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POLICY DIRECTIONS

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TAXATION, RESOURCE MOBILISATION, AND STATE PERFORMANCE

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HIGHLIGHTS:

- **Taxation is a useful (and neglected) indicator for measuring state performance**. Examining several tax indicators contributes to identifying state authority and legitimacy, and the likelihood of state resilience.

- **Tax patterns illuminate the shape and character of the elite bargain, which is central in understanding state resilience**. At the same time, the nature of elite bargains provides a window onto the political limits of expanding tax capacity. How the elite bargain is constructed and how it is related to political stability is central to proposing tax reforms that are politically sustainable.

- **How aid is delivered affects the 'fiscal social contract' and thus state-building**. The greater the amount of aid that is delivered through the state and the more aid that is reported 'on budget' the greater the contribution to state capacity in general and to sound public financial management in particular.

- **Taxation policy needs to be linked to production strategies**. A *pro-growth* approach to tax policy should take precedence over a *pro-revenue* approach.

WHY TAXATION MATTERS FOR STATE-BUILDING AND DEVELOPMENT

The process of tax collection is one of the most powerful lenses in political economy to assess the distribution of power in a polity. Long ago Edmund Burke remarked: "Revenue is the chief preoccupation of the state. Nay more it is the state" (quoted in O'Brien, 2001: 25). Indeed, there is a long history of thinking in political economy and history that links the process of state-building with the capacity of rulers to collect taxation (Schumpeter [1918] 1954; Tilly, 1990). *Taxation is also one of the few objective indices we have that measures the power, authority and legitimacy of the state to mobilise resources*. Other well known indices of governance such as 'corruption' or 'participation' are more indirect and vague since they rely on *subjective* surveys.

Taxation and tax reform is central to state-building for several reasons. First, governments need to ensure sustainable funding for social programmes, and for public investments to promote economic development. Second, taxation is the main nexus that binds state officials with interest groups and citizens. Not only can taxation enhance government accountability, it also provides a focal point around which interest groups can mobilise to support, resist, and even propose tax policies. In other words, taxation is as constitutive of state formation as it is of interest group formation. Third, taxation, particularly in the form of land and property taxes, customs and border collection can help increase the territorial reach of the state. The diversity of the tax base is a telling indicator of the ability of the state to engage with different sectors and regions and is indicative of the degree to which state authority permeates society. Fourth, fiscal capacities are needed to build a legitimate state. Democratic elections do not themselves ensure state legitimacy. Elections provide an avenue for the citizenry to voice demands; responding to those demands requires capacity to mobilise, allocate, and spend public resources effectively.

This policy brief presents the findings of research on the political economy of taxation undertaken in several countries by the Crisis States Research Centre. The countries considered in the research are Zambia, Rwanda, Mozambique, Uganda, Tanzania, Democratic Republic of Congo, Afghanistan, the Philippines, and Colombia, and the results are discussed in greater detail in Di John (2010a).

TAXATION AS AN INDICATOR OF STATE PERFORMANCE

Tax collection capacity is a useful (but neglected) indicator of state performance and provides important clues as to where polities lie on the spectrum between fragility and resilience (on fragility and resilience, see Di John, 2008; Putzel, 2010a). There are several components of tax collection that matter.

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First, the ability of the state to monopolise the collection of tax enhances state resilience. This is because it reduces the prospects of non-state actors financing rebellions and/or challenging state authority in the delivery of social services. Monopolisation of tax collection may be as indicative of a resilient state as tax collection itself, if not more so.

In the post-1990 period, in Zambia, Rwanda, Tanzania, and Mozambique, the state has maintained a monopoly over tax collection in the country even though there have been substantial episodes of smuggling in all four countries. In Uganda, Colombia and the Philippines, there is monopoly of tax collection in most parts of the country though there are territorially limited, but significant, episodes of non-state actors collecting or attempting to raise revenue. While there is significant smuggling in the Philippines and Colombia, its effect on conflict and violence (and ultimately resilience) is different than in Zambia or Rwanda. When communities, enterprises or those moving goods through the country are forced to buy protection from political organisations determined to challenge the authority of the state (Philippines and Colombia), this becomes an important source of conflict (Putzel, 2010a). In Zambia, Tanzania, Mozambique and Rwanda there is no evidence that smuggling is linked to such organisations and thus it has a less negative impact on state resilience. In the DRC and Afghanistan, the state is far from having a monopoly over taxation, and as a result these are the least resilient, that is, the most fragile, states. In both cases, because smuggling is controlled by political organisations determined to challenge the state, substantial violence and conflict emerge (Putzel, 2010a).

The second sense in which tax collection both reflects and contributes to state resilience is through the territorial reach of the state. There are a range of outcomes across the cases. In Zambia, Tanzania, Mozambique, Rwanda, Colombia, and the Philippines, the state maintains border stations capable of collecting customs/trade taxes at least of most licit trade, though smuggling and illicit trade continue. In Afghanistan and the DRC state control over customs collection is much more limited and concentrated geographically.

Third, levels of tax collection and the diversity of tax revenue sources also matter for state resilience. Tax levels matter because greater tax revenue mobilisation increases the prospects of financing broad-based service delivery and enhances the prospects of financing the security apparatus of the state. The *diversity* of tax revenue sources also matters for state resilience. There are several reasons for this. First, a state may have very high tax collection due only to mineral or fuel abundance. For example, in Angola, state leaders may not necessarily be accountable to their citizens because such revenues are 'unearned'. This is because revenues flow into state coffers without leaders having to bargain with domestic interest groups over tax policy and tax collection. This can sever state-society links and lead to predatory behaviour on the part of state elites (Moore, 2004). Second, increasing the diversity of the tax base, and not just relying on VAT, has been central to keeping tax revenues from collapsing in the face of trade liberalisation (IMF 2005). Finally, diversifying tax revenue towards personal and corporate income tax has important consequences for state resilience since it is a direct tax that is particularly effective in institutionalising state-citizen relations. This is because direct taxes tend to be most effective in activating 'voice' among citizens (Lieberman 2002).

In our cases, performance varies in terms of both tax collection levels and the diversity of its sources. Our research findings suggest that resilient states such as Zambia have relatively high tax levels and a diversity of tax sources (Di John, 2010c). Our findings also suggest that low tax states (including those beyond the case studies such as Sierra Leone) have been vulnerable to episodes of political violence. These include Mozambique, Rwanda, DRC, and Uganda. What is also striking is that successful cases of post-war or post-genocide reconstruction have been accompanied by improvements in tax collection and tax diversity (Di John, 2010a, Tables 1-3). In Rwanda, the tax take increased from 9% of GDP in 1994 to over 14% of GDP in 2008. In Uganda, the tax take increased from 7% of GDP in 1986 to 12% of GDP by 2005 though it has stagnated since. In Mozambique, the tax take increased from 9.5% of GDP in 1995 to over 16% of GDP in 2008. In cases where the state remains fragile, the tax take has remained relatively low. The extreme case is Afghanistan where the tax take averaged 4.7% of GDP in the period 2003-5 though this ratio increased to 7% in 2008. In the DRC, the tax take averaged 6.5% of GDP in the period 2000-3 but has increased to an average of 10% of GDP in the period 2004-5.

Finally, a revealing way to assess the tax performance is to examine tax effort. Tax effort is defined as the ratio between actual tax share and the expected or predicted tax share.[1] An index greater (less) than one suggests that a country is collecting more (less) than would be predicted given its economic structure. Table 1 presents the tax effort of our cases, but excludes mineral resource rents from the calculation.

Table 1: Tax Effort in African Case Studies, 2007

Country	Fiscal Revenue per capita (US $)	Tax Effort Index (excluding resource rents)
Zambia	219.2	1.29
Uganda	66.7	1.19
Rwanda	57.1	1.17
Mozambique	66.1	1.02
Tanzania	70.6	0.96
DRC	30.7	0.88

Source: OECD (2010a)

The evidence suggests that tax effort varies considerably across the countries with Zambia, Uganda, and Rwanda 'overachieving', while Mozambique and Tanzania are 'performing as predicted' with the DRC 'underachieving'. The ranking of tax effort is consistent with our notional ranking of state resilience and fragility. The DRC, being the most fragile, has the lowest tax effort while the other historically resilient (Zambia, Tanzania) or increasingly resilient states (Rwanda, Mozambique) all have higher or even substantially higher tax efforts.

Finally, the manner in which tax is collected and the degree of participation in the budgeting process enhances state legitimacy and thus can contribute to state resilience. The extent to which tax is collected through quasi-voluntary compliance is a sign that the tax regime has at least a broad passive legitimacy among the population (Levi 1988). Our research suggests that most resilient states among our cases collect taxes in a non-coercive manner.

1 A high tax ratio is not necessarily a good measure of a country's tax capacity and does not necessarily mean that a country with high tax share is exerting itself more than one with a lower one. This is "because a higher share may be the result of 'windfall gains' or accounted for by favourable structural variables or 'tax handles' other than a government's own efforts, with the consequence that a country with a higher tax ratio may actually be collecting less tax than is warranted by these structural determinants" (Mkandawire, forthcoming).

TAXATION, STATE RESILIENCE AND THE ELITE BARGAIN

Beyond being a means for establishing administrative reach and authority, a given tax regime, is also embedded in patterns of state-created rent allocation. The creation and deployment of economic rents and privileges to relevant elites is the essence of elite bargains. In turn, exploring tax patterns can illuminate the shape and character of the elite bargain, which is important in generating state resilience in general (North et al. 2007) and across some of our cases in particular (e.g. Lindeman 2009, 2010; Di John 2010b). At the same time, the nature of elite bargains provides a window on the political limits of expanding tax capacity. The most general case is that increasing taxes and/or enforcing tax collection may become difficult if it substantially reduces the income flows of elite and allied upper-income groups. In terms of elite rent creation, *tax exemptions, low income tax rates and the systematic toleration of tax evasion can create rents* for particular companies, public or private.There are several ways in which tax patterns and policy contribute to the creation of rents for elites:

One of the common patterns that emerges in most cases is that high levels of tax evasion are tolerated. This is the case for all types of taxes. If one includes the substantial amount of assets held abroad by economic elites, a common feature in sub-Saharan African economies (Collier et al. 2004), as well as suspected high levels of capital flight through transfer pricing by multinationals (often with domestic elites as junior partners) then the level of income-tax evasion rises further. Much of this toleration for tax evasion is linked to the fact that big business groups are important financers of political parties, as in the Philippines (Putzel, 2010b).

A second common pattern that emerges in our cases (and elsewhere) is the negligible collection of urban and rural property taxes. This provides a large benefit, especially to elites who own valuable property assets. In Zambia, for instance, property taxes in the period 2001-5 comprised a mere 0.13 percent of GDP (Di John, 2010c). A similar story applies in Rwanda (Putzel, 2010c). This low property-tax collection limits the degree to which local governments can fund public goods and social spending.

A third pattern that emerges in some of the case studies (Zambia, Rwanda, Mozambique, Tanzania) is the relatively low rate of taxation on agriculture that, while part of investment incentives, can be seen to benefit elite landowners and large farmers and agro-processors in particular.

Fourth, there has been a significant decline in the corporate tax burden on big business, which has benefitted both foreign firms (particularly in mining) and political and economic elites. This has taken place through several mechanisms. First, there is substantial evasion of taxation as discussed earlier. Second, there has been a decline in corporate taxes in most of our cases from an average of 35-40% in the 1980s and early 1990s to around 25-30% since the late 1990s. Much of this decline in corporate tax rates has been the result of worldwide trends and influential IMF advice and conditionality, but has nevertheless enhanced the profits accruing to big businesses. Third, tax regimes in mining and for other large 'mega-projects' have tended to be extraordinarily investor-friendly through such mechanisms as low royalties, tax holidays, VAT and import tariff exemptions among others (see Di John, 2010a on Zambia, Mozambique and DRC).

The main policy lesson is that the tax reform process requires political analysis to understand what types of reforms are feasible in a given context. In particular *understanding how the elite bargain is constructed and how it is related to political stability is central to proposing tax reforms that are politically sustainable*.

AID AND ITS EFFECTS ON TAXATION AND STATE-BUILDING

We find little evidence that aid is crowding out domestic tax collection. Four of the aid-dependent cases, where aid is around 50% of government expenditure, (Rwanda, Mozambique, Tanzania and Uganda) have experienced increases in tax collection over the period 1990-2010.

However, important policy lessons have emerged that are relevant to the process of state-building. *The first concerns Large Taxpayer Offices*. In Rwanda, DRC and Afghanistan, IMF assistance to ministries of finance in designing and reforming tax administrations seems to have made at least some contribution to improving efficiency (Hesselbein et al. 2006).

The second concerns the ways in which aid that by-passes state systems in the delivery of social services can give rise to a 'dual public sector' (Gahni et al., 2007). This occurs when an important part of aid funds is channelled directly to sub-national or non-state actors (Boyce 2008: 14). If power to decide on spending is located in NGOs or private contractors, those who wish to make a claim on these resources will look to and interact with those NGOs and contractors and not the state. This can leave the central state weaker, giving much more room to organised rivals to emerge as more important actors than the state. In the DRC, OECD estimates that 146 parallel management units currently exist. In Afghanistan, research suggests that the problem of the dual public sector in aid delivery can be overcome through setting up 'dual-control oversight mechanisms' that can reduce corruption and still ensure resources flow through the state. The Afghanistan Reconstruction Trust Fund seems to play this role (OECD, 2010b).

The third concerns the high levels of project aid which wind up 'off budget'. In most of our cases, nearly two-thirds of aid is project aid, most of which is not 'on budget'. This exacerbates problems of macroeconomic planning and aid coordination. This problem is of particular concern for very fragile states that have yet to build sound fiscal systems, such as the DRC and Afghanistan. In the latter, our research suggests that one important mechanism to avoid creating a dual public sector is the sector-wide approach (SWAp) *if donors work through state systems* and pool funds to be applied to an integrated sectoral programme designed by the government (OECD, 2010b).

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BOX 1: COLOMBIAN NATIONAL COFFEE FEDERATION: LINKING TAX AND PRODUCTION

From the 1930s, the state delegated the right to collect taxes to the private National Coffee Federation (NCF) and gave the fund the right to spend the collected funds on rural infrastructure, technical agricultural assistance and to provide local social service delivery in health and education. For over eight decades, it developed into one of the developing world's most successful examples of collective action. The Coffee Fund under its auspices guaranteed internal minimum prices for coffee, acting as a buyer of last resort, which reduced the risks of production. Financed by a small surcharge on members' coffee sales, the Federation has been instrumental in organising improvements in quality, pest-control, technical advice, credit and international marketing and branding for nearly 400,000 smallholder producers.

TAX POLICY AND ITS EFFECTS ON PRODUCTION

Often, tax administrative reforms are designed to increase the tax take and are not coordinated with how taxation affects production patterns. That is, a *pro-revenue approach* often takes precedence over a *pro-growth approach* in tax policy.

History provides several examples of the importance of land tax in increasing agricultural production. In the case of Japan, Taiwan and Korea, a land tax was introduced as part of a production strategy to help improve agricultural production (see Bird, 1977; Grabowski, 2008). Extensive land surveys were undertaken that mapped all plots of land in the territory and classified it according to type, productivity, and ownership. As a result of land surveys, the state in each country secured a revenue base, and was able to finance improvement in agricultural production through investment in roads and irrigation. *The case of the Colombian National Coffee Federation* (see Box 1) suggests that the state can use taxation of agriculture to solve collective action problems in production (such as the provision of funds for storage, distribution, and marketing for thousands of dispersed smallholder producers) and help forge strong state-society negotiations and mutual obligations (Thorp, 2000).

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