



## CENTRE FOR THE FUTURE STATE

Research by the Centre for the Future State has demonstrated the relationship between taxation and governance and the role of tax bargaining in constructing effective and accountable public authority. The research received widespread interest among international donors and NGOs, as well as politicians and senior tax officials in Africa. This second phase of the research explored the policy implications of these findings and what might be done in practice to strengthen the relationship between taxation and broader improvements in governance in developing countries.

### *Why is tax important for governance?*

Taxation is fundamental to sustainable development as revenue generation supports the basic functions of an effective state and enables economic growth. However, taxation is not only a financial issue. Increased revenue from tax will not produce developmental outcomes if it is not translated into productive public expenditure through effective governance arrangements.

A governance approach recognises that taxation can be an important catalyst for the development of wider state capacity. It can also increase state responsiveness and accountability through the attainment of a mutually beneficial ‘tax bargain’ or ‘fiscal contract’, whereby citizens comply with taxes in exchange for government provision of effective services, the rule of law and accountability.

Governments, with the support of development partners, have the opportunity to systematically promote wider gains from tax reform. Although some of the measures discussed below may be politically difficult in the short-term, in the long-term they represent the surest path to stable and reliable domestic revenue mobilisation. Rather than adopting technocratic approaches that aim to increase short-term collection rates, policymakers should thus seek to address politically difficult issues that can lead to better long-term outcomes.

### *Taxation and state capacity*

Innovations in tax administration and its extension across territories can have a positive effect on capacity in other sectors. This can happen when reforms entail administrative innovations that spread throughout the civil service; generate pressure for improvements in related agencies upon which tax collection is dependent; require enhanced government presence in remote areas or generate data or information that facilitates other government activities, such as economic planning.

However, research suggests that positive externalities are dependent upon the particular character of reform. Beneficial spillovers from tax administration to other sectors may be more likely when the following conditions are met:

- Income taxes are emphasised:  
Income taxes are likely to be particularly important as a catalyst for broader gains in state capacity. They are difficult to administer and likely to require improved bureaucratic performance.
- Strong linkages are formed with other areas of administration:  
In addition to contributing to the likelihood of wider uptake of positive reforms, forming linkages with other sectors is very practically useful as sharing information with other branches of administration and private sector institutions facilitates tax collection.
- Data collection and sharing are given priority:  
The information generated by tax collection can have system-wide benefits, for example in monitoring national economic policy or clarifying land ownership.
- There is administrative innovation that is relevant to and feasible in other sectors.
- Taxation administration is extended to relatively remote areas:  
Taxation structures can act as a catalyst for improvement of local government capacity. This is a timely observation as many governments are showing increased interest in decentralisation, but local tax capacity often remains weak and coercive.

### ***Taxation and state responsiveness and accountability***

Taxation can enhance responsiveness and accountability by providing incentives for citizens and government to enter a ‘tax bargain’ or ‘fiscal contract’. This bargain entails citizens accepting and complying with taxes in exchange for government provision of effective services, the rule of law and accountability. The arrangement is mutually beneficial: tax-paying citizens are able to make demands of their governments, and by responding to citizen demands governments can enhance tax compliance and sustain state revenues.

In order to bargain constructively, taxpayers need to be able to act collectively. This is dependent upon perceived shared interests between taxpayers, taxpayers’ understanding of taxation and trust in government. Policy options aimed at increasing the likelihood of taxpayer collective action may include making tax enforcement more equitable, broadening the tax base and improving the transparency and visibility of taxation. Although these strategies may be politically difficult for governments in the short-term, they will increase tax compliance and provide a basis for long-term domestic revenue mobilisation.

- Improving equity in tax enforcement and administration:  
Tax compliance is more likely if citizens are confident that others are also contributing. Equitable tax enforcement can also increase trust between taxpayers and a perception of shared interests, important for taxpayer collective action. Particularly important, but challenging, is better enforcement

of taxes for elites. Better collection of property and personal income taxes and measures to address offshore tax havens are important ways in which this might be attained. Efforts should also be made to bring the informal sector within the tax net, perhaps through offering positive incentives such as reduced police harassment, access to business support services, improved public services or a broader political commitment to inclusiveness by governments.

- **Improving transparency and awareness of tax:**  
Lack of transparency around tax collection, levels of compliance and the use of tax revenue undermine trust in government and reduce compliance, whilst hindering citizen attempts to engage in political discussion of taxation and public spending. Governments should attempt to provide information about levels of tax compliance, consider ‘naming and shaming’ tax evaders and ensure that tax incentives are administered transparently and fairly. There is some potential to work directly with community organisations in collecting revenue. Improved taxpayer services can also improve understanding of and willingness to pay tax through education and awareness-raising and better monitoring of tax officials to prevent arbitrary and coercive practices.
- **Improving understanding of the connection between taxation and expenditure:**  
Although governments typically try to reduce visibility of taxes hoping to avoid political opposition, this is not a viable long-term strategy and may increase conflict and mistrust. Increased use of direct taxes, including income taxes and property taxes, is one way in which tax can be made more visible. Civil society and the media may play a key role in raising awareness of the tax component of the cost of purchases. Earmarking of tax revenues for specific expenditure can, if implemented effectively and honestly, be a useful means of making explicit the linkages between tax collection and public spending. Strengthening local taxation would also increase visibility and make it easier for citizens to connect their payments with spending.
- **Broadening and improving direct taxation:**  
Related to all of above, is the importance of improving the rate of collection of direct taxes. From a governance perspective, improved direct taxation is essential to increasing equity and increasing the visibility of taxes. This in turn is likely to increase citizen awareness of taxation and enhance trust among taxpayers and between taxpayers and the government, thus making public engagement and tax bargaining more likely. Crucial to realising these benefits is improved collection of personal income taxes, particularly from elites. Property taxes are also often poorly enforced in developing countries and have significant potential to raise revenue and increase public engagement with taxation. Tax collection at the local level is often highly reliant on direct taxes and, depending upon local conditions, it may be beneficial to strengthen local taxation.

### ***Strengthening citizen engagement with tax***

In addition to selecting reform strategies that are conducive to effective tax bargaining, governments and development partners can support the capacity of

citizens to engage with government over tax constructively. For an effective tax bargain to be reached, tax payers must be organised in order to make demands on government that are not based only on narrow particularistic agendas. The formation of inclusive business and taxpayers' associations and stronger partnerships between tax authorities and civil society should be pursued.

***Further reading***

Brautigam, Deborah; Fjeldstad, Odd-Helge and Moore, Mick (eds) (2008) *Taxation and State-building in Developing Countries: Capacity and Consent*, Cambridge: Cambridge University Press

Fjeldstad, Odd-Helge and Moore, Mick (2009), 'Revenue Authorities and Public Authority in Sub-Saharan Africa', *Journal of Modern African Studies* 47.1: 1-18

Moore, Mick (2007) *How Does Taxation Affect the Quality of Governance?* IDS Working Paper 280, Brighton: IDS

Prichard, Wilson (2010) *Taxation and State Building: Towards a Governance Focused Tax Reform Agenda*, IDS Working Paper 341, Brighton: IDS