A Contribution to the Third Financing for Development Conference in Addis Ababa

Discussion Paper
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In order to implement the Post-2015 Agenda, governments will have the lead role in mobilising domestic revenues, providing the right mix of public goods and services – particularly investment in human capital, infrastructure, social protection and safety nets – and creating an enabling environment for broad participation. Despite sustained growth rates and abundant natural resources, many developing countries have not been able to increase their fiscal space to step up expenditures in a sustainable manner and achieve development goals. The reasons for this shortcoming are multiple and complex. In response, development partners including the EU have joined forces and proposed the Addis Tax Initiative to support developing countries to overcome these challenges.

‘Collect More – Spend Better’ aims to contribute to the domestic public finance discussions in the context of the 2015 Financing for Development (FFD) conference and the Post-2015 Agenda. A key message emerging from the lead-up to Addis Ababa is that domestic public finance should be at the heart of all countries’ efforts to increase their fiscal space to successfully implement global agreements, such as the Sustainable Development Goals (SDGs) and to achieve the overriding objectives of inclusive growth, poverty eradication and sustainable development.

The discussion paper has to be seen in the broader context of the EU support to developing countries to increase domestic revenue mobilisation (DRM) and use financial resources more effectively. The paper follows the messages in the EU “Programme on Global Public Goods and Challenges”, and will contribute to identifying the framework of the two proposed EU flagships: the EU Resource Transparency Initiative (EURTI) and the Domestic Revenue Mobilisation Initiative (DRMI).
‘Collect More – Spend Better’ does not aim to tell developing countries to increase the tax burden on the poor but rather to explain what the international community can do to support developing countries’ efforts to improve their tax systems and to benefit more from their domestic resources.

The paper explores ways to expand fiscal space and proposes support to developing countries in three critical areas: i) improved domestic revenue mobilisation, ii) more effective and efficient public expenditures and iii) debt management. It first defines the challenges faced by developing countries to improve their fiscal space, then lays out an approach addressing them, and finally outlines ways to assist developing countries in tackling these challenges.

2. WHY ‘COLLECT MORE AND SPEND BETTER’?

‘Collect More’ discusses closing the tax policy gap and tax compliance gap with a particular focus on tax evasion, tax avoidance, and illicit financial flows. The latter three have a major negative impact on the amount of domestic revenues. According to Global Financial Integrity, the ratio of illicit financial flows-to-GDP was on average 3.9% for all developing countries during the period 2003-2012. Sub-Saharan Africa had the highest ratio of illicit financial flows-to-GDP (5.5%) of any region 2003-2012. Although entitled ‘Collect More’, it goes beyond the important but often superficial tax-to-GDP ratio discussion and focuses on the efficiency, effectiveness, fairness and transparency of the tax systems at the national and international levels.

‘Spend Better’ comprises equally relevant aspects of domestic public finance. Public expenditure management is the critical ‘throughput’ process, which, if properly executed, should lead to an efficient and effective transformation of revenues into public goods and services. The distributional aspects of taxation can only be meaningfully assessed in conjunction with public expenditures. This way of thinking about domestic public finance is based on the three main “deliverables” of a sound PFM system: i) aggregate fiscal discipline, ii) the strategic allocation of resources and iii) efficient and effective resource use. This paper focuses on the third deliverable, efficient and effective resource use.

All in all, ‘Collect More’ and ‘Spend Better’ are two sides of the same process to deliver the SDGs in a sustainable manner. The EU has a long-standing record in supporting developing countries in collecting more and spending better, particularly with its budget support programmes in more than 80 countries. In addition, EU direct support to domestic public finance reforms in developing countries amounts to EUR 140 million annually.

2.1 COLLECT MORE – CLOSING THE DUAL TAX GAP TO INCREASE DRM

Domestic revenue mobilisation is by far the most important dimension. On average, developing countries raise less than 20% of GDP in taxes compared to 30-45% of GDP in taxes in OECD countries. Around half of all low income and lower middle income countries (LICs and LMICs respectively) still have tax-to-GDP ratios below 15%. Studies comparing tax effort – the actual tax-to-GDP ratio of a country with a potential tax-to-GDP capacity based on the country’s economy – suggest there is considerable room to improve the tax effort in many developing countries. An IMF working paper estimates that average tax effort is about 65% of tax capacity in developing countries; some countries could increase revenue collection by 25 to 50% in the medium to long term.
The ‘Collect More’ pillar is based on two concepts:

- **Closing the tax policy gap** between the tax due under an optimal tax policy and the tax due under current tax policy. The focus is on tax policies to broaden the tax base where appropriate, close loopholes and fight tax avoidance.

- **Closing the tax compliance gap** between the tax due under the current tax policy and the tax actually collected. The focus is on improving the efficiency and effectiveness of tax administration, reinforcing voluntary tax compliance and good tax governance, and fighting tax evasion and illicit financial flows.

Closing the dual tax gap requires understanding its causes and implies a sequenced approach to address policy and capacity constraints. This comprehensive approach to tax policy reforms and tax administration capacity building emphasises: i) a better understanding of the political economy and policy implications of tax reforms; ii) tackling capacity constraints undermining tax administration performance; iii) addressing tax avoidance, tax evasion and illicit financial flows; and iv) addressing the international governance dimensions of taxation and development, including the setting of international tax standards. Closing the dual tax gap expands fiscal space in a sustainable manner, building fiscal resilience against external economic shocks and aid fluctuations.

**i) International Drivers of the Dual Tax Gap**

The two main international drivers of the dual tax gap are illicit financial flows and harmful tax competition between countries.

Global Financial Integrity estimates that corporate tax evasion makes up 60% to 65% of illicit financial flows. The role of national revenue systems in tackling illicit financial flows is more difficult with the increasing international mobility of taxpayers, the globalisation of economic activities, high volumes of trade and capital flows, new technologies, non-cooperative tax jurisdictions, and aggressive tax planning, including abusive transfer pricing and trade misinvoicing practices of multinational enterprises (MNEs). Illicit financial flows transcend national borders and affect a multitude of countries.

Tax competition creates spillover effects that arise from the interactions of national tax policies. The potential economic impact of international spillover effects goes well beyond tax revenues, with wider implications for the distribution of welfare across nations. Developing countries, particularly LICs and LMICs, are badly affected, as corporate income tax is a higher share of total tax revenues in LICs and LMICs (16%) compared to developed countries (8%). Estimated spillover effects imply large revenue losses for developing countries, and require better international tax governance and cooperation.

Those issues are all the more important when they concern the natural resource sector. Revenues from extractive industries (oil, gas, mining and forestry) have major macroeconomic and fiscal implications, since they account for over half of government revenue in petroleum-rich countries and for over 20% in mining countries. Many natural resource-rich countries have adopted special fiscal regimes, which create complex policy and administrative challenges and stretch the capacity of tax administrations to manage them.

**ii) Domestic Drivers of the Dual Tax Gap**

Less visible in the international debate but also very important is the domestic component of tax policy and compliance gaps. Reducing these ‘internal gaps’ requires overcoming three kinds of difficulties:

**Political constraints** – As in all countries, special interest groups lobby governments and tax administrations to obtain...
tax incentives favourable treatment. Transparency and strong political backing are necessary to design and implement fair tax rules.

**Administrative constraints** – Tax administrations in developing countries can face capacity constraints, lose skilled personnel to international organisations and private sector firms, lack tax collection infrastructure, and have difficulties adapting to the taxation challenges of globalization and technological development.

**Economic constraints** – Developing countries typically have a narrow tax base, a large proportion of the population living in poverty, a large portion of their economic activity in the informal and agricultural sectors, heavy dependence on natural resources as well as tax rules that grant poorly-motivated tax incentives to investors.

Particularly important in explaining the tax policy gap is the large amount of potential tax revenues that are given away by governments in the form of tax incentives. The use of tax incentives is widespread in developing and developed countries. When well designed, tax incentives may serve useful social and economic purposes, if the benefits they generate exceed the associated costs in tax expenditures. However, quite often those incentives are poorly designed, ineffective, inefficient and linked with abuse and corruption.

More broadly, low tax morale can be an important factor in the domestic dimension of tax compliance. In some developing countries, the VAT compliance gap is about 50-60% of the potential VAT.

### 2.2 SPEND BETTER – IMPROVING THE EFFECTIVENESS AND EFFICIENCY OF PUBLIC SPENDING

Good public expenditure management – improving the efficiency, transparency and accountability of public expenditure – increases fiscal space in the same way as receiving additional resources: the government can provide more and better public goods and services with the same amount of financial resources, if it uses its resources more effectively. Four areas deserve particular attention: subsidy programmes, public investment, public procurement and debt.

Many subsidy programmes are ineffective in that they cost a lot while delivering limited benefits to deserving target groups, particularly compared with well targeted safety net programmes. Some subsidies need a substantial rethinking of their purpose in terms of economic and social objectives. For example, a recent IMF working paper estimates energy subsidies cost 6.5% of global GDP in 2013, more than global public spending on health and education (6% and 5% of global GDP respectively). Now is the right time to address this issue, as oil prices are going down and renewable energy would be more viable.

**Public investment** in social and physical infrastructure is important for inclusive growth, social development and poverty eradication as well as for attracting foreign direct investment (FDI). Low returns to public investment arise from poor planning, allocation and implementation of projects due to limited information, waste and leakage of resources, and weak technical expertise and institutional capacity. The average inefficiency in public investment across countries is estimated at around 30%, measured by comparing the value of public capital to infrastructure coverage and quality. The country with the most efficient public investment gets more than twice the economic return of the country with the least efficient public investment.

**Public procurement** represents an estimated 15%-28% of countries’ GDP, i.e. about 50% of public expenditure. Because of the significance of these expenses in the GDP, public procurement has important policy implications in improving public expenditure efficiency and offering considerable business opportunities to the private sector as well as attracting FDI.

**Borrowing** is a way of leveraging public resources to increase fiscal space. Increasing public investment by contracting debt in a sustainable manner requires a strong emphasis on the quality of public investment and sound debt management.
3. A CALL FOR GLOBAL ACTION

The call for global action will cover the national and international dimensions of domestic public finance based on mutual accountability, shared responsibility, fairness and solidarity. The call starts from two principles: **Leading by example** focuses on national regulations and their spillover effects on other countries; **Global partnerships** address the international dimension of tax governance and domestic public finance, fight against tax evasion, tax avoidance and illicit financial flows, and promote an international environment that is efficient, effective, fair and transparent.

3.1 TOWARDS GOOD NATIONAL TAX GOVERNANCE – LEADING BY EXAMPLE

The EU has consistently shown leadership in good governance in tax matters and promoted the principles of transparency, exchange of information, and fair tax competition that are now gaining traction worldwide. This has put the EU at the forefront in improving tax governance within its own borders and given the EU a leading role in pushing for an ambitious global agenda. Major improvements have been made in tax governance in the EU internal market while taking into account implications for third countries.

The EU intends to continue its reforms to foster good governance in tax matters and to fight tax evasion and tax avoidance in the EU internal market and internationally. The EU therefore presented a package of tax transparency measures as part of its ambitious agenda to tackle corporate tax avoidance and harmful tax competition in the EU. It aims to ensure that Member States are equipped with the information they need to protect their tax bases and effectively target companies that try to avoid paying their fair share of taxes.

With these initiatives, the EU not only leads by example; it also creates positive spillover effects for other countries and regions.

3.2 TOWARDS GOOD INTERNATIONAL TAX GOVERNANCE – A GLOBAL PARTNERSHIP

With the 2010 EU communication “Tax and Development – Cooperating with Developing Countries on Promoting Good Governance in Tax Matters,” the EU has laid out the basis for its DRM support to developing countries. The communication focused specifically on the synergies between tax and development policies and on suggesting ways in which the EU could assist developing countries in building efficient, fair and sustainable tax systems. The EU is engaged in global partnerships with UN, G20, OECD, IMF, World Bank and other international and bilateral partners to support developing countries in strengthening their tax policies and administration.

The EU actively supports developing countries and regional bodies, such as the African Tax Administration Forum (ATAF) and the Inter American Center of Tax Administrations (CIAT), to participate and increase their “voice” in international discussions and standard setting processes, including in the Global Forum on Transparency and Exchange of Information for Tax Purposes and in the G20/OECD Base Erosion Profit Shifting (BEPS) Initiative.

The EU has also been active in its cooperation on transfer pricing, working closely with the UN Committee of Experts on International Cooperation in Tax Matters on the establishment of a United Nations Practical Manual on Transfer Pricing for Developing Countries and launching a Tripartite Partnership with the World Bank and OECD to support developing countries in their efforts to set up transfer pricing regimes.
Promoting better governance in extractive industries has become a priority for the EU. The EU approach combines a series of regulatory and voluntary measures aimed at increasing transparency, enhancing government accountability and fighting corruption. The disclosure requirements of the Accounting Directive and the Transparency Directive, including Country-by-Country Reporting will have a series of benefits at international level and will enhance other EU supported initiatives such as the Extractive Industry Transparency Initiative (EITI).

### 3.3 ADDIS AND BEYOND

Implementing the Post-2015 Agenda requires an international tax environment that promotes efficient, effective, transparent and fair taxation. All countries need to cooperate on an ambitious agenda to create such an environment. A future agenda could include the following overall objectives:

i) **‘Collect more’**: Close the tax policy gap and tax compliance gap by increasing the efficiency, effectiveness, fairness and transparency of DRM and by tackling tax avoidance, tax evasion and illicit financial flows;

ii) **‘Spend better’**: Improve the efficiency and effectiveness of public spending by addressing public investment expenditures, public procurement and debt management.

Progress in the achievement of these objectives can be measured by using international assessment tools, such as PEFA, TADAT, RA-GAP (see annex 3).

A future common agenda could be based on the following key elements:

- Promoting the principles of good tax governance at national and international level;
- Developing international standards and action plans to avoid base erosion and profit shifting and to improve exchange of tax information;
- Strengthening transfer pricing legislative and regulatory frameworks;
- Strengthening capacity building in tax policy and tax administration;
- Improving revenue statistics;
- Improving coordination and cooperation amongst key players at international and regional levels;
- Supporting the development and implementation of fiscal assessment tools;
- Improving transparency and accountability in the extractive industry sector;
- Improving transparency, accountability and oversight in domestic public finance;
- Promoting efficiency in public investment and public procurement;
- Strengthening sustainable debt management.

The EU is currently preparing a staff working document which will provide the underlying principles for the implementation of the two EU flagships (see annex 1 and 2) and the EU contribution to the call for global action.

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Extractive resources, including oil, gas and minerals, affect the economic conditions of countries that represent half of the world’s population: some 4 billion people live in countries whose economic trajectories have been shaped to a large extent by their natural resource endowments. Some developing countries have succeeded quite well in transforming their natural resources into assets for change but many others still experience their abundance of natural resources as a curse, unable to translate natural wealth into economic and human development. In many countries, e.g. in conflict affected and high-risk ones, resource exploitation and trade fuel instability, which explains why the Commission and the High Representative proposed an integrated EU approach to stop the profits from trading minerals being used to fuel conflicts and to promote the responsible sourcing of a number of key minerals.

At the World Summit on sustainable development in 2002, the Extractive Industries Transparency Initiative (EITI) was launched with a view to remedy the lack of transparency in the governance of payments and revenues from extractive resources. Building on EU legislation (Accounting and Transparency Directives) adopted in June 2013, requiring the EU oil, gas, mining and timber companies to publish their payments to partner governments, the proposed flagship initiative will enable partners at various levels to better align with the enhanced transparency requirements. The reporting of payments to government by the extractive industries will provide local authorities and civil society with significantly more information enabling local communities and civil society organisations to hold their government accountable for the use of these revenues, and for ensuring adequate consideration of the environmental and social cost that can result from their exploitation. The initiative will promote this policy vis-à-vis all investor countries and build upon relevant existing international initiatives to fulfil the relevant objectives set out in Section 5.2 under Growth, Jobs and Private Sector Engagement.

The flagship scope will be expanded to development aspects of other EU initiatives linked to transparency in the supply chain addressing in particular conflict-free and responsible exploitation of resources, as stated in the recent corresponding joined Communication of the Commission and the High Representative. Furthermore, it could also be expanded to possible follow up of the mapping exercise on raw materials. . This will be done keeping in mind the need for complementarity with regional and national programmes and other external action instrument.
Domestic Revenue Mobilisation (DRM) is essential for the well-functioning of the State and the provision of public goods. Beyond providing fiscal space for priorities, Domestic Revenue Mobilisation is also part of a social contract that underpins participation, social cohesion and contributes to shaping good governance. DRM thus supports sustainable and inclusive growth as well as good financial governance and accountability.

While improving Domestic Revenue Mobilisation is the prime responsibility of each country, the increasing integration of international markets and economic globalisation infuses a supranational or global nature to the challenges to raise domestic revenues and often hamper countries’ national efforts. Therefore, a joint approach by both developing and developed countries as well as international organisations is needed to provide the global public good of an international tax environment that is efficient, effective, fair and transparent. The flagship also responds, inter alia, to the G20 Declaration making a strong commitment to tackle tax evasion and avoidance, harmful practices, and aggressive tax planning. Illicit financial flows alone cause developing countries an estimated loss of € 442 billion per year in domestic revenues. Illicit financial flows out of developing countries, difficult to measure and most likely significantly underestimated, are therefore more than double the amount of ODA from OECD countries to developing countries.

The flagship will promote a transparent, cooperative and fair international tax environment at global level to efficiently tackle international challenges such as tax evasion and tax fraud as well as illicit financial flows and therefore to contribute to an enabling international environment for domestic revenue mobilisation. It will enhance participation and involvement of all countries and regions in the global tax dialogue in order to help them build up effective, efficient, fair and sustainable national DRM systems. The Flagship will also aim at enhancing the voice from civil society for accountability, government effectiveness, regulatory quality and compliance.
The Revenue Administration Gap Analysis Programme (RA-GAP) is a methodology developed by the IMF for estimating both the tax policy gap and tax compliance gap. The methodology consists of a top-down element comparing taxes actually collected with potential taxes estimated from economic statistics and a bottom-up element using a sample of tax audits to estimate the gaps for individual taxes. The RA-GAP does not estimate the value of tax expenditures, for which there are already well established techniques.

The Tax Administration Diagnostic Assessment Tool (TADAT) is a new diagnostic instrument to help governments measure the performance of their tax administrations. TADAT is designed to deliver an objective, standardized assessment of the most critical outcomes of any country’s system of tax administration. TADAT helps create a shared view of the quality of tax administration among stakeholders, set the reform agenda, evaluate the success of reforms and coordinate external support.

The Public Expenditure Financial Accountability (PEFA) programme is a multi-donor programme established in 2001 by seven organisations including the EU with the objective of supporting public financial management reforms. The PEFA PFM Performance Measurement Framework is an evidence-based diagnostic tool that aims to (i) assess country revenue, public expenditure, procurement and financial accountability systems, (ii) to support design of PFM reform and capacity-building actions and (iii) to provide a common source of information for dialogue among stakeholders. The main “deliverables” of a sound PEFA system are:

- Aggregate fiscal discipline – keeping public spending in line with the available resources and the government’s macroeconomic and fiscal stability goals.

- The strategic allocation of resources – planning and executing the budget in line with government priorities in order to achieve government’s policy objectives.

- Efficient and effectiveness in resource use – using public resources in such a way that public goods and services are efficiently delivered and provide good value for money – the maximum benefit with the available resources.
REFERENCES


2 See annex 1 and 2 for further information.


