

Business tax as state-building in developing countries: applying governance principles in private sector development*

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Abstract

The new concern for the 'state-building' approach to taxation requires an understanding of how to construct effective and fair taxation systems that constitute an important component of good regulatory and governance regimes. A systemic approach requires the construction of a tax policy and its administration, which can deliver state-building by strengthening the legitimacy of the state in the eyes of its citizens through five core characteristics—political inclusion; accountability and transparency; perceived fairness; effectiveness; and political commitment to shared prosperity.

This paper provides evidence of these operational principles for state-building tax reform. The state's 'fiscal social contract' with its private sector is a critical intermediary step on the political development path towards full citizen-taxpayer liberal democracy. Formalizing the often largely informal private sector in developing countries and creating 'quasi-voluntary compliance' of MSEs (micro- and small-sized enterprises) are essential for the state-building objectives of broadening the tax base, increasing the reach of the state and providing incentive for institutionalized engagement with the political process. The importance of medium-sized business, particularly MSE taxation regimes, has been neglected for too long because revenue-raising administrative concerns have predominated long-term state-building concerns. Based on the ongoing work in Yemen, Sierra Leone, and Vietnam, this paper offers recommendations on potential reforms to implement the principles of 'tax as state-building'.

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Introduction: 'Pay your taxes and set your country free'¹

The process of state-building is slow and complex but is now increasingly recognized as the necessary condition for effective social and economic development. An effective state requires a social contract between a ruling elite and its population, based on a political settlement that allows the elite to collect taxes without excessive coercion in return for delivering basic freedoms and essential public goods. The state-building approach to taxation, therefore, recognizes tax as one of the few core capabilities that any state needs in order to function. Further, the more effective the tax system, the stronger the capability, prosperity, and legitimacy of the state. This insight is not new: Aristotle and Confucius both noted that a prosperous and politically stable society required a political leadership and administration funded through fair and effective tax systems. In a lecture in 1755, Adam Smith famously observed that little else was required to 'carry a state to the highest degree of opulence from the lowest barbarism but peace, easy taxes, and a tolerable administration of justice.' This is easily said, but the details of how to deliver that result in practice remains a major obstacle to international development.

Recent research has highlighted the importance of tax as 'state-building' (Brautigam, Fjeldstad, and Moore 2008). But tax practitioners are usually too overwhelmed by the daily pressures to prioritize the broader long-term importance of taxation for creating an effective and just society. One reason for this neglect lies in the multidisciplinary complexities of tax and customs. Taxation's state-building importance necessitates comprehending politics, policy, administration, history, politics, and economics along with the technical detail of law, public administration, and business accountancy. Yet, besides the wealth of historical evidence in western Europe and North America ('No taxation without representation'), there are several remarkable pointers to the universal importance of taxation for state-building.

First, the state's capacity to raise taxes is closely linked to its ability to deliver good policies and suggests that tax-raising is a good proxy indicator of overall governance capability.² Second,

¹ Kenyan Revenue Authority slogan 2007.

² Through the ability to encourage economic growth, decrease inflation, increase private investment, and develop policies to manage the economy effectively (Arbetman-Rabinowitz and Johnson 2007).

tax levels remain surprisingly static in countries over long periods of time, despite frequent tax policy reform. Third, differences in the treatment of taxpayers by tax authorities may be explained by differences in citizens' rights to political participation (Feld and Frey 2002). Fourth, tax levels, in general, rise with higher levels of GDP (gross domestic product). This implies, among other causes, that better governed people are more willing to pay more taxes,³ but more heavily taxed states are not necessarily more legitimate. It is the way taxes are collected, by coercion or by consent, which reflects state legitimacy. Finally, the tax/GDP ratio is strongly and negatively associated with the incidence of conflict—as taxation increases as a share of national economic output, conflict becomes less likely (Hendrix 2007).

Political governance, economic growth, and taxation create mutually reinforcing processes of state-building—institutional and political factors shape tax systems, while how taxes are raised influences the effectiveness of state institutions as well as the dynamics of the investment climate and economic growth. Economic growth and the resulting higher tax revenues in turn pay for more capable public administration and better public goods. A tax system should aspire to this virtuous circle of state-building. The 'fiscal social contract' is a key factor in delivering both political legitimacy and sustainable economic growth—a stable, transparent, even-handed tax system is perceived by investors as a sign of established 'rule of law'. In other words, tax is a key indicator of an institutionalized framework of political stability and fairness (Bird, Martinez-Vasquez, and Torgler 2006).

The relationship between taxation and state-building combines three critical, but complex, dynamics: (1) taxes and political governance, (2) taxes and economic growth, and (3) political governance and economic growth. 'Taxation for state-building', therefore, requires understanding tax as a system—one that needs to be administratively effective, economically efficient, and politically equitable. The long-term aim of state-building must be 'quasi-voluntary compliance'—that taxpayers develop an intrinsic willingness to pay taxes to a state that they perceive to be legitimate and to a tax authority that they regard as a competent agent of a legitimate state and that the revenues are well spent on improving public welfare. Only when states become more capable, more accountable, and more responsive to the

³ This also suggests that in the long term, reducing tax rates is not the central priority.

needs of their population will citizen–taxpayers become convinced of governments’ credible commitment to the ‘fiscal social contract’. Taxes must be administered by a state, which is regarded by legitimate taxpayers. If a tax system is regarded by actual or potential taxpayers as administratively incompetent and corrupt, economically damaging to the long-term prospects for economic growth and private sector development or politically captured and unfair, technical reforms and changes in the tax structure (rates and bases) will have, at best, a limited impact.

State-building, therefore, depends on local political context. This is fashioned in part by ‘tax culture’, that is, ‘the entirety of all interacting formal and informal institutions connected with the national tax system and its practical execution, which are historically embedded within the country’s culture, including the dependencies and ties caused by their ongoing interaction.’ (Nerré 2002, 2006, 2008). A central component of this is ‘tax morale’, the intrinsic willingness to pay taxes based on citizen acceptance of the legitimacy of the state.

Private sector taxation as state-building: business tax culture and compliance

Very little research has been undertaken on business ‘tax culture’ and ‘tax morale’. Investigation on the intrinsic willingness of the private sector to pay taxes has, to date, been sidestepped by a narrow focus on compliance costs, the ‘burden’ of tax on economic efficiency rather than the more holistic private sector tax culture—how the effective rate of taxes reflects state-business relations (World Bank and IFC 2008).

Recent research has underlined the complex determinants of business tax compliance (Alm and Martinez-Vazquez 2001). Citizens’ tax culture and morale are significantly and positively associated with their perception of the benefits derived by society from the public delivery of goods and services, weighted against the risk of free-riding by others (Everest–Phillips and Sandall 2008). However, the business tax culture and morale of the private sector are more complex. The complex relationship between tax authorities and taxpayers reflects a country’s ‘tax culture’ (Frey and Holler 1998; Nerré 2003; Torgler 2007). Therefore, how the tax authority treats different segments of the formal and informal economy shapes the business tax culture. At the same time, the attitudes of entrepreneurs in the different

sectors of the economy to the legitimacy of the state, the extent of corruption, voice and accountability are critical to trust in the state on which economic growth depends. 'Tax effort' and tax collection depend not just on the income base but also on the political and institutional bases, specifically the extent to which taxpayers trust their governments (Bird, Martínez-Vazquez, and Torgler 2006). Even the poorest countries have considerable discretion as to how much they raise in taxation (Bird and Zolt 2007). The average tax ratio of 17.8% of GDP for developing countries on which the data was available in the late 1970s was, two decades later, only 18.6% (Tanzi 1987). The majority of countries show either low tax collection and low tax effort or high tax collection and high tax effort, but the business political economy of business taxation is particularly challenging in countries with low collection (like Uganda) despite comparatively greater effort, and where the tax system appears as a significant impediment to investment and formality (Chen, Matovu, and Reinikka 2001). As a result, the revenue collection has, for example, stagnated at about 11% since the early 2000s in Uganda (Gauthier and Reinikka 2006).

The key question is what creates that political determination to have an effective tax system. The political dimension is also central as to why there is no magic tax strategy to encourage economic growth. Some countries with high tax burdens have high growth rates, and some countries with low tax burdens have low growth rates. What is needed is political 'sense of purpose', political leadership, and inclusion identified as central by the 2008 Growth Commission.

The UK's DFID (Department for International Development), in partnership with the FIAS (Foreign Investment Advisory Service) investment climate reform arm of the IFC (International Finance Corporation) at the World Bank, has started to address the challenge of devising reforms to improve business tax culture, with the aim of strengthening 'quasi-voluntary compliance' in developing countries. An innovative programme on taxation has combined the World Bank expertise on the importance of taxation in the investment climate with the DFID strategic concern for tax as the state-building basis of broader development outcomes. Both the World Bank and DFID are concerned about the importance of better tax systems for international development. A sound tax system, along with economic growth, is essential for the exit from aid dependency.

Higher aid levels appear to be associated with the decline in the quality of governance and tax revenues as a share of GDP for African countries (Brautigam and Knack 2004). The link between dependence on domestic tax revenues and quality of governance has been demonstrated; for example, in Tanzania and Zambia, where local governments apparently produce more public services as their budgets' share of taxes, rather than grants from the centre, increases. The converse was also true: the revenue that local governments receive from sources outside – transfers from the central government and foreign assistance – increases the share of local budgets consumed by employee benefits and administrative costs (Hoffman and Gibson 2005). Effective tax systems are associated with a strong, developmental state: 'That a strong positive correlation exists between tax extraction and level of development suggests that overall, the negative effects of excessive state scope are in the long-run counterbalanced by the positive effects of greater administrative capacity' (Fukuyama 2004).

Between 2005 and 2007, the DFID/World Bank tax programme undertook case studies of the effects of tax systems on business and economic growth in 12 countries across Africa and the Middle East. The resulting studies confirmed that the tax system's effectiveness for delivering not just revenue but social equity, economic growth, and political legitimacy depends on the local interplay of effective tax policy, administrative efficiency, and political dynamics. The studies confirmed that revenue administrations have often focused on the very small number of large, formal sector corporations at the expense of genuine efforts at broadening the tax base. Therefore, any resulting increases in revenue collection have not reflected the development of a broad-based fiscal contract between the state and society. Tax administration has also often remained too complicated and non-transparent, with high compliance costs and wide discretionary powers, which, combined with (usually correct) perceptions of corruption or limited tangible benefits in return for taxes paid, may continue to undermine any potential intrinsic willingness to pay tax.

Since 2007, the DFID and the World Bank have been collaborating on a programme titled 'Promoting investment, growth and governance through improved tax systems'. The goals of the programme are to help developing countries achieve two objectives. 1) A tax system that stimulates increased productive investment and employment by the private sector so as to enhance

its contribution to shared economic growth for poverty reduction.

- 2) A tax system that can promote better political governance through improvements in tax policy and its administration, which strengthen state accountability and responsiveness to its citizens (the 'fiscal social contract'). The approach links policy and its administration together to the broader governance challenge that many developing countries face.

The explicit focus is on business, particularly small business and taxation. The rationale for this focus is the recognition that state-building requires economic growth, which is undermined when developing country governments depend on narrow tax bases and coercive tax collection. Often, a small formal sector bears heavy financial and time burdens in complying with tax obligations. These burdens create a strong disincentive to investment and participation in the formal economy. Dominant enterprises may use political influence to secure tax exemptions. Micro and small firms can disappear into informality. These dynamics undermine growth prospects and the broad-based political mobilization by the private sector, which can help improve the accountability and responsiveness of the political process.

The focus on business taxation is also political: governance cannot directly change from a weak state funded by a narrow tax base to a liberal democracy of citizen-taxpayers with a high intrinsic 'tax morale' (willingness to pay) (Torgler 2007). For example, both Finland and Sierra Leone collected 31% of total current revenue in income and property taxes in 1990, yet the state-building difference is shown by the fact that Finland was able to collect more than seven times the revenue take, as a share of GDP, than Sierra Leone (Lieberman 2002). While in developed countries, the proportion of individual income taxpayers as a percentage of the total population ranges between 35% and 78%, with an average of about 46%, figures for developing countries are between 0.14% and 12%, with an average of less than 5% (Bird and Zolt 2005). The private sector pays most of the tax in developing countries; therefore, it must be at the centre of a state-building tax system. Historical parallels confirm that a missing element in tax as state-building is the role, ideas, interests, and incentives of the business community to make the state more responsive, capable, and accountable.

Low-tax countries tend to have lower income per capita, but higher per capita incomes are not necessarily associated with higher tax takes. For instance, in 2003, Zambia, with a per capita income of \$785, collected 18.1% of GDP in tax, whereas Uganda had a per capita income of \$1167 but collected only 11.4% of GDP. At the same time, the levels of tax collection certainly do not necessarily indicate better state-building – that the state has the capacity and national purpose to promote rapid economic growth – nor that a state or government is perceived by its citizens to be legitimate. Recent episodes of political violence in Kenya and Zimbabwe, two relatively high-tax states, illustrate that relatively high tax collection does not preclude violent challenges to the state's authority (Di John 2008; Fox and Gurley 2005).

To progress beyond a narrow tax base and to avoid 'state capture', a state-building tax system requires the effective treatment of business and not just large corporations and medium-sized companies but also MSEs (micro- and small-sized enterprises). MSEs in all developing countries employ the overwhelming majority of the economically active in the population and the overwhelming majority of voters. Sustained economic growth depends on MSEs, but in most developing countries, MSEs remain overwhelmingly in the informal economy. Many studies have demonstrated the benefits of formalization for strengthening economic growth dynamics. The informal sector is less productive than the formal economy (Palmade 2005).⁴ Firms in the informal sector are extremely sensitive to the business climate and grow more slowly and generate fewer jobs. They are market-constrained (they cannot take government contracts), potentially resource-constrained (they can only access finance in the informal market and cannot participate in donor-funded projects), and are unable to participate in capacity building. Formalization may not always be appropriate. The benefits of being regulated may be comparatively small for those involved in subsistence activities.

A small business taxation reform, therefore, targets enterprises that are likely to benefit significantly from obtaining formal status, through accessing new markets and financial services, and security of tenure and investments. MSEs may not generate significant revenues in the short run, will but do so in

⁴ Studies show that on average in a given industry, informal companies are three times less productive than formal ones (McKinsey Global Institute).

the long run as firms grow – and formal firms grow much faster than the informal economy so are critical for the growth and job creation on which social development, prosperity, and political stability will depend. Evidence and experience show that the skills needed to pay taxes are the same as the business and accounting skills needed to run and grow an enterprise effectively. Middle-sized companies, where they shoulder a disproportionate share of the tax burden, are potentially most concerned about effective public services and have the capacity to mobilize politically. However, where they suffer disproportionately heaviest tax burden, middle-sized firms have little incentive to grow the economy and every incentive to break up and try to disappear.

This ‘missing middle’ (IFC 2007) suggests that the politics of broadening the tax base develops around political mobilization of the heterogeneous MSE sector, which needs to grow into medium-sized companies to fill the ‘missing middle’ of many developing countries’ economies. How to tax the MSE section of the economy and population effectively in order to promote economic growth and political governance is, therefore, the biggest challenge in state-building. From a state-building perspective, broadening the tax base to MSEs is a key intermediary stage of improving governance and political development. MSEs emerge as a politically crucial constituency for fair and effective tax systems on which state-building depends. Politically effective business organizations, which can engage transparently and efficiently with the politics and administration of MSE treatment within the tax system, are needed. Because small businesses will not be a major source of revenue for the government, the traditional cost-recovery requirement for a tax system will not be achieved by even the most efficient MSE tax system, which is why most developing country governments pay little attention to such MSE tax systems, as they are seen as resource drains. A state-building approach, however, suggests that the goal of a MSE tax system should be broadened beyond simple cost-recovery to include the benefits of having more formalized firms in the economy.

A coherent approach to the importance of tax for development requires an understanding tax as a ‘state-building system’ and not only taxes that deliver revenues to fund public services and promote economic growth, so as to explicitly generate a stronger political culture around the ‘fiscal social contract’. This depends on ‘quasi-voluntary compliance’—the willingness to

pay tax based on the taxpayer's overall perception of the fairness, legitimacy, and effectiveness of the tax system. Taxpayers will evaluate taxation (1) in providing public goods that benefit the citizen efficiently (at a reasonable cost), (2) in legitimately and effectively exercising state power, and (3) in reflecting legitimacy in the tax authority's powers of enforcement (not unaccountable coercion) and capacity to make all taxpayers shoulder their fair burden. The actual level of tax compliance is the combined outcome of the intrinsic with the instrumental willingness to pay tax, along with the taxpayers' acceptance of the level of tax burden and the effectiveness of enforcement. When higher compliance strengthens effective enforcement, a virtuous circle of mutually reinforcing taxation and governance emerges, enabling tax authorities to focus attention efficiently on high-risk categories of taxpayers. The 'quasi-voluntary compliance' of the private sector is dependent on the extent and the manner in which the private sector concerns are identified and addressed. The private sector levels of 'tax morale' and their attitudes towards the effectiveness of the tax authority and legitimacy of the state and political leadership provide an essential diagnostic of the political context of state-building tax reform.

Principles for business tax as state-building

In what ways can taxation policy and administration promote economic growth, political legitimacy, while also mobilizing revenue for the state? A business-enabling tax environment still eludes most developing countries. Even in countries with appropriate tax instruments calibrated at appropriate rates, the administration of these regimes is too often an onerous financial and time barrier for business. Frequently, the technical assistance provided in the past has focused on revenue generation, a short-run goal, and not revenue growth over time, which happens through investment and private sector development.

The five characteristics of a state-building tax system provide the principles for a sound taxation system based on strengthening state legitimacy and the 'fiscal social contract'.

- 1) *Political inclusion* Paying taxes gives citizens a powerful incentive to engage with government and the political process. Democracy is thus stronger and more effective in states where a higher proportion of people pay taxes. This matters across the whole state—its territorial reach is essential to state-building, since tax systems of sub-national government are frequently highly coercive.

- 2) *Accountability and transparency* The usage of tax revenues is justified to taxpayers, who demand to know if tax revenues are properly used.
- 3) *Perceived fairness* Within a strong tax system, taxpayers perceive that they are treated equally and justly by the state. Perceptions of unfairness, such as failure to address widespread tax exemptions or the informal economy, limit both revenue and 'willingness to pay'.
- 4) *Effectiveness* The administrative capability that translates increased public revenues into better public goods, more capable government, and increased political stability.
- 5) *Political commitment to shared prosperity* Successful state-building demands political leadership with a vision of tax as delivering a 'national purpose' that actual and potential taxpayers will support (and pay for). The tax system component of the state-building effort must explicitly link to a national strategy for promoting economic growth.

The DFID/World Bank programme applying these principles is in progress, with country pilots in Sierra Leone, Yemen, and Vietnam. However, from the understanding of 'tax as a system', some themes have emerged in relation to each of these principles that highlight how business taxes, particularly of MSEs, are critical to the state-building objective for taxation.

State-building principle

Political inclusion

Tax is always politically highly sensitive. Persuading taxpayers to be more willing to pay tax and spend less on evasion is a political process. For example, one study showed that tax is an expression of identity politics, drawing the comparison of the impact on tax levels by the politicization of race in apartheid South Africa and of regional loyalties in Brazil over the same period (Lieberman 2003). Therefore, technical solutions to tax design are not enough. Tax simplification programmes, for example, will always be constrained by the political desire to offer targeted treatment to different parts of the electorate—the more advanced democracies, it should be noted, typically have the most complex of functioning tax systems.

Business tax reform should also be addressed as political state-building reforms can easily focus on technical fixes.

Reformers often target the detailed design of taxes rather than the political attitudes toward paying taxes, which underpin both compliance and state legitimacy. Firms' willingness to pay taxes, like more general taxpayer tax morale, is based on the translation of taxes into the public goods and services the private sector needs and the effectiveness of tax administration.

Broadening the tax base requires political will to tackle politically powerful exemptions and addresses complex causes of widespread informality. A tax 'simplification' reform approach is often in tension with regard to the political desire to desegregate the electorate to secure votes. Tax collectors, both institutionally and personally, have stronger incentives to concentrate on trying to extract more revenue from the existing, registered base than to go about broadening the base by bringing smaller enterprises and individuals into the net. A state-building approach is, therefore, a significant challenge to the status quo, and to the administrative and political convenience of excluding smaller taxpayers from the tax net. For example, in Yemen, it appears that businesses do not trust the state's commitment or ability to deliver public service in exchange for tax 'investment'. Thus, the programme is helping the authorities to 'market' the benefits derived from paying taxes in addition to lowering the compliance cost barriers to formalization.

The politics of MSE tax reform is central to broadening the tax base for state-building

Broadening the tax base to include small business is a key intermediary stage of improving governance and political development. It is also essential for improving both the investment climate and political engagement in developing countries (DAC GOVNET 2008). But tax reform reports everywhere and always call for broadening tax bases and simplification of the tax system. Why is it so rarely achieved? The answer is often that the aims of reform are too often contradictory and technocratic, and are not rooted in political process.

Trying to broaden the tax base raises an immediate political problem. The potential MSE taxpayer is, by definition, close to the 'median voter' (GTZ 2005). In a responsive and democratic political systems, micro and small business will represent the overwhelming majority of the votes in the business community. No politician would relish the gratuitous challenge of trying to make the majority of their constituents pay tax. The IMF

data⁵ confirms that in Africa, for example, the MSE sector will represent the overwhelming proportion of the business community's votes.

- Large businesses are 1% of taxpayers but 70% of revenues;
- medium-sized business represents 10%–20% of taxpayers and 20%–25% of revenues; but
- MSEs are 80%–90% of taxpayers, but generate only 5%–10% of revenue in Africa. Vietnam shows a similar ratio of MSEs representing 90+% of actual and potential taxpayers but less than 10% of current tax revenue—an essential political constituency and also the engine of potential future economic growth and employment generation.⁶

Inclusive economic growth

Good incentives for politicians and MSEs are, therefore, required, otherwise broadening the tax base creates considerable political pain for apparently limited fiscal gain, which is precisely why it occurs infrequently. However, the challenge, as the programme aspires to demonstrate, is not insurmountable. The strongest political incentive is the state-building aim of inclusive economic growth. Given the right combination of 'carrot' with 'stick', it is clear that the private sector is willing to pay taxes for state-building, which will benefit them either directly (that is, a particular public good) or generally (that is, by removing market barriers and reducing costs and political risks). This self-interest also matters for state-building: spurring economic growth is essential for poverty reduction and provides resources for stronger state institutions.

Formal businesses grow faster than informal businesses

The formal economy enjoys more commercial opportunities, has access to cheaper and more reliable finance, and does not need to worry about business expansion risks crossing any threshold, which might attract the attention of the state. In Mauritius, for example, the government has been successful in bringing MSEs into the tax net by offering targeted access to finance. Therefore, delivering incentives and essential public goods are critical to 'tax morale', the willingness to pay taxes. A DFID-funded research by the IDS (Institute of Development Studies), 'Future

⁵ ITD 2007 Conference Background Paper.

⁶ Ministry of Finance Department of Tax Policy: presentation to DFID/FIAS workshop July 2008.

State' Programme, found that in China, larger firms may be willing to pay higher rates of local taxation in return for more secure property rights, which allow the business to develop securely.

The MSE/informal sector, therefore, has an intrinsic and instrumental willingness to pay tax if and when this compliance is an explicit exchange for improving legitimacy, stability, and protection from arbitrary harassment required for shared prosperity (Baróss 1990). In Zambia, for instance, 83% of the overall labour force (56% in urban areas) is involved in the informal economy. Surveys on informality and private sector perceptions have produced important evidence on quasi-voluntary compliance of MSEs. Interviewed firms turned out to be well aware of the benefits and disadvantages of operating in the informal or formal economy. Not surprisingly, avoidance of income tax, compliance costs, and social contributions were identified as the main advantages of being informal. However, firms were also aware of the cost and barriers resulting from tax avoidance. Entrepreneurs pointed to important direct costs of staying informal. In Liberia, over 60% of respondents, who had begun to formalize, were driven by the desire to avoid rampant corruption, and the high unofficial 'payments' were needed to maintain their informal status, which also undermined the effectiveness and legitimacy of the state. Overall, informal firms and partially formal firms in the surveyed countries agree that formal firms are in a better situation: over 60% of informal businesses in Sierra Leone believed that formalization would be beneficial to their enterprise. The surveys also suggested that the state could fairly easily tackle these state-building barriers: in Madagascar, almost half of MSEs had no or little information about how to formalize; in Liberia, over 40% of MSEs tried but failed to formalize, often because the bureaucratic procedures to do so were too complicated; and many informal MSEs in all countries surveyed reported paying more to stay out of the formal economy than they would have paid if they formalized their businesses and paid taxes.

The organizational capacity of the private sector to engage with the state and so have 'political voice' is critical for state-building and political inclusion

The capacity building of the private sector is as important as the capacity building of the state. Bargaining over taxes is central to building relations of accountability based on mutual rights and

obligations, rather than on patronage and coercion. Such bargaining, to avoid corruption, requires an effective civil society 'voice', which is able to engage constructively with the state. Therefore, state-building requires paying more attention to providing information, training, and education on tax issues to comply—the same skills that are also necessary to grow a business and with it to deliver the economic growth essential for poverty reduction. In Yemen, the medium-sized enterprises, MSEs, and informal businesses have been more willing than the larger formal private sector to consider how tax morale shapes the sustainability of reform. But the role and effectiveness of the Sana'a Chamber of Commerce and the Federation of Chambers of Commerce have proved to be critical for creating private sector consensus.

Different political economy dynamics of different sectors in any economy will affect businesses' tax morale⁷ (McDonald and Jumu 2008). Strikingly different METR (marginal effective tax rates) for different sectors in developing countries' economies suggest different political incentives, which need to be recognized.⁸

Mapping sub-national government's fees, licenses, and taxes is essential. Lack of coordination between the central and the local government can lead to an increasing number of local taxes. In Tanzania, local taxation was found to be a major constraint on the formalization of MSEs.⁹ Multiple taxes, licenses, fees, and charges make it difficult to enter new businesses and markets. Levies are perceived as exorbitant, often charged upfront, irrespective of the size and the type of business, and some local and central taxes are duplicated. Many in the Zambian informal economy feel that they already pay significant local fees and licenses without receiving benefits in return (Langmead 2006). The recent mapping of local taxes in Yemen found over 1500 different tax instruments covering various bases at different rates, which led businesses to worry most about the administrative burden and harassment from 'inspectors' rather than about the actual financial burden. That sub-national government taxation in many developing countries is frequently coercive due to political mistrust of local governments, which often lack

⁷ A point underlined by the programme's METR (marginal effective tax rates) sectoral studies; and studies that show coercive taxation is more likely in rural, agrarian economies, particularly in Africa.

⁸ The DFID/World Bank programme 2005–07.

⁹ DFID/FIAS Tanzania report 2006.

adequate, transparent, and accountable authority or responsibility to make their own tax decisions (Fjeldstad 2003). This problem also applies to compliance-enhancing initiatives such as taxpayer education. This contributes to undermining the legitimacy of the tax system, encourages tax evasion, and further hinders the formalization of the informal economy.

Accountability and transparency

Accountability and transparency are key issues for state-building and 'tax morale'. Explaining how taxes are spent and maintaining a relationship of trust with taxpayers are crucial in maintaining public confidence in the tax system and in performance of the tax administration. A business would be ready to pay taxes if governments show that public revenues are well spent. More needs to be done to enhance the capacity of legislatures in developing countries to scrutinize tax policy and its administration and to ensure that taxation is being treated within the architecture of public financial management as a system that can strengthen economic efficiency and better political governance.

Another important element of accountability is the rights of taxpayers. Internationally, there has been a substantial shift in the attitudes of tax administrations toward 'customer service' and 'user friendliness'. The 'quasi-voluntary' nature of compliance recognizes that there is always a tension between effective enforcement and the 'taxpayer service culture'—tension which increases wherever state-building is weak. Though still in their infancy in most developing countries, taxpayer charters upheld by tax appeals boards and tax tribunals are important institutions for securing taxpayers' rights and establishing fair and transparent procedures to address tax disputes. In Zambia, a special RAT (Revenue Appeals Tribunal), which works autonomously under the Ministry of Justice's auspices, is in place. The Tribunal is chaired by lawyers and accountants and is perceived to work more professionally and expeditiously than the 'normal' court system in Zambia. The RAT has ruled on average fifty to sixty cases per year. Entrepreneurs and tax officials, however, consider the Tribunal as 'a mechanism of last resort with only limited relevance to the day-to-day interaction between taxpayers and the ZRA (Zambian Revenue Authority)' (von Soest 2006, p. 113). In Tanzania, the Tax Revenue Appeals Board and the Tax Revenue Tribunal Board became operational in 2002. To make these institutions accessible for a wider segment of taxpayers,

there is, in general, a need to simplify the procedures for instituting appeals and disseminate more accessible information to the general public on the roles and functions of the appeals board.

Information encourages formalization

The informality survey results show that the majority of completely informal businesses were not well informed about formalization steps. About 36% of completely informal businesses in Sierra Leone knew nothing about the formalization procedures, and another 40% only knew a few details. Similarly, in Madagascar, less than a third of informal MSEs were well informed about necessary formalization steps. Only 6.2% surveyed businesses in Liberia knew exactly what to do to undergo formalization. In Sierra Leone, most of the surveyed businesses that had moved into the formal economy had done so because information on the required procedures became available. Moreover, in Rwanda, most interviewed enterprises, which recently formalized their operations, accepted that taxes were not too high and tax administration was fair.

These important findings strongly suggest that providing better information alone can go a long way in encouraging enterprise formalization. The importance of transparency and accountability also underlines that state-building requires a cultural shift in the tax authority as much as in the private sector. The challenge is how to build a tax administration's trust in the private sector in order to be able to move towards a risk-based, self-assessment tax system: this is the challenge of the next 'state-building tax' principle.

Perceived fairness

This is essential for 'taxation as state-building'. Tax administrative attitudes, incentives, and discretion are potentially problematic and can result in unequal treatment. For large and medium-sized formal sector businesses, aggressive tax enforcement strategies applied by the revenue officers are perceived to be a major problem. Some foreign-owned enterprises also report such tax administrative practices. Some tax practitioners refer to the discrimination of large, already compliant businesses as 'hunting within the zoo' in order to improve revenue performance. Business people in Lesotho, Mozambique, Tanzania, and Zambia complain that the revenue administration concentrates on the formal sector of the economy, which is registered and visible.

Frequent and uncoordinated tax audits are considered to be harassment and intimidation tactics to force taxpayers into extra-legal compliance. A member of the ZRA's Governing Board conceded that 'large companies tend to be soft targets' and that 'there are genuine concerns that some (tax) officers' approach is very heavy-handed'. The manager of a foreign supermarket chain stated, 'We have nothing to hide but they come here three to four times a year' (von Soest 2006, p. 113). Similar statements have been reflected from business people in Lesotho and Tanzania.¹⁰

In many developing countries, corruption around tax is endemic; not just from underpaid staff in tax administration, but through the politics of rent seeking and vested interests reflected in the uncertain manner in which many tax concessions and other 'tax expenditures' are offered. Corruption is perceived by the private sector to be a major problem in the revenue administrations. However, progress has been made: for example, the ZRA has pursued a tough and commendable stance against petty corruption. The ZRA's annual reports regularly list the number of corruption cases, their completion rate, and the time required for their processing. Accordingly, 32 and 24 corruption cases in the ZRA were investigated by its Internal Affairs Unit in 2003 and 2004, respectively (von Soest 2006, pp. 111–112). In Tanzania, the TRA (Tanzanian Revenue Authority) management invested substantially in awareness-raising and anti-corruption training of its staff.

A high occurrence of tax exemptions reduces the tax base, creates general cynicism about the legitimacy of the tax system, opens up space for bribery and corruption, and increases loopholes for tax evasion. Therefore, the extent of tax exemptions is often an indicator of a government's political will to fight fiscal corruption and tax evasion and generally deliver state-building. In 2007, the DFID and the World Bank advised Sierra Leone's new president that various fiscal exemptions had been granted in the recent past to specific companies without compensating increases in other revenues. Exemptions had been issued in an ad hoc fashion, often by ministers acting beyond their authority or the Parliament had enacted bespoke tax laws at variance with the general tax laws. These practices undermined the overall tax regime. They created unequal treatment across categories of

¹⁰DFID/FIAS country studies 2006.

economic activity, and the implied weakness of the 'rule of law' reduced foreign and domestic new investment, curtailing long-term growth prospects.

The small numbers of medium-sized firms in many developing countries illustrate that fairness, in terms of tax exemptions and avoidance, also matters for economic growth. If large companies can use their political contacts to avoid tax and small businesses disappear into informality, it is middle-sized companies that typically shoulder a disproportionate share of the tax burden. In such an environment, middle-sized firms have little incentive to grow the economy and every incentive to break up and try to disappear, hence the phenomenon of the 'missing middle'. Tackling this requires a state-building approach to medium-sized business taxation as a long-term political challenge.

Perceptions matter

A fair revenue authority should be perceived to be just, equitable, and effective. A survey of the informal sector in South Africa, therefore, found that non-registration and non-compliance were the result of 'the various attitudes and beliefs that were widely held by these informal small businesses with respect to taxation in general and tax registration and tax compliance in particular.' However, the survey discovered that 'reassuringly, perceptions of the SARS (South African Revenue Service), while not necessarily always positive, were nevertheless more neutral than were attitudes towards taxation in general. The corruptibility of the SARS officials was also not a major issue. Importantly, the SARS was perceived as a potential partner/actor in facilitating the growth of these businesses' (FIAS/USAID 2008). Unfortunately, what the survey from a state-building perspective did not explore is the post-apartheid evolution of attitudes of the informal sector to tax morale, their intrinsic 'social contract' obligation to pay tax, and their instrumental incentives to exchange compliance for better public goods. These issues are of universal concern: for example, in the UK, the strategy is that 'the type of interaction customers have with us will become increasingly and more explicitly tied to their behaviour. Customers who pay the right tax at the right time and meet their responsibilities will incur less burden; those who do not understand or who make mistakes will be supported to make it easier for them to comply in the future; and those who deliberately do not comply will be targeted quickly with an intervention designed to change their behaviour' (HMRC 2008).

Effectiveness

Even with strong tax morale and political consensus on the importance of delivering essential public goods, taxpaying will always present a moral hazard—so effective revenue collection is also critical. Taxation has always acted as a key incentive for states to create competent administrations. Effective taxes require the ability to collect enormous amounts of information efficiently: for example, this process occurred in England through the compilation of a complete register in the Domesday Book of all taxable assets in 1086 (Besley and Persson 2007). This Domesday Book dynamic has occurred not just in western Europe but also in recent examples of successful developmental states such as in East Asia's 'tiger' economies (Sindzingre 2006). This drive for capacity is an important part of the virtuous circle of taxation and state-building. As the systems and skills of the revenue authority increase, so do the reach and the capacity of the state—this is the essence of state-building.

Everywhere, formalization is deterred by expensive and administratively burdensome procedures. Effectiveness requires the tax administration to make formalization easier, including simpler procedures, accompanied by more attention to information and taxpayer education. In Sierra Leone, one-quarter of completely informal businesses have attempted to become formal by at least actively collecting necessary information about the required procedures. The businesses attribute this failure to formalize to expensive (27%) and complicated (26%) procedures and lack of information (22%). Similarly, almost every other completely informal business in Liberia has tried and failed to formalize because of expensive (24.9%) and complicated (22.7%) procedures. In Madagascar, the potential for voluntary formalization is highest, with more than half of the informal respondents claiming that they have tried to become more formal. Again, the largest share of these firms stopped their formalization attempts because of high costs of these procedures (40%).

The surveyed businesses mostly claimed to operate informally because of the tax system, with many agreeing that they would formalize if taxes were reduced and tax incentives provided. Businesses in Sierra Leone operate informally, generally due to licensing and tax issues, and lack of information on how to formalize. Seventy five per cent of interviewed businesses saw the tax burden and administration or lack of information as a main

driver of informality. Even though some of Sierra Leone's tax policies, such as imputed taxes based on revenues and profits imposed on unregistered businesses, were designed to broaden the tax base and bring informal enterprises into the formal economy, the arbitrary way in which these taxes are assessed may have the opposite effect and prevent small businesses from moving to the formal economy.

Similarly, despite the set-up of a simplified tax regime for SMEs (small and medium enterprises),¹¹ high taxes are the principal reason for tax avoidance in Liberia, where 68.3% of respondents identified high tax rates as the main reason for not paying taxes. Lack of information (38.7%), weak enforcement (38.2%), and the number of inspections (21.9%) are other barriers to compliance with the tax regime. In both countries, roughly four out of five respondents, who are sceptical about their chances of formalizing, would consider formalization if taxes were lower and followed in importance by a general reduction of the administrative burden (51.1% in Liberia). When asked what additional government actions would increase their chances of formalizing, the majority of businesses in Sierra Leone (56%) stated that they would seriously consider becoming formal if information on the procedures required became more freely available. About 37% of businesses would formalize if tax rates/administration were improved, and 34% would formalize if administrative barriers were reduced. A reduced fiscal burden was more prominent in Liberia, with 42.9% saying it is the single most important formalization incentive, and in Madagascar, where 67% would consider formalizing with a reduced tax burden.

Political commitment to shared prosperity

The recent UN/World Bank Growth Commission concluded that economic growth is a political process requiring political inclusion delivered by effective political leaders, with a vision of improving prosperity for all—with their incentive being to secure political stability and state legitimacy. The development of an effective and equitable tax system is a vital part of that political process. The importance of political commitment to an effective tax system – one that can deliver a political vision of 'national purpose' built on political stability and economic growth – for

¹¹An annual flat fee system of three categories is available for petty traders, depending on the nature of their business operation. Enterprises with annual revenue between LD 200 000 and 5 000 000 (about \$3200–80 000) pay a 4% revenue tax.

example, a former ZRA top official observed, 'You need a lot of sturdiness, you must be able to brief Cabinet and you need support from the Minister. No (revenue) authority can survive without political support.' (von Soest 2006, pp. 97–98).

In weak or fragile political contexts, where this ambition is often lacking or problematic, the problems can be acute. In 2007, in Afghanistan, for example, the revenue department warned the finance minister of 'continued political interference, particularly from the president's office in relation to individual taxpayer decisions.'¹² In Cambodia, the World Bank found a lack of political accountability, which explains 'a vicious cycle of taxpayer non-compliance (that) feeds on poor and corrupt administration and inadequate service delivery.' (World Bank 2004). A reflection of the importance of political support is the positive development of the RRA (Rwanda Revenue Authority). From the outset, the RRA has been able to count on the personal support of the president, who has played a major role in the campaign to change public attitudes towards paying taxes and related challenges such as corruption.¹³

Business taxpayer perception surveys are an invaluable tool for state-building tax reform

Perception surveys offer a baseline for measuring progress on all aspects of success of tax reform, not least on tax morale and state legitimacy. Attitude and perception surveys of current and potential taxpayers identify perceived weaknesses in the fairness of the tax system and, therefore, clarify the extent of quasi-voluntary compliance, revealing the governance issues underlying tax reform and offering a way for measuring progress.

These types of survey are well established for OECD (Organization for Economic Co-operation and Development) countries but are nascent in developing country contexts. However, surveys may be controversial in countries where the political contest is oppressive and tax authorities are unwilling to invite criticism of their integrity, public acceptance, and effectiveness. Perception surveys highlight that the state-building approach will have a different emphasis on prioritizing the effectiveness, efficiency, and equity objectives of the tax system. Surveys in Yemen, in March 2008, of the private sector views on problems in the tax system found that 57% believed reducing time to comply with

¹²Letter of 12 June 2007.

¹³DFID/FIAS Rwanda country study 2006: p. 89.

tax was very important, 71% thought reducing the cost of tax compliance to be a top priority, 91% regarded as critical simplifying tax laws and using revenues fairly and efficiently, 97% thought tax equity mattered to ensure that all firms paid a fair amount of tax, and 100% believed tackling corruption was essential. Surveys of actual and potential taxpayers are an essential tool of 'tax as state-building'. Measuring perceptions affecting the governance aspects of taxation is an important diagnostic, offering a baseline for building a culture of tax compliance.

Putting the five principles of state-building tax working into practice

The DFID-FIAS approach is being piloted in three countries to represent different regions and political economy contexts: the post-conflict challenge in Africa in Sierra Leone; the only low-income country in the Middle East, Yemen; and the latest 'East Asian tiger' economy with a one-party communist political system, Vietnam. These illustrate different challenges and priorities, but all confirm the importance of MSE taxation for state-building.

In Sierra Leone, state-building is an urgent priority after decades of conflict. The Sierra Leone Programme on MSE taxation addresses this in various ways. Improving effectiveness means strengthening the Ministry of Finance in Policy formulation. The tax policy in Sierra Leone was led by the Tax Administration, giving it a strong revenue focus. While this was efficient in the short term, it did not address the issues of taxpayer engagement and the role of tax morale in overall tax compliance. The Tax Administration could not address the overall tax burden faced by business resulting from various other taxes, fees, and charges levied by other ministries, departments, and agencies. Addressing taxpayer morale, including its expenditure dimension, is being addressed by strengthening the Tax Policy Unit of the Ministry of Finance. Strengthening perceived fairness requires a strong focus on taxpayer engagement by the tax authority. There has been a 'disconnect' between the business community and the tax administration. Limited transparency and accountability meant most businesses perceived taxes as pure expropriation by the government. This resulted in a vicious circle of low tax compliance and increased coercion, generating even lower tax revenues to pay for essential public services. In order to address this disconnect and improve 'tax morale', the first-of-its-kind taxpayer education workshops have been carried

out in Sierra Leone. The first workshop targeted medium-sized businesses while the second addressed small- and micro-business owners. The topics covered included an overview of the tax system, simple accounting principles for business, income tax procedures, and customs procedures, with presentations from tax policy and tax authority officials. More workshops are planned for the provinces and shall then be internalized into the tax authority's outreach programme run by its Tax Payer Education Department and subsequently run solely by them.

Developing quasi-voluntary compliance requires working on all the principles by improving the following.

- Political inclusion through implementation of an MSE tax regime that brings the small taxpayers into the tax system in the right balance of incentives and administrative effectiveness.
- Perceived fairness evaluated through a survey on taxpayer perceptions as a benchmark to measure 'state-building' success.
- Political commitment to shared prosperity requires the political leadership of the country to support tackling non-transparent and discretionary tax incentives – with technical support.
- Effectiveness by consolidating tax payments with the tax administration and reducing the cost of compliance for taxpayers.

In Yemen, 'political inclusion' and 'political commitment to shared prosperity' are key drivers of reform to address the high degree of mistrust between the private sector and the tax administration, with the endemic symptom of rampant corruption. The country generally lacks all five characteristics of state-building taxation, with the result of widespread non-compliance of tax payments, misreporting of business activities, informal negotiations on tax obligations, unofficial payments to the collectors, and revenue loss for the government. The taxpayer survey evidence suggests that while the bribe ranges between 25% and 40% of the total assessed tax amount, paying a bribe can lower the tax assessment by 50%. Because of this, even many large firms tend not to disclose their accounts and file their informally negotiated tax under the presumptive regime. The private sector does not want to reveal its proper accounts and under-invoiced imports, thus maintaining the scope for tax evasion and perpetuating widespread corruption. Similarly, as the appeal procedure enables them to defer the tax payment until the case is resolved (which can take as long as seven to nine years), many businesses choose this route to avoid paying taxes. Corruption flourishes

where there is a high tax burden and compliance cost, and where there is no significant risk of detection and punishment. While the CIT (corporate income tax) rate in its face value is 35%, because of the current incentive regime and corruption, the effective rate is about 15%–20%. However, the complexity and lack of clarity in the tax and incentive policies means most private sector firms perceive the CIT rate as 35%. The incentive regime is ineffective not only in reducing the effective tax burden, but also makes the tax policy inequitable.

Reform is needed based on all five principles to address Yemen's problems. The programme is, therefore, working with political leadership and the private sector to develop a shared vision of 'national purpose' and the state-building objective of business tax reform. The private sector complains about harassment by the tax officials, which in turn compel them to engage into unofficial negotiation. Even if a business keeps proper books, and its accounts are audited by an accredited auditor, the tax official disregards this and makes an assessment based on informal negotiation. If the business does not accept informal negotiations, it is likely to face endless visits by the tax official, each time with a new list of required documents that the business needs to submit. This further discourages businesses from using the recently introduced self-assessment system, as they claim that the real interaction with tax officials starts after filing the self-assessment. The time and financial cost burden of auditing are non-trivial. The tax authority has complaint mechanisms, but most firms do not trust this system and fear that if they complain, they will be further harassed. Similarly, even though there is a well-defined appeal procedure in place (defined by the relevant tax laws and their subsequent amendments), most businesses do not use it to resolve tax assessment disputes because they perceive the system to be non-transparent and unfair—the result will be in favour of the tax authority and they will be penalized by a substantial amount of fine (200%–300% of the assessed amount). Moreover, it takes many years to settle a dispute, and during this time, the business faces visits of the tax officials with the pressure to settle the matter informally with a 'negotiation fee' (that is, bribe).

Lack of trust in the judicial system and the MSEs' lack of knowledge further deter participation in the appeal system. Most taxpayers remain ignorant of tax policies and procedures despite the communication and outreach measures of the taxpayers' services department. Corruption by tax officials results

from complexity and lack of clarity in tax laws and procedures, which provide an opportunity for the tax officials to apply discretion and results in unclear and incompetent hiring process. This results in low skill, lack of professional ethics and integrity, low pay and lack of incentives, conflicts of professional and personal interest, the 'get-rich-quick' syndrome or basic greed, and lack of institutional checks and balances.

Therefore, reforms in Yemen aim at the following.

- *Effectiveness* through an appropriate incentive mechanism for the tax officials. Tax officials need to be more satisfied than they are with their pay levels, financial incentives, and prospects of career progression based on performance rather than satisfying their superiors.
- *Political inclusion* with a strengthened legal framework, outreach taxpayers undertaking administrative measures to enforce compliance and record keeping.
- *Perceived fairness* by a reduced tax burden and the compliance cost through simplified tax procedures and a streamlined and transparent appeal procedure.
- *Transparency and accountability* from, amongst other things, an effective complaints and appeal mechanism, accompanied by more taxpayer training, information, and education.

Vietnam

The MSE tax reform support to the government has only just begun, but Vietnam already has a state-building understanding of taxation. This year marks the centenary of the Tax Protest Movement in the central Annam region of Vietnam against the perceived unfairness of the tax administration and the legitimacy of the French colonial rule. This provides the foundation for the Vietnamese state-building understanding of taxation, as reflected in Article 12 of the Vietnam 2001 law on tax administration, the stated aims of which are 'ensuring lawfulness, democracy, publicity (that is, transparency), fairness, and reasonableness.'

Applying the five principles

Based on the lessons of the programme, our findings on how five principles of tax reform for promoting the state's ability and legitimacy can be applied suggest that the following are key activities needed for state-building tax reforms.

Political inclusion

- Support business associations, including the informal sector to mobilize ‘voice’.
- Improve taxpayer education, services, and public–private dialogue to engage the private sector in the reform process from the outset.
- Map all central but also sub-national taxation—local government’s fees, licenses, and taxes usually have a greater impact and are frequently more coercive.

Accountability and transparency

- Help business associations participate in policy formulation and implementation.
- Enhance the capacities of parliaments to scrutinize tax policy and its administration.
- Make tax administration accountable through a complaints and appeals procedure.
- Foster public–private dialogue on tax through a formal process of private-sector engagement with the government on tax policy.
- Create visible links between taxes and expenditure; compliance rates increase when firms know taxes are properly used.

Perceived fairness

- Broaden the tax base and reduce exemptions to increase sense of justice.
- Constrain discretion and corruption by publishing consistent and accessible tax regulations, rates, and procedures.

Effectiveness

- Simplify law, regulations, and administration as far as possible.

Political commitment to shared prosperity

- Conduct taxpayer perception surveys of small business and the informal sector—surveys monitor views of the benefits of working in the formal economy and of the effectiveness of incentives to do so. Current and potential taxpayers’ perceptions provide a strong indicator, along with growing tax base diversification of the legitimacy of the tax system.
- Seek out political champions of reform.

Conclusion: state-building tax system

The previously mentioned state-building approach involves understanding tax as a system—its ‘morale’ institutional and cultural determinants. How the state collects taxes in totality is what influences its relations with its citizens. In most developing countries where personal taxation is limited, the state’s political development through taxation may critically depend on the MSE business population and electorate. Harnessing this for state-building requires bringing tax policy and its administration explicitly together with political governance and economic growth to explore new ways for strengthening state through the political economy of the taxation of the private sector. By taking this perspective, we are beginning to understand the priorities and practical reforms needed for tax systems, which can deliver long-term state-building—the process by which states enhance their ability to deliver essential public services, economic growth, political stability, and perceived legitimacy.

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