Domestic Resource Mobilization
Tax System Reform

Daniel F. Runde and Conor M. Savoy

This is the first in a series of four policy memos that explore various facets of domestic resource mobilization (DRM) and will examine the role of tax systems. DRM is commonly defined as the mix of financial resources available to a government to fund its operations, including direct and indirect taxes, other revenue, and borrowing from local capital markets. This series of policy memos is concerned with the tax or domestic revenue side of DRM, whereas the three subsequent memos will explore other topics related to DRM: the role of donors in supporting DRM, how good public financial management impacts DRM, and the political side of DRM. Donors have long provided support for tax reform, but since the adoption of the Millennium Development Goals in September 2000, donor and recipient governments have increasingly placed local resources at the center of efforts to tackling development challenges. This conversation has gained importance in the last five years as the international development community adopted the more ambitious Sustainable Development Goals (SDGs) in 2015, which aim to end extreme poverty by 2030.

Introduction

DRM is not new; indeed, donors have discussed this as a priority for development finance since the first conference on financing for development was held in Monterrey in 2002 (indeed donor support for DRM was around for decades prior to Monterrey). Since then, though, DRM has moved to the center of the discussion over how to pay for development. This occurred largely because of dramatic increases in the amount of taxes and other revenues that developing countries collected during this period. The dramatic increase in domestic revenue available is a function of the broad economic growth over the past three decades; there are far fewer very poor countries than there used to be. In July 2015, the UN hosted the third Financing for Development (FFD) Conference in Addis Ababa—aimed primarily at identifying how the international community will pay for the new SDGs. This conference, more than previous conferences, reflected the changing reality of development finance: official development assistance (ODA) represents an increasingly small slice of total financing

\[^1\] Daniel F. Runde holds the William A. Schreyer Chair in Global Analysis and is director of the Project on Prosperity and Development at the Center for Strategic and International Studies (CSIS) in Washington, DC. Conor Savoy is a fellow and deputy director of the CSIS Project on Prosperity and Development. This project was made possible through the generous support of the U.S. Agency for International Development. The authors would like to thank Erin Nealer for her research and editing support and James Michel for his willingness to review and provide comments on an early draft of this paper.
available. Domestic resources and international resources (i.e., ODA, long- and short-term debt, foreign direct investment, remittances, philanthropy, and other) represent the vast majority of financing. The numbers are truly astounding: in 2014 it is estimated that developing countries (excluding China) collected just over $3 trillion in tax and other government revenue. On a regional level, sub-Saharan Africa saw total taxes collected rise from $100 billion in 2000 to $461 billion in 2014. Contrast that with global ODA, which during the same period, rose from $80 billion to just over $137 billion. All local resources are approximately two times all international resource flows to developing countries.

DRM was a major focus of the Addis FFD conference. This is reflected in the outcome document—the Addis Ababa Action Agenda, which stated, “For all countries, public policies and the mobilization and effective use of domestic resources, underscored by the principle of national ownership, are central to our common pursuit of sustainable development, including achieving the sustainable development goals.”

Central to improving DRM in developing countries is reform of the existing tax systems. Taxes—direct and indirect—constitute the vast majority of government revenue raised; though the exact mix varies from country to country. To be sure, DRM encompasses the totality of resources that a government can tap to fund its operations, meaning it can include long-term and short-term debt. One of the main outcomes of the Addis FFD conference was a new commitment by aid donors to support DRM through the Addis Tax Initiative (ATI). This is a joint effort between donors and recipient countries that aims to double the amount of ODA directed toward DRM (from approximately 1 percent of global ODA to 2 percent). (The second policy memo in this series will discuss the ATI in more depth.)

It is important to keep in mind that this focus on taxes is not simply about more resources. More importantly a country that can raise its own revenue and use this to pay for public goods (education, health, and infrastructure) will strengthen the societal bond that exists between it and its citizens. The Organization for Economic Cooperation and Development and Development (OECD) in a 2008 report made the following point: “Tax is not the sole determinant of rapid development but it is one pillar of an effective state, and may also provide the basis for accountable and responsive democratic systems.” A more recent report stated clearly, “Strengthening tax institutions is viewed as an important component of state-building, which helps to improve accountability relationships between a government and its citizens.” Moreover, as the above quote from the Addis Ababa Action Agenda

---


indicates, this is also about country ownership, the principle that nationally driven development strategies should guide a country’s development.

Tax Systems in Developing Countries

As noted, for most governments, the single largest source of revenue is through the collection of taxes. Taxes are broken into direct (income or property taxes) and indirect taxes (sales, consumption, or value-added taxes). Although the commodities boom helped to produce much of the wealth and income that drove much of the increase in government revenue collected by developing countries, there has been a corresponding increase in the capacity of governments to collect taxes, along with a growing middle class, increased urbanization, and overall high economic growth. This is reflected in the decrease in the percentage that ODA contributed to a country’s budget. For example, Tanzania saw the percentage decline from 28 percent in 2000 to 9 percent in 2015; revenue as a percentage of its budget saw an increase from 72 percent to 91 percent. This occurred even as total grant funding remained largely the same at around $1 billion per year.7

In the spite of the progress, tax systems remain relatively weak across most developing countries and overall tax-to-GDP ratios (a common measure used to determine the strength or weakness of a country’s tax system) remain significantly lower than in advanced economies. In low-income countries the average ratio is around 10–15 percent compared to the 34.4 percent average that most high-income OECD countries achieve. According to the IMF, 50 percent of all developing countries still have ratios below 15 percent, though there is significant variation from country-to-country.8

Much of this is driven by the many individuals and companies that exist in the informal economy due to the large barriers to entry to the formal market. Property taxes, the bedrock of the U.S. tax system at the sub-national level, are difficult to implement because of the lack of or low level of formal land titling that exist.

There is a divide between resource-rich and nonresource-rich countries. Resource-rich countries have largely driven the spectacular rise of government revenue in developing countries. This has proved to be a double-edge sword for many. On the one hand, the increased revenue has led to new resources that allowed a decrease in reliance on foreign aid. On the other hand, however, as the commodity boom has faded in recent years this over-reliance has created untenable budget situations. A recent Washington Post article looked at the impact that the decline in global oil prices has had on the country of Angola, a major oil producer and a country that saw its government revenue increase dramatically as a result. Seventy-five percent of all of Angola’s tax revenue comes from oil production, which has led the government to cut its budget by 53 percent.9 This has tangible

results: Angola is now struggling to fund its health system, with the result that malaria and yellow fever are staging a comeback. In contrast, some nonresource-rich countries have made steady progress on improving direct and indirect taxation capabilities; this is especially true in sub-Saharan Africa in countries such as Kenya, Tanzania, and a number of Francophone countries.

Different types of taxes—income, corporate, property, and value-added—all serve different purposes and create different challenges as governments endeavor to simplify and clarify their tax codes. While personal income taxes form a significant proportion of tax revenues in high-income countries (around 9–11 percent of GDP), developing countries raise only around 1–3 percent of GDP from personal income tax. Corporate income tax raises about 17 percent of total tax in developing countries, compared to 10 percent (pre-crisis) in the OECD. Property taxes represent 6.7 percent of total revenues in OECD countries, compared to 2.4 percent in larger developing and transitional countries. Other broad trends include the decline of trade taxes as developing countries have opened their economies to the global economy by reducing tariffs and duties on imports and exports. This is true across most developing countries, but in sub-Saharan Africa trade taxes continue to constitute approximately one-third of all tax revenue collected. Though the reduction in trade taxes is good from the perspective of reducing barriers to trade, it does mean that there is additional pressure to reform tax systems to make up for the lost revenue.

Barriers to Tax System Reform

Barriers to the reform of tax systems in developing countries are well known as bilateral and multilateral donors have a long history of working on reform projects. There are several barriers to increased collection of taxes: a narrow tax base, weak institutional capacity, and corruption. These are generalized and affect each country differently, but by and large all or a mix of these are at play in developing countries.

Narrow tax base. Developing countries suffer from a high level of informality in their economies, because of the high barriers to entry that exist: the compliance costs are either too high (from a monetary standpoint) or the procedures are too complex that individuals or firms chose to remain outside of the formal economy. These choices further erode what are already often narrow tax bases that rely on a small number of high net worth individuals, large corporations, or less sustainable or stable types of taxes (i.e., taxes on resource extraction, excise tax, or trade taxes). The size of the informal economy in countries gives one a sense of how much potential government revenue is left on the table: in El Salvador the informal economy is estimated to be 60 percent of GDP; in the Philippines it is estimated that 45 percent of the GDP is informal; and in Kenya over 70 percent of the work force is employed in the informal sector.

---

In addition, many countries face a significant problem of tax avoidance or evasion as individuals or companies in the formal sector find ways not to pay their taxes. This is often attributed to a “tax morale” problem, meaning that citizens or companies do not have faith that their money will be well spent and thus avoid taxes altogether. In contrast, most high-income countries do not face a similar problem. For example, tax evasion in the United States is a relatively small problem, with only 9 percent of total legal income not properly reported.\textsuperscript{13} Brazil, on the other hand, sees only 15 percent of small businesses regularly filing taxes. In many instances this is driven by crony arrangements that help to support the existing political and economic power system. This is important to keep in mind as it highlights that tax system reform will not require simply a technocratic solution, but will need to find ways to tackle the underlying political-economy of individual countries.

One area of concern in promoting tax compliance is illicit financial flows, and specifically cross-border tax arrangements that facilitate evasion by businesses and individuals. According to Global Financial Integrity, almost $1.1 trillion is lost per year to corruption and illicit transfers, some of which may be characterized as tax evasion.\textsuperscript{14} Before determining how to tackle illicit financial flows, it is important to unpack the concept and understand, first, which flows have genuine tax implications, and second, the extent to which those flows represent tax evasion or otherwise are the result of cross-border tax avoidance schemes (which are, strictly speaking, legitimate applications of tax rules). The international “gray economy” or “parallel market”—not the black market, but rather an illicit market of otherwise legal goods—is a challenge to measure, especially in least developed countries (LDCs). The gray economy is made up of those who participate outside of the formal economy in order to make a modest living as well as those who manage and oversee the transfer of huge illicit flows. The former, while troublesome, has less of an impact on tax administration than the latter.\textsuperscript{15} But there is an impact: a high incidence of illicit financial flows (IFFs) tends to correlate to a low score in the Human Development Index (HDI) and a larger poverty gap.\textsuperscript{16}

**Weak Institutional Capacity.** The capacity of developing country governments remains weak to collect taxes due to a combination of complicated regulations, poor policies, and lack of trained staff to implement policy. Local revenue authorities operate in weak governance contexts and are susceptible to corruption given weak oversight. This weak capacity results in out-of-date taxpayer rolls, lack of enforcement mechanisms to compel payments, and an inability to use risk-based auditing systems to identify problems. This lack of institutional capacity manifests itself further as an inability by weak states to program and spend increased tax revenues in productive ways while controlling for waste and corruption. It perpetuates the lack of public confidence that taxes will be

\begin{itemize}
\end{itemize}
well spent and leads to further tax evasion and fraud, weakening the tenuous social compact between citizens and government.

Adoption of technology is one way to strengthen institutional capacity and avoiding the high evasion rates that accompany more extensive taxation programs, and tax filing programs that make use of cellular phone technology have shown great success in many developing countries. Rwanda, for example, has implemented M-declaration, a mobile platform that allows small businesses to file their taxes electronically using their phone and passport number or other ID card and by following the instructions provided by the program. Making compliance easier than noncompliance will strengthen the tax base and prevent falloff in the event of increased tax rates or changes in tax policy. According to the 2016 Paying Taxes report by the World Bank Group, 84 economies have a fully implemented electronic filing system for paying taxes.

Case Study: Tax Collection in El Salvador

After decades of civil conflict, El Salvador’s government developed a tax reform program in 2004 in order to broaden tax bases and increase collection. With a $5 million investment from USAID, El Salvador’s government was able to implement reforms that reaped over $1.5 billion in returns between 2005 and 2010 without increasing the tax rate. Despite slower growth since the 2008 financial crisis, support from USAID has led to tax revenues surpassing 15 percent of El Salvador’s GDP in 2013. Following this rapid growth in El Salvador over the last two decades, government spending on health, education, and other public goods and services has increased, resulting in steep declines in total poverty levels. A modernized tax system will help finance this continued effort at providing public goods and services.

USAID was responsible for several efforts at improving taxpayer services, including creating a taxpayer assistance center with regional offices that encourage conversation and understanding of the tax policies. Taxpayer advocate units were created to guarantee legal assistance to protect taxpayers’ rights. These services saw an average of 1,300 taxpayer queries per day—up to 5,000 on peak days—compared to only 200 daily before the reform. Both the ease with which these services can be accessed as well as the improved, simplified tax code that encourages participation could be responsible for this surge in queries from taxpayers.

In addition, USAID implemented a computer-assisted audit selection system (CSMS) in 2010, which automated case selection and the assignment of audit personnel, rather than leaving those decisions to the discretion of tax officials to avoid bias and human error, in the hopes of avoiding both a

---


backlog as well as corruption related to human involvement. Training programs to provide more rigorous and productive tax audits saw immediate returns—after six months, the program completed over 300 audits and found over $100 million in underreported taxes. With the support of USAID, El Salvador’s new government recommitted itself to continuing to expand the tax base and provide reliable and transparent services to its taxpayers in 2009, and their commitment to an improved tax system has paid off; social spending in 2012 reached 8.1 percent of GDP, up from 6.6 percent in 2008, with an emphasis on restoring underfunded social protection programs.

Conclusion

A country’s domestic resources are the primary way in which the SDGs and development progress will be achieved. The ambition of the SDGs means far more financing will be needed than is currently available. But moreover, if counties are able to reform their tax systems correctly, then these are, long term, the most stable and sustainable source of development financing available. Not only will this help to generate the revenue needed to pay for the SDGs and fund normal government operations, it will also help to build or reinforce the social compact between governments and their citizens. Tax systems by relying upon the direct or indirect taxation of individuals and companies are critical to this dimension. Donors and their partners are having success. Though it is true that much of the growth in domestic resources that occurred up to 2013 was driven by the commodities’ boom, there has been slow progress in a number of nonresource-rich countries. It is critical that donors fulfill the commitment made at Addis to double the amount of ODA directed toward DRM reform programs. As discussed above, donors working in partnership with local governments in El Salvador and Kenya (to name just a few) have been able to make progress in improving tax systems. But this cannot simply be a technocratic solution; tax system reform gets at the heart of the governance challenge facing many developing countries, as it will require a fundamental realignment of political and economic power to achieve lasting success. This will not be easy, but the fundamentals are in place.