

Summary of Development Assistance Research in Fiscal Year 2017
“Research on the Policy of Other Major Donors for Grant Aid toward Developing Countries
(with focus on the Legal Framework for Tax Exemptions and other Recipient Country’s
Obligations as well as their Applications)”

1. Research Background and Objectives

Japanese grant assistance has been playing a significant role in the history of the Japanese government’s foreign affairs, by contributing to promoting developing countries’ economic and social development on the one hand, and to strengthening the ties between Japan and those countries on the other.

Nevertheless, the necessity of policy improvement in Japanese grant assistance has been pointed out in addition to challenges such as budgetary constraints and external factors. In particular, there is lack of recipient government’s commitment on their obligations that are agreed in the Exchange of Notes (E/N) signed by the both governments as well as in the Grant Agreement (G/A) signed between JICA and the executing agency in the recipient country. In fact, some recipient governments failed to fulfill their obligations such as tax exemptions, relocation of the residents and securement of land for implementation of the grant assistance. Moreover, one of the surveys conducted by Japanese government revealed that this situation has made the implementing partners of grant assistance such as consultants and construction companies reluctant to participate in Japanese grant assistance projects, and they even suggest that the lack of commitment has led to a bid price higher than the budget to avoid bearing the tax amount that are not certain to be exempted or refunded by the recipient government in some cases.

With the above background, this research aims to contribute to the Japanese government’s efforts to improve the policies on grant aid by collecting information on and analyzing other major donors’ legal framework as well as their practice and efforts to secure tax exemptions and other obligations of recipient governments.

2. Research Subjects and Methods

(1) Legal framework and its practice of other major donors

As a preliminary study, literature review was conducted for five countries and two international organizations in order to understand how other major donors stipulate tax exemptions and other obligations in international agreements and other legal frameworks in the implementation of grant aid. As it was found that the United States (the U.S.), the United Kingdom (the UK), and France have made efforts that are deemed useful for the Japanese government to consider measures to improve policies on grant aid, further study was conducted focusing on the practice and efforts of these donors to secure tax exemptions and other obligations, primarily through interviews with their aid agencies and embassies.

(2) Possible measures for Japanese government toward policy improvement

Through the studies in (1) above, information on efforts by major donors was collected, categorized and analyzed,

based on which direction for the improvement of policies for Japanese grant aid was considered in terms of both regulation and practice with respect to tax exemptions and other obligations.

3. Results of the research

Most importantly, it was confirmed that among the major donors the U.S., the UK, and France have legal framework to secure tax exemptions in the implementation of their grant aid programs. All of these three donors stipulate in their international agreements and/or grant agreements with the recipient governments that the taxes imposed in the recipient countries in relation to the implementation of grant aid programs must be exempted. It was also found that the government of the U.S. takes the most detailed and rigorous measures among the major donors both in regulation and in practice.

(1) Other donors' legal framework related to the tax exemptions and other obligations on grant aid

The U.S. clearly states in the guidelines for United States Agency for International Development (USAID) their basic stance of requiring recipient countries to exempt taxes in relation to their aid programs. Importantly, specific tax items to be exempted and scope of exemptions are detailed in the international agreements mainly in their bilateral agreements and assistance agreements with the recipient governments. Furthermore, those agreements stipulate that the parties agree to promptly meet and resolve the matters in the event of a disagreement about the application of an exemption and that if a tax has been levied and paid contrary to the provisions, USAID may offset the amount of such tax from amounts to be disbursed in the following fiscal year.

In contrast, although the UK and French governments also require the recipient governments to grant tax exemptions, the tax items and scope of exemptions are not specified in their international agreements. The provisions for mutual resolution and penalties to be applied when non-compliance occurs are also absent in those documents.

(2) Other donors' practice of securing tax exemption

According to the interviews with relevant agencies, it was found that other donors are facing the issue of non-compliance by the recipient countries. The reasons include conflict with the recipient countries' domestic laws and complicated procedures for tax exemption/reimbursement, and donor countries are taking a wide range of measures locally through their embassies and representative offices to resolve the issue often in cooperation with implementing partners and external resources.

The U.S. takes the most detailed and strict measures among three donors, in terms of the practice of securing tax exemption. For example, the U.S., in some cases, exchanges diplomatic notes with the recipient governments in addition to the original international agreement in order to secure tax exemptions. It is also a remarkable effort that USAID makes use of legal experts for monitoring of tax exemption records and for negotiations with the recipient countries on tax exemptions/reimbursement. Furthermore, it appears that the U.S. enforces the provisions on penalties as a last resort when it is impossible to secure tax exemptions.

Meanwhile, the UK and France face the similar issues on tax exemptions in the implementation of their aid programs. They are striving to secure the tax exemption/ reimbursement by establishing working groups with other donors and implementing partners to exchange information and to lobby the recipient government to resolve the issue. At this moment, they do not apply penalties on the recipient governments.

4. Possible measures for Japanese government toward policy improvement

Below is an analysis of possible measures both in regulation and in practice that the Japanese government could take to improve the policies on grant aid based on the result of this research as well as the measures currently being examined by the Ministry of Foreign Affairs and JICA.

Table 1 : Policy improvement option on regulatory aspects

Policy improvement option	Feasibility	Effectiveness	Evaluation comments
Clarification of basic tax exemption policy in guidelines	△	△	Although certain effects are expected in clarifying the basic policy of the Japanese government to all recipient countries, they are not legally binding.
Addition of detailed tax exemption clause in E/N and G/A	△	●	It is likely that it will take time to revise E/N and G/A, and to obtain consent from recipient governments.
Addition of consultation clause in E/N and G/A to resolve disagreement over tax exemption	●	●	It is considered effective to include the provision in the E/N and G/A as a foundation to set up a consultative body as necessary.
Addition of penalty clause in E/N and G/A	△	●	It is necessary to consider the negative impact on diplomatic relations based on the scale of aid to each recipient country as well as technical issues such as accounting treatment of received funds.

Table 2 : Policy improvement option on practical aspect

Policy improvement option	Feasibility	Effectiveness	Evaluation comments
Conclusion of additional agreement	●	●	It is effective to clarify tax exemption items and scope that are not specified in the current E/N. However, there is a concern that consent may not be obtained easily from some recipient governments for reasons such as conflict with domestic laws.
Monitoring tax exemption/refund status utilizing legal experts.	△	●	It enables local offices and embassies to deal with issues that require legal knowledge in an appropriate and timely manner, while it would involve added costs.
Information exchange and collective lobbying by setting up consultative body	●	△	It helps to grasp policies, challenges of recipient government and best practices of other donors. It is also effective in collectively lobbying to recipient government.

Policy improvement option	Feasibility	Effectiveness	Evaluation comments
among donors and implementing partners			
Discussion of improvement measures by setting up a working group between donor and recipient governments	●	●	It enables the direct approach such as improving the efficiency of tax exemption procedures at recipient countries' governments.
Negotiations with recipient governments	△	●	Taking into account the limitation of human resources at the embassies and JICA offices, it should be considered in combination with the use of legal experts.
Enforcement of penalties for non-compliance	△	●	Although there is an effect of demonstrating a strict attitude, possibility of negatively affecting diplomatic relations needs to be taken into consideration.
Payment of taxes using grant fund	△	△	Although it is difficult to accept as it goes against the Japanese government's policy of requiring tax exemption, there is room for consideration as an exceptional measure from the viewpoint of reducing the burden on the implementing partners.

● Feasible/Effective
△ Limited Feasibility/Effectiveness

Based on the results of the above analysis, the following direction of policy improvement is proposed in order to maintain Japanese grant aid as an important diplomatic tool and to make it attractive to implementing partners.

(1) Integrated approach combining regulation and application

As seen in the case of other major donors including the U.S., it is necessary to deal with the issue integrally in terms of regulation and its practice to ensure the tax exemption. In regulatory aspect, in addition to clarifying the tax exemption items currently under consideration, it seems realistic to consider inclusion of a provision that refers to the possibility of mutual resolution through consultations when issues arise over tax exemptions. Then on the application side, Japanese embassies and JICA representative offices can take a lead in negotiation with recipient governments in accordance with the provision, which should lead to mitigation of burden on the implementing partners and improvement in the process of tax exemption (including refund) in the recipient countries.

(2) Reinforcement of local functions making use of external resources

Regarding the above (1), it is expected that legal interactions with the recipient government that would require understanding and interpretations of international agreements will be involved. However, it may sometimes be difficult to deal with this appropriately due to the lack of capacity in the local offices. Under this circumstance, as

seen in the example of the U.S., it could be an option to make use of external resources such as experts in law and taxation.

Also, as an initial step toward reinforcement of local functions, it would be useful to prepare guidance for officers in Japanese embassies and JICA representative offices that summarizes and explains, for example, the key issues on tax exemptions in E/N and G/A with clarity.

(3) Familiarization of implementing partners with a consultation desk for issues on tax exemptions

It is often the case with implementing partners in Japanese grant aid that they deal with the issues on tax exemptions and other obligations by themselves through their local office. Familiarization of them with a consultation desk in the Ministry of Foreign Affairs or JICA which accepts all consultations on the issues through their websites will contribute to mitigation of burden and risks of the implementing partners.

(4) Consideration of track records during appraisal of new projects

When non-compliance on tax exemptions happens, regardless of its effectiveness, explicit application of penalties as in the case of the U.S. may not be easy out of consideration for negative impact on diplomatic relations. A realistic measure would be to take into consideration the track records of the recipient country with regard to tax exemptions in past projects during the appraisal of a new project and to refrain from implementation of a new project until improvement is observed. It is expected that this could serve as an incentive for the recipient government to take action.