Medium-term Revenue Strategy (MTRS) – Taxation and Development

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It is very appropriate for me to speak about how to build tax and state capacity in Vienna. That is because I often start from Schumpeter: The Crisis of the Tax State. As many of you may know, his original lecture was presented here in Vienna in 1917. The article was then published in the following year and translated into English much later. Its most important contribution was the idea that taxation constitutes the form of financing that is used by the state and by the state alone. Taxation appears as the financial backbone of state capacity. It is interesting to note that about 100 years ago, Austria had Schumpeter as Minister of Finance of its first republic. He was about to leave the job after only a little over six months.[1]

Today we emphasize that tax capacity is required if the state is to fulfill its role in sustainable and inclusive growth. Taxation is necessary to enable the state. Taxation is thereby at the center of development policies.[2] Development in turn is a concomitant with overall prosperity.

I hope that these brief words and references have persuaded you of the importance of our topic. The question is then: how can countries improve their tax capacity?

For countries committed to improving their tax capacity, in an enduring way, the Platform for Collaboration on Tax (PCT—a partnership of the IMF, OECD, UN, and WBG—put forward the concept of Medium-Term Revenue Strategy (MTRS) to Tax System Reform.[3]

The MTRS – A process and not a static concept

So, what exactly IS an MRTS? The MTRS starts from the formulation of *a high-level road map of tax system reform* in a country—extending over 4 to 6 years. The MTRS is the sustained process of implementation of this tax system reform over time.

Why an MTRS?

"Why is an MTRS needed? How will it help countries achieve lasting and meaningful tax system reforms?" Many have asked us these questions.

The organizing principle is *a vision for the future tax system that the country aims for. Clarity of purpose helps to* overcome well-known problems in the political economy of tax system reform. Experience points to the fact that erratic, inconsistent efforts at change frequently result in no change at all—or in quick reversal.

Building a country-specific vision requires a government-led effort and whole-of-government buy-in and support, and a broad social and political commitment to tax system reform. Thus, an MTRS process is a country endeavor leading to a broadly supported, public, transparent, tax system reform. The process is fundamentally political and social. Here we continue to follow Schumpeter who asserts: “The spirit of a people, its cultural level, its social structure, the deeds its policy may prepare—all of this and more is written in its fiscal history, stripped of all phrases.”[4]

I should add that the idea of the MTRS approach is well-rooted in best practice: our medium-term design and sustained implementation are the most successful approaches to tax system reform. Those experiences have led to the MTRS.

MTRS’s four interdependent components

The MTRS has *four interdependent components:*

The **first MTRS component** is *about determining spending required to support economic and social development*. This goal-setting exercise has to be led by the government and, at the same time, be inclusive; involving a broader stakeholder community; and ideally society as a whole. Developing a good understanding across the government, parliament, civil society organizations, and taxpaying community will help navigate the political economy difficulties of tax system reform. This will enable building broad consensus and commitment to a substantial and well-thought-out tax system reform road map—based around suitable and realizable longer-term revenue and other goals. (This links to the third component that I will cover later).

When thinking about tax capacity for inclusive growth, for example, it is crucial to consider spending needs for priority items like public infrastructure—better economic connectivity—and health and education to strengthen human capital. In this way, the MTRS links closely to the Sustainable Development Goals (SDGs), and their financing.

Additional spending required in low-income developing countries—like Rwanda and Benin—is quite considerable at about 20 percent of GDP by 2030.[5] In emerging market economies, the estimates are much lower with, for example, 5.6 percent in the case of Indonesia. For advanced economies, the question is more how to facilitate an inclusive transition to green and digital economies and societies. The example of Indonesia is particularly well documented. The central importance of tax capacity in economic development comes out crystal clear.[6]

The **second MTRS component** *is the tax system reform road map itself*—covering tax policy, revenue administration, and the legal framework. Why take this comprehensive view of the tax system? Because policy and administration linkages influence the overall tax system effectiveness. And the legal framework is the enabler to apply and enforce countries' taxation.

Tax system reform must be formulated to mobilize the needed revenues in the medium to long term. At the same time, it should be shaped so as to contribute to economic and social development. The key is to use the positive synergies among tax policy, revenue administration, the legal system and, in general, the functioning of public administration. A common difficulty comes from urgent revenue needs. Those may require prompt actions. But these have to be taken with a view to meeting ultimate reform goals.

Exactly what this tax system reform will look like must, of course, be very country-specific. It depends on existing capacity, and the shape of the current tax system. The idea is to follow a holistic tax system reform plan for ultimate success and sustainability.

In supporting countries to formulate MTRSs, key challenges have been observed in adopting a more comprehensive approach to tax system reform. The siloed approach is predominant in initiatives to improve tax systems, sometimes with piecemeal endeavors that do not exploit the potential synergies in taking a more holistic approach. Quantification of impact (especially on revenues) is another significant issue, which is somehow easier with tax policy options—if, a big if, good statistical data and tax records are available—and much more difficult with the administrative reforms and legal changes.

Here, too, Schumpeter continues to be our guide. Writing about the origins of the tax state he affirms: *"Taxes not only helped to create the state. They helped to form it. The tax system was the organ the development of which entailed the other organs."* Besley and Persson likewise link up tax capacity, state capacity and legal capacity.

The **third MTRS component** *is about sustained medium-term government commitment to reform*. For the formulation and steady implementation of the tax system reform, enduring political support is necessary. And government commitment must be expressed in concrete and visible measures. A whole-of-government approach is crucial to support the tax system reform formulation and implementation across its different fronts. Some of the elements of reform demand support from government entities beyond the revenue agencies and the ministry of finance. For example, policy changes to rationalize sectoral tax expenditures need line ministries to align behind them; modernization of revenue agencies' human resource policies requires civil service agencies to be supportive; enforcement of taxpayers' compliance in certain sectors demands cooperation with other enforcement agencies, just to name some examples. Secured funding support to revenue agencies modernization, notably in their path to digitalization, requires medium-term budgets that are sustained during the span of reform.

A critical enabler (and success factor) in this third MTRS component is the reform governance arrangement at the highest level in government—the leadership of the minister of finance is certainly critical. The political economy of a tax system reform effort of this magnitude requires that it be led by a high-level official resourced and empowered to mobilize the government and engage with the broader society. This will demonstrate the political commitment and priority the government is assigning to the reform. And it has to be sustained and with clear accountabilities of the entities contributing to the tax system reform. Achieving this government stance to the tax system reform will send a clear signal to taxpayers from whom voluntary compliance is expected.

Reform governance has been a major challenge in our capacity development support to countries, when undertaking targeted tax system reforms. In the scenario of an MTRS, this requirement (even pre-requisite) is much more critical given the broad coverage of several entities involved in making the MTRS a success. Revenue agencies are more familiar with the need to organize their reform efforts under well-structured reform management offices; however, finance ministries often are not. Thus, adopting the MTRS approach to tax system reform requires strengthening of reform management capabilities, which is crucial for guiding the MTRS process and its accountability.

The active engagement of economic and social stakeholders is also required. The perception that economic agents and citizens are getting value for money is crucial for quasi-voluntary compliance.

The same can be said about perception of fairness of the budget. Transparency and accountability are important dimensions of lasting understanding with civil society.

Finally, through its **fourth component the MTRS** approach *calls for a coordinated but 'subordinated" external support to the government-led tax system reform*. Thus, an MTRS identifies the resources needed for the process of reform itself. Those will come from the country concerned, but additional assistance will be required in many cases. So, the MTRS will help align and coordinate external support under the umbrella of the government-led reform effort. Also, it can help development partners plan ahead not only to ensure appropriate resources to help the government deliver on the strategy—but also to overcome situations in which partners provide support on a fragmented basis, not based upon effective sequencing. This, like the political economy of reform within government, frequently arises from the political economy of technical assistance. Outcomes are notoriously hard to measure, let alone show causation for—and each provider of course has to answer to its own leadership. In some countries, too, especially but not only the lowest income, external support will be helpful to assist the government in structuring the tax system reform itself, building on progress already achieved, so that all providers can line up around and behind it.

We have gained experience in this area. Effective coordination has proved to be challenging. It is important to avoid gaps and overlaps. Sequencing of support has not always been aligned. Sometimes it has not been timely. But let me repeat for emphasis: the key principle is government leadership, so each external partner provides its support under the government-led tax system reform agenda.

We at the IMF are enthusiastic—even passionate! —about the MTRS. We believe that it has the potential to help overcome the difficulties that serious, broad tax system reform always faces. So, we greatly look forward to hearing from our panels today and tomorrow, and also to listen to your thoughts during the discussions. We see these two days as an important moment in making the development and application of the MTRS approach a landmark in the support provided to build effective and fair revenue systems so critical for sustained development.

With that, I would like to thank you for your attention and invite you to actively participate in the conference and share your views on how tax systems can be improved. It is central. To repeat Schumpeter's historical insight: *"The tax system was the organ the development of which entailed the other organs."*

[1] Joseph Alois Schumpeter, 1918, The Crisis of the Tax State, chapter 1, in Richard Swedberg (editor), 1991, *The Economics and Sociology of Capitalism,* Princeton: Princeton University Press.

[2] For analysis, evidence and further references see, for example, Vitor Gaspar, Laura Jaramillo and Philippe Wingender, 2016, Political Institutions, State Building and Tax Capacity: Crossing the Tipping Point, Working Paper 16/ 233, International Monetary Fund; and: Tax Capacity and Growth: Is There a Tipping Point? Working Paper 16/ 234, International Monetary Fund. Very good general references are Roger Gordon (editor), 2010, *Taxation in Developing Countries,* Columbia, Columbia University Press; Timothy Besley and Torsten Persson, 2009, The Origins of State Capacity: Property Rights, Taxation and Politics, *American Economic Review,* 99: 1218-1244; 2011, *Pillars of Prosperity: The Political Economics of Development Clusters,* Princeton: Princeton University Press and, finally, 2013, Taxation and Development, in Alan Auerbach et al. (editors), *Handbook of Public Economics,* volume 5, Oxford: Elsevier.

[3] The original reference is IMF, OECD, UN, WBG, 2016, *Enhancing the Effectiveness of External Support in Building Tax Capacity in Developing Countries,* July.

[4] Here, Schumpeter is himself paraphrasing Goldscheid: "the budget is the skeleton of the state stripped of all misleading ideologies". In Schumpeter, op. cit., Goldscheid, is quoted at page 100 and the sentence quoted above in the following page.

[5] Gaspar, V., D. Amaglobeli, M. Garcia-Escribano, D. Prady, and M. Soto, 2019, "Fiscal Policy and Development: Human, Social, and Physical Investment for the SDGs", IMF Staff Discussion Note 19/03.

[6] See Luis Breuer et al. (editors), 2018, *Realizing Indonesia's Economic Potential,* International Monetary Fund. Specifically, chapter 6, Implementing a Medium-Term Revenue Strategy, by Ruud de Mooj, Suahasil Nazara and Juan Toro.