Domestic Revenue Mobilization in Low Income Countries: Where To From Here?

By

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1. Why Focus on DRM in LICs?[1]

Developing countries need to finance the spending necessary for sustainable development, with domestic revenue mobilization (DRM)[2] critical to achieving that goal. The IMF has estimated that the average additional spending to achieve the sustainable development goals (SDG)[3] in in five key areas (education, health, roads, electricity and water) in Low-Income Countries (LIC) by 2030 is 15.4 percent of GDP, and 4 percent of GDP for emerging market countries (EME).[4] In the average LIC, the IMF estimates that of the required additional financing, 5 percentage points of GDP would have to come from domestic taxes. As the estimates only cover five areas, it is likely the actual amounts will be substantially more if all SDGs are to be covered. Many developing countries have tax-to-GDP ratios below 13 percent, which is estimated to be the minimum tax-to-GDP ratio necessary to achieve a significant acceleration in growth and development, [5] and significantly below what is necessary to fully fund the spending to achieve the SDGs. Therefore, DRM is critical to finance higher essential spending, while maintaining debt sustainability and reducing monetary financing.

Another reason why LICs need to mobilize more revenue domestically is to help improve their debt sustainability over the medium term. Average unweighted public external debt service in 63 low-income countries fell from 16.6 percent of government revenue in 1998 to a low of 5.5 percent in 2011. Since 2011, average external debt payments have increased gradually, to an average of 12.4 percent of government revenue by 2019, a rise of 125 percent (Jones, 2020). Rising principal and interest payments have crowded out public spending, which declined relatively more in countries with higher debt and interest payments.

DRM has now taken on greater urgency given the fiscal implications of the COVID-19 crisis. Countries have adopted various fiscal policies in addressing the crisis including increasing spending on health and related services and providing fiscal stimulus to businesses and the economy through direct transfers and/or tax relief.[6] The significant reduction in economic activity is also severely impacting revenue collections. The recent decline in commodity prices has also had an impact, especially for oil producers. The extent of the impact on public finances is still uncertain and will depend on the duration of the crisis and how quickly economies can recover. There is also the chance that the crisis will leave a permanent mark on the economic structure of these countries, with important implications for the tax base. Experience from the financial crisis of 2008-2010 suggests that severe output contractions are associated with falling tax compliance. It is likely therefore that tax revenues will be significantly affected for a number of years. The IMF estimates that for LICs the average general government revenue will fall from 14.7 percent of GDP in 2019 to 13.6 percent in 2020 (a reduction of 7.5 percent). The average

[1] For the purposes of this paper the different country categories are based on the World Economic Outlook classification, with a list set out in the Appendix.

[2] The international community has committed to assisting developing countries in addressing DRM. In 2015, all United Nations (UN) Member States adopted the 2030 Agenda for Sustainable Development. In July 2015, the Third UN Conference on Financing for Development in Ethiopia agreed to the *Addis Ababa Action Agenda*, aimed at addressing the challenges of financing and creating an enabling environment for sustainable development. This agreement included measures to assist developing countries in setting nationally defined revenue targets and timelines for enhancing revenues, and supporting countries in reaching these targets.

[3] The sustainable development goals are 17 global goals set by the UN to be met by 2030. The goals aim to address poverty, protect the environment, and advance peace and prosperity.

[4] See Gaspar et al. (2019).

[5] See Gaspar, Jaramillo and Wingender (2016).

[6] Some countries have provided both tax administration and tax policy concessions as part of fiscal stimulus during the crisis. For example, Kenya has cut its VAT rate from 16 to 14 percent; Paraguay has reduced the VAT rate on tourism; other countries, such as Kosovo, Mali, Mozambique, Paraguay and Tanzania, have either exempted or reduced the VAT rate on medical supplies and/or certain basic foods.

fiscal deficit for LICs is projected to expand from 4.1 percent of GDP in 2019 to 5.7 percent of GDP in 2020.[7]

The DRM needs will vary across countries. For example, the revenue needs to fund SDGs are estimated to be higher in sub-Saharan Africa (SSA), where countries face additional spending of about 19 percent of GDP, compared to the average for all LICs of 15.4 percent.[8] The resource needs will also depend on the country's starting point, in terms of tax-to-GDP. For example, in Benin the tax-to-GDP is 9.2 percent (in 2016) yet it requires additional spending of an average of 21.3 percent of GDP, while in Rwanda the tax-to-GDP is 15.5 percent and the estimated additional spending is 18.7 percent of GDP.[9]

This paper considers the DRM efforts in LICs and the opportunity for reforms to improve DRM. The paper is organized as follows: the next section discusses the revenue performance of LICs over the past 20 years; section 3 focuses on SSA and considers the buoyancy of tax revenues in SSA and what that could mean for revenue performance in the future; section 4 discusses potential tax reforms to improve DRM in LICs; and section 5 concludes.

2. What have LICs achieved in the past 20 years?

The revenue performance of LICs has improved over the past 20 years. Figure 1 shows that average tax-to-GDP for LICs has increased from around 10 percent in 2000 to around 14 percent in 2018, which is a significant increase. Fragile states have also had a similar increase. This compares to a much smaller increase for EMEs, while the average tax-to-GDP has remained stable for advanced economies during that time. Resource rich countries have also had a small increase in revenue during the past 20 years, which has levelled over the past few years as commodity prices have fallen.

Figure 1. Tax Revenue for Country Groups, 2000-18 (as a share of GDP)

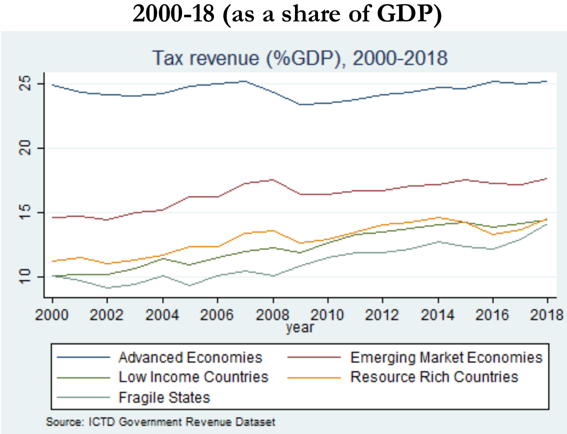


Figure 2. Tax Revenue for Selected Regions, 2000-18 (as a share of GDP)

There have also been notable changes in some regions, in particular in SSA. Figure 2 shows that average tax-to-GDP in SSA has increased by around 3 percentage points of GDP between 2000 to 2018 (from just over 12 percent to almost 15 percent, although it had peaked at around 16 percent in 2014 but declined in part due to falling commodity prices). The increase in other regions (Latin America and Emerging and Developing Asia) has been considerable, but not to the same extent as in SSA.

[7] IMF (2020a).
[8] Gaspar et al. (2019).
[9] Gupta and Liu (2020).

A significant portion of the increase in LIC revenue has come from increasing VAT collections. VAT revenues as a share of GDP in LICs have increased by around 2 percent of GDP (Figure 3). There is a similar increase in VAT revenues for fragile states and resource rich countries, with a smaller increase for EMEs. This is despite VAT rates for LICs only increasing by a very small percentage during that time (the average LIC VAT rate has increased from 15.0 to 15.2 percent over the past 10 years). The widespread adoption of a broad-based consumption tax, such as the VAT by most low-income countries has helped strengthen tax administration, as countries have adopted improved technology, such as electronic filing systems. Thus, the increase in VAT revenue may be due to a greater proportion of consumption in the formal/taxed sector and better compliance, although this is not reflected in improved C-efficiencies for LICs or fragile states for which data are available—the C-efficiency ratio is actual tax collections in relation to the potential revenue from the tax. It is calculated as consumption in GDP divided by the standard VAT rate, and is a measure of the VAT's performance in a country. Figure 4 shows that C-efficiencies in LICs have been high and volatile, which could be due to inadequate payment of timely refunds rather than having a broad tax base or better compliance. Another reason for the high C-efficiency is because of small island countries in the dataset, as these countries tend to have a high C-efficiency because most VAT is collected on imports at controlled borders. For fragile states, the C-efficiency ratio is very low, suggesting poor compliance and narrow tax bases.

Figure 3. VAT Revenues for Country Groups, 2000-18 (as a share of GDP)

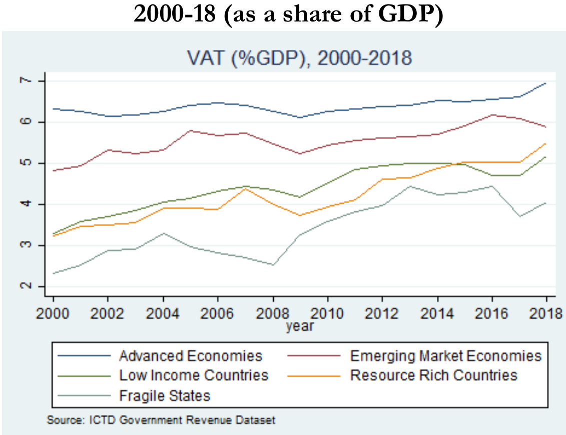
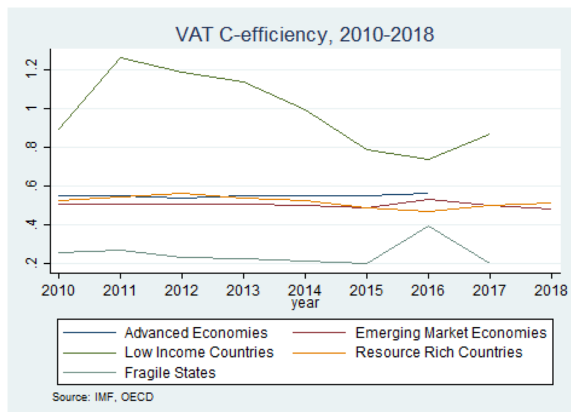


Figure 4. VAT C-efficiency for Country Groups, 2010-18



The increase in VAT revenues has been partly offset by a fall in trade taxes, although excise tax revenues have increased. There has been a small decrease in average trade tax revenues in LICs, by less than 0.5 percent of GDP over the past 20 years, with a slightly larger decrease in fragile states (see Figure 6). Economic literature has shown that a move away from trade taxes in favor of consumption taxes is growth friendly. Countries reduced their trade taxes due to various free trade agreements (FTA). A policy strategy consistent with the FTAs is to offset some of the reductions in trade taxes by introducing, or increasing, excises on certain specific goods. The usual excisable goods are tobacco, alcohol, motor vehicles, and fuel, and more recently sugar products, mostly to address harmful externalities, including for health, caused by use of these goods. Excise revenues in LICs and fragile states have increased by just over 0.5 percent of GDP (Figure 7).

Figure 6. Trade Tax Revenues for Country Groups, 2000-18 (as a share of GDP)

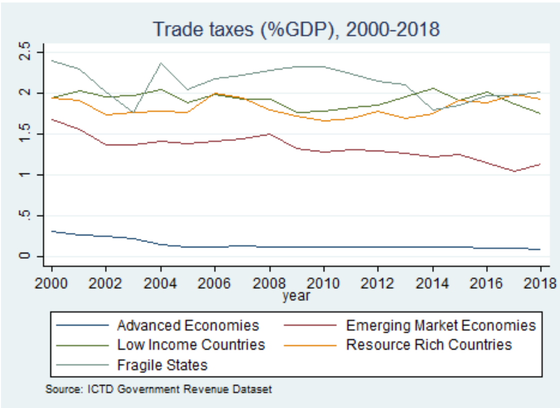
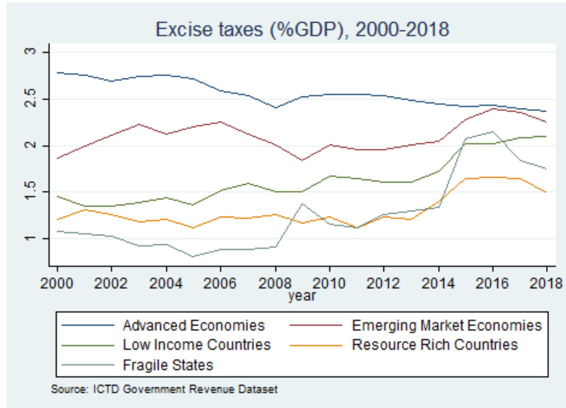


Figure 7. Excise Tax Revenues for Country Groups, 2000-18 (as a share of GDP)



The Corporate Income Tax (CIT) in LICs has been fairly stable, despite falling CIT rates and concerns with tax planning by multinational enterprises (MNEs). CIT revenues as a share of GDP have remained stable over the past 20 years for LICs and fragile states (see Figure 8). This is consistent with the experience in advanced economies and EMEs, although for these economies CIT as share of GDP is much higher than for LICs. The CIT revenues have held up despite falling CIT rates over the same period (see Figure 9) and despite evidence of widespread tax planning by MNEs. CIT revenues have been more volatile for resource rich countries, with significant increases around 2006 to 2008, followed by a decline likely due to falls in commodity prices.

Figure 8. CIT Revenues for Country Groups, 2000-18 (as a share of GDP)

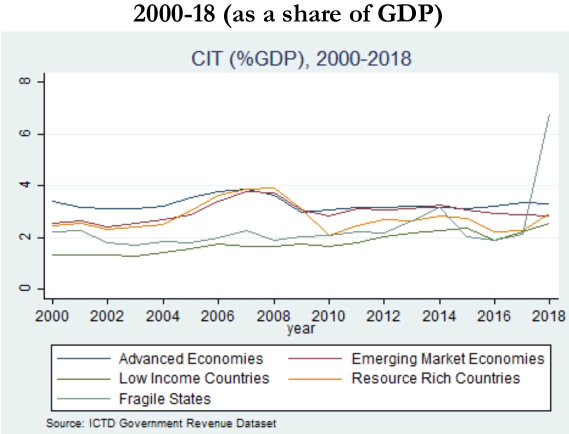
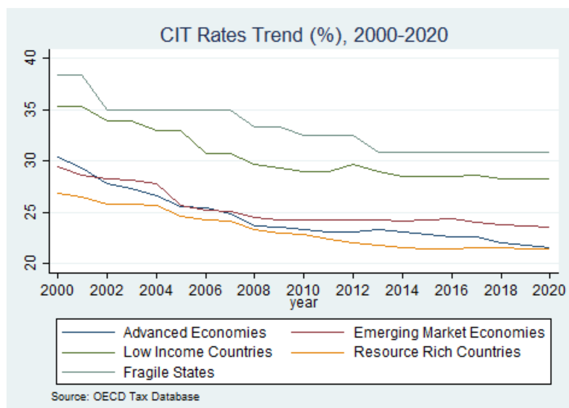


Figure 9. Trend in CIT Rates by Country Groups, 2000-18



Personal income tax (PIT) revenues in LICs have also remained fairly stable, suggesting there has not been much progress on making tax systems more progressive. Figure 10 shows that for LICs, fragile states and EMEs, average PIT as a share of GDP is small, at less than 3 percent of GDP. This compares to average PIT in advanced economies, which is over 8 percent of GDP. This difference is likely due to higher, and more progressive, PIT rates in advanced economies and better collection and enforcement mechanisms (i.e., smaller share of workers in the informal economy). As the PIT is a progressive tax, it would be expected that higher PIT revenues reflects a more progressive tax system.

Figure 10. PIT Revenues for Country Groups, 2000-18 (as a share of GDP)

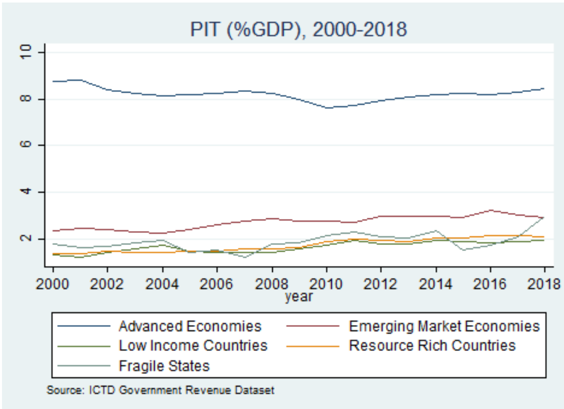
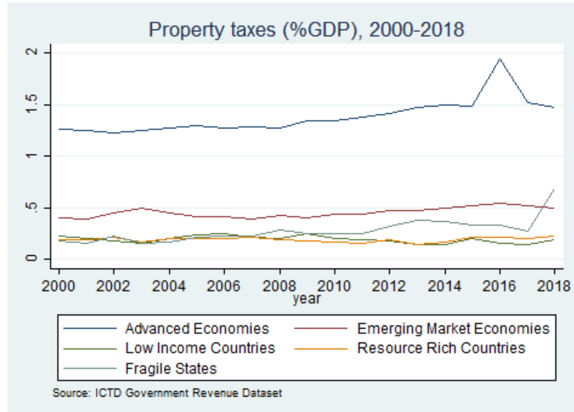


Figure 11. Property Taxes for Country Groups, 2000-18 (as a share of GDP)



Property taxes in LICs have also remained stable over the past 20 years, but make a small contribution to overall tax revenues. In LICs and fragile states, average property tax revenues are less than 0.5 percent of GDP, as shown in Figure 11. Good information on property ownership and on the base for valuing property is hard to obtain in developing countries' due to thin markets for property transactions. In LICs, agricultural activities take up a relatively large share of land area and income derived from agriculture is relatively low. Urban middle-class property owners resist paying property taxes; that may lie behind governments' often providing extensive tax exemptions to different classes of property owners (for example in SSA countries, Kenya, South Africa, and Tanzania exempt different classes of land and give the minister and local authorities a wide latitude in granting exemptions). Property taxes are unlikely to raise significant revenues in the short term, but property tax revenues above 0.5 percent of GDP in an LIC are not unreasonable (for example, EMEs have increased to that level in recent years.

The LIC tax systems have seen little change in the ratio of direct to indirect taxes, indicating that the tax systems have not become more regressive. **The ratio of direct to indirect taxes is indicative of the whether the tax system is becoming progressive or regressive as direct taxes are viewed as more progressive.** There has been a shift within indirect taxes (away from trade taxes towards VAT and excises), but not so much of a shift between direct and indirect taxes, with both increasing in a similar way (see Figure 12). There has been more of a shift in SSA countries, with greater growth in direct taxes during the past 20 years, and a levelling of indirect taxes over the past decade (see Figure 13), suggesting that the region's tax systems on average have become progressive over time.

Figure 12. Tax Revenues by Type in LICs, 2000-18 (as a share of GDP)

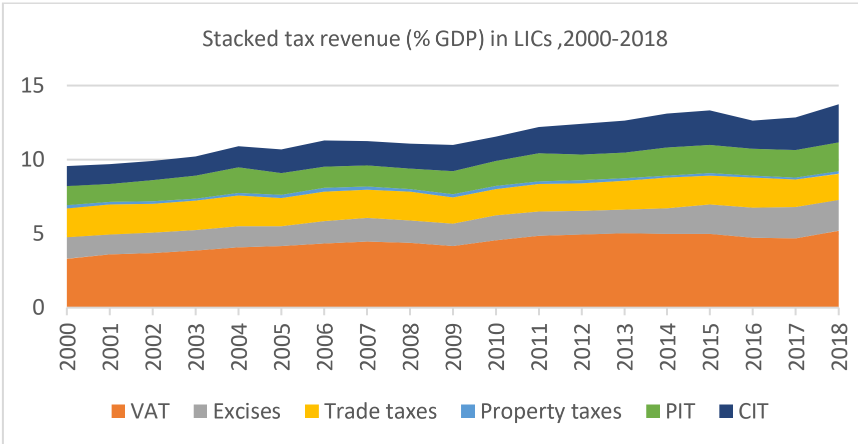
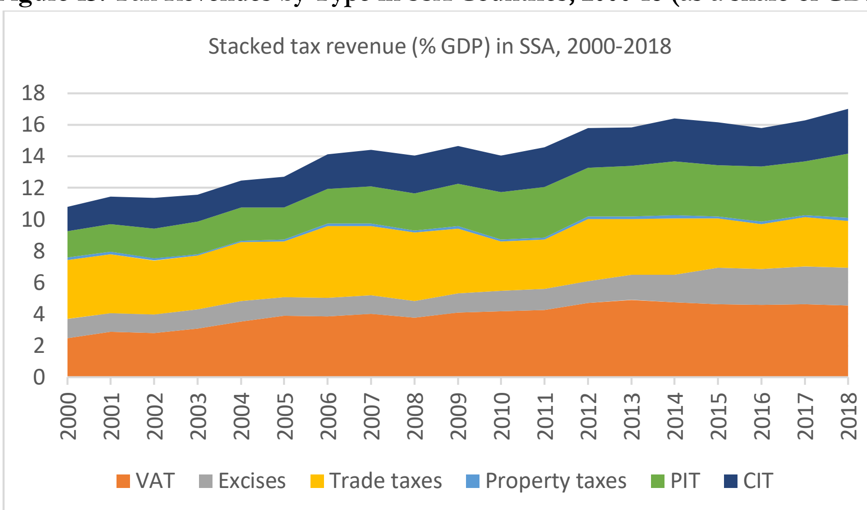


Figure 13. Tax Revenues by Type in SSA Countries, 2000-18 (as a share of GDP)



The tax reforms undertaken by LICs and EMEs during 2000-2015, while increasing revenue, have also raised the income share of the poorest population groups. Recent research by Gupta and Jalles (2020) finds that tax reforms implemented in 45 countries (23 EME and 22 LICs) lessened the inequality of disposable income over time, using the Gini index. Personal income tax reforms and strengthened tax revenue administration are particularly effective at improving income distribution—they widen the tax net by improving compliance. Well-designed tax reforms can improve the progressivity of the tax system and also raise additional resources to fund transfer programs. The design of the reforms has to be suited to a country's specificities and local circumstances (e.g., the approach in fragile states will differ from that in other developing countries, given their particular social and economic environments). However, the results show that the design of tax reforms, in particular the PIT reforms, has been ineffective in reducing disposable income inequality in SSA.

3. Where would SSAs be if the current tax systems prevailed and average growth of the past ten years was achieved?

A key question is whether tax revenues will continue to grow in the future, assuming average revenue growth continues. Economic growth has fallen significantly with the onset of the COVID-19 crisis. The IMF has estimated that average growth for LICs will decrease from just over 5 percent in 2018 and 2019 to –1.0 percent in 2020.[10] For SSA countries the average growth is expected for fall from just over 3 percent to -3.2 percent during the same period. Growth is expected to rebound in 2021 for both LICs and SSA countries, but the outlook is very uncertain given the uncertainties of the virus and bringing it under control. Therefore, it is difficult to estimate what may be the impact on revenue, given the uncertainties about the future economic growth.

Revenue growth will depend to some extent on the buoyancy of the tax system. The buoyancy of the tax system captures the response of tax revenues to changes in national income, including discretionary changes made by countries to their tax systems. A tax buoyancy of one implies that a 1 percent increase in GDP will increase tax revenues by 1 percent thus leaving the tax-to- GDP ratio unchanged, while a tax buoyancy exceeding one will result in tax revenues rising by more than the increase in GDP. If a country wants to raise more revenues as the economy grows, then a buoyancy greater than unity is desirable. LICs should have this as an objective. A country may use discretionary changes to compensate for a low tax buoyancy.

The tax buoyancy in SSA is a useful guide to the potential growth of tax revenues for LICs in the future. Gupta and Liu (2020)[11] have estimated the short- and long-term tax buoyancies of 44 SSA countries between 1980 and 2017. They show that for all SSA the long-term buoyancy is slightly greater than one, suggesting that revenues will increase faster than economic growth (see Table 1 below). This is consistent across the different country groupings they identified—that is, fragile countries, foreign-aid dependent countries and natural resource rich countries. However, short-term buoyancy is lower, and in the case of fragile countries and natural resource rich countries it is less than one. They also consider the buoyancy of different taxes and find that the short-term buoyancy of PIT is significantly less than one—possibly due to wage rigidity in the formal sector and to changing tax brackets in response to growing incomes. The long-term buoyancy suggests that most taxes are progressive, except for trade taxes. While they show that tax buoyancy appears neutral to discretionary tax changes, there is an increase in long-term buoyancy in the more recent period reflecting tax reforms implemented by SSA countries, suggesting that future tax reforms will need to capture the changing economic structure to improve buoyancy.

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[10] IMF (2020b).

Table 1. Buoyancy of Total Tax Revenue Across Different Country Groups		
	Long-term buoyancy	Short-term buoyancy
All countries	1.088	1.004
Fragile	1.067	0.892
Foreign-aid dependent	1.089	1.043
Natural-resource rich	1.069	0.969
Source: Reprinted from Gupta and Liu (2020).		

While tax buoyancy in SSA appears to be greater than one, domestic tax revenues generated by 2030 will not be adequate to cover spending needed to achieve the SDGs. Gupta and Liu (2020) estimated the revenue growth in SSA as a whole and in two SSA countries (Benin and Rwanda), taking account of the tax buoyancy. They estimated that the tax-to-GDP ratio for the SSA region would grow modestly by 0.8 percent by 2030, while the tax-to-GDP ratio in Benin would grow to 10.6 percent (an increase of 1.4 percent) and in Rwanda to 18.7 percent (an increase of 3.2 percent) (see Table 2 below)—these may now be greater given the impact of COVID-19. In all SSA and in Benin and Rwanda, incremental taxes generated by 2030 would fall short of the average 5 percent of GDP additional revenues needed by LICs to finance the SDGs. This suggests that SSA countries must continue to implement tax reforms to make their systems more responsive to income changes. The revenue shortfall could be larger if COVID-19 were to dampen SSA's growth prospects over a long period. It could also delay implementation of critical tax reforms as countries seek to mitigate the virus' impact through a fiscal stimulus.

Table 2. Projected Increases in Tax-to-GDP Ratio by 2030 in SSA, Benin and Rwanda				
	Tax-to-GDP Ratio, 2016 (in percent)	Estimated Tax Buoyancy	Projected Tax-to-GDP Ratio in 2030 (in percent)	Increase in Tax-to-GDP Ratio
SSA	15.8	1.08	16.6	0.8
Benin	9.2	1.18	10.6	1.4
Rwanda	15.5	1.13	18.7	3.2
Source: Reprinted from Gupta and Liu (2020).				

4. Opportunity for reforms

There are a number of tax reforms that LICs should consider, to improve tax revenues and tax buoyancy into the future. The fiscal impact of the COVID-19 crisis has made it imperative for LICs to begin reforming their tax systems to generate more resources domestically—reforms which they may have been postponed until now because of vested interests. The reforms relevant for any particular country will depend on that country's circumstances. However, there are some reforms that are likely relevant for almost all LICs. These reforms are discussed below.

1. Limit tax expenditures

One of the key reasons why the tax systems in LICs do not meet their revenue collection potential is due to significant tax expenditures—these are also known as tax incentives, and include exemptions, reduced rates, special deductions, and tax credits that reduce the taxpayer's liability. Tax expenditures can arise for all taxes, especially the CIT and VAT. While tax expenditures are used widely to pursue different policy goals, they are costly and often ineffective in reaching their objectives. Reforming tax expenditures would improve taxpayers' perception of the fairness of the tax system and enhance budget transparency, but more importantly generate additional revenues. Estimates show that tax expenditures in Latin America account for slightly more than 4 percent of GDP on average, ranging from 1.3 percent of GDP in Bolivia and Paraguay to 8 percent of GDP in Colombia. [12] In Africa, the tax expenditures average 2.9 percent of GDP, but can be as high as 7.8 percent (in Senegal) and can exceed 20 percent of tax revenues. These estimates are likely to be underreported due to inadequate reporting of tax expenditures.

LICs should reassess their tax expenditures, and then significantly rationalize them. If tax expenditures are to be provided, they should be well-targeted with clear criteria, and should be reviewed regularly to ensure they are achieving their objectives. It is also good practice to publish, on an annual basis, a tax expenditure statement, which estimates the revenue cost of tax expenditures.[13]

Donors also need to contribute in this regard. Many donors get exemptions from paying custom duties and the value-added tax on aid-funded projects in countries where they operate. The cost of these tax concessions depends on the size of aid budget and has been estimated to be as high as three percent of GDP in countries that rely more heavily on aid. These countries tend to be fragile, emerging from a war or conflict with a tax ratio of less than 15 percent of GDP (Gupta, 2020).

2. Improve VAT efficiency through improved compliance and policy design

The VAT is an important source of tax revenue for LICs, but its revenue potential is being underutilized. The reasons for this lower than optimal performance, is likely due to low compliance, and possibly enforcement, and potentially poor policy design. The latter is usually due to tax exemptions, which were discussed in (1) above. To address these weaknesses LICs should reduce concessionally taxed goods and services—that is, exemptions, reduced rates and zero-rated goods (other than for exports)—and improve compliance including, if necessary, increasing the VAT registration threshold if there are too many small taxpayers overloading the tax administration. While there can be concerns that a VAT is regressive, LICs can use the revenue from the VAT for progressive spending to offset the regressivity of the VAT. VAT exemptions are sometimes justified as another means to reduce the regressivity of the VAT, but these exemptions are not a good instrument for promoting equity. This is because even if the poor spend a larger proportion of their income on some particular item (such as food) the better-off will typically spend a larger absolute amount.[14] Therefore, a VAT exemption on that item actually transfers more money to the better-off than it does to the poor. The better policy is to tax at the standard rate and

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[12] See Gupta and Redonda (2020).

[13] The IMF has prepared a guide on how to develop a comprehensive tax expenditure statement—*Tax Expenditure Reporting and Its Use in Fiscal Management: A Guide for Developing Economies*, IMF How To Note 19/01. The note is available at: https://www.imf.org/en/Publications/Fiscal-Affairs-Department-How-To-Notes/Issues/2019/03/27/Tax-Expenditure-Reporting-and-Its-Use-in-Fiscal-Management-A-Guide-for-Developing-Economies-46676.

[14] For a further discussion of the distributional aspects of a VAT, see 'The VAT Experience in LIDCs' in Macroeconomic Developments and Prospects in Low Income Developing Countries—2019, December 2019, IMF Policy Paper.

use the enhanced revenue this yields to finance pro-poor spending that may be better targeted. The other area for reform is in relation to applying VAT to the growing digital services. As an initial step, LICs could consider requiring non-resident suppliers of online goods and services to register for VAT and remit VAT for goods and services provided to the country's residents.

3. Review excise taxes

Excises can play a dual role in the tax system: providing a stable source of revenue and addressing negative externalities. The usual excisable goods are alcohol, tobacco, fuel and motor vehicles, although increasingly they are being expanded to include sugar products. There are several reasons these goods are often taxed at a higher rate including: they have a low elasticity of demand and therefore are a good stable source of revenue; the tax addresses a negative externality (e.g., the health costs of smoking or unhealthy eating, or pollution and congestion caused by vehicles); and, paternalism, in that society does not support the consumption of the particular goods.

In many countries there is scope to increase these excises, to raise revenue and better offset the costs of the negative externality. Also, in those countries that impose specific excises (i.e., a specific amount per item of the good) rather than ad valorem excises (i.e., based on the value of the good), the rates may not have been updated for some time. Therefore, LICs should review the excises on a regular basis and consider increasing them. In particular, now is a good time to correct fuel pricing, given the current low prices. In reviewing excises, LICs should avoid the temptation to expand the goods subject to excises too broadly, such as to include luxury items. The international experience is that excises on these types of goods complicate the tax system and raise little revenue, so it is preferable to limit excises to a few goods that have significant negative externalities.

Imposing excises or special taxes on telecommunication services, is one area that many countries are now pursuing. These taxes have been introduced as they can potentially raise a substantial amount of revenue without significantly impacting on phone usage. Telecommunication taxes take many forms (e.g., higher rate of VAT, turnover taxes on telecom companies, additional taxes on handsets, sim cards, calls, data usage and social media). If LICs are looking for a new source of revenue, one option is to consider introducing an additional tax on telecommunication services.

4. Strengthen progressive taxation, through the PIT and property tax

LICs collect significantly less than advanced countries from PIT (see Figure 10). This is due in part to very large informal economies in LICs, so that many employees are not in the formal system. However, it is likely that the policy design of the PIT also impacts on the revenue performance of the PIT. In particular, the top PIT rates in LICs are much lower than in advanced countries. For example, the average top PIT rate for OECD countries is 42.8, while for LICs it is 28.1 percent. The top PIT rate also tends to apply at a much higher income level (i.e., as a multiple of GDP per capita) than in advanced countries.

Therefore, LICs should consider serious PIT reforms, including increasing the PIT rates applying to higher income earners (but not too high). Such reforms will not only increase revenue, but make the tax system more progressive and improve vertical equity.

Another reform to improve the progressivity of the tax systems in LICs, is greater use of property taxes. Property taxes may be considered the most desirable source of revenue mobilization as such taxes are: efficient—the tax base is immobile, so risks not disappearing like mobile capital; equitable—real property is often the main source of wealth for households, and wealth and income are highly correlated; and administratively simpler—evading the base of the tax is difficult with real properties, with under-declaration able to be checked by tax assessors. A property tax is a good tax particularly for subnational governments, but as discussed above its revenue raising capacity is not large compared to the other main tax types, rarely raising more than two percent of GDP in advanced economies. The main purpose of a property tax is for funding local government spending which usually requires much less revenue than funding national government spending. Imposing property taxes will help make the tax system more progressive by taxing more educated and productive middle-class workers who capture a share of unpriced benefits of urban life, including the rising value of their urban property. A fully functioning property tax also requires a good tax administration and an efficient and accurate cadaster (i.e., a record of all properties). The advent of new technologies means that it is possible to overcome some of the administrative constraints to taxing urban property.

5. Strengthen international taxation and anti-avoidance measures

International tax issues are a growing concern for LICs as well as advanced countries, due to concerns about aggressive tax planning by MNEs. These tax planning opportunities often result from weaknesses in the design of the international tax framework, as well as from taking advantage of deliberate policy choices by some countries to obtain competitive advantages. The digitalization of economic activity has further complicated the international tax system.

LICs need to respond to the international tax challenges, so as to protect, and potentially gain, revenue from MNEs operating in the country. While the challenges are significant, there are feasible steps that developing countries can take to begin to address these challenges including: legislating simple and comprehensive international tax rules in domestic laws (including transfer pricing rules); imposing a limit on interest deductions, as overpayment of interest to related parties is one of the simplest means to shift profits; imposing withholding taxes on payments to non-residents—set at a rate of 10 to 15 percent, and not reduced by double tax treaties—to cover dividends, interest, rent, royalties, management fees and technical service fees; being careful about entering into new double tax treaties, at least until countries have a clear tax treaty policy that protects their revenue base; limiting deductions for other non-interest payments between related parties (e.g., management fees); introducing a simple minimum corporate income tax, to address potential tax avoidance; taxing gains on offshore indirect transfers of interests; and reconsidering tax holidays and incentives provided to foreign investors.[15]

6. Consider environmental taxes

Fiscal instruments have a role among a range of instruments available to governments to mitigate risks to the environment, such as carbon emissions, pollution and congestion. While there are complex instruments, such as carbon taxes, LICs can consider utilizing existing fiscal measures to assist in mitigation, including increasing fuel excises, reforming the taxation of vehicles to encourage the use of fuel-efficient vehicles, and correctly pricing electricity. Reviewing fuel excises is discussed in (3) above, but any reform should be undertaken as part of a coherent overall environmental strategy. One option for smaller LICs is to undertake a Climate Change Policy Assessment, which is a joint initiative by the IMF and World Bank to assist small states to understand and manage the expected economic impact of climate change, while safeguarding long-run fiscal and external sustainability.[16]

7. Review non-tax revenues and ensure there is a clear regulatory framework and procedures for these revenues

Although the emphasis for DRM is on increasing tax revenues, non-tax revenues can also have a role in DRM. Non-tax revenues come from a number of different sources including: dividends; interest;

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[15] For a further discussion of international taxation and developing countries, see Mullins (2020).
[16] A number of countries have completed Climate Change Policy Assessments including: Belize; Grenada; Micronesia; Seychelles; Saint Lucia; and Tonga. These assessments are available at: https://www.imf.org/en/Topics/Environment.

royalties; sale of fixed assets; rents charged for use of public assets; fees for government services or goods; regulatory charges or licenses; and fines and penalties. In most countries these fees and charges are unlikely to be a large source of revenue, compared to other main taxes, but they can be a reliable source of revenue, and for some LICs they can be significant, such as fishing license fees in small island countries. Many countries do not pay enough attention to regular fees and charges, so that this source of revenue is often underutilized or misused. Well-designed fees and charges can encourage the efficient use of scarce public resources, as free or underpriced goods and services may lead to overconsumption to the detriment of society. Common weaknesses with fees and charges include: lack of updating; poor initial pricing that does not reflect the value of the service provided; absence of regular review to determine if the fees and charges still achieve their purpose; the number of fees and charges may proliferate, becoming nuisance fees that burden businesses creating inefficiencies; lack of effective collection and monitoring; and lack of accountability by collecting government agencies. LICs should review their non-tax revenues and consider introducing a clear regulatory framework and procedures for non-tax revenues.

8. Focus more on the distributive consequences of tax reforms

As illustrated previously, tax reforms can reduce income disparities, and still increase revenue. Gupta and Jalles (2020) find that the tax reforms most likely to achieve these goals are those affecting PIT and tax administration, in particular increasing tax compliance. However, to be effective the reforms must be well designed. The reforms are particularly beneficial for income distribution where the government and the tax system are smaller. This suggests that LICs should pursue the reforms for PIT outlined in (4) above, as well reforms to the tax administration to improve compliance and enforcement.

Other Issues to Consider in Progressing DRM

Progressing these reforms will require strong political leadership, and should include wide consultation, to achieve effective and supported policy outcomes. Any major tax reform will usually only succeed with strong political will and leadership. Tax reforms are often unpopular, or at least face resistance from some sections of society, so significant political leadership is required to progress such reforms. If the political will is weak, then the reforms are unlikely to proceed or may be watered down with concessions, which complicate the tax system and reduce the revenue potential. It is also important to engage with citizens, business and civil society in developing tax reforms. Citizens and local civil society have an important role to play in helping identify local policies that may ease the tax burden on marginal populations, while also being fiscally responsible. This is especially important at this time with the COVID-19 crisis, as countries consider fiscal policy responses to the crisis and the impact this may have on easing tax burdens on vulnerable populations and small- and medium-sized businesses who are particularly impacted by the crisis. Donors also can play an important role in bringing together citizens and governments to develop mutually beneficial tax policies that increase revenue and build social cohesion.

Another important component of DRM is assessment of the tax system and revenue performance measurement. Tax-to-GDP ratio is one popular measure of performance, but countries should also benchmark their revenue systems both against good practices as well as the performance of other countries in deciding on future reforms. Measurement is also important once reforms have been implemented, to ensure they are achieving their policy objectives, by increasing revenues and making the tax system more efficient and equitable. There are a number of tools developed by capacity development (CD) partners that are available to LICs to assess their tax systems, such as the Tax Administration Diagnostic Assessment Tool (TADAT), Revenue Administration Gap Analysis Program (RA-GAP), and Revenue Administration Fiscal Information Tool (RA-FIT/ISORA).[17] Developing countries need to

[17] TADAT provides an objective health assessment of a tax administration by assessing key functions, processes and institutions of tax administration systems across nine performance areas; RA-GAP is a quantitative analysis of the gap between potential

decide on which tools to use, and that will depend on their individual experiences. A recent paper by the Norwegian Agency for Development and Cooperation compares the various tools and finds that:[18] no tool is complete in providing diagnostics, data collection, design advice, and monitoring, so countries are forced to choose several tools to meet their needs, often doing so with limited resources and understanding of the tools; CD partners should exploit existing tools rather than design their own, and should work together to design a guide to the tools; the cost of using the various tools is difficult to estimate and reporting on which countries have used the tools is uneven; CD partners should work with developing countries to exploit and analyze the data, which now has wide coverage, including for policy design; and the toolbox should be reviewed periodically to ensure complementarity and relevance of the various tools and whether there is scope for merging some of them.

While governments focus on DRM, this effort should be complemented by enhancing the efficiency of public spending. It is unlikely that the additional spending needed to achieve the SDGs can be solely met by DRM. Therefore, policymakers must complement the tax-enhancing reforms with efforts to improve the quality of spending. Gupta (2018) has estimated that it is possible to generate up to 3 percent of GDP in resources by adopting efficiency-enhancing spending measures. Therefore, LICs should periodically review their spending programs to identify and address inefficiencies, and international institutions and donor partners should not just focus on strengthening tax systems, but should also complement this with enhancing the efficiency of spending programs. This also has the potential to strengthen tax compliance as taxpayers see better use made of their taxes.

Conclusions: the way forward

Spending needs for financing the SDGs in LICs are large and the need for DRM has taken on further significance due to the fiscal impact of COVID-19. The latter likely having a long-lasting impact on the revenue-generating capacity of LICs. In this regard, the first and foremost challenge facing these countries is to prevent the erosion of revenue gains made since 2000 as it would make achievement of the SDGs even harder. This would require reversal of fiscal measures introduced to provide support to households and businesses to counter income losses from COVID-19. In this regard, the second half of 2021 becomes crucial assuming that the pandemic is brought under control by then.

There is potential to raise more revenues from domestic sources in LICs, but this would require strong political leadership to overcome resistance from vested interests. Effective consultation with citizens, business and civil society may help overcome opposition to change and achieve effective and supported policy outcomes. The preceding analysis showed that there are numerous potential reform areas that can contribute to mobilizing additional domestic revenues including: limiting tax expenditures; improving the efficiency of the VAT through better compliance and policy design; reviewing excises; strengthening progressive taxation, through the PIT and property tax; strengthening international taxation and anti-avoidance measures; introducing environmental taxes; and reviewing non-tax revenues.

The reform packages should focus more on the distributive consequences of tax reforms to ensure they benefit the less well-off members of society. In this regard, it is important to ensure that LICs make an effective use of available tools to assess their tax systems and to measure revenue performance.

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revenues and actual collections for the VAT and CIT, and identifies the extent the gap relates to policy and compliance; and RA-FIT/ISORA is a survey-based dataset on revenue administration practices, with the most recent survey conducted in 2018, covering tax administrations in 159 countries.

[18] See Lindseth (2020).

While it is essential governments focus on DRM, this effort should be complemented by enhancing the efficiency of public spending. While DRM efforts are needed, governments and donor countries should be realistic in their expectations, as even with these reforms, DRM by itself will not be sufficient to fully meet the spending needed to meet the SDGs.

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Appendix

Country Classifications

The country classifications in this paper follow the WEO country classification, accordingly:

Advanced Economies (39): Australia, Austria, Belgium, Canada, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hong Kong SAR, Iceland, Ireland, Israel, Italy, Japan, Korea, Latvia, Lithuania, Luxembourg, Macao SAR, Malta, Netherlands, New Zealand, Norway, Portugal, Puerto Rico, San Marino, Singapore, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Taiwan Province of China, United Kingdom, and United States.

Emerging Market Economies (96): Albania, Algeria, Angola, Antigua and Barbuda, Argentina, Armenia, Aruba, Azerbaijan, The Bahamas, Bahrain, Barbados, Belarus, Belize, Bolivia, Bosnia and Herzegovina, Botswana, Brazil, Brunei Darussalam, Bulgaria, Cabo Verde, Chile, China, Colombia, Costa Rica, Croatia, Dominica, Dominican Republic, Ecuador, Egypt, El Salvador, Equatorial Guinea, Eswatini, Fiji, Gabon, Georgia, Grenada, Guatemala, Guyana, Hungary, India, Indonesia, Iran, Iraq, Jamaica, Jordan, Kazakhstan, Kosovo, Kuwait, Lebanon, Libya, Malaysia, Maldives, Marshall Islands, Mauritius, Mexico, Micronesia, Mongolia, Montenegro, Morocco, Namibia, Nauru, North Macedonia, Oman, Pakistan, Palau, Panama, Paraguay, Peru, Philippines, Poland, Qatar, Romania, Russia, Samoa, Saudi Arabia, Serbia, Seychelles, South Africa, Sri Lanka, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, Syria, Thailand, Tonga, Trinidad and Tobago, Tunisia, Turkey, Turkmenistan, Tuvalu, Ukraine, United Arab Emirates, Uruguay, Vanuatu, Venezuela.

Low Income Countries (59): Afghanistan, Bangladesh , Benin, Bhutan, Burkina Faso, Burundi, Cambodia, Cameroon, Central African Republic, Chad, Comoros, Cote d'Ivoire, Democratic Republic of the Congo, Djibouti, Eritrea, Ethiopia, Ghana, Guniea-Bissau, Guinea, Haiti, Honduras, Kenya, Kiribati, Kyrgyz Republic, Lao People's Democratic Republic, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Moldova, Mozambique, Myanmar, Nepal, Nicaragua, Niger, Nigeria, Papua New Guinea , Republic of the Congo, Rwanda , Sao Tome and Principe , Senegal , Siera Leone, Solomon Islands, Somalia, South Sudan, Sudan ,Tajikistan, Tanzania, The Gambia, Timor-Leste, Togo, Uganda, Uzbekistan, Vietnam, Yemen, Zambia, Zimbabwe.