

Strengthening the capacities of tax administration to raise  
domestic resource mobilization (DRM) in partner countries:

Draft Proposal from Pillar IV



## **Strengthening the capacities of tax administration to raise domestic resource mobilization (DRM) in partner countries**

### **DRAFT**

The importance of domestic resource mobilization (DRM) in providing stable and predictable finance for sustainable growth and poverty reduction has been widely recognized. Also, the governance aspect of DRM and its importance for state building and the citizen-state-relationship is by now well known. The political awareness and visibility of DRM has been further increased in the context of the latest G8 and G20 presidencies, which placed special emphasis on tax issues.

Despite these developments, domestic resource mobilization remains a challenge for many governments. Especially low-income countries suffer from low tax ratios, high levels of capital flight as well as little transparent and inefficient tax systems with low capacities to collect revenues. The taxation of multinational enterprises poses additional challenges for developing countries' tax systems as does the taxation of extractive industries.

The ability of tax administrations in developing countries to mobilize revenues is limited by a number of factors, such as the lack of financial and material resources, poorly qualified and trained staff, highly ineffective procedures and corrupt practices.

Evidence suggests that international assistance can be a powerful catalyst and leverage for domestic resource mobilization and that it can play an important role in building sustainable national revenue systems in developing countries.

This input paper is based on the German experience in supporting tax reform in developing and transition countries. German Development Cooperation considers DRM as an objective within a wider framework of "Good Financial Governance" - which considers aspects of good governance as well as the political economy and favours an integrated approach which includes tax policy and administration as well as budget reform, accountability and control mechanisms.

The paper is written by the German Federal Ministry of Economic Cooperation and Development as member of the Effective Institutions Platform (EIP) and serves as a EIP proposal for the Global Partnership High Level Meeting.

Comments on this draft are very welcome.

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## **Proven strategies to strengthen capacities of tax administrations**

Even though many developing countries face similar challenges in mobilising domestic revenues, a one-size-fits-all approach to strengthening tax administration does not exist. In order to be successful, reform programmes need to be customised to fit the economic, structural, cultural, and political conditions in a country.

### **1) Holistic and systemic approach**

- Tax reform cannot be limited to strengthening tax administration alone, as transparent, fair and efficient tax systems do not only require efficient, citizen-oriented tax administrations but also equitable, efficient and sustainable tax policies.
- Tax reform should take into account linkages between the revenue and the expenditure side as there should be a balance between revenue collected from taxpayers and the public services that citizens expect. Transparent and efficient budget systems, for instance, will ensure that the spending of collected revenues is planned and managed in an effective and efficient way, while efficient financial control helps account for the use of funds and the results achieved.
- Broader governance reforms can contribute to influencing citizen's attitudes to the quality of governance and value for money in paying taxes. Supporting institutions and organisations outside the revenue system, such as the justice system, Parliament, and civil society can help address linkages between taxation and governance.
- In countries with decentralized government structures, responsibilities and revenue sources available to sub-national governments have to be taken into account.
- Effective coordination of donor support plays an important role in ensuring a holistic approach to tax reform.

### **2) Taxation and governance**

- The objective of tax reform should not be limited to improve revenue collection, efficiency or growth. Rather, those considerations have to be balanced with broader objectives of sustainable development as well as social and governance objectives.
- Taxation occupies a central role in building states and shaping their ties and accountability to society. Transparent, fair and efficient tax systems contribute to strengthening state accountability and legitimacy for public action as well as to promoting the identification of the citizens with the state.
- Both tax policy and tax administration are necessary to establish transparent, fair and efficient tax systems:

Tax policies need to be transparent and accountable and to lend themselves to public and civil society scrutiny. They should ensure predictability and equity of taxes in order to reduce opportunistic tax avoidance and possibly evasion. Tax policy design must always take into account the administrative dimension of taxation.

Tax administration needs to work efficiently in accordance with the rule of law. Transparency in tax administration contributes to reducing corruption. Transparent and comprehensible tax procedures as well as the provision of quality service helps build taxpayers' acceptance and strengthen the legitimacy of the state. Participation of businesses and civil society fosters the policy dialogue on domestic resource mobilisation and build broad coalitions for reform.

### 3) Political Economy of tax reform

- For tax reform to be successful, the political economy dimensions in a country have to be taken into account, such as formal and informal rules, interest and incentives of the different actors in the system, power structures in and of organisations, available resources, as well as processes and procedures within institutions. This will help avoid constraints to tax reform and develop reform alliances.
- Political economy analysis helps determine constraints to reform and identify opportunities for change.
- Ownership, political will as well as political steering capacity are essential preconditions for effective and lasting reforms.
- Successful tax administration reform requires a clear and comprehensive reform strategy and effective management of the reform process. Effective internal and external communication facilitates effective stakeholder involvement and reform ownership of tax administration staff. Timing and sequencing of reform activities are equally important.

### 4) Capacity development in tax administration

- Tax administration reform in developing countries generally entails organizational and institutional as well as human resource development.
- Typical strategies for organisational reform include the establishment of a unified tax administration organized on a functional basis and the introduction of risk management through the adoption of segmentation in taxpayer services and audit programs.
- Reform measures to improve performance of tax administration often include adopting a taxpayer identification number, introducing self-assessment procedures and strengthening tax audit.
- Measures to strengthen voluntary compliance include improving taxpayer services and ensuring consistency and fairness. Simplifying the tax system and streamlining compliance procedures reduce taxpayers' compliance costs. Voluntary compliance is also fostered by transparency and integrity of tax administration.
- For tax administration to work effectively, it has to be provided with adequate resources in terms of salaries and equipment.
- Human resource management has to provide attractive and motivating work conditions as well as clear career opportunities and competitive pay scales. Staff qualification and training have to be based on systemic needs analysis.
- The automation of tax administration can increase efficiency by standardizing procedures, lower corruption by reducing discretion and interfaces between tax payers and tax officials as well as reduce tax evasion. The development and introduction of IT-systems needs to be accompanied by comprehensive reorganisations of administration procedures as well as intensive training and capacity building for tax officials.
- The increasing globalisation of the national economies poses new challenges for tax administrations: The taxation of multinational enterprises and international tax evasion requires additional capacities of tax administrations on international tax policy, transfer pricing and exchange of information.
- Additional sector-specific capacities are needed to effectively tax extractive industries.

### **Recommendations for donors and partner countries**

- Adapt tax reform programmes to the economic, structural, cultural, and political conditions in a country.
- Adopt a holistic approach to tax reform and take into account linkages between the revenue and the expenditure side and between national and sub-national level. Consider supporting institutions and organisations outside the revenue system, such as the justice system, Parliament, and civil society to further address linkages between taxation and governance.
- Take into account governance aspects such as accountability, transparency or participation. Do not limit the objective of tax reform to revenue or efficiency gains.
- Base tax reform on comprehensive analysis to identify capacity constraints and needs. Use political economy analysis to determine opportunities for change.
- Ensure national ownership of the development process. Strengthen countries' capacity to exercise leadership. Foster tax dialogue with civil society and include tax education activities in tax reform programmes.
- Strengthen change management capacities. Pay attention to the timing and sequencing of reform activities. Provide for up-scaling successful pilot projects in the programme design.
- Involve a broad range of stakeholders to increase acceptance of reform. Foster public-private dialogue with businesses and civil society.
- Complement organisational and institutional reform activities with comprehensive staff qualification and training.
- Enable developing countries to benefit from international tax cooperation, e.g. by supporting them to be able to use data provided by exchange of information.
- Offer support for institutional, organisational and human resource development in the field of natural resource taxation.
- Coordinate with other donors according to the Paris Declaration commitments. Follow the aid effectiveness principles and commitments, including division of labour and the use and strengthening of partner systems.
- Combine different aid modalities (short-/long-term support, financial / technical cooperation, bilateral / multilateral cooperation, cooperation with international networks, platforms and NGOs). Ensure coherence and coordination across modalities.
- Foster South-South cooperation. Support the regional networks of tax administrations such as ATAF or CIAT to promote regional exchange of experience.
- Make DRM part of policy dialogue.