



Christian Aid
Occasional Paper No. 1
June 2008

Can tax challenge bad governance?

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Abstract

Debates about development finance tend to focus on which forms deliver best for growth, development and poverty reduction. However, development finance can be looked at from a governance perspective. This paper finds that it does matter where the money comes from, and that money raised from taxation generates stronger state-citizen relationships than both aid and natural resources. It is important, therefore, to promote reforms to make aid and natural resources 'more like tax', through securing greater transparency and ownership by citizens of those revenues. But more importantly it means prioritising tax system development and for accountable governance to be a core objective. There are no hard and fast rules about what tax system is best for governance, but our analysis reveals four main areas to consider: the process of deciding tax policies; who pays tax and how; whether tax is coerced or negotiated; and where tax is paid. This research has clear implications for the advocacy agenda of organizations like Christian Aid, but also for the projects we support in developing countries.

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Can tax challenge bad governance? Olivia McDonald and Kadi Jumu¹

Summary

Tax has long been neglected in development policy, seen as either too technical or too political. And yet an effective tax system is crucial, raising revenues and addressing inequality while playing a key role in determining and strengthening the relationship between the state and its citizens.

Drawing on Christian Aid's experience and on analysis by experts in this field, this paper looks at two questions. First, we ask whether the source of government revenue has an impact on governance. **We find that where revenue from natural resources and aid can have negative impacts on governance, taxation can have a positive effect.**

Second, we ask what sort of tax system works best for governance. **We find that tax systems and reforms should be designed with good governance as a core objective.** There are no hard and fast rules about what tax system is best, but our analysis reveals four main areas to consider:

- the process of deciding tax policies
- who pays tax and how
- whether tax is coerced or negotiated
- where tax is paid

Finally, the paper considers what this means for an organisation like Christian Aid. For our advocacy work it means promoting reforms that make revenue from natural resources and aid work 'more like tax', through securing greater transparency and ownership by citizens of those revenues. But more importantly it means pushing for tax system development to be prioritised as the development finance source that delivers best for governance. It is important for developing country governments and donors to analyse and understand this area better, and Christian Aid and its partners can help by documenting good examples.

If, as an organisation, we accept the link between a good tax system and good governance, it means working with our partners on projects that mobilise citizens as taxpayers. We should ensure that any budget monitoring projects we support help people think about where their country's revenue comes from, not just where it gets spent. And we should support partners to analyse how people are taxed, to consider if it is done in a way that promotes accountability.

As we increase our work on corporate tax evasion, we need to ensure that our belief that tax forms a social contract remains central; that we do not fall into the trap of seeing tax policy as purely a technical discussion about how to raise revenue.

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Introduction

Governance describes the rules that guide governments, companies and NGOs, as well as the rules that guide their interactions with ordinary people. Governance is about processes – *how* things are done rather than *what* is done. Making governance more accountable is a strategic priority for Christian Aid because it is ultimately about stewardship: the way in which those in power exercise it (or fail to exercise it) for the greater good. It is also about the means by which poor people influence decisions that affect their lives.

Christian Aid welcomes the shift by donors like the UK's Department for International Development away from a technocratic understanding of governance that focused only on *government capability*. Instead, increasing emphasis is placed on the degree to which governments *respond* to the needs of citizens and the ways in which they are *accountable* to citizens for what they do (or don't do). This shift in focus to the relationship between state and citizens, as well as how the state works, is important.

When we look at how government money is raised, it is clear that the volume of **aid**, the availability of **natural resources** and the levying of **taxation** all have quite different impacts on the quality of the state-citizen relationship.

Section one: Aid, natural resources or tax: does it matter where the money comes from?

1. The impact of aid on governance

There are serious concerns about the impact of aid on governance, specifically on capability, accountability and responsiveness. As this section will show, this is because the resources are ultimately controlled by donors, leaving developing country governments dependent on them rather than their citizens. Furthermore, specific aid practices, such as complying with different donor reporting requirements, can actually make the business of government harder.

Effects of aid on the capability of the state

The impact of aid on *state capability* is well documented, partly because it is easier to see and measure those impacts, but perhaps because it has been a central concern throughout the evolution of development policy (unlike the focus on *state accountability*, which has ebbed and flowed).

A key function of government is the management of the state budget. However, despite donors providing technical support for public financial management, there is evidence that aid can actually weaken the ability of governments to budget appropriately:

- It can lead to the overestimation of revenue, particularly as aid commitments tend to overestimate actual disbursements. Moreover, 'aid tends to increase total spending by more than the amount of the aid'.¹
- In low-income countries where aid is a significant part of government income and macro-economic instability is often a major issue, aid that is volatile and pro-cyclical (increases when the economy is doing well but falls when it is not) can worsen the situation.²

- Aid can be associated with reductions in tax and other recurrent revenue.³

Aid generates heavy donor demands (often called 'transaction costs') upon recipients, including managing the reporting needs of a country's many donors. Such demands have led, for example, to the Tanzanian government declaring an annual four-month mission holiday.⁴ Technical assistance has traditionally been carried out by expatriate experts – this can actually weaken institutional reform and the capability of governments to creatively solve problems. Learning by doing is prevented by a technocratic approach which requires recipients to implement standard reforms, often many simultaneously. This is exacerbated by poaching, whereby highly skilled and capable civil servants leave their jobs for more lucrative donor contracts.⁵

Dollar and Burnside have presented evidence that aid is most effective when the institutions are already in place, but these practices perversely weaken the institutional environment in which aid is given. In response, some donors are shifting more towards a long-term capacity building approach.⁶

Effects of aid on state responsiveness

Aid has traditionally come with heavy conditions that have dictated policies favoured by donors, regardless of their popularity with citizens. The space and flexibility to set their own policies is not, however, sufficient to ensure governments will respond to the needs its citizens. Quite rightly donors have focused more and more on how to institutionalise a role for citizens and their organisations in policy making through Poverty Reduction Strategy Papers (PRSP). But many countries are now into their second PRSP and it is clear from the evidence that donors are loath to cede control of policy making, particularly in the area of macro-economics, limiting the degree to which this process can build state responsiveness.⁷

Effects of aid on state accountability

Aid often bypasses governments completely. Since ousting the Taliban in Afghanistan in 2001, donors have channelled only 12 per cent of resources through the national government.⁸ This may superficially be easier while concerns around the capacity of the government remain, but it perpetuates institutional weakness and may even increase it.

If it goes to government, aid often bypasses those actors that hold government to account, such as parliaments. For example, in 2004 the IMF persuaded the Ghanaian government to overturn a pledge in the national budget to increase the tariff for imported rice and poultry included in the state budget, despite being already approved by the parliament.⁹

Parliaments, local governments and even national governments are not without serious problems in terms of capability, responsiveness and accountability – but by-passing them is a governance own-goal. Avoiding state structures and those institutions that hold the state to account is counter-productive. It might secure a quick-win development goal but actually erodes state capability *and* accountability. Donors are increasingly recognising this, hence their commitments to channel more of their aid through government systems.

Finally there is evidence that aid to governments undermines their accountability to citizens because recipient governments perform for their donors. The evidence (detailed above) that the discrepancy between planned and actual spending increased as aid

flows increased suggests that the budget process was more directed toward satisfying external donors rather than reflecting actual public spending preferences. In Malawi the budgetary process has been described as theatre,¹⁰ and in Ghana, a façade.¹¹

Money talks: aid in the Philippines

Easy access to what may seem to be attractive external financing can contribute to unwise spending, as was the experience during the Marcos years. The Philippines had access to so much credit from financial institutions that the government went on a spending spree that culminated in a debt crisis.

Money talks, especially when a country is economically vulnerable and dependent on economic aid. Aid agencies exert much influence under these circumstances and can push for the adoption of policies that suit donors' interests but are not responsive to development needs.

Even the best intentions of creditors can be undone without the involvement of a vigilant citizenry. Unfortunately, policy development involves a top-down process that mainly relies on experts and academics who share the same perspective as donors. The voice and inputs of grassroots organisations are rarely absorbed, given the many institutional weaknesses that prevent their meaningful participation in the policy process

Filomena Santa Ana, Action for Economic Reform, Philippines

Solutions

The Paris Declaration on Aid Effectiveness strives to improve many of the more technical and procedural problems that undermine government capability, ensuring that aid is better coordinated and in line with a country's domestic budgetary processes. This becomes fundamental as donors increasingly shift to budget support, where donors agree to put their aid directly into the overall government budget to support the full national development strategy. Budget support aims to increase predictability but is actually quite volatile: donor disbursement and conditions mean payments are irregular and difficult to plan around. *Some* of the negative aspects of aid's impact on governance can clearly be mitigated by improvements in donor operations.

The Paris declaration only goes so far. It does not address the two ways that aid can undermine governance. Firstly, there is a clear reluctance by donors to step back and allow recipients to set their own policy priorities. We are entering an era of mutually agreed benchmarks rather than donor-imposed conditions, capacity building rather than technical assistance and aligning with national budgets rather than those of donors. However, donors still cling to a set of preferred policies and use their influence to secure them.

Secondly, and more fundamentally, even if donors displayed model behaviour – giving space to recipients to set policies in consultation with citizens – aid-giving would still weaken accountability to citizens because it remains a revenue source independent of them. Full, proactive transparency of donors to citizens in recipient countries about what they are paying to governments and asking governments to do in return will not overcome this structural problem, but it could mitigate it. So too would allowing citizens

to monitor progress and results, as opposed to donor staff. A more radical option could be to give aid directly to the poor, as recommended by Joseph Hanlon – recognising it as a resource of the people rather than the government.¹²

Conclusion

Long-term dependence on aid by developing countries used to be a more central concern for donors than it has been in recent years. This led to a focus on how countries could raise money domestically, including through tax. Recently the focus has shifted to ending bad aid practices that weaken government capability but these are unlikely to address all aid's negative impacts on accountability. As well as increasing their own transparency to citizens, donors should really be thinking of a more medium-term aspiration – such as an exit from aid.

2. The impact of natural resources on governance

The 'curse' that accompanies the prevalence of natural resources is well documented and broadly accepted.¹³ Studies have shown that a reliance on natural resources is linked to lower economic growth.¹⁴ This is known as 'Dutch disease'. Most relevant here, however, are analyses that link natural resource dependence to poor governance. Paul Collier described this as one of the four 'traps' that generate the poverty in the states within which the 'bottom billion' live. In such countries it is easier for states to simply buy votes than have to win them through public service delivery and investing in economic development.¹⁵

This 'trap' or 'curse' is seen particularly with non-renewable resources such as oil. Michael Ross's analysis of 105 countries from 1971-1997 found that for every one-point rise in oil wealth there was a 0.72 drop on a 0-10 democracy scale.¹⁶ There is greater debate about whether the 'curse' occurs with non-renewable resources as such as forestry, fisheries or even agriculture. However, a comparison of 141 countries between 1950 and 1990 found a link between natural resource dependence (measured by the ratio of primary exports to GDP) and the probability of authoritarian government.¹⁷

As well as the link with political systems, Collier and others have found a link between natural resources and conflict, particularly with the duration of a conflict.¹⁸ Natural resource extraction often brings with it localised governance failures and conflicts. Conflict in the Niger Delta region of Nigeria, for example, is in part driven by social and environmental impacts of the industry, perceived corruption and collusion by state officials with oil firms, and limited access to oil receipts (which are distributed nationally by central government).

Solutions

While there is a strong correlation between natural resources and poor governance, it is not a foregone conclusion. Some countries, like Botswana, are resource rich and do not appear to have not fallen victim to the curse. The curse may be avoided when strong institutions are already in place, but the question is what to do where those institutions are weak at the outset?

The two main solutions focus on *transparency* – ensuring that the amount the state receives for the resources are known to its citizens; and *ownership* – ensuring that natural resources are perceived as belonging to all (rather than the elite).

The Extractive Industries Transparency Initiative (EITI), established by Norway and the UK, requests companies and governments to voluntarily publish such payments. This initiative is significant because it represents acceptance by the international community of the importance of transparency for natural resource revenues, and sets obligations on host governments, companies and governments of countries where companies are based (i.e. rich countries).

The EITI has been criticised for its lack of coherent benchmarks, a lack of civil society involvement and an over-emphasis on host countries rather than international companies and their governments. 'While most activists still praise EITI's intent,' said Ben Schiller of Ethical Corporation, 'some have begun to wonder whether a voluntary scheme can ever deliver more than a few disclosures here and there, and whether tougher, mandatory measures might be required.'¹⁹

A recent Transparency International report found that oil and gas companies do not sufficiently report on their payments to governments. They call for mandatory reporting of all payments to governments by domestic oil and gas companies at home and abroad.²⁰

Implementation of the Tax Justice Network's proposals for country-by-country reporting of tax payments by all multinationals would increase this corporate accountability beyond the oil and gas sector.²¹ As would getting the broader international legal framework right, which means fully implementing the UN Anti-Corruption Convention and the OECD Bribery Convention.

Paul Collier recently recommended setting up five new international standards which - while not being compulsory - would enable donors, diplomats and citizens to coordinate around some key demands. These are:

- auctioning concessions
- taxing revenues from concessions
- saving some of those revenues, particularly when commodity prices are high
- implementing reforms to guard against corruption
- implementing reforms to ensure efficiency.

However, the problem is, as ever, persuading governments to comply with these standards when there is not incentive to do so.

While strong on *transparency*, very few of these initiatives deal with the problem of *ownership*. The Alaska Permanent Fund is a well-documented model of how the revenues from natural resources can be distributed to citizens, not only providing people with a boost to their income but increasing citizen interest in - and scrutiny of - the use of natural resources.²² In Alaska it appears then that revenues from natural resources have strengthened to the connection between state and citizens.

Martin E Sandbu's proposal for 'natural wealth accounts' is a good model for applying and improving the Alaska model in developing countries. As well as transferring revenues from natural resources directly to the population, he proposes that that a proportion of these payments are then recouped in tax. The problem of incentive

remains, however, with this more country-specific approach. Sandbu argues that there could be opportunities when the international community could secure its adoption, such as after a regime change, after the discovery of natural resources, through getting the political opposition to promote them or by convincing the elite that they will gain more through stronger national economic growth.²³

Conclusion

There is a clear link between natural resources and poor governance. Simply having oil or diamonds does not, however, make governments *bad*. But having this resource flow stops governments depending on their citizens, which combines with other drivers of poor governance. The trade in natural resources is unlikely to stop because of this, so the focus needs to be on how to mitigate these effects. Increased transparency is urgently needed. This not only includes demands for greater budget transparency from developing country governments, but much more transparency from the firms that purchase the resources. It is well within the power of the international community, if they act collectively, to do the latter.

3. The impact of tax on governance

‘Government support via tax will lead to more influence by citizens than where government is reliant on external sources for funding.’

Siapha Kamara, SEND Foundation, Ghana.

Historians who have looked at the political development of Europe and the US have identified a link between tax and establishment of representative institutions. Representative government first came about in early modern Europe when monarchs were compelled to relinquish some of their authority to parliamentary institutions, in exchange for the ability to raise new taxes. Often those taxes were used to fund wars and often wars were fought in response to taxes, the most quoted example being the war for independence in the United States with the well-known rallying cry ‘no taxation without representation.’²⁴ In the UK the Suffragette movement coalesced around the slogan ‘not vote, no tax’.

There appears to be some cross-country statistical evidence for the claim. Ross decided to look at the direct link between democracy (regime type) and taxes in 113 countries between 1971 and 1997. He found a link, but it was not simply that introducing or increasing taxes led to democratic reforms. Rather it was that the attempt to raise taxes without simultaneously increasing and improving service delivery generated the discontent or even conflict that preceded democratic reforms.²⁵

James Mahon looked at the link between tax levels and liberalism, and the existence of constraints on tax power. According to Mahon, ‘we have good support for the idea that the proportion of direct and domestic indirect taxes in state revenues, as opposed to rents from oil, minerals or other sources, is a fair predictor of democracy and an even better predictor of liberalism.’²⁶

Comparative analysis from 21 Argentinean provinces over a 20 year period presents a similar story. The provinces most dependent on broad taxation of their citizens were more democratic, while local political leaders in those provinces financed by central

government transfers or oil revenues had been able to buy-off or suppress competition from democratic opposition.²⁷

So what creates the link between tax, services and representation? Social psychology and behavioural economics show that people are generally more concerned about out-of-pocket losses than foregone gains, in other words, that 'possession increases perceived value'.²⁸ It could be argued, then, that the link between tax and increased state accountability plays out in three ways:

- a state that depends on taxes therefore depends on prosperous citizens and enterprises – this reinforces the governments' interest in development and growth, making them more responsive to the needs of their economies and people;
- to raise tax reliably, governments need efficient, accountable and honest revenue services (i.e. good administrative governance);
- most importantly, citizens who pay tax are more likely to hold their governments to account for the way in which it spends their money.

As well as linking with accountability and responsiveness, there is evidence also that domestic taxation is important for state capability. When a tax base erodes it can have serious negative consequences: Saudi Arabia dismantled its tax agency when its economy shifted to petroleum and Yemen 'jettisoned' its bureaucracy when it shifted to aid and labour remittances.²⁹

Tax reform has for long been the terrain of the technocrats, but the political implications are increasingly being realised and it is to be hoped that this will lead to tax reforms that deliver for better representation of citizens. At the OECD DAC, the governance network is looking at the links between tax and governance, and has noted that there is potentially a long-term dividend of improved governance to be gained from taxation, a *social fiscal contract*.

Conclusion

Increasingly, comparative data is showing a strong link between reliance on taxation and the accountability of states. Given the recognition of the importance of governance for development, it would seem urgent for donors to change their thinking. Rather than fixating on increasing aid and investment inflows, the priority would rather seem to be how they can help developing countries strengthen their tax systems.

Summary: it matters where the money comes from

States that rely on aid and natural resources rather than tax are less likely to be accountable to their citizens. We have seen, however, that the damage to governance done by these revenue sources can be mitigated to some extent.

For aid this can be done through improving the transparency and predictability of aid. Supporting the process by which citizens and states engage – while not controlling the outcomes of those negotiations – is important, but something with which donors struggle. This represents a power imbalance that will be mitigated by, not resolved through, improvements in aid management.

For natural resources the focus to date has been on voluntary commitments by host governments and international firms. Unfortunately these have not brought about the greater transparency needed. Instead attention should focus on securing international standards which *bind* companies and banks from rich countries: transparency will be the best weapon against the threat that natural resource wealth poses to governance.

In both cases, these are measures that should certainly be pursued – but should be seen as at best, limiting the damage done to governance. If serious governance improvement is to be found through the government finance channel, we must look elsewhere – to tax.

That's my money': tax and governance in Kenya

Only a few years ago Kenya financed 50% of its budget from donors. The donor community could dictate how the budget was decided (especially in health and education). The government established semi-autonomous tax authority, and now 98% of recurrent budget comes through tax. More people are interested in tax now because they see it as 'my money' – money being spent on cars, perhaps corruptly. This induces government to increase accountability.

Tax provides people with a weapon: if government doesn't act well, you can withhold tax, particularly when it comes to high-level corruption.

Government responsiveness is higher from government to citizen than before. When government was more dependent on international aid, it was answerable to that club. Now the debate on how to spend resources on different priorities is more internal. There is a clear link between income and expenditures.

Alvin Mosioma, Tax Justice Network Africa

Section two: Does it matter how the tax is raised?

There are four main goals for taxation: raising revenue, redistribution, re-pricing and representation.³⁰ Revenue provides the funds to pay for the administration of government and to deliver services, whilst re-pricing allows governments to use taxes to influence behaviour – for example taxing tobacco because of health concerns or petrol because of environmental concerns. Through redistribution taxes can contribute to the reduction of poverty and inequality. This 'r' can have a positive governance effect, as people living in extreme poverty or socially excluded often lack the confidence or skills to participate. Representation is often overlooked in the technical approach that currently dominates tax policy and reform. However there is evidence that this can be an outcome of taxation and thus should also be considered a goal.

The global tax family

While social welfare systems differ from country to country, Fjeldstad and Moore argue that 'national tax systems, like central banks, seem more like members of a distinct

global family'.³¹ The IMF is a key driver of this policy consensus, but it is driven also by tax professionals and staff of major consultancy firms.

'The overall message binding this family is that, used too eagerly and frequently, taxation becomes a blunt, ineffective or perverse policy instrument. Governments should concentrate on establishing simple, predictable, neutral tax systems that will not discourage private enterprise and will minimise interference with market signals.'³²

'Interventionist' taxation that seeks to achieve socio-economic goals is most definitely out of this picture. Instead the focus is on:

1. consumption taxes such as VAT, which have been introduced in poor countries in particular to make up the shortfall resulting from reducing or removing taxes on trade, commonly known as tariffs following liberalisation. As well as being a tool to encourage or restrict trade from other countries, trade taxes have traditionally been an important revenue source for governments.
2. simpler tax systems, due in part to concerns around corruption, that reduce space for discretionary action to decide tax liabilities for companies, tax exemptions and the number of different tax rates (to name a few)
3. improved tax administration – from IT systems and tax identification numbers, to instigating a degree of autonomy for revenue authorities.³³

This dominant model has been criticised for leading to substantial tax leakages – particularly as a result of low company taxation – that dwarf aid inflows.³⁴ While the goal remains neutral taxation – a tax system that does not distort production or consumption decisions – there is insufficient consideration being paid to the ways taxation *has* and *can* bring about better representation.

Tax reforms for increased representation

Drawing on the analysis of Mick Moore and other experts in this field, we have identified four areas to reflect on when considering how tax policy – and the setting of that policy – can contribute to better governance. These are:

- the process of deciding tax policies
- who pays tax and how they pay it
- whether tax is coerced or negotiated
- where tax is paid.

The process of deciding tax policies

'The general feeling towards tax depends on how the tax is introduced.'

Siapha Kamara, SEND Foundation, Ghana

The dominant tax model is pursued through advice, aid conditionality, country rankings (such as the World Bank's *Doing Business* indicators) and technical assistance. Tax policy may be perceived as dry and technical, but debates around it can become heated and volatile, and lead to mass mobilisations. In Bolivia in 2003, violent protests erupted when the government attempted to meet IMF targets for deficit reduction by imposing a tax increase that was perceived as unfair.³⁵ Protests were also seen in Zambia when the IMF proposed extending VAT to include food and other basic commodities.³⁶

Yet, we have already seen that bargaining over taxation is fundamental in building not just states, but state-citizen linkages. While aid inflows mean recipients are more

accountable to their donors that their citizens, donor control over taxation policy exacerbates this. Donor support for taxation reform would be more pro-governance if it focused on the mechanisms by which tax policies are set and who participates. It is vital that civil society is in a position to offer its perspective on tax policies so that it can influence these policies and the impact they have on all citizens. Tax *is* political, and donor involvement must recognise and support this if it is to support good governance.

Who pays tax and how they pay it

Moore and Schneider have argued that the weaknesses of different fiscal social contracts can be 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 that have encouraged covert engagement over tax by narrow interest groups rather than broader, collective action.³⁷

Indirect versus direct taxation: The value-added tax has been adopted by at least 136 countries worldwide. Its spread has been rapid in recent years, particularly in developing and transitional countries. Over the past decade, the number of low- and middle-income countries with a VAT has more than doubled.³⁸

VAT supporters believe that, when properly implemented, VAT can raise significant revenue without ‘distorting’ economic decisions as much as other taxes might. VAT critics are concerned that in poor countries, governments lack the capacity to counter the negative effects of VAT on poor households, for example through direct cash transfers.

With regard to governance impacts, a recent OECD analysis argued that the shift away from indirect trade taxes in favour of VAT has had a positive governance impact, making tax more visible, especially to small businesses.³⁹ However, indirect taxes may not be as effective as direct taxes in securing improvements in state-citizen relations. Not only are they unpopular and perceived to be coercive, Mahon has shown that when citizens contribute *directly* to expenditures through income tax this strengthens that relationship.⁴⁰

Broadening the tax base: There appears to be evidence that the state will pursue policies beneficial to the sector of society on which it relies most. If it predominantly relies on taxing rich people, it will seek to deliver for that constituency.⁴¹ Does this mean Christian Aid should be calling for very poor people to be taxed more?

Very few people actually pay income tax in developing countries, which explains the low tax take, particularly in sub-Saharan Africa.⁴² In Tanzania and Peru very few people actually pay direct taxes – less than one per cent of the population.⁴³ In both cases, professionals such as lawyers, doctors and private consultants are not paying taxes. All these groups pay VAT, but if the payment of direct taxes drives people to demand more of their governments, then directly taxing such a small proportion of the population is an opportunity lost. Poor men and women are often already contributing a substantial amount of their income in tax via VAT, but broadening the tax base to include middle class professionals could be very important for government accountability.

However, if governments are more accountable to those they depend on for revenue, it *is* important to look at how to tax poor men and women as well. This requires exploring creative (and fair) ways to tax the informal economy.

Corporates and donors: As well as bringing more cash to government coffers, addressing revenue lost through tax havens used by companies and individuals could challenge a tax apathy that sees powerful side-step their obligations. Mick Moore makes a similar case for 'one of the more murky aspects of the development aid business' – the tax exemptions donors enjoy.⁴⁴ Rather like corporate tax evasion 'it matters more that this practice sets a bad example: it encourages other people also to demand tax exemptions'.⁴⁵

Whether tax is coerced or bargained

Coercive taxation is arbitrary, forced, does not result in services from the state and those taxed have no influence on tax policy or practice. If tax is levied coercively, this can damage state-society relations. By contrast, revenue-bargaining sees the negotiation between state and society, with taxes being provided in exchange for services and security in ways that are acceptable for citizens.

Coercive taxation is more likely in rural, agrarian economies, particularly in Africa.⁴⁶ But even the response to coercive taxation at a local level can be important in the evolution of improved representation and accountability.

Democratic Republic of the Congo: unofficial taxes and magic passes⁴⁷

On the road from the village of Kandolo to the nearest market in the town of Kalima are small, often camouflaged huts where civil servants sit in wait for passers by. They demand a percentage of the produce – be it rice, cassava leaves or fruit – as tax and provide no receipt. Unaware of what's legally required, and afraid of police, people pay up. A few kilometres down the road, they pay again. And again. By the time people reach the market they may have less than two thirds of the produce they started with.

Many farmers have stopped trying to sell their produce in Kalima and struggle without the precious additional income. But things have improved since they joined the local Farmer's Association established by Christian Aid partner UKPA and were taught about illegal taxation.

Mwanzo Walimbwa and other members of the Farmer's Association now wear a 'magic pass'. 'We wear passes in order to visibly be a member of the association, and, so, 'educated'; much like [as with] the university students – who put their school cap in front of their bikes – they know not to even bother us.

'Since we have been taught about the illegal taxation by UPKA, if one of the civil service asks for taxation we say "no papa – we know all about what is legal and not legal" and he runs away. UPKA taught us how to do that.' Members of the farmer's movement – assured of the correct tax rates – can now also confidently ask for a receipt on paying legitimate taxes, to ensure they won't be taxed again. 'It makes me angry to know they're still taking from other people,' explains Mwanzo, who shares what he learns from UKPA with others in his community – including the local chief who takes more convincing, thanks to the personal benefit Mwanzo says he enjoys from his own local taxation schemes.

Where tax is paid

Taxation at a local level is increasingly important as countries decentralise political and fiscal authority to local authorities. Decentralisation is underpinned by an assumption that government is both more efficient and more accountable if it is closer to the people.

This is backed up by Huther and Shah's analysis, exploring the relationship between fiscal decentralisation and governance quality in 80 countries, which found that decentralised systems are more responsive to citizens' preferences than centralised ones.⁴⁸

Local government taxation systems are often complicated, opaque, coercive and not coordinated with national government. Sometimes coercion is physical, with people taking extreme actions to evade taxes, such as hiding in the bush when tax collectors are approaching.⁴⁹ But local taxation, as with national taxation, can bring with it opportunities for state-building. And even with local taxation it appears that it still matters where the money comes from, as we have seen in Argentina, where provinces most reliant on tax are more democratic.⁵⁰

Summary: taxation must have good governance as a core objective

This section has highlighted that the fundamental importance of tax – going well beyond revenues – has not been reflected in either the priority accorded it or in the type of reforms supported by donors. There are potential gains from approaching tax reform more politically, with the aim of securing increased representation. This section has given four areas to consider when aiming to do this: how tax policy is set; who pays and how they pay; the degree of coercion and where tax is paid.

These considerations are far from rules, however. Evidence shows that broadening the tax base is often very unpopular, creating opportunities for appropriation by authorities and generating resistance. But at the same, this kind of reform could over the long-term actually improve relations between the authorities and citizens. Perhaps the only rule is that reform needs to be strongly context specific and embedded in a thorough political-economy analysis.

It is important that donors get out of the 'aid is the solution' trap. Instead the focus needs to be on how to improve the level of revenues and the efficiency with which they are raised, *and* how to ensure that they contribute as much as possible to strengthening state-citizen relations. The governance network at the OECD-DAC seems to recognise this, and a recent briefing recommends that OECD member countries help recipients improve their revenue generation by:

- constructing a compact between developed and aid-dependent countries in which more – and more predictable – aid is provided in the short term, in return for enhanced domestic resource mobilisation (or more tax take);
- helping to ensure that multinational enterprises pay their fair share of taxes;
- facilitating dialogue with international tax specialists on how they can help to improve governance through taxation;
- giving special priority to regional initiatives and south-south learning on tax reform for improved governance;
- providing more collective and harmonised support to tax reform, and tax and customs administration.⁵¹

Another important area for donors is to support civil society organisations who are directly making the link between taxes and governance.

Centro Montalvo: **making the links between tax and governance**

We need to understand that the tax system in the Dominican Republic is regressive, it penalises the poor and many taxes are indirect. Centro Montalvo's work in this area includes education sessions (awareness raising about how regressive the tax system is) and direct advocacy to government (pointing out the regressive nature, and producing direct proposals for a better system).

The Dominican Republic doesn't really have a culture where people see the relationship between what they pay in and what they get. Instead, people see the state as being there to resolve problems. Centro Montalvo is working to try to get people to look at spending more; and to learn about the system.

Juan Luis Corporan, Centro Montalvo, Dominican Republic

Section three: What does this mean for Christian Aid?

'Tax issues have been used as a trigger for debates about governance in Ghana. Even if some taxes are contradictory and poor people taxed, the government can spend it on poor people's services, although they need political structures to exert influence through. It is hard to mobilise poor people and their organisations around tax, however, unless the issue is picked up by the political class.'

Siapha Kamara, SEND Foundation

'Certainly when citizens pay tax they are more likely to be interested in local and national governance... and more likely to have expectations from their governments. Governments in countries where taxes are an important part of national revenues recognise that their citizens have rights to demand accountability, but I am still not sure that they are as accountable as they should be.'

Shalmali Guttal, Focus on the Global South

What do these findings mean for an organisation like Christian Aid, supporting partners in around 50 countries to push for greater government accountability? The main implication is that we should push for increased tax revenue to be a priority. Not only because it is possibly the best (or least worst) source of development finance from a governance perspective, but because it is probably one of the most versatile tools with which to promote and encourage greater state accountability.

The above analysis shows that many of the problems of revenue from aid and natural resources can be mitigated by seeking to 'make them more like tax'. Christian Aid and our partners should use this analysis to push for reforms that do just that. This means pushing for reforms that increase transparency of these sources of revenue, putting the onus on donors and multinational firms as well as recipient/host governments. Such obligations must be mandatory. But in addition, both natural resources and aid need to be seen by citizens as *their* resources. This could be achieved through the giving some of those revenues directly to citizens.

But it seems clear that not all development finance is equal. As well as looking at how to make aid and natural resources more like tax, it is important to more attention to tax as well, particularly how to develop and design systems that make states more accountable and responsive to their peoples. Shalmali Guttal's comment above reminds us to be cautious about overstating the case. Reliance on tax revenue *by itself* does not bring about governments that are fully accountable to their citizens. But it seems to have a better chance than reliance on other sources and Christian Aid and its partners can help by documenting good examples of where tax revenue has brought about greater state accountability.

If as an organisation we accept the link between tax and governance, it means working with our partners on projects that mobilise citizens as taxpayers. We should ensure that any budget monitoring projects we support consider revenue as well as expenditure, helping people think about where the money comes from. And we should support partners to analyse how people are taxed, to consider if it really delivers for accountability. As we increase our work looking at corporate tax evasion, we need to ensure that we don't fall into the trap of seeing tax policy as a technical discussion about how to raise revenue rather than the foundations of a critically important social contract.

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