Linking Policies: Inter-Nation Equity, Overseas Development Assistance, And Taxation

by Tatiana Falcão

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The goal of this article is to connect overseas development assistance (ODA) with the international tax framework more generally, and double tax treaties in particular. The 2017 revision of the OECD and U.N. models have had the effect of revising the preamble of both models and conferring on them a revived objective, which is no longer restricted to the avoidance of double taxation, but also includes forestalling “opportunities for non-taxation or reduced taxation through tax avoidance or evasion.”¹ They do so without paying attention to equity or distributional considerations among the treaty states.

Bilateral tax treaties are concerned with tax base allocation between states, splitting them into source and residence countries. Within the realm of ODA, to put it crassly, the primary concern is redistribution and assistance granted by rich countries to poor. However, redistribution is significantly affected by tax considerations, as this article will demonstrate. If improperly attuned, the interaction between redistribution and taxation — two seemingly distinct but parallel cash flow and transfer networks — can create a system that first allocates most (or as many as possible) taxing rights to the resident state, and then requires the residence state to donate a part of the accumulated resources to the source state through direct or indirect transfers in the form of ODA.

The first part of this article discusses the trends in ODA, following the data publicized in the April 13 Inter-Agency Task Force on Financing for Development (IATF) report, “Financing for Development: Progress and Prospects 2018.” It discusses some of the conditions for redistribution of funds to recipient states — in particular, by considering the exemption mandated by most international assistance projects. The second part considers how the tax system might provide a better answer to the issue of redistribution, if redistributive goals were included in the preamble of bilateral tax treaties. It further highlights how national rent might be allocated in accordance with inter-nation equity principles.

**ODA Trends**

According to the OECD,² ODA is defined as “government aid designed to promote the

¹U.N. model (2017), preamble; and OECD model, preamble.
economic development and welfare of developing countries." Loans and credits for military purposes are excluded from the definition.

ODA is an aid transfer that developed countries pay to developing countries to assist development. The word “aid” is not synonymous with a cash transfer, however. The aid may be in cash, but it can also be in kind, a grant, a “soft loan” (in which the grant element is at least 25 percent of the total), or technical assistance.

Donor countries tend to prefer to tie their donations to a particular project through targeted assistance (for example, building schools or hospitals, or running a vaccination campaign). Donations can also be connected with an emergency situation, such as a natural disaster, humanitarian crisis, or event that requires peacekeeping operations.

Under the U.N. system, countries are divided into high-, middle-, and low-income countries. High-income countries are generally referred to as developed countries; middle- and low-income countries make up the developing country category. Among developing countries, there are least developed countries, small island developing states, and landlocked developing countries. There are 150 countries and territories within the developing country category with 2010 per capita incomes below $1,276. This figure, incidentally, is the ceiling to qualify for ODA. Per capita incomes of about $12,200 trigger graduation from ODA eligibility, because this level of per capita income signals a move from middle-income to high-income country levels. Jurisdictions with per capita incomes below $1,200 are classified as low-income; those with incomes between $1,200 and $12,200 constitute the middle-income countries, the largest category.3

A standard proxy to measure the degree to which a country is rich or poor is gross national income (GNI) — sometimes also expressed as GDP. The U.N. has set 0.7 percent of GNI as a donor country contribution target for ODA. According to the 2018 IATF report, only Denmark, Germany, Luxembourg, Norway, Sweden, and the United Kingdom met or exceeded the U.N. target. On average, OECD Development Assistance Committee (DAC) donors5 contributed only 0.32 percent of GNI. Between 2015 and 2016, nine DAC members actually decreased their ODA contributions to least-developed countries.6 In the aggregate, the IATF report shows an ODA increase in real terms of 10.7 percent in 2016, contributing to an overall rising trend.

However, further analysis shows that ODA contributions tend to increase at times of crisis or emergency, such as a major weather event. The 2015-2016 increase in ODA is partially explained by an increase in funds for hosting and processing refugees in the donee states.6 Likewise, an increase in ODA to small island developing states resulted from two extraordinary events: Spain’s restructuring of Cuba’s debt and a spike in ODA flows into Haiti because of the earthquake. Absent these events, the pattern would have been one of decreased flows to all categories of developing countries.7

In the same vein, country programmable aid (CPA) (the share of aid that providers can program for individual countries and regions over which recipient countries have a significant say) and budget support have also declined.8

This means that countries are getting less of a chance to say where the money, grant, or asset they are receiving will be employed, and receiving less ownership over deployment of the funds in their economy. Non-budgeted funds may be synonymous with one-off deals, and countries cannot rely on donor countries to make investments in infrastructure, education, and health — key investment areas within any country’s government structure.

When these non-budgeted funds are earmarked for a particular project (also known as “international project assistance”), a further

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3IATF report, supra note 3, at 89.
4The DAC currently has 30 members, which roughly coincides with the OECD membership.
5IATF report, supra note 3, at 89.
6Although the IATF argues that even without that increase in funds to handle the refugee crisis, ODA would have increased by 8.6 percent in real terms. See IATF report, supra note 3, at 88.
7IATF report, supra note 3, at 89.
problem arises in the current donor practice of requesting ODA tax exemptions.

**ODA Tax Exemption**

The U.N. Committee of Experts on International Cooperation in Tax Matters has been working on the tax treatment of donor-financed projects almost from its inception in 2005. The first paper was released in 2006. According to the U.N., tax exemptions relating to international aid can take various forms:

- Imports of goods may be exempt from customs duties, VAT (or other general sales tax), excises and other indirect taxes. Goods or services procured locally may be exempt from VAT or sales tax. Income tax exemption may be extended to persons working under contracts (for example, employees and enterprises).

- Exemptions may be included in double tax treaties or bilateral agreements, but they can also be granted via the domestic tax system or through specific legislation introduced to directly address ODA.

- Exemptions are a mechanism through which countries ensure that aid will be used only in the approved project, and that none of the resources will directly or indirectly contribute to the country’s general budget. However, exemptions related to a particular international project assistance can take various forms within the targeted country’s tax system and create serious equity problems. They might involve, for example:
  - an exemption from customs duties and VAT on the import of goods by a nonresident (without reexport obligations);
  - an exemption from profits tax for a nonresident contractor providing services financed with project funds without a permanent establishment in the country; or
  - an exemption from individual personal income tax and social security contributions for resident individuals hired to work for a resident or nonresident contractor operating with project funds.\footnote{United Nations, Second Session of the Committee of Experts on International Cooperation in Tax Matters, “Tax Treatment of Donor-Financed Projects,” E/C.18/2006/5 (2006).}

- Exemptions are the result of a donor country’s unwillingness to provide budgetary support to the recipient country, despite international calls to increase this type of assistance.\footnote{Id. at 5. This is not a complete list. The document provides a more thorough list of cases in which a donee country might be required to confer an exemption.} The preference of providing targeted or project-based assistance is driven by the fear that otherwise the funds will be misused or misappropriated in the recipient country, especially if the recipient is tarnished with corruption. Additionally, budgetary support may suffer from a failure of donor country political support for direct cash transfers. It is easier to justify a large donation when one can physically verify the construction of ten hospitals than it is to justify a cash transfer that became part of a country’s general budget.

Despite potentially increasing the transactional cost of administering the donated money, donor countries continue asking for recipient country exemptions,\footnote{Id., at 5. This is not a complete list. The document provides a more thorough list of cases in which a donee country might be required to confer an exemption.} creating serious equity problems and further complicating frail domestic tax systems. Draft guidelines meant to deal with this issue were prepared by the staff of the International Tax Dialogue Steering Group in 2007 and put forward for consideration by the tax committee. However, the guidelines never made it past the approval stage.\footnote{Id. note 3.}

The sums at stake are substantial, particularly from a developing country perspective. According to the U.N. document, in Niger, for example, “tax expenditures on vouchers — one method by which exemptions may be implemented — amounted in 2002 to 18 [percent] of project financing, and 10 [percent] of total tax revenue.”\footnote{In 2004 the World Bank changed its policy and determined that it would allow financing of nondiscriminatory tax costs, provided they are reasonable. The assessment is done on a country-by-country basis but tends to cover virtually all taxes in a recipient state. The Inter-American Development Bank and the Asian Development Bank also revised their policies following the World Bank’s decision.} One could argue that the project would not have taken place without the ODA,
and that the revenue would not have arisen in the first place. However, not all projects rely exclusively on another country’s public funds.

**Tax Exemptions and Blended Finance**

Blended finance is an increasingly popular form of development assistance. It “uses financial instruments such as grants, loans, guarantees and equity to improve the risk-return profile of investments, [and] to mobilize additional commercial financing that would not have been available without public intervention.” In other words, blended finance uses public resources from a donor country to attract foreign direct investment to a recipient country or region by making it more attractive to private foreign investors. It uses development finance to engage commercial actors and finance in sustainable development projects. These commercial instruments are often referred to in economic literature as “catalyzing instruments.”

When extended to blended finance instruments, tax exemptions targeting ODA funds might pose an even more serious threat. Take the example of the contractor (resident in the recipient state) who receives an exemption of individual income tax and social security contributions. Assume that the private corporation contributing to blending finance through investment (which may take the form of an equity-financed expansion of its infrastructure services) is part of the multinational group partnering with the donor country to catalyze the project’s financing structure. Assume further that the project is executed and managed by a contractor belonging to the corporation’s multinational group.

The effect of a proposed exemption would be to create unfair competition in the host state. No other player (domestic or foreign) would be able to compete or invest in the same field, because the conditions for investment by the foreign financing partner would be significantly and unreasonably better than normal conditions. This effect could tamper with the “temporariness” of a blending finance project.

Depending on the significance of the project for the domestic economy, the exemption could also have a negative impact on the country’s social security system, possibly creating a crisis. The consequences might all be averted through regulation and a solid transparency framework, as mandated by the OECD’s DAC blended finance principles. However, in reality, most ODA recipients do not have strong regulatory frameworks. This is an area in which policy is being developed almost ad hoc and in tandem with the execution of real projects. There is not enough tax exemption/blended finance-related literature or guidance to rule out the above scenario.

Furthermore, exemptions may limit a country’s ability to accumulate resources that could be used in areas that are not targeted by private investors. According to the IATF report, blended facilities and funds tend to target sustainable development goal investment areas in which the business case is clearer: energy, growth, infrastructure, and climate action, for example. Important public areas such as education, ecology, and the consolidation of a strong institutional framework for peace and justice are left destitute of funds, despite being key U.N. sustainable development goals.

**Could the Tax System Provide the Answer?**

According to the IATF report, both CPA and budget support — the two types of aid over which partner countries can have a significant say in fund deployment — have declined in recent years.

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16. The OECD found that donor governments had set up 167 dedicated facilities between 2000 and 2016 to pool public financing for blending, using a variety of approaches and instruments. Volumes are increasing annually, from $15 billion in 2012 to $26.8 billion in 2015. OECD, “Development Co-operation Report 2018,” at 32.
17. Id.
19. Id.
20. The investigation by the Committee of Experts on International Cooperation in Tax Matters related only to the tax treatment of assistance provided by or on behalf of governments and international organizations. It is conceded that while recommendations could apply to private assistance, this raises a separate set of issues and is therefore not addressed in the paper. See E/C.18/2007/CRP.12, supra note 14, at 5.
21. IATF report, supra note 5, at 104.
Budget support — the type of aid that is paid directly to a country’s general budget, and therefore allows the recipient country complete ownership over the resources — amounted to 1.9 percent of DAC donors’ total bilateral aid commitments in 2016. This number fluctuates largely from country to country, with some institutions providing as much as 21 percent of their total donations to general budgetary support. Others provide much less: Norway contributes 1 percent to budget support and several countries contribute 0 percent, even with significant overall donations. The starkest contrast is in the United States, which in 2017 provided 0 percent to general budgetary support, and 87 percent to project-type interventions, despite making sizeable ODA allocations.

The U.N. supports the view that sustainable and long-lasting development relies on national ownership. However, ownership over projects can only be achieved through the untangling of funds. Under the development assistance framework, that might be a difficult task to achieve, but not so much so under the international tax framework.

Revenue gains derived from the uneven — yet fair — allocation of taxing rights could allow countries — particularly least-developed countries struggling to attract investment from donor countries — to take control and ownership over their own resources and expand their budget.

Ian Beshalom has pointed to the use of the international tax system for redistributive purposes as one of the remedies against the frequent failures of the international aid framework. More recently, Miranda Stewart has defended transnational taxation as a form of redistribution. This is in line with the U.N. development system goals of the 2030 agenda for sustainable development.

It is unusual, but not unheard of, for tax treaties to foresee unilateral (nonreciprocal) obligations. There are several examples in treaty practice in which developed countries (to put it broadly) concede to an uneven allocation of source taxing rights, particularly when entering into a treaty with a developing country. For example, in the 1982 Cameroon-Canada tax treaty, Canada’s withholding tax allocation for dividends, interest, and royalties is 15 percent, whereas Cameroon’s is 20 percent. The same is true for the 1992 Canada-Zimbabwe tax treaty on dividend withholding (15 percent Canada, 20 percent Zimbabwe) and the 1999 Algeria-France tax treaty on interest withholding (10 percent France, 12 percent Algeria).

Even more significant is the 1981 Morocco-U.K. tax treaty, in which the United Kingdom has conceded to exempt dividend income beneficially owned by a resident of Morocco, while allowing Morocco to apply a withholding tax ranging from 10 to 25 percent (depending on the level of ownership) on dividends paid to the United Kingdom and beneficially owned by a U.K. resident. The latter example could serve as a real case study on how countries might be able to use the tax system to provide development assistance outside the ODA structure.

Of course, a country’s actual level of withholding is determined by domestic law, so it could be that in some cases both parties are applying lower withholding taxes. However, the domestic law treatment is not significant in this case, because the treaty is the instrument setting the ultimate “right to tax.”

As pointed out by Bob Michel, nonreciprocal commitments are more pronounced in bilateral agreements involving countries with

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22 Id. at 89.
23 The European Union’s Institutions’ Official Development Assistance for 2017 was 21 percent of contributions to budget support, 65 percent to project-type interventions, 6 percent to technical assistance, 6 percent to pooled programs and funds, and 2 percent to NGOs.
24 Norway provided 1 percent of contributions to budget support, 48 percent to project-type interventions, 10 percent to technical assistance, and 41 percent to pooled programs and funds.
25 Greece, Hungary, Ireland, and Iceland are some of the countries contributing 0 percent to general budget.
26 The U.S. allocated 0.18 percent of GNI, which is far from the U.N. recommendation, but sums up to the sizeable contribution of $35.3 billion in net ODA for 2017.
27 All data contained in this paragraph is derived from OECD, “Development Finance and Policy Trends,” supra note 16.
30 The examples are not exhaustive; there might be other examples in treaty practice.
asymmetrical levels of development. According to Michel, there is almost 100 percent reciprocity in treaties negotiated between two OECD member states. In his 2012 research, he concluded that nonreciprocity occurs twice as much in treaties signed between states with asymmetrical levels of development.

My proposition is to use asymmetric taxing rights allocation as a tool to foster development. Provided this tool does not have a significant budgetary impact on donor countries, there should not be much political opposition because it does not concern the transfer of resources — it concerns the waiving of taxing rights. From an academic perspective, this is a proposition that is in line with the inter-nation equity principle introduced in the 1970s by Richard and Peggy Musgrave.

Inter-Nation Equity

Inter-nation equity is a notion that was introduced by the Musgraves in the early 1970s. It relates to the fundamental question of how to divide the gains stemming from the cross-border movement of labor and capital. The outcome of the application of the inter-nation equity principles depends on the extent to which the source state imposes taxes. Inter-nation equity is not a self-standing principle or norm. Whether or not inter-nation equity is achieved depends on the criteria chosen to make the evaluation. The Musgraves proposed three different criteria that can be used: the benefit principle, national rent, and distributional considerations.

Under distributional considerations, inter-nation equity is achieved to the extent that the taxation of foreign-owned capital in the source state contributes to the global redistribution of resources and per capita income among countries.

According to the Musgraves, this can be achieved by inversely linking the level of taxation (corporate tax and withholding tax rates) to the level of per capita income in developing states, and then linking this factor directly to the level of taxation in the developing state. A high level of asymmetry in development would confer the developing state the right to levy more tax, to offset unequal levels of development. A consequence (and really, the main impediment to this approach) is that the principle of formal reciprocity of legal obligations is sacrificed for the sake of redistribution.

Of course, the theory is not without problems. A significant criticism that has basically made it impracticable is that it risks deterring capital inflow into developing states because of the disproportionately high rates the source state applies. Until now, this issue might have been dealt with by making sure the capital exporting state (the would-be donor country) strictly adheres to the principle of capital export neutrality. However, the fact that capital export neutrality is not a guarantee in the eyes of the investing company (that is, if the ordinary credit in the residence state is insufficient to cover the tax levied in the source state), has proven to be a potential impediment to foreign direct investment. Another, less significant problem is that it sacrifices the principle of non-discrimination in the source state.

The OECD’s base erosion and profit-shifting initiative seems to have partially addressed this issue, and revived the Musgraves’ doctrine, to the extent that countries agree that there should be an overall “entitlement to tax.” Under the Musgraves’ framework, entitlement to tax translates into achieving international individual equity: A taxpayer’s liability to his country of residence should be the same irrespective of whether income is derived from foreign or domestic sources.

The more modern, anti-BEPS-derived construct assumes that economic operators should pay a fair share of tax. Conversely, states should levy their fair share of tax — meaning an

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31 According to Michel’s research in 2012, only 2.7 percent of the treaties signed between two OECD member states contained nonreciprocal obligations, as compared with 5.3 percent in treaties between an OECD and a U.N. member state. Bob Michel, “The Principle of Reciprocity in International Tax Treaties,” presentation in Amsterdam at IBFD Conference in Honour of Prof. Ave. Guglielmo Maisto (May 11, 2012) (author’s conference notes).


34 Musgrave and Musgrave, supra note 32, at 74.

35 Id. at 68.
adequately priced, reasonable amount of tax. For example, if a fair share is defined as 20 to 25 percent of the tax base, then all that countries would need to agree to is apportioning the proper amount of tax.

In the anti-BEPS movement, strong emphasis is laid on assigning the tax base according to where economic activity occurs or value is created. The redistributional considerations of inter-nation equity could be relied on to further shape the allocation of taxing rights between developed and developing states, adding a new criterion to the distributive rule. Should the developing state decide not to make use of the extra portion of tax base because of redistribution considerations (for example, if the developing country, as a source state, waives the right to tax by conferring a credit or an exemption under domestic law), then the residence state would be entitled to tax the corresponding, as yet untaxed, tax base to ensure the income is taxed at an appropriate level. This might also lock in greater tax certainty for the foreign direct investor, because its tax position will always be one of paying some percent to one country or the other, depending on the actual tax base split. 36

Using the tax system may be a more modern and equitable way of supporting developing countries, especially the least developed countries. It allows the least developed countries to take control and ownership over priority investment areas, invest in priority areas even when there is no commercial interest (for example, sanitation and waste management), and allow assisted development to the extent needed.

Conclusion

What is suggested here is no simple feat. To provide an “economically meaningful and generally agreed upon division of tax base,” from both a tax and distributional perspective, would require revisiting the preamble of the model agreements once more and rethinking the transfer system through ODA or private financing in light of this “new” fiscal redistributive approach. However, it might provide a simpler, more equitable alternative for offering developing countries, particularly the least developed countries, a greater say on how the funds they receive are assigned within their general budgetary framework.

36 My assertions are not totally in line with the Musgraves’ inter-nation equity proposition. According to the Musgraves’ theory, “inter-nation equity is not predicated on the allocation of the tax revenue, but rather on the allocation of national gain, which is affected by the source country’s decision to tax (or not) the gain. The tax decisions of the residence state are irrelevant.” Under my proposition, the decisions of the residence state are equally relevant. See Brooks, supra note 33, at 4.