



## Approach Paper

# Review of IDB Support to Tax Policy and Administration, 2007-2016



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## I. CONTEXT AND RATIONALE

### A. The objectives and design of tax systems

- 1.1 **While a main goal of taxation is to raise revenue to fund the expenditure of government goods and services, taxes also influence resource allocation, help mitigate market failures, and affect income distribution.** Tax systems do more than just yield revenue; they have implications for sustainable and inclusive growth. As taxes can change relative prices, they may affect the behavior of individuals and firms and, ultimately, the economy's resource allocation. For example, payroll or labor taxes can negatively affect incentives to work in the formal sector (Mirrlees et.al, 2011). Precisely because taxes can create distortions in economic behavior, policy-makers may want to use them to correct market failures. For instance, taxes can be used to discourage the use of environmental pollutants, mitigating the production of negative externalities. Finally, taxes may also affect income distribution. Although the literature stresses that spending programs are typically the most effective instrument for income redistribution, taxes may draw revenues from the upper deciles relatively more (progressivity) or less (regressivity) than the lower deciles.
- 1.2 **Both economic efficiency and equity are thus key criteria in designing tax policy.** On the one hand, economic efficiency calls for designing tax structures that are neutral and simple, minimizing distortions and costs of taxation (Mirrlees et al, 2011). There are three widely-accepted principles in this regard: tax bases should be as broad as possible; tax rates should be limited in number and set as low as possible given revenue needs; and tax expenditures<sup>1</sup> should be as small as possible (Bird, 2003a). On the other hand, fairness or equity calls for progressivity, which is often best achieved through direct taxes, especially through individual income and wealth taxes. That being said, the distributive impact of different tax systems depends on how they work in practice.<sup>2</sup> For instance, the regressive aspects of indirect taxes, such as the value-added tax (VAT), can be reduced through exemptions for “essential goods” in the consumption basket of the poor. Since these exemptions might reduce the economic efficiency of the system, in practice there may be trade-offs between efficiency and equity.
- 1.3 **The design of tax policies must also consider the capacity of revenue administration agencies— “the best tax policy in the world is worth little if it cannot be implemented effectively” (Bird, 2003a).** The main task of any tax administration is to facilitate compliance and deter evasion. Noncompliance not only leads to losses in revenue, but also distorts competition (putting the noncompliant at an advantage) and compromises equity (Keen, 2015). Simpler tax systems—i.e. those with broad bases, a limited number of rates, and few exemptions—are considered easier and cheaper to manage and monitor. Five other dimensions also matter for compliance. Taxpayer registries should be complete. Tax authorities should have transparent and effective procedures for

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<sup>1</sup> Tax expenditures are government revenues foregone as a result of differential treatment, including allowances, exemptions, rate relief, credits, and tax deferrals.

<sup>2</sup> For instance, even though indirect taxes such as a VAT are generally more regressive than direct taxes, a VAT may be more progressive than a personal income tax that falls largely on a limited group of wage earners (Bird, 2007).

determining tax liabilities and penalties. Tax authorities should provide adequate taxpayer services. Individuals should be willing to honor their tax obligations. And tax authorities should function under appropriate institutional arrangements. In this regard, the governance and managerial structure of revenue agencies is of high importance—they should be able to perform their mandate free from political interference, should be adequately staffed with trained officials, and should have a properly-defined organizational structure (Keen, 2015).

1.4 **Hence, administrative efficiency and effectiveness of tax agencies are key aspects in tax systems.** Administrative efficiency lowers the costs of collecting taxes, while effectiveness leads to lower compliance gaps. Given that administrative costs are not zero, however, the optimal compliance gap might also be different from zero (Keen, 2015).

1.5 **Finally, the interaction between political and economic variables also influences tax policy and tax administration.** There is a broad literature that identifies why governments may choose too little taxing or too much spending. In addition to opportunistic policy-makers, the literature has pointed out the role of political fragmentation and conflict among different interest groups (Talvi et. al, 2005). The structure of the economy (including the level of dependence on commodities) and the degree of decentralization also affect fiscal policy choices.<sup>3</sup> In this last regard, ideally, local taxes should generate enough revenue to stabilize local spending, especially if subnational governments depend on volatile transfers from central governments.

## **B. Tax systems in Latin America and the Caribbean**

1.6 **Despite regional diversity, tax systems in most LAC countries share certain characteristics and face similar constraints. First, several tax systems have failed to yield a revenue level consistent with the countries' development level.** Tax revenue has risen significantly in almost all LAC countries in the last 25 years, growing from an average of 12.5% of GDP in 1990 to an average of 18.1% of GDP in 2014. Still, several countries are far from reaching their revenue potential and have a level of tax collection lower than in comparable countries elsewhere. For example, Guatemala, El Salvador, Dominican Republic, Panama, and Paraguay have a tax revenue between 10% and 15% of GDP, below that of countries with similar income levels (Figure 1.1).

1.7 **Second, tax systems in LAC tend to be tilted towards indirect taxes, with little redistributive impact.** In the 1990s, many LAC countries opened their economies and lowered restrictions on trade, which led to significant changes in their tax structures. Revenues from the VAT and other sales taxes compensated for the lost income from tariffs and became the principal tool for revenue collection (except in the Caribbean countries).<sup>4</sup> In contrast, the region continues to be “allergic” to income taxes (Tanzi, 2000). The relative importance of income and capital gains taxes has remained nearly constant since the 1990s and is substantially lower than in OECD countries. And, unlike in OECD countries,

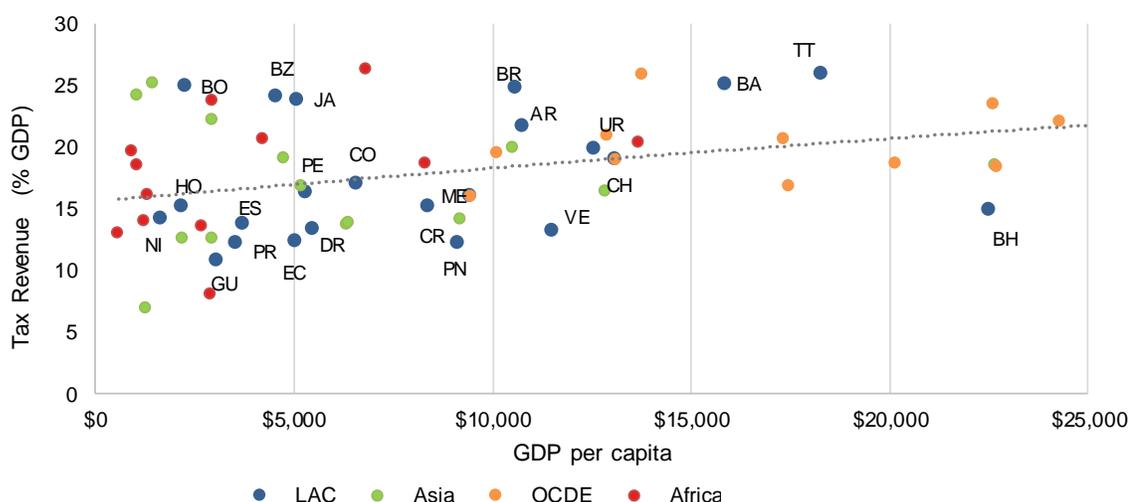
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<sup>3</sup> For a survey on the political economy of fiscal policy see Eslava, Marcela, 2011, “The Political Economy of Fiscal Deficits: A Survey”, *Journal of Economic Surveys* Vol. 25, No. 4, pp. 645–673. On the relationship with natural resources see Barma, Naazneen et al., 2012, *Rents to Riches: The Political Economy of Natural Resource-led Development*, Washington, DC: The World Bank, Chapter 4.

<sup>4</sup> In fact, VAT receipts are similar to those of OECD countries (about 6.1% of GDP on average in LAC, compared to 6.6% of GDP in OECD, in 2013) (OECD, 2016).

corporate income taxes continue to be more important than personal income taxes, even though the redistributive effect of corporate income taxes is unclear as firms can pass-through the burden to consumers by means of higher costs for goods and services (Gómez-Sabaíni et. al, 2012).<sup>5</sup> These characteristics help explain the limited redistributive impact of taxation in LAC and the fact that redistributive policy relies almost entirely on public spending (Lustig, 2016 and World Bank, 2013).<sup>6</sup>

**Figure 1.1 - Tax Revenue and Income, 2007-2014**



Source: OVE based on OECD (2016) "Revenue Statistics in Latin America, OCDE, Asia and Africa: Comparative tables", IMF (2016) "Government Finance Statistics", BID y CIAT (2015), "Presión fiscal Equivalente de ALC" and World Bank (Oct 2016) "World Development Indicators".

Note: Includes tax revenue for all Government levels, excluding Social Security Contributions. Data is average from 2007-2014, except for BZ, VE, Australia, Japan, Poland, Netherlands, Korea, Indonesia, Malaysia, China and Mongolia (2007-2013); Cabo Verde (2008-2009); Congo and Yemen (2007-2012); Tanzania (2013); Iran (2007-2009); Jordan (2008-2013); Timor-Leste (2010-2013).

- 1.8 **Third, tax expenditures and distortionary taxes are widespread, narrowing tax bases and hindering equity and economic efficiency.** Since the 1950s governments in LAC have sought to encourage investment through fiscal incentives, reducing horizontal equity and on the neutrality of the tax system (Tanzi, 2008; IDB, 2013). Although reforms in the 1990s improved tax neutrality and reduced the relative importance of selective taxes, most countries maintained numerous tax expenditures that narrowed tax bases. For example, about 0.9% of GDP is estimated to be lost due to incentives linked to the corporate income tax (Lora, 2012). Moreover, as developing countries aimed to increase tax revenues, they turned to easy-to-collect taxes such as those on financial transactions and exports, which are also distortionary. These taxes represent as much as 5% of total tax revenues in Argentina, Brazil, Colombia and Venezuela (IDB, 2013).
- 1.9 **Fourth, non-compliance with taxes remains high, an indicator of limited effectiveness of tax administration.** Some of the trends mentioned above are the result of high levels of non-compliance, including the establishment of easy-to-

<sup>5</sup> Receipts from corporate income tax has increased significantly since the 1990s in LAC, generating an average of 3.4% of GDP.

<sup>6</sup> The estimated average of the redistributive impact of taxed in the OECD is 13 times greater than corresponding estimates for Latin America (Gómez-Sabaíni et. al, 2012).

collect taxes and the increasing importance of the VAT. In recent years, many countries in the region have also introduced simplified taxes for small firms and implemented strategies to control evasion, such as creating large taxpayer units. Notwithstanding this, deficiencies in the enforcement of tax obligations remain. For example, the level of evasion of both personal and corporate income taxes is estimated to be about 50% (IDB, 2013). This is attributed to several factors, ranging from high informality levels in markets for goods and services<sup>7</sup> and low levels of tax morale, to low institutional capacity of revenue agencies and complex design of taxes (Gómez-Sabaíni et. al, 2012). Moreover, there is substantial room to improve coordination and information sharing, particularly in cases where domestic taxes, customs and social security are not administered by the same collection agency.

- 1.10 **Finally, administrative capacity remains low in several countries, especially so at the subnational level.** There is great variation in the capacity of tax administrations across the region, though overall they have become stronger in the last two decades and administrative costs as a share of revenue are currently close to that of OCED countries (1.4% in LAC compared to 1% in OECD) (IDB, 2013).<sup>8</sup> However, deficiencies persist. At the national level, frequent turnover of top authorities and political interference continues to affect the performance of revenue agencies.<sup>9</sup> At the subnational level, the availability of professional staff, technology, and financial resources lags behind that of national agencies. It has been estimated that with some improvements in local collection agencies in Brazil, for example, revenue from property tax could triple (IDB, 2013).

### C. Going forward

- 1.11 **According to the IDB “no major reform is more important for the sustainable and inclusive growth [...] than the one pending in the region’s fiscal and tax systems.” (IDB, 2013).** From 2001 to 2011 the region enjoyed a period of strong commodity prices that translated into high growth and relatively stable macroeconomic environments. Against this backdrop, many LAC countries used fiscal buffers and counter-cyclical policies to overcome the 2008-2009 crisis. However, the increase in current spending, in particular the share not derived from the action of automatic stabilizers, will be difficult to sustain in the long run given weaker commodity demand and the likely exit by the United States from an accommodative monetary policy.<sup>10</sup> This provides a window of opportunity to advance tax reforms in LAC.
- 1.12 **In this context, an evaluation of the Bank’s role in supporting LAC countries in tax policy and administration is both relevant and timely.** It is useful to take

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<sup>7</sup> Note that informality is not synonymous with noncompliant. As pointed out by M. Keen (2015), many informal enterprises are so small that they have no legal liability to remit tax.

<sup>8</sup> Yet, it must be taken into account that the scope of activities varies from one tax administration agency to another. Most collect only internal taxes but some also oversee custom taxes and social security contributions.

<sup>9</sup> OVE conducted several interviews with tax experts in LAC and they all agreed that frequent turnover of top authorities and political interference continue to be a challenge in most countries in the region.

<sup>10</sup> See International Monetary Fund, 2015, Fiscal Policy in Latin America: Lessons and Legacies of the Global Financial Crisis. Staff Discussion Notes No. 15/6

stock of IDB's experience in the last decade and extract lessons from Bank's support to policy and administration of taxes.<sup>11</sup>

## II. BANK INVOLVEMENT IN TAX POLICY AND ADMINISTRATION

### A. Strategic documents

- 2.1 **Bank Strategy:** Under the Seventh General Capital Increase (IDB-7) in 1989 and, in particular, under the Eight General Capital Increase (IDB-8) in 1994, the Bank identified tax reform as a key area of work (AB-1704). In line with the IDB-8 spirit, the Bank's 1999 Institutional Strategy identified Modernization of the State as a strategic priority, which led to the development of the "Strategy for Modernization of the State" (GN-2235-1) in 2003. In 2010, in the context of the Ninth General Capital Increase (IDB-9), the Bank outlined as one of its development goals increasing the ratio of actual to potential tax revenues, and called for the development of a "Strategy for Institutions for Growth and Social Welfare." Said strategy was developed a year later (GN-2587-4), and identified Public Sector Management and Finance and Registries for Social and Economic and Growth as two key components. Within these components, the Strategy defined the improvement of revenue mobilization and the strengthening of personal, property, and business registries as main objectives. Previous Bank strategies only tangentially covered IDB's role in revenue collection.
- 2.2 **Sector Framework Documents:** As part of the "Strategy for Institutions for Growth and Social Welfare", the Bank prepared two Sector Framework Documents (SFD): the "Decentralization and Subnational Governments" SFD (GN-2813-3) in 2015 (GN-2813-3) and the "Fiscal Policy and Management" SFD (GN-2831-4) in 2016. The former identifies the Bank's main goal in the sector as fostering more effective and efficient subnational management in LAC, including revenue collection capacity. The latter identifies the Bank's main goal in the sector as promoting fiscal policy management that fosters robust, stable, sustainable, and equitable growth. Two of its lines of action are to *"improve the structural design of tax systems, placing particular emphasis on their neutrality, adequacy, simplicity, and progressivity,"* and *"institutionally and technologically modernize the tax administrations."*
- 2.3 **Bank's Structure:** Before the Realignment in 2007, tax policy and administration did not have a specific home within the Bank.<sup>12</sup> In 2007, the Fiscal and Municipal Management Division (FMM) was created under the Institutions for Development Department (IFD), giving fiscal matters an institutional home. Some operations of the Trade and Integration Division aimed at enhancing revenue collection from trade complements FMM's work.

### B. Operational and knowledge portfolio

- 2.4 **The Bank has approved 87 loans (and 47 TCs) that include components on tax policy and/or administration since 2007; the total amount of lending**

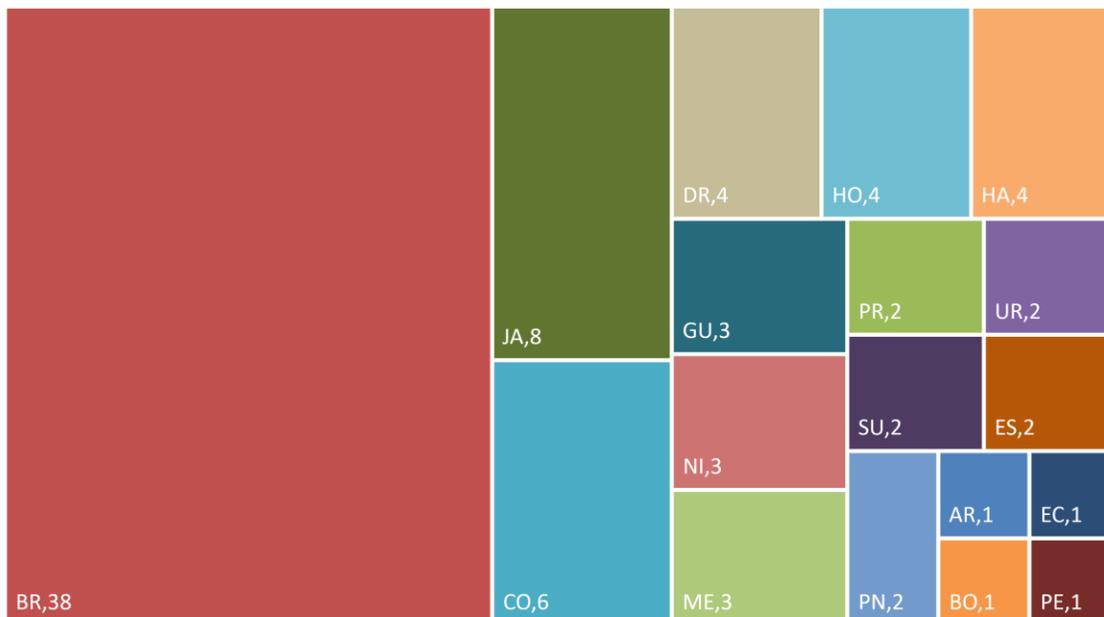
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<sup>11</sup> In 2006, OVE conducted an evaluation of the Bank's role in the fiscal sector between 1990 and 2004 (RE-317-2). The evaluation did not focus on taxation yet the evidence gathered suggested that the Bank had contributed to improving the efficiency of fiscal services related to modernization of tax administration.

<sup>12</sup> As part of the 1994 Bank reorganization, a Fiscal Unit (INT/FIS) was created but many other functional divisions still managed most policy-based loans (including those aimed at supporting fiscal reforms).

(including both tax-related and other components) was US\$10.5 billion—equivalent to roughly 11% of total SG Bank lending during the period. The large majority of the portfolio took the form of policy-based loans and is distributed in 18 IDB borrowing member countries (Figure 2.1). Brazil, Mexico and Colombia are the countries with the highest approval amounts, accounting together for two-thirds of the lending over the evaluation period. In several countries, including Brazil, Colombia, Bolivia, Uruguay, Honduras, Suriname, and Peru, the Bank has worked both at the national and subnational levels, supporting state and municipal governments' revenue management capacities.

Figure 2.1. Numer of loans with tax policy and/or administration components, 2007-2016



Source: OVE

- 2.5 **The Bank's main objective has been to help countries increase tax revenues, mostly by means of enhancing tax administration.** Most of Bank's work has centered on strengthening the capacity of tax collection agencies, and 36% of the lending operations have also supported policy reforms (usually related to changes in the tax structure).
- 2.6 **In addition to the operational portfolio, the Bank has produced an extensive body of knowledge in the field.** OVE identified 94 fiscal knowledge products led by FMM in IDB's Repository of Institutional Knowledge, most of which cover tax policy and administration issues. Salient publications include the report Development in the Americas 2013, More than Revenue; Taxation and Latin American Integration; and Revenue Statistics in Latin America and the Caribbean, 1990-2013.

### III. EVALUATION DESIGN

#### A. Evaluation objectives and scope

- 3.1 **The objective of the evaluation is to assess the relevance, implementation and effectiveness of IDB's support for tax policy and administration during the last decade.** OVE will assess IDB's contribution to tax policy and administration, with a focus on domestic taxes.<sup>13</sup> To contextualize Bank's work on revenue, OVE will provide an overview of the entire fiscal portfolio, which also includes macro-fiscal, expenditure policy, and public financial management interventions. The evaluation findings will seek to identify factors that affect the success of various types of interventions in different contexts, and to provide recommendations on how the Bank can enhance its support to tax policy and administration.
- 3.2 **OVE will analyze the Bank's support along four inter-related dimensions:**
- **Fairness:** Making tax systems more progressive and with broader tax bases.
  - **Economic efficiency:** Making tax systems simpler and less distortionary.
  - **Administrative capacity:** Increasing the professionalization and technological modernization, and improving the governance and management of collection agencies, both at the national and subnational levels.
  - **Effectiveness:** Reducing tax non-compliance.
- 3.3 **The unit of analysis is the country program, namely the set of all financial and non-financial interventions that sought to enhance tax policy and administration in the country.** The country program includes the Bank's operational portfolio (investment loans, policy-based loans, and technical-cooperation operations) as well as relevant knowledge products.

#### B. Evaluation questions

##### Relevance:

1. To what extent has the geographic distribution of the Bank's support for tax policy and administration reflected the distribution of critical tax-related needs by country?
2. To what extent have the objectives of tax-related operations been aligned with the critical tax-related challenges in the countries studied?
3. To what extent has the Bank's support for tax *policy* been consistent with, and complemented by, its support for tax *administration* in the countries studied?
4. To what extent have the designs of Bank operations in the countries studied been aligned with the existing body of knowledge on best practice in tax policy

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<sup>13</sup> The evaluation will not attempt to measure attribution—doing so in a rigorous way would be nearly impossible from a methodological standpoint. Even a synthetic control method would probably fail to generate a fair control group to reproduce counterfactuals as all possible comparable countries in the region have undertaken fiscal reforms over the evaluation period. Moreover, other development partners have supported reforms in the revenue field simultaneously to the IDB, thus disentangling the impact of IDB's interventions would not be feasible.

- and administration, as well as with the specific contexts of the countries in which they have been undertaken?
5. How has the Bank balanced fairness, economic efficiency, administrative capacity, and effectiveness, in the design of these operations?
  6. Has the Bank used an appropriate mix of instruments to address tax-related challenges in the countries studied?

**Effectiveness:**

1. To what extent have individual operations within programs in the countries studied met their objectives?
2. Which factors explain success or failure?
  - a. What implementation problems have the Bank's projects faced?
  - b. How has the Bank addressed implementation problems?
3. To what extent have the various operations in a country program combined to advance the tax-related objectives of the country concerned?
4. To which extent has the Bank's implemented program complemented that of other financial institutions, such as the IMF?

**C. Methodology and Building Blocks**

- 3.4 **The evaluation will be based on a portfolio review and a comparative evaluation of Bank's work in seven countries.** To take advantage of synergies between evaluations, OVE will draw on any relevant findings of other recent evaluations (e.g., Country Program Evaluations).
- 3.5 **Portfolio Review.** OVE will conduct a portfolio review at two levels. First, to contextualize IDB's engagement in tax policy and administration, the team will identify the Bank's entire fiscal portfolio for the period 2007-2016 (including macro-fiscal, tax policy, tax administration, expenditure policy, and public financial management interventions), and track Bank's activity by thematic area and country. Second, OVE will review the Bank's work in tax policy and administration during 2007-2016, considering loans, TCs, and knowledge products. In particular the team will analyze the relationship between the performance of key revenue and other tax-related indicators<sup>14</sup> in all IDB member countries and the distribution of IDB's operational support.
- 3.6 **Comparative program evaluations.** To further assess the relevance and effectiveness of the Bank's support for tax policy and administration, the team will undertake seven country case studies in Jamaica, Colombia, Paraguay, Guatemala, Honduras, Mexico, and Uruguay (Table 3.1). These seven countries have received significant support from the Bank in tax policy and administration, and represent different regions and income levels (Table 3.2 and Figure 3.1). This sample accounts for half of lending amounts and roughly 35% of the number of loans approved in the evaluation period in the revenue portfolio. Brazil, another country with a high level of Bank support, was excluded from the sample because

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<sup>14</sup> Such as tax burden, direct and indirect taxes as share of revenue collected, tax gap, tax expenditures as share of GDP, tax evasion rate, administrative costs as share of revenue collected, among others.

the PROFISCO program has been evaluated in OVE's Country Program Evaluation (RE-482-1).

- 3.7 **For each of the case study countries, the evaluation will analyze both the overall Bank program in tax policy and administration as well as individual operations**, with an eye to addressing the relevance and effectiveness questions laid about above.

**Table 3.1 - Programs to be evaluated in tax policy and administration, 2007-2016** <sup>15</sup>

Region	Country	Investment Loans	PBLs - PBPs	TCs
South-America	Uruguay	UR-L1038	UR-L1036*	UR-T1071 UR-T1103 UR-T1135
	Paraguay	PR-L1027 PR-L1035	-	PR-T1103
	Colombia	CO-L1125 CO-L1133 CO-L1155	CO-L1117 & CO-L1072 CO-L1142	CO-T1206 CO-T1283 CO-T1345
Central America	Honduras	HO-L1015 HO-L1108	HO-L1030 HO-L1103	HO-T1136 HO-T1188 HO-T1200 HO-T1220
	Guatemala	-	GU-L1008* GU-L1020 GU-L1064	GU-T1102 GU-T1174 GU-T1193 GU-T1221
	Mexico	-	ME-L1090 ME-L1144 & ME-L1189	ME-T1138 ME-T1139 ME-T1222
Caribbean	Jamaica	JA-L1039	JA-L1001, JA-L1010 & JA-L1014 JA-L1032 & JA-L1034 JA-L1038 & JA-L1051	JA-T1066

\*These are the second loans of PBP series. For completeness, OVE will also review the previous operations

**Table 3.2 – Country programs to be evaluated, by region and income level, 2007-2016**

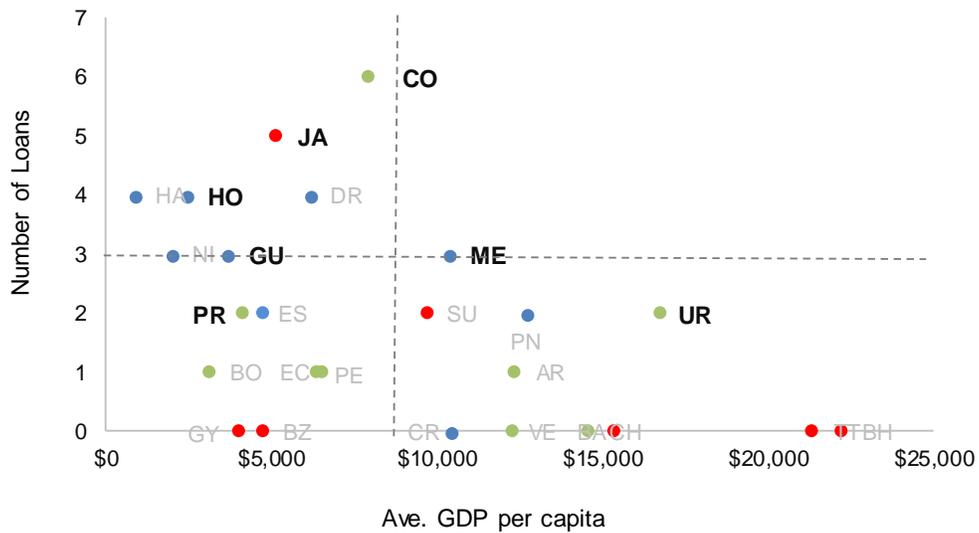
		GDP Per Capita	
		Below LAC Average	Above LAC Average
Region	South-America	Paraguay Colombia	Uruguay
	Central America	Honduras Guatemala	Mexico
	Caribbean	Jamaica	-

Source: OVE based on IDB Data warehouse and IMF

Note: GDP per capita values are for 2014 or 2013

<sup>15</sup> To date, CO-L1155, CO-L1125, CO-L1133 and HO-L1108 have disbursed less than 20%; therefore, OVE will not be able assess their effectiveness.

Figure 3.1 – Country programs to be evaluated, by region and income level, 2007-2016



Source: OVE based on IDB Data warehouse and IMF  
 Note: Colors indicate IDB country groups: South-America (green), Central-America (blue), and the Caribbean (red). Dotted-lines indicate LAC averages. GDP per capita values are for 2014 or 2013. Brazil is excluded for clarity

#### IV. OVE TEAM AND TIMELINE

- 4.1 **The team consists of Juan Manuel Puerta and Agustina Schijman (co-team leaders), Pablo Alonso, Maria Jose Hernandez, Maria del Mar Carpanelli, Nadia Ramirez Abarca, and Maya Jansson.** OVE will also hire experts to provide technical support in for the comparative program evaluations.
- 4.2 **The expected timeline for the evaluation is as follows:**

Activity	Date
Draft for management review	June 2017
Submission of final draft to SEC	July 2017
Discussion at the Board of Executive Directors	August 2017

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