

Barriers to increasing tax revenue in developing countries

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Questions

Why has progress in increasing tax revenues remained slow in many developing countries?

What gets in the way of increasing tax revenues, and how can such barriers be best addressed?

How does the shape and structure of an economy impact on its ability to increase tax revenues?

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1. Executive summary

A brief review of the literature, informed by comments from a range of tax specialists, suggests four principal groups of reasons why tax systems do not yield higher revenues in many developing countries:

- Internal political factors
- Administrative constraints
- External political factors: multinational companies and other investors
- The structure of developing country economies

However, the issues involved are complex, and simple and direct answers do not exist. Professor (Emeritus) Richard Bird, chair of the Advisory Group of the International Centre for Tax and Development at the Institute for Development Studies, comments that “My more than 50 years of

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work on these matters in more than 50 countries continues to provide me more with questions than with answers.”

Internal political factors

The problem may be that governments do not prioritise tax revenue mobilisation, and if they do, they may find it difficult to reform systems which stakeholders (certain taxpayers, the tax administration or political insiders) benefit from. Seeing that tax collection is part of a political bargaining system, it is necessary to look at reform prospects from a political economy lens.

Administrative constraints

Many developing countries face the dual challenge of a lack of modern infrastructure, such as IT systems and property registers, and weak capacity in tax authorities due to shortage of skilled staff. Training and capacity building for new and existing staff coupled with resources to make investments in modern infrastructure should help increase the amount of taxes collected.

External political factors: multinational companies and other investors

- **Bilateral tax treaties:** Many developing countries have effectively signed away their rights to tax multinational companies operating within their borders through bilateral tax treaties. Aggregate estimates of the scale of the problem are not available but some country assessments are indicative of the problem. It is estimated that developing countries lost over US\$ 800 million in 2011 as a result of treaties with the Netherlands alone, and estimates show that US tax treaties cost non-OECD countries around US\$ 1.6 billion in 2010. There have been recent calls for developed and developing countries alike to assess the developmental impact of their tax treaties and renegotiate the treaties accordingly.
- **Tax evasion and avoidance in international trade:** Developing countries' tax losses from aggressive tax planning and avoidance by multinational companies is sizable. Profit-shifting by multinational corporations through transfer mis-pricing results in the erosion of the tax base and, consequently in lower tax revenues. Recent estimates suggest that losses could be between USD 100 to 240 billion annually in global corporate income tax revenue. Tax avoidance and transfer mis-pricing have received heightened international policy attention in recent years through the OECD BEPS process. The question is whether the proposed reforms, which have largely been put forward by OECD countries, are suitable for or will have positive effects for low income countries.
- **Tax avoidance in the extractive sectors:** Profit shifting, and other kinds of tax avoidance, is a real concern in the extractive sectors, especially in mining. Estimates around tax losses in the extractive sectors show that the losses are sizable and that developing countries are particularly vulnerable. For example, research suggests that African countries could have collected an additional USD 70 billion in tax over the 2003-08 period if they had taxed the mining industries operating in their countries in the same way as Australia does. Taxing progressive gross income as opposed to taxing companies' profit may make the system less vulnerable to profit-shifting.
- **Tax exemptions and incentives given to investors:** Developing country governments typically offer various tax exemptions in order to attract investment, which lowers tax revenues. The problem with this practice is that exemptions do not appear to result in

higher investment and are, therefore, a pure loss of revenues. The problem is also that exemptions are often used for political reasons, and consequently, risk being linked with corruption. One obvious solution to this problem is to take away exemptions. If this is politically difficult, the negative effects of exemptions could be mitigated by inducing transparency into the system, either by making rules about exemptions firmly stated in laws and regulations, or by publicly disclosing information about exemptions.

Structure of developing country economies

Many developing countries are characterised by a small tax base, a cash-based and informal market structure, and a heavy dependence on agriculture: all of which makes taxing difficult and tax rates low. Broadening the tax base may be politically more feasible than increasing tax rates. In addition, efforts to include the informal sector in the tax net may have positive indirect impact by contributing to improved governance and accountability.

2. Realistic expectations of tax increases for developing country economies

Developing country governments collect much lower proportions of their GDPs in tax revenue than the governments of the OECD countries do: 10-20% compared with 30-40%. The lowest tax shares are observed in South East Asia and in the Pacific region, at levels close to 10%. Sub-Saharan Africa, the MENA region, and Latin America have higher average tax-to-GDP ratios (around 18%), although there is great variation within each region. Latin America and MENA have seen larger increases in tax revenue in recent years than Sub-Saharan Africa. Within Africa, countries differ according to income level, with upper-middle income countries approaching OECD levels of tax-to-GDP ratios. Low-income countries still lag behind, with many having rates below 15% of GDP, which is generally considered the threshold below which contemporary governments find it hard to finance their basic functioning and services (Mascagni et al, 2014).

Tax take is broadly proportional to national income levels because in higher income (and urbanised, non-agricultural) countries it is much easier for tax agencies to tap into revenue sources without incurring high collection costs or generating adverse political reactions (Moore, 2013). A high-tax state may even be seen as part and parcel of development. As economic development creates a need for institutions that can support and sustain markets, it simultaneously fosters incentives for higher levels of taxation (Besley and Persson, 2014).

As country tax effort indices (revenue collections relative to estimated revenue potentials) for many developing countries show, there is considerable potential to increase tax revenue (Mascagni et al, 2014). However, it is not realistic to expect developing countries to reach the tax proportions of OECD countries quickly; there are no quick fixes and no prospects for sharp increases. Tax reform and public financial management reforms more broadly have been happening over decades in many of today's high income countries, and we should not expect similar changes to happen very quickly in low income countries. Even an increase of two percentage points in the tax to GDP ratio over a period of five years would be quite good, as such an increase would mean that tax revenue has not only kept up with GDP growth but performed better than the economy (Giulia Mascagni, personal communication, 2017).

ICTD's Mick Moore argues that we should be sceptical of claims that any specific tax innovation could lead to major increases in revenue collection in low income countries in the short term – that is, within years rather than in decades. Tax collection has a 'sticky' nature, with total revenues collected by governments varying little from year to year. This is partly because, especially in low income countries, the behaviour of tax agencies is governed by annual incremental collection targets set by ministries of finance. The 'sticky' nature also reflects a more structural factor. Revenue agencies are highly 'networked' organisations, dependent on active cooperation from a wide range of other stakeholders, including ministries of finance, the police, border security forces, and many others. As a result, new tax policies and administrative improvements within a revenue agency may have limited impact if not supported by corresponding changes in the network (Moore, 2013).

Where rapid increases in tax revenues have occurred in recent times, they have often been coupled with social upheaval in one way or another. Looking at the evolution of tax revenues across 18 countries over the past century, Besley and Persson (2014) found that significant rises in tax have come about as a result of war (the two World Wars), and the introduction of direct withholding of income taxes which coincided with World War II. Some developing countries have seen radical reforms of tax administration in recent decades – notably Peru in the early 1990s, and Uganda and Rwanda in the late 1990s and early 2000s. These reforms happened when state power was effectively reconstituted after near-collapse, including the breakdown of revenue collection. In these cases, rapid increases in tax revenue were possible because another characteristic of the 'sticky' nature of tax collection was removed: the political bargaining system over tax, which had in effect collapsed with stakeholders having lost their bargaining power (Moore, 2013).

So, how should we go about inducing reform to increase tax rates in developing countries? Professor Richard Bird suggests that one should go into specifics in details, focus on policy process, and be patient, very patient (personal communication, 2017).

3. Internal political factors

Although tax rates, to an extent, go hand in hand with economic development, economic growth does not mechanically translate into higher taxes. Widening the tax net and increasing the tax base require governments to put effective policy in place and to be determined to ensure compliance. Having the political will to increase taxes is therefore necessary (Besley and Persson, 2014). Governments know where the potential is and where most of the gaps are; if a government wants to tax, it will (Jalia Kangave, personal communication, 2017).

Political will is, in turn, a product of a country's political bargaining structure around tax. The process of bargaining and exchange is central to decisions about the design of tax regimes and to operational decisions about which taxpayers will be pursued by the tax authorities, how, and how far. The tax collection bargaining process involves at least four categories of actors and interests: taxpayers, tax intermediaries, governments, and revenue collection organisations (Moore, 2013). These stakeholders can all benefit from a status quo of low taxes and discretionary tax collection practices. Therefore, appreciating their role in tax bargaining processes is essential to any reform project.

In every country, a great deal of theoretically tax-liable income, transactions or assets escapes the tax net, sometimes because the administrative costs of pursuing them are too high, and

sometimes because political influence and corruption enable some people and companies to escape their obligations. Tax regimes tend to be biased in favour of taxpayers with the greatest bargaining power, who can most easily evade or avoid taxes, and whose cooperation is most valuable in the long term (Moore, 2013; personal communication 2017).

As a result of this distribution of bargaining power, governments show great reluctance to tax the personal incomes of their own rich citizens as well as the increasingly large accumulations of capital invested in real estate in low income countries. In fact, income tax and property tax – the two best ways to tax the wealthy – are almost wholly ineffective outside taxes on the wages of formal sector employees (Kangave et al, 2016). From an organisational and logistical perspective, there are good prospects for increasing the tax take in low income countries by establishing more effective property tax systems, but because such taxes affect relatively wealthier people who have more political influence, they have been very difficult to effectively introduce in practice (Monkam and Moore, 2015). Among taxpayer constituencies we also find domestic businesses and multinational companies. Their relations vis-à-vis governments, and the resulting tax losses, will be discussed in section 6 below.

The other three identified tax stakeholders (the political and administrative insiders) may also benefit from a sub-optimal tax process, and stand in the way of reform. Tax collectors and tax administrators can be quite powerful groups in developing countries, since their specific expertise makes them difficult to replace. They therefore have the bargaining power to resist reform and to get away with extracting revenues from inefficient or even illicit tax practices for private gain (Mascagni et al, 2014). Revenue agencies may also transfer funds informally and illegally to their political masters, and while we have no hard information on the extent to which this takes place, these flows seem to be quantitatively and politically significant in many low income countries (Moore, 2013).

A recent study exploring the political economy of tax reform in Bangladesh illustrates how the bargaining process around tax favours insiders and the politically powerful. The authors found that the repeated failure to reform the country's tax system was due to significant resistance to change that cut across political, economic and administrative elites. In the current, highly ineffective tax system (with a tax share of only 9% of GDP), the economic elite is catered for by low and predictable tax rates to businesses, tax administrators enjoy extensive discretion and opportunities for corruption, and the political elite can use the system to raise funds and distribute patronage and economic rents (Hassan and Prichard, 2013).

Seeing that politics is at the heart of tax systems, adopting a political economy approach to reform is necessary in order to identify the progressive reformers within governments and revenue authorities; ways in which they can be assisted without putting their domestic political support under threat; and the incentives required to persuade the more reticent to allow reform of their tax systems (DFID 2016). Bird (2013) echoes this approach, arguing that focus should be on the process instead of the precise configuration of the reform package, and that sustainable reforms need to be developed in-house by countries themselves.

4. Administrative constraints

Many developing countries face considerable administrative constraints in revenue mobilisation. These concern the dual challenges of a lack of modern infrastructure, such as IT systems and property registers, and weak capacity in tax authorities due to shortage of skilled staff.

In Uganda, for example, one of the biggest challenges to revenue collection is around collecting, managing and analysing data and information. This problem affects how the revenue authority shares and analyses the information it has, as well as how it accesses and utilises information from other government agencies. This is made even more difficult by the fact that the economy is largely cash-based, which makes it hard to track transactions. Improving capacity and resources to access and analyse information could result in increased revenue collection. (Jalia Kangave, personal communication, 2017)

In terms of capacity, the greatest challenge for tax administrations is retention of skilled staff, particularly those with scarce and valuable skills in IT, accounting, and forensic auditing (IDS, 2014). The drain of skilled personnel away from tax administration poses a serious obstacle to improving capacity and therefore to increasing tax revenue in developing countries (Mascagni et al, 2014).

In Uganda, for example, there are several angles to this brain drain (Kangave, personal communication, 2017). First, competent professionals often move with their former bosses to other government agencies. This is partly due to better pay in other agencies, but also because in some cases contract terms (for commissioners) require that the person cannot serve for more than a certain number of years, which increases the need for building capacity, particularly of lower level staff. Human resource decisions within the Ugandan Revenue Authority are also to blame for capacity shortages. There is a general feeling that staff are not allowed to develop capacity within a given field because they can be moved from one position to another with little warning. Someone may undergo training in one sector, start working in the position they have been trained for, and within a year or two are moved to something totally unrelated. Finally, capacity is also drained away from the public sector as good auditors are likely to end up working for big companies, banks or the larger professional services firms (IDS, 2014).

Another administrative challenge for revenue agencies concerns coordination with other entities. Collecting revenue efficiently and effectively involves establishing robust connections and interactions between various kinds of systems. Different units within the revenue collection apparatus need to learn to co-operate with one another and establish IT systems that interface with one another. Similarly, revenue collection units need to work effectively with banks, utility companies, property registration systems, passport authorities, tax practitioners and a wide range of other public and private sector actors. It takes time and much continuous effort to ensure that these connections work effectively. (Mick Moore, personal communication, 2017)

5. External political factors: multinational companies and other investors

Shortcomings in the ability and willingness of some developing country governments to effectively tax domestic businesses and multinational companies operating in their countries can constitute a very large loss in tax revenues. Four such barriers to effective tax mobilization are 1) bilateral tax treaties and the resulting loss of right to tax multinational companies; 2) tax evasion and avoidance in international trade; 3) loss of potential tax revenues from the extractive sectors; and 4) tax exemptions and incentives given to investors.

Bilateral tax treaties

One major reason why tax revenue is not higher in many developing countries is that these countries have effectively signed away their rights to tax multinational companies operating within their borders through so-called bilateral tax treaties.

Around 3,000 bilateral tax treaties are currently in force, governing whether, how, and how much signatories can tax multinational companies and other cross-border economic activity. Often justified on the grounds of needing to prevent double taxation, tax treaties which lower the tax paid by international business are often used to compete against other countries for foreign investment. However, the relationship between treaties and investment has repeatedly been questioned, and the evidence suggests that any benefits that tax treaties might bring cannot be assumed (Hearson, 2016).

Bilateral tax treaties can lower developing countries' tax revenue both in aggregate and relative to richer, capital-exporting countries. The full scale of the problem is difficult to assess, but some estimates have been published. The Dutch Centre for Research on Multinational Corporations has estimated that developing countries lost US\$ 812 million (€770 million) in 2011 as a result of treaties with the Netherlands alone, and the IMF estimates that US tax treaties cost non-OECD countries around US\$ 1.6 billion in 2010. At the developing country level, Bangladesh has been estimated to be losing approximately US\$ 85 million every year from just one clause in its tax treaties that severely restricts its right to tax dividends. These estimates only focus on two types of losses: lost dividend taxes and lost taxes on interest payments. Tax treaties also cause many other losses – such as lost profit tax contributions and lost tax on capital gains, royalties and services fees – but the size of these losses is still unknown (ActionAid, 2016).

In addition to suppressing overall tax paid by multinationals, the second problem associated with bilateral tax treaties is how they disproportionately repress tax revenues for developing countries. Tax treaties carve up tax rights between two countries that could claim the right to tax a multinational – the country where the (foreign-based) corporation makes money ('source-based taxation') and the country where the internationally active corporation is based ('residence-based taxation'). Most tax treaties restrict the source-based right to tax foreign corporations making money locally, in other words restricting developing countries' right to tax. For example, in 2004 Uganda signed a tax treaty with the Netherlands that completely took away Uganda's right to collect tax when a corporation pays out certain earnings (i.e. dividends that meet certain criteria) to shareholders resident in the Netherlands. A decade later, as much as half of Uganda's foreign direct investment is owned in the Netherlands, at least on paper (ActionAid, 2016; for an in-depth review of tax treaties in Uganda, see Hearson and Kangave, 2016).

Whilst the developmental impact of bilateral tax treaties has not received much attention in the past, this is now starting to change with calls for developing and developed countries alike to assess the impact of their tax treaties and ensure they do not contradict development policy and aspirations. A new dataset, the *ActionAid Tax Treaties Dataset*, includes more than 500 treaties that low- and lower-middle income countries in sub-Saharan Africa and Asia have signed since 1970. From this public dataset researchers and civil society campaigners can draw attention to those treaties that impose the greatest restrictions on developing countries' taxing rights and advocate for renegotiations. A number of developing countries have recently begun to reconsider their approach to tax treaties. South Africa, Rwanda, Argentina, Mongolia and Zambia have all cancelled or renegotiated agreements since 2012, and others, such as Uganda, are undertaking reviews (ActionAid, 2016).

The Netherlands and Ireland have recently reviewed the impact of their treaty networks on developing countries, and started offering renegotiations to some of their treaty partners as a result (Hearson, 2016). However, as a group, OECD countries appear to be moving towards treaties with developing countries that impose more restrictions on the latter's taxing rights. The UK and Italy are tied as the countries with the largest number of very restrictive treaties with lower income Asian and sub-Saharan African countries (ActionAid, 2016).

Tax evasion and avoidance in international trade

Another major reason why tax revenue is relatively low in developing countries is that tax is evaded and avoided by multinational companies. While outright tax evasion is illegal, tax avoidance and aggressive tax planning is more of a grey area.

One such tax avoidance practice is profit-shifting by multinational companies. This involves mispricing goods and services transferred within a multinational company group – amongst subsidiaries and affiliates, or between a subsidiary and the mother company – with the aim of transferring profits to low-tax jurisdictions. Transfer mis-pricing results in the erosion of the tax base through the outflow of capital from high to low-tax jurisdictions, and thus in lower tax revenue (Mascagni et al, 2014).

With currently available data, it is not possible to pinpoint the amount of tax that multinational groups avoid each year through shifting profits to tax havens. However, recent estimates reported by the OECD indicate that the losses from base erosion and profit shifting could be between 4% and 10% of total global corporate income tax revenue, or USD 100 to 240 billion annually (Durst, 2016).

While aggregate estimates of profit shifting are difficult to make, individual examples of such practices abound. For example, an investigation by ActionAid into the British multinational, Associated British Foods, found that by shifting over a third of its subsidiary's profit out of Zambia, the company has denied the Zambian government USD 17.7 million since 2007 (Lewis, 2013). ActionAid also found that SABMiller, one of the world's largest beer companies based in the Netherlands, deprived African governments of as much as USD 20 million per year by channelling profits to sister companies through tax havens as 'management fees', and running procurement through a subsidiary based in Mauritius (ActionAid, 2010).

Transfer pricing and profit shifting have received great attention in international policy circles in recent years, notably through the G8/G20 tax agenda. Many of the policy prescriptions focus on increasing transparency and the flow of tax-related information across countries (IDS, 2014). However, for real change to result from these efforts and for change to benefit lower income countries, two conditions need to be met.

First, substantial reductions in transnational tax avoidance require sustained collective action by the governments of many countries, especially those of the OECD and the large and emerging middle- and low- income countries. However, the countries whose cooperation is most needed are those best placed to maximise their individual shares of investment and tax revenue by pursuing competitive tax policies (Moore, 2013). Effective collective action in this sense requires all governments to stop using taxes to compete for investment, which might be easier said than done. As pointed out in a recent IDS publication, while the British Prime Minister has been promoting the G8/G20 tax reforms, the UK Treasury has continued to develop new tax incentives

such as reduced corporate taxes on income attributable to intellectual innovation to attract capital from abroad (IDS, 2014).

The second condition concerns lower income countries and whether or not they are likely to be able to reap the potential benefits of the international tax agenda's focus on transparency and information sharing. Two barriers exist in this regard. The first is linked to the balance of bargaining power between low income country governments and international investors: power too heavily tilted towards the latter would reduce the potential benefits to the former. The second barrier relates to the capacity of developing country tax authorities to effectively deal with tax-avoiding practices and to fully take advantage of tax-related information that is becoming available from other countries (Moore, 2013).

Tax avoidance in the extractive sectors

The biggest single cause of low tax takes in many developing countries is low taxation in their extractive sectors. The extractive sectors, especially mining activities which are more likely than oil and gas to be entirely in the hands of overseas private transnational companies, are grossly under-taxed in low income countries. There are a range of reasons for this, the most general being that mining companies are very powerful political actors (Moore, 2013).

The ways in which investments in the extractive sector are taxed vary widely across countries, with various mixes of royalties and taxes on rents and on business profits. The taxation trend has in recent decades gone from being predominantly based on royalties (which are usually based on the gross value of the product that is extracted) to various kinds of levies based on the net income that a company derives from the extraction of product. This has reduced the risk to extractive companies of being taxed on loss-making investments. However, income-based natural resource taxes are much more difficult for governments to enforce and natural resource taxation has become increasingly vulnerable to revenue erosion. The seriousness of this vulnerability is magnified by the fact that extractive companies typically engage heavily in transactions with other members of their multinational groups, in which the companies have substantial opportunity to engage in profit-shifting (Durst, 2016).

The extent of profit-shifting taking place in the extractive sectors, and the resulting loss in government revenues, can be substantial. One study estimated that, globally, profit shifting of various kinds reduces the income tax base of the oil and gas sector by between 12% and 35%, depending on the characteristics of the country's tax system, and that non-OECD countries generally appear to be more vulnerable to profit shifting than OECD member countries (Beer and Loepick, 2015). Some aggregate estimates suggest that, while turnover in the mining sector increased globally by a factor of 4.6 during the period 2000-2010, tax revenues earned by African governments increased only by a factor of 1.15.

According to one study, a group of African governments could have collected USD 70 billion in additional tax in the years 2003-8 if they had levied the same implicit rate of tax on mining as the Australian government (Moore and Lundstøl, 2016). Another study found that profit-based corporate tax made only a very modest contribution to mining revenue in Tanzania and Zambia, and that Zambia, in one year alone, could realistically have increased its tax revenue from mining by more than USD 1 billion, which would have been more than the total net development aid to the country for that year (Lundstøl et al, 2013).

If developing countries are not able to fully benefit from the international tax agenda with its focus on transparency and information sharing, can anything else be done to stop these countries from losing such sizable amount of government revenues? One suggestion, as a temporary measure, is for countries to introduce progressive royalties, based on gross product value. The rate of a progressive royalty adjusts with changes in product prices, production volumes, or both, so that the rate of the royalty will generally change in correlation with the extractive company's net income. This could help mitigate the risk involved in income-based levies until the vulnerabilities of income-based instruments have been addressed (Durst, 2016).

Tax exemptions and incentives given to investors

Another major cause of the tax gap seen in many developing countries is tax exemptions. Governments from low-income countries offer various tax holidays and exemptions that are difficult to categorise and control, with the aim of attracting investors and fostering economic growth (Mascagni et al, 2014). Governments are often under strong political and other pressures to grant large-scale investment incentives and, in effect, give away tax revenues (Mick Moore, personal communication, 2017).

There are several problems with how tax exemptions are generally given. First, tax incentives are often given in ways that are inefficient and not transparent. The discretionary manner in which many exemptions are given have a purpose, as they are widely used by politicians to reward political supporters and businesses willing to contribute to political party funds or private bank accounts. In Tanzania, for example, a major driver of the spread of tax exemptions in that country was the increasing competition within the ruling political party, with the resulting search for political finance to fund that competition. Business offered political financing in return for tax exemptions (Therkildsen, 2012).

Another problem with tax exemptions is that they are not economically effective. Many, if not most, tax incentives actually have little impact on investment levels. Data from investment motivation surveys shows a high redundancy ratio for tax incentives, meaning that investors would have invested regardless of the incentive (James, 2013). Research also shows that it is likely that governments could attract more private investment if they were to grant fewer tax incentives and rather use the additional revenue to address the problems that rank high in the minds of potential investors, such as the poor quality of road, port, transport, electricity and water services (IDS, 2014).

Eliminating or substantially reducing tax incentives is usually seen as a low-hanging fruit in tax revenue mobilisation. Since most of the companies involved are already in the tax net, additional revenue could be obtained at a relatively low administrative cost. Where such reform has been possible, for example in Mauritius, the results have been positive (Mascagni et al, 2014).

From a political point of view, however, reform may not be that easy. Politicians (at least in countries where markets are politicised, like in many developing countries) like discretionary investment incentives because they facilitate political and administrative corruption. Moreover, the cost of tax incentives is usually unknown and dispersed over a long time while the political benefits, as well as the private benefits to the person entitled to make the decisions, are immediate. Finally, incentives are easier to provide than infrastructure, labour skills or other investment climate improvements (James, 2013).

If reform is difficult for political reasons, two sets of transparency measures may at least help make tax exemptions less usable as a political tool. The first type of transparency reform focuses on making the system of granting and administering investment incentives less discretionary. This is done by clearly defining criteria for granting incentives in relevant laws and/or regulations to limit discretion in the approval, verification and valuation stage of granting the incentives (Munyandi, 2011). The second way of inducing transparency into granting and administering investment incentives focuses on publicly disclosing information. Identifying, quantifying and publicising tax expenditures—the revenue cost of preferential tax treatments—can be a powerful tool in avoiding and scaling back preferences that do not generate some offsetting social benefit (G20, 2011).

There are two types of information that transparency initiative may focus on. The first type concerns public disclosure of decisions about any granted investment incentive, i.e. the public announcement of which investors benefit from such incentives. These can be put into databases and disseminated to the public (James, 2013). In this case, adverse reactions from the public would primarily work to discourage favouritism and corruption. The second type of transparency initiative focuses on analysing and disseminating the actual revenue cost of investment incentives. By bringing the cost of investment incentives upfront, it is possible to place a budget on incentives and ensure that they are part of responsible economic policy making. In this case, transparency would primarily inhibit economic policy that would be deemed wasteful and contrary to public benefits (USAID/RCSA, 2004).

6. Structure of developing country economies

The final barriers to effective revenue mobilisation in low income countries are related to the shape and structure of national economies. It is much easier to increase revenues in wealthy countries where economic transactions are officially recorded in various ways, and take place through banks and other financial intermediaries. Instead, many developing countries are characterised by a small tax base, a cash-based and informal market structure, and a heavy dependence on agriculture, all of which makes taxing difficult and tax rates low.

The first of these problems is the small tax base. Income below a certain threshold is not and should not be taxed due to considerations related to poverty and equality. This implies that in countries where a large proportion of the population lives in poverty, a considerable share of GDP is not taxable (Mascagni et al, 2014). This means that comparatively few individuals and companies are taxed. For example, in Tanzania, a country where the population exceeds 35 million, a mere 286 companies contribute about 70 percent of domestic tax revenues (Fjeldstad and Moore, 2009). Similarly, 0.4 percent of taxpayers in Kenya and Colombia are estimated to account for 61 and 57 percent of total domestic tax revenues respectively (Baer, 2002). Hence, if only a small proportion of these companies and individuals chose to evade tax, this could have a large impact on these countries' public revenues. Recalling the discussion about internal politics and the bargaining powers of wealthy and influential individuals, broadening the tax base, rather than changing tax rates, could be the key to increasing tax revenues in many low-income countries (Besley and Persson, 2014).

With undeveloped markets comes a high degree of informality, which is another constraint to revenue mobilisation. Since by its nature informal economic activity falls under the radar of tax officials, the administrative cost of reaching the informal sector can be very high. This sector is usually composed of a multitude of small and micro enterprises that are likely to be below the

threshold for paying tax or just above it (Mascagni et al, 2014). However, as recent analysis from Uganda shows, there is also a small proportion of very wealthy individuals who thrive in the informal sector. Their businesses have various characteristics: they transact mainly in cash, do not keep proper books of account, are not registered with government agencies, many do not deposit their money in bank accounts, and they have less than five employees. The same research also found a large informal sector within the formal sector in Uganda. In such cases, professionals – both in the private and public sector – who may pay taxes on their employment income and/or importation of goods, take advantage of the loopholes created by the informal sector to undertake additional lucrative commercial enterprises on which they do not pay taxes (Kangave et al, 2016).

An increase in formality is a key part of the process by which taxation increases with development. That said, economic growth does not necessarily mean less informality, and the government has a large role to play in this process by constructing a functional legal system. Besley and Persson (2014) argue that government institutions and tax systems evolve together; a weak and unaccountable state is unlikely to have strong motives to build effective systems for revenue mobilisation, and its citizens are unlikely to develop strong norms for tax compliance.

Finding ways to include more of the informal sector in the tax net can also have benefits in relation to state-building and democratisation as this would allow for broader engagement of citizens on tax matters (Joshi et al, 2012) and could have positive effects on the tax-accountability relationship. Taxation engages citizens collectively in politics and leads them to make claims on government. The government is in turn compelled to respond to these citizen demands in order to enhance tax compliance and sustain state revenues. This relationship induces accountability and responsiveness (OECD, 2010).

Finally, the composition of economic activity affects tax revenues. In many developing countries, the industrial sector is typically underdeveloped while agricultural sectors are large. This has revenue implications since taxes from the former sector are usually considered easy to collect due to visibility and accessibility of firms, while taxes in the agricultural sectors are typically hard to collect (Mascagni et al, 2014).

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