

Accountability,

[Economics](#), [Tax](#)



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development: for most countries taxation goes hand-in-hand with economic growth and taxes have become the lifeblood for governments to deliver essential services and to make long-term investments in public goods. For decades, the OECD and other international organisations have worked intensively on technical aspects of tax policy with an increasingly global community of tax officials and practitioners from North and South. Yet, surprisingly little attention has been paid to how taxation can underpin the way in which states in the developing world relate to their citizens and how better governance may come about from the way in which taxes are raised and tax systems are implemented. Recent research suggests that not only can the process of taxation generate capable administrations but tax can also be a key means to promote accountability. The OECD/DAC Network on Governance (GOVNET) considered it essential to shed more light on the implications that taxation has for governance, and this paper on taxation and accountability gives the results of their findings. Governance, Taxation and Accountability: Issues and Practice provides an overview of the different streams of evidence linking tax policy and governance performance. It explains the need to develop a broad tax base as a means of enhancing the bargaining process between citizens and governments. Finally, it argues that the mobilisation of citizens around taxation issues may be a good avenue to promote further engagement in other public policy matters. The paper also offers insights for the donor community. It warns of the dangers that long-term aid dependency may have on recipient countries' incentives to raise taxes and to be accountable to their citizens. Donors are encouraged to take more proactive steps to support revenue raising activities in partner

countries as a way of strengthening their capacity and to phase out external assistance in the medium term. The publication outlines concrete success stories and offers valuable guidance on what partner countries can do to construct tax systems conducive to better governance. I am confident that this publication will help partner countries and donors to think through tax reforms that can yield tangible improvements for governance.

Eckhard
Deutscher Chair Development Assistance Committee GOVERNANCE,
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ACKNOWLEDGEMENTS Acknowledgements This publication is the result of a collaborative effort by members of the DAC Network on Governance (GOVNET) and its Taxation and Accountability Task Team since the end of 2006. Within the OECD Ben Dickinson in the DAC Secretariat leads this work. We would like to express our appreciation to members of the GOVNET's Taxation and Accountability Task Team for their inputs, collaboration and dedication to this work. Particular thanks are due to Kevin Carroll (Chair of the Task Team) and Ben Dickinson who managed and provided guidance on this publication with support from Richard Parry (OECD CTPA) and Bathylle Missika and (OECD DAC Secretariat). We would also like to thank members of the Task Team for their commitment to this project: Joanna Athlin, Soren Davidsen, Max Everest-Phillips, Finsas Frode, Mirco Goudriaan, Luc Leruth, Miguel Angel Lombardo Chico, Eli Moen, Kathleen Muktan, Birger Nerre, Pascal Raess, Carlos Santiso, Richard Testa, Matthias Witt and Pablo Zoido. In addition, we are very grateful to Sue Unsworth and Mick Moore from the UK Institute of Development Studies, Odd-Helge Fjelstad from the Christian Michelsen Institute, Christian von Soest from the German Institute of Global

and Area Studies and David Booth from the UK Overseas Development Institute who helped conceptualize and fine tune this paper. In order to achieve its aims the OECD has set up a number of specialised committees. One of these is the Development Assistance Committee, whose members have agreed to secure an expansion of aggregate volume of resources made available to developing countries and to improve their effectiveness. To this end, members periodically review together both the amount and the nature of their contributions to aid programmes, bilateral and multilateral, and consult each other on all other relevant aspects of their development assistance policies. The members of the Development Assistance Committee are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom, the United States and the Commission of the European Communities. 4

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ACRONYMS AND ABBREVIATIONS Acronyms and Abbreviations AATA African

Association of Tax Administrators ATI African Tax Institute BMZ German

Federal Ministry for Economic Cooperation and Development CATA

Commonwealth Association of Tax Administrators CIAT Inter-American
Center of Tax Administrations CIOTA Committee of International Organization
of Tax Administrations CREDAF Centre de Rencontres et d'Etudes des
Dirigeants des Administrations Fiscales COTA Caribbean Organization of Tax
Administrators CTPA Centre for Tax Policy and Administration (OECD) DAC
Development Assistance Committee (OECD) DFID Department for
International Development (UK) GOVNET Network on Governance (OECD
DAC) GTZ German Agency for Technical Co-operation IDS Institute of
Development Studies IFA International Fiscal Association IFI International
Financial Institution IMF International Monetary Fund IOTA Intra-European
Organisation of Tax Administrations ITD The International Tax Dialogue OECD
Organisation for Economic Co-operation and Development SARS South
African Revenue Service SGATAR Study Group on Asian Tax Administration
and Research SITC South African International Tax Center TJN Tax Justice
Network UNO United Nations Organisation VAT Value added tax WCO World
Customs Organization GOVERNANCE, TAXATION AND ACCOUNTABILITY:
ISSUES AND PRACTICES — © OECD 2008 7 , EXECUTIVE SUMMARY Executive
Summary The quality of a country's governance is recognised as a critical
factor in its ability to develop. It is therefore surprising how little attention is
given to one of the most fundamental drivers of the relationship between a
state and its citizens - the way public revenues are raised. Taxation systems
can contribute significantly to shaping accountability relationships and
strengthening state capacities. This remains true and becomes more of a
concern when countries receive large volumes of external assistance. This
paper summarises the substantial evidence supporting this proposition. It

describes ways in which developing countries can make their tax systems more supportive of good governance and how donors can help, based on a proposed forward agenda. Taxation and governance: The evidence

Historically, the formation of accountable and effective states has been closely bound up with the emergence of taxation systems. In Western Europe and later in North America, bargaining between rulers and taxpayers helped to give governments an incentive to promote broad economic prosperity and improve public policies in ways that meet citizens' demands. In East Asian countries, too, developmental states had broadly based tax systems. These were not in the beginning associated with Western-type political democracy but they did help to forge a relationship between governments and citizens that generated both widely spread economic growth and improved state efficiency. Pioneers of good governance in Latin America and Africa, such as Costa Rica and Mauritius, tell a similar story: tax is one of the keys to an accountable and effective state. The opposite hypothesis - that governments which do not need to tax their citizens have little incentive to be accountable, responsive or efficient - is equally well supported. The most striking examples are those showing the malign effects on governance of abundant natural resource rents, particularly those from oil and minerals - the so-called "resource curse". Rentier states represent the extreme case, although some countries have managed their natural resources successfully. However, there are a number of examples where bad governance is associated with limited state dependence on taxes. Today's poor developing countries have a different history than countries in the North usually cited as examples of effective and accountable governance. It

cannot be a question of simply replicating the experiences of other countries. Rather, it is a matter of applying the same logic to the different circumstances prevailing today. A notable feature is that there is little bargaining between governments and citizens, and that existing interactions tend to be focused on spending, not taxation. GOVERNANCE, TAXATION AND ACCOUNTABILITY: ISSUES AND PRACTICES — © OECD 2008 9 EXECUTIVE SUMMARY Taxation and aid The combined effects of the donor countries' commitments to scale up development assistance and the new demand for raw materials generated by China's economic growth are putting poor countries in Africa and elsewhere in a position they have not faced for a generation. Such countries are now quite likely to be both aid-dependent and recipients of substantial natural resource revenues. This combination of circumstances poses a substantial challenge to the improvement of governance in the affected countries. Aid is, in several important respects, not the same sort of external resource inflow as a resource rent since aid has a less damaging effect on governance than oil if it is provided in "purposive" ways, and accompanied by mechanisms of scrutiny, expertise and management techniques that can add value and create some pressure for accountability. Nonetheless, it has some of the same effects on the incentives of governments, freeing them from the imperative of raising taxes from a wide range of economic agents and from the scrutiny of tax-paying ordinary citizens and thus from an important kind of pressure to improve general economic and social conditions. Donors' preoccupations with propoor expenditure may also take attention away from the longer-term challenge of domestic resource mobilisation. It is not clear, however, to what

extent aid dampens domestic resource mobilisation. This situation calls for a deliberate and co-ordinated response. There is already international recognition of the need to address ways in which the global system contributes to corruption and weak accountability in developing countries, notably by initiatives to promote greater transparency in regard to natural resource rents. These include the Extractive Industries Transparency Initiative (EITI) and the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (OECD Anti-Bribery Convention, 1997). These initiatives need to be matched by a renewed focus on the positive drivers of enhanced domestic accountability, with broadening the tax base as a central issue. What can developing countries do? The challenge for poor countries is not necessarily to tax more, it is to tax a larger number of citizens and enterprises more consensually. This is not easy for various reasons, including economic structure and history. In many poor countries, the informal sector is quite extensive and hard to tax.

Nonetheless, recent experience suggests that taxpayers' behaviour can be transformed by reforming the tax system, leading to both a greater willingness to pay and an increased propensity to mobilise demand for better public services. The relative decline of trade taxes (as a result of tariff liberalisation) and the introduction of consumption taxes such as VAT or energy taxes, has made tax more visible and transparent in a number of countries. This represents an important first step towards making the tax relationship a focus for constructive bargaining between taxpayers and the state. While VAT is not an ideal instrument, it works to some degree like a direct tax applicable to most consumers and may in some cases provide a

practical way forward in widening the tax base in economies with large smallholder and informal sectors. An important challenge is to avoid relying on taxes that are widely perceived as unfair or as liable to be collected in unfair (corrupt or coercive) ways. Such taxes have been relatively common, contributing to poor collection rates and blocking the emergence of any kind of "social pact" around taxation in many countries. However, recent efforts to change the attitudes of tax administrations towards taxpayers have been promising in this regard.

10 GOVERNANCE, TAXATION AND ACCOUNTABILITY: ISSUES AND PRACTICES — © OECD 2008 EXECUTIVE SUMMARY

While some tax reforms have mainly focused on the national level, revenue mobilisation at the local and regional level has been a key element in decentralisation efforts over the past twenty years. Working with sub-national tiers of government, where for example the taxation of urban property has significant potential, is an important component of tax reform. Finding equitable and efficient ways of taxing the informal sector is not entirely to be excluded either in the light of experience in some countries. In all of these areas, there may be limited government interest in reform at first, but small changes can tip the balance of incentives and begin to create virtuous circles of change in which the payment of taxes and state responsiveness to taxpayers become mutually reinforcing over a period of years. How can donors help? Donors can do more to support revenue-raising efforts in partner countries in ways that are likely to improve governance.

Nonetheless, donors should not assume any automatic link between tax dependence and better governance, and acknowledge the complexities involved. Tax reforms in developing countries have been supported by

external actors like the IMF and World Bank with macroeconomic and trade concerns primarily in view. While potential governance improvements should be taken into account when considering tax reforms, they must be balanced against possible fiscal costs and benefits and the trade-offs involved. Over the last twenty years, tax reforms world wide have exhibited three main elements: i) a shift away from reliance on trade taxes, and the introduction of broad-based consumption taxes (VAT); ii) simplified tax design; and iii) giving less discretion to tax officials and improving tax administration.

Bilateral assistance has focused mainly on improved tax administration, with a heavy reliance on the establishment of semi-autonomous revenue authorities. In this area, important early gains have sometimes proven difficult to sustain. Experience suggests that rather than advocating autonomous organisational models as a panacea, donors should examine each context on a case by case basis. For instance, political commitment to reform is crucial. Experience from support to tax reform echoes lessons learned from support to capacity development in other policy areas. These include the importance of local leadership, locally designed solutions and donor approaches that are sensitive to each country specific socio-economic environment. A significant feature of the more successful aspects of recent tax reform efforts is that they have not just been externally driven. Tax officials from developing countries increasingly participate in an organised global community of tax professionals. This has supported the emergence of a consensus about the key technical elements of reform. As in other fields, donors need a more consistent and strategic approach. This implies combining high-level international efforts with work to improve the enabling

environment for improved revenue generation and more co-ordinated direct support to organisational changes which have the potential to spark off positive dynamics of change. The following specific actions should be considered. At the international level: - As a follow up to the 2002 Monterrey Consensus on Financing for Development (UNO, 2002, Paragraph 4), construct a compact between developed and aid dependent countries in which more - and more predictable - aid is provided in the short term while partner countries commit to enhancing domestic resource mobilisation efforts. GOVERNANCE, TAXATION AND ACCOUNTABILITY: ISSUES AND PRACTICES — © OECD 2008 11 EXECUTIVE SUMMARY In respect of the enabling environment: - Think more carefully about the political incentives for taxation and the impact of different aid modalities on domestic accountability and tax. This means looking more systematically into the political economy of taxation, and respecting the diversity of different country situations and different tax arrangements. - Facilitate dialogue with international tax specialists on how the reform agenda can take more account of the governance aspects highlighted in this paper as a means to foster a consensus between tax professionals about the key technical elements of reform. - Place more emphasis on professional networking, including more support for technical training and networking within international communities of practice. - Give special priority to regional initiatives and South-South learning on tax reform for improved governance. In providing more co-ordinated direct support: - Review existing support to civil society with a view to identifying partners, issues and debates with strong linkages to the revenue side of public policy. - Provide more collective

and harmonised support to tax reform and tax and customs administration, including greater efforts to document and evaluate current experiences and their impact on governance. 12 GOVERNANCE, TAXATION AND

ACCOUNTABILITY: ISSUES AND PRACTICES — © OECD 2008 I.

INTRODUCTION I. Introduction The quality of a country's governance is critical to its ability to develop and make effective use of aid. It is also recognised that a central factor in governance and state-building is the pattern of interaction between state and society. 1 It is surprising, therefore, how little attention is given to one of the most fundamental drivers of the relationship between a state and its citizens - the way public revenues are raised. Taxation systems can contribute significantly to shaping accountability relationships and strengthening state capacities. State-society bargaining around tax makes a unique contribution to building more effective, accountable states and public institutions. This publication summarises the substantial evidence supporting this proposition. It highlights the potential for taxation to provide the stimulus for effective mobilisation of citizens, and the importance of a "social contract" centred on taxation in establishing better governance. It describes ways in which countries can make their tax systems stronger and more supportive of good governance. The importance of taxation is increased, not reduced, when countries receive large volumes of external assistance. One reason for this is that aid can inadvertently undermine the foundations of a tax-based bargain between the state and its citizens. This is not an argument that outweighs the case for increased aid to meet urgent gaps in basic services and investment programmes in very poor countries. But it does underline the

need for donors to focus on the drivers of improved governance, within the longer-term perspective of progressively phasing out aid. The paper therefore considers ways donors might assist tax reform efforts in a more coherent and strategic way, including through a targeted set of proposed actions for the GOVNET. GOVERNANCE, TAXATION AND ACCOUNTABILITY: ISSUES AND PRACTICES — © OECD 2008 13 , II. TAXATION AND GOVERNANCE: THE EVIDENCE II. Taxation and Governance: the Evidence The historical experience Historically, the formation of accountable and effective states has been closely bound up with the emergence of taxation systems (Moore, 2007). In Western Europe and later in North America, bargaining between rulers and taxpayers helped to give governments an incentive to promote broad economic prosperity and improve public policies in ways that meet citizens' demands. The concept of a "fiscal social contract" is central to explanations of how representative government and democracy emerged in Western Europe and the United States. Citizens accepted obligations to pay tax in return for rights to be represented in processes of decision-making about how public money was raised and spent. American colonists in the 18th century captured this in their famous protest, "no taxation without representation". The more detailed historical story is less well known. Under constant threat of interstate warfare, some governments (notably in Britain and the Netherlands from the mid-17th Century) negotiated with taxpayers, especially holders of mobile capital, in ways that created joint gains to both rulers and taxpayers. The fact that tax was negotiated meant that tax collection became less costly to administer, less onerous and more predictable. This encouraged governments to undertake better long-term

planning, and businesses were encouraged to invest. Rulers had incentives to strengthen the bureaucracy to collect and administer taxes, and to extend its reach. Systems for recruiting, training and managing revenue-collection cadres became the models for civil service efficiency generally. Taxpayers in parliament adopted mechanisms to oversee revenue-raising and public expenditure management. Rulers had a stake in the prosperity of their citizens, and incentives to nurture that prosperity to generate more revenues. By using reliable tax flows to leverage loans from domestic lenders, first the Dutch and then the British were able to turn their tax states into more powerful "fiscal states" (Brewer, 1989; Tilly, 1992). The basic mechanisms involved are summarised in Table 1. Bargaining around tax simultaneously increased government capability, accountability and responsiveness. Both states and citizens benefited. GOVERNANCE, TAXATION AND ACCOUNTABILITY: ISSUES AND PRACTICES — © OECD 2008 15 II.

TAXATION AND GOVERNANCE: THE EVIDENCE Table 1. The effects on governance of state reliance on broad taxation Immediate effects Effects on the state The state becomes focused on obtaining revenue by taxing citizens Effects on citizens The experience of being taxed engages citizens politically Results of interaction Intermediate effects Direct governance outcomes (i) The state is motivated to promote citizen prosperity More responsiveness (ii) The state is motivated to develop bureaucratic apparatuses and information sources to collect taxes effectively More bureaucratic capability (i) (Some) taxpayers mobilise to resist tax demands and/or monitor the mode of taxation and More accountability the way the state uses tax revenue (i) Taxes are more acceptable and predictable, and the taxation process more

efficient (ii) Better public policy results from States and citizens begin to debate and negotiation bargain over revenues. Taxpayers comply with tax demands in (iii) Wider and more professional exchange for some institutionalised scrutiny of how public money is influence over the level and form of spent taxation and the uses of revenue (i. e. public policy). (iv) The legislature (assuming one exists) is strengthened relative to the executive

More responsiveness, political and bureaucratic capability
More responsiveness and political capability
More accountability
More accountability

Source: Adapted from M. Moore (April 2007), " How Does Taxation Affect the Quality of Governance? ", IDS Working Paper 280, Brighton, p. 17. The links between taxation and the emergence of capable government can be illustrated with a wider range of historical experiences. In East Asian countries, developmental states had broadly based tax systems. These were not in the beginning associated with Western-type political democracy; but they did help to forge a relationship between governments and citizens that generated both widely spread economic growth and improved state efficiency. Dependence on broad taxation gives governments incentives to extend their reach into rural and peripheral areas. It also requires governments to develop a widespread taxation apparatus, including basic population registration systems, and a tax collection administration that can become the model for improving the public service more generally. In South Korea and Chinese Taipei, a strong tax system underpinned effective economic policies and government capability more broadly. In Chinese Taipei, a broadly based revenue system required government agencies to interact with, and keep records of, a wide range of enterprises

and households (thereby largely avoiding the creation of an informal sector). In the 1950s, governments in South Korea paid considerable attention to tax, especially direct taxation (34% of its revenue came from direct taxes). This provided the basis for increasing broad-based taxation under the first "developmentalist" regime of President Park in the 1960s, and later the development of an information system that permitted the government effectively to target credits, subsidies and other interventionist measures towards individual firms (Shafer, 1997).

16 GOVERNANCE, TAXATION AND ACCOUNTABILITY: ISSUES AND PRACTICES — © OECD 2008 II. TAXATION AND GOVERNANCE: THE EVIDENCE Both South Korea and Chinese Taipei made steady and stable transitions to something close to electoral democracy as they became wealthier under governments that taxed relatively broadly and directly. Pioneers of good governance within the Latin American and African regions, such as Costa Rica and Mauritius, 2 tell a similar story: tax is not the sole determinant of rapid development but it is one pillar of an effective state, and may also provide the basis for accountable and responsive democratic systems. The natural resource curse

The negative proposition - that governments which do not need to tax their citizens have little incentive to be accountable, responsive or efficient - is equally well supported. The most striking examples are those showing the malign effects on governance of abundant natural resource rents, particularly those from oil and minerals - the so-called "resource curse". Evidence of the relationship between bad governance and natural resource rents comes from an extensive literature on "rentier" states, including country case studies as well as strong quantitative evidence based on cross-

national statistical analysis (Moore, 2007, pp. 21-22; Ross, 1999). Rentier states have limited incentives to build up institutions to collect and administer tax, or to extend the reach of government to poorer, more remote regions. In particular, large oil and mineral revenues are associated with low levels of democracy and states unbound by law. Many states in the Middle East, the Caspian basin and Africa earn large surpluses from exporting oil to rich countries. Because oil is a valuable, physically concentrated resource, the benefits accrue to a small number of big companies and central states, and the individuals who control them. Evidence suggests that states dependent on oil tend to: - be independent of citizen-taxpayers, and therefore unresponsive to them; - have few incentives to promote broad economic development; - use oil revenues to buy off opposition, and to fund repressive internal security; - attract external military and political support; - lack incentives for taxpayers to engage in the local political process, because there is no political bargaining over sources and use of public revenues; - have untransparent revenues, with low oversight from legislatures; - have few incentives to establish effective bureaucracies to raise and manage taxes. Rentier states represent the extreme case and some countries, such as Botswana, have managed their natural resource wealth with success. However, the association of bad governance with limited state reliance on taxes is found across a wide range of countries and regions. Russia's government continues to depend for revenue on a relatively small number of large enterprises working on natural resource extraction in the energy sector. There is little political debate around taxation and no "social contract". Comparisons of provincial governments in

Argentina show that those most dependent on broad taxation of citizens have historically been the most democratic. Where provinces received more GOVERNANCE, TAXATION AND ACCOUNTABILITY: ISSUES AND PRACTICES — © OECD 2008 17 II. TAXATION AND GOVERNANCE: THE EVIDENCE generous financial transfers from central government, or oil revenue, local politicians were better able to buy off or suppress democratic opposition (Gervasoni, 2006). Taxation and governance in developing countries today Today's poor developing countries, particularly in Africa, have a different history than those usually cited as examples of accountable governance. It cannot be a question of simply replicating the experiences of other countries.

Nonetheless, there are good reasons for thinking that the historical experience of taxation as the basis for state building still has relevance for developing countries today. It is a matter of applying the same logic to the different circumstances prevailing today. In many developing countries, governments have little incentive to bargain with organised groups of citizens. This is a major part of the explanation for poor governance. A complex set of historical factors, including state formation through colonisation, has resulted in the concentration of political and economic power in the hands of elites. These elites often represent the major tax payers, resist tax reform and are relatively unrestrained by organised societal interests. The state tends to be powerful in relation to citizens (and accountability is lacking), but weak in relation to its capacity to make or implement policy (so competence or capability is lacking). The need for states to bargain domestically with organised groups of citizens over tax is further weakened by the global context. A combination of high levels of

inequality with increasingly close interaction between rich and poor countries provides unprecedented opportunities for political elites to gain access to large, non-tax sources of income from a range of legal and illegal activities. The availability of external military support, especially in heavily aid dependent countries, may further reduce the need for states to tackle difficult tax reforms and to mobilise internal political support for change. In today's developing countries, some bargaining does take place over spending. Unlike taxation, issues of spending and the illicit use of these resources feature prominently in public political debates. But bargaining tends to be confined to narrow political and elite circles, and without any link to taxpaying, which means citizens have little incentive to mobilise or use leverage to influence outcomes. The lack of organised bargaining on the revenue side is understandable but nonetheless unfortunate. Even when the bargaining relationship between the state and groups of citizens is very unbalanced by historical standards, taxation has the potential to mobilise social groups with genuinely countervailing power and a shared interest in holding governments accountable. Most importantly, it can bring together members of business and trade associations that have common concerns around taxation. Even in economies with quite small formal sectors, the representative bodies of small and medium-sized enterprises (SMEs) are potentially a key group for increasing mobilisation around tax. Unlike other typical forms of social protest, such mobilisation is likely to be sustained (because taxation is an ongoing process), and it is potentially constructive, because the concerns typically raised are susceptible to bargaining and compromise. Mobilisation of citizens around taxation issues may be a good

avenue into their engagement with public policy more generally because tax policy decisions are central to public policy and particularly to public expenditure decisions. Such mobilisation can help, over time, to move the focus of debate over public expenditure from patronage concerns to more broadly based, interest-group bargaining and the provision of public goods. This in turn has the potential to strengthen democratic institutions, for example by giving elected representatives the incentive and leverage to gain more influence over fiscal matters.

3 18 GOVERNANCE, TAXATION AND ACCOUNTABILITY: ISSUES AND PRACTICES — © OECD 2008 III. TAXATION AND AID III. Taxation and Aid The combined effects of donor countries' commitments to scale-up development assistance and the new demand for raw materials generated by China's economic growth are putting poor countries in Africa and elsewhere in a position they have not faced for a generation. Such countries are now quite likely to be both aid-dependent and recipients of substantial natural resource revenues. This combination of circumstances poses a substantial challenge to the improvement of governance in the affected countries for both partner countries and donors. Aid is in several important respects not the same sort of external resource inflow as a resource rent. It has been persuasively argued that aid has a less damaging effect on governance than oil if it is provided in "purposive" ways, and accompanied by mechanisms of scrutiny, expertise and management techniques that can add value, and create some pressure for accountability (Collier, 2006). Nonetheless, aid can have similar disincentive effects on governments, freeing them from the imperative of reforms to broaden the tax base, and thus from an important kind of pressure for the provision of

economic and social services. Even in countries that are not highly aid dependent, donors need to be alert to the possibility that a substantial increase in aid flows over a sustained period without a complementary effort in domestic resource mobilisation could have a harmful effect on institutional development (Moss et al., 2006). How far aid dependency is a concern depends on i) how far donor commitments to increase aid are met, and ii) whether, as has happened in Africa in the past few years, rates of economic growth and increases in domestic revenue mobilisation outpace increases in aid. It seems likely that very high levels of aid dependency (i. e. 20% or more of GDP)⁴ may be quite rare. A relatively small group of countries in Africa⁵ is likely to be affected, in addition to a significant number of very small countries, and countries emerging from crisis. On the other hand, if countries avoid the extremes of aid dependency thanks in part to enhanced natural resource revenues, the governance implications are potentially severe. It is not clear how far high aid levels actually depress domestic revenue mobilisation. The statistical evidence is inconclusive. Some research indicates a depressing effect (Remmer, 2004), but a review of the evidence for sub-Saharan Africa suggests that the case is not proven (Moss et al., 2006), and this is confirmed by a recent study for the French government (Brun et al., 2007). This study observes an overall positive effect of aid, both loans and grants, on the tax effort in developing countries. Moreover, the 2006 Evaluation of General Budget Support found no evidence of a reduction in revenue mobilisation effort in response to increases in this form of aid (IDD, 2006). However, it should be noted that the results of any statistical research on this topic are likely to be contentious. It is hard to find reliable

fiscal data for very low income (aid dependent) countries. Overall, donors and partner governments need to be alert to the risks of aid dependency, particularly if and when aid levels to some countries rise significantly. As a most recent IMF working paper concludes, revenue-raising capacity is essential to guarding against aid volatility and preparing an orderly exit from long-term reliance on aid (Gupta et al., 2007). Moreover, GOVERNANCE, TAXATION AND ACCOUNTABILITY: ISSUES AND PRACTICES — © OECD 2008

19 III. TAXATION AND AID programmes financed by scaled up aid flows will give rise to future recurrent spending, which will need to be financed by domestic resources. There are reasons to expect that different types of aid may have different effects on revenue raising and domestic accountability. One suggestion is that while concessional loans are associated with higher domestic revenue mobilisation, the opposite is true of grants. However, the cited French study finds no such variation, so much more research is needed if useful policy recommendations are to be drawn (Gupta et al., 2003; Brun et al., 2007). Donor behaviour also matters. Although the primary responsibility for improving governance rests with leaders in developing countries, scaling-up aid without giving attention to the possible effects of certain donor behaviour risks exacerbating existing problems of weak engagement between governments and their own citizens. Such behaviour may include overloading already weak administrations with multiple demands and overambitious advice; reducing the scope for local experimentation with policy options; weakening the voice of legislatures; and emphasising spending rather than sources of income. These issues call for a deliberate and co-ordinated response. There is already international

recognition of the need to address some of the ways in which the global system contributes to corruption and weak accountability in developing countries, notably around the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (OECD Anti-Bribery Convention, 1997). Initiatives have been taken to promote greater transparency in regard to the spending of natural resource rents, including innovative ventures such as the Extractive Industries Transparency Initiative (EITI)⁶, the special fund created for managing oil revenues in Chad⁷ and the Oil Fund supported by Norway in Timor Leste. ⁸ These initiatives need to be matched by a renewed focus on the positive drivers of enhanced domestic accountability, with the raising of broadly based taxes as one central issue.

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— © OECD 2008 IV. WHAT CAN DEVELOPING COUNTRIES DO? IV. What can developing countries do? The scale of the challenge The challenge for poor countries is not necessarily to tax more. How tax is raised matters, as well as how much. The challenge is to tax a larger number of citizens and enterprises more consensually. This is not easy for various reasons, including economic structure and history. Broadly speaking, tax ratios tend to rise as incomes rise. The average tax to GDP ratio for low income countries is about 18%, compared to 22.5% for medium income countries, and over 29% for high income countries. In the short to medium term tax ratios tend to be “sticky”. Despite repeated attempts at tax reform, the overall tax take changes little from one year to another (Zolt and Bird, 2005; Baunsgaard and Keen, 2005). Citizens’ willingness to pay tax may be low for historical, political or cultural reasons, and also reflect a perception that governments

consistently misuse public funds. It is difficult to collect tax from low income, agrarian economies, and to do so without resorting to coercion. Taxable units are small, so the costs of collection are high; and incomes are seasonal and unstable. Records are lacking, and there is limited use of banks. Collection depends on face-to-face interaction, where assessment and collection are done by the same people (thus increasing discretionary power and facilitating extortion). Poor farmers are highly immobile, and therefore especially vulnerable to predatory tax collection, which is more prevalent at a local level. It is also difficult, and costly, to tax the large informal urban sector that exists in many developing countries. Economic structure also influences the tax mix. Income tax (corporate and personal) plays a much smaller role in developing countries (24. 3% as opposed to 38. 6% of total tax revenues in developed countries), and personal income tax accounts for a smaller proportion of the mix. Compared to OECD countries, a low proportion of citizens in poor countries pay the kind of direct income, wealth, property or social security taxes that are most conducive to taxpayer mobilisation (Zolt and Bird, 2005). Problems of domestic revenue-raising have been exacerbated by a global shift away from trade taxes as a principal source of revenue. This has been one of the consequences of trade liberalisation policies over the last 20 years. It has posed particular problems for low income countries. IMF research shows that, whereas rich countries have managed to offset the decline with other sources of revenue, notably VAT, the poorest countries have at best replaced about 30% of lost trade taxes (Baunsgaard and Keen, 2005). Poor countries may lack resources and capacity to build comprehensive tax collection systems. Despite aspirations

to broaden the tax base, revenue authorities tend to focus their efforts on a very small number of large taxpayers, who generate most revenue, to the exclusion of many other groups, GOVERNANCE, TAXATION AND ACCOUNTABILITY: ISSUES AND PRACTICES — © OECD 2008 21 IV. WHAT CAN DEVELOPING COUNTRIES DO? including professionals and a large number of workers in the informal sector. 9 This makes sense from the point of view of containing administrative costs of collection, but has perverse outcomes for governance. Globalisation may also exacerbate fiscal problems, as internationally mobile capital becomes more difficult to tax. Controllers of capital have increased their bargaining power over governments, and can take advantage (legally or illegally) of lower tax rates payable in offshore financial centres and tax havens. Governments may have limited powers to resist this trend even if they achieve a sensible domestic policy balance combining a fiscal environment favourable to foreign direct investment and means of securing a fair share of the tax base from such investment. Evidence of the actual impact on poor countries is as yet mixed, and incomplete. The net effect of these various factors has been to weaken revenue mobilisation. After remaining basically unchanged between early 1990 and early 2000, total government revenue as a share of GDP has been steadily improving in most sub-Saharan African countries over the last few years (APF, 2006; Zolt and Bird, 2005). However, most of this improvement is attributed to more effective tax administration and collection, rather than to broadening the tax base. In some cases, it has been achieved from a very low base. Half of sub-Saharan African countries still mobilise less than 15% of their GDP in tax revenues compared to an average of 18% for low income

countries, and an average of 29% for high income countries (APF, 2006; Zolt and Bird, 2005). Encouraging trends Despite these difficulties, recent experience suggests that taxpayers' behaviours can be transformed by reforming tax systems. This can lead to both a greater willingness to pay and an increased propensity to mobilise demand for better public services. Over the last twenty years, several distinct trends have emerged in tax reform worldwide. In addition to a general move away from using the tax system actively to pursue socio-economic goals, tax reform programmes have exhibited three main elements: i) a shift away from reliance on trade taxes, and the introduction of broad-based consumption taxes (VAT); ii) simplified tax design, including abolition of some taxes, simplification of others, reducing the number of different tax rates, widening the tax net, reducing high marginal tax rates; and iii) giving less discretion to tax officials and improving tax administration. This agenda has been led by the International Financial Institutions (IFIs), in particular the IMF, with an emphasis on efficiency and revenue collection. The evidence indicates that this agenda broadly serves state-building as well as economic policy objectives (Fjeldstad and Moore, 2008). For example, the simplification of tax systems can encourage political mobilisation of taxpayers. Tax systems become more transparent and accessible to ordinary citizens, and the temptations and opportunities to seek exemptions or cut personal deals with the tax authorities are reduced. Building on this positive record provides an opportunity to investigate how donor assistance in these areas can contribute to better governance. The shift from trade taxes to more visible taxes on consumption also appears to help. VAT has the disadvantage of

being harder to collect than the trade taxes it has replaced. On the other hand, recent research does not support the widely held perception that it makes tax systems more regressive (Bird and Gendron, 2007). Furthermore, although VAT is an indirect tax (i. e. it is paid by the consumer to the government via an intermediary when purchasing goods or services), it has a certain degree of visibility and therefore capacity to mobilise taxpayers, mainly because of the burden of book-keeping 22 GOVERNANCE, TAXATION AND ACCOUNTABILITY: ISSUES AND PRACTICES — © OECD 2008 IV. WHAT CAN DEVELOPING COUNTRIES DO? that it imposes on small businesses. For example, VAT has been highly visible in Ghana and Uganda, where its introduction was contentious, and where recurrent political debate about VAT rates suggests that its political effect has been quite direct (von Soest, 2008). This represents an important first step towards making the tax relationship a focus for constructive bargaining between taxpayers and the state. Another relevant example of the introduction of visible consumption taxes includes energy taxes which can offer environmental benefits (since they are likely to lead to reduced energy consumption), can have a pro-poor effect, especially if linked to the reduction of payroll taxes, and are relatively easy to implement. 10 An important challenge is to avoid relying on taxes that are widely perceived as unfair or as liable to be collected in unfair (corrupt or coercive) ways. Such taxes have been relatively common, contributing to poor collection rates and blocking the emergence of any kind of “ social pact” around taxation in many countries. Coercive taxation can be a source of bad governance, and can undermine the potential for constructive political bargaining over tax. This is a particular problem in

poor, agrarian economies, and at local level, although its negative impact should not be overstated. 11 Recent efforts to change the attitudes of tax administrations towards taxpayers have been promising in this regard. Actual practice often falls far short of the rhetoric, but the aspirations are summed up in the mission statement of the Tanzania Revenue Authority: "... to be an effective and efficient tax administration, which promotes voluntary tax compliance by providing high-quality customer services with fairness and integrity through competent and motivated staff". In the case of the successful South African Revenue Service (SARS), a more user-friendly approach is balanced by the establishment of special investigative units that work in collaboration with a tough national crime investigation unit (the Scorpions) to pursue high-profile defaulters. Opportunities for change Quite small, practical changes to tax design and improvements in tax administration can be important in encouraging taxpayers to mobilise. A climate for better tax relations can be fostered by designing incentives for compliance. As the Malawi case in Box 1 illustrates, these can have benefits for tax payers and revenue authorities alike.

GOVERNANCE, TAXATION AND ACCOUNTABILITY: ISSUES AND PRACTICES — © OECD 2008 23 IV. WHAT CAN DEVELOPING COUNTRIES DO? Box 1. Tax Compliance Certificates in Malawi In 2004, the Malawi Revenue Authority decided to reward tax compliant taxpaying businesses by giving them tax compliance certificates on an annual basis at the end of their accounting period if their legal requirements and liabilities are met. In return, certificate holders are assigned Revenue Officers who are in charge of all issues affecting the taxpayer, including all reminders, tax information and notices for audits to

be carried out. A key aspect of broader significance is that local banks have unilaterally started using such certificates as a requirement for businesses seeking loan finance as an index of overall credit worthiness. The Government of Malawi reports that this initiative has led to an increase in tax compliance for large and medium taxpayers and there has been a motivational effect on other smaller taxpayers, who are keen to qualify for the certificates. Overall, incentives on both sides have resulted in a climate of improved relationships between the Malawi Revenue Authority and businesses, based on the principle of reciprocity, and the way in which this initiative has been used by the banks has considerably reinforced its practical effect. Source: Adapted from Government of Malawi (2007). In some countries, efforts to enhance the tax relationship take the form of "fiscal pacts". Fiscal pacts are negotiated agreements between organised societal and political interests about public expenditures and how to finance them. These kinds of negotiations are useful not only for getting agreement on fiscal goals, but also for putting crucial discussions - debates over big social, political, and economic issues affected by fiscal policy - onto the public agenda. They also highlight the political economy dimensions and the challenges of convincing citizens to accept tax reforms, especially when they involve tax rate increases. Box 2 provides an example from Guatemala. Box 2. Guatemala's Pacto Fiscal Guatemala's Pacto Fiscal, signed in 2000, brought together government, private sector and civil society groups to develop a package of tax and spending proposals that would help the government carry out social and economic reforms promised in the country's Peace Accords. It not only set targets for total revenues to be allocated for

this purpose (8-12% of GDP), but also for expenditures on specified goals for social sectors; for fiscal balance (the average deficit was not to exceed 1% of GDP), and for tax administration efficiency. Further, it articulated a consensus that in order to improve the quantity and quality of public expenditures, the government would need to launch major tax reforms.

Seven years after inaugurating the Pacto Fiscal in Guatemala, government, business and civil society groups are still discussing it, and it continues to play an integral role in deliberations about where the country is headed.

Some of the reforms may get watered down and rolled back over time -

Guatemala's pact set a goal of raising the country's tax ratio to 12% of GDP by 2000, a date later pushed back to 2002 but never reached. Nonetheless, participatory discussion creates a space for government to negotiate with business, civil society organisations and citizens in determining how best to use the country's resources. Source: Ernst, Ulrich (ed.) (2007), From Curse to Cures: Practical Perspectives on Remediating the Resource Curse,

Development Alternatives, Washington. 24 GOVERNANCE, TAXATION AND ACCOUNTABILITY: ISSUES AND PRACTICES — © OECD 2008 IV. WHAT CAN DEVELOPING COUNTRIES DO? While some tax reforms have mainly focused on the national level, local level revenue mobilisation has been a key element in decentralisation efforts over the past twenty years. Tax reforms at the local level have in some cases proved easier than at the national level. Focusing on sub-national tiers of government is an important component of tax reform to achieve improvements in governance. Donors need in particular to guard against the tendency of central governments to off-load responsibilities to lower levels of government without adequate funding or

capacity. It is important not to push revenue mobilisation responsibilities down to too low a level, where there may be no realistic prospect of raising significant amounts of revenue (e. g. from taxes on the agrarian economy or marketing). Australia's experience with cash hand outs and performance grants at the local level in Africa suggests donors should also be alert to the possible disincentive effects on local revenue generation. One high-potential revenue source for subnational governments is taxing urban property.

Property taxation is one of the potential sources of significant income for many municipal and metropolitan authorities. Digital databases make taxing urban property much easier now than in the past. Another useful mechanism is charges of various kinds for the provision of collective services, such as water, electricity and markets. Such charges have the potential to enhance pressure from service users for accountability and efficiency. Much can be learned about such mechanisms from decentralisation efforts in Latin America and Asia. Improved tax relations at the local level depend critically on ordinary people being able to see that they are getting something in return from taxation. This can become the focus of special measures, as some recent French research highlights (Box 3). Finding equitable and efficient ways of taxing the informal sector is not entirely to be excluded in the light of experience in some countries. This is difficult, and sometimes dangerous; and costs of collection are high in relation to revenue raised. So it holds little attraction for tax officials. Donors worry that taxing the informal, urban sector could place additional burdens on poor people who

Box 3. Tax compliance in Africa: The importance of reciprocity A 2006 study by the French Ministry of Foreign Affairs (MAE) on strengthening local

taxation in Africa, based on surveys in Benin, Cameroun, Ghana, Mali and Mauritania, showed that people often refused to pay tax because they could see little in return in terms of government services or investments. The study showed that this circle of non-compliance is hard to break. Lack of resources and a lack of capable local administration staff resulted typically in low quality goods and services to citizens. Moreover, local tax administrations often lacked the motivation to pursue the collection of taxes from which services could be provided. However, the study concluded that some actions can improve attitudes towards taxation. For example, in some cases local authorities made efforts to communicate and explain actions they had taken to provide services. Exchanges between local authorities and people took place during public meetings or through local radio broadcasts, for example to inform citizens of a market renovation which was carried out with public funds coming from local taxes. Experience showed that these awareness-raising measures only succeed when a link could be established between taxes and a concrete project considered useful by citizens. Source: Ministry of Foreign Affairs, France (2006). GOVERNANCE, TAXATION AND ACCOUNTABILITY: ISSUES AND PRACTICES — © OECD 2008 25 IV. WHAT CAN DEVELOPING COUNTRIES DO? already pay for some services in the form of bribery and informal fees. However, transitioning from the informal to the formal sector can give small business owners access to bank loans and government subsidies, and can contribute to stabilising their business in the longer run. In addition, experience in Ghana suggests there may be scope for innovative approaches to taxing the informal sector that could bring benefits to poor people, replacing rather than adding to informal impositions (Box 4).

Box 4. Taxing the informal sector in Ghana Since 1987 the government of Ghana has effectively franchised taxation of incomes in the large private road passenger transport sector to one of the major trade unions. This has generated revenue for the government, income and authority for the union, and protection against a range of potential illegal levies for the vehicle operators. However, much of the tax levied was not reaching the public Treasury, and other, less visible sectors, such as manufacturing were still hardly captured by taxation. In response, the government introduced two new instruments: the Vehicle Income Tax (VIT) for commercial drivers, and the Tax Stamp for small-scale enterprises. The VIT, which operates with stickers on the windscreen of buses and taxis controlled by the police, has shown noteworthy results. However, the Tax Stamp has not yet had any notable effect on revenue. Source: von Soest, Christian (2008), " Donor Support to Tax Administration in Africa : Experience in Ghana, Tanzania, Uganda and Zambia", Discussion Papers 2/2008, DIE (German Development Institute), Bonn. Looking ahead, therefore, there appear to be considerable opportunities to build on the existing tax reform agenda, with a view to: i) making it more responsive to the particular challenges faced in poorer countries; and ii) seeking to engage a broader range of citizens in politics by mobilising them as taxpayers. In all of the areas considered, there may be limited government interest in reform at first, but small changes can tip the balance of incentives and begin to create virtuous circles of change in which the payment of taxes and state responsiveness to taxpayers become mutually reinforcing over a period of years. 26 GOVERNANCE, TAXATION AND ACCOUNTABILITY: ISSUES AND PRACTICES — © OECD 2008 V. HOW

CAN DONORS HELP? V. How can Donors help? Donors can do more to support revenue-raising efforts in partner countries in ways that are likely to improve governance. The IMF has been the major source of expertise and support on tax policy and administration in poor countries for several decades. In the context of a huge international effort to support Public Expenditure Management in the developing world, some bilateral donors have been less active in the field of tax policy and administration. Of the USD 7. 1 billion spent in 2005 on bilateral aid fo