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Domestic Revenue instead of Development Cooperation?

Low- and Middle-Income Countries Facing the Challenge of Generating Additional Revenue

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Summary

Exacerbated by the cuts in development cooperation (DC), many low- and middle-income countries (LMICs) are currently facing severe financial constraints. Against this backdrop, higher domestic revenue is a desirable goal for most countries. Greater attention is being devoted to enhancing domestic revenue in the international development policy discourse too – across the entire political spectrum. For some, the goal is to extend the decision-making scope of government and enhance the development focus of public action, while others hope to relieve the burden of transfers on industrialised nations of the Global North and end the recipient countries' "addiction" to DC payments.

Yet what options are actually available to LMICs to generate more domestic revenue? The present policy brief shows that taxing personal income and landed property in particular could offer opportunities for additional revenue. Another important area is the rationalisation of tax expenditures, which often lead to substantially less revenue without providing any evident benefit.

At the same time, however, it is also important to recognise the systemic – and eminently political – nature of tax reforms. Above and beyond the issue of technical and administrative feasibility, the political achievability of reforms must also be taken into account. Short-term tax increases – for example through higher consumer taxes or tariffs – are often not very sustainable in their own right.

Instead, the aim must be to place the "fiscal contract" between taxpayers and the state on a broader and more stable base where better public services also play a role. One type of revenue (in this case DC) therefore cannot simply be replaced by another (taxes) – a fact that advocates of DC cuts often fail to mention. During the transition, DC must continue to provide contributions, despite declining overall funds.

International players, including the German Government and the EU, can support partner governments in a variety of ways. They are already doing so, for example by promoting the Addis Tax Initiative (ATI). In addition, Germany and the EU should make a determined effort to help strengthen multilateral approaches to cooperation. This particularly applies to the United Nations (UN) Framework Convention on International Tax Cooperation currently being negotiated.

Introduction

It is now 18 months since US President Trump essentially dismantled the US Agency for International Development (USAID) on his first day in office. Other Western countries have also made significant cuts to their development budgets, including Germany, whose development cooperation (DC) budget has already been shrinking since 2024. The budget allocated to the German Federal Ministry for Economic Cooperation and Development (BMZ) does not cover Germany's entire DC, but it does reflect the general trend. The current year's budget is just over EUR 10 billion – compared with EUR 11.1 billion back in 2024.

Global cuts in DC come at a time when many low- and middle-income countries (LMICs) are already under pressure. Climate change, the COVID-19 pandemic and wars have led to a huge growth in public debt, while tax revenue has often decreased. For many people who depend on health care, food security and refugee support programmes, the current cutbacks spell disaster.

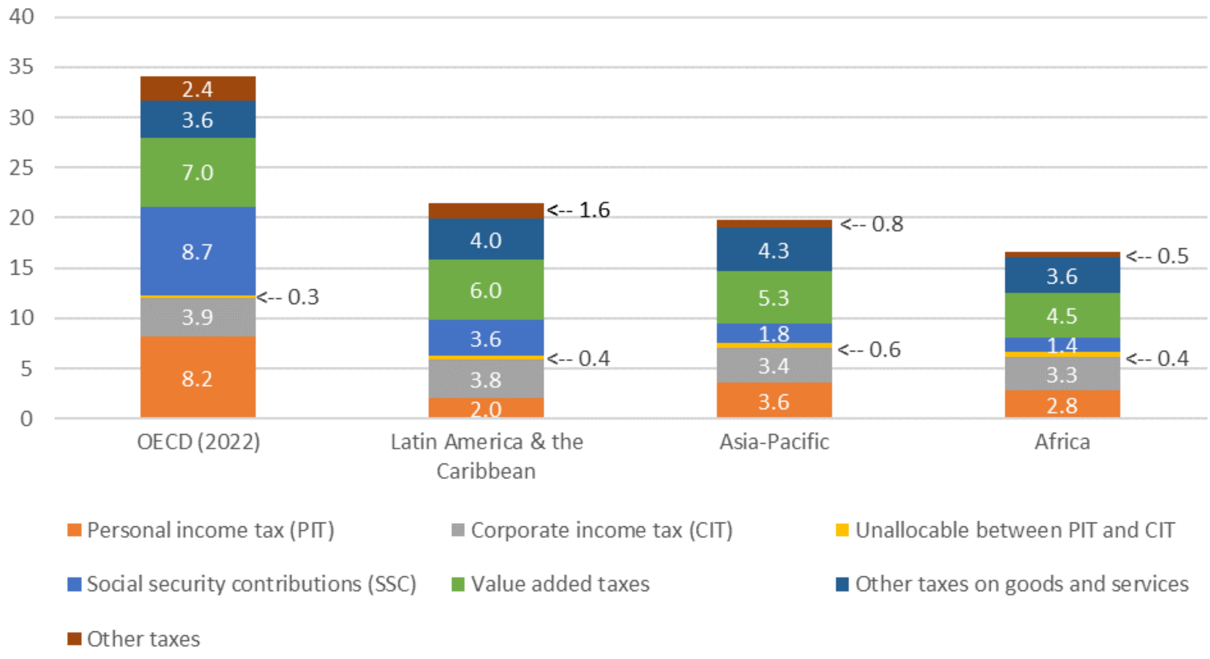
Yet there are certainly voices – even outside the right-wing populist camp – that present these cuts as an opportunity. Critics have already been pointing out for some time now that DC cements global dependencies and stifles self-initiative. Research results on the topic are mixed: the crowding-out effect, whereby the mobilisation of a country's own domestic resources is displaced by the inflow of funds from external sources, has been demonstrated in multiple academic publications (e.g. Belmonte et al., 2025; Benedek et al., 2012), yet there are also studies that point in the opposite direction or have observed no statistically significant effects (e.g. Liu et al., 2024; Mascagni, 2016). Nevertheless, the political message that DC recipients should become more self-reliant is attracting considerable attention in many areas of the world.

Differences in levying taxes

In contrast to the crowding-out effect, a different link is uncontested: tax revenue correlates with a country's general level of prosperity (often measured as per capita income). On average, wealthier nations siphon off a larger percentage of the country's economic output than poorer ones. That is initially merely a statistical finding, which obscures large differences between the two groups. It is primarily explained by the fact that wealthier countries have larger and more diversified economies, their private households are more prosperous on average and at the same time the population demands more and better public services, which increases the countries' spending pressure.

The crucial factor is who or what is actually taxed, however. The Organisation for Economic Co-operation and Development (OECD) and other organisations provide data that permit a comparative view of the tax revenue structure in the OECD member states and three regions of the world (Africa, Latin America & the Caribbean, and Asia-Pacific) (OECD et al., 2025).

Figure 1: Tax revenue structure in Africa, Asia-Pacific, Latin America & the Caribbean and the OECD as a percentage of GDP, 2022/2023



Source: OECD et al. (2025)

Firstly, the diagram confirms the aforementioned statistical correlation: OECD countries, the majority of which are high-income countries, generate tax revenue averaging more than a third (34 per cent) of gross domestic product (GDP). In contrast, tax revenue in Africa, where there are a particularly large number of low-income countries, is less than half this figure (16.6 per cent). Latin America & the Caribbean and Asia-Pacific, home to many middle-income countries, have rates of around 20 per cent.

Of particular interest is the tax mix. There are differences here – but also surprising similarities. Revenue from corporate income tax is one such area. As a percentage of GDP, this revenue is relatively constant at around 3.6 per cent – slightly lower in Africa (3.3 per cent) and slightly higher on average in the OECD countries (3.9 per cent), but essentially at the same level. At a time when competition for investment is on the rise globally, this finding suggests that countries will not be rescued from their fiscal woes by additional business tax payments, even though tax avoidance and evasion are widespread and resolute efforts must be made to combat them.

There are considerable differences in how personal income is taxed. In OECD countries, this is one of the main sources of financing, generating revenue equivalent to 8.2 per cent of GDP. In contrast, this figure is only 3.6 per cent in Asia-Pacific, 2.8 per cent in Africa and merely 2.0 per cent in Latin America & the Caribbean.

What does that mean in concrete terms? Direct taxes on personal income generally have a progressive distributional impact: better-off households have a higher tax burden than poorer ones. In LMICs, however, it is primarily employees working in the public sector and large companies who pay these taxes, because they are deducted by the employer as payroll tax and remitted directly to the tax authorities. In contrast, income elites often contribute little to nothing towards funding public services in their countries. At the other end of the spectrum, there are a large number of workers in the informal sector who do not pay any tax either. The tax base for income tax in these countries is therefore often very narrow and is perceived to be unfair.

Another major difference is seen in the group of "other taxes": while some OECD countries (e.g. USA, Australia, UK) obtain considerable revenue from property taxation, this tax generates little revenue in LMICs. This is particularly relevant on the African continent, where high urbanisation rates mean that the value of property in urban areas is increasing rapidly. Municipal authorities could tax this value increase to some extent, using it to finance local infrastructure measures, for example, yet they are still too rarely doing so.

In many countries in the Global South, the main burden of financing from tax revenue lies on consumer taxes. In Africa, they account for more than half (52.1 per cent) of total tax revenue. The distributional impact of consumer taxes is often problematic, because poorer households spend a higher proportion of their income on consumption than wealthier ones. Faced with fiscal pressure, governments sometimes increase the value-added tax rate in order to generate additional tax revenue in the short term. That places an additional strain on poorer sections of the population, weakens economic growth and can drive inflation. This approach is thus rarely suitable as a long-term method to compensate for the loss of DC funds.

Taxes as part of the fiscal contract

The differences in the tax mix outlined above reflect the social and political conditions that are often subsumed under the term "fiscal contract". This concept is based on the observation that both citizens and companies are more likely to meet their tax obligations if, in return, they receive an appropriate level of public services, feel that they are being treated fairly and have the impression that the state is responsive to their demands and needs. Research shows that a tax system based solely on the risk of being caught and sanctioned for tax evasion is less efficient and less stable than one with a properly functioning fiscal contract (Besley, 2020; Levi, 1988).

Yet the idea of an implicit contract also highlights the fact that taxes are always political. Just because a measure is technically and administratively feasible – such as more effective taxation of landed property – does not mean that it is necessarily politically implementable. Many of those actors from whom higher contributions to development financing are expected also belong to those groups that wield the most political influence. Proposals that make fiscal sense must therefore be integrated into broader reform approaches. The extent to which governments can credibly offer the prospect of real improvement in public services and infrastructure, for example, plays a major role here. Transparency and fairness are also important, because reforms are more likely to be accepted if tax burdens and tax reliefs are transparent and fair.

What reforms make practical sense (and are feasible)?

It is difficult but not impossible to implement reforms that have a lasting impact. Many tax systems are already in urgent need of reform. That is true both of the relevant legislation and of tax administrations. Revenue authorities are not seldom chronically underfunded, ineffective and vulnerable to corruption. Lack of capacity also hinders international cooperation on fiscal issues, which is important to combat tax avoidance and evasion effectively.

In some cases, considerable increases in revenue can be achieved through administrative improvements alone. That would be possible with property tax, for example. Outdated land registers and hugely undervalued landed property are often a crucial factor in low tax revenue. This does not require any comprehensive legislative interventions but rather targeted measures to modernise administration.

In other cases, fiscal policy reforms are needed, for example for the taxation of digital services (including financial services), the introduction of environmental taxes and "sin taxes" on sugar, etc. These taxes are sometimes geared less towards generating revenue than to achieving changes in behaviour; generally speaking, however, they can help to broaden the tax base and hence make it less vulnerable to crises.

Finally, tax expenditures must also be discussed, as they often offer untapped potential for increasing tax revenue. The term covers deviations – exemptions, reduced rates, etc. – from a standard or benchmark tax system which governments use to promote particular groups, activities, regions or business sectors. Tax expenditures are used to promote investment and fight poverty, for instance. However, studies show that they often miss the mark. They tend to make tax systems more complicated, more regressive and less transparent – and may even be harmful if they create negative external effects (von Haldenwang et al., 2025).

Moreover, tax expenditures are costly. According to the Global Tax Expenditures Database (GTED), the published revenue losses resulting from tax expenditures averaged 4 per cent of GDP globally in 2023 (Redonda et al., 2025). As very few rigorous cost-benefit analyses have been conducted, most governments do not know exactly what their tax expenditures actually cost, let alone what positive or negative effects they have. Many governments are currently considering reforming or completely abolishing obsolete and costly tax expenditures, which could generate considerable funds.

What role can external actors play?

There certainly are options for ensuring that tax systems generate more revenue and that they are more sustainable and equitable. In most cases, these approaches are well known but their implementation often entails political costs and administrative challenges. External support can play a role in overcoming obstacles. The reduction in DC funding across the globe must not lead to this connection being neglected.

Examples of useful initiatives include regional workshops that promote horizontal exchange between the countries, as the Addis Tax Initiative (ATI) has already been organising for some time now, for example in cooperation with the German Institute for Development and Sustainability (IDOS) and the Council on Economic Policies (CEP) on the topic of tax expenditures. Experience from neighbouring countries can be extremely useful for a country's own reform efforts, including their political implementation. The German Government has recognised this and has been supporting the ATI since it was founded in 2015.

Many other international organisations and initiatives are supporting tax administrations worldwide in their modernisation efforts. One example is the Tax Inspectors Without Borders programme, which has been operated jointly by the OECD and the United Nations Development Programme (UNDP) since 2015 and has supported and assisted tax audits in more than 70 countries during this period. The programme helps enable tax authorities to meet companies as equals.

States are not completely free in how they design their fiscal policy and revenue administration. Their decision-making scope is restricted to some extent by the actions of third states but also by international rules and standards. Over the past 15 years, the international community has agreed on deeper cooperation on tax matters. This includes exchanging information between tax authorities and introducing a minimum tax rate of 15 per cent on the profits of large multinationals, for example.

Many initiatives are driven by civil society organisations and research institutions. At the Fourth International Conference on Financing for Development held last year in Seville, for example, IDOS teamed up with four other international think tanks to launch the Coalition on Tax Expenditure Reform (COATE). COATE seeks, among other things, international agreement on voluntary minimum standards for reporting on tax expenditures in order to further enhance transparency in this area.

The Framework Convention on International Tax Cooperation, which is currently being negotiated under the aegis of the UN, is based on an initiative by African states. It is designed to establish rules and standards with a view to curbing tax evasion and avoidance and adapting national tax systems to the challenges of the modern global economy. Some industrialised countries are currently still actively slowing progress, but they may be overlooking the fact that multilateral approaches within the framework of the UN might offer greater protection against one-sided actions by major powers in future than the present structures would appear to be able to provide.

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