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Taxation and State Building:
Towards a Governance Focused
Tax Reform Agenda

Wilson Prichard
May 2010



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Wilson Prichard

Summary

Taxation is fundamental to sustainable development, as it supports the basic functions of an effective state and sets the context for economic growth. More often overlooked is the role of taxation as a catalyst for the development of responsive and accountable government, and for the expansion of state capacity. Recent research has begun to focus on this broader relationship between taxation and state building, but the analysis has frequently remained relatively theoretical and abstract. This paper seeks to chart new territory by translating the findings of existing research into a practical agenda for action, focusing on the specific measures that governments, with the support of development partners, could be taking to strengthen the state building role of taxation. In short, this paper seeks to outline the core elements of a governance focused tax reform agenda.

Keywords: taxation, tax bargaining; public administration; governance; responsiveness; accountability; state capacity.

Wilson Prichard is completing his DPhil in the Governance Team at IDS. He will be joining the University of Toronto in July 2010 as an Assistant Professor jointly appointed to the Department of Political Science and Munk Center School of Global Affairs, while retaining strong ties to IDS. He is currently working on a book manuscript tentatively titled *Taxation, Responsiveness and Accountability in Sub-Saharan Africa*, while his broader research is focused on issues related to good governance, revenue systems, foreign aid, extractive industries and post-conflict reconstruction.

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Since 2000, the Future State DRC has been working together with a number of international partnerships through research institutes in various countries. The main focus of the Future State DRC is to help reduce poverty, promote development and increase the rate of economic growth by helping to increase state capacity, i.e. by making public authority more effective, more accountable and more responsive.

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Acronyms

CDF	Constituency Development Funds
EPZ	Export Processing Zones
ETRs	Electronic Tax Registers
GET	Ghana Education Trust
GPRTU	Ghana Public Road Transport Union
IRS	Internal Revenue Service
KEPSA	Kenya Private Sector Association
KLDA	Karen and Langata District Association
LTUs	Large Taxpayers' Units
NTA	National Taxpayers' Association
OECD	Organisation for Economic Cooperation and Development
OFCs	Offshore Financial Centers
SARAs	Semi-Autonomous Revenue Agencies
TINs	Taxpayer Identification Numbers
SUNAT	Superintendencia Nacional de Administration Tributaria
USAID	United States Agency for International Development

‘We should elevate ourselves from being just tax collectors and tax administrators to being state builders.’

Ms Allen Kagina, Commissioner General of the Uganda Revenue Authority

1 Introduction

Taxation is fundamental to sustainable development, as it supports the basic functions of an effective state and sets the context for economic growth. More often overlooked is the role of taxation as a catalyst for the development of responsive and accountable government, and for the expansion of state capacity.

Recent research has begun to focus on this broader relationship between taxation and state building, but the analysis has frequently remained relatively theoretical and abstract (OECD 2008; Moore 2007, 2008). This paper seeks to chart new territory by translating the findings of existing research into a practical agenda for action, focusing on the specific measures that governments, with the support of development partners, could be taking to strengthen the state building role of taxation. In short, this paper seeks to outline the core elements of a governance focused tax reform agenda.

Until now, the dominant tax reform agenda has focused overwhelmingly on increasing public revenue in an economically efficient manner. Yet, there is a compelling case for linking revenue enhancement much more explicitly to broader governance objectives. The 2008 Doha Declaration on Financing for Development called for pursuing tax reform ‘with an overarching view to make tax systems more pro-poor’. While this was a narrow reference to the importance of redistributive tax structures, it was also an acknowledgement of the need to focus on linking increased revenue mobilisation to improved public expenditure on poverty reduction programmes.

Increased domestic revenue generation will only lead to improved development outcomes if the new revenue is translated into productive public expenditure. While governments and donors have generally treated the dual goals of revenue generation and improved public spending separately, a governance focused tax reform agenda is based on the conviction that the two goals are fundamentally interconnected, and should be addressed in tandem. In more practical terms, if tax reform is undertaken in a way that promotes greater responsiveness and accountability, alongside improvements in state capacity, then tax reform can become a catalyst for broader improvements in government performance.

Such an approach is not only attractive because of the potential governance benefits that it implies, but also because it is consistent with a political economy view of the challenge of tax reform. Existing work tends to present tax reform as a primarily technical challenge, while the importance of political considerations is given secondary attention. Yet, there is compelling evidence that in the long term measures to increase dialogue, transparency, equity and bargaining are essential to building a culture of tax compliance, and thus to maximising revenue and minimising political conflict (Lieberman 2002; Bird, Martinez-Vazquez and Torgler 2004). While some of the measures presented in this paper may be politically

challenging for governments in the short-term, they represent the surest path to stable and reliable domestic revenue mobilisation in the long term.

The paper begins with a very brief review of the key elements of the current tax reform agenda, in order to set the context. The next section presents a similarly brief model of the linkages between taxation and state building. The fourth and fifth sections propose specific tax reform strategies that may strengthen these linkages, providing case examples of the benefits, challenges and risks that are likely to accompany reform efforts. Finally, the sixth section offers some general conclusions.

2 The existing tax reform agenda

Tax reforms efforts in recent decades are remarkable for the extent to which they have been extremely similar across countries and circumstances, owing to pressure from international institutions but also the growth of a global epistemic community of tax professionals (Fjeldstad and Moore 2008; Sanchez 2006). What follows here focuses on three, interrelated, aspects of this global tax reform agenda: tax structure, tax administration and the political economy of reform. The discussion here is intentionally very brief, as it is dealt with in detail elsewhere (i.e. Gillis 1989; Thirsk 1997).

2.1 Tax structure

Historically, tax structure has been at the forefront of most tax debates. Since the 1980s the focus has been on achieving economic neutrality – that is, minimising economic distortions caused by taxation – and maximising revenue collection. In practical terms this has implied several measures that have been adopted by virtually all developing nations:

- A shift away from trade taxes;
- A shift towards goods and services taxes, and Value Added Taxes (VATs) in particular;
- Reduced corporate and personal income tax rates;
- An effort to broaden the tax base; and
- A general simplification of tax codes.

Recent years have further witnessed increasing concern with expanding taxation of the informal sector and decentralising revenue-raising functions, though reform remains in its infancy in both cases (Gillis 1989; Thirsk 1997; Fjeldstad and Moore 2008).

2.2 Tax administration

Over time tax administration has become ever more central to reform, reflecting the old dictum that ‘tax administration *is* tax policy’ (Casanegra de Jantscher 1990). Aside from general improvements in capacity, four elements have characterised the reform agenda: reorganisation, information technology, taxpayer services and autonomy.

Reorganisation has focused on moving from agencies organised by tax type, to organisation by core functions and, more recently, organisation by tax segments. The leading edge of change has been the creation of Large Taxpayers’ Units (LTUs), which are functionally organised and deal with a single tax segment, but reorganisation in other areas of administration has been much slower.

Information technology upgrading has been a part of virtually all reform programmes, in hopes of improving data management and analysis, lowering compliance costs, reducing the scope for corruption and collusion and improving monitoring. While there is great potential, and there have been notable successes, many highly ambitious projects have ultimately disappointed due to large delays, poor integration with existing processes and weak implementation (Bird and Zolt 2007; Peterson 2006; Berman and Tettey 2001).

Taxpayer services have gained greater prominence, with a focus on improving taxpayer education and awareness, reducing compliance costs and adopting a ‘customer’ orientation (LeBaube and Vehorn 1992; Jenkins and Forlemu 1993; Land 2004). While some change in attitudes is apparent, the lack of detailed assessments suggests the limits of actual progress.

Autonomy from the civil service has been a major feature of reform in a subset of countries in Latin America and Africa, with a particularly strong push from donors. This agenda has been pursued in hopes of improving performance by reducing political interference, increasing flexibility and improving wages and conditions of work. This has been exemplified by the creation of Semi-Autonomous Revenue Agencies (SARAs) in at least 14 African countries and 10 countries in Latin America (Fjeldstad and Moore 2009). While SARAs have often achieved dramatic short-term improvements in performance, those gains have frequently proven difficult to sustain once the initial urgency of reform has subsided (Therkildsen 2004; Fjeldstad 2002, 2005; Devas *et al.* 2001).

2.3 Political economy

The political economy of reform remains an under-explored question in many respects. The basic pattern is that while formal tax structures and tax administrations have been transformed in many countries, levels of tax collection have tended to be surprisingly stable over time. While some countries have experienced relatively large expansions of goods and services taxes, improvements in levels of income tax collection, and in the redistributive potential of taxation, have been much more infrequent and difficult to achieve (Lieberman 2002; Mahon 2004; Ascher 1989).

The difficulty of dramatically altering levels of collection is partly explained by issues common to most public sector reform programmes, among them the need for political will, local ownership, contextually appropriate design and effective sequencing in implementation (Boesen 2004; Heredia and Schneider 2003; Stevens and Teggeman 2004). That said, two more basic issues lie at the heart of the tax reform challenge:

- First, certain types of tax changes confront strong vested interests that stand to lose from any proposed changes. These vested interests are often economic and political elites who are particularly able to block reform (Bird 1989, 1992a, 1992b).
- Second, it is difficult to mobilise public support for tax reform. Tax reform tends to be perceived as threatening even by those who, in fact, stand to benefit, owing largely to limited trust in government (Ascher 1989; Bates 1989).

Existing research suggests two lessons about successful reform. The first is that successful reform is most likely during periods of significant political and economic change. Such episodes of crisis often disrupt networks of resistance to reform and create the urgency needed for greater cooperation (Bates 1989; Ascher 1989; Mahon 2004; Durand and Thorp 1998). The second is that a focus on improving equity in the enforcement of existing taxation (horizontal equity) can be a particularly effective strategy. Such a strategy can disarm opposition by vested interests by reducing the scope for public opposition, while also generating some degree of popular support for reform (Ascher 1989).

3 Taxation and good governance: an overview

While the tax reform agenda has traditionally focused on maximising revenue, economic efficiency and compliance, recent research has focused on the role of taxation as a central plank of a state building agenda. A recent OECD (2008b) paper defines state building as ‘an endogenous process to develop capacity, institutions and legitimacy of the state driven by state–society relationships.’ Consistent with this definition, recent research on taxation and development finds that the need to raise taxation can lead to the strengthening of state–society relationships, with positive consequences for state capacity and the extent to which governments are responsive and accountable to their citizens (Prichard 2009a; Ross 2004).

The nature of the mechanisms linking taxation and state building is a complex topic in its own right, which is ably handled elsewhere (OECD 2008a; Moore 2007, 2008). What follows presents a very simplified summary of the theoretical literature, so as to avoid unnecessarily duplicating earlier work and retain a focus on the practical recommendations to follow.

In simplified terms, tax reliance may generate improved governance through three channels:

- *Common interest processes*: Because governments are dependent on taxes, and therefore on the prosperity of taxpayers, they will have stronger incentives to promote economic growth.
- *State apparatus processes*: Dependence on taxes, and direct taxes in particular, requires states to develop a complex bureaucratic apparatus for tax collection. This may become the leading edge of broader improvements in public administration (Brautigam 2008a; Prichard and Leonard forthcoming).
- *Accountability and responsiveness processes*: Taxation engages taxpayer-citizens collectively in politics and leads them to make claims on government for reciprocity, either through short-term conflict or long-term increases in political engagement. Governments are compelled to respond to these citizen demands in order to enhance tax compliance and sustain state revenues (OECD 2008a; Moore 2007; Prichard 2009a).¹

This paper is focused on exploring the implications of the latter two processes for tax reform in the developing world. Much of the existing evidence for the processes emerges from the history of state building in Europe and North America (Tilly 1990; Brewer 1989; North and Weingast 1989), but there is a growing body of research from developing countries that points to the existence of similar processes (Prichard 2009a; Prichard and Leonard forthcoming; Ross 2004; Timmons 2005; Chaudhry 1997; Brautigam 2008b; Hoffman and Gibson 2005; Gervasoni 2010).² Unfortunately, this research has generally not gone beyond relatively broad statements about the potential governance benefits of reliance on domestic revenue sources. The remainder of this paper asks what, in practice, could be done to strengthen the relationship between taxation and broader improvements in governance in contemporary developing countries.

Section 4 focuses on the linkages between taxation and state capacity, while Section 5 focuses on the linkages between taxation, responsiveness and accountability. Sections 6 and 7 then turns to several broader issues related to the role of development partners and foreign aid.

4 Tax reform and state capacity

Improvements in tax administration may lead to broader improvements in state capacity through four channels. Reform of tax administration may:

- Prompt *administrative innovations*, such as increased meritocracy or improved internal monitoring, which subsequently spread throughout the civil service;

1 My thanks to Mick Moore for proposing the specific terminology used here.

2 This report draws heavily on the author's ongoing research, which is the first effort to directly address these questions in a contemporary context through case study research. Unless otherwise noted, case examples from Ghana, Kenya and Ethiopia are based on this ongoing research.

- Generate pressure for *improvements in related agencies* essential to tax collection, such as business registration, foreign investment promotion and land registration;
- Require an *enhanced government presence in remote areas*, thus also expanding the reach of government services; or
- Provide *data and information* that is essential to other government activities, such as economic planning, business promotion or service targeting.

Unfortunately, while historical evidence of these relationships is relatively strong, contemporary research is extremely limited. Early work by Chaudhry (1989, 1997) finds that the erosion of tax reliance led to the erosion of broader state capacity in Saudi Arabia and Yemen, but this says little about how improvements in revenue administration may lead to broader gains. A recent study by Prichard and Leonard (forthcoming) finds tentative cross-country regression evidence of such processes, but says little about the specific process of reform. Ongoing research by Prichard, reported in Box 4.1, provides a relatively detailed account of such processes in Ethiopia, though at a much earlier stage of political and economic development.

One of the lessons from these emerging examples is that the existence of positive spillovers is likely to be contingent on the particular character of reform (Prichard and Leonard forthcoming). A general prediction of the literature is that more administratively demanding taxes are more likely to generate broader administrative benefits. What follows, while embracing that message, seeks to be more specific about particular mechanisms and suggests four considerations that may make positive outcomes more likely:

- Linkages with other areas of administration are strong;
- Data collection and sharing is given priority;
- There is administrative innovation which is potentially replicable; and
- Tax administration is extended to relatively remote areas.

What follows considers each of these claims in greater detail.

4.1 Focus on building linkages within government

Improvements in tax administration may lead to broader gains in state capacity through a simple demonstration effect, but experience suggests that such automatic learning is far from guaranteed (Box 4.2). Learning is more likely when there are strong linkages between tax administration and other areas of government, such that improvements and innovations in tax administration are either (a) transmitted relatively explicitly to other areas of government, or (b) create pressure for reform in those related agencies. The experience of the introduction of unique Taxpayer Identification Numbers (TINs) in Latin America is indicative of this potential. While initially introduced for tax administration alone, additional government agencies quickly began to make use of the same TINs in order to improve information sharing, leading to broad improvements in performance and data management. In Chile, for example, the TIN number is

used by various agencies that interact directly with the tax administration, including municipal governments, the civil and company registries and private banks.

Box 4.1 Taxation and administrative development in Imperial Ethiopia

From 1930–1974 Ethiopia was ruled by Emperor Haile Selassie, whose central state-building challenge was to expand the strength of the central state against that of the regional landowning aristocracy. Taxation figured centrally in these efforts, as it was essential to building the fiscal capacity of the state and was symbolically important in replacing feudal rule with modern government. Efforts to expand taxation in turn had profound implications for the nature of public administration and authority in the country. In 1941 the need to improve collection led Selassie to create a salaried civil service for the first time, replacing the practice of granting tax collection powers to regional government officials. This marked a turning point in the establishment of centralised bureaucratic government. Soon after, Selassie decreed that all peasants be given tax receipts in exchange for land tax payments. While seemingly innocuous, these tax receipts came to act as a guarantee of peasant property rights, thus giving the central government greater formal power over regional property rights. Finally, when the government established a more sophisticated agricultural income tax in 1967 it brought with it the establishment of local Tax Assessment Committees, which were a precursor to a more extensive central government presence in the regions. It is perhaps not a coincidence that, 40 years later, Ethiopia continues to have amongst the highest levels of local administrative capacity in the region outside of South Africa (Schwab 1972; Bahru Zewde 2002).

Aside from encouraging positive spillovers, a focus on building linkages across government is also a very practical administrative strategy, as tax collection is, at its core, about information gathering. Income tax collection in particular is reliant on being able to collect information about the business activities and assets of income-earning individuals and businesses. The simplest means to achieve this goal is to improve information sharing with other government agencies, including business registration, the land registry, the department of industry, investment promotion agencies, vehicle licensing and local tax agencies (Boxes 4.3 and 4.4). Connections with private sector institutions, including banks and insurance companies, have been an important strategy in many middle-income countries.

In practice, reform over the past two decades has often gone in the opposite direction, focusing more on building administrative autonomy than strengthening linkages between agencies. As noted earlier, SARAs became very popular because of the potential for autonomy to dramatically accelerate reform. Unfortunately, while SARAs achieved notable successes in accelerating reform in the short term, sustaining reform has been more problematic. One factor appears to be that, far from building linkages with the rest of government, SARAs have

sometimes disrupted such linkages and caused resentment within other government divisions (Prichard and Leonard forthcoming; Devas, Delay and Hubbard 2001; Fjeldstad 2005; Durand and Thorp 1998; Prichard 2009a).

Box 4.2 The benefits and pitfalls of autonomy in the Peruvian tax reform

The success of the Peruvian tax reform relied heavily on the creation of a semi-autonomous revenue authority, the Superintendencia Nacional de Administracion Tributaria (SUNAT). SUNAT was given autonomy from the Ministry of Finance, partially controlled its own budget, enjoyed the active support of the President and increased salaries spectacularly, from an average of \$50 per month to \$890 per month. Aside from improving revenue generation, it was hoped that these measures would allow SUNAT to pursue innovative new programmes and become a model for other agencies. In practice, rather than spurring improvements elsewhere, SUNAT became an island of efficiency, and by 1995 many reforms began to be eroded due to repeated changes in leadership, a loss of urgency, weaknesses in the police and judiciary and jealousy at other Ministries about the special privileges enjoyed by SUNAT. Thus, while autonomy facilitated dramatic short-term improvements in performance, the government failed to focus on transmitting these gains to other areas of administration, and this eventually weakened the impact of the initial reforms (Durand and Thorp 1998).

While poorly documented, it appears that there often continues to be poor information sharing even within SARAs in low-income countries, and certainly between domestic tax officials and customs officials. Illustrative of the importance of this issue is the experience of the Kenya Revenue Authority. Of all of the reforms that facilitated large improvements in revenue collection, many within the agency point to relatively straightforward improvements in data sharing between the income tax, VAT and customs departments as the most important change, as it immediately transformed their ability to cross reference tax information and improve enforcement.

Stressing the importance of linkages need not imply antagonism towards the creation of autonomous revenue authorities. The creation of SARAs can easily lead to the neglect of linkages with the broader public administration, but this need not be the case. What is important is continuously stressing the importance of linkages and information sharing. In this way reform programmes may maximise the benefits of autonomy for achieving reform and innovation in the short-term, while making explicit efforts to build system-wide linkages and capacity over the medium-term, thus consciously using tax agencies as 'motors' for broader reform (Baer, Benon and Toro 2002: 33).

Box 4.3 The use of vehicle and property data to enforce income taxes

Intuitively, using data on the consumption of luxury goods should be an effective strategy for monitoring tax evasion; if consumption far exceeds reported income, then this is a strong basis for a tax audit. Harberger (1989) notes that one of the most striking, and effective, initiatives of the very successful Chilean tax reform launched in 1973 was an audit of luxury consumption as a means to detect tax evasion. More striking is the case of Bolivia, where the 1986 tax reform eliminated the personal income tax entirely and replaced it with progressive taxes on property, cars and the net worth of enterprises. Though most experts would not advocate the elimination of the income tax, they acknowledge the logic of replacing a difficult to enforce income tax with a focus on highly visible and taxable assets, and this speaks to the potential for at least incorporating such information into tax enforcement efforts (Bird 1992b).

Box 4.4 E-Ghana – a model project repeatedly delayed

In Ghana, planning began early in the decade to pursue tax modernisation as part of a larger 'E-Ghana' IT modernisation programme, supported by the World Bank. The programme called for creating an IT system that would explicitly link the Internal Revenue Service (IRS) to agencies responsible for business registration, vehicle licensing, land registration and customs. The envisioned information sharing stands to vastly improve IRS performance, but is equally expected to spur much broader capacity gains. Unfortunately, the project has been repeatedly delayed, apparently due to bureaucratic resistance, disagreements between government and donors and resistance to greater informational transparency among some large tax taxpayers (Prichard 2009a; World Bank 2006).

4.2 Focus on data gathering and transparency

Tax systems provide essential data to inform broader economic management. This role receives relatively little attention in contemporary discussions of taxation, but the ability of the tax administration to collect data, and share it with other agencies, warrants greater attention. It has the potential to produce system-wide benefits, while the costs of failing to collect and share tax data are equally great. Chaudhry (1989, 1997) studied the impact of large non-tax revenues on the development of state institutions and capacity in Saudi Arabia and Yemen. She found that the dramatic growth of oil revenues in Saudi Arabia led to the virtual elimination of the domestic tax authority. This, in turn, reduced the quality of data collection about the economy, which undermined the quality of economic regulation and planning. She writes: 'With the decline of DZIT [the tax administration], the only method for collecting data on the economy was the use of contracts for government projects and customs statistics. Other forms of

independent verification and information gathering atrophied, and massive projects were initiated [by the Ministry of Finance] and carried out in a blind frenzy of state spending' (Chaudry 1989: 125).

This example suggests that improved data gathering would be of particularly immediate benefit in the areas of investment promotion and industrial policy. Most low-income countries provide different forms of support to particular economic sectors, most frequently in the form of investment incentives. Yet, governments have virtually no systematic information about the effectiveness of these policies, owing to the absence of even basic data on economic activities and the cost of incentives. If tax agencies were empowered to collect and process systematic data on taxes paid by firms in particular sectors, and of taxes forgone due to incentives, economic management would likely improve (also see Section 5.2.4).

Suggestive of the potential for improved data gathering to yield broader benefits is the fact that tax administrators themselves frequently point to such benefits. In Bolivia improvements in customs administration are credited with improving the quality of national accounts and balance of payments data, both valuable for economic planning. In Zambia, the Commissioner of internal revenue, confronted with the politically vexing challenge of taxing the informal sector, has instead set the intermediate objective of systematically registering informal sector operators and their activities, in hopes of improving policy planning.

Tax data can also potentially be valuable in less closely related domains. Data collected by the tax administration is often a useful input to law enforcement efforts in developed countries. At the simplest level, tax returns are a means to quickly identify unexplained incomes or suspicious assets that cannot be explained by declared income (i.e. Department of the Treasury 2007). It is likewise sometimes suggested that improved data collection related to property taxation could help to clarify land ownership in countries where land claims are frequently contested. In Ethiopia, for example, land tax payments are used as an informal guarantee of property rights (Kassahun 2006; Bird 1974; Majumdar, Banerjee and Ghosh 2007). While these more sophisticated benefits are not likely to emerge in full in the short-term, they do point to the potential for improved data collection to spur broader gains.

4.3 Focus on replicable reforms

Simply put, improvements in tax administration are not likely to generate broader gains if they are highly specific to tax administration, and the lessons are thus not transferable. As a result, there is a case for emphasising reform strategies and innovations that may have broader relevance for building state capacity.

For example, reforms that emphasise meritocracy in hiring, performance management and evaluation or citizen outreach may be very relevant to other areas of government. In Chile and Mauritius, the revenue authorities were pioneers in introducing sophisticated performance based management systems, which became models for other areas of government. The tax agencies likewise were pioneers in introducing innovations in internal strategic planning, while the Chilean tax agency also introduced modern internal auditing tools that became a model for the broader civil service.

Similarly, changes such as introducing incremental IT reform, deconcentrating certain activities to rural areas or experimenting with different salary scales may eventually lead to innovations elsewhere. Throughout Latin America the tax authorities were frequently leaders in the introduction of e-government functions, particularly through e-filing of tax returns and the electronic management of customs clearance. This connection is also apparent in Ghana, where the company that runs the IT system for customs administration, GCNet, is now responsible for a broader civil service IT reform programme. In Peru, the tax agency was the first major government agency to establish fully functional and relatively autonomous offices outside of the capital city, and this appears to have contributed to the adoption of similar measures elsewhere (Durand and Thorp 1998).

By contrast, reforms that cannot reasonably be implemented elsewhere in the civil service, while they may often still be warranted, are not likely to spur positive spillovers. Major investments in capital intensive IT reform or the introduction of very large salary increases likely fall into this category, as they may be useful, but it is not reasonable to assume that a similar model could be followed throughout the civil service. In Bolivia, tax administrative reform was explicitly intended to be a 'pilot' for broader civil service reform plans, but parts of the model never fully took off elsewhere. One of the major reasons was that the reform package called for much higher civil service salaries, but while this was feasible for the relatively privileged tax agencies it was unaffordable more broadly. Paying higher salaries may, of course, remain an important tax reform strategy (and civil service reform strategy more broadly), but tax reform measures that are plausibly replicable in the short term appear more likely to allow tax reform to be a catalyst for broader gains in state capacity.

4.4 Improve local tax administration

One of the most striking features of governance in much of sub-Saharan Africa is the overwhelming centralisation of government, and the weakness of the state in localities generally, and remote regions in particular (Herbst 2000; Mkandawire 2002). As such, efforts to improve local taxation, and improve cooperation between national and local tax officials, could be a particularly valuable setting in which to use tax administrative reform as a wedge for improving broader government capacity. In Bolivia, the expansion of customs administration to remote areas involved the construction of a telecommunications network that became the backbone for improved telecommunications for other government agencies. Attention to similar possibilities is timely, as many governments are showing an increased interest in decentralisation, but local tax capacity remains very weak in most countries (Box 4.5).

Despite official pronouncements about decentralisation, central government transfers continue to dominate local government budgets (Fessha and Kirkby 2008). Moreover, high levels of arbitrariness, coercion and corruption, an anti-poor bias and the creation of major economic distortions are characteristic of most local tax systems (Bahigwa *et al.* 2004; Fjeldstad and Therkildsen 2008; Juul 2006). While data is very problematic, available evidence suggests that official local

government revenue collection frequently comprises less than 5 per cent of total government revenue.³ This weakness guarantees that governments will have limited autonomy and capacity to provide basic services, while it also may reduce the potential for local accountability, as discussed in Section 5.

Box 4.5 Popular unhappiness with local tax systems in East Africa

While research on the dynamics of local taxation in low-income countries is rare, it is clear that arbitrariness, corruption and regressivity have made local taxes generally unpopular and ineffective. In 2003, the Tanzanian government abolished the Development Levy (effectively a local poll tax) in response to these concerns, but in so doing dramatically reduced the revenue raising potential of local governments. Uganda abolished the very similar graduated personal tax in 2005 in response to its growing unpopularity and politicisation, with a similar impact on local revenues. A report at the time argued that the unpopularity of the Graduated Tax was primarily due to poor administration, as it was inconsistently and regressively applied, and this is a finding that is echoed in other contexts as well. At a more general level, surveys in both Tanzania and Uganda indicate that citizens have a general appreciation of the necessity of taxation to support local services, but chose non-compliance due to an overwhelming lack of confidence in local government (Bahigwa *et al.* 2004; Fjeldstad and Semboja 2001).

The absence of effective taxation outside of major centres appears to result largely from neglect, and a dramatic lack of coordination between national and local tax officials. In Ghana, for example, national tax officials report that local tax officials sometimes urge citizens to pay local taxes *instead* of national taxes. Meanwhile, local officials complain that the national government has monopolised virtually all available tax bases and offers little if any administrative support. This neglect and lack of coordination has allowed the emergence of a high degree of arbitrariness and abuse in local tax systems, while little attention is paid to economic efficiency.

Examples of taxation acting as a driver for improved state capacity in local areas have so far been poorly documented. One exception is Prichard's ongoing research in Ethiopia, which provides both historical (Box 4.1) and contemporary examples in which the need to raise local taxes required construction of new bureaucratic structures. There is substantial anecdotal evidence of similar processes elsewhere, but this evidence has generally not been documented, thus making the case for further research in this area. One example that has been

3 This figure is based on the IMF Government Finance Statistics, as well as sporadic country level evidence, for example Mogue *et al.* (2009), for Ghana. Indicative data on the level of fiscal decentralisation in a handful of relatively decentralised states is available in Bird and Vaillancourt (1998a).

informally cited by donors is the success of the deconcentration of tax administration in Peru, which, as noted earlier, has become a model for broader reform.

The Peruvian case also points towards the possibility that taxation may be the most basic expression of the presence of state authority in remote areas and may therefore be important to the construction of state legitimacy, and to discouraging the emergence of rival groups (Mkandawire 2002; Moore 2007). While this claim is difficult to prove, the Peruvian case suggests the importance of taxation to popular perceptions of state authority. In the early 1980s a rebel movement known as the Shining Path emerged, and by the end of the decade was 'more efficient than the old state in collecting 'revolutionary taxes' and applying sanctions in cases of 'evasion' (Durand and Thorp 1998: 137). When the government rehabilitated tax collection in the early 1990s, the rebels repeatedly targeted the central tax office for attacks, including a major bombing in May 1992. These attacks appear to be indicative of the extent to which the rebel movement considered the tax authority a threat, and associated tax collection with the existence of state authority (Weinstein 2007).

5 Tax reform, responsiveness and accountability

Taxation can lead to the expansion of responsiveness and accountability by providing incentives for citizens and government to enter into a 'tax bargain', or a 'fiscal contract'. In such a bargain, citizens accept and comply with taxes in exchange for government provision of effective services, the rule of law and accountability (Moore 2007, 2008). Such tax bargains are mutually beneficial, as citizens receive improved governance while the government receives larger, more predictable and more easily collected tax revenues (Levi 1988). While governments may initially perceive tax bargaining as a type of political concession, the reality is that few, if any, governments have been able to deploy highly effective tax systems without first entering into a national dialogue about taxation (Tilly 1990). While these dialogues may be politically challenging in the short term, and involve important changes in government behaviour, they are the most mutually beneficial strategy in the long term.

Chile has arguably Latin America's most effective tax system, able to raise significant revenue relatively equitably and with a minimum of conflict. While this owes in part to technocratic reform, many dramatic improvements in the Chilean tax system can be traced to 1990, when representatives from across the political spectrum came together during the transition from dictatorship in an effort to establish a broader democratic alliance known as the *concertacion*. Part of this coming together, which prefaced a prolonged period of political stability and economic growth, was the establishment of an inclusive fiscal pact, establishing broad agreement on the contours of tax and expenditure policy. Whereas many countries in Latin America experienced revenue gains in the early 1990s, Chile was more successful in maintaining and expanding those gains on the back of this broad political consensus (Bergman 2002, 2003; Weyland 1997).

The potential revenue costs of failing to foster a national dialogue about taxation, and of failing to provide reciprocal services to citizens, are equally beginning to be documented. At a micro-level, limited survey evidence continues to highlight the fact that citizens would be more willing to pay taxes if they observed real benefits in return. In a survey of taxpayers in two localities in Tanzania over 80 per cent of taxpayers expressed the view that taxes were used 'only partly' or 'not at all' for public services, while 55–60 per cent believed that taxpayers avoided taxes as a result of poor services. As importantly, over 90 per cent of respondents in one district expressed a willingness to pay more taxes if public services were improved (Fjeldstad and Semboja 2001). A more recent survey of urban property taxation in Tanzania echoes these findings. For example, 80 per cent of respondents accepted that property taxes were justified to fund local services, but half of that group argued that in practice the tax was not justified given the lack of services (Kayuza 2006: 188).

In practice, tax bargains may take the form of a relatively explicit *quid pro quo* between governments, taxpayers and their representatives, but they are equally likely to take the form of implicit behavioural adjustments. Recent research points to two general processes that seem to be particularly important in practice.

The first process, which can be termed direct tax bargaining, involves governments making relatively explicit concessions to citizens in response to the threat, or emergence, of public resistance to taxation. A compelling example comes from Ghana, where in 1995 the government sought to introduce a VAT. The process lacked significant public consultation, as the formerly military government retained a very hierarchical governing style and was under significant pressure from donors. The new tax was met by arguably the largest public protests since the arrival of the government in 1981 and the government was forced to quickly repeal the tax. While the protests were motivated by the new tax, they came to encompass demands for greater democracy, a stronger rule of law and improved service provision. The protests were sufficiently large and unexpected to fundamentally shake government confidence, leading it to significantly expand the inclusiveness of its governing style in the lead up to new elections in 1996. With greater inclusiveness, and acceptance of the 1996 election outcomes by the opposition, the government was able to peacefully reintroduce the tax in 1998. The importance of this type of bargaining was reinforced when in 1999 and again in 2003 successive governments sought to increase the VAT rate, but, rather than risk major political protests, preemptively committed new tax revenues to publicly popular health and education programmes (Osei 2000; Prichard 2009a).

The second process is more indirect, and covers cases in which taxpayer resistance to taxation by an unresponsive government undermines the stability of the government, leading to future reform. A particularly telling example comes from Kenya where, in the late 1990s, political opposition to the Moi government began to be reflected in declining income tax compliance, following large gains earlier in the decade. Many observers claim that tax resistance was an implicit opposition strategy, aimed at reducing the fiscal capacity of the government and accelerating its demise, while an increasingly disillusioned bureaucracy facilitated this evasion. The incumbent party lost the 2002 election decisively and its limited

fiscal capacity, at a time when tax receipts were already low due to an economic downturn, appears to have played an important role. The incoming government made a renewed commitment to improving compliance, including efforts to explicitly link taxation to new social programmes, including free primary education, the development of Constituency Development Funds and the achievement of aid independence. In doing so the government made taxation a central element of public debate, featured prominently in major newspapers and media sources. Thus, resistance by taxpayers helped to precipitate change, and sent a strong signal to the subsequent government that a stronger tax bargain was needed.

Of course, while taxation can prompt such processes of constructive bargaining, it is equally possible that taxation may remain purely coercive, that taxpayers may angrily reject taxation or that tax bargaining will be dominated by small groups of rent-seeking elites. What is most important here is to understand what factors make tax bargaining, either explicit or implicit, more likely to be successful.

Ongoing research suggests that constructive tax bargaining may be more likely when:

- Diverse taxpayers perceive themselves to have common interests, and will thus pursue a broad tax bargain rather than narrow benefits;
- There is a high degree of mutual trust amongst taxpayers (Fjeldstad 2004);
- Taxpayers are well organised politically and thus have the strength and unity to bargain constructively with government (Olson 1965; Levi 1988; Prichard 2009a; Mahon 2005);
- Levels of awareness and education are high, so as to encourage political engagement (Prichard 2009a);
- Links between taxation and expenditure are relatively clear to taxpayers (Bahiigwa *et al.* 2004; Ssewakiryanga 2004);
- Voluntary compliance is relatively important, thus providing stronger incentives for governments to seek a tax bargain (Bates and Lien 1985); and
- There is a minimum level of trust between taxpayers and government in order to facilitate bargaining.

In the broadest terms this suggests that an accountability-enhancing tax reform agenda is likely to create public awareness, spur public engagement, generate taxpayer unity and offer citizens leverage in bargaining with government. Translated into practical terms, an accountability-enhancing tax reform agenda may include four priorities, which are addressed in the sections to follow:

- Improving equity in tax enforcement and administration;
- Improving public awareness, transparency and taxpayer services;
- Broadening and improving direct taxation; and
- Strengthening civil society engagement with tax issues.

5.1 Improving equity in tax enforcement and administration

A first important step towards making constructive tax bargaining more likely is to improve the equity with which tax laws are enforced, such that all taxpayers are equally subject to existing tax laws. Bargaining over taxation is dependent on both the ability and willingness of taxpayers to engage in collective political action, and the existence of minimal trust in government and the viability of any tax bargain. Where taxpayers are not treated equally under the law, do not trust one another and do not trust the government, constructive tax bargaining is unlikely. A focus on increasing equity in tax enforcement stands to address these concerns, while also increasing revenue collection, compliance, progressivity and political support for reform (Fjeldstad 2004).

In simplest terms, the central message is that collective political action is most likely when taxpayers perceive themselves to have shared interests, and this is most likely when tax enforcement is equitable. The contrasting experience of anti-VAT protests in Ghana and Kenya is a stark illustration of the importance of taxpayer unity to successful tax bargaining. Protests against the introduction of the VAT in Ghana were highly successful in bringing about long-term improvements in governance. By contrast, protests in Kenya against the introduction of Electronic Tax Registers (ETRs) for improving VAT compliance failed to result in any kind of tax bargain, as the government made few concessions and taxpayer anger remained unresolved.

The key difference was that the Ghanaian protests succeeded in bringing together political elites, businesses and small taxpayers in making shared demands on government, whereas Kenyan taxpayers remained seriously divided throughout the ETR protests (Prichard 2009a). While these patterns have diverse roots, the extent of perceived equity in tax enforcement was crucial. Despite administrative weaknesses, the Ghanaian government had earlier signaled a commitment to taxing elites and small taxpayers alike through high profile efforts to tax the former (Nugent 1995). By contrast, Kenyan citizens believed that despite higher levels of administrative capacity many elites continued to pay less than their fair share,⁴ while mid-sized firms were singled out in part because they were largely owned by the Indian minority. Thus, rather than supporting taxpayer resistance, and lower consumer prices, most citizens appear to have sided with the government even during large protests by shop owners.

The greatest challenge is improving enforcement equity, and thus strengthening the basis for collective tax bargaining, lies in improving taxation of elites. The poor enforcement of personal income taxes is in some respects the defining feature of developing country tax systems, with implications for revenue and legitimacy. This relates in particular to the failure to effectively tax professional salaries, self-employment income, investment incomes, property and large informal sector businesses, while many countries also suffer from high levels of politicisation and corruption in enforcement (Bird 1992a; Bird and Zolt 2005). These failures are, in

4 It should be noted that the Kenya Revenue Authority has recently made impressive strides in improving enforcement among elites.

turn, linked to capacity constraints, but also to political interference, corruption and widespread tax incentives and exemptions, all of which erode the legitimacy of tax systems. In Kenya, despite relatively effective tax administration generally, exemptions from taxation for the politically well connected were widespread and well known until recently. The major business associations, far from presenting unified demands for better governance, became conduits for seeking individual privileges. This pattern not only undermined the legitimacy of the tax system, it weakened the potential for tax bargaining by ensuring that elites would have incentives to seek narrow privileges rather than supporting demands for broader tax bargains.

While the weak enforcement of taxation amongst elites can be largely attributed to domestic political and technical constraints, tax evasion by elites, and by multinational corporations, is also facilitated by the existence of offshore financial centers (OFCs). These OFCs, more commonly known as 'tax havens' or 'secrecy jurisdictions' facilitate aggressive, and frequently illegal, forms of tax evasion through the existence of a combination of low or no taxation, weak regulatory standards and the total absence of transparency about ownership or exchange of information with other tax jurisdictions.

While it is difficult to precisely estimate the impact of these practices on tax collection due to the secrecy involved, recent studies suggest that the lost tax revenue may be very substantial. Recent data being compiled by the Tax Justice Network and Christian Aid suggests that revenue losses from only a single method, transfer mispricing, may be as high as 5–10 per cent of total tax revenue in many low-income countries (Prichard 2009a; Cobham 2005). Regardless of precise estimates, it is clear that these practices undermine the ability of tax authorities to tax wealthy individuals and large firms, with serious consequences for the equity of tax systems.

This is an area of policy in which international actors have a particularly important role to play. The leading international organisation in this respect has long been the OECD, beginning with the release in 1998 of the OECD report on *Harmful Tax Competition*. Unfortunately, progress in curbing the growth of tax havens has been extremely limited, but recent years have offered some cause for renewed optimism. Amidst growing international attention in the aftermath of the global financial crisis, meaningful progress has been made in calling for greater transparency within tax havens, and improved information exchange between tax havens and national tax authorities. That said, the measures to date are unlikely to be sufficient to significantly curtail abuses in the developing world, where limited technical capacity makes enforcement difficult and severely limits the ability of tax administrators to take advantage of international provisions for the exchange of information. Thus significant work remains to be done with respect to promising initiatives around several issues, including: (a) creating multilateral, and easier to access, mechanisms for information exchange, (b) implementing new corporate accounting standards that would require the reporting of revenues, profits and tax payments on a country-by-country basis, and (c) providing capacity building support and international cooperation to improve enforcement in the developing world.⁵

While improving tax enforcement among elites stands out as the greatest challenge facing low-income countries, there are also important gains available from taxing the informal sector, though these gains may be as important for symbolic reasons as for their revenue implications. Torgler and Schneider (2007) have presented cross-country evidence that where the informal sector is large, the willingness of other citizens to pay taxes is reduced. The logic for citizens is simple: 'I will pay taxes as long as everyone else pays their fair share.' Unfortunately there is limited country level research on this topic, but what does exist supports this conclusion (Goldsmith 2002). For example, in both Ghana and Kenya the governments successfully used the promise of greater tax enforcement in the informal sector as a bargaining chip in seeking to encourage greater tax compliance among formal sector businesses (Prichard 2009a).

One of the reasons that it is so difficult to tax elites is that they are a politically powerful vested interest opposing greater tax enforcement (Ascher 1989). It is similarly difficult to improve taxation of the informal sector, as well as local taxation, because the political costs can be very high relative to the revenue gains, leading to a 'Devil's Deal' in which tax exemptions for low-income taxpayers are used to purchase political support (Tendler 2002). In both cases the underlying problem is the difficulty of mobilising political support for tax reform, despite the fact that many citizens would benefit from improved enforcement. As noted earlier, accumulated experience suggests that a focus on more equitable enforcement can be an effective means to mobilise public support for reform.

5.2 Improving awareness, transparency and services

Efforts to encourage a reciprocal exchange of tax compliance for improved responsiveness and accountability must be founded on dialogue between citizens and government about taxation. Taxpayers must, implicitly or explicitly, express their expectations of government and their willingness to support those goals through fiscal contributions. Governments, in turn, must draw clear connections between taxation, public spending and the achievement of broadly held goals in order to obtain the support of taxpayers. While governments can collect some tax revenue, and citizens will receive some government services, even in the absence of such a national dialogue, already cited examples from Chile, Ghana and Kenya, among others, highlight the fact that those countries that have enjoyed the greatest success have fostered some degree of tax bargaining.

In order to have such a national dialogue about taxation, citizens must be aware of the taxes they are paying and educated about the tax and budgetary systems, while government must be transparent about tax collection and public spending. Awareness and transparency are a basic requirement for building public engagement and essential trust; without some degree of both, taxation is likely to remain characterised by conflict. By the same token, greater transparency and

5 A 2009 report by the Norwegian Government Expert Commission on Capital Flight from Poor Countries, titled *Tax Havens and Development: Status Analysis and Measures* provides a particularly detailed look at the problem, and at the actors involved in trying to address it.

improved tax services are likely to lead to immediate improvements in compliance by increasing the perceived legitimacy of the system. The strength of public demands for greater tax transparency is starkly apparent from a survey of Tanzanian taxpayers in the late 1990s. It found that 75 per cent of respondents favoured the publication of the names of tax evaders and 84 per cent believed that the names of those receiving any kind of tax incentives or exemptions should be published, along with the cost to the treasury. The strength of public demands for transparency surprised even the authors of the survey (Gray 2001).

Unfortunately, in most low-income countries trust in tax administration and government is very low, owing to inequitable enforcement of tax laws and a significant lack of transparency about what taxes are collected and how the money is used (Gloppen and Rakner 2002; Fjeldstad and Semboja 2001; Bahiigwa *et al.* 2004; Fjeldstad and Therkildsen 2008). Basic awareness of taxation is likewise limited, as taxpayers are aware that they are paying, but seem to often have only a partial understanding of how much, why and what for, particularly with respect to indirect taxes.

Unfortunately, short-term political calculus often breeds resistance to efforts to improve transparency and awareness, out of a belief that ignorance may lead to politically convenient complacency among taxpayers. On the whole this appears to be a misguided strategy: the most successful tax collectors have generally made taxation relatively more, not less, transparent, while it appears that in the absence of information taxpayers tend to assume the worst, and place little trust in tax authorities. As such, a governance-enhancing tax reform agenda could incorporate five related elements: (a) increasing transparency, (b) improving taxpayer services, (c) improving the visibility of major taxes, (d) reporting tax expenditures and (e) using tax earmarking to strengthen tax-expenditure linkages.

5.2.1 Increasing transparency

Taxpayer compliance is shaped to a large degree by (a) whether or not they believe that *other* taxpayers are paying, (b) how effectively they believe that revenue is being used and (c) whether or not they believe that tax administration is honest and fair (Fjeldstad 2004; Berenson forthcoming). All of these forms of trust are undermined by the lack of transparency around (a) tax collection, (b) tax compliance and (c) the use of tax revenue at both the national and local levels. There is reason to believe that improvements in transparency could improve tax compliance while facilitating citizen engagement in political discussions of taxation and public spending.

It is often impossible for the public to access even basic information about tax collection. At a minimum, citizens should be able to access information about total tax collection, disaggregated by tax type and geographic area. Ideally, governments should attempt to approximately estimate levels of compliance (Box 5.1), and to demonstrate connections between revenue and spending. In practice many tax administrations in low-income countries lack good quality tax data and rarely share the information that they do have. Even less common are explicit efforts to link tax collection to observable changes in public spending.

Box 5.1 Calculating tax compliance and expected revenues

While the failure of governments to provide basic information about tax compliance is often attributed to capacity constraints, it appears that reasonable estimates are well within the capacity of most tax administrations, particularly at the local level. In Ethiopia, Warner *et al.* (2005a, 2005b) estimated expected land tax revenue by simply multiplying the rate per hectare by the amount of arable land, both of which should be relatively obtainable by a determined administration. In Uganda, Iversen *et al.* (2006) estimated expected market fees by simply stationing someone at the market entrance on several market days and counting the numbers of traders and livestock. In Tanzania, Fjeldstad, Lucas and Ngalewa (2009) estimated the collection of a broader array of local taxes, while flat taxes that exist in many localities can easily be estimated by simply knowing the number of households – this, in fact, appears to be done in many places, though it does not appear that data is often shared with taxpayers (Fjeldstad and Semboja 2001).

At the national level the task is somewhat more difficult, but rough estimates are certainly possible. A USAID project in the late 1990s estimated the collection efficiency of most taxes in Tanzania and Madagascar using consumption and other basic economic data (Gray 2001). Even simple comparisons of tax ratios across countries with similar economic structures can yield useful indicators. Here governments could draw on simple databases like those from USAID's Fiscal Reform and Economic Governance programme or on more sophisticated tax effort studies (i.e. Gupta 2007). At the simplest level, reporting revenue in real terms and as a share of GDP, as opposed to in absolute terms, might improve the ability of the public to assess performance.

The creation of Constituency Development Funds (CDF) in Kenya has been controversial in many respects, but provides a compelling example of the potential for transparency and strengthened tax-expenditure linkages to significantly affect levels of citizen engagement. The CDFs allocate a fixed share of central government revenue to each district and grant primary control over allocations to the local MP. While they have received a positive reception in some quarters, the CDFs have also been criticised both for bypassing and weakening local authorities and for high levels of corruption that owe, at least in part, to politicisation and ineffective accountability mechanisms. Yet, amidst these important debates, there seems to be a widespread sense that the CDFs have succeeded in strengthening public understanding of the links between taxation and public service delivery and, in at least some cases, encouraging public engagement. Changes in public attitudes appear to have resulted from relatively determined efforts by the central government to emphasise these tax-expenditure linkages through transparency about resource transfers and an emphasis on the message that 'this is *your* money'. This finding does not necessarily validate the use of CDFs, but does speak to the potential for transparency and education to strengthen the basis for citizen engagement with tax and expenditure issues.

A particularly concrete example of the potential benefits of linking taxation and expenditure comes from a USAID project on market taxes in Guinea. As with many countries, market taxes are an important revenue source for local governments in Guinea, but are also poorly collected and unpopular. The project sought an agreement with government to explicitly link the collection of market taxes to the construction of improved market facilities. It then posted easy to understand information about revenues and expenditures, both from market taxes and more generally, in public places around the locality. These relatively straightforward measures reportedly resulted in a doubling of revenues collected from the markets in one year, owing to greater compliance and improved community monitoring of the behaviour of tax collectors. The government reports that this increase was sustained in subsequent years and was replicated in other areas as well, though levels of success differed from location to location (Korsun and Meagher 2004: 164).

National taxes comprise the overwhelming bulk of total government revenues, and thus warrant being the focus of reform efforts. Efforts to improve transparency should include improved reporting of revenue collection and compliance (Box 5.1), fostering a national dialogue about tax-expenditure linkages, publishing information about public spending by purpose and by location, ‘naming and shaming’ tax evaders and, possibly, making use of revenue earmarking to make tax-expenditure linkages explicit (see Section 5.2.5).

Despite comprising a much smaller share of total revenue, reforming local taxation could also play a particularly crucial role in promoting tax bargaining. The majority of citizens experience taxation most directly at the local level, through poll taxes, market fees, business fees, user fees and so forth. At the same time, public trust in local tax systems appears to be particularly low, suggesting that if governments want to change the nature of the relationship between taxpayers and the tax administration, the local level must be an important part of the equation.

Two studies of local taxation in Uganda echo this conclusion, and provide some practical strategies for action. Bahigwa *et al.* (2004) propose that the key challenge for improving local taxation is rebuilding public confidence in the system. They suggest that rebuilding trust from such a low existing level must rely on strengthening explicit linkages between tax collection and public expenditure. Among their recommendations is to work directly with neighbourhood groups to collect the graduated personal tax (since abolished), publicly declaring amounts collected relative to expectations on a regular basis, and explaining the specific implications of changes in collection for public spending. In a similar study, Ssewakiryanga (2004) notes the importance of making budget and expenditure data available to citizens as a means to build public support for taxation and enhance citizen engagement.

The latter recommendation draws on a well-publicised government initiative that made information about public spending widely available using newspapers and radio. The result of this dramatic increase in budget transparency was a significant improvement in the quality of public service delivery, apparently driven at least in part by increased citizen engagement (Reinikka and Svensson 2005). While recent work has emphasised the need to have realistic expectations about the potential benefits of such transparency, and to understand such changes in

broader context (Hubbard 2007), the message that greater transparency can make a valuable contribution to improving citizen monitoring, and thus outcomes, remains valid. As such, the potential benefits of greater transparency in publicising tax information appears substantial, particularly when linked to efforts at broader community mobilisation.

Arguably the most direct means to improve tax transparency, strengthen linkages between taxation and expenditure and rebuild public trust in the tax system is to work directly with community organisations to collect tax revenue. This appears to be increasingly common in East Africa, as part of broader efforts to improve collection by outsourcing collection to private tax collectors. Putting aside the general question of privatising collection, the tentative message from efforts to work with community organisations to collect taxes is that significant gains are possible, but there are also substantial risks of corruption and politicisation (Iversen *et al.* 2006; Fjeldstad, Lucas and Ngalewa 2009).

The potential of the arrangements is apparent in the example, cited earlier, of market traders' associations in Guinea, who took on a larger role in tax collection and thus contributed to dramatic improvements in both revenue yields and public service delivery (Korsun and Meagher 2004: 164). Experience from Ghana points to similar potential benefits, but also highlights the risks of politicisation. There the national government introduced a system of associational taxation, which granted small business associations tax collection powers among their members. In the short-term the benefits appear to have been significant, as revenue yields, while small in absolute terms, increased, taxpayer satisfaction with the system improved and taxpayers received some new benefits from government, minimally in the form of reduced harassment by the police. The system was also a means to bring new groups into the tax net with a minimum of conflict. On the other hand, over time the system came to suffer from increasing corruption and politicisation. Levels of collection increased less quickly than expected and there were increasing accusations of corruption, embezzlement and co-optation directed at the leadership of the small business associations. As a result the system was eventually replaced by a standardised system of pre-paid tax stamps. The message is that efforts to partner directly with taxpayer organisations for tax collection purposes seem to hold significant potential, though there is always a need to guard against corruption and politicisation (Joshi and Ayee 2008; Prichard 2009a).

5.2.2 Improve taxpayer services

Building trust also depends on efforts to provide better services and education to taxpayers. By increasing awareness and the perceived legitimacy of the tax system such measures have the potential to immediately improve compliance while laying the foundation for a more effective tax bargain.

The importance of tax services to tax compliance has always been difficult to prove, but is widely accepted among tax experts and is a regular feature of tax reform programmes (LeBaube and Vehorn 1992). Unfortunately, the absence of documented successes suggests that efforts to improve taxpayer services have yet to consistently alter the often antagonistic relationship between taxpayers and

the tax administration in developing countries. Taxpayers still complain regularly about high compliance costs, a lack of clarity about tax regulations, seemingly arbitrary behaviour by tax officials and a lack of transparency. At a minimum, public demand for improved services appears undeniable. In a survey of small and medium businesses in South Africa firms expressed a powerful demand for an improved taxpayers' helpdesk. In fact, the survey found that demand for a helpdesk exceeded demand for a simplified tax regime or a higher VAT threshold, among other things (Abrie and Doussy 2006).

Efforts to improve tax services are generally focused on general tax outreach and education and measures to reduce compliance costs, including taxpayer support services. One of the best-documented examples is that of Peru during the 1990s, where improved tax services and education were a major focus. This included major investment in staff training, the creation of a central information centre, the development of a free taxpayer bulletin, the hosting of tax fairs in localities throughout the country and the dissemination of important information through newspaper ads and brochures (Durand and Thorp 1998). Within Africa, the South African Revenue Service has made the extension of taxpayer outreach and services a major priority, and views this as central to dramatic improvements in performance over the last decade. In both cases, the success of these efforts is not only reflected in improved revenue generation, but in improved public perceptions of the tax agencies.

Experience in several countries suggests that two other areas may be particularly important. The first is improved monitoring of tax officials in order to reduce arbitrary behaviour. A series of studies has found that the nature of interactions between tax officials and citizens significantly shapes taxpayers' overall perceptions about tax system fairness. Studies by Fjeldstad and Semboja (2001), Fjeldstad 2004, Therkildsen (2004), Friedman (2003) and Ssewakiryanga (2004) are particularly explicit on this point, warning against the consequences of apparently arbitrary behaviour by tax collectors. Fjeldstad (2004) goes so far as to argue, based on survey evidence from South Africa, that when tax officials seek to impose penalties for tax evasion that are perceived as arbitrary or excessive this can actually reduce compliance among other taxpayers. As Ssewakiryanga argues, 'citizen engagement in revenue processes is still very dependent on how they negotiate their relationship with tax collectors.'

The second, and more ambitious, possibility is to explicitly engage communities in tax collection efforts. The previous section highlighted examples of outsourcing tax collection to taxpayer organisations, while an alternative is to work directly with community representatives. Both Ethiopia and Uganda have adopted such a strategy to deal with the widespread controversy created by presumptive tax assessments, with relatively positive results in terms of trust, transparency and reduced conflict. The Ethiopian example was noted earlier, while some local governments in Uganda have introduced Revenue Mobilisation Teams, which are committees vested with tax assessment powers at the most local level of government. The teams conduct assessments and then transmit this information to higher levels of government for collection purposes. The new system appears to have been well received due to a greater sense of fairness, and despite the fact that much of the revenue flows to higher levels of government (Ssewakiryanga 2004).

5.2.3 Emphasise the visibility of taxes

Having noted the importance of taxpayer awareness and government transparency, it is essential to recognise that taxpayers are often not fully aware of what taxes they are paying, particularly with respect to indirect taxes. Thus, efforts by government and civil society to increase the visibility of taxes appear to be a potentially beneficial area for reform. While governments have often intentionally reduced the visibility of taxes in an effort to avoid public opposition, this report has repeatedly argued that while this may be effective in the short term it cannot form the basis for a long-term fiscal contract, and may even exacerbate conflict and mistrust. In fact, anecdotal evidence from Ghana and Uganda, among others, suggests that public misunderstanding of proposed VATs contributed significantly to the severity of public protests (Therkildsen 2004; Prichard 2009a).

Awareness of different taxes generally follows the distinction between direct and indirect taxes. Direct taxes, including income and property taxes, as well as many local taxes, are paid directly by taxpayers to the government. By contrast, indirect taxes, of which the two most important are customs duties and sales taxes, are often invisible to consumers. Trade taxes are paid at the port, and are thus captured in consumer prices, but never explicitly. Similarly, VAT is often not paid by small retailers, on whom most customers rely. Yet the retailers, and their customers, are, in fact, paying VAT due to tax payments made earlier in the value-chain.

A shift towards direct taxes is one means to increase the visibility of taxes and is discussed in the next section. That said, the full replacement of indirect taxes is not feasible in practice, so it is important to consider strategies to increase visibility and awareness. The most explicit means to achieve this goal is to focus on questions of implementation and enforcement. The United States and Canada increase visibility by adding sales taxes to prices at the point of sale, rather than including them in advertised prices, as is common in Europe. Unfortunately, this is unlikely to be a sufficient strategy in low-income countries, given the generally limited use of receipts, though it may increase the visibility of taxes somewhat in urban areas and in the case of some fuel taxes.

An alternative possibility is to improve taxpayers' understanding of the taxes they pay by explicitly publicising research about the share of taxation in common household purchases, and the incidence of taxation amongst households at different income levels. While such information is currently difficult or impossible to access, increasing interest among researchers in studying the incidence of indirect taxes at all income levels is beginning to make such information more readily available (i.e. Gemmill and Morrissey 2005). In order to publicise this information, partnerships with civil society and the media appear to present important opportunities. In Kenya the National Taxpayers' Association (NTA), an initiative of the Center for Governance and Development, has discussed such a possibility. While still in its infancy, one of the NTA's goals has been to strengthen public understanding of existing tax burdens and of the connection between taxes and public spending. During initial activities in several cities and towns across Kenya it found evidence that the public was eager for greater information, and that a clearer understanding of actual tax payments could motivate public engagement. More recently, an event in Kenya hosted by the NGO Panos brought

together researchers, civil society and the media, in hopes that the media could play a more active role in raising public awareness of the actual tax burden, and tax issues more generally.

5.2.4 Track tax expenditures more effectively

The reality or perception that politically connected elites are not paying taxes can be particularly damaging to levels of trust in tax systems, and thus to the potential for tax bargaining. While many countries have made progress in improving compliance, this is being undermined by the lack of transparency, and outright corruption, around tax expenditures (Box 5.2).

Box 5.2 The abuse of tax incentives in Ghana

Ghana appears to have a relatively well-administered incentives scheme, with incentives relatively clearly defined in law and requiring parliamentary approval. The fact that there is still strong evidence of significant abuse is indicative of the prevalence of this issue. The most glaring example was the registration of major timber companies in tax-free Export Processing Zones (EPZs) during the 1990s. These timber companies were granted EPZ status despite the fact that they secure most of their inputs, and conduct most of their operations (i.e. logging), within the domestic economy and that there is little need for incentives because the resource (timber) is a fixed asset. As a result the country received only a fraction of potential tax revenue at the same time that logging was leading to widespread deforestation. It is widely believed that the economically unjustifiable granting of EPZ status was driven by political patronage. In 2008 the government passed a law forbidding logging firms from acquiring EPZ status, and while the new law is good news for Ghana, it is also an implicit acknowledgement of the scope of earlier abuses. The same law forbade EPZ status for plastics firms, apparently in response to evidence that they were illegally trading within the domestic economy without paying appropriate taxes (Prichard 2009b; Hansen and Treue 2008; Birikorang, Hansen and Treue 2007).

Tax expenditures are revenues that are foregone due to the granting of preferential tax treatment to specified companies, industries or groups, and are most conspicuously associated with investment incentives. Governments argue that such incentives, including the creation of Export Processing Zones, are necessary to attract increasingly mobile foreign investment, particularly given that other countries are providing similar incentives. Economists have long been skeptical, arguing that tax exemptions are a poor way to attract investment even in theory, while in practice they are prone to poor targeting and abuse (Klemm 2009; Prichard 2009b; Zee, Stotsky and Ley 2002).

While the economic efficiency of incentives is an important question, the short-term goal should minimally be to ensure that systems are administered fairly and transparently. At present most low income countries cannot, or will not,

estimate revenue foregone, let alone transparently report the recipients of incentives. Not only does this prevent the emergence of a meaningful policy debate around incentives, but it appears to create space for widespread corruption and abuse. Whereas politically and economically well-connected firms may once have simply avoided paying taxes, they are now often granted legal tax relief through an opaque and weakly enforced system of incentives. This not only undermines revenue, but also undermines public confidence in the legitimacy of tax systems.

While sophisticated analysis of the long-term cost of tax expenditures is complex,⁶ a more basic accounting of direct revenue foregone, by recipient, tax type, region and economic sector, holds the potential to dramatically improve transparency, economic management and the overall legitimacy of the tax system. Yet, even such simple accounting remains essentially unheard of in low-income countries, and is often of limited quality in middle-income nations.

Despite the general lack of transparency around incentives, there are positive examples for countries to draw on. In the realm of legal requirements, the Brazilian Federal Constitution of 1988 included a requirement that every budget be accompanied by a full report of all tax expenditures and their estimated impact on the budget. This was a response to the role of proliferating tax expenditures in exacerbating Brazil's fiscal difficulties and undermining the legitimacy of the budget process (UN ECLAC 1998: 47). In similar fashion, research in Madagascar in the late 1990s revealed deep public displeasure with the lack of transparency around tax incentives. In response, the government published a list of major tax defaulters and of recipients of significant tax incentives. The list covered an impressive five pages of the most important national newspaper, and gained credibility from the fact that it included several prominent political figures, of which some were supporters of the ruling party.

5.2.5 Use tax earmarking to strengthen tax-expenditure linkages

Tax earmarking refers to the act of legally committing specific tax revenues to specific expenditures. The most explicit form of earmarking is benefit taxation: charging for a particular service in order to provide that same service. Other forms of earmarking are much less direct, for example when a specified share of income tax revenue is earmarked for transfers to local government. In both cases, the attraction of tax earmarking is that it can regularise spending on essential tasks and create greater transparency about the connection between taxation and public spending. By doing so, it can give taxpayers a say over how tax revenue is spent, improve monitoring of expenditures, build trust around taxation and encourage public engagement.

In practice, all countries use tax earmarking to some degree, but the practice remains unpopular with fiscal experts. One reason is that tax earmarking reduces

⁶ Calculating the overall revenue implications of tax incentives is notoriously difficult, as one must account for the impact of incentives on total levels of investment in order to calculate the overall impact of revenue.

fiscal flexibility in the long-term. Perhaps more importantly, in practice many tax earmarks serve a political purpose, but do not actually affect spending patterns or improve monitoring. The most common problem arises from the fact that revenues are highly fungible, meaning that newly earmarked revenues can be offset by shifting existing revenues to other priorities, thus leaving the aggregate pattern of spending unchanged.

Despite these critiques, there may be a particularly strong case for using tax earmarking in developing countries (Bird 1992a). For one, in the face of political instability earmarking can stabilise funding for priority needs, as in the case of Road Funds funded by fuel taxes (Gwilliam and Shalizi 1999). More importantly, from a governance perspective, tax earmarking may be a useful strategy for building trust, achieving important revenue and spending objectives, improving monitoring and increasing public engagement.

Recent experience in Ghana provides explicit evidence of the particular risks and benefits of tax earmarking, as tax earmarking has become a prominent revenue strategy at the national level. In 2000 the Government of Ghana sought to increase the VAT rate from 10 per cent to 12.5 per cent, but faced heavy public opposition. In order to secure public acceptance, the Government earmarked 100 per cent of the new revenues to a new Ghana Education Trust (GET) Fund, designed to fund scholarships and educational infrastructure, primarily at the tertiary level. In 2003 the newly elected Government sought to increase the VAT rate to 15 per cent, but again faced stiff public opposition. In response, the tax increase was renamed the National Health Insurance Levy and allocated to the creation of a National Health Insurance Fund.

As a political strategy, earmarking was highly effective. The practical impact also seems to have been positive, though the story is more complex. The impact can be analysed in terms of two primary issues: *fungibility* and *accountability*. Fungibility asks whether earmarking led to significant new spending in the designated areas, or simply displaced pre-existing funds, leaving aggregate spending unchanged. The evidence is that there has been some fungibility with respect to particular uses, but overall funding in both areas has increased significantly. Accountability is concerned with the transparency of accounts and the potential for citizen oversight and presents a more mixed story. The two new funds are managed by appointed Boards of Directors, and this has raised public awareness and engagement. On the other hand, there were delays in setting up both funds, there seems to be insufficient transparency about the specific activities of the funds, and some civil society actors have accused the funds of irregularities (Prichard 2009a).

The basic message is that earmarking has the potential to formalise important tax bargains between citizens and governments. That said, positive outcomes will only be achieved if earmarking is implemented effectively and honestly. This means that earmarking is:

- *Substantive and specific*, and guarantees actual increases in spending in the designated area;
- *Transparent and easy to monitor*, as only transparency and improved monitoring will ensure long-term improvements in governance;

- *A moderate share of the total budget*, as excessive earmarking can, as noted earlier, undermine fiscal flexibility, while complicating oversight.

5.3 Broadening and improving direct taxation

Direct taxes as a share of revenue are dramatically lower in developing nations than in OECD countries, and have shown relatively little progress in most countries despite tax reform efforts (Bird and Zolt 2005). This reflects the difficulty of improving direct tax collection, due to both the simple administrative challenges of effective direct tax collection and the existence of political barriers to taxing local elites. While income taxes now represent a major share of tax collection in OECD countries, it is important to recall that their introduction was a slow and torturous process in most of those countries (Aidt and Jensen 2009).

Despite these caveats, it remains the case that improving direct taxation is possible and could have large benefits for revenue generation, the legitimacy of the tax system and for the responsiveness and accountability of government. From a governance perspective, improving direct tax enforcement is essential for increasing horizontal equity as well as for increasing the visibility of taxes. This is, in turn, likely to increase awareness, enhance trust amongst taxpayers and enhance trust between taxpayers and the government, all of which are likely to make public engagement and tax bargaining more likely. Direct taxes are also generally more reliant on voluntary compliance than indirect taxes, which implies stronger incentives for governments to engage in tax bargaining and large potential gains from doing so.

5.3.1 *Emphasise personal income taxes*

The greatest barrier to equity in the application of tax laws in developing countries is the failure to effectively tax the personal incomes of many elites.⁷ Significant improvements could dramatically improve both revenue and the legitimacy of the tax system.

Unfortunately, improving income taxation is among the most administratively and politically challenging tax reform objectives. During the 1980s and 1990s direct taxes received reduced attention in tax reform programmes due to doubts about whether developing countries had the administrative capacity, and political commitment, to collect income and wealth taxes effectively. Administratively, direct taxes require that the tax administration effectively monitor the economic activities and assets of taxpayers, in order to estimate tax liabilities. Yet, while these administrative challenges are real, there is also an urgent need not to allow 'capacity constraints' to be used as a blanket excuse for inaction, as there are many countries that have achieved significant gains in recent decades (Box 5.3). In most countries, measures such as improving information sharing across tax

⁷ The weakness of taxation in natural resource sectors is arguably significantly more problematic, but this report is not focused on so-called 'resource rents'.

agencies, using data on vehicle and property ownership to detect tax evasion or implementing basic property taxation would be technically feasible, and could yield large gains. The primary barrier to such initiatives is an absence of political will, as income taxes have traditionally affected a relatively narrow economic elite, which has wielded sufficient political power to resist improved collection (Bird and Zolt 2005).

While these challenges remain, there is an opportunity for renewed emphasis, for several reasons. First, growing attention to the governance implications of direct taxation has generated some renewed impetus for such a focus. Second, the spread of information technology has eased, though certainly not eliminated, the administrative challenges involved. Third, growing commitment to collecting income taxes from the informal sector (discussed in the next section) is providing justification for an equal focus on personal income taxes, as well as easing resistance to taxation among some elites (Prichard 2009a; Torgler and Schneider 2007). Finally, there is at least anecdotal evidence that democratisation can provide a mechanism for organising public support for progressive tax reforms.

Box 5.3 Dramatic improvements in income tax collection

While improvements in income tax collection are politically difficult, there is ample evidence that where the political commitment exists, major gains are possible. Over the last few decades large improvements in short periods of time have been witnessed in a wide variety of countries. In almost all cases the reform prescriptions were not particularly complex or unique, and relied overwhelmingly on a willingness to signal a commitment to enforcing taxes on the relatively economically and politically powerful. Examples include, but are not limited to: Ghana (1983–88, 2001–2004), Kenya (1993–96), Rwanda (1996–2002), Sierra Leone (2000–01), Swaziland (1987–88), Uganda (1993–2000), Chile (1973–75, 1990–93), Colombia (1991–92), Jamaica (1979–85), Mongolia (1999–2003), Nicaragua (1980–84) and Peru (1992–96).

5.3.2 Expand the tax base using positive incentives for compliance

Expanding taxation of the informal sector has recently become an important focus for national governments and development partners alike. This focus holds the potential to increase revenue and to support important improvements in responsiveness and accountability.

The potential for governance benefits reflects several factors. First, there is evidence that the taxation of informal sector operators increases the willingness of formal sector businesses to comply with taxation and engage with government. By contributing to the normalisation of business taxation, informal sector taxation may support the growth of broader and more inclusive business associations that can constructively engage with government (see Section 5.4.1). This not only holds the potential for a stronger tax bargain, but also potentially increases the breadth of interests represented. In Kenya expanded efforts to tax the informal sector were linked to government efforts to secure greater compliance from larger

businesses, while one of the outcomes of the process was increased cooperation between the major business associations and nascent informal sector associations.

Second, and more generally, improving taxation of the informal sector has the potential to increase the political engagement of small businesses. In Kenya taxation appears to have encouraged organisation among informal operators, though more evidence is needed. Though poorly documented, there are likewise myriad examples of local taxes helping to mobilise traders' associations of various kinds. At the beginning of the 1990s, for example, the emergence of the Ghana Union of Traders' Associations was largely a reaction to increasingly assertive tax enforcement efforts by the government (Prichard 2009a). In similar fashion, the introduction of associational taxation, discussed earlier, appears to have provided incentives for the greater formalisation of small business associations.

While informal sector taxation has become an important part of the tax reform agenda, a governance perspective suggests problems with the approach that has been adopted. Most efforts have focused on finding technocratic solutions to improving compliance. Yet technocratic solutions alone appear unlikely to succeed in the absence of positive incentives for informal sector operators to enter the tax net. These positive incentives can take the form of tangible benefits, such as reduced police harassment, access to business support services or improved public services, or of a broader political commitment to inclusiveness by governments. Rather than increased taxation leading to expanded political engagement, a new tax bargain is needed in order to bring informal sector operators into the tax net.

In a recent speech,⁸ the Commissioner General of the Uganda Revenue Authority explained, 'We need to give incentives for these small businesses to be in the formal sector. We are only trying to use the police to force people into the formal sector. I think we need to do just the opposite.' Others go even further, explaining that the key barrier to taxing the informal sector is the potential political costs of broader taxation (Tendler 2002). If the strategy for taxing the informal sector were based on positive incentives, there is growing evidence that these political risks would be avoided and there would be much greater success in bringing the informal sector into the tax net (Box 5.4).

5.3.3 Strengthen property taxes

The absence of effective property taxation is perhaps the most conspicuous weakness of tax systems in most developing countries. This implies significant revenue losses and reduced redistribution, while it has also long been suggested that land taxation could encourage more efficient land use, though this goal has remained elusive. Property taxes are also the most frequently suggested means to improve local taxation, because, unlike most large taxes, they can efficiently be collected by local government (Bird 1974; Rajaraman 2004).

8 20 November 2009, African Tax Administration Forum meeting, Kampala, Uganda.

Box 5.4 The potential for formalisation using positive incentives

There is a growing body of evidence that informal sector firms would be willing to join the formal sector, and pay reasonable taxes, if the costs of doing so were reduced and if real benefits were available. A DFID project found that across many countries in Africa informal sector firms were aware of the costs of informality and the potential benefits of formalisation.

Everest-Philips (2008) reports that in Sierra Leone 60 per cent of firms believed that formalisation would, in principle, help their enterprises to grow. In Liberia, over 40 per cent of medium-sized enterprises had actually tried to formalise, but had given up due to complicated procedures and bureaucratic costs.

Greater formalisation must rely on reducing the costs of formalisation and providing visible benefits to those that formalise. With respect to costs, the most important barrier does not appear to be levels of taxation as such, but bureaucratic complexity and the costs of business registration and tax compliance. With respect to benefits, Kamunyori (2007) found that *jua kali* operators in Kenya would be willing to accept taxation if the business registration process was made more transparent and less costly and if they were protected from corrupt local officials and offered greater political legitimacy. In the DFID study, Liberian firms likewise emphasised a desire to avoid corruption and abuse by local officials as a potential incentive to formalise.

Governments have enjoyed greatest success in bringing small operators into the tax net when they have offered explicit positive incentives. The Ghana Public Road Transport Union (GPRTU) accepted new taxation in exchange for guarantees that they would be protected from police harassment (Joshi and Ayee 2008). Moreover, the system initially allowed the transport union to collect the taxes itself, as an intermediate step towards a normalised system of prepaid tax stamps (Prichard 2009a). In Mauritius, the government provided targeted access to financial services for SMEs in a successful effort to encourage formality (Everest-Philips 2008). Governments could equally also offer SMEs improved access to government contracts (which are generally dominated by larger firms), or targeted support services, as measures to encourage formalisation. As Engelschalk (2004) writes of experience in former Soviet states, 'the creation of [simplified] tax systems as such does not provide sufficient incentives for businesses to register' (307–8).

More often overlooked is the fact that property taxation can engage taxpayers in a political dialogue with government, and thus encourage the forging of a fiscal contract (Box 5.5). Property taxes affect a relatively large number of taxpayers and are highly visible, which, in principle, makes them a likely candidate to encourage public engagement. Moreover, because property taxes are specific to a location (unlike other income taxes) they can more easily be linked to specific public expenditures, particularly on infrastructure. In Burkina Faso, for example,

the government is attempting to link the level of property taxes explicitly to the level of public services enjoyed by particular properties and locations. As noted earlier, taxes that are amenable to relatively clear tax-expenditure linkages can potentially have strong governance benefits by encouraging public engagement and by building trust when the government fulfills its commitments.

Of course, visibility, which is so attractive from a governance perspective, has made property taxation politically contentious, and largely explains the relative weakness of such taxes across the developing world. In Latin America efforts to reform property taxes have frequently led to political conflict, often because land taxation has been associated with broader discussions of land reform (Bird 1974). While these experiences have led to skepticism about the political feasibility of land taxes, they also speak to their positive potential, as conflict is often a precursor to political reform.

While there are major technical challenges inherent in expanding property tax collection, major progress is possible with sufficient political will. Ethiopia, despite having particularly limited technical capacity within government, provides an example of a highly effective land tax regime, albeit at very low rates. In 2004 the two primary rural land taxes generated 0.27 per cent of GDP in revenue, which, while small in absolute terms, is comparatively high for the region. More importantly, the government has remained committed to collecting the tax, apparently for political reasons, and compliance levels in the same year are estimated at over 90 per cent in two of the country's largest regions, Amhara and SNPPR. As interestingly, unlike public hostility to local taxes in most countries, citizens frequently support the land tax as a guarantee of their property rights (Warner *et al.* 2005a, 2005b; Kassahun 2006). Ultimately, while decisions about property tax regimes are clearly context specific, there is significant evidence that greater attention to property taxation is warranted.

Box 5.5 Property taxation and political engagement

During the 1980s members of the Karen and Langata District Association in Kenya became increasingly frustrated with high municipal property taxes and the absence of effective service provision or fiscal transparency. In response the KLDA went to court to demand that the city council improve transparency before collecting additional taxes. The KLDA won the case, though the City Council refused to comply, and the result is that taxes have been placed in an untouched bank account for over a decade. In recent years the KLDA has offered to release the funds if the City Council will grant them greater control over local planning and public spending. While the lack of progress is discouraging, there continues to be hope that the initial tax conflict may, belatedly, lead to a more constructive partnership between the district association and the government.

5.3.4 Strengthen local taxation

Finally, cutting across these three opportunities for strengthening direct taxation is the potential importance of local taxation. Fiscal decentralisation has become an

increasingly popular topic in recent years, and is intriguing from the point of view of this study because it was one of the first areas of study to embrace a connection between taxation, responsiveness and accountability. One of the arguments in favour of fiscal decentralisation has long been the belief that decentralised revenue collection and budgeting would improve government accountability because 'people take more interest in what they have to pay for and are hence more likely to be interested in ensuring that they get value for their contributions' (Bird and Vaillancourt 1998b: 10–11). By taking revenue and expenditure decisions to the local level, and therefore making them more visible, decentralisation is expected to strengthen these connections between what people pay and what they get in return.

Local taxation may, thus, be particularly important to fostering positive linkages between taxation, responsiveness and accountability because local taxes are more visible and broad based, owing to the simple fact of proximity and the types of taxes that are predominant at the local level. Whereas national taxation is dominated by indirect taxes and by narrowly based income taxes, local taxation is heavily reliant on broad based direct taxes, including poll taxes, taxes on small businesses, various levies and, in principle at least, property taxation. It is this aspect of local taxation that may make it particularly capable of promoting broad based tax bargaining, even when the absolute amounts collected are modest.

Unfortunately, actual examples linking local taxation to expanded responsiveness and accountability have been poorly documented. One exception is Prichard's ongoing work in Ethiopia, which captures the strengthening and reform of a presumptive tax system for small businesses in 2001. The key administrative challenge, as with any presumptive tax, was the estimation of turnover for businesses that did not keep accounts. Such turnover estimation is inherently controversial, and when enforcement was tightened significantly it caused substantial public discontent. In response the government reduced rates and, more importantly, undertook two modest but important processes of political liberalisation. First, it expanded participation in the tax assessment process, thus vesting power with citizens' representatives and increasing engagement and awareness. Second, in the immediate aftermath of the election it created new forums in which citizens could raise questions and concerns about tax collection and public expenditure. While these measures are modest in absolute terms, in a relatively closed political environment they represent important, incremental, processes for institutionalising consultation and participation, and thus increasing accountability. This example, like several others presented earlier in this paper, points to the potential for even relatively modest local taxes to have important political benefits.

Of course, it is important not to naively look to fiscal decentralisation as an unproblematic path to improved political outcomes. The literature dealing with the consequences of fiscal decentralisation for development outcomes is vast, and has arrived at conflicting conclusions (i.e. de Mello and Barenstein 2002). While some studies have argued that greater reliance on local tax revenue leads to improved government performance (Hoffman and Gibson 2005), other studies of local taxation find that decentralisation may also lead to greater coercion, exploitation and abuse (Juul 2006; Fjeldstad and Semboja 2001; Fjeldstad 2001).

This section has thus emphasised a particular dimension of this relationship – the potential for strengthening bargaining between citizens and government around taxation – but the actual decision to pursue fiscal decentralisation must clearly embrace a detailed understanding of local conditions and of the multiple factors that shape the outcomes of decentralisation.

5.4 Strengthening civil society engagement with tax issues

In discussing the relationship between business associations and governments, Handley (2008) has argued that what is needed is ‘constructive contestation’. By this, she means that the business sector must be strong enough to *contest* economic policy, but must also do so *constructively*, seeking broad based improvements in economic policy rather than narrow, corporatist, type bargains.

Reaching an effective tax bargain presents a similar challenge, as taxpayers must be organised to make demands on government, but both sides must also be in a position to reach an inclusive tax bargain, rather than dispensing narrow privileges, or engaging in endless conflict. Governments, civil society and development partners can contribute to promoting such ‘constructive contestation’ by pursuing a number of measures that are beyond the direct realm of tax reform.

5.4.1 Support the formation of inclusive business associations

In principle, business associations should be among the most important voices arguing for an effective tax bargain. Unfortunately, this has often not been the case in practice: business associations in low-income countries have tended to be both relatively weak and highly fragmented (Goldsmith 2002; Brautigam, Rakner and Taylor 2002). Because they are weak, they are unable to have a significant influence on tax policy, or in pushing the government to make reciprocal commitments in exchange for tax compliance. Because they are fragmented, a subset of powerful business interests has tended to pursue narrow benefits, such as tax exemptions or special privileges, at the expense of broader improvements in governance. The tendency of powerful business people to maintain personalistic ties to government has undermined the ability of business to develop an independent and effective political voice (Handley 2008). In some case governments have gone so far as to intentionally weaken business associations in order to reduce political threats, but this short-term perspective overlooks the extent to which a unified business sector can be an indispensable ally in pursuing reform (i.e. Weyland 1996).

Unfortunately, relatively little is known about how to foster the growth of unified and effective business associations. The basic challenge is not technical, but is to generate incentives for businesses of all sizes to prioritise their collective needs over fragmented rent-seeking. One lesson of experience is that government itself plays a large role in setting incentives: success is more likely when the government adopts cross-cutting economic policies, institutionalises consultation with business associations and provides distinct advantages to members of these associations. While research is limited, tax issues appear to be potentially

important for galvanising the growth of business associations because taxation is often relatively broad and universal in its impact (Doner and Schneider 2000; Prichard 2009a; Durand 1991) (Box 5.6). Another lesson is that business associations are more likely to be effective when they engage in income generating activities centred on providing valued services to members, such as information, quality control or training. Such activities provide incentives for membership and generate greater autonomy for the association (Doner and Schneider 2000).

A particularly interesting possibility is to support efforts to create associations of SMEs. Major business associations have historically been controlled by large firms with a rent-seeking agenda, to the exclusion of even mid-sized firms. While smaller business associations exist in most countries, they are generally extremely weak and under-resourced. Yet the potential for such associations is evident in scattered examples of success, such as in Tanzania, where the relatively broad based Tanzania Chamber of Commerce, Industry and Agriculture wields meaningful political influence despite the existence of a separate association for larger firms.⁹ While it is inevitable that larger firms will be particularly influential, strengthening broader participation in business associations is likely to expand the scope of any political bargain, and may also provide incentives for governments and larger firms to support broad, rather than particularistic, aims.

The process by which business associations may come to be more inclusive of smaller firms is, unfortunately, poorly researched. That said, a nascent process of broadening in Kenya does provide some interesting insights into the incentives at work. As business associations in Kenya became more institutionalised after 2002 they also began to expand their breadth, with associations representing SMEs and the informal sector taking shape. Government helped to encourage this trend by seeking consultation, motivated largely by the desire to increase tax compliance through formalisation. The larger private sector organisations, under the umbrella of the Kenya Private Sector Association (KEPSA) also invested in this development, motivated by the desire to improve tax compliance among small firms and to expand its own political legitimacy.

5.4.2 Support the formation of taxpayers' associations

The counterpoint to business associations is the development of taxpayers' associations. Similar to business associations, such associations of taxpayers have the potential to engage in processes of constructive contestation with government. They can create pressure for greater equity in tax reform, and for reciprocity around taxation, but can also be valuable partners to government, organising debates around taxation and expanding public education and engagement. Unfortunately, taxpayers' associations remain rare, politically weak and almost completely un-researched in low-income countries.

9 My thanks to Dr Odd-Helge Fjeldstad for this example.

Box 5.6 Taxation as a catalyst for stronger business associations

Throughout the 1980s and 1990s business associations in Kenya were relatively weak, and were viewed as corrupt patronage organisations. This was exemplified by the Kenya National Chamber of Commerce and Industry, which slowly lost credibility and had virtually vanished by the late 1990s. While many businesses secured lucrative benefits from government, business associations showed little interest in pursuing an inclusive economic and political agenda.

This began to change in 2002, as the newly elected government immediately showed an interest in working more closely with business associations and reduced the scope for particularistic benefits. Thus empowered, the business associations have gradually become a more unified political voice, most notably lobbying aggressively for a peaceful resolution when violence erupted after the 2007 elections. Taxation has been a central component of interactions between business and government, and an important catalyst for greater organisation within the business community, as improved taxation was a leading priority for the new government. Similar cases of taxation figuring centrally in the growth of business associations have been documented in Ghana (Prichard 2009a), Uganda and Tanzania (Gloppen and Rakner 2002).

The newly formed National Taxpayers' Association (NTA) in Kenya is one example in sub-Saharan Africa to establish a relatively inclusive and nationwide body, though it remains in its infancy.¹⁰ The NTA was formally launched in 2007 and was explicitly influenced by the belief that taxation could be a catalyst for improving governance. The initiative also enjoyed the informal support of the Kenya Revenue Authority, which supported efforts to increase taxpayer education and awareness. The practical focus of the NTA has been on monitoring local expenditure under the Constituency Development Funds (CDF), and this objective is shared with several other organisations in the country. But while the agenda remains focused on expenditure monitoring, there is an internal desire to link these efforts more explicitly to issues of tax policy and administration.

Throughout, the goal has been to use taxation as an organising idea to engage citizens in broader based advocacy, and organisers report significant success in this regard. To quote one leader of the campaign, 'They [local residents] get really excited when you explain to them that they are actually the ones who fund the government, [and that] this can be negotiated.' At a micro level this provides compelling, though still preliminary, evidence that taxation can be a catalyst for community mobilisation for responsiveness and accountability. This perspective

¹⁰ Very little research has been conducted about the activities, or even existence, of such organisations in other counties, though similar organisations exist in Tanzania and Uganda. This is an area in which much more research is needed.

and agenda is now being adopted by local groups across the continent, loosely organised under the umbrella of the Tax Justice Network-Africa. This is a model that warrants attention and support, as the theoretical case for supporting organisations to constructively engage taxpayers is very strong.

5.4.3 Strengthen partnerships between tax authorities and civil society

The concept of constructive contestation implies both contestation and partnership, and governments have the opportunity to partner with civil society organisations in pursuit of a more equitable and effective tax agenda. Aside from the broad potential for bargaining with societal groups to facilitate reform and improved compliance, governments can partner with these groups to improve tax education, awareness, compliance and trust.

At a minimum, civil society bodies can be an important conduit for improving awareness and education, both because of their existing links to taxpayers, and the fact that taxpayers may trust civil society organisations more than the tax administration itself. Where trusted non-governmental bodies reinforce the importance of paying taxes, and can explain otherwise controversial tax issues, this can increase trust through greater understanding. In countries as different as the United States and Rwanda, governments have sought to strengthen the role of independent tax professionals and accountants, in order to develop an impartial, and trusted, source of information on tax law.

As part of its tax reform strategy, the Rwandan government has actively sought to strengthen societal groups for this purpose. One element has been to work closely with local private sector associations, which, despite their relative weakness, have at least served as a conduit for information and discussion. The government has also supported the emergence of tax professionals outside of government who can work with private firms for tax filing purposes and act as a general resource for taxpayers. While tax professionals are sometimes viewed as facilitators of tax evasion, this must be balanced against the trust enhancing benefits of professionalising tax accounting (Land 2004; Friedman 2003; LeBaube and Vehorn 1992).

As importantly, effective partnerships between the tax administration and civil society may actually lead civil society organisations to encourage compliance among their members. Those who are tax compliant always have a strong incentive to encourage compliance by others, and organised groups can facilitate this process. In Ghana, for example, the government proposed to the business community that if tax receipts increased then the corporate tax rate would decline. This created incentives for the major business associations to encourage compliance, and the tax rate was subsequently reduced (Prichard 2009a).

6 Conclusions

This report has argued that taxation can be an important catalyst for state capacity development and the expansion of responsiveness and accountability, and that governments, with the support of development partners, have the opportunity to systematically promote these linkages. It has argued that such an approach is not only potentially beneficial, but essential, for two reasons. First, increased revenue generation cannot guarantee improved development outcomes unless it is accompanied by simultaneous efforts to enhance state capacity and build public engagement and accountability. Second, the measures proposed here – broadly aimed at building a national dialogue about taxation and building more integrated administrative structures – are indispensable to any long-term strategy for achieving revenue stability and self-sufficiency.

This report has pointed towards specific, concrete, steps that can be taken by governments and donors to strengthen tax-governance linkages. These measures fall into two broad categories. First, and most importantly, this paper has proposed specific measures to enhance and reorient the dominant tax reform agenda. None of the proposals presented here are entirely new, as all of them have appeared in existing work on tax reform in the developing world. Thus, what is being proposed is not a radical re-conceptualisation of what is needed. Instead it is a call for two things: an increased appreciation of the importance of tax reform in general, and a new focus for those reform efforts, which places relatively less emphasis on simply expanding revenue collection, while placing greater emphasis on *how* revenue is collected, and how this can contribute to broader state building goals.

The second set of measures proposed here has focused on the importance of supporting civil society actors to engage in debates about tax issues. Such actors can be essential to strengthening the state building role of taxation. Conspicuously absent from this paper has been a focus on the systemic impact of foreign aid on incentives for domestic revenue generation and on the nature of political accountability in aid dependent states (Moore 1998; Brautigam and Knack 2004; Knack 2009; Moss, Pettersson and van de Walle 2006). These are hugely important questions, but warrant a much more sophisticated analysis than what would have been possible here, and will thus be addressed in a future paper.

To conclude, a growing literature suggests that the benefits from pursuing the measures proposed here are potentially large, and tax administrators themselves are increasingly echoing this sentiment. This report is nonetheless still only a preliminary statement on the topic. Systematic country-level research on the linkages between taxation and state building remains limited, and this is reflected in a heavy reliance here on case studies from a relatively small number of countries. More generally, while the suggestions presented here are carefully derived from existing case literature, very few of them have been rigorously and specifically tested in practice. There thus remains significant scope for further research, ideally in direct partnership with tax administrators and donors in the process of attempting to implement some of these ideas.

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