feature

HOW TAX AFFECTS GOVERNANCE

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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 starting to change. There is a growing literature on the connections between tax and governance, and a debate is starting to emerge about its relevance to policy.

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 British colonial rule in the eighteenth century famously demanded "no taxation without representation".

The message from history is this: governance, or the way that states acquire and use their power and authority, is shaped by the ways that citizens are taxed. Better governance comes from making states respond better to the needs of their citizens; first, from rules-based mechanisms (such as electoral democracy) – which require them to answer to and be accountable to their citizens; and second, from the capability of the state – this means not just political capability (determining what the needs are, or managing competing interests) but also bureaucratic capability to design and implement policy, and to enforce authority.

Research by the Centre for the Future State based at the Institute of Development Studies (IDS), suggests that while most states rely on broad taxation to raise revenue, some states rely instead on other, more problematic forms: notably from natural resources, but also from aid. Foreign borrowing can also have this effect. States relying on these alternative forms of taxation tend to feel less need to negotiate with, or be accountable to, their citizens, or to build their capacity to raise and administer tax. By contrast, states that rely on broad taxation have greater incentives to practice better governance, for three main reasons. First, broad taxation affects the state itself, which focuses more on obtaining revenue by taxing citizens. Second, tax affects citizens: it engages them politically. Third, through taxation states and citizens begin to interact, and to bargain over revenues. Citizens pay tax in exchange for being able to influence the level and form of taxation and the uses of revenue. Better accountability tends to follow.

Poor countries and the politics of tax

The clearest illustrations of these basic mechanisms come from the history of states in Western Europe, where governments used to raise taxes mainly to fight wars. But in poor countries nowadays, the politics of taxation are more complex. For example, taxpayers in poor countries are often more diverse, with fewer shared interests. Complex tax systems, with large numbers of exemptions, often encourage taxpayers to make individual bargains with government instead of taking collective action on behalf of taxpayers generally. In such countries, tax collection can be arbitrary, unfair or brutal, and it can even undermine constructive political engagement between government

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and taxpayers. Tax collection is difficult, for example, in agrarian economies: there are few records so it involves face to face interaction, which can increase discretionary power and thus extortion. Coercive, arbitrary taxation can poison relationships between citizens and governments.

Even though the links between tax and governance are complex, there is compelling research evidence that the core argument about the contribution of broad taxation to better governance remains valid.

Tax reform can help

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

In general, policymakers need to concern themselves with how tax is raised, not just how much. The goal is not necessarily just to raise more taxes, but also to foster more consensual tax relationships. For example, a shift from indirect trade taxes to more direct kinds of tax makes taxation more visible, which is more likely to mobilise taxpayers politically, generating the healthy relationships of accountability. It can also be helpful to abolish some taxes, to simplify other taxes, to widen the tax net by reducing exemptions, by extending tax registration, and by increasing transparency. All of these measures reduce the scope for individual lobbying, and boost the incentives for public action. Better administrative capacity can, of course, also help. In particular, there are six things that aid donors can do:

- 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.
- 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 internationally to help make revenues from natural resource exports more transparent.
- Clamp down on money laundering, and on corruption by companies from donors' home countries, thus limiting the access of political elites in poor countries to this source of 'unearned' income.
- Keep supporting professional networking of tax experts from developed and developing countries, to exchange views and experience on tax policy, and to enhance professionalism.
- Seriously consider ending tax exemptions for aid inflows. This would set a good example; it might reduce transaction costs for national revenue authorities; and **it could** narrow opportunities for fraud.

Unlike several other, more intrusive, plans to improve governance, tax is a relatively low-profile entry point for policymakers. These policy changes could mostly be made in small steps, yet they could nevertheless have a very tangible impact on governance by increasing the chances of constructive bargaining between governments and taxpayers.

This article is based on a Policy Brief written by Mick Moore and Sue Unsworth. It draws on research conduced by Mick Moore, the Director of the Centre for the Future State, a DFID-funded Development Research Centre based at Institute of Development Studies, Brighton.

The full text of this Policy Brief (http://www.ids.ac.uk/gdr/cfs/pdfs/PB34.pdf) and a longer Working Paper are available for free download at: http://www.ids.ac.uk/gdr/cfs/

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