrequent, and the system has become entrenched over 70 years.

A renewed focus on taxation for development has re-opened the debate on official development assistance (ODA) tax exemptions. The Addis Tax Initiative (ATI) goals on capacity-building and policy coherence (ATI, 2015) are potentially inconsistent with ODA tax exemptions. Two ATI members – the Netherlands and Norway – have unilaterally decided to refrain from requesting some ODA tax exemptions. The World Bank has relaxed its restriction on loan proceeds for Bank-financed projects being used to pay taxes in borrower countries. The Platform for Collaboration on Tax (PCT) – a joint effort by the International Monetary Fund (IMF), OECD, United Nations (UN) and World Bank – has committed to review current practice and issue guidance and recommendations (PCT, 2018). This follows a similar effort around 10 years ago by the UN Committee of Experts on International Cooperation in Tax Matters to review and issue guidelines (see Thuronyi, 2005; 2006; UN, 2007).

The purpose of this note is to contribute to the discussion on the rationale for ODA tax exemptions by setting out the arguments for and against them. As well as reviewing the literature and providing insights from discussions with those close to the debates, we also provide empirical evidence on the impacts of ODA tax exemptions from the results of a recent survey. Finally, we make specific recommendations for the PCT review on improving transparency, building the evidence base, and ending the more harmful practices identified in this review.

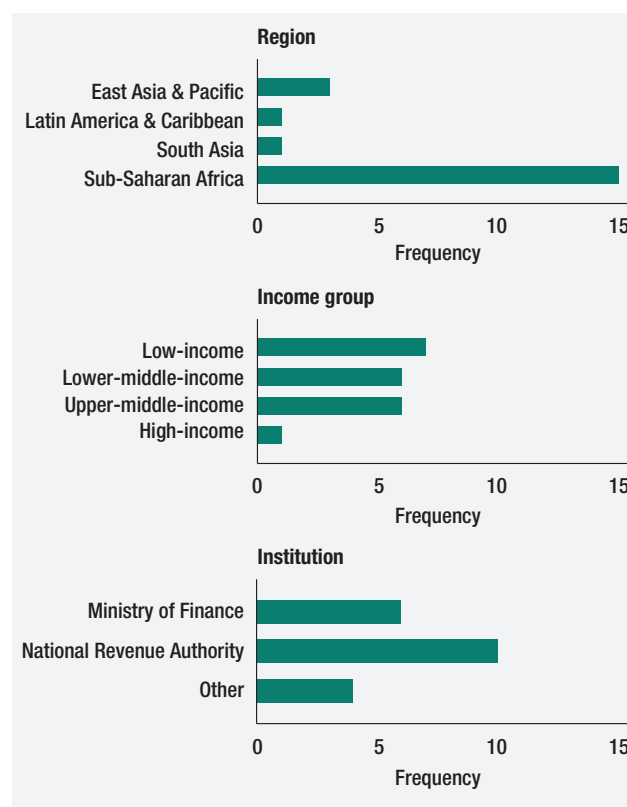
2. Survey on ODA tax exemptions

The survey was issued by email to 47 developing countries including all members of the African Tax Administration Forum (ATAF) and the Commonwealth Association of Tax Administrators (CATA). The survey asked respondents in tax administrations and/or finance ministries to respond to 31 questions relating to the scope, legal framework, administration and fiscal impact of ODA tax exemptions as well as their attitudes towards the use of ODA tax exemptions in their countries. Twenty countries provided responses, with 15 of those being from sub-Saharan Africa. The response rate is relatively even across low-income, lower-middle-income, and upper-middle-income countries. Responses are from officials working in finance ministries and revenue authorities, or other related departments that do not fit neatly into these definitions (see Figure 1). Some of the results are discussed in the main body of the note, and the full results are provided in a separate appendix.

All countries indicated that they provide ODA tax exemptions but not for all categories of tax (see Figure 2). Among our respondents, 95% and 85% indicated that they provide tax exemptions on ODA with

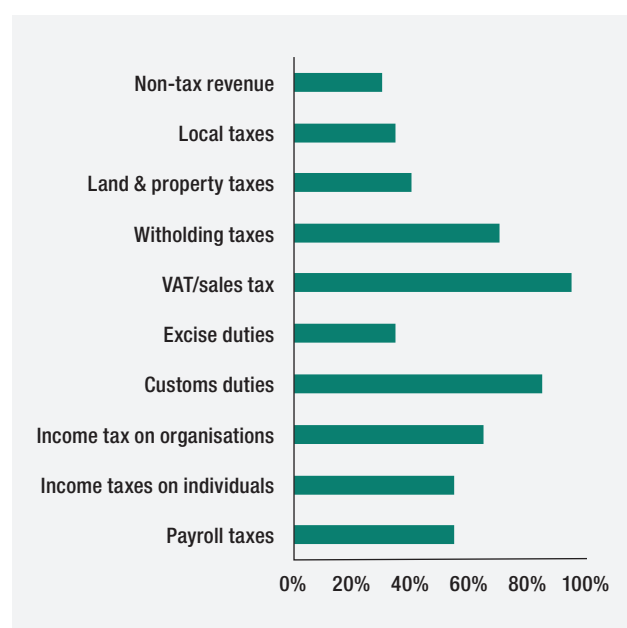
respect to value-added tax (VAT)/sales tax and customs duties, respectively. Just 35% of countries indicated that they provide tax exemptions on ODA with respect to excise duties and local taxation.

Figure 1 Survey responses by region, income group and institution



Source: ATAF and ODI survey

Figure 2 Share of sample providing ODA tax exemptions by tax category



Source: ATAF and ODI survey

3. History of ODA tax exemptions

The current system of international development assistance, and the tax exemptions that go with it, took shape at the end of the Second World War (see Fjeldstad, 2009; USAID, 2011). The UN, IMF and International Bank for Reconstruction and Development (IBRD, part of the World Bank Group) were formed in the 1940s through international treaties (see UN, 1946; 1947; 1949) that exempted these organisations and their employees from many forms of taxation. Around the same time, the United States (US) implemented the European Recovery Program (ERP) of economic cooperation and assistance to stabilise and rebuild European economies. More frequently referred to as the ‘Marshall Plan’, the ERP was enacted through domestic legislation and a series of bilateral treaties that exempted US missions and supplies from taxation.¹

Other providers of ODA have followed these approaches. The constituent instruments of subsequent international organisations involved in development, such as the International Development Association (IDA) and the regional development banks, include clauses on tax exemptions² nearly identical to those of the IMF and IBRD instruments. Other countries that provide ODA followed the US lead in requiring tax exemptions for foreign assistance.

4. Overview of ODA tax exemptions

There is no single, unified system of ODA taxation as ODA encompasses a range of activities in many countries performed by different entities under various legal instruments. ODA tax exemptions can be considered along three lines: how the exemption is legally provided; which entities are entitled to the exemption; and what specific property, income and transactions are exempt from taxation.

4.1 The legal basis for ODA tax exemptions

ODA is an international activity where states provide finance and assistance to other states directly or through the international organisations they fund. Tax exemptions for ODA are therefore often provided in international treaties, but are also found in project agreements between providers and recipients, and the domestic law of recipients.

International treaties with ODA tax exemptions are usually bilateral ODA framework agreements (between donor and recipient), multilateral ODA framework agreements (between groups of donors and recipients), or the constituent instruments of international organisations

that implement ODA (i.e. the multilateral treaties that created these organisations).

Tax exemptions for ODA can also be found in project agreements between providers and recipients. Unlike treaties, which are negotiated once, are general in application and are long-lasting, project agreements are negotiated for each project and apply only to that project. For these agreements to have legal effect, they usually require an overarching framework treaty providing tax exemptions, ratification by the national legislature of the recipient state, or for the executive agencies of the recipient government that sign the agreement to have delegated tax-waiving powers under law.

As illustrated in Figure 3, our survey responses indicate that in many countries, tax-waiving powers reside with either the national legislature or the finance minister. However other countries noted more than one decision-maker with waiving powers. Usually this is a combination of finance minister and national legislature, but some countries noted discretionary privileges for ministers of commerce, heads of revenue agencies, local governments, and heads of state for some tax categories.

Domestic tax law of the recipient state can also provide for ODA tax exemptions. This can be a discretionary effort to exempt ODA from taxation in the recipient state, or to implement in domestic law obligations from international treaties requiring ODA tax exemptions.

Donor states cannot directly provide ODA tax exemptions in their domestic law, but they can legislate the terms and conditions under which they will provide ODA. Donor legislation can prohibit ODA funds from being used to pay taxes and/or require state agencies to seek and benefit from the maximum permitted exemptions in recipient states. To have effect, these provisions require agreement with the recipient state through treaty or project agreement.

Despite the potential for complexity, many of our respondents indicated that their legal frameworks for ODA tax exemptions range from ‘somewhat clear’ to ‘very clear’ (see Figure 4).

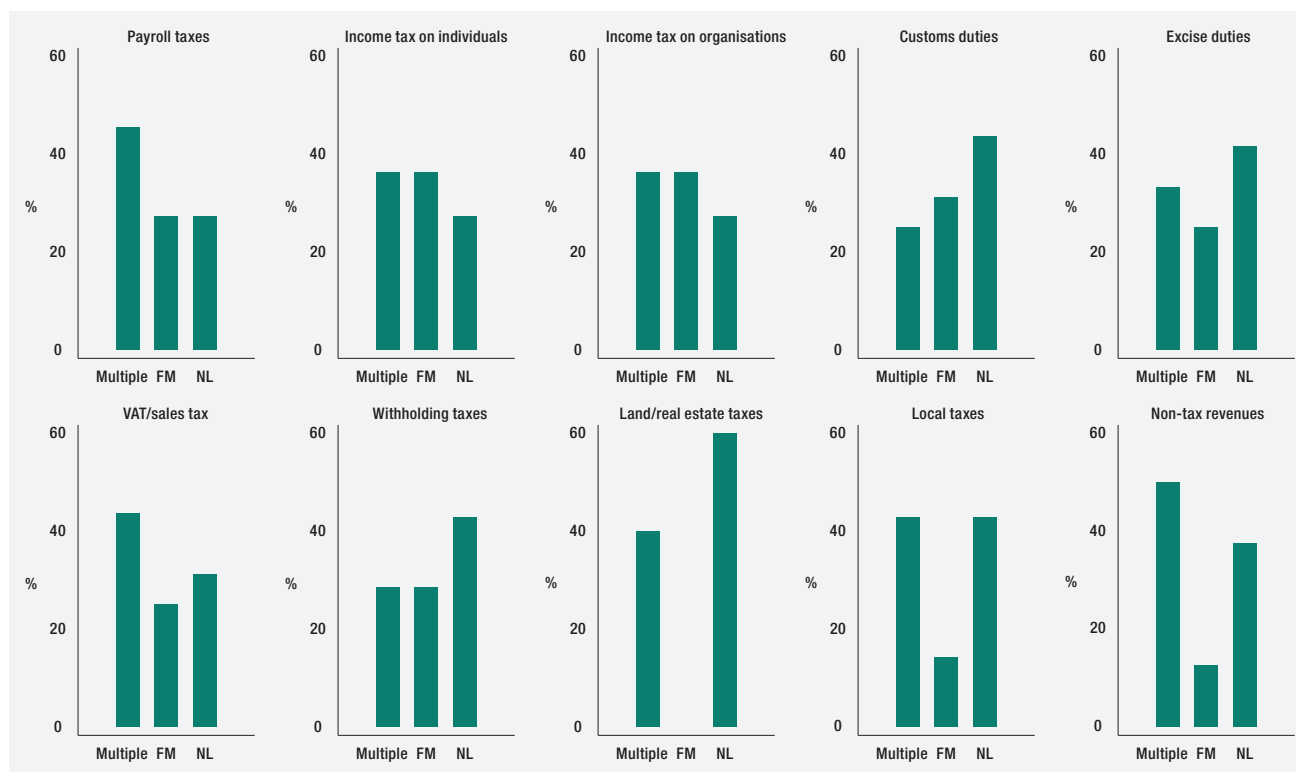
4.2 Entities entitled to ODA tax exemptions

ODA is provided by official agencies of governments but can be implemented by different entities: the state’s executive agencies, international organisations, non-governmental organisations (NGOs), individual contractors, and private firms. Implementing entities are often entitled to benefit from the same ODA tax exemptions as the official agencies of government that fund ODA.

1 The US Congress (1948) Foreign Assistance Act required the Secretary of State to make arrangements where practicable with participating countries for the free entry of supplies and relief packages (section 117 (d)). The Economic Cooperation Agreement between the US and France (1948), for example, implemented the duty-free provision (Article VI) and conferred diplomatic status (including immunity from taxation) on the US Special Mission for Economic Cooperation (Article IX).

2 Where there have been changes to the clauses used for the IMF and IBRD, these have tended to increase the scope of ODA tax exemptions. See UN (1957; 1959; 1960; 1966; 1982).

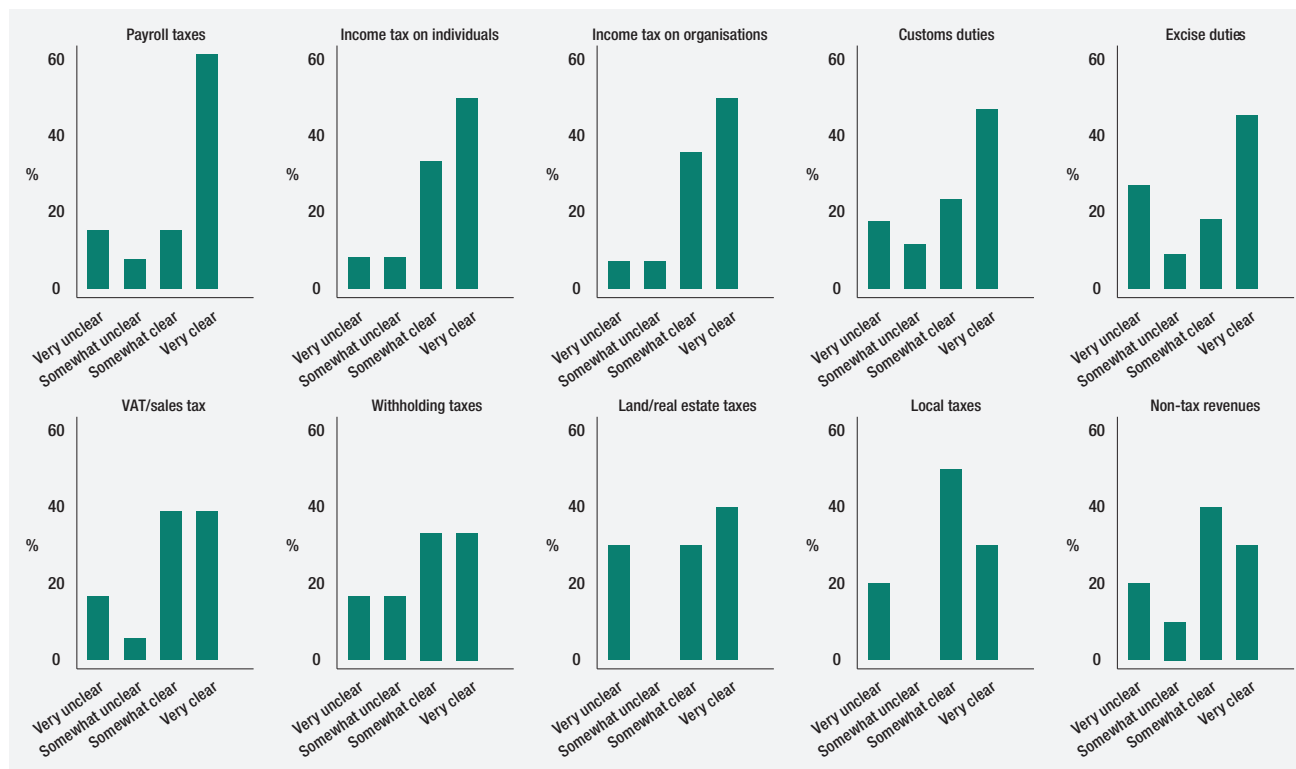
Figure 3 Who has the legal authority in domestic law to grant exemptions on ODA?



Notes: FM = Finance minister; NL = National legislature

Source: ATAF and ODI survey

Figure 4 To what extent is the legal framework clear for ODA exemptions?



Notes: Very clear = problems arising from different interpretations of the legal framework by the tax authorities and recipients of ODA exemptions are rare; somewhat clear = there are occasional problems; somewhat unclear = there are frequent problems; very unclear = major source of problems

Source: ATAF and ODI survey

Tax benefits can also cascade out from implementing entities to their employees (and sometimes their family members), individual contractors and any private firms that they use to implement ODA. Exemptions can therefore proliferate far beyond official agencies. If an international organisation funds an infrastructure project that is implemented by a private firm that hires a sub-contractor to perform works, the sub-contractor's employees may be exempt from taxation under an ODA agreement. This tendency for ODA tax exemptions to proliferate is illustrated in Figure 5.

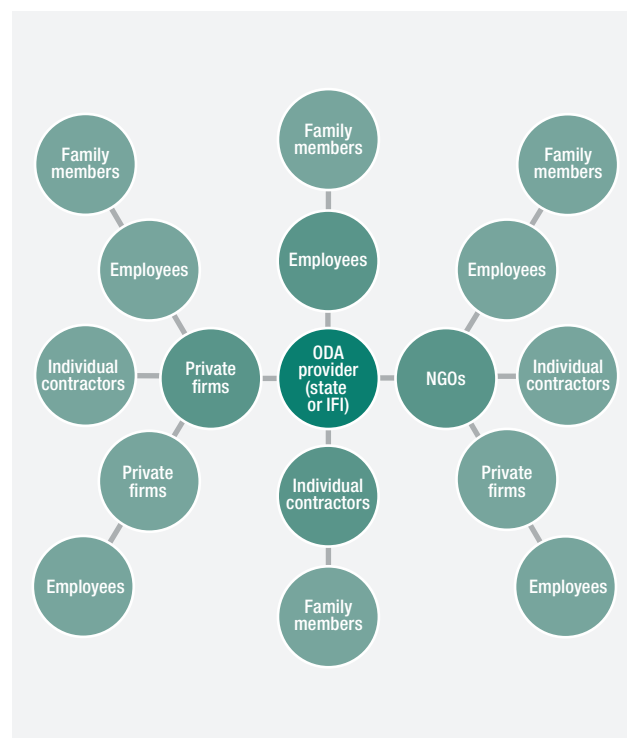
4.3 Common tax exemptions for ODA

ODA providers could ordinarily be liable for various taxes on income, property or transactions in recipient countries. ODA projects can provide supplies to government agencies, such as medical supplies for healthcare clinics or information technology equipment for ministries, that would be subject to import duties, VAT or sales taxes. International advisors providing technical assistance in a developing country could be liable for local tax on their income through residency rules or withholding taxes on non-residents, and be required to pay duties on imported personal effects. Organisations that provide ODA may own or lease property in the recipient country that requires payment of property taxes.

The entities that provide ODA are often exempt from a range of different taxes, including income tax, property taxes, and indirect taxes. Some providers of ODA are also exempt from withholding taxes on payments to other taxpayers, even if those taxpayers are not exempt from taxation.

For example, a payment for services from a tax-exempt international finance institution to a company that is not tax-exempt is not subject to withholding tax. Some common examples of the type of ODA tax exemptions that different entities benefit from are outlined in Table 1.

Figure 5 Scope of ODA tax exemptions by entity



Source: ODI review of ODA framework treaties

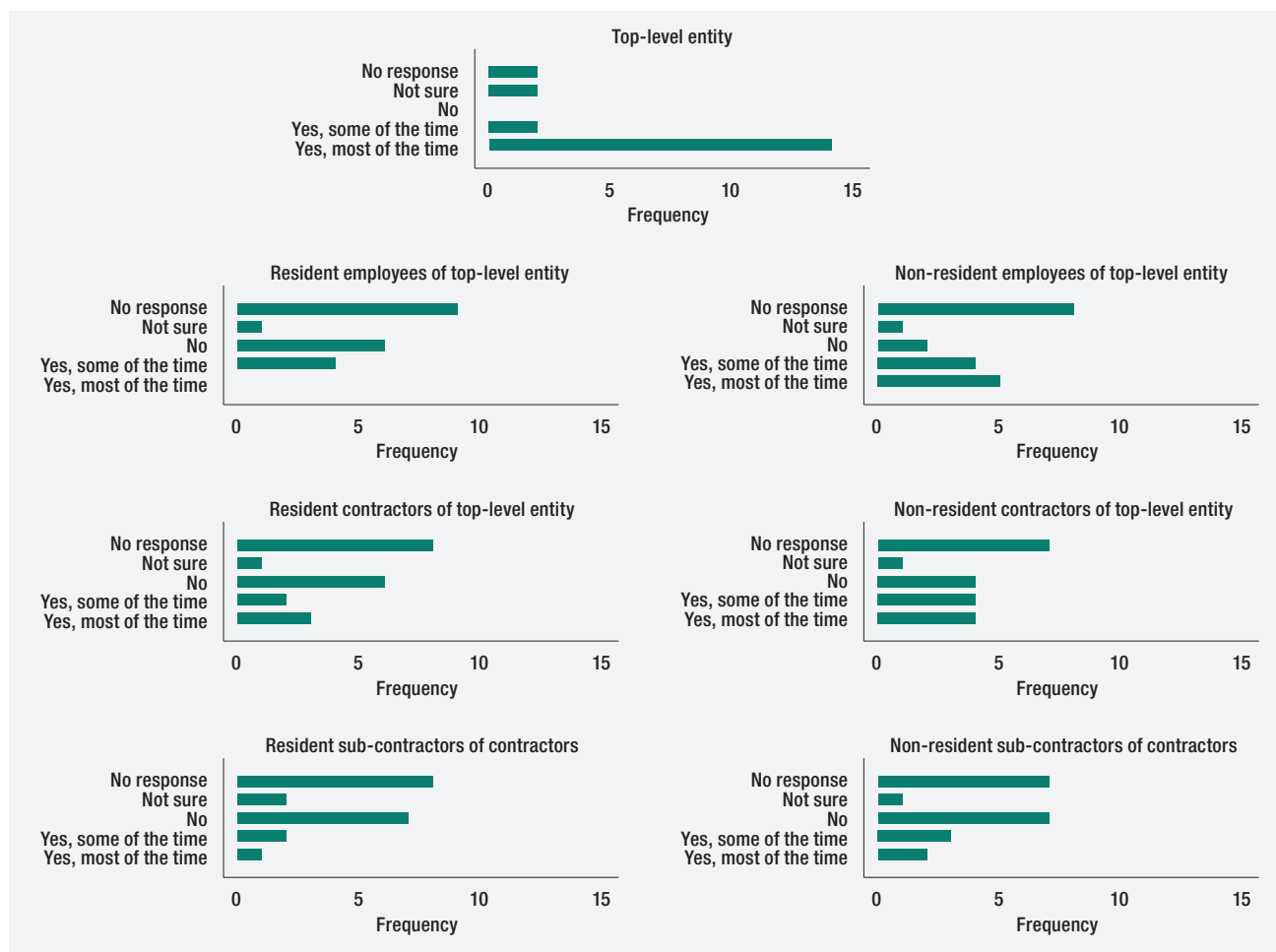
Notes: IFI = International financial institution

Table 1 Common ODA tax exemptions

Entity	Common ODA tax exemptions
Foreign aid agencies and international organisations	<ul style="list-style-type: none"> Direct tax on assets, property, income, operations and transactions Customs duties and indirect taxes on imported goods Indirect taxes on goods purchased locally Withholding tax on payments of interest on concessional loans
NGOs implementing ODA	<ul style="list-style-type: none"> Direct tax on income from donor (including through withholding) Direct tax on assets and property Customs duties and indirect taxes on imported goods Indirect taxes on goods purchased locally
Private firms implementing ODA	<ul style="list-style-type: none"> Direct tax on income from donor (including through withholding) Direct tax on assets and property Customs duties and indirect taxes on imported goods Indirect taxes on goods purchased locally
Individual contractors (resident or on missions)	<ul style="list-style-type: none"> Direct tax on income from donor or implementing agency (including through withholding) Customs duties and indirect taxes on imported goods needed to carry out functions Customs duties and indirect taxes on personal and household effects imported on taking up post
Employees of any of the above (resident or on missions)	<ul style="list-style-type: none"> Direct tax on salaries (including through withholding) Customs duties and indirect taxes on imported goods needed to carry out functions Customs duties and indirect taxes on personal and household effects imported on taking up post

Source: ODI review of ODA framework treaties

Figure 6 Beneficiaries of ODA tax exemptions



Source: ATAF and ODI survey

Our survey responses indicate that the entities that benefit from ODA tax exemptions differ across countries (see Figure 6). While 14 of 20 countries indicated that top-level entities benefit from ODA tax exemptions most of the time, we found high levels of non-response for whether or not employees, contractors and sub-contractors of these entities benefit from ODA tax exemptions. For those countries that did provide responses, there is a contrast between resident and non-resident entities. Non-resident employees, contractors, and sub-contractors appear more likely to benefit from an ODA tax exemption than their resident counterparts.

5. Arguments for ODA tax exemptions

The most common arguments for ODA tax exemptions found in the literature and in discussions with those close to the debate focus on maximising the value of aid. ODA tax exemptions are thought to increase aid and reduce costs for donors, although there is limited empirical evidence available to substantiate these claims.

5.1 Taxation will reduce the available aid

A common concern is that taxing aid reduces the amount of money available for development projects. As a United Kingdom Undersecretary of State in the Department for International Development stated: ‘the current exemption for aid-funded goods...does mean that the money is getting to the purpose intended’ (IDC, 2012).

This argument applies at the project level. If a project’s imported goods are taxed, then for a given budget fewer goods can be provided. At the country level the argument is weaker, because the tax collected goes into the national budget of the recipient country and is still a benefit to that country.

Moreover, if donors use both project and budget support, then the case for exempting aid becomes especially weak. If project aid is taxed, donors can offset this taxation by reducing budget support accordingly. The amount of goods procured and financial flows into the recipient country’s budget are unaffected. Box 1 provides a simplified exposition of how, in theory, donors who provide both budget support and project aid should not be concerned if project aid is taxed, because they can offset the additional outlays in project aid by reducing budget support, allowing them to deliver the same quantity of both ex-post.

Box 1 Reducing budget support to offset taxation of an ODA project

Country A provides \$10 million in direct budget support to Country B and delivers an ODA project that imports \$5 million of goods. The imports are exempt from a 10% customs duty in Country B.

With ODA exemption	A	B
Budget support (a)	-10	+10
Project budget (b)	-5	+5
Import duties (c)	0	0
Net budget finance (a + c)	-10	+10
Value of imports (b – c)	-5	+5
Total (cost)/benefit	-15	+15

If import duties were imposed on the project, Country A could deliver the same value of goods and budget finance to Country B at the same total cost (\$15 million) by increasing the project budget to cover import duties and decreasing budget support by an equal amount.

Without ODA exemption	A	B
Budget support (a)	-9.5	+9.5
Project budget (b)	-5.5	+5.5
Import duties (c)	-0.5	0.5
Net budget finance (a + c)	-10	+10
Value of imports (b – c)	-5	+5
Total (cost)/benefit	-15	+15

Source: ODI

5.2 Caesar should not tax God

Another common defence for ODA tax exemptions relates to a philosophical argument about its charitable nature: aid is somehow different and should therefore not be subject to taxation (Goodwin, 1985; Brody, 2002). However, these arguments are often ‘more ideological than logical’ and imply a lack of understanding of the importance of resource mobilisation for state-building (Carnahan, 2007).

5.3 Removing exemptions will cause donors to shop around for the best deals

If donors care about the quantity of goods and specific aid projects, rather than the financial value of aid, then imposing taxes on project aid might distort the allocation of aid. Those countries that tax ODA would lose out to those that maintain exemptions. While a UN report has suggested that such shopping around is unlikely, it is not

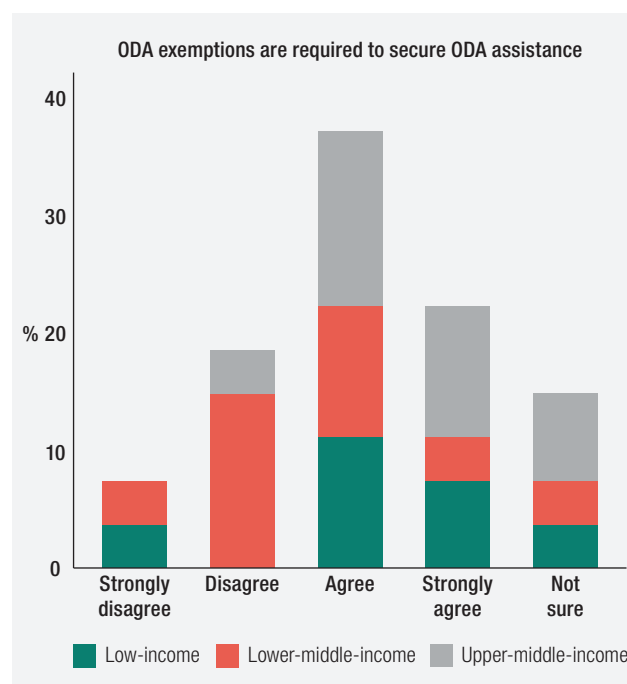
unthinkable (Thuronyi, 2006). Some ODA framework agreements, such as the Cotonou Agreement between the European Union (EU) and the Africa, Caribbean and Pacific group of states, include a most-favoured nation clause allowing EU donors to benefit from any ODA tax exemptions granted to other donors (ACP-EU, 2000). The existence of such clauses suggests that some donors do care about the tax competitiveness of their aid relative to other donors.

Our survey shows that more than half of respondents believe ODA tax exemptions are required to secure ODA assistance (see Figure 7). This suggests a multilateral approach to reform may be required, as individual developing countries may fear losing ODA assistance if they act alone.

5.4 Removing exemptions might be costlier than the gain obtained from doing so

Two arguments are often made. The first is that aid flows are typically more volatile than domestic taxation. Taxing aid therefore imports this volatility (Thuronyi, 2006). However, aid flows are included in the budget process anyway, so aid volatility already affects the government’s public financial management. Second, the removal of tax exemptions might come with a renegotiation cost (ibid.). Even so, it remains an empirical question as to whether the benefits of removing ODA tax exemptions outweigh these transaction costs.

Figure 7 Are ODA tax exemptions required to secure ODA assistance?



Notes: The survey allowed up to 3 responses per country. Results are based on 7 respondents from 7 low-income countries, 10 respondents from 6 lower-middle-income countries, 10 respondents from 5 upper-middle-income countries.

Source: ATAF and ODI survey

6. Arguments against ODA tax exemptions

Arguments against ODA tax exemptions usually relate to negative impacts on DRM: ODA tax exemptions reduce revenues, increase administrative burdens, and undermine fairness in the tax system. As with the arguments for ODA tax exemptions, there is relatively little empirical evidence.

6.1 Aid exemptions are a form of donor hypocrisy

Donors are increasingly pushing recipient countries to use tax exemptions more effectively and improve their transparency (see, for example, IMF (2011) and PCT (2015)). Simultaneously, donors seek exemptions for their aid, sometimes through opaque private agreements. Donors are ‘preaching tax morality but practicing tax avoidance’ (Fjelstad, 2009). This not only represents a serious case of donor hypocrisy (Prichard et al., 2012), it also goes against the principles of aid delivery in the Paris Declaration of Aid Effectiveness, which specifically calls for increased alignment of aid with partner countries’ priorities, systems and procedures (OECD, 2005).

Many ODA tax exemptions claimed under international treaty or project agreement are often already available under domestic law in the recipient state. Imports and purchases of medical and educational supplies are often exempt from indirect taxes, the temporary import of personal effects for experts on missions is duty-free under temporary admission rules, and non-profits are often exempt from taxation on their income. Where donors seek their own exemptions instead of making use of existing systems and procedures, they can introduce parallel systems and increase complexity.

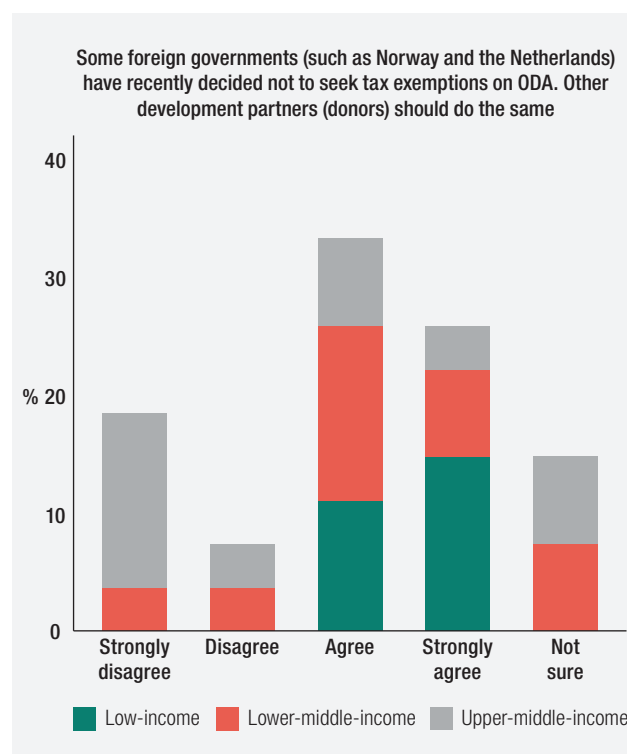
The constituent instruments of international organisations often explicitly exempt the organisation from acting as a withholding agent, even though withholding taxes are taxes on third parties, not taxes on the international organisation. Other donors can also be exempt from withholding taxes under bilateral framework agreements. This can result in the income of non-exempt entities going untaxed as no tax is withheld on payments, undermining the local tax system.

The Netherlands and Norway have both recently elected not to seek tax exemptions for ODA. Our survey shows that more than half the respondents, and particularly those from low-income and lower-middle income countries, believe other donors should do the same (see Figure 8).

6.2 Aid exemptions reduce the government's tax capacity

ODA tax exemptions can reduce the recipient country's tax capacity. There is relatively little evidence on the impact of ODA tax exemptions on government revenues, but the estimates that have been made suggest revenue

Figure 8 Should development partners follow the lead of Norway and the Netherlands?



Notes: The survey allowed up to 3 responses per country. Results are based on 7 respondents from 7 low-income countries, 10 respondents from 6 lower-middle-income countries, 10 respondents from 5 upper-middle-income countries.

Source: ATAF and ODI survey

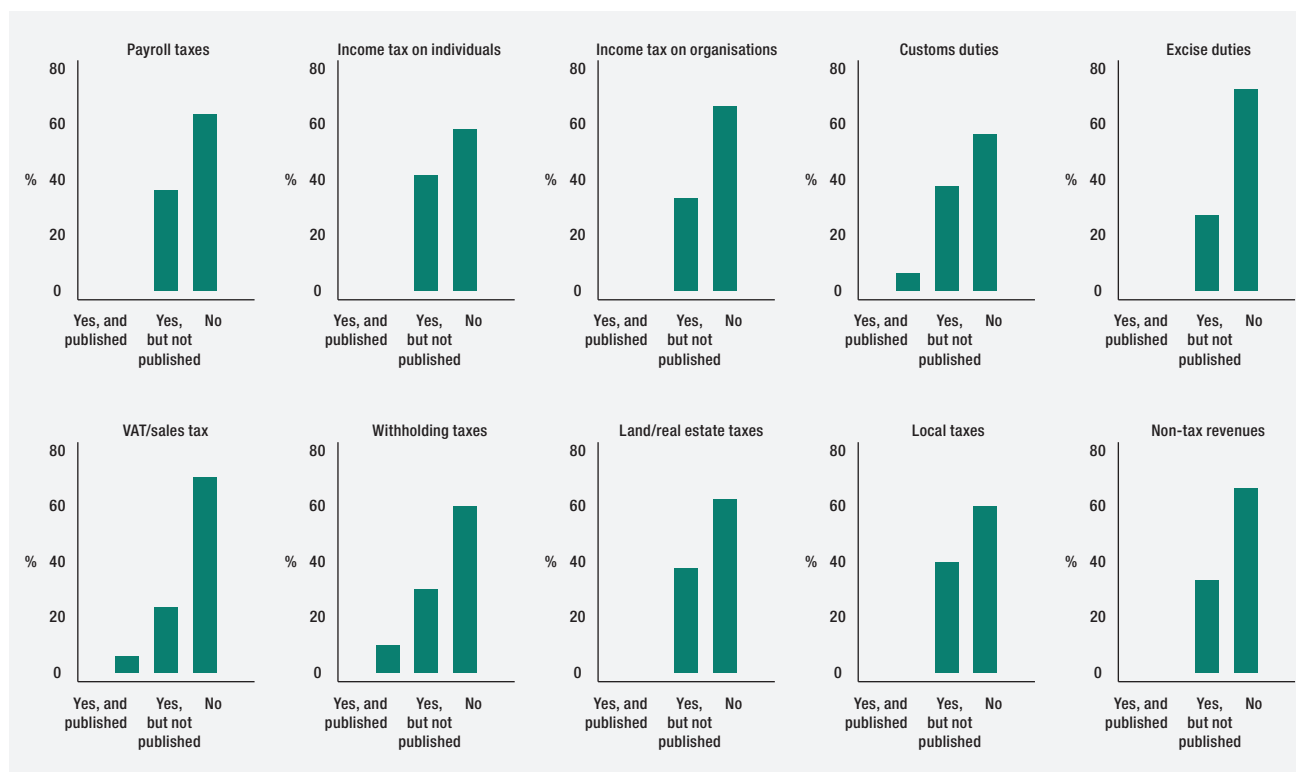
Table 2 Estimates of revenue foregone from ODA tax exemptions

Country	Estimate	Source
Mali	Customs exemptions worth 1.7% of GDP	Chambas (2005)
Niger	10% of revenue in 2002	Thuronyi (2006)
Tanzania	Customs exemptions equal to 17% of gross import value in 2005	Thuronyi (2006)
Burundi	Aid-related exemptions constituted 50% of total customs exemptions	MFBP (2013)

foregone can be significant, for example up to 10% of total revenue in Niger in 2002 (Thuronyi, 2006).

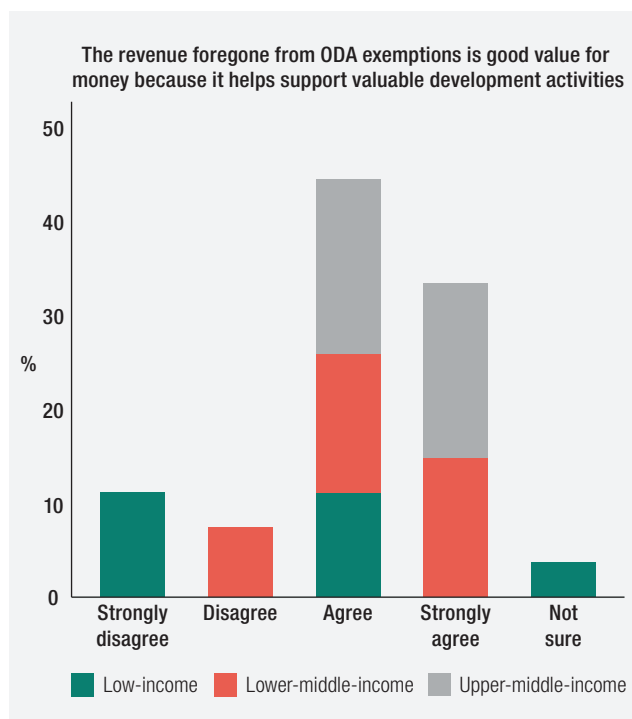
Many developing countries do not estimate or report on revenue foregone from tax expenditures in general, let alone the specific case of ODA tax exemptions. Our survey responses suggest that, across tax categories in our sample, just 20–40% of developing countries analyse the amount of revenue foregone from ODA tax exemptions (see Figure 9).

Figure 9 Estimates of revenue foregone



Source: ATAF and ODI survey

Figure 10 Is the revenue foregone from ODA tax exemptions good value for money?



Notes: The survey allowed up to 3 responses per country. Results are based on 7 respondents from 7 low-income countries, 10 respondents from 6 lower-middle-income-countries, 10 respondents from 5 upper-middle-income countries.

Source: ATAF and ODI survey

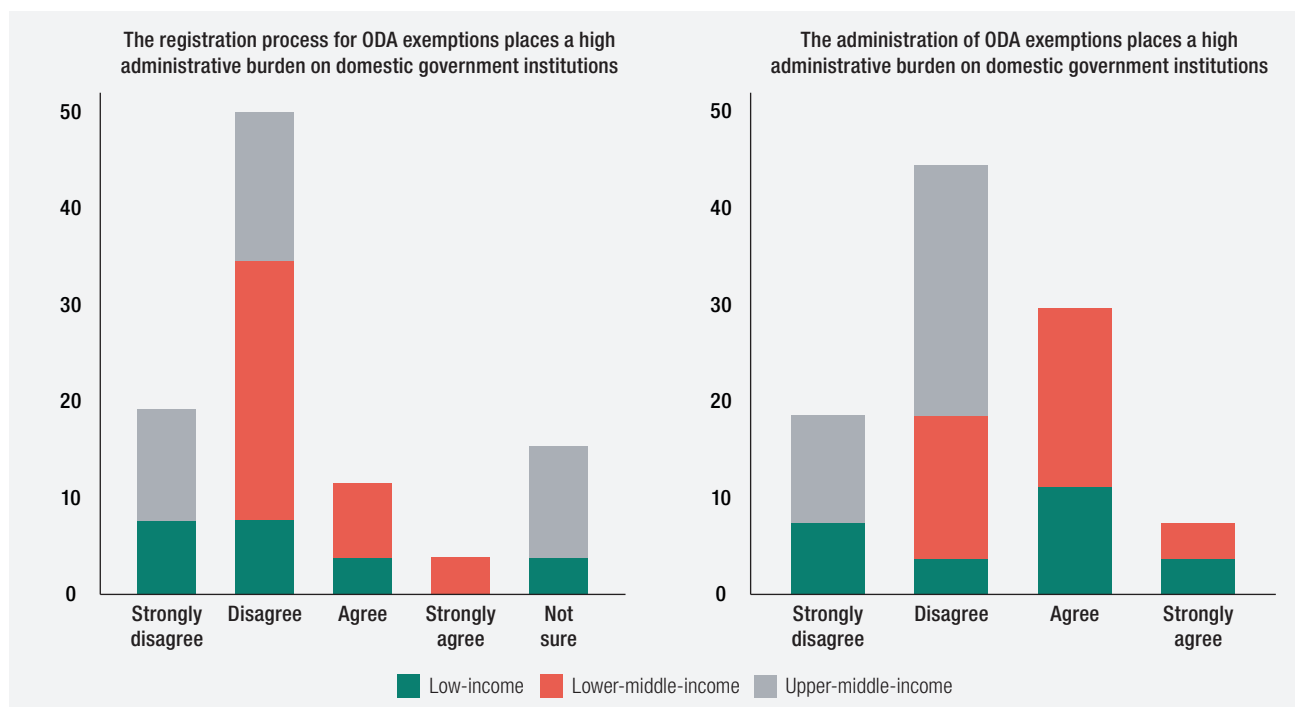
Even though there are few reliable estimates of revenue foregone from ODA tax exemptions, our survey shows most respondents in developing countries believe the revenue foregone from ODA tax exemptions is good value for money because it helps support valuable development activities (see Figure 10).

Tax exemptions for ODA also increase complexity and impose additional administrative burdens on recipient countries' tax administrations. This can include requirements to pay refunds on indirect taxes charged on local purchases. Processing refunds can drain resources away from revenue-generating activities and impact adversely on cash management. In Benin, a specialised administrative unit with 11 employees was used to manage tax exemptions on aid-related projects (Chambas, 2005). Our survey responses suggest that the administration of ODA tax exemptions is a greater burden for lower-income countries (see Figure 11).

6.3 ODA tax exemptions undermine the integrity and credibility of the tax system

The integrity and credibility of the tax system is undermined by ODA tax exemptions. Exempting aid sets a bad example, creates a precedent for more exemptions, and increases the pressure for future tax exemptions (Thuronyi, 2006). This is probably one of the most important effects of aid-related tax exemptions (Fjeldstad and Moore, 2008). The use of discretionary and often opaque agreements for ODA tax exemptions potentially legitimises a practice that, when applied to investors and other taxpayers, could facilitate corruption and exacerbate political divisions (Moore, 2015).

Figure 11 Do ODA tax exemptions place a high administrative burden on tax administrators?



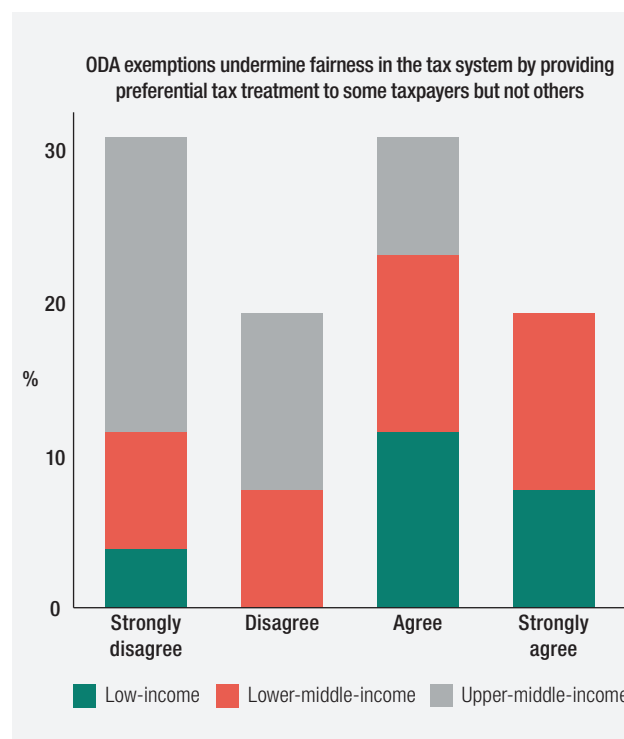
Notes: The survey allowed up to 3 responses per country. Results are based on 7 respondents from 7 low-income countries, 10 respondents from 6 lower-middle-income countries, 10 respondents from 5 upper-middle-income countries.

Source: ATAF and ODI survey

ODA tax exemptions also harm perceptions of fairness in the tax system that can undermine tax compliance. Wealthy expatriates are often among the richest members of society in developing countries but often do not pay any taxes. This can lead to resentment within the local population and questions about why they should bear the tax burden when much higher earners are excused (Prichard et al., 2012). ODA exemptions also send the message that the international community does not trust the government with their money, raising questions for citizens about whether they should either (Boyce and Forman, 2010). Our survey responses suggest that developing-country perspectives on ODA tax exemptions undermining fairness vary, with respondents from low-income countries more likely to agree that they undermine fairness in the tax system compared to upper-middle-income countries (see Figure 12).

Part of the reason for the emphasis in the Paris Declaration on local systems was to encourage learning-by-doing in the recipient country. By bypassing the tax system through tax exemptions, this learning-by-doing function is undermined – which could hinder institutional development (ibid.). This is particularly important given the role the tax administration plays in the development of other functions of the state (Prichard and Leonard, 2010). For providers of technical assistance to DRM, tax exemptions imply that they do not personally experience the systems their assistance is intended to improve.

Figure 12 Do ODA tax exemptions undermine fairness?



Notes: The survey allowed up to 3 responses per country. Results are based on 7 respondents from 7 low-income countries, 10 respondents from 6 lower-middle-income countries, 10 respondents from 5 upper-middle-income countries.

Source: ATAF and ODI survey

6.4 Aid exemptions create economic distortions

Taxes and duties are part of the normal cost structure of economic activity. Governments rarely exempt their purchases and imports from taxes as this would be distortionary, creating an unequal and anticompetitive playing field (World Bank, 2004). ODA tax exemptions create economic distortions with potentially undesirable consequences. Imported duty-free products for ODA projects favour importers over local retailers. This might encourage dishonest business, as avoiding taxes becomes a way to compete with exempted goods and services (Carnahan, 2007). Exemptions on imported goods for aid projects put domestic producers at a competitive disadvantage and hinder local economic development. When capital goods are exempt, this creates incentives for substitution away from (taxable) local labour and towards an increased reliance on capital goods (Thuronyi, 2006). Where non-resident employees, contractors and sub-contractors benefit from ODA tax exemptions but their resident counterparts do not (as our survey responses show is often the case, see Figure 6), the market between resident and non-resident providers is distorted by making the latter group more competitive.

6.5 ODA tax exemptions can assign taxing rights away from developing countries or facilitate tax avoidance

When ODA tax exemptions cascade from implementing agencies to their individual and corporate contractors, they can assign taxing rights away from developing countries and facilitate tax avoidance. Donor policy is often to leave the tax affairs of independent contractors to the contractor, and donors often do not act as withholding agents in the countries they support, which effectively amounts to a ‘don’t ask, don’t tell’ policy on the taxation of ODA contractors.

For contractors working in development, ODA tax exemptions often ensure they pay no local income tax in developing countries. ODA tax exemptions effectively assign taxing rights to developed countries, who often retain the right to tax their citizens and domestic corporations on worldwide income, and away from developing countries where the income-generating activities take place. Rather than aid money sticking in the developing country, it is recycled back to developed countries through tax. Without ODA tax exemptions, the domestic legislation of each country and any double-taxation agreement (DTA) between them would assign taxing rights, allowing the developing country to collect tax on residents and potentially non-residents that provide ODA through withholding. DTAs and unilateral credits and exclusions would often prevent double taxation.

Exemptions from income tax for ODA contractors can also facilitate tax avoidance when combined with non-residency status, remittance rules, or foreign earned income exclusions in the contractor’s country of citizenship or incorporation. Exploiting ODA tax exemptions and other legal loopholes enables development contractors to pay no

tax on their income anywhere in the world, as shown in the example in Box 2.

Box 2 Example of how ODA tax exemptions can facilitate income tax avoidance

A US citizen works for an international educational NGO in Liberia for one year. The NGO is funded by the United States Agency for International Development (USAID) and is within the scope of the Development Objective Agreement (DOA) for better-education of Liberians (USA-Liberia, 2012). The US citizen receives \$100,000 gross pay for the year.

The DOA provides a general exemption from taxation (Section B.4.) that applies to income and social security taxes on the income of non-national employees of non-national organisations (B.4. (c) (2)). The US citizen therefore pays no tax on the \$100,000 income in Liberia.

US citizens are taxed in the US on their worldwide income, but citizens and residents living and working abroad can be entitled to a foreign earned income exclusion up to \$102,100 of income in 2017 (IRS, 2017). The US citizen does not return to the US during the calendar year in which they work in Liberia and qualifies for the foreign earned income exclusion. The US citizen pays no income tax in the US on the \$100,000 income.

Had the ODA tax exemption not existed, the US citizen would have been liable for income tax in Liberia under section 800 (a) (2) of the Liberia Revenue Code (MoF, 2012) that defines a resident natural person as someone present in Liberia for more than 182 days in a 12-month period that ends during the tax year. The tax due would have been approximately US\$24,200. The ODA tax exemption facilitates income tax avoidance as the aid worker pays no tax on their income anywhere in the world.

Notes:

This example uses the US due to the relative transparency of its ODA tax exemptions. The US lists its treaties, publishes them in full, and provides guidelines on USAID’s tax policies in the Automated Directives System. This is to the credit of the US. That ODA tax exemptions facilitate double non-taxation is true for any country pairing where the income of an individual performing ODA services is untaxed in the recipient country due to an ODA tax exemption and the individual can claim non-residency or a foreign income exclusion in their home country.

The progressive income tax table in Liberia has a top rate of 25% on income above 800,000 Liberian dollars (LRD). At the time of writing the US\$/LRD exchange rate would have led to a tax liability of \$24,206.50.

Source: USA-Liberia (2012), MoF (2012), IRS (2017)

6.6 ODA tax exemptions can be abused, leading to revenue leakages

Tax exemptions for ODA are often broad, with funds provided for ODA programmes free from any and all taxes in the recipient country without limit. Broadly defined ODA tax exemptions can cover goods and activities that are not fundamental to ODA projects. This can be abused by ODA providers, leading to revenue leakages. For example, tax-exempt providers of ODA can import petroleum, alcohol and tobacco products duty-free for their employees' personal consumption. Employees could even sell those products on the black market. Goods that attract high excise taxes and import duties, and that are easily resold, are particularly susceptible to abuse. Tax authorities often guard against such abuses when granting tax incentives to investors by agreeing lists of specific items needed directly for the project that can be imported duty-free, or by listing items that are explicitly not covered by exemption. This practice is not generally followed for ODA tax exemptions.

6.7 ODA tax exemptions lack transparency and legitimacy

ODA tax exemptions are primarily implemented through international treaties. In principle this should be transparent and legitimate. Bilateral treaties are agreed by two sovereign states, implemented consistent with domestic procedures (for example via ratification by the legislature) and published by the UN. In practice ODA tax exemptions lack transparency and legitimacy. Despite recent efforts to improve aid transparency, project agreements are not systematically published and there is no central repository for ODA agreements.

All international treaties should be registered with the UN (see Article 102 of UN, 1945) and published in the UN Treaty Collection. However, the text of many ODA treaties cannot be accessed as the regulations giving effect to Article 102 permit limited publication of 'administrative and cooperation agreements of limited scope concerning financial, commercial, administrative and technical matters'.³

The UN frequently uses the limited publication regulation for development assistance agreements. For example, the IDA has registered 108 bilateral treaties⁴ with the UN since it was formed in the 1960s, covering up to \$345 billion of investments in 113 countries.⁵ Of

these, only nine have been published in full, all with Ethiopia. The most recent agreement published was a 1972 Development Credit Agreement with Ethiopia (IDA-Ethiopia, 1972) that included a broad exemption from taxation (Article VI). Some countries, such as the US, are more transparent and publish the text of treaties on their own online databases.⁶

While agreements between sovereign states should be legitimate, developing countries that receive aid may lack negotiating power against providers of aid, and may be unwilling to risk renegotiating such agreements if they fear aid will be withdrawn (see Figure 7). In some cases, bilateral assistance is provided to developing countries under a framework treaty that was signed by European colonial powers on its behalf and inherited upon independence.⁷

6.8 ODA tax exemptions can be claimed without a sound legal basis

ODA tax exemptions should be provided directly in domestic tax law in the recipient state, by international treaty, or be granted by government entities in the recipient state that have tax-waiving powers under law. These requirements may not be met when donors enter into opaque agreements with agencies in the recipient government, but the lack of transparency around these agreements makes it difficult to determine the incidence of ODA tax exemptions being claimed without a sound legal basis.

A report on the taxation of US assistance (GAO, 2004) shows that ODA exemptions can be claimed without a firm legal basis. In six states and territories in which USAID provided assistance, the US did not have a bilateral ODA framework agreement providing tax exemptions and relied instead on other arrangements. These included a letter from the Palestinian Authority granting VAT-free status, an administrative procedure involving the Palestinian Authority and the Israeli Customs Department, and grant agreements for specific projects in Eritrea, Mozambique, the Philippines, and Indonesia.⁸ The report also showed that USAID was able to claim exemptions from taxes on local purchases where bilateral framework treaties did not specifically provide such exemptions, as 'USAID had interpreted such agreements to implicitly include such an exemption' and 'had been able to persuade recipient governments to accept its interpretation of the agreements' (GAO, 2004).

3 Article 12 (2) of the General Assembly regulations give effect to Article 102 of the Charter of the UN.

4 Based on the UN Treaty Collection search function. See <http://treaties.un.org>

5 See <http://ida.worldbank.org/about/what-ida>.

6 See www.state.gov/s/l/treaty/tif for a list of US treaties and www.state.gov/s/l/treaty/tias/index.htm for an online database.

7 The US lists all bilateral foreign assistance treaties in *Treaties in Force*. The UK's Marshall Plan treaty from 1948 is listed as the current foreign assistance agreement for Gambia, Kenya, Malaysia, Malta, Mauritius, Nigeria, Solomon Islands, Trinidad and Tobago, and Zambia.

8 The validity of tax exemptions granted in these project agreements would depend on whether the signatories in the recipient state had tax-waiving powers under law, or if the agreements themselves were ratified by the legislature.

7. Recommendations for reform

The current system of ODA tax exemptions is complex, opaque, and inconsistent with broader development efforts to support DRM. There is relatively little empirical evidence on the impacts of donor tax exemptions. It is therefore difficult to make an empirical case that ODA tax exemptions improve aid outcomes and that these benefits outweigh the costs in terms of revenue foregone and administrative burdens.

Given that the PCT has pledged to review ODA tax exemptions and issue guidelines, it should focus first on increasing transparency and improving the evidence base before issuing guidance on what specific ODA tax exemptions should or should not apply. Without greater transparency and better evidence, reform efforts are likely to fail given positions have become entrenched over time. In addition, donors should end some of the most harmful aspects of ODA tax exemptions, such as the ‘don’t ask, don’t tell’ policy that facilitates tax avoidance by contractors.

The following recommendations are concrete steps that the PCT, donors, recipient countries and regional tax organisations could take in this direction.

1: The OECD Development Assistance Committee (DAC) should take up this issue alongside the PCT

The DAC can act as a forum for sharing experiences and information on ODA tax exemptions, including the lessons learned from those countries that have recently decided not to seek ODA exemptions. Its 30 members pledge to implement recommendations adopted by the DAC and to use DAC guidelines and reference documents in formulating development policies, which makes it uniquely placed to drive forward changes to the current system of ODA tax exemptions. The DAC can therefore help ensure that, unlike previous reform efforts, the PCT review process leads to substantive change.

2: The UN should publish all ODA framework treaties in full

The limited publication rule enabled the UN not to publish many ODA framework treaties. ODA treaties that were previously unpublished could be published in full in digital format by the UN at relatively little cost. This would enable donors and recipients to benchmark their ODA tax practices against other countries and allow civil society to understand better the terms and conditions under which foreign assistance is provided.

3: Donors should publish project agreements

Even if all ODA treaties were published in full, there would still be opacity for those tax exemptions provided in project agreements. A lot of detailed information on ODA projects is already published online by donors directly or through the International Aid Transparency Initiative (IATI), yet the project agreements that govern these projects and that can include tax exemptions are rarely

published. Donors should publish all project agreements. This could be done directly by donors or through a central repository, such as the IATI or similar body.

4: Recipients and donors should review ODA tax practices to ensure they are consistent with international treaties and domestic law. Project agreements should be amended where not consistent to conform with applicable law.

ODA tax exemptions should have a solid grounding in law. Project agreements that provide for tax exemptions may not do so if there is no overarching framework treaty and domestic law does not permit negotiated tax waivers. Exemptions granted by convention and administrative procedures may also lack a solid legal basis. Recipients and donors should review their ODA tax arrangements to ensure they are consistent with law. Where ODA tax arrangements are not consistent with law, they should cease until they are put on a sound legal footing through treaty or legislation.

5: Recipients and donors should systematically assess and publish the revenue foregone and administrative burden of ODA tax exemptions for all new projects

There are limited estimates of the detrimental impacts of ODA tax exemptions on revenue capacity. Few developing countries estimate and publish the revenue foregone and administrative burden of tax expenditures across the system, let alone the specific development sector. Even so, project agreements often require recipients and donors to produce an impact assessment. That assessment could be expanded to include the impact of tax exemptions on revenues and administrative capacity, and the estimates published.

6: Donors and implementing agencies with a long-term physical presence in a recipient country should act within the tax system and withhold tax on payments to non-exempt entities

Withholding taxes are taxes on third-party recipients of payments, not on the donors and international organisations that make those payments. Where these third parties are not tax-exempt, donors and international organisations should withhold taxes and remit these to revenue authorities to support DRM.

7: Donors should seek to use tax exemptions generally available under recipient tax law and follow standard administrative procedures where possible

Many ODA tax exemptions claimed under international treaties or project agreements are often already available under domestic law. Donors should seek to make use of these existing exemptions first, before seeking special treatment. This would reduce the

administrative burden on tax authorities from having multiple systems and situate donors within the tax system and general law, rather than operating on a separate legal plane.

8: Donors should end the ‘don’t ask, don’t tell’ approach to the taxation of contractors that facilitates tax avoidance. Exemptions should only be granted where contractors can demonstrate double taxation.

ODA tax exemptions on the private income of contractors can facilitate tax avoidance. DTAs and credits, exemptions and exclusions provided in home-country tax law should be sufficient to prevent double taxation in many cases. ODA tax exemptions should only be extended to contractors and their employees where they can demonstrate a reasonable likelihood of double taxation.

9: Recipients should have a ‘no-blame’ mechanism for renegotiating ODA framework agreements

Many ODA framework agreements were made in a different age and, sometimes, inherited by countries upon their independence from European colonialism. Attempts to review and improve agreements in the public interest may fail if recipients fear that renegotiation may rock the boat and lead to donors withdrawing from their country. Individual action may disadvantage some recipients relative to others that maintain broad ODA tax exemptions. The PCT should facilitate a multilateral, no-blame mechanism for renegotiating international treaties with ODA tax exemptions. Regional tax organisations such as ATAF, CATA, the Inter-American Center of Tax Administrations (CIAT) and Centre de Rencontres et d’Etudes des Dirigeants des Administrations Fiscales (CREDAF) and the Network of Tax Organisations (NTO) have a key role to play in ensuring ODA recipients negotiate in their collective interest rather than individually.

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