

IDS RESEARCH SUMMARY

Research findings at a glance from the
Institute of Development Studies

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How Does Taxation Affect the Quality of Governance?

Taxation is normally treated as purely a financial issue. It is now increasingly recognised that it is also a governance issue. This paper summarises the policy implications of a growing debate about the connections between the sources of government revenues and the quality of governance.

This Working Paper deals first with the question of where governments obtain their money - whether it is from natural resource exports, aid, or taxation of citizens; and second with the question of how taxes are assessed and collected.

Good governance is defined in terms of the *responsiveness* and *accountability* of the state to citizens, and its capability, both politically and organisationally, to determine and respond to citizens' requirements. There is an argument that greater dependence of states on general taxation – as opposed on revenues derived from natural resources or foreign aid – will improve governance. This seems generally to be valid.

Dependence on taxation, as opposed to other revenue sources, motivates the state to promote citizen prosperity and to develop bureaucratic capacity. Simultaneously, the experience of being taxed tends to mobilise citizens politically. The bargaining between states and citizens that results tends to produce

more capable, accountable and responsive government.. Even those citizens too poor to pay taxes still seem to benefit from the creation of the kinds of stable institutions and predictable political behaviours that tend to accompany state reliance on taxation.

However, taxation also has its dark side. Taxes may be raised coercively, and taxpayers may be granted few rights. This is especially likely at the level of local government in low income agrarian societies. The difficulties attached to collection in these environments tend to lead to a high level of direct contact between taxpayer and tax assessor/collector, endowing collectors with considerable discretionary power, and so facilitating corruption and perhaps extortion. The immobility of poor agriculturalists makes them prime targets for predatory tax collectors. There is also some concern that international financial institutions may themselves contribute to coercive taxation through pressuring

recipient governments to meet annual revenue collection targets, or that government may simply use this argument as an excuse for coercive taxation. Donors may also fail to make sufficient effort to encourage aid recipients to expand their domestic tax base and reduce their dependence on aid in the long-term.

Key research findings

- There is a growing realisation within development policy debates that the nature of the taxation relationship between state and citizens itself contributes to the quality of governance.
- Greater government dependence on taxation for its revenues encourages the development of good governance, measured in terms of accountability, responsiveness and capacity.
- This outcome, however, is not guaranteed. Taxation can be coercive and militate against progress towards good governance.

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- There are many policy changes, some of them relatively minor, which can improve the taxation-governance relationship.
- Aid donors have a crucial role to play, particularly in encouraging the expansion of efficient domestic revenue-raising capacity.

In contemporary poor countries, there are two major forms of taxation that undermine the quality of governance: reliance on large non-tax incomes, and coercive taxation. Fortunately, there are many policy changes that can help improve the situation and that could mostly be made in small steps. Aid donors could, for instance, link aid to improvements in domestic revenue performance. Tax instruments such as value added taxes are effective in raising more revenue fairly. Autonomous revenue authorities generally contribute to creating more effective revenue systems, and reducing tax exemptions and extending registration to a wider group of potential taxpayers are recognised routes to widening the tax net.

Key policy lessons/implications of research

- abolish some taxes
- replace them with more modern and effective alternatives that can be levied less coercively
- use widely known techniques to make the tax-paying experience less coercive
- find national revenue sources to replace aid in the long term.

Credits

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

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