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Taxation, governance and poverty: where do the Middle Income Countries fit?

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Summary

Tax reform can contribute to improved governance and poverty reduction both directly and indirectly: by redistributing income, and by helping establish stronger *fiscal social contracts* in poorer countries. Middle Income Countries can play an especially important role in this process. First, they are especially likely to suffer very high levels of income and wealth inequality and very unjust tax systems. Second, recent experience shows that Middle Income Countries have a greater capacity than Low Income Countries to design tax reforms that are appropriate to local circumstances and likely to command local political support. Because of a series of recent and current changes in the fiscal environment and in tax policies, tax-payers in many Middle Income Countries are likely to become politically more engaged in the near future. Issues of taxation and public spending will become more prominent in public policy debates and election campaigns. This represents an opportunity to promote constructive tax reform – directly in Middle Income Countries, and indirectly in the many Low Income Countries over which some Middle Income Countries are beginning to exert increasing development policy influence. Aid donors and international financial institutions have made substantial useful contributions to tax policy reform in the South in recent decades. They could continue to have a positive influence, especially if they remain engaged with Middle Income Countries and become more willing to allow and encourage the opening up of tax and fiscal policy issues to broad democratic debate.

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1 Introduction

This paper answers four linked questions:

i) How are taxation and tax reform relevant to poverty reduction and good governance in poorer countries?

The answer comes in two parts:

- Many poorer countries are characterised by both high levels of income and wealth inequality and taxation regimes that are simultaneously inefficient and regressive. More efficient and equitable taxation regimes would both change the distribution of income in favour of poorer people and, where needed, permit governments to raise more financial resources to address poverty (Toye 2000).
- The *fiscal social contract* tends to be weak in many poorer countries. Neither in attitudes (political culture) nor in behaviour (political institutions) is there a high level of engagement of citizens in decisions about how public revenues are raised and spent, framed by a broad understanding that both obligations to pay taxes and entitlements to the benefits of public expenditure are an important component of citizenship. Tax reform that strengthens the fiscal social contract should improve the quality of governance and, indirectly, contribute to poverty reduction.

ii) Why focus especially on Middle Income Countries?

Again, there are two parts to the answer:

- Middle Income Countries are by definition wealthier than Low Income Countries. They also have higher levels of income and wealth inequality, and many enjoy under-taxed natural resource wealth. The inefficiencies in their existing tax regimes tend to be especially regressive in their impact on the poor. There is correspondingly considerable scope in Middle Income Countries for efficiency reforms that would simultaneously either directly redistribute income to the poor or provide governments with more financial resources to address poverty.
- There is an increasing awareness that some Middle Income Countries have considerable influence, including actual or potential policy influence, on other countries around them. The best route to influence policy for the better in many poorer countries may be to try to shape the examples set by more powerful Middle Income Countries. And Middle Income Countries tend to be more capable than poorer countries of shaping their own tax reform agendas. They have larger populations of educated professionals, who provide both a constituency for tax reform and the ideas and skills needed to adapt and enlarge the relatively standard reform principles promoted by international financial institutions.

iii) Why focus attention now on the linkages between taxation, governance and poverty reduction?

A series of recent changes in tax policy and in the fiscal environment suggest that, in many Middle Income Countries, taxation issues are likely to become much more prominent on the public political agenda in the near future than they have been in the past. In particular, tax-payers are more likely to become a conscious and politically-mobilised interest group. That could have both positive and negative implications for poverty and governance. It is a good time to be interested in these issues.

iv) What should the international aid and development community have learned about the politics of tax reform?

The taxation component of the *Washington Consensus* has been remarkably successful. A coherent and economical basic formula – simplify tax systems, work with rather than against market signals, focus on administration rather than on tax policy – has dominated the global tax reform agenda in the past two to three decades. It has generated a great deal of positive reform, in part because the reform agenda and process have to a large degree been de-politicised. Tax policy decisions have in large part been presented as technical and administrative issues, and the reform agenda largely set by a transnational network of taxation professionals. Much of the controversy inherent in tax policy has been side-stepped. This technical approach to the subject has many advantages. It also has clear limits, most evidently when it comes to mobilising strong societal support for substantial reform. Without this societal support, it may be difficult to institutionalise current gains to protect them against deterioration in the future, or to deepen reforms into areas that have escaped the *Washington Consensus* agenda.

The conclusions of this paper cover a great deal of territory. We focus in the text on those elements of the story that are not widely treated in the existing literature: the concept of a *fiscal social contract*; the changing fiscal political agenda in poorer and Middle Income Countries; the specific features of taxation systems in Middle Income Countries; and the political dimensions of donor engagement in tax reform. We explain the notion of fiscal social contracts in Section 2, and in Section 3 explore why, historically, they tend to be weak in Middle Income Countries. But the situation is changing. In Section 4 we argue that, in the near future, taxation is likely to feature more prominently on the public political agenda in some Middle Income Countries. That conclusion supports the case we make in Section 5 for aid donors and development agencies concerned about poverty to pay attention to taxation issues in Middle Income Countries. Extended or deeper tax reform will be a more "political" process than many of the reforms adopted in recent years under *Washington Consensus* principles. We present in Section 6 some lessons for aid donors or other external agencies about the politics of tax reform in Middle Income Countries.

2 Fiscal social contracts

The concept of a social contract has a long and varied history. In contemporary discussions on taxation and public finance, it is especially likely to be used by Latin Americans. But the term can mean many different things.[1] When we talk here of a fiscal social contract, we refer simultaneously to both behaviour (political institutions) and to attitudes (political culture). A fiscal social contract exists to the extent that

[1] One can begin by distinguishing between purely heuristic and substantive uses of the term. Many social theorists have used it heuristically to stimulate thought about what political and social arrangements might have resulted if, at some points in time, individuals or groups had voluntarily contracted these arrangements with one another. We use it here in the substantive sense: to refer to observable, even if diffuse, attitudes and behaviour.

there is (a) a high level of routinised, institutionalised engagement of citizens in decisions about how public revenues are raised and spent and (b) that engagement is framed by a broad understanding that both obligations to pay taxes and entitlements to the benefits of public expenditure are an important component of citizenship. The concept remains abstract and rather nebulous: two equally well-informed people might legitimately disagree about the extent to which a fiscal social contract exists in a particular case. They are however more likely to agree on something of more immediate practical value: the list of socio-political and institutional factors that contribute to the construction of fiscal social contracts. The broad sweep of history indicates the importance of six factors that (a) help produce these contracts and, (b) in some cases, are reinforced by its existence.[2]

- First, the *revenue imperative*: the national political executive ("the state"), lacking major alternatives to broadly based tax revenues to meet its financial needs, is motivated to design a system that taps into most major potential revenue sources, to exploit them in ways that will not seriously discourage the economic activities on which they are based, and to exhibit an active and continual interest in revenue raising.
- Second, the *representative constraint*: the appetite of the state for tax revenue is counterbalanced by arrangements for political representation that make it possible for tax-payers and citizens more broadly to have a substantial, institutionalised influence over fiscal policy.
- Third, *public contestation*: fiscal policy issues occupy a significant, routine place in the national political and electoral agendas, and are not reserved for small groups with privileged political or bureaucratic connections. Questions of government's taxing, spending, borrowing and saving are among those issues around which citizens take part in politics, individually and collectively.
- Fourth, *fiscal competence*: the government is able to depend on competent, professional institutions that enjoy a degree of autonomy in managing the tax collection, budgetary, treasury and fiscal policy processes, including routine incremental changes in policy and practice. Routine fiscal management and routine politics are separated.
- Fifth, *fiscal transparency*: legislators and publics have access to relevant and valid fiscal information.
- Sixth, *fiscal integrity*: financial control and auditing functions are conducted with sufficient proficiency and independence that public money is not misappropriated on a large scale.

On a day-to-day basis, there may be a degree of tension between any two of these supportive conditions. For example, more autonomy for the revenue authority to determine procedures for filing property tax returns implies less influence for the legislature. There may be short-term gains to trading off one condition against another, but in the long-term, these conditions are mutually supportive: more of one will

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2 For a detailed account of the long-term development of the British fiscal system in these kinds of terms, see Daunton (2001). For broader historical material, see Moore (2004b forthcoming), Tilly (1992), and Schumpeter (1918/1991).

tend to nurture more of the others. A fiscal social contract is to a large degree created discursively, in repeated debates about competing notions of good fiscal procedure and policy.[3] Conflict and compromise, conducted in a civic fashion, are central to the process.

Like all realistic conceptions of good governance, the concept of a fiscal social contract is built around the notion of tension and a balance of authority, power and responsibility, both (a) between different state institutions and (b) between the state and society. We cannot assume that any increase in the fiscal authority of citizens, whether through strengthened electoral democracy, greater fiscal transparency, participatory budgeting, or some other means, will necessarily help nurture a fiscal social contract. Citizens cannot exercise much actual influence over finances unless there are effective revenue authorities able to raise money, competent budget offices to coordinate expenditure requests, authoritative policy-making institutions to take strategic revenue and expenditure decisions, capable treasuries to manage the money in public hands, and proficient auditing authorities to ensure that little of it goes astray.[4] However, in practice, and as a result of complex interplay of historical and contemporary geo-political factors, contemporary states in the South tend to be unduly powerful in relation to the wider citizenry, and, sometimes, unduly weak in relation to narrow groups (Moore 2004b forthcoming). To that extent, the empowerment of wider groups of citizens is likely to be an important generic component of the strengthening of the fiscal social contract in MICs, as is protecting the state from predatory narrow interests. We can get a better grasp of that issue by looking in more detail at different categories of MICs.

3 Why are fiscal social contracts weak in Middle Income Countries?

The category of 'Middle Income Countries' is not simply a convenient label for a bunch of "intermediate" nations that happen to be neither rich nor poor. While they have no one thing in common apart from middling per capita income levels, MICs are a relatively distinct category from a structural and historical perspective. One can see this more easily by dividing them into three relatively discrete sub-groups: *former Communist countries*; the *countries rich in energy and mineral resources*; and "*other MICs*".

The Development Assistance Committee of the Organisation for Economic Cooperation and Development (OECD/DAC) list of aid recipients indicates that, in 2003, there were 62 MICs with a population of more than a million. About a third of these (19) were formerly part of the Soviet Bloc or Yugoslavia. They overlap a little with the sub-group that are rich in energy and mineral resources – countries that are in most cases MICs simply because they possess these resources, and would otherwise be Low Income Countries. We cannot define this resource-rich group with any precision, partly because market value of their resource base can change appreciably from year to year as world commodity prices change, but also because there is no clear cut-off point at which a country becomes "rich" in resources. Using the data described in Annex 1 relating to the average of 12 years 1990–2001, and defining countries

3 The discursive creation and reaffirmation of an effective fiscal social contract is a central theme of Daunton's (2001) account of the fiscal history of nineteenth century Britain.

4 Fung and Wright (2001: 23–24) make the same general point about the empirical conditions for the existence of what they term 'empowered participatory democracy': effective state institutions are central.

as resource rich if rents from sales of energy and mineral products exceeded 5 per cent of GDP (see below), we can label 20 MICs as resource rich. Three of these are also former Communist countries. There are then 26 countries in the category "*other MICs*", half of them located in Latin America and the Caribbean. Most "*other MICs*" have passed initial stages of industrialisation and development but have not overcome serious domestic and international constraints to providing sustainable livelihoods. In sum, nearly all MICs fall into one or more of three distinct categories: ex-Communist; rich in energy and mineral resources; or other. The resource-rich and the Latin American MICs in particular tend to have high levels of income and wealth inequality. By contrast, the ex-Communist countries that do not enjoy large energy and mineral resources tend to have low levels of inequality.

With a particular focus on taxation, we sketch out here the main long-term reasons why the fiscal social contract is weak within each of our three categories of MICs, leaving a discussion of recent and likely future changes for Section 4.

3.1 The former Communist countries[5]

Communist governments were very successful in appropriating a high proportion of GNP in the form of taxation. The reasons for that were so deeply embedded in the institutional mechanisms of central planning that the ratio of tax to Gross National Product (GNP) did not change suddenly after the end of Communist rule in 1989/1990. Statistical analysis of data relating to the period 1990–2001 shows that, when all else is taken into account, governments of formerly Communist countries were still high revenue raisers (Annex 1). The character of revenue-raising under Communism was however quite distinctive, and far in spirit and substance from the kind of fiscal social contract that we discussed above. The essence was the appropriation by the state of much of the surplus that accrued to state-owned enterprises. Using the institutions of central planning and central banking as well as the relatively rudimentary taxation apparatus, it was relatively easy to identify and appropriate those surpluses. A few turnover taxes were levied on some consumer goods and services, but many of the standard modes of taxation in the rest of the world – notably taxes on international trade and on personal income and wealth – were insignificant or absent.

In addition to (a) the continuing frailty of democracy in many post-Soviet regimes, (b) the associated continuing distrust of governments by citizens, and (c) the problems of transition to a different economic system, many of the inherited institutions and ideas about taxation were inimical both to a recognisably modern tax system and to the development of a fiscal social contract. Databases on potential tax-payers were highly incomplete because they were rooted in information on (former) state enterprises. There was no established practice of tax-payers, corporate or individual, filing tax returns. They were accustomed rather to wait for the tax collector to come to them, generally in person. Taxes had often been negotiated individually with enterprises, and sometimes altered retrospectively so that public revenue targets could be met. The assessment and collection process was largely unregulated by law.

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5 For a succinct summary of the issues treated here, see Martinez-Vazquez and McNab (2000).

In the ex-Communist countries, the adoption of "modern" taxation practices seems to be a precondition for the development of state-society accountability in fiscal terms. They can generally learn a great deal by adopting tax systems from other parts of the world.

3.2 Countries rich in energy and mineral resource

Large energy and mineral resources – oil, gas, cobalt, mined diamonds, etc. – provide wealth and, simultaneously, something much more dangerous: *large rents*. *Rents* are essentially the difference between the cost of bringing a product to market and the price obtained in the market. In some parts of the world it would be profitable to extract and export oil even if the world price were only a fifth of its current level. The remainder of the sales value constitutes rent. Large proportions of energy and mineral rents are appropriated – or are appropriable – by governments, and thus available to whatever group controls state power. Because they can be so very big in relation to all other potential sources of income, large rents provide, in countries with fragile political systems, (a) a standing temptation for "outsider" groups to take over government power by force and (b) a strong motivation for "insider" groups to spend a high proportion of rents on military, security and intelligence apparatuses to fend off competitors. In the 1990s, energy and mineral rents alone – not production, sales or export values – comprised about 22 per cent of the total Gross National Product (GNI) of the Middle East and North Africa region, 20 per cent in the Caucasus, Central Asia and Russia, and 7 per cent in sub-Saharan Africa.[6] Recent research convincingly demonstrates that, when all other factors are taken into account, large energy and mineral resources lower the level of democracy and human welfare and heighten the level of civil conflict.[7]

Rents from energy and mineral resources constitute a far higher proportion of income and wealth in MICs than in either Low or High Income Countries. One simple indicator is whether, on average over the period 1990–2001, rents from the exploitation of energy and mineral resources constituted 5 per cent or more of GDI. By this definition, and taking account only of countries with populations of more than a million people, 42 per cent of MICs were resource rich, compared to only 23 per cent of Low Income Countries and 9 per cent of High Income Countries.[8]

The near-absence of any kind of fiscal social contract in countries "enjoying" (cursed by?) large energy and mineral rents is, in social science jargon, over-determined. There is no dearth of apparently obvious explanations. Correspondingly, we do not know exactly what causes what. Because it is the simplest, we should assume that the most powerful single explanation for the adverse political and institutional effects of resource rents is the one sketched out in the previous paragraph: the behaviour that is stimulated by the fact that high proportions of total national income and wealth are effectively "up for

6 The sources of data are those used in Annex 1.

7 Fearon and Laitin (2003), Quinn *et al.* (2003), Ross (2001a and b; 2003, 2004a forthcoming and 2004b) and Soysa (2000).

8 These figures were calculated using World Bank data relating to 64 MICs, 56 Low Income Countries, and 25 High Income Countries.

grabs", and may be enjoyed in relative security by those who manage to grab first.[9] Other causal mechanisms are also at play. They include the effect on governance of external intervention by powerful countries seeking security of supplies of strategic commodities.[10] This is normally relatively visible. At the other end of the visibility spectrum is the way in which easy access of energy or mineral revenues leads to the non-development of the tax system. Why bother to establish complex tax systems when large regular monthly cheques from energy or mining enterprises meet revenue needs? We know that, although energy and mineral rents are in a logistical sense very easily taxable, they are in practice partial substitutes for tax revenues. Comparing African countries Stotsky and WoldeMariam (1997) demonstrated that enjoyment of such revenues actually lead to a reduced tax effort. We found the same for a large sample of MICs over the period 1900–2001: clear evidence that energy and mineral rents are associated with a reduced ratio of tax to GDP in cross-sectional time series analysis (Annex 1). This blunting of the state's imperative to tax can have adverse effects on the quality of governance. The search for taxes is one important motivation for states to extend effective rule to more remote, rural territories and populations. Without any strong incentive to tax, the incentives to rule those areas are also weakened. The consequent failure to bring some populations into the ambit of a regular civilian bureaucracy leaves the state vulnerable to the (armed) organisational challenge of competitors – guerrillas, private armies based on the narcotics and arms trades, and non-state movements of various kinds. The key insight, shared *inter alia* by counter-insurgency specialists, is that active – but non-coercive – revenue-raising may be an important means of keeping the state machinery alive and active at the grass-roots.[11] Conversely, the fact of paying taxes helps provide the basis for the political mobilisation of citizens to engage with the state over fiscal issues. If citizens pay little tax, they have fewer incentives or institutional opportunities to organise in this way.

In sum, energy and mineral wealth, especially in large quantities, is a major cause of authoritarian rule and civil conflict in many MICs, and is inimical to state-society bargaining over taxation, and thus to the development of fiscal social contracts.

3.3 Other Middle Income Countries

As explained above, the *other MIC* category is relatively diverse, although with a strong Latin American core. One can make a few generalisations about the countries concerned. They are more democratic than either Low Income Countries or MICs with large energy and mineral resources. Like the governments of most Low Income Countries (LICs), the rulers of "other MICs" have in recent decades (a) depended substantially on trade taxes for revenue (Zee 1996), and (b) exploited property taxes to a very small degree, sometimes less often than in the early part of the twentieth century (Bird 2003; Kaldor 1963; Skinner

9 This mechanism is especially powerful when, as in most of the South, resource extraction is directly controlled by the state or by foreign companies. In some circumstances, powerful domestically owned private companies can bargain with the state and mitigate the degree of "grabbing" of rents (Jones Luong and Weinthal 2004).

10 External intervention sometimes involves attempts to change the government, but more often is designed to maintain the existing one in power.

11 See Chaudhry (1989, 1997), Moore (2001 and 2004b forthcoming), and Odon (1992).

1991). Like most poorer countries, but in contrast to most OECD nations, the level of *public contestation* over tax and fiscal issues is relatively low even in the more democratic *other MICs*. There seem to be three reasons for this:[12]

- The first is a history, especially in Latin America, of high levels of inflation. High inflation has very marked effects on the policy agenda. On the one hand, it is an urgent and pressing issue that tends to consume political attention. Governments have to be seen to be trying to do something about it (Hirschman 1981). On the other hand, high inflation discourages broader, representative political agents from engaging in public debate over the details of tax policy or fiscal policy generally. Any gains could be wiped out very quickly, because high inflation tends also to change relative prices in complex and sometimes almost unknowable ways. Broad disengagement is more likely. Instead, the politics of tax are likely to be dominated by narrow interest groups motivated to try to amend policy to protect themselves, e.g. by pegging pensions to inflation. In Brazil, for example, public sector workers mobilised effectively to index wages and pensions to inflation and to enshrine such indexation in constitutional legislation. Inflation also provides distorting and illusory benefits to states. Inflation allows cash management practices that index revenues and delay payments and thus provide an (invisible) inflation tax. During the late 1980s and early 1990s, the real fiscal capacity of national and subnational governments declined precipitously in Brazil, but they survived on these cash management techniques (Samuels 2003).

- The second factor is the relatively high dependence on indirect taxation, mentioned above. Political resistance to taxes tends to be greater when (a) the logistics of collection makes tax-payers very conscious that they are making payments and (b) taxes impact directly on incomes, and cannot be passed on to other people in a chain of economic transactions. Governments prefer not to levy such visible and non-avoidable taxes if there are politically easier alternatives. This is the major reason why relatively efficient and equitable property taxes provide declining proportions of public revenue in countries like the US and the UK (Bird 2003: 44). It has proven easier to shift the burden of revenue-raising onto less visible taxes, especially value-added taxes (VAT). Let us for the minute accept the conventional terminology and assumptions of taxation specialists and agree that politically less visible taxes largely overlap with the category of *indirect taxes*, i.e. taxes that are levied on economic transactions, rather than directly on income or wealth. Just as *tax takes* – the ratio of tax revenue to GNI – increase as countries become wealthier, so too, with equal predictability, does the ratio of *direct* to *indirect* taxes. Until recently, governments of many poorer countries depended heavily on indirect taxes levied on imports and exports. Over the past two decades or so, many have replaced these trade taxes with another form of indirect tax – VAT. We suggest in Section 4 that this shift from one form of indirect tax to VAT is politically significant: that VAT is, from a political

12 These issues are discussed in more detail in Moore (2004a, forthcoming).

perspective, somewhere between a *direct* and an *indirect* tax. But the immediate point here is that governments of MICs depend heavily on relatively invisible indirect taxes. Further, while they derive much the same proportions of their tax revenue from direct corporate income taxes as do OECD governments, unlike OECD governments, they raise very little money from direct taxes on personal incomes or wealth.[13] [14]

- The third factor is that the structure of the tax system itself creates incentives for tax-payers to pursue individualised, covert political strategies in engaging with the state over taxation issues. In some cases, a small number of taxpaying units individually account for a significant proportion of government income. Much public tax revenue comes from a relatively small number of relatively large (corporate) tax-payers.[15] Further, as a result of a history of interventionist economic strategies and/or pressure from narrow interest groups, tax-payers often face taxation systems that are (a) complex, with a wide range of taxes, many different rates for individual taxes, and a large number of potential exemptions or special cases (*tax expenditures)*;[16] (b) changeable, constitutionally or in practice, through the decisions of a few individual ministers; and, as a result, (c) highly discretionary in application. Tyre manufacturers, importers, wholesalers, retailers and re-treaders may each face a different set of taxes, and a different set of rates. The combination of all these factors means that, relative to OECD countries, tax-payers, both individual and corporate, face strong incentives to negotiate with (i.e., normally, bribe) taxation officials and/or politicians rather than engage in (overt) collective action among themselves to put pressure on government to change tax policy or practice.[17] Evidence on this is mainly impressionistic and anecdotal. We do not know in detail what strategies tax-payers pursue. Some large companies might in some circumstances pursue both the "negotiation" and the "collective action" route simultaneously, although the one is likely to undermine the effectiveness of the other. It does however seem clear that this combination of features of current

13 Some MICs, especially in Latin America, have been like OECD countries in finding a significant source of revenue in social security contributions from employers or employers. For data on these points, see Zee (1996: 1662), Tanzi and Zee (2000), and Bird and Zolt (2003).

14 The ability to raise significant revenues without engaging citizens over direct taxes is both a blessing and a curse. In Brazil, only about 7.5 per cent of GDP is collected in direct taxes while a remarkable 28 per cent of GDP is collected through a maze of contributions, fees, sales, and turnover taxes (Werneck 2000). The effectiveness of the state in squeezing extra revenues from indirect tax sources has been a vital component of fiscal adjustment; yet, the inability to engage citizens directly to negotiate additional revenues has meant that adjustment has come at the cost of increasing inefficiency and distortion to the economy.

15 We do not have very detailed information on this, not least because most tax records are supposed to be confidential. It is not unusual that in relatively small and poor economies, one large brewing or tobacco company enjoying a quasi-monopoly in the local market might account for several percentage points or more of total tax revenue. A recent study of Peru concludes that 54 large tax-payers account for more than 40 per cent of total tax revenue from internal sources (i.e. excluding trade taxes), partly because large companies assist the revenue authority, National Tax Administration Superintendancy (SUNAT), in collecting VAT and consumption taxes (Mostajo 2004).

16 For example, before the 1986 tax reform, the Bolivian government collected nearly 400 different taxes earmarked for specific groups – 'regions, unions, retired employees, and other specified groups and entities' (Cabezas 1990: 533).

17 Conversely, tax collectors have strong incentives to operate arbitrary and extortionary collection processes. Tax-payers have few rights in much of the South (Luoga 2002).

taxation systems in many poorer countries is a significant political obstacle to placing tax-payers' concerns – whether about tax levels or the collection processes – onto the public political agenda.[18]

It is partly for these reasons that, even in democratic MICs where legislatures have significant fiscal influence, there is limited *public contestation* over fiscal issues.[19] However, that situation seems to be changing.

4 The evolution of tax and fiscal policy agendas

Circumstances are more conducive to effective fiscal social contracts in the average MIC today than they were 30 years ago. One of the most widespread reasons is democratisation, notably in Latin America in the 1980s and in East and Central Europe in the 1990s. We can best sketch a fuller story by looking at our three categories of MICs, starting first with the resource-rich.

4.1 Countries rich in energy and mineral resource

The main recent change in this category of countries lies not so much in the internal situation as in the fact that the international community has increasingly recognised the extent to which energy and mineral rents blight and undermine the quality of national governance. The response so far has taken two main forms. One is to try to "sterilise" natural resource rents, politically and economically, by locking them up in the kinds of long-term funds pioneered above all by Norway. The other is to push for more transparency in the revenues that governments receive from companies involved in the extraction or purchase of energy and mineral resources. The Extractive Industries Transparency Initiative of 2003 represents an important milestone along that road. However, neither of these measures is likely to have more than a marginal impact on the problem. Neither can directly prevent governments from abusing resource rents, nor deter global powers from supporting authoritarian regimes as part of a strategy to ensure security of energy supplies. We can be sure that the resource curse will continue to blight many areas of the South for the foreseeable future. Because of current uncertainties about the stability of oil supplies from the Middle East, about the future of the world oil price, and about the likely rate of exploitation of new West African oil fields, it is not possible to predict how particular countries will be affected.[20]

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18 We are grateful to John Toye for originally drawing our attention to this point.

19 As Tony Killick has reminded us, personal income tax has been a significant political issue in many poorer countries. But, because most people who pay this are public sector employees caught by PAYE systems, debate is often confined within the framework of negotiations between governments and public service unions over public sector pay and conditions.

20 Oil rents are now becoming a significant factor in those parts of West Africa where newly-discovered onshore and offshore oil fields are being prepared for exploitation (See *The Economist* 26 October 2002: 85–6, and Global Witness 2004). By contrast, many Middle Eastern oil states are now running into unprecedented fiscal difficulties. In the long-term the real price of oil has declined, and there is little prospect of any reversal. Many Middle Eastern populations have become accustomed to generous state welfare expenditures in return for their acquiescence to paternalistic or authoritarian rule. But in recent decades those populations have expanded faster than in any other region of the world. Oil regimes can no longer afford to provide the (relative) luxury to

4.2 The former Communist countries

The trends are clearer here. From the political and institutional perspective, this category of countries is becoming less distinctive over time. Their governments no longer raise the same high proportion of gross domestic product (GDP) in taxes as they did in the early 1990s, immediately after the end of Communist rule. With many variations between countries, the average ratio has declined steadily (Stepanyan 2003). Internal differences between different categories of former Communist countries are becoming more pronounced. Two distinct groups are emerging. One comprises those Central European, Baltic and Balkan countries that have met, or are meeting, the conditions for admission to the European Union. In addition to democratic rule, these conditions include modernising tax systems such that they are broadly similar to those of most OECD countries, including in particular a substantial dependence on VAT and on personal and corporate income taxes. The other group is becoming stereotypically "resource-cursed": characterised by narrowly-based authoritarian regimes; the failure to spend rents on improving popular welfare; enmeshment in the international geo-politics around energy resources; and taxation systems that, although reformed in some respects, have many of the "extractive" features characteristic of the former Soviet regimes. The Caspian Basin oil states – Azerbaijan, Turkmenistan, Uzbekistan, and Kazakhstan – fit this characterisation clearly (Esanov *et al.* 2001). Ukraine is similar, with the distinctive feature that a large proportion of its "natural" resource endowment takes the form of transit fees for the oil and gas pipelines that cross its territory. So too is Russia. Easter's (2002) comparative analysis of tax reform in Poland and Russia in the 1990s highlights some important differences in fiscal sociology between those ex-Communist countries that have become EU accession states and those that are resource rich:

- In Poland the overall ratio of taxation to GDP has been maintained at a high level, despite a rapid decline in heavy industry and the consequent disappearance of the tax base that had sustained the Communist regime. Polish governments have managed to introduce a direct income tax that now impacts on a large proportion of households, and provides the government with a quarter of its revenue. Success in this area has enabled the state to avoid punitive taxation of new economic enterprises. The process of introducing this tax has strengthened democracy and pluralism. There was considerable popular resistance to various versions of the new income tax. Polish governments bargained with the trades unions and other organisations that articulated these protests, negotiated compromises, brought the unions into a Tripartite Commission with government and industrial managers in 1994, and won the acquiescence of the population. Direct income taxes on ordinary households are now accepted as legitimate in Poland.

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which some segments of their societies have become accustomed. GNP per head in Saudi Arabia has halved since 1980. The previous implicit political deal – welfare spending for the masses in exchange for opulence and absolute authority for ruling families – no longer seems viable. Reduced public expenditures and serious attempts to tax citizens are both on the cards. (See 'A Survey of the Gulf States' in *The Economist* 23 March 2002.)

- Russia presents a different story. After the end of Communism, the large reserves of minerals, metals, oil and gas that provide the main source of export earnings came under the control of a small number of fully or partly private conglomerates. Rather than broadening their revenue base, in the 1990s Russian governments relied heavily on these conglomerates for their revenue. The Kremlin was however obliged to compromise with powerful groups that had a strong stake in these conglomerates: their owners and managers; the regional political authorities where the commodities are produced; and the banks that, starting life as the financial departments of these enterprises, now have an entrenched role as money managers for the Russian state. This "lock-in" had adverse fiscal, economic and political consequences. Throughout the 1990s, the Kremlin was unable to tax the big commodity conglomerates at a reasonable level. Partly in consequence, its taxation authorities continued to raid and squeeze smaller economic enterprises that lack political muscle. There was no significant or transparent negotiation between government and organised socio-economic interests over taxation issues: the tax contributions of the conglomerates were determined through elite bargaining.[21]

In sum, elements of a recognisable *fiscal social contract* have been forged in Poland (and most of the EU accession states), but not in most of the resource rich ex-Communist countries. The outcome in Russia is uncertain, but potentially very important because of its direct and indirect influence on several other neighbouring MICs.

4.3 Other Middle Income Countries

The picture in the more typical MICs is considerably more encouraging. In addition to the substantial movement toward greater democracy, other widespread recent trends have significantly increased the scope for strengthening fiscal social contracts, especially through stimulating greater *public contestation* over fiscal issues. We can summarise these changes under two main headings: *changes in the fiscal environment*; and *changes in political activism around budgetary transparency.*

i) Changes in the fiscal environment

Three important changes that have taken place in the fiscal environment of most MICs – and many other countries – in recent years increase the prospects that (a) tax-payers will become politically more organised and (b) more broadly, that fiscal and taxation issues will become more prominent on public political agendas:

21 Jones Luong and Weinthal (2004) present a more optimistic interpretation of the Russian case, on the basis of a series of substantial tax reforms negotiated between the Kremlin and the large private Russian oil companies in 2001–2. They argue that these reforms have introduced more stability and transparency into the taxation system, and have improved the investment environment for large companies. It is not yet clear that this optimism is yet justified, or how far these reforms are likely to improve the situation for ordinary tax-payers, as opposed to large oil and gas companies.

- As a result principally of a general shift in macroeconomic policy, the global annual inflation rate has fallen from about 30 per cent in the early 1990s to 4 to 5 per cent in 2003, with most of the reduction taking place in Middle and Low Income Countries. For several years now, average inflation rates have been in single figures in most of the South. They remain higher than in most OECD economies, but not radically so (Rogoff 2003). They are sufficiently low that individuals and interest groups can engage in political action over taxation and fiscal issues with some confidence that the monetary data that they employ have a close relationship to real economic statistics, and will continue to do so for some years. In addition, monetary stability has forced governments into a more transparent management of fiscal accounts. No longer can obligations be hidden and avoided by inflating them away.

- Value Added Tax has spread rapidly (Toye 2000: 39), and by 2001 was estimated to have been introduced in at least 123 countries, accounting for about 70 per cent of the world's population (Ebrill *et al.* 2001). It has been popular with governments because it is (a) such an effective means of raising revenue, even in economies where the low level of record-keeping in small businesses would appear likely to pose major practical obstacles; and (b) politically relatively invisible from the perspective of those who actually pay the tax in an economic sense – virtually all consumers (Toye 2000). However, despite the fact that it is classified as an indirect tax, VAT is the opposite of invisible from the perspective of those who actually hand over the money to the tax authorities (and re-claim refunds). Even when it was first introduced in Europe, VAT was recognised to impose a heavy burden on smaller businesses because of the additional and relatively complex record-keeping obligations it places on them (Dosser 1981). The introduction of VAT has been resisted quite strongly in some developing countries. It has not yet been introduced in India because of strong resistance from traders' organisations. Its introduction led to large scale protests, and to some riot deaths, in Ghana and Uganda. Some of this resistance stems from a combination of bad political tactics on the part of government and a perception, at least partly accurate, that VAT is being introduced in poor countries at the behest of the international financial institutions. VAT was re-introduced relatively smoothly in Ghana once the government paid attention to political tactics and presentation (World Bank 2001). VAT may generate less political resistance than direct taxes, but will generate more reaction than other indirect taxes like import and export duties. It has considerable potential to stimulate interest-based collective action on the part of a broad spectrum of tax-payers, especially smaller business people. There are three reasons for this. The first is that the most irritating feature of VAT – the need to maintain written records of all sales and purchases in order to reclaim payments on intermediate transactions – tends to impact especially heavily on smaller businesses unused to keeping extensive records. The second is that the partial self-checking nature of VAT, that helps make it a relatively effective mechanism for raising revenue, reduces the opportunities and incentives for tax-payers to use bribery to reduce their obligations (Toye 2000: 40). The third is the fact that the coverage is typically limited, especially initially: many types of business or economic sectors are excused registration, formally or informally, because of the logistical obstacles involved. Yet both the logic of the VAT system and its proven capacity to raise revenues tends to drive tax authorities continually to try to expand coverage. There may be a continual threat of expansion to relatively distinctive categories of businesses, who will in turn tend to mobilise to prevent that happening.

- Tax systems in many countries have been considerably simplified in recent years as a result of their adoption of what we term the *Washington Consensus reforms*. These reforms, promoted in particular by international financial institutions, are built around a few core elements, including: the reduction in trade taxes; the introduction where feasible of VAT; fewer attempts to use the tax system directly to redistribute income or to change market signals; more emphasis on administration and administrative feasibility; and, most important for present purposes, the general simplification of taxation systems – fewer taxes, fewer rates for individual taxes, fewer exemptions, and less discretion on the part of the tax collector, with the attendant incentives for corruption (Goode 1993; Tanzi and Zee 2000).[23] These reforms are far from complete, and, in some cases at least, they have been subject to some reversals.[24] Tax systems in the South still provide the kind of scope for bureaucratic and political discretion – and the incentives for both corruption and individualised political strategies on the part of tax-payers – that were described in Section 3. But this is less true now than a decade ago. To the extent that large groups of tax-payers now face a common, simplified taxation regime, and reduced opportunities and incentives to use particularistic political and bureaucratic channels to solve their problems, they are more likely to engage in overt collective political action in pursuit of their demands. The Chilean fiscal pact, described in Section 5, illustrates that point.

ii) Changes in political activism around budgetary transparency

The second cluster of changes is equally amorphous: the growing popularity of a set of ideas about the virtues and possibilities of both budgetary transparency and more direct popular participation in budgeting. This movement – if it can be characterised as a movement – has several roots. The most developed and tangible is the apparent relative success of participatory budgeting in Porto Alegre and, to a

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23 There are many dimensions to what we have here termed "simplification". For example, clearer functional specialisation within tax offices – the separation of functions like processing returns, auditing, and receiving payments – is likely to help reduce corruption (World Bank 2000).

24 It is very hard to assess overall progress. The introduction of VAT is normally an important step, because it tends to replace a range of other taxes, and normally provides only limited scope for discretionary decisions by tax collectors (Toye and Moore 1998: 74). However, some governments formally committed to simplification have sometimes in practice done the opposite, notably when introducing new tax measures in a hurry to meet enhanced revenue targets under structural adjustment programmes (Toye and Moore 1998: 81). More generally, governments are more likely to announce their simplifying reforms than to publicise the occasions when they effectively back-track by re-introducing complications and exemptions. For example, the Government of Peru has exempted the Amazon Department from fuel taxes, and thereby created incentives for fuel smuggling and major administrative problems for the Peruvian tax authority, SUNAT (Carlos Santiso, private communication).

far lesser extent, other cities in Brazil (Goldfrank and Schneider 2002). There has been in addition a set of research and advocacy activities around gender budgeting (Cagatay 2003); a number of grass-roots movements, notably in India, for public budget transparency at the local level (Jenkins and Goetz 1999); a growing pressure from transnational NGOs for transparency about payments of natural resource royalties and taxes made by transnational companies to national governments (Global Witness 2004); a increasing concern by the international financial institutions to press for fiscal transparency in poorer countries as a result both of enhanced attention to these natural resource issues and a perception that the 1996 Asian financial crisis was caused in part by "crony capitalism"; a relatively new interest in budgetary issues on the part of many legislatures worldwide (Schick 2002: 16); and a range of advocacy activities around budgeting in general (Lavielle *et al.* 2003). Finally, a number of international aid and development agencies, having concentrated to date mainly on the public expenditure dimension of public finance, are paying more attention to taxation.

It is possible that the world is in the middle of what will in retrospect be viewed as a major upsurge of citizen activism over fiscal issues. This upsurge began in some OECD countries in the later twentieth century. By the 1980s, public budgets and tax burdens had expanded very steadily in the OECD countries over the three decades since World War Two. This expansion, along with increasing levels of education, created a constituency of tax-payers concerned to know more about where their money was going. The spread of new information and communication technologies made it much easier for organisations and groups outside the state apparatus to appraise government's fiscal performance, and to publicise the results. The earliest major manifestation of citizens' fiscal activism took the form of the strong anti-tax elements of 'New Right' of the 1970s and 1980s. Opposition to the steadily increasing tax burden was a major theme in the work of the most prominent populariser of the ideas underlying this new pro-market movement, Milton Friedman (Friedman and Friedman 1980: 89). This same scepticism about the tax burden and the size of the public sector to a large degree underpinned "Thatcherism" in the UK in the 1980s, the introduction of the "new public management" and the growth of anti-tax movements and political parties in several OECD countries.

In the North, citizens have become more activist over fiscal issues in their roles as both tax-payers and beneficiaries of government spending. It has been different in the South. There the initiative has come mainly from groups speaking for or in the name of citizens defined as potential citizen-beneficiaries of public expenditure. Classic tax-payers' anxieties about "waste" of public money have received less attention than citizen-beneficiaries' concerns about efficiency and equity in public service provision – or citizens' worries that the corrupt use of public money might undermine democracy. The broad reasons for this difference in agendas seem clear. As explained in Section 3 above, the material and institutional basis for tax-payer activism has been weak in much of the South. And much of the initiative over budgetary transparency often has been taken by development NGOs with strong transnational links, whose ideological positions are broadly leftish.[25] It is hard to imagine such organisations identifying closely with

[25] See, for example, the annual Latin American Index of Budgetary Transparency (Lavielle *et al.* 2003).

tax-payers' concerns. However, the more that the civil society organisations, NGOs and international financial institutions expose the waste and misuse of public money within the state apparatus, the more ammunition they may be providing to incipient tax-payer organisations animated mainly by the wish to be treated more fairly by tax collectors or by the desire to keep "their" money out of the hands of the government. The intrusion of some fiscal concerns onto the public political agenda in MICs is likely to stimulate the emergence of others.

5 Why Middle Income Countries?

Why should people and organisations concerned about taxation and poverty in developing countries be especially interested in Middle Income Countries? The two answers to that question have already been summarised in Section 1. The first arises from the fact that MICs tend to be characterised by high income and wealth inequality, under-taxed natural resource wealth, and inefficient and regressive taxation systems. Correspondingly, there is a higher potential here than in Low Income Countries for tax reforms that would simultaneously improve efficiency, directly redistribute post-tax incomes toward poorer people, and/or permit governments to raise more resources to address poverty and disadvantage. The second answer is that MICs are a potential gateway to change in poorer countries.

Part of the reason is that "footprint" countries – those that are recognised as having powerful direct and indirect potential impacts on the development paths and policies of their neighbours – tend to be MICs. In the non-OECD world, there are about 10 countries liable to be especially influential because of their large size in relation to their neighbours and a tradition of economic, cultural or military influence over those neighbours. Of these, eight – Brazil, China, Egypt, Indonesia, Mexico, Russia, South Africa and Thailand – are MICs.[26] Another part of the reason is more specific to the international tax reform agenda. This has become dominated by one set of ideas that, at least in many poorer countries, may become dangerously hegemonic (monopolistic); MICs are better placed to induce more pluralism into the policy debate.

The *Washington Consensus* ideas about tax reform, sketched out in Section 4, have been dominant for some time at the global level and within many Low and Middle Income Countries. This reflects a number of factors. One is the fact that, in this case at least, the *Washington Consensus* agenda is largely consensual. While some tax specialists might disagree with some elements of the package,[27] there is little radical dissent. Indeed, to many specialists, statements of the *Consensus* sound rather like common sense.[28] The

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26 That leaves India and Nigeria.

27 Concerns include, for example, the potentially regressive effect of the increased reliance on VAT.

28 There is no single authoritative statement of the consensus, and it can be expressed at various levels of abstraction. The following statement of the characteristic of a good tax system, from a routine recent IMF publication, is typical of the genre:

- 'The tax system should be efficient in that private consumption, saving, production, and investment decisions should differ as little as possible from what they would be in the absence of taxes. However, in the presence of market imperfections, such as externalities, some distorting taxes may improve efficiency and enhance growth. The tax system should thus support efforts to increase economic growth.

fact that this *Consensus* partly derives from and is continually reaffirmed by *the* specialist international organisation dealing with taxation developing countries – the International Monetary Fund – gives it added credibility. So too does the fact that improving *administration* is a core and distinctive component of the *Consensus* agenda. Tax administration is amenable to global standardisation, and therefore to relatively standard prescriptions. Concentration on this area is a way of sidestepping the more political – and more contentious – issues of tax policy. The fact that tax reform is widely perceived as a technical issue makes it easier to justify giving an important role in poorer countries to Washington-based networks of international experts.[29]

This combination of policy consensus, global standardisation, IMF dominance and substantial de-politicisation can be a way of quickly achieving a great deal of legislative and administrative reform. The reforms that have been widely adopted are generally very positive. Our purpose in pointing out the underlying politics of the process is not to criticise the outcome, or any institution involved. Our concern is rather that monopolies, including monopolies of policy ideas, can have costs, in the long if not the short-term. There are three longer term implications of the success of the *Washington Consensus* tax reforms that need attention:

- First, the reform agenda is actually rather narrow. It is actually rather a good place for many countries to be in terms of tax policy for some period of time, but few would be advised to stay there forever. As we explore in a little more detail below and in Section 6, the *Consensus* fails to deal with some important issues, places too much emphasis on relatively technocratic measures, and does not

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- The tax system should be fair or equitable in the distribution of the tax burden. Vertical equity implies that those with the greater ability to pay tax should pay a larger proportion of their income or wealth in taxes, while horizontal equity implies that those with an equal ability to pay tax should pay the same proportion in taxes.
- The tax system should facilitate tax administration and reduce tax-payer compliance costs.
- The tax system should be stable, often with phasing in of significant changes, to ensure that tax-payers can make rational economic decisions. It should also match tax instruments to tax objectives.
- The tax system should be transparent and rules-driven, with scope for discretion on the part of administrators minimized, to reduce uncertainty and the incentive for corruption. The legal framework should be clear and applied in a uniform manner' (Stotsky and WoldeMariam 2002: 5).

(Stotsky and WoldeMariam 2002: 5) go on to sketch out some of the more concrete implications of these general principles. For example:

'. . . Tax bases should be broad-based and the tax rate should be as low as possible to achieve revenue goals. Income taxes should have relatively few tax rate brackets and corresponding rates, and few deductions or allowances. VATs are best levied at one rate, and should have few exemptions' (Stotsky and WoldeMariam 2002: 5).
'The goal of administrability requires that the tax system be simple (or as simple as necessary to account for the complexity of economic decision-making). This goal can be accomplished by using final withholding for certain forms of income tax, making the tax system schedular to some extent, and relying on a limited number of rates under the different taxes. Finally, the goals of stability and transparency require that tax laws and regulations be clear and comprehensive. Judicial reform is critical in this regard. Tax liabilities should be determined in accordance with the tax law and not negotiated. The tax administration should have sufficient powers to enforce the tax laws. Tax-payers should have recourse through the legal system to challenge or clarify the tax laws' (Stotsky and WoldeMariam 2002: 6).

29 Heij (2001) recounts how, in Indonesia in the 1980s, expatriate advisers working with a few local political leaders helped accomplish a major tax reform.

encourage engagement with the deeper political and institutional issues that we have discussed above in the language of fiscal social contracts. There is a need for local (national and regional) capacity in the South to amend, extend or supersede *Washington Consensus* ideas to suit local contexts.

- Second, as far as one can judge from the impressions of specialists, the dominance of the *Washington Consensus* agenda has resulted in the decline or disappearance of the tax policy departments of Ministries of Finance in many Low and Middle Income Countries. Because the big policy issues are believed to be resolved, the capacity for tax policy-making at national level has been allowed to decay. There is a danger of the onset of a vicious circle: the more that international organisations shape national tax policy, the lower the domestic capacity to debate or shape that policy (Fjelstad *et al.* 2003: 75).
- Third, because MICs are larger and wealthier, and have larger cadres of trained professionals, national tax policy-making capacity is greater there than in most poorer countries. To that degree, MICs are likely to be able – indirectly by example, and possibly directly by advice – to provide the kind of countervailing ideas about tax policy that poorer countries need to allow them to move, where necessary, beyond the confines of the *Washington Consensus* agenda.

How do we know that MICs have this capacity for generating indigenous, appropriate tax reform? One cannot demonstrate it rigorously: there is no good data base on recent tax reform experiences in developing countries. We have to depend rather on impressions and examples. At the level of specific taxes, there has been considerable innovation in Latin America in recent years, notably in respect of gross asset taxes, the taxation of small firms, bank debit taxes, and seeking ways of taxing increases in urban property values stemming from public investment (Lledo *et al.* 2004). In Russia, the Kremlin and a small number of big energy firms have reached a series of positive agreements on business taxation that have been passed into law (Jones Luong and Weinthal 2004). The South African Revenue Service, implicitly supported by a political consensus that companies can afford to pay more tax to help the post-apartheid government meet the "social debt", has demonstrated that considerable additional revenue can be raised by administrative effectiveness and "firmness" in the implementation of the rules (Annex 2). Between 1995 and 2000, the Brazilian government combined a few tax innovations with firmer exploitation of the existing tax base to increase its tax take by an extra 10 per cent of GDP (Varsano 2003). As we mentioned in Section 3, domestic political negotiations over tax reform in Poland in the 1990s helped create at least the outlines of a fiscal social contract. More strikingly, experience in Chile in 1990–1 has demonstrated how a "fiscal pact" – an explicit agreement between different social interests and political parties about revenue and expenditure reform – can help strengthen the (implicit) fiscal social contract.

An elected government took power in Chile in 1990 after 17 years of military rule. The fiscal pact that followed was an explicit national agreement stemming from extended negotiations between various organised groups both inside and outside the legislature. The new five-party governing coalition included most of the political spectrum from left to centre, and secured the support of an important moderate right-wing party that often voted with the opposition. The pact also engaged other actors outside the political party system. The technical team that designed the reforms, including respected professors from the University of Chile, spent a year in consultations with major social groups. The main business association, the Production and Commerce Confederation was closely involved. Their agreement helped obtain support for both the legislative measures and the efforts to reduce tax avoidance which were an important component of the pact. Substantively, the reform comprised four major elements on the revenue side: increases in corporate income tax rates, in the standard VAT rate, and in marginal personal income tax rates in intermediate income brackets; and the elimination of various tax exemptions for the private sector. The tax changes themselves were either neutral or perhaps even regressive in their impact on income distribution. Yet the net effect of the pact was redistributive: as had been clearly agreed in advance by the various parties, the enhanced tax revenues were used to increase social spending.

At least two factors specific to the previous history of Chile helped make this pact possible. One was that there was a widespread notion that there was indeed a "social debt" to the poor, arising from the previous experience under the military regime. The other was that the tax increases could be represented as a dimension of restoring the country to normality: the military regime had cut the government's tax take by 5 per cent of GDP between 1980 and 1990. And it is clear that a great deal of attention was paid to the careful management of the negotiation process. However, an insider's account provided by a former Chilean Minister of Finance makes clear the importance of broader factors relevant to current concerns. The fiscal environment was supportive in two senses. First, the taxation system was relatively clear and simple, partly because the previous military government had to a large degree adopted the *Washington Consensus* taxation principles. Debate around the pact did not become too mired down in ambiguities about apparent and actual tax obligations. The different interests could engage with one another in a relatively straightforward way. Second, inflation had been kept low. There was little danger that any agreements reached in one year would be undermined or obscured by rapid and uneven price changes. A few sentences of the Minister's analysis are worth reproducing here:

> An important lesson is that changes in non-discriminatory taxes with a wide base invite a debate where national interests predominate. Changes affecting particular vested interests have a more corporativist seal, especially since pressure groups seldom prioritize national interests over their own concerns. To this extent, the choice of concentrating most of the reform on a few taxes with a wide base . . . proved to be a wise decision. However, that outcome strongly depended on the fact that the inherited tax structure was based on general rules with few exceptions.
>
> (Marfan 2001: 8)

The success of the Chilean pact has generated considerable interest in Latin America.[30] Several countries, notably the Central American nations torn by civil war in the 1980s, have been exploring the idea. While

30 The Economic Commission for Latin America has been encouraging (CEPAL 1998).

the Chilean example has not yet been replicated, an approach to tax reform that goes well beyond the *Washington Consensus*, and deeply into issues of domestic political support and negotiation, is at least on the agenda for Latin America.

6 Aid and tax reform: some lessons from experience?

International aid and development agencies have a rather creditable recent record of engagement with tax reform in developing countries. Guided and led by the IMF, and taking advantage of possibilities for revenue raising offered by the introduction of VAT, they have concentrated attention on important issues – notably tax administration and system simplification – that can largely be treated as technical and specialist, rather than political and meriting open public debate. With the exception of the introduction of VAT, the *Washington Consensus* tax reforms have generally not been the subject of great political controversy. That is one positive lesson for international agencies: all else being equal, they will tend to be more effective to the extent that they are perceived to be driven by technical expertise rather than overtly political choices. There are however second and third sides to this story. We summarised the second in Section 5: the kind of technical and administrative engagement with tax reform implied by the *Washington Consensus* might help prepare the ground for deeper reform, but does not itself directly lead to such reform. In particular, it does little directly to address the inequitable nature of much taxation in many MICs. Tax reform that tackles these deeper issues requires deeper local political roots. The third side of the story is that, even when generally performing well, international aid and development agencies are always prone to make mistakes that stem from their particular institutional and ideological positions and biases. Three of the more common biases are (a) policy preferences that are unduly influenced by a perception of what seems to work in OECD countries; (b) excessive interventionism, especially in countries very dependent on aid; and (c) standardised or formulaic interventions that might not always match well the diversity of developing countries. In this section, we provide one example of each kind of bias: (a) the near-neglect of property taxation; (b) heavy-handed revenue targets; and (c) an excessive faith in the "autonomy" of "autonomous revenue agencies".

6.1 OECD-bias: the neglect of urban property taxation

Most MICs should be actively concerned with improving their urban property taxation systems and using them as a means to raise more revenue.[31] There are three reasons for this. One is that property incomes and property wealth are significantly under-taxed in many MICs, and an important source of inequity. The second is that property taxation is one of few potential sources of significant income for many municipal and metropolitan authorities to whom central governments have devolved increased responsibilities

[31] We accept that, in most poorer countries, the scope to tax most rural and agricultural properties is very limited for a combination of practical and political reasons (Skinner 1991). While there are possibilities for more effective taxation of larger and corporate agricultural enterprises through income taxes in particular, property taxes will probably continue to play a small role.

without commensurate increases in fiscal transfers (Dillinger 1992). The third is that the digital databases that provide the core of modern property registers create strong synergies between urban property taxation and urban planning.

Yet there is little about property taxation in the *Washington Consensus* agenda, or in the various guidelines emanating from the IMF. There is little international encouragement for MICs to pay more attention to property taxation, and in practice there has been little progress on this front. Why this unwillingness to confront this significant source of inequity and inefficiency in taxation systems in poorer countries? There are three plausible explanations; each probably plays some role. One is that property taxation is the domain of sub-national governments, and the IMF in particular, with its strong mandate to deal with macro-economic issues, relates almost exclusively to central governments. Another is that the establishment of effective property tax systems is a long-term enterprise, that requires considerable early investments, and that this has been much less attractive a focus than the introduction of VAT, that generates more revenue in relation to effort in the medium term. The third is that the content of the *Washington Consensus* tax reform agenda really is directly influenced by the recent experiences and practices of the OECD countries, especially the Anglophone OECD countries. Property taxes have historically been more important in the US and the UK than in most OECD countries. But they have in recent decades been increasingly unpopular with wealthy and articulate tax-payers, and have diminished in importance (Heady 2002). According to Richard Bird, possibly Latin America's most distinguished expert on public finance, this hostility has spilled over into the development policies of the rich countries:

> Consider, for instance, the sad story of property taxation in North America. Once seen as the bulwark of local democracy and accountability, this tax has, over time, come to be considered by the public at large as regressive and unfair, thus fostering elite interests in lowering the tax burden on an asset base they disproportionately control. The spillover of the anti-property tax rhetoric into even more unequal societies to the south has made it even more difficult to institute . . . even the low-rate effective property taxes needed to finance local governments.
>
> (Bird 2003: 44)

6.2 Externally-determined revenue targets and tax reform

International financial institutions, and especially the IMF, have a complex relationship with the governments of many Low and Middle Income Countries over taxation issues. The IMF is viewed as the custodian of macroeconomic stability. That means in practice that it often urges governments to increase their tax revenues, and indeed often sets quantitative targets, which might be the condition for further external assistance. Simultaneously, the IMF, along with other international organisations, may be promoting tax reform. The two roles are often highly complementary. International organisations can learn more about the scope for a potential timing of reform if they are also deeply engaged in discussions over macroeconomic policy. However, the roles might also clash. There are concerns from a number of countries that tax reforms might be undermined domestically because they are perceived as mechanisms to meet revenue targets imposed externally by international financial institutions. In general, public opinion tends to be hostile to attempts to increase taxes that appear to be motivated by attempts to meet a fiscal deficit.[32] It is hard to establish the truth about many situations where international agencies are involved, because national governments will naturally – and often quite appropriately – play the game of blaming international agencies for policies that are domestically unpopular. There are however enough stories to constitute grounds for concern. In December 2001, the IMF suspended its financial support to Bolivia through the Poverty Reduction Growth Facility because of the failure of the Government of Bolivia to comply with a condition of introducing a new income tax law. That in turn led to a vicious circle: the suspension of disbursements worsened the fiscal deficit, which in turn made relations with the international financial institutions more difficult. In East and Central Africa, autonomous revenue authorities established with donor support have responded to IMF revenue targets in the easiest possible way: by trying to squeeze more revenue from the existing and very small number of tax-payers, rather than through trying to broaden the tax base. That in turn throws into general question the motives and credibility of tax reform (Gloppen and Rakner 2002). There are no simple policy lessons here, but reasons to believe that the international financial institutions might sometimes need to be more alert to the domestic political dimensions of their tax and revenue prescriptions.

6.3 Standardisation: (semi-)autonomous revenue agencies

Over the past two decades, aid donors and international financial institutions have encouraged the creation of (semi-)autonomous revenue agencies (henceforth ARAs) in many countries in the South. There are two generic features of ARAs: the centralisation of all (or most) national-level tax collection activities within a single agency; and the granting of considerable administrative and/or political autonomy to the managements of those agencies. Neither of these generic features closely reflects practices in OECD countries. The donors' attachment to ARAs seems to stem from a number of sources:

- A perception of the existence of major problems in existing tax administrations, including (a) significantly corruption, often because tax agencies are expected to be a source of funds for the politician, party or political clique that controls them; (b) the use of selective tax inspections to harass political opponents; and (c) inefficiency arising from low public service salaries and the restrictions of standard civil service procedures and regulations.
- A natural inclination for donors supporting tax reforms focused on administrative issues to favour considerable administrative reorganisation and the creation of a single powerful tax authority to which they could conveniently relate.
- The recent popularity in national and international policy-making circles of the general notion of providing major public economic agencies with the "autonomy" from immediate political masters

32 This appears to have been one significant reason for popular opposition to tax reform efforts in Brazil in recent years.

that might enable them to take decisions influenced by long-term and collective – rather than short-term and narrow – considerations. The experience with central bank reform has played a major role here.

The experience with ARAs has been mixed. We can point to at least one case of clear success: South Africa (Annex 2). The reform of SUNAT in Peru, begun under President Fujimori in 1991, is perhaps more typical. It was largely an indigenous affair, and to some degree an inspiration for the creation of later ARAs. Initiated in a situation of deep economic crisis, the reform was at first strikingly successful in terms of both the amount of revenue raised and improved procedures. However, after a few years, the SUNAT leadership lost the direct backing and political protection of the President, and became enmeshed in elite-level political conflicts. Its performance reached a plateau (Durand 2002; Thorp 1996). A number of ARAs in Africa appear to have followed a similar if less dramatic trajectory: some initial achievements in terms of revenue raising at least, followed by a period of relative stagnation or backsliding that coincided with more political interference in their operations (Fjelstad *et al.* 2003; Therkildsen 2003). It is not yet clear whether and in what senses the introduction of ARAs has been successful.[33] It is likely that we shall never be able to reach a clear judgement on that issue, because in practice each ARA tends to be a rather distinct animal. The ARA "formula" is not very restrictive. The formulaic element in donor promotion of ARAs has lain largely in an excessive faith in power of "autonomy". The problem with that belief is not so much that it is wrong. It is rather unclear, and misleading in that it may divert attention from other important issues. What do we mean in practice by the "autonomy" of a revenue agency? And how much "autonomy" is good?

One can best begin to answer these questions by distinguishing between *managerial* and *political* autonomy. The general case for a degree of managerial (or administrative) autonomy of revenue agencies from normal civil service procedures is not very contentious. The arguments are largely the same as those for introducing in the public service *executive agencies* that operate at arms length from, and to some degree in a contractual relationship to, central ministries. A degree of autonomy permits managers to select the procedures and personnel that are best suited to their particular operation. Because of the wide scope for corruption in revenue agencies and the need to employ people with the accounting and legal skills that are normally highly remunerated in the private sector, there is a good case for targeted recruitment and relatively high remuneration compared to other parts of the public service. In addition – although this

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33 Robert Taliercio of the World Bank has looked in detail at several ARA experiences, and concludes that they are indeed effective (Taliercio 2003 and 2004). While we acknowledge the enormous value of his work and his willingness to share it with us, it is not possible at present to accept the main conclusion. There are four related reasons for this. One is that he may not have selected a representative sample of cases. The second is that his measures of performance are largely subjective, and may be influenced by extraneous factors. The third is that, in part because he was unable despite much effort satisfactorily to measure the degree of autonomy of different ARAs, it is not clear how far improved organisational performance might be due to (a) the specific autonomy elements in a given ARA or (b) the general reform packages of which ARAs have formed a part. Even if improved performance has followed the creation of ARAs, the reasons might lie in other elements of the reform. Nevertheless, Taliercio's work has greatly enriched our understanding of the issues.

36 Corruption in central banks is more likely to be detected in financial markets.

remains an area of contention among specialists – there may be a good case for rewarding staff partly in proportion to their individual and/or group performance in revenue-raising. ARAs have often been established with (a) a large influx of specially-recruited new staff, often from the private sector and (b) salaries well in excess of those in most other parts of the public service. While there are always questions about exactly how to operationalise the notion of managerial autonomy, the path is well trodden. Many central banks have long enjoyed a similar standing, especially in relation to staff recruitment, and have often been recognised as "islands of efficiency" in countries where the overall competence of the public service is low.

It is the *political autonomy* of ARAs that is more contentious, normatively, analytically and practically. Part of the problem is conceptual. A revenue authority cannot be autonomous politically in the same sense that it can be autonomous managerially. The chief executive can be "free to manage", but cannot be "free to do what she wants". A revenue authority must be controlled by and answerable to some superior authority, and all the more so because, compared to central banks, there is a wide scope for the senior staff of revenue agencies to engage in large-scale corruption unless they are closely monitored and audited.[36] The main practical questions about "political autonomy" are not about "how much" autonomy, but about "to whom" is the organisation responsible, and through what mechanisms. In a number of cases, the creation of putatively "autonomous" revenue authorities has involved a shift of political oversight from the Minister of Finance to the (Executive) President. If the President chooses not to use that oversight power in an interventionist fashion, then the results might be positive, at least in the short-term. But such arrangements do not constitute political autonomy in any meaningful sense. One of the main reasons why some ARAs begin life well and then undergo a performance decline is that, after a honeymoon period, the President either becomes more interventionist or permits other senior politicians (or family members) to be so (Durand 2002; Therkildsen 2003). To some degree, this kind of sequence is built into the process of establishing ARAs. For the autonomy they do enjoy typically is employed to considerably increase employee remuneration, and to otherwise privilege the organisation and its employees. This tends to cause jealousy, especially as there are often many other people working for much lower salaries in the public service who feel equally well qualified to collect taxes. That in itself might be enough to make the ARA the target of various political interventions.[37] As the experience of SUNAT in Peru case again illustrates, this kind of resentment can overlap with institutional rivalry between the ARA and the Ministry of Finance over control of tax policy, and generate considerable political conflict around the ARA.

The *political autonomy* of a revenue authority can never be as extensive as its potential managerial autonomy. The authority is always answerable to the government in power. In practice, variations in the degree of political autonomy depend on (a) how directly it is answerable and (b) how pluralistic are the oversight arrangements. An ARA is politically more autonomous to the extent that (a) it has a guaranteed budget that cannot be changed by the government in power; (b) its status, responsibilities and powers are

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[37] We are grateful to Ole Therkildsen for this point.

enshrined in law and can be protected through the police and the courts; (c) appointments to the supervisory board are made by a variety of agents (e.g. different ministries), including perhaps non-state agents (e.g. business or lawyers associations); (d) appointments to the supervisory board are of long-term and fixed duration; and (e) operational staff are answerable only to the supervisory board.[38] On these criteria, many ARAs have rather little political autonomy.

Is this a bad thing? Not necessarily. Recent experiences of tax reform tell us that revenue agencies can have too much autonomy as well as too little. For revenue agencies are not just tax collectors. They are also the repositories of unique sets of data on the taxation system, and potentially important sources of ideas about how tax collection or tax policy might be improved. Like all public organisations, they may be tempted to hoard the unique information they control as a bargaining chip in relation to other public organisations. This is especially likely to become an issue in the relation between ARAs and the Ministries of Finance from which most of them originally sprang, and may manifest itself in overt conflict over control of tax policy. This was very much the case in Peru in the 1990s (see above). The current situation in the Ukraine is very similar. The revenue authority, the STA, is directly under the control of the President. This gives the STA enormous autonomy in relation to the legislature. It uses that autonomy to maintain its monopoly over data on taxation, and effectively prevents the legislature – or any other agency – from engaging in any informed debate over tax and fiscal policy.[39] By contrast the South African Revenue Authority (SARS), while enjoying a high level of managerial authority, actually cooperates closely on a routine basis with the other government agencies that have an interest and mandate over taxation-related issues:

> First, SARS has cooperated with the special criminal investigation unit attached to the National Directorate of Public Prosecutions, known colloquially as 'The Scorpions'. SARS's inquiries into tax evasion often lead to the discovery of other illicit activities, such as money laundering: the Scorpions are trained to investigate these areas of crime. At the same time, the Scorpions are able to provide greater investigative capacity to SARS. The information flows between these departments help to strengthen their capacities. SARS also works closely with the central bank, the SA Reserve Bank, to track the overseas investments and financial activities of South African residents. But most important has been SARS's cooperative relationship with the Ministry of Finance. The cooperative approach of the political authority, in the form of the Finance Ministry's Treasury, has created an enabling environment for SARS and has contributed to its enhanced revenue raising performance since its formation. In particular, the Treasury has been willing to table legislation designed to enable SARS to fulfil its function more effectively. SARS's enhanced performance has also made it easier for the government to achieve some of its budgetary goals.

[38] We are grateful to Robert Taliercio for sending us his unpublished work on this topic. We have used his ideas, but not adopted wholesale his schema, because that refers to both managerial and political autonomy.

[39] We are grateful to Alexandra Zayarna and Katya Maynzyuk for this information.

The authors of the South African study, Steven Friedman and Laila Smith, talk in terms of "cooperative autonomy". Their research chimes with a growing realisation that ARAs, with "autonomy", are very far from a quick-fix solution to major obstacles to the professionalisation of tax collection in poor countries. There is no reason to think that the creation of a single tax agency is intrinsically problematic. The problem lies rather with "autonomy": the word can mean very different things in practice; and tax agencies can have too much of it, as well as too little. In this as in other cases, the focus should not be solely on factors that might improve the performance of a single agency taken in isolation, but on the creation of an effective pattern of inter-organisational relationships.

7 Conclusion

The considerable tax reform that has been achieved in many poorer countries in recent decades owes a great deal to a combination of factors we have outlined above: substantial expert consensus over the important substantive issues; a concentration on relatively "non-political" reforms, including administration and the general simplification of systems; the availability of a relatively new piece of taxation technology – VAT – that enabled governments quickly to replace the revenues that were lost through the reduction or abolition of other taxes, notably trade taxes; and the leadership of the IMF, especially in focusing attention on the implementation of a well-defined reform agenda over a long period of time. There is more to do along those lines: the role of the *Washington Consensus* tax reform agenda is not yet played out. However, that role will and should diminish. That agenda is limiting in various ways, and perhaps even wrong in some contexts. The limitations lie in method as well as substance. The success of the *Washington Consensus* agenda derives in part from the non-engagement with internal political processes in poorer countries, and a corresponding reliance on technical expertise and the influence and prestige of international agencies. That will be less and less effective in countries that are larger, less poor, and more democratic. It is decreasingly likely to be an entry point for major tax reform anywhere.

This situation offers more opportunities than problems. Many Middle Income Countries have not been tightly constrained by the *Washington Consensus* agenda. They have more autonomy to make their own tax policy, and have gone ahead with their own reforms. Some of those reforms may be more appropriate to their situation than those found within the *Washington* menu. Some Middle Income Countries have been the site of the kind of broad bargaining about taxation and fiscal issues that is badly needed in many poorer countries. The debate about tax reform in both Middle and Low Income Countries needs to become more pluralistic at the level of policy; and more internal and societal at the level of process. Some Middle Income Countries have made a good start down these paths. They could become a significant and positive source of influence on tax reform in the poorest countries.

Annex 1 The political economy of taxation: statistical analysis

We will use the term Tax Take as a simple way of referring to the actual percentage of GDP that governments raise in tax revenue. There is a long history of researchers employing cross-national statistical analysis to try to discover what determines the Tax Take. Many of these efforts produce inconclusive or contradictory results. There can be many reasons for this, including absence of adequate data, the fact that the real world answers might change over time, and the weaknesses of the statistical methods and models employed. As part of this research, we undertook some very thorough statistical analysis of this question. The answers advance our understanding in several respects. The main features of our method and conclusions are summarised here, in as non-technical a language as we could manage.[41]

We begin with a brief summary of the method we used:

(i) The overall objective was to identify the factors that were consistently associated with variations in the Tax Take.

(ii) We used data for 208 countries, with individual observations for each of the years from 1990 to 2001 ('panel data').

(iii) We analyse both (a) patterns of change over time within countries ('fixed effects' in statistical terms; here labelled *within country analysis*) and (b) differences between countries ("panel-corrected standard errors" in jargon; *between country analysis* in this paper).[42] The fact that we do both *within country* and *between country* comparisons is important to the interpretation and the robustness of the results. For example, when we confirm that the Tax Take is associated with levels of wealth, we mean both that the Tax Take is higher in richer countries, and that it increases over time as individual countries become richer.

(iv) Because we have a large panel data set covering a period of 12 years, we are able to take into account the high degree of inertia in taxation patterns: changes occur incrementally, and few countries witness huge changes in the Tax Take from one year to the next. We do this by including among the variables that might explain the Tax Take for each country in each year the level of the Tax Take for that country in the previous year. This corrects for both endogeneity and auto-regression in the error terms.

(v) For the between country analysis, we use dummy variables for countries to control for country-specific factors, i.e. fundamental differences between countries, related perhaps to national culture or history, that change little over time.

(vi) In addition, during certain years, many/all countries in a sample might be affected simultaneously by similar events, such as an economic shock or recession. We control for such eventualities by using dummy variables for years.

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41 These findings will be published elsewhere in a technical form.

42 When applied to datasets such as ours, in which the number of countries far outnumbers the number of time periods, panel-corrected standard errors increase the standard errors of the estimates compared with other possible estimators. This effectively raises the hurdle one has to leap to achieve statistically significant results, and implies that the results are more credible than those derived from alternative methods.

Taken together, these methodological procedures ensure that our results are not artefacts of inappropriate assumptions or misleading econometric models.

We began by re-testing for the impact of those variables that have been proven to be most closely associated with the level of the Tax Take in the research reported in the existing literature. These are *economic structural* variables: e.g. the overall level of income, the ratio of imports and exports to GDP, and the proportion of the population that is urbanised. It is in fact only these *economic structural* variables that have been shown to be consistently associated with the level of the Tax Take in previous studies. Some variables prove significant in some studies and not in others, while the apparent effects of some factors, such as the ratio of exports to GDP, appear to change from one study to another. However, the average level of income generally emerges as consistently associated with the Tax Take. The underlying mechanism seems quite clear, despite some variations from one study to another. The Tax Take is generally higher where it is easier, in a logistical sense, for governments to tax: where incomes are higher; more people are in urban areas; more of the GDP appears in the form of relatively easily taxable imports, etc.

We first tested different variants of *economic structural* models, examining *within country* and *between country* variations. The final results, summarised in the second and third columns of Table A1, are consistent with the existing literature: high income levels, urbanisation, and a high ratio of imports to GDP are separately and consistently associated with a higher Tax Take. The ratio of exports to GDP is not significant in the *within country* analysis, and negatively associated with the Tax Take in the *between country* analysis.[43]

It was however evident from examination of the statistical residuals that our model explaining global variations in the Tax Take did not fit one portion of the cases very well – the MICs. The fourth and fifth columns of Table A1 make the same point: a statistical pattern that fits all countries of the world taken together does not fit quite so well when applied only to MICs. Are there special or additional factors that help provide a better explanation of variations in the level of the Tax Take among MICs? Yes. We get a much better explanation for the MIC sample if we add in some specific *political economy* variables:

(i) To a far greater extent than Low or High Income Countries, MICs include producers and exporters of naturally-occurring mineral and energy resources, notably oil, natural gas, and a variety of mined minerals. Natural resources typically give rise to *rents*, i.e. to an economic surplus that represents the difference between the income obtained from selling the resources (on world markets) and the actual cost of extracting and exporting the product. We have country-by-country estimates of the size of these rents. They tend to be especially high in MICs (Section 3). There is a large recent literature on the political and

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[43] One might expect the export ratio to be positively associated with the Tax Take, because exports are generally easily taxable in a logistical sense. The fact that we get neither this finding nor any consistent finding in relation to exports probably reflects the consequences, over place and time, of at least three different factors: (a) exports are easily taxable in a logistical sense; (b) an increasing number of governments desist from taxing exports because they are trying to promote export sectors; and (c) high export ratios often reflect large natural resource exports and, as is explained below in the text, these reduce the incentive to collect revenues through other mechanisms.

economic consequences of the possession of these natural resource rents, which is often termed the "resource curse" literature. This literature suggests that such resources are associated with a series of curses, including: low rates of economic growth; authoritarian rather than democratic governance; the absence of the rule of law; civil conflict; and, for the mass of the population, low levels of education, life expectancy and nutrition (Section 3). We were interested to know if resource wealth also makes it more difficult to develop effective tax states.

(ii) Nearly a quarter of MICs had Communist governments until 1990. Those governments achieved very high Tax Takes (Section 3). We were interested in the durability of this legacy.

(iii) We found that in a number of MICs recent political decisions about taxation (and expenditure) issues have been made in the context of a more or less explicit *social contract* (Section 2), where major political and socio-economic interest groups consent to tax reforms and tax increases on the understanding that the money will be spent to bring them benefits. The statistical data available to measure popular consent to tax and benefits provided by the state varied. And it is not clear how far, in different countries, citizens perceive causal links between taxation and public expenditure. To keep our model as clear and simple as possible, we hypothesised that, were there to be any evidence of a *fiscal social contract*, it would most likely manifest itself in a connection between the Tax Take and the proportion of public expenditure devoted to education.[44] In sum, the hypothesis is that, all else being equal, the allocation of higher proportions of public spending to education would be associated statistically with high Tax Takes.

Table A2 summarises the results of our statistical testing of a *political economy* model of the determinants of the Tax Take in MICs, that adds the three variables listed above to the basic *economic structural* model. We found the following:

(i) Governments with access to large natural resource rents (from energy and mineral products) are likely to levy less in taxes than one would expect (given their income levels and other relevant factors). It is particularly significant that this finding holds for both the *within country* and the *between country* analysis. It is sometimes suggested that such a result derived from *between country* comparisons might be misleading, on the grounds that some governments might obtain significant non-tax revenue from energy or mineral resource exploitation, whether informally or in the shape of royalties and other charges that are not classified as taxes. If that were true, one could not conclude from the *between country* analysis that high resource rents actually reduce tax revenues in a causal sense. But we find here striking *within country* **(**time series) evidence for the general proposition: when natural resource rents decline over time within

[44] Education seemed a more appropriate sector to use than other social sectors with cross-national data available. Levels of expenditure on social security vary very much by region, and reflect in part regionally-specific traditions. To a greater extent than education expenditures, the benefits of high government health expenditures might be concentrated on small population groups.

countries, governments tend actually to increase the Tax Take. This finding supports the "resource curse" proposition that the easy availability of natural resource rents discourages governments from developing a general taxation capacity.

(ii) On average, the governments of MICs that were Communist until 1989/90 retained an unusually high capacity to tax in the period 1990–2001. We know there were variations. Some suffered moderate or severe declines in the Tax Take in the first half of the 1990s, while others – Latvia, Estonia, Belarus, and Ukraine – maintained or even increased their already-high capacity to tax. As time goes on, the picture becomes more complex. The Baltic States have maintained high Tax Takes. Aided by some tax reforms and recent oil price increases, the Russian government has now dragged the Tax Take back up to the relatively high levels of the early 1990s. The "new" oil producers of the Caspian region – Azerbaijan, Kazakhstan, Turkmenistan and Uzbekistan – generally remain under the rule of much the same people who headed their Communist regimes, and have done little to build up effective tax systems. Having held its Tax Take steady in the early 1990s, the government of the Ukraine has since experienced a steady decline in its capacity to raise tax money. By contrast, Latvia, Estonia, Belarus, and Ukraine – maintained or even increased their already-high capacity to tax.

(iii) Both in the *within country* and the *between country* analysis, the size of the Tax Take varies significantly and positively with the proportion of government spending devoted to education. The interpretation of this variable is somewhat difficult, but it does at least suggest that *fiscal social contract* mechanisms might be in operation: tax-payers might be willing to approve or pay for higher taxes if they can trace some positive connection with levels of public spending on things from which they benefit and of which they are likely to approve.

Table A1 Results of multiple regression analysis with economic-structural model

Country sample	**All Countries**	**All Countries**	**Middle Income Countries**	**Middle Income Countries**
Type of analysis	*Within countries*	*Between countries*	*Within countries*	*Between countries*
Results				
Independent variable	Signs in brackets indicate the direction of a statistically-significant association. The text summarises the implication of the statistical association.			
Level of economic development	(+) As income per capita increases, countries tax more.	(+) High income countries tax more.	*	*
Degree of urbanisation	(+) As urbanisation increases, countries tax more.	(+) Urbanised countries tax more.	(+) As urbanisation increases, countries tax more.	*
Imports as a % of GDP	(+) As imports increase, countries tax more.	(+) High importers tax more.	(+) As imports increase, countries tax more.	(+) High importers tax more.
Exports as a % of GDP	*	(-) High exporters tax less.	*	*

- = result not statistically-significant.

Table A2 Results of multiple regression analysis with political economy model

Country sample	**Middle Income Countries**	**Middle Income Countries**
Type of analysis	*Within countries*	*Between countries*
Results		
Independent variable	Signs in brackets indicate the direction of a statistically-significant association. The text summarises the implication of the statistical association.	
Natural resource rents as a % of GDP	(-) As natural resource rents decrease, countries tax more.	(-) Countries with large natural resource rents tax less.
Whether formerly Communist	(Not applicable.)	(+) Ex-Communist countries tax more.
% of public expenditure devoted to education	(+) As education spending increases, countries tax more.	(+) Countries that spend more on education also tax more.

Annex 2 Tax and society in South Africa

(By Steven Friedman and Laila Smith, Centre for Policy Studies, Johannesburg.)

At first glance, South Africa would appear, at least by the standards of the "developing" world, to offer an extremely propitious environment for effective tax collection.

It is a Middle Income Country whose per capita gross national income is estimated by the World Bank at $3,020 a year, placing it 91st in the world, immediately behind Turkey. But, when purchasing power parity is considered, it rises to 72nd, ahead of major "transitional" or "developing" economies such as Russia, Mexico and Brazil (World Bank 2002).

This level of economic development ensures a significant domestic tax base – even if people registered for income tax comprise a small proportion of the population: in 2001/2002, just over 3.5m individuals, in an estimated economically active population of 16.1m were registered as payers of income tax.[45] More importantly for the South African Revenue Service (SARS), which is charged with tax collection, some 1.08 million companies are registered for company tax and about 220,000 collect income tax from their employees using the Pay As You Earn (PAYE) or Standard Income Tax on Employees (SITE) system in which tax is collected by the company and paid over to SARS. A further source of revenue is Value Added Tax, a sales tax collected in 2001/2002 from some 480,000 registered vendors. In principle, VAT ensures that all residents, whatever their income, contribute to tax by paying it every time they buy a commodity or service – in practice, not all vendors are registered and so not all pay over VAT to the revenue authority. Nevertheless, this base ensures that, in the 2002/03 fiscal year, taxation comprised 98 per cent of government revenue[46] in sharp contrast to states, which depend on development assistance or on the export of commodities for their revenue.

However, tax coverage remains limited by the existence of a growing informal sector which is assumed to be largely beyond the tax authorities: one study finds that the number of people engaged in informal employment almost doubled between 1996 and 1999 from 996,000 to 1.9m – or from 12 per cent to 22.5 per cent of the formally employed (Bhorat 2003). While current figures are not available, if this trend has continued, and there is specialist consensus that it has, then the informally employed would already total about half the formally employed and thus about one third of the Economically Active Population – this likelihood is increased by the fact that some estimates put the informal sector at present at around 30 per cent of the workforce, a claim broadly consistent with these calculations. Since informal activity is unregulated, much of it is assumed to escape the tax net – although a study of undocumented migrants in which most insisted that they pay tax suggests the need for further research in this area (since undocumented migrants would be assumed to be engaged in the informal economy since they are not

45 Number of registered tax-payers provided by SA Revenue Service. Population estimates from Statistics South Africa *Labour Force Survey February 2002* Statistical Release P0210 25 September 2002: 9 and cited in South African Institute of Race Relations *South Africa Survey 2002/2003* SA Institute of Race Relations, Johannesburg 2003: 140.

46 Derived from South African Reserve Bank *Quarterly Bulletin* September 2003 Table: 'National Government Finance': S–55.

permitted to engage in economic activity) (Reitzes 1998). While at least one source insists that potential revenues from the informal sector could far outweigh what is currently being collected in the formal sector,[47] specialist consensus agrees that the revenue which would be raised from the informal economy is relatively small compared to that collected from major companies and high net worth individuals, suggesting that a failure to tax informal activity is not a particular problem for revenue raising agencies. However, there are significant concentrations of economic activity in the informal sector and, even if there were not, there is a strong argument for seeking to raise revenue from informal economic activity based on governance principles – such as the notion that engendering a culture of compliance is important to state-building – rather than revenue projections.

It also worth noting that tax collection occurs in the context of substantial pressure on the authorities – and businesses – to address social inequality, calculated as the second highest in the world behind Brazil[48] – or, by some, as the highest.[49] Since the governing African National Congress has a substantial constituency among the poor – and inequality is seen (albeit not necessarily entirely accurately) – as a consequence of racial discrimination under apartheid,[50] egalitarian pressures, and expressed public support for assistance to the poor, are higher than in other countries attempting to improve the workings of their tax system. This is crucial to the way the system has evolved since democracy's advent in 1994.

A2.1 The context of collection

If that brief introduction suggests that conditions in South Africa are particularly favourable, this view has to be tempered by the economic, historical and political context in which tax is collected.

On the first score, South Africa is rich in minerals – gold has been its historic source of wealth, but a wider range of metals and minerals now contribute to GDP.[51] Access to commodities, which are easily traded on international markets such as minerals or oil, is often said to encourage elites to create a *rentier* state, dependant not on taxes extracted from citizens but from rents derived from sale of the commodity.[52] This is said to reduce incentives to extract resources from domestic sources. The assumption that mining plays a key role in resorting the state persists in, for example, the contention among some senior officials that improved revenue collection in South Africa in recent years is primarily a consequence of windfall profits in the mining industry.[53] This is based on the reality that mining can indeed still play a role in determining the economy's fortunes – an increase in the platinum price therefore

47 Interview with Judy Parfit, Former Human Resource Director for the restructuring of SARS, 16 October 2003.

48 Haroon Bhorat, 'Labour market challenges in the post-apartheid South Africa', paper presented at colloquium on poverty and development, Cape Town, 1 October 2003.

49 Statistics South Africa, *Measuring poverty*, 7 September 2000.

50 The relationship between race and inequality is complex – while the poor are overwhelmingly black, a clear consequence of apartheid, inequality within racial groups is now almost as high as that within the economy as a whole, the result of the erosion of racial controls. Bhorat (2003); Steven Friedman (2002).

51 Thus for example an increase in the price of platinum is said, with the depreciation of the currency, to have prompted a rapid rise in profits in mining and other export sectors in 2001/2002. See Ministry of Finance (2002).

52 There is an extensive literature on rentier states. See for example Mick Moore (2001); Ole Therkildsen (2002).

53 Personal communication, Department of Finance official.

contributed to the increased revenues (see note 55). But recent research has demonstrated that the reasons for increased revenue collection can be found in enhanced effectiveness in the revenue-collecting agency rather than in increases in economic growth alone (Smith 2003). Also, mining's role in the economy is now too modest to provide the foundations for a *rentier* state – it contributed only 8.1 per cent to Gross Domestic Product in 2002.[54] Mineral resources play a role in resorting the state but are not decisive.

The historical and political context plays a much more prominent role in shaping revenue collection. It is firmly rooted in the fact that, until ten years ago, South Africa was a racial oligarchy – first as a British colony and then as a Republic. Historically, income tax-payers were overwhelmingly white because this group owned almost all the country's wealth despite constituting less than one fifth of the population.[55] Whites were also more likely to be willing to pay tax since they enjoyed political representation: black people were, during the colonial period in particular, subject to a variety of taxes, whose imposition led, at critical times, to resistance or rebellion (Roux 1964). And, from 1984 until the end of apartheid a decade later, the imposition of "rent" or municipal service charges[56] was a key source of the black urban rebellion which played a major role in destroying racial minority rule.

Despite this history, black people were incorporated into the tax system well before apartheid ended. With the introduction of General Sales Tax in 1978, later to become Value Added Tax in 1991, all consumers became tax-payers. And, as restrictions on black job mobility began to erode in the 1970s, an increasing number of black people began to earn enough to pay income tax – almost invariably, since these new tax-payers were almost all employees of formal companies, they were subject to PAYE or, later, SITE, a similar tax for people earning less than R60,000 ($9,188) a year. VAT did become a source of political conflict in the early 1990s as a new constitution was being negotiated – a celebrated trade union mobilisation against an increase in VAT, denounced by the unions as an attempt at unilateral decision-making by a minority government, forced the suspension of the tax increase and prompted the formation of a National Economic Forum which was meant to negotiate economic policy and its implementation. But, in the main, it was municipal service charges rather than national taxation, which was a focus of anti-apartheid resistance. An obvious presumed cause was the fact that VAT and PAYE are collected and paid over to the authorities by vendors and employers respectively, making them less direct and therefore a less visible focus of protest by consumers or employees.

Nevertheless the advent of democracy in 1994 was the beginning of the incorporation of black people on a wide scale into the system of direct taxation, for it was then that the much accelerated influx

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54 SA Institute of Race Relations 'SA Survey': 46.

55 In 2002 the white population was estimated at 4.5m of a total of 45.5m, less than 10 per cent. SA Institute of Race Relations 'SA Survey': 2. The white proportion of the total population declined through the twentieth century.

56 Until 1985 black people did not enjoy property rights in the cities. Housing was, therefore, either rented from the state or, among a minority from 1978, held on 99-year lease. However, while the expected monthly payment to the local administration was widely described by township residents as "rent", by the mid-1980s, the bulk of the amount was a service charge. When racially segregated Black Local Authorities attained a formal autonomy in 1984, they were forced to raise service charges substantially, sparking violent protest.

of black people into the public service and managerial and professional jobs in the formal economy turned the relatively small group of black professionals and managers who had been embedded in the income tax system over the past decade into a significant and growing stratum in the economy and society.

This history has, as a recent set of focus group interviews on tax paying behaviour revealed,[57] prompted perceptions among South Africans, which query the willingness of both the black majority and white minority to pay tax. Thus there is a widespread white perception that black people, because they are unused to paying tax, have a recent history of resisting public obligations as a means of fighting apartheid, and are said to believe that they are entitled to excessive compensation for past discrimination, do not pay – and an equally common assumption among black people that whites, because they distrust and reject the legitimacy of a predominantly black majority government, evade tax. At this stage of the country's post-apartheid development, neither of these assumptions appears to be accurate. But the two questions which arise from this history – whether whites will continue to pay despite their lack of trust in majority rule and whether blacks, excluded until very recently from the practice and habits of tax-paying, will remain content to pay once the initial flush of freedom has worn off – remain the key determinants of the viability of the post-apartheid tax system.

One final and related point should be made here – that commentators see compliance with public obligations in post-apartheid South Africa across the political and racial barriers and by many citizens as very low.[58] This obviously affects perceptions of tax compliance too, prompting politicians to denounce low levels of "tax morality" [59] even when levels of compliance seem to be high by the standards of other Middle Income Countries. But it does mean that relatively high levels of compliance with tax obligations is seen as an anomaly, leading to constant suspicions that current trends may not last. Tax compliance in democratic South Africa is not, therefore, taken for granted – whether it will remain at current or comparable levels remains an important research question.

A2.2 The tax system and its impacts

The South African tax system, as implied above, is a fairly orthodox mix of taxation measures.

Thus the prime source of state revenue is a progressive income tax and a tax on company profits which yielded 58 per cent of total tax revenue in 2002/03 or R140,840m or US$21,568m of the R268,471m ($48,113m) collected in that year.[60] The proportion contributed by personal and company tax in 2002/03 is not available, but if the figure for 2000 is a guide, then personal income tax contributed just

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57 Focus group research in progress by Ebrahim Fakir, Centre for Policy Studies, Johannesburg.

58 For a discussion of the general problem of compliance see Riaan de Villiers (1993); on the current debate see Steven Friedman (2003).

59 See for example Trevor Manuel (1997).

60 This and adjoining calculations derived from SA Reserve Bank *Quarterly Bulletin* September 2003 Table 'National Government Finance': S–54/55.

over double the contribution of company tax.[61] A key distinction in the personal tax system is that between tax-payers who contribute purely through PAYE or SITE, in which case the money is deducted by the employer, or provisional tax-payers – people who are self employed or, if they work in a formal job, derive a specified portion of their income from other sources. Obviously, the latter category, which is taxed on income, declared in their annual tax forms, have a leeway to avoid or evade tax, which is not available to PAYE payers. The other key source of revenue is Value Added Tax, which contributed 25 per cent in 2002/03. Initially, VAT, in contrast to many other societies, was universally applied and did not allow for any exemptions. However, exemptions or zero-ratings have been introduced since 1994 for a range of commodities said to be consumed primarily by the poor.[62] As of 2001, enterprises making taxable supplies of less R300,000 ($45,941) a year need not register for VAT, a doubling of the threshold from R150,000 ($22,970). Other significant sources of tax revenue are: customs and excise duties, which contributed 8 per cent in 2002/3, and a fuel levy (6 per cent). Property taxes, payroll taxes (a skills development levy on employers to pay for industrial training), and unspecified other taxes comprise the balance. The total revenue from tax is some 25 per cent of gross domestic product.[63] This is a result of policy decision to maintain tax at 25 per cent of GDP based on a late 1995 recommendation by the Katz Commission, an inquiry into the tax system established in 1994 which has produced nine reports in the period since then and has had a strong influence on the development of the post-apartheid tax system, that the previous tax year's ratio of some 25 per cent should be neither increased nor decreased (Katz *et al.* 1995).

The legal framework is, on the surface, similar to that in middle income or upper income countries – tax-payers who feel aggrieved by tax decisions can appeal to a special income tax court or, ultimately, to the ordinary courts. However, a key feature of tax administration since 1998 has been a drive to enhance effectiveness through aggressive enforcement tactics. SARS, with the support of the courts, has thus enforced an unusual principle which may threaten to undo any goodwill it has accrued among tax-payers through its efficiency increases – this "pay now, argue later" principle assumes that the tax-payer is guilty until proven innocent if suspected of irregularities in tax assessments – its concrete effect is that SARS can impose financial penalties before a tax-payer's guilt or innocence has been tested in court. This approach

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61 According to the Minister of Finance, personal and company tax contributed 35.8 per cent and 16.8 per cent of tax revenue in 2002. Trevor Manuel, *The South African Tax Reform Experience Since 1994 Address by the Honourable Trevor A Manuel, MP, Minister of Finance to the Annual Conference Of the International Bar Association*, Thursday 24 October 2002.

62 Items subject to zero-rating that have minimised low-income household expenditure patterns are: brown bread, brown wheaten meal, illuminating paraffin, maize meal, samp, maize rice, dried maize, dried beans, rice, lentils, fruit and vegetables, milk, cultured milk and milk powder, cooking oil, eggs, edible legumes, dairy powder blends, petrol, diesel SARS (2002/3).

63 Calculated by computing total tax revenue as a proportion of gross domestic product at market prices – the latter in SA Reserve Bank *Quarterly Bulletin* Table 'National Income and Production Accounts of South Africa': S–110.

is embedded in tax legislation that has increasingly favoured SARS over the tax-payer; section 36 of the Income Tax Act empowers it to enforce payment of an amount before the individual or business has had the opportunity to appeal against the claim in court.[64]

A second point that constrains the ability of the tax-payer to defend him or herself against faulty tax assessments is that there is simply insufficient administrative legal capacity within South Africa to do so. Should a case against SARS move beyond the tax court to the constitutional court, which enjoys the power to overturn legislation it deems unconstitutional, the tax issue moves into the realm of administrative law. Few tax lawyers are sufficiently trained to defend their client's case in this realm, whereas SARS has the resources to hire a battalion of administrative law experts. This creates an inequality in ability to access and interpret the law.

If elite tax-payers cannot defend their rights against SARS, it is far less likely that average tax-payers will be able to leverage the legal capabilities to defend their case when they have been wrongly assessed by SARS. In short, the average tax-payer can hardly afford to contest an assessment by SARS.[65] Part of the social contract with the state is that in agreeing to pay taxes, the citizen must have access to the vehicles of justice for holding the state accountable. SARS's institutional legitimacy may be tested if its aggressive enforcement tactics are perceived by the public to be applied unfairly to individuals who have no recourse through the justice system. A recent case introduced a procedural requirement by SARS to first provide an assessment before obtaining a judgement against a tax-payer, but the "pay now, argue later" principle was not changed.[66] SARS has attempted to deal with perceptions of inequity by setting up a complaints office to respond to concerns about administrative difficulties in dealing with changes to the tax laws. This office is also beginning to handle a dispute resolution process that will permit tax-payers to negotiate with the revenue service, rather than using the courts. SARS acknowledges, however, that it remains a significant challenge to ensure both equity and efficient collection.[67]

The search for greater effectiveness in collection also prompted the formation, in 2001, of a special investigative unit staffed by forensic investigators which handles many of the 8,000 monthly "tip-offs" from anonymous phone callers or reports made at SARS offices. It has also audited companies in targeted industries such as electronics, music and banking (the latter partly because of its capacity to become a source of information on a wide range of economic activities). The unit is said to have deepened and broadened SARS's knowledge of business in general, which has enabled it to improve its tax collection in other economic sectors too.[68] Its greater understanding of business behaviour has enabled it to improve corporate enforcement. This puts it in a position in its bi-weekly meetings with the national treasury (see below) to offer concrete suggestions for legislative changes that can help it to induce compliance where it

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64 For example, in 2002 SARS assessed a company, Metcash, for the payment of VAT and obtained a judgement against it even though Metcash claimed the assessment was faulty. Metcash took SARS to court, but the court ruled that SARS had the right to recover the VAT and that the provisions of the VAT Act were not unconstitutional.

65 Personal communication with Judge Dennis Davis, 17 February 2003.

66 *Sowetan* 8 April 2003.

67 Interview with Pravin Gordhan, commissioner of SARS, 12 March 2003.

68 Personal communication with senior SARS personnel as well as a former auditor of the Woodmead project.

suspects systematic avoidance and evasion. SARS's efforts to target high net worth individuals has also entailed administrative innovations; it has introduced lifestyle questionnaires to examine discrepancies between tax returns and an individual's standard of living. It has also set up a special investigative unit to randomly audit home owners with a monthly mortgage of more than R750,000. It has also used information from banks to track individual non-disclosure of interest on investments. All these innovations seem specific to South African circumstances even though SARS has enjoyed access to advisors from countries such as Australia, New Zealand, Singapore and Canada.

A2.3 Cooperative autonomy

Perhaps the most important feature of the SA system is that it appears to challenge a widely held notion in current thinking on tax collection in the global South – that revenue-raising authorities are most effective when they are insulated from the government and the political process. Like tax collection authorities in several other countries, South Africa's enjoys administrative autonomy. The initial spur to autonomy was the Katz Commission. Its first interim report, released late in 1994, found a substantial gap between the amount of tax collected and that owed to the government (Katz *et al.* 2003).[69] Customs and Excise enforcement had also deteriorated in the view of key current officials.[70] The commission therefore recommended that the tax administration, which in the view of the current governing party had deteriorated in the latter part of the 1980s and early 1990s, be granted administrative autonomy from the Public Service Commission,[71] which controls the civil service. The ineffectiveness of revenue collection was said to be a result of its location in the Treasury department, which, because it did not want to be perceived as extravagant at a time when it was advocating the streamlining of government budgets, did not allocate itself the money needed to improve its effectiveness.[72] It lacked infrastructure and staff training, and was unable to offer market related salaries to recruit people with the necessary skills.[73] The decentralisation of tax administration to regional offices without adherence to a homogenous set of policies and procedures with a lack of access to centralised information systems, led to differing interpretations of tax law within the collection system.[74]

The Katz commission recommended strengthening the authority of the Revenue Services by allowing it to govern its own administrative affairs. Parliament's joint standing committee on Finance which dealt with the Katz recommendations, proposed that an autonomous revenue agency was needed because efficiency required the revenue collection agency to be allowed to offer market related salaries for the skilled personnel it was trying to recruit; have the freedom to budget for its infrastructure needs, and to design career packages and human resources training to improve the morale of its workforce. These

69 Interview, Gill Marcus, Deputy Governor of the Reserve Bank, 30 September 2003.
70 Interview, Marcus.
71 Interview with Barbara Hogan, Chair of the Finance Portfolio Committee, National Assembly, 15 September 2003.
72 Interview with former SARS official, 2 October 2003.
73 Interview, Parfit.
74 Interview, Marcus.

recommendations were implemented. During this period of transition, SARS was given the power to determine its required staffing, bargain with employees, determine conditions of employment and set salaries, acquire or dispose of property, and enter into agreements to obtain services. The British Customs Office was influential in addressing the human resource needs of the Customs and Excise office and the Swedish Tax Authority was influential in setting the strategic directions for the Inland and Revenue Services. One significant outcome of SARS's administrative autonomy was its ability to hire professionals from business, a change which is said to have significantly increased its effectiveness.

Creating an autonomous revenue-raising agency initially entailed integrating the functions of the Inland Revenue and Customs and Excise departments which had been demoted to directorates within the Treasury department in the mid 1980s, on the initiative of then president P.W. Botha, who was seeking to streamline government departments. In 1995, the two directorates were promoted to departmental status and the following year they were integrated into a single South African Revenue Services (SARS), which, in 1997, was granted administrative autonomy and was able to set its own policies and procedures. However, this administrative autonomy has not isolated SARS from the government – on the contrary, cooperation with other sections of government have been the key to enhanced revenue collection over the past few years.

First, SARS has cooperated with the special criminal investigation unit attached to the National Directorate of Public Prosecutions, known colloquially as 'The Scorpions'. SARS inquiries into tax evasion often lead to the discovery of other illicit activities, such as money laundering: the Scorpions are trained to investigate these areas of crime. At the same time, the Scorpions are able to provide greater investigative capacity to SARS. The information flows between these departments help to strengthen their capacities. SARS also works closely with the central bank, the SA Reserve Bank, to track the overseas investments and financial activities of South African residents. But most important has been SARS's cooperative relationship with the Ministry of Finance. The cooperative approach of the political authority, in the form of the Finance Ministry's Treasury, has created an enabling environment for SARS and has contributed to its enhanced revenue-raising performance since its formation. In particular, the Treasury has been willing to table legislation designed to enable SARS to fulfil its function more effectively. SARS's enhanced performance has also made it easier for the government to achieve some of its budgetary goals. This suggests that a mutually supportive relationship between the legislature and the public service on the one hand, and the revenue-raising authorities on the other, can improve the state's extractive capacity.

From 1997, when it gained administrative autonomy, until 2001, SARS was given significant latitude in how it could interpret the tax policies announced by the Minister of Finance's Budget Speech: the Ministry had few senior staff members with tax expertise and was thus unable to provide much support to the Ministry in setting tax policies. The policy directions for revenue reform were vague,[75] giving SARS the leeway to interpret tax policy in ways which maximised its enforcement capacities. In 2001, capacity was increased in the tax policy unit (TPU) of the Treasury by the long-term hiring of highly qualified staff,

[75] Interview with former SARS official, 22 October, and Judge Dennis Davis, 28 October 2003.

as opposed to a continued reliance on consultants. Arrangements since then have been designed to ensure SARS's accountability to the ministry. The TPU now refines broad ministerial directives into concrete policies and advises the Minister and Director General (the most senior public servant in the finance department) on tax reform. This has enhanced the Minister's ability to provide more precise recommendations in the Budget Speech. The Budget Review outlines in detail how policy guidelines should be interpreted, which curtails SARS leeway for divergent interpretations: in the 2002 Budget Review, the ministry ruled that the repatriation of foreign dividends should be taxed and the TPU subsequently developed the legislation that effectively dictated how SARS should administer it.

Despite this change in the formal position, however, the framing of tax law remains a cooperative enterprise between the Treasury and SARS, based on a flow of information between them. The TPU writes tax policy, monitors where SARS tax practice is not covered by the legislation and then designs the necessary policies to ensure that the legislation mirrors tax practices. The legislative unit within SARS, responsible for implementation, reviews the suggested tax policies to determine whether they are administratively feasible. If they are, this section within SARS then translates the suggested policy into proposed legislation.

Shared responsibility for the legislative process and the manner in which critical information is conveyed between the two has been effective in closing the loopholes in tax laws. SARS has paid particular attention to the gap between legislation and how tax policy is actually implemented, which, international evidence suggests, leaves a vacuum, which facilitates tax avoidance.[76] SARS and the Treasury have tended to agree on the general direction of tax reform – which seem to be a subject of consensus among officials. This includes support for continuing Value Added Tax, introduction of a Capital Gains Tax (see below) and neutrality of tax incentives for different investments such as tax holidays and exemptions. These are commensurate with international norms of tax reform and were also initially suggested by the Katz Commission[77] – which has played a key role in establishing the tax principles of the post-apartheid government – and fully endorsed by the Cabinet. Cooperation has, therefore, focused on tightening administrative effectiveness rather than a review of the policy framework. The Treasury is able to offer SARS insights on changes in the economy which require its attention, just as SARS is able to advise on the practical effects of legislation: the areas of expertise offered by each create a more effective governance system.[78]

Cooperation between the tax authority and the Treasury does not rest on administrative arrangements, but on a common political perspective. Pravin Gordhan, the Commissioner of SARS, appointed in 1998, is not a technical tax specialist but a veteran of the fight against apartheid who was a governing party member of Parliament before his appointment. Gordhan was active both in the United

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[76] See for example Parthasarathi (1999), *Some Taxation in Latin America: Structural Trends and Impact of Administration*: 19, quoted in Victor Lledo, Aaron Schneider and Mick Moore, *Pro-poor Tax Reform in Latin America: A Critical Survey and Policy Recommendation,* report commissioned by DFID, March 2003.

[77] Katz Commission First Interim Report (1994) *Final Draft Report of the Joint Standing Committee on Finance on the First Interim Report of the Katz Commission* (1995).

[78] Interview, Hogan.

Democratic Front (UDF), the broad coalition of anti-apartheid organisations which fought the system within the country during the 1980s,[79] and in the South African Communist Party. In a significant parallel, the Finance Minister Trevor Manuel, had no formal economic training before becoming head of the ANC's department of economic planning in 1992. He too was a UDF leader. They played roles in the formulation of the Reconstruction and Development Programme, an ambitious plan for the redistribution of wealth and power adopted by the ANC, and the writing of the Constitution, which also proclaims egalitarian ideals. The two therefore share values, which see revenue collection not simply as a professional or administrative task, but as a means of realising common political goals – these are shared by Treasury officials and some senior SARS officials and by the Cabinet. A belief that tax collection is a key element in a shared political project has ensured high degrees of coordination between the Treasury and SARS – the fact that a significant egalitarian impulse remains as part of this project may explain why, contrary to current international trends, both the priorities of SARS – which has targeted companies and wealthy individuals in its revenue collection strategy – and the Treasury – which has used enhanced revenue collection to increase the funds available for poverty reduction – retain strongly redistributive features. Clearly, as noted above, a political context relatively conducive to redistribution is a significant factor here but the officials and politicians appear to be relatively responsive to that environment. This may explain why, despite constant claims to the contrary by left critics of government policy, the tax system has redistributed a degree of wealth from the rich to the poor.

A2.4 Impacts of the system

To examine the distributive effects of the tax system, it is firstly necessary to look at collection trends since SARS became an autonomous entity.

Revenue collection has, since 1995/96, increased each year – the 15.6 per cent gain recorded in 1996/97 was the highest during the period, the average increase per year over the period amounted to 11.5 per cent.[80] Gains in efficiency of collection from the corporate sector have been most significant. Since 1998, company tax receipts have increased from R22.5bn ($3.4bn) to R42.3bn ($6.5bn) – an increase of 88.5 per cent, even though the tax rate has remained the same at roughly 30 per cent. This is not in itself an indication of the extent of gains in efficiency – these are calculated by comparing enhanced receipts with increased company profits: company tax receipts during the past three financial years have increased by 60.5 percentage points more than profits, with an annual efficiency gain, calculated as improvements in collections adjusted to take into account increased profits, of some 20 per cent on average each year. This can be taken as a measure of enhanced corporate contributions to revenue.

Personal income tax collection has improved, but to a lesser degree than the corporate equivalent. Since 1998–9 revenue from personal income tax has increased overall by about R12.5 bn ($1.9bn). Rough calculations reveal that, in the period 1998/9 to 2000/01, the collection of personal income tax has shown

[79] The UDF was not the only anti-apartheid coalition operating within that period but was closest to the African National Congress, which was then in exile. See Jeremy Seekings (2000).

[80] Calculated from Dumisani Hlophe and Steven Friedman (2002).

an efficiency gain of about 7 per cent a year.[81] SARS's collection of VAT during this time period, however, actually declined by 50 per cent because of changes in exemptions.[82] Further significant developments in personal tax are two policy changes, which have reduced tax avoidance. PAYE has brought in greater revenues through two distinct policies. SARS has eliminated most deductibles that had often been used as fringe benefits and its cash flows have improved through a 4 per cent increase in the PAYE register over the last fiscal year due to legislative changes requiring directors of private companies to render PAYE.[83]

These trends suggest that a significant redistributive effect has ensued from changes in revenue collection. While companies could, in principle, respond to increases in tax collection by retrenching workers and raising prices, thus ensuring that the effect is to redistribute away from the poor, there is no evidence from company annual reports that tax levels are prompting these decisions. Since, therefore, company profits might be expected to accrue to the affluent, enhanced collection is likely to have been redistributive away from the affluent. And, since personal income tax is only paid by individuals earning more than a legislated floor (see below), while everyone must pay VAT, enhanced collection with a static VAT return would also be expected to be redistributive towards the poor. The PAYE changes would suggest the same since recipients of fringe benefits are usually in the upper income brackets – as, of course, are company directors. The introduction of Capital Gains Tax in 2001[84] – another Katz Commission recommendation – would also tend to give the system a more egalitarian effect.

The general conclusion that tax changes have redistributed towards the poor is enhanced by recalling how SARS has gone about reducing the tax gap. It has anticipated its enforcement efforts will yield higher returns if it tackles fewer entities that earn more – high net worth corporations as well as individuals. Most of the high-income companies that SARS has targeted are in the corporate sector. Given the political background of the Commissioner, Gordhan, it is hardly certain that this strategy was adopted for instrumental reasons only: since the post-apartheid government has been more business friendly than expected, it is conceivable that egalitarians might, with some relish, conclude that tax collection is one of the few areas of public life in which assertive assaults on business are consistent with both law and policy. The notion that aggressive enforcement is an egalitarian measure is supported to a degree by the Katz Commission's warning that "horizontal inequity" which 'arises partly as a consequence of a difference between tax-payers in their capacity to avoid or evade tax' is, according to international evidence, 'severe in progressive income tax systems'.[85] While this point is used by the Commission to justify 'broad-based indirect taxes such VAT", which critics label regressive, egalitarians within SARS could equally see it as a warning that "horizontal inequities" can only be reduced or eliminated by targeting high income companies and individuals. But, even if SARS has not adopted this strategy as a redistributive measure, it has had moderately redistributive effects in favour of the poor.

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81 For the calculation method see Smith (2003).

82 Interview with Franz Tomasek, Assistant General Manager of Tax Legislation, SARS.

83 SARS *Annual Report and Financial Statements* (2002: 25).

84 *Taxation Laws Amendment Bill 2001*.

85 Third Interim Report, 2.5.7. The commission cites Vito Tanzi, 1994, 'The IMF and Tax Reform' in A. Bagohl and N. Stern (eds), *Tax Policy and Planning in Developing Countries*, New York, Oxford University Press.

This surface impression is enhanced by a closer look at the details of tax reform. Post-apartheid reform has been guided by two imperatives, which are in tension with each other – pressure to redistribute resources towards the lower income groups and the need to offer the affluent incentives to remain and to invest in the hope that this would contribute to growth, a need enhanced by the scepticism among the affluent of the competence of a majority-ruled government. This tension was perhaps exemplified by the Katz Commission which sought, as one of its key members put it, to recommend that the tax system be used as a means of promoting economic growth, but also that it '. . . be responsive to the need for social justice, and approach the plight of the poor with constructive empathy'.[86] The commission therefore did not express itself on whether the maximum marginal rate of personal income should be increased beyond noting that current trends in international tax reform included reductions in the maximum marginal rate and then urging a national debate on the relationship between income distribution and tax reform.[87] It did, however, seek a more egalitarian system by proposing relief for lower-income tax-payers, particularly focusing on those earning between R20,000 ($3,062) and R80,000 a year ($12,251), and an increase in the income tax floor, the amount of income at which tax-payers become eligible for income tax.[88] While these measures do not reach the poorest citizens – the commission argued that 'It is not in the tax system that the remedy for poverty is to be found', adding that very poor households paid so little tax that even a complete exemption would make no difference[89] – they did seek to strike a balance between redistributing downwards and reducing top tax rates in an attempt to stimulate the confidence of the affluent.

The government has adopted this approach but has been more emphatic in its concern to "square the circle" than the Commission: it has cut the maximum marginal rate but has also given priority to lower income tax-payers in its reform programme. The increased effectiveness of collection has been a significant resource here – collection by SARS repeatedly exceeded the 25 per cent tax/GDP ratio mentioned above, and this has enabled the cabinet, at the initiative of the Finance Minister, to ensure that surpluses over this target were returned to the tax-payer by a lowering of the maximum marginal rate from 45 per cent to 40 per cent over four years (1998–2002), while other measures have provided relief to lower income tax-payers and the tax floor has been raised from R17,000 ($2,603 per year) in 1998 to R30,000 ($4,594) in 2003, a real increase of some 37.4 per cent over the five years (Smith 2003). The poor do pay indirect taxes through VAT but many consumption items considered the most common expenditures for low-income households have been zero-rated. The technical policy advice given to SARS by the Tax unit within the Treasury has been instrumental in facilitating the administration of these tax changes.

Enhanced tax collection has also enabled the Finance Ministry to square another important policy circle, this time on the expenditure side of the budget, by maintaining its commitment to fiscal discipline, keeping the budget deficit below 2 per cent of GDP, while addressing social needs by moving away from spending cuts to substantial budget increases. Since 1998 SARS's efforts have increased the public purse

86 Pierre du Toit 'What the Katz report actually did say' *Mail and Guardian,* 17 February 1995.
87 Third Interim Report Section 2.5 'The Relationship between Income Tax and Income Distribution'.
88 First Interim Report, Third Interim Report.
89 Third Interim report, Paragraph 2.4.3.

by some R92bn ($14.1bn) giving the treasury the space to allocate more resources to the poor. It has allocated an 8.5 per cent increase in its non-interest expenditure to social services, moving from 49.8 per cent in 1997/8 [90] to 58.3 per cent in 2002/3. This spending does redistribute in favour of the poor – according to the Minister of Finance, 57 per cent in 2000 was allocated to the poorest 40 per cent, under 9 per cent to the wealthiest 20 per cent.[91] Thus, although SARS does not decide how the revenue it raises is spent, its increases in collection have allowed the government to increase social spending within its general commitment to hold down the budget deficit. It has thus been able to move contrary to an international trend in which countries undertaking tax reform have tended to move away from redistributive goals. Whether enhanced government spending will lead to positive welfare effects depends, of course, on government capacity. However, the evidence is clear that the effect of tax reform thus far has been to raise revenues which are being used to reallocate resources to the poor even as fiscal discipline remains in place and efforts to send encouraging signals to upper income earners by reducing the maximum marginal rate continue.

A2.5 Current policy issues

Tax collection has been one of the key governance "success stories" of post-apartheid South Africa. Not only has SARS's performance demonstrated that majority rule need not bring a decline in government effectiveness but, as noted above, it has enabled the government to meet apparently conflicting policy goals – stimulating business confidence and addressing social needs, maintaining fiscal discipline and high levels of social spending. It may well, therefore, have played an important role in enabling the government to stabilise the economy and to weather external shocks during the period.

Inevitably, perhaps, in a transitional society with marked disparities and in which redistribution towards the poor is seen by some as a crucial means to rid the society of racial discrimination (since the poor are overwhelmingly black), the overarching framework of the tax system is a subject of heated debate in which participants range from libertarians advocating a flat tax through to demand on the left for more egalitarian policies which would increase the tax commitments of the affluent to pay for more extensive social programmes. The authorities, while remaining committed to fiscal discipline, have, as noted above, sought to offer concessions to both sides of the debate – as a continuing indication of its egalitarian commitments, the government announced, in late 2003, reasonably generous allocations to both an ambitious public works programme and the provision of antiretroviral medicines to people living with HIV and AIDS, even as its commitments to controlling the deficit and limiting taxes on the affluent continue.

As long as the reigning political balance of forces is maintained, the governing party is likely to remain on the current course – it cannot discard a degree of egalitarianism without abandoning millions of its voters but the power of the egalitarians remains limited, constraining a decisive shift to more egalitarian

[90] Ministry of finance, *National Budget Review, 1998*: 25.
[91] Trevor A. Manuel, *Budget Speech,* 23 February 2000 (www.finance.gov.za).

policies (Friedman and Chipkin 1991). However, its ability to remain on the present course is, as this analysis has suggested repeatedly, significantly aided by enhanced tax collection which enables it to avoid uncomfortable choices: 2003/04 is expected to be the first tax year since SARS's formation in which revenue collection will fall short of targets (because of unanticipated currency fluctuations rather than a decline in the revenue agency's effectiveness) and this may ensure a 2004 budget far less able to smooth over the interest differences which have been partly blurred by the revenue performance of recent years. Because collection plays so crucial a role in role in shaping policy, this suggests that its effectiveness remains the key strategic and policy issue facing SARS and the treasury.

At present, prospects for continued effectiveness in enforcement seem strong. As the analysis at the beginning of this paper implied, it has been argued by one of the authors of this paper that SARS's enhanced effectiveness is a consequence not only of more aggressive collection strategies and improved technical capacity but of the existence among white tax-payers (who remain crucial since whites remain the key owners of resources in the society) of a culture tending towards compliance which make it likely that they will pay even if they disapprove of the government. It went on to suggest that, although black tax-payers were not automatic adherents of this culture, because their alienation from the apartheid order prompted them to resist rather than to comply with obligations to the state, it was possible that they, because of their identification with the new order or because of their increasing incorporation into the upper echelons of the formal economy, would become enthusiastic adherents of that culture (Friedman 2003). This argument has been confirmed to a degree by the focus group exercise discussed earlier which finds, firstly, that white respondents continue to see tax payment as obligatory despite clear hostility to the post-apartheid order while upper income back respondents in particular see payment as an important obligation to a post-apartheid society with which they identify – in their case, this view holds even where respondents are unhappy with the governing party.[92]

Continued effectiveness is, however, not guaranteed. It is not, for example, clear how much of a role leadership has played in SARS's performance and, therefore, whether it would continue to maintain collection levels if the current commissioner was replaced by someone less inclined to share a common agenda with the Treasury and less committed to aggressive pursuit of enhanced collections. Similarly, political circumstances could change, prompting the government and political leadership to undermine rather than support the activities of the revenue raising authority.[93] Nor do we know the likely impact if the revenue agency were to begin to fall consistently short of revenue targets – it is conceivable that compliance would decline as tax-payers concluded that SARS's image of invincibility was misplaced and that it could be ignored or defied. And in those circumstances, the aggressive pursuit of affluent tax-payers and companies – a tactic, which has included use of the media to shame well-known individuals who are accused of evasion – may become an asset rather than a liability.

92 Focus Groups, Ebrahim Fakir, forthcoming.

93 A senior SARS official notes that the restraint shown by politicians in allowing the service to collect tax without interference has been a major ingredient of its success. Interview, March 2003.

An important issue here is SARS's failure to penetrate informal economic activity. Not only does this leave a significant section of the citizenry beyond the reach of a key governance function, the tax system, but it could, in different circumstances, prompt resistance from tax-payers in the formal sector who might feel that the revenue-raising authority is selective in who it taxes, thus creating resistance based on the notion that selective tax collection is unfair. Thus, although whether taxes should be collected from the informal sector is itself a subject of heated policy debate, with opponents arguing that this would inhibit a source of economic dynamism, the incentives for SARS to seek to penetrate informal activity is strong. Actual performance, however, has been extremely modest: it has made tentative inroads into the informal taxi industry but has found the costs of ensuring compliance too prohibitive given its limited understanding of this realm.[94]

The challenge seems daunting since what is required is the creation of a culture of compliance, not the ability to make use of an existing culture, and cultures are not created quickly or easily. But there is no reason why such a culture should not be established once again among people who now operate outside the formal rules, even if success is likely to be neither easy nor rapid. And it also seems to follow from this analysis that a starting point will need to be a painstaking and lengthy attempt to understand the ideologies[95] and institutions, which underpin informal activity. While it seems axiomatic that the elements of a culture of compliance will be less evident, the strategic exercise would depend on trying to identify elements of informal economic and political culture, which might tend towards a compliance-oriented culture – and ways in which they might be strengthened at the expense of the understandings and institutions, which obstruct it. Progress may be slow and much preliminary work may be needed before greater understanding can produce sustained gains in much wider and more permanent compliance.

Penetrating informal activity may also require policy changes – the benefits for a participant in the informal economy of choosing not to comply might far outweigh the incentives for complying. Findings from the Small Business Project in Johannesburg claim that the cost of compliance for small business is prohibitive as the tax laws are too complex for small businesses to comply without seeking external expertise at significant cost.[96] This is a problem that faces revenue-raising authorities in most if not all sub-Saharan countries.

Enforcement, therefore, remains a key area for policy debate. As this discussion has shown, this centres not only on how but also on whether some economic actors, such as people engaged in informal activity, should be taxed. Among those who argue for an attempt to enhance and broaden incorporation into the obligations entailed by the tax system, differences centre on whether non-compliers need to be wooed into the system with policy changes which reduce the costs of compliance or coerced into it by more effective tax administration. This of course, is part of wider debate on the relative roles of responsiveness to citizens and enhanced coercive capacity in ensuring deeper and broader tax compliance.

94 Email communication with Andrew Fisher, SARS, 18 February 2003.

95 "Ideology" is understood here as 'the subjective perceptions . . . all people possess to explain the world around them', North (1990).

96 'Taxes take their toll', *Financial Mail*, 31 October 2003: 46.

It seems likely that this largely specialist debate will continue parallel to that over the broader goals of the tax system which tends to dominate national debate on tax at present. But it seems equally likely that the two will continue to intersect and to shape each other for they are, of course, related: just as enforcement can have important implications for tax policy so, as the small business finding cited above shows, can policy shape prospects for enforcement.

A2.6 Conclusion: how rare a resource?

Effective tax collection, this analysis has suggested, can be a vital resource for governments and societies, which face difficult distributive conflicts and are vulnerable to external shocks.

The revenue gains achieved in South Africa over the past few years have clearly made it easier for the authorities to soften the edges of choices in response to competing claims and to adopt both revenue and expenditure policies which offer improvements to the poor while keeping the affluent within the economy and the tax system. It also enabled it to adopt a deficit reduction strategy, which, in the view of mainstream economists, enabled the economy to weather shocks, which posed far greater difficulties to other societies, which did not enjoy the options opened by a tax collection agency, which regularly exceeded its revenue targets. This also has clear political and governance implications since enhanced collection makes it easier to resolve or at least defuse social conflicts – it also enhances the penetration of the state into society, a key requirement of the strengthening of democratic government and the incorporation of citizens into a relationship of mutual obligation with the state. The prerequisites of enhanced tax collection therefore deserve far greater attention from students and practitioners of democracy, effective governance and appropriate economic management in those societies, which do not enjoy a significant tax collection capacity. It may well be a key to determining the development of states.

But replication of South African experience over the past five years will not be easy. The evidence and argument assembled here suggests that increased collection may have as much to do with the peculiar circumstances of the society's past and present as it does with the strategies and methods used by the revenue raising authority. SARS's effectiveness may stem at least partly, therefore, from its ability to develop strategies appropriate to the culture in which it operates (Friedman 2003). The challenge for scholars and practitioners in other societies in which tax collection is an important governance challenge may, therefore, be to attempt to identify the elements of their own pasts and presents which may enable a culture tending towards compliance to be built – or an existing set of values, rules and practices which, given appropriate intervention, may underpin an effective tax system and administration.

The circumstances, which permit governments to establish effective revenue-raising capacities, are often elusive and the responses required from tax agencies and governments are often equally difficult to discern. But this conclusion that the revenue-raising function is both more central to societies' prospects and more demanding of intellectual and strategic effort than we often imagine merely confirms our earlier conclusion that this is an aspect of the state-society relationship which is yet to receive the attention it deserves.

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