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**DIRECTIONS IN DEVELOPMENT**  
**Public Sector Governance**

# Strengthening Domestic Resource Mobilization

*Moving from Theory to Practice in  
Low- and Middle-Income Countries*

Raul Felix Junquera-Varela, Marijn Verhoeven, Gangadhar P. Shukla,  
Bernard Haven, Rajul Awasthi, and Blanca Moreno-Dodson



**WORLD BANK GROUP**

# Introduction

This report presents an overview of current trends in tax policy, tax administration, and international taxation and provides a broad landscape of practical examples drawn from World Bank operations across Global Practices over the past several decades.<sup>1</sup> As a starting point for a more comprehensive research agenda, it is intended to play two roles: to provide guidance to World Bank staff working on related tax issues and to trigger a wider external dialogue through a forthcoming flagship report addressing strategic aspects of taxation in greater depth (World Bank 2017).

Public spending has consistently played a key role in the economic growth and development of most low- and middle-income countries (LMICs) and continues to do so today. This report analyzes the status of government revenues and identifies policy and administrative steps that may help to mobilize domestic resources in LMICs with a view to helping to frame the strategic position of the World Bank at this particular time. The suggestions are meant to support the role of the Bank in the context of the Addis Tax Initiative and the Sustainable Development Goals 2030 as well as to facilitate the collection of tax and non-tax revenue in order to provide LMICs with a stable and predictable fiscal environment.

## **Domestic Resource Mobilization as an Instrument of Sustained and Inclusive Development**

Domestic revenues can lead to improved development only if they are translated into productive and beneficial public expenditure. For this reason, both sides of the fiscal equation—revenue and expenditure—need to be examined together. However, both governments and donors tend to analyze revenue generation and public spending separately, except when it comes to their joint effects on macroeconomic stability and income inequality. As a result, either revenues are taken as given or spending is considered without addressing the tax policy and administrative measures needed to yield the requisite resources.

Considering tax and expenditure policy issues jointly greatly enhances the likelihood of achieving revenue sufficiency for sustained economic and social development. The two goals are linked and should be addressed in tandem. Both revenue and expenditure reforms should therefore be embedded in broader public financial management reforms. When this is done, domestic resource mobilization (DRM) rightly becomes a development tool for generating revenues to support sustained and inclusive economic development.

At subnational levels in most LMICs, public expenditures have been growing in quantum and importance. The provincial and municipal governments provide critical services to the population and need commensurate resources to be able to do that. They may use some of the same revenue instruments as are used by the central government, such as income tax, value added tax, or sales tax, but they also use a different set of taxes, such as property taxes, and nontax instruments, such as user fees, that constitute an important source of revenue. Sometimes, they receive part of the rents from natural resources. The role of subnational governments in mobilizing revenue as well as in spending on service provision should therefore be part of the broad DRM agenda.

### **Taxation as a Plank of State Building**

The state-building process involves ongoing negotiations between the state and its citizens. On the one hand, tax reform is influenced and guided by the political economy; on the other hand, taxation can be instrumental in the state-building process in a variety of ways, particularly in LMICs. As government depends on taxes and on the prosperity of the people, it has a strong incentive to promote economic growth and engage with the public. This dependence leads to accountability and responsiveness on the part of the state.<sup>2</sup>

Taxation may also help to introduce good practices within different parts of government. For example, in many countries, the introduction of unique taxpayer identification numbers has strengthened other parts of the public and private sectors, including municipal governments and commercial banks. Tax systems build databases that are essential for broader economic and administrative management. Tax reforms emphasize merit-based hiring and performance management, which are highly relevant to other agencies and departments in government. Tax reform should, therefore, be seen as an essential part of state building.

### **Organization of the Report**

Chapter 2 provides an overview of the opportunities and challenges presented by DRM, covering its centrality to the sustainable development agenda, revenue trends and gaps, and requirements for tax reform. Chapters 3 and 4 detail outstanding issues in reforming tax policy and in modernizing and reforming tax administration. Chapter 5 concludes by outlining a strategy for the World Bank to engage and lead on DRM.

# Domestic Resource Mobilization: Opportunities and Challenges

### **DRM as a Key to Economic Growth and Development**

Domestic resource mobilization (DRM) has become a core priority of the sustainable development agenda. The 2015 Addis Ababa Action Agenda on Financing for Development emphasized the importance of DRM, noting that the “mobilization and effective use of domestic resources ... are central to our common pursuit of sustainable development.” On the revenue side, the only reliable and sustained sources of government revenue are taxes and some non-tax revenue instruments, such as royalties and resource rents from extractive industries and, to a limited extent, user fees for public services, generally delivered by local governments. Public sector investments through state-owned enterprises have not been a reliable source of revenue in low- and middle-income countries (LMICs); instead, they have often been a drag on the budget. On the expenditure side, legal obligations often make it difficult to lower administrative overhead, curtail debt servicing, and reduce transfer payments. Thus, lack of sufficient domestic revenue mobilization often results in the cutback of new capital assets and the poor maintenance and operation of existing assets. These cutbacks have an adverse impact on both the level and the quality of present-day services as well as the rate of future economic growth and development.

In most LMICs, particularly low-income countries (LICs), government revenues fall short of the rising need for public expenditures and have to be supplemented through borrowing, multilateral development assistance, or both. Excessive public borrowing from domestic sources can crowd out borrowing and investments by the private sector, with adverse effects on economic growth. Foreign borrowing inherently raises the interest rate on future debt and often leads to high indebtedness. In order to service the loans and avoid falling into a debt trap, the funds borrowed from abroad must be invested in projects and programs that are productive and economically viable. Such investments



require capacity for project appraisal and expenditure analysis on the part of line ministries and the ministry of economy and planning, which is weak in many LMICs.

Official development assistance (ODA) is clearly finite and fluctuates over time, creating uncertainty for recipient countries about planning, budgeting, and expenditures in the public sector. Thus, a chronic and substantial dependence on debt and foreign aid raises serious concerns about the sustainability of government spending and its implications for future economic growth. ODA has uncertain impacts on long-term DRM. Grants may fully displace domestic revenues, but a better understanding of the links between foreign assistance and domestic revenues is needed so that aid supports countries' own efforts to generate tax revenue. Continued, long-term dependence on aid is unlikely to be conducive to enhanced DRM (IMF 2011).<sup>1</sup>

### ***The Challenge of Funding the Sustainable Development Goals***

The Sustainable Development Goals (SDGs)—the post-2015 development agenda espoused in the 2015 United Nations (UN) Summit, which replaced the Millennium Development Goals (MDGs) of 2000—have raised the bar for all nations, particularly LICs. They aim to meet the dual challenges of eradicating global poverty, on the one hand, and protecting the environment, on the other. Picking up the unfinished agenda of the MDGs, the SDGs have set ambitious goals that combine economic growth and social development with environmental sustainability. The financial resources required to achieve the SDGs, therefore, far exceed the resources presently devoted to development expenditures. While the goal of transforming the world by 2030 is both attractive and desirable, funding these goals clearly poses unprecedented challenges, particularly for LMICs.

According to the Intergovernmental Committee of Experts on Sustainable Development Financing, providing a social safety net to eradicate extreme poverty globally would cost roughly US\$66 billion a year, while improving infrastructure to protect the environment could cost as much as US\$7 trillion a year (UN General Assembly 2014). LMICs, particularly low-income countries, rely on public international finance to fund their development agendas. However, in 2013 only five donors from the Organisation for Economic Co-operation and Development (OECD) Development Assistance Committee met the UN's long-standing target of spending 0.7 percent of gross national income on ODA, and ODA reached only US\$135 billion in net terms at its peak amount. Meanwhile, LICs have followed a consistent pattern in which they lose access to concessional loans, but do not expand domestic taxes and foreign private and market-related public borrowing enough to compensate for the loss of ODA.

Even if the annual ODA level were to double, LMICs would still face a large financing gap with regard to the cost of implementing the SDGs. According to the Intergovernmental Committee of Experts, resources generated from the private sector, through tax reforms and a crackdown on illicit financial flows and corruption, are vital to achieving these goals. Most development spending occurs

at the national level in the form of public resources, received largely from private businesses, finance, and investment. The SDG agenda has shifted the focus of sustainable development from relying solely on “billions” in ODA to unlocking “trillions” in internal and external, private and public capital (Development Committee 2015). This shift in financing for development ultimately requires strengthening the sources of domestic revenue.

### ***Inevitability of Domestic Resource Mobilization***

During the UN Addis Ababa Financing for Development conference in July 2015, all of the participating nations seemed to acknowledge the complexity of obtaining development finance from households, businesses, and governments. Thus, DRM reemerged as a key source of funding for national development plans for LMICs. At its core, the topic of DRM through taxation is once again on the global front burner (McArthur 2015).<sup>2</sup>

The experience of LMICs also shows that there are ways to improve DRM, including through more efficient taxation and improved management of extractives revenues. Since 1990, while average government revenue in high-income countries (HICs) has more or less plateaued, in LICs it has increased from 18 percent to 21 percent of gross domestic product (GDP), with similar increases posted by lower-middle-income countries and by upper-middle-income countries (UMICs).

However, domestic revenues still fall short of what is needed to support a more robust development agenda in countries where poverty is highest and needs are most pronounced. Countries with some of the lowest revenue-to-GDP ratios are also those where the vast majority of the world’s extremely poor live—Bangladesh, China, India, and Nigeria all have tax-to-GDP ratios below 15 percent. Over the past two decades, however, trends in revenues and taxes have gradually improved in countries across all income categories, as discussed in the next section.

### **Trends in Total Revenues and Taxes**

Revenue trends are typically reported using the tax-to-GDP ratio over time. However, this measure has pitfalls mainly because revenue collection figures sometimes vary by source and the computation of GDP figures itself is often questionable. Some countries (for example, Ghana) go through a process of reestimating GDP figures that affects this ratio considerably. This metric also assumes away differences in countries’ socioeconomic structure, institutional arrangements, and demographic trends. Ideally, tax effort is a better indicator.<sup>3</sup> In practice, most available revenue collection data use the tax-to-GDP ratio, so the calculations presented here also use this ratio.

This section presents trends in government revenues as well as tax revenues (1990–2013) for both HICs and LMICs. (For further details on the type of tax revenue by country income group and region during 1990–2012, see appendix A.)

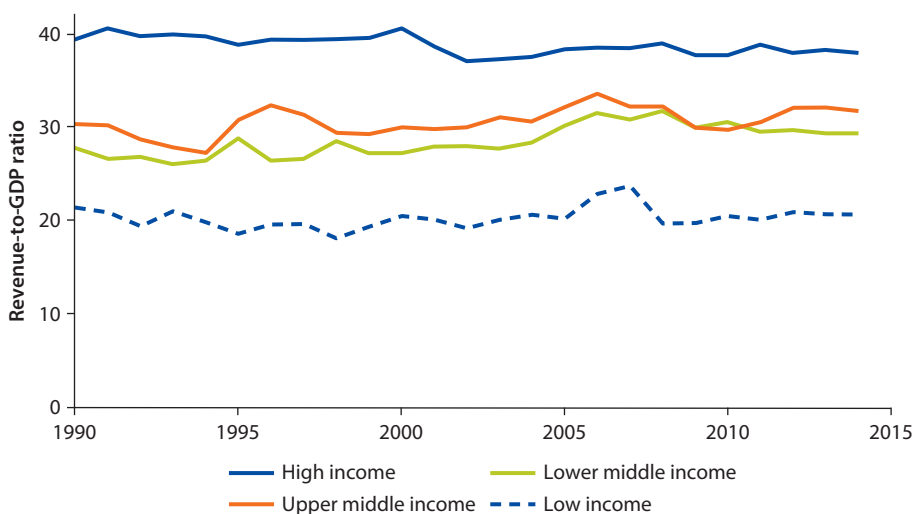
Total revenue increased from 18 percent to 21 percent of GDP in LICs during the period between 1990 and 2014. Trends were similar in both lower-middle-income countries and UMICs, while revenue growth was generally static in HICs.

In LICs, total tax revenue increased from 11 percent to 14 percent of GDP during the period between 1990 and 2014 (figure 2.2). The gradual increase in total tax revenue, primarily owing to an increase in income taxes and value added tax (VAT), contributed to much of the growth in total revenue in LICs.

While LICs and lower-middle-income countries increased the amount of revenue received from VAT and income taxes, UMICs and HICs shifted away from income taxes and toward consumption taxes. The aggregate growth in income tax—individual and corporate—was small, increasing only slightly from 11 percent to 12 percent in HICs and from 6 percent to 7 percent in UMICs between 1990 and 2013. In the same period, the goods and services tax rose from 8 percent to 12 percent in HICs and from 5 percent to 15 percent in UMICs, with a similar increase in the VAT.

VAT collections have increased in countries at all income levels since the beginning of the new millennium. LICs introduced VAT around the turn of the century, and VAT revenue has grown steadily since then. Since VAT revenue also rose in lower-middle-income countries and in UMICs, the average VAT was around 7 percent of GDP for countries at all income levels in 2013, up from 3 percent of GDP in 1990. The increase in VAT and excise taxes generally has affected consumption; as a result, the tax burden is being borne by the middle- and working-class population. The combination of higher taxes on consumption

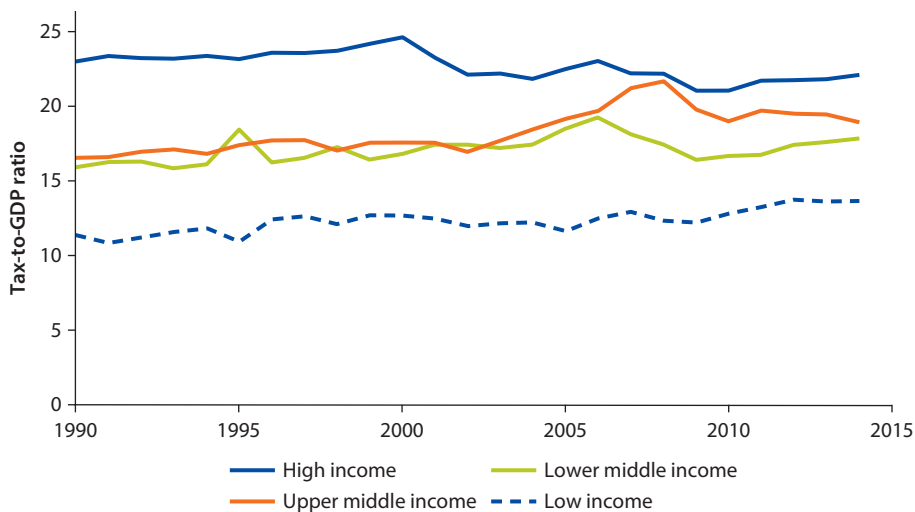
**Figure 2.1 Total Revenue as a Percentage of GDP, by Country Income Group, 1990–2014**



Source: International Monetary Fund, World Revenue Longitudinal Dataset, <http://data.imf.org/>.

Note: GDP = gross domestic product.

**Figure 2.2 Tax Revenue (Excluding Social Contributions) as a Percentage of GDP, by Country Income Group, 1990–2014**



Source: International Monetary Fund, World Revenue Longitudinal Dataset, <http://data.imf.org/>.

Note: GDP = gross domestic product.

and lower taxes on income has eroded the overall progressivity of taxes. During this period, UMICs and HICs witnessed a steady decline in trade transaction taxes, largely due to trade liberalization. In addition, countries compensated for lower trade taxes with higher VAT.

Countries can close the revenue gap in several ways, as discussed in the following section.

## Closing the Revenue Gap

Revenue gaps persist in a country for four main reasons: low tax capacity, lack of a “good” tax system, low tax effort, and globalization.

### Low Tax Capacity of the Economy

One reason a country does not collect sufficient tax revenues is due to the low tax capacity of its economy. Even if everyone agrees that DRM is a key to sustainable development and that tax revenues as a percentage of GDP should be higher, can LMICs tax more? While the size of government (and taxation) is a political choice, the prevailing level of economic growth and structural characteristics of the economy affect the feasibility and costs of collecting taxes. Cost-effective tax administration is affected by the availability or absence of “tax handles,” such as level of per capita income, literacy rate, urbanization, presence of a large corporate sector, existence of a tourism industry, presence of natural resources, and size of the formal sector.<sup>4</sup>



Tax capacity is hard to change in the short run. Nevertheless, it is important to estimate tax capacity before assessing whether the existing tax capacity and revenue potential are being exploited fully and effectively. Starting in the early 1970s, the International Monetary Fund ran a series of regressions using cross-country data from LMICs to arrive at equations for estimating a country's tax capacity based on its parameters, such as per capita income and size of the various economic sectors as a share of GDP. These regressions were followed by several other empirical studies considering the question of tax capacity in LMICs (Le, Moreno-Dodson, and Bayraktar 2009). Most of these studies concluded that, in economic terms, most countries have underutilized tax capacity and can indeed tax more in order to reach their full revenue potential. The main issue is whether there is political will to exploit that tax capacity on a sustained basis (Tanzi 1987).

To estimate the tax capacity of any country, it is often difficult to collect large-scale data from a group of countries and to run a regression. As an alternative, it may be easier and more practical to compile data on revenue collection as a percentage of GDP for a select group of countries with similar economic characteristics for each kind of tax—VAT, personal income tax (PIT), corporate income tax (CIT), and excises—and then to compare the sum total, taken as an estimate of tax capacity of the country in question.

### ***Lack of a “Good” Tax System***

Another reason for a country's revenue gap is the lack of a “good” tax system, which features four basic elements: equity, economic efficiency, technical efficiency, and revenue stability.

First, an equitable tax system should have both horizontal and vertical equity—people in equal circumstances should be taxed equally, while those with greater ability to pay should pay a higher percentage of their income in taxes. A tax system that taxpayers perceive to be fair commands better compliance and raises more revenue. Also, improving equity in the enforcement of taxation is particularly effective not only for neutralizing public opposition but also for creating some degree of support for tax reform.

Second, economic efficiency entails minimizing tax-induced distortions in consumption, savings, work effort, and investment. With regard to economic efficiency, the high costs of taxation are related mostly to high tax rates and large differentials in tax rates across sectors. So, a tax system with fewer and more moderate tax rates imposes lower deadweight loss or excess burden.

Third, technical efficiency demands low costs of both administration and taxpayer compliance. Low costs may, in turn, be achieved by simplifying the tax structure, enhancing awareness and transparency, and streamlining administrative procedures. Many tax reforms have sought to raise more tax revenue without paying adequate attention to improving the tax system and facilitating compliance. The costs of compliance for businesses are often nontrivial and may constitute a significant share of taxes owed.<sup>5</sup> In the World Bank's investment climate

assessment survey, almost 40 percent of businesses overall said that they consider the tax administration to be a major constraint. This is especially true in LMICs (World Bank 2009).

Finally, stability of the tax system basically means that the rate of revenue growth should keep pace with the rate of economic growth in the country. This stability can be achieved more easily if the tax base is well diversified and broad and encompasses the sectors that are contributing to economic growth.

The lack of a “good” tax system indicates a poor tax policy, which, of course, is possible to remedy through a well-designed and properly implemented tax policy reform. This reform would, in turn, require the existence of a tax policy unit or creation of a change management unit within the ministry of finance with the necessary entrepreneurial and technical skills. Given the proper level of political support, a sound tax policy reform can be accomplished over a span of three to five years.

### ***Low Tax Effort***

The third reason for a revenue gap is a low tax effort, which is defined as the ratio of actual tax collection to tax capacity. An alternative but effective approach—estimating the tax base (for each kind of tax), forecasting different kinds of tax revenues, and comparing them with actual intake—could be used to assess the tax effort in most LMICs. This approach has the advantage of yielding an approximate idea of tax revenue performance. In any case, a low tax effort basically points to a weak tax administration and low level of compliance on the part of domestic taxpayers. Compliance could be poor for a variety of reasons, including a culture of tax avoidance and tax evasion and a perception of poor or zero linkage between taxes paid and public services provided.

To improve tax administration, a government usually adopts a two-prong approach. First, the institutions of tax administration and compliance mechanisms need to be strengthened; this effort would include enhancing the procedural and legal framework covering assessment, collection, audit, sanctions, appeals, record keeping, use of information technology, and reward and punishment structure of the civil service; the disclosure requirement of firms; and the accounting conventions used by them. Sometimes corruption and rent seeking hamper the performance of tax administration. Reorganizing and segmenting the tax administration to handle large, medium, and small taxpayers separately and improving the use of information technology may help to improve tax performance. Improving data management and analysis may help to lower the costs of compliance and to reduce the scope for corruption and collusion.

Second, a capacity-building program for personnel of the tax administration at different levels and a sustained campaign of taxpayer service and taxpayer education and awareness may be necessary. Reducing compliance costs and adopting a customer-oriented focus are the key to better compliance and collection.

Reforming and strengthening both tax administration and compliance are again a doable, though time-consuming, process, just like tax policy reform.

### ***Globalization and International Trade and Capital Flows***

The final reason for a revenue gap is globalization and the accompanying growth in international trade and capital flows, which have increased the difficulty of taxing transnational transactions. Businesses now have great scope for aggressive tax planning through tax shelters, profit shifting, and abusive transfer pricing practices. For instance, U.S. Senate investigations in 2013 exposed cases of many highly profitable multinationals that did not pay tax in any country and were doing so in a perfectly legal way. Similarly, the European Union has recently started legal action against several multinational enterprises operating in its territory but shifting profits elsewhere.

For instance, a highly profitable unit of Apple was registered in Ireland, controlled from the United States, and not paying tax in any country. This “stateless-income” structure was quite legal, highlighting the prevalence of big loopholes in the global system for taxing multinationals. Countries such as Ireland and the Netherlands allow big companies to register local subsidiaries even though they have no physical presence in the country. The Netherlands alone has more than 10,000 “letterbox” firms in Amsterdam alone. Naturally there has been growing public outrage over firms not paying their “fair share.”

The reason behind such gaps and loopholes is clear: the set of national laws, rules, and bilateral treaties governing how much tax a multinational company owes and to whom are outdated and inadequate. These rules and laws were designed for the manufacturing sectors, but businesses today have become highly digitalized and service-oriented companies, holding intangible assets and intellectual property. These businesses are easier to move from subsidiaries in high-tax jurisdictions to subsidiaries in low-tax regions. This ability has enabled some multinationals to engage in aggressive tax planning.

According to a conservative estimate of the OECD, the resulting revenue losses to governments globally is about US\$240 billion annually, which amounts to about 10 percent of global CIT receipts. The share of profits that U.S. firms alone book in low-tax havens has almost doubled in the last three decades. This circumstance effectively reduces the actual tax rate these companies pay relative to the statutory rate in the United States. America’s 500 largest firms hold more than US\$2 trillion in profits offshore because, according to U.S. tax laws, the profits that companies make abroad are taxable in America only when they are repatriated (Zucman 2015).

In HICs, the problem arises mainly due to the difficulty of taxing intangibles and e-commerce. In LICs, there is the added difficulty of taxing extractive industries, which is significant in addition to other sector-related challenges, thereby yielding low fiscal revenues and allowing multinational companies to capture a high share of the rents.

Coupled with an asymmetry of capacity between businesses and tax administrations, the problem of taxing transnational firms gives rise to new