

## **Summary #3 -Taxation, Governance and Poverty: Where Do Middle Income Countries Fit?**

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*This paper forms part of a five year research programme under the Centre for the Future State, based at the Institute of Development Studies. Below is a summary of principal findings. Further details are available at [www.ids.ac.uk/gdr/cfs/index.html](http://www.ids.ac.uk/gdr/cfs/index.html)*

### **Introduction**

The paper explores how tax reform can contribute to improved governance and poverty reduction in poorer countries. It argues that Middle Income Countries (MICs) can play an important role in this process. Due to recent changes in the fiscal environment including changes in tax structures, it suggests that taxpayers in MICs are likely to become more engaged politically, and that issues of taxation and public spending will become more prominent in public policy debates. There is an opportunity to promote constructive tax reform directly in MICs, and indirectly in Low Income Countries where MICs exercise influence on development policy. Aid donors can contribute positively to such tax reform by encouraging local initiative and broad democratic debate over tax.

### **Tax, Fiscal Social Contracts and Governance in MICs**

Tax and tax reform are relevant to poverty reduction and good governance in poorer countries a) because more efficient and equitable tax regimes can lead to redistribution of income, and an increase in financial resources to address poverty; and b) because tax reform can strengthen the fiscal social contract and so improve the quality of governance, which can contribute, indirectly, to poverty reduction. The paper explores the second of these propositions. It identifies three broad categories of MICs, and the main long-term reasons why social fiscal contracts are weak for each one. In former communist countries, the state acquired revenue by appropriating surpluses from state owned enterprises, and thus had little need to engage with citizens over tax. In the second category - countries rich in energy and minerals - those who control state power have access to large rents from sale of these resources, which reduces the need for state - society bargaining over tax, as well as fomenting civil conflict and entrenching authoritarian rule. The third category - "other MICs" - is more diverse, but includes a core of Latin American countries. Here, the weakness of fiscal social contracts is traced to a history of high inflation (which quickly erodes the benefits from negotiation over tax); high dependence on indirect taxation (which does little to provoke taxpayers to organise); and tax structures which have encouraged covert engagement over tax by narrow interest groups, rather than broader, collective action.

### **Changes in Tax and Fiscal Policy Agendas**

The paper argues that recent changes in MICs may be creating circumstances more conducive to the development of *fiscal social contracts*. Democratisation, notably in Latin America and East and Central Europe, has had a widespread impact. In the case of mineral and energy rich countries, the 'resource curse' is likely to remain a major impediment to better governance, in spite of recent, welcome initiatives such as the Extractive Industries Transparency Initiative. Among former communist

countries, two distinct groups are emerging. Those which have met or are meeting conditions for accession to the European Union have modernised their tax systems, with substantial dependence on VAT and on personal and corporate income taxes. The other group, including the Caspian Basin oil states, Russia and (until recently) Ukraine, are characterised by narrowly based authoritarian governments, suffering from many classic symptoms of the 'resource curse'. The contrast is highlighted by a comparison between Poland, which introduced direct income tax through a negotiated process that has strengthened the social fiscal contract; and Russia, where tax contributions of the conglomerates were determined through elite bargaining.

The situation in the "other MICs" is more encouraging. In addition to the deepening of democracy, two major developments have encouraged greater levels of public contestation over fiscal issues. The first includes changes in the fiscal environment, notably falling inflation; the spread of VAT (though often seen as an indirect tax, it has the potential to stimulate collective action, especially by small businessmen); and simplification of tax structures and reduced reliance on trade taxes as a result of tax reforms led by the IMF. Secondly, there has been increased political activism around budgetary transparency, for example participatory budgeting in Brazil.

### **Why Are Tax and Poverty Issues in MICs of Particular Interest?**

Two main reasons justify the focus on MICs. Firstly, they have high levels of income and wealth inequality, under-taxation of natural resource wealth and regressive tax systems. There is therefore considerable scope for reforms which could redistribute income and increase financial resources to address poverty. Secondly, MICs have the ability to influence the policy agendas of poorer neighbours; and they have the capacity to adapt and extend the 'Washington Consensus' tax reform agenda, moving beyond a focus on technical and administrative issues to address more deep-seated and politically contentious reforms. Evidence for this includes 'home grown' innovations introduced in Latin American countries, and the negotiation of a fiscal pact in Chile.

### **Lessons for Aid Donors**

Tax reform led by the IMF has been relatively effective, not least because it has generated expert consensus, and focused on technical and administrative issues. But this approach is also limiting. Contentious but urgent issues of equity have been neglected. Donor interventions have been biased towards policies which have worked in OECD countries, leading to the neglect, for example, of urban property taxes. Donor interventions can be damaging – for example if externally imposed fiscal targets lead to coercive collection which undermines more constructive state / society engagement over tax. Standardised approaches – such as advocacy of semi-autonomous revenue authorities – can fail to take account of local context and the political dimensions of reform. So there is a need to move beyond the Washington Consensus agenda. There is scope for MICs to take the lead in developing their own reform agenda, and to broaden their political engagement with citizens over tax, which in turn could influence tax reform in the poorest countries.