

MAY 09

Why Tax Matters for International Development and what DFID is doing about it

The tax system is at the heart of an effective state. Taxes, raised in ways that encourage economic growth and promote political accountability, build the political legitimacy of the state and offer the eventual 'exit strategy from aid'. Effective tax systems are central to DFID's core priorities including promoting economic growth, tackling climate change and achieving the Millennium Development Goals. Effective tax systems are central also to the 'Monterrey Consensus', by which developing countries committed themselves to improve their tax efforts in order to mobilise the domestic resources required for poverty reduction. This Briefing Note highlights DFID's commitment to help deliver better tax systems for sustainable international development.

*'How people are taxed, who is taxed, and what is taxed tell more about a society than anything else.'*¹

Why tax matters

Tax (meaning both domestic taxation and customs tariffs and excise) is **central** to achieving the Millennium Development Goals (MDGs) because the ability to collect taxes is a **core function of an effective state**.

Promoting better tax systems deserves attention because:

- Taxes, if designed well, can **promote economic growth, lessen extreme inequalities, tackle climate change and fund the delivery of the MDGs**, significantly improving the lives of all citizens and especially poor people.

¹ C. Adams (1993). For Good and Evil. The Impact of Taxes on the Course of Civilization. London: p.21

- Tax is a core part of **state-building** and the most visible sign of the **social contract** between citizens and the state. Fair and transparent tax collection demonstrates good governance and shapes **government legitimacy** by promoting accountability of governments to tax-paying citizens, and by stimulating effective state administration and good public financial management.
- Taxes shape economic growth by altering the incentives for work, investment, savings and innovation. In addition, tax revenues that increase with economic growth ensure sustainable **funding of essential public services** for poor people: '**public goods**' such as security, health and education on which economic growth and social development depend.
- Rising tax revenues combined with sustainable economic growth are the eventual **exit strategy** for developing countries out of aid dependency.
- Tax is central to the '**Monterrey Consensus**' agreed in 2002 and reaffirmed in 2008, by which developing countries committed themselves to deliver 'effective, efficient, transparent and accountable' taxation systems, in return for increased international development assistance.² Developing countries must be able to show their serious intent to maintain this commitment. Evidence of increasing 'tax effort' also matters for sustaining **public support** in OECD countries for international development.

The tax system, along with public debt and aid, are part of the framework of public finances. But how taxes are raised, not just how much or how they are spent, matters for reducing poverty, promoting growth, and improving governance. Tax is fundamental to state-building, economic opportunity and social cohesion. Yet:

- The importance of tax is too often **overlooked** (public expenditures alone do not deliver state-building) or **understood only in narrow technical terms**.

² UN International Conference on Financing for Development 2002 Report para 15; the Consensus also [para 64] committed the international community to 'increased tax cooperation', dialogue between tax authorities and coordination between multilateral bodies, on tax.

- As a result, international support to developing countries on tax reform remains **too fragmented and possibly under-resourced**.³

The **aim** is not to tax poor people or increase the taxes in poor countries, but to mobilise for development the domestic resources that currently unfairly escape the tax net. To address this challenge, **DFID is committed** to:

- **Helping developing countries deliver** on their Monterrey Consensus commitment and **tackle tax evasion**.
- **Delivering reforms that reflect** taxation as **state-building**, shaping political governance, economic growth and social cohesion.
- **Improving the effectiveness and coherence of the international community's** work on taxation within the framework of public finances.

To achieve these objectives, **we will**:

- Stress the importance of tax to **international development**.
- Continue to **work with partner governments** and **Whitehall** to improve tax systems.
- Improve **international collaboration** on tax issues in developing countries.
- Promote the **role of civil society** in demanding better tax systems.

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³ Of the USD 7.1 billion spent in 2005 on bilateral aid for government administration, economic policy and public sector financial management, only 1.7% went on tax-related assistance: OECD DAC: Governance, Taxation and Accountability: 2008.

Part 1: Introduction

1. Tax systems need to be Effective, Efficient and Equitable

All countries, even the very poorest and most aid dependent, need to collect taxes to fund the state. The tax 'system' comprises the laws and regulations that set out a country's tax policy, combined with the administrative reality of how policy is actually applied. The shape of public finances – the mix of tax, debt and aid – matters because raising taxes well requires active state engagement with its citizens. Tax systems should be economically **efficient** (raising most revenue with least cost and effort, without creating a significant disincentive to work or invest); **effective** (administratively capable of delivering the desired policy objectives at minimum administrative and compliance cost); and **equitable** (offering fair treatment of taxpayers and promoting social cohesion). Tax systems and individual taxes should be as predictable, simple and transparent as possible, be internally consistent, and be accepted as just.

These objectives frequently conflict: a simple tax system is unlikely to be fair; an efficient system may be inequitable. A weak or corrupt tax administration may undermine an otherwise effective tax policy. Tax systems fund public services and promote better governance and more sustainable economic growth on which long-term poverty reduction depends. Poor tax policies can undermine development: declines in public revenues have frequently triggered political violence and state failure.⁴ How political choices about raising and spending tax are made reflect and shape the nature of the relationship between the state and its citizens. **The way taxes are raised** has profound effects on the state. Political equality and economic efficiency cannot be addressed solely through public expenditure provision of public goods like security and public services like health and education.

Making tax systems efficient, effective and equitable is difficult everywhere, and especially in those developing countries with **weak political institutions, widespread corruption, and poor administrative capacities**. Too often this process of 'tax as state-building' does not happen: in many developing countries the

⁴ R. Bates (2008): *When Things Fell Apart: State Failure in Late-Century Africa*: Harvard.

tax base remains dangerously narrow, its administration overly ineffectual or coercive.

Taxes influence incentives for investment, savings, entrepreneurship and therefore economic growth. However, some developing countries have tax systems that impose an impossible burden on the private sector. In some African countries multiple taxes and poor tax design mean that the tax burden on business is much higher than in OECD countries.⁵ This forces firms out of business or to

Broadening the sources of tax revenue and widening the tax base on individual taxes is a priority for developing countries. The WTO and regional trade agreements require developing countries to move away from their dependence on trade taxes, and encourages them to promote economic development by reducing tax rates and improving tax administration. Reforms need to be carefully crafted according to each country's context. This also applies to tax administration.

operate informally or illegally.⁶ The average size of the informal economy of low-income countries is 32.7 per cent of official GDP.⁷ The informal sector in sub-Saharan Africa has increased in the last fifteen years from about two-thirds to nearly three-quarters of non-agricultural employment

So to be efficient, effective and equitable, and to deliver better governance and more sustainable growth, **tax policy and its administration** in many developing countries needs to be improved. In Yemen, for example, only 7% of GDP is raised in taxes and the tax authority collects no more than 20-25% of taxes due.⁸ In Nigeria the federal government in 2004 collected only around 10% of taxes due, and then half the revenue collected was believed to have been subsequently lost or embezzled.⁹ Losses stem not only from **corruption and ineffective revenue collection**. **Tax evasion and avoidance** have been calculated to cost developing countries \$385 billion

per year, or nearly eight times total international development aid.¹⁰

⁵ World Bank 'Doing Business' Report 2008 calculates the 'total tax rate'. The methodology is contested. Nevertheless it does illustrate the problem. The lowest total tax rates in Africa are in Zambia and Botswana, where they are well below the OECD average.

⁶ A. Cobham: The Tax Consensus Has Failed: Oxford 2007.

⁷ F. Schneider and D. Enste (2000). Shadow Economies around the World. IMF Working Paper, WP/00/26.

⁸ FIAS Investment Climate review: 2007.

⁹ A. Odusola (2006): Tax Policy Reforms in Nigeria: WIDER Research Paper No. 2006/03

¹⁰ A. Cobham (2005): Tax evasion, tax avoidance and development finance: QEH Working Paper 129: Oxford University. The German development minister in October 2008 suggested the figure to be \$500bn per annum.

These problems however highlight that a good tax system also requires 'rule of law' institutions and taxpayer rights. Tax **avoidance** is legal (tax planning) rather than illegal (tax **evasion**). In many developing countries this clear distinction is inadequately institutionalised and taxpayers have few well-defined legal rights.

Taxation is at the centre of good governance and state-building

- The perceived fairness of the tax system is crucial to building an effective state based on citizens' consent. Willingness to pay taxes is a good indicator of the legitimacy of the state.
- What citizens and governments are themselves prepared to pay for may be the **best indication of genuine political ownership** of development objectives.
- Tax as revenue-raising is a core '**Survival Function**' of the state; developing citizens' tax compliance is an expression of the 'social contract', an '**Expected Function**' for state-building by engagement with society.

So tax policy and its administration needs to be understood as a **coherent system**. Different components combine to shape and reflect **state-building** through the political settlement of the process for balancing the demands for raising revenue, promoting economic growth and delivering social cohesion by funding adequate public services and welfare.

Part 2: Why tax matters for development

2. Effective Tax Systems Reduce Aid Dependency

At the UN Financing for Development Summit in **Monterrey** in 2002, developing countries agreed, in return for increases in aid, to improve **domestic resource mobilisation** (that is, taxes and other sources of government income such as royalties on natural resources, along with private savings and government debt). This commitment was strongly reaffirmed at Doha in December 2008.¹¹ Yet improving tax systems in developing countries is frequently neglected.¹² The IMF suggests a revenue-to-GDP ratio of **fifteen percent** as a reasonable minimum for developing countries. Although the average tax ratio for developing countries is already in this range, many more aid-dependent countries fall below it.¹³

The need for public revenue depends on the whole **context of public finances**: levels of aid, capacity to borrow, and the size of public expenditure. There is no optimal size for the public sector, but it is clear that the MDGs create an increased demand for public services. This, in turn can generate increases in recurrent expenditures that later need to be funded by higher tax revenues. High taxes and spending do not necessarily deliver effective public services and improved poverty reduction.¹⁴ Overall, donors should make a greater collective effort to encourage and support domestic revenue collection in aid-dependent countries, particularly those where levels of dependence are high or rising significantly.¹⁵

.Taxation and aid are inter-connected: the effectiveness of both taxes and aid need to be examined together. Aid provides funding for long-term development but may also act, like natural resource revenues, as a '**resource curse**'. States which are financed by natural resources, aid or other income not raised through the political effort of persuading their citizens to pay taxes, may be less likely to develop effective

¹¹ http://www.un.org/esa/sustdev/documents/Monterrey_Consensus.htm

¹² P. Heller (2005): Understanding Fiscal Space, IMF Policy Discussion Paper PDP 05/04

¹³ Fox and Gurley, 2005. 44 out of 168 countries examined had tax ratios less than 15 percent in the 1990s, with 18 of those being in sub-Saharan Africa; 71% of African countries receiving more than 10% of GDP in aid had less than expected tax effort:: Stotsky et al. 1997. IMF

¹⁴ E.g. in Latin America, Brazil collects 35% of GDP in tax, and Mexico collects less than 15%, but both score poorly on numerous measures of the quality of public goods: OECD Latin America 2008; Africa Partnership Forum 2008: Development Finance in Africa: p.17.

¹⁵ OECD 2006 Development Co-operation Report (26 October 2006, para 47)

and democratic institutions.¹⁶ If aid does undermine 'tax effort' it may also undermine public expenditure accountability, leading to the possibility of irresponsible spending by governments, further diminishing incentives to raise domestic revenues.¹⁷ The evidence that this is happening is unclear.¹⁸ But there is econometric evidence that aid is undermining the quality of tax systems.¹⁹ The OECD DAC has noted that in cases in which aid constitutes 10% or more of GDP, as much as 10% of grant flows may be offset by domestic revenue reduction; it also seems likely that loans and grants may have different effects on tax 'effort'.²⁰

3. Tax Systems build Effective States

Few governance challenges are as important as collecting taxes. Taxes supply the revenues to govern, and therefore establishing basic tax systems is a **priority** in even the most fragile contexts. Widespread corruption, tax avoidance and evasion by politically influential businesses and access to tax havens by wealthy taxpayers all undermine tax effort. The political challenge for building an effective state is not only *what* and *how much* to tax, but *how* to tax, *who* pays, and *why* (that is, the balance between degrees of voluntary compliance and coercion).

'Revenue is the chief preoccupation of the state. Nay more, it is the state'.²¹

Sound and fair domestic taxation systems **promote good governance** because:

- Raising taxes **efficiently** requires political effort to secure taxpayer consent;
- Raising taxes **effectively** requires the development of a competent bureaucracy; and
- Raising taxes **equitably** requires concern for the fair and equal treatment of citizens by the state.

¹⁶ For a useful review of the 'Resource Curse' evidence, see A. Rosser (2006): The Political Economy of the Resource Curse: A Literature Survey: IDS Working Paper.

¹⁷ S. Gupta et al. (2003): Foreign aid and revenue response: does the composition of aid matter? IMF Working Paper No. 03/176; L. Gambaro et al (2007): Does Aid Decrease Tax Revenue in Developing Countries? LSE.

¹⁸ Brautigam and Knack (2004), Remmer (2004) and Kjaer (2004) found it was. The 2006 DFID review of general budget support concluded that it did not dampen domestic resource mobilisation efforts,. Some studies have found that aid, especially aid grants rather than loans, reduces tax effort: S. Feeny: Foreign Aid and Fiscal Governance in Melanesia : World Development, vol. 35, no. 3, March 2007, pp. 439-53.

¹⁹ S. Knack 2008: Sovereign Rents and the Quality of Tax Policy and Administration: World Bank working paper 4773.

²⁰ Clemens et al (2004): Foreign Aid: Grants versus Loans: find that additional grants, whether from an overall increase in foreign aid or from a conversion of loans into grants, may be completely offset by a reduction in domestic revenues in countries where institutions are weakest. This risk is perceived to be much lower in the case of loan financing.

²¹ Edmund Burke, quoted in P. O'Brien (2001): Fiscal Exceptionalism: Great Britain and Its European Rivals: LSE Paper 65/01: p.21

Legitimacy strongly influences citizens' willingness to pay tax.²² State legitimacy emerges from the quality of governance institutions and the extent to which they deliver political stability, accountability, rule of law, the absence of violence, regulatory quality and control of corruption. **Trust** in the government, in the justice system and in the legislature helps citizens' confidence that that government will spend tax revenues wisely and efficiently. This increases tax compliance, which in turn increases the efficiency of tax collection.

From coercion to consent: So creating a high **tax 'morale'** (citizens' intrinsic willingness to pay taxes based on acceptance of the legitimacy and effectiveness of the state) requires governments not just to be able to compel but also to persuade - it is hard to raise tax efficiently without 'bargaining' with citizens and building up their trust in government.²³ Tax levels reflect citizens' perception of the capability and responsiveness of the state. As a result, despite frequent tax changes, the government's share of national income usually remains remarkably constant.

'No representation without taxation'? Tax has been central to **the emergence of effective democracy** at least since 1340, when the English Parliament for the first time explicitly linked its approval of taxation to the redress of public grievances over bad governance. Citizens as voter-taxpayers, acting collectively, can play a key part in building the constitutional checks and balances that provide oversight of the executive. This applies not only to the political evolution of all OECD countries;²⁴ but also in developing countries.²⁵

So, where governments must finance themselves by **persuading rather than coercing** their citizens, they are more likely to rule democratically and to spend

²² B. Torgler et al: Tax Compliance, Tax Morale and Governance Quality: Working Paper 2007/17; L. Feld et al (2007): Tax Compliance as the Result of a Psychological Tax Contract: The Role of Incentives and Responsive Regulation: Law & Policy 29 (1), 102–120; J. Scott. 1987. Resistance without Protest and Without Organisation.

²³ An increase in the trust in government by one unit increases tax morale by over 5 percent: B. Torgler (2001b). What Do We Know about Tax Morale and Tax Compliance?, International Review of Economics and Business (RISEC). 48: 395-419.

²⁴ D. North: Institutions, Institutional Change, and Economic Performance: Cambridge 1990: in high-income countries have high tax 'take' that pays for public services and 'public goods' such as effective legal systems that help to generate and maintain the state's high legitimacy.

²⁵ e.g. C. Clapham: War and State formation in Ethiopia and Eritrea: 2000; O-H Fjeldstad (2004): To Pay Or Not to Pay?: Citizens Views on Taxation in Local Authorities in Tanzania.; D. Hlophe et al (2002): ... And their Hearts and Minds will Follow? Tax Collection, Authority and legitimacy in Democratic South Africa

money providing services to citizens.²⁶ As a result, increases in the tax burden can predict increases in the degree of democracy and constraints on state authority.²⁷ The benefits of strengthening tax systems on the social contract between governments and citizens are dependent on country circumstances. Progress will be most readily realised in an already accountable state, where there is representation of tax payers, and the social contract already in place. In Argentina since 1983, for example, the provincial governments most dependent on taxing their citizens have become more democratic. By contrast, in those provinces most generously supplied with financial transfers from central government or oil revenues, local political leaders have tended instead to buy off or suppress competition from democratic opposition groups.²⁸

The ‘fiscal social contract’ is the implicit agreement between the state and its citizens that taxes are paid in return for good governance. A ‘fiscal social contract’ has two components: a high level of routine, institutionalised process for citizens to be engaged in decisions about how public revenues are raised and spent; and general acceptance that obligations to pay taxes (‘contributive justice’) and entitlements to the benefits of public expenditure (‘distributive justice’) are important components of citizenship.²⁹ These processes strengthen domestic accountability and encourage the emergence of civil society to claim citizens’ rights: ‘*No taxation without representation*’.³⁰

Oversight: Parliaments, audit agencies and other oversight institutions, business associations and the media can then scrutinise government revenues and expenditures. For example, taxation appears to be driving the emergence of political ‘voice’ within the business communities in Tanzania, Uganda and Zambia.³¹ Post-apartheid South Africa’s strong ‘fiscal social contract’³² compares with the apparent lack of a ‘fiscal social contract’ delivering for the poor in countries as diverse as

²⁶ Ross: Does Taxation Lead to Representation? The British Journal of Political Science (2004), 34: 229-249.

²⁷ Ross (2004); Mahon (2005).

²⁸ C. Gervasoni (2006): A Rentier Theory of Subnational Authoritarian Enclaves: The Politically Regressive Effects of Progressive Federal Revenue Distribution: The American Political Science Association.

²⁹ Moore and Schneider (2004): p.3

³⁰ Eg. M. Levi 1988. Of Revenue and Rule. Berkeley; R. Hettich: Democratic Choice and Taxation 2005; Mahon, J.E. (2006): Revenue and Regimes: Washington, DC; M. Moore: How Does Taxation Affect the Quality of Governance? IDS 2006; J. Di John: The Political Economy of Taxation and Tax Reform in Developing Countries: WIDER 2006; OECD DAC: Taxation and National Accountability: GOVNET 2007; D. Brautigam et al: Taxation and State Building in Developing Countries: Cambridge 2008.

³¹ E.g. O-H. Fjeldstad and L. Rakner (2003): Taxation and tax reforms in developing countries: Illustrations from sub-Saharan Africa: Christian Michelsen Institute, Bergen.

³² G. Smith (2003): The Power of Politics: the Performance of the South African Revenue Service and Some of its Implications.

Peru³³, Nigeria,³⁴ and China.³⁵ State legitimacy and social cohesion are closely correlated with increasing tax compliance.³⁶

Anti-Corruption: Tax encourages transparency in the way public resources are raised and managed as citizens seek ‘value for money’ in public expenditure from their tax revenues. This demand for greater transparency provides a political incentive to tackle corruption. Corruption in many developing countries means that firms with political connections pay tax at significantly lower effective rates than other businesses.³⁷ Countering corruption throughout the tax system therefore matters not just to raise revenues but because of the wider importance of tax for good governance.³⁸

Delivering Services to Poor People: Better political representation, stronger civil society ‘voice’, and a more effective bureaucracy mean poor people are more likely to be better served by the government. The role of effective tax systems is reflected in two leading development successes in Africa, Mauritius and Botswana.³⁹

Effective Bureaucracy: Taxation has always acted as a key incentive for states to create competent administration. Effective taxes require collecting enormous amounts of information efficiently: for example, this process occurred in England through the compilation of a complete register in the Domesday Book of all taxable assets in 1086.⁴⁰ This ‘*Domesday Book dynamic*’ has happened not just in Western Europe but also in recent examples of successful developmental states such as in East Asia’s ‘tiger’ economies.⁴¹

Accountable administration: Revenue authorities in all countries have considerable power and discretion. But in many developing countries without effective institutional checks and balances it is difficult to ensure that discretionary authority is used fairly

³³ D. Mostajo (2004): Prospects for an Integral Tax Reform With Equity: Toward a Fiscal Covenant in Peru: DFID.

³⁴ J. Guyer (1992): Representation without Taxation: Democracy in Rural Nigeria, 1952–1990’, *African Studies Review* 35.1: 41–80.

³⁵ Bernstein, T.P. and Lu, X. (2003) *Taxation Without Representation in Contemporary China*, Cambridge.

³⁶ Li (2005):

³⁷ A. Adhikari et al (2006): Public policy, political connections, and effective tax rates: longitudinal evidence from Malaysia: *Journal of Accounting and Public Policy*, vol. 25, no. 5, pp. 574-595.

³⁸ O-H. Fjeldstad and B. Tungodden (2001): Fiscal corruption: A vice or a virtue? CMI working paper.

³⁹ E.g. D. Brautigam *Contingent Capacity: Export Taxation and State-building in Mauritius: 2007*.

⁴⁰ T. Besley et al (2007): *The Origins of State Capacity: Property Rights, Taxation, and Politics: CEPR Discussion Papers: 6370*.

⁴¹ A. Sindzingre: *Financing the Developmental State: ODI 2006*.

and transparently. As a result, allegations of tax evasion are often used as a political instrument to harass opponents of the regime; or at a petty level to extract bribes from taxpayers and businesses. Tax authorities are also often under enormous political pressure to raise revenues, creating widespread undermining of due process and taxpayer rights. Introducing greater transparency and external oversight, and reducing the scope of discretion [and so also corruption] is therefore a priority.

Voters and taxpayers: Tax is always highly political: taxes express the ‘political settlement’ that defines the collective national interest. Taxes both fund public goods and also help to entrench political authority.⁴² In democracies there is always a tension over fiscal discipline between citizens’ interests as voters or citizens’ concerns as taxpayers. In developing countries this relationship between the citizen as taxpayer or as voter is particularly difficult since most voters do not pay tax. In Bangladesh, for example, less than one percent of the population fall within the tax net, with 4% of taxpayers (or less than 0.04% of the population) paying 40% of the tax revenue while 50% of taxpayers (less than 0.5% of the population) pay less than 1% of the total tax revenue.⁴³ The same ‘social contract’ is needed with the private sector. The informal sector is a major part of the economy in many developing countries in part because of low ‘tax morale’ (intrinsic willingness to pay taxes).⁴⁴ Business owners like all citizens do not want to pay taxes unless they feel the tax is legitimate, services will be delivered, and others are also paying their fair share.

The **political settlement** for ‘elites to pay taxes’⁴⁵ is, however, weak in many developing countries: in other words, too many politically powerful people may not be prepared to pay a fair share of the tax burden to improve the effectiveness of the state. As a result, there is no political will to address huge inequalities by taxing easily identified assets such as property. This **lack of ‘fiscal legitimacy’** exacerbates the doubts of ordinary citizens about whether governments will spend tax revenues wisely. In Latin America, for instance, less than 25% of the population

⁴² T. Besley et al: The Origins of State Capacity: Property Rights, Taxation, and Politics: CEPR 2007; DFID (2007): DFID and Statebuilding.

⁴³ T. Sarker & Y. Kitamura (2006): Technical Assistance in Fiscal Policy and Tax Administration in Developing Countries: The State of Nature in Bangladesh: Keio University Tokyo.

⁴⁴ B Torgler and F. Schneider (2007): Shadow Economy, Tax Morale, Governance and Institutional Quality: Panel Data: IZA Discussion Paper No. 2563

⁴⁵ Stotsky, J. and WoldeMariam, A. 1997. Tax Effort in Sub-Saharan Africa: IMF WP/97/101, Washington, DC

believe taxes are well spent.⁴⁶ This can also lead to an **excessive use of coercion to raise tax**, further alienating citizens from an already fragile state.⁴⁷

*'Pay your taxes and set your country free'*⁴⁸

Fragile states: Healthy tax systems improve the state's capacity to ensure **security** which is crucial to its development. The tax/GDP ratio is strongly and negatively associated with the incidence of conflict: as taxation increases as a share of national economic output, conflict becomes less likely.⁴⁹ To achieve this, promoting tax systems that explicitly seek to build government legitimacy and effectiveness, creating in turn a culture of compliance among citizens, is particularly important for states that are 'fragile' or **emerging from conflict**.⁵⁰ 'in post-war economies, capacity to collect even the 'easiest' taxes is closely linked to issues of security and the legitimate monopolization of violence on the part of the central state.'⁵¹ Better **customs** is a priority in fragile states since taxation of imports and exports is usually the most feasible source of revenue.

During democratic transitions or post-conflict peace agreements, '**fiscal pacts**' have, especially in Latin America, helped to legitimise the state's role to tax for agreed development outcomes and political reconciliation.

Local Government: The 'fiscal social contract' matters not just at national but also at sub-national levels of government – indeed at local level it may matter more because citizens can move more easily to escape punitive local taxation and may see the benefits more immediately. For example, in Tanzania and Zambia, where district populations have the greatest scope to flee from coercive local taxation, district governments spend higher proportions of their revenues on providing services for their citizens.⁵²

⁴⁶ Latinobarometro Surveys, quoted in OECD Latin American Economic Outlook 2008, ch.3, p.32.

⁴⁷ E.g. Juul, K. (2006) 'Decentralization, Local Taxation and Citizenship in Senegal', *Development and Change* 37.4: 821–46

⁴⁸ Kenyan Revenue Authority slogan.

⁴⁹ C. Hendrix 2007. *Leviathan in the Tropics? Environment, State Capacity, and Civil Conflict in the Developing World*

⁵⁰ Bird, R., et al (2006): Societal Institutions and Tax Effort in Developing Countries: in Alm, et al (eds.), *The Challenges of Tax Reform in the Global Economy*. New York: the size and nature of tax systems largely reflects the political context; see also D. Acemoglu (2005): *Politics and Economics in Weak and Strong States*: NBER.

⁵¹ J. Di John, op cit, p.18. See also T. Addison et al. 2002. *Taxation and Reform in Conflict-Affected Countries*, IDS. See also M. Manthri (2008): *Security sector financing and fiscal sustainability in Afghanistan*: ODI.

⁵² B. Hoffman and C. Gibson (2006): *Political Accountability and Fiscal Governance: Evidence from Tanzania and Zambia*: UCLA.

Box 1: The State-building approach to reforming tax systems

Engage with the political process:

- **Politics matters!** Understand the **history and political context** of taxation.
- **Conduct 'tax morale' surveys** of citizen attitudes to the legitimacy of the tax system [for more detail, see Briefing Note 2: *Better Taxes, Better Governance*].
- **Strengthen the political rationale for broadening the tax base**, in ways that explicitly encourage citizen groups as taxpayers to seek political 'voice'.

Promote:

Accountability

- **Parliamentary and other institutional oversight of the tax authority.**
- **Media and civil society** attention to tax, especially the importance of a sound tax system for poverty reduction and development.
- **Taxpayers associations**, to demand greater accountability.
- **Greater visibility of direct taxation – income and property taxes** – that appear particularly important in promoting political representation.
- **Link taxes paid and benefits/services received:** Compliance rates go up when citizens and businesses know what they are getting in return for their payments.

Responsiveness

- Balance discretionary powers of the tax authority with **taxpayer rights, a customer service** attitude to taxpayers, and better **appeals process** to improve trust.

Transparency

- **Private sector associations** formally engaging with government over tax policy and its administration.
- **Transparent laws, regulations and procedures,**

Capacity

- **International networks of tax administrators**, to raise professional standards and ethics.
- The capacity, accountability and transparency of **sub-national taxation.**

Source: DFID/FIAS Programme on Promoting Investment, Growth and Governance through Improved Tax Systems 2007; Business Taxation as State-Building: TERI December 2008.

4. Taxes influence Economic Growth

Taxation provides government with the capacity to manage the economy and shape society. Taxes can promote economic growth by providing incentives to encourage and reward efficiency, entrepreneurship, savings and investment. Economic growth is the single most important way of pulling people out of poverty. Tax systems need to raise revenues effectively and must evolve with changes in the economy. They do this by minimising impact on economic efficiency and by allowing the tax 'take' to

grow in line with economic growth ('buoyancy'): taxes in low-income countries are often not 'buoyant'.⁵³

An effective tax system will encourage an **efficient economy** and movement **from the informal to the formal economy**, by providing an environment conducive for business, including through reducing the costs involved in complying with tax regulations.⁵⁴ Taxes fund the essential 'public goods' like public security and the 'rule of law' on which economic growth depends. The state's capacity to raise taxes is closely linked to its ability to deliver economic growth.⁵⁵

But the **relationship between taxation and economic growth is complicated**, depending on the level of tax burdens, the impact of the design of tax systems and the characteristics of individual taxes. Some countries with high tax burdens achieve high growth rates and other countries with low tax burdens have low growth rates.⁵⁶ This highlights the fact that it is not only the overall tax burden that matters but also the structure of the tax system, comprising factors such as the balance between different types of tax and the way that individual taxes are designed.⁵⁷

What is clear, however, is that **badly designed tax systems undermine the prospects for growth and job creation** by discouraging business expansion.⁵⁸ As a result, many developing countries suffer from a comparative lack of medium-sized firms, a phenomenon known as the '*missing middle*'.⁵⁹ This is because medium-sized businesses often pay a disproportionate share of the tax burden, since large companies use political clout to secure tax exemptions, and much of the small business community 'disappears' into informality⁶⁰.

⁵³ J. Teera (2002): Tax performance: A comparative study: *University of Bath Working Paper*.

⁵⁴ Costs (both directly financial, and in time) for complying with domestic taxes have been estimated as 2 to 10 percent of the revenue of these taxes, up to 2.5 percent of GDP: C.Evans (2003): Overview of Recent Research into Taxation Operating Cost, *Journal of Tax Research*.

⁵⁵ Through the ability to encourage economic growth, decrease inflation, increase private investment, and develop policies to manage the economy effectively: M. Arbetman-Rabinowitz et al 2007.

⁵⁶ E.g. the United States had its greatest periods of economic growth during those years in which the tax rates were the highest (Slemrod and Bakija 1996).

⁵⁷ This has been demonstrated for OECD countries by Å. Johansson, C. Heady, J. Arnold, B. Brys and L. Vartia (2008), *Tax and Economic Growth*, Economics Department Working Paper No. 620, OECD:Paris.

⁵⁸ The World Bank's Doing Business Report in 2004 pointed out that the data from the Enterprise Surveys over complaints about tax rates were completely uncorrelated with the actual tax rates (i.e., businesses always complain about tax, no matter how low).

⁵⁹ J. Tybout (2000) Manufacturing Firms in Developing Countries: How Well Do They Do, and Why?: *Journal of Economic Literature*.

⁶⁰ B. Gauthier and R. Reinnika (2006): Shifting Tax Burdens through Exemptions and Evasion: An Empirical Investigation of Uganda: *Journal of African Economies*, Vol. 15, pp.373- 398.

A **'pro-growth' tax regime** avoids economic distortions and disincentives to effort and risk-taking, and encourages formalisation by the informal sector. In many developing countries however, companies perceive tax systems as a significant barrier to growth, with inefficient and corrupt tax administration among the top five obstacles to doing business.⁶¹ Taxes affect prices, and can distort the efficient allocation of resources, and dampen incentives to work, trade, save and invest. Simpler, lower taxes therefore may create fewer economic distortions but may undermine social development (see Section 5 below). Low tax rates also require a broad tax base in order to raise the required revenues.

Broadening the tax base and tackling informality: In many developing countries, a broader tax base allowing lower tax rates could reduce administration and compliance costs, minimise economic distortions and so may be able to promote the economic growth and job creation needed for poverty reduction. Lower tax rates should increase the incentive for the sizeable **informal economies** of many developing countries to formalise, thus increasing tax revenues and/or allowing further reduction in tax rates. Operating in the informal economy reduces access to formal credit, to markets and to government contracts. Encouraging formalisation requires a comprehensive strategy to reduce costs and barriers to formal markets, and encourage engagement with the state. While the tax system is rarely the sole reason for business to operate informally, it can often be a major contributing factor. Tax systems for growth therefore often emphasise **indirect taxation** of consumption, and also provide incentives for the informal sector to formalise. Box 2 lists some of the issues that are of importance.

Box 2: Towards pro-growth tax systems:

- **Broaden the tax base and lower tax rates** to encourage economic activity.
- **Measure, reduce or eliminate exemptions and incentives ('tax expenditure')**.
- **Improve tax administration:**
 - Simplify laws and regulations
 - Streamline payment procedures: Tax administration is more often cited as a problem than tax policy.
 - Establish a dedicated tax department for Small and Medium enterprises
 - Consider a simplified tax regime for micro and 'informal' sector.
 - Develop taxpayer education and outreach to small and informal firms.
- **Support taxpayer and business associations'** engagement with the state on tax issues.
- **Carry out tax compliance cost surveys** to identify the full extent of the burden of the tax system on different types of business
- **Remove barriers to formalisation** such as retroactive taxation for businesses that formalise

Source: DFID/FIAS Programme on Promoting Investment, Growth, Governance through Tax Systems 2007.

Value Added Tax (VAT), combined with moderate taxes on corporate and personal income, has become the **main instrument** to achieve a broader tax base. This change has been pushed by the concern that increased international tax competition – different tax rates or provisions in different countries – makes it more difficult for governments to collect direct (ie. corporate and personal income) taxes, so that indirect taxes on consumption become a more important source of revenue. The move may improve economic efficiency and competitiveness. The introduction of VAT has been the most significant tax policy reform in the last two decades, usually replacing inefficient and distorting sales taxes and tariffs. Today, 141 countries worldwide operate VAT. VAT has developed in conjunction with the reform of excise taxes that now usually concentrate on a small number of high revenue potential goods, in particular on alcohol, tobacco, and fuel.

An efficient VAT is a major contribution to revenue generation, but the **operation of VAT creates challenges for developing countries and raises equity concerns**. VAT must be designed not to be regressive or to overburden the formal economy and should offer incentives to the informal sector to formalise. A suitable registration threshold to relieve smaller businesses of VAT may be needed. Other **administrative challenges** of VAT include the refund process (which should be quick, efficient and secure against fraud) and the prevention of evasion (which may require measures such as specialised VAT audits and invoice cross-checking systems).

The proliferation of other inefficient **tax incentives, concessions and exemptions ('tax expenditures')** often non-transparent and motivated by short-term political advantage or the influence of powerful vested interests, can prove costly to developing countries – for example in Guatemala these lost revenues are estimated to equal in value the country's entire total tax receipts.⁶² The poor seldom benefit.⁶³

⁶² A. Mann et al. (2000): Administracion Tributaria de Guatemala: Un Estudio de Benchmarking: USAID.

⁶³ E.g. in Mexico the poorest quintile receives less than 10% of the subsidies implicit in VAT exemptions: Larre and Heady 2007.

Agriculture and urbanisation: efficient taxes are an urban phenomenon - the size of public revenue in different countries closely mirrors the agricultural share of their GDP (along with per capita GDP).⁶⁴ Both practical and political reasons make it difficult to tax the agricultural sector. Doing so however may stimulate economic growth and modernisation of the economy by shifting resources away from inefficient farming.⁶⁵

Special sectoral taxation arrangements apply to capital-intensive, risky **petroleum and mining** operations. Production royalties, special income taxes, 'resource rent' taxes and production sharing arrangements are common in these industries and need careful design and management. This will ensure that the state collects a **fair share** of the profits generated, consistent with the investors earning an appropriate return that compensates for those exceptional costs and risks.

Better local taxes: Sub-national tax reforms are often needed, especially if decentralisation is to be effective. At present, many local governments in developing countries rely on a plethora of business licences, fees, duties, fines and so forth that hinder economic growth by unduly burdening business in general, and small and medium-sized firms in particular.

Trade liberalisation: Globalisation has had a major impact on the design of tax systems and the composition of tax revenues. As a result of trade liberalisation, taxes on cross-border trade - which constituted one of the main pillars of the tax system of developing countries in the 1980s - have been reduced, and trade tax revenues have decreased. This has caused a shift in the focus of the tax system from the taxation of cross-border transactions to domestic revenue mobilisation, but the transition remains highly problematic especially in low-income countries.⁶⁶ Meanwhile, customs authorities are increasingly concerned about non-tax issues, such as border security and drug-smuggling. The World Customs Organisation, through its mandate to promote international trade, is achieving progress on international harmonisation in customs policy and practice.

⁶⁴ Martinez-Vazquez and Torgler 2006.

⁶⁵ Bird, R. 1974. *Taxing Agricultural Land in Developing Countries*. Harvard University Press.

⁶⁶ On average, low-income countries have replaced less than 30% of the resulting lost revenues by introducing VAT and other new indirect taxes, because of large informal sector (T. Baumsgaard & M. Keen 2005: Tax revenue and (or?) trade liberalization: *IMF Working Paper* 05/112; S. Emran and J. Stiglitz, 2002: On selective indirect tax reform in developing countries: University of Columbia.)

Tax competition for foreign direct investment: The UK's 2001 White Paper on International Development warned of the dangers of countries competing for foreign investment by lowering corporate taxes to the point of undermining the national revenue base and creating economic distortions.⁶⁷ Competition for foreign direct investment creates constructive pressure to reduce corporate taxes, but also leads to concerns about harmful tax reduction undermining tax revenues. In an environment of increasing global competition for investment, low tax rates can encourage new investment and even contribute to the relocation of existing business operations from high tax areas. However, tax concessions geared towards attracting foreign investment can also put local businesses at a disadvantage. That impedes the development of the domestic private sector, essential to job creation and poverty reduction.

International aspects of tax design are important but complex. The relevant issues include transfer pricing, thin capitalisation and other leakage or evasion mechanisms, Double Taxation Treaties and international exchange of information, and regional tax cooperation initiatives to facilitate economic growth. The UK has a potentially important role to ensure that the international structures around taxation support developmental outcomes.

5. Taxes influence Inequality and Poverty Reduction

To secure the consent of the population, tax systems must not only be fair but **perceived to be fair**. The **social impacts** of taxation, including on **gender and equity**, reflect tax as 'the official theory of inequality'.⁶⁸ Fair tax systems achieve **horizontal equity** (taxpayers in the same circumstances with the same level of income pay the same amount in taxes) and **vertical equity** (people with different levels of income shoulder different tax burdens).⁶⁹

⁶⁷ DFID (2001): Eliminating World Poverty: Chapter 4.

⁶⁸ Guyer (1992), p.57. Equity in tax systems can be based on vertical or horizontal inequality.

⁶⁹ Different concepts of tax fairness change how people with different incomes should be taxed (e.g., regressively, proportionately, or progressively), based on different beliefs about whether tax burdens should match the benefits that taxpayers receive from government goods and services.

Social justice and equity can be promoted through **progressive direct taxation**, especially on income and on less mobile capital assets such as property. Social welfare and therefore tax levels rise with increasing levels of development: the tax-take in low-income countries is on average 18% of GDP, 22% in middle-income countries and 29% of GDP in high-income countries.⁷⁰ High-income countries with high levels of tax take, are also the countries with the **highest levels of human development**. The relationship between social equality and economic enterprise is politically contested around assumptions about the impact of tax on the balance between personal prosperity and equality.

Redistribution through taxes and welfare transfers has been central to reducing inequality in developed countries, and may be necessary to deliver the MDGs and human development generally, but progressive taxes in highly unequal societies is difficult to achieve. As a result, personal **income tax** still plays only a marginal role in many developing countries: it yields 8-10% of GDP in developed countries (and is paid on average by around 46% of the adult population), but in developing countries raises less than 2% of GDP (paid, on average, by fewer than 5% of the population); and direct taxation in total raises between 12% and 18% of GDP in OECD countries, but only 2% to 6% in the developing world.⁷¹ Similarly, **property taxes** in many developing countries are not well established. Land taxes might be a stable source of

Box 3: Towards pro-equity tax systems:

- **Broaden the tax base** and improve progressivity through income tax & property taxes.
- **Eliminate tax exemptions** and incentives granted to politically powerful lobbies
- Tackle tax causes of **capital flight**: the 2005 Commission for Africa noted 40% of African savings is held outside the continent (compared to 3% for South Asia), with the outflow estimated at \$15 billion per year over the last decade.
- **Establish a dedicated tax unit** for Small and Medium enterprises.
- **Consider a simplified tax regime** for micro and 'informal' sector.
- **Develop taxpayer education** and outreach to the informal sectors.
- **Support civil society groups'** capacity to engage with the state on tax issues.
- **Carry out tax informality surveys and surveys of taxpayer perceptions**, to identify willingness to pay issues around inequality and social injustice
- **Apply Gender impact assessments** to tax policy and its administration, and gender disaggregated tax incidence analysis.

relatively progressive sub-national revenue generation, but often create strong political resistance and require improved valuation and collection systems. The

⁷⁰ Bird 2007.

⁷¹ R. Bird & R. Zolt: Redistribution via Taxation: The Limited Role of the Personal Income Tax in Developing Countries UCLReview 2005.

political process has to resolve the trade-off between equity and efficiency in tax systems,⁷² but must **minimise the burden on the poor**. Simple flat taxes are regressive, but complex systems often pose a disproportionate burden on small taxpayers and the poor as both employees and consumers. For example, tax ‘incidence’ analysis (identifying who pays what taxes) often reveals that certain taxes tend to be particularly burdensome for small farmers, or hit poor urban consumers.

6. Tax matters for Climate Change and the Environment

Better tax systems and international collaboration on taxation to tackle **climate change** and protect the environment will be required, including in developing countries. Global efforts to reduce greenhouse gas emissions need to be actively supported by appropriate tax measures. Taxation has a role to play in helping countries reduce the amount of green house gases they emit. Global emissions are far in excess of those the planet can absorb because people do not directly have to pay the cost of the damage caused by these gases.

Taxes which reflect the cost of carbon could help remedy this ‘market failure’ by directly signalling the cost of this damage to producers and consumers. That is, taxes can set a price on the production or consumption of carbon. The Stern Report in 2007 concluded that ‘both taxes and tradable quotas have the potential to deliver emission reductions efficiently’⁷³. An IMF study in 2008 observed that climate change ‘as a global externality problem, calls for some degree of international fiscal cooperation’ and that ‘the potential fiscal implications are immediate as well as lasting’ for all developing and developed countries.⁷⁴ So both market mechanisms and taxes will have a role to play.

Environmental taxes: Taxation can help to curb undesirable or promote desirable economic behaviour in the use of energy, transport and resources, and the emission of pollution. Promoting sustainable and competitive natural resource sectors requires the **right mix of taxes**, both to raise revenues and to change behaviours. Ill-conceived tax regimes generate serious obstacles to the development of sustainable

⁷² Inequality aversion is very sensitive to the way that the issue is framed: Pirttilä, J. et al (2007) Estimating Inequality Aversion: 2026.

⁷³ Op cit., p.352.

⁷⁴ IMF: The Fiscal Implications of Climate Change: 2008.

natural resource sectors and competitive natural resource industries. Designing tax regimes with a focus on maximising revenues from natural resource sectors often leads to a net reduction in economic welfare. The tropical forestry sector provides an example of this: Emissions from deforestation by far outweigh revenues generated from the exploitation or conversion of forests. Landfill taxation has been shown to be particularly effective in changing private sector behaviours in the UK.⁷⁵

Box 4: Tax systems for climate change and the environment

Incentives to encourage carbon emissions reduction and generate new technologies for mitigation and adaptation to climate change will be part of the international and domestic response to the urgent need to build environmentally sustainable economies. Environmental tax measures either impose a tax cost on a product or activity that is environmentally damaging, or they give a tax benefit to a product or activity that is environmentally beneficial: for example, Kenya and Tanzania have a 120% excise duty on plastic shopping bags.

What is needed remains uncertain but is likely to include:

- **Carbon taxes** to encourage energy efficiency and reduced carbon dioxide emissions. Because the global damage caused by greenhouse gases is the same where-ever they are emitted, any carbon tax should ideally be standardised across countries.
- **Environmental taxes** to create incentives to use cleaner technologies and to invest in approved energy saving technologies.

Part 3: What DFID is doing

7. Background: DFID's Record on Tax Reform

DFID has a long record of successful support for tax reform. Between 2001 and 2006, DFID undertook 181 tax-related projects or programmes across 44 countries, with a financial commitment of about £159 million. The principal aim was to support developing countries to improve their tax and customs **administration**, with the emphasis on better organisational governance, human resource development and tax efficiency. More recent work has focused on **tax policy** and **tax systems** that can contribute to growth, state-building and the 'fiscal social contract'. DFID has been working in partnership with other development agencies in at least half of the tax projects implemented since 2001.

⁷⁵ PwC: Saving the Planet – can Tax and Regulation Help? Discussion paper, July 2007.

Tax reforms supported by DFID have been particularly important in Africa: they were crucial for restoring public finances, and so delivering on the MDGs, in the post-conflict contexts of **Mozambique** (where customs revenues, as a percentage of a fast-growing GDP, increased from 2.9% in 1996 to 5.8% in 2005); and **Rwanda** (where the Rwanda Revenue Authority doubled tax revenue between 2002 and 2005 to 14% of GDP); in improving administration in Uganda, Tanzania, Zambia and Lesotho; and in improving tax policy in Ethiopia. In Asia, DFID has helped deliver improved tax policy and administration of particular taxes in Pakistan, and significant state-level reforms in India. In Latin America, DFID, in collaboration with the Inter-American Development Bank, contributed to rights-based approaches to taxation, in developing the 'fiscal social contract', which is particularly difficult to develop in a region of high inequality.

DFID has helped a number of countries – especially in Africa - to establish **unified revenue authorities** and to give more autonomy to their revenue administration to facilitate reform, including the modernisation of human resource management. Experience with such reforms has been mixed. Success depends on such factors as the context of the government administrative systems, insulation from political interference, and the extent of corruption in the public sector. Better standardised diagnostic tools and international benchmarks are needed to evaluate what works best.⁷⁶

DFID also supports a number of important **international initiatives** that are directly related to tax and improving public finances.. These include the Extractive Industries Transparency Initiative, the Investment Climate Facility for Africa, and the Aid for Trade programme.

8. DFID's Comparative Advantage: Tax as state-building

There is **no 'ideal' tax regime**: each country's political process has to decide on the fair and feasible mix of taxation appropriate for its context. Politics, policies and administration all matter. Technical assistance programmes in the tax area have

⁷⁶ L. Barbarone et al: Reforming Tax Systems: The World Bank Record in the 1990s: World Bank 2003.

been often too narrowly focused and too short-term. The long-term needs of aid recipient countries require a complex balancing of different objectives in the tax system. Reform programmes need to reflect the politics of tax reform that can deliver both better tax policy and administration, while improving the tax compliance understood as the manifestation of the social contract between the state and society.

Building on detailed political economy analysis, the politics of tax, tax policy and administration must also be understood together within the broader system of public finance. Successful tax reform requires an institutional framework that can provide an appropriate balance between raising revenues, promoting economic growth, advancing social development, and developing the legitimacy of the state. Too often however, reform of tax administration may be too concerned with ease of collection; or policy reforms may be too impractical. The quality of tax administration matters, since higher taxes may discourage enterprise and encourage greater evasion. Trust in government and improving public services will enhance **'tax morale'** or citizens' willingness to pay.

Tax as State-building: Many developing countries need better **tax systems** – tax policy and its administration reformed in a coherent fashion based on a good analysis of the **political economy**. Tax effort requires the political ambition for constructing an effective state supported by citizens' and private sector's willingness to pay tax. Political interests and identities are created in part through the rhetoric around taxation. The tax system articulates political assumptions about the governance, the market, consumption and society. Political factors shape the feasibility of tax and tax reform: for example, reform opportunities are often dictated by political and electoral cycles. The political challenge is particularly problematic in efforts to increase the formal sector of the economy, given the sizeable percentage of the electorate who work in the informal sector in many developing countries. In contexts where both tax policy and its administration may suffer from political corruption, reform may be particularly challenging. All tax systems depend on the trustworthiness and fiscal prudence of political leaders.

Effective tax policies are those that are technically sound, properly sequenced and administratively, as well as politically, feasible. Many developing countries lack the capacity to analyse properly, within their national contexts, the implications of tax policy options advocated by international agencies. Stable, predictable tax regimes are important as an indication of governments' commitment to the 'rule of law'. Frequent alterations in tax rates diminish the credibility and predictability of the tax regime. Reducing such volatility and improving predictability will improve both the investment climate and citizens' voluntary compliance.

Better tax administration: weaknesses within the administrative system, more than tax policy itself, are often a major constraint on private sector development.⁷⁷ But evasion by business is also often rampant.⁷⁸ DFID recognises that, to promote political stability, better governance, stronger social cohesion and sustainable economic growth, while improving the efficiency of tax collection, a modern tax administration must aspire to develop the features outlined in Box 5.

Box 5: Reforming tax administration

A modern tax system and its administration aspires to promote voluntary compliance through the following desirable features:

- **Clear and simple laws, better information and taxpayer services** to minimize taxpayer effort and compliance costs.
- **Efficient collection systems and procedures** by simple forms and straightforward assessment, filing, and payment arrangements to ease administration and compliance.
- **Adequate enforcement power of tax administration** to ensure compliance with basic obligations by taxpayers on record keeping, return filing, and voluntary payment.
- **Risk analysis** to cut unnecessary, unproductive audits, while the non-compliers are targeted. This ensures efficiency in enforcement.
- **Function-based organizational structure:** Tax departments organized according to key functions (registration, filing and payment, processing, enforced collection, and audit) operate more efficiently than those structured by tax-type.
- **Automation** promotes risk-based management and fast and simple file returns, declarations and payments. Web-based information and inquiry services are also highly appreciated by taxpayers.
- **Focus on taxpayers by their revenue potential** paying particular attention to the large and medium taxpayers who are the largest sources of revenue.
- **Human resource management** for integrity and professionalism: eg. competitive and transparent process of recruitment, effective incentive mechanisms and training in ethics, supported by a zero tolerance approach to cases of dishonesty.

Source: IMF: Reforming Tax Administration and Implementing GST: 2006

⁷⁷ DFID/FIAS: Tax and the Investment Climate in Africa: Zambia workshop February 2007.

Tackling corruption: Transparency International's Corruption Barometer identifies tax authorities as among the most corrupt of government institutions.⁷⁹ Beyond specific measures to increase integrity in revenue administration, such as the establishment of an internal audit function, a comprehensive anti-corruption strategy addressing both the motives and opportunities for corruption is needed: see Box 6.

Box 6: Anti-corruption strategy for revenue administrations

*Tackle **opportunities** for corruption*

- Reorganise tax administration along functional lines
- Limit direct contact with taxpayers
- Arm's-length, transparent and non-discretionary business processes
- Computerise tax assessment and collection processes
- Regular internal audits
- Citizen and business feedback (corruption surveys, hotlines)

*Address **motives** for corruption*

- Competitive base pay and transparent reward system
- Code of conduct, ethics training and development of an esprit de corps
- Effective sanctions

Source: World Bank/IFC Note: Tax Administration and Corruption: 2007; M. Purohit: Corruption in Tax Administration: in A. Shah (ed.): Performance Accountability and Combating Corruption: World Bank 2007.

9. DFID's Tax Task Team

DFID's 'virtual' Tax Task Team is working in partnership within DFID and with other UK government departments, international organisations, partner countries and civil society to improve tax systems. The overall aim is to help partner governments deliver their **Monterrey Consensus** commitment to generate more domestic revenues to sustain the higher levels of expenditure made possible by aid, and to exit from aid dependency. Improved tax systems should eventually end aid dependency,⁸⁰ and provide countries with the resources needed to improve the fairness and accountability of tax systems.

⁷⁸ Transparency International: Global Corruption Report 2006, p.329: found evasion rate of 64% in one sector in Mozambique.

⁷⁹ The 2007 Report however suggests some improvement globally for corruption in tax authorities: Report p.10.

⁸⁰ S. Gupta et al. (2006): Macroeconomic Challenges of Scaling Up Aid to Africa: A Checklist: IMF.

The Tax Team has identified DFID's *comparative advantage* as highlighting the centrality of taxation for poverty reduction with a particular focus on **tax as state-building** (outlined in Section 8 above). This means collaborating with partners to:

- Address the political economy and administrative challenges to increasing tax compliance in developing country contexts, to achieve better economic growth with improved political stability on which state-building depends;
- Learn lessons for tax reform in peace-building/post-conflict/fragile states;
- Support research on the size of tax evasion and politically non-transparent tax expenditures, to strengthen ways to reduce these problems; and
- Improve understanding of the connections between tax morale, political governance and economic growth, to create effective states.

DFID's Tax Team *seeks to improve* **international collaboration** on tax issues. At present the international effort and expertise on tax is fragmented among such institutions and networks as the IMF, the OECD, the World Bank, the UN committee of tax experts, and the Commonwealth Association of Tax Administrators. Other major bilateral development agencies are also active, and DFID has an important role in working with them to improve co-ordination by international agencies on tax reforms in the context of the Paris Declaration on aid effectiveness of 2005 (reaffirmed at Accra in 2008).

DFID's Tax Team *is committed to* **strengthening civil society** 'voice' in building demand for better tax policy and administration, to complement the efforts made by DFID and other donors in helping NGOs to monitor public expenditure. DFID will work in collaboration with others to support this effective civil society demand for better tax systems, such as through taxpayer associations that can monitor government performance on tax policy and administration.

For further information, please contact: Max Everest-Phillips (m-everest-phillips@dfid.gov.uk)