TAXATION, STATE BUILDING AND AID

Factsheet – Update December 2009

The link between taxation and governance is not immediately apparent, but in fact one is vital for the other. Taxation can stimulate a process of negotiation and bargaining between states and their citizens. Recent work[1] by the OECD/DAC GOVNET[2] demonstrates how taxation can contribute to more effective and accountable states. Donors can take practical steps to support tax reforms that strengthen better governance.

WHY DOES TAXATION MATTER FOR GOVERNANCE?

Historically, bargaining between governments and taxpayers has played a central role in state building and the emergence of democratic governance. Box 1 identifies how a social contract can be established around tax. More recently, tax relationships have also helped to underpin broad-based growth and state efficiency in some East Asian developmental states.

Box 1: Taxation can increase state capacity, accountability and responsiveness

When governments depend on a large number of taxpayers for revenue they have incentives to promote broad prosperity, and to develop bureaucracies capable of collecting and administering taxes effectively. This makes governments more responsive to their citizens and helps build state *capacity*.

Bargaining with citizens over tax makes governments more *accountable*, as taxpayers mobilise to resist or negotiate tax demands, monitor how tax is collected and used, and insist on having a greater say in public policy in exchange for compliance with tax demands. As tax compliance increases, state *capacity* improves and the taxation process becomes more efficient and predictable. Better public policy results from debate and negotiation with citizens.

Today the circumstances facing developing countries are different, so the historical experience of tax bargaining as the basis for state building does not automatically follow. But the lessons are the same. Lack of dependence on citizens for revenue is a major cause of weak, unresponsive governance in many poor countries. In addition, domestic resource mobilisation often relies heavily on large tax payers, including multinationals, which makes it inherently difficult to create a valid social contract with the poor.

The malign effect of the "resource curse" is well documented: states that earn large surpluses from oil and minerals exports are not dependent on their citizens for revenue. Consequently, they have few incentives to promote broad economic development, or to be responsive to their citizens. Moreover, extractive industries are often in the hands of multinationals which exploit the international tax system to avoid their fiscal responsibilities. This undermines the fiscal contract even further. Making governments more responsive and accountable to their own citizens is a global priority. Taxation can help to do this.

1. Governance, Taxation and Accountability: Issues and Practice
2. Network on Governance, *www.oecd.org/dac/governance*.

CAN AID UNDERMINE TAX RELATIONSHIPS?

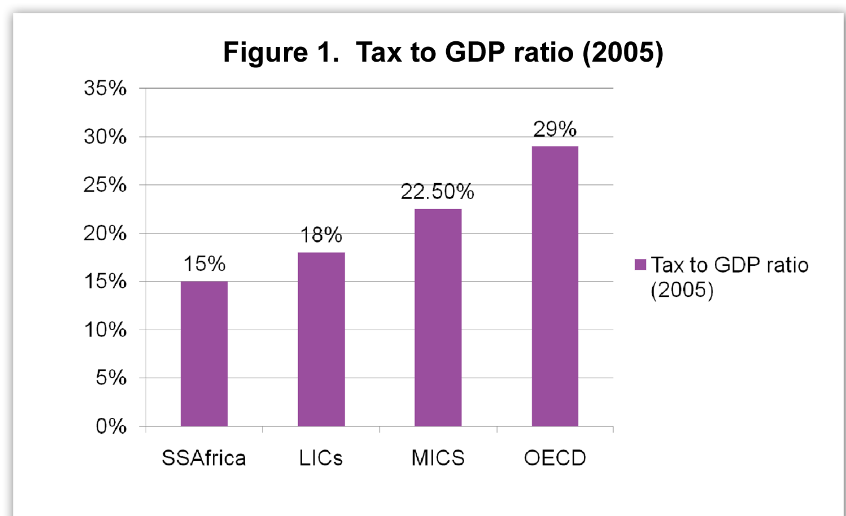
This question has become more urgent in the light of donor commitments to scale up assistance to aid-dependent countries, especially in Africa. Here, many aid-dependent countries are generating increasing revenue from natural resource exports, fuelled by growing demands from developed and transitional economies.

Aid has arguably a less damaging effect on governance than natural resource rents and there is no conclusive evidence that it actually depresses domestic revenue mobilisation. Nevertheless, donors should be alert to the risk that long-term aid dependency can further weaken the need for partner governments to be accountable to their own citizens. A renewed focus on enhancing domestic revenues through broadly-based taxation is therefore needed, alongside higher aid flows. Increased revenue can also help guard against unpredictable aid flows, ensure that aid-funded investments are sustainable, and prepare for an orderly exit from aid in the long term.

WHAT CAN DEVELOPING COUNTRIES DO?

How tax is raised matters, not just how much. Governments need to tax a larger number of citizens and enterprises more consensually. This is very challenging in many poor countries.

Poor countries often lack the resources and capacity to build effective tax collection systems. Citizens may be unwilling to pay tax, frequently reflecting an often accurate perception that governments consistently misuse public funds. It is also difficult to collect tax from low income, agrarian economies with large informal sectors, and to avoid coercion, especially at local level. Moreover, the poorest already pay an equivalent of tax in the form of bribes and informal fees. The global shift away from trade taxes has added to the problems of domestic revenue-raising in poor countries. They often lack the resources and capacity to build effective tax collection systems.



Although there have been improvements in revenue raising efforts over the last few years, half of sub-Saharan African countries still mobilise less than 15% of their GDP in tax revenues (*Figure 1*).

However, there are also reasons for optimism. Global programmes of tax reform, although focused on fiscal objectives, have the potential to improve governance. A shift away from indirect trade taxes in favour of VAT has made tax more visible, especially to small businesses. Simpler, more transparent tax systems and a widening of the tax net can encourage taxpayer mobilisation. Better tax administration can improve relations with taxpayers, and thus voluntary compliance. Small, practical changes to tax design and improvements in tax administration can encourage taxpayers to engage in constructive bargaining with government.

At the international level significant progress was made in 2009 by the OECD in tackling tax havens – with strong political support from the G20. The G20 and the OECD are working with the Global Forum on Transparency and Exchange of Information to enable developing countries to benefit directly from the increasingly transparent international tax environment.

Box 2. Tax Compliance Certificates in Malawi

In 2004, the Malawi Revenue Authority decided to reward tax compliant businesses by giving them tax compliance certificates on an annual basis. Local banks have unilaterally started using such certificates as a requirement for businesses seeking loans, as an index of overall credit worthiness.

This has led to an increase in tax compliance for large and medium taxpayers, and there has been a motivational effect on other smaller taxpayers, who are keen to qualify for the certificates.

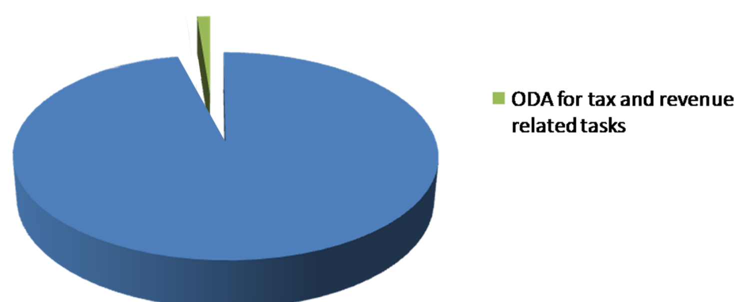
Source: adapted from Government of Malawi, 2007.

Taxing the informal sector remains a challenge, although experience, for example from the road transport sector in Ghana, suggests that innovative approaches can work. There is also potential for reform at sub-national levels, for example, through the introduction of an urban property tax. Effective communication by local authorities to show people how their tax is contributing to specific public programmes can help improve compliance.

HOW CAN DONORS HELP?

Donors can do more to support revenue raising efforts in partner countries in ways that are likely to improve governance. In 2007, only 0.15%[3] (USD 185.6 million) of official development assistance (ODA) was dedicated to tax and revenue related tasks (*Figure 2*).

Figure 2. Tax related assistance as a proportion of total Official Development Assistance (ODA) in 2007



There are successful examples to build on *(Box 3)*; and also lessons to learn from past tax assistance. Political commitment to reform is crucial, and more important than the formal status of revenue authorities. Experience underlines the importance of local leadership, locally developed solutions, and donor sensitivity to local political and social context. A good entry point is provided by tax officials from developing countries, who increasingly participate in organised global networks of tax professionals and contribute to an emerging consensus about tax reform.

Box 3. Tax reform: The governance dimension in Rwanda

DFID's support to the Rwandan Revenue Authority (RRA) has resulted in a significant increase in domestic revenue (from 9% of GDP in 1998 to 14.7% in 2005). Costs of collection have also been reduced. This success is the result of strengthening internal organisational structures and processes and of building accountable relationships with external partners, such as central and local government, a growing tax profession and taxpayers themselves. The RRA now plays an important role in strengthening relationships between citizens and the state, helping to build a "social contract" based on trust and co-operation.

Source: DFID, 2007.

3. Excludes IMF.

OECD member countries and donors can also do more to influence the enabling environment for improved revenue generation by:

- Constructing a compact between developed and aid-dependent countries in which more - and more predictable - aid is provided in the short term, in return for enhanced domestic resource mobilisation.
- Helping to ensure that multinational enterprises pay a fair share of taxes.
- Facilitating dialogue with international tax specialists on how they can help to improve governance through taxation.
- Giving special priority to regional initiatives and South-South learning on tax reform for improved governance.
- Providing more collective and harmonised support to tax reform, and tax and customs administration.
- Continue to ensure developing countries have the capacity and voice to take advantage of the more transparent international tax environment.