Citizen-State Relations

IMPROVING GOVERNANCE THROUGH TAX REFORM

OECD

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ORGANISATION FOR ECONOMIC COOPERATION AND DEVELOPMENT

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Foreword

Taxation is fundamental to development and economic growth. Tax can also catalyse state building and enhance accountability between citizens and the state. In half the countries in sub-Saharan Africa the rate of domestic resource mobilisation is less than 15% of GDP. This compares to 35% in OECD countries. Thus, effective tax reforms can help to raise the resources needed to deliver essential services. But as this publication shows, they can also enhance accountability between citizens and the state, thereby helping to build effective states.

The benefits of taxation underpinned African efforts to launch the African Tax Administration Forum (ATAF) in Kampala in November 2009. The ATAF brings African tax administrations together to work for better tax administration throughout Africa. ATAF is very happy to work closely with the OECD, drawing on its long experience in working on taxation and development, and playing a key role on the multi-stakeholder Task Force on Tax and Development.

While the tax reform agenda has so far mainly focused on increasing domestic resources, little attention has been paid to the wider role of taxation in building effective citizen-state relations. Establishing an effective tax bargain involving civil society and business associations is critical for increasing tax compliance and clarifying the links between tax and expenditure.

Citizen-State Relations: Improving Governance through Tax Reform draws on developing country experience, mostly from Africa. It lays out how donors can effectively support the efforts of developing countries in building self-reliance through effective domestic resource mobilisation and accountability. As this publication argues, donors should support upward accountability and manage aid in ways that maximise positive revenue raising incentives and enhance domestic accountability. The publication sets out key elements of a governance-enhancing tax reform agenda that will enable developing countries to strengthen state capacity and effective tax bargaining.

I am confident that this publication lays the foundation for a governance focused tax reform agenda that puts state-citizen relations at its heart.

Oupa Magashula

President
African Tax Administration Forum (ATAF)

Acknowledgments

This publication was written by Wilson Prichard, Institute of Development Studies, on behalf of the OECD/DAC Governance Network (GOVNET). It draws on the work of the GOVNET Taxation and Governance Task Team, including its report on *Governance, Taxation and Accountability: Issues and Practices* (2008).

We would like to thank the Taxation and Governance Task Team for its input and collaboration in this work. The publication was prepared by a team of OECD staff co-ordinated by Ben Dickinson and Maria Zandt. Isabel Huber, Fiona Hall and Peter Vogelpoel provided valuable editorial assistance and Stephanie Coic contributed to the graphic design.

In order to achieve its aims the OECD has set up a number of specialised committees. One of these is the ***Development Assistance Committee****, whose members have agreed to secure an expansion of aggregate volume of resources made available to developing countries and to improve their effectiveness. To this end, members periodically review together both the amount and the nature of their contributions to aid programmes, bilateral and multilateral, and consult each other on all other relevant aspects of their development assistance policies.*

The members of the Development Assistance Committee are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Korea, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom, the United States and the European Commission.

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Acronyms and Abbreviations

ATAF	African Tax Administration Forum
CDF	Community Development Fund
DAC	Development Assistance Committee (OECD)
DFID	Department for International Development (UK)
EPZ	Export Processing Zones
ETR	Electronic Tax Register
GOVNET	Network on Governance (OECD/DAC)
GTZ	German Agency for Technical Co-operation
IDS	Institute of Development Studies
KEPSA	Kenya Private Sector Association
KLDA	Karen and Langata District Association
LTU	Large Taxpayers' Unit
NTA	National Taxpayers' Association
PRSP	Poverty Reduction Strategy Paper
SARA	Semi-autonomous revenue agencies
SME	Small or medium-sized enterprise
SUNAT	Superintendencia Nacional de Administration Tributaria
TIN	Taxpayer Identification Number
URA	Uganda Revenue Authority
UNECLAC	United Nations Economic Commission for Latin America and the Caribbean
USAID	United States Agency for International Development
VAT	Value added tax
YES	Youth Employment Scheme

Executive Summary

Introduction

Taxation is fundamental to sustainable development: it supports the basic functions of an effective state and sets the context for economic growth. However, there is another role for taxation that is often overlooked – as a catalyst for more responsive and accountable governments, and for expanding state capacity.

Recent research has begun to focus on this broader relationship between taxation and statebuilding, but it is still relatively theoretical and abstract. This publication charts new territory by translating research into a practical agenda for action. It focuses on specific measures by governments, supported by development partners, to strengthen the state-building role of taxation.

What are the links between tax and governance?

Taxation can improve governance in three ways:

1. *Developing a shared interest for economic growth:* Governments which depend on taxes have stronger incentives for promoting economic growth.
2. *Developing the state apparatus:* Tax collection requires a functioning administration. Its development may spur improvements in state capacity elsewhere.
3. *Developing accountability and responsiveness:* Taxation engages taxpayer-citizens in politics. Governments which rely on taxes have incentives to improve governance in order to ensure tax compliance.

This paper explores the implications of the latter two processes for tax reform in the developing world. It also looks at the influence of foreign aid on domestic revenue generation – reliance on aid instead of taxation can undermine all three processes.

Improving the state apparatus

Improvements in tax administration may lead to broader improvements in state capacity through:

- *Administrative innovations*, such as increased meritocracy in hiring or improved internal monitoring, which can subsequently spread throughout the civil service.
- Pressure for *improvements in other agencies* essential to tax collection, such as business registration, foreign investment promotion and land registration.

- An *enhanced government presence in remote areas*, thus also expanding the reach of government services.
- Providing *data and information* that are essential to other government activities, such as economic planning, business promotion or service targeting.

In order to improve the state's administrative systems, a supportive tax reform agenda should:

- *Focus on linkages rather than autonomy*: Tax reform usually tries to improve performance by either strengthening linkages between the tax administration and other areas of government, or by building the autonomy and internal capacity of the tax administration alone. While autonomy may be important for spurring reform, system-wide gains are more likely where linkages are strong. Such linkages may: *(i)* generate direct incentives for improved performance elsewhere in government, and *(ii)* create a direct channel for successful innovations to be adopted elsewhere. Most reforms tend to over-emphasise autonomy, and fail to link internal reform to more system-wide change.
- *Focus on data gathering and transparency*: The data gathered by tax administrations can help improve government performance more broadly in areas like investment promotion, industrial policy, land management and law enforcement. Achieving this will require a greater focus on data gathering, as well as investment in data management, sharing and transparency.
- *Focus on replicable reforms*: Tax reform is more likely to stimulate broader public administrative reform when the model can be adopted by other departments (is "replicable"), rather than only being relevant to tax. Replicable reforms can include greater meritocracy in hiring, performance evaluation, citizen outreach, reform of rules governing hiring and firing, incremental information technology reform or experimenting with different salary scales. By contrast, major investments in capital-intensive IT projects or the introduction of enormous salary increases are examples of reforms that may be narrowly useful for the tax authority, but which are unlikely to provide a model for broader reform.
- *Focus on local taxation improvements*: History suggests that tax administration can lead the way for the broader expansion of effective government in rural areas. Thus, efforts to build more robust tax administration in local areas, with stronger links to the national tax system, may encourage broader improvements in local government performance. The need for such a focus is largely independent of whether fiscal decentralisation is a priority or not.

Improving accountability and responsiveness

Taxation can improve responsiveness and accountability by providing incentives for citizens and government to enter into a "tax bargain" or "fiscal contract". Through this process, citizens accept and comply with taxes in exchange for government providing effective services, the rule of law and accountability. Tax bargains are mutually beneficial, as citizens receive improved governance while the government receives larger, more predictable and more easily collected tax revenues. Few, if any, governments have been able to implement highly effective tax systems without first entering into a national dialogue about taxation.

Unfortunately, in many countries tax systems remain essentially coercive, offer benefits and exemptions for elites, and most taxpayers have little faith in them. Research indicates that a consensual tax bargain is more likely where taxpayer awareness and education are high; the tax system is transparent and highlights tax-expenditure linkages; taxpayers have shared interests and a high level of mutual trust; there is adequate trust in the integrity of the tax system; taxpayers are organised politically; and voluntary compliance is emphasised.

Thus, in order to improve responsiveness and accountability, reform should:

1. *Improve equity in tax enforcement and administration:* At present, huge gaps in compliance – particularly by national elites and the informal business sector, and in the areas of personal income taxes and natural resources – severely undermine the legitimacy of tax systems. Patchy compliance undermines the belief that others are paying their share, that taxpayers share a common set of interests and that government can be trusted, all of which make collective tax bargaining much less likely. While it will thus be important to tax the informal sector, the consistent taxation of elites is a more pressing, albeit more politically challenging, objective in most countries.

2. *Improve public awareness, transparency and taxpayer services:* Awareness and transparency are basic requirements for building public engagement and trust; without some degree of both, taxation is likely to be characterised by conflict rather than co-operation. Citizens must be aware of the taxes they are paying and be educated about the system of taxation and budgeting, while government must be transparent about tax collection and public spending. At the local level transparency can be achieved by publicising revenue collection and its links to public spending, and by engaging citizens directly in budgeting, revenue raising and assessment processes. At the national level governments can do much more to share revenue information, transparently estimate compliance and revenue performance and more closely monitor tax incentives and their costs. Both levels should consider the use of well-designed tax earmarking to strengthen the links between taxes and what they are spent on.

3. *Broaden and improve direct taxation:* Direct taxes make up a dramatically lower share of revenue in developing nations than in OECD countries. Improving direct taxation would increase equity in taxation and increase the visibility of taxes. This is 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. Property taxes are a particularly politically and administratively difficult issue but deserve renewed attention as part of a governance enhancing agenda.

4. *Strengthen civil society engagement with tax issues:* Tax bargaining requires a process of "constructive contestation": taxpayers must be organised to make demands on government, while both sides must be in a position to reach an inclusive tax bargain, rather than dispensing narrow privileges or engaging in endless conflict. Governments and development partners can help to promote such "constructive contestation" by working to strengthen the involvement of business associations and, more ambitiously, by working with civil society to build the awareness and organisation of taxpayers. Civil society can contribute to political engagement and advance the broader goals of improving transparency, taxpayer awareness and education.

The role of development partners

There has recently been growing policy interest in the ways that foreign aid and development partners influence the relationship between tax and governance. Much of that attention has focused on the impact of aid on levels of domestic tax collection. However, there is no evidence that aid consistently reduces tax effort. On the one hand, aid can reduce a recipient government's need to collect taxes. On the other hand, donors have often:

- provided direct support to strengthening revenue administration;
- applied conditionality aimed at encouraging good domestic revenue performance;
- generated increased demand for public spending and, thus, taxation.

The impact of aid on levels of tax collection is important, but equally important is the impact of aid on how taxes are collected and on the dependence of governments on tax revenue, as a share of total revenue. By reducing the dependence of governments on tax revenue, aid can reduce political pressures for greater responsiveness and accountability. More optmistically, conditionality and technical assistance, when applied carefully, can contribute to the emergence of tax systems that are likely to foster broader governance improvements.

The analysis in this paper concludes by exploring two more speculative insights for donors that emerge from recent research on taxation and state building. These insights suggest that in order to support increased accountability in recipient countries donors may:

1. *Make revenue-raising processes an entry point for efforts to strengthen domestic institutions of accountability, particularly in states recovering from conflict. This could occur at two levels:*
   i. At the **local level:** Support governments to develop transparent and inclusive budgets and revenue-raising plans in order to strengthen tax-expenditure linkages and thus rebuild trust, public engagement and the legitimacy of government.
   ii. At the **national level:** Support the multiple, interlinked, institutions of accountability that are involved with tax policy and administration, as an entry point for the broader strengthening of these institutions.
2. *Make aid funds "more like taxation" in the way that they are linked to accountability.* This would mean supporting downward accountability to citizens for aid funds, instead of prevailing practices that rely on upward accountability to donors. An emphasis on transparency and consultation around budgeting and aid funds, at both the national and local levels, could be an important part of such an agenda.

Chapter 1

Introduction

"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*

Taxation is fundamental to sustainable development – it supports the basic functions of an effective state and sets the context for economic growth. However, the role of taxation in developing a responsive and accountable government and for expanding state capacity is often overlooked.

Recent research has begun to focus on this broader relationship between taxation and statebuilding, 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, can take to strengthen taxation's role in statebuilding. In short, this paper seeks to outline the core elements of governance-focused tax reform.

Until now, most tax reform 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 tax reform "to make tax systems more pro-poor". While this was a specific reference to the importance of redistributive tax structures, it was also an acknowledgement of the need to focus on linking increased public revenue mobilisations to improved public expenditure on poverty reduction programmes.

Increased domestic revenue generation will only lead to improved development outcomes if it 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 it can become a catalyst for broader improvements in government performance.

This 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 political considerations are given secondary attention. Yet, there is mounting evidence that in the long term measures to increase dialogue, transparency, equity and bargaining are essential for building a culture of tax compliance, and thus for 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 publication first sets the scene with a very brief review of the key elements of the current tax reform agenda. The next chapter briefly summarises the linkages between taxation and statebuilding. The third chapter proposes specific tax reform strategies for strengthening these linkages using case examples of the benefits, challenges and risks that are likely to accompany reform efforts.[1] Finally, the fourth chapter turns more explicitly to the impact of aid on revenue-raising incentives, and asks how more positive incentives can be created. It includes some proposals for linking taxation and statebuilding more closely in donor programmes.

1.1. The existing tax reform agenda

The prevailing tax reform agenda in developing countries has focused on three interrelated issues: tax structure, tax administration and the political economy of reform. Here we discuss each very briefly, as they are dealt with in detail elsewhere (*e.g.* Gillis, 1989; Thirsk, 1997).

1.1.1. 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;
- a general simplification of tax codes.

Recent years have witnessed an increasing focus on 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).

1.1.2. 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, autonomy, information technology and taxpayer services.

Reorganisation has focused on moving from agencies organised by tax type, to organisation by core functions and more recently organisation by taxpayer groups. The leading edge of change has been the creation of large taxpayers' units (LTUs, Box 2.5), which are functionally organised and deal with a single tax segment. Reorganisation in other areas of administration has been much slower.

A common strategy in Latin America and Anglophone Africa has been to make the tax function relatively *autonomous* of the civil service and Ministry of Finance in the hope of improving performance by reducing political interference, increasing flexibility and improving wages and working conditions (although see Boxes 1.1 and 2.2). 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; Devas *et al.*, 2001).

Box 1.1. **Integration, reorganisation and autonomy in the Uganda Revenue Authority**

The Uganda Revenue Authority (URA), created in 1991, is among the most studied autonomous revenue agencies in the developing world. At the time of its creation Uganda was still recovering from an extended period of conflict and suffered from low domestic revenue generation and a high degree of aid dependence. The URA was designed to quickly increase revenue collection and was shaped to a large degree by donor input and pressure. The URA was given a large degree of autonomy from the Ministry of Finance and the civil service generally, and enjoyed the direct support of the president. The agency was substantially reorganised along functional lines, over 200 ineffective or corrupt staff were removed, a Ghanaian was selected to lead the agency in an effort to disrupt patronage networks and salaries were increased by an average of 250%, which aided in the recruitment of highly skilled staff. Revenue collection increased spectacularly, from 7% of GDP in 1991 to 12.3% in 1996.

These dramatic gains stopped suddenly in 1996 following widespread protests against an unpopular VAT imposition. Over the next decade revenue collection stagnated at a relatively low level, while accusations of corruption proliferated, and were echoed by the president. The autonomy of the URA was similarly eroded, in part owing to resentment within the civil service about the special treatment it had received. Salary gains were largely eroded by inflation, tax policy authority was returned to the Ministry of Finance and staff hiring, and appointment became politicised once again. While performance has begun to improve again in recent years, the apparent lesson is that while autonomy can be a useful strategy for spurring initial change, autonomy alone is not enough to sustain those gains.

Sources: Therkildsen, 2004; Fjeldstad 2002, 2005; Devas *et al.*, 2001.

Information technology upgrading has been a part of virtually all reform programmes. The aim is to improve data management and analysis, lower compliance costs, reduce the scope for corruption and collusion and improve monitoring. However, 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. They aim to improve taxpayer education and awareness, reduce compliance costs and adopt a "customer" orientation (LeBaube and Vehorn, 1992; Jenkins and Forlemu, 1993; Land, 2004). While some change in attitudes is apparent, progress appears to be limited.

1.1.3. The political economy of reform

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 redistribution of tax gains 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. These include 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). However, two more basic issues lie at the heart of the tax reform challenge:

1. Tax changes invariably confront strong vested interests that stand to lose from any proposed changes. These vested interests are often economic and political elites who are especially able to block reform (Bird, 1989, 1992a).
2. It is very difficult to mobilise public support for tax reform. Tax reform tends to be perceived as threatening even by those who stand to benefit, owing largely to limited trust in government and poor tax education (Ascher, 1989; Bates, 1989).

Box 1.2. **Economic crisis, political change and tax reform**

Dramatic tax reforms usually follow major political change or economic crisis, which underlines the importance of timing in reform. In Nicaragua, the Sandinista guerrillas seized power in 1979 and ushered in an increase in tax revenue from roughly 10% of GDP in 1979 to 30% in 1984. In both Bolivia and Peru tax revenues fell dramatically during the 1980s, to below 5% of GDP. Facing economic crisis Bolivia embarked on a major tax reform in 1986, including granting autonomy to the tax authority, and had more than doubled domestic tax revenues by the end of the decade (Bird, 1992b). Peru pursued a similar course from 1991, and had almost tripled revenue collection by 1995 (Durand and Thorp, 1998). In both cases economic crisis was sufficiently profound to temporarily overcome the resistance of vested interests and generate a national commitment to stabilisation.

Box 1.3. **Horizontal equity as a reform strategy**

The Kenyan government has been a relatively successful tax reformer and has repeatedly used a focus on horizontal equity to reduce public opposition. In the first half of the 1990s, the government implemented a major tax reform which dramatically improved personal and corporate income tax collection. Despite the large increase in tax payments, resistance was relatively muted, largely because the reform promised to increase revenues by reducing rates and expanding enforcement. As a result, those who were already paying supported the reform, while those who were not found it difficult to mount public resistance. In similar fashion the government passed a law requiring the use of electronic tax registers (ETRs) by all VAT-registered businesses in 2005. The goal was to reduce the extent of tax evasion, and it immediately prompted major public protests by the medium-sized businesses that were being targeted. Yet the protests ultimately collapsed as the bulk of citizens did not support the protesting businesses, despite the fact that it was consumers who would bear any price increases. The reason was that the protesters had effectively been labeled “tax evaders” (bolstered by the fact that many of the businesses were owned by the Asian minority), and most citizens supported the concept of equity in tax collection.

Existing research suggests two lessons about successful reform. First, 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). Second, a focus on improving equity in the enforcement of existing taxation (horizontal equity) can be a particularly effective strategy, generating some degree of popular support for reform (Ascher, 1989; Box 1.3).

1.2. 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 strategy for statebuilding. Statebuilding has been defined as "an endogenous process to develop capacity, institutions and legitimacy of the state driven by state-society relationships" (OECD, 2008b). Recent research on taxation and development has found that the need to raise taxation can strengthen state-society relationships with positive consequences for state capacity and the extent to which governments are responsive and accountable to their citizens (Prichard, 2009; Ross, 2004).

The nature of the mechanisms linking taxation and statebuilding is a complex topic in its own right, which is ably handled elsewhere (OECD, 2008b; Moore 2007, 2008). Here we present a simplified summary of the theoretical literature so as to avoid unnecessarily duplicating earlier work. We instead focus on the practical recommendations for taking these ideas forward.

In simplified terms, tax reliance may improve governance through three processes:[2]

1. *Developing a shared interest for economic growth:* Because governments are dependent on taxes and therefore on the prosperity of taxpayers, they will have stronger incentives to promote economic growth.
2. *Developing the state apparatus:* Dependence on taxes and direct taxes in particular requires states to develop a complex bureaucratic apparatus for tax collection. This may lead the way for broader improvements in public administration (Brautigam, 2008a; Prichard and Leonard, forthcoming).
3. *Developing accountability and responsiveness:* Taxation engages taxpayer-citizens collectively in politics and leads them to make claims on government, 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).

This publication explores the implications of the latter two processes for tax reform in the developing world. Much of the evidence comes from the history of statebuilding 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 and b; Prichard and Leonard, forthcoming; Ross, 2004; Timmons, 2005; Chaudhry, 1997; Brautigam, 2008b; Hoffman, and Gibson, 2005; and Gervasoni, 2006). Unfortunately, this research has generally not gone beyond relatively broad statements about the potential governance benefits of reliance on domestic revenue sources. Thus, the remainder of this publication asks what practical steps can be taken to strengthen the relationship between taxation and broader improvements in governance in developing countries.

The next chapter focuses on the linkages between taxation and state capacity, while Chapter 3 explores the linkages between taxation, responsiveness and accountability. Chapter 4 then outlines the broader influence of development partners and foreign aid on these relationships.

Notes

1. This publication 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, the case examples from Ghana, Kenya and Ethiopia are based on this research.
2. With thanks to Mick Moore for proposing the specific terminology used here.

Chapter 2

Tax reform and state capacity

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

1. prompting *administrative innovations*, such as increased meritocracy or improved internal monitoring, which subsequently spread throughout the civil service;
2. generating pressure for *improvements in related agencies* essential to tax collection, such as business registration, foreign investment promotion and land registration;
3. requiring an *enhanced government presence in remote areas*, thus also expanding the reach of government services;
4. providing *data and information* that are 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) found that the erosion of tax reliance undermined 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 in at least some cases, but says little about the specific process of reform. Ongoing research by Prichard, reported in Box 2.1, provides a relatively detailed account of such processes in Ethiopia, though at a much earlier stage of political and economic development.

Box 2.1. **Taxation and administrative development in imperial Ethiopia**

From 1930-1974 Ethiopia was ruled by Emperor Haile Selassie, whose main 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: it was essential for building the fiscal capacity of the state and was symbolically important in replacing feudal rule with modern government. In turn, efforts to expand taxation had profound implications for the nature of public administration and authority in the country. In 1941 the need to improve tax 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 afterwards, 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, a more sophisticated agricultural income tax in 1967 also established 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.

This body of research provides meaningful evidence that tax administration can be a catalyst for broader administrative gains. One of the messages from existing research is that the potential for positive spillovers is likely to be shaped by context. Central to many studies is the prediction that taxes that are particularly demanding from an administrative standpoint are more likely to create positive spillovers. However, research has yet to provide a detailed picture of the conditions that are likely to contribute to positive spillovers (Prichard and Leonard, forthcoming; Leonard and Strauss, 2003). Limited existing research and evidence from tax reform experience suggests four other, less explored considerations that may make positive outcomes more likely:

1. Strong linkages are created with other areas of administration.
2. Data collection, sharing and transparency are given priority.
3. Administrative innovations are potentially replicable.
4. Tax administration is extended to relatively remote areas.

2.1. Building linkages within government

Improvements in tax administration may build state capacity through a simple demonstration effect. However, experience suggests that such automatic learning is far from guaranteed (Box 2.2). Learning is more likely when there are strong linkages between tax administration and other areas of government. In this way improvements and innovations in tax administration either: *(i)* are transmitted relatively explicitly to other areas of government; or *(ii)* create pressure for reform in those related agencies. The experience of the introduction of unique taxpayer identification numbers (TINs) in Latin America illustrates this potential. While initially introduced for tax administration alone, other 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.

Aside from encouraging positive spillovers, building linkages across government is also a very practical administrative strategy. Tax collection involves information gathering,

Box 2.2. **The benefits and pitfalls of autonomy in Peruvian tax reform**

The success of the Peruvian tax reform described in Box 1.2 relied heavily on the creation of a semi-autonomous revenue authority, the *Superintendencia Nacional de Administration Tributaria* (SUNAT). SUNAT was independent of the Ministry of Finance, partially controlled its own budget, enjoyed the active support of the president and increased salaries spectacularly from an average of USD 50 per month to USD 890 per month. Aside from improving revenue generation, it was hoped that these measures would allowed SUNAT to pursue innovative new programmes and become a model for other agencies. However, 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 within 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.

Source: Durand and Thorp, 1998.

especially about the activities and assets of income-earning individuals and businesses. The simplest way 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 2.3 and 2.4). Connections with private sector institutions, including banks and insurance companies are an important strategy in many middle-income countries.

Box 2.3. **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. This underlines the potential for at least incorporating such information into tax enforcement efforts (Bird, 1992b).

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 rather than 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).

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. One example is the experience of the Kenya Revenue Authority: of all of the reforms that improved revenue collection, the relatively straightforward improvements in data sharing between the income tax, VAT and customs departments were noted by many as the most important, as they immediately transformed their ability to cross-reference tax information and improve enforcement.

Box 2.4. **E-Ghana – a good idea still waiting to be implemented**

In Ghana, planning began early this decade to modernise taxation as part of a larger “E-Ghana” information technology (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. This would have vastly improved IRS performance, but several years later the programme remains in the planning stages due to high costs and bureaucratic and political resistance.

Sources: Prichard, 2009a; and World Bank, 2006.

Stressing the importance of linkages need not be at the expense of creating autonomous revenue authorities. Whilst the creation of SARAs can easily lead to the neglect of linkages with the broader public administration, this need not be the case. What is important is to continuously stress the value of linkages and information sharing. Thus, 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. In this way, tax agencies are consciously used as "motors" for broader reform (Boxes 2.5 and 2.6).

Box 2.5. **Learning from the experience of large taxpayers' units**

The creation of large taxpayers' units (LTU) across the developing world parallels the experience of SARAs. The creation of LTUs has been aimed at accelerating reform by setting up a specialised administrative sub-unit to deal with large taxpayers. It was hoped that LTUs would be able to test administrative innovations that could then be transferred to other areas of tax administration. The obvious risk was that collection from large taxpayers would improve, but other areas of administration would be neglected, leading to declining morale and a lack of system-wide reform. A review of LTU experiences conducted by the International Monetary Fund (IMF) found that while they improved tax collection, there was only mixed success in generating positive spillovers to other areas of tax administration. In Argentina, for example, LTU processes were "successfully used to modernise other tax offices", but these gains never reached small taxpayers, while over time "it has not continued to be a motor of change" (Baer, Benon and Toro, 2002). This suggests that there is potential for such a strategy, but it will need to be accompanied by explicit and sustained commitment to building broader linkages.

2.2. Improving data gathering and transparency

As touched on above, tax systems provide essential data to aid broader economic management. This role receives relatively little attention in 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 economic data collected, undermining the quality of economic regulation and planning.

> "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" (Chaudhry, 1989).

This example suggests that improving data gathering would immediately benefit 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. Economic management would likely improve if tax agencies were empowered to collect and process systematic data on taxes paid by firms in particular sectors and on taxes lost due to incentives (Chapter 3.2.4).

Tax administrators themselves frequently point to the broader benefits of improved data gathering. 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 the hope of improving policy planning.[1]

Tax data can also potentially be valuable in other domains. Data collected by the tax administration can often help with law enforcement efforts in developed countries. At the simplest level, tax returns can quickly identify unexplained incomes or suspicious assets that cannot be explained by declared income (*e.g.* Department of the Treasury, 2007). It is likewise sometimes suggested that better data on property taxation can help to clarify land ownership in countries where the overlap of traditional and state land tenure systems has generated insecurity and conflict. While this possibility remains un-researched, it does seem that in many local areas tax payments act as a partial claim to land ownership (Kassahun, 2006; Bird, 1974; Majumdar, Banerjee and Ghosh, 2007). While these more sophisticated benefits are not likely to emerge fully in the short-term, better tax data can sow the seeds of future gains.

2.3. Reforms that can be applied more broadly

Specific improvements in tax administration are unlikely to spread to other areas of public administration, when the elements of tax reform are not relevant to other areas of administration. There is thus 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 Peru, Durand and Thorp (1998) argue that the revenue agency, SUNAT, was the first major government agency to establish fully functional and relatively autonomous offices outside of the capital city. They tentatively propose that this may have become a model for later decentralisation initiatives in Peru. In Chile and Mauritius the revenue authorities have pioneered sophisticated performance-based management systems which became models for other areas of government. The tax agencies also pioneered 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 in rules governing hiring and firing, introducing incremental IT reform or experimenting with different salary scales may eventually lead to innovations elsewhere. Throughout Latin America tax authorities have frequently led the introduction of e-government functions, particularly through electronic filing of tax returns and the electronic management of customs clearance. This 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 (Box 2.4).

By contrast, reforms that cannot reasonably be implemented elsewhere in the civil service, while they may often still be warranted, are not likely to have positive spillovers. Major investments in capital-intensive IT reform or the introduction of very large salary increases fall into this category – they may be useful, but a similar model is unlikely to 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 in order to recruit better skilled staff and discourage corruption. While these were feasible for the relatively privileged tax agencies, they were unaffordable more broadly. Paying higher salaries may, of course, be an important tax reform strategy (and civil service reform strategy more broadly), but tax reform measures that can be replicated in the short term are more likely to allow tax reform to enhance state capacity.

2.4. Improving 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 local areas, especially remote regions (Herbst, 2000; Mkandawire, 2002). As such, efforts to improve local taxation and co-operation between national and local tax officials could allow tax administrative reform to be used as a vehicle for improving broader government capacity. In Bolivia, the expansion of customs administration to remote areas involved constructing a telecommunications network that became the backbone for improved telecommunications for other government agencies. Many governments are showing an increased interest in decentralisation, but local tax capacity remains very weak in most countries (Box 2.6).

Box 2.6. **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 a heavy burden on the poor 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 finding is echoed in other contexts as well. At a more general level, surveys in both Tanzania and Uganda indicate that citizens generally appreciate the need for taxation to support local services, but choose not to comply due to an overwhelming lack of confidence in local government.

Sources: Bahiigwa *et al*., 2004; Fjeldstad and Semboja, 2001.

Despite official pronouncements on decentralisation, central government transfers continue to dominate local government budgets (Fessha and Kirkby, 2008). Moreover, most local tax systems are characterised by their high levels of arbitrariness, coercion and corruption, an anti-poor bias and their contribution to major economic distortions (Bahiigwa *et al*., 2004; Fjeldstad and Therkildsen, 2008; Juul, 2006). While available data is very problematic, evidence suggests that official local government revenue collection frequently comprises less than 5% of total government revenue in low-income countries.[2] This undermines governments' autonomy and capacity to provide basic services, while it also may reduce the potential for local accountability, as discussed in Chapter 3.

The absence of effective taxation outside of major centres appears to result largely from neglect and a dramatic lack of co-ordination 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 co-ordination has provoked 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 2.1) and contemporary examples of how the need to raise local taxes required 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 informally cited by donors is the success of the deconcentration of tax administration in Peru, which, as noted earlier (and further in Box 3.6), has become a model for broader reform, despite some weakening over time (Box 2.2).

The Peruvian case also highlights that taxation may be the most basic expression of the presence of state authority in remote areas. It may therefore be important for creating state legitimacy, and for discouraging the emergence of rival groups (Mkandawire, 2002; Moore, 2007; Box 3.3). While this claim is difficult to prove, the Peruvian case suggests that taxation is important for popular perceptions of state authority. In the early 1980s, the Shining Path rebel movement emerged. By the end of the decade it was "more efficient than the old state in collecting "revolutionary taxes" and applying sanctions in cases of "evasion"" (Durand and Thorp, 1998). 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 indicate the extent to which the rebel movement considered the tax authority to be a threat – thus tax collection was associated with state authority (Weinstein, 2007).

Notes

1. Examples are drawn from the author's own research.
2. This figure is based on the IMF Government Finance Statistics, as well as sporadic country-level evidence, for example Mogues *et al*. (2009), for Ghana. Indicative data on the level of fiscal decentralisation in a handful of states are available in Bird and Vaillancourt (1998a).

Chapter 3

Tax reform, responsiveness and accountability

Taxation can expand responsiveness and accountability by providing incentives for citizens and government to enter into a "tax bargain", or a "fiscal contract": citizens accept and comply with taxes in exchange for government providing 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 on taxation, and of failing to provide reciprocal services to citizens, are also beginning to be documented. At a micro-level, limited survey evidence highlights 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 parts of Tanzania, over 80% of taxpayers expressed the view that taxes were used "only partly" or "not at all" for public services, while 55-60% believed that taxpayers avoided paying taxes as a result of poor services. As importantly, over 90% 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% 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).

In practice, tax bargains may take the form of a relatively explicit *quid pro quo* between governments, taxpayers and their representatives (Chapter 3.2.5), but they are equally likely to take the form of implicit behavioural adjustments:

- If it senses taxpayer resistance to taxation, a government may make certain governance improvements in order to explicitly encourage compliance or acceptance of new taxes (Box 3.1).
- Taxpayer resistance to taxation by an unresponsive government may undermine the stability of the government, leading to future reform (Box 3.1).

Box 3.1. **Implicit tax bargaining: examples from Ghana and Kenya**

1) VAT protests in Ghana

In 1995 the Ghanaian government sought to introduce a VAT. However, 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, causing 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. In 1999, and again in 2003, successive governments sought to increase the VAT rate. To avoid major political protests, they ensured that these new tax revenues were committed to publicly popular health and education programmes.

Sources: Osei, 2000; Prichard, 2009a.

2) Tax resistance and compliance in Kenya

In Kenya in the late 1990s, political opposition to the Moi government began to be reflected in declining income tax compliance despite 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. 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 (Box 3.2 and 3.3). What is most important here is to understand what factors make tax bargaining, either explicit or implicit, more likely to be successful.

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, thus encouraging 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).
- There is a minimum level of trust between taxpayers and government in order to facilitate bargaining.

Box 3.2. Narrow tax bargains with big business in the former Soviet Union and China

Gehlbach (2008) found that many governments in the former Soviet Union provide significant incentives and benefits to large, formerly state-run businesses because those businesses are the largest taxpayers. He focuses on the efforts of the Governor of Pskov region in Northwest Russia to support the emergence of a local vodka industry because vodka production generated large and highly reliable tax revenues for the state. While this is a case of a clear-cut tax bargain – government support in exchange for tax revenue – the bargain is very narrow and does not focus on broad-based governance improvements. A similar pattern is apparent in China where, until recently, local governments controlled a significant share of the corporate tax revenue raised from enterprises within their territory. As a result they often provided special benefits to local firms, such as direct state support and trade protection in order to increase local tax revenues, even when this ran counter to national industrial policy. They were also more likely to support initiatives that generated large profit margins, and thus larger tax revenues, regardless of broader considerations (Bahl, 1998).

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. In practical terms, an accountability-enhancing tax reform agenda may include four priorities, which are addressed in the chapters which follow:

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

3.1. Improving equity in tax enforcement and administration

At present, huge gaps in compliance – particularly for personal income taxes and by national elites, extractive sectors and the informal business sector – severely undermine the legitimacy of tax systems and the likelihood of tax bargaining. A first important step towards making constructive tax bargaining more likely is to improve the equity with which tax laws are enforced, so that all taxpayers are equally subject to them. This approach can also substantially increase revenues, compliance, progressivity and political support for reform. This is true for several reasons:

- Taxpayers are very unlikely to improve compliance if they doubt that existing taxes are enforced equitably. In a survey of local government taxpayers in South Africa, respondents felt that by far the most important factor in improving compliance would be to increase confidence that other taxpayers are also paying their fair share. This emphasises the need for government to create more equitable administration, or at least to establish a credible commitment to achieving it (Fjeldstad, 2004).

- Tax bargaining depends on citizens trusting government to improve governance. When elites receive special treatment, either explicitly or informally, this undermines basic trust in the system. Where trust is low citizens are more likely to simply evade and resist taxes than enter into a tax bargain with government (Box 3.3).
- Taxpayers will only engage in collective action if they are all affected by new or existing taxes in similar ways. When certain groups do not pay taxes this is likely to lead to fragmentation of taxpayer interests, and reduce the likelihood of constructive engagement. Such fragmentation is central, for example, to the weakness of business associations in many developing countries (Chapter 3.4.1). Widespread tax evasion and exemptions among elites poses particular risks, as elites frequently play an important role as catalyst to broader collective action (Box 3.3).

The contrasting experiences of anti-VAT protests in Ghana and Kenya starkly illustrate 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 (Box 3.1). The success of the protests is, in turn, strongly attributable to success in bringing together political elites, large businesses, small businesses and consumers in making shared demands for political liberalisation (Prichard, 2009a). 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 (Box 1.3). The primary reason that the protests failed to gain political traction was that neither consumers nor large taxpayers supported the medium-sized businesses involved in the protests. This reflected the relatively heavier impact of ETRs on medium-sized firms, the implicit importance of ethnic divisions, a lack of trust amongst taxpayers, the effectiveness of horizontal equity as a reform strategy, and a lack of unity amongst businesses which had historically experienced differential tax treatment.[1]

Box 3.3. **Taxation and elite exemptions in Kenya**

Kenya has long been an unusually successful tax collector, but public engagement with tax issues has often been weak and data from the Afrobarometer survey indicates significant hostility to taxation. Both reflects the fact that elites have traditionally enjoyed extensive tax privileges, thus angering regular taxpayers and fragmenting any tax bargaining coalition.

During the 1970s and 1980s exemptions from taxation for the politically well-connected were widespread and well known. The major business associations, far from presenting unified demands for better governance, became conduits for seeking individual privileges. This became a vicious cycle, as elite exemptions undermined the perceived legitimacy of the tax system, thus eroding administrative probity and discouraging taxpayers from seeking a more equitable bargain. By the late 1980s, this had begun to take a toll on both revenue and public satisfaction, thus precipitating reform.

The situation improved in the 1990s, with the glaring exception of Members of Parliament, who remained exempt from benefits taxation despite much higher salaries than most people. In 2006 and again in subsequent years, the Minister of Finance proposed taxing these benefits to increase the legitimacy of the tax system, and this measure received substantial public support. Yet MPs have repeatedly rejected any increase in their tax liabilities despite widespread public anger. Exemptions for MPs have undermined public confidence in the system and appear to be threatening the tax bargain that underpinned large revenue gains after 2002 (Box 3.6).

While many factors contributed to the greater sense of unity amongst Ghanaian protesters, it appears that earlier efforts to improve equity in the application of tax laws played an important role. Furthermore, while taxpayer unity led to short-term conflict with government policy, in the longer term it facilitated dialogue and the passage of a relatively successful new VAT in 1998. This is consistent with the claim that when a government makes a clear commitment to enforcing taxes equitably at all income levels, it can increase both taxpayer unity and trust between taxpayers and government.

The most important challenge to equity in tax enforcement lies in improving tax enforcement among elites, including large informal sector businesses. 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. Many countries also suffer from high levels of politicisation and corruption in enforcement (Bird, 1992a; Bird and Zolt, 2005). In both Ghana (Box 3.4) and Kenya (Box 3.3) tax evasion by elites has undermined the culture of tax compliance, while in both countries efforts to improve enforcement equity have significantly improved broader tax compliance more recently.

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 centres (OFCs). These OFCs, more commonly known as “tax havens” or “secrecy jurisdictions”, offer low tax rates, reduced regulatory standards and extreme forms of secrecy to both individuals and firms, and, in so doing, facilitate aggressive and frequently illegal forms of tax evasion. 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 suggest that revenue losses from only one method – transfer mispricing[2] – may be as high as 5-10% of total tax revenue in many low-income countries (Prichard, 2009; Cobham, 2005). Regardless of precise estimates, it is clear that these practices undermine the ability of 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 OECD has long been the leading international organisation in this respect, beginning with the release of the report on *Harmful Tax Competition* (OECD, 1998). International attention in the aftermath of the global financial crisis has led to meaningful progress by the G20, a group of finance ministers and central bank governors from 20 economies, calling for greater transparency within tax havens and improved information exchange between tax havens and national tax authorities. However, these measures 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. Significant work is needed on several promising initiatives: *(i)* creating multilateral and easier to access mechanisms for information exchange; *(ii)* exploring new corporate accounting standards that require the reporting of revenues, profits and tax payments on a country-by-country basis; *(iii)* reducing secrecy in offshore jurisdictions, including clear reporting of the beneficial owners of offshore assets; and *(iv)* providing capacity building support and international co-operation to improve enforcement in the developing world.[3]

Box 3.4. **Rebuilding a culture of tax payment in Ghana**

When Flt. Lt. Jerry Rawlings seized power in Ghana in a 1981 coup, tax collection had fallen to perilously low levels and confidence in the state was at an all-time low. Rebuilding the tax system was among the first priorities taken on by the government, and it granted significant power and autonomy to the newly created Ministry of Revenue. A central concern was to rehabilitate public confidence that political and economic elites would be fully subject to taxation and that special privileges would be curtailed. To this end the government aggressively pursued suspected tax evaders, with the collection of arrears leading to stunning growth in income tax collection. However, the methods used by the government were often of questionable legality, were sometimes violent and aroused enormous resentment among many elites, and are thus not an ideal model for future reformers. Nevertheless, the more basic decision to target elite taxpayers was vindicated because it appears to have rehabilitated the culture of tax payment and the notion of a social contract, thus laying the foundation for sustained improvements in revenue generation.

Sources: Nugent, 1995; Prichard, 2009a.

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) show that where a country's 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". The limited country-level research on this topic 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; and Chapter 3.3.2).

One reason it is so difficult to tax elites is that they are a politically powerful vested interest against 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. This can lead 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 way of mobilising public support for reform (Box 1.3).

3.2. Improving awareness, transparency and services

Efforts to encourage tax compliance by promising better responsiveness and accountability must be based on dialogue between citizens and government about taxation. Taxpayers must, implicitly or explicitly, be able to 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 without such a national dialogue, governments can still collect some tax revenue, and citizens will still receive some government services, the examples from Chile, Ghana and Kenya, among others, highlight that the most successful countries have fostered some degree of tax bargaining.

In order to have a national dialogue about taxation, citizens must be aware of the taxes they are paying and be educated about the tax and budgetary systems. Government must be transparent about tax collection and public spending. Awareness and transparency are basic requirements 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 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% of respondents favoured the publication of the names of tax evaders and 84% believed that the names of those receiving any kind of tax incentives or exemptions should also 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 also limited – while taxpayers are aware that they are paying tax, too often they have only a partial understanding of how much, why and what for, particularly for indirect taxes.

A belief that maintaining ignorance may lead to politically convenient complacency among taxpayers is misplaced. The most successful tax collectors have generally made taxation more, not less, transparent. It appears that in the absence of information, taxpayers tend to assume the worst and place little trust in tax authorities (Box 3.7).

As such, a governance-enhancing tax reform agenda could incorporate five related elements, each of which will be discussed in turn below: *(i)* increasing transparency; *(ii)* improving taxpayer services; *(iii)* improving the visibility of major taxes; *(iv)* reporting tax expenditures; and *(v)* using tax earmarking to strengthen tax-expenditure linkages.

3.2.1. Increasing transparency

Taxpayers' compliance is shaped to a large degree by:

- whether or not they believe that *other* taxpayers are paying;
- how effectively they believe that revenue is being used;
- whether or not they believe that tax administration is honest and fair. (Fjeldstad, 2004; Berenson, 2006).

All of these forms of trust are undermined by a lack of transparency around tax collection, tax compliance and the use of tax revenue at both the national and local levels. There is reason to believe that improving 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 on 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 3.5), 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 3.5. **Calculating tax compliance and expected revenues**

The failure of governments to provide basic information about tax compliance is often attributed to capacity constraints. However, 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 easy to obtain 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 similar fashion, flat taxes can easily be estimated by simply knowing the number of households. While this appears to be done in many places, it seems that data are rarely 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 (*e.g.* Gupta, 2007). At the simplest level, reporting revenue in real terms and as a share of GDP, as opposed to in absolute terms, would substantially 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 CDFs have partly received a positive reception, they have also been criticised both for bypassing and weakening local authorities, and for their high levels of corruption that are due, at least in part, to their 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 by being transparent about resource transfers and emphasising the message that "this is *your* money". This finding does not necessarily validate the use of CDFs, but underlines the potential for transparency and education to strengthen the basis for citizen engagement with tax and expenditure issues.

Another concrete example of the potential benefits of linking taxation and expenditure comes from a USAID project on market taxes in Guinea. As in 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 the government to explicitly link the collection of market taxes to the construction of improved market facilities. It then posted clear information about revenues and expenditures, both from market taxes and more generally, in nearby public places. 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).

National taxes comprise the overwhelming bulk of total government revenues, and should thus be an important focus of reform efforts. Efforts to improve transparency should include improved reporting of revenue collection and compliance (Box 3.5), 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 (Chapter 3.2.5).

Reforming local taxation could also play a particularly crucial role in promoting tax bargaining, even though local taxes are a much smaller share of total revenue. Most 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. Bahiigwa *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 level must rely on strengthening explicit linkages between tax collection and public expenditure. Their recommendations include: *(i)* working directly with neighbourhood groups to collect the graduated personal tax (since abolished); *(ii)* publicly and regularly declaring how the amounts collected compare to expectations; and *(iii)* explaining the specific implications of changes in collection for public spending. In a similar study on Uganda, Ssewakiriyanga (2004) notes the importance of making budget and expenditure data available to citizens so as to build public support for taxation.

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, driven at least in part by increased citizen engagement (Reinikka and Svensson, 2005). While recent work has emphasised the need to be more realistic about the potential benefits of such transparency, and to consider them in a 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 can be substantial, particularly when linked to efforts of broader community engagement.

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 in collecting revenue. This happened in Guinea, where the markets sellers' association directed the USAID project. In Ghana the government introduced a system of associational taxation for taxing the informal sector. Under this system, small business associations were granted tax collection powers on the understanding that they would then give the revenue to government at the end of a pre-defined period. While the system was not without flaws, it did succeed in bringing significant parts of the informal sector into the tax net with a relatively modest degree of resistance, while providing discrete benefits to taxpayers, such as reduced harassment by police and increased political legitimacy (Joshi and Ayee, 2008; Prichard, 2009). Such efforts to partner directly with the community for tax collection purposes seem to hold significant potential, as long as an appropriate balance can be struck between autonomy for societal groups and clear dictates and enforcement by government.

3.2.2. 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 can immediately improve compliance while laying the foundations for a more effective tax bargain.

The importance of the link between better tax services and 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 over 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 South African survey, small and medium businesses made powerful demands for a better taxpayers' help-desk. 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 (Box 3.6) and measures to reduce compliance costs, including taxpayer support services. Experience in several countries suggests that two other areas may be particularly important: *(i)* improved monitoring of tax officials in order to reduce arbitrary behaviour; and *(ii)* to explicitly engage communities in tax collection efforts, which is possibly the more ambitious of the two.

Box 3.6. **Improved taxpayer services, expanded collection and trust**

The Peruvian tax reform during the early 1990s (Box 1.2) included extensive efforts to improve services and educate taxpayers in order to rehabilitate public perceptions of the tax agency, SUNAT. Efforts to expand public outreach included creating an information centre downtown in the capital city; developing a free taxpayer bulletin, which was reaching 5 000 people by 1994; hosting tax fairs throughout the country; and disseminating important information through newspaper ads and brochures. At the same time a large investment was made in training, with more than one-third of employees sent to professional training courses between 1992 and 1996 and all staff involved in ethics courses. Coupled with good performance, the result was that SUNAT quickly came to be viewed as a model agency by much of the public (Durand and Thorp, 1998). In Rwanda the government has also prioritised public outreach and education, with significant success. This has included a series of Taxpayers' Week events, a focus on improving customer service, making tax issues a prominent subject of speeches by the president, working with local private sector associations and developing taxpayer surveys to identify problem areas and measure success in changing public perceptions (Land, 2004).

Improved monitoring of tax officials

A series of studies has found that the nature of interactions between tax officials and citizens significantly shapes taxpayers' overall perceptions of 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 con-sequences 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 tax evasion penalties that are perceived as arbitrary or excessive, this can actu-ally reduce compliance among other taxpayers. As Ssewakiryanga (2004) argues, "citizen engagement in revenue processes is still very dependent on how they negotiate their relationship with tax collectors."

Engaging communities in tax collection efforts

A second and more ambitious measure is to explicitly engage communities in tax collection efforts. This may simply mean creating institutionalised channels for consulting with taxpayer groups and business associations (Chapter 3.4 and the earlier example of market taxes in Guinea). However, it could go so far as to explicitly involve communities in tax assessment efforts, particularly for local government taxes on property and on small businesses. Both Ethiopia and Uganda have adopted such a strategy to deal with the widespread controversy created by presumptive tax assessments. Both countries have had relatively positive results in terms of building trust and transparency and reducing 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).

3.2.3. Increase the visibility of taxation

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 indirect taxes. Thus, increasing the visibility of taxes appears to be a potentially beneficial area for reform. Governments have often intentionally reduced the visibility of taxes to avoid public opposition, but 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 (Box 3.7).

Some taxes are more visible than others. 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 included in consumer prices, but never explicitly. Similarly, VAT is often not paid by the 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.

Box 3.7. **The political risks of invisible taxes and a lack of public understanding**

While governments are often reluctant to share information about tax incidence due to concerns about public opposition, the absence of accurate information can also give rise to problems. When the VAT was first introduced in Ghana in 1995, a lack of effective public education meant that rumours began to circulate about large price increases, even though such price increases were often either fictitious or driven by misunderstanding of the new tax (Prichard, 2009a). In similar fashion, when Uganda introduced a VAT in 1996, public misunderstanding appears to have played a large part in prompting major protests, as rumours abounded that there would be major price increases. Even the president appears to have made unintentionally misleading statements about the tax, and this appears to have added to the confusion (Therkildsen, 2004).

A shift towards direct taxes can increase the visibility of taxes and is discussed in the next chapter. However, the full replacement of indirect taxes is not feasible, so it is important to consider strategies to increase their visibility and public awareness. The most explicit way to do this is to focus on implementation and enforcement. The United States and Canada increased 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 useful in low-income countries where receipts are rarely used, though it could work in urban areas and for some fuel taxes (Box 3.8). There is thus a need for innovative strategies to improve visibility.

One possibility is for civil society and the media, in partnership with shop owners and government, to play a role in calculating and publicising the share of tax in common purchases. In Kenya the National Taxpayers' Association (NTA), an initiative of the Center for Governance and Development, has discussed this possibility. While still in its infancy, one of the NTA's goals is to strengthen public understanding of 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 more 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 and the Institute of Development Studies brought together researchers, civil society and the media to give the media a more active role in raising public awareness of the actual tax burden, and tax issues more generally.[4]

Box 3.8. **Hidden taxation in fuel prices**

While more research is needed, in most low-income countries consumers appear to be aware of taxes on goods and services, but have little day-to-day sense of their magnitude. In the case of fuel taxes, governments have frequently increased taxes discreetly, disguised by changes in world prices. In Ghana fuel prices were increased substantially in 1990 in response to global oil price increases triggered by the first Gulf War. Yet, when global prices fell in 1991, the government did not reduce prices, thus dramatically increasing the share of taxes in total prices (Prichard, 2009a). In 2008/09, Ethiopia followed an almost identical path, increasing fuel prices in response to high global prices in 2008, but maintaining those high prices even after global prices fell during 2009. While the government argued that tax increases were needed to offset earlier price subsidies, the underlying lesson is that public awareness of indirect taxation is often very limited.

3.2.4. Track tax expenditures more effectively

The fact, or even the perception, that politically-connected elites are not paying taxes can undermine trust in tax systems, and thus damage the potential for tax bargaining. While many countries have improved compliance, this is being negatively affected by the lack of transparency around tax expenditures (Box 3.9). Tax expenditures are revenues that are lost from granting 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 sceptical, 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 *et al.*, 2002).

While the economic efficiency of incentives is an important question, the short-term goal should be to at least ensure that such 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 a meaningful policy debate around incentives, it appears also 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,[5] a more basic accounting of direct revenue foregone – by recipient, tax type, region and economic sector – can 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.

Box 3.9. **The abuse of tax incentives in Ghana**

Ghana appears to have a relatively well-administered incentives scheme – incentives are quite clearly defined in law and require parliamentary approval. However, the fact that there is still strong evidence of significant abuse indicates the widespread abuse of tax incentives in the developing world. 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. This means 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 the potential tax revenue, while 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 *et al*., 2007).

Despite the general lack of transparency around incentives, there are positive examples for countries to draw on. For example, the Brazilian Federal Constitution of 1988 required 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). 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, some of whom were supporters of the ruling party.

3.2.5. Use tax earmarking to strengthen links between tax and public spending

Tax earmarking involves 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 over the link 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.

However, while all countries use tax earmarking to some degree, the practice remains unpopular with fiscal experts. One reason is that tax earmarking reduces 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. Such behaviour can actually undermine public confidence in the tax system if it is perceived to be manipulative (Box 3.10).

Box 3.10. **The risks of purely political earmarking**

The Ghanaian government has repeatedly used earmarking as a legitimate means to achieve revenue and expenditure goals, but it also recently used tax earmarking in a more political and misleading fashion. In need of revenue before the 2008 elections, the government sought to introduce a tax on mobile phone usage. News of the new tax sparked public resistance, and the government responded by promising to earmark the new revenues for a popular Youth Employment Scheme (YES). Yet, in practice, the legislation creating the new tax allocated only 30% of revenues to the YES, and did not put any mechanisms in place to ensure that this revenue would actually be delivered or that it could be easily monitored. This political strategy took advantage of most citizens' lack of information, but the deception reduced trust among citizens who did become aware of it (Prichard, 2009a).

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, such as 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.

Other experience from Ghana, where tax earmarking has become a prominent revenue strategy at the national level, underlines the particular risks and benefits of tax earmarking. In 2000, the government sought to increase the VAT rate from 10% to 12.5%, but faced heavy public opposition. In order to secure public acceptance, the government earmarked 100% 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%, but again faced stiff public opposition. In response, the tax increase was renamed the National Health Insurance Levy and was 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:

1. *Fungibility.* Analysing fungibility looks at 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 for some uses, but overall funding in both areas has increased significantly.

2. *Accountability*. Analysing accountability is concerned with the transparency of accounts and the potential for citizen oversight. This analysis presents a more mixed story. The two new funds are managed by appointed Boards of Directors, which has increased 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 can formalise important tax bargains between citizens and governments. But positive outcomes will only be achieved if earmarking is implemented effectively and honestly. This means that earmarking must be:

- *substantive and specific*, and guarantee 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.

3.3. 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 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 difficult 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. The following subchapters explore four ways of broadening and improving direct taxation:

1. Emphasise personal income taxes.
2. Expand the tax base using positive incentives for compliance.
3. Strengthen property taxes.
4. Strengthen local taxation.

3.3.1. 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 (Chapter 3.1).[6] Significant improvements could dramatically improve both revenue and the legitimacy of the tax system (Box 3.11).

Box 3.11. **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 enforce 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).

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. In most countries, measures such as improving information sharing across tax 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, who have wielded sufficient political power to resist improved collection (Bird and Zolt, 2005).

Box 3.12. **Using information technology to improve income taxation**

Information technology has featured prominently in virtually all major tax reform programmes of the past 20 years, and there is no doubt that better use of IT holds enormous potential. That said, IT reform cannot succeed in isolation and fixation on large, transformational projects has often led to long delays and high costs at the expense of making more gradual progress.

The reform of the IT budgeting system in Ethiopia, while not specific to taxation, provides a compelling example of a successful programme. The Ethiopian budgeting and accounting systems present particularly difficult challenges, owing to their relatively high degree of decentralisation. Despite this complexity, the reform programme, which aimed to automate the entire public financial management system, adopted a strategy of *incremental process change* rather than *radical process innovation*. By building from existing processes and capacity, and implementing additional process reforms only when there was demand and capacity to do so, the project was delivered both early and under budget. This was achieved despite the fact that during the 10 years of the project the country experienced a major new decentralisation law, a two-year war and significant political uncertainty (Peterson, 2006).

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 this focus. Second, the spread of information technology has eased, though certainly not eliminated, the administrative challenges involved (Box 3.12). Third, growing commitment to collecting income taxes from the informal sector (discussed in the next chapter) is providing justification for an equal focus on personal income taxes, as well as easing resistance to taxation among some elites (Prichard, 2009; Torgler and Schneider, 2007). Finally, democratisation has provided a mechanism for organising public support for progressive tax reforms (Box 3.13).

Box 3.13. **Democracy as a catalyst for more equitable taxation**

The impact of democracy on taxation and redistribution remains a contentious question (Cheibub, 1998; Ross, 2006; Boix, 2001). Democracy certainly does not guarantee popular support for equitable tax reform, but whereas it is generally very difficult to mobilise public support for tax reform, electoral processes can galvanise public support and overcome powerful vested interests. This publication has already noted several cases, in which democratisation was accompanied by greater tax collection (*e.g.* Ghana, Kenya and Chile). In Kenya elections also provided a mechanism for citizens to call for greater equity in taxation. Despite being very highly paid, Kenyan MPs do not pay taxes on the non-monetary benefits that they receive (Box 3.3). The public has long expressed demands for change, but MPs have repeatedly rejected reform. When MPs explicitly rejected reform in 2006, the public vowed that those MPs who had rejected the measure would suffer at the ballot box, and observers believe that public anger over the tax conflict did, in fact, affect election results. By making tax an electoral issue, greater pressure for reform was created, although the Kenyan conflict continues.

3.3.2. 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 the government (Chapter 3.4.1). This not only holds the potential for a stronger tax bargain, but also potentially increases the breadth of interests represented. In Kenya, the expansion of efforts to tax the informal sector was linked to government efforts to secure greater compliance from larger businesses, while one of the outcomes of the process was increased co-operation among the major business associations and nascent informal sector associations (Box 3.18).

Second, and more generally, improving taxation of the informal sector can 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 Association was largely a reaction to increasingly assertive tax enforcement efforts by the government (Prichard, 2009a). Similarly, 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, there are governance 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 could be tangible benefits – such as reduced police harassment, access to business support services or improved public services – or a broader political commitment to inclusiveness by governments (Box 3.14).

Box 3.14. **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 project by the UK Department for International Development (DFID) 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% of firms believed that formalisation would, in principle, help their enterprises to grow. In Liberia, over 40% of medium-sized enterprises had actually tried to formalise, but had given up due to complicated procedures and bureaucratic costs.

Achieving greater formalisation requires reducing the costs and providing visible benefits to those that formalise. The most important barrier does not appear to be levels of taxation, but bureaucratic complexity, the costs of business registration and tax compliance. Kamunyori (2007) found that *informal sector* operators in Kenya would be willing to accept taxation if the business registration process was more transparent and less costly, if they were protected from corrupt local officials and offered greater political legitimacy. In the DFID study, Liberian firms also emphasised a desire to avoid corruption and abuse by local officials as a potential incentive to formalise (Everest-Philips, 2008).

The most successful cases are those in which governments have offered explicit positive incentives to enter the tax net. The Ghana Public Road Transport Union (GPRTU) accepted new taxation in exchange for guarantees that members 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). It is not hard to imagine efforts to improve access by SMEs to government contracts, or to provide 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”.

In a recent speech, 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.”[7] Others go even further, explaining that the key barrier to taxing the informal sector is political resistance due to the potential for controversy; if the strategy for taxing the informal sector were based on positive incentives, this political resistance would also be reduced.

3.3.3. 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. It has also long been suggested that land taxation could encourage more efficient land use, though this outcome has remained elusive. Property taxes are also the most frequently suggested means to improve local taxation, because, unlike most large taxes, they can be efficiently collected by local government (Bird, 1974; Rajaraman, 2004).

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 3.15). Property taxes have a very wide incidence 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 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 among taxpayers when the government fulfils its commitments.

Box 3.15. **Property taxation and political engagement**

During the 1980s, members of the Karen and Langata District Association (KDLA) in Kenya became increasingly frustrated with high municipal property taxes and the absence of effective service provision or fiscal transparency. The KLDA went to court to demand that the City Council improve transparency before collecting additional taxes. Although the KLDA won the case, the City Council refused to comply, and the result is that tax payments have been languishing 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.

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 scepticism about the political feasibility of land taxes, they also reflect their positive potential, as conflict is often a precursor to political reform.

As with income tax reform, it is essential to recognise that despite the technical challenges inherent in expanding property tax collection, major progress is possible if the political will can be developed. Ethiopia, despite having particularly limited technical capacity within government, has a highly effective land tax regime, albeit at very low rates. In 2004, the two primary rural land taxes generated 0.27% 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. Compliance levels in the same year were estimated at over 90% in two of the country's largest regions, Amhara and SNPPR. 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).

Box 3.16. **Partnering with traditional authorities**

In many countries in sub-Saharan Africa property taxation must take account of the role of traditional authorities, as these authorities often exercise full or partial control over large tracts of land. The existing approach has overwhelmingly been to leave lands controlled by traditional authorities outside of the tax net, and this was, for example, explicit in South Africa's new property tax law (Bahl, Smoke and Soloman, 2003). An alternative may be to seek to engage traditional authorities in the tax collection process, while simultaneously reserving some areas for traditional authorities alone. This may mirror the success of other efforts to partner with local communities for tax assessment purposes described earlier. In Ghana, the government has partnered with GTZ to conduct such a pilot project. After an extended period of consultation, a decision was taken to initially involve traditional authorities in improving tax education in local areas, as an uncontroversial way to use taxation as a catalyst for linking the formal and the traditional in local government. While every country will be different, engaging traditional authorities around tax issues may be a way to spur broader governance improvements (Edling and Nguyen-Thanh, 2006).

3.3.4. 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 because it was one of the first approaches to embrace a connection between taxation, responsiveness and accountability. One of the arguments for fiscal decentralisation is the belief that decentralised revenue collection and budgeting will 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). By moving revenue and expenditure decisions to the local level, therefore making them more visible, decentralisation should strengthen the connections between what people pay and what they get in return. 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. This is why local taxation may be particularly suitable for promoting tax bargaining, even when the absolute amounts collected are modest.

Unfortunately, concrete examples linking local taxation to expanded responsiveness and accountability have been poorly documented. One exception is Prichard's ongoing work in Ethiopia, which explores the strengthening and reform of a presumptive tax system for small businesses beginning in 2001. The key administrative challenge, as with any presumptive tax, was estimating 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 giving power to citizens' representatives and increasing engagement and awareness. Second, following 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 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 publication, points to the potential for even relatively modest local taxes to have important political benefits.

Of course, it is important not to see fiscal decentralisation as a panacea for better governance. The literature on the development impact of fiscal decentralisation is vast and conflicting (*e.g.* de Mello and Barenstein, 2002). While some studies argue that greater reliance on local tax revenue improves government performance (Hoffman and Gibson, 2005), others find that decentralisation may also lead to greater coercion, exploitation and abuse (Juul, 2006; Fjeldstad and Semboja, 2001; Fjeldstad, 2001). This chapter has emphasised a particular dimension of this relationship – the potential for strengthening bargaining between citizens and government around taxation. However, the decision to pursue fiscal decentralisation must be based on a detailed understanding of local conditions and of the multiple factors that will shape the performance of decentralisation.

3.4. 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. Taxpayers must be organised to make demands on government, but both sides must also be willing to reach an inclusive tax bargain rather than dispensing narrow privileges or engaging in endless conflict. Governments, civil society and development partners can help promote such "constructive contestation" by pursuing a number of measures that are beyond the direct realm of tax reform:

1. Support the formation of inclusive business associations.
2. Support the formation of taxpayers' associations.
3. Strengthen partnerships between tax authorities and civil society.

3.4.1. 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 tend to be relatively weak and highly fragmented (Goldsmith, 2002; Brautigam *et al*., 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 personal ties to government has undermined the ability of business to develop an independent and effective political voice (Handley, 2008). In some cases 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 (Boxes 3.17 and 3.18).

Unfortunately, relatively little is known about how to foster the growth of unified and effective business associations. The basic challenge is to generate incentives for businesses of all sizes to prioritise their collective needs over fragmented rent-seeking. One lesson from 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 3.18). Another lesson is that business associations are more likely to be effective when they engage in income-generating activities that provide 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).

Box 3.17. **Fragmented business associations and failed reform in Brazil**

Brazil is unique in that it collects very substantial tax revenue but has struggled to build an effective, and equitable, income tax system. This failure to improve income taxation has been blamed on sharp divisions within society, which has made arriving at a broadly acceptable tax bargain difficult (Lieberman, 2002). Consistent with this view, Brazilian business associations are notable for their weakness and fragmentation (Schneider, 2005). While the absence of organised opposition might be expected to make tax reform easier, Weyland (1996) finds just the opposite. The disorganisation of business has ensured a near universal rejection of tax reform efforts. Throughout the 1980s and 1990s, the government repeatedly sought to reform and expand business taxation in order to cope with both economic and political crises, but despite the urgent need for reform, the divisions within the business community prevented any constructive engagement with government.

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 there is evidence for the potential for such associations through 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.[8] 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.

Box 3.18. **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, b), Uganda and Tanzania (Gloppen and Rakner, 2002).

There is little research into the process through which business associations may come to include smaller firms. However, an emerging process in Kenya does provide some interesting insights into the incentives at play. As business associations in Kenya became more institutionalised after 2002 (Box 3.18) 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. KEPSA was motivated by the desire to improve tax compliance among small firms and to expand its own political legitimacy.

3.4.2. Support the formation of taxpayers' associations

The counterpoint to business associations is the development of taxpayers' associations. Like business associations, these associations can also engage in "constructive contestation" with government. They can create pressure for greater equity in tax reform, and for reciprocity in taxation, and can also be valuable partners to government, organising debates on taxation and expanding public education and engagement. Unfortunately, taxpayers' associations are rare, politically weak and almost completely unresearched in low-income countries.

The newly-formed National Taxpayers' Association (NTA) in Kenya is one example in sub-Saharan Africa of an effort to establish a relatively inclusive and nationwide body, though it remains in its infancy. 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 of the Constituency Development Funds (CDF; Chapter 3.2.1), 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."[9] At a micro level this provides compelling, though still preliminary, evidence that taxation can mobilise communities to seek government responsiveness and accountability. A similar 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.

3.4.3. Strengthen partnerships between tax authorities and civil society

The concept of constructive contestation implies both contestation and partnership. Governments can partner with civil society organisations to achieve a more equitable and effective tax agenda. Aside from the broad potential for bargaining with social groups to facilitate reform and compliance, governments can also work 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 because of their links to taxpayers, and the fact that taxpayers may trust them more than the tax administration. Where trusted non-governmental bodies reinforce the importance of paying taxes, and can explain controversial tax issues clearly, this can increase trust and 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 social groups. It has worked 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 non-government tax professionals who can help private firms with tax filing 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 their members to comply. Those who pay taxes 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).

Notes

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

2. In simplified terms, transfer mispricing refers to the undervaluation of exports, and overvaluation of imports, in order to transfer reported profits out of developing countries and into low tax jurisdictions.

3. There is a wide array of forums and organisations involved in these processes. Two have a particularly sharp focus on issues affecting developing countries: (i) the OECD Tax and Development Task Force created in 2010; and (ii) the International Tax Compact, launched by the German Federal Ministry for Economic Cooperation and Development.

4. Additional information available at *http://www2.ids.ac.uk/gdr/cfs/TaxNews/PANOSPARTNERSHIP.html*.

5. 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.

6. The weakness of mining and forestry taxation is arguably equally problematic, but this publication is not focused on these so-called "resource rents".

7. 20 November 2009, African Tax Administration Forum meeting, Kampala, Uganda.

8. With thanks to Dr. Odd-Helge Fjeldstad for this example.

9. Interview conducted by the author.

Chapter 4

The role of development partners in building tax-governance linkages

This publication has so far addressed ways that governments, civil society and development partners can work together to build tax systems that contribute to the broader state-building process. This chapter looks in greater detail at the implications of these findings for development partners. It proceeds in four parts, beginning with relatively well known issues and moving towards more speculative possibilities for donors to improve their impact.

4.1. The influence of foreign aid on tax effort

There is increasingly widespread concern that the availability of foreign aid may reduce incentives for developing country governments to raise domestic revenue. This may in turn negatively affect the quality of governance by reducing pressure for state capacity development and incentives for governments to bargain with citizens over taxes (Moore, 1998). In practice, most governments are genuine in their desire to raise revenue, but the availability of large foreign aid flows may reduce the urgency with which revenue collection is pursued. There is an additional risk that aid-dependent governments will particularly shy away from politically demanding income, property and local tax reforms, even though these are precisely the areas that are likely to be most important to tax-governance linkages.

Despite frequent discussion of this risk, there is no compelling evidence that foreign aid consistently leads to reduced levels of tax collection in recipient countries. Many early studies concluded that foreign aid has had a systematically negative impact on tax revenue and tax administration (Remmer, 2004; Gupta *et al*., 2004; Devarajan, *et al*., 1999; Brautigam and Knack, 2004; Knack, 2009). However, several more recent and more econometrically robust studies have found a negligible or even positive impact of aid on tax revenue (Gupta, 2007; Clist and Morrissey, 2010; Brun, Guerineau and Chambas, 2008).

The ambiguity of these findings almost certainly reflects the fact that foreign aid impacts domestic tax collection in multiple ways. In simplified terms, aid can be conceptualised as affecting revenue collection through four channels:

1. *Pure revenue incentives*: On its own, the presence of foreign aid is almost certainly a disincentive to revenue collection, similar to access to natural resource revenue.
2. *Technical assistance*: Development partners frequently provide direct technical support to tax reform projects, as well as support the growth of international communities of tax professionals that have been essential to tax reform in recent decades.
3. *Conditionality*: Donors frequently make domestic revenue collection a condition for aid disbursement, both through broad program conditionality at the national level and requirements for matching funds for aid projects at the local level.

4. *Increased demand for public spending*: While frequently overlooked, it has long been recognised that aid may contribute to escalating public spending, and thus greater need for tax revenue. Aid projects from schools to roads frequently imply long-term maintenance and operational costs for governments (Collier, 2006; Fjeldstad and Moore, 2008; Sanchez, 2006).

The fundamental question is whether these positive incentives for revenue generation are sufficiently strong to offset the basic fiscal disincentives created by foreign aid, and available evidence suggests that the answer is likely to be context specific. It is abundantly clear that in some cases direct donor support for tax reform has been important to large increases in revenue generation. The effectiveness of revenue conditionality is more ambiguous and contested, and there is little direct research on the topic. However, it appears that revenue conditionality often is an important factor in promoting revenue enhancement. Research from Ethiopia suggests that conditionality can vary in its effectiveness even within a given country and over time (Box 4.1). In broad terms, it appears likely to be most effective when the political environment is already conducive to reform, and when donor governments have a high degree of political leverage with the recipient government.

The message that emerges is that the relationship between foreign aid and levels of domestic taxation is much more complicated than the simple models that have sometimes been proposed. In different settings, and at different times, foreign aid has had conflicting impacts on domestic tax collection, as well as a profound influence on how revenue is collected. These impacts are likely to have very important implications for linkages between taxation and statebuilding, but further research and analysis is urgently needed.

Box 4.1. **Mixed experience with revenue conditionality in Ethiopia**

When Ethiopia emerged from civil war in 1991, it began to receive large inflows of foreign aid, which have continued ever since. By the late 1990s, it had made some progress in increasing its domestic revenue base, but revenue remained a low priority amongst the many demands of reconstruction. At the end of 1998, Ethiopia went to war with neighbouring Eritrea, placing further strain on government revenues. In the aftermath of the war the government implemented a long-awaited tax reform and enjoyed impressive revenue gains given the low level of economic development. Yet, in 2005, following a highly controversial election, revenue again declined as the government reduced tax rates and enforcement in an effort to ease public discontent. These tax cuts were undertaken despite a looming fiscal and economic crisis, and renewed revenue effort only fully emerged in 2009.

What does this tell us about the relationship between foreign aid and revenue? On the one hand, it appears that foreign funds reduced tax effort from 1995-2000 and after 2005. Without foreign funds the government would have had little choice but to move more urgently to increase revenue during the 1990s. Likewise, given Ethiopia's relatively weak revenue base, it is hard to imagine that it could have allowed the relatively large revenue decline that occurred after 2005 if it was not receiving foreign revenues. On the other hand, during interviews conducted by the author senior officials almost universally cited external pressure (especially from the IMF) and support as crucial factors in motivating the 2001 tax reform. These conflicting messages reflect the complex impacts of donors on revenue generation.

The most pressing question is whether, on balance, foreign aid has undermined tax-governance linkages. Much more research is needed here. Speculatively, it is difficult to be overly critical of the fiscal space created by donors in the 1990s, given the huge demands of post-war reconstruction. More controversial is the extent to which donor funds after 2005 may have facilitated government efforts to buy political support through tax cuts, when it may otherwise have been forced to take a more politically challenging route. Unfortunately, it is impossible to know with certainty how taxation would have evolved in the absence of aid, let alone what this would have meant for governance; this example serves largely to highlight the risks and complexity of the issue as a starting point for further research.

4.2. The broader impact of aid on tax-governance linkages

The preceding discussion suggests that the impact of aid on taxation is relatively ambiguous, and that blanket claims about the negative impact of aid on domestic taxation are unjustified. However, the equally important message for development partners is that aid may shape the relationship between taxation and improved governance in much broader ways.

At the most basic level, aid alters the "dependence" of governments on tax revenue as a share of total government revenue. This may undermine the potential for taxation to contribute to the expansion of responsiveness and accountability. There are two reasons for this. First, access to aid may make governments less willing to make concessions to taxpayers in order to secure tax revenue. In other words, access to aid may reduce the urgency of government revenue needs and thus reduce pressure for tax-related concessions to taxpayers. Whereas a government without access to aid may make concessions to taxpayers in order to secure urgently needed revenue, a government with ready access to aid may be able to adopt a more coercive approach or may be able to achieve revenue gains at times when it is politically less costly.

Second, the presence of significant foreign aid may reduce the likelihood that taxpayers will engage in collective action to make demands on government. When the government has access to significant foreign aid, the apparent "price" of public services, defined as the level of services relative to the taxes paid, will decline, potentially reducing the likelihood of political mobilisation (Ross, 2004). In addition, governments that are heavily reliant on foreign aid may be responsive to donor demands rather than the demands of citizens, contributing to a sense of disempowerment among citizen groups with long-term consequences for levels of public engagement (Moss, Pettersson and van de Walle, 2006; van de Walle, 2005). Taken together, these arguments provide a strong *a priori* case for believing that while foreign aid does not consistently lead to lower levels of tax collection, it remains likely to reduce the potential for tax bargaining through its impact on levels of dependence on tax revenue. Unfortunately, this claim is extremely difficult to test empirically, and more research is warranted.

As important as the impact of aid on levels of dependence on tax revenue is the impact of aid on *how tax is collected*. The core message of this paper has been that the specific character of tax systems and of tax reform is very important to strengthening connections between taxation and broader governance gains, but this possibility has never figured centrally in tax reform efforts. The likely components of a governance-focused tax reform agenda have already been discussed at length; it is worth paying special attention to the implications of this approach for donor conditionality.

Fjeldstad (2001) has studied the impact of conditionality at the local government level in Tanzania, focusing on donor requirements for local matching funds for aid projects. He found that donor demands that local authorities increase their own revenue in order to access donor funds succeeded in motivating local authorities to significantly increase revenue. But he also found that the increase in revenue was achieved by the use of increasingly coercive tax collection methods, effectively extracting additional resources from the most readily available sources, irrespective of equity and the rule of law. In effect, he argues that conditionality led to increased levels of tax collection, but also encouraged the use of increasingly coercive methods, reducing the potential for taxation to contribute to the expansion of responsiveness and accountability.

While there are no such studies at the national level, similar dangers appear likely. One of the underlying messages of this study is that while modest revenue gains can be achieved through increased coercion and technical efficiency, the construction of effective revenue systems in the long term requires building a social contract around revenue and expenditure. Thus, donor conditions which require short-term increases in revenue may lead governments to focus on "hard" measures – short-term technical and coercive measures – to increase revenue. This may come at the expense of investing in "soft" areas – such as building a national dialogue around taxation – which are essential in the long term, but may yield limited revenue gains in the short term.

As revenue conditionality is likely to promote coercion and short-term measures, an alternative approach is for donors to place greater emphasis on how tax is collected when designing conditions and support for tax reform efforts. These "soft" aspects of tax collection include horizontal and vertical equity, taxpayer awareness and education, transparency, strengthening tax-expenditure linkages and bargaining with taxpayers and organised groups. None of these issues are entirely new and have long been part of the tax reform agenda in theory, but in practice they have received relatively little attention. Governments and donors also need performance indicators related to these areas, rather than focusing overwhelmingly on changes in the tax share of GDP. These indicators should measure equity, awareness, transparency and public engagement. These are difficult, but not impossible, to quantify and are essential for ensuring that tax reform improves accountability. Some donor programmes do emphasise broadening the tax base, but unless this issue is approached carefully this may create pressure for increasingly coercive behaviour towards informal sector operators, rather than encouraging long-term bargaining with small taxpayers.

4.3. Using revenue-raising processes to strengthen accountability

This paper has presented a growing body of evidence that taxation can be a spur to broader improvements in governments. This argues for strengthening tax systems in developing countries, and for pursuing tax reform in a way that encourages broader governance gains. It also points to the more speculative possibility that governments and donors may be able to use the revenue-raising process as an entry point for improving governance more broadly.

There is no existing research on this topic, due to the fact that tax reform has rarely been a central element of state building programs (Boyce and O'Donnell, 2007). However, anecdotal evidence suggests that successfully linking taxation to improved public spending and performance can rapidly improve trust in government, public engagement and government performance. Surges in voluntary tax compliance have, for example, recently been noted by observers in Freetown, Sierra Leone, and Lagos State, Nigeria.[1] In both cases these very rapid gains have been attributed to government explicitly linking tax compliance to specific governance commitments, and then following through on those promises, while in Sierra Leone compliance again declined when the government was perceived to have violated its promises. While much more rigorous research is clearly needed, the potential for such processes appears to be reasonably widely accepted among tax administrators themselves, thus suggesting their credibility.

This suggests that supporting robust and inclusive revenue-raising processes may be an effective entry point for promoting broader improvements in accountability. This is not a magic bullet for success, but it is attractive in that it seeks to build accountability relatively organically, beginning with one of the most basic aspects of statebuilding and state-society relations. Such efforts would be likely to vary between the local and national levels, and it is worth sketching the broad contours of such a strategy.

At the **local level**, the goal would likely be to strengthen the basic effectiveness of local government by simultaneously building legitimacy, public trust in government and public engagement in oversight. This may be particularly valuable in countries recovering from conflicts where trust, legitimacy and engagement have been severely eroded. An idealised process might involve the following steps:

- The local government announces that it will provide a set of public goods as long as it can raise a certain level of public funds. An increase or decrease in revenue could be explicitly linked to increased or decreased services.
- The government then turns to the community or community representatives to endorse a plan for raising that revenue and to implement that plan as transparently as possible.
- Where possible the government might work directly with community groups in implementing the revenue collection plan, as in cases noted earlier in this publication in which citizens were directly involved in tax assessment or tax collection was outsourced to well-defined community groups (Chapter 3.4).
- If the government succeeds in raising the revenue and delivering on its spending promises, this may sow the seeds for further gains in subsequent years.

At the **national level**, such explicit and binding tax-expenditure linkages are more difficult to achieve, though specific tax earmarking may be able to play a positive role (Chapter 3.2.5). Reform could centre on strengthening the role of parliaments, political parties, courts, media and other civil society organisations in the revenue-raising process. This possibility follows recent work by the OECD that proposes that strengthening accountability across institutions around a single issue may be more effective than trying to strengthen individual institutions in isolation (Hudson, 2009). If this strategy was adopted, revenue raising would be an ideal focus because it involves a broad range of accountability institutions and because it is so fundamental to the statebuilding process. Schematically, such a tax-focused accountability agenda might include a variety of institutions and roles:

- The role of parliament in setting tax policy and the reform agenda for tax administration. There is a pervasive feeling that international institutions have dominated this process, while parliament has lacked the capacity or inclination to be more actively involved. The remarkable similarity of tax policies and administrations across the developing world, and the persistence of certain legacies of colonial administration in sub-Saharan Africa in particular, would seem to support this contention.
- The oversight role played by parliament to oversee tax incentives or the use of earmarked tax revenues, such as road funds.
- The oversight roles played by anti-corruption agencies or the auditor general, and the ability of these institutions to confront internal corruption in the tax agencies, elite tax evasion and/or the granting of tax incentives without appropriate oversight.
- The role of the judiciary and police in supporting tax collection efforts and prosecuting tax fraud. Both institutions have been cited as major impediments to effective tax collection in many countries (Durand and Thorp, 1998; Therkildsen, 2004).

- The extent to which relevant agencies make information on revenue collection readily available to the public and the possible need for legislation to improve the public right to information.

4.4. How can aid be more like taxation?

Having made a series of specific proposals, this final chapter focuses on a question: Given that taxation is more likely to promote domestic accountability than foreign aid or resource rents, could aid be delivered in a way that makes it "act" more like taxation? While the absence of specific research in this area makes concrete answers impossible, the analysis presented in this publication does permit a more conceptual reflection on this question.

This study began by noting that taxation may be a catalyst for broader improvements in accountability through three general channels:

1. Tax payments may promote a greater sense of ownership of government programmes among taxpayers. This may lead to direct conflict sparked by taxation or the long term expansion of public engagement, oversight and demands for accountability.
2. Tax reliance gives the government stronger incentives to meet citizen demands in order to improve voluntary tax compliance; it correspondingly gives citizens leverage over government through their ability to reduce compliance and thus weaken unpopular governments.
3. Tax reliance gives governments stronger incentives to support economic growth, as its revenue base is directly reliant on the wealth of taxpayers.

To what extent can aid emulate these processes in practice? The last two processes imply that tax-reliant governments will often lose revenue when they either *(i)* become excessively unaccountable and unpopular; or *(ii)* unreasonably undermine local wealth creation, for example through widespread corruption or politically-driven economic intervention. Aid can have the same effect if aid volumes fall in response to a lack of government accountability or government behaviour that undermines local wealth creation.

In theory donors already adhere to these principles, with aid conditionality designed to ensure that improved government performance is rewarded, and poor performance is met by declining aid flows. In practice, the question is more complicated, as donors have often failed to effectively implement such performance-based conditionality (van de Walle, 2005; Moss *et al.*, 2006). This debate is far beyond the scope of this paper; the point here is simply to note that the basic logic of broad conditionality related to accountability and growth promotion appears consistent with the goal of "making aid more like tax".[2]

More interesting are the implications of the fact that taxation encourages improved governance by promoting downward accountability through citizen ownership of, and engagement with, government programmes. This model is in sharp contrast to the reality of aid, which tends to re-orient accountability relationships upward, making government respond to donor demands rather than to the demands of citizens. Critics argue that this upward accountability may actually reduce downward accountability – *i.e.* citizen activism and engagement – by creating a sense of disempowerment and a lack of ownership of government programmes. The prominence of upward accountability systems may also deprive citizens of the basic information and forums needed to demand downward accountability

(Moss *et al.*, 2006; Radelet, 2006). Thus, citizens are less likely to demand accountability in the use of aid funds because they do not think of aid as "their money", have no accurate information on aid volumes and lack channels for providing input into the effectiveness of aid funds.

This line of reasoning suggests that if aid is to be more like taxation, then aid conditionality should focus on the emergence of accountability from below, rather than relying on accountability from above.[3] This, in turn, means generating a sense of citizen ownership of aid revenue and providing them with the information and forums needed to effectively oversee aid spending and accountability. This objective is distinct from the issue of "ownership" discussed in the Paris Declaration on Aid Effectiveness,[4] which primarily refers to ownership of the development process by country governments and implementing agencies. It also goes far beyond the participatory processes for preparing poverty reduction strategy papers (PRSP), which solicit citizen input, but do not provide strong mechanisms for citizens to shape and oversee aid programmes over time. Moreover, PRSPs largely pursue accountability through contracting between governments and donors.

While promoting downward accountability around aid funds is attractive, implementation is more complex and there is little practical experience on which to draw. A starting point is to look at the two tangible things that are missing, and which could facilitate downward accountability: *(i)* public information on aid funded programmes; and *(ii)* channels and forums for citizens to oversee aid-funded programmes.

Improving public information should be straightforward, although genuine access to information (at the grassroots level and in a form that is meaningful to average citizens) remains surprisingly limited in much of the developing world. This suggests that donors could, in principle, reduce the emphasis on conditionality related to policy and implementation in favour of a demand for total transparency at the national and local levels. This demand, it should be noted, should also be directed at donors themselves. They too frequently lack transparency about their programmes, which is likely to perpetuate feelings of disenfranchisement among citizens.

Creating channels and forums for citizens to oversee aid implementation dovetails with the demand for transparency, as donors could likewise downplay traditional demands for upward accountability in favour of process driven conditionality requiring the creation of community forums to discuss the use of donor funds. These discussions might, most logically, be linked to revenue raising and budgeting processes at the local level, as these processes are natural building blocks for local accountability. This proposal is not entirely unlike existing donor programmes designed to encourage participatory development, but it differs in emphasising citizen oversight, rather than merely citizen input, and in focusing on the most natural locus for such deliberation: the annual revenue raising and budgeting process. Unfortunately, research dealing with these ideas in practice is extremely scarce, and these recommendations are correspondingly speculative, and primarily designed to spur further debate and research.

Notes

1. Katrina Manson, "Sierra Leone's Ghetto Taxpayers", BBC News, 12 September 2008; Discussion at the West Africa Regional Meeting of the Tax Justice Network-Africa, 28-29 October 2009, Accra, Ghana.

2. It should be noted that this is very different from the argument that aid should only be given to countries with strong institutions. Instead, it is an argument for conditioning aid on relative progress, even where institutions are weak, rather than on absolute levels, as existing research suggests that it is relative progress (or regression) that plays an important role in shaping domestic revenue performance (Prichard, 2009a).

3. While often implicit in discussions about aid, particularly among national civil society networks, this line of thinking appears to be surprisingly weakly developed as an explicit research topic. It was the subject of a workshop at the Civil Society Forum at the World Bank and IMF Board of Governors Meeting in October 2009. The Center for Global Development has made more general reference to the importance of access to information on donor projects as part of encouraging accountability from below, in relation to proposals for so-called cash-on-delivery aid modalities.

4. *www.oecd.org/document/18/0,3343,en_2649_3236398_35401554_1_1_1_1,00.html*.

Chapter 5

Conclusions

This publication 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 development unless it is accompanied by simultaneous efforts to enhance state capacity, responsiveness and accountability. Second, the measures proposed here – broadly aimed at strengthening national dialogues around taxation and supporting more integrated administrative structures – are indispensable to any long-term strategy for achieving revenue stability and self-sufficiency.

This publication has pointed towards specific, concrete steps that can be taken by governments and donors to strengthen tax-governance linkages. These measures fall into three broad categories:

1. specific measures to enhance and re-orient the dominant tax reform agenda;
2. support for civil society actors to engage in debates about tax issues;
3. managing the provision of foreign aid in ways that maximise positive revenue raising incentives and local accountability.

A growing literature suggests that the benefits from pursuing these measures are potentially large, and tax administrators themselves are increasingly echoing this sentiment. This publication is nonetheless still only a preliminary statement on the topic. Systematic country-level research on the linkages between taxation and statebuilding 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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Citizen-State Relations

IMPROVING GOVERNANCE THROUGH TAX REFORM

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