How Does Taxation Affect the Quality of Governance?

Imlications 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. Widder 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.

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


Credits


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 CEBHRP, Brazil; Centre for Policy Research and Social Engineering (CERPSE), 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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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.
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 practise better governance. This conclusion is based on three main sources of evidence:

- historical experience, especially of European countries in the seventeenth, eighteenth and nineteenth centuries;
- contemporary evidence that governments depend 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 local state spending and 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.

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 revenues 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 immersive, and therefore especially vulnerable to predatory tax collection, which is more prevalent at a local level. Decentralized 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.

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

**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. Ulhiores 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 depend a higher proportion of revenue providing services to taxpayers.

**Recent case studies linking taxation and governance**

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The degree of coercion that can be applied without damaging relations between taxpayers 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 Added Tax (VAT). This makes taxes more visible, and therefore more likely to motivate citizens politically. VAT, though often considered an indirect tax, imposes a continuing, visible burden on small and medium scale business owners;
- 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 accrual;
- 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 seen as unfair and coercive by all, and so are largely uncontested by any political organization 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.