

INTERNATIONAL MONETARY FUND

Building Tax Capacity in Developing Countries

Juan Carlos Benítez, Mario Mansour, Miguel Pecho, and Charles Vellutini

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STAFF DISCUSSION NOTE



Building Tax Capacity for Revenue Mobilization

FEBRUARY 2024

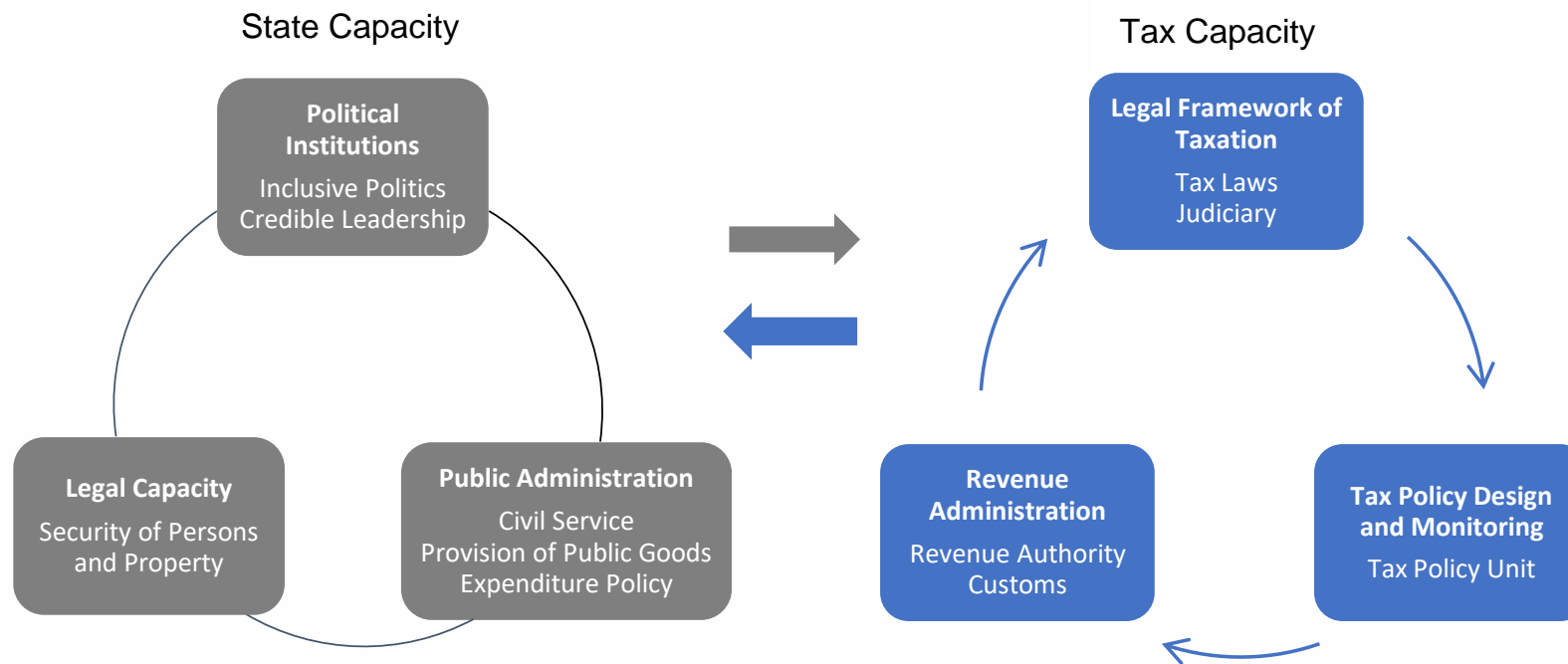
Juan Carlos Benítez and Cindy Negus

Outline

1. Building state capacity through tax capacity
2. Tax capacity – getting tax policy right
3. Tax capacity – focus on revenue and customs' administrations

Building state capacity through tax capacity

Tax capacity defines the essence of a state that relies on taxation to play its role effectively

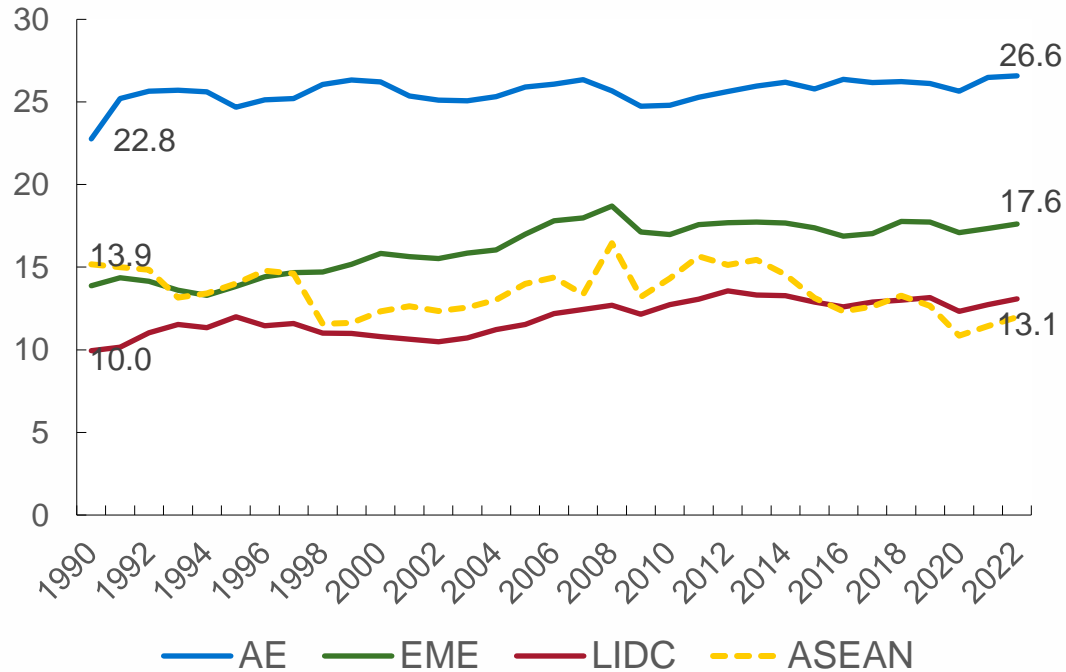


Source: IMF staff.

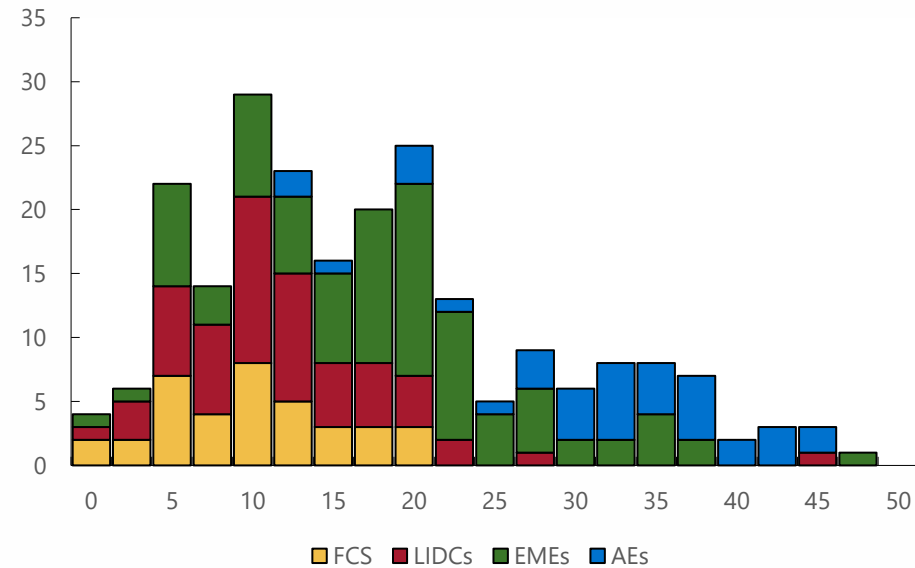
Tax capacity – Getting tax policy right

Tax revenues in LIDCs have increased since 1990 but remain low, and progress has stalled since 2010

Tax Revenue (Percent of GDP)



Country Dispersion around Tax Revenue, 2020 or latest available year (number of countries)

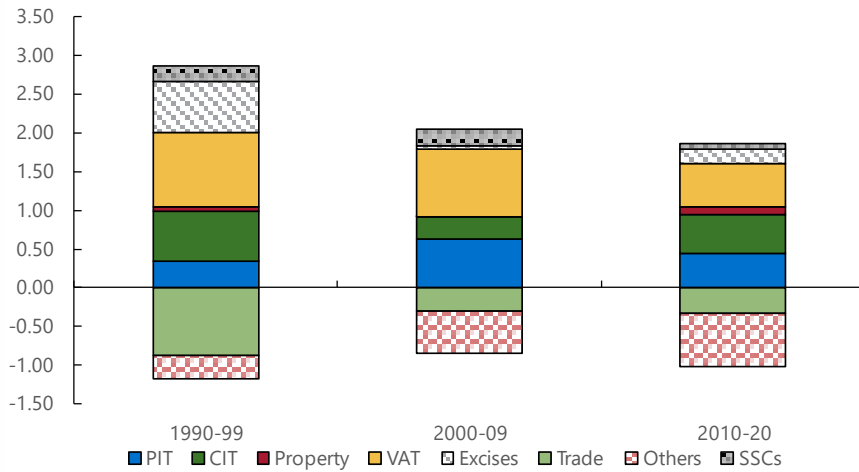


Source: IMF staff based on WoRLD (2022).

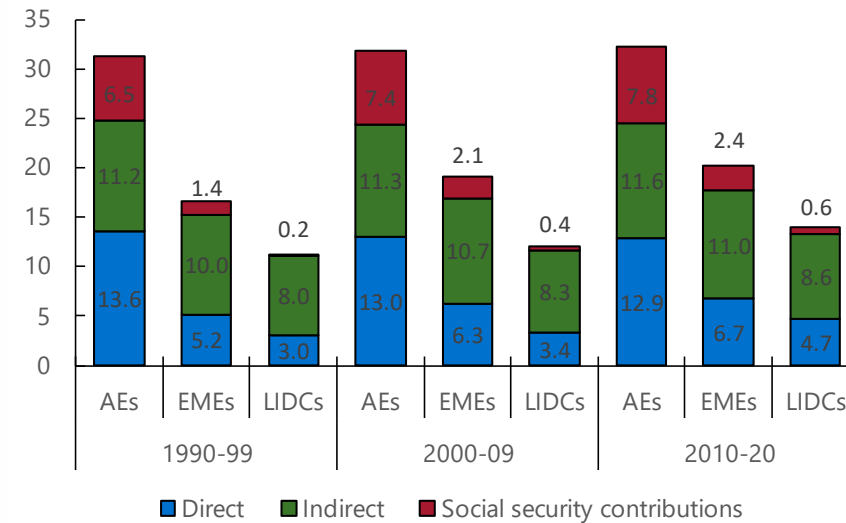
Notes: a) Tax revenue includes SSCs; b) Countries with tax revenue-to-GDP below 5 percent are either Fragile and Conflict-Affected States (FCSs), or resource rich with ample non-tax revenue.

Consumption taxes have contributed most to revenue growth in LIDCs, but income taxes are catching up

VAT and income taxes have contributed most to tax revenue growth since 1990...



...but tax mix remains heavily reliant on VAT and excises

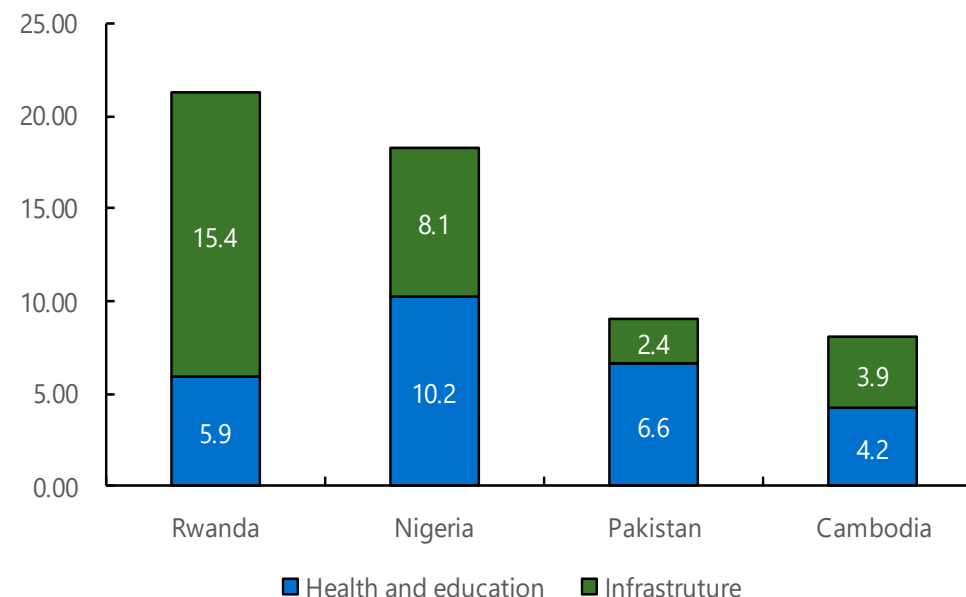


Source: IMF staff estimates, based on WoRLD (2022).
 Note: Figures are in percent of GDP.

Tax capacity more critical than ever to meet SDGs

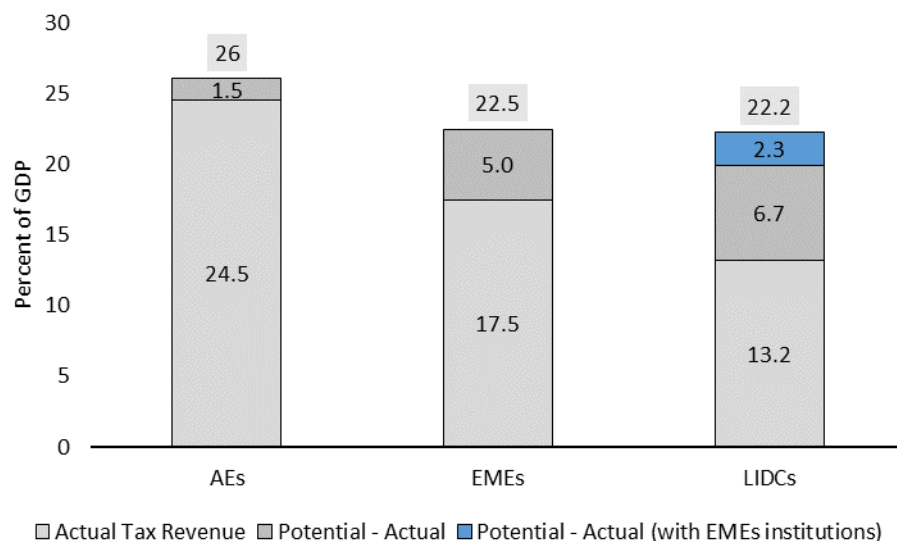
- Taxation is called upon to achieve multiple objectives:
 - ▶ 16 percent of GDP annually for SDGs
 - ▶ 28 LIDCs have high risk of debt distress, and 11 are in debt distress
 - ▶ Climate mitigation and reducing inequalities
- Tax systems should be resilient
- Reforms to international taxation of MNEs provides only a modest revenue contribution to LIDCs

Additional Annual Financing to Meet the SDGs (percent of GDP)



Large tax revenue gap (excluding SSCs), compared to their potential

Actual tax revenue, tax gap and tax potential, 2020



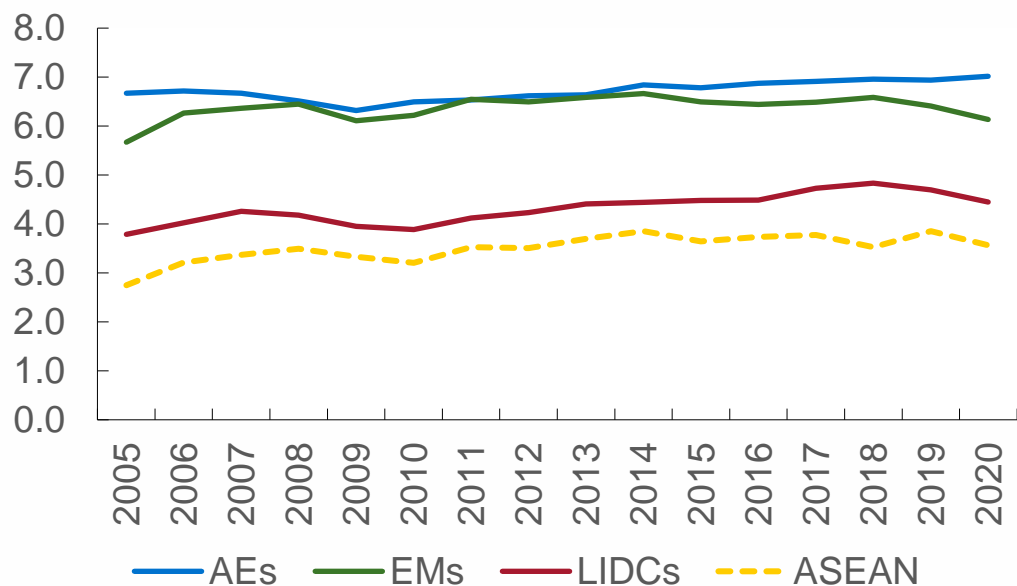
Source: IMF staff estimates.

Note: Actual and potential estimates exclude SSCs.

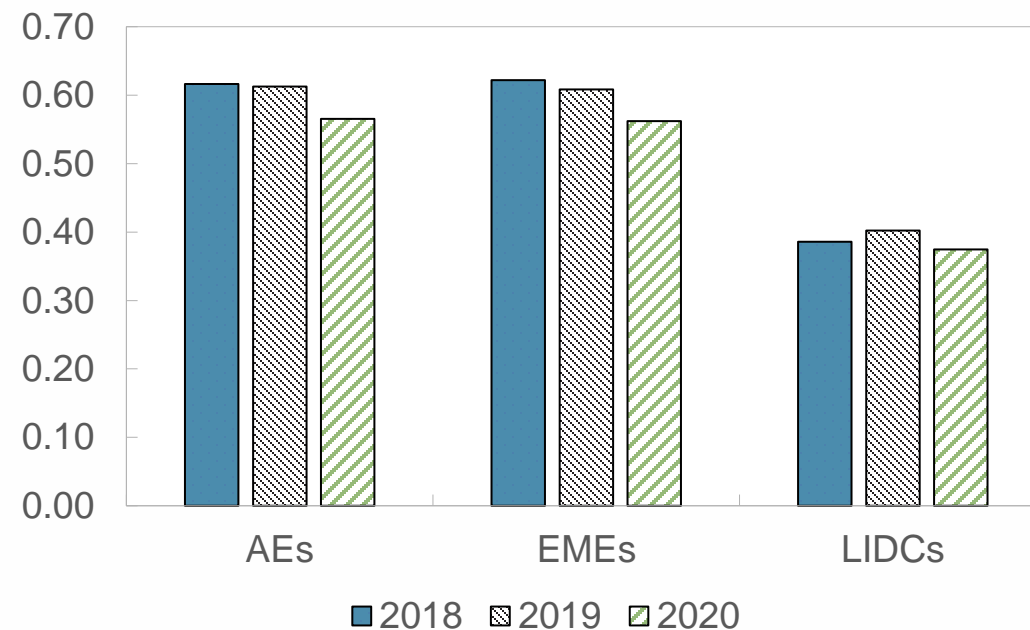
- In LIDCs, a 6.7 percentage points of GDP is feasible through policy and administration improvements,
 - ▶ An additional, 2.3 points of GDP is the result of simulations on institutional variables.
- In EMEs, the tax gap was estimated at 5.0 percent of GDP.
- Tax potential estimations are empirically derived using stochastic frontier analysis

Turning the tide: VAT remains a key source of revenue

VAT Revenue, percent of GDP



C- Efficiency Scores



Source: IMF staff based on WoRLD database (2022).

Reduced VAT rates and exemptions are poorly targeted as distributional devices

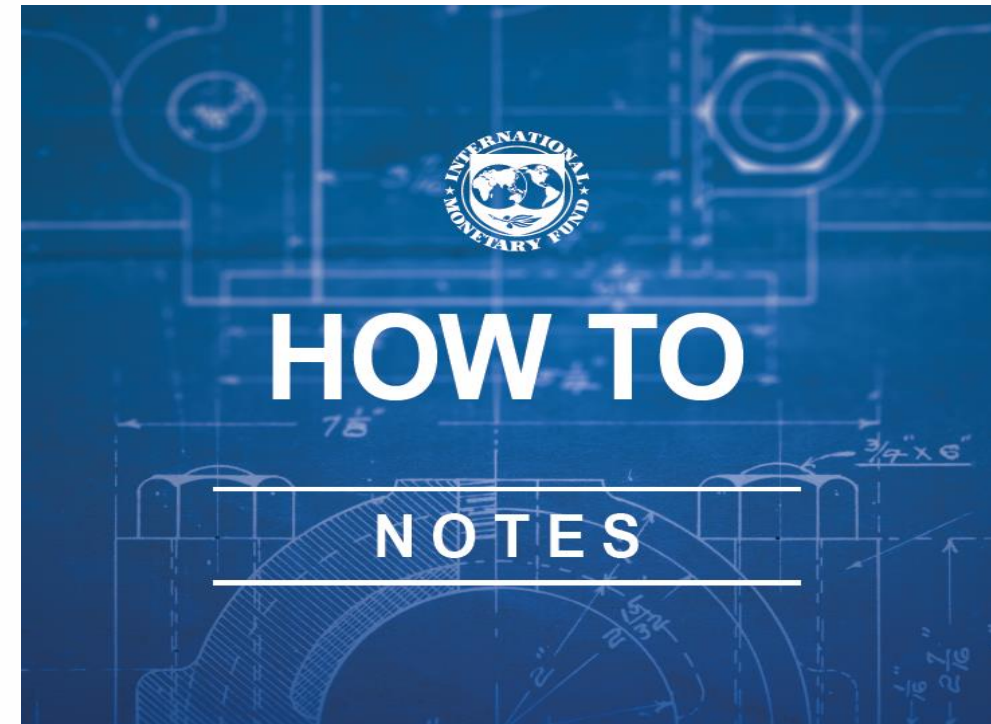
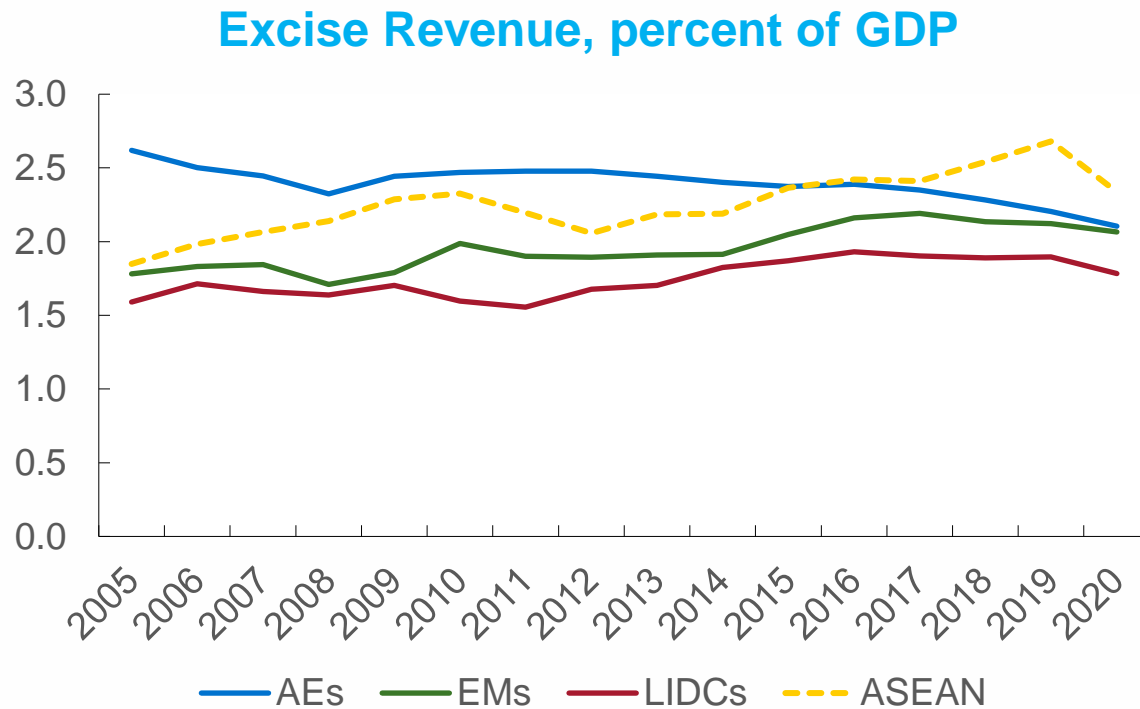
Distribution of VAT exemptions and differentiated rates

| Country | Quintile | | | | | Total |
|-------------------------------------|----------|------|------|------|------|-------|
| | 1 | 2 | 3 | 4 | 5 | |
| Differentiated Rates | | | | | | |
| 20 OECD countries | 13.5 | 17.3 | 20.0 | 22.5 | 26.7 | 100.0 |
| Exemptions and Differentiated Rates | | | | | | |
| Honduras | 7.3 | 12.4 | 17.1 | 22.5 | 40.7 | 100.0 |
| Nicaragua | 4.0 | 7.0 | 10.2 | 23.7 | 55.1 | 100.0 |
| Colombia | 5.6 | 9.2 | 13.3 | 21.0 | 50.9 | 100.0 |
| Dominican Rep. | 10.3 | 14.1 | 16.8 | 21.8 | 37.0 | 100.0 |
| Mexico | 10.8 | 17.2 | 21 | 23.1 | 27.9 | 100.0 |
| South Korea | 6.3 | 13.8 | 20.2 | 25.7 | 33.9 | 100.0 |
| Morocco | 14.5 | 12.0 | 15.0 | 19.7 | 38.8 | 100.0 |
| Tunisia | 7.9 | 12.7 | 17.0 | 23.2 | 39.2 | 100.0 |

Source: Benítez and Fenochietto (2021), based on OECD (2014); Honduras: IMF based on the household survey of 1998. Nicaragua, IMF based on household survey of 2006-2007. Colombia, IMF, based on data from DIAN 2006. Dominican Republic, E. Morales. OECD-LAC Tax Policy Forum Presentation , September 2010. South Korea: Park and Jung (2014); Morocco, Fouzi Mourji (2011); Tunisia, Mansour (2015); and, Mexico SHCP (2016) (includes only the zero rate on basic foods).

- VAT and inequality reduction need to be seen in the context of the overall tax and spending system.
- Advances in digitalization are offering ways to temper the regressivity of the VAT

Excises can be more effective in raising revenue and addressing externalities



How to Design Excise Taxes on Alcoholic Beverages

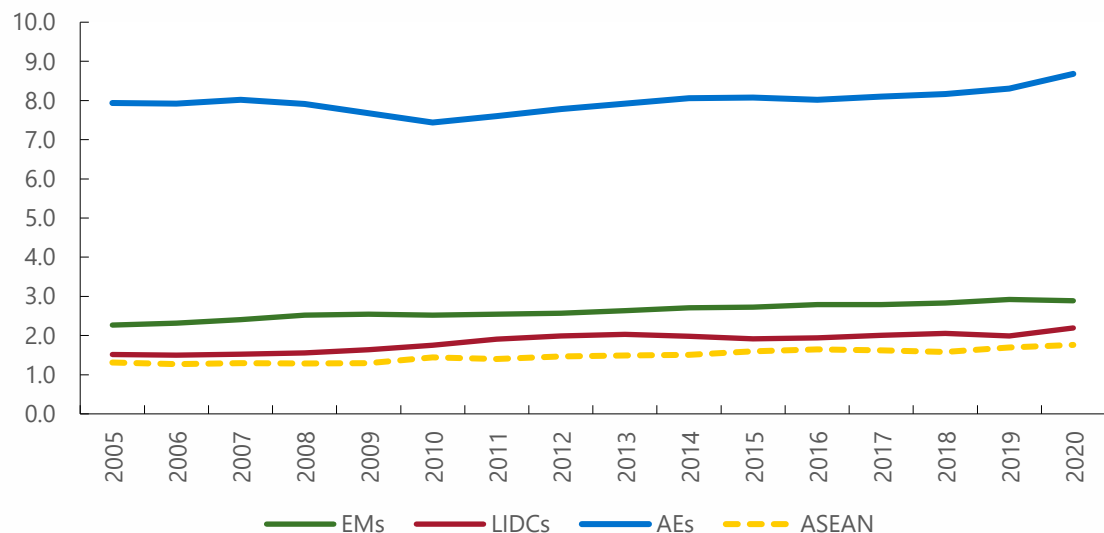
Source: IMF staff based on WoRLD database (2022).

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The revenue and redistributive goals of the PIT remain modest in LIDCs and EMs

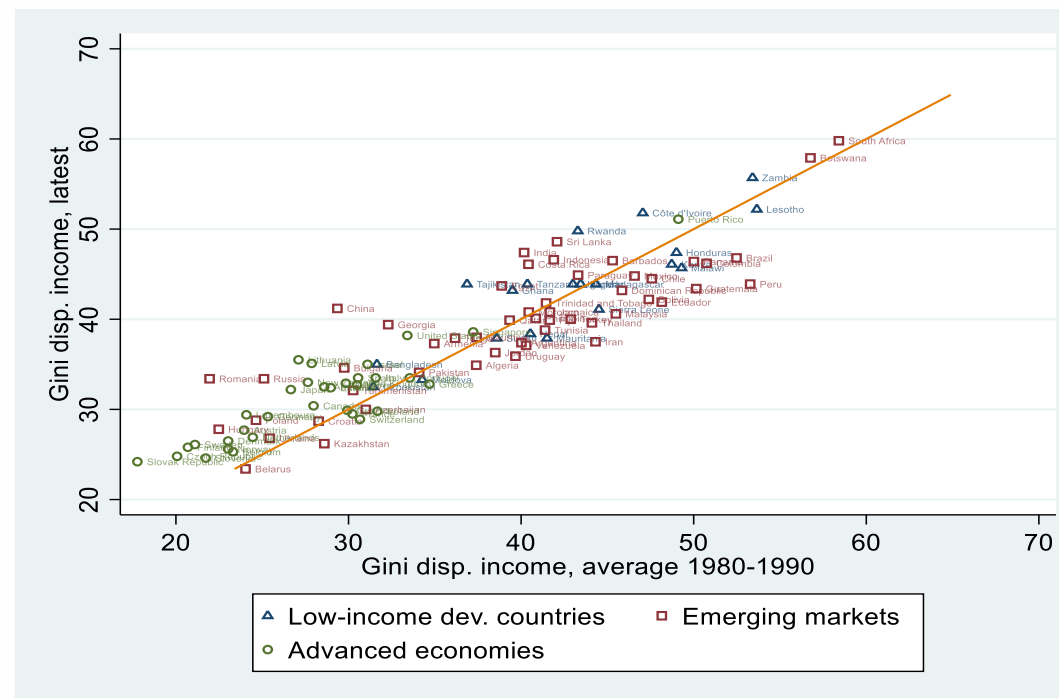
Personal income tax revenue continues to grow, but design features as high thresholds continue to affect its revenue potential

PIT revenue, percent of GDP



Source: IMF staff based on WoRLD database (2022).

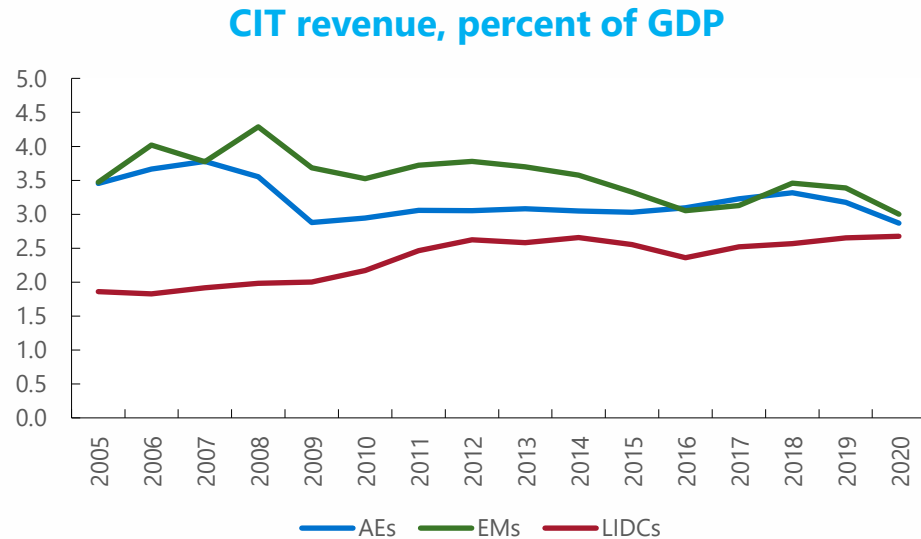
Changes in disposable income inequality 1980-1990 vis-à-vis 2020



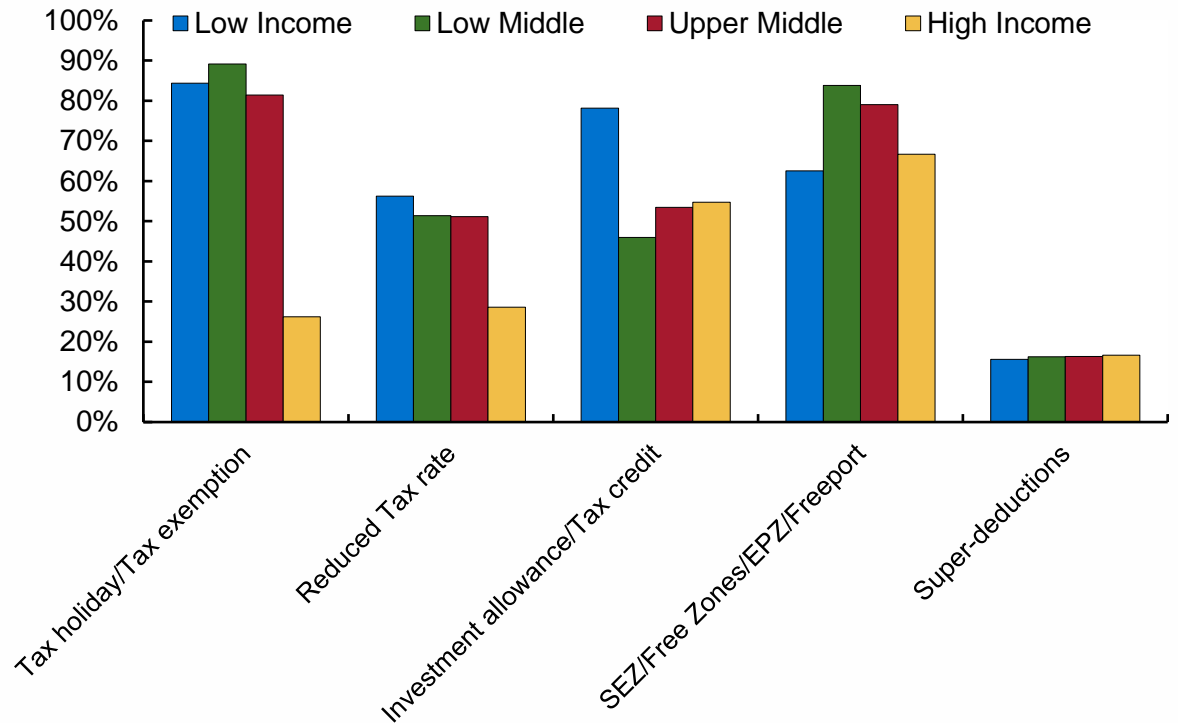
Source: Benedek, Benitez and Vellutini (2022).

CIT is an important source of revenue, but pervasive exemptions are costly

In contrast to other taxes LIDCs and EMs exhibit a smaller revenue gap relative to AEs



But incentives and exemptions are ubiquitous



Source: IMF staff based on WoRLD database (2022).

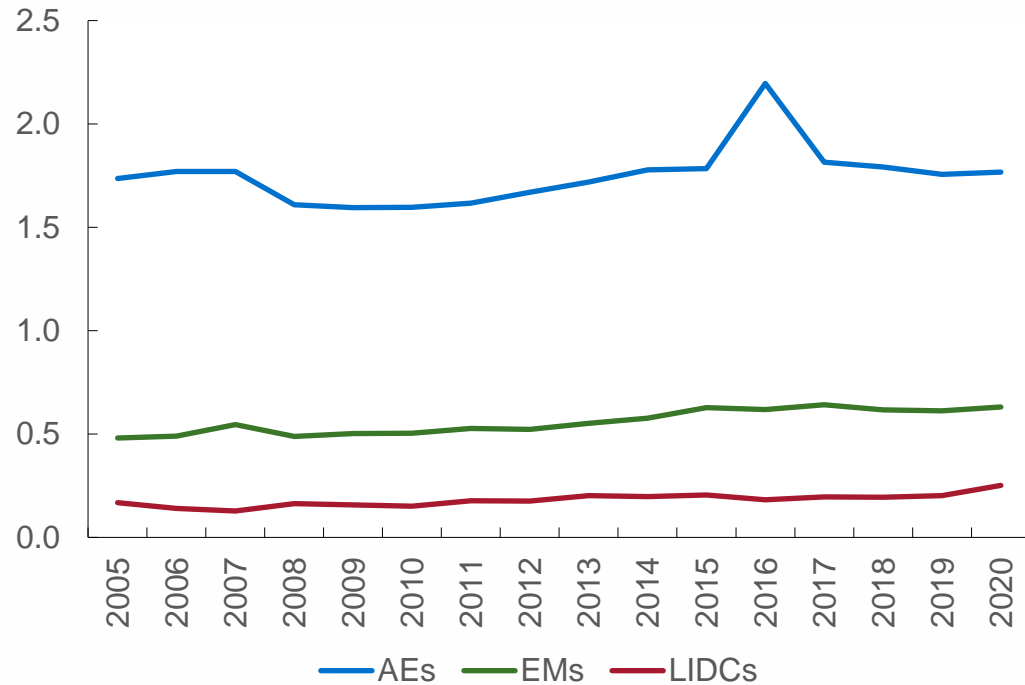
Source: PCT(2015)

Property taxes are untapped potential

Property taxes can be effective at enhancing progressivity

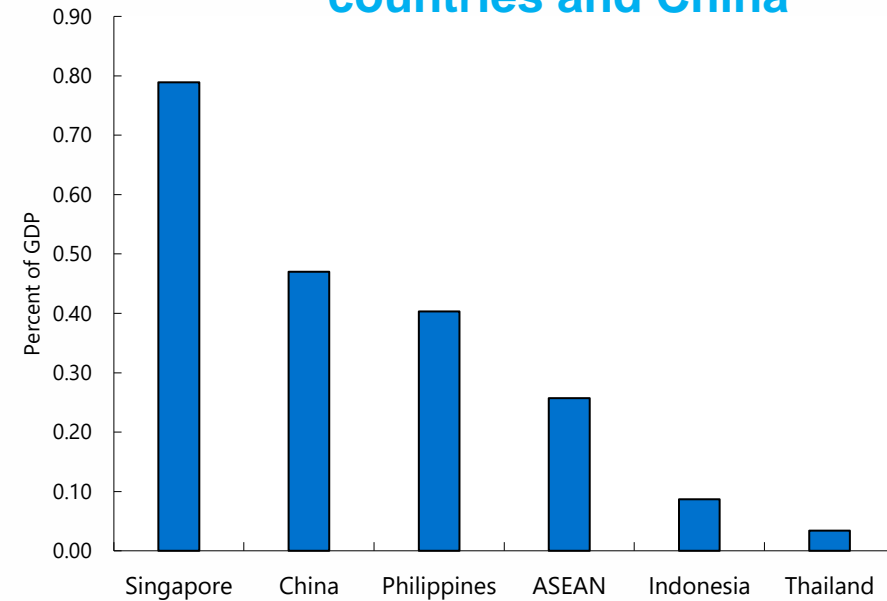
Easy to collect but require upfront investments to set up the appropriate administrative infrastructure.

Property taxes, percent of GDP



Source: IMF staff based on WoRLD database (2022).

Property tax revenue in selected ASEAN countries and China



Source: IMF staff based on OECD global revenue statistics.

With taxation called upon to achieve multiple objectives, quality of taxation becomes an increasing concern to citizens and policymakers

▶ Efficiency

- ◆ Minimize distortions and disincentives to work and invest
- ◆ Address externalities—both negative (e.g., climate) and positive (e.g., R&D)

▶ Equity

- ◆ Increase progressivity of taxation and improve redistributive capacity through design as well as administration—e.g., compliance enforcement on top earners

▶ Tax certainty

- ◆ Predictability of tax outcomes—also lowers compliance and administration costs

▶ A balancing act

- ◆ A broader perspective on taxing and spending can be more effective in balancing equity/efficiency/certainty
- ◆ This is especially the case in low-income countries, where consumption taxes can be more efficient and easier to collect income/wealth taxes are low relative to consumption taxes

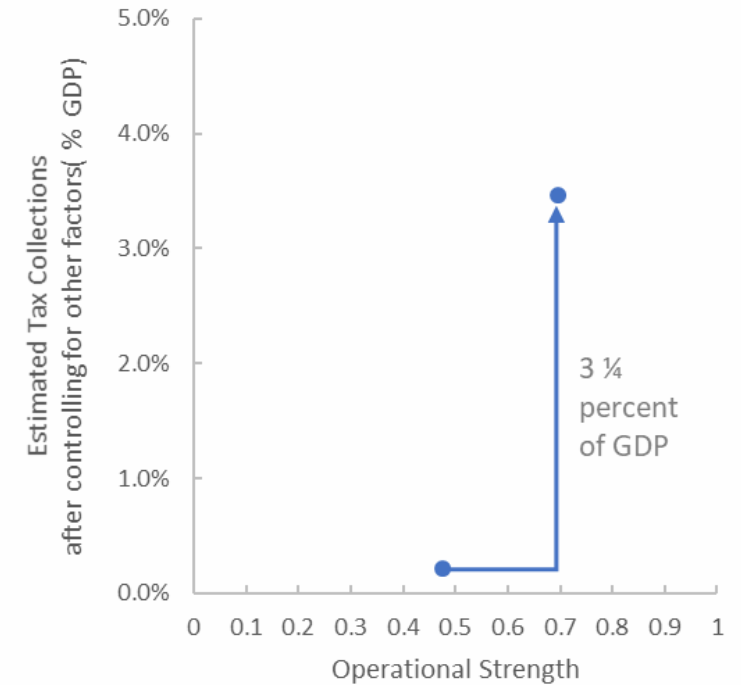
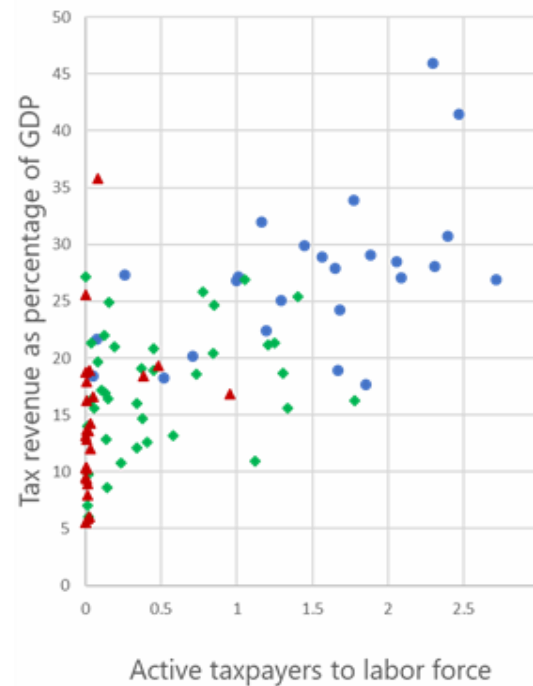
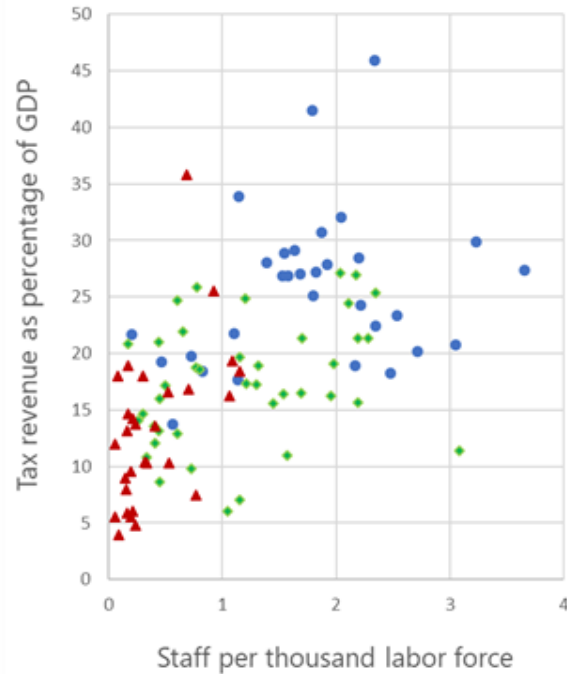
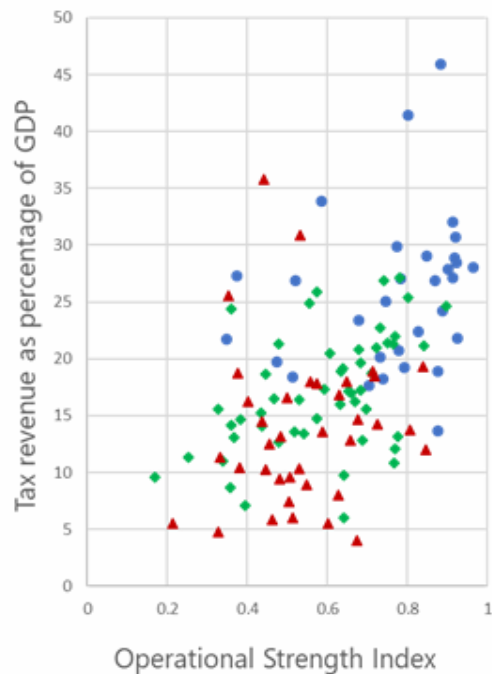
The role of tax institutions: tax policy units provide holistic and cross-cutting analyses

- Policy design starts with good data, proper analysis and forecasting, and capacity to lead a public debate based on analytical results
- Institutionalizing tax policy units to support fiscal policy management can:
 - ▶ Inform policy choices by ex-ante analysis, monitoring and ex-post evaluation,
 - ▶ and address more effectively the increasing cross-cutting nature of tax analysis-- e.g., climate, industrial policy, health policy
- Over the past decade, at least **17 EMEs and LIDCs institutionalized tax policy units.**

Tax capacity – focus on revenue and customs' administrations

Growing tax revenue through building revenue administration capacity

- Advanced Economies
- Emerging Markets
- Low Income Developing Countries



Countries with a stronger tax operational capacity collect more tax, after controlling for tax policy and macro-economic factors

Source: IMF Working Paper WP/20/142, using ISORA data

Administrative reform vs policy choices?

- When mobilizing additional revenue, the choice between improvements in tax administration practices or interventions and policy changes is important, and likely deserves more attention than given.
- In countries where there is low capacity and low compliance, more revenue would likely be realized with increased administrative capacity. Increased capacity would then permit improved impact of tax policy changes.
- Consider this example: Country X has very low filing and payment compliance and therefore an increase in the rate of VAT will likely result in marginal returns. An investment in administrative capacity to increase filing and payment compliance would increase revenues, and ensure that future rate increases lead to expected revenues.

Leveraging tax and customs collaboration to strengthen compliance

- Strengthening cooperation between tax and customs administrations could leverage data use and improve efficiency and effectiveness in revenue collection.
- With appropriate governance and management arrangements, separate revenue agencies can work cooperatively.
- Non-compliance in customs may signal tax non-compliance, and vice-versa. There are several strategies to improve detection.
- Of the 166 countries that provided data to the 2021 International Survey on Revenue Administration (ISORA), 40 percent have integrated tax and customs administration (34 percent of LIDCs, 44 percent of AEs). Even with organization integration there is significant opportunity to improve sharing.

The case for sharing: customs-tax sharing contributes to better revenue integrity



Revenue Identification & Recovery

Improved sharing will result in revenue identification and improved recovery



Process & Control Improvement

Permits an increase in effectiveness of processes and closes control gaps across the organization



Compliance Adherence

Enables better line of sight and increased assurance to regulation and policies

Effective tax administration includes

- Operating at arm's length to reduce opportunities for rent-seeking behavior.
- Autonomy, but accountability, and transparency to build and maintain public trust in a fair tax system.
- Effective oversight, including internal and external auditing.
- A strong focus on maximizing voluntary compliance with an integrated, approach combining preventive, detective, and corrective actions.
- Robust taxpayer service strategies that include measures to lower compliance costs.

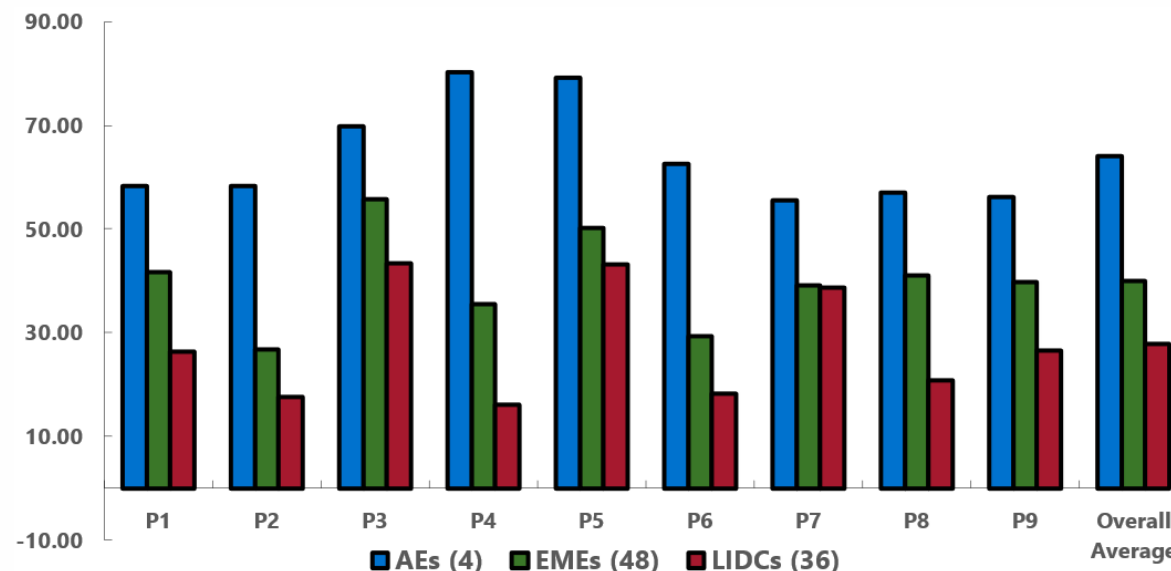
Improved Compliance Risk Management

- Categorizing the taxpayer population in segments with similar characteristics and organizing the tax administration around these segments can contribute positively to managing compliance risk.
- Segmentation by size, profitability, income level, etc., is a key element of a broader compliance risk management, which promotes taxpayer services tailored to a set of common characteristics and enforcement actions targeted to taxpayers who are the most likely to be non-compliant.
- The key to managing compliance is robust risk assessment, and an overall approach to managing files in a holistic way.

The role of tax institutions: modernizing and digitalizing revenue administrations

- ▶ Well-funded, well managed, and autonomous revenue administrations are central to tax capacity
- ▶ Digitalizing is critical for regular functions (e.g., compliance risk management) and future challenges
- ▶ Digital adoption in revenue administrations is associated with a reduction in VAT compliance gaps

LIDCs lag, in some cases significantly, on key characteristics of effective revenue administrations



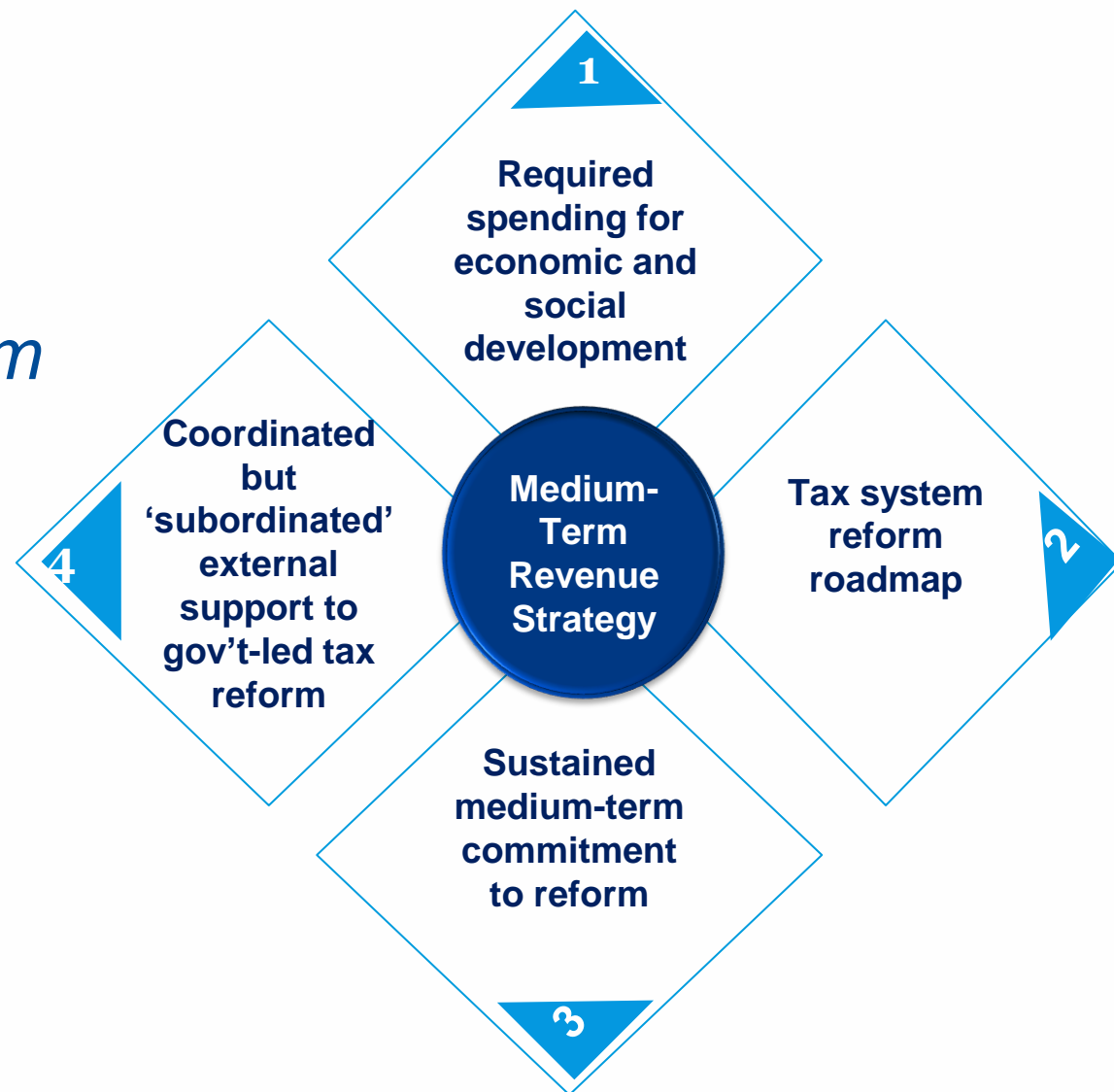
Source: IMF staff calculations based on reports provided by the TADAT secretariat.
P1: Integrity of the Registered Taxpayer Base; P2: Effective Risk Management; P3: Supporting Voluntary Compliance; P4: Timely Filing of Tax Declarations; P5: Timely Payment of Taxes; P6: Accurate Reporting in Declarations; P7: Effective Tax Dispute Resolution; P8: Efficient Revenue Administration; P9: Accountability and Transparency.

The role of tax institutions: a sound legal framework for taxation

- Simple and effective tax legislation requires expertise and attention to legal framework design
- Needs to balance simplicity and comprehensiveness, while keeping the framework **stable and transparent**
- Legal framework is a key component of **tax certainty**, which can impact economic growth

Improving taxation with MTRS

A comprehensive strategy—a Medium-Term Revenue Strategy (MTRS)—can help identify tax reform measures and facilitate their implementation.



Takeaways

- **LIDCs need significant additional revenue** to pursue SDGs, ensure debt sustainability, and finance other priorities
- There is **scope to increase tax capacity in LIDCs**, centering on reforms of core domestic taxes and improving revenue administrations' performance
 - ▶ At about 13.3 percent of GDP on average, tax revenues (excluding SSCs) in LIDCs are well below their estimated **22.2 percent potential**
 - ▶ Quality of tax systems matters—administrative simplicity, legal certainty, transparency, equity and efficiency
- Tax capacity development should increasingly focus on **building fiscal institutions**
- **A holistic approach** to building tax capacity, such as MTRSs, could facilitate coordination across institutions, and achieve a better balance between revenue and other objectives

THANK YOU