

Taxation and tax reforms in developing countries: Illustrations from sub-Saharan Africa

Odd-Helge Fjeldstad
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Preface

This report presents the major areas of research and key findings of the research programme *Taxation, aid and democracy*. The research programme aims to contribute to a better understanding of the evolution of tax systems in African countries. Furthermore, it aims to explore the constraints and options available for policy making on revenue mobilisation and democratisation. In depth studies on the tax systems in Namibia, Tanzania and Uganda have been carried out. Moreover, on specific issues such as tax administration and local government finances, the research has also covered other sub-Saharan countries, including South Africa and Zambia.

The research, including methods and theoretical perspectives, is based primarily in the disciplines of economics and political science, but also involves public administration, law and economic history. By December 2002, twenty-three researchers from six countries had been engaged in the research programme, although none on a full time basis and some only provided minor inputs. Funding has been acquired from the Research Council of Norway; the Ministry of Foreign Affairs (Danida), Denmark; Chr. Michelsen Institute, Bergen; and Institute for International Studies, Copenhagen. The programme is co-ordinated by senior researchers Odd-Helge Fjeldstad (CMI) and Ole Therkildsen (IIS). Further details on the research programme can be found on www.cmi.no

A previous version of this study was presented at a seminar on 'taxation and development' organised by the *Norwegian Agency for Development Co-operation* (NORAD) in Oslo, 24 April 2003. We thank the participants for useful comments. We have also benefited from comments by Jan Isaksen.

Bergen, May 2003

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Executive summary

1 Why taxation matters for development

- 1.1 Most sub-Saharan countries face a trilemma with respect to taxation: (1) There is an urgent and obvious need for more revenues to enable resource poor states to provide and maintain even the most basic public services. (2) The reality is, however, that those with political power and economic ability are few and do not want to pay tax. (3) Moreover, those without political power are many, have almost nothing to tax, and do also resist paying taxes.
- 1.2 It follows that the challenge for taxation is to raise domestic revenues from consenting citizens in poor and increasingly open economies. Elected governments in African countries are therefore facing hard choices about taxation. These decisions will most likely have profound impacts on the future of democratisation itself and on public service provision. They will also have considerable implications for the politics and sustainability of aid.

2. Central government taxation

- 2.1 There are several general criteria against which any revenue scheme should be judged. These include the ability to raise revenues, effects on economic efficiency, equity implications and administrative feasibility. Tax systems in many African countries score low on most of these criteria.
- 2.2 During the 1990s tax reforms became part of the larger structural adjustment programmes and incorporated in the economic restructuring agreements with the International Finance Institutions. These reforms focused on the central government tax system.
- 2.3 The tax policies now recommended for developing countries are much the same as those which are advocated for industrial countries. In most cases this involves the introduction of measures to broadening the tax base while simultaneously flattening the tax rates. Despite important differences in their economic and cultural background, developing countries have tended to modify their tax systems in roughly the same direction. The following trends in taxation can be clearly seen:
 - introduction of the value-added tax;
 - lower personal and corporate income taxes;
 - simplification of the tax bands and broadening of the bases for personal and corporate income taxes;
 - reduction of import duties and simplification of the rate structure;
 - simplification of the excise duty structure; and
 - abolition of export taxes.
- 2.4 In spite of recent reforms, the central government tax systems in many African countries are characterised by an excessive number of different taxes with rate structures that are difficult for taxpayers to understand. The tax law is often written in a confusing way and manuals to consult absent, opening up for discretionary powers by tax enforcers. Tax officials may, for instance, have discretion over important decisions, such as those related to the provision of tax exemptions, determination of tax liabilities, selection of audits, litigation, etc.
- 2.5 Many administrative procedures, including the procedures for reporting tax revenues, lack transparency and are poorly monitored both within the tax administration and by the Auditor General's Office. Moreover, the legal sanctions to enforce punishments on either taxpayers or collectors who do not comply with the law are often weak. Each of these factors contributes to a non-transparent and complicated tax system, where taxpayers' are left to the discretionary power of collectors and politicians. A system that also is costly to administrate.

3. Local government taxation

- 3.1 Despite recent and major central government tax reforms, local government tax systems have remained largely unchanged. Our research shows that many local taxes have a distorting effect on resource allocation decisions, and an inhibiting effect on the start-up of new enterprises. These effects occur because the effective tax rates vary greatly between different goods that are traded, and because license fees are set too high for start-up small-scale enterprises to survive. In addition, the levels and types of local taxes often result in the tax burden falling more on the poor than on the relatively better off in local communities. Moreover, a widely found characteristic of local government revenue systems in Africa is the huge number of revenue instruments in use. The complicated and non-transparent local government tax system is costly to administrate and it facilitates corruption and mismanagement.
- 3.2 Little or no co-ordination with respect to taxation is observed between various levels of government in Africa. This has partly to do with lack of capacity at all levels of government. At the local level the serious shortage of qualified staff at the treasury and planning departments is particularly critical. But also at the ministerial level there are only few tax experts. This has led to double-taxation of the same revenue base, as well as inconsistencies between local and central government tax policies. In Tanzania, for instance, some local governments are imposing high taxes on export crops, which are inconsistent with the national government's policy to encourage export production. Also in Namibia there seems to be little co-ordination between the Ministry of Finance and the ministry responsible for regions and local governments with respect to taxation.
- 3.3 Widespread tax resistance is observed in many local authorities. People may take to the extreme to evade taxes, for instance, by literally hiding in the bush when tax collectors are approaching. Many local governments rely heavily on simple physical coercion ensure compliance. Roadblocks manned by the local militia or police and village-by-village invasions by collectors are frequently used as tools of tax enforcement. Our research shows that coercive methods yield higher taxes per capita, but the need for coercion also reflects higher levels of distrust in the governmental system and dissatisfaction with service delivery. Moreover, harsh tax enforcement combined with poor service delivery contributes to undermine the legitimacy of the local government and increases tax resistance.

4. Intergovernmental fiscal relations

- 4.1 The general nature of intergovernmental fiscal relations is surprisingly similar across a wide range of countries. Almost without exception countries assign more expenditure functions to sub-national governments than can be financed from the revenue sources allocated to those governments. The result of this mismatching of functions and finances is that sub-national governments are generally dependent upon transfers from higher levels of government. The most common methods to close the fiscal imbalances of sub-national governments are systems of *revenue sharing* and *grants*.
- 4.2 Tax revenues can be shared on a tax-by-tax basis or on the entire pool of central government tax revenues. Examples of the first kind are not common in Africa, but exist in some Latin-American countries, Russia and Pakistan. A key element in many ongoing decentralisation reforms in Africa is the provision of *conditional* block grants from the centre to sub-national governments. The conditionality refers to earmarking the financing to certain broad-based services, such as primary education, primary health, water supply, agricultural extension and roads. These grants usually relate to recurrent costs only. To even out income among jurisdictions, allocation of grants is often based on a redistributive formula which may combine population, income per capita, indicators of backwardness, etc.

4.3 Promoting fiscal responsibility at sub-national levels calls for implementation of a stable and transparent system of transfers. Mechanisms of fiscal transfers may, however, impose considerably rigidity to the central government budget. Therefore, substantial devolution of revenues and spending responsibilities to sub-national jurisdictions can affect the central government's ability to carry out stabilisation and macroeconomic adjustment through the budget. The destabilising potential of sub-national governments' is greatest when they face no hard budget constraint. Thus, short-run macro-economic management considerations call for effective limits on sub-national governments' deficits, consistent with national objectives for growth, inflation and balance of payments.

5. Tax administration

5.1 Administrative reforms are increasingly stressed as key elements of tax reforms. This is reflected in the establishment of semi-autonomous revenue authorities in a number of African countries, including Malawi, Tanzania, Uganda and Zambia. Inspired by new public management paradigms, effectiveness and efficiency concerns are typical reasons for establishing an autonomous revenue authority. Recent experiences, however, indicate that the revenue authority model has run into deep problems in some sub-Saharan African countries.

5.2 Reforms of the tax administrations in Tanzania and Uganda in the 1990s resulted in short term revenue increases. But these achievements have proved to be difficult to sustain in the longer run. After the initial success, revenues in percent of GDP have stagnated or declined and the level of fiscal corruption seems to increase. Our research has explored factors that may explain this trend. Two factors are highlighted; one is related to the limits of autonomy, and the other to patterns of fiscal corruption.

5.3 Firstly, when the autonomy of a tax administration is compromised, revenue collection performance suffers. The establishment of a proclaimed autonomous revenue authority with comparatively generous remuneration packages and substantial budgets does not protect the authority from political interference. To the contrary, as observed in Uganda, it may make it a more attractive target because the authority offers both relatively well paid jobs and considerable rent-seeking opportunities. Consequently, such an authority is vulnerable to political interference, especially in personnel matters.

5.4 Secondly, with respect to fiscal corruption, our research has highlighted two lessons of broader relevance: First, even with relatively high wages and good working conditions, corruption may continue to thrive. In a situation where there is high demand for corrupt services, it is unrealistic to provide tax officers with pay rates that can compensate for the amount gained through bribery. Without extensive and effective monitoring, wage increases may produce a highly paid but also highly corrupt tax administration. Second, hiring and firing procedures may lead to more corruption. Corrupt tax officers often operate in networks, which also include external actors. These corruption networks seem to have been strengthened because many of those fired are recruited to the private sector as 'tax experts'.

5.5 Is privatisation of tax collection a possible solution? In recent years, the assessment and collection of customs duties in Mozambique have been managed by the private British company *Crown Agents*. Private management of the tax administration is also raised as a possible approach in other countries, (e.g., in Uganda). But the experiences from Mozambique give reason to concern: Although there has been a sharp increase in revenues, the reform has achieved few sustainable results; the transfer of skills has been limited and it is a very expensive contract for the government.

5.6 Tax practitioners are therefore increasingly questioning the value of outsourcing tax administration. Outsourcing of some customs activities, for instance, verification, convoy security and warehousing, can in some cases be appropriate, though experience suggests it is more expensive and no less susceptible to corruption. Instead it might be a better approach

to upgrading customs capacity to carry out the tasks. Outsourcing of other activities such as valuation and entry processing is fraught, since it places the collection of government revenue directly into the hands of non-government interests. In high corrupt countries, there is no reason to believe that those interests will be any less corrupt or more transparent in their dealings than staff of the Revenue Authority. Furthermore, placing expatriate customs personnel in line jobs in operational units may compound the current failure to manage and, thus, entrench the problems.

6. The politics of taxation and accountability

- 6.1 Western historical experience with taxation has been that a government's increased financial dependency on tax revenues may generate governance benefits, because it encourages the accountability of the state to its citizens. Explicit or implicit agreement about who should pay tax, at what rates and for what purposes was reached through bargaining between the ruler and the potential taxpayers. In contemporary OECD countries issues of taxation remain central and important - especially around elections.
- 6.2 In contrast, taxation is **not** high on the domestic political agenda in sub-Saharan Africa. With the exception of South Africa, the politics of taxation are, in general, limited to involve a few specialised interest groups, and tend to take place in non-public arenas. Small lobby groups pressure for exemptions, for rate reductions on imports, or bargain with officials or ministers about tax liabilities.
- 6.3 Local government taxation is, however, a major exception to this. Around election time, this form of taxation is often high on the political agenda of both national and local politicians. But, this politicisation of local government taxes does not increase tax compliance among citizens. To the contrary, it often undermines local government tax collection efforts.
- 6.4 The main reason why issues of taxation has not entered the political agenda in most sub-Saharan African countries is that only a minority of citizens pay direct taxes to the state and the failure of revenue-raising seems most acute in countries that receive large amounts of aid. Partly as a result of this, donors are increasingly directly involved in recipient country tax policy making and administration. Typically, donors push for ambitious overall revenue targets. This may, in some contexts, have significant but unintended negative influences on (i) taxpayers' rights through coercive tax enforcement, and (ii) accountability by empowering the bureaucracy at the expense of elected politicians.
- 6.5 As part of the research programme, we have analysed the relationship between taxation and accountability in the context of tax reforms carried out in a number of sub-Saharan African countries. We focused on three interrelated issues affecting the relationship between taxation and accountability: i) The *internal accountability* of the tax system was assessed with reference to administrative reforms of the tax system; ii) the *democratic accountability* of the tax reforms was analysed by assessing whether the tax reforms created closer links between African governments and their citizens; and iii) we also studied to what extent *external accountability* relations between African governments and international donors affected domestic accountability relations. In this part of the research project we emphasised the ongoing tax reforms in Uganda, Tanzania and Zambia where reforms were introduced as part of the economic restructuring agreements with the international donor community.
- 6.6 The research has found that generally, the tax reforms have only to a limited extent succeeded in widening the tax net. Only formal business corporations appear visibly affected by the central government tax reforms. However, our research suggests that a voice and an organised response to the new revenue policies are developing within the business communities in Tanzania, Uganda and Zambia. The fact that these issues are being treated through formal, public organisations, rather than through bribery and public deals may indicate the beginning of a link between economic elites and government in issues of revenue generation.

6.7 Our research indicates that it is not easy to introduce democratic accountability through externally imposed tax reforms. The tax reforms carried out in Tanzania, Uganda and Zambia in the 1990s were to a large extent formulated and imposed by the international donor community. To meet the targets set by the IMF and Ministry of Finance, the revenue authorities in Uganda, Tanzania and Zambia have focused on increasing collection and compliance from existing taxpayers rather than attempting the more complicated task of widening the tax base. Attempts to meet externally set tax-to-GDP targets may undermine democratic accountability if legal processes and taxpayers' rights are set aside in order to comply with external accountability demands. The semi-military operations to prevent smuggling and tax evasion in Uganda illustrate this concern. Our findings suggest that if coercion is accepted as an integral part of tax collection it is unlikely that state-society relations can become more accountable and democratic.

7. Tax reforms and the role of donors

7.1 In 1997, aid represented 10% or more of GDP in 21 African countries. Without aid, governments would have to cut spending, raise taxes, or borrow from other sources. The donors' recipe for reducing aid dependence is straightforward: increase domestic revenue generation in the recipient countries. The assumption is that the current tax effort is low. There is some statistical evidence in favour of this view. On average, the tax-to-GDP ratio in sub-Saharan Africa is around 21%, compared with the OECD average of about 32%. In Tanzania and Uganda the tax share is as low as 10%.

7.2 But the statistical comparisons ignore substantial differences in economic structure, degree of commercialisation and urbanisation, size of the peasant population and poverty. Historical data also indicate that the tax share of many European countries did not reach 15% of GDP until World War II - when incomes were substantially higher than they are in many African countries today. Another problem with such comparisons is that informal taxation is probably higher in Africa than in other regions of the world. Family obligations, user charges and various self-help activities are extensive.

7.3 The research concludes that there is undoubtedly room for improved fiscal and financial management in the public sector in the case countries as well as improved co-ordination between the different levels of government. But, attempts to squeeze additional revenues from poorly designed taxes may exacerbate the negative effects of the tax system on the economy and the society in general:

7.4 Firstly, donors push for ambitious overall revenue targets (measured as the tax-to-GDP-ratio) may, in some contexts, have significant but unintended negative influences on (i) taxpayers' rights through coercive tax enforcement, and (ii) accountability by empowering the bureaucracy at the expense of elected politicians. Secondly, it is unlikely that a substantial widening of the tax base can be achieved without increasing the tax burden of the poorer segments of the population. Thus, the donors' push for revenue enhancement may have negative impacts on income distribution. Thirdly, improved tax administration cannot compensate for bad tax design. Excessive and arbitrary taxation are major constraints for economic and social development. Thus, reforming the tax structure should precede the reform of tax administration, since there is not much merit in making a bad tax system work somewhat better.

7.5 In redesigning the tax structure, the following options should be considered (1) abolition of unsatisfactory taxes; and (2) improvements to remaining revenue bases. Further simplifications of the tax system may also provide a positive contribution towards reducing revenue losses through corruption and tax evasion. There is also an urgent need to improve co-ordination between the various levels of government with respect to tax policies. At the same time, improved tax structure will not work properly unless it can be properly administered. Thus, reforming the tax structure is only the first step, albeit a necessary one. These

recommendations must be translated into tax laws, changes in administrative procedures, preparation of lists of tax-payers with relevant addresses, redesigning tax forms, modification of penalties, new audit concepts, new training of administrative personnel, taxpayer education, etc.

- 7.6 Some observers argue that a lack of a 'taxpaying culture' is the largest obstacle to building a firm long-term revenue base. The opposite may, however, also be the case: as long as the 'tax administration culture' is perceived to be influenced by sectarianism, nepotism and corruption, it is unlikely to contribute to the fostering of a more conducive taxpaying culture.

8. The way forward – issues for further research

- 8.1 In low income countries the importance of general taxes as major revenue sources for the government will most likely increase. Revenue enhancement will therefore continue to be a primary goal of tax reforms, as a measure to reducing budget deficits. Thus, looking ahead, and keeping in mind that any revenue scheme should also be judged according to its effects on economic efficiency, equity and administrative feasibility, there is, firstly, a need for better empirical understanding of the impacts of taxation on poverty, income distribution and economic growth.
- 8.2 Secondly, there is a need for better theoretical and empirical understanding of the fiscal relations between states, donors and citizens, and how these relations may affect accountability relations. This dimension of taxation includes the statutory characteristics of the tax system (including taxpayers' rights) and the organisation of revenue collection (e.g., incentive systems for tax officials, revenue assessment and planning systems). For instance, a tax system that is complex, that is poorly understood by both tax administrators and taxpayers, that creates numerous opportunities for corrupt behaviour, and that involves coercion in the collection of taxes from reluctant citizens provides a poor basis upon which to build trust between citizens and the government. Without trust, coercion provides a reasonable guide for governance.
- 8.3 One possible trust enhancing approach is to establish better links between demand and supply of public services. While extensive tax evasion and resistance to pay service charges characterises the official revenue systems, this contrasts with observations of high compliance and less free rider problems in many self-help activities (SHA) in local communities. Self-help activities may therefore appear as a more attractive approach to service provision than the official system of taxation. Important aspects of how SHAs operate within local communities are unexplored. How is compliance ensured? For instance, are those involved in SHAs homogenous groups or mixed along ethnic, religious and economic variables? How are the internal power relations in the SHAs? Why do some SHAs succeed and others not?
- 8.4 Better links between demand and supply of public services can also be achieved through cost-recovery charging systems, which tie the amount paid directly to the amount consumed. User charges have the potential of enhancing resource allocation by reducing wasteful usage since users pay from their own resources. However, there are number of constraints on user charges and other means of cost recovery in poor countries, which need further exploration. These constraints are related to (i) equity considerations; (ii) fluctuations in demand; and (iii) the relations between services financed by charges and private sector provision compared to those financed by general tax revenues. Moreover, as the experiences from Namibia and South Africa show, the politics of cost recovery is not straight forward: The way the user fees are collected and the severity of sanctions against defaulters appear to be crucial to establish trustworthy relations between the state and citizens and to ensure compliance.

1. Why taxation matters for development

Most sub-Saharan countries face a trilemma with respect to taxation: (1) There is an urgent and obvious need for more revenues to enable resource poor states to provide and maintain even the most basic public services. (2) The reality is, however, that those with political power and economic ability are few and do not want to pay tax. (3) Moreover, those without political power are many, have almost nothing to tax, and do also resist paying taxes.

The trilemma is amplified by three trends common to many African countries (Fjeldstad *et al.*, 2000). One is a recent process of *democratisation*, which, if Western experiences hold, will have profound implications for taxation. It is likely that governments, seeking power on the basis of popular consent, face restrictions in their use of coercion in tax collection. The other is that *aid flows*, which presently constitute more than half of state budgets in some countries, are declining, making tax revenues even more important for state incomes. Aid flows are, furthermore, increasingly conditioned on improved domestic revenue mobilisation. The third trend is that *globalisation* leads to increasing integration of the world's goods and capital markets. Countries have to adhere to international trade and investment agreements. These developments impose severe constraints on the ability of developing economies to choose their own tax policy directions.

It follows that the challenge for taxation is to raise domestic revenues from consenting citizens in poor and increasingly open economies. It should be added that most of these economies are not growing rapidly. Elected governments in African countries are therefore facing hard choices about taxation. These decisions will most likely have profound impacts on the future of democratisation itself and on public service provision. They will also have considerable implications for the politics and sustainability of aid.

This situation forms, in short, the basic motivation for the ongoing research programme *Taxation, aid and democracy*.¹ The research aims to contribute to a better understanding of the evolution of tax systems in African countries. Furthermore, it aims to explore the constraints and options available for policy making on revenue mobilisation and democratisation. In depth studies on the tax systems in Namibia, Tanzania and Uganda have been carried out. Moreover, on specific issues such as tax administration and local government finances, the research has also covered other sub-Saharan countries, including South Africa and Zambia.

This paper presents the major areas of research dealt with in the programme and key findings. The paper is organised as follows: Section 2 presents some major characteristics of the central government tax system and reforms in sub-Saharan Africa. The local government tax system is discussed in section 3, while intergovernmental fiscal relations are the focus of section 4. In section 5 experiences with tax administrative reforms and, in particular, revenue authorities are discussed. Section 6 focuses on the politics of taxation and accountability. Options for future tax reforms and the possible role of donors are discussed in section 7. Finally, section 5 outlines issues for future research.

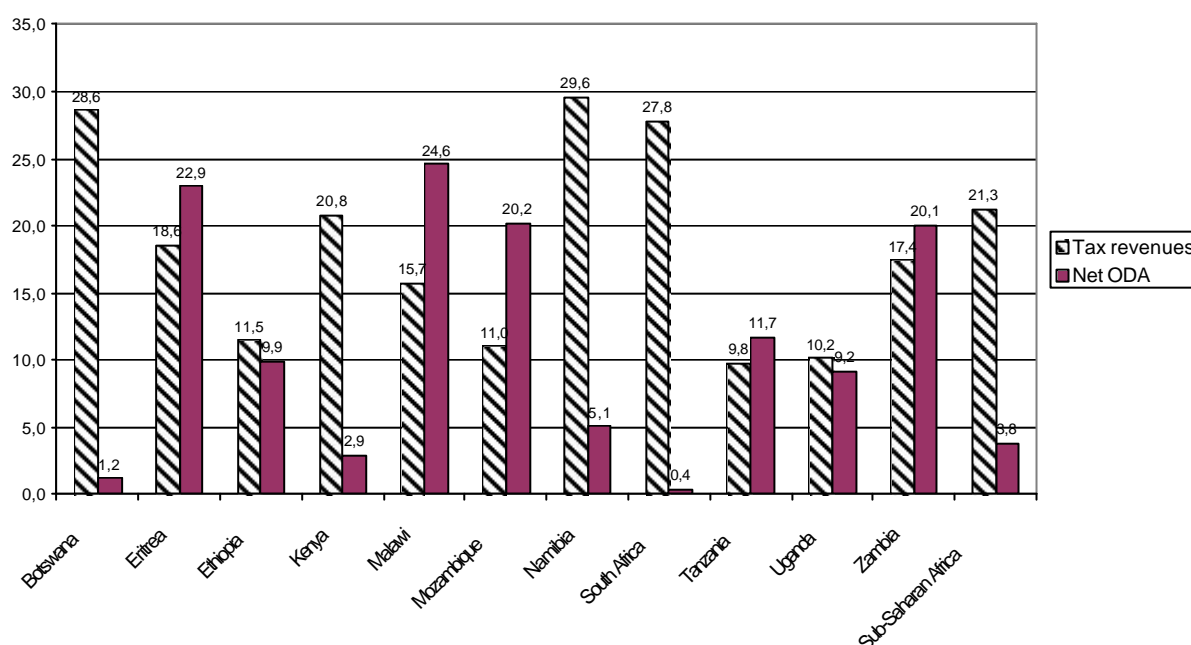
¹ The research programme is carried out as a joint study by Chr. Michelsen Institute (CMI), Bergen; Institute for International Studies (IIS), Copenhagen; Makerere University, Kampala; the Namibian Economic Policy Research Unit (NEPRU), Windhoek; the Norwegian School of Economics and Business Administration (NHH), Bergen; and REPOA/Economic Research Bureau, University of Dar es Salaam.

2. Central government taxation

2.1 Tax effort and foreign aid

On average, the tax-to-GDP ratio in sub-Saharan Africa is around 21%, compared with the OECD average of about 32% (see Figure 1).² However, there are substantial differences between African countries with respect to their tax share. In Tanzania and Uganda, for instance, the tax share in 2000 was around 10%, compared to almost 30% in Namibia and about 28% in South Africa. Foreign aid, on the other hand, represented on average almost 4% of total sub-Saharan Africa GDP in 1999. However, in several countries aid represents more than 20% of GDP (e.g., Malawi, Mozambique and Eritrea) and more than 10% of GDP in others (e.g, Tanzania), reflecting an extreme degree of aid dependence.

Figure 1: Tax revenues and aid in % of GDP (1999)



Source: World Bank (2002) *African Development Indicators*.

In recent years there has been an increasing focus on the possible linkages between high levels of development aid and taxation in Africa (Therkildsen, 2001, 2002a). Without aid, governments would have to cut spending, raise taxes, or borrow from other sources. Thus, it is argued, high levels of aid may diminish a government's incentive to make full use of its domestic resources for revenue generation (Brautigam & Botchwey 1999; Moore 1998).³ Therefore, in many aid dependent African countries, revenue targets have become a major component of aid conditionality. For instance, the *International Monetary Fund* argues that

² Tax revenue data in Figure 1 only include central government tax revenues, and not non-tax revenues and local government taxes.

³ The empirical evidence is, however, inconclusive on the actual impacts of aid on domestic revenue raising effort (White 1994; Devarajan *et al.* 1998).

African countries 'have significant potential for raising tax receipts by broadening the tax base, improving tax administration, and rationalising the tax system' (Hadjimichael *et al.* 1995: 44). Furthermore, some donors involved in district development programmes have adopted matching schemes, under which aid is supplied only on the basis of matching funds from the local government (Catterson & Lindahl 1998).

The rationale behind this policy is based on the perception that the current tax effort in most African countries is low. Heller (1997: 39), for instance, calls the tax effort in most African countries 'disappointingly low'. Some observers, however, question the premise behind this policy. Collier (1997: 56), for example, claims that tax levels in Africa are already high. He argues that high taxation retards the growth process and induces tax evasion. Thus, the build-up of the taxable base of the economy is delayed, and so is the time at which fiscal sustainability can be achieved. Accordingly, increasing tax effort would be 'both ludicrous and self-defeating' (*ibid.*: 54).

Moreover, simple statistical comparisons of tax share ignore substantial differences in economic structure, degree of commercialisation and urbanisation, size of the peasant population and poverty. By adjusting for such structural differences and thereby estimating a more realistic revenue potential, Tanzania's tax share is, for instance, above the average of sub-Saharan Africa (Stotsky & WoldeMariam, 1997). Furthermore, historical data show that the tax share of many Western countries, including Sweden, did not reach 15% of GDP until World War II - when incomes were substantially higher than they are in many African countries today (Steinmo, 1993).

Another problem with such comparisons is that informal taxation, not captured in official statistics, are probably higher in Africa than in other regions of the world. Family obligations, which can to some extent be considered as social insurance, are extensive (Prud'homme, 1991). User charges and various self-help activities, which contribute to the maintenance of services like primary schools and health facilities, are also significant (Semboja & Therkildsen, 1995). Such groups have proliferated in recent years in response to the public sector's inability to deliver services. In some countries, these contributions are increasing. It is therefore reasonable to question a basic premise underlying donor policy that the tax effort in Africa is low. It might even be argued that the combined level of informal and formal taxes is already too high in some countries.

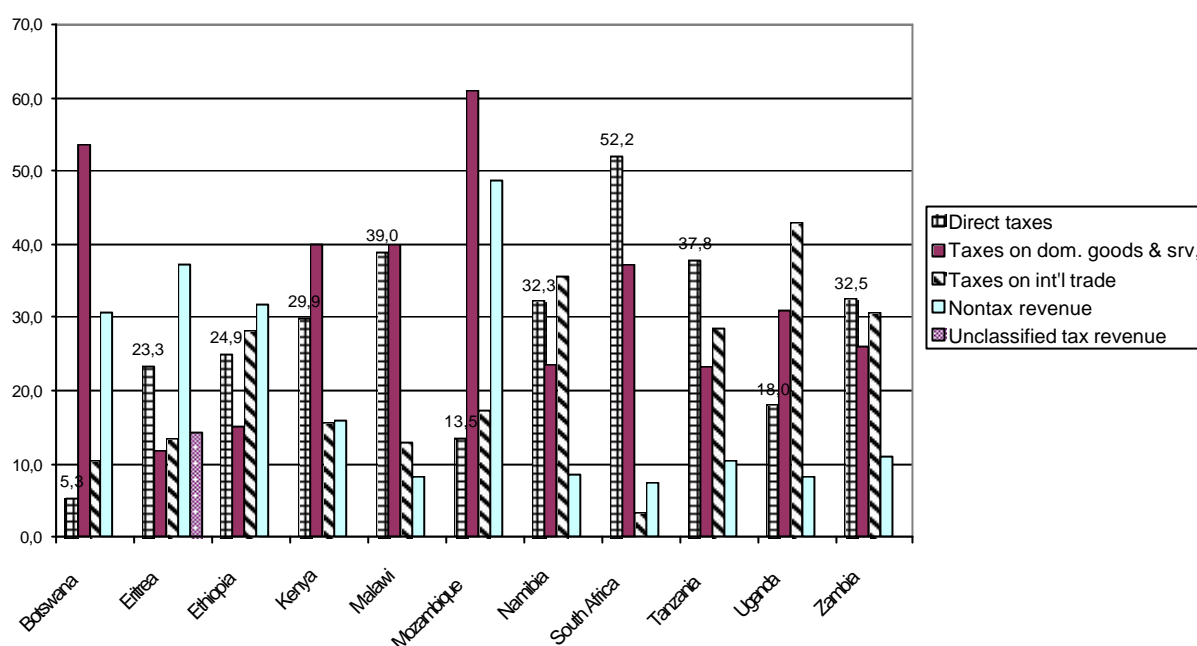
2.2 Tax structure

The tax structure is generally composed of direct and indirect taxes. For the direct taxes, the factors that produce the incomes are assumed to pay the associated taxes while for the indirect taxes, households or firms that consume the taxed items are assumed to pay the associated taxes (Obwona & Muwonge, 2002a). Direct taxes often include corporation tax, personal income tax (e.g., Pay-as-you-earn (PAYE)), withholding tax, rental income tax, tax on interest in banks, and presumptive income tax. The indirect taxes include taxes on domestic goods and services such as value added tax (VAT), and excise duty on so-called demerit goods (e.g., on beer and cigarettes). Moreover, indirect taxes comprise taxes on international trade transactions such as import duty, VAT on imported goods and services, and excise duties on specific imported goods such as beer and cigarettes.

In general, indirect taxes on goods and services are the major revenue bases (Figure 2). However, direct taxes on income and wealth are important revenue bases in many poor

countries. For instance, in Malawi and Tanzania direct taxes generated almost 40% of total tax revenues in 2000. Of these, corporate income taxes are most important, followed by pay-as-you-earn (PAYE) taxes on formal sector employees. Local government taxes, however, may contribute with 5% or less of total tax revenues.

Figure 2: Composition of tax revenues in % of total revenue, excl. grants (2000)



Source: World Bank (2002) *African Development Indicators*.

Though most countries apply the IMF's *Government Finance Statistics* (GFS) categorisation of taxes, some of the differences between countries reflected in Figure 2 are due to different ways of registering domestic revenues. For instance, government revenues from mineral extraction are registered as non-tax revenue (royalties) in Botswana, while they are basically registered as corporate income tax revenues in South Africa.

2.3 Reforms

The tax systems in Africa have proved remarkably resistant to even major political changes - except widespread internal conflict. Colonial tax systems remained largely unchanged until recently. Malawi and Tanzania are examples of countries that inherited their tax structures from their colonial past and only made *ad hoc* and piecemeal changes to this structure until the fiscal crises of the 1980s. During the 1990s tax reforms became part of the larger structural adjustment programmes and incorporated in the economic restructuring agreements with the *International Finance Institutions* (Obwona & Muwonge, 2002b; Tanzi & Zee, 2000; Thirsk, 1993) Another reason for the reforms was due to increased awareness of the extensive administrative problems and constraints connected with tax systems in many developing countries, resulting in widespread tax evasion and enforcement problems. Thus, developments brought the issues of simplification, tax administration and tax enforcement to the core of central government tax reforms. Until recently, these reforms have almost exclusively focused

on the central government tax system. Table 1 provides a summary of the major tax reforms in Tanzania during the last decade. The Tanzanian reforms mirror the general characteristics of tax reforms in sub-Saharan Africa during the same period.

The tax policies now recommended for African countries are much the same as those which are advocated for developed countries. In most cases this involves the introduction of measures to broadening the tax base while simultaneously flattening the tax rates (Heady, 2002; Bebi, 2001). Despite important differences in their economic and cultural background, developing countries have tended to modify their tax systems in roughly the same direction. The following trends in taxation can be clearly seen:

- introduction of the value-added tax;
- lower personal and corporate income taxes;
- simplification of the tax bands and broadening of the bases for personal and corporate income taxes;
- reduction of import duties and simplification of the rate structure;
- simplification of the excise duty structure; and
- abolition of export taxes.

Administrative reforms are also increasingly stressed, and reflected in the establishment of semi-autonomous revenue authorities in a number of African countries (see section 5). More recently, reforms of the local government tax system and harmonisation of local and central government taxes have also been addressed in some countries (see section 3).

In spite of recent reforms, the tax systems in many African countries are characterised by an excessive number of different taxes with different rate structures that are difficult for taxpayers to understand. The tax law is often written in a confusing way and manuals to consult absent, opening up for discretionary powers by tax enforcers. Tax officials may, for instance, have discretion over important decisions, such as those related to the provision of tax exemptions, determination of tax liabilities, selection of audits, litigation, etc. Many administrative procedures, including the procedures for reporting tax revenues, lack transparency and are poorly monitored both within the tax administration and by the Auditor General's Office. Moreover, the legal sanctions to enforce punishments on either taxpayers or collectors who do not comply with the law are often weak - if existent at all. Each of these factors contributes to a non-transparent and complicated tax system, where taxpayers' are left to the discretionary power of tax officers. A system that also is costly to administrate.

Table 1: Tax reforms in Tanzania since the early 1990s

Form of taxation	Reforms
Direct taxes	Substantial simplifications of tax structure during the last decade. Reduction in marginal tax rate to 30%. Personal income tax bands reduced to 5. The increased income tax threshold (from TSh 20,000 to TSh 45,000 per month) has removed more than 40% of all taxpayers from the tax system. Corporate income taxes and PAYE most important.
Indirect taxes	Contribute with about 65% of total revenue. Include at present value added tax (VAT), excise duties and import duties, and “other taxes” (mainly road toll and stamp duty).
Export taxes	Export duties were abolished in FY 1991/92 and later re-introduced in FY 1996/97. In FY 1999/2000 export duties on traditional export crops (cotton, coffee, tea, tobacco, sisal and pyrethrum) were again abolished.
Import duties	Import duty is levied on the c.i.f. value of imports. Statutory exemptions are diplomatic corps, foreign government projects, and religious, educational and charitable institutions. The tariff structure is basically <i>ad valorem</i> for most items. Effective from 1 July 2001 customs duties comprise four tariff bands; 0, 10, 15 and 25%. Recent simplifications of the customs duty structure have made the system more transparent. However, still extensive tax evasion, which is made possible by weak customs administration and a lack of effective surveillance and deterrence mechanisms.
Excise duties	Since 1992/93 substantial simplifications and reduction of rates. Previously, the base was very wide covering several hundred items. Both <i>ad valorem rates</i> and <i>specific rates</i> as well as composite rates for some items were levied. In January 1999 excisable items were grouped into 9 main groups covering 40 excisable items. However, the bulk of excise revenues (> 90%) comes from only five products, both imported and domestically produced, i.e., beer, cigarettes, petroleum products, spirits, and motor vehicles.
VAT	VAT introduced in July 1998. Replaced the previous sales taxes and part of stamp duty and entertainment taxes. Two VAT rates are imposed; a zero rate and a standard rate of 20%. The zero rate is applied on exports. The standard rate applies on all other goods not exempted. Food, most basic goods, inputs to agriculture and NGOs are exempted. VAT exemptions to Government and its institutions were abolished in July 2001. The threshold for being registered for VAT is set to an annual turnover of TSh 20 million in FY 1998/99. The VAT base is significantly broadened vis-à-vis the previous sales tax. However, the scope of VAT exemptions and relieves has been broadened steadily since the original VAT legislation was approved by the National Assembly in August 1997. For instance, the number of zero-rated and exempted items has increased from 19 to 39. Furthermore, the number of special relieves has been increased from 5 to 17. These amendments narrow the VAT base, reduce its revenue productivity, and introduce various distortions and inequities in the tax system.
Local government taxes	Complicated and non-transparent tax system. It is not uncommon that local authorities have more than 50 different taxes and fees, not including the various sub-groups of particular revenue bases. Often large variations between councils on tax rates on similar revenue bases, for instance on agricultural products. Extensive corruption and embezzlement of tax revenues. The complex revenue structure is due to the large tax autonomy of local authorities that may pass by-laws without serious approval by the ministry concerned. Lack of co-ordination between the central and local levels has led to duplication of taxes and inconsistencies between taxes imposed by local authorities and the national government’s development policies. The major local tax in rural councils is the poll tax ‘development levy’, which is imposed on men above the age of 18 and women who are wage earners. Little voluntary compliance. Coercive enforcement methods. Recently (FY 2002/03), the central government has issued directives to simplify the local tax system, and also banned the use of roadblocks and militia in tax enforcement.

Sources: Fjeldstad, Hussein & Shallanda (2002) and Fjeldstad & Semboja (2000)

3 Local government taxation

3.1 Characteristics and impacts of the local tax system

Despite the recent central government tax reforms, local government tax systems in sub-Saharan Africa have remained largely unchanged. They are often distortive, costly to administer, and exacerbate inequity. In particular, they are biased against poor men because of the frequent use of poll taxes which often exempts women (Livingstone & Charlton, 1998; Fjeldstad & Semboja, 2001).

In many countries local governments raise whatever taxes they are capable of raising, often without worrying excessively about the economic distortions and distribution effects that these taxes may create. For instance, a widely found characteristic of local government revenue systems in Africa is the huge number of revenue instruments in use (Brosio, 2000).⁴ Uganda and Tanzania illustrate this point. Some figures for Kamuli district, Uganda, in 2003 are given in Table 2. The district council sets 136 separate flat rate market dues, 81 separate flat rate business license fees, and of course, in theory at least, there are 22 different graduated tax bands. In Tanzania (Table 3), it is not uncommon that local authorities have more than 50 different taxes and fees, not including the various sub-groups of particular revenue bases. Furthermore, there are often large variations on the tax rates imposed by councils on similar revenue bases, for instance on agricultural products. This has led to extensive ‘smuggling’ of agricultural goods across council boundaries. The complex revenue structure is due to the large tax autonomy of local authorities that may pass by-laws without serious approval by the ministry concerned.

Table 2: Tax types, Kamuli District, Uganda (March 2003)

Formal revenue sources	No. of rates applied
Market Dues	136
Business	81
Graduated Tax Bands	22

Source: Bahiigwa *et al.* (2003)

Our research shows that the complicated and non-transparent local government tax system is costly to administer and it facilitates corruption and mismanagement (Fjeldstad & Semboja, 2000). Moreover, many local taxes have a distorting effect on resource allocation decisions, and an inhibiting effect on the start-up of new enterprises and the achievement of economic growth. These effects occur when effective tax rates vary greatly between different goods that are traded, or when license fees are set too high for start-up small-scale enterprises to survive (Bahiigwa *et al.*, 2003). In addition, the levels and types of local taxes can by themselves result in the tax burden falling more on the poor than on the relatively better off in local communities. This is mainly due to the basic design of the tax system.

⁴ However, as discussed in section 3.3, the local government revenue systems in Namibia and South Africa differ from the general picture presented in this section.

Lack of co-ordination between the central and local levels has led to duplication of taxes and inconsistencies between taxes imposed by local authorities and the national government's development policies. In Tanzania and Uganda, for instance, some local governments are imposing high taxes on export crops, which are inconsistent with the national government's policy to encourage export production (Fjeldstad & Semboja, 2000; Ellis & James, 2003). Also in Namibia there seems to be little co-ordination between the Ministry of Finance and the ministry responsible for regions and local governments with respect to taxation (Fjeldstad & Therkildsen, 2002). Moreover, while central government taxes affect only relatively few people directly (perhaps less than 5 percent of the total population), local government taxation affects many more (perhaps 30 percent, largely men). To the extent that state-citizens relations are influenced by taxation (which is the experience in Western countries), local government taxation is therefore central to a better understanding of state-citizen relations.

A major impediment for tax collection in local authorities is direct political interventions in the tax enforcement processes. To maintain their political positions politicians may advocate low rates (or free services), and accept that their constituents don't pay the tariffs. Generous tax exemptions provided to political supporters are also observed in some countries. Direct political intervention is often most visible at the local government level. The problem stems from the fact that taxes and fees are generally disliked and councillors who want to be re-elected disassociate themselves from increased rates. Councillors may also be reluctant to raise taxes and charges because they are major local landowners or business people who seek to minimise their personal tax burden. Political interference is often exacerbated during election campaigns when politicians may instruct the administration not to push tax enforcement, and not to "harass" taxpayers. Thus, local authorities may experience substantial revenue shortfalls during election years.

3.2 Coercion

Our research shows that widespread tax resistance is observed in many local authorities. People may take to the extreme to evade taxes, for instance, by literally hiding in the bush when tax collectors are approaching (Fjeldstad, 2001a; GoU, 2002; Ellis & James, 2003). Many local governments rely heavily on simple physical coercion to obtain the resources they need from their subjects and to ensure compliance. Roadblocks manned by the local militia or police and village-by-village invasions by collectors are frequently used as tools of tax enforcement. The use of coercion in raising local government taxes in Tanzania and Uganda is so pronounced and detested that this mode of collection is not conducive for improved accountability links. In particular, the poll taxes (e.g., 'development levy' in Tanzania and 'graduated tax' in Uganda), are notorious for the use of coercion in their extraction, and the lack of sensitivity displayed in the timing of collection relative to the seasonal income position of the taxpayer.

Taxpayers reciprocate sometimes in the form of violent 'counter-attacks' on collectors, burning tax offices, etc. The well documented 1998 tax revolt in Arumeru District in North-East Tanzania, included the refusal of almost the entire district population to pay the poll tax ('development levy'), the beating up of council collectors, and the burning of the council chairman's house and his subsequent resignation (Kelsall, 2000).

Thus, in circumstances where taxes are perceived to be unfair and people receive few tangible benefits in return for taxes paid, we may expect that only coercive methods of tax enforcement will generate tax revenues (Fjeldstad, 2002a). The reciprocity or contractual

relationship between taxpayers and the local government seems to be absent. Our research finds that coercive methods yield higher taxes per capita (at least in the short term), but the need for coercion also reflects higher levels of distrust in the governmental system and dissatisfaction with service delivery. Moreover, harsh tax enforcement combined with poor service delivery contribute to undermine the legitimacy of the local government and increase tax resistance.

It is beyond doubt that major changes are necessary to improve performance and to establish legitimacy of local authorities in poor African countries. However, the claim that increased fiscal autonomy will improve the efficiency and responsiveness of the public sector has to be taken with caution. Sustained development in local governments cannot grow from an institutional framework, which encourage coercion and extra-legal tax enforcement. Furthermore, attempts to squeeze additional revenues from poorly designed taxes may exacerbate the negative effects of the tax system on the economy and the society in general. Thus, reforming the local tax structure should precede the reform of tax administration. In particular, there is a need to simplify the licence and fee structures by reducing the number of rates and coverage. Fees and licences that have regulatory functions, such as hunting and business licences, should be harmonised with central government taxes, to avoid double taxation and conflicts with national development policies such as export promotion and environmental protection.

Moreover, it is unrealistic to expect that the present staff in many councils has adequate capacity and the required integrity to manage increased fiscal autonomy. In fact, there is a real danger that, in the absence of substantial simplification and restructuring of the current revenue system combined with capacity building and improved integrity, increased autonomy may cause greater mismanagement and corruption in local authorities. On this background, it is positive to register that the central government in Tanzania recently issued a directive to all local authorities that they within April 2003, shall provide proposals for the rationalisation of own revenue sources. Based on further elaborations and discussions, the proposals will be revised and are expected to be included in the Budget Speech for FY 2003/2004 to be implemented from July 2003. Another directive issued in 2002 instructed local authorities not to use roadblocks and the local militia as instruments for tax collection.

3.3 The local revenue systems in Namibia and South Africa

The local government revenue systems in South Africa and Namibia are very different from the broader picture presented above (Fjeldstad & Therkildsen, 2002; Fjeldstad, 2002b). Firstly, local authorities in Namibia and South Africa aim - or are pushed - to operate on a full cost recovery basis for all services that they deliver, although some - mainly sector specific and area based - cross-subsidisation is made. Secondly, they generate most of their funds from user fees on services (electricity, water and sanitation), and property rates in urban areas. The prevailing revenue sources are, thus, to a large extent consistent with the former apartheid tax regimes for local governments. Thirdly, they receive limited funding from central government, and then mainly for specific investment projects on an ad-hoc basis. There is also some recurrent cost support from the central government on an ad-hoc basis. In South-Africa, in aggregate, more than 90% of total local government revenues come from their own sources. The remaining revenues are transfers from the national and provincial governments.

In other words, Namibian and South African local authorities are forced, partly by default and partly due to political and historical reasons, to survive financially on their own without much

financial support from the central government. They are, in a financial sense, relatively autonomous.

This is quite remarkable. Namibia and South Africa are among the richest countries in sub-Saharan Africa and their public revenues are quite substantial. At the same time, the countries have among the highest income inequalities in the world. A proclaimed objective of both the ANC in South Africa and SWAPO, the ruling party in Namibia since independence, has been to provide services – also to the poor. ANC and SWAPO are also firmly politically entrenched, having won all national and the large majority of the local elections since the fall of apartheid. Yet, the central government in neither country has developed a local government finance system that could help it to provide equal access to services across local authorities. Instead, local authorities rely mainly on user charges - especially on water and electricity - to obtain the revenues that are needed to finance their operations. This revenue is generated by a surcharge added to the cost of the utilities that the local authorities typically buy from the utility companies, or, if the authority itself produces the utility, added to the cost of producing it.

A major financial problem in local authorities in Namibia and South Africa is inadequate collection of revenues, mainly due to widespread non-payment. The result is year-end deficits, a reduction of services to balance the budget, and higher fees and taxes for those who do pay. In recent years non-compliance with respect to service charges, fees and rates has worsened. Some observers argue that the non-payment is due to poverty or inability to pay. Others claim that there is exist a ‘culture of non-payment’. We do not contest these arguments, but our research in South Africa finds that the causes of non-payment are more multifaceted and complex (Fjeldstad, 2002b). In a number of cases the way the law is enforced and the severity of sanctions appear to have contributed to undermine trust in local authorities and fuelled resistance. This contradicts the standard economic theory, which tells us that the more severe the sanctions perceived by ratepayers, the higher the compliance expected. Observations from South Africa point in the opposite direction: The more severe the sanctions, the more widespread and organised resistance to paying rates and charges.

However, the issue of (non-)compliance is not only a question of state-society relationships, but also a question of relationships between citizens and/or between groups of citizens within local communities. In particular, three dimensions of trust seem to affect compliance (Slemrod, 2002; Levi, 1998): (1) trust in the local government to use revenues to provide expected services; (2) trust in the authorities to establish fair procedures for revenue enforcement and distribution of services; and (3) trust in other citizens to pay their share of service charges. In particular, trust in other citizens to pay their share seems to be important. The larger the fraction of the local population that is observed not paying, the lower the perceived risk of being prosecuted. This has impacts on the individual ratepayer’s perception of the credibility and trustworthiness of the revenue administration. Moreover, the attitude of local political leaders with respect to payment seems to be important, e.g., by legitimising non-payment through their own behaviour. Furthermore, the interaction between social networks and overlapping collective activities may in some instances, such as in Soweto, provide a framework in which it is difficult for individuals to pay their charges without provoking reactions from their non-paying neighbours and other members of the community.

Table 3: Current local government revenue sources in Tanzania

<i>TAXES</i>	<i>NON TAX SOURCES</i>		
	<i>Licences</i>	<i>Fees and Charges</i>	<i>Other Revenue</i>
1. Development levy	1. Business licence	1. Market fees	1. Road toll
2. Crop cess	2. Street vending and hawking licence	2. Tax registration fees	2. Land rent and service charge
3. Livestock cess	3. Intoxicating liquor licence	3. Street vending fee	3. Rent from council's houses/buildings
4. Industrial cess	4. Foreign liquor licence	4. Sand fee	4. By-law fines
5. Property taxes	5. Local liquor licence	5. Entertainment fees	5. Stray animals fine
6. City service levy	6. Livestock licence	6. Advertising board fee (billboards)	6. Permit to move animals in urban areas
7. Hotel levy	7. Dog keeping licence	7. Cattle market charge	7. Tourist hunting fee
8. Guest house levy	8. Fisheries licence	8. Abattoir (slaughter) fee	8. Sale of fish commission
9. Entertainment levy	9. Hunting licence	9. Bicycle registration fee	9. Bank interest
10. Bicycle tax	10. Gun holding licence	10. Business licence application fee	10. Sale of assets
	11. Blood drying activity licence	11. Licence transfer fee (for business people changing area or type of business)	11. Hire of plants and vehicles
	12. Forestry product	12. Tender application fee	12. Sale of plants and seeds
	13. Road licence	13. Refuse collection charge	13. Sale of identity cards
	14. Taxi, pick-up and lorry licence	14. By-law permit charge	14. Investment dividends
	15. Bus stand licence	15. Burial charge	15. Other transfers
	16. Scaffolding licence	16. Business premises inspection charge	16. Other income
	17. Plying licence	17. Playing ground charge	
	18. Human resource licence	18. Cesspit emptying fee	
		19. Planning scrutiny fee	
		20. School fee	
		21. UPE contributions fee	
		22. Weights and measures fee	
		23. Motor vehicle parking fee	
		24. Water pipe installation fee	
		25. Storm water drainage fee	
		26. Inoculation/vaccination fee/clinic fee	
		27. Medical examination fee	
		28. Fire service fee	
		29. Market stall renting fee	
		30. Hire of plant fee	
		31. Valuation fee	
		32. Cultural games/recreation fee	
		33. Ambulance hire fee	
		34. Public convenience fee	
		35. Recovering charge of lost dev. levy receipt	
		36. Contract approval fee	
		37. Skin treating fee	
		38. Push cart fee	
		39. Cattle trekking fee	
		40. Pupil transfer fee (paid by parents)	

Source: Fjeldstad & Semboja (2000).

4 Intergovernmental fiscal relations⁵

The general nature of intergovernmental fiscal relations is surprisingly similar across a wide range of countries. Almost without exception countries assign more expenditure functions to sub-national governments than can be financed from the revenue sources allocated to those governments. The result of this mismatching of functions and finances – often referred to as ‘vertical imbalances’ - is that sub-national governments are generally dependent upon transfers from higher levels of government. Table 4 illustrates this point.

Table 4: Vertical imbalances in selected countries

Country	<i>Vertical imbalances</i>			
	Share of sub-national government (%)			
	In total public expenditure		In total tax revenue	
	1990	1997	1990	1997
Argentina	46.3	43.9	38.2	41.1
Brazil	35.3	36.5	30.9	31.3
Ethiopia	1.5	..	1.6	..
France	18.7	18.6	9.7	10.8
India	51.1	53.3	33.8	36.1
Italy	22.8	25.4	3.6	6.5
Kenya	4.4	3.5	2.2	1.9
Malaysia	20.2	19.1	3.7	2.4
Philippines	6.5	..	4.0	..
South Africa	20.7	49.8	5.5	5.3
United Kingdom	29.0	27.0	5.9	3.6
United States	42.0	46.4	33.8	32.9

Source: World Bank (2000)

Vertical fiscal imbalance exists in all the selected countries because none of their lower level government systems raise sufficient revenue to match expenditure responsibilities. However, Table 4 reveals considerable variations between countries with respect to the degree of vertical fiscal imbalances. The sub-national jurisdictions in Argentina, Brazil, the United States and India come closest to achieving fiscal balance. The gap between expenditure and revenue (in 1997) is widest for South Africa, Malaysia, Italy and the United Kingdom. Lower levels of government in these countries are therefore especially dependent on transfers from the central government. Furthermore, the table shows that Argentina has the least centralised tax system with respect to share in national tax-raising, while Kenya, Malaysia, the United Kingdom and South Africa are the most centralised.

The basic rationale for a system of transfers is the existence of a fiscal gap at the local government level arising out of own-revenue and own-expenditure assignments. There are a number of methods to close the fiscal imbalances of sub-national governments, some of which also reduce imbalances between jurisdictions (Ahmad, 1997:6). In practice we may distinguish between systems of *revenue sharing* and *grants*.

⁵ This chapter is based on Fjeldstad (2001b).

4.1 Revenue sharing

The most revenue generating tax bases 'belong', in general, to the central government. Based on the standard 'tax assignment rules' considerations, the central government should keep the major taxes, especially the corporate income tax, multistage taxes such as the VAT, and taxes on foreign trade. Thus, if the sole concern of the central government is simply to fill a vertical fiscal gap one way would be to give lower levels of government a share of major national taxes collected in the area. Sub-national governments may assist in revenue mobilisation by providing information on local taxpayers, and thereby increasing the pool of tax revenues.

Tax revenues can be shared on a tax-by-tax basis or on the entire pool of central government tax revenues. Such arrangements are not common in sub-Saharan Africa, but are in place in other regions. Examples of the first kind exist in Argentina, Brazil, Pakistan, and Russia (Tanzi, 2000). In principle, the distribution of shared revenues among sub-national governments are made on a derivation basis, with each jurisdiction getting the same share of the revenue collected in its area.

One problem with the tax-by-tax sharing arrangement is that it may give the central government an incentive to concentrate its collection and enforcement efforts on the taxes that are either not shared or shared to a lesser degree (Ahmad, 1997). Furthermore, the central government may have an incentive to concentrate increases in rates (for instance for stabilisation purposes) on the shared taxes, something that may distort the tax system. Therefore, revenue sharing based on the entire pool of government revenues may be preferable. Revenue sharing, which transfers a portion of the national proceeds of a tax according to a predetermined formula, is much like a general-purpose unconditional block grant. However, this does not address the problem of horizontal imbalances, i.e., between jurisdictions within the same level. Sub-national governments' autonomy over revenue bases and rate structures are also sacrificed.

Revenue sharing arrangements may have both pro- and contra-cyclical effects. For instance, if the central government tries to tighten fiscal policy by raising shared taxes, this move will also give the provincial or local governments more resources for spending. This outcome may be avoided if the portion of revenue going to the sub-national governments is levied at a constant rate on the shared tax base. Fixed revenue-sharing arrangements may also have pro-cyclical effects as tax revenue automatically rises during a boom, and thereby increases the spending capacity of the sub-national governments, while declining revenue during economic downturns forces them to cut back spending. To address this problem, some element of flexibility could be introduced in these sharing arrangements. For instance, this can be done by relating the transfers to a moving average of central government revenues or by requiring provincial or local governments to build up revenue stabilisation funds to even out cyclical fluctuations in shared taxes.

4.2 Grants

Besides revenue sharing, the main mechanism for intergovernmental transfers is grants from central to local governments. In principle, there are three broad categories of grants.⁶

- *Unconditional grants*: These are general-purpose transfers aimed at addressing vertical imbalances.
- *Conditional grants*: These grants carry conditions regarding the use of the funds.

⁶ Ahmad (1997) provides a thorough and readable 'state-of-the-art' study on grants.

Sometimes the conditions are tied to the performance to be achieved in the programmes financed through them.

- *Equalisation grants*: These are used to address horizontal imbalances between local authorities. The purpose of horizontal equalisation is to equalise the capacity of local governments to provide a 'national standard' level of public goods and services. The grants also have the effect of closing the vertical fiscal gap.

A variety of *unconditional* (or general) grant systems are in use to determine the total amount to be distributed among sub-national governments. Brosio (2000) discusses various grant systems in use in Africa: Ghana, for instance, uses a system where no less than 5 % of total central government revenues are to be allocated to a 'Common Fund' for the disposal of sub-national governments. In Uganda, unconditional grants are determined annually with reference to the reassignment of tasks between the national and sub-national governments. According to the Ugandan Constitution, the total amount is calculated on the basis of a formula that includes the unconditional grant of the previous year, corrected by the increase in the general price level, plus the net change in the budgeted costs of running newly devolved or subtracted services. Thus, the Ugandan formula takes into account the actual devolution of functions and its budgetary implications. Ethiopia, in contrast, follows a less transparent system. When determining the size of the grant one starts with estimates of total resources available from tax and non-tax revenue and counterpart funds. However, direct foreign assistance, which is extensive in some jurisdictions, is not included. After negotiations with the regions, the national government allocates the total pool between itself and the regional governments. In 1995/96 a formula based system was introduced in Ethiopia. However, according to Brosio (2000) the formula has changed every year since its introduction.

A key element in many ongoing decentralisation reforms in developing countries is the provision of *conditional* block grants from the centre to sub-national governments. The conditionality refers to earmarking the financing to certain broad-based services, such as primary education, primary health, water supply, agricultural extension and roads. The grants are often based on minimum standards of service to be defined by the sector ministries in negotiation with representatives of sub-national governments. These grants usually relate to recurrent costs only. Such earmarking of grants will of course limit the autonomy of sub-national jurisdictions, and thereby partly negating the arguments for decentralisation (Wolman, 1990). However, imposing conditions may be justified by distributional considerations, such as the need to ensure minimum nation-wide standards for the provision of services of national concern. Thus, to even out income among jurisdictions, the allocation of grants is often based on a redistribution formula which may combine population, income per capita, indicators of backwardness, etc.

Other public services than the major nationally defined ones discussed above, are often funded by unconditional block grants. These services may include district culture, community development, natural resources. As unconditional grants there are no minimum standards of service defined nor any performance indicators. Therefore, these grants may be used at the discretion of sub-national level of government to provide services in line with the objectives of the area, and will be accounted for through the individual jurisdiction's accounting system.

Two factors seem to be critical to ensuring the effectiveness of the block grant system. These are (1) accountability, and (2) predictability. Regarding accountability, financial management and control of the recurrent grants suffer from several weaknesses in many developing countries. These often relate to the absence of internal audit sections, poor reporting systems

and non-compliance with established financial regulation. Semboja (1999) reports from Tanzania that some local authorities divert large shares of the grants disbursed for the education and health sectors to other issues. Regarding predictability, sub-national governments often experience delays and irregularities in the receipt of grants. According to Semboja (1999), local councils in Tanzania, in general, receive less than the budgeted charges approved by the Parliament. For instance, during the five months period October 1998 to February 1999, Kisarawe district council received only 45% of the approved budget. The corresponding figure for Dar es Salaam city council was 66%. Predictability is further weakened since there is no objective criterion for determining the level of charges disbursed to the various councils.

Thus, experiences indicate that it may be problematic in practice to design and enforce appropriate conditions for grants. Without substantial capacity building in financial management and monitoring, controls may end up being more formal than substantive, opening up for mismanagement and corruption. It may even become more difficult to specify and enforce conditionality on the performance of the sectors supported by the block grants.

4.3 Macroeconomic aspects of fiscal decentralisation

Promoting fiscal responsibility at sub-national levels calls for implementation of a stable and transparent system of transfers, geared to filling any gap between the assigned spending and revenue-raising responsibilities of lower level governments (Ter-Minassian, 1999). The creation of such a system is far from easy, especially given the need to preserve adequate incentives for tax effort and cost effectiveness in spending by the sub-national governments. However, in the process of fiscal decentralisation it is important to be aware of the risks for macroeconomic management and fiscal discipline. Mechanisms of fiscal transfers may impose considerably rigidity to the central government budget. Therefore, substantial devolution of revenues and spending responsibilities to sub-national jurisdictions can affect the central government's ability to carry out stabilisation and macroeconomic adjustment through the budget.

The destabilising potential of sub-national governments' is greatest when they face no hard budget constraint (Ter-Minassian, 1999; World Bank, 2000). Expectations of bail-out in case of financial trouble weaken the incentives to economise on costs, and may generate resource waste and rigidity within local authorities. These inefficiencies, in turn, may spill over into macro-economic imbalances. In particular, concern for macro economic imbalance lies behind the common recommendation that strict limits should be imposed on the borrowing ability of sub-national jurisdictions (Bird & Vaillancourt, 1998). It is feared that sub-national governments that are highly dependent on national transfers, may increase their current expenditures above their capacity to fund them out of current revenues and then close the gap through borrowing. For instance, in Mexico provincial borrowing contributed in the mid-1990s to a situation where some states were defined as 'bankrupt' (Tanzi, 2000).

Short-run macro-economic management considerations call for effective limits on sub-national governments' deficits, consistent with national objectives for growth, inflation and balance of payments. To ensure a regular and frequent dialogue between the central government and provincial and local authorities on budget trends, institutional forums, such as the South African 'Financial and Fiscal Commission', may play an important role.

Stability and transparency considerations call for formula-based revenue-sharing and other transfer systems. Thus, many developing countries are currently shifting from totally discretionary methods to formula-based systems of allocation from the centre to sub-national governments. For example, South Africa introduced in 1998/99 a formula-based system of allocation which also includes an equalisation component. However, according to Brosio (2000), the main problems in many African countries at present appear to be: (i) frequent changes in the allocation formula; (ii) use of variables reflecting discretionary policy choices made by the recipient sub-national governments; (iii) little attention paid to equalisation; and (iv) few incentives to increase own revenue generation by lower level governments. The South African system deserves attention since it has made important improvements in terms of transparency and efficiency in the allocation of resources from the centre to the provincial level.

5 Tax administration

Tax administration comprises three interrelated activities: (i) the identification of tax liabilities based on existing tax legislation; (ii) the assessment of taxes to determine if the taxes actually paid are smaller (or larger) than tax liabilities; and (iii) the collection, prosecution and penalty activities that impose sanctions on tax evaders and ensure that taxes and penalties due from taxpayers are actually collected (Das-Gupta & Mookherjee, 1998:28). Such activities require some degree of autonomy if a tax administration is to enforce a government's tax policies.⁷

In order to increase revenue and curb corruption, a number of African countries have implemented comprehensive reforms of their tax administrations over the past ten to fifteen years and established revenue authorities (Devas *et al.*, 2001).⁸ The choice of a revenue authority model, which originates in the so-called executive agency model, aims partly to limit direct political interference into day-to-day operations by the Ministry of Finance, and partly to free the tax administration from the constraints of the civil service system.⁹ Firstly, by being run on business principles, it is assumed that the revenue administration will be less vulnerable from political interventions in its day-to-day operations. Secondly, a semi-autonomous revenue authority can, in principle, recruit, retain and promote quality staff by paying salaries above the civil service regulations, and also easier dismiss staff. It is assumed that such steps will provide incentives for greater job motivation and less corruption. Moreover, it is believed that a single purpose agency can integrate tax operations and focus its efforts on collecting revenues better than what is possible under civil service rules. Furthermore, a shift to an autonomous revenue authority model may also be attractive to donors and senior politicians because it opens opportunities for more widespread reforms of

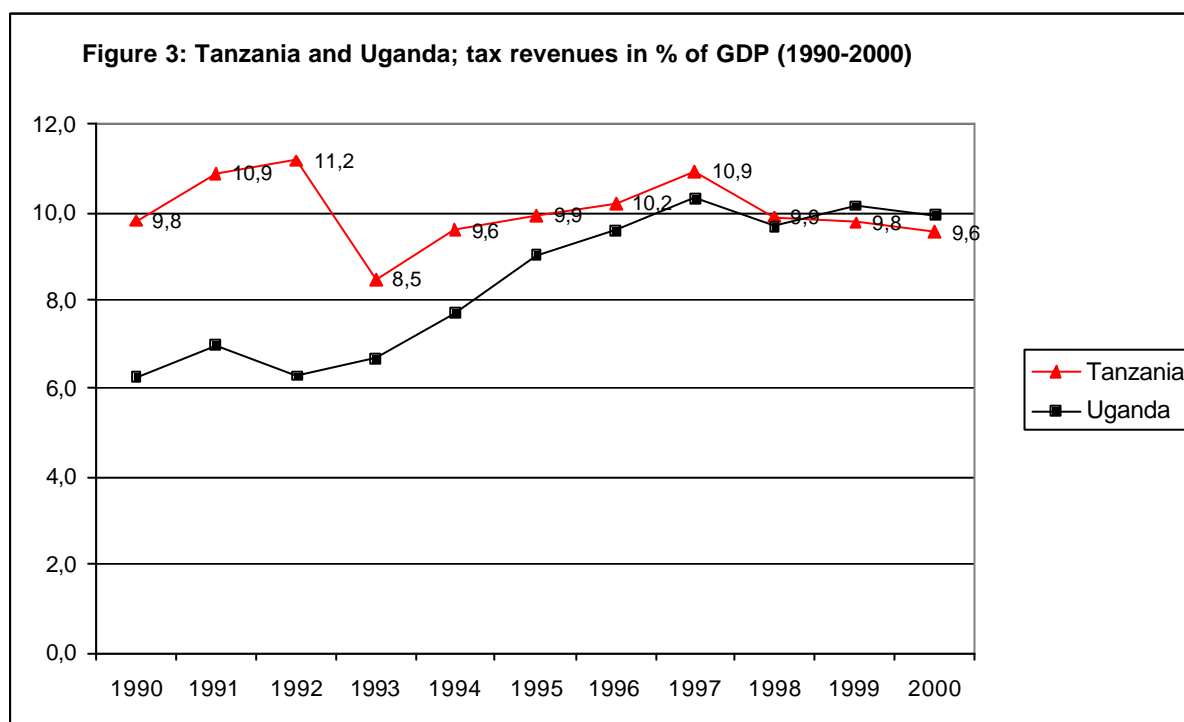
⁷ Other issues are, obviously, also important. For instance, Das-Gupta & Mookherjee (1998) argue for the importance of economic incentives of taxpayers to improve tax compliance and show how such incentives are closely related to tax administration.

⁸ In Africa, the revenue authority model has been instituted in Ghana (1985), Uganda (1991), Zambia (1994), Kenya (1995), Malawi (1995), Tanzania (1996), South Africa (1997), and Rwanda (1997). Mauritius is planning an authority and several West African countries may follow.

⁹ The executive agency model is one institutional model of the new public management (NPM), which is inspired by the radical public sector reform programmes of the 1980s that began in the UK, USA, Australia and New Zealand. Executive agencies provide a way of separating certain governmental functions into arms-length units, giving the management the autonomy to operate the activity like a business, emphasising economic norms and values, rather than a civil service department. McCourt & Minogue (2001) examine the conceptual and practical problems connected with such policy transfers to developing countries.

tax administration (Therkildsen, 2002b:5). To this should be added an additional concern: the deep fiscal crisis of many governments and the chronic inefficiencies of existing tax administration arrangements – typically placed in Ministries of Finance.

Reforms of the tax administrations in Tanzania and Uganda in the 1990s, in the form of the establishment of semi-autonomous and well-funded revenue authorities, resulted in short term revenue increases. But these achievements have proved to be difficult to sustain in the longer run. After the initial success, revenues in percent of GDP are decreasing and the level of fiscal corruption seems to increase (see Table 5). This pattern, initial increases in revenue collection followed by stagnation or decline, is not atypical for tax administrative reforms in Africa as the experiences from Ghana, Tanzania and Uganda show (see Chand & Moene, 1999; Hadler, 2000; Therkildsen, 2002b; Fjeldstad, 2003). According to Taliencio (2001), similar developments are observed in several Latin-American countries. How to explain this trend? Two factors are highlighted; one is related to the limits of autonomy, and the other to patterns of fiscal corruption.



Source: World Bank (2002) *African Development Indicators*.

5.1 The limits of autonomy

To enforce tax legislation vis-à-vis individuals and groups of taxpayers requires not only legal powers to coerce but also some political legitimacy to actually use such powers. To operate a tax administration effectively requires that chief executives have some autonomy over the setting of organisational goals and recurrent operations vis-à-vis the political system and donors. Obviously, it needs ‘adequate’ resources, too, without which autonomy has little

practical meaning. Finally, to secure internal discipline and efficient operations, the chief executive needs some control over resources, staff and their use. According to Grindle (1997:491), autonomy in personnel matters is crucial. This autonomy implies that an organisation can identify positions, advertise for candidates, establish routines for hiring people to fill positions, promote staff based on organisational defined standards, and punish those that do not meet them (Therkildsen, 2002b:6). Such autonomy is associated with good performance as it facilitates effective chief executives and management practices so that performance-oriented norms and behaviours are possible. But, obviously autonomy does not assure these outcomes.

Experiences from revenue authorities in Africa show that the establishment of a proclaimed autonomous authority with comparatively generous remuneration packages and substantial budgets has not protected them from political interference. To the contrary, as argued by Therkildsen (2002b), it has made the revenue authority (RA) a more attractive target because the authority offers both relatively well paid jobs and considerable rent-seeking opportunities. Consequently, a revenue authority is vulnerable to political interference - especially in personnel matters.

The empirical evidence supporting this finding can be summarised as follows:

1. Politics dominates over law: Legal provisions for organisational autonomy of revenue authorities have limited importance in contexts where political elites do not respect them.
2. Autonomy may also contain seeds of its own destruction: RAs have become attractive targets of political interference due to both comparatively favourable remuneration packages and to rent-seeking opportunities.
3. Success may help to protect autonomy: Respect for organisational autonomy established by law depends to some extent on the success of the tax administration. The undermining of, for instance, Uganda Revenue Authority's autonomy became increasingly open once it did not meet its revenue collection targets after 1996.
4. Inflated expectations may help undermine autonomy: Donors and the Ministry of Finance, by pushing for high revenue targets help to undermine the RA's credibility in the eyes of state elites and the public, because such targets create expectations that cannot be met.
5. Autonomous organisations often become easy targets for political blaming: In Uganda, for instance, the public denunciation of the URA by high level political figures, the president included, has helped to undermine the credibility of the tax administration, and hence its capacity to enforce tax laws.

Taken together, these factors may contribute to explain why the initial success of the RA after a period fades somewhat.

5.2 Fiscal corruption

Rising levels of corruption may help explain why the growth in revenue has tailed off in recent years (see Figure 3).¹⁰ But there are clearly other explanatory factors also at work.

¹⁰ One should be careful in drawing too confident a conclusion about successes and failures on the basis of the tax-to-GDP ratio since it tends anyway to be a relatively imprecise measure of performance (see Stotsky & Wolde Mariam, 1997). However, increase in revenues has been the major performance criterion publicly

First, tax revenue depends on external factors over which the tax administration has no control. For instance, general economic trends impact on tax bases such as income tax, VAT and import duties (Fjeldstad, 2003). Import restrictions and politically allocated tax exemptions for different sectors and businesses also contribute to reducing the tax base.¹¹ Furthermore, staff productivity may have changed possibly due to falling motivation caused by, for instance, declining real wages. However, there are many indications that an increase in fiscal corruption has contributed to reducing the growth in reported revenues. Thus, a closer look at the pattern of corruption may shed light on the development of tax revenues. Table 5 provides an overview of different types of tax evasion and fiscal corruption prevalent in the Tanzanian tax administration in the 1990s.

One lesson to be learned from both URA and TRA is that even with relatively respectable salaries and working conditions, corruption may still thrive. Our research shows that pay level is only one of several factors affecting the behaviour of tax officers. In an environment where the demand for corrupt services is extensive and monitoring ineffective, wage increases may end up functioning as an extra bonus on the top of the bribes taken by corrupt officers. The situation requires strong internal control mechanisms and effective sanctions that make it easier to dismiss staff.

Moreover, hiring and firing procedures may lead to more corruption. Corrupt tax officers often operate in networks, which include both internal and external actors. The way the administrative reforms was implemented, where many of those dismissed were recruited to the private sector due to their knowledge of the workings of the tax system and their inside contacts, may have strengthened the corruption networks. Thus, a major challenge facing reformers of tax administrations is to crack corruption networks and the inherent trust that appears to prevail between members of such networks. One suggestion is to introduce rotation systems for staff in tax administrations, where tax collectors remain only for shorter periods in the same post (Das-Gupta & Mookherjee, 1998). But a danger of the rotation system is that the uncertainty which is thereby created for employees may result in increased corruption as collectors may use the opportunity to try enriching themselves while they are stationed in the most 'lucrative' posts. The rotation of officials may also give corrupt superiors undue power (URT, 1996a, p. 284-285). For instance, they might 'sell' assignments to attractive positions or reassign officials to remote stations as a punishment for honesty. The scarcity of qualified personnel like auditors and accountants further reduces the potential of rotation schemes in the poorest countries.

Furthermore, partial reforms may soon run into difficulties. Despite quite comprehensive changes in the tax structure (rates and bases) in recent years, the tax systems in many African countries, including Tanzania and Uganda, are still complicated and non-transparent. Moreover, tax legislation is often unclear and causes random and partly *ad hoc* collection procedures (see Luoga, 2002). Assessors are considered to have wide discretionary powers to interpret tax laws, for instance, to allow or disallow expenses or charges, or to exempt import duty on items imported. Reforms of tax legislation and procedures, including measures to improve transparency in the taxpayer-tax officer relations, should therefore take place

announced by the government in the annual budget speeches of the minister of finance. Targets for the ratio of revenue to GDP are also often written into agreements with the IMF (Therkildsen, 2002b:45).

¹¹ In Tanzania, for instance, there has been a considerable increase in the use of tax exemptions in recent years, which obviously erodes the tax base, at least in the short run. For instance, generous investment incentives in the form of tax exemptions have been granted foreign investors, especially in the mining and tourism sectors (Mokoro & Oxford Policy Management, 2001).

concurrently to reduce opportunities for corruption and the demand for corrupt services. If not, one faces the risk that the administrative reforms will leave behind them highly paid, but also highly corrupt civil servants.

But the successful implementation of such reforms requires political will to back them up. In Tanzania, for instance, an indication of the limited political willpower to fight fiscal corruption and tax evasion is the rise in tax exemptions granted in recent years. While exemptions accounted for 15.2% of total tax revenues (actually collected tax plus exemptions) in 1996/97, this percentage grew to 37% in 1998/99 (Mokoro and Oxford Policy Management, 2001). Experience has shown that tax exemptions create room for bribery and corruption, reduce the tax base, and increase loopholes for tax evasion. In the 2002/03-budget, however, the Government of Tanzania discontinued customs duty exemptions for public sector imports of goods and services. This is a step in the right direction. But, many openings remain to abuse the system. The removal of tax exemptions, including those granted to aid organisations and their employees, would help boost the credibility of both the authorities and the donors in relation to anti-corruption measures, and, at the same time, contribute to widening the tax base and simplifying the tax system.

5.3 Outsourcing of revenue collection

Is privatisation of tax collection a possible solution? Currently, international Pre-Shipment Inspection companies assess the value of imports to Tanzania. But the collection of customs duties is carried out by TRA. In Mozambique, however, both the assessment and collection of customs duties have been managed for some years by a private contractor (i.e., the British company *Crown Agents*), who retains a percentage of the collected revenue. The intention was not to privatise, but rather to carry out a change programme. This management contract was introduced in 1997, and, already in the first year, customs revenues jumped by 40%. In 2000, the contract was extended for another three years, and will thereafter be terminated.

The reform in Mozambique was less a decision to hand over the management of customs to a private organisation than to engage a private organisation temporarily in order to reorganise customs to reduce corruption and clearing times, and to increase customs revenues. The intention was to carry out a change programme, based on developing a management cadre and transferring operational skills to local staff in key areas. However, already after the first three-year contract period, it was clear that the project had achieved few sustainable results (Jenkins, 2003). The promised management cadre was still in training and the transfer of skills was limited. In spite of these experiences and the fact that doubts about its effectiveness were being discussed openly, the contract was renewed for another period. Thereafter, the project will be terminated.

Though it is raised as a possible approach in other countries, (e.g., in Uganda), tax practitioners are increasingly questioning the value of outsourcing tax administration. Outsourcing of some customs activities, for instance, verification, convoy security and warehousing, can be appropriate, though experience suggests it is more expensive and no less susceptible to corruption (Jenkins, 2003). Instead it might be a better approach to upgrading customs capacity to carry out the tasks. Outsourcing of other activities such as valuation and entry processing is fraught, since it places the collection of government revenue directly into the hands of non-government interests. In high corrupt countries, there is no reason to believe that those interests will be any less corrupt or more transparent in their dealings than staff of

the Revenue Authority. It is expensive and placing expatriate customs personnel in line jobs in operational units, could risk to merely compound the current failure to manage and, at the same time, entrench the problems.

With respect to donors, there are no financing problems for recipient governments as long as donors are willing to provide aid at present levels. This may change. It is one thing for donors to fund a government as long as there is progress in revenue collections, but when the tax share stagnates and the financial sustainability of the public sector is routinely postponed, donor motivation may suffer. It also seems unlikely that the recipient government's optimistic long-term revenue projections will continue to be credible in the face of stagnating performance. Thus, the pressure on RAs to deliver more revenues is likely to grow while the causes for increased political interference do not seem to diminish.

Table 5: Tax evasion and corruption in Tanzania – typologies (mid-1990s)

Different types of tax evasion and corruption	Mechanisms and extent
1. 'Unadulterated' tax evasion (without the involvement of tax officers)	
Smuggling	Smuggling of goods (beer, spirits, soap, sugar, cooking oil, etc.). Border police is involved in some cases. Extensive.
The Zanzibar loophole	Goods are imported via Zanzibar where tariffs are lower. They are then transported to the mainland. <i>Tanzania Harbour Authority</i> may be involved in some of the cases. Extensive.
Underreporting of the value of imports	A general problem in imports of goods.
Underreporting of turnover	Common within retail and wholesale sectors.
Misclassification of goods	Import goods with high tax and duty rates are classified as goods with lower rates. One example is the classification of alcoholic beverages as mineral water. Extensive.
Taxable income/transactions are not reported or are underreported in accounts	Several ledgers are often used, including one for taxation purposes that shows a deficit. Common within many businesses. Extensive.
Goods in transit are sold on the domestic market	Could involve many types of commodities. Extensive, especially for oil and petrol.
VAT fraud	Falsified claims for VAT refunds. Can occur with the help of collaborators within the tax administration.
Overreporting of expenditures	An accounting trick to reduce tax burden. Common.
2. External corruption (involves both tax officers and taxpayers directly)	
Goods in transit	Tanzania is a major transit country for the importation of goods to Burundi, Eastern DR Congo, Rwanda, Uganda and Zambia. One way of evading tax is to report import goods as transit goods. Customs officers and importers work together occasionally. Substantial taxation losses. A review in 1996 concluded that at least 50% of all transit imports were unable to provide final documents proving that goods had arrived at their final destination. Most likely they ended up on the domestic market. Extensive.
False classification of goods	Customs officers may be involved (see above).
Underreporting value of goods	To avoid pre-shipment inspection of goods before shipment from the export country, a common method is to split the goods into units which individually are worth less than the minimum required to trigger inspection. The goods are therefore exempted from pre-shipment inspection. Underreporting the value of goods is also common, in particular for used cars. Customs and excise officers may be involved.
Tax exemption	Involves the tax administration, the Ministry of Finance, and Tanzania Investment Centre (TIC). In some cases, the tax payer is not registered in the tax registers, but pays a lower tax "privately" to tax collectors. Goods imported to religious and non-governmental organisations are exempted from taxation by law, but this is misused by business people who, by bribing tax officers, register goods as if they were intended for these types of organisations. In some cases business people also collude with NGO officials. Extensive.
Extortion	Taking advantage of taxpayers incomplete knowledge of tax legislation, tax collectors threaten taxpayers to increase rates and/or assume that taxpayers will not be financially able to press charges. Difficult to quantify, but small businesses, e.g., hotels and restaurants, claim that this is a big problem.
3. Internal corruption within the tax administration (does not involve taxpayers directly)	
Embezzlement of collected revenue	Tax officers steal tax money, leaving little or nothing behind for the treasury. May take place with or without the collusion of bank employees and/or auditors within the tax administration. Extensive.
Fraud	Falsifying tax receipts is common.
Corrupt inspectors/auditors	Internal auditing within Customs is considered inefficient and corrupt. Exacerbates the problems of corruption since it undermines the credibility of the monitoring policy. Extensive.

Source: Fjeldstad (2002c)

6 The politics of taxation and accountability

Western historical experience with taxation has been that a government's increased financial dependence on tax revenues may generate governance benefits, because it encourages the accountability of the state to its citizens (Tilly, 1992). Explicit or implicit agreement about who should pay tax, at what rates and for what purposes was reached through bargaining between the ruler and the potential taxpayers. In the process, the effectiveness and legitimacy of the state increased: the consultations reduced the need for coercion to get people to pay taxes; the bargaining helped to create acceptance about national policies; and taxpayer status became a valid platform for claiming political influence. In contemporary politics in the OECD countries, taxation issues – especially around elections – remain central and important.

In contrast to these experiences, taxation is generally **not** high on the domestic political agenda in sub-Saharan Africa. With the exception of South Africa, the politics of taxation involve, in general, only a few specialised interest groups, and tend to take place in non-public arenas. Often, as the case of Namibia clearly illustrates, small lobby groups with close, informal links to the government pressure for exemptions, for rate reductions on imports, or bargain with officials or ministers about tax liabilities (Rakner 2001; Hansohm *et al.*, 2002). In terms of local government taxation, the picture is different. Around election time, local taxes are often high on the political agenda of both national and local politicians. Our research suggests, however, that this politicisation of local government taxes does not increase tax compliance among citizens. To the contrary, it often undermines local government tax collection efforts (Fjeldstad, 2001a).

The main reason why issues of taxation has not entered the political agenda in most sub-Saharan African countries is that only a minority of citizens form part of the tax-net through payment of direct taxes to the state. Based on World Bank data, showing that in low income countries tax revenue as percentage of GDP has declined by almost 3% between the 1970s to the 1990s, Brautigam (2002) argues that the failure of revenue-raising seems most acute in countries that receive large amounts of aid. Due – in part - to problems of fungibility, since the late 1980s donors, and especially the World Bank and IMF, have increasingly pushed aid recipients countries to meet specific revenue targets as part of their aid conditionality. The International Finance Institutions (IFIs) have also provided technical assistance for that purpose.

Can improved revenue collection and reform of tax policies provide for more democratically accountable government? Although it is quite complicated to sort out the specific effects of taxation and donor interventions in concrete situations, it is clear from the research that fiscal relations between states, donors and citizens do affect accountability relations in direct and indirect ways (Moore & Rakner, 2002). Thus, a better understanding of the fiscal relations in society is important when seeking to promote more democratic and accountable government. As part of the 'Taxation, aid and democracy research programme', we have analysed the relationship between taxation and accountability in the context of tax reforms carried out in a number of sub-Saharan African countries (Gloppen & Rakner, 2002, 2003). In order to assess whether the tax reforms provided a 'governance bonus' in terms of greater responsiveness in state-society relations, we have focused on three interrelated issues affecting the relationship between taxation and accountability: i) The *internal accountability* of the tax system has been assessed with reference to administrative reforms of the tax system; ii) the *democratic accountability* of the tax reforms have been analysed by assessing whether the tax reforms created closer links between African governments and their citizens; iii) last, we assessed to

what extent *external accountability* relations between African governments and international donors affected domestic accountability relations. In this part of the research project we particularly emphasised the tax reforms currently undertaken in Uganda, Tanzania and Zambia where reforms were introduced part of the economic restructuring agreements with the international donor community.

6.1 The internal accountability dimension of tax reforms

If the tax collection apparatus is inefficient, incompetent and corrupt, this is a strong disincentive for potential taxpayers. As a result, the semi-autonomous revenue authorities established in a number of sub-Saharan African countries in the 1990s were perceived to have a positive effect on political accountability relations. However, as argued in the sections above, while compliance from known taxpayers has been increased, the tax base remains narrow. Furthermore, studies and reports from all three countries suggest that the level of transparency and independence from the central government remain low. Can it then be argued that the tax reforms have affected democratic accountability to the extent that the tax reforms have been ‘felt’ by any major groups in society?

6.2 The democratic accountability effect of tax reforms

For taxation to have a positive effect on democratic accountability, taxation must be ‘felt’ by a majority of citizens in order to trigger a response in the form of demands for greater accountability. But the tax reforms have only to a limited degree succeeded in widening the tax base. It has proven difficult or even undesirable to apply the tax law with full force to informal operators. With food commodities often zero-rated and most agricultural inputs exempted, VAT has not included many new groups into the tax net.

Only formal business corporations appear visibly affected by the central government tax reforms. The effectiveness of institutions like Tanzania Revenue Authority with regard to business is illustrated by the fact that until 1995, Tanzanian manufacturers rarely raised the issue of taxation in member-meetings or in member-surveys carried out by their association (*Confederation of Tanzanian Industries*, CTI). Since 1996 taxation has become the main issue of concern. Formal sector business is also the group most affected by the overlapping central and local government taxes in Tanzania (Luoga, 2002). Surveys of Ugandan firms reveal that high taxes, excessive levels of tax bureaucracy, ad hoc assessments, and audits are their major complaints (Obwona, 2002a).

Our research suggests that a voice and an organised response to the new revenue policies are developing within the business community in both Tanzania and Uganda (Luoga, 2002; Kasimbazi, 2003). In Tanzania, the tax grievances of large taxpayers are increasingly being taken to the legal system. According to observers, a constructive dialogue has developed with an increased understanding on both parts on the needs of government and business and a culture of reaching compromises appears to be developing. This is important in a country where the private sector was something completely shunned two decades back. The fact that these issues are being treated through formal, public organizations, rather than through bribery and public deals may indicate the beginning of a link between economic elites and government in issues of revenue generation.

6.3 External accountability

With aid increasingly being conditional and with tax reform part of the conditionality agenda, aid and taxation *may* be positively related. But, external accountability relations could also

hamper democratic accountability. Our research indicates that it is not easy to introduce democratic accountability through externally imposed tax reforms. The tax reforms carried out in Tanzania, Uganda and Zambia in the 1990s were to a large extent formulated and imposed by the international donor community. In all three countries, the IMF performed a lead role in advising governments on major issues of design of tax policies. Typically, donors have pushed for ambitious overall revenue targets. In some contexts, this may have had significant, but unintended, negative influences on (i) taxpayers' rights through coercive tax enforcement, and (ii) accountability by empowering the bureaucracy at the expense of elected politicians.

To meet the targets set by the IMF and Ministry of Finance, the revenue authorities in Uganda, Tanzania and Zambia have focused on increasing collection and compliance from existing taxpayers rather than attempting the more complicated task of widening the tax base (Rakner & Gloppen, 2002, 2003). In the case of Uganda it may be argued that the Ugandan Ministry of Finance, by pushing for high revenue targets, undermined the Uganda Revenue Authority's credibility in the eyes of the public, as the targets were set unrealistically high (Therkildsen, 2002b). Attempts to meet externally set tax-GDP targets may undermine democratic accountability if legal processes and tax payers' rights are set aside in order to comply with external accountability demands (Luoga, 2002). The semi-military operations to prevent smuggling and tax evasion in Uganda are illustrative. As these operations have been staffed by military personnel, the practice should be characterized as a militarisation of the revenue collection (Kasimbazi, 2003; Gariyo & Anena, 2001). Our research findings suggest that if coercion is accepted as an integral part of tax collection it is unlikely that state-society relations can become more accountable and democratic.

7 Tax reforms and the role of donors

7.1 The sequencing of tax reforms

7.1 In 1997, aid represented 10% or more of GDP in 21 African countries. Without aid, governments would have to cut spending, raise taxes, or borrow from other sources. The donors' recipe for reducing aid dependence is straightforward: increase domestic revenue generation in the recipient countries. Our research concludes that there is undoubtedly room for improved fiscal and financial management in the public sector in the case countries as well as improved co-ordination between the different levels of government. However, in the current debate on revenue mobilisation few concrete suggestions are presented on how to increase the tax effort, except for improving the effectiveness of the tax administration. Obviously, tax administrations in many African countries are weak, inefficient and corrupt. Thus, it is argued, the remedy is to build administrative capacity for collection. But, attempts to squeeze additional revenues from poorly designed taxes may exacerbate the negative effects of the tax system on the economy and the society in general. The research project points at three matters of concern with respect to a myopic emphasis on revenue enhancement:

Firstly, donors push for ambitious overall revenue targets (measured as the tax-to-GDP-ratio) may, in some contexts, have significant but unintended negative influences on (i) taxpayers' rights through coercive tax enforcement, and (ii) accountability by empowering the bureaucracy at the expense of elected politicians. Secondly, it is unlikely that a substantial widening of the tax base can be achieved without increasing the tax burden of the poorer

segments of the population. Thus, the donors' push for revenue enhancement may have negative impacts on income distribution. Thirdly, improved tax administration cannot compensate for bad tax design. Excessive and arbitrary taxation are major constraints for economic and social development. Thus, reforming the tax structure should precede the reform of tax administration, since there is not much merit in making a bad tax system work somewhat better. In redesigning the tax structure, the following options should be considered (1) abolition of unsatisfactory taxes; and (2) improvements to remaining revenue bases. Further simplifications of the tax system may also provide a positive contribution towards reducing revenue losses through corruption and tax evasion.

In general, a fundamental requirement when redesigning the tax system is greater emphasis on the cost-effectiveness of revenue collection, taking into account not only the direct costs of tax administration, but also the overall excess burden to the economy, including the compliance costs to the taxpayers. In addition, reduced losses through corruption and tax evasion are needed. To reduce the disincentive effects of taxation, average and marginal effective tax rates should be reduced by broadening tax bases through the elimination of ineffective tax preferences while levelling the rates. Such improvements may take a long time to achieve, although a simplification of the tax system should provide a positive contribution towards these aims.

At the same time, improved tax structure will not work properly unless it can be properly administered. Thus, reforming the tax structure is only the first step, albeit a necessary one. These recommendations must be translated into tax laws, changes in administrative procedures, preparation of lists of tax-payers with relevant addresses, redesigning tax forms, modification of penalties, new audit concepts, new training of administrative personnel, taxpayer education, etc.

7.2 Harmonisation of local and central government tax systems

There is an urgent need to improve co-ordination between the various levels of government with respect to tax policies (Fjeldstad & Semboja, 2000). There is no ideal assignment of taxes between central and lower levels of government. However, a set of 'tax-assignment rules' has been developed in the traditional fiscal federalism theory (Boadway *et al.*, 2000). These principles relate to the respective responsibilities of central and lower tiers of government in macroeconomic stabilisation, income redistribution and resource allocation. Furthermore, the administrative capabilities of local governments in tax design (i.e., deciding on revenue bases and setting rates) must be taken into consideration. Moreover, in large and diverse countries the issue of tax harmonisation between jurisdictions is important when assigning taxing powers.

The stabilisation objective of the fiscal system calls for central control over the tax instruments that may substantially influence central budget deficits or inflation. Thus, taxes on international transactions (customs duties) and a considerable share of income and general sales taxes (such as VAT) should be assigned to central government. Export taxes should, in general, be discouraged. Moreover, the distributive function of government is an argument for centralised corporate income and wealth taxes. If there are wide disparities in income and wealth across regions, as there are in many African countries, then local taxing powers may exacerbate these differences. Since the central government can borrow money to make up for shortfalls, it can live with the more unstable revenue sources. Local governments, by contrast, require relatively stable sources of revenue, such as land and property taxes.

Property tax is at present and will most likely continue to be an important source of revenue in urban councils (Fjeldstad & Semboja, 2000). It may also become important in semi-urbanised centres in district councils. Some tax consultants even claim that commercial land tax can be one of the principal revenue sources for most of the rural councils (see, e.g., Price Waterhouse, 1998). Certainly, land and property taxes have some attractions as local bases since they are imposed on immobile resources, and therefore are difficult to avoid - at least in principle.¹² However, they also have some obvious weaknesses that need to be taken into consideration before heavy reliance is placed on them. Political and partly administrative weaknesses are manifested in problems of valuation and tax enforcement. In theory, assessment of property value and revenue collection are straightforward: conduct a cadastral survey that assesses the market or site value of each plot of land or property, and send a tax bill to each owner. In practice, cadastral surveys are expensive and time-consuming. Tax offices in African countries are, in general, short on assessors, if they have any at all. Thus, it is often difficult to maintain assessments, which are also often eroded by inflation. In principle, non-compliance of property tax can be enforced by confiscation and sale of the owner's personal effects in the building initially, and ultimately upon the collateral of the real estate itself. However, it may prove difficult to carry out such tax enforcement: Firstly, experience shows that courts are often swamped by appeals from angry property- and landowners (Skinner, 1993:364). Secondly, harsh enforcement mechanisms may result in intervention from politicians facing complaints from their constituents (Enemuo, 2000:193).

Thus, experience from various developing countries advocate cautiousness when (1) extending the present property tax to rural councils, and (2) when imposing a commercial land tax in local authorities. In particular, it is important to seriously consider the administrative capacity to maintain assessments of property value. Furthermore, the enforcement mechanisms must be carefully designed to avoid a mushrooming number of court cases and widespread resistance from taxpayers.

7.3 Enhancing tax compliance

Increased efficiency of the tax administration, however, is not enough. Many observers conclude that a lack of a taxpaying 'culture' is the largest obstacle to building a firm long-term revenue base (see Therkildsen, 2002b). The opposite may, however, also be the case: as long as the tax administration culture is perceived to be influenced by sectarianism, nepotism and corruption, it is unlikely to contribute to the fostering of a more conducive taxpaying culture.

Taxes are perceived to be unfair and people receive few tangible benefits in return for taxes paid (Fjeldstad & Semboja, 2001). In such circumstances only coercive methods of tax enforcement can generate revenues. Indeed, in Uganda, the government has established special military units to collect taxes and fight smuggling (Kasimbazi, 2003). Roadblocks manned by soldiers, police and local militia and physical punishment of suspected tax defaulters have become common. At times taxpayers reciprocate violently with "counter-attacks" on collectors or by burning tax offices. Tax riots are now reported from across the African continent.

¹² In some Western countries, including Denmark and Norway, local property taxation is a good source of local taxation.

Both the history of and present capacity of government actors (civil servants as well as politicians) to make credible commitments about the use of their taxes, and government's procedures to design and implementing policy non-arbitrarily are crucial to maintain – or regain – legitimacy. Credible commitments also depend on institutions to ensure that non-compliers will be punished. Moreover, the morality of public office holders can be an important source of political trustworthiness (Fjeldstad & Tungodden, 2003). Thus, corruption is likely to undermine tax compliance.

Our research concludes that tax resistance is likely to continue (and increase) if service provision does not improve, necessitating costly and coercive methods of tax enforcement that may undermining the legitimacy of the government. Improvement in service delivery for the majority of citizens is therefore a necessary condition to improve tax compliance. The existence of positive benefits in the form of public services, security etc. may therefore increase the probability that taxpayers will comply voluntarily, without direct coercion.

7.4 Maintaining tax reforms

Genuine tax reforms require time as well as the commitment of the country's government, which will have to use up some of its political capital in order to bring about changes in the system. This is the situation, for instance, when the benefits from the tax reform are widespread, while the costs are concentrated among specific groups that can get organised and oppose it. There is always a cost and a risk for a government engaging in tax reform. The costs of the reform are always immediate, while the benefits often are spread over the future.

It may therefore be difficult to maintain tax reform. For example, the broadening of the base of income taxes, when accompanied by the lowering of tax rates, does not invite significant opposition. If, however, after introducing these changes, tax preferences are later restored to appease special interests, the initial tax reform effort would have contributed to a tax deform (deterioration of the tax structure) because, in the final analysis, lower rates would be applicable to still narrower bases.

A stable tax policy environment encourages the business community to take a longer-term perspective and reduces the risk in their financial and investment decisions. Tax changes should therefore be made after transitional arrangements have been adequately considered, and they should be presented as part of a long-term strategy. Establishing business confidence in the credibility of the tax regime requires greater attention to preparation, analysis of reforms, advance consultation, and provision of a reasonable period of adjustment before implementation.

In theory, comprehensive reforms would enable the tax system to meet the multiple objectives of taxation and tax reforms. In practice, because the gains from comprehensive reforms become visible only in the medium to long term, it may be difficult to get politicians to commit themselves to a comprehensive reform. Therefore, pragmatism may lead governments' to strive for periodic, incremental reforms. However, a co-ordinated tax reform may offer significant advantages over isolated piecemeal 'patchups' with the tax system, since a coordinated reform is more likely to ensure consistency of individual tax changes with the overall objectives (Thirsk, 1993). For example, reduction in tariffs without a corresponding increase in other taxes may increase the fiscal deficit and exacerbate macroeconomic imbalances. Furthermore, to enhance overall economic performance, tax reform should be integrated closely with overall public sector reforms and economic restructuring measures.

For example, Anderson & Isaksen (2002) looking at SIDA's and NORAD's experience in capacity building in various areas of public financial management (PFM) find that '...the degree of development and success of interventions in one component [of the PFM system] are limited by the state of play in other components'.¹³ It is therefore important to undertake interventions that are balanced between components. Revenue raising tax reforms, for example, make little sense if their proceeds are used to finance an inefficient set of public expenditures. In this sense, if an expenditure reform does not accompany tax reform, it should ideally precede it.

A general lesson from tax reforms is that reformers should as a rule be *risk averse*. This implies that recommended changes should be considered carefully to ensure that their full introduction will not damage revenue yields severely or produce unexpected (and undesirable) inequities. Thus, as stressed by Bird (1983) two decades ago, tax reformers should introduce change with caution. This counsel of caution means that considerable thought and effort have to be devoted to institutionalising and implementing even the most desirable reforms before serious - and in the worst cases, irreversible - mistakes are made. An essential element in a meaningful tax reform is thus a careful, detailed, and realistic study of the limits and potentials of the administrative system that is expected to implement the desired tax reforms. Such a study, while focusing on the taxation system, will also have to take into consideration the limits of reform given by the other components in the PFM system.

8 The way forward – issues for further research

In low income countries the importance of general taxes as major revenue sources for the government will most likely increase. Revenue enhancement will therefore continue to be a primary goal of tax reforms, as a measure to reducing budget deficits. Thus, looking ahead, and keeping in mind that any revenue scheme should also be judged according to its effects on economic efficiency, equity and administrative feasibility, there is, firstly, a need for better empirical understanding of the impacts of taxation on poverty, income distribution and economic growth.

Secondly, there is a need for better theoretical and empirical understanding of the fiscal relations, on both the revenue and the expenditure sides, between states, donors and citizens, and how these relations may affect accountability relations. This dimension of taxation includes the statutory characteristics of the tax system (including taxpayers' rights) and the organisation of revenue collection (e.g., incentive systems for tax officials, revenue assessment and planning systems). For instance, a tax system that is complex, that is poorly understood by both tax administrators and taxpayers, that creates numerous opportunities for corrupt behaviour, and that involves coercion in the collection of taxes from reluctant citizens provides a poor basis upon which to build trust between citizens and the government. And without trust, there is little basis for social co-operation and voluntary compliance with laws and regulations that could potentially benefit everyone. Thus, without trust, coercion provides a reasonable guide for governance. And why should the taxpayer not take advantage of the opportunity to free ride? In this perspective, citizens are likely to trust government only to the extent that they believe that it will act in their interests, that its procedures are fair and reasonable, and that their trust of the state and others is reciprocated.

¹³ The authors see the PFM system as consisting of a number of components, including governance, planning and budgeting, accounting, payments, audit and revenue.

One possible trust enhancing approach is to establish better links between demand and supply of public services. While extensive tax evasion and resistance to pay service charges characterises the official revenue systems, this contrasts with observations of high compliance and less free rider problems in many self-help activities (SHA) in local communities. Self-help activities may therefore appear as a more attractive approach to service provision than the official system of taxation. Increasingly, such projects also involve donor funding through matching schemes. It is argued that matching external funding with local contributions in cash and/or kind provides stronger incentives for local participation and commitment in the involved communities, by linking service delivery and own contributions. Still, many important aspects of how SHAs operate within local communities are unexplored. How is compliance ensured? For instance, are those involved in SHAs homogenous groups or mixed along ethnic, religious and economic variables? How are the internal power relations in the SHAs? Why do some SHAs succeed and others not?

Better links between demand and supply of public services can also be achieved through cost-recovery charging systems, which tie the amount paid directly to the amount consumed. User charges have the potential of enhancing resource allocation by reducing wasteful usage since users pay from their own resources. User charges may also stimulate a supply response by service producers closer to customer demands that in turn may raise quality and remove unnecessary production. However, there are a number of constraints on user charges and other means of cost recovery in poor countries, which need further exploration. These constraints are related to (i) equity considerations; (ii) fluctuations in demand; and (iii) the relations between services financed by charges and private sector provision compared to those financed by public general revenues. Furthermore, as the experiences from Namibia and South Africa show, the political and administrative dimensions of cost recovery may be major obstacles for the sustainability of such schemes.

In this paper we have stressed the importance of taking into consideration administrative, economic and political issues in tax reforms in poor countries. This is also in accordance with recent efforts at tax reforms in developing countries that emphasise the simplicity of tax design and the ease of its administration as fundamental criteria for choosing among alternative measures. However, in this area both a framework for evaluating alternative policies in terms of political constraints and administrative efficiency, as well as estimates on the relative size of marginal administrative and compliance costs of various tax instruments, are scarce. Additional theoretical and empirical research on alternative ways of organising tax collection can potentially yield important insights for tax reform. Moreover, a better theoretical and empirical understanding in this area could ensure that the criterion of administrative simplicity in the design of tax reform is put in appropriate perspective and not overemphasised at the expense of economic efficiency, equity and other policy objectives.

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Summary

Many low income countries face a trilemma with respect to taxation: (1) There is an urgent and obvious need for more revenues to enable resource poor states to provide and maintain even the most basic public services. (2) The reality is, however, that those with political power and economic ability are few and do not want to pay tax. (3) Moreover, those without political power are many, have almost nothing to tax, and do also resist paying taxes. It follows that the challenge for taxation is to raise domestic revenues from consenting citizens in poor and increasingly open economies. Elected governments in poor countries are therefore facing hard choices about taxation. These decisions will most likely have profound impacts on the future of democratisation itself and on public service provision. They will also have considerable implications for the politics and sustainability of aid.

This situation forms the general motivation for the ongoing research programme 'Taxation, aid and democracy'. The research aims to contribute to a better understanding of the evolution of tax systems in selected sub-Saharan African countries. Furthermore, it aims to explore the constraints and options available for policy making and implementation on revenue mobilisation in light of current political, economic and administrative reforms. In depth studies on the tax systems in Namibia, Tanzania and Uganda have been carried out. Moreover, on specific issues such as tax administration and local government finances, the research has also covered other sub-Saharan countries, including South Africa and Zambia. This report presents the major areas of research dealt with in the programme and key findings.

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