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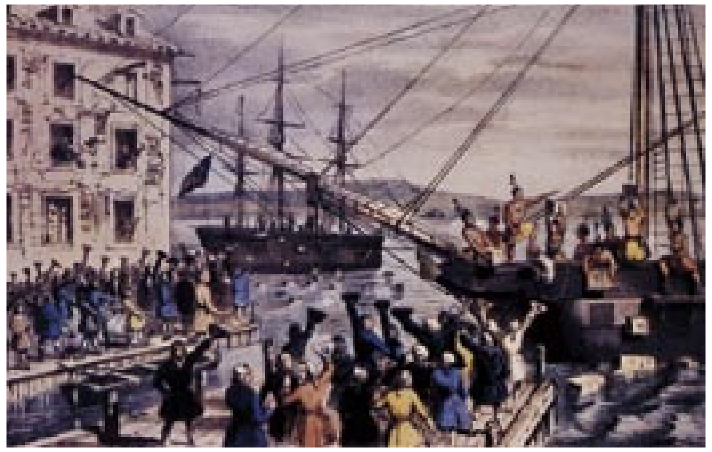
How Does Taxation Affect the Quality of Governance?

There are clear connections between how states obtain revenue, and the quality of their governance. If governments are not dependent on taxes for their finance, they are less accountable and responsive to citizen taxpayers, and have little incentive to build political and organisational capacity to negotiate and collect revenue and spend it effectively. The likely outcome is arbitrary governance and weak states. However, tax dependence does not necessarily guarantee better governance. Taxes may be collected coercively. This may poison relations between government and citizens. The good news is that there are some very practical ways of improving the tax relationship that could contribute to better governance.

Historians are familiar with the links between taxation and governance. In seventeenth century Britain, conflicts between the king and Parliament revolved around a struggle for control of public finance. American colonists rejecting colonial rule in the eighteenth century demanded "no taxation without representation". But in the field of development policy, debate over tax has mostly been conducted by economists concerned with fiscal stability, equity or economic efficiency. That is now changing. There is a growing literature on the connections between taxation and governance, and the beginnings of a debate about its relevance to policy.



"No taxation without representation." American colonists reject the tax on tea and colonial rule at the Boston Tea Party.

Governance refers to the processes through which states acquire and use their power and authority. Better governance comes from strengthening the responsiveness of states to the needs of their citizens; their accountability to citizens through rules-based mechanisms (for example, electoral democracy) which require them to answer for their actions, and through which they can be rewarded or sanctioned; and state capability – both political capability to determine needs and manage competing interests, and bureaucratic capability to design and implement policy, and enforce authority.

Key issues

- State dependence on tax can enhance government responsiveness, accountability and capability, but the links are complex and not automatic.
- Dependence on income from natural resource exports or aid often contributes to bad governance, because states have fewer incentives to nurture broad economic prosperity, or to engage actively with their citizens.
- How governments raise tax affects their scope for productive bargaining with taxpayers, and so opportunities to improve governance.
- Small steps by governments and donors could change tax policy and administration in ways that lead to improved governance.

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" states that rely on broad taxation have much greater incentives to practice better governance "

Implications for policymakers

There are some very practical steps that donors and national policymakers could take to increase the chances that tax policy contributes to better governance:

- Policymakers, including the IMF, need to concern themselves with *how* tax is raised, not just how much. The objective from a governance perspective is not necessarily higher tax, but more consensual tax relationships.
- Reforms to tax policy and administration need to be pursued with a view to their implications for governance, and not seen just as a fiscal issue. Wider policy reform (for example decentralisation) needs to take account of the impact on tax relationships.
- Aid donors can do six things in particular:
  - stop focusing only on the scrutiny of public spending, and encourage more debate about the links between sources of revenue and the goals of public spending;
  - be prepared gradually to offer longer term aid commitments in exchange for tax reforms that make revenue raising fairer and more effective, with a view eventually to phasing out aid;
  - take more urgent action at an international level to help make revenues from natural resource exports more transparent – along the lines of the Extractive Industries Transparency Initiative.
  - clamp down on money laundering, and on corruption by their own companies, thus limiting the access of political elites in poor countries to this source of 'unearned' income;
  - continue to support professional networking of tax experts from developed and developing countries, to exchange views and experience on tax policy, and enhance professionalism;
  - give serious consideration to ending the exemption of aid inflows from tax in the recipient countries, thus setting a good example, reducing transaction costs for national revenue authorities, and narrowing opportunities for fraud.

Unlike many more intrusive plans to improve governance, tax is a relatively low-profile entry point for policymakers. There is already substantial global consensus around desirable reform, with organisations such as the OECD DAC Network on Governance (GOVNET) now identifying taxation and accountability as a future focus for their work.

Policy changes could mostly be made in small steps. They could nevertheless have a very tangible impact on governance, by increasing the chances of constructive bargaining between governments and taxpayers. Action by donors at a global level to curtail corrupt practices and encourage more transparency about export revenues could strengthen incentives faced by political elites in poor countries to engage with their own citizens.

Further reading

The Centre for the Future State (2005) Signposts to More Effective States: *Responding to governance challenges in developing countries* Chapter 1, Brighton:IDS

Mick Moore (2004) 'Revenues, State Formation, and the Quality of Governance in Developing Countries' *International Political Science Review* Vol 25, No3 297-319

Mick Moore (2004) 'Taxation and the Political Agenda, North and South', *Forum for Development Studies* Vol 31, No 1

Mick Moore and Aaron Schneider (2004) *Taxation, Governance and Poverty: Where do the Middle Income Countries Fit?*, Working Paper 230, Brighton:IDS

Mick Moore and Lise Rakner (eds) (2002) 'The New Politics of Taxation and Accountability', *IDS Bulletin* Vol 33, No 3

Credits

This Policy Briefing was written by **Mick Moore** and **Sue Unsworth** and edited by **Caroline Knowles** and **Natasha Hickman** based on Mick Moore, (2007) 'How Does Taxation Affect the Quality of Governance', Working Paper 280, IDS: Brighton.

It draws on research by the Centre for the Future State, a DFID-funded Development Research Centre based at IDS which has the following partners CEBRAP, Brazil; Centre for Policy Research and Social Engineering (CEPRESE), Ghana; Centre for Policy Studies (CPS), South Africa; Lahore University of Management Sciences (LUMS), Pakistan and Madras Institute of Development Studies (MIDS), India.

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Institute of Development Studies at the University of Sussex, Brighton BN1 9RE UK
T +44 (0) 1273 606261 **F** + 44 (0) 1273 621202 **E** ids@ids.ac.uk **W** **www.ids.ac.uk**

CENTRE FOR THE FUTURE STATE

How Does Taxation Affect the Quality of Governance?

Figure 1: The effects on governance of state dependance on broad taxation

Immediate effects	Intermediate effects	Direct governance outcomes
Effects on the state The state becomes focused on obtaining revenue by taxing citizens	(i) The state is motivated to promote citizen prosperity	**More responsiveness**
	(ii) The state is motivated to develop bureaucratic apparatuses and information sources to collect taxes effectively	**More bureaucratic capability**
Effects on citizens The experience of being taxed engages citizens politically	(i) (Some) taxpayers mobilise to resist tax demands and/or monitor the mode of taxation and the way the state uses tax revenue	**More accountability**
Results of interaction States and citizens begin to bargain over revenues. Taxpayers comply with tax demands in exchange for some institutionalised influence over the level and form of taxation and the uses of revenue (i.e. public policy)*	(i) Taxes are more acceptable and predictable, and the taxation process more efficient	**More responsiveness, political and bureaucratic capability**
	(ii) Better public policy results from debate and negotiation	**More responsiveness and political capability**
	(iii) Wider and more professional scrutiny of how public money is spent	**More accountability**
	(iv) The legislature is strengthened relative to the executive (assuming one exists)	**More accountability**

* Bargaining is especially likely if representative institutions (legislatures) already exist

Sources of revenue

All governments need to raise large amounts of revenue – to pay for public services including health, education, infrastructure, security, and the administration of justice. Most states rely principally for revenue on broad taxation of citizens and enterprises, especially taxes on incomes, imports and exports, assets, and economic transactions. However, many governments of poor and middle-income countries depend on two more problematic revenue sources:

- surpluses from exports of natural resource products, especially oil and minerals. This became a major source of revenue for a significant number of states only after the first oil price shock in the early 1970s;
- aid, including grants and concessional loans.

What are the links between tax and governance?

Research by the Centre for the Future State based at IDS, suggests that states that rely on revenue from natural resource exports or aid have little need to negotiate with, or to be accountable to citizens, or to build capacity to raise and administer tax. However, states that rely on broad taxation have much greater incentives to practice better governance. This conclusion is based on three main kinds of evidence:

- historical experience, especially of European countries in the seventeenth, eighteenth and nineteenth centuries;
- contemporary evidence that governments dependent on natural resources (especially oil, gas and some minerals) rule badly;
- recent case studies comparing experiences between countries, and between sub-national governments within the same country.

Figure 1 summarises the basic mechanisms through which the dependence of governments on broad taxation contributes to enhancing state effectiveness, creating rules-based institutions, and stimulating the growth of organised societal interest groups that can place constraints on excessive state power.

These basic mechanisms can be observed most clearly in the historical experience of states in Western Europe, at a time when governments raised taxes mainly to fight wars. In poor countries nowadays, the politics of taxation are more complex, because:

- taxpayers are also beneficiaries of higher regular levels of state spending and/or employment, so there may be tension between their interest as taxpayers in efficient and effective public spending and their interests as public employees or consumers of public services.
- taxpayers are more diverse, with fewer shared interests. Complex tax systems, with large numbers of exemptions, often encourage taxpayers to make individual bargains with government rather than to take collective action on behalf of taxpayers generally;
- borrowing on international markets gives governments some autonomy from taxpayers (but at the risk of dependence on the IMF, which may substitute for the role of legislatures in placing fiscal constraints on the executive).

Although the links between tax and governance are more complex today than the table above implies, there is compelling research evidence that the core argument about the contribution of broad taxation to governance remains valid. This includes national case studies and cross national statistical analysis showing that the dependence of governments on income from unearned natural resource exports tends to degrade the quality of institutions over time. Oil and mineral resources are associated with militarism and low levels of democracy.

Why oil is bad for governance

Many states in the Middle East, the Caspian Basin and Africa earn large surpluses from export of oil to rich countries. Because oil is a valuable, physically concentrated resource, the benefits accrue to a small number of big companies, and central states. Research suggests that states dependent on oil tend to:

- be independent of citizen-taxpayers, and therefore unresponsive to them;
- have few incentives to promote broad economic development;
- use oil revenues to buy off opposition, and to fund repressive internal security;
- attract external military and political support;
- lack incentives for taxpayers to engage in the local political process because there is no political bargaining over sources and use of public revenues;
- have untransparent revenues, with low oversight from legislatures;
- have few incentives to establish effective bureaucracies to raise and manage taxes.

CPP, courtesy of Photoshare

A field worker for the International Foundation for Election Systems explains to villagers in Bokariah, Guinnea, how their tax money can be used to pay for community projects, like the construction of bridges or schools.

Recent case studies linking taxation and governance

Comparisons between ex-Communist states.

Russia's government continues to depend for revenue on a relatively small number of large enterprises, increasingly in the energy sector. There is little political debate around taxation and no social contract. Tax is raised coercively, and government is becoming more authoritarian. By contrast, Polish governments have introduced direct income taxes that affect a large proportion of households, and account for a quarter of government revenue. The state has been forced to bargain with organised interest groups, including business and trade unions. This has strengthened democratic participation and interest group politics.

Provincial governments in Argentina

Comparisons of provincial governments in Argentina show that those most dependent on broad taxation of citizens have historically been most democratic. Where provinces received more generous financial transfers from central government, or oil revenue, local politicians were better able to buy off or suppress democratic opposition.

Taxpayers in Tanzania

A study comparing districts in Tanzania shows that, where taxpayers are more economically mobile and thus have more scope to escape from predatory local tax collectors, local governments spend a higher proportion of revenue providing services to taxpayers.

The role of tax collection

It is not just the amount of tax but how it is assessed and collected, that matters for governance. If collection is arbitrary, unfair or brutal, this will undermine constructive political engagement between government and taxpayers. Tax is always potentially coercive, but this is particularly likely in poor countries, where states are powerful in relation to their citizens, and face few constraints. In particular:

- It is difficult to collect tax from low-income agrarian economies. Taxable units are small, so the costs of collection are high; and incomes are seasonal and unstable. Records are lacking, and there is limited use of banks, so collection depends on face-to-face interaction, where assessment and collection are done by the same people (thus increasing discretionary power and facilitating extortion). Taxes are levied on a wide range of goods and services, increasing opportunities for coercion.
- poor farmers are highly immobile, and therefore especially vulnerable to predatory tax collection, which is more prevalent at a local level. Decentralising service delivery without providing local government with adequate financial resources adds to the pressure to tax coercively.
- it is sometimes alleged that central governments raise tax coercively because they are under pressure to meet annual revenue targets agreed with the IMF. Whether this is a real problem or simply an excuse to squeeze formal, medium-sized businesses that lack political protection, it has the effect of deflecting attention away from what should be a major policy objective, namely expanding the tax base by reducing exemptions.

The degree of coercion that can be applied without damaging relations between states and citizens will vary according to local circumstances: the more fair a tax system is seen to be, the more it will be possible for tax authorities to take a firm stance in enforcing the law. The South African Revenue Authority, for example, has managed to increase overall tax while improving the service to taxpayers, helped by widespread support for redressing the inequalities of Apartheid, alongside special investigative measures to enforce compliance.

Tax reform can help

In recent years, many countries have introduced policy and administrative reforms (often with IMF and World Bank support) that have the effect of helping to reduce coercion, and contribute to more constructive tax relationships. They include:

- a shift from indirect trade taxes to more direct taxes, and widespread introduction of taxes on goods and services such as Value Add Tax (VAT). This makes taxes more visible, and therefore more likely to mobilise taxpayers politically. (VAT, though often considered an indirect tax, imposes a continuing, visible burden on small and medium sized businesses);
- abolition of some taxes, simplification of others, widening the tax net by reducing exemptions and extending registration, and increasing transparency. These can all reduce opportunities for individual lobbying, and increase incentives for public action;
- stronger administrative capacity (including autonomous revenue authorities), that can improve effectiveness and reduce the need for coercion.

What about poor people?

Concerns are often raised that political engagement by relatively wealthy taxpayers will increase their influence at the expense of poorer people. This is a risk, but in many poor countries with bad governance, the major problem is that governments are barely responsive to anyone. So organisation by more powerful groups around social, economic and political interests is likely to have broader benefits, imposing some constraints on repressive, over-powerful governments, strengthening legislatures, encouraging interest group bargaining in place of more arbitrary patronage politics, and giving governments more incentives to safeguard human and property rights, and to promote economic growth. Poor people are likely to benefit as well, and are very unlikely to be worse off.