

# TAX AND DEVELOPMENT: DONOR SUPPORT TO STRENGTHEN TAX SYSTEMS IN DEVELOPING COUNTRIES

ODD-HELGE FJELDSTAD\*

*Chr. Michelsen Institute, Norway*

## SUMMARY

Recent years have seen a growing interest among donors on taxation in developing countries. This reflects a concern for domestic revenue mobilisation to finance public goods and services, as well as recognition of the centrality of taxation for growth and redistribution. The global financial crisis has also led many donor countries to pay more attention to the extent and effectiveness of the aid they provide and to ensuring that they support rather than discourage developing countries' own revenue-raising efforts. This article reviews the state of knowledge on aid and tax reform in developing countries, with a particular focus on Sub-Saharan Africa. The article argues that considerable and sustained efforts are required before the tax systems in most low-income countries will be significantly broadened and perceived as legitimate by the majority of citizens. Thus, donors should complement the traditional 'technical' approach to tax reform with measures that encourage constructive engagement between governments and citizens over tax issues. Finally, the article cautions against potential problems of donor duplication and fragmentation, which may weaken reform efforts by diverting local capacities, reducing local ownership and undermining the coherence of reform programmes. Copyright © 2014 John Wiley & Sons, Ltd.

KEY WORDS—tax policy; tax reform; tax administration; tax effort; technical assistance; Sub-Saharan Africa

## INTRODUCTION

Recent years have seen a growing interest among donors on taxation in developing countries. The link between taxation and development is highlighted by the European Commission (EC, 2010) and by the Organisation for Economic Co-operation and Development (OECD) Development Assistance Committee (OECD, 2012). The importance of strengthening domestic revenue mobilisation is also emphasised by the G20 leaders at recent summits. The renewed interest in taxation reflects a concern for domestic revenue mobilisation to finance public spending, as well as recognition of the centrality of taxation to growth and redistribution. An effective tax system is considered central for sustainable development because it can mobilise the domestic revenue base as a key mechanism for developing countries to escape from aid or singular natural resource dependence. The global financial crisis has also led many donor countries to pay more attention to the extent and effectiveness of the aid they provide, and to ensure that they support rather than discourage the latter's own revenue-raising efforts.

At the same time, there is a growing recognition that taxation and state building are linked (Bräutigam *et al.*, 2008).<sup>1</sup> There is a strong argument in the literature that a substantial governance 'dividend' can be gained from mobilising domestic financial resources through the tax system. The tax system may contribute to improved governance through three main channels (Moore, 2008). First, fiscal bargaining and negotiation between the state and citizens over taxes is central to the development of a social fiscal contract. Taxpayers have a legitimate right to expect something in return for taxes paid and are more likely to hold their government to account if it underperforms. Second, governments have stronger incentives to promote economic growth when they are

\*Correspondence to: O-H. Fjeldstad, Senior Researcher, Chr. Michelsen Institute, P.O. Box 6033 BD, N-5892 Bergen, Norway. E-mail: odd.fjeldstad@cmi.no

<sup>1</sup>State building can be defined broadly as 'increasing the capacity of governments to interact constructively with societal interests, to obtain support and resources from those interests, and to pursue consistent lines of action' (Moore, 2008).

dependent on taxes and therefore on the prosperity of taxpayers. Third, dependence on taxes requires states to develop a bureaucratic apparatus for tax collection. This is also expected to lead to broader improvements in public administration.

Although these tax–governance linkages are complex and context specific and much of the evidence is anecdotal, it is clear that there are strong synergies between tax reforms and governance. If tax reform is undertaken in a way that promotes greater responsiveness and accountability, alongside improvements in the state’s institutional capacity, then tax reform can become a catalyst for improvements in government performance. Seen in this light, taxation is not just an administrative task for governments and citizens. It is also about politics and power, and the way that authority is exercised in a country through its formal and informal institutions.

How can donors assist in building effective tax systems in developing countries? Although much has been written about overall reform trends and progress (Bird, 2008; IMF, 2011; Drummond *et al.*, 2012; Keen, 2012), less attention has been paid to questions about how donors could support efforts to strengthen the links between tax reform and broader governance and state-building goals (Prichard *et al.*, 2012). This includes the development of the sub-national tax system, which is likely to impact large segments of the population and thus the shaping of accountability relations between citizens and the state. This article examines donor support to taxation in developing countries over time, to draw attention to changes and innovations and new thinking about how to strengthen donor support in this area. On the basis of my own research over the last two decades and a review of recent research and experiences from Sub-Saharan Africa, a key argument in this article is that considerable and sustained efforts are required before the tax systems in most low-income countries are perceived as legitimate by the majority of citizens. State legitimacy rests to a large degree on the ‘quasi-voluntary compliance’ of citizens with respect to taxation (Levi, 1988). To secure compliance in a sustainable way requires an adequate degree of consensus from the taxed (Bird, 2013). Thus, donors should complement the traditional ‘technical’ approach to tax reform with measures that encourage constructive engagement between governments and citizens over tax issues.

The remainder of the article proceeds as follows. Section 2 gives a brief review of historical perspectives of donor assistance to taxation. Against this background, donor support to taxation is grouped into three broad working areas, which are discussed in the following sections. Section 3 examines donor support to improving tax policy and design. Approaches to and experiences with technical assistance to tax administrations are assessed in Section 4, whereas Section 5 focuses on challenges to build accountable state–citizen relationships around taxation. The final section addresses some areas where there is need for continued donor support in order to build effective, transparent and accountable tax systems. The concluding remarks caution against potential problems of donor duplication and fragmentation, which may weaken reform efforts by diverting local capacities, reducing local ownership and undermining the coherence of reform programmes.

## A BRIEF HISTORY OF DONOR ASSISTANCE TO TAXATION

Donor involvement with tax reform in developing countries is not new. The Shoup mission to Japan in 1949 is often referred to as the birth of foreign technical assistance on taxation to developing countries (Gillis, 1990). Over the next three decades, Carl Shoup together with other leading fiscal economists advised tax reform packages in countries as diverse as Japan, Liberia, Venezuela, Korea, Taiwan and Bolivia. Much of the early efforts focused on the development of income tax as the centrepiece of a ‘modern’ tax system.

In the 1960s, a period when a number of African countries gained their independence from the colonial powers, leading economists argued that the new states should give the development of effective tax systems priority (Kaldor, 1963). For example, an economic survey mission, organised by the International Bank for Reconstruction and Development at the request of the Governments of Tanganyika and the UK in 1959/1960, provided detailed advice on tax reforms (IBRD, 1961). The survey mission concluded that greater tax revenues should be sought not through higher tax rates, but through expansion of taxable economic activity. The study also proposed the introduction of a low and uniform tax on exports, in line with many other developing countries at that time, which relied rather heavily on export taxes as a source of revenue.

In the 1980s and 1990s, the reform of trade taxes was a major component of donor-funded structural adjustment reforms (Bird and Oldman, 1990; Thirsk, 1997). According to Gillis (1990, pp. 77–78), the impetus for tax reform during this period did not come from those responsible for assessment and collection of tax, but rather from a donor government or from the ministry of finance in the specific country advised by the International Monetary Fund (IMF) and/or the World Bank. The general advice was to abolish export taxes and lower import duties.

After a period of declining funding beginning in the latter part of the 1990s, funding for tax-related assistance appears to have increased recently, although it remains relatively modest as a share of total donor programmes (ITC, 2012).<sup>2</sup> There is an expanding interest in taxation among a wide range of bilateral donors, regional development banks and other international agencies. The content of the tax reform agenda has also broadened. Where earlier reform efforts focused strongly on the reduction of trade taxes, their replacement with value-added tax (VAT) and the lowering of direct tax rates, contemporary reform efforts focus increasingly on improving tax administration (Bird, 2008; IMF, 2011). There is also a growing interest in the links between taxation, accountability and broader state-building goals (Bird, 2012; Prichard *et al.*, 2012).

Against this backdrop, donor support to taxation can be grouped into three broad working areas: (1) improving tax policy and design; (2) creating more effective tax administrations; and (3) encouraging constructive state–society engagement around taxes. In the following sections, I discuss key features and outcomes of each of these broad donor-supported reform areas and recommendations for scaling up and improving donor efforts in future.

### IMPROVING TAX POLICY AND DESIGN

Technical assistance has included reforms of tax legislation, simplification of tax structures and abolishment of some taxes and introduction of new ones. The overarching objective has been to raise revenues. Until the mid-1980s, income redistribution considerations also played a significant role in shaping many of the decisions on tax reform (Gillis, 1990, p. 81). Much of the early efforts focused on the development of a progressive personal income tax system.

Progressive income taxation has not become the major tax base as initially anticipated. Personal income tax accounts for less than 10 per cent of all tax revenue in most low-income countries, compared with an average of more than 25 per cent in OECD countries (Keen, 2012, p. 10). It comes almost entirely from wage withholding (pay-as-you-earn) tax on public sector and large-enterprise employees. Commonly, less than 5 per cent of the population pay personal income tax, compared with nearly 50 per cent in developed countries (IMF, 2011, p. 31). Bird and Zolt (2005, p. 32) characterise the current personal income tax regime as follows: ‘The global progressive personal income tax long advocated by tax experts as it has operated in most developing countries is in fact neither global nor progressive, nor personal, not often even on income’. The reasons for the failure of personal income taxation reflect both administrative and political weaknesses, including a very narrow set of taxpayers, poor capacity to expand the tax base to the self-employed and resistance from the elite and wealthy individuals with plentiful opportunities to conceal their income.

By the 1980s, donor-funded technical assistance to tax reform had come to encompass a standard set of recommendations and priorities.<sup>3</sup> The popularisation of these ‘best practices’ has led Fjeldstad and Moore (2008) to refer to a ‘global tax reform agenda’. Governments in developing countries have been urged to desist from using taxation to try to mobilise savings or to transfer resources from agriculture to non-agriculture, to rely less on revenue from easily taxable imports and exports and to place less emphasis on using high marginal tax rates in the effort to reduce income and wealth inequality (Tait, 1990; Thirsk, 1993; Tanzi and Zee, 2000; Stewart, 2003). Governments are now advised to concentrate on establishing simple and predictable tax systems that will not discourage private enterprise and minimise interference with market signals. Specific tax policy changes associated with these reforms

<sup>2</sup>According to unpublished OECD data, less than 0.1 per cent of official development assistance was allocated to identifiable tax activities in 2009 (OECD-DAC, 2012, p. 38).

<sup>3</sup>Goode (1993) provides a review of advice until the early 1990s. He observes (p. 37) that ‘...experts often uncritically recommend transplanting the systems of their home countries, perhaps with modifications they have unsuccessfully proposed at home’. My own experiences from Tanzania, Uganda and other countries in East and Southern Africa over the last two decades indicate that Goode’s observation still is relevant.

have included the following: (a) simplification of tax structures and procedures; (b) the elimination of export taxes; (c) reduced tariffs and less reliance on trade taxes; (d) a dual-income tax system with a simplified progressive tax on labour and a simple, often flat, and fairly low corporate tax; and (e) expanded reliance on goods and services taxes, in particular the VAT.

Value-added tax has emerged to become one of the main modes of revenue raising worldwide. First introduced in France in 1948 and in Brazil in 1967, VAT is now in place in more than 130 countries. Currently, around 80 per cent of the countries in Sub-Saharan Africa levy a VAT, typically raising about one quarter of all tax revenue (Keen, 2012, p. 11). Because it is such an efficient means of extracting tax revenue in countries with good written or electronic records of economic transactions, VAT has facilitated trade liberalisation by replacing import and export taxes and also contributed strongly to the steady increases in governments' shares of rising national incomes. In poor countries, where governments have traditionally been especially dependent on revenue from trade taxes, the promotion of VAT has been even more closely tied to trade liberalisation.

Although trade taxes in 1980 were a minor source of government revenue in high-income countries, they were significant in both middle-income and low-income countries. An important component of the global tax reform agenda, aiming to address this tax bias against international trade, was the reduction of trade taxes and an increasing emphasis on broad-based consumption taxes such as the VAT.<sup>4</sup> Total trade tax revenue to governments of low-income countries began to decline in the mid-1980s. Baunsgaard and Keen (2005) estimate that by 2000, governments of middle-income countries had found other means to replace about 45–60 per cent of the trade tax revenues they had foregone, whereas for low-income countries, the figure was at best around 30 per cent.

With regard to total government revenues, the tax reform agenda has not lived up to the promise of delivering the revenues that the poorer countries undoubtedly need through replacing trade taxes with VAT and by broadening the income tax base while lowering the rates (Fjeldstad and Moore, 2008, p. 243). The most direct explanation why it has not succeeded is that in many developing countries, VAT is harder to collect—unless it is collected at the border like a trade tax. Governments in poorer countries in general do not have the organisational capacity to make a successful transition to a more demanding revenue source. Furthermore, the VAT base is often undermined by extensive exemptions and zero rating. The effectiveness of VAT depends in large part on thorough bookkeeping and reliable self-assessment. Experts have long been warning that it would not work well in countries where these conditions are not in place. Even within high-income countries, VAT provides opportunities for fraud and corruption. The VAT has also been criticised for being a regressive tax. However, most studies find it to be distributionally neutral (Keen, 2012, p. 11). In some countries, VAT is found to be less regressive than the trade and excise taxes it has replaced (Bird and Zolt, 2005, p. 7). Thus, the issue now is not whether to remove VAT in poorer countries, but how to improve it in specific country contexts.

Exemptions are not specifically connected to VAT but characterise the tax system in many developing countries reflected in generous investment incentives to specific companies, institutions and sectors. Proponents of tax incentives often argue that it is imperative to provide tax incentives to attract investors, given the generally poor investment climate in poorer countries. This position is disputed. In a study using data from a cross section of 80 countries, Van Parys and James (2010) find that it is ineffective to lower the tax rate to compensate for a bad investment climate. Instead, they argue that countries should focus on improving the basic investment climate, such as the time required in starting a business, registering property and dealing with construction permits, as well as protection of investors, the quality of infrastructure and so on. A joint report by the IMF *et al.* (2011) reaches the same conclusion (p. 19): where governance is poor, corporate income tax exemptions 'may do little to attract investment', and when they do, 'this may well be at the expense of domestic investment'. In addition to distorting competition, tax incentives may lead to large revenue losses. According to the OECD, tax incentives tend to reduce government revenues by 1–2 per cent of gross domestic product (GDP; TJN-AA, 2012, p. 14). This figure is probably at the lower end. A recent study on Tanzania, for instance, suggests that exemptions and tax incentives could account for up to 6 per cent of GDP (AfDB, 2011, p. 242). A high occurrence of tax exemptions reduces the tax base, creates room for bribery and corruption and increases the appearance of loopholes for tax evasion

<sup>4</sup>See Bird and Gendron (2007) for an extensive discussion of VAT in low-income countries.

(Zee *et al.*, 2002). Obstacles to address these challenges are frequently rooted in politics, rather than in the absence of local understanding or lack of donor funding to tax reform.

Donors may actually be a part of the problem. Although the IMF, OECD and other multilateral agencies have engaged in the policy dialogue on tax exemptions in developing countries, few bilateral agencies are involved. Generally, transactions associated with foreign development assistance are exempted. Poor countries are often forced to administer a myriad of exemptions that typically vary from donor to donor. Imports of goods may be exempted from customs duties, VAT or sales tax, excises and other indirect taxes (ITD, 2006). Goods or services procured locally may be exempted from VAT. Income tax exemption may be extended to persons working under contracts. Commonly, there are exemptions from other taxes too.

This places unnecessary burdens on already weak tax administrations. Even worse, it fuels a tax exemption culture and promotes corruption. The removal of tax exemptions granted to aid agencies and their employees would help boost the credibility of both the government and of donors in relation to building taxpaying culture. It would also contribute to widening the revenue base and simplifying the tax system. A step forward in the right direction would be to abolish exemptions granted donor projects and programmes. Taxes paid in relation to project assistance should be included in measured official development assistance (ODA), and thus contribute to meeting donors' targets in this area.

Donor support to tax reform has largely focused on the national tax systems. Because of the overall fiscal constraints, the reform of the sub-national tax system has not been a priority over the mobilisation of central government revenues. Local government tax systems in many low-income countries have remained largely unchanged since independence.<sup>5</sup> The neglect of the sub-national tax system is problematic as local taxes often have broad and direct impacts on citizens. A widely found characteristic of local government revenue systems in Africa is the huge number of revenue instruments in use, mainly in the form of fees, charges and licences. They are often distortive, costly to administer, exacerbate inequity and have an inhibiting effect on the start-up of new enterprises and, thus, economic growth. Moreover, there is generally little or no co-ordination with respect to taxation between various levels of government. This has partly to do with lack of capacity at any level. Donors ought to give higher priority to local government tax reforms and to strengthening intergovernmental fiscal relations.

### CREATING MORE EFFECTIVE TAX ADMINISTRATIONS

Ineffective tax administration is often seen as one of the main constraints on the ability of states to collect revenues in general and direct taxes in particular. Hadler (2000, p. 10) estimates that better administration of existing tax legislation may increase revenue by 30 per cent or more in many countries in Sub-Saharan Africa. Simplification of tax legislation and improved tax administration are closely linked. Tax agencies will be more effective if their tasks are made more simple, stable and predictable (Keen, 2012, p. 17). On the other side, questionable options in tax policy sometimes lead to equally questionable administrative practices. Exemptions, for instance, not only pose control problems for the tax administration but also create opportunities for corruption. In practice, the distinction between administration and policy is often hard to make. But there is no doubt that weak and often corrupt revenue administration remains a fundamental barrier to effective and fair taxation and to building wider trust between government and citizens in many countries (Fjeldstad and Tungodden, 2003).

During the last two decades, support to tax administrations has been part of foreign technical assistance to public sector reform in developing countries (von Soest, 2007, 2008; Kloeden, 2011). The content of administrative reform in specific countries has depended a great deal on what was already in place (Owens and Hamilton, 2004; Bird *et al.*, 2006). Some of the more widespread components are exploiting new information and communication technologies; introducing unique taxpayer identification numbers; moving from a system organised around different taxes to one organised around localities and/or industries so that individual taxpayers have to deal with fewer tax officers; establishing different offices and procedures for different categories of taxpayers, typically starting with big companies; trying to make the collection process more 'user-friendly';

<sup>5</sup>Among the exceptions are reforms in East Africa, which have led to the abolishment of so-called nuisance taxes, including poll (head) taxes in Tanzania and Uganda, and simplification of the local tax structure (Fjeldstad and Therkildsen, 2008).



in some countries using commercial banks as collection agents; and creating revenue authorities across much of Latin America and anglophone Africa.

The establishment of semi-autonomous revenue authorities (ARAs) has been a widely noted tax administrative innovation during the last two decades. Several aid agencies and international financial institutions have concentrated much of their tax work on support for the creation and development of ARAs. In particular, the British Government, first through Overseas Development Administration (ODA) and later through the Department for International Development (DFID), has been influential in the establishment of revenue authorities in anglophone Africa. ODA/DFID has funded UK experts from the British revenue administration, Crown Agents and various consulting firms to provide technical assistance to tax administrations. During the last decade, multilateral institutions and an increasing number of bilateral developing agencies have provided technical assistance to tax administrations in developing countries. Recently, the OECD has launched the *Tax Inspectors Without Borders* initiative that aims to transfer tax audit knowledge and skills to tax administrations in developing countries through a 'learning-by-doing' approach.

Currently, there are more than 30 semi-ARAs in the developing world, of which 17 are in Sub-Saharan Africa. The choice of the revenue authority model aims to remove the revenue collection function partly or fully from the direct control of the Ministry of Finance by integrating tax operations that previously were conducted by different departments into a single-purpose agency, and to free the tax administration from the constraints of the civil service system (Taliervo, 2004a, 2004b; Fjeldstad and Moore, 2009). It is assumed that the revenue authority model will be less vulnerable to political interventions in its operations. Moreover, a semi-ARA can, in principle, recruit, retain and promote quality staff by paying salaries above the civil service regulations and also more easily dismiss staff. It is expected that such steps will provide incentives for greater job motivation and less corruption. A shift to a semi-ARA model has also been attractive to donors and senior politicians because it opens opportunities for more widespread reforms of tax administration.

Although no formal evaluations exist, there seems to be consensus that the experiences with ARAs have been mixed (Devas *et al.*, 2001; Kidd and Crandall, 2006). Some ARAs have made impressive advances, for instance the Rwanda Revenue Authority and the South African Revenue Service (House of Commons, 2012), and to some extent Autoridade Tributária de Moçambique and the Tanzania Revenue Authority (Fjeldstad and Heggstad, 2011). In Mozambique, the tax share increased from 14.1 per cent of GDP in 2006 to approximately 19 per cent in 2010 (exclusive non-tax revenue), despite reduced import duty rates during the period. Other revenue authorities have seen little progress, like in Sierra Leone, or progress has been followed by stagnation like in Zambia (Keen, 2012). This may understate real improvements, as revenue has largely been sustained despite a decline in both trade tax revenue and income tax rates, but it also appears to reflect the relative persistence of corruption and politicisation.

The diversity of ARAs is one reason why it is difficult to say whether they are a good thing. A second reason is that most are still relatively new and evolving (Fjeldstad and Moore, 2009). One can understand why autonomous agencies were introduced. In environments characterised by large-scale corruption and politicisation of the taxation process, radical institutional reform is very appealing. However, although we do not know how far this was the right kind of reform, we do know that it has raised problems of its own. Anecdotal evidence suggests that managerial and staff capacities often have improved (IMF, 2011, p. 20). But the integration of customs and domestic tax administration has proven to be problematic in several countries, partly because some functions are unique and partly because of different 'working cultures' (Kloeden, 2011, p. 16). In Mozambique, for instance, it has proven difficult to effectively integrate customs, which is a uniformed, paramilitary entity, and the domestic tax department (Fjeldstad and Heggstad, 2011). Further, even substantial increases in the salaries of tax officers compared with other parts of the public sector still leave these dwarfed by the potential gain from corruption (Fjeldstad, 2003, 2006).

Another feature of donor-supported tax administrative reforms in recent years is a shift in the tax administrations' attitudes towards taxpayers. 'Customer service' and 'user-friendliness' have become the norm. National tax administrations have opened customer-friendly 'one-stop shops', simplified procedures, made possible online filing of returns and provided extensive information for taxpayers in printed and digital form. Some administrations, for instance in Mozambique, Rwanda, South Africa and Tanzania, have developed innovative methods to deliver key messages to the public, including the use of school curricula, secondary school tax clubs, road shows

and radio and television programmes. Most administrations have websites, varying from outdated static general information to more dynamic tools (Kloeden, 2011, p. 35). Yet, it is evident that much of the new 'user-friendliness' of many tax administrations is so far mainly window dressing: taxpayers continue to experience extortion, bribery and obstructiveness rather than willing, responsive service. It is also clear that 'user-friendliness' is most widely practised in the relations between tax administrations and their larger corporate clients. For smaller-sized and middle-sized formal sector businesses, tax enforcement strategies applied by revenue officers are perceived to be a major problem in many countries. Frequent and uncoordinated tax audits are considered to be harassment and intimidation tactics to force taxpayers into extra-legal compliance. Discretion leads to unpredictable tax bills, arbitrary fines and corrupt practices.

What is the rationale behind the discretionary implementation of the tax code? Observers believe that tax officers levy arbitrary assessments in order to meet revenue targets. Structural and administrative features of the tax system add to the problem. Many smaller, but also many middle-sized enterprises, lack the skills required to provide minimally acceptable accounts and accurate information on total sales. This is an open invitation for discretion and negotiation by tax officers. In particular, frontline staff in the customs and the domestic revenue departments are exposed to and involved in corruption. According to the Bribe Payers Index 2008, the customs administration is perceived by business executives to be one of the most corrupt sectors of government in many African countries (TI, 2008). This is supported by the Afrobarometer survey, covering a large number of Sub-Saharan African countries, which finds that the most discredited institutions are the police and the tax administration, including customs (Lavallée *et al.*, 2008). Addressing these challenges will require a combined set of efforts, including measures to improve the integrity of tax officers, e-taxation, dialogue forums between taxpayers and the tax administration and taxpayer education.

These observations highlight a wider problem—the extent to which improvements in revenue performance result from a focus on formal sector corporations by the tax administrations, at the potential expense of genuinely broadening the tax base. Thus, improvements in revenue collection may not reflect the development of a broad-based fiscal contract between the state and society, but the fact that the revenue administration is targeting its efforts towards the few most revenue-productive taxpayers. This argument is all the more pointed in situations where national governments are under strong pressure from the IMF and donors to meet revenue targets. Often, the tax administrations respond with some combination of an even tighter squeeze on registered taxpayers, and quasi-military 'raids' on other businesses on which they do not have detailed information. By pushing for unrealistically high revenue targets, the Ministry of Finance, the IMF and donor agencies may contribute to undermining the reputation and credibility of the tax administration in the eyes of the public. Performance measurement is important for both accountability and promotion of a culture of effectiveness in the tax administration. However, a more 'balanced' set of performance indicators is required. In particular, there is a need for striking a balance between revenue targets and service targets such as the processing time per tax declaration, processing time for VAT refund requests and average time for customs inspections (Crandall, 2010; Kariuki, 2012).

Broadly, donor support to tax administrations has contributed to building capacity in a range of areas. Currently, the need for further technical assistance is particularly related to the development of taxpayer services, e-tax systems and expertise within areas such as specialised audit functions of large taxpayers in growing sectors, such as natural resource extraction, tourism, telecommunications, bank and finance. Tax administrations need better training on how to recognise the transfer mispricing opportunities by multinational companies and stronger capacity to detect and respond to the problem.

### ENCOURAGING CONSTRUCTIVE STATE–SOCIETY ENGAGEMENT AROUND TAXATION

Tax systems can potentially contribute to shaping accountability relationships between the state and citizens (Bräutigam *et al.*, 2008). As argued earlier, bargaining over taxes is central to building relations of accountability between the state and citizens on the basis of mutual rights and obligations. This implies that taxes should be levied as consensually and as transparently as possible. However, for taxation to have a positive effect on accountability, taxes must be 'felt' by a majority of citizens, to secure that tax issues become prominent on the public political

agenda (Moore, 2008). This is about building a taxpaying culture. Although donors and tax practitioners seem to acknowledge the importance of these issues, they have yet to be translated into a clear-cut governance-focused tax reform agenda in practice.

Common features of the tax systems in many developing countries are that the number of registered taxpayers is small and relatively few medium-sized and large enterprises account for the majority of tax revenue. In Tanzania, for instance, with a total population of more than 45 million people, the number of taxpayers registered in the Taxpayer Identification System was about 400 000 in 2008 (Fjeldstad and Heggstad, 2011). In November 2010, less than 400 large taxpayers contributed about 80 per cent of total domestic revenue collection. The revenue base generally excludes the large number of small and micro enterprises, as well as many professionals, such as lawyers, doctors and private consultants.

A large share of the economic activity in poor countries is located within the informal sector.<sup>6</sup> That sector is hard to tax (Tendler, 2002; Bird and Wallace, 2003). Tax administrations tend to give it little priority, because returns to effort may be low in cash terms, and collection is likely to be difficult and unpleasant. From economic and administrative perspectives, it makes a great deal of sense *not* to tax multitudes of poor people. The VAT system generally exempts basic goods consumed heavily by the poor, and the income tax code generally excludes individuals and entities with incomes below a certain threshold.

One should not expect that large amounts of revenue can be raised by taxing small and micro enterprises. Thus, Terkper (2003) and others argue that the tax system can be improved by having tax officers concentrate on handling a few thousand files efficiently, rather than trying to cover tens of thousands of very small taxpayers. According to the IMF, there is a strong case for raising the thresholds for tax coverage, which would actually narrow the coverage of the tax base, but with little effect on revenue (IMF, 2011). However, the removal from the tax net of taxpayers who generate little net revenue is contrary to the emphasis within the tax reform programme to broaden the tax net. A wider tax net is not always a good thing, but there is reason for concern that tax reforms have been driven by a calculus that emphasises the advantages of excluding marginal payers. The political arguments for inclusion have not been heard (Fjeldstad and Moore, 2008). This would be less of a problem if the actual tax burdens in poor countries were fairly and effectively distributed. But they are not. In particular, as noted earlier, they often fall heavily on a small number of registered, formal sector companies. It makes therefore sense to question the arguments for excluding smaller taxpayers from the tax net on pure efficiency grounds and to explore the potential political advantages of widening that net, while also carefully considering the administrative implications.

Broadening the revenue base is vital to building the social fiscal contract. It is also central to creating an equitable tax regime. In this perspective, there are good public policy reasons for paying more attention to taxing informal urban economic activity, in terms of both broadening the tax net and exploring alternative ways of building the capacity to tax the sector more effectively in the long term. Finding better ways of taxing the informal sector is in general not high on the tax reform agenda in most developing countries. In some countries, however, it is gaining increasing attention. For instance, the revenue authorities in Mozambique and Tanzania have recently made substantial efforts to broaden the tax base by incorporating informal sector operators (Fjeldstad and Heggstad, 2012). This has been achieved by a combination of measures, including simplified tax procedures for small and micro enterprises, taxpayer education and outreach programmes using local languages, engagement of informal sector/micro enterprise associations and closer collaboration and exchange of information with sub-national authorities.

Efforts to broaden the tax base are closely connected to the quality of government expenditure. In many developing countries, there is widespread resistance to paying taxes because citizens perceive they receive little in return for taxes paid (Fjeldstad *et al.*, 2012). If taxpayers feel that their tax payments are wasted or misdirected, then compliance will be low, and tax reforms will be far less effective. Programmes to improve public expenditure management and increase efficiency in the delivery of public services go hand in hand with tax reform and revenue enhancement. There is a strong case for linking revenue enhancement much more explicitly to broader governance objectives. Increased domestic revenue generation will only lead to improved development outcomes if the revenue

<sup>6</sup>The size of the informal economy is hard to estimate. Recent estimates from West Africa suggest that more than 80 per cent of total employment is informal and up to 60 per cent of GDP is produced by informal activities (Benjamin and Mbaye, 2012, p. 48).



is translated into productive public expenditure. In more practical terms, if tax reform is undertaken in a way that promotes greater responsiveness and accountability, alongside improvements in the state's institutional capacity, then tax reform can become a catalyst for improvements in government performance.

An important opportunity for building political support for reform lies in more emphasis on the 'demand side', that is, in building broader citizen engagement around taxation. Public debates on taxation in many African countries are to a large extent limited to natural resources and taxation of multinational companies. Through co-ordinated efforts, donors should consider enhancing their support to domestic civil society organisations engaged on tax issues. There is also a demand for technical assistance to build tax capacity and knowledge in business communities, especially in those representing small and micro enterprises.

### CONCLUDING REMARKS

An effective tax system is essential to strengthen the state's legitimacy, accountability and responsiveness. It matters that governments tax their citizens, and it matters how they tax them. This article has argued that the challenge for many developing countries is not only to tax more (i.e. to increase the tax-to-GDP ratio) but also to tax a larger number of citizens and enterprises more consensually and to encourage constructive state–citizen engagement around taxation. In this perspective, cutting down on tax exemptions and building capacity for more effective taxation of the informal sector are complex, challenging but potentially rewarding areas to focus efforts to broaden the revenue base and build a taxpaying culture. Historical and contemporary experiences show that taxpayers' behaviour can be transformed by reforming the tax and expenditure system, leading to both a greater willingness to pay and an increased propensity to mobilise demand for better public services. During this process, it is also important to strike the right balance between the expansion of the tax base, compliance and enforcement. Still, considerable and sustained efforts are required before the tax systems in most Sub-Saharan African countries will be significantly broadened and perceived as legitimate by the majority of citizens.

Although the technical aspects of tax reforms are crucial, a better understanding of the sustainability of tax reforms is not possible without a better understanding of how reforms become legitimate. Because taxation affects incentives and distribution simultaneously, tax reform requires either a degree of social consensus that taxation is in the collective interest and/or it requires a state with the ability to coerce those who challenge its allocations. The focus therefore on institutional designs and other technical issues is incomplete because it ignores the political nature of taxation. More emphasis on the political economy of taxation is required for designing and implementing effective tax systems. That leaves open the practical question of what can be done, in the face of opposition from interest groups of various kinds and through tax administrations that are often inefficient and resistant to change.

In this article, I have suggested that donor support should aim to build effective tax systems through tax policy reforms, capacity building of the tax administration and improved accountability. With respect to tax policy, the article has pointed at the importance of addressing the generous tax incentives that characterise current tax systems in many aid-recipient countries. Why should taxpayers in donor countries pay for tax exemptions granted to politically well-connected domestic actors and international companies? In this perspective, donors should consider to provide advisory, training and research support to improve the technical capacity and basic skills of Parliamentarians in public finance and tax policy. Further, the article has argued that donors ought to give higher priority to local government tax reforms and to strengthen intergovernmental fiscal relations.

The need for further technical assistance to tax administration is particularly related to the development of taxpayer services, e-tax systems and expertise within areas such as specialised audit functions of large taxpayers in growing sectors, such as natural resource extraction, telecommunications, bank and finance. Capacity building in tax administrations should also aim to strengthen taxpayers' rights and improve taxpayer outreach. An important element of administrative accountability is the rights of taxpayers vis-à-vis the tax authority. Although still in their infancy in most African countries, tax appeals boards and tax tribunals are potentially important institutions to securing taxpayers' rights and to establishing fair and transparent procedures to address tax disputes. However, to make these institutions accessible for a wider segment of taxpayers, there is in general a need to simplify the procedures for instituting appeals and to disseminate more accessible information to the general public on

the roles and functions of the appeals board. Because a large proportion of the economically active citizens in developing countries belong to the informal sector, 'tax literacy' is generally poor, and many people are not able to comprehend the technical issues of paying taxes. Although revenue administrations in some countries have undertaken vigorous taxpayer education interventions, they have had a limited outreach because most of them have been concentrated in the urban centres. Although some donors already provide support to taxpayer education campaigns, there is a need to expand measures that aim to improve taxpayer–tax administration dialogue.

The article emphasises the importance of building broader citizen engagement around taxation. Civil-based organisations, including business associations, trade unions and religious organisations can help broaden the debate and bring a new focus to the discussion of tax policy, for instance on fairness, and thus influence the policy decisions that are being made. Through co-ordinated efforts, donors should consider to enhance their support to domestic civil society organisations engaged on tax issues. This support could also be extended to legislators and the media. Building domestic research capacity on taxation could be part of this agenda, thereby laying the foundation for a better-informed policy debate.

The sustainability of donor support requires that the government of each country must take the lead and define the needs. Efforts and priorities must be tailored to the economic, political and institutional factors in each country. There is no single 'package' that fits the requirements of any individual country. The importance of locally designed solutions and donor approaches that are sensitive to each country's specific socio-economic environment cannot be overstated. Further, long-term commitment by the international community is required. It takes time to build institutions and change peoples' behaviour, whether they are policymakers, tax officers or ordinary citizens.

There is now a much wider appreciation of the importance of taxation in development, and many more development agencies are active in the field. Unfortunately, this poses serious problems of duplication and fragmentation, which may weaken reform efforts by diverting local capacities, reducing local ownership and undermining the coherence of reform programmes. Donor co-ordination and co-operation should be supported. Development agencies need to increase the level of information sharing to secure that assistance is complementary and aligned (ITC, 2012, pp. 50–54). Information exchange and co-ordination would also allow for an improved division of labour between donors. The fact that multiple organisations work in the same country or regional context or on identical thematic issues indicates that there is a high potential for a more focused approach. An improved division of labour may also contribute to build up more in-depth expertise with respect to the regional or country-specific background, as well as in terms of technical knowledge.

#### ACKNOWLEDGEMENTS

This article builds on work prepared within the UNU-WIDER project 'ReCom—Research and Communication on Foreign Aid'. I have benefitted from comments by Eva Beuselinck, Rachel Gisselquist, Jan Isaksen, Aslak Orre, Ingrid Hoem Sjursen, Paul Wade and two anonymous referees and from discussions with my colleagues Mick Moore and Wilson Prichard at the International Centre for Tax and Development.

#### REFERENCES

- African Development Bank [AfDB]. 2011. *Domestic Resource Mobilization for Poverty Reduction in East Africa: Lessons for Tax Policy and Administration*. The Knowledge and Information Center (KVRC), African Development Bank: Tunis.
- Baunsgaard T, Keen M. 2005. Tax revenue and (or?) trade liberalization. *IMF Working Paper* WP/05/112. International Monetary Fund: Washington, DC.
- Benjamin N, Mbaye AA. 2012. The informal sector in Francophone Africa: firm size, productivity, and institutions. *Africa Development Forum Series*. World Bank: Washington, DC.
- Bird R. 2008. Tax challenges facing developing countries. *Institute for International Business Working Paper* 12 (March). University of Toronto: Toronto.
- Bird R. 2012. Taxation and development: what have we learned from fifty years of research? *ICTD Working Paper* 1. International Center for Tax and Development: Brighton.
- Bird R. 2013. Foreign advice and tax policy in developing countries. *International Center for Public Policy Working Paper* 13-07 (April). Georgia State University, Andrew Young School of Policy Studies: Atlanta.
- Bird R, Gendron P-P. 2007. *The VAT in Developing and Transitional Countries*. Cambridge University Press: Cambridge.

- Bird R, Oldman O. 1990. *Taxation in Developing Countries*. The John Hopkins University Press: Baltimore and London.
- Bird R, Wallace S. 2003. Is it really so hard to tax the hard-to-tax? The context and role of presumptive taxes. *ITP Working Paper* 0307. International Tax Program, Rotman School of Management, University of Toronto: Toronto.
- Bird R, Zolt EM. 2005. Redistribution via taxation: the limited role of the personal income tax in developing countries. *ITP Working Paper* 0508. International Tax Program, Institute for International Business, Joseph L. Rotman School of Management, University of Toronto: Toronto.
- Bird RM, Martinez-Vasquez J, Torgler B. 2006. Societal institutions and tax effort in developing countries. In *The Challenges of Tax Reform in a Global Economy*, Alm J, Martinez-Vasquez J, Rider M (eds). Springer Science+Business Media, Inc.: New York.
- Braütigam D, Fjeldstad O-H, Moore M. 2008. *Taxation and State-building in Developing Countries: Capacity and Consent*. Cambridge University Press: Cambridge.
- Crandall W. 2010. Revenue administration: performance measurement in tax administration. *Technical Notes and Manuals* (June). International Monetary Fund: Washington, DC.
- Devas N, Delaym S, Hubbard M. 2001. Revenue authorities: are they the right vehicle for improved tax administration? *Public Administration and Development* **21**: 211–222.
- Drummond P, Daal W, Srivastava N, Oliveira LE. 2012. Mobilizing revenue in Sub-Saharan Africa: empirical norms and key determinants. *IMF Working Paper* WP/12/108. International Monetary Fund: Washington, DC.
- European Commission [EC]. 2010. Tax and development: cooperating with developing countries on promoting good governance in tax matters. *Communication from the Commission to the European Parliament*, COM(2010)163 final (21 April). The Council and the European Economic and Social Committee, European Commission: Brussels.
- Fjeldstad O-H. 2003. Fighting fiscal corruption: lessons from the Tanzania Revenue Authority. *Public Administration and Development* **23**: 165–175.
- Fjeldstad O-H. 2006. Corruption in tax administration: lessons from institutional reforms in Uganda. In *International Handbook on the Economics of Corruption*, Rose-Ackerman S (ed.). Edward Elgar: Cheltenham, UK/Northampton MA, USA; 484–511.
- Fjeldstad O-H, Heggstad K. 2011. The tax systems in Mozambique, Tanzania and Zambia: capacity and constraints. *CMI Report* R 2011:3. Chr. Michelsen Institute: Bergen.
- Fjeldstad O-H, Heggstad K. 2012. Building taxpayer culture in Mozambique, Tanzania and Zambia: achievements, challenges and policy recommendations. *CMI Report* R 2012:1. Chr. Michelsen Institute: Bergen.
- Fjeldstad O-H, Moore M. 2008. Tax reform and state building in a globalized world. In *Taxation and State Building in Developing Countries*, Braütigam D, Fjeldstad O-H, Moore M (eds). Cambridge University Press: Cambridge; 235–260.
- Fjeldstad O-H, Moore M. 2009. Revenue authorities and public authority in Sub-Saharan Africa. *The Journal of Modern African Studies* **47**: 1–18.
- Fjeldstad O-H, Therkildsen O. 2008. Mass taxation and state–society relations in East Africa. In *Taxation and State Building in Developing Countries*, Braütigam D, Fjeldstad O-H, Moore M (eds). Cambridge University Press: Cambridge; 114–134.
- Fjeldstad O-H, Tungodden B. 2003. Fiscal corruption: a vice or a virtue? *World Development* **31**: 1459–1467.
- Fjeldstad O-H, Schulz-Herzenberg C, Sjursen IH. 2012. Peoples' views of taxation in Africa: a review of determinants of tax compliance. *ICTD Working Paper* WP 2012: 8. International Center for Tax and Development: Brighton.
- Gillis M. 1990. Micro- and macroeconomics of tax reform: Indonesia. In *Taxation in Developing Countries*, Bird R, Oldman O (eds). The Johns Hopkins University Press: Baltimore and London; 76–95.
- Goode R. 1993. Tax advice to developing countries: an historical survey. *World Development* **21**: 37–54.
- Hadler SC. 2000. *Best Practice in Tax Administration in Sub-Saharan Africa: A Handbook for Officials* (June). International Tax Program, Harvard Law School: Boston.
- House of Commons. 2012. Tax in developing countries: increasing resources for development. International Development Committee, Fourth Report of Session 2012–13. The Stationery Office Limited: London.
- International Bank for Reconstruction and Development [IBRD]. 1961. *The Economic Development of Tanganyika*. International Bank for Reconstruction and Development, The Johns Hopkins Press: Baltimore.
- International Monetary Fund [IMF]. 2011. Revenue mobilization in developing countries. Policy Paper prepared by the Fiscal Affairs Department (8 March). International Monetary Fund: Washington, DC.
- International Monetary Fund [IMF], OECD, UN, World Bank. 2011. Supporting the development of more effective tax systems. Report to the G-20 Development Working Group. Washington DC/Paris/New York.
- International Tax Compact [ITC]. 2012. *Study on Mapping International Support to Taxation*. International Tax Compact, Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ): Eschborn.
- International Tax Dialogue [ITD]. 2006. Tax treatment of donor-financed projects. *Discussion Paper* Document ID: 9276 (October): Paris.
- Kaldor N. 1963. Will underdeveloped countries learn to tax? *Foreign Affairs* **41**: 410–419.
- Kariuki E. 2012. Performance measurement in African semi-autonomous revenue authorities: the case of Kenya, South Africa and Tanzania. PhD thesis, University of Bradford: Bradford.
- Keen M. 2012. Taxation and development—again. IMF Working Paper WP/12/220. International Monetary Fund: Washington, DC.
- Kidd M, Crandall W. 2006. Revenue authorities: an evaluation of their impact on revenue administration reform. *IMF Working Paper* 6/240. Washington, DC: IMF.
- Kloeden D. 2011. Revenue administration reforms in Anglophone Africa since the early 1990s. IMF Working Paper WP/11/162. International Monetary Fund: Washington DC.
- Lavallée E, Razafindrakoto M, Roubaud F. 2008. Corruption and trust in political institutions in Sub-Saharan Africa. *Afrobarometer Working Papers* 102 (October).
- Levi M. 1988. *Of Rule and Revenue*. University of California Press: Berkeley.
- Moore M. 2008. Between coercion and contract: competing narratives around taxation and governance. In *Taxation and State-building in Developing Countries: Capacity and Consent*, Braütigam D, Fjeldstad O-H, Moore M (eds). Cambridge University Press: Cambridge; 34–63.
- OECD-DAC. 2012. *Tax and Development: Aid Modalities for Strengthening Tax Systems*. Organization for Economic Co-operation and Development (August): Paris.

- Owens J, Hamilton S. 2004. Experience and innovations in other countries. In *The Crisis in Tax Administration*, Aaron HJ, Slemrod J (eds). Brookings Institution Press: Washington, DC.
- Prichard W, Brun J-F, Morrissey O. 2012. Donors, aid and taxation in developing countries: an overview. *ICTD Working Paper* WP 2012:6. International Centre for Tax and Development: Brighton.
- von Soest C. 2007. Measuring the capability to raise revenue: process and output dimensions and their application to the Zambia Revenue Authority. *Public Administration and Development* **27**: 353–365.
- von Soest C. 2008. Donor support for tax administration reform in Africa: experiences from Ghana, Tanzania, Uganda and Zambia. *German Development Institute Discussion Paper* 2. German Development Institute: Bonn.
- Stewart M. 2003. Global trajectories of tax reform: mapping tax reform in developing and transition countries. *Harvard International Law Journal* **44**: 140–190.
- Tait A. 1990. IMF advice on fiscal policy. In *Public Finance and Steady Economic Growth*, Krause-Junk G (ed.). International Institute of Public Finance: The Hague.
- Taliercio RJ. 2004a. Administrative reform as credible commitment: the impact of autonomy on revenue authority performance in Latin America. *World Development* **32**: 213–232.
- Taliercio RJ. 2004b. Designing performance: the semi-autonomous revenue authority model in Africa and Latin-America. *Policy Research Working Paper* 3423. World Bank: Washington, DC.
- Tanzi V, Zee HH. 2000. Tax policy for emerging markets: developing countries. *IMF Working Paper* WP/00/35. International Monetary Fund: Washington, DC.
- Tax Justice Network-Action Aid [TJN-AA]. 2012. *Tax Competition in East Africa: A Race to the Bottom?* Tax Justice Network-Africa and ActionAid International: Johannesburg/Nairobi.
- Tendler J. 2002. Small firms, the informal sector and the devil's deal. *IDS Bulletin* **33**(3): 98–104.
- Terkper S. 2003. Managing small and medium-size taxpayers in developing countries. *Tax Notes International*, 211–34.
- Thirsk WR. 1993. Recent experience with tax reform in developing countries. In *Fiscal Issues in Adjustment in Developing Countries*, Faini RDM (ed.). St. Martin's Press: New York.
- Thirsk WR. 1997. *Tax Reform in Developing Countries*. Regional and Sector Studies. World Bank: Washington, DC.
- Transparency International [TI]. 2008. Bribe payers index 2008. [Online]. TI International Secretariat, Transparency International: Berlin. Available at: [http://www.transparency.org/whatwedo/pub/bribe\\_payers\\_index\\_2008](http://www.transparency.org/whatwedo/pub/bribe_payers_index_2008) [Accessed on 19 Sept 2013].
- Van Parys S, James S. 2010. Why tax incentives may be an ineffective tool to encouraging investment? The role of investment climate. *Working Paper* 2010/676 (Sept.). Faculteit Economie en Bedrijfskunde, Universiteit Gent, Belgium. Available from: [http://www.feb.ugent.be/nl/Ondz/WP/Papers/wp\\_10\\_676.pdf](http://www.feb.ugent.be/nl/Ondz/WP/Papers/wp_10_676.pdf) [Accessed 16 September 2013].
- Zee H, Stotsky J, Ley E. 2002. Tax incentives for business investment: a primer for policy makers in developing countries. *World Development* **30**: 1497–1516.