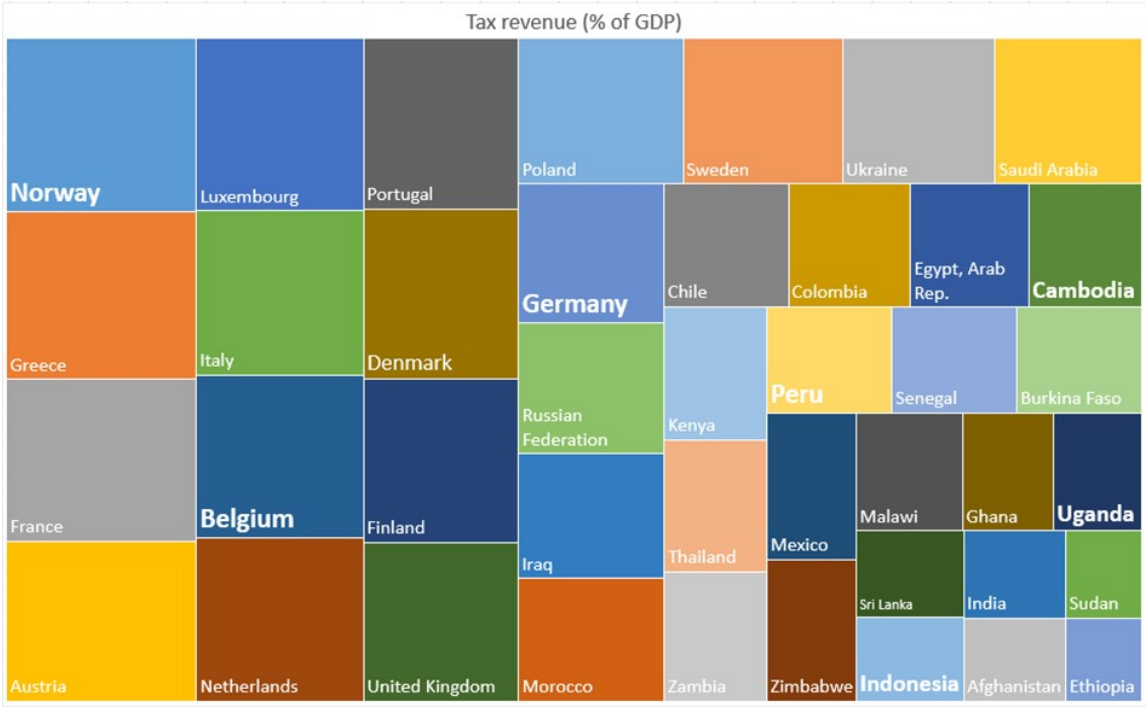
››› A change of perspective



Private enterprises as major source of government revenue

How the private sector delivers on SDG 17

KFW DEG

This report is a result of DEG's evaluation work regarding development effectiveness. DEG's monitoring and evaluating team checks at regular intervals whether the transactions it co-finances help to achieve sustainable development successes and points to ways of making further improvements for DEG and its customers. To ensure the independence of evaluation results, external consultants regularly support the work of the team.

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1 Executive Summary

Sustainable Development Goal 17 (SDG) states that governments and their budgets play a crucial role in reaching the global SDG targets and to boost human development**.**

When discussing government revenue and revenue creation, the role of the private sector is often underestimated. In this context, most discussions focus exclusively on the role of corporate income tax – a tax that is levied on a company's profits – and often include the negative impact of tax optimizing structures on government revenues in Emerging Markets. While this discussion is important, there exist various other linkages between the private sector and government revenues that are rarely taken into account.

This paper discusses how private sector contributes through different linkages to government revenue. It follows a three-step process:

1. Identifying and discussing relevant sources of government revenues;
2. Linking private sector activities to these sources;
3. Estimating the overall government revenue amount that can be linked to DEG's portfolio companies through the outlined channels

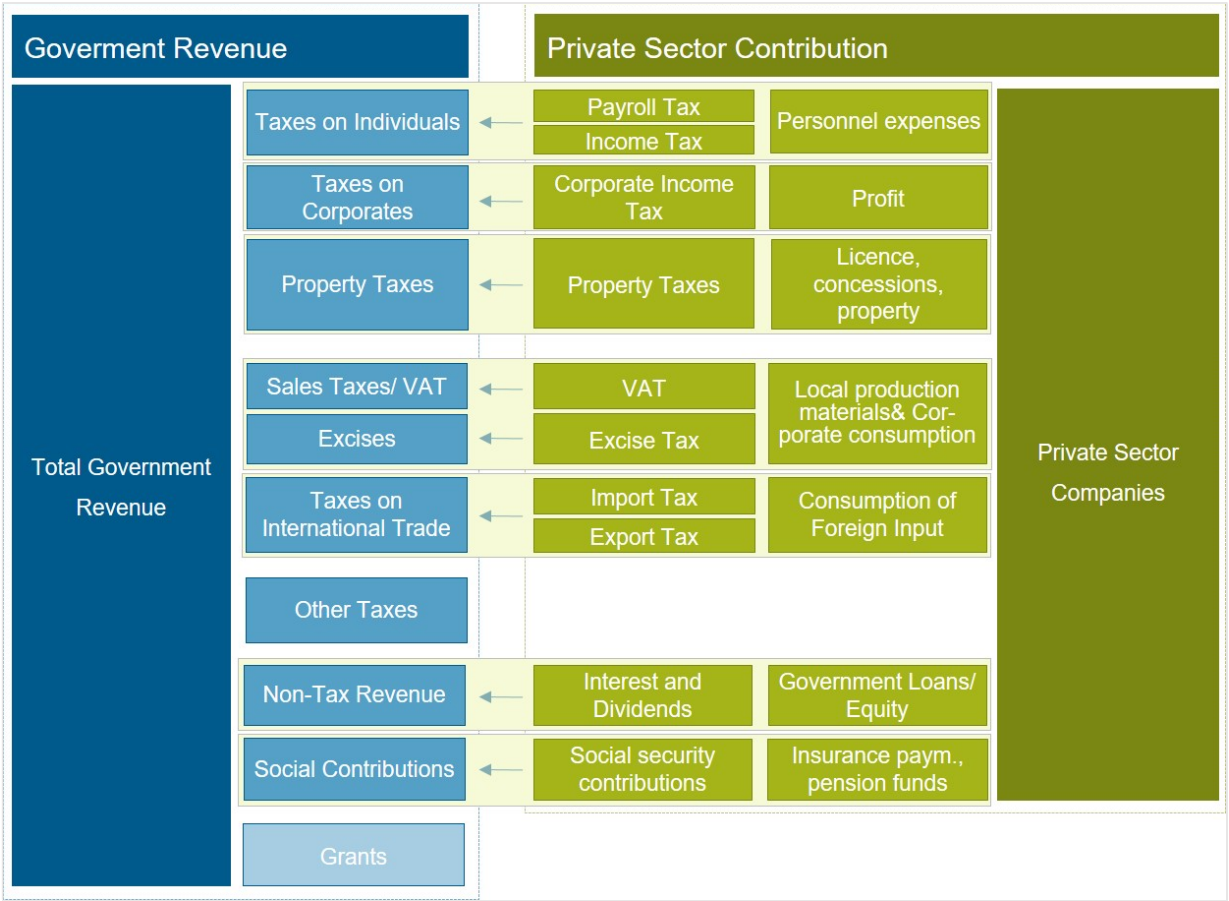

Figure 1: Different linkages of private sector companies' activities to government revenue creation

Compared to the traditional reporting of Corporate Income Tax (CIT) only, the tax contribution of DEG's portfolio companies triples when taking into account some of the additional revenue sources. This significant increase highlights that the private sector and its income/value creation processes are an often-underestimated source for government revenue creation and play an important role in achieving SDG 17. Additional government revenue directly affects the potential to reach other SDGs as governments use these revenues at least partly to contribute to national SDG targets.

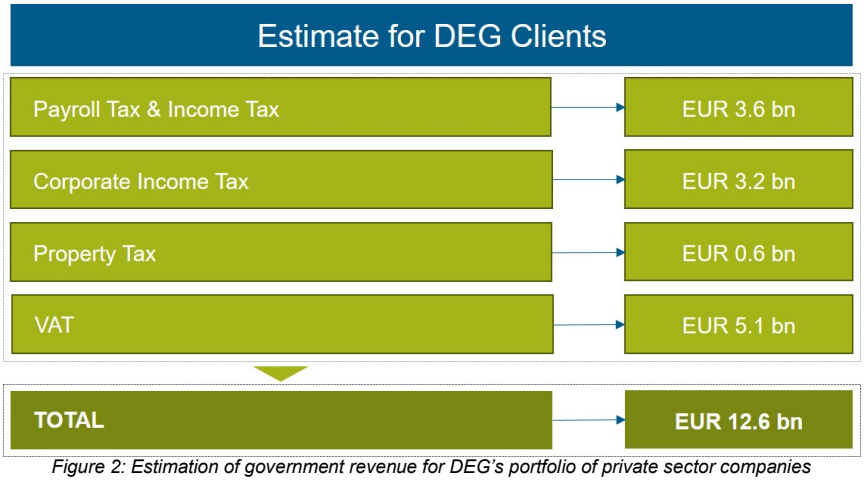

Figure 2: Estimation of government revenue for DEG's portfolio of private sector companies

Our main learnings from this exercise:

1. **Government revenue creation and private sector companies have a multitude of interlinkages.** Reducing the private sector contribution to government revenues to CIT misses the point and leads to a severe underestimation: in fact, there exist various interlinkages between government revenue and private companies that are often not obvious and can come as a surprise.
2. **The SDGs and other international frameworks should continue to push for an inclusion of the private sector as a relevant vehicle to boost development.** Support of the private sector can boost government budgets through various ways that are often not very obvious. This should be taken into account when formulating policies and assigning government support for a country's development. Generally, policies that support private sector activity, for instance by improving the business environment, will also lead to an increased government revenue contribution. This directly supports "SDG 17.1.1 – Government Revenue: Strengthen domestic resource mobilization".
3. **Impact reporting on government revenue can help to increase transparency:** Impact reporting by Development Finance Institutions and other institutions underestimates the government revenue created by the companies they support. The overall contribution of DEG's portfolio companies to government revenues amounts to EUR 12.6bn and exceeds the usual reporting benchmark – the corporate income tax contribution – by a factor of 3-4. A clear and concise way of aggregating and reporting these payments would provide transparency and a good basis from which to start analyzing the role of the private sector in increasing government revenue and to get a better understanding of how to increase its overall contributions to the SDGs.

Contents

2 Government revenue and its link to development

Setting the scene for this chapter:

- Government revenue consists of multiple sources.
- Government revenues are strongly linked to the global development framework, the Sustainable Development Goals (SDGs),
- Developing countries are constrained by a lack of government revenue to achieve the SDGs.

2.1 Government revenue consists of multiple sources

We can understand government revenue by identifying its sources. There exist several different instruments for governments to generate revenue or "income". Revenue consists of cash receipts from taxes, social contributions, and other revenues such as fines, fees, rent, and income from property or sales. It further includes grants, typically in the form of development assistance transfers. Depending on the definition, debt or more precisely budget deficits, or reductions of budget surpluses can be included

We can display a conceptual classification of revenues to show its sources. Figure 1 shows that total government revenue includes grants, direct taxes (such as taxes on income, profits, property, etc.), indirect taxes (including taxes on consumption, sales, trade etc.), and social contributions (Prichard et al., 2014). Debt is not included.

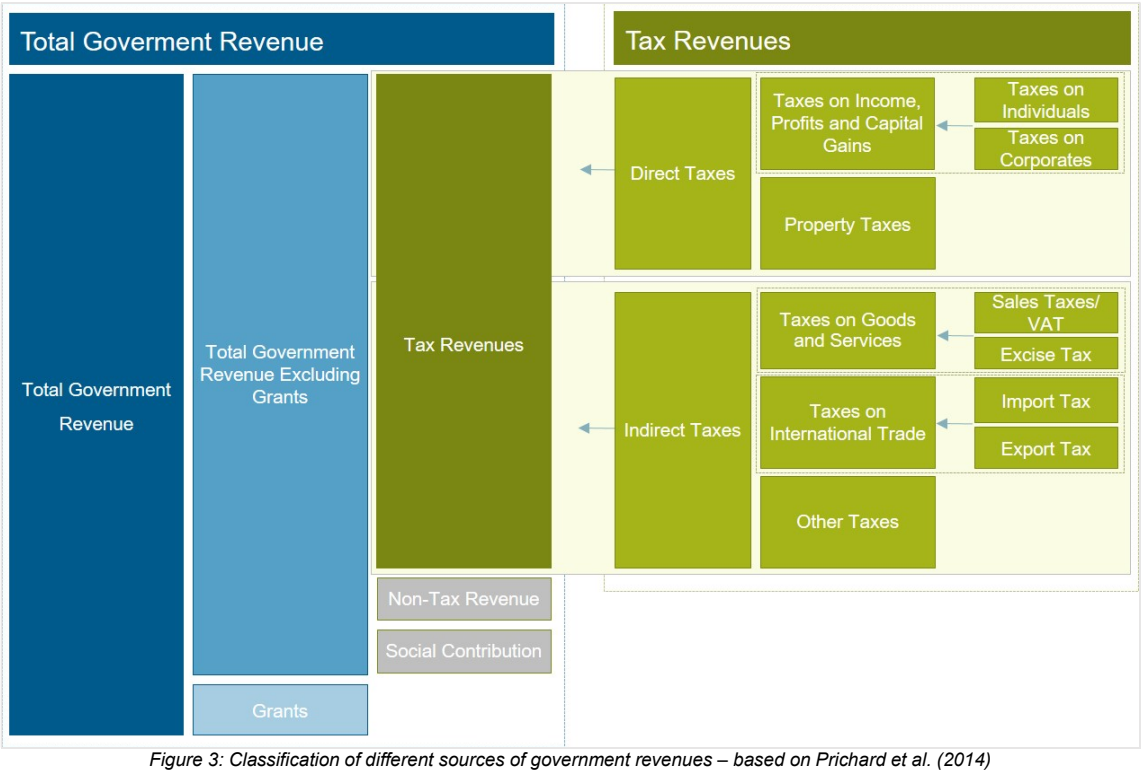

Figure 3: Classification of different sources of government revenues – based on Prichard et al. (2014)

2.2 Government revenue and the SDGs

The relevance of government revenue creation gains substance when discussing its role in the SDG framework. In 2015, the United Nations (UN) General Assembly adopted the 2030 Agen-

da for Sustainable Development and the 17 UN Sustainable Development Goals (SDGs), calling on all countries to improve the lives of people everywhere (UN, 2019).

Government revenue enables states to deliver on the SDGs – they are an essential element in facilitating the achievement of the SDGs. Revenues enable the respective public institutions to deliver on all other SDGs, especially the ones with a strong role of direct government financing, e.g. SDG 4 "Quality education" or SDG 6 "Clean water and sanitation".[1]

For this reason, the domestic creation of government revenues has its own SDG sub-target and target indicators under SDG 17 ("Strengthen the means of implementation and revitalize the global partnership for sustainable development"). SDG 17 has three sub-goals, the first of which is entirely about government revenue creation (Ritchie, Roser, Mispy, Ortiz-Ospina, 2018).

UN definition of SDG 17.1

"Strengthen domestic resource mobilization, including through international support to developing countries, to improve domestic capacity for tax and other revenue "collection.

- **SDG 17 – Sub-Goal 17.1.1:** Government Revenue: Strengthen domestic resource mobilization, to improve domestic capacity for tax and other revenue collection across all countries by 2030. The target indicator is total government revenue as a proportion of GDP.
- **SDG 17 – Sub-Goal 17.1.2: Domestic Tax:** Strengthen domestic resource mobilization, to improve domestic capacity for tax and other revenue collection across all countries by 2030. The target indicator is the proportion of domestic budget funded by domestic taxes.

2.3 A lack of government revenues constrains development

Taxes account for a significant part of government revenue. According to one estimate, total tax revenues make up **80 percent** of total government revenue in nearly every second country in the world, and more than **50 percent** in almost every country (Ortiz-Ospina & Roser, 2019). There is a tremendous variation in tax systems and the tax base around the world. A pronounced difference can especially be observed between developed and developing countries.

[1] This holds true under the postulate of an efficient and purposeful (SDG-focused) use of government revenues.

Developing countries have lower tax revenues than industrialized countries: The tax ratio – the relation of total tax revenue to GDP – provides an indicator for the level and ability of national revenue collection. To provide sufficient spending for public goods that ensures the basic livelihood of the population, estimates suggest that a country needs a tax ratio of a minimum of 15 percent (Ritchie, Roser, Mispy, Ortiz-Ospina, 2018).

However, many developing countries fall short of this target. Figure 2 depicts the average tax ratios by country income category, based on World Bank data[2]. Low-income countries do only have a tax ratio of roughly 14% on average, and lower-middle income countries are barely above the threshold of 15%. Furthermore, there are considerable differences within the various income groups. Analyzing the data on an individual country level, around 31 of the 59 low- and lower-middle income countries for which data is available have a tax ratio below the threshold of 15%. From a geographical perspective, most of these countries are in Africa and South-East-Asia. The higher a country's income group, the higher its tax revenues (in % of GDP), as also observed by Korte and Lucas (2013).

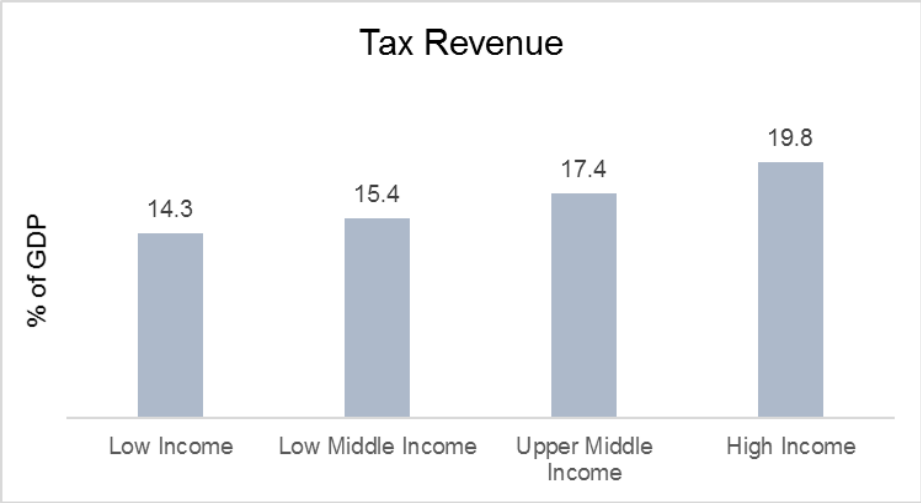

Figure 4: Tax revenue as share of GDP, Source: The World Bank

Although the differences in tax ratios between income clusters appear to be rather small in relative terms, they are enormous in absolute terms. On a global level, the accumulated tax revenue is worth around USD 9.8 trillion (Table 1): low- and lower-middle-income countries account for tax revenues of USD 40 billion and USD 400 billion respectively, while upper-middle and high-income countries have tax revenue of USD 2 trillion and USD 7 trillion, respectively.

Low Income	Low Middle Income	Upper Middle Income	High Income
$ 39.896.679.266,73	$ 399.228.971.891,93	$ 2.260.908.302.157,56	$ 7.084.588.725.379,04
Total	**$**		**9.784.622.696.695,26**

Table 1: Tax Revenue in current USD, The World Bank

[2] Following the World Bank definition, "tax revenue refers to compulsory transfers to the central government for public purposes. Certain compulsory transfers such as fines, penalties, and most social security contributions are excluded. Refunds and corrections of erroneously collected tax revenue are treated as negative revenue." https://data.worldbank.org/indicator/GC.TAX.TOTL.GD.ZS

These differences reflect several structural features and bottlenecks of the respective country.[3] Among them are the actual size of the economy and hence the tax base. Furthermore, there are several challenges that hamper the potential of generating tax revenue for development. These include, for instance, an inefficient fiscal policy structure or administration, including tax collection or the suboptimal exploitation of the actual tax potential (including tax evasion by companies or individuals). Especially in developing countries, there are significant constraints to administrative and institutional capacity, which impede the expansion of the tax base (Bruhn, 2011).

Developing countries need to step up their efforts for a more effective domestic resource mobilization. To achieve the SDGs, much of the required increases in public financing need to be generated domestically. "This is not a matter of simply taxing more or lowering taxes for corporations, but of taxing better by simplifying and improving the efficiency of tax administration, bringing tax laws up to date, and making sure tax administrators know how to audit local and multinational companies." (Walliser, 2018)

In this regard, private sector activities play a vital role in supporting domestic resource mobilization in developing countries. In the following section, we will focus on the different activities and channels through which private sector companies contribute to public finances.

3 Private sector companies' contribution to government revenues

Setting the scene for this chapter:

- Through multiple direct and indirect linkages, private sector companies contribute significantly to government revenue.
- In developing countries, this contribution is smaller than in industrialized countries, despite higher effective income tax rates. One reason lies in the narrower tax base.
- Improving the environment for private sector activity, for instance by getting the business environment right or implementing growth-enhancing structural reforms, will have a positive effect on tax revenues.

3.1 Exemplary mapping of cash flows that can be linked to government revenue

Private sector activities make up a significant part of government revenue. Companies that are actively operating in a country contribute to government revenue through their business activities The more the respective business model is embedded into the local economy, i.e. by employing local staff or sourcing from local suppliers, the stronger the contribution to the national budget.

Mapping sources of government revenue to private sector companies' activities and related payments reveals multiple linkages. Figure 3 depicts an exemplary – and not exhaustive – mapping of private sector contributions to government revenue. Companies pay direct taxes, which comprise income, corporate and wealth tax. They also pay indirect taxes consisting of VAT and excise tax, as well as import and export taxes (customs), which are levied on goods and services to the consumer and are paid to the government by the vendor (Coady, 2018).

[3] There are several ways to increase domestic tax revenues, as discussed in more detail in Akitoby et al. (2019), among others. This paper focuses on private sector companies as one of the key contributors of tax revenue creation.

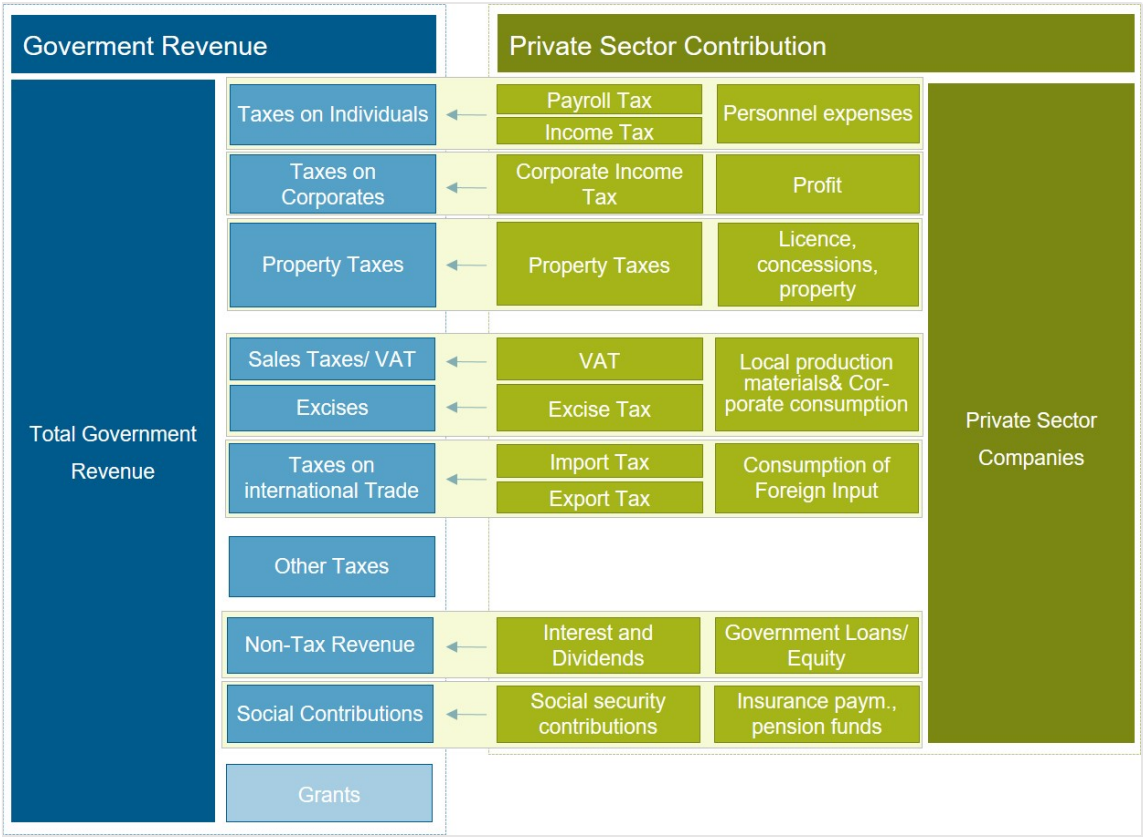

Figure 5: Tax payments by corporates and the contribution to the respective categories of tax revenue (based on Pritched et al., own further development) /No comprehensive mapping, only visualization of examples.

One example to explain our mapping: Private sector companies pay salaries to their employees, which are part of the companies' production costs. These wages are subsequently taxed as well. Therefore, the taxes paid on wages are based on the private sector companies' activities. The other categories in Figure 3 – and how we mapped them to government revenues – are further explained in a separate Annex.

3.2 Quantifying the private sector contribution to public finances

Taxes on Income, Profits and Capital Gains as a rough proxy. In order to quantify the total contribution of private sector companies to public finances, we would ideally compare data for all of the different subgroups (as outlined in Figure 3) from the individual private sector company perspective and aggregate the results. Unfortunately, comparable worldwide data on the individual categories do not exist, especially for the large number of non-OECD countries. Therefore, we analyze the indicator "Taxes on income, profits and capital gains" (TIPCG) provided by the World Bank[4] as a rough approximation for the contributions of the private sector to public finances.[5]

[4] The World Bank defines the indicator taxes on income, profits and capital gains as "taxes on income, profits, and capital gains are levied on the actual or presumptive net income of individuals, on the profits of corporations and companies, and on capital gains, whether realized or not, on land, securities, and other assets".

[5] This indicator provides only a rough estimation and has several shortcomings: first, bear in mind that these categories represent only a subset of the direct taxes paid by private sector companies and are hence a lower-bound estimate for the direct, let alone the overall contribution of the private sector. At the same time, the indicator also includes contributions by the public sector, for instance the wage contribution of public sector workers. Furthermore, our focus on aggregate country income groups does not take into account country-differences with regard to private sector size and development into account. However, for a first indication on the macro-level, we consider this approach to be valid.

The relevance of TIPCG on overall tax revenues is significant across income categories, as depicted in Figure 4. However, there is considerable variation. While TIPCG account for 32.5% of total tax revenues in low-income countries, the share in high-income countries rises by more than 7 percentage points to 40%.

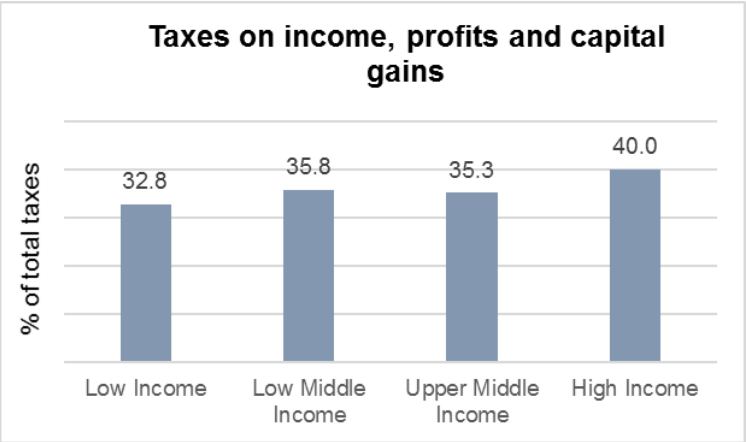

Figure 6: Share of taxes on income, profits and capital gains to total taxes, The World Bank

Analogously, the share of TIPCG in relation to gross domestic product is especially small in low income countries. Figure 5 reveals that with 8.1%, TIPCG make up roughly twice the share of GDP in high income countries compared to 4.8% in low income countries. Firstly, one reason lies in the lower tax base, since many developing economies have a smaller formal sector that can ultimately be taxed. Secondly, the tax administration is not able to collect taxes as efficiently, while levels of tax evasion might be more elevated (Thuronyi, 1996). Finally, it is also about the positive relationship between a tax structure that ensures certainty and stability, and a functioning tax administration that ultimately leads to higher economic activity and a growing tax base (Bruhn, 2011).

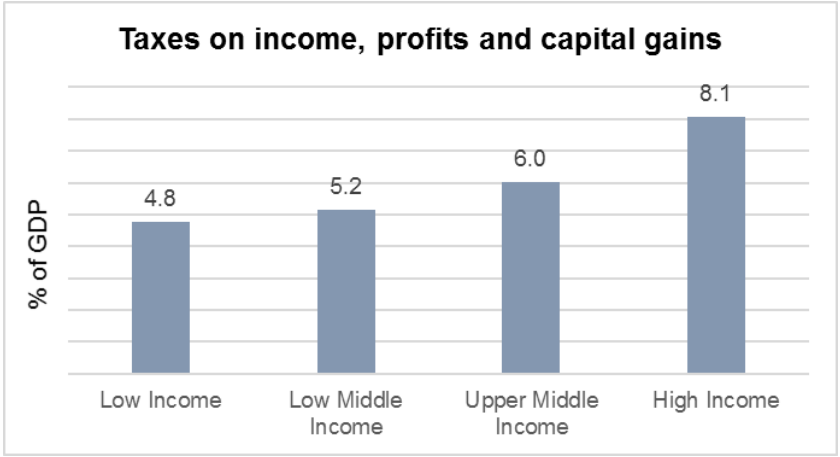

Figure 7: Taxes on income, profits and capital gains as share of GDP, The World Bank

Differences in corporate income tax (CIT) rates do not explain this disparity. Figure 7 depicts the average corporate income tax rates – one of the tax rates that the TIPCG is subject to – across the four income clusters. Astonishingly, corporate income tax rates are highest in low-income countries.

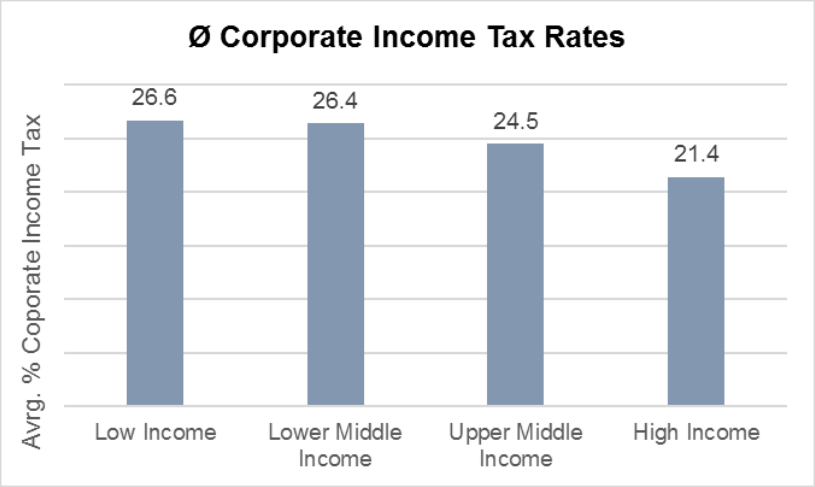

Figure 8: Average Corporate Income Tax Rates by income cluster (KPMG, 2016)6

The overall tax burden for many businesses in developing countries is actually quite elevated. For instance, as recent research suggests, the average total tax and contribution rate, i.e. all taxes borne by private companies expressed as a percentage of commercial profit, is around 13 percentage points *higher* for low-income economies than for high- and middle-income ones (PWC & World Bank, 2018).

To increase private sector contributions to government revenues, policy makers have several options, e.g. by implementing a more effective tax administration or tax structure. More generally, all structural reforms that lead to an increase in economic activity will lead to a broader tax base and ultimately higher revenues. One important pillar relates to getting private sector framework conditions right. Increasing corporate investment and employment rates contribute positively to tax revenues through different channels.

To sum it up: Private sector companies play an important role for government revenue creation in developing countries, through various channels. However, their overall contribution is lower in developing economies than in industrial countries, even though their individual tax burden is higher.

[6] KPMG: Corporate and Indirect Tax Rate Survey 2007, 2009 und 2016, KPMG's Corporate Tax Rate Survey – An international analysis of corporate tax rates from 1993 to 2006

Estimating government revenue of DEG's portfolio clients

EUR 9.2 to 12.6 billion. This is the amount of government revenue generated by DEG's portfolio companies when adding estimated payroll tax and VAT to data on corporate income tax and license fees. This very rough estimate provides a more hands-on understanding of the role of private sector companies in generating government revenue.

A focus on the company level allows an improved understanding of the societal value of individual or groups of private sector companies. We have already seen the significant role of private sector companies on a macro perspective for government revenue creation. While the macro-level perspective provides us with a general understanding of private sector companies, the micro or company level can help us understand in detail how a company's value creation is linked to government revenue creation in the country of economic activities.

4.1 DEG's Development Effectiveness Rating provides data for estimation

DEG and DERa: At the beginning of 2017, DEG introduced a new method for measuring the development contributions of private enterprises – the Development Effectiveness Rating (DERa). It measures the development effects of the companies and projects that DEG finances and at the same time provides the impulse to increase them.

The DERa uses five outcome categories to assess the development contributions of each client and to present the development impact of investments made by DEG's clients. Each category contains several quantitative and/or qualitative indicators that capture our clients' contribution to that specific category. The categories are as follows:

- Decent Jobs
- Local Income
- Market and Sector Development
- Environmental and Social Stewardship (E&S)
- Community Benefits

The first three categories assess major contributions to development by the private sector while the remaining two show whether a company is acting in a sustainable manner on behalf of the environment and the communities within it. Points are given for the indicator results for each category – the final result being a score by category and an overall DERa-score that serves as the single key performance indicator (KPI) for development impact.

DEG has been using the DERa since the beginning of 2017. It is applied annually to DEG's entire portfolio and has been used for all new commitments since January 2017, achieving 100% coverage of DEG's clients in 2017, 2018 and 2019. The DERa score is one of the most important KPIs for assessing DEG's overall performance. DERa data are therefore used for all impact-related DEG reviews, including the annual reporting on development impact. (DEG, 2019).

DERa and Local Income: The more a business model is linked to the local context, the more it contributes to the creation of local income (e.g. companies employing local personnel, paying taxes locally and sourcing from local suppliers). Local income is a key link between economic growth and human development: When businesses procure and supply locally, when they pay taxes and fair

wages and fully utilize the local economy, their growth immediately contributes to human development, among others via **increased government revenue**.

In the DERa, local income is assessed based on two pillars: The first pillar is the total sum of local income generated, assessed by all monetary transfers to local stakeholders, such as flows to employees (salaries, bonuses, pensions), government (taxes, fees, licensing), suppliers (procurement) as well as capital providers and shareholders (capital expenditures, interest expenses, share profits).

The second pillar is about the average local income growth, approximated through the three-year average of turnover growth. In case local income growth can be assessed directly, this value is used. This second pillar thus introduces a dynamic component, which allows small (low local income) but fast growing (high local income growth) companies to score as well.

4.2 Estimating government revenue based on DERa data

As can be seen from the above explanations, DEG collects a range of data points on private sector companies for its impact reporting. Combined with national data for payroll/income tax and VAT, we can utilize some of the DERa sub-indicators to achieve a rough approximation of the total contribution of DEG's clients to government revenue creation.

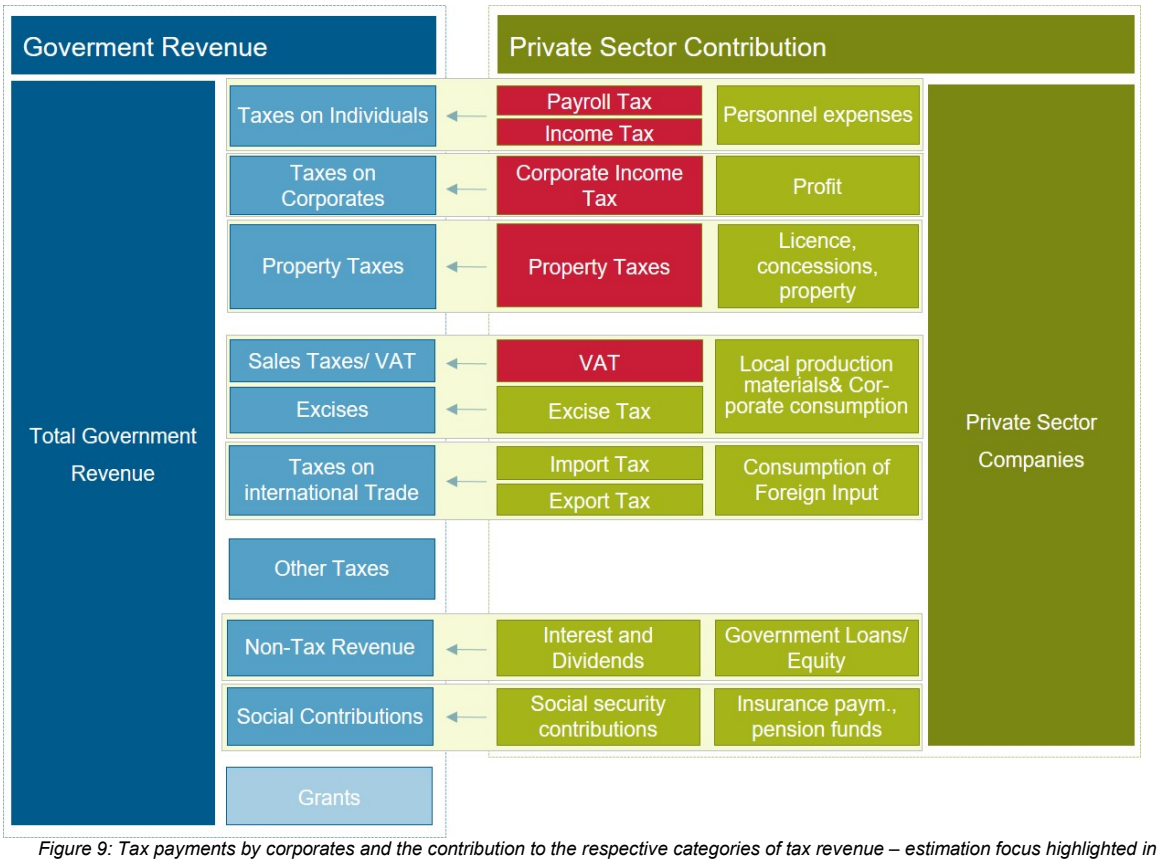

Figure 9: Tax payments by corporates and the contribution to the respective categories of tax revenue – estimation focus highlighted in red.

The final portfolio estimation results in government revenues created of between **EUR 9.2 and 12.6 billion** for 2018**.**

- **EUR 3.2 billion of corporate income tax paid**. For the analysis, we used the DEG customer portfolio with 1,007 clients , including corporates, project finance, financial institutions and investees from funds. Corporate income tax is a standard data field in the financial statements of DEG's customers.
- **EUR 621 million of property taxes**, or as the DEG data field is defined: license and concession fees. This is an explicit indicator in DEG's impact indicator system as well and reported by all clients.
- **Approximated payroll and income tax of employees**: DEG's clients pay EUR 12.5 billion in personnel expenses to local staff. DEG's clients are part of the formal sector, providing salaries for formal employment – therefore, these jobs are taxed adequately. Applying the lowest and highest marginal personal income tax rate for each portfolio country, results in a range of between **EUR 286 million (avg. rate 4.5%) to EUR 3.6 billion (avg. rate 26%)** of government revenue created via income tax.
- **Approximated value-added tax (VAT):** Procurement costs are at EUR 29.2 billion for DEG's portfolio clients, which when applying a standard VAT rate for each country (where applicable) results in a total of **EUR 5.1 billion of VAT** paid.

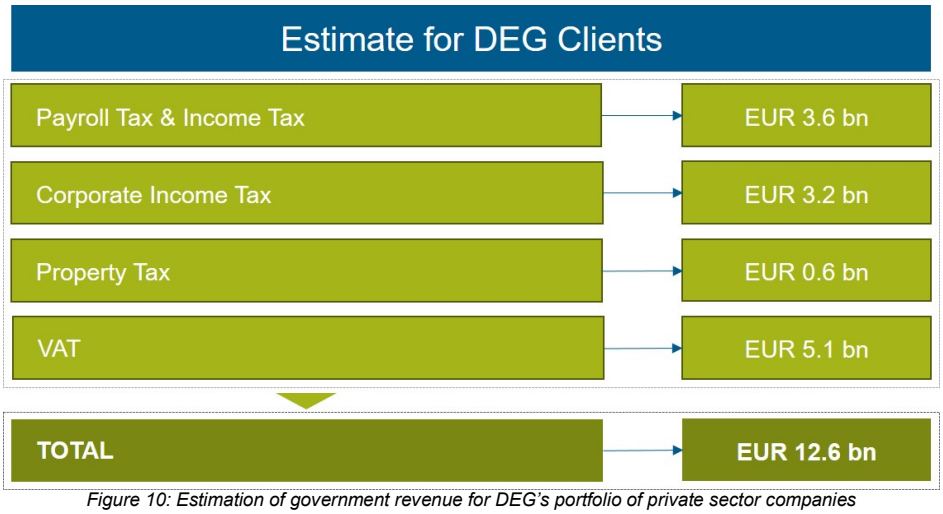

Figure 10: Estimation of government revenue for DEG's portfolio of private sector companies

This analysis is a very practice-oriented approach to illustrate how companies' activities actually generate much more government revenue than the official statistics show. More research is necessary to provide a more robust estimation of these effects. However, these numbers already show: DEG's 1,007 clients are only a tiny fraction of all firms, but they generate a substantial amount of government revenue in their respective local economy.

4 Learnings

Our main learnings from this exercise (for the reader: this is a repetition of the Executive Summary)**:**

1. **Government revenue creation and private sector companies have a multitude of interlinkages.** Reducing the private sector contribution to government revenues to CIT misses the point and leads to a severe underestimation: in fact, there exist various interlinkages between government revenue and private companies that are often not obvious and can come as a surprise.

2. **The SDGs and other international frameworks should continue to push for an inclusion of the private sector as a relevant vehicle to boost development.**
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ANNEX

On demand