

# Taxation, Governance and State-Building: Concepts and Issues

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# Outline of the presentation

- I. Why taxation matters for development
- II. Perspectives on taxation and state-building
  - Core concepts and analytical approaches
- III. The 'Taxation - aid – governance' discourse

# I. Why taxation matters for development

1. Developing state capacity for service delivery

2. State building

- Shaping state-citizens relations
- Democratisation

*“The history of state revenue production is the history of the evolution of the state” (Margaret Levi, 1988:1)*

- Still, taxation rarely central in economic and policy debates in poor, aid dependent countries
- Why?

# The politics of taxation in poor countries

- Taxation generally *not* high on the domestic political agenda in the case countries
- The politics of taxation tend to take place in non-public arenas
- Typically, small lobby groups pressure for exemptions, for rate reductions on imports, or bargain with officials or ministers about tax liabilities
- Major debates in Parliament about tax issues or about tax reforms are rare as are statements by political parties about *their* tax policies
- Central government taxation is shaped by technical staff (from MoFinance, RAs, IFI and donor advisors) rather than by Parliament
- Local government taxation is a major exception to this:
  - Around election time, local gov. taxation often high on the political agenda of both national and local politicians
  - The politicisation of local gov. taxes undermines tax collection efforts

# Taxation and Governance

## Propositions

- Bargaining over taxes is central to building relations of accountability between state and citizens based on mutual rights and obligations
- The emergence of a representative government is more likely when the state faces incentives to increase income through bargaining with citizens than through foreign aid & natural resource rents
- For taxation to have a positive effect on accountability taxes must be 'felt' by a majority of citizens

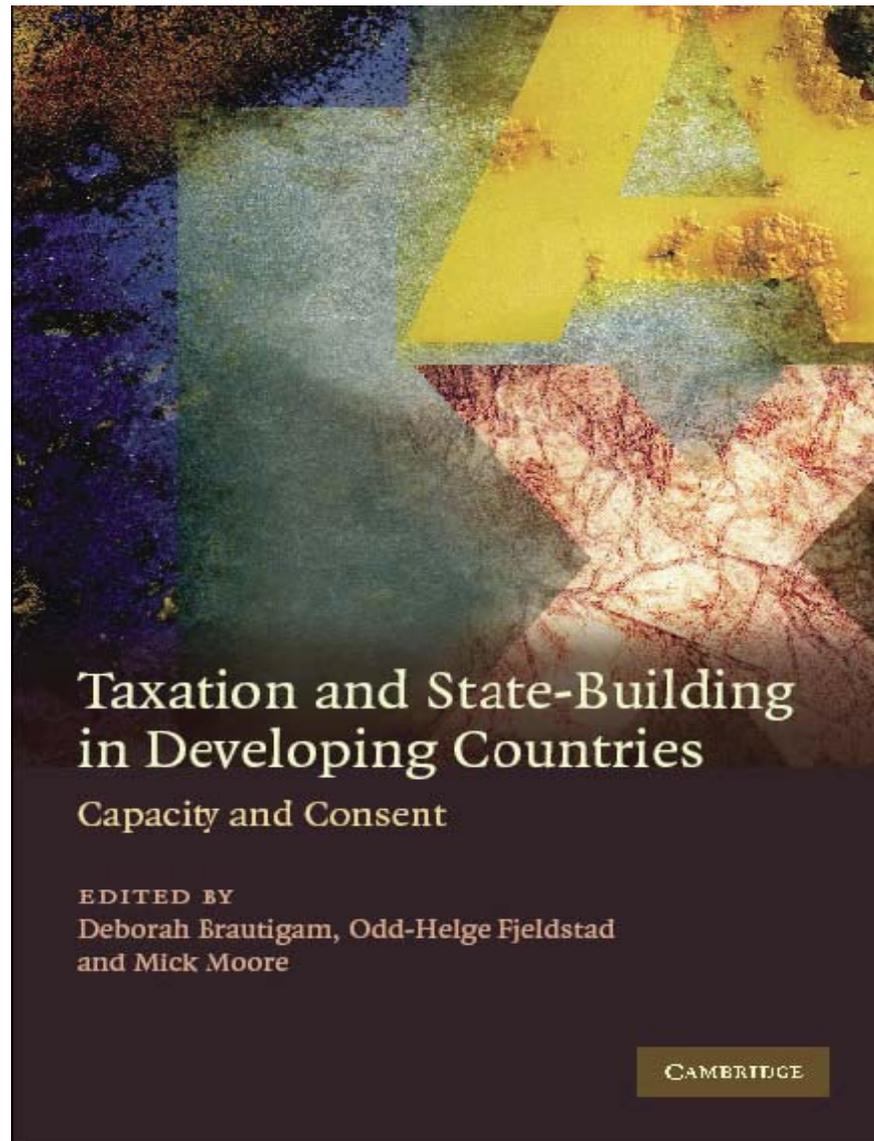
**Developing countries differ** structurally from those in wealthier regions:

- Politically and economically dependent on commodity exports
- Often large agrarian and informal sectors
- Some recently emerged from central planning systems
- High levels of exposure to external political and economic influence and to aid donors and IFIs

# Taxation and Governance in developing countries

## Two main questions:

1. *How do taxation and sources of public revenue affect state building and governance in contemporary developing countries?*
  - Coercion versus consent
2. *What are the key political considerations involved in constructing arrangements that enable governments of contemporary developing countries to tax more effectively, more equitably, and more sustainably?*



# Taxation and state-building in developing countries: Capacity and Consent

## **Purpose of the book:**

- To demonstrate how tax systems and polities interact with and shape one another in developing countries

## **Core policy position:**

- A politically-informed analysis of the relationship between taxation and state formation often leads to recommendations different from those espoused by the “Washington Consensus”

## II. Perspectives on taxation and state-building

1. New institutionalism perspective
  - Fiscal contract and quasi-voluntary compliance
  
2. Historical institutionalism perspective
  - Political domestic institutions and historical development of tax systems
  
3. Political economy perspective
  - Taxation and accountability
  - 'Unearned' versus 'earned' revenues

# 1. New institutionalism perspective on taxation:

## Fiscal contract and quasi-voluntary compliance

Levi (1988, 1997, 2006):

- *Social fiscal contract*: the idea of bargaining and negotiation over taxes, whereby a pattern of accountability based on reciprocity and mutual obligations between state and society is established
- *Rulers are predators* who maximise revenue under constraints
- *Quasi-voluntary compliance* will occur when taxpayers have confidence that rulers keep their part of the 'contract' and other constituents keep their

## Taxation in democracies and dictatorships

- Cheibub (1998): Regime type has no independent effect on the government's ability to tax
- Fauvelle-Aymar (1999): Autocracies have higher levels of taxation than democracies
- Boix (2001): Taxation grows more rapidly in democracies
- Ross (2004) and Mahon (2005): Find support for the fiscal contract idea: Statistical evidence between increases in tax burden and, within a few years, increases in the degree of democracy

## 2. Historical institutionalism perspective: Political institutions

Steinmo (1993): 'Taxation and democracy' (Sweden, USA & UK)

- Gives credit to periods of war for raising the overall tax take, but ...
- tax systems differ in systematic ways that can be explained by differences in the design of democratic institutions:
  - Constitutions
  - Electoral rules
  - Parliamentary committees
  
- These democratic institutions affect:
  - the relative bargaining power of those most interested in tax outcomes
  - the information available to them
  - their incentives for seeking particular kinds of tax policy

### 3. Political economy perspective: Taxation and accountability

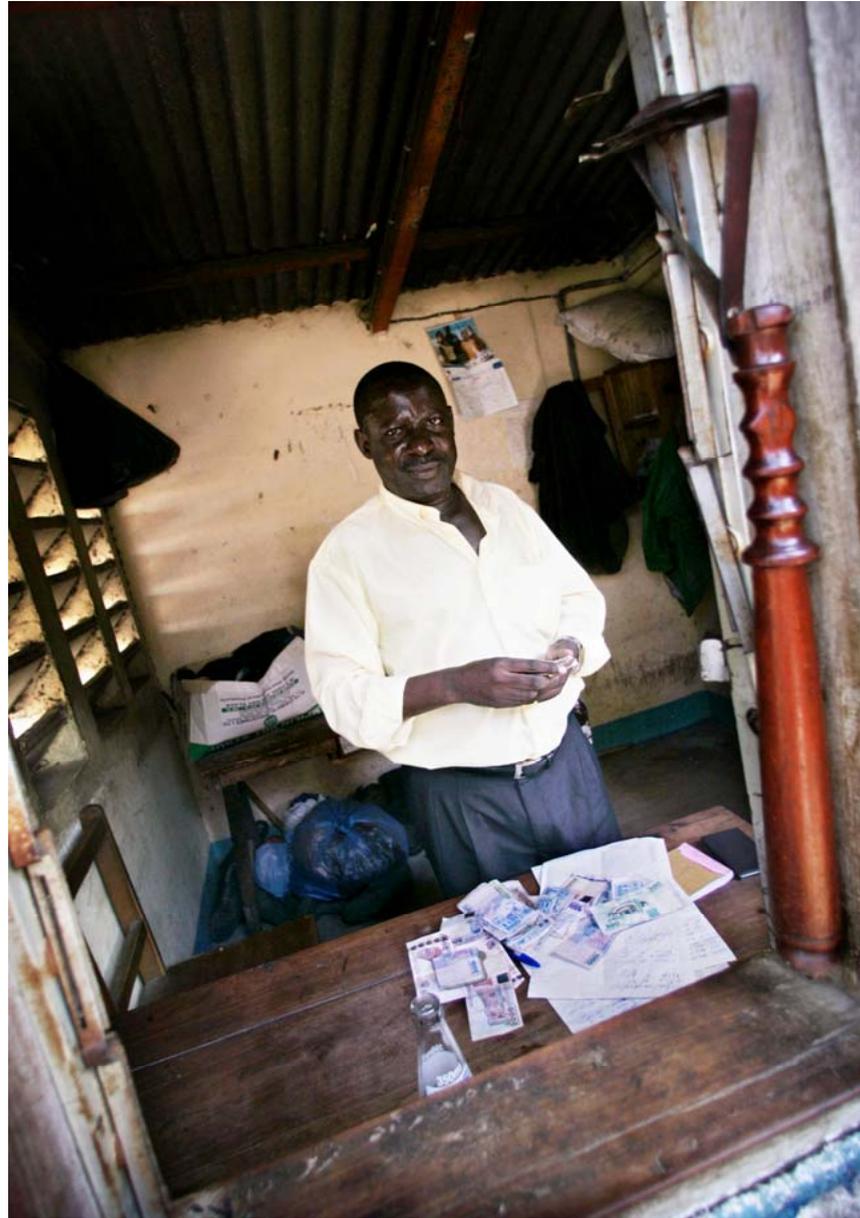
Moore (1998, 2004, 2008):

- The emergency of a representative government is 'more likely' when states face incentives to increase income through bargaining with citizens, than through natural resource rents and aid
  
- Taxes are 'earned income' which depends on:
  - The state's bureaucratic efforts to raise revenues
  - The degree of reciprocity between citizens and state (services in exchange for tax payment)
  
- Democratic governance is undermined when a state relies on a high degree of 'unearned' income derived from aid or natural resource rents, and minimal efforts are used to raise revenues by direct forms of taxation agreed with citizens through political involvement

Fjeldstad (2003; Fjeldstad & Therkildsen 2008; Bernstein & Lü 2008):

- Taxation in poor agrarian economies tends to be coercive and conflictual, and the overall tax take tends to remain low

## A tax collector and his tool: Tanzania (2006)



### **III. Questions arising from the 'taxation-aid-governance' discourse:**

- Considerable differences in tax-to-GDP ratios across poor countries:
  - How to explain these differences?
  
- Fiscal contract:
  - How does taxation and sources of public revenues affect state-society relations in contemporary developing countries?
  
- Aid dependency likely to increase:
  - Does aid dependency reduce domestic efforts to raise taxes and undermine the future sustainability of the public sector?
  - How does aid dependency affect accountability relations between state and society?

## Aid dependency is set to worsen (OECD-DAC 2006)

Country	ODA in % of GDP	ODA in % of GDP (DAC simulation)	ODA per head (USD)	ODA in % of Gov expenditure
	2004	2010	2003	2004
Burundi	53.4	63.2	31.0	88
Sierra Leone	33.4	48.5	57.0	128.0
Malawi	26.3	43.3	47.0	71.0
Rwanda	25.3	40.5	40.0	78.0
Ethiopia	22.6	31.7	23.0	79.0
Nicaragua	28.3	29.5	152.0	103.0
Zambia	20.1	27.4	56.0	48.0
Uganda	17.0	26.7	39.0	64.0
Tanzania	16.1	26.1	47.0	77.0
Ghana	15.7	23.0	46.0	37.0
Cambodia	10.4	13.5	38.0	67.0

# Aid dependency and taxation

Moore (1998): Countries highly dependent on foreign aid over long periods will face difficulties in developing (tax) extractive capacity

Brautigam & Knack (2004): Large levels of aid reduce government revenue generation

Deverajan, Rajcooner & Swaroop (1999): Aid to African countries reduces tax revenues by an average of ten percent (though variations among countries)

Two aspects of aid dependence:

- (i) Aid creates more financial autonomy as governments' prolonged reliance on 'unearned' income requires little bargaining with taxpayers
- (ii) The aid system, with multiple uncoordinated donors and their independent project management units, can promote institutional destruction in what already are weak states

# Tax versus oil revenues

- **Aid has certain similarities with oil as a form of revenue**
  - Empirical evidence that oil and mineral rich countries tend to be less democratic than states which depend on taxation of citizens for their fiscal base
  
- **A main difference between oil and aid income** is that donors are increasingly directly involved in recipient country tax policy making and administration:
  - Donors push for ambitious overall revenue targets
  - In some contexts this may have significant but unintended negative influences on:
    - Taxpayers' rights through coercive tax enforcement
    - Accountability by empowering the bureaucracy at the expense of elected politicians