4 Financing for development in the Dominican Republic: Towards a more inclusive, resilient and sustainable model

To finance a development model that is inclusive, sustainable and resilient the Dominican Republic needs to mobilise further public and private resources. On the public side, further tax revenues that reduce inequalities can be levied by rethinking the tax structure, rationalising tax exemptions, and fighting tax evasion. Similarly, there is space to improve the quality of public spending, to ensure its efficiency and increase its impact. Regarding the private sector, strengthening the role of the financial system is crucial to mobilise the necessary resources for development. Actions include further developing the banking system, strengthening the public debt market, and deepening the private debt market. The chapter first examines public finance, analysing revenue and expenditure and exploring potential areas for improvement. It then analyses the financial system and ways to improve private sector finance and further develop capital markets. Finally, the chapter presents the main conclusions and offers policy recommendations, arguing that advancing towards a more robust "financing for development" model will necessitate agreement on a comprehensive fiscal pact.

Introduction

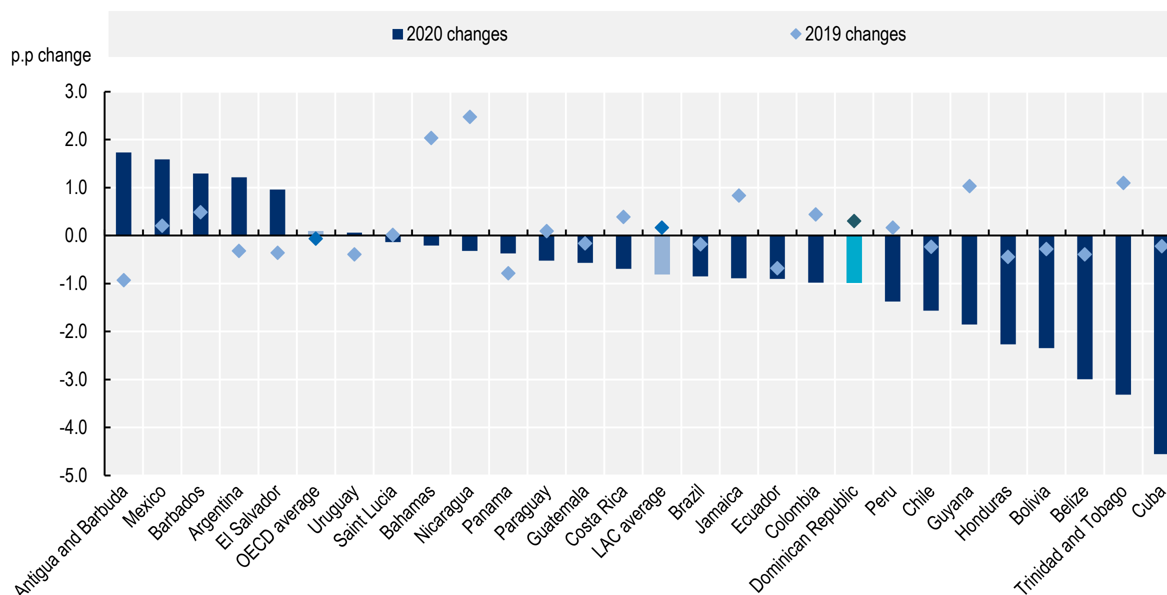
The aftermath of the COVID-19 crisis and the complicated external context have highlighted pre-pandemic structural challenges in the Dominican Republic such as low mobilisation of resources for development. The country needs to mobilise more resources in order to finance an inclusive, sustainable and resilient development model, Nevertheless, the country is currently in the difficult position of shouldering the costs of managing the crisis, external shocks and financing the recovery, and, more broadly, puts the "Financing for Development" model under stress.

In this context, this chapter seeks to explore where the Dominican Republic stands in its capacity to build a "Financing for Development" model that is inclusive, sustainable and resilient. The chapter aims to examine and address the per-pandemic structural challenges that the Dominican Republic faced to mobilise the necessary public and private resources. To this end, Chapter 4 is organised into three main sections. The first examines public finance, analysing revenue and expenditure and exploring potential areas for improvement that could increase the country's fiscal capacity. The second section focuses on the financial system and on how to improve private sector finance, as well as on the potential for further developing capital markets. The final section of this chapter presents the main conclusions and offers a number of policy recommendations, arguing that advancing towards a more robust "financing for development" model will necessitate agreement on a new and comprehensive fiscal pact.

Public finance in the Dominican Republic

As in other countries in Latin America and the Caribbean (LAC), the COVID-19 pandemic pushed the Dominican Republic's government to take urgent action in response to the crisis. Various emergency programmes were put in place to support households, businesses and workers, including the Employee Solidarity Assistance Fund (Fondo de Asistencia Solidaria al Empleado; FASE), which covered up to 70% of salaries for employees whose contracts had been suspended due to COVID-19 pandemic lockdowns, and which also supported small and medium-sized enterprises (SMEs) that continued to operate with the same staff. Other programmes targeted more vulnerable populations with specific cash transfers, such as the Programa de Asistencia al Trabajador Independiente (Pa' Ti programme) for independent workers, or the Quédate en Casa (Stay at home) programme for households with at least one member who was particularly vulnerable to COVID-19 (Cejudo, Michel and de los Cobos, 2020[1]). These actions involved a high fiscal cost, and social spending rose by 57.3% in 2020 compared with 2019 (Ministerio de Hacienda, 2022[2]). Between April and June 2020, the cost of these measures represented 1.1% of gross domestic product (GDP) (Ministerio de Hacienda, 2021[3]). As in the rest of the LAC region, tax reliefs were used in the Dominican Republic to mitigate the economic impacts of the crisis, mainly in the form of tax deferrals. These were applied to both direct (personal income tax) and indirect (goods and services) taxation and, in some cases, were applied to specific sectors, such as tourism (OECD et al., 2022[4]), where, for example, the deadline for filing and paying income tax (and the "simplified tax regime") was extended and those who owed additional taxes had the option of paying in four interest-free instalments. Overall, tax measures coupled with the economic slowdown decreased tax revenues in the Dominican Republic by around 7% (or 1% of GDP) in 2020, while the average fall in tax revenue in LAC in 2020 was 4% (Figure 4.1) (OECD et al., 2022[4])

Figure 4.1. Evolution of tax receipts in LAC, year-on-year real variation in percentage, 2020



Note: The LAC average represents the unweighted average of 26 LAC countries included in this publication and excludes Venezuela due to data availability issues. The OECD average represents the unweighted average of the 38 OECD member countries. Chile, Colombia, Costa Rica and Mexico are also part of the OECD (38).
Source: (OECD et al., 2022[4]).

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The COVID-19 pandemic hit at a time when fiscal space in the Dominican Republic was traditionally tight, mainly due to particularly low levels of tax revenues and generally higher expenditures. In this context, the short-term requirements for responding to the crisis, combined with the lower levels of tax collection associated with reduced economic activities, pushed fiscal deficit of the central government to 6.6% of GDP in 2020, compared with the 0.7% average during the years following the 2008 financial crisis (ECLAC, 2021[5]; BCRD, 2022[6]). Similarly, the medium-term costs of the post-COVID-19 recovery, and the reforms needed to overcome long-standing structural challenges, will demand stronger mobilisation of public finance.

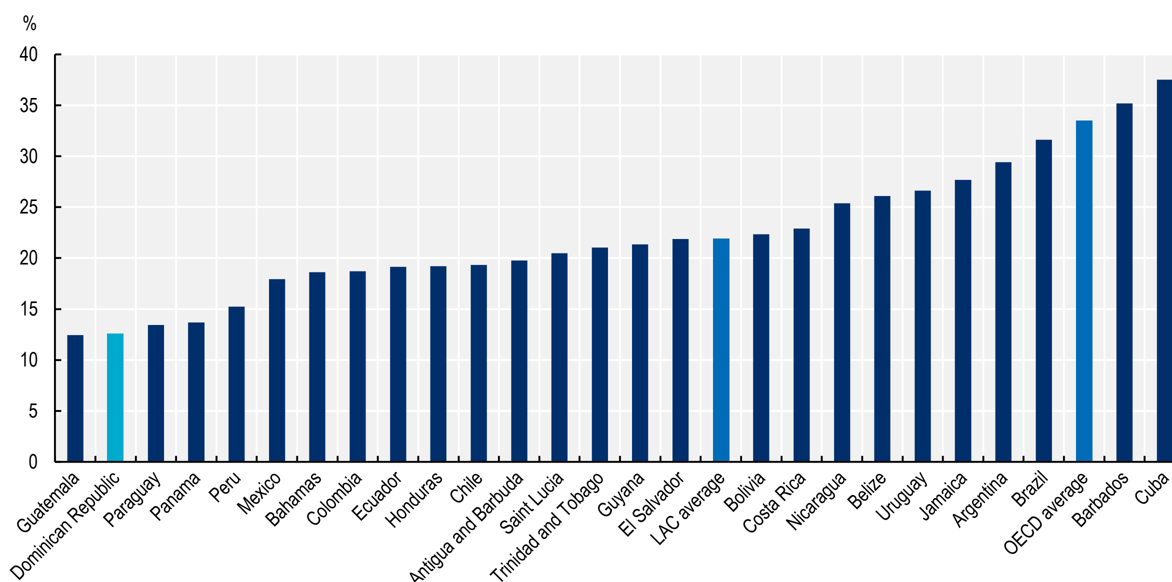
Tax revenues can be strengthened through a combination of measures, including rethinking the tax structure, rationalising tax exemptions and fighting tax evasion

Increasing tax revenues is a key policy objective for the Dominican Republic, but achieving this goal presents numerous structural challenges and complex choices. A variety of policy options can lead to greater tax revenues; identifying these and finding the right balance of measures will be crucial for success and for maintaining the taxation system as a catalyst for equality and economic growth. This section analyses the structure of the taxation system in the Dominican Republic and identifies potential areas for policy action that should be at the centre of the debate for fiscal reform and a broader fiscal pact. In particular, it is argued that the main areas of action should revolve around the following: 1) rethinking the tax structure; 2) rationalising tax expenditures; and 3) fighting tax evasion and avoidance.

Tax revenues are low in the Dominican Republic compared with the LAC and OECD averages, and are insufficient to finance the post-COVID-19 recovery

There is space for increasing tax revenues in the Dominican Republic, which represented 12.6% of GDP in 2020. This is the second-lowest tax-to-GDP ratio in the LAC, only just above that of Guatemala (12.4%) and just below those of Paraguay (13.4%) and Panama (13.7%) (OECD et al., 2022[4]). These figures are particularly low when compared with the tax-to-GDP ratios in countries such as Brazil (31.6%) and Uruguay (26.6%), and to some Central America and Caribbean countries such as Trinidad and Tobago (21.1%) and Costa Rica (22.9%). Tax revenues in the Dominican Republic are low in comparison with the LAC average of 21.9% and the OECD average of 33.6% (Figure 4.2). Furthermore, tax revenues in the Dominican Republic have remained relatively constant during the last decade: they had increased before the pandemic in 2019 by slightly more than one percentage point since 2010, when the tax-to-GDP ratio stood at 12.4% (OECD et al., 2022[4]). This is similar to the LAC tax-to-GDP ratio average over the same period. Moreover, in the Dominican Republic tax revenues as a percentage of GDP remain at a lower level than before the 2008 international financial crisis.

Figure 4.2. Tax revenues as a percentage of GDP in the Dominican Republic, LAC and OECD, 2020



Source: (OECD et al., 2022[4]; OECD, 2022[7]).

The Dominican Republic's tax structure shows some imbalances that suggest potential areas for readjustment in order to increase tax revenues, expand the tax base and build a more efficient and equitable tax system

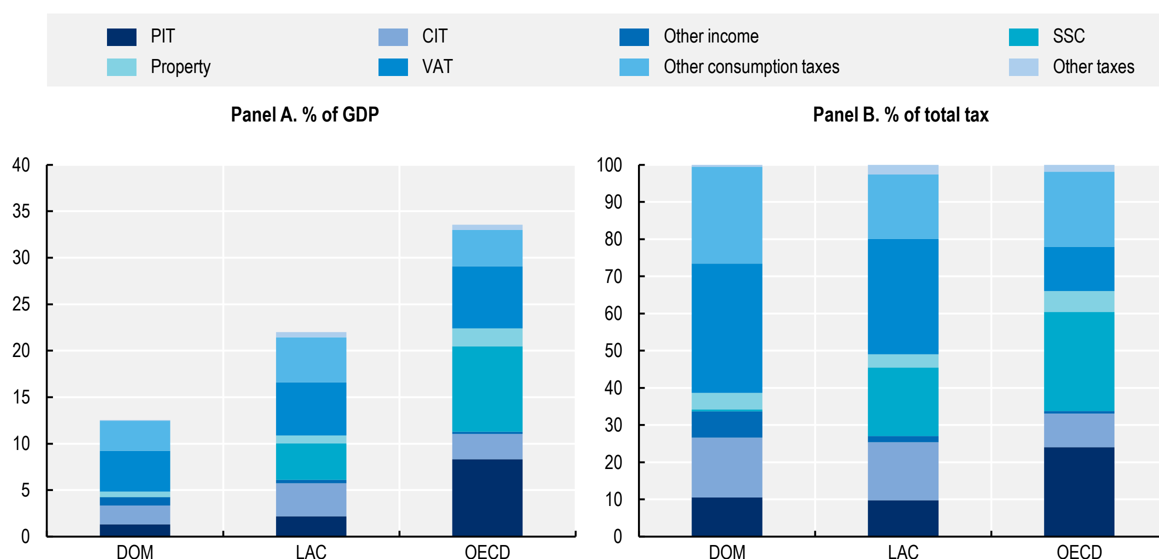
Indirect taxes are the main source of tax revenues, although their efficiency could be improved in order to increase tax collection

The tax structure in the Dominican Republic is particularly reliant on the indirect taxes that are levied on goods and services (Figure 4.3). They account for almost two-thirds (60.7%) of total tax revenues, representing 7.6% of GDP in 2020. This is well above the average share that indirect taxes contribute towards total tax revenues in LAC (48.4% of total tax revenues) and among OECD member countries

(32.1% of total tax revenues), although revenues from indirect taxes account for a higher proportion of GDP both in LAC (10.5% of GDP) and in OECD member countries (10.6% of GDP) than they do in the Dominican Republic.

The main source of indirect taxes is value added tax (VAT), known in the Dominican Republic as the tax on the transfer of industrialised goods and services (Impuesto sobre Transferencia de Bienes Industrializados y Servicios; ITBIS), which accounts for more than one-half of total revenue from indirect taxes. The VAT rate in the Dominican Republic is set at 18%, the fifth-highest in the LAC region along with Peru (also 18%) and behind Argentina, Chile, Colombia and Uruguay. In the Dominican Republic VAT accounts for 34.7% of total tax revenues, above the LAC average of 31.0% (Figure 4.3, Panel A). However, tax revenues from VAT represent 4.4% of GDP in the Dominican Republic, below the LAC average of 5.7% (Figure 4.3, Panel B). The proportion of tax revenues collected from the ITBIS has increased steeply since the 1990s, when it represented 15.1% of total tax revenues, and from 2000, when it represented 20.5%. From 2010 onwards, this has remained stable at around 34% of total tax revenues (OECD et al., 2022[4]).

Figure 4.3. Tax structure in the Dominican Republic, LAC and OECD member countries, 2020



Source: (OECD et al., 2022[4]).and (OECD, 2022[7])

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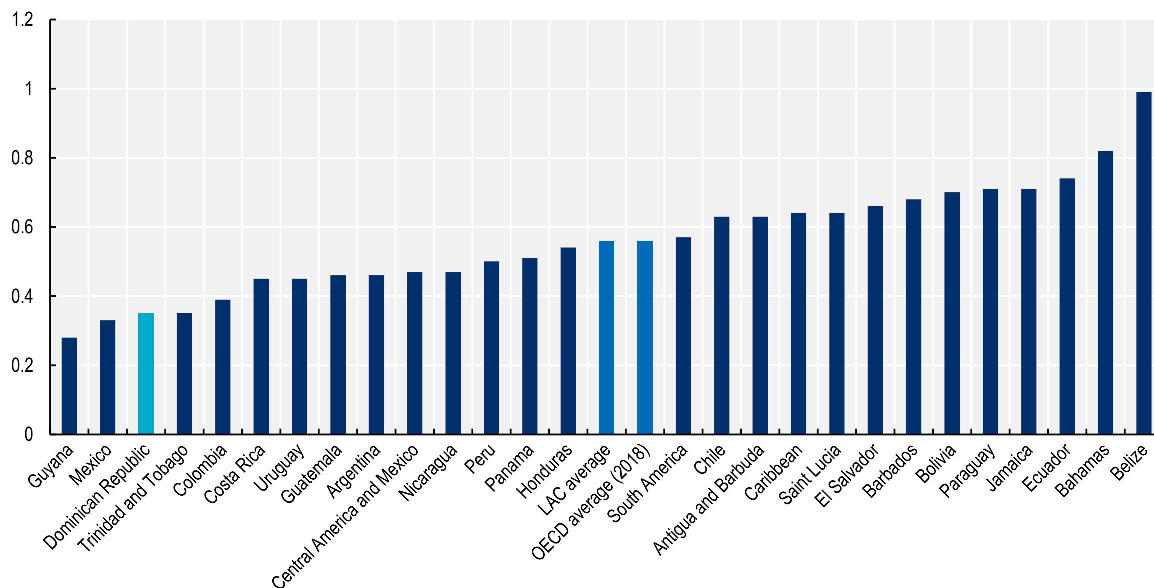
VAT is generally perceived as a tax with large collection potential; it can therefore be an important source of revenue to finance the COVID-19 pandemic recovery as well as more general longer-term development (OECD, 2021[8]). Particularly in contexts of high informality, where the tax base is reduced, VAT could help increase revenues from the informal sector as it taxes some of the goods and services that informal businesses purchase. It can also act as an incentive for informal companies that do business with formal companies, and that wish to request VAT recovery, to formalise (OECD, 2017[9]).

Significant scope exists to strengthen VAT functioning and design in order to improve its revenue-raising capacity in the Dominican Republic. In fact, despite the high share of total tax revenues collected through the ITBIS, there are a number of inefficiencies in the collection of this tax. In fact, the VAT Revenue Ratio (VRR) in the Dominican Republic is low relative to that in other LAC countries. The VRR measures the difference between the VAT revenue that has actually been collected and what theoretically could have been raised if the VAT were applied at the standard rate to the entire potential tax base, as in a "complete"

VAT regime under full compliance. The VRR in the Dominican Republic is one of the lowest in LAC, at 0.35, well below the LAC and OECD averages of 0.56, and the average in the Caribbean sub-region of 0.71 (OECD et al., 2021[10]) (Figure 4.4).

Figure 4.4. VAT Revenue Ratio (VRR) in LAC countries and OECD



Source: (OECD et al., 2021[10]).

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Low efficiency in VAT collection is caused by a variety of factors, including tax evasion, tax exemptions and weaknesses in tax administrations (Schlotterbeck, 2017[11]). VAT evasion is one critical factor that accounts for low VRR levels in the Dominican Republic, reaching a level of 43.8% in 2017 (Ministerio de Hacienda, 2018[12]). VAT evasion in the Dominican Republic is one of the highest in the LAC region, well above the LAC average of 30.1% (see the section on Fighting Tax Evasion). Similarly, ITBIS exemptions are used, with numerous specific goods and services being exempted from the ITBIS; this could partly explain the low VAT efficiency (see section on Rationalising Tax Expenditures). Exempted goods include educational materials, medicines, health services, financial services, utilities, non-conventional or renewable energy equipment, and the supply of inland transportation services of individuals and cargo. Exempted services include education, cultural services and electricity (KPMG, 2022[13]).

In order to improve ITBIS efficiency and increase tax revenues from this source, one option is to rethink existing exemptions and reduced rates. This option should be explored with caution, as many of those exemptions are intended to favour access to basic goods and services for the general population. However, these exemptions can be regressive in certain cases, as some of these goods and services are consumed in larger proportions by wealthier socio-economic groups. Similarly, in contexts of high informality, ITBIS exemptions may only have limited success in supporting low-income families, as these citizens buy some of their basic goods from the informal sector, and hence do not pay the ITBIS. This implies that keeping a uniform ITBIS rate for all formal consumption could actually be progressive, as it will mostly be paid by those who can afford it (Bachas, Gadenne and Jensen, 2020[14]). If a reduction of ITBIS exemptions is complemented by targeting social spending towards lower-income groups, it could result in higher ITBIS revenues (and overall fiscal revenues) without affecting people who are really in need.

Improving compliance is another relevant option for increasing ITBIS revenue, particularly through the use of digital tools. Two important areas of action will be expanding the use of electronic invoicing (e-CF) (introduced in the Dominican Republic in early 2019) and advancing towards making it compulsory, and strengthening the implementation of the destination principle (O'Reilly, 2018[15]). One increasingly relevant challenge is linked to the growing importance of e-commerce in the modern economy. This is particularly true in LAC, which is one of the fastest growing e-commerce regions in the world, particularly as a result of the COVID-19 pandemic. This expansion poses significant challenges to VAT collection, as the growth in online sales of services and digital products is not subject to effective provisions under traditional VAT rules. Similarly, there is an increased volume of imported low-value goods from online sales on which VAT is not collected effectively via traditional customs procedures (OECD/WBG/CIAT/IDB, 2021[16]).

VAT must adapt and modernise in line with an ever-evolving digital economy (Pineda and Gonzalez de Frutos, 2021[17]). Achieving correct and fair taxation of the digital economy could provide additional revenues, but faces key challenges in terms of VAT. The OECD's *VAT Digital Toolkit for Latin America and the Caribbean* is useful in this context. By its very nature, the digital economy is constantly evolving and innovating with new forms of doing business and buying products and services, meaning that current legislation can easily fall behind. Similarly, and in particular in the case of VAT, providers are not always located in the same country where the product or service is consumed (and where the VAT is collected), complicating the taxation of the sale. Therefore, innovative solutions are needed for better collection of VAT, as outlined in the *OECD/G20 Base Erosion and Profit Shifting Project Explanatory Statement* (OECD, 2015[18]). There are two key options: first, reduce or eliminate VAT exemptions on imports of low-value goods. These exemptions were designed to avoid an overload of customs but are no longer a problem thanks to the development of technology. Second, apply the OECD's vendor model, which consists of the supplier ("vendor") of these goods, or the digital platform or another intermediary that intervenes in the supply, being liable for collecting the VAT and remitting it to the jurisdiction of taxation (OECD/WBG/CIAT/IDB, 2021[16]).

Alternative and innovative policies should also be kept in mind as possible means of raising further revenues from VAT. For example, personalised VAT is a policy that has been used by other LAC countries to compensate low-income taxpayers and reduce the regressive nature of VAT. As a means of reducing these inefficiencies and encouraging formalisation, countries such as Argentina, Bolivia, Colombia, Ecuador and Uruguay have introduced personalised VAT, which consists of refunding VAT paid to targeted population groups. This refund can be total or partial and can be structured as a refund or as compensation (Barreix et al., 2022[19]). Simulations suggest that the incidence of VAT would be proportional to the level of income. In the case of the Dominican Republic, the use of personalised VAT in 2018 would have resulted in the lowest income decile contributing 0.05% of GDP instead of 0.10%, while the highest income decile would have contributed 0.97% of GDP instead of 0.64%. In terms of successful implementation of personalised VAT, the Dominican Republic's access to digital technologies and information, and expanded use of the e-CF, is essential (Barreix et al., 2022[19]).

Excise taxes represent the second-largest source of indirect taxes in the Dominican Republic, although their importance has diminished in the last decades. Excise taxes are commonly used to raise revenues and to discourage the consumption of specific products and services. The Dominican Republic levies two types of excise taxes: the Impuesto Selectivo al Consumo (which is a selective consumption tax,ISC), and a selective tax that depends on the value of the product. These taxes levy revenues on specific products or services, such as tobacco products, hydrocarbons, alcohol, telecommunication services and wire transfers. In 2020, taxes on specific goods and services accounted for 23.9% of total taxes (or 3.0% of GDP), higher than the LAC average of 15.9% in terms of total taxes, but below it in terms of share of GDP revenue (3.5% of GDP). The role of taxes on specific goods and services has considerably diminished in the Dominican Republic: in 1990 they accounted for more than one-half of total revenue. More than 50% of these revenues come from taxes on fuels and petroleum derivatives, while about 35% is derived from alcohol and tobacco (OECD et al., 2022[4]). In the case of fuel, there is space to increase revenues, as the

fuel excise tax rates in the Dominican Republic are below the OECD average; for example, its tax rate on gasoline is USD 1.45 (United States dollars) per gallon, considerably below the OECD average of USD 2.24 per gallon (World Bank, 2021[20]).

Revenues from personal income taxes are limited due to a narrow tax base and the impact of widespread informality

Taxes on income and profits accounted for almost one-third (33.7%) of total tax revenues in 2020 in the Dominican Republic, higher than the LAC average (26.9%) and slightly lower than the OECD average (33.1%, registered in 2020) (OECD et al., 2022[4]). Of these revenues from taxes on income and profits in the Dominican Republic, 30.5% corresponded to personal income tax (PIT) and 47.1% to corporate income tax (CIT), these being the two main sources of direct taxation.

Revenues from PIT are relatively low by international standards, suggesting a potential area for improving tax collection. Since 2000, PIT in the Dominican Republic has remained below 11% of total tax revenues, increasing slightly from 8.5% in 2000 to 10.5% in 2020. This is less than half the average share of tax revenues from PIT in OECD member countries (24.1%) and is similar to the average share of PIT revenues in LAC (9.7%) (Figure 4.3, Panel A). PIT revenues represented 1.3% of GDP in the Dominican Republic in 2020, well below the averages in LAC (2.2%) and in OECD member countries (8.3%) (OECD et al., 2022[4])(Figure 4.3, Panel B).

Several factors limit PIT revenues in the Dominican Republic. These include a small tax base, a high concentration of income earners at low income levels, and high levels of informality and tax evasion.

Expanding the PIT tax base represents a challenge for various reasons. While lowering the minimum taxable personal income threshold could be a possibility, the viability and desirability of this option should be carefully analysed in a country where 57% of the workforce is informally employed (see Chapter 3), most of which have relatively low levels of income. In this respect, making sure that specific groups pay taxes, for instance those who are in informal but still earn relatively high levels of income will be vital. In fact, the estimated rate of PIT non-compliance was 57.1% in 2017, which represents around 1.7% of GDP (Ministerio de Hacienda, 2018[12]). Utilising new technologies (e.g. large-scale automated data) to cross-check PIT with information from online vendors could help reduce tax evasion (World Bank, 2021[20]).

Rationalising tax exemptions, deductions or credits could also increase the tax base and PIT revenues. The existence of generous exemptions, deductions or tax credits also limits the tax base. These include exemptions on travel allowances, Christmas bonuses, deductions on education, contributions to social security, and for those who contribute to the Solidarity Fund for Cultural Patronage (World Bank, 2021[20]).

Innovative PIT policies could be a useful tool for increasing formalisation and expanding the tax base, and hence tax revenues. For instance, negative income tax (NIT) or the Earned Income Tax Credit (EITC) are good examples of innovative tools that could generate fewer distortions or disincentives to formalisation than traditional tools. For individuals who are unemployed or informally employed, NIT guarantees revenue from a traditional cash transfer. The main advantage to this is that someone who is employed in the formal sector will continue to receive government aid, plus their salary. The benefits only fade gradually as wages begin to increase and the worker stops receiving support and begins to pay income tax. This type of programme guarantees that wages are higher in the formal sector, and is much more affordable than universal basic income, as it is targeted at a specific population and not at all individuals (Pessino et al., 2021[21]).

CIT is a main source of tax revenue, but this can impose a high burden on some domestic firms outside Free Trade Zones

CIT is one of the main sources of tax revenues collected in the Dominican Republic. Tax revenues from CIT account for 15.6% of total tax (2.1% of GDP), which makes it the second-largest source of tax revenues

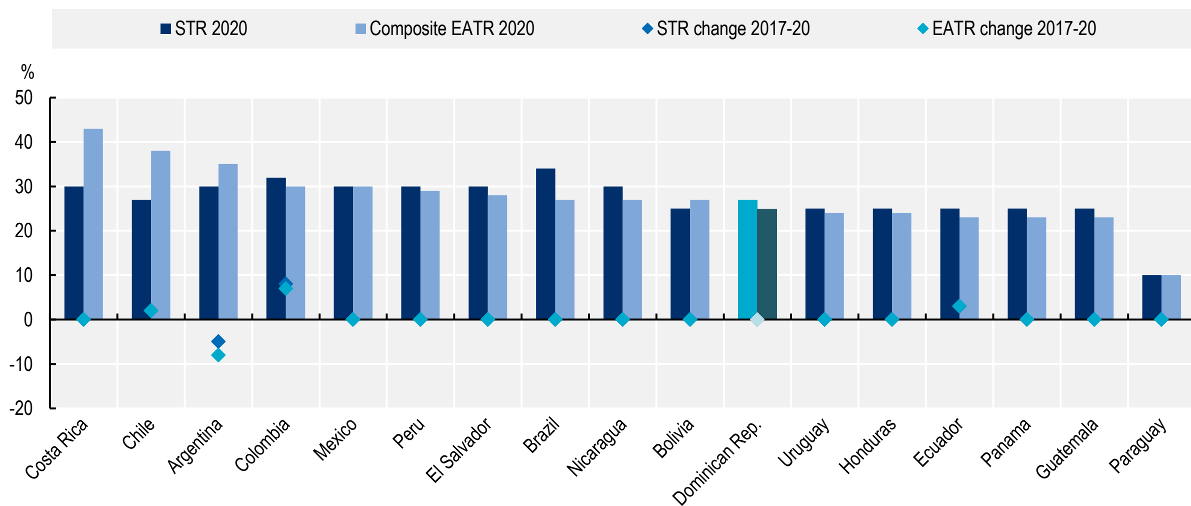
after the ITBIS (Figure 4.3). CIT has been on the rise since 2010, when it represented 8.8% of total taxes (1.1% of GDP), but CIT revenues as a percentage of GDP are substantially lower in the Dominican Republic than the averages for LAC (3.6% of GDP) or OECD average (2.8% of GDP) (OECD et al., 2022[4]). The increase in CIT revenues happened despite the decrease in the statutory tax rate from 29% in 2011 to 27% in 2015, where it has since remained. This tax rate is near the 28% average in the LAC region but above the 22% average among OECD countries. The increase in CIT revenues despite falling rates can be partly explained by recent reforms that aimed to reduce distortions and widen the tax base (World Bank, 2021[20]).

The corporate tax rate in the Dominican Republic is near the LAC average, yet CIT efficiency levels are low. CIT efficiency refers to the actual CIT revenues that are collected relative to the potential CIT that could be raised, and is calculated as a ratio of actual CIT revenues as a share of GDP by the weighted average of the statutory tax rate. Of the LAC countries where the efficiency rate has been calculated, the Dominican Republic lags behind Brazil, Chile, Colombia, Costa Rica, Mexico, Panama, Paraguay, Peru and Uruguay, and only outperforms Ecuador and Guatemala. Increasing the revenue efficiency of the Dominican Republic's CIT to the LAC average would boost revenue collection by an estimated 0.9% of GDP (World Bank, 2021[20]).

Low CIT revenues and efficiency can be explained by the proliferation of tax incentives and high tax evasion. The Dominican Republic has traditionally used tax incentives to attract investment, such as via Free Trade Zones (FTZs). Tax incentives are targeted tax provisions that provide favourable deviations from the standard tax treatment and can take many different forms and designs (Celani, Dressler and Hanappi, 2022[22]) (Box 4.1). Sectors that have benefited from tax incentives include mining, forestry, energy, tourism and border development areas.

Generous tax treatment measures can reduce the actual tax liabilities faced by companies and can be usefully assessed through a forward-looking effective tax rate (ETR) (Hanappi, 2018[23]). The ETR differs from the statutory tax rate because the rules of fiscal depreciation, a number of related provisions (e.g. allowances for corporate equity, half-year conventions and inventory valuation methods) and tax incentives might reduce tax liabilities (OECD, 2020[24]).[1] The Dominican Republic's effective average tax rate (EATR), excluding incentives, is 2.2 percentage points lower than the statutory rate (Figure 4.5). This is similar to other LAC economies, such as Guatemala (1.9 percentage points lower than the statutory rate), Colombia (1.9 percentage points lower), Nicaragua (2.8 percentage points lower) and Brazil (6.7 percentage points lower), indicating generous corporate tax bases (Botey et al., forthcoming[25]). Providing generous tax incentives can result in much lower ETRs (Box 4.2). Moreover, corporate tax evasion in the Dominican Republic is as high as 61.9%, or a tax gap of 4.2% of GDP (see Section on Fighting Tax Evasion) (ECLAC, 2020[26]; Ministerio de Hacienda, 2018[12]).

Figure 4.5. EATRs in LAC, excluding incentives



Note: STR refers to standard statutory rate. EATR refers to effective average tax rate.
Source: Botey et al. (forthcoming[25]).

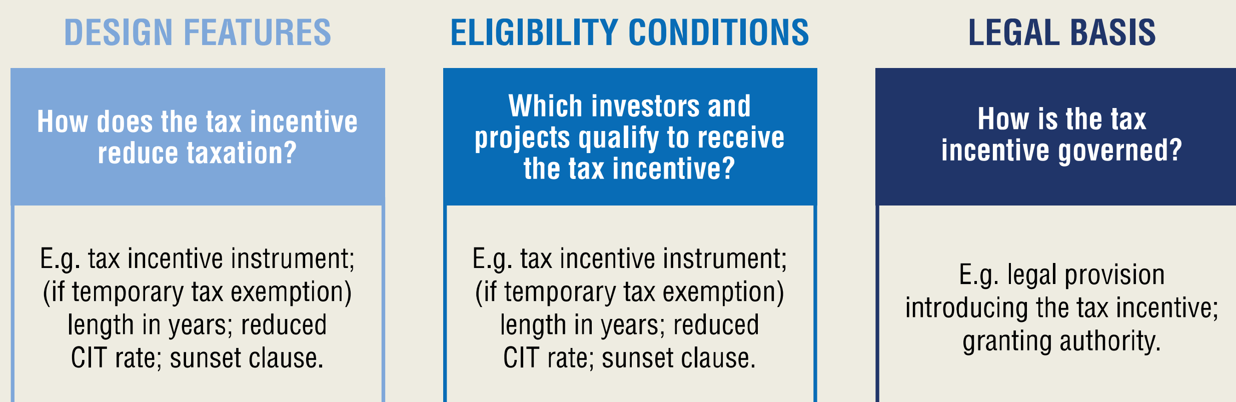
Box 4.1. Building an Investment Tax Incentives Database

Tax incentives for investment are frequently used worldwide, including in LAC countries. Tax incentives are targeted tax provisions that provide favourable deviations from the standard tax treatment in a country. They can potentially promote investment and positively affect output, employment, and productivity, or other objectives related to the United Nations Sustainable Development Goals (SDGs). If poorly designed, they may be of limited effectiveness and could result in windfall gains for projects that would have taken place regardless of the incentives. Tax incentives can also reduce revenue-raising capacity, create economic distortions, increase administrative and compliance costs, and potentially increase tax competition. Striking the right balance between an efficient and attractive tax regime for domestic and foreign investment and securing the necessary revenues for public spending and development is a particular concern in developing countries.

The widespread use of tax incentives globally, along with concerns about their net impact, is an important policy concern for national governments and the international policy community. Recent OECD research provides insights into tax incentive policies and increases the policy relevance of tax incentive analysis, with the objective of helping policy makers make smarter use of tax incentives and reform inefficient ones.

The OECD Investment Tax Incentives Database (ITID) systematically compiles quantitative and qualitative information on the design and targeting of CIT incentives across countries using a consistent data collection methodology. For each tax incentive, the ITID includes information along three dimensions (Figure 4.6): instrument-specific design features, eligibility conditions, and legal basis. As of July 2021, the database covers 36 developing countries in Eurasia, the Middle East, North Africa, Southeast Asia and sub-Saharan Africa. Future additions to the ITID could include LAC countries.

Figure 4.6. Key dimensions of the OECD ITID



(Celani, Dressler and Wermelinger, 2022[27])present the methodology and key classifications underlying the ITID and provide the first descriptive statistics based on information from the 36 included countries. Tax incentive designs are multidimensional, complex, and often specific to a certain sector, region or investor within a country. Adjusting design features of incentives in specific contexts can improve tax incentive policy making by, for example, improving effectiveness or limiting forgone revenue. However, this also reduces transparency and can have unintended effects. ETR analysis can help make complex features of tax incentives comparable (Box 4.2) and is an additional step towards developing policy guidance based on detailed information from the ITID.

Source: Elaboration based on (Celani, Dressler and Wermelinger, 2022[27]).

Box 4.2. Assessing tax incentives for investing in LAC using ETRs

As in most countries around the world, governments in LAC countries frequently use tax incentives to reduce the tax costs of investment in specific activities, sectors and locations. Comparison of preferential tax treatments is not straightforward, as tax incentive designs and targeting strategies are complex and multidimensional. Tax incentive analysis should account for such complexities and evaluate them jointly with standard tax system features, as these provide the starting point with respect to which incentives provide relief, and can vary across countries. ETR-based analysis can capture the combined effects of the standard tax system and tax incentive designs. It allows comparison between the effective tax costs associated with a given investment across locations, sectors and activities. The OECD is currently conducting new research to extend the ETR methodology for estimating ETRs under tax incentives in order to evaluate the incentives' effect on providing tax relief and to develop recommendations for policy reform (Celani, Dressler and Hanappi, 2022[22]).

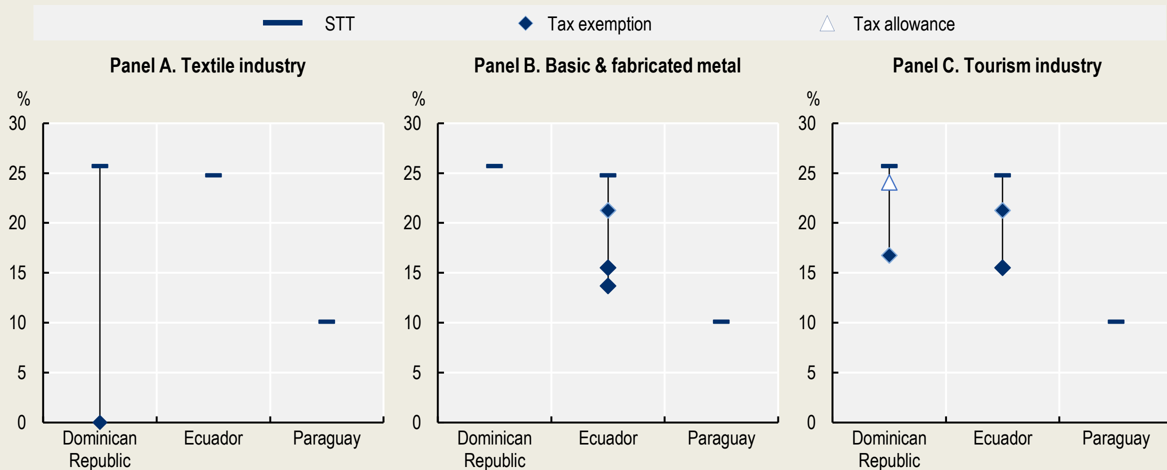
This box illustrates how the ETR framework can be useful in analysing investment tax incentives. It presents ETRs for a standardised investment project in three industries (textiles, metals and tourism) in the Dominican Republic, Ecuador and Paraguay. Figure 4.7 presents ETRs under standard tax treatment, i.e. excluding tax incentives (denoted by the horizontal black marker) and accounting for industry-specific tax incentives, if available. The blue diamonds represent tax exemptions and the white triangles represent tax allowances. Multiple markers in a specific country and industry indicate that various incentives apply,

depending on additional eligibility conditions. For example, investment in tourism in Ecuador (Panel C) benefits from a ten-year tax exemption when located in an Economic Special Development Zone and a five-year exemption otherwise.

Investment tax incentives lower the tax costs of investment to various degrees across the three industries and countries. While the Dominican Republic and Ecuador start from a 25% standard ETR, they offer tax incentives that substantially lower effective taxation in some industries. For example, ETRs can be as low as 0% in the Dominican Republic's textile industry and up to 45% lower than standard taxation in Ecuador's metal industry (13.7% compared with 24.8%). While Paraguay does not use CIT incentives, it applies a relatively low standard CIT rate, reaching the lowest ETR in the three countries' metal and tourism industries.

Figure 4.7. Investment tax incentives lower ETRs across industries

EATR under standard tax treatment (STT) and investment tax incentives in the corresponding



Note: This figure considers investment tax incentives and STT on 1 January 2020. EATRs are calculated for a standardised investment in a single non-residential building asset. STT considers country-specific standard CIT rates, asset-specific capital allowance rates and cost recovery method. Temporarily or permanently tax-exempt income does not give rise to standard capital allowances.
Source: Authors' elaboration on (Celani, Dressler and Hanappi, 2022[22]).

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As a member of the OECD/Group of Twenty (G20) Inclusive Framework on Base Erosion and Profit Shifting (BEPS), the Dominican Republic has agreed on the two-pillar solution to address the challenges of digitalisation and globalisation. This two-pillar solution, which has been agreed by 135 countries and jurisdictions, aims to ensure that multinational enterprises (MNEs) pay their fair share in taxes. Pillar One aims to ensure a fairer distribution of profits and taxing rights among countries with respect to the largest MNEs, which are the winners of globalisation. Pillar Two aims to limit tax competition by putting a floor on CIT through the introduction of a global minimum corporate tax rate of 15% that countries can use to protect their tax bases. The new framework for international tax and the agreed Detailed Implementation Plan envisages implementation of the new rules by 2023 (OECD, 2021[28]).

Property and wealth taxes have great potential for expansion while improving the efficiency and equality of the system

Property taxes in the Dominican Republic account for a small proportion of total taxes levied. These taxes are an appropriate tool for taxing the wealthiest families and increasing the redistributive power of the tax system in a country where large inequalities persist. Indeed, recurrent taxes on property have been found to be among the least detrimental to growth and can have a positive impact on equity, while being difficult to evade due to the immobility of the tax base (O'Reilly, 2018[15]).

Property taxes accounted for 0.7% of GDP (or 5.0% of total taxes) in the Dominican Republic in 2020. Their main components are recurrent taxes on immovable property or real estate (11% of total property and wealth taxes), recurrent taxes on net wealth (18%), inheritance and gift taxes (2%), taxes on financial and capital transactions (62%), and other or non-recurrent taxes (7%) (OECD et al., 2022[4]). Immovable property and real estate taxes and inheritance and gift taxes are of special interest because of their potential to raise further revenues with low distortionary effects and high redistributive impact.

Real estate taxes and inheritance and gift taxes remain a potential revenue source for Dominican authorities. These account for 2% of total property taxes, well below the levels in OECD member countries, which average 7%. These taxes not only generate few changes in behaviour, as net wealth in later life is not sensitive to changes in inheritance tax, but can also be highly progressive and can generate greater equality of opportunity. Gifts, for example, are highly tax responsive and are not commonly used as a strategy for reducing inheritance taxes. A main advantage of these types of taxes is that they are relatively easy to levy, as the tax is levied at the time that the property or inheritance is transferred. Given the low levels of tax revenue from these types of taxes in the Dominican Republic, it could be worth strengthening their design and implementation and rationalising the exemptions. Although the political costs of this kind of reform can be high as it mostly affects the elites, in a context of growing inequalities and social unrest, it can have clear benefits, especially in a situation of low tax morale and low trust in institutions (OECD et al., 2019[29]; Pineda et al., 2021[30]; OECD, 2019[31]; Jiménez et al., 2021[32]).

Taxes on immovable property accounted for 0.06% of GDP in 2020 (11% of total property and wealth taxes) in the Dominican Republic. These taxes are low when compared with the LAC average of 0.4% of GDP, or with the average in OECD member countries of a little more than 1% of GDP. These figures suggest that there is still room for further improvements concerning property tax in the Dominican Republic (OECD et al., 2022[4]).

A number of factors undermine tax revenue from immovable property in the Dominican Republic. There is a low level of property registration due to high levels of informality, which erodes the tax base. The tax base is also eroded by high threshold exemptions (all properties below DOP 8 138 353.26 (Dominican pesos) are exempt, almost the average price of a two- or three-bedroom house in Santo Domingo). Similarly, only urban properties are required to pay property tax, and foreign property investments in selected tourist zones are also exempt. The lack of a unified and easy-to-access property registry results in a system with high transaction costs and creates uncertainty among the business sector, hampering investments. Two systems coexist simultaneously: the Title Registry (Registro de Títulos), also known as Sistema Torrens Dominicano, and the Civil Registry and Mortgage Conservatorship (Registro Civil y Conservaduría de Hipotecas), also known as Sistema Ministerial. The Title Registry covers only 13% of total properties in the Dominican Republic, whereas the Mortgage Registry has better coverage but provides weaker legal protection. As only one out of every four properties is registered with the Directorate General of Internal Taxes (Dirección General de Impuestos Internos), a very low proportion of properties are taxed and property values are outdated.

Correct and up-to-date information alongside a capable tax administration are essential to unleashing the potential of immovable property taxes. The tax base for the immovable property tax is the appraised value that the local authorities calculate, but often the information that authorities have is outdated and thus differs from the market value. Therefore, reducing the gap between the appraised value and the market

value is a key priority and an exercise in adjustment that needs to be regularly performed. This must be accompanied by an up-to-date land and property registration in central cadastres that makes real efforts to formalise informal settlements. Digital maps, aerial photographs or geographic information systems could also be useful tools. Colombia is a good example of a country where the tax base is determined by decentralised cadastral offices and is based on self-declaration in some cities. Any structural changes to the tax base must be accompanied by strengthening local tax authorities, a stronger co-ordination with the national tax authority and the property registry, and rationalisation of tax exemptions (Ehtisham, Brosio, and Jiménez, 2019[33]; OECD et al., 2022[4]; World Bank, 2021[20]).

The efficiency of taxation on specific sectors (like energy) can be improved, and new taxes can be explored in areas like the digital economy or the green transition

In the Dominican Republic initiatives have already slowly started to create a framework for environmental taxes. For instance, at the end of 2012 the Dominican Republic introduced a tax concerning either new or used vehicles, which is determined based on carbon dioxide (CO_2) concentration per kilometre. In addition to the existing rate of 17% for registration of the first licence plate, tax is calculated based on the declared value of the vehicle in Customs and on the CO_2 emissions in grammes per kilometre, with rates of up to 3%. Other current initiatives include medium-term projects, such as Bono Verde to finance solid waste treatment or the 0.2% Green Tax on the import and production of goods with a high proportion of solid waste such as paper, wood, tires and batteries (Ministerio de Hacienda, 2018[12]).

The potential of environmental taxes (such as carbon taxes) needs to be balanced with measures to protect more vulnerable groups. Among the different tools available, carbon taxes are a simple and cost-effective way to limit climate change, increase tax revenues and limit health damage from local pollution (OECD, 2019[34]; OECD, 2021[35]). Other taxes (such as creating a tax for vehicles that are more than ten years old in order to protect the environment and biodiversity from pollution) offer a new opportunity to raise tax revenues and promote green growth. Moreover, a green tax, or Impuesto Verde, is currently being analysed as a selective tax on the consumption of final goods and intermediate goods that generate solid waste. A rate of 0.2% would be applied to the product for both imported and local goods in order to create a "green bonus". The effects of climate change and green policies such as environmental taxes will further expose the most vulnerable, highlighting the need for compensation schemes. These schemes could include cash transfers, in-kind transfers and support for retraining.

The digitalisation of the economy has led to important challenges in business models and in the value-creation processes of companies. One proposal currently under discussion is to extend the 18% VAT (ITBIS), or the 10% Selective Consumption Tax, to digital platforms such as Netflix, Spotify, Uber, Cabify and Airbnb, as well as online gaming and data storage platforms. Estimates suggest that the potential of VAT revenue derived from taxes on digital services could have represented 0.4% of the Dominican Republic's GDP in 2018, 0.5% in 2019 and 0.6% in 2020 (Jiménez and Podestá, 2021[36]). These efforts are essential not only for diversifying tax sources, but also for guaranteeing fair competition between these international platforms and local companies that provide these services.

Table 4.1. Strengthen tax revenues by restructuring the tax mix

Policy recommendation	Challenges and opportunities for implementation
1.1 Rebalance the tax structure to increase the share of direct taxes and increase progressivity	
Launch a technical and political discussion on the feasibility of decreasing the minimum taxable personal income, so that high-income deciles are effectively included.	The country must calibrate and evaluate the sensitivity of the tax rates to reach an optimal balance between collection and equity.
Explore the potential of personalised VAT (ITBIS) as a way of increasing the overall revenues from these taxes while compensating low-income taxpayers and thus reducing the regressive nature of VAT.	In the implementation of new and innovative taxes, the increases in administrative costs will increase and must be considered. This due to the creation/adaptation and training of the area in charge of identifying the target population and carrying out the compensations.

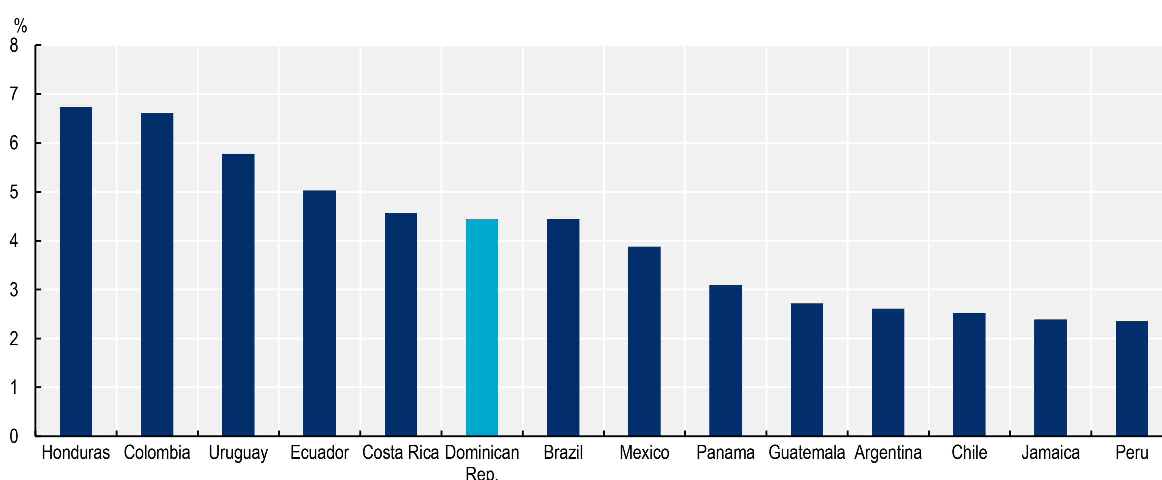
1.2 Enhance the revenue potential of other taxes	
Strengthen property registries in order to boost revenues from property taxes by: 1) moving towards a unified and simplified property registry with an up-to-date land and property registration in central cadastres, and 2) reducing information asymmetries in immovable property; closing the gap between the appraised value and the market value is a key priority and an adjustment that needs to be regularly performed.	A fundamental action is to strengthen the cadastre department (update values) alongside a study to assess the cost-opportunities and calculate how much revenue is foregone. Similarly, Inter-institutional co-operation that allows obtaining the value of the properties in real time through an interconnection of databases will be essential. A proposal is to evaluate the strategy of having a graduated rate for IPI (real estate tax), which increases according to the aggregate value of the properties owned. This would entail a change in legislation, as well as internal measures to detect irregularities and potential evasion of this tax.
Explore the potential of new taxes adapted to the emerging economy, such as digital and green taxes, which serve the dual purpose of raising revenues while creating the incentives for a greener and more digitalised development model.	In the case of green taxes, it will require an amendment of the tax code law, national consensus backed by strong political will (see section and recommendations on fiscal pact).

Note: Based on the meeting held on 23 June 2022, to discuss the draft analysis and policy recommendations with officials from the Ministry of Finance, the Ministry of Economy, Planning and Development (MEPyD), the Central Bank, the National Statistics Office (ONE), the World Bank, the IDB and the European Union.
Source: Authors' elaboration.

Rationalising tax expenditures can create fiscal space and improve the overall impact of the tax system in terms of equity and efficiency

Tax expenditures represent the amount of forgone revenue as a result of special tax provisions that reduce or eliminate the tax liability for specific individuals, economic sectors or businesses. Tax expenditures can be defined as "resources not collected by the state, due to the existence of incentives or benefits that reduce the direct or indirect tax burden of specific taxpayers in relation to a benchmark tax system, in order to achieve certain economic or social policy objectives" (CIAT, 2011[37]). These tax expenditures are typically used by governments to achieve different economic, social and equity objectives by providing specific conditions to incentivise behavioural change. Tax expenditures take the form of exclusions, exemptions, allowances, credits, reduced rates or tax deferrals.

Figure 4.8. Tax expenditures in selected LAC countries as a percentage of GDP, 2021 or latest year available



Source: Authors' calculations based on national sources, (Redonda, von Haldenwang and Aliu, 2021[38]) and (Peláez Longinotti, 2019[39]).

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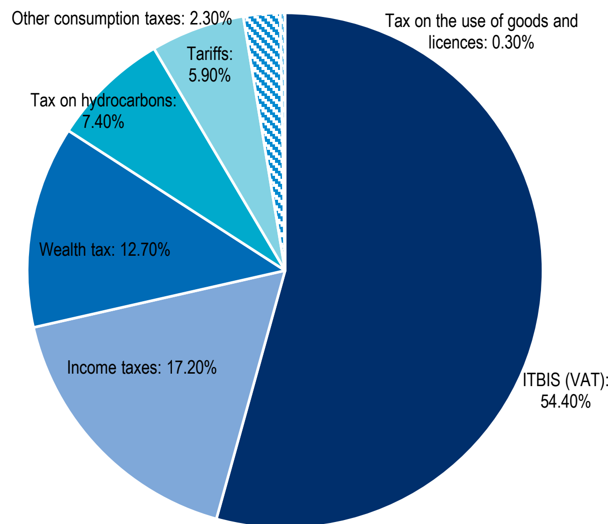
Tax expenditures represent a significant amount of financial resources in the Dominican Republic. In 2020, tax expenditures accounted for 4.6% of GDP, one of the highest levels in the LAC region (Figure 4.8). Most tax expenditures in the Dominican Republic are associated with indirect taxes. In 2021, as much as 70.1% of tax expenditures came from indirect taxes, with the majority of them related to the ITBIS (54.4% of total tax expenditures) and taxes on hydrocarbons (7.4%) (Figure 4.9). Tax expenditures from direct taxes represented the remaining 29.9% of total tax expenditures, and was split between income taxes (17.2% of total tax expenditures) and wealth tax (12.7% of total tax expenditures). Tax expenditures from the ITBIS represented 2.41% of GDP, and all tax expenditures from indirect taxes accounted for 3.12% of GDP, while those resulting from direct taxes represented 1.32% of GDP, divided between 0.76% of GDP from income taxes and 0.56% from wealth and property tax (Ministerio de Hacienda, 2020[40]).

In a country where tax revenues as a share of GDP are low (and among the lowest in the LAC region), exploring the potential to rationalise these tax expenditures is critical. Indeed, the narrow tax base observed in the Dominican Republic is partly the result of widely implemented tax provisions, which are often not well designed or targeted. This can lead to regressive tax expenditures that provide greater benefits to those who need them less, or that are not conducive to job creation or economic growth. Likewise, the proliferation of tax expenditures increases the complexity of the tax system, creating greater opportunities for evasion and tax planning. In sum, tax expenditures can undermine tax revenue collection, increase inequalities, reduce efficiency and add complexity. A reform or the elimination of outdated, poorly targeted tax expenditures that do not achieve the associated policy objectives can be a source of greater tax revenue by broadening the tax base while supporting a more effective, equal and simple tax system.

Figure 4.9. Tax expenditure breakdown, as a percentage of total tax expenditures, 2021



Source: Authors' elaboration based on (Ministerio de Hacienda, 2020[40]).

There is room to evaluate the distributional and efficiency implications of tax expenditures in the Dominican Republic. In the case of the ITBIS, which is the main source of tax expenditures (Figure 4.9), around 88% of tax expenditures in 2013 benefitted higher-income groups (World Bank, 2019[41]). There is scope to reconsider exemptions of non-essential goods and services; for instance, those related to tourism or certain cultural products. This could increase tax revenues from the ITBIS. Other exemptions could also be re-evaluated, as long as their potential elimination is accompanied by measures to support and

compensate the most vulnerable groups, such as direct cash transfers or targeted reductions of social security contributions.

A non-negligible share of tax expenditures is derived from income taxes (Figure 4.8). Regarding PIT, there is scope for reconsidering some of these exemptions, particularly because these taxes tend to be progressive in nature, meaning that tax provisions in this domain can limit their positive distributional impact (OECD/DIAN, 2021[42]; Solidaridad, 2018[43]).This is the case in the exemptions on expenditure in education, which have the rationale of incentivising investment in education but can end up benefitting people with higher levels of income, as evidence points to wealthier people making greater use of these advantages (OXFAM, 2020[44]).

When examining tax expenditures from the perspective of productive sectors of the economy, FTZs, power generation, tourism and mining account for the largest share, altogether representing 23.8% of the total tax expenditure expected in 2021 (Ministerio de Hacienda, 2021[3]). FTZs and special zones in border regions provide particularly strong privileges to the firms operating in these areas of the country, significantly undermining CIT revenues. In 2020, 692 firms were part of Free Trade Zones, contributing 3.2% of the GDP; these firms were mostly concentrated in services (23.4% of total firms), tobacco and derivatives (14.3%), textiles (12.6%) and agroindustrial products (7.8%) (CNZFE, 2021[45]). FTZs account for 13.5% of total tax expenditures in the Dominican Republic, while tourism accounts for 3% and mining accounts for 1.8%. These exemptions represent a cost of around 1.8% of GDP and also include fuel for electricity generation, imports for production in FTZs, and some taxes on property. Within this share, FTZs account for 0.6% of GDP and exemptions within the tax on hydrocarbons for electricity generation represent 0.4% of GDP (Ministerio de Hacienda, 2021[3]).

The advantages granted to firms in FTZs and other special tax regimes raise an important question about whether they generate more benefits than costs and, consequently, whether there is scope to restructure some of these tax regimes in order to increase the tax base and overall tax revenues. Several studies have been conducted in the Dominican Republic to evaluate the convenience of these regimes, with mixed results. The World Bank (2017) used administrative data on income tax declarations in order to assess the net benefits of totally exempting firms in FTZs in the Dominican Republic from paying CIT. The results showed that while these firms create a greater number of jobs compared with those that are not part of this special regime (FTZs create three times more employment than non-FTZ firms), that job creation comes at a very high cost: each of those jobs costs five times more in terms of revenue forgone. In addition to this, the Inter-American Center of Tax Administrations (CIAT) and the United Nations Department of Economic and Social Affairs (UN-DESA) (2018) conducted a cost–benefit analysis using administrative data on tax incentives for the tourism sector from 2002 to 2015. The conclusions of this study pointed out that the negative impact of the costs of these tax incentives on GDP is greater than the benefits. Investment in infrastructure rather than fiscal incentives would definitely be more profitable for both the tourism sector and economic growth. More recently, a cost-benefit analysis of the FTZs concluded that, at the aggregate level, this regime has an average net positive annual contribution of 2.7% of GDP, including the direct and indirect effects (Cardoza, Vidal and Taveras, 2019[46]). However, when the results are analysed at the company level, around 16% of all companies operating in FTZs create greater tax expenditures than benefits, suggesting that a more granular evaluation of these tax regimes can help identify specific firms or sub-sectors whose participation in them is not justified.

Periodical assessments are needed in order to continuously evaluate the distributional and efficiency implications of tax expenditures. The Dominican Republic's Ministry of Finance already publishes tax expenditure reports, providing a good overview of forgone revenues. However, the analysis could be further developed to more explicitly present how tax expenditures contribute to the policy objectives they were designed to achieve, including economic growth, job creation or supporting lower-income groups. If the social benefits of these tax expenditures are not greater than the social costs, or if there is a better mechanism through which to deliver those benefits, then the tax expenditures should be reconsidered. Similarly, in the case of special tax regimes, regular cost–benefit analyses should be conducted in order

to carefully evaluate their contribution to achieving policy objectives, given that these are a major source of forgone tax revenues that need well-grounded justification. In the Dominican Republic, information on the net benefits of these special tax regimes is scarce and should be expanded to all special regimes.

Avoiding arbitrariness in the criteria for admitting firms into FTZs and other special tax regimes by setting up clear qualification conditions can be an effective policy for limiting the forgone tax revenue as a result of the FTZ special tax regime. In this respect, the governance of special economic regimes must also be redesigned so as to reduce the excessive influence of private interests, which tend to shape the criteria in their favour in order to perpetuate their advantageous position. Once implemented, these systems generate significant benefits for the recipients, thus serving vested interests with a particular motivation to keep the incentives in place and to make their modification extremely difficult (Daude, Gutiérrez and Melguizo, 2014[47]). Including all tax expenditures in the tax code, or giving the Ministry of Finance responsibility for granting all these incentives, could be effective methods of reducing arbitrariness.

Table 4.2. Rationalise tax exemptions to raise revenue capacity and improve the overall impact of the tax system in terms of equity, efficiency and simplicity

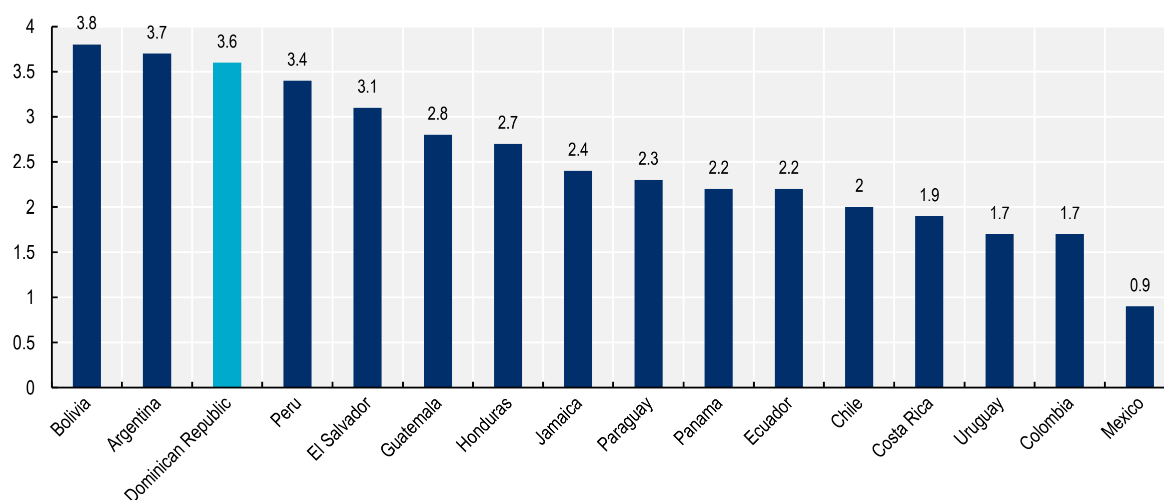
Policy recommendation	Challenges and opportunities for implementation
2.1 Rethink tax exemptions on main sources of revenue	
Rethink VAT (ITBIS) exemptions in order to improve efficiency and reduce its regressive impact – for example, exemptions applied to financial services or to the imports of low-value goods, or exemptions on certain non-essential goods and services such as those related to tourism or certain cultural products. Measures aimed at reducing VAT exemptions should be accompanied by clear measures to compensate lower-income groups, such as direct cash transfers or the targeted reductions of social security contributions.	It would be of key importance to periodically and accurately estimate the corresponding fiscal sacrifices and political/social costs of eliminating or implementing tax exemptions.
Evaluate PIT deductions, such as exemptions for educational expenditure, which can be regressive	It was suggested than rather tax exemptions, it would be better to apply a general tax and compensate possible affected sectors.
2.2 Evaluate the overall impact of special economic regimes and consider a gradual phasing out of those where the costs – in terms of forgone tax revenues – outweigh the benefits	
Rethink tax incentives associated with special economic regimes through periodical assessments in order to ensure that their distributional and efficiency implications are evaluated regularly.	Reconsidering the tax incentives should consider the legislative and political/social costs.
Include an analysis in tax expenditure reports of how these incentives contribute to key development objectives such as economic growth, job creation or supporting lower-income groups.	A cost-benefit methodology similar for tax expenditures is needed, and to be used and published periodically. In that sense, Law 253-12 must be enforced (the law establishes that the governmental institutions that administer laws that contemplate exemptions or exonerations must submit to the Ministry of Finance to undergo a cost-benefit analysis of the incentives).
Limit the potential arbitrariness associated with special economic regimes by, for example, strengthening the criteria for admitting companies; rethinking the governance of these regimes in order to balance the distribution of power; including all tax expenditures in the tax code; or giving the Ministry of Finance the main responsibility for granting all these incentives	The criteria and institutions that admit companies to these special regimes might need to be re-examined. Similarly, it is important to follow up on the exemption periods granted.

Note: Based on the meeting held on 23 June 2022, to discuss the draft analysis and policy recommendations with officials from the Ministry of Finance, the Ministry of Economy, Planning and Development (MEPyD), the Central Bank, the National Statistics Office (ONE), the World Bank, the IDB and the European Union.
Source: Authors' elaboration.

Fighting tax non-compliance can be a source of greater tax revenues, while making the tax system more equitable and fair

Tax non-compliance in the Dominican Republic ranks among the highest in the LAC region, and addressing this could be an important source of greater tax collection. Estimated tax non-compliance in the Dominican Republic in 2017 was 61.8% (4.2% of GDP) for CIT and 57.07% (1.68% of GDP) for PIT (Ministerio de Hacienda, 2018[12]). Concerning the ITBIS, tax non-compliance reached 43.5% in 2017, representing 3.6% of GDP (Figure 4.10). In general, tax non-compliance in the Dominican Republic ranks among the highest in the LAC region, although high heterogeneity is observed across countries. In 2017, tax non-compliance for VAT ranged from 14.8% in Uruguay to 45.3% in Panama, while levels in the European Union were as low as 11.5% (Gómez Sabaini and Morán, 2020[48]). Similarly, in 2017 tax non-compliance for PIT ranges from 18.7% in Mexico to 69.9% in Guatemala, and for CIT it ranges from 19.9% in Mexico to 79.9% in Guatemala (Gómez Sabaini and Morán, 2020[48]).

Figure 4.10. Estimated tax loss from VAT non-compliance, 2017 or latest available year (in percentage of GDP)



Source: Authors' elaboration based on (Gómez Sabaini and Morán, 2020[48]).

Recent efforts and experiments to tackle tax non-compliance show that there is room for effective, short-term measures. The Central Tax Administration made attempts to launch coercive policies and initiatives to fight against terrorism financing (which included tax evasion measures) in 2018. Law 155-17 against Money Laundering and Terrorism Financing was approved by the National Congress in 2017, enacted by the President in November 2017 and enforced by the Dominican Republic's Ministry of Finance from 2018. This law sought to curb tax evasion and other tax-related violations with severe criminal punishments, including prison and substantial monetary fines. Among measures to control tax evasion, the Dominican Republic's Ministry of Finance increased the number of audited taxpayers, resulting in the probability of being audited increasing from 8% in 2017 to 12% in 2018 (Holz et al., 2020[49]). In order to increase tax morale, high-profile public servants have highlighted the success and accomplishments of this law, and the media widely reported on the imprisonment, preventive detention trials, house arrests, electronic monitoring devices and travel restrictions imposed on taxpayers accused of tax evasion (Holz et al., 2020[49]).

Information campaigns and efforts to raise awareness can have an impact on lowering tax non-compliance. A field experiment conducted in the Dominican Republic put in place a number of "nudges" and assessed their impact on tax compliance among both companies and individuals (Holz et al., 2020[49]). These nudges consisted of sending messages to more than 28 000 self-employed workers and more than 56 000 firms describing prison sentences and publicly announcing tax evaders, and these were found to increase tax compliance, mainly through the channel of decreasing the amount of tax exemptions claimed. The results of the experiment also showed that firm size is a determinant in the effectiveness of the nudges: larger firms were more responsive to the nudges than smaller firms were. Overall, the messages increased tax revenue by USD 193 million (around 0.23% of the Dominican Republic's GDP) in 2018, of which more than USD 100 million could be attributed solely to the experiment on nudges. This initiative underlines the extent to which a deeper understanding and consciousness of taxpayers could influence their behaviour.

The simplification of the tax system can be beneficial in fighting tax non-compliance, particularly among firms. The existence of multiple tax regimes for different sectors allows firms to undergo aggressive tax planning in order to avoid paying taxes by exploiting gaps and mismatches in the tax rules. These tax planning strategies are not only done locally, but also on an international scale, as businesses artificially shift profits to low- or no-tax locations where there is little or no economic activity, or they erode tax bases through deductible payments such as interests or royalties. This international challenge is addressed by the OECD/G20 Inclusive Framework on BEPS. This framework includes 135 countries and jurisdictions – including the Dominican Republic, which has been a member since 2018 – and outlines 15 domestic and international actions that governments must take in order to tackle tax avoidance. Since its enrolment, the Dominican Republic has participated in many of the associated agreements and actions (such as those related to addressing the challenges arising from the digitalisation of the economy, strengthening the transfer pricing legislation to align with OECD standards, and setting requirements for of tax and financial information by MNEs), but it still has to address the existence of possible harmful tax regimes in the country, which are currently being revised or amended. The Dominican Republic has made progress on the implementation of the transparency standard from the Global Forum on Transparency and Exchange of Information for Tax Purposes, and is considered largely compliant with this standard.

Table 4.3. Fight tax non-compliance

Policy recommendation	Challenges and opportunities for implementation
3.1. Use digital tools to fight evasion and to leverage existing international agreements	
Launch information campaigns, increase efforts to raise awareness, and use nudges, all of which can have an impact on lowering tax non-compliance.	The country must encourage a tax paying culture through voluntary contributions. To achieve it, taxpayer education (both taxpayers and internal staff), alongside educational campaigns will be essential.
Use new technologies to cross-check information (for example, large-scale automated data and cross-checking of PIT against information from online vendors), as this could help reduce tax evasion.	The Use of electronic invoicing (e CF) has increased compliance and bill was introduced to expand its coverage and make it mandatory for large companies as of January 2023 Administrative and technological costs of implementing automation should be considered and properly planned. In the case of new technologies, documented examples from other countries must be used. A possible revision of the regulation that regulates the procedure for the application of ITBIS to digital services received in the Dominican Republic and provided by foreign suppliers might be needed.

Note: Based on the meeting held on 23 June 2022, to discuss the draft analysis and policy recommendations with officials from the Ministry of Finance, the Ministry of Economy, Planning and Development (MEPyD), the Central Bank, the National Statistics Office (ONE), the World Bank, the IDB and the European Union.
Source: Authors' elaboration.

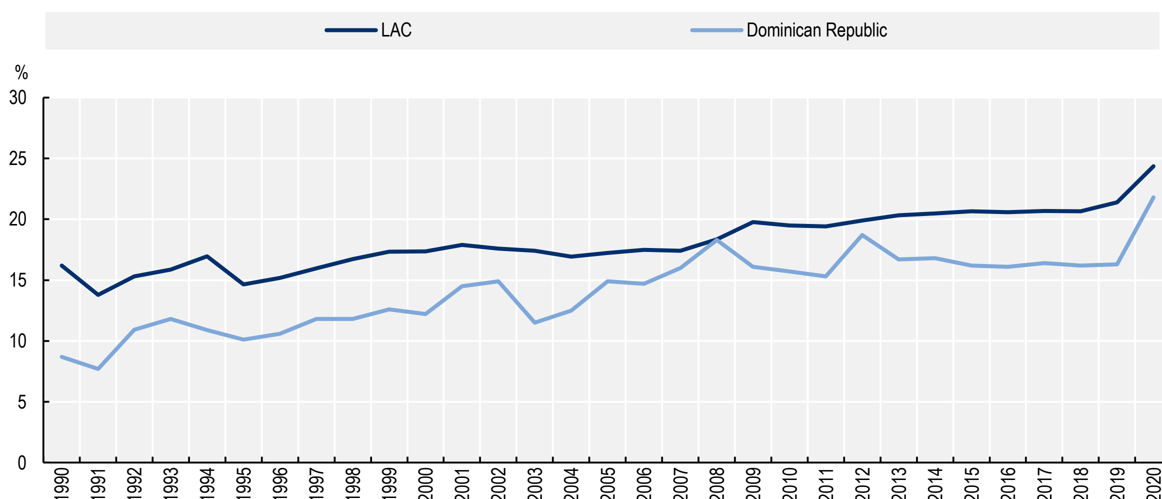
Improving the quality of public spending to enhance its impact on well-being

Public spending plays a key role in development by providing basic public services, decreasing inequalities, protecting vulnerable populations and investing in essential infrastructure to promote inclusive growth. Spending in the form of cash transfers can reduce poverty and inequality in the short term, an important factor in the present day. Effective social spending can also provide a buffer for vulnerable populations, giving them at least partial protection in case of an economic, social or environmental shock (Zouhar et al., 2021[50]). Public spending also plays an important role in providing security, education and healthcare for all, which can reduce inequality and poverty in a country. Investment projects can help a country realise long-term goals for instance by improving infrastructure. The COVID-19 pandemic forced a strong response from the government of the Dominican Republic, with significant public spending increases. However, this can also be taken as an opportunity to revisit the mechanisms for spending and to prioritise efficient spending that aligns with development goals and has a lasting positive impact.

Public spending in the Dominican Republic has recorded sustained growth in the last decades, but has persistently remained below LAC average levels

Public spending in the Dominican Republic has trended steadily upward in the last decades, with a notable spike due to COVID-19; between 1990 and 2019, public spending increased from 8.7% of GDP to 16.3%. However, the country's public spending as a share of GDP has consistently been below the LAC average, which was 21.4% of GDP in 2019 (Figure 4.11). Disparities across the region in levels of public spending are large, with countries like Brazil, Chile, Colombia and Uruguay regularly spending over 20% of GDP on public programmes and services in the years prior to the COVID-19 pandemic.

Figure 4.11. Evolution of public spending in the Dominican Republic, 1990-2020



Source: Authors' elaboration based on (ECLAC, 2022[51]).

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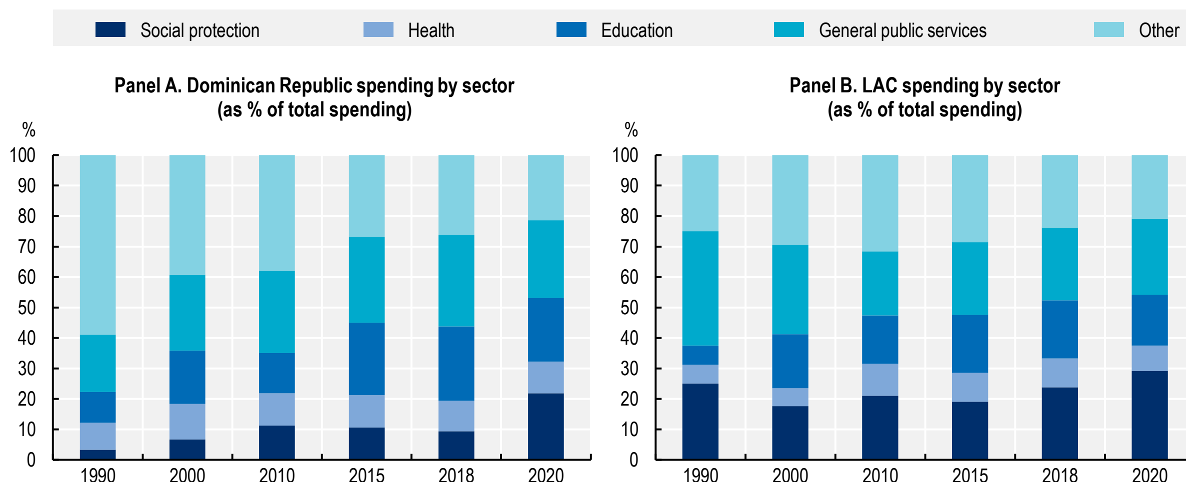
The crisis induced by the COVID-19 pandemic demanded a large increase in public spending in order to finance the necessary health, economic and social protection measures. As a result, public spending as a share of GDP rose dramatically by 5.5 percentage points, reaching 21.8% of GDP in 2020. In LAC, the average public spending as a share of GDP increased to 24% in 2020, with Brazil and El Salvador spending over 30%. Social protection expenditures experienced a particularly steep upsurge, increasing from 1.5% of GDP in 2018 to 4.8% in 2020.

The structure of public spending in the Dominican Republic has notably evolved over the last decades, with public services growing in importance. In 2018, almost one-third (30%) of total public spending was directed towards general public services, representing 4.8% of GDP. Similarly, spending on education rose from 10% of total spending in 1990 to more than 24% in 2018 (3.9% of GDP), mostly owing to the legislative approval of an annual spend of 4% of GDP on education. Social protection expenditures also increased during this time, from 3.3% of total spending in 1990 to 9.4% in 2018 (1.5% of GDP). Spending on public health has grown at a slower pace, however, increasing from 8.9% of total spending in 1990 to 10.5% in 2018 (1.6% of GDP). The main difference between LAC economies is in social protection expenditure; in 2018, this accounted for almost 24% across LAC economies (or 5% of GDP) (ECLAC, 2022[51]) (Figure 4.12). These figures, in general, are below the OECD average, where public spending on health accounted for 9.9% of GDP in 2020 and spending on education made up 4.5% of GDP in 2018 (OECD, 2021[52]; OECD, 2021[53]).

Figure 4.12. Public spending by sector in the Dominican Republic and in LAC (as a percentage of total public spending), 1990-2020



Source: Authors' elaboration based on (ECLAC, 2022[51]).

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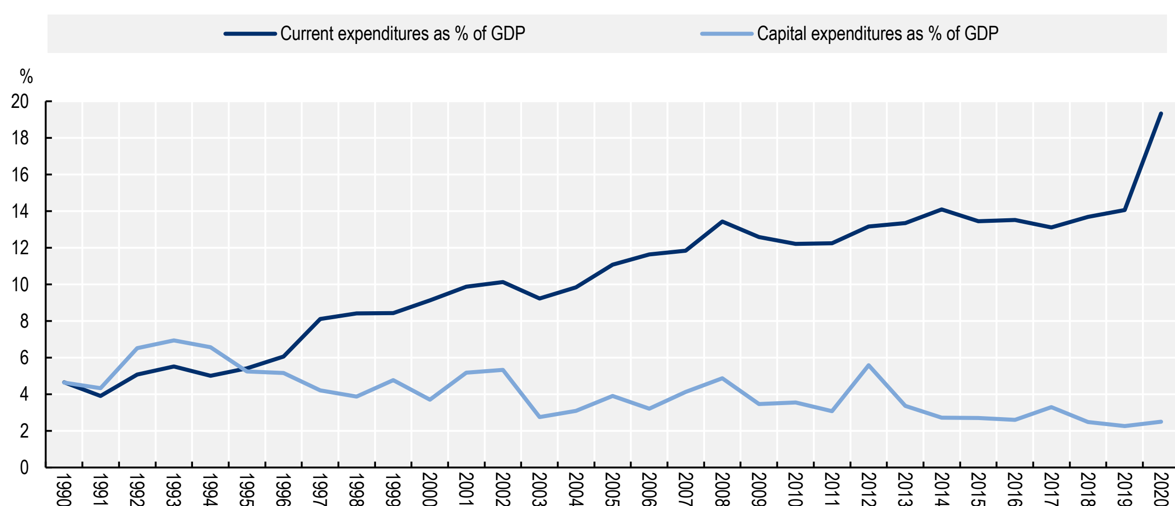
The COVID-19 pandemic has further biased expenditures towards current spending, but long-term investments must be protected in order to stimulate sustained growth

The Dominican Republic needs to balance today's expenditure (current) against tomorrow's (capital), especially in times of crisis. Pre-COVID-19 figures show that current expenditure represented 86.2% of total public spending in 2019, with capital expenditure accounting for the remaining 13.8%. The bias against capital expenditure was further accentuated by the crisis, with current expenditure rising from 14.1% of GDP in 2019 to 19.3% of GDP in 2020, representing the vast majority of public spending due to the COVID-19 pandemic (which accounted for 97% of the increase in public spending in 2020) (Figure 4.13). While the unprecedented impact of the pandemic largely justifies increased public spending in order to protect workers, businesses and households, the recovery will demand a more balanced approach. The multiplier effect of capital spending is often greater than that of public consumption, making the protection of such investments critical during fiscal adjustments in order to reduce costs for long-term output, neutralising the contractionary effects or even stimulating growth in the medium term (Ardanaz et al., 2022[54]). However, budget rigidities make some categories of public spending inflexible, limiting the capacity of policy makers to make any significant adjustment to expenditures.

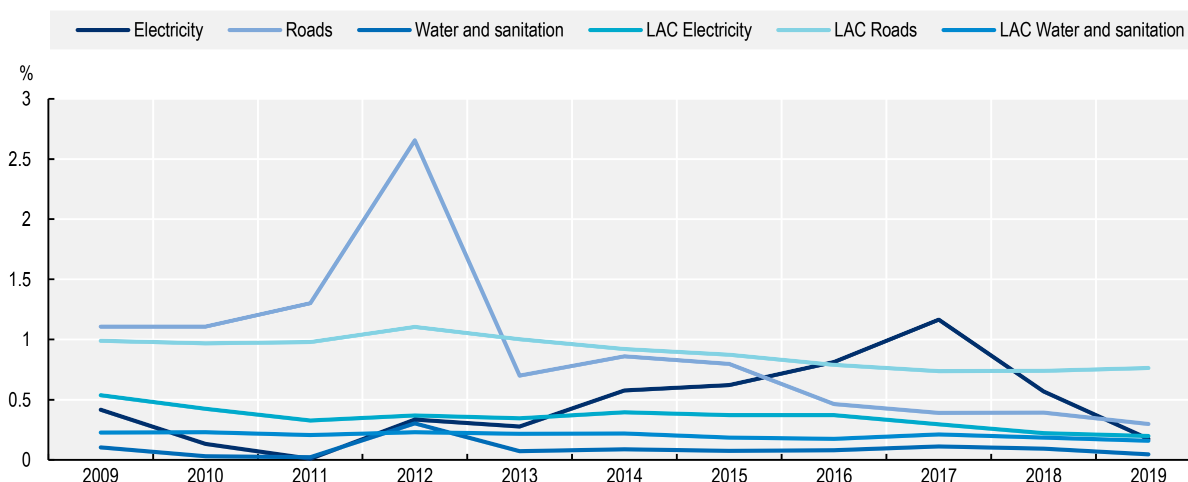
Figure 4.13. Current and capital expenditures in the Dominican Republic, 1990-2020



Source: Authors' elaboration based on (Ministerio de Hacienda, 2022[2]) and (IMF, 2021[55]).

As much as current spending is essential in financing day-to-day basic public services and fostering a faster economic recovery, low levels of capital expenditure can also have strong medium- and long-term effects on economic growth. Addressing and maintaining transport infrastructure, electricity, and sanitation, among other services, has a crucial influence on long-term development. By focusing public spending on short-term programmes, limited funds are left for longer-term infrastructure projects. As of 2019, the Dominican Republic was investing less than 0.5% of GDP in each of the key infrastructure areas of electricity, roads, and water and sanitation. In all three cases, the Dominican Republic spent below the LAC average (Figure 4.14). While Dominican state-owned entities remain dependent on government transfers, over the past few years the government has decreased its overall investment in one of the largest: electricity. While current transfers to this sector have remained steady, the decrease manifests as a reduction in capital expenditures, reflecting a reduction in the overall investment in electricity. The financial performance of the electricity sector is largely determined by oil prices, leading to large losses in 2019 and 2020 and potential risks for government finances in the future. Studies showed that a one-standard-deviation increase in the average price of oil in 2020 would have increased overall costs in the sector by 0.2 percentage points of GDP (World Bank, 2021[56]).

Figure 4.14. Public investment in infrastructure in the Dominican Republic (as a percentage of GDP), 2009-19



Source: Authors' elaboration based on (INFRALATAM, 2022[57]).

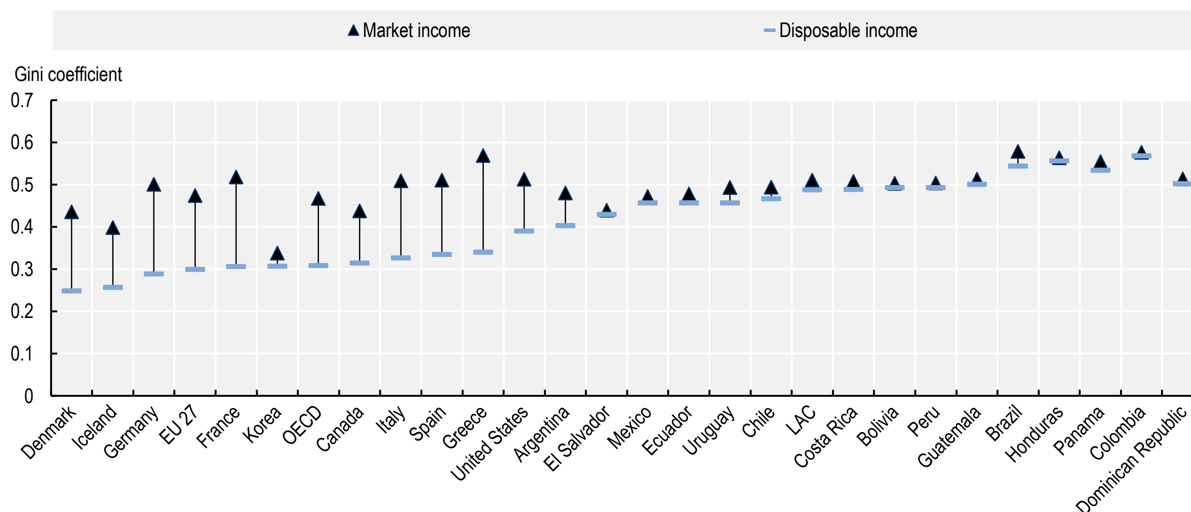
Reduced levels of fiscal space underscore the need to strengthen the efficiency of public spending, increasing its impact on equity and growth

The COVID-19 crisis has put pressure on public finances in the Dominican Republic. Low levels of public revenues, coupled with the increased pressure on public expenditure to respond to the immediate impact of the crisis, have reduced the room for manoeuvring in financing the recovery. Against this background, the efficiency of public spending emerges as a key policy area, and making the most of the available public resources becomes particularly relevant in order to ensure an inclusive recovery.

Inefficiencies in public spending in the Dominican Republic are relatively large and are estimated to account for up to 3.8% of GDP, although this is below the LAC average of 4.4% of GDP (World Bank, 2019[41]). Inefficiencies are primarily caused by leakages in transfers and procurement waste (World Bank, 2019[41]). In 2018, the Dominican Republic was ranked 131st out of 137 countries in government spending efficiency, and 135th out of 137 countries in the diversion of public funds (WEF, 2018[58]). A government study that examined the quality of public spending between 2008 and 2017 found that the Dominican Republic ranked 9th in the LAC region overall, but ranked among the worst in terms of spending on health (16th in the region out of 17 countries) and education (12th in the region out of 17 countries) (MEPyD, 2020[59]). These results suggest that more efficient and effective spending in health and education could help boost the overall efficiency of public spending in the Dominican Republic and increase the quality of life.

The role of public spending in reducing inequalities in the Dominican Republic is very limited. In fact, taxes and transfers contributed to a reduction of the Gini coefficient by only 1 percentage point, below the average 2 percentage points recorded in LAC economies, and still far from the 16-percentage-point reduction achieved by OECD member countries on average (Figure 4.15) (Lustig, 2018[60]; OECD et al., 2019[29]).

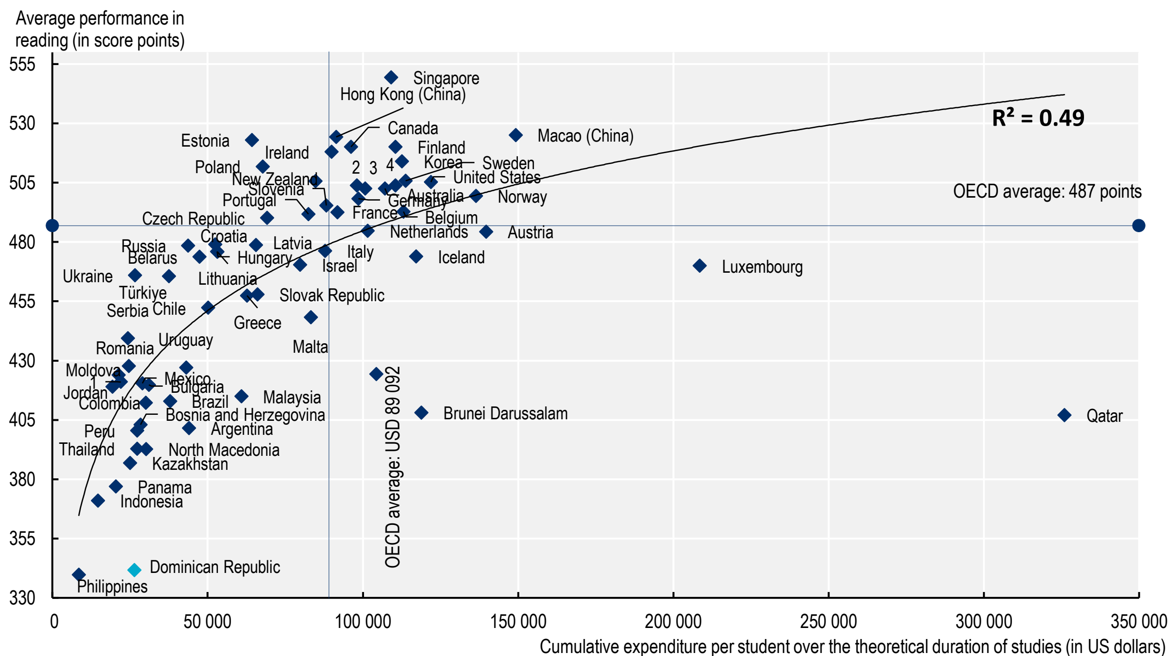
Figure 4.15. Impact of taxes and transfers on income distribution in the Dominican Republic and selected LAC and OECD member countries



Source: Authors' elaboration based on (OECD et al., 2019[29]; Lustig, 2018[60]).

Despite increases in education spending, learning outcomes in the Dominican Republic remain low, and lower than in some countries with similar levels of education expenditures. In 2013, results from the United Nations Educational, Scientific and Cultural Organization (UNESCO) cognitive test showed that the Dominican Republic had the lowest performance in education in the LAC region. At the time, this was partly attributed to lack of investment in education relative to other countries in the region and also to the poor quality of education spending (OECD, 2013[61]). In the PISA 2018 test, the Dominican Republic scored the lowest among the 79 participating countries in the mathematics and science test, and scored only above the Philippines in the reading test (OECD, 2018[62]). Countries such as Indonesia or Panama managed to achieve better results in PISA tests, while spending a similar amount as the Dominican Republic. Similarly, countries like the Philippines had similar results than the Dominican Republic, but with lower levels of education spending (Figure 4.16). Compared with 2015, results from the 2018 OECD Programme for International Student Assessment showed (PISA) that performance the Dominican Republic in mathematics and sciences was similar, while reading scores were lower (OECD, 2018[62]). These results were achieved in a context of increased levels of public spending in education since 2013, up to 4% of GDP. This performance suggests there are still challenges regarding the efficiency of public spending in education, although investments in education take time to deliver results and some of the impact of increased levels of spending may only become evident in future performance tests.

Figure 4.16. Spending per student aged 6-15 years and reading performance in PISA (2018)



Source: (OECD, 2018[62]).

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In the last decade, public spending on health has grown modestly in the Dominican Republic, and key health indicators have shown little improvement. Between 2010 and 2019, life expectancy at birth in the Dominican Republic increased by 2.1 years (from 72.0 years to 74.1 years). The country scores below the LAC average (76.5 years) and far below the regional leaders Costa Rica (80.3 years) and Chile (80.2 years). The Dominican Republic ranks below the LAC average in both numbers of hospital beds per 1 000 inhabitants and average medical and nursing staff per 10 000 inhabitants (below 2 beds and 30 staff). In fact, while public spending in health saw a modest increase from 1.6% to 1.7% of GDP between 2010 and 2017, the share of hospital beds (per 10 000 inhabitants) fell from 1.59 to 1.56 in the same period.

Improving the institutional framework for public spending must be a key priority in order to enhance its impact

Improving public spending by strengthening institutional frameworks is essential in the context of the post-COVID-19 economic recovery. Institutional and fiscal frameworks can play a stabilising role in fiscal policy making, as seen in Chile and Colombia. Instituting a multi-year budgetary framework, promoting greater transparency and establishing fiscal rules that take into account the phase of the business cycle and protect capital investment and key social spending can improve the efficiency of public spending (OECD, 2013[61]). The Dominican government took action in 2021, with the support of the European Union, by adopting a programme to improve the management of public finances. The main goal of the Reform Support Program of the Public and Financial Administration of the Dominican Republic and the mobilisation of national resources (PROGREF) is to improve co-ordination and communication between budget systems and to ensure transparency and accountability of public spending. Additionally, the programme will seek to ensure that public funds are allocated based on the country's development priorities as suggested by the National Multiannual Plan for the Public Sector and the National Development Strategy (MEPyD, 2020[59]). Some inefficiencies may be handled without changing current procurement laws, but instead by modifying current

practices, which can include consolidating purchases across government departments (bulk buying) and avoiding non-competitive contracts (World Bank, 2021[56]).

Setting up a fiscal rule could be useful for the Dominican Republic in setting guidelines for balancing budgets and/or for the evolution of debt, revenues and expenditures. In general, fiscal rules can help reduce the risk of a large and rapid reversal of external capital inflows, which can greatly harm foreign financing, cause a sharp depreciation and result in financial instability. Studies show that introducing a fiscal rule can also reduce the risk of sovereign default, especially for emerging markets (Arreaza et al., 2022[63]). In Colombia, fiscal rules helped the country attain investment grade, and the possibility of a debt anchor for controlling public debt has been explored. Additional changes also highlight the importance of establishing an escape clause in the case of an exogenous shock, such as that experienced as a result of the COVID-19 pandemic. A well-designed escape clause can allow increased government spending in dire situations and can include fiscal measures for returning to the rule's goals in the medium term (Arreaza et al., 2022[63]). A fiscal rule in the Dominican Republic could be the cornerstone of a future fiscal pact, as part of a broader set of fiscal measures.

Improved targeting of social programmes is a priority in order to enhance their impact and support the most vulnerable populations, particularly in the post-COVID-19 recovery context. Reducing poverty and improving living standards must continue to be the focus, but particular attention must be given to households in extreme poverty and households where all members work in informal jobs. In fact, using the household as the unit of analysis can provide greater efficiency in targeting social protection programmes (OECD et al., 2022[64]). The response to the COVID-19 crisis leaves some lessons regarding social protection. In particular, measures to improve the interoperability of existing registries, as well as innovative ways of giving cash transfers to informal workers, point to some interesting methods for improving the impact of social protection programmes (Basto-Aguirre, Nieto-Parra and Vázquez-Zamora, 2020[65]). Finally, the variety of small interventions in social protection can undermine their efficiency due to their limited scopes and budgets. Having a small number of well-implemented programmes is preferable to having numerous programmes with overlapping initiatives.

Combining new policies with *ex ante* evaluations can improve the quality and legitimacy of new measures. In economies where fiscal space is limited, it is important to use every available tool to ensure that the policies being designed are sound. *Ex ante* evaluations can help guide budget allocations in order to increase efficiency, improve the design of future policies and increase transparency by providing a level of accountability to citizens. A recent Inter-American Development Bank (IDB) study revealed that 44% of OECD member countries believe that *ex ante* evaluations have a high degree of influence on their budget decisions. If the goal of the *ex ante* evaluation is to influence the allocation of budgetary resources, then the best, most centralised option is to have the central budget authority spearhead the study, as this offers the best alternative for linking the findings of the evaluation to the budget (Fritscher, Roy Rogers and Motta, 2022[66]).

The need for a fiscal pact in the Dominican Republic to face the post-COVID-19 recovery

In its 2030 National Development Strategy, the Dominican Republic included a fiscal pact as part of its commitment to sustainably finance development in the country. In 2022, a decade later, this fiscal pact was yet to be introduced, but the context of the post-COVID-19 recovery, together with the findings presented in this chapter, underscore the importance of moving forward in building a holistic and well-co-ordinated fiscal strategy backed by a broad consensus.

This is particularly true not only because of the different fiscal challenges facing the Dominican Republic, as well as the financial requirements for a post-COVID-19 recovery, but also because as much as 40% of Dominicans found it justifiable to evade paying taxes in 2015 (OECD et al., 2019[29]). These low levels of "tax morale" reveal that citizens do not see value in paying taxes. This can be due to many factors, including

low levels of trust in public institutions. For this reason, a fiscal pact must also be seen as an opportunity to build and restore trust – a fundamental ingredient for policy making – in the country.

While the political economy of a fiscal pact is complex, achieving such type of broad consensus is also an opportunity to build an inclusive and sustainable recovery. The role of fiscal policy for the post-COVID-19 recovery must be holistic, making use of all fiscal policy tools and co-ordinating measures not only to strengthen tax revenue collection, but also to improve the efficiency of expenditures and underpin debt sustainability. Bundling the various fiscal reforms into a comprehensive package can help to build fiscal legitimacy, as well as reduce political constraints, facilitating political support and addressing distributional issues by making the system more progressive. Fiscal measures should be co-ordinated under a well-defined sequence of policies that can be adapted to the different stages of the recovery. Finally, there needs to be a broad consensus and national dialogue surrounding the timing and dimensions of the required fiscal measures, not only for the immediate recovery from the crisis, but also for longer-term development that is sustainable and inclusive (Nieto-Parra, Orozco and Mora, 2021[67]).

Strengthening the role of the financial system for development in the Dominican Republic

Mobilising domestic public and private financial resources is key to boosting long-term growth and promoting citizens' well-being. First, it increases the financing available for scaling up gross domestic investment in physical capital, infrastructure, housing and other intermediate goods. Second, it supports technical progress and innovation by allowing riskier investors to discover more investment options. Third, it bolsters productive diversification, resulting in more formal economic activities and hence tax revenues to finance development. Finally, it promotes a virtuous circle of investment in registered productive sectors, employment, additional public revenues (as the tax base rises) and productivity growth.

In a context of limited fiscal space and major financial constraints, mobilising private resources is critical. The Dominican Republic has scope for mobilising financial resources through private and public savings from both domestic and international sources, as well as room to manoeuvre in order to implement public policies in support of that mobilisation. Despite having modestly raised private credit to GDP and public revenues to GDP in the last 15 years, together with growing opportunities to fund private investment in local, dynamic and tradeable sectors, the Dominican Republic's financial system remains underdeveloped compared with other LAC and OECD member countries.

More sustainable and diversified financing is required to finance the recovery from COVID-19 and spur long-term growth. This section analyses the financial markets in the Dominican Republic and examines the main barriers to more effectively mobilising financial resources and channelling these towards financing inclusive and sustainable development.

The remainder of this section is organised as follows. First, it analyses the Dominican Republic's banking system, its strengths and weaknesses, and the main barriers to increasing access to credit and financial inclusion. Second, it centres on the public debt market, focusing on analysing debt levels and sustainability, improvements and pending challenges in debt management, and the development of the local currency bond market. Third, it explores the main challenges to, and opportunities for, further deepening the private debt market. The chapter concludes with a series of policy recommendations for achieving greater depth and improving the institutional framework of the Dominican Republic's financial system.

Developing the banking system

The banking system has been resilient to recent global crises

The Dominican Republic's formal financial system is regulated by the Junta Monetaria (Monetary Board), which is responsible for financial, monetary and exchange rate policy. The Central Bank and the Superintendency of Banks are subordinate to the Junta Monetaria and are in charge of regulation and supervision of the compliance of financial intermediaries (including banks) with financial and macroprudential policies.

Since the banking crisis in 2003-04, banks and the financial system in the Dominican Republic have managed to weather subsequent crises, namely the global financial crisis of 2008-09 and the recent crisis resulting from the COVID-19 pandemic. The Dominican financial system's resilience is mostly due to sound and credible regulatory standards, which can be further strengthened by progressive adherence to Basel III standards. This allowed an ambitious monetary policy response to the COVID-19 crisis involving reductions in minimum reserve requirements and cuts in monetary policy rates. A flexible exchange rate regime acted as a shock absorber during the pandemic.

The banking system exhibited relatively sound liquidity and solvency indicators over the last decade. The share of non-performing loans (NPL) as a percentage of total loans has decreased from 2.9% in 2011 to 1.3% in 2021 (Table 4.4). The return on assets and return on equity of the financial intermediaries also showed a downward trajectory as a result of slightly narrowing bank spreads and changes in non-performing loans. The experience in recent years showed that lending rates reacted more than deposit rates to changes in monetary policy, causing a reduction of bank spreads when monetary conditions eased. Despite narrowing bank spreads, the profitability of the financial system increased on the back of economic growth during 2021. The overall solvency ratio improved by 50% between 2011 and 2021, with limited growth during 2020 due to the COVID-19 pandemic.

Table 4.4. Financial indicators in the Dominican Republic's financial system

	Dec-2011	Dec-2013	Dec-2015	Dec-2017	Dec-2019	Dec-2020	Jun-2021	Dec-2021
Return on Asset	2.35	2.33	2.29	1.93	2.28	1.75	2.4	2.29
Return on Equity	19.93	20.63	20.07	16.7	19.52	15.59	21.77	20.66
Financial Income/Loans	14.71	14.27	13.02	12.75	11.55	10.85	10.77	9.78
Cash/Deposits	36.62	33.37	34.33	29.65	25.93	30.47	26.97	23.86
Non-Performing Loans (NPL)/Total Loans	2.87	2.19	1.68	1.86	1.55	1.94	1.69	1.3
Provision for NPL/NPL	111.74	134.82	152.37	149.3	162.07	203.91	252.96	332.81
Solvency Index	17.33	16.69	15.97	18.25	16.57	21.07	22.37	ND

Source: Authors' elaboration based on (Superintendencia de Bancos, 2021[68]).

During the COVID-19 crisis, the Central Bank and the Superintendency of Banks adopted macroprudential and supervisory measures in order to provide additional liquidity to support the economy. The new regulations allowed banks to cover reserve requirements with public bonds (and Central Bank notes in local currency) up to the amount of DOP 36 billion (about 0.75% of GDP), which was equivalent to a 3.25% reduction in reserve requirements. These resources were earmarked to provide credit to households and businesses at an interest rate capped at 8%, injecting significant liquidity to the system (IMF, 2020[69]). Additionally, the Central Bank temporarily froze internal debtor scorings in case of refinancing needs, and returned loan provisioning to the prevailing levels as of March 2020.

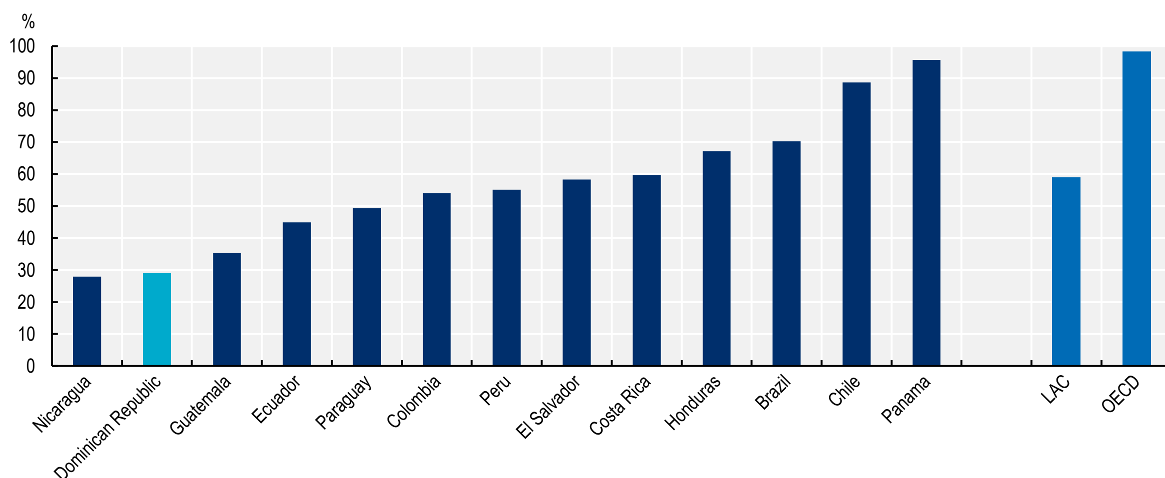
Mobilising additional, less costly resources without compromising financial stability is a significant challenge ahead in the public policy agenda. As became apparent during the COVID-19 pandemic, there remains large scope for the banking system to continue assisting the economic and social development of the Dominican Republic through reducing real lending interest rates, increasing credit to the private sector and SMEs, implementing more effective and comprehensive financial inclusion and education strategies, and fostering competition.

Banking depth remains low compared with other LAC and emerging countries

While the banking system in the Dominican Republic has proven to be resilient, it does not contribute sufficiently to financing development, despite the expansion of banking depth. Banking depth, measured as the percentage of banking credit to GDP, has been improving since 2010. The banking-credit-to-GDP ratio stood at 28.9% of GDP in 2019, five percentage points higher than in 2010. The increase in banking depth was a well-established trend in most LAC countries during the last decade, supported by macroeconomic stability, economic growth and abundant global liquidity.

However, the Dominican Republic shows lower levels of banking depth than most of its LAC and international peers (Figure 4.17). Peer LAC countries have raised the average banking-credit-to-GDP ratio by 14 percentage points since 2010 to reach 60% of GDP. This ratio averages almost 98% in OECD member countries.

Figure 4.17. Banking credit as a percentage of GDP, 2019



Source: Authors' elaboration based on (World Bank, 2022[70]).

The composition of the Dominican Republic's loan portfolio has been relatively stable since 2012. Banking credit to the private sector is led by commercial loans (56% of total lending in December 2020), followed by consumer loans (26% of total lending in December 2020), while mortgage lending accounts for 18% of total lending. Other types of lending (such as microcredit) represent less than 1% of total banking credit (Superintendencia de Bancos, 2021[68]).

Finally, as of the latest internationally comparable data available from 2017, 56% of Dominican people aged 15 years or over hold a bank account, which is roughly the LAC average but well below the OECD member country average of 95%. Banking lending is very low among individuals, and only 20-25% of people who save money do so with formal financial institutions according to the National Survey of

Financial Inclusion. Only 16% of those aged 15 years or over possess a credit card; that is three percentage points below the LAC average (19%) and far below the OECD member country average (57%) (Table 4.5).

Table 4.5. Bank account holdings and credit card ownership in selected LAC countries, 2011-17

Country	Financial Indicator/Year					
	Account (% age 15+)			Credit Card Ownership (% age 15+)		
	2011	2014	2017	2011	2014	2017
Dominican Republic	**38%**	**54%**	**56%**	**12%**	**11%**	**16%**
Panama	25%	44%	46%	11%	10%	8%
Costa Rica	50%	65%	68%	12%	14%	14%
Honduras	21%	31%	45%	5%	6%	5%
Ecuador	37%	46%	51%	10%	6%	9%
Peru	20%	29%	43%	10%	12%	12%
LAC	39%	52%	55%	18%	22%	19%
OECD	90%	94%	95%	51%	53%	57%

Source: Authors' elaboration based on (World Bank, 2021[71])

The banking system remains highly concentrated, and real interest rates and spreads are high

The financial system in the Dominican Republic remained highly concentrated in the last decade. The ten largest entities by assets held controlled 90.2% of deposits by the end of 2020, 3.3 percentage points higher than in 2012. This level of concentration is also higher than in other LAC countries. Among a sample of 19 regional peers, the Dominican Republic presented the fourth-most concentrated financial system in LAC, with a strong average correlation between the degree of concentration and the level of net interest margins (Tambunlertchai et al., 2021[72])

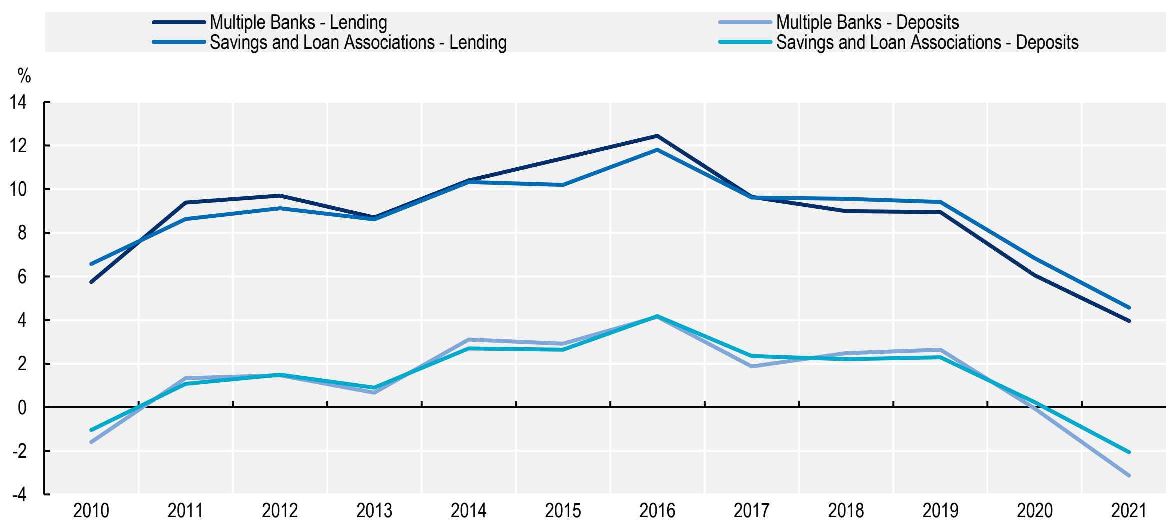
The financial system in the Dominican Republic is made up of 17 Multiple Banks (MBs), 10 Savings and Loan Associations (SLAs), 14 Savings and Loan Banks (SLBs), 6 Credit Unions and Cooperatives (CUCs), and 1 state-owned financial institution (Superintendencia de Bancos, 2021[68]). MBs and SLAs alone account for 97% of assets held. Other types of financial intermediaries have a minor share in the financial system, including microfinance institutions; these usually provide financial services (i.e. credit) to informal microenterprises and informal workers, which account for more than 50% of total employment.

Real lending interest rates faced by the private sector remained high, at close to 10%, between 2010 and 2019 (Figure 4.16). However, in 2021, real interest rates fell to 3.9% in MBs and to 4.6% in SLAs following the easing of financial conditions implemented by the Central Bank as part of the countercyclical measures adopted during the COVID-19 pandemic. Between August 2020 and October 2021, the monetary policy rate was lowered to 3.0% (from 4.5% at the end of 2019). However, the Central Bank afterwards decided to begin a normalisation process for its monetary policy, given that inflation has been affected by higher oil prices and supply chain disruptions (Banco Central de la Republica Dominicana, 2022[73]). The monetary policy rate has been increasing since November 2021 when it stood at 3.50. Since then it has been increased 9 times to reach a monetary policy rate of 8.7% in October 2022.

High real interest rates are key barriers to accessing banking finance in the formal sector of the Dominican Republic's economy. Operating costs remained high and stable between 2010 and 2019; the ratio of operating costs to total assets was above 6% before the COVID-19 pandemic, but it reached an average of 5.3% in December 2021, the lowest level since 2000, showing that there is room for improving efficiency and lowering net interest margins (Banco Central de la Republica Dominicana, 2022[73]).

Real deposit interest rates have been positive over the last decade. In 2016, these reached 4% in MBs and were even higher in other types of financial institutions (Figure 4.18). This is a major and positive change compared with the prevailing negative interest rates of the 2000s because it stimulates formal savings in the banking system. Positive real interest rates in the long term contribute to the development of the banking system and the availability of credit to the private sector through increased private savings. In this regard, low banking depth is also reflected in the deposits-to-GDP ratio, which is also lower in the Dominican Republic (30.4% of GDP) than in the LAC (55.3% of GDP) and OECD (98.2% of GDP) averages (Figure 4.19), and in the considerably low percentage of people saving in the formal financial system (Banco Central de la Republica Dominicana, 2022[73]) (Box 4.3).

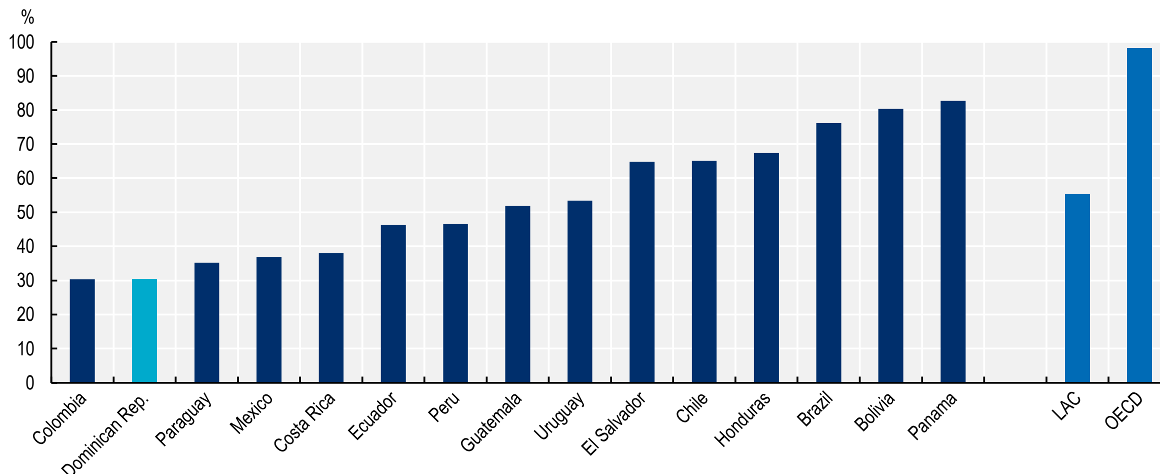
Figure 4.18. Real Lending and Deposits rate in Multiple Banks and Savings and Loan Associations



Source: Authors' elaboration based on (Banco Central de la Republica Dominicana, 2022[73]).

https://stat.link/y5rgzt

Figure 4.19. Deposits as a percentage of GDP, 2020



Note: LAC and OECD averages are simple averages of countries available.
Source: Authors' elaboration based on (IDB, 2020[74]; World Bank, 2020[75]).

https://stat.link/bwsl8q

Box 4.3. Mobilising resources for greater financial inclusion

Financial inclusion means that individuals and businesses have access to useful and affordable financial products and services – transactions, payments, savings, credit and insurance – that meet their needs and that are delivered in a responsible and sustainable way. Financial inclusion is a key enabler to reduce extreme poverty and boost shared prosperity (World Bank, 2021[76]).

Financial inclusion in the Dominican Republic faces challenges of a structural nature, such as high levels of informality, relatively low levels of tax collection, a small public pension system, low levels of financial literacy and relatively high levels of mistrust. These barriers are not unique to the Dominican Republic, however, and can be found in other countries in LAC (OECD et al., 2019[29]).

According to *Informe de Encuesta Nacional de Inclusión Financiera (ENIF) 2019*, published by the Central Bank of the Dominican Republic, 54% of people surveyed did not have any financial product in a financial institution; the remaining 46% had at least one financial product. The most used financial services and products are savings accounts (34%) and payroll accounts (23%), with a low percentage of people holding personal credit cards (9%). That report also found that access to and possession of financial products and services is less than their actual use (BCRD, 2020[77]).

Another important finding of the report is that 80% of Dominicans borrow money through the informal sector. The main reasons for borrowing are a lack of sufficient savings (36%) and insufficient salaries to cover expenses (32%). On the other hand, survey participants indicated that the main reasons to neither have nor request a loan are high interest rates (42%) and cultural issues (BCRD, 2020[77]).

In the last decades, there was a significant increase in the total nominal volume of credit granted to microenterprises, but in comparison with the volume of total credit granted to the private sector or as a percentage of GDP, the amount of credit granted to microenterprises has actually decreased. This type of credit represented only 2.5% of total credits granted to the private sector and 0.7% of GDP in 2020.

All of this offers an opportunity to develop a financial inclusion strategy in the medium to long term, with the objective of increasing the supply and use of financial products and services by Dominicans. This will require structural changes in order to promote the creation of formal jobs, as well as greater financial awareness and the dissemination of education campaigns to all Dominicans who remain informal.

Partial dollarisation could pose some risks to the system

The current financial regulations allow banks and other financial institutions to take deposits and lend money in US dollars. The Dominican Republic has a partially dollarised financial system, with 24% of loans and close to 30% of deposits denominated in foreign currency. Commercial credit accounts for more than 90% of foreign currency loans, whereas a very small proportion of such loans are for consumer credit and mortgages. As has been stressed by many (De la Torre and Schmukler, 2004[78]), partial dollarisation could lead to currency and maturity mismatches between assets and liabilities, or even between revenues and expenditures. This might cause some financial instability in the face of a deposit withdrawal, a credit crunch, and/or a currency depreciation. Therefore, specific regulations are needed in order to avoid these risks.

The public debt market

The Dominican Republic succeeded in lengthening maturities at lower costs in 2020

Developing domestic debt markets can be growth-enhancing and promote socio-economic development. Long-term financing through bond issuances and other related securities allow economies to raise investment capital for infrastructure, housing or equipment investment, to smooth consumption, and to cope with climate and health emergencies, and thus support long-term economic, social and environmental progress. More accessible and affordable debt markets and the diversification of the investor base while managing portfolio risks contribute to lower refinancing costs and longer maturities.

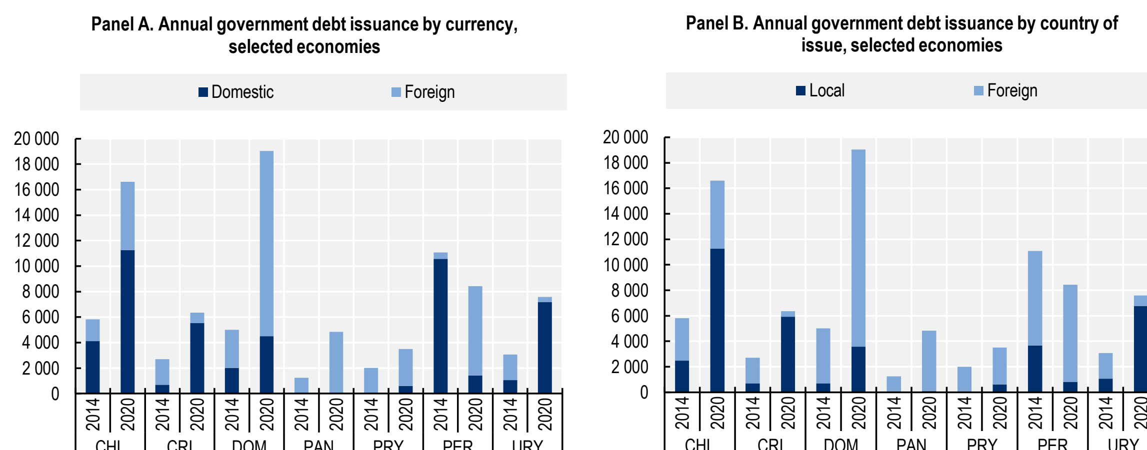
In spite of the COVID-19 crisis, the Dominican government succeeded in accessing the international bond market in 2020. The country issued public securities in the amount of USD 6 000 million at maturities of 10, 12 and 40 years. Indeed, in January 2021, the Dominican Republic was able to issue a ten-year bond for USD 1 000 million with an interest rate of 4.50%, the lowest issued by the country at this maturity. Moreover, it also issued a 40-year bond, the longest-term instrument issued on international markets, at a rate of 5.875%, the lowest issued for a bond with a maturity greater than 30 years. This constitutes a historical milestone in the international capital markets for the Dominican Republic. Investors' demand exceeded the amount bid by more than four times. In addition, this issuance allowed the average maturity of the debt to be extended from 9.7 years to 11.0 years, which reduced the risk of refinancing the debt, while maintaining the average interest rate levels of the portfolio (Ministerio de Hacienda, 2020[79]).

In 2020, the Dominican Republic also executed a liability management operation which consisted of repurchasing bonds due in 2021, 2024 and 2025 with the proceeds of a 12-year maturity bond issuance of USD 1 266 million. According to the Ministry of Finance, this operation had multiple benefits for the debt portfolio. First, it entailed a reduction of the debt service burden by USD 1 132 million for the 2021-25 period; second, it caused a decrease in the average cost of debt from 6.16% to 6.06%; and third, it brought about an increase in the average maturity of the global USD bond portfolio from 17.19 years to 17.79 years, with a minimum increase in the total public debt of USD 6.1 million (Ministerio de Hacienda, 2020[80]).

In February 2022, the country issued USD 3 564 million in 7- and 11-year maturity bonds with 5.5% and 6.0% coupons, respectively. The proceeds allowed the government to reduce USD 1 100 million in debt payments that were due between 2022 and 2024 through a repurchase of local and external bonds. This liability operation extended the duration of USD-denominated debt by 0.3 years (Ministerio de Hacienda, 2022[2]).

From a regional perspective, the COVID-19 pandemic increased the need to provide financing through bond issuances in most LAC countries in 2020. The Dominican Republic also increased its market access at the lowest rate on record, issuing a mix of foreign and domestic bonds. High international liquidity (and in particular, capital flows towards sovereign bonds) in emerging markets during the pandemic contributed to this positive trend (Figure 4.20) (OECD et al., 2021[81]).

Figure 4.20. Annual government debt issuance of total active debt in selected LAC countries, by currency and by country of issuance, 2014 and 2020



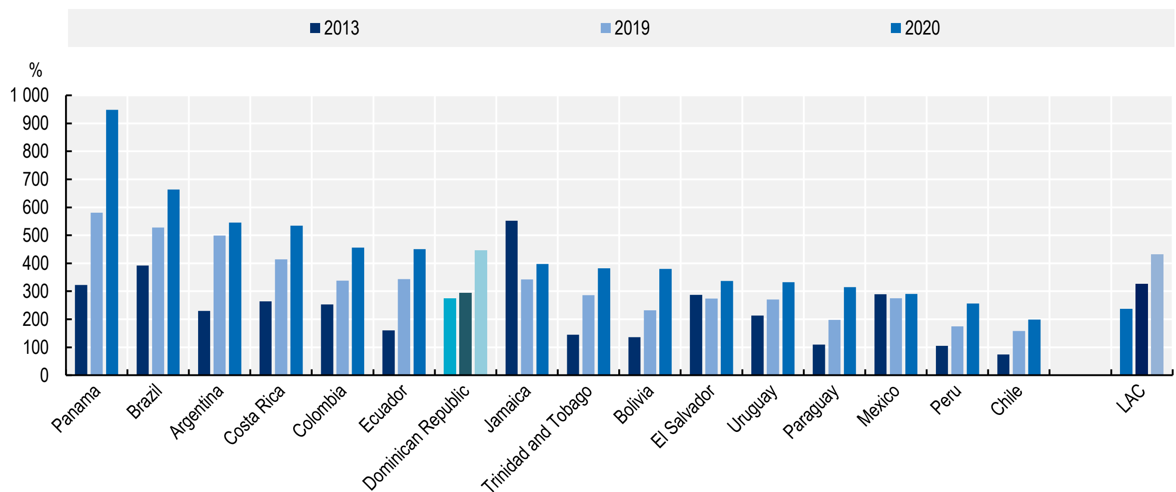
Source: (OECD et al., 2021[81]).

In April 2020, the Dominican Republic obtained emergency financial assistance through the International Monetary Fund's (IMF's) Rapid Financing Instrument (RFI) of about USD 650 million for essential COVID-19-related health expenditures and to support vulnerable populations. Multilateral institutions, such as the World Bank and the IDB, also provided USD 1 453 million for development projects and budget support in 2020.

Despite successful debt management practices and the reduction of average bond financing costs, public debt ratios have increased considerably

Levels of public debt in the Dominican Republic have increased considerably compared with the levels before the 2008 global financial crisis. The public debt-to-tax ratios (a proxy indicator of a country's financial capacity to pay for its public debt) increased from close to 274% in 2007 to around 294% in 2019, up to 447% in 2020 leaving the Dominican Republic in a weaker position after the COVID-19 crisis (Figure 4.21) (OECD et al., 2021[81]). Moreover, the COVID-19 pandemic deteriorated the consolidated public sector debt-to-GDP ratio, which reached 70.3% in 2020, almost 20 percentage points higher than in 2019 (53.2%) (IMF, 2022[82]) (Ministerio de Hacienda, 2021[3]). This sharp rise in 2020 was fuelled by the impact of the COVID-19 pandemic, which triggered a 6.7% fall in economic activity with an overall fiscal deficit of 7.7% of GDP. However, public debt was reduced to 62.1% of GDP in 2021 and the ratio should continue to trend downward, to an estimated 59.2% in 2022 (IMF, 2022[82]). Non-financial public sector debt, according to national data, was at 40.4% of GDP in 2019, increased to 56.6% in 2020, and decreased again to 50.4% in 2021 and to 46.5% by October 2022 (Dirección General Crédito Público, 2022[83]).

Figure 4.21. Ratio of public debt to tax revenues in selected LAC economies, 2007-19



Source: (OECD et al., 2021[81]).

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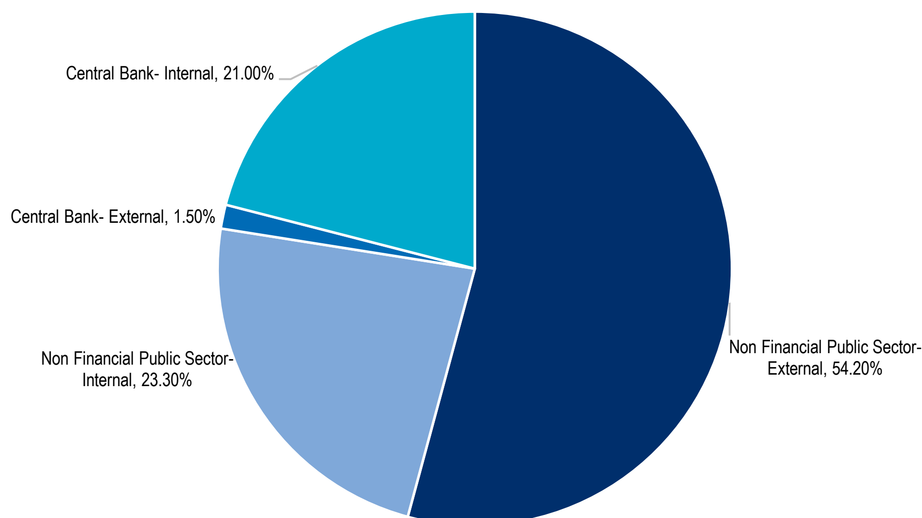
As of December 2021, most public debt of the Dominican Republic – including IMF, bilateral and development loans – was external (55.7%). The outstanding internal debt issued by the Treasury and by the Central Bank represent similar shares of total debt (23% and 21% of the portfolio, respectively), giving both entities similar importance in the local debt market (Figure 4.22). Regarding external public debt, as of 2020, foreign bonds (77% of total) made up the largest share, followed by multilateral financing (17%), bilateral financing (3%) and commercial banks (2%); this pattern is similar to that in other countries with good access to the international bond market (e.g. Mexico, Peru) (Figure 4.23).

Figure 4.22. Composition of outstanding public debt by issuer and legislation – December 2020



Source: Authors' elaboration based on (Dirección General Crédito Público, 2022[83]).

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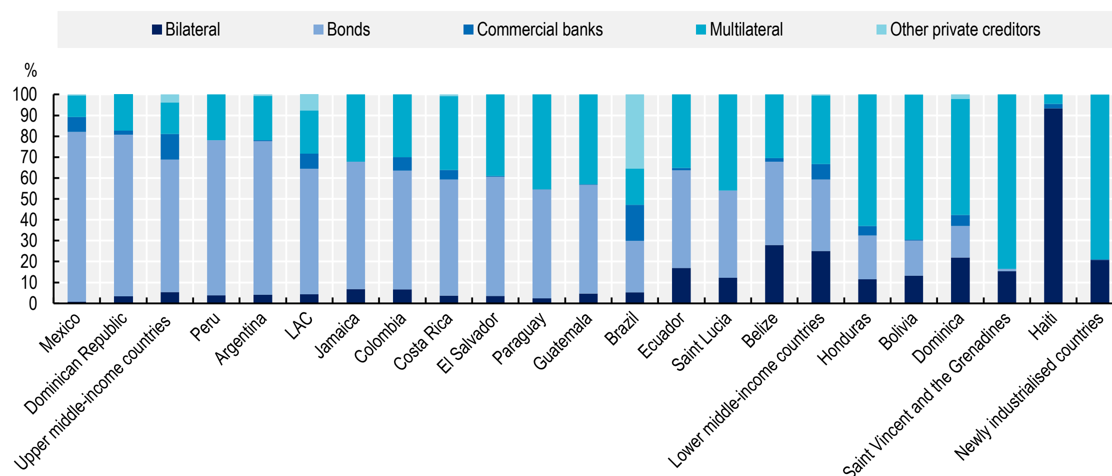
Figure 4.23. Total external public debt stock by creditor (public and private) in selected LAC countries, 2020



Note: LAC is the simple average, which gives equal weight to all creditors; LAC takes into consideration the amount issued by each LAC country. "LMI" and "UMI" are all lower-middle-income and upper-middle-income countries in the world, respectively, as classified by the World Bank in International Debt Statistics.
Source: Authors' elaboration based on (World Bank, 2022[84]).

The Dominican Republic has developed a medium-term debt strategy following best international practices, but new efforts should ensue in order to guarantee sustainability and expand its financing potential

Following best international practices in public debt management, the Debt Management Office (DMO) also developed a Medium-Term Debt Management Strategy (MTDS) for the period 2016-20 (Ministerio de Hacienda, 2016[85]). An MTDS is a plan that a government intends to implement over the medium term in order to achieve the desired composition of the government debt portfolio, which captures the government's preferences regarding the cost-risk trade-off. It operationalises debt management objectives with a strong focus on managing the risk exposure embedded in the debt portfolio (IMF, 2009[86]).

In the case of the Dominican Republic, the MTDS for 2016-20 had five strategic guidelines: 1) to reduce the exchange rate risk of the portfolio by increasing the share of local currency debt; 2) to deepen the local debt market; 3) to diversify the investors' base in the international market; 4) to increase the average maturity of external financing and execute liability operations (such as the one executed in 2020) in order to reduce exposure to refinancing risk; and 5) to set an adequate maturity profile in order to avoid strong fiscal pressures from a high debt service burden (Ministerio de Hacienda, 2016[85]).

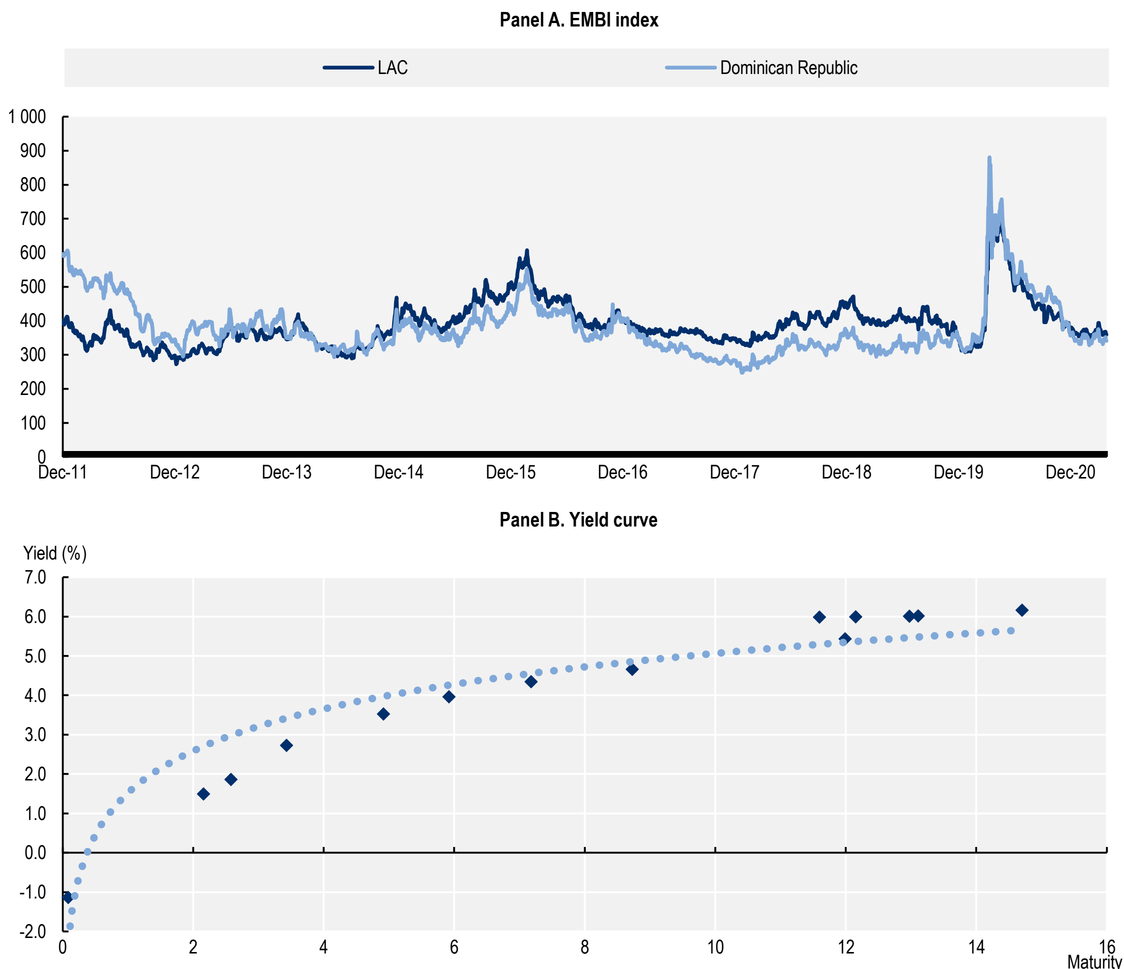
These broad guidelines were translated into four quantitative targets: 1) the percentage of foreign-currency-denominated debt had to remain between 74% and 80% of the total outstanding debt; 2) the short-term debt should be equal to or less than 12% of the total outstanding debt; 3) the average maturity of internal debt should be 7 years (±1 year); and 4) the proportion of debt refinancing interest rates in a year should be between 14% and 20% of portfolio. The DMO monitored the goals carefully and periodically reported on compliance with the targets. By December 2020, all quantitative targets had been met with the government playing an active role in liability management; some progress had also been made in the development of local currency debt markets and in the extension of the average lifespan of the portfolio (Ministerio de Hacienda, 2020[87]).

The fulfilment of quantitative targets set in the MTDS to enhance debt management practices is consistent with the strategic guidelines and strengthens the reputation of the DMO to meet its long-term goals. In this regard, the creation of a new MTDS which benefits from the lessons learned would be a natural step to continue to strengthen the management capabilities of the DMO over time. Recent debt management operations in 2021 suggest that the Dominican government is currently committed to an efficient debt management strategy with goals similar to those contained in the MTDS for 2016-20 (Ministerio de Hacienda, 2022[2]).

Country risk has returned to pre-pandemic levels, and the yield curve of international issuances displays a normal shape

In general, the Dominican Republic's sovereign spreads have followed regional trends of country risk measured by the Emerging Markets Bond Index (EMBI) Latam. By March 2021, one year after COVID-19 began to affect Western economies, country risk was between 300 and 400 basis points (bps), close to pre-pandemic levels. In November 2022, country risk in the Dominican Republic was at 382, well below the LAC level, at 452 bps ((Banco Central de la Republica Dominicana, 2022[73]) Moreover, the yield curve of external bonds (in US dollars) has the typical upward slope shape. Bonds on the long end yield 6%, while those on the short end yield less than 2% (Figure 4.24).

Figure 4.24. Country risk and yield curve on external bonds



Source: Authors' elaboration based on (Bloomberg, 2021[88]) and (Banco Central de la Republica Dominicana, 2022[73]).

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In order to obtain the investment grade in the medium term, the Dominican Republic will need to circumvent some structural hurdles and diminish its fiscal and external vulnerability to shocks. Major credit rating agencies place the country at the same level in their scales (BB- with a negative outlook for the Standard and Poor's (S&P) and Fitch ratings, and Ba3 for Moody's), two notches below investment grade. This rating implies that the Dominican Republic is a less vulnerable issuer in the short term but still faces diverse uncertainties related to adverse business, financial and economic conditions (Banco Central de la Republica Dominicana, 2022[73]).

Credit rating agencies also recognised that COVID-19 severely affected economic activity, especially the tourism, construction and manufacturing sectors. However, these agencies did not downgrade the country during the worst period of the pandemic in 2020. S&P recognised that the Dominican Republic has greater potential growth compared with countries with similar creditworthiness, which eases some external weaknesses in the medium term (S&P Global Ratings, 2020[89]).On the other hand, long-lasting difficulty in delivering structural reforms in order to reduce fiscal and external vulnerabilities is still present and could limit long-term growth. In the last decade, good economic performance and fluid access to international markets helped the country consistently improve its ratings. Since 2010, S&P and Fitch have upgraded the Dominican Republic's credit rating by two notches and Moody's has upgraded it by one notch, but the country's rating provided by these agencies has remained below investment grade (Table 4.6) (Banco Central de la Republica Dominicana, 2022[73]). In December 2021, S&P raised the Dominican Republic's credit outlook from "negative" to "stable" due to an impressive economic recovery that reversed the external deterioration caused by COVID-19. Fitch Ratings also changed the credit perspective from "negative" to "stable" thanks to higher-than-expected economic growth and the reduction of the country's fiscal deficit.

Table 4.6. Credit ratings for the Dominican Republic, 2010-21

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
S&P	B	**B+**	B+	B+	B+	**BB-**	BB-	BB-	BB-	BB-	BB-	BB-	BB-
Fitch	B	B	B	B	**B+**	B+	**BB-**	BB-	BB-	BB-	BB-	BB-	BB-
Moodys	B1	B1	B1	B1	B1	B1	B1	**Ba3**	Ba3	Ba3	Ba3	Ba3	Ba3

Source: Authors' elaboration based on (Banco Central de la Republica Dominicana, 2022[73])

Although co-ordination in the local debt market between the Central Bank and the Treasury has improved, it requires additional fine-tuning

Co-ordination between the Ministry of Finance and the Central Bank is crucial for the development of the Dominican Republic's local debt market (OECD, 2012[90]). This co-ordination is critical in order to avoid debt fragmentation, unnecessary competition, yield curve distortions and additional issuance costs. These two entities are the main public issuers of domestic debt. However, each entity has different goals in managing internal debt. The Treasury is primarily concerned with the cost of lending, while the Central Bank uses its liabilities to fulfil monetary policy objectives and intervene in exchange rate markets.

In 2012-13, the Treasury and the Central Bank used to issue bonds at similar maturities (Figure 4.25, Panel A) with little or no co-ordination regarding issuance dates, interest rates, types of securities or placement methods (OECD, 2012[90]). This created inefficiencies in the market and prevented it from developing further, mainly because the lack of co-ordination caused a significant crowding out of the private sector, which was in an unfavourable position to compete for domestic financing in the medium term.

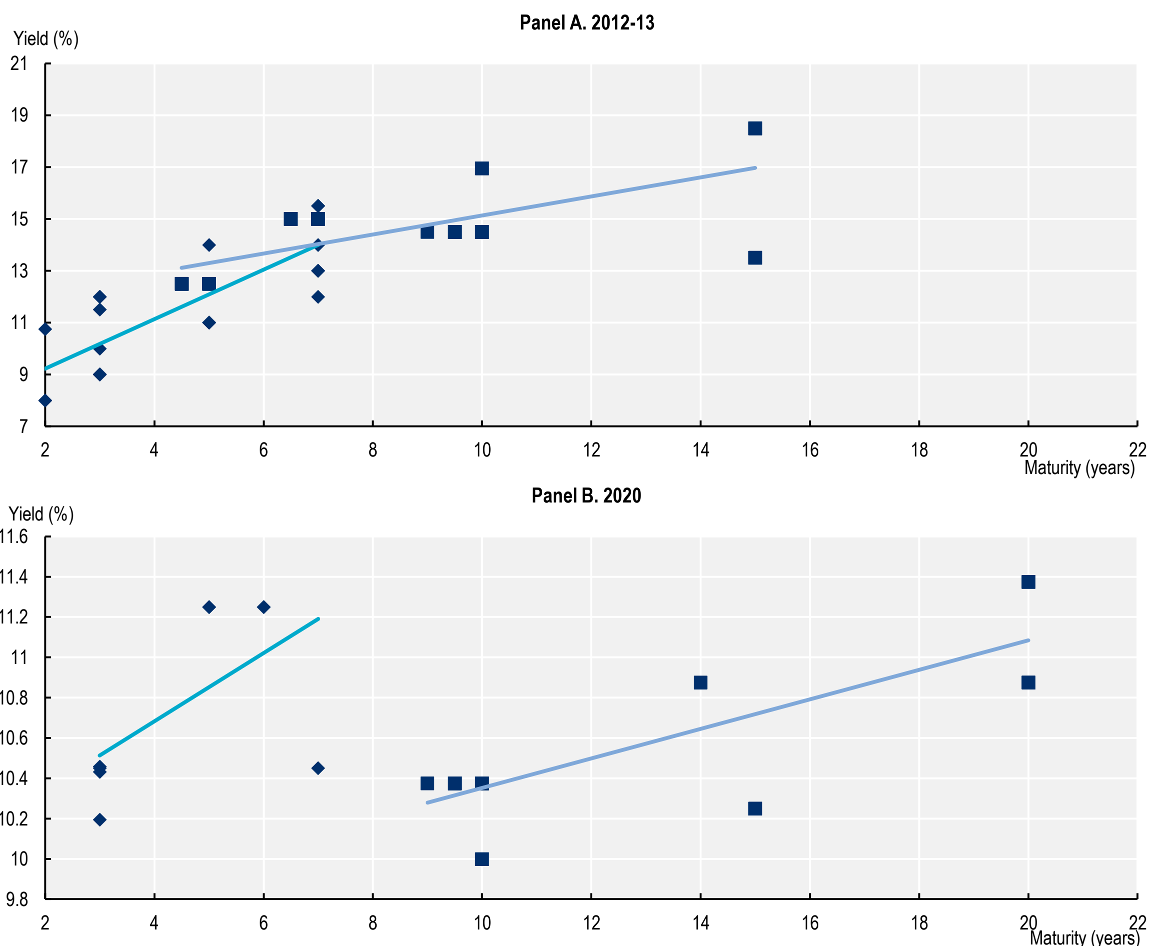
Improving co-ordination between both entities has been indicated as a key policy priority, including maturity space separation and the establishment of a Co-ordination Committee (OECD, 2012[90]). In recent years, the Central Bank and the Ministry of Finance have established regular meetings to strengthen the co-ordination of public debt issuances in the local market. In particular, co-ordination was strengthened

with the signing of a Memorandum of Understanding between both institutions in October 2019, which established periodic co-ordination meetings. In each meeting, the calendar of issuances and the amounts and types of bonds are discussed given the segmentation in duration for each issuer (the Central Bank at the short end and the Treasury at the long end of the yield curve).

Maturity segmentation has improved, but further co-ordination could still reduce the cost of financing at the short end of the curve, provided that good macroeconomic and financial conditions persist. In 2020, the Central Bank issued notes with a maturity of less than 8 years and the Treasury sold notes with a maturity of between 9 and 20 years (Figure 4.25, Panel B). It is worth noting that the Treasury was able to issue 20-year bonds, the longest maturities ever in the local market. Together with the issuance of 10- and 15-year notes, the Treasury has managed to lengthen the average maturity compared with issuances in previous years. In turn, the Central Bank has moved in the opposite direction, lowering the average maturity to less than four years.

However, despite different maturities, the average interest rate was similar between the two entities in 2020. Given the different objectives of the Central Bank and the Treasury – that is, monetary and exchange rate policy versus refinancing debt obligations or supporting the development of a bond market, respectively – relatively high short-term interest rates for Central Bank securities could undermine the Treasury's ability to achieve lower long-term interest rates in local currency bonds.

Figure 4.25. Domestic public debt issuances by the Central Bank and the Treasury: Yield and maturity



Source: Ministerio de Hacienda y Banco Central de Republica Dominicana.

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To summarise, while the Central Bank and the Ministry of Finance have made considerable efforts to improve co-ordinated issuances in capital markets (e.g. differentiation regarding debt maturity by both issuers), the cost of debt issuance remains relatively high for the Central Bank compared with that for the Ministry of Finance. This affects the cost of public debt and therefore public finances, as well as the development of the private fixed-income market.

The market of local currency bonds is being developed, but additional efforts are needed

Beyond better co-ordination between the Central Bank and the Ministry of Finance in relation to debt issuances in the domestic bond market, improving the functioning of the local currency bond market is critical, and indeed there have been improvements in this in recent years. A first step was the implementation of a market maker programme (programa creadores de mercado). The main objectives of the programme were to: 1) improve the liquidity and transparency of the local sovereign debt market; 2) reduce the liquidity premium; and 3) develop a yield curve of Treasury debt (Dirección General de Crédito Publico, 2012[91]).

The main obligations of market makers (MMs) are: to place minimum bids for each security with a spread below 500 bps, underwriting at least 4% of each primary auction; to complete a monthly survey about the programme; to issue a research paper reviewing the recent evolution and perspectives of the primary and secondary markets; and to comply with the Guide of Good Practices and Ethics. In return, there are several benefits for MMs: 1) access to first and second rounds in primary auctions, 2) participation in meetings with the Ministry of Finance to review debt management perspectives, 3) access to liability management operations, and 4) access to external bond auctions.

The evaluation of MMs relies on three indicators: 1) participation in primary market auctions, 2) participation in secondary markets, and 3) "on-screen" liquidity. Each December the DMO evaluates each participant and designates the top seven brokers as MMs. Other market participants enter the programme as market maker candidates (MMCs), with fewer obligations and benefits. MMCs can become MMs if they improve their position in the ranking. According to interviews with authorities from the Treasury, this programme is progressing satisfactorily.

Another important milestone for the local currency debt market is the issuance of external bonds denominated in Dominican pesos. In February 2018, the Dominican Republic issued DOP 40 000 million (USD 833 million) of 5-years external bonds with a coupon of 8.9%. This was the country's first issuance of external bonds in the international markets, reflecting the confidence in the macroeconomic framework, exchange rate stability, and an increasing appetite for risk. In 2019, the Treasury made another issuance of DOP 50 253 million with a 15-year maturity and a 9.75% interest rate. The threefold increase in the maturity of this issuance at a cost of 0.85 percentage points higher than the previous issuance represented significant progress. The issuance of local currency bonds on the external market contributed to reducing the share of foreign currency debt and diversifying the investor base, two of the goals set out in the MTDS for 2016-20.

These issuances were followed by the inclusion of the Dominican Republic in the JPMorgan Government Bond Index-Emerging Markets (GBI-EM) in Q2 2018. Investors view the GBI-EM as a global benchmark of local currency bond allocation. Many investment funds use benchmark indexes to guide their portfolio allocation and to create additional demand for qualified local currency bond issuers. The inclusion of the Dominican Republic in the GBI-EM may have indicated the existence of a benchmark-driven investor base of around USD 340 billion at the time (Arslanalp et al., 2020[92]).

The future development of the investor base and the increased liquidity in the local currency bond market could be promoted in several ways. A repurchase agreement, or "repo", is a short-term agreement to sell securities in order to buy them back at a slightly higher price. A repo market could increase investors' capacity to invest in long-term bonds. Repos and reverse repos are thus used for short-term borrowing and lending, often with a tenor of overnight to 48 hours, in order to provide temporary liquidity.

Malaysia and Poland are two recent examples of successful implementation of a repo market for local currency bonds (IMF/World Bank, 2021[93]). The issuance of benchmark medium- and long-term bonds could also provide a reference for the repo market. Such initiatives often require action from a broad range of stakeholders such as the DMO, financial regulators and other policy makers. The market infrastructure should be enhanced accordingly.

Private debt market and mutual funds

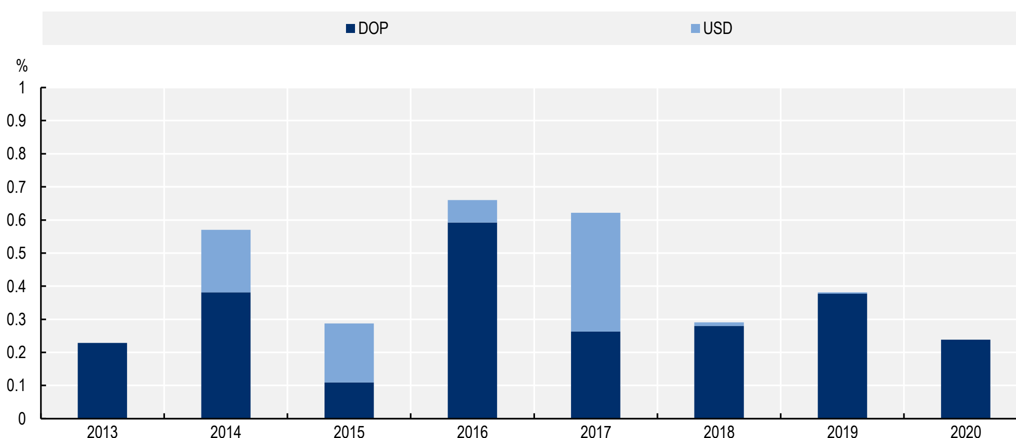
New players came into the local private bond market, but it remains underdeveloped

After the global financial crisis of 2008-09, the rise of nonfinancial corporate debt was concentrated in emerging economies. Corporate debt rose almost twice as fast as GDP in emerging economies, from 56% to 96% of GDP between 2008 and 2018 (Abraham, Cortina and Schmukler, 2020[94]). However, the main catalyst for this growth was the expansion in bond issuances in the People's Republic of China and East Asia.

The local private bond market in the Dominican Republic has made some progress in recent years, mainly in terms of better market regulation and diversification of issuers. However, the capital market remains underdeveloped. Since 2013, the total amount of private debt issued as a percentage of GDP has fluctuated between 0.7% and 0.2%, while in LAC countries it has ranged from 25% to 50% of GDP (Abraham, Cortina and Schmukler, 2020[94]). New issuances reached its higher amount in 2017, with 131 issuances amounting to DOP 23 648 million. Since then, issuances returned to previous levels with minimal participation by USD-denominated bond issuances (Figure 4.26). In 2020, the size of the local private bond market was approximately 20 times smaller than public sector issuances.

One explanation for this trend in issuances on the local market is that large local companies prefer to issue international notes or to access credit facilities or loans in the United States or the international market in foreign currencies. This gives companies access to more liquid and to deeper debt markets, and reduces financing and transaction costs compared with the local market (OECD, 2012[90]), which is linked to the still high interest rates in the Central Bank's issuances in the domestic market. A recent example of access to the foreign debt market was the case of AES Dominicana, an oil company that in May 2021 executed a liability management operation issuing USD 300 million of 2028 notes at a rate of 5.7%, the lowest ever for a Dominican firm. Other companies, such as Aeropuertos Dominicanos Siglo XXI (AERODOM) and Grupo Diesco, are also active players in the external debt market. Another impediment to issuing bonds domestically is the narrow investor base (IOSCO, 2011[95]).

Figure 4.26. Private bond issuances in the Dominican Republic as a share of GDP, 2013-20



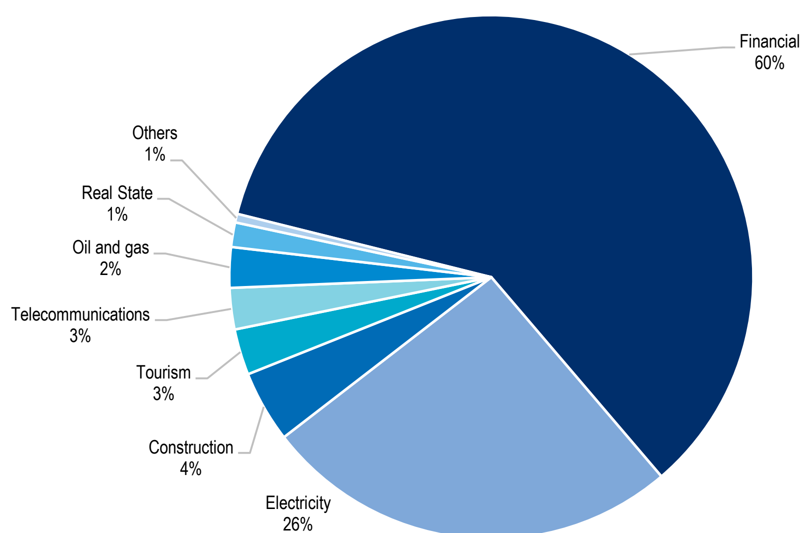
Source: Authors' elaboration based on information provided by Dirección de Oferta Pública/ (SIMV, 2021[96]).

According to the capital markets regulator, the Superintendencia del Mercado de Valores (SIMV), the number of private issuers grew from 24 in 2012 to 32 in 2021, despite the decreasing number of issuances during the later years (SIMV, 2021[96]). This is probably because international development organisations, such as the International Finance Corporation (IFC) and IDB Invest, issued their first bonds to finance development projects in the Dominican Republic. In 2012, the IFC launched a DOP 390 million bond (the Taino Bond) to support the development of capital markets in the Dominican Republic and increase the availability of local-currency financing for private sector companies. The Taino Bond was the first domestic placement by an international triple-A-rated issuer in the Dominican Republic (IFC, 2012[97]).

Four years later, the IFC issued another 6.5-year maturity DOP 180 million Taino Bond to support domestic capital markets and boost financing for micro-entrepreneurs in the Dominican Republic. In 2019, IDB Invest, a member of the IDB Group, issued its first bond in the Dominican capital markets in the amount of DOP 500 million (IDB Invest, 2019[98]). The bond, which has a fixed rate of 8.8% and matures in 2022, received interest from local investors, especially pension funds and other institutional investors. In 2020, a securitisation company, TIDOM, made the first issuance of mortgage-backed securities in the history of the Dominican Republic for DOP 1 210.5 million in order to promote the development of a mortgage market (SIMV, 2020[99]).

Other sectors (e.g. construction, oil and mining) have also entered the market. The main issuers come from the financial sector (61% of total issuances between 2013 and 2020) and electricity and road maintenance companies (34% of total issuances between 2013 and 2020) (Figure 4.27). The electricity companies mainly issued foreign currency-denominated bonds. As previously noted, the issuance of USD-denominated bonds is mostly recommended to companies whose income is at least partially generated in foreign currency, as it reduces exchange rate risks in its balance sheet and hence the cost of financing. Most of the bonds (86% of the total) were issued with a maturity greater than five years, demonstrating that the private market allows companies to obtain medium-term financing (SIMV, 2021[96]).

Figure 4.27. Local private bond public offerings by economic sector, 2012-Q1 2021



Source: Authors’ elaboration based on information provided by Dirección de Oferta Pública/ (SIMV, 2021[96]).

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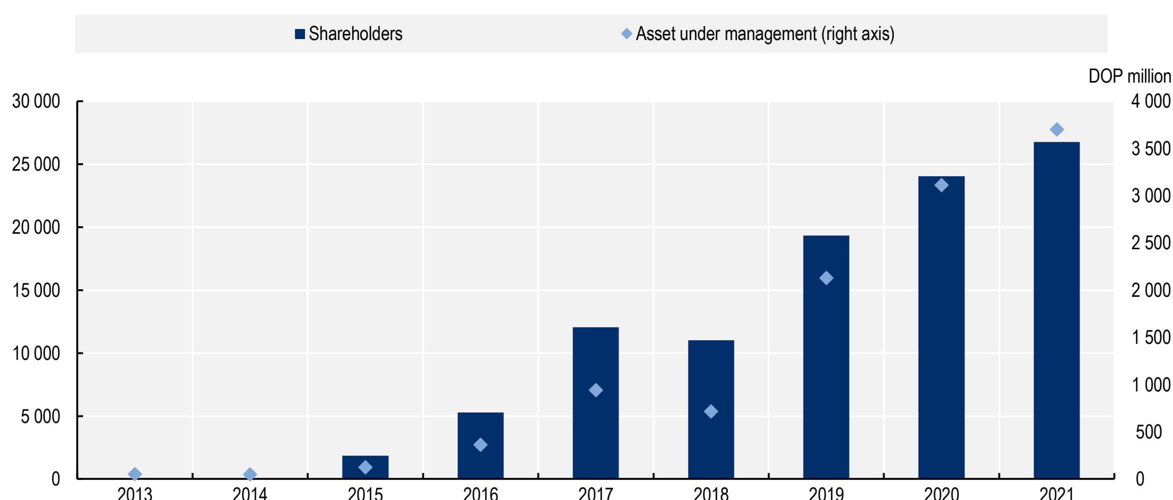
Another recent development in the local capital market since 2012 is the creation of the mutual fund industry in the Dominican Republic. The first mutual fund was approved in 2012; since then, 56 mutual

funds have been approved (22 closed funds and 34 open funds), reaching DOP 3 701 million in assets under management (3.5% of GDP on average). Fixed income funds are the predominant players in the market (51.8% of approvals), followed by development funds (26.8%) and real estate funds (19.6%). Shareholders of mutual funds have also skyrocketed since 2015, when mutual funds only had 1 861 shareholders. As of 2022, 26 768 individuals and firms have invested in mutual funds, a 14-fold increase since 2015 (Figure 4.28) (SIMV, 2021[96]).

Figure 4.28. Mutual funds (2013-21): Assets under management and shareholders



Source: Authors' elaboration based on information provided by Dirección de Oferta Pública/ (SIMV, 2021[96]).

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Market turnover has also increased substantially. According to recent data provided by the SIMV, centralised market's turnover reached 82% of GDP in 2020, four times higher than in 2012. Transactions have also risen by 1 147% between 2012 and 2020. Both indicators demonstrate a positive trend in liquidity fuelled by the growth in issuances of public and private bonds and by the new industry of mutual funds (SIMV, 2021[96]).

A new securities law was passed to improve minority investor protection and market functioning

On the regulatory side, a claw (Law 249-17) to improve the functioning of the stock market and companies in the Dominican Republic was passed in 2017, strengthening the protection of minority investors by increasing the independence of the boards of directors of public companies. The enhancements for minority investors and corporate governance were acknowledged by the *Doing Business 2019* report. In this respect, the Dominican Republic managed to climb 13 positions in the Minority Investor Protection indicator (Superintendencia del Mercado de Valores, 2018[100]). The law also promoted the use of centralised systems of compensation and liquidation of orders, improving price formation and liquidity.

In October 2019, an additional regulation, based on Law 249-17, was issued by the National Council of Securities Markets to regulate public offering of fixed income and equity. It specified the role and obligations of the issuers, the structurers, and the regulator (SIMV) during the issuing process and once placed on the market.

Law 249-17 and the related regulations have benefitted greatly from consultations with several key stakeholders such as the Central Bank, the Ministry of Finance, the Stockbroker Association (APB), the

Dominican Association of Investment Fund Management Companies (Asociación Dominicana de Sociedades Administradoras de Fondos de Inversión, ADOSAFI), the Dominican Stock Exchange (Bolsa de Valores de la República Dominicana; BVRD), the local securities depository (CEVALDOM), and relevant stockbrokers. The legal framework is based on best practices recommended by the International Organization of Securities Commissions (IOSCO). As part of the ongoing efforts to continue improving regulatory and compliance standards, the SIMV signed a Memorandum of Understanding of technical assistance with IOSCO in 2018.

The process of public offerings has been shortened; the regulatory authority has 3 business days to check if a request is complete and a maximum of 25 business days to formally respond. This period could be extended by another 25 business days, if required. The response time to authorisation requests, once completed, averages 21 business days, a major improvement on the 90 days that a successful authorisation might have taken before the legal reform.

The regulation also includes a faster reviewing process for frequent issuers (issuers who have had a previous issuance in the last 12 months) and for issuances restricted to institutional or professional investors. In these cases, the regulatory body must answer within ten business days after the initial review period of three days. It should be noted that the average approval time for applications by frequent issuers has been 7 business days since 2020, which is a considerable reduction from the previous time of up to 90 days and should contribute to improving the efficiency and development of the domestic private market. Standardised forms and manuals were published to contribute to a better performance of the requests.

In November 2020, the SIMV also signed a co-operation agreement with the Superintendencia de Bancos (Banking Superintendency), the Superintendencia de Seguros (Superintendency of Insurance) and the Superintendencia de Pensiones (Superintendency of Pensions) in order to simplify and review the documentation of public offerings. This agreement includes a single window for public offerings so that financial institutions and other regulated entities can make a single request on a public offering, reducing approval time and enhancing transparency.

Issuances of SMEs are promoted by specific requirements of financial information to lower the barriers to accessing the market. Credit rating assessment is not required if the total public issuances by an SME do not exceed DOP 60 million.[2] The new framework also redefined retail investors as those whose offer in the primary market is less than DOP 2 million, or USD 40 000,[3] in primary market auctions. The participation of such investors is prioritised in primary market auctions and retail investors have priority to subscribe up to 30% of issuances with an investment grade rating. After the allocation to retail investors, the remaining amount will be available to investors in general (including retail investors).

The regulation also laid the foundations for further innovations in the domestic market, such as green and social bond issuances and integration with foreign stock markets. In 2020, the regulator issued guidelines for the issuance of green, social, and sustainable bonds. These enhancements encouraged EGE Haina, an electricity producer, to become the first Dominican issuer of green bonds (USD 100 million) in April 2021. A green bond is a debt security that is issued to raise capital specifically to support climate-related or environmental projects. This specific use of the funds raised distinguishes green bonds from regular bonds, and investors also assess the environmental purpose of the projects that these bonds intend to support (World Bank, 2015[101]).

Recent reforms in the stock market solved the regulatory issues identified in previous studies (OECD, 2012[90]), promoting better investor protection, market functioning and the primary market placement process. The process of new issuances has been considerably shortened and transaction costs have been reduced, with additional benefits for frequent investors and SMEs. Co-ordination between regulatory agencies and standardisation of forms also boost both private and public offerings. New regulations also promoted the issuance of green, social, and sustainable bonds, which, given the growing importance of the climate change agenda in the international investor community, are key to diversifying the private investor base and promoting environmentally focused investment projects.

Pension funds continue to invest a large portion of their portfolios in public sector bonds. This bias reduces the liquidity of the private bond market and hinders the availability of funding for private sector investment. As recognised in previous reports (OECD, 2012[90]), this trend is a long-term problem and appropriate incentives in the regulation of pension fund portfolios could be a step towards stronger demand for private bonds in the Dominican Republic.

Trading in foreign stock markets is allowed under the new regulatory framework. However, further steps should be taken to integrate the local stock market into regional initiatives. Regional institutions such as the Central American Monetary Council have been co-ordinating efforts to harmonise capital markets, with some success. In 2007, the Asociación de Mercados de Capitales de las Américas (Capital Markets Association of the Americas, AMERCA) initiative was announced by the stock markets of Costa Rica, El Salvador and Panama. The integration of stock markets provides efficiency gains through economies of scale and lower financing costs for the private sector.[4]

Policy recommendations

Box 4.4. Policy recommendations

Policy objective 1: Strengthen tax revenues by restructuring the tax mix

1.1 Rebalance the tax structure to increase the share of direct taxes and the level of progressivity:

- Launch a technical and political discussion on the feasibility of decreasing the minimum taxable personal income, so that high-income deciles are effectively included.
- Explore the potential of personalised VAT (ITBIS) as a way of increasing the overall revenues from these taxes while compensating low-income taxpayers and thus reducing the regressive nature of VAT.

1.2 Enhance the revenue potential of other taxes:

- Strengthen property registries in order to boost revenues from property taxes by: 1) moving towards a unified and simplified property registry with an up-to-date land and property registration in central cadastres, and 2) reducing information asymmetries in immovable property; closing the gap between the appraised value and the market value is a key priority and an adjustment that needs to be regularly performed.
- Explore the potential of new taxes adapted to the emerging economy, such as digital and green taxes, which serve the dual purpose of raising revenues while creating the incentives for a greener and more digitalised development model.

Policy objective 2: Rationalise tax exemptions in order to raise revenue capacity and improve the overall impact of the tax system in terms of equity, efficiency and simplicity

2.1 Rethink tax exemptions on main sources of revenue:

- Rethink VAT (ITBIS) exemptions in order to improve efficiency and reduce its regressive impact – for example, exemptions applied to financial services or to the imports of low-value goods, or exemptions on certain non-essential goods and services such as those related to tourism or certain cultural products. Measures aimed at reducing VAT exemptions should be accompanied by clear measures to compensate lower-income groups, such as direct cash transfers or the targeted reductions of social security contributions.

- Evaluate PIT deductions, such as exemptions for educational expenditure, which can be regressive.

2.2. Evaluate the overall impact of special economic regimes and consider a gradual phasing out of those where the costs – in terms of forgone tax revenues – outweigh the benefits:

- Rethink tax incentives associated with special economic regimes through periodical assessments in order to ensure that their distributional and efficiency implications are evaluated regularly.
- Include an analysis in tax expenditure reports of how these incentives contribute to key development objectives such as economic growth, job creation or supporting lower-income groups.
- Limit the potential arbitrariness associated with special economic regimes by, for example, strengthening the criteria for admitting companies; rethinking the governance of these regimes in order to balance the distribution of power; including all tax expenditures in the tax code; or giving the Ministry of Finance the main responsibility for granting all these incentives.

Policy objective 3: Fight tax non-compliance

3.1. Use digital tools to fight evasion and to leverage existing international agreements:

- Expand the use of e-CF and advance towards making it compulsory, and work to strengthen the implementation of the destination principle.
- As a member of the OECD/G20 Inclusive Framework on BEPS, implement the two-pillar solution in order to address the challenges of digitalisation and globalisation.

3.2. Use digital tools to increase tax compliance through the simplification of the tax system or a better taxation of digital trade:

- Launch information campaigns, increase efforts to raise awareness, and use nudges, all of which can have an impact on lowering tax non-compliance.
- Adopt recommendations from the OECD/WBG VAT Digital Toolkit for Latin America and the Caribbean, aimed at addressing the VAT challenges of the digital trade.
- Use new technologies to cross-check information (for example, large-scale automated data and cross-checking of PIT against information from online vendors), as this could help reduce tax evasion.

Policy objective 4: Improve the quality and efficiency of public expenditure

- Improve the targeting of social programmes, strengthen the interoperability of existing registries, and make use of measures of vulnerability at the household level and of innovative ways of giving cash transfers to informal workers. Having a small number of well-implemented programmes is preferable to, and more cost-efficient than, having numerous overlapping programmes.
- Accompany new policies with ex ante evaluations led by the central budget authority. Ex ante evaluations can help guide budget allocations in order to increase efficiency, improve the design of future policies, and increase transparency by providing a level of accountability to citizens.
- Strengthen solid fiscal frameworks. Instituting a multi-year budgetary framework that includes a fiscal rule can promote greater transparency and protect capital investment as well as key social spending at different stages of the economic cycle or against possible internal or external shocks. A fiscal rule could set guidelines to achieve budget balance and/or for the evolution of debt, revenues and expenditures.

Policy objective 5: Implement a fiscal pact to support the recovery and build a more inclusive and sustainable financing model in the Dominican Republic

- Build a holistic and well co-ordinated fiscal strategy for the recovery, backed by a broad consensus, and advance towards the objective established in the National Development Strategy 2030 of increasing tax revenues to 21.5% of GDP by 2025 and 24% of GDP by 2030.

Policy objective 6: Strengthen the banking system to channel financial resources to productive activities and increase financial inclusion

- Pursue the convergence of regulatory standards to international standards such as NIIF and Basel III standards, in order to preserve the banking system solvency and liquidity and allow the financial system on the whole to act countercyclically in the face of external shocks.
- Seek further reductions of real lending interest rates to promote investment and long term growth, through increased competition among banks and other financial institutions, including by promoting Fintech or digital banks.
- Advance in an ambitious National Strategy for Financial Inclusion.

Policy objective 7: Deepen and further develop the public and private debt market in the country

- Elaborate a new Medium Term Debt Strategy (MTDS) with new guidelines which reflect the new environment after the COVID-19 shock and the lessons learned from the previous MTDS (2016-2020) to enhance the risk management and planning capabilities of the Debt Management Office.
- Continue strengthening the co-ordination between the Treasury, the Central Bank, and other regulatory bodies like the Superintendencia de Valores in the local market to lower lending interest rates, promote long term bond liquidity and continue diversifying in the investor base.
- To advance in efforts to develop a local-currency risk-free bond yield curve, and developing the private debt market in a sustainable manner, promoting the diversification of the investor base through appropriate changes in pension fund and mutual portfolio regulations and tax incentives for individuals.

Notes

[1] The ETR can be calculated using forward indicators, synthetic tax policy indicators (calculated using information about specific tax policy rules), or backward indicators (calculated by dividing actual tax payments by profits earned over a given period) (OECD, 2020[24]).

[2] This amount is indexed to inflation on an annual basis.

[3] The previous thresholds to be considered a retail investor were DOP 0.5 million or USD 10 000.

[4] For a detailed analysis of financial integration efforts in Central America, see Barboza (2013).

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