

# Charting a path toward self-reliance

## Case Studies of Domestic Resource Mobilization (DRM) Reform

### Introduction

This brief highlights recent experiences of five developing countries in improving domestic resource mobilization (DRM) and forging more transparent, efficient, and effective public revenue systems. The profiled countries are Afghanistan, Bosnia and Herzegovina (BiH), Nepal, the Philippines, and Rwanda.<sup>1</sup>

These five countries differ in important ways, but with respect to their revenue modernization experiences, they also have much in common. These cases illustrate the potential for increasing revenue-to-GDP (gross domestic product) under the right circumstances, highlight key themes of how this was achieved in these countries and provide several salient lessons with implications for international support or aid for DRM.

### Results

Each of the profiled countries has made considerable progress in terms of increasing government revenues. Rwanda saw its revenue-to-GDP ratio increase from a few percentage points of GDP to almost 20 percent of GDP over the past two decades. In Nepal, government revenues also rose quite rapidly, from 12 percent of GDP in 2007 to about 22 percent in 2016. BiH, where essentially no revenues were being collected at the end of the civil war in 1995, today mobilizes close to 35 percent of GDP in public funds each year. In Afghanistan, public revenues were less than one percent of GDP under the Taliban and today are about 12 percent. Even the Philippines, where there have been many challenges from domestic rent-seeking and continuing policy and administration weaknesses, revenues have started to climb and a widely touted “sin tax” reform is viewed as a model of

*Figure 1 – Selected DRM Achievements of Case Study Countries 2001 – 2016*



how tax policy can simultaneously support revenue mobilization and social goals.

Beyond revenue mobilization, three of the cases provide concrete examples of where DRM modernization has led to improvements in the business environment and reduced corruption. In BiH, reforms contributed to a drop in the number of required tax payments from 55 to 34 between 2006 and 2017, dramatically reducing the costs of tax compliance. Furthermore, in 2006, 66 percent of surveyed Bosnian businesses felt they were expected to bring a gift to their meetings with tax officials; by 2013, only seven percent of firms made that complaint. In Rwanda, the time a typical firm spent complying with tax regulations declined from 168 hours per year in 2006, to 109 in 2016. In Nepal, the time spent on tax compliance also declined, from 408 hours per year in 2006 to 334 in 2016.

<sup>1</sup> This note summarizes common themes and findings across the five case studies

## Key Themes

These case studies demonstrate several common themes:

**Achieving sustainable improvements in revenues requires a balanced approach to compliance improvement.** In the most successful cases, host-country authorities and their development partners have embraced a dual strategy of supporting voluntary compliance on the one hand, while pursuing non-compliant taxpayers through enhanced enforcement on the other. This strategy has included making it easier to register for, file and pay taxes, while also increasing the tax administrations' capacity to enforce tax law, through better organization, use of information technology, and enhanced skills of tax officials.

**Rebuilding fiscal systems in fragile contexts starts with the basics.** The revenue systems of BiH, Afghanistan and Rwanda needed to be constructed almost from the bottom up at the end of hostilities while Nepal strengthened its tax system substantially during a long episode of political instability. Despite numerous competing priorities in rebuilding infrastructure, restoring public services and basic structures of the state, and attracting needed staff following the brain drain during hostilities, the profiled countries successfully improved tax administration procedures, bolstered taxpayer registries, introduced modern tax information technology (IT) systems to better capture data, and raised tax collections.

**Simply getting taxpayers into the tax net can yield important gains.** An early effort to register taxpayers in BiH led to more than doubling the number of persons and companies registered for tax in the early 2000s, contributing to a rapid rise in government revenues. The Afghan Revenue Department undertook a concerted effort to expand the tax registry as one of the very first actions at the start of its revitalization process in 2003. The Rwanda Revenue Authority (RRA) made a targeted effort to get more small and medium size enterprises (SMEs) registered, with considerable success: from 2010 to 2012, the number of registered SME taxpayers doubled as did the amount of money the RRA collected from this taxpayer segment.

**Electronic ("e-") services for registration, filing, and payment offer benefits for both taxpayers and the government.** Nepal's Bureau of Internal Revenue streamlined the tax registration process by linking taxpayer registration and business registration electronically in a single process, also helping the tax administration to better identify companies listed in the commercial registry but not registered for tax. In the Philippines, many e-services have been available to the public for many years, but due to technical challenges, most taxpayers either could not or would not use these services. Now, with USAID assistance, these e-services are functioning well and the number of users has soared. In Rwanda, the RRA rolled out e-filing and e-payment services over a decade ago, which has contributed to better taxpayer compliance as well as to reduced burdens on the taxpayer.

**Reorganizing the tax administration can streamline operations, strengthen compliance management, and at the same time improve responsiveness to taxpayer needs.** Reorganization was on the agenda in each of the case countries. BiH had to first reorganize its sub-national or 'entity' tax administrations (there was no national-level revenue administration until 2005) to operate along functional lines.<sup>2</sup> The Philippines, Rwanda, Afghanistan, and Nepal all introduced taxpayer segmentation into their organizational structures, in each case creating special units or offices for large taxpayers and in some cases for medium and even small taxpayers. In so doing, the revenue authorities were able to enhance and better target taxpayer services, improve audit and control (especially for large taxpayers), and promote risk management that both reduces official discretion and helps to direct tax administration resources to where they will have the most impact on compliance.

BiH and Rwanda have each established semi-autonomous revenue authorities (SARA) to manage their revenue systems, while the Philippines has considered the idea but has not been able to overcome entrenched opposition. SARAs generally have considerable autonomy compared to ministry-controlled tax departments, with a leadership

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<sup>2</sup> For example, based on common functions, such as tax accounting, services, audit, and enforcement, rather than by specific tax types, such as sales, income, and property

responsible to an external board of directors. They often also have considerable authority over their budget, human resources, and institutional strategy. In both BiH and Rwanda, as is now common with SARAs around the world, these new organizations combine domestic tax and customs operations under one institutional roof. Nepal has been considering establishing a SARA, and this is on its agenda of “unfinished business.”

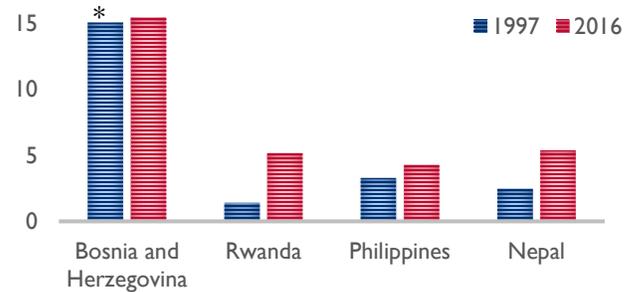
**Tax reform has been crucial to supporting trade liberalization.** Increases in revenue mobilized through domestic taxation have more than compensated for the reduction in trade taxes that countries have undertaken in an effort to spur economic growth and comply with international trade commitments. In BiH and Rwanda, trade liberalization has seen import duties dwindle, yet, in both countries domestic revenue increases, especially from introduction of the value-added tax (VAT), have more than offset these declines.

**Customs modernization can support and reinforce DRM reforms.** In each case country, customs operations were strengthened, capacity was built and attempts to meet international standards of performance were introduced. These efforts have included significant investments in the automation of customs operations, creating opportunities for process streamlining, risk-management, and greater control of imports and exports even while reducing disruptions or delays in trade flows. In all the cases, except for BiH, these countries implemented the Automated System for Customs Data (ASYCUDA) software solution.<sup>3</sup> BiH implemented a similar solution based on European standards. Future efforts to improve customs operations might give more attention to business processes that support effective revenue generation. These include collection of VAT and excises on imported goods, improved control over exports that generate VAT refund requests, as well as enhanced information sharing and collaboration between customs and domestic tax authorities.

<sup>3</sup> A proprietary system of the UN Conference on Trade and Development (UNCTAD)

**Improvements to tax policy, especially the introduction of a modern VAT, can complement tax administration reforms.** The single most important tax policy reform among the four countries profiled was to substitute the modern VAT for archaic, cumbersome, and distorting taxes on company sales or turnover. In each case, the VAT brought in greater revenue than the taxes it replaced, and arguably at lower economic cost. Figure 2 presents the increase in VAT collections in each case country over the period under analysis. Raising tax rates was not a core feature of VAT reforms in BiH or the Philippines, but it was in Rwanda and Nepal. Rwanda raised the VAT rate from 15 to 18 percent in 2002 and immediately saw collections rise from 3.0 to 3.8 percent of GDP. Nepal raised its VAT rate from 10 percent to 13 percent in 2005 that, in conjunction with a remittance-fueled boom in Nepal's imports, led to a substantial increase in VAT collections over the following few years.

**Figure 2 - Importance of VAT for DRM in Case Study Countries (VAT as a % GDP)**



Sources: Ministries of Finance, IMF (Nepal 1997)

Note: First observation for BiH is for 2006, the first year the VAT was introduced

Reforms to corporate and personal income taxes (CIT and PIT, respectively) have demonstrated varied results. Rwanda, to improve competitiveness, lowered its CIT rate from 35 to 30 percent in 2005, yet CIT revenues rose as a percentage of GDP. The Philippines increased the CIT rate from 30 to 35 percent in 2006, and then lowered it back again to 30 percent in 2009, without an appreciable impact on revenues. BiH implemented significant reforms to both the CIT and PIT in all jurisdictions of the country and, for the CIT, harmonized rates and procedures throughout the country, making it easier for businesses to operate. As part of this harmonization, the Federation of BiH (one

of the subnational entities) reduced its CIT rate from 30 percent to 10 percent, but also reduced or eliminated so many breaks and benefits that revenues actually increased.

Another notable case of tax policy reform was the 2012 “sin tax” reform in the Philippines, which substantially raised rates of excise taxes on tobacco and alcohol, built in an adjustment factor for price inflation, and earmarked the increased revenue to support health sector spending. In just two years, from 2012 to 2014, excise revenue on “sin” products doubled from 0.5 percent to 1.0 percent of GDP. Increased revenues have enabled the Philippine government to bring millions of poor Filipinos into the national health scheme. As an added public health spillover, the increased tax on cigarettes has contributed to decreased smoking, especially among youth.

## Lessons for Development Partner Engagement

The experience of international donors and development partners that have supported DRM in these five countries, together with other studies, provide a few key lessons.

**DRM assistance delivers value for money.** Support for DRM can have high returns. Most of these cases show that technical and material assistance can contribute to large increases in tax and non-tax revenues, generally several times the investments made by development partners.

**DRM reform is a long-term affair.** Major progress is almost never achieved quickly. The DRM modernization process in developing countries may require a decade or more to generate transformative results. While the payoff can be large, a long-term perspective and sustained commitment is required.

**Sustainability requires local ownership.** Local leadership in DRM reform and modernization is essential. Where local ownership is weak, international support can play a role, such as in BiH, to spur reform along; but, without committed leaders and managers at all levels, it will be very difficult to bring about lasting change.

**Strong political, economic, and institutional foundations are vital.** The durability of Rwanda’s revenue agency owes much to an enabling external environment of good governance and the rule of law to curb corruption and ward off political interference. Similarly, continuing improvements in governance in BiH have helped to quash corruption overall and in taxation, in particular.

**Progress requires systematic and routine measurement and monitoring.** The value of many elements of the five cases profiled was difficult to assess because of inadequate collection of relevant quantitative and qualitative performance indicators. Donors and development partners can improve this situation and demonstrate impact by improving the systematic use of indicators. Some indicators and tools that DRM projects might consider include:

- *Taxpayer costs of compliance*, typically assessed through surveys, which can quantify the costs and burdens businesses incur in complying with tax laws. Compliance cost surveys can both inform the targeting of reforms and also assess their economic impact.
- *Savings to taxpayers* in terms of queuing, record keeping, data management, and filing of forms both ex ante and ex post from innovations such as e-filing, e-payments, elimination of nuisance taxes, consolidation of taxes, charges and others.
- *Impacts on revenue streams*, ex ante and ex post, from specific administrative measures, such as cleansing the taxpayer registry, implementation of e-services, and specialized training in fields such as audit of the financial and insurance sectors. Data collected and analyzed for Rwanda showed that the compulsory use of electronic billing machines resulted in six percent more VAT revenue.
- *Savings to government*, in terms of staff and related costs that can arise from process modernization and streamlining, such as e-filing, on-line taxpayer service portals, and risk-based audit selection. Such savings can be redirected to higher payoff compliance activities demanding greater human intervention.