Research Summary #2 - Revenues, State Formation and the Quality of Governance in Developing Countries

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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

Introduction

This paper starts with the proposition that patterns of state formation are heavily influenced by sources of state revenue. It suggests that this proposition is valid in the context of western European history, and in the light of the contemporary experience of countries in the South. It investigates the extent to which the quality of governance in the South might improve if states were more dependent for their financial resources on domestic taxpayers. It considers the circumstances which might encourage states to negotiate over tax. The very different context for state formation in the South cautions against firm conclusions, but the paper highlights the potential importance of state relations with taxpayers as a route to improving governance.

Tax and Representation in Western Europe

The paper examines the causal links between dependence of governments on earned revenue from taxpayers, and the creation of representative institutions, in the context of state formation in Western Europe. The incentive for rulers to negotiate with taxpayers was the need to raise revenue to fight foreign wars. The causal links between taxation and representation are briefly as follows: Negotiated taxation made collection less costly, and more predictable, encouraging taxpayers to invest, and enabling governments to plan. The existence of a (parliamentary) forum for negotiating tax encouraged a search for mutually beneficial policies, and made taxpayers more willing to respond to calls for emergency war finance. Parliaments developed oversight functions in relation to revenue raising and public expenditure. Rulers had a stake in the broad prosperity of citizens, and incentives to develop an effective bureaucracy to collect tax. A further development in Britain was the ability of governments to borrow against future tax revenues (thus creating a fiscal state) – this seems to have strengthened accountability, helped by the substantial overlap between bondholders, large taxpayers and legislators. There were special factors underpinning the links between tax and representation in western Europe (especially in Britain and the Netherlands), not least the importance of seaborne trade, which created common interests between merchant taxpayers and the state in strengthening the navy, without providing rulers with the repressive power of a standing army. But the literature on rentier states also points to causal connections between taxation and good government.

Rentier States

Rentier states – which derive revenue from natural resource rents and 'strategic rents' such as development aid – are the product of recent developments, notably the existence of a rich – poor bipolar world, and increasing global inter-connectedness. Dependence on unearned rents creates conditions for bad governance, including the autonomy of government from citizens; incentives for external intervention, and internal coups; failure to control the territory by extending the reach of the (tax collecting) bureaucracy; non-transparency in public expenditure; and absence of incentives for civil politics. Cross-national statistical analysis further demonstrates the links between access to rents and poor governance.

The paper explores patterns of state formation and governance in the South by comparing the international environment in which those states were formed with the very different context for state formation in Western Europe. In particular the fact that state power in the South was often forged by colonial rule; the destructive power of modern military technology which increases state power in relation to citizens; and the access of political elites to rents all mean that there are few parallels with the process of state formation in the North.

Could there still be a Governance Dividend from Taxation?

It is clearly not possible to reconstitute the circumstances in which a fiscal contract was established in Western Europe. But the paper looks at the circumstances in which states in the South might be more – or less – likely to engage in negotiation with citizens over tax. It suggests that coercion is more likely at a local level in agrarian environments, whereas negotiated tax relationships are more likely at national levels and in urban, high income settings (this has some operational significance for policymakers). Incentives to negotiate may be higher where there is less access to concessional finance; conversely, high levels of indebtedness to foreign lenders (notably the IMF) can undermine the bargaining relationship. The lack of overlap between large taxpayers and membership of the legislature makes collective action within parliaments more problematic, but public debate between business associations and government outside parliament might enhance the fiscal authority of legislators. The nature of the tax regime and the mode of tax collection also have an impact on incentives for collective action. Reduction in inflation, and the introduction of VAT could increase potential for collective action by taxpayers[1].

Conclusion

The paper argues that it is worthwhile pursuing the possibility of a *governance dividend* from taxation. It points to recent experience in Poland to suggest that negotiations between government and organised labour over the introduction of income tax can produce a 'governance dividend' in the shape of a social contract within a relatively short period of time. The paper suggests that there is broad agreement about the importance of state – society bargaining as the foundation for effective states, but less consensus about which groups are important for this purpose. For example should electoral democracy and the relationship with citizen voters take priority, or is the structural power of mobile capital more significant? The paper underlines the importance of taxpayers, as a group separate from and additional to citizen voters and capitalist investors, and with the potential to impose some constraint on state power.

[1] See summary #1 "Taxation and the Political Agenda, North and South"