



## Briefing Note 1: Increasing domestic resource mobilization

### Context

The overriding long-term financing for development need for Fragile and Conflict-Affected States (FCAS) is to rebuild and enable their own state institutions to raise revenues and meet the financing needs of their development. This is a key element of statebuilding and the path to long term peace. The g7+ welcomes the growing recognition by the development community that the pursuit of sustainable development requires the mobilization and effective use of domestic resources and that the international community needs to redouble its efforts to improve tax policy and build administrative capacity in developing countries. However, the issue of domestic resource mobilization takes on particular salience in FCAS, where the distribution of taxation and spending is a vital element of the political settlement needed to establish peace and stability.

Countries with the most urgent development needs struggle to mobilize adequate domestic resources. While the average advanced economy has government revenues of around 40 per cent of GDP, emerging economies around 30 per cent, FCAS **often have tax to GDP ratios of between 10 and 15 per cent.**

Countries affected by conflict and fragility tend to have a **narrow tax base**, meaning that they are reliant on a relatively small number of large taxpayers. The population in general has low income, and some sections of it are unaccustomed to paying taxes. Their economies tend to have **large informal sectors**, which are inherently difficult to tax, and are also heavily dependent on ODA and natural resources, both of which are often subject to tax treaties which limit revenue. In addition, the **tax administrations are often under-resourced**, with staff lacking technical skills and equipment, with little capacity to formulate policy, monitor performance and manage basic functions.

But despite the many challenges faced by FCAS, there have been some successful examples of building domestic revenue institutions and great progress on domestic resource mobilization is possible. For example after a decade-long civil war in Sierra Leone, the government established the National Revenue Authority with a mandate to reduce collection costs, promote accountability, and strengthen internal controls. The government simplified outdated taxes and introduced a goods and services tax in 2010 with an accompanying taxpayer education campaign. Revenues rose by around 1.5 percentage points of GDP (from 2009) and continued to grow until Ebola struck in 2014. Since the mid-nineties, the IMF has praised significant progress in g7+ including Afghanistan, Burundi, Chad, Cote d'Ivoire, Democratic Republic of Congo and Guinea. **International support has often played a significant role in successful tax reforms.**

### Key issues

When considering how international support can further help domestic resource mobilisation, the following key issues in particular need to be taken into account.

For many g7+ countries, **the effective taxation of extractive industries and commodity exporters** is their top priority. This requires specialist skills. Their other tax policy options are constrained by the

realities of limited tax administration capacity in the presence of low state capacity, especially the costs and difficulties of information gathering and verification. These realities may justify tax policies that look very different from the standard recommendations of economic theory, for example it can be easier to verify and tax corporate sales than profits.

**Weakly administered taxation systems can impede development.** Weak management of tax administration constrains the collection of revenue, especially where rules and laws are complicated. Building administrative capacity and is key challenges in FCAS. Technical assistance from development partners that is tailored to the local realities has a major role to play. Finding the right balance that also prioritises the training and strengthening of local staff is a challenge.

Last but not the least, in many FCAS **progress on increasing domestic revenues is critically dependent on tackling illicit flows and international tax evasion and avoidance.** USD 35.3 billion is lost every year in illicit financial flows facilitated by the global network of tax havens only from Africa while total ODA received is USD 30 billion This will require much greater international cooperation. Many g7+ governments also find it hard to assess the value of double-taxation treaties which may offer needlessly costly tax holidays and exemptions to domestic and multinational firms. An important challenge in many countries is how to set appropriate limits on tax incentives, in particular how to make them more rules-based rather than discretionary and more open to public scrutiny.

### **Key solutions**

Specific concrete commitments/actions that would have a transformational impact on domestic resource mobilisation include commitments to:

- a) Provide additional finance and expertise to support major contract negotiations and the review of tax treaties, recognising the urgency of some requests and the need for longer term support to build national systems. International assistance from tax experts to perform audits and establish national guidelines on the use of tax incentives may be especially helpful.
- b) Localise assistance within national institutions for tax collection, in order to better support and address illicit financial flows and build national capacity for domestic resource mobilisation. Some g7+ countries might benefit from thorough public reviews of tax policy, administration, treaties and exemptions. While numerous tools are available to assess and diagnose problems with tax systems, these are only a starting point. Reforms needs to address the problems that confront each individual country and not impose a blueprint. The consultation process is crucial. Tax reforms can only be enacted only after careful consideration of the political ramifications.
- c) Abolish the requirement that conflict-affected states must provide tax information before benefitting from automatic exchange of information (AEOI) on the overseas incomes of resident companies and citizens. Support should also be provided to enable countries to make full use of this information to enforce tax claims.
- d) Address the costs of participating in international processes to address illicit flows, such as the OECD Base Erosion and Profit Shifting initiative, which can be extremely onerous for the g7+. Special consideration is needed to ensure the g7+ voice is heard in all relevant fora.
- e) Review bilateral tax treaties with FCAS, in particular with the purpose of simplifying rules so as to facilitate implementation and to ensure treaties are not being abused by internationally operating companies through loopholes such as double taxation rules, tax holidays, and other exemptions.