Nordiska Afrikainstitutet
The Nordic Africa Institute

Policy Notes 2010/4

More Tax, Better Governments

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It has been argued that aid donors should focus more on supporting low-income countries to broaden their tax base and raise overall taxation. Besides increasing revenue, this has also a political objective. When citizens are taxed without excessive coercion, taxation can contribute considerably to improved governance and accountability, and to state building.

Due to the effects of the financial crisis, calls for increased mobilisation of domestic resources are now being renewed. But is broadened taxation a viable strategy? Some signs of progress are visible in sub-Saharan Africa. However, governments and donors need to see taxation as part of the broader framework of social contracts and not to lose sight of the bigger picture.

There are several reasons why mobilisation of domestic resources and taxation is in focus right now in sub-Saharan Africa. Decreasing financial flows following the global financial crisis is one. Even if the crisis has not hit sub-Saharan Africa as hard as expected, the assessment is that remittances, net private capital flows, the share of domestic revenue to GDP and overall economic growth fell during 2009 as a consequence of the crisis. At the same time, aid did not increase as much as promised.[1]

Another reason is that the implementation of the Uruguay Round trade agreements and the signing of Economic Partnership Agreements (EPAs) with the EU have led to decreased revenue from trade taxes. Even though increased trade is believed to be beneficial for the economies of the region, governments still need to find new sources to finance their expenditures. Many governments in sub-Saharan Africa have been heavily dependent on revenue from trade taxes.

A third reason is that attempts to attract Foreign Direct Investments (FDI) might lead countries to compete with their neighbours by offering tax exemptions. This makes it difficult to increase the revenue from FDI. In this situation, both the UN Economic Commission for Africa Annual Report and the African Economic Outlook (published by the African Development Bank and OECD Development Centre) carry domestic resource mobilisation as their main theme in 2010.

1. Africa Partnership Forum, 2010: "Development Finance in Africa: Update of the 2008 Report". The OECD recently noted that Africa will in 2010 receive US$11bn of the additional US$25bn billion pledged at the G8 summit in Gleneagles in 2005.

The focus of this Policy Note is on what the push for domestic resource mobilisation and taxation implies for aid donors, and why it is important for them to place these issues in a wide and largely political framework of social contracts.

It is important to be clear about the scope of tax reforms. For Africa as a whole and on average, taxes account for much larger revenues than aid. This is mainly because a limited number of countries, not least in North Africa, raise large revenues by taxing natural resources such as oil, gas or mining. In 2008, 13 countries in sub-Saharan Africa had larger per capita revenues from aid than from taxes. For another 13 countries in sub-Saharan Africa, aid per capita fell somewhere between half and the full amount of tax per capita.[2] Hence, for most of these countries, an exit from aid can be only partial and will take a long time. This theme is further discussed in the African Economic Outlook 2010 report.

Aid dependency and taxation

Aid has two distinct roles: to transfer money to finance state activities in poor countries, and to contribute to the build-up of capacity for development in these countries. These two roles are not always separated, and the latter is sometimes contradicted by the first. For instance, the aid effectiveness agenda (Paris Declaration on Aid Effectiveness, signed by donor and partner countries in March 2005) aims at improving both roles. However, donors

2. Stijns 2010, and African Partner Forum 2010.

ISSN 1654-6695
ISBN 978-91-7106-670-1

This issue in the Policy Notes series was initiated by the NAI-research cluster on Globalization, Trade and Regional Integration. The purpose of the Policy Notes series is to engage in a public debate and a policy dialogue on current African issues informed by research taking place at the Nordic Africa Institute. For more information or comments on this issue contact Fantu.Cheru@nai.uu.se or the series editor Birgitta.Hellmark-Lindgren@nai.uu.se

have tended to give the concept of harmonisation primacy over the concepts of alignment or ownership. Consequently, the reduction of transaction costs involved in the transfer of money receives relatively more emphasis than conditions for capacity development.

Even more intriguing are issues related to aid dependence and adverse incentive structures that might emerge from the transfer of free financial resources. Alternative ways of financing state activities might be overlooked or made more difficult in low-income countries. In this respect, aid flows would be no different from incomes stemming from oil or other natural resources. A vast literature has treated the issue of aid dependence, both in terms of financial as well as organisational or mental dependence.

It is in this perspective that domestic resource mobilisation, and typically the evolution of taxation in low-income countries, becomes interesting to donors. Non-resource taxation[3] theoretically has advantages for state-building through a process of raising public demands for accountability. The "angry tax-payer" is an invaluable force for increased efficiency in the provision of public services and for better governance in general. Even more important is society's structural capacity to hold governments to account. Improved political organising and debates are essential. Through public pressure, governments may become accountable to their own citizens, rather than to foreign donors.

However, the argument that taxation contributes to state building is mainly based on examples from the history of Western and Northern Europe from the seventeenth century onwards. During this period, most public expenditures concerned the military. When rulers needed to finance wars, they turned to tax their citizens, since no other sources of finance were available. This in turn pushed rulers to become responsive to citizens' needs and to be more accountable. In England, large taxpayers only accepted new taxation if the parliament was strengthened, which would give them greater influence over how the money was used. Over time, this led to better governance and the build-up of state capacity.[4] Only recently has the hypothesis that taxes contribute to state building been tested empirically in sub-Saharan Africa. There, the current situation is different. It is not evident that the same processes are at play. Governments now have a host of different financial sources to choose from. In addition, there are many more areas in which to spend public money, for instance education, health, infrastructure and social security.

Some researchers have questioned whether the relationship found in Europe really holds for sub-Saharan Africa.[5] Others point to some recently emerging empirical support for the links between taxation of citizens and increased responsiveness and accountability by leaders. Apart from cross-country statistical findings, a comparison of district governments in Tanzania and Zambia has shown political accountability to be higher where citizens – through taxes – finance a larger amount of the local government's budget. Significantly larger shares of revenues were spent on public services that benefited citizens than in other districts. By controlling for level of development, the authors provided an argument about why causation in this case would run from taxes to accountability, and not the other way around.[6] Similar results were found in Argentina, where provinces that were more dependent on broad taxation of their citizens were also found to be more democratic. And – back in Africa again – a clear relationship between taxation and accountability was found in Ghana between 1981 and 2008, even though this relationship was dependent on factors such as the role of elites, the capacity of civil society and types of taxes, among others.[7]

This relationship may also be looked at from other angles. The evidence that incomes from export of natural resources such as oil and minerals lead to negative governance effects is overwhelming. At the same time, the effects of aid on governance are more mixed and contested. While aid could be seen as a "free" financial resource, much of it has at the same time had precisely the objective of improving governance. Hence, the effects of aid on taxation may work both ways.[8]

Aid donors role

In sum, the calls on African governments and donors to put emphasis on taxation seem to have some merit. The challenge donors face is how to shape aid in a way that promotes rather than hinders the evolution of DRM and non-resource taxation. Have they done enough?

The issue of DRM was a central part of the Monterrey consensus signed by governments at the UN conference on development finance in 2002. Even if low-income countries have themselves made much progress in developing their tax systems and tax administrations, donors have not always reformed their aid programmes accordingly. In 2004, it was assessed that from the US$6,6 bn that aid donors spent on government administration, economic policy and public finance management, only 2.7 percent included some taxation element.[9] In 2009, still only 2 percent of donor's total technical cooperation with Africa was geared towards "public sector financial management" – a label that includes more than just support for the build-up of tax systems.[10]

Admittedly, donors relate to DRM in more ways than this. Aid flows may have indirect effects on taxation in

3. Taxation of natural resources such as oil, gas, diamonds and other minerals tends to contribute to a financing of state activities that is not dependent on the consent of the citizenry. Hence, such taxation is the equivalent of the financial part of foreign aid in the sense that it is not state building.

4. North and Weingast 1989.

5. Rakner and Gloppen 2003.

6. Devarajan, Minh Le and Raballand 2010, showed a correlation between personal tax and accountability. Hoffman and Gibson 2006, undertook the Tanzania and Zambia study.

7. Gervasoni 2010, studied Argentina, while Pritchard 2009, studied Ghana.

8. On natural resources and governance, see Karl 1997. On aid and governance see Carter 2010.

9. Ben Dickinson, head, Governance, Conflict and Fragile States, Development Cooperation Directorate, OECD, Paris.

10. Jean-Philippe Stijns, economist, OECD Development Centre, based on OECD DAC statistics.

low-income countries by crowding-out or crowding-in tax revenue. Effects differ between countries and depending on how aid is delivered. Partly because of this, donors often place conditions on tax reforms in their aid programmes. This has been the case since the early 1990s. Donors sometimes also use tax as share of GDP as a performance indicator. Nevertheless, a continued donor focus on taxation seems warranted.

Have donors, then, supported the right things?

Based on donor advice, tax reforms in low-income countries have mainly focused on how to raise as much revenue as possible without disturbing the markets. Attempts have been made to minimise distortions and keep taxes economically neutral. Hence, reforms have included reductions in trade taxes, reduced corporate and personal income tax rates, simplified tax codes, broadened tax bases and the introduction of taxes on goods and services, typically value added taxes (VAT). Further, tax administrations have been reformed, with autonomous authorities established in a number of countries, IT systems introduced and taxpayer services improved.

While economic efficiency is of the utmost importance, a narrow focus on such aspects tends to draw attention away from the political aspects of tax reform. Short-term efficient tax reforms can contradict state building by implementing the wrong kinds of taxes (which we will return to). Suffice it to say that state-building tax reforms could contribute to long-run economic efficiency when they result in better governance.

In order to contribute to state building, taxation has to be of a certain kind and follow certain principles. There are wide differences between countries and regions, not least depending on different economic structures. However, in general, taxation should be transparent, rule-based and impersonal. Further, it should increasingly tax citizens, small and medium enterprises and try to move into the informal sector, rather than taxing only a few big companies. Governments should try to spread the tax base into remote or "ungoverned" spaces, or areas that are difficult to reach for other reasons. High collection costs and much hard work may be justified if there is the potential for expansion in the medium to long run. Efforts to simultaneously improve public service delivery and transparency in these areas are essential to make tax reform possible.

The objectives are that the state should become more responsive to the needs of its citizens, governments should share interests with citizens; state elites should become increasingly accountable to citizens; the political and administrative capacities of the state should increase. To achieve all this, administrative or technical tax reforms will not be enough. It might be even more important to initiate national dialogues and promote informed, transparent political exchanges on tax issues. It is also imperative for governments to see the links to the expenditure side of the national economy. A study of two localities in rural Tanzania showed that over 90 percent of the population would be ready to pay tax if they knew that this money would benefit them in terms of education, health and other public services.[11] Hence, increased transparency in public spending is apparently of great importance. People need to know how money is used if they are to trust the authorities.

A priority list for governments with state-building ambitions, and for donors supporting them, would include the following:

- Initiate broad dialogues and debate on tax issues;
- Increase equity in tax administration and enforcement;
- Increase transparency, improve public awareness and introduce better taxpayer services;
- Broaden and improve direct taxation – notwithstanding that some forms of indirect taxation, like VAT, might also contribute to state building;
- Strengthen civil society involvement in tax issues.

Achieving the above is both difficult and challenging. For instance, in order to broaden the tax base, equity in taxation would need to increase. Otherwise, such reforms would hardly be accepted. Greater equity would in turn imply increased reliance on property taxation – a politically complicated issue, because it implies taxation of elites. Here, donor support to improve capacity is essential, even if probably not sufficient.

Complex realities

A common result of recent tax reforms in sub-Saharan Africa is increases in overall tax revenue following the introduction of semi-autonomous revenue authorities. These increases have, however, levelled out after some time, because the tax base has not been widened enough. Governments have managed to increase the taxation of formal business corporations. By contrast, very few inroads have been made into the informal sector and agriculture, and little progress has been made in extending the property tax. In the latter areas, political difficulties have been important.

In sub-Saharan Africa, tax reforms are implemented in governance systems often described as neo-patrimonial. Warnings have been issued that tax reforms – by raising the level of revenue – might actually reinforce neo-patrimonialism.[12] A patron-client relationship is a personalised relationship, whereas a taxation relationship ought to be formal. When tax reforms are introduced in a neo-patrimonial system, they imply a shift from an informal to a formalised system. Such shifts might be more complex than they seem at the outset. The whole governance culture needs to change. Sometimes, reforms in the tax sector might spread to other sectors, but sometimes they fail to do so. The risk that reforms might be partial and wrongly sequenced needs to be seriously considered.

One could ask why money raised from taxation should be different in a state-building perspective? Why would citizens place higher demands on their leaders to use tax

11. Fjelstad and Semboja 2001.
12. von Soest 2006:21.

money more responsibly than they would on any other money the rulers control? As we have seen, this remains a contested issue. A possible answer is that it becomes more difficult for citizens to stay away from politics and the affairs of state when they themselves contribute financially. Their own activities become circumscribed, and they are gradually drawn into the sphere of the state.

Whereas a patron distributes resources that stem from some outside source to his clients, a tax relationship starts with a resource flow from below, from the citizens. To raise such money, rulers would need to seek some sort of consent from citizens. This implies that a tax relationship contains the seed of a growing financial contract between citizens and rulers. However, this has to be nurtured in a broader climate of increasing transparency, accountability and trust.

Donors can contribute to this by:

- Opening their own aid-financed activities to taxation in low-income countries, increasing transparency about the aid they give and improving its predictability;
- Continuing and strengthening such support to tax reforms in low-income countries that aim at direct income taxation, increased transparency and improved equity in taxation;
- Increasing their support for political dialogues that engage citizens on tax issues;
- Being vigilant about the links between tax reform and wider governance reforms, in particular following how the formalisation process evolves.

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May 2010