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Should we Engage in Development Cooperation with Countries that Have a Notoriously Low Tax Ratio?

Some countries fail to ensure that their citizens and businesses make an appropriate contribution to the financing of public tasks. In such cases one can think of a number of reasons for reducing development cooperation or even stopping it altogether. But not all countries with a low tax ratio automatically fall into this category.

Development policy should analyze countries carefully. It should not, however, shrink from linking resource allocation to the strengthening of tax systems if a partner country consistently fails to make efforts to increase its own revenues.

Countries with a low tax yield or lax enforcement of tax laws are running out of time. Such international players as the Organisation for Economic Co-operation and Development (OECD), the World Bank and the G20 are calling for more determined action to combat tax evasion and avoidance. With the world fighting the global financial and economic crisis, there is growing pressure on tax havens to increase the transparency of their tax systems and put an end to unfair competitive practices. Developing countries, too, are being urged to do more to mobilise domestic resources rather than rely on a constant inflow of development cooperation funds.

In its development policy the German government adopts a cooperative approach. It is the initiator of an *International Tax Compact* (ITC), which brings together OECD members and developing countries in a dialogue on an equal footing. The initiative aims to support developing countries in their efforts to increase tax revenues, and to promote international cooperation in this sphere.

However, there is no lack of voices advocating more robust action. In a communication published in April 2009 the European Commission proposed that development funds should be reduced where countries do not honour their commitment to good governance in tax matters. Occasionally, it is even suggested in the development policy debate that there should be no more development cooperation with countries whose tax ratios fall below a threshold of, say, 20 per cent of gross domestic product (GDP).

Are these demands justified? Could it even be in the long-term interests of the developing countries themselves for development cooperation to cease in such cases? The next section sets out the arguments in support of this position. The paper then asks how low-revenue countries can be defined from the development policy perspective and discusses the factors that may influence tax ratios. Finally, the options open to development policy for addressing the tax issue in partner countries are considered.

Box: Tax ratio

The tax ratio is the share of GDP which a state collects through taxes and levies (including compulsory social security contributions). According to OECD figures, the tax ratios of the industrialised countries in 2006 were between about 27 and 50 per cent of GDP, with the USA and Japan at the lower end of the scale, the Scandinavian countries at the upper end and Germany (at 35.7 per cent) in the middle. Developing countries' tax ratios are often significantly lower. According to data assembled by the UN Economic Commission for Latin America and the Caribbean (ECLAC), the average tax ratio in Latin America in 2006, for example, was 17.4 per cent. The OECD and ECLAC figures include social security contributions, unlike the *International Finance Statistics* of the International Monetary Fund (IMF)(see below, Graph 1).

Arguments for reducing development cooperation resource allocations or stopping them altogether

In the international debate three main reasons are given for stopping allocations of development resources to countries with a low tax ratio: (1) Cooperation with such countries weakens the legitimacy of development policy in donor-country societies. (2) It stabilises political regimes with bad governance. (3) It encourages rent-seeking and undermines the partners' development efforts.

– **Legitimacy of development policy:** Our sense of justice is offended when donor countries use tax money to support developing countries whose governments do not do enough to mobilise their own resources. This argument becomes all the more cogent when the composition and relative importance of the various kinds of tax are considered: Developing countries often find it particularly difficult to collect direct taxes on private incomes and

wealth, whereas it is the private households – and especially the strong middle class – which bear the main brunt of taxes and levies in the industrialised countries. In plain English, this means that the middle class in the donor countries compensates for the lack of willingness of the developing countries' elites to contribute to the financing of public tasks.

– **Bad governance:** When it comes to governance in developing countries, concerns over legitimacy become even more critical. The inability of political regimes to persuade their elites to pay taxes can be seen as an indication of poor governance in other spheres, too: recent contributions to the taxation literature show that a broad tax base with many taxpayers does a great deal to improve the public accountability of the political authorities and to strengthen democratic practices. By compensating for poor fiscal policies, development cooperation may well be helping to stabilise political regimes with bad governance.

– **Rent-seeking:** Such critical authors as Easterly and Moyo have been pointing out for some time that for many developing countries development cooperation represents a rent collected and distributed by governments without any real effort on their part. As with rents from extractive industries, development is, according to this argument, hindered rather than promoted by development assistance. It seems reasonable to assume that governments will dispense with the laborious mobilisation of internal resources if they have access to external funds (i.e., the substitution effect of development cooperation). The available empirical evidence is not clear in this respect, but recent studies detect a negative correlation between the level of development cooperation allocations on the one hand and revenue from direct taxes and the quality of tax systems on the other.

It is also possible, of course, to cite arguments that take a less critical view. There are, after all, development cooperation programmes geared specifically to improving governance in general and tax systems in particular. Where certain conditions are attached to development cooperation (such as governance criteria or cofinancing requirements), it also increases the incentives to governments to undertake tax reforms. However, the arguments outlined above apply at least to those countries whose tax revenue stubbornly remains at a low level. But which countries are these?

Tax states compared

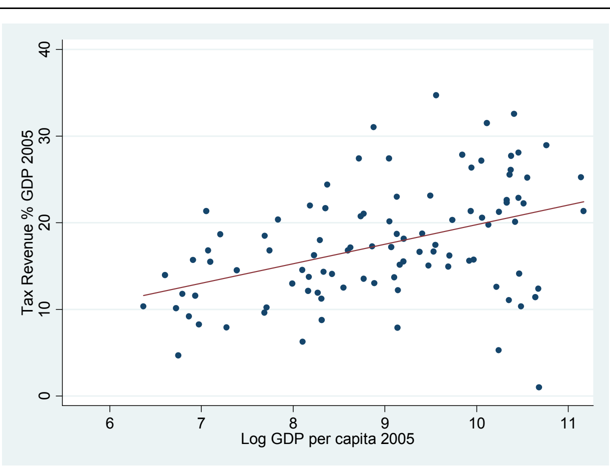
An initial approach to identifying low-revenue countries might consist in defining a fixed tax ratio threshold. Unfortunately, that calculation does not make much sense. If, for example, the threshold was set at the 20 per cent of GDP mentioned above, a clear majority of Germany's partner countries in development cooperation throughout the world would have fallen below that line in 2005.

It would of course be possible to lower the threshold further. But setting a fixed line, at whatever level, overlooks the fact that the tax ratio correlates closely with income per capita. This link has been demonstrated in the literature since the 1970s. There may be exceptions, such as Ghana (2005: 21.3 per cent) and Jordan (24.3 per cent), but the trend is clear nonetheless.

State capacity always includes the capacity to collect taxes. States where per capita income is low do not, as a rule, meet the administrative and institutional requirements for a tax system at OECD level. An appropriate appraisal of a state's efforts to tax its citizens must therefore take its level of development into account. A possible guide in this context might be a trend line indicating the link between tax ratio and income per capita (see Graph 1).

States with tax ratios on or above this trend line seem to make greater use of their taxation capacity – measured against income level – than states whose tax ratio lies below the trend line. A modified "threshold approach" would thus use the trend line rather than a fixed limit.

Graph 1: Link between tax ratio and per capita GDP, 2005



Source: Authors' own calculations based on the IMF's *International Finance Statistics* (Central Government Revenues as a Percentage of GDP)

To illustrate this, although a number of partner countries of importance for German development cooperation had tax ratios of less than 20 per cent in 2005, they were well above the trend line. Kenya's tax ratio, for instance, was 18.6 per cent of GDP. If the income trend was taken as the sole indicator, the tax ratio would have had to be slightly below 14 per cent. The same is true of Mali (15.6 rather than less than 13 per cent) and of Nicaragua (16.8 rather than just under 15 per cent).

However, significant downward deviations are equally demonstrable. According to the trend, Cambodia and the Republic of Congo should be skimming off some 13 to 14 per cent of GDP in taxes. But Cambodia achieved only 7.9 per cent, the Republic of Congo a mere 6.2 per cent. In general, many sub-Saharan African countries broadly fit the trend line or are even doing far better. Numerous Latin American countries, on the other hand, are performing less well, significantly in some cases. Comparative studies by the World Bank and the IMF in the past 15 years confirm these regional patterns, although the positions of individual countries may gradually change with the passage of time.

Compared to a fixed threshold, the trend line is a better indicator of the ability or willingness of states to collect taxes. A single observation, like that shown in the graph, tells us nothing, however, about trends over time. It could be that a country is actually still below the trend line, although it has increased its tax ratio in past years. Only long-term observation will provide information on the fiscal development of a country or group of countries, even more so as the tax ratio usually rises slowly. Sudden changes are, as a rule, the result of special economic effects and are by no means irreversible.

Here, however, a practical problem emerges, that of available data. The IMF is able to provide reliable data on many countries' revenue, expenditure and GDP only with a few years' delay. At present, for instance, data on many countries are available up to 2005. The period of global expansion from 2003 until 2008 is covered only in part – and this is not to speak, of course, of the effects of the financial and economic crisis. An added factor is that the IMF's statistics include only central government revenues. In a few countries (especially those with a federal structure) subnational units (federal states, provinces, *départements*, etc.) collect revenues of their own on a considerable scale – in Brazil, for instance, they account for over 40 per cent of total government revenues. Also, quite a few countries do not appear in these statistics at all, because reliable data are not available or not publicly accessible. Thus there are no figures on fragile states such as Afghanistan, Haiti and the Democratic Republic of Congo. Not the least problem is the difficulty of making time-series comparisons, because older data are often less reliable or methods of calculation change.

Other factors influencing the tax ratio

Even if complete and comparable data covering longer periods were available, the trend line approach alone would not be sufficient, because it considers only the influence of per capita income on the tax ratio and leaves aside other decisive factors, particularly the political situation and the structure of the economy.

Countries engaged in military conflict or in a post-conflict situation and countries with government structures that are fragile for other reasons, have a limited capacity to collect taxes. Where there are figures on fragile or post-conflict states, such as Nepal and Cambodia, they are well below the trend line. This finding suggests that such states should be treated as special cases. It may be appropriate to pay particular attention to strengthening their tax systems in addition to general state- and peace-building tasks. This will, however, require donors and national actors to change their approach to some extent, their focus usually being on public services and expenditure rather than government revenue.

However, the literature also refers to other factors, especially the structure of the economy. Countries in which the agricultural sector accounts for a large share of the economy tend to fall short of the trend line, while countries with a large volume of foreign trade often do better. Agriculture, especially subsistence agriculture, is hard to tax, whereas traded goods arriving in and leaving a country at specific points are relatively easy to tax. Leaving aside political and institutional considerations, taxes are simply more readily collected in some economies than in others. The influence of development cooperation on factors associated with the structure of the economy is likely to be limited.

Rent income from natural resources is a further reason for some states to collect fewer taxes in the long term. A state that is able to finance itself from the rents it receives from extractive industries, especially oil and gas, will feel little inclination to resort to the laborious business of depriving its citizens of some of their income when it can finance its essential functions as things are. The best example is the Persian Gulf countries, which achieve tax ratios well below the trend line despite having medium to high per capita incomes. Mexico and Venezuela, too, have significantly lower tax ratios because, in good years at least, revenue from raw materials makes up the difference. That an approach of this kind entails high risks for a country's governance is well documented in the literature on the so-called *rentier states*.

Conclusions for development cooperation

In its dealings with fiscally weak partner countries development policy must proceed on a case-by-case basis. It must not focus solely on the tax ratio, but consider the tax system as a whole: its composition, its development over the years, its redistributive effects and its impacts on economic activity and public participation. Even if a case-by-case approach is adopted, however, development policy can find support in a number of general indicators or approaches.

– A country's position in relation to the trend line (or the change in this position over a number of years) can be taken as a first indicator. Where states fall persistently and significantly below the trend line, there is at least a need for further analysis of the possible reasons for their continuously low tax ratio.

- The implementation of the OECD guidelines on good governance in fiscal matters (proposed as an indicator by the European Commission) can in some cases be taken as an indication of the decision-makers' political will actually to tackle tax reforms. However, the guidelines principally concern questions of transparency and the exchange of information and relate no more than indirectly to tax revenue, the quality of tax collection or the composition of tax regimes. Their usefulness is therefore limited.

- The World Bank's *Country Policy and Institutional Assessments* (CPIAs) cover, among other things, the "efficiency of revenue mobilization" in respect of both tax policy and tax administration. These assessments have been conducted annually in some 135 countries since 1997. In the case of countries with low values in this CPIA dimension particular attention should be paid to the composition of the tax regime: often, low direct taxes can be taken as a sign of bad governance in this sphere.

In countries with poor tax collection, stagnant or worsening indicators and a "badly" composed tax regime the focus of development cooperation should be shifted to the reform of their tax systems. According to OECD figures, less than 0.1 % of official development cooperation funds was spent on taxation-related tasks worldwide in 2007. Even though the scale of resources is not in itself a particularly meaningful criterion, this is undoubtedly too little for any substantial influence to be brought to bear on the existing incentive structures.

Is it appropriate to stop development cooperation with these countries altogether? Not necessarily, but the nature of cooperation should at least be adjusted in such cases. States that are highly fragile, are engaged in a military conflict or post-conflict situation or have difficulty in collecting taxes for structural reasons should not be uncoupled from development cooperation, but greater emphasis in that cooperation should be placed on strengthening their tax systems. Governments should be supported in their efforts to increase tax revenue (through the linking of financial allocations to improvements in the tax system, for instance). However, in the absence of success and when the partner countries' decision-makers obviously lack the will, donors must ask themselves how cooperation with such governments can be justified in development policy terms and continue to be legitimised at home.

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