

a Train4Dev / OECD DAC POVNET Joint Learning Event: Promoting Pro-Poor Growth

Policy Instrument Note # 2

Increasing revenue collection without damaging the livelihoods of the poor



The issue

OECD guidelines suggest that a well-functioning state is important for responding to the interests of the poor. Tax matters because it provides sustainable funding for social and economic development programmes; and it **provides the nexus which binds the state to the citizen**. Not only can taxation enhance government accountability, it also provides a focal point around which interest groups (such as producers groups, labor unions, and consumer groups) can mobilize to support, resist, and even propose tax policies. In other words, taxation is a central plank of state formation and enhances the construction of interest groups in civil society.

The challenge for the design of any tax system is the challenge provided by the trade-off between **equity, efficiency and growth**. While taxation is necessary to finance public goods and re-distribute income, the process through which a government collects tax can entail substantial costs in terms of efficiency. The most obvious cost is that higher tax rates on business and labour can reduce incentives of labour effort, investment and risk-taking - because post-tax wages and profits would decline. Most tax theories predict the

following:

- a. a regressive tax system (one that relies more on consumption taxes or Value Added Tax) is unlikely to improve income distribution unless social spending is particularly pro-poor or Value Added Tax (VAT) is targeted at luxury items;
- b. a progressive tax system (one that relies more on income and property taxes) is likely to improve income distribution unless social spending benefits the rich disproportionately notwithstanding the expense and difficulties associated with periodic evaluations of property;
- c. no tax system is likely to result in poverty reduction if it does not provide incentives – such as fiscal breaks and administrative efficiency – to encourage investment and economic growth; and
- d. if the tax effort is not high, pro-poor growth can only be achieved – even under a progressive tax system – with very high levels of economic growth.

The challenge of increasing taxation in low-income countries:

In sub-Saharan Africa, improving taxation to meet developmental needs is one of the main challenges facing the region (Gupta and Tareq, 2008). The average tax-to-GDP ratio in sub-Saharan Africa has increased from less than 15 percent of GDP in 1980 to



more than 18 percent in 2005 compared to an average tax-to-GDP ratio of 30% in advanced industrial countries. The low tax-to-GDP ratio in SSA reflects low compliance and enforcement – as well as numerous tax provisions. The overall tax base in high-income countries is, of course, much higher than the tax-to GDP ratios suggests because the level of GDP is significantly higher compared with sub-Saharan African countries. But virtually the entire increase in tax revenue in sub-Saharan Africa comes from natural resource taxes, such as income from production sharing, royalties, and corporate income tax on oil and mining companies. Non-resource-related revenue increased by less than 1 percent of GDP over 25 years (Keen and Mansour, 2008). This reflects the decline in trade taxes, as a result of trade liberalization, has been compensated by increases in VAT – but the net effect has been very small. Therefore, all the increase in tax revenues has come from natural resource-related taxes. What this implies is that, if VAT had not increased to compensate for lost trade revenues, there would have been a net reduction in tax revenues.

While the tax levels in many SSA countries are low in comparative terms, there is historical evidence to suggest that the tax level currently achieved by many African countries is much higher than the tax level in some industrialized countries when they had the same level of income (Ruhshyankiko and Stern, 2005). Moreover, considering that about one half of African GDP is accounted for by the informal and subsistence sectors, a tax level of 20 percent of GDP means about 40 percent of formal sector GDP.¹ Thus, the problem of tax collection in SSA has as much to do with a system where the tax incidence (who bears the burden of tax in the first instance) being primarily limited to a few large, formal sector firms and fails to reach the vast majority of the population (who tend to pay tax indirectly in the form of higher prices for consumption goods).

There are, however, important **challenges to increasing the tax base, particularly in low-income countries**. First, structural factors often limit the number of taxpayers and the tax base. These include: 1) a large share of (subsistence) agriculture in total output and employment; 2) large informal sector and occupations; 3) many small establishments; 4) small share of wages in total national income; and 5) small share of total consumer spending made in large, modern establishments. Combined, these factors mean that the take as a percentage of GDP tends to

be much lower than in countries with greater levels of per capita income. It also implies that the number of direct taxpayers (i.e. personal and corporate income tax and property tax) is a small proportion of the population (normally less than 5 percent) in low-income countries. *Thus a main challenge of policy-makers is to achieve a pro-poor widening of the tax and the number of taxpayers.*

How tax is raised matters, as well as how much. *The challenge is to tax a larger number of citizens and enterprises more consensually.* This is not an easy task. The perceived legitimacy of a tax by the majority of the tax payers is important to revenue collection. Levi (1988), for instance, argues that increases in tax capacity are intimately related to the voluntary compliance of large sections of the population. There is a danger that ambitions and pressures to meet revenue targets can result in tax administrations responding with some combination of (a) an even tighter squeeze on registered taxpayers; and (b) quasi-military 'raids' on other businesses on which they do not have detailed information. Such coercive methods can undermine a tax authority's legitimacy.

Policy Options

One of the key objectives for low-income countries is to widen the tax base. This is important since a wider tax base would reduce the necessity of 'squeezing' those already paying taxes. *The dominant approach to improving tax collection has been to focus on enhancing administrative capacity.* Administrative constraints are often identified as the main constraint to the ability of states to collect revenues in general and direct taxes such as income tax in particular (Bird, 2007). As Bird and Casanegra (1992) argue: "In developing countries, tax administration is tax policy."

While identifying administrative constraints needs to be central when designing short-term tax policies, the longer-run goal of improving tax capacity (and therefore state-building) also needs to be part of policy interventions. There are many shortcomings to the administrative approach. First, the conception of capacity is static. There is no attempt to explain why and how administrative capacities change. Second, there is no explanation as to why tax capacities differ across countries in countries at similar levels of per capita income. Third, there is often little analysis as to why sound tax policies are not enforced. Although not often emphasised, low

¹ The contents of this paragraph need to be validated.

levels of legitimacy are often behind a state's inability to ensure compliance (Levi, 1988) and the genesis and variation in this legitimacy is not analysed in the administrative approach.

Perhaps most importantly, a purely administrative approach often treats tax collection as an isolated capacity. However, it is well known that many people often evade taxes because they do not trust that the government will use the revenues effectively, or even worse, might appropriate them through corrupt means. Thus, issues of taxation cannot be separated from expenditure policy. A second drawback of this approach is that tax collection policy is not linked to production strategies. For example, to increase the tax take from the small business sector, tax collection should be linked with the provision of business incentives for informal firms to register as taxpayers (as discussed in Case 1).

While there has been considerable work on the technical aspects of tax administration, policy interventions need to focus more on the historical, political and political economy factors that influence tax reform. The reasons for a historical and political economy focus have not only to do with the abundant work on tax administration but also due to the limitations of a purely administrative approach to taxation. While identifying administrative constraints needs to be central when designing short-term tax policies, the longer-run goal of improving tax capacity (and therefore state-building) also needs to be part of policy interventions. The case examples cited and the issues covered below are not meant to be exhaustive but to highlight the importance of how an understanding of history and politics can help policy-makers think strategically, and propose tax reforms in a way that is more likely to be feasible and sustainable given the relevant political and economic context. The political economy of taxation is a key aspect of the design of a feasible tax system in low-income countries (see Briefing Note #2).

Much IMF supported taxation reform focuses on national systems and short term impact. There is a need for a longer-term perspective in tax reform and capacity building – looking beyond impacts on revenue and ease of administration.

Policy Instruments

Policy instruments in taxation are likely to be more effective when one views taxation not only in terms of administrative capacity but also when tax is viewed in wider developmental processes. Some examples of a more developmental way of viewing taxation are as follows:

a) *Taxing the informal sector* can make a significant contribution to widening the number of taxpayers and thus can enhance the depth of

the 'fiscal contract'. In fact, the goal of widening the tax base is at odds with much current policy (Bräutigam, Fjeldstad and Moore, 2008). According to the prevailing wisdom, the main priority should be to simplify tax systems and to improve tax administration. This is justified in terms of reducing both the administrative costs of collection incurred by the tax administration and the compliance costs incurred by taxpayers. The result of such a view has been the removal from the tax net of those taxpayers (particularly small farmers and urban businesses) who generate little net revenue.

Taxing the informal sector is difficult for economic, administrative and political reasons and there are several important challenges to be met.

b) *The introduction of simplified tax schemes can have a positive impact in increasing tax compliance of small firms.* Since 1990, several Latin American countries have introduced simplified taxation schemes for small firms. Costa Rica, Dominican Republic, Guatemala, Mexico, Nicaragua, and Paraguay have implemented simplified, or presumptive, taxes for small taxpayers that (a) are levied on gross corporate revenues and (b) substitute either for VAT or income tax. Other Latin American countries such as Argentina, Bolivia, Brazil and Peru went further by creating a unique tax levied on small enterprises that replaces more than one of the major taxes (VAT, income, and social security taxes) (Tanzi 2000).

Such schemes were designed to reduce the compliance costs of small enterprises, which often lack the economies of scale and the technical capacity to assess and fulfil their tax liabilities under the conventional tax system. In particular, the gross revenue tax base entails less valuation problems than standard taxes on corporate income and even presumptive income taxes on assets. The simplicity of such a tax has helped reduce the costs of monitoring and collecting revenue from small firms, which have usually been large relative to the revenue potential.

c) *Export taxes on agriculture* are generally inadvisable for developing countries because of the well known disincentives they provide for producers. However, these taxes can play a developmental role when they are explicitly part of a production strategy to improve agricultural productivity. For such taxes to work, they need to be earmarked directly to finance infrastructure investment in agriculture. Apart from this, such taxes can play an important role in expanding the territorial reach of the state and the territorial dimension of state-society relations. In the case of Mauritius, export taxes on sugar, the main

export commodity in the 19th and most of the 20th century had several positive effects on state-society relations and in increasing the productive capacity of the sugar sector. Moreover, the tax provided the basis for progressive tax collection which is a necessary condition for sustainable pro-poor spending (see Bräutigam, 2008 for how and why export taxes worked in the Mauritian case).

d) *History provides several examples of the importance of land and property taxes in enhancing the territorial, social and economic reach of the state.* In the case of Japan, Taiwan and Korea, the land tax was introduced as part of a production strategy to help improve agricultural production (see Bird, 1977; Grabowski, 2008). The link between tax collection strategies and production strategies is often missing in contemporary discussion of tax collection. Extensive land surveys were undertaken which mapped all plots of land in the territory and classified it according to type, productivity, and ownership. As a result of land surveys, the state in each country secured a revenue base, and was able to finance improvement in agricultural production.

e) *Creating autonomous tax authorities.* International financial institutions and aid donors have developed the proposition that, in weak states, revenue collection authorities are more effective when they operate autonomously from the state (and particularly the finance ministry), as a commercial entity at arms length from the government rather than as a department within the government administration (Taliciero, 2004). This is the reasoning behind the promotion of the so-called autonomous revenue agencies (ARAs).

While there is some evidence in Africa and Latin America that autonomous revenue authorities may have been instrumental in initiating reforms, it is less clear that such arrangements are sustainable. Important issues to consider are: the extent to which autonomy becomes legitimate politically, whether tax collection (the domain of ARAs) can be feasibly separated from tax policy (the domain of the finance ministry), and how tax is collected (i.e. is it done through coercion or through voluntary compliance). All of these factors influence the effectiveness and legitimacy of ARAs (see case study on South Africa)

f) *Participatory budgeting* provides a useful example of how civil society participation can work to improve fiscal management. In Porto Alegre, Brazil, success was based on the capacity of The Workers Party (PT) to mobilise support for increases in income and property taxes in order to finance pro-poor spending at the municipal level. Because the budget was based on consultation with different municipal stakeholders and was undertaken in a transparent manner, middle- and upper-income groups increased their tax compliance (Schneider and Baquero 2006). For a Workers' Party seeking to appeal to citizens on the basis of income, property tax represented both the most productive tax handle available as well as the most just. This result is consistent with more general findings that making spending and taxing more pro-poor has historically depended on pro-poor political parties gaining power (Bräutigam, 2004).

The Porto Alegre case also demonstrates that it is important to link tax effort with expenditure patterns. The legitimacy of a government is reflected not only in achieving voluntary tax compliance but also in how and for whom expenditure is undertaken. The expenditure side involved changes to public services that included an increase in quantity, more transparent delivery, and a greater effort to target poor communities

Key Issues

Some key issues emerge from the above discussion.

First, taxation is not simply a technical or economic issue it is inherently political. Taxation provides one of the main links between the state and the citizen and thus is integral to the development of an accountable nation state.

Second, tax policy is a developmental, not just an administrative, issue which can be used to incentivise growth and development. Viewing taxation in isolation of expenditure and production limits the options of designing tax reforms.

Third, tax policy is not simply about how much you tax, what matters more for understanding the political and economic sustainability of tax systems involves analysing *who* you tax; *what* you tax and *how* you tax.

Conclusions

In summary, some of the policy initiatives that are likely to enhance the promotion of a more

3 During the price spike of 2007/08 the cost of urea on world markets rose dramatically before plunging again in the second half of 2008.

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effective redistributive tax system are listed below:

- Broaden the tax base while improving progressivity through income tax and property taxes
- Eliminate tax exemptions and incentives granted to politically powerful lobbies
- Promote national dialogue on the desirability of more progressive taxation
- Tackle 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 unit for Large Taxpayers
- Promote the coordination of central bank, the finance ministry, the tax authorities and intelligence surveys to better trace the assets and income flows of high income individuals and large corporations
- Establish a dedicated tax unit for Small and Medium enterprises
- Consider a simplified tax regime for the micro and 'informal' sector.
- Develop taxpayer education and outreach to the informal sectors.
- Support civil society groups' and political party 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.

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Case Study 1

Taxing the informal sector: The Case of North East Brazil

Taxing the informal sector is difficult for economic, administrative and political reasons and there are several important challenges to be met. First, cash transactions dominate which makes data collection and tax registry difficult. On the government side, the costs of collection are high in relation to revenue raised; so it often holds little attraction for tax officials. Donors worry that taxing the informal, urban sector could place additional burdens on poor people who already pay for some services in the form of bribery and informal fees. Moreover, the low profit margins and low productivity of most informal activities means that the tax burden may reduce employment creation in informal activities, which would also be politically unpopular. From the perspective of informal sector firms, producing beyond the purview of the state and therefore avoiding taxes is the main competitive advantage such firms have and thus there incentive to register as legal firms is generally low. However, transitioning from the informal to the formal sector can give small business owners access to bank loans and government subsidies, and can contribute to stabilising their business in the longer run.

One strategy that is worth considering is to increase the incentives of informal firms to register as taxpayers. For this to happen, the government would need to offer something in return for the legalization of informal sector firms. A promising approach to this challenge could be to *link the expansion of the tax base to the informal sector in exchange for providing incentives for small and medium-sized firms to increase productive capacity.*

The rationale for this suggestion is based on the case of garment firms in North East Brazil (Tendler, 2002). In the northeast Brazilian state of Pernambuco, the challenge was to create a growth pole around cluster of small, but vibrant informal sector firms in the garment industry. These firms were notorious for not paying taxes and not observing other government regulations. An implicit deal

(what Tendler calls a devil's deal) was struck between politicians and informal firms: in exchange for votes, politicians promised *not* to try and enforce taxation and other government regulations such as health and environmental standards. This made informality more attractive. However, the lack of local infrastructure and credit limited the economic expansion, formalisation and technological upgrading of such firms.

The dynamic of the devil's deal also reinforces the dismissive attitudes held by many development planners and by development-bank managers toward smaller and informal-sector (IS) firms. They often view small-firm and informal sector assistance as a 'welfare' measure that belongs in 'social' rather than economic development agencies – in ministries or departments of labour or social welfare, or special small-firm agencies. In their eyes, support to small firms will help mitigate the ravages of unemployment. Thus, the small firm sector becomes mainly an instrument for preserving and even creating jobs – albeit often poor quality jobs in poor quality firms – rather than as an opportunity to stimulate economic development. *From this perspective, small firm assistance programmes do the important work of helping to maintain the 'social peace,' rather than helping to modernise the local economy.**

The other characteristic of the 'devil's deal' is that governments often grant small firms a particular kind of support in which there is *something for everyone* – special lines of cheap credit, blanket credit amnesties when times are bad, and blanket exemptions for small firms from certain taxes and regulations. The exemptions are 'burden-relieving', in that they reduce the small firms' costs (or keep them from increasing) in a way that requires no effort on their part. They are also 'universalist' or 'distributive' in that they benefit all small firms – whether they want to grow or not, whether they are seeking to improve their efficiency or not, and regardless of sector.

In maximising the number of satisfied

* Tendler argues that many international donors and non-government organisations couch their current support for SF/IS assistance, such as micro-credit and other programmes, in terms of 'safety-net' measures for poverty reduction.

constituents, this kind of support to small firms is ideal for maintaining and increasing electoral loyalty. *It is less than ideal, however, for stimulating local economic development that is sustained and employment enhancing.* This is because effective production strategies require selectively identifying promising sectors and trying to remove bottlenecks to improved efficiency, productivity, and marketing for the sector as a whole.

In the Brazilian case, the association of small footwear producers – faced with a significant increase in cheap footwear imports in the late 1990s – lobbied the state government of Rio Grande do Sul for tax relief. The government denied the burden reducing relief, but proposed a different kind of exchange. It offered to finance and assist in other ways the participation of these firms in an important major trade fair, an annual event held in the shoe producing Franca region of Brazil, so as to increase their exposure to the large Brazilian market. As a result, their sales increased significantly, which also increased the state's sales-tax return by more than the amount expended for this support.

The Brazilian story also shows that such strategic deals can yield political returns as robust as those of the burden-reducing measures. The state's footwear cluster, located a few hours from the capital city, had typically voted against the party that was in power at the time of this offer – the Workers' Party. Many of the smaller firms who benefited from the trade-fair experience, however, subsequently shifted their allegiance to that party, in a first-time split of the political loyalties of the footwear-producing sector as a whole.

Policy Lessons

First, the prospects of taxing the informal sector require a change in approach in how the informal sector and small firms are viewed. Instead of viewing the sector as a 'social safety net', it is important to identify how the productive capacity of some sectors can be

enhanced.

Second, the prospect of expanding the tax base to the informal sector (that is, formalising the informal) requires an explicit production strategy so that firm owners have an incentive to register formally with the tax authorities. Such incentives might include infrastructure investment, marketing and distribution support, quality control regulations and so on. Indeed, recent cross-country data suggests that tax compliance of informal sector firms is correlated with previous efforts to improve access to credit for such firms (Gatti and Honorati, 2008)

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Case Study 2

Land and urban property taxes and pro-poor development: Asian Examples

History provides several examples of the importance of *land and property* taxes in enhancing the territorial, social and economic reach of the state. Through much of the 19th century, Japan relied much more heavily on land taxes than trade taxes, which contrasts with the conventional wisdom that countries at lower levels of development necessarily have to rely on indirect taxes (especially trade taxes) as their main sources of domestic revenue mobilization.

In Japan, with emergence of the Meiji elite in the 1860s, there was concerted effort to reduce the power of feudal landowners in an attempt to centralize state power and mobilize more resources for development, which was seen as essential in the face of external threat of Western colonisation. In the period 1868-1872, the state derived 87 percent of all taxes from land taxes. Reform of land taxes included the introduction of land taxes to be paid in cash, which helped monetize transactions in the economy.

The land tax reform was accepted because the state offered two important things in return: a) the Meiji leaders terminated feudal rights and strengthened the property rights of tenants, and b) the state provided services in the form of a research and extension system for the agricultural sector (Grabowski, 2008: 37-39). Tenants were favoured overwhelmingly in conflicts with landlords. As a result, the landlord system was significantly weakened which paved the way for land reform which the US government promoted in the post-World War II period (ibid.). *Another important feature of the land tax in Japan was that it was introduced as part of a production strategy to help improve agricultural production.*

Similar policies were followed by the Japanese colonial administration in Taiwan and Korea. The Japanese colonial authority dramatically increased the level and diversification of tax revenues in Korea, where historically the state had been incapable of collecting much revenue due to the power

of landowners. The most substantial increase occurred, as in Japan, in land taxes. Extensive land surveys were undertaken which mapped all plots of land in the territory and classified it according to type, productivity, and ownership. Land taxes increased 30 percent in the period 1905-1908, and total revenues increased 300 percent in the period 1905-1911.

As a result of the land survey, the colonial state secured a revenue base, and enhanced its control over the Korean agrarian sector by bringing in the landowning class as ruling partners. *As in Meiji Japan, land tax policy was linked directly with a production strategy for agriculture.* In return for increased land taxes, the colonial state made significant investments in rural infrastructure (especially roads and irrigation) and provided subsidised fertilizer and improved seeds. The economic outcomes were impressive. The percentage of land paddy under improved seeds doubled between 1915 and 1940, reaching 85 percent; fertilizer input expanded 10 times in the same period. Rice production grew at 3 percent per annum in the period 1920-1935, and between one-half and two-thirds of this growth was due to improvements in land productivity.

The role of land taxes is especially important as local governments seek to raise revenues in the context of decentralization reforms. The same is true for local governments in urban areas. However, in this case, the relevant tax would be the *urban property tax*. There are several reasons why governments, particularly at the local levels should focus on this tax.

First, urban property tax is one of the most underutilized forms of taxation in LDCs and can potentially provide the financing of urban infrastructure investment which is central to improving the production and export capacity of light manufacturing plants, many of which are located in urban centres.

Second, urban property taxes provide one of the few potential sources of taxation for municipal governments which have received increasing responsibilities in the delivery

of services but so far have been unable to generate sufficient local revenue collection.

Third, property taxes can provide the impetus for the creation of urban property databases which could help improve the synergy between municipal taxation and urban planning. Until now, urban property taxes have not received sufficient attention because IMF reforms focus on national taxation reform, and not municipal tax reform; and also because urban property tax reform requires long-run investments in capacity which is often downplayed compared to the quicker returns initiating VAT can provide. To the extent that tax capacity is an investment in the long-run capacity of the state, and to the extent that decentralisation is a political and economic reality, urban property taxation needs to be given a much higher priority than it has been given in the past.

Fourth, urban property tax provides one of the few mechanisms through which progressive taxation can be developed in LDCs. This can be particularly important in post-war economies where some re-distributive policies may be required to reduce past grievances and horizontal inequalities (Stewart et al. 2007).

Fifth, *recurrent taxes on land and buildings have a small adverse effect on economic performance* (Johansson et al. 2008) This is because these taxes do not affect the decisions of economic agents to supply labour, to invest in human capital, to produce, invest and innovate to the same extent as some other taxes. Also, as real estate and land are highly visible and immobile these taxes are more difficult to evade.

Finally, urban property taxes can contribute to making property rights more secure. This is because the development of a property tax requires a simultaneous government and private effort in property registration and the official titling of property deeds. It is well known that secure property rights are central to promoting long-run investments and economic growth (North, 1990). As well,

secure titles on properties also would increase the prospects of property owners in securing loans for business expansion

Potential dangers: The degree of progressivity of such taxes depends mostly on the pattern of use of the revenues collected. Prioritising pro-poor spending is central to making property taxes progressive. If they are earmarked only for the contributing community, they may increase spatial socioeconomic disparities. If, however, jurisdictions are able to shift revenues from areas with high value public investment to areas that require greater public infrastructure, the potential for progressivity is significant.

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Case Study 3

Creating Autonomous Revenue Authorities: The Case of South Africa

In the mid-1990s, South Africa reformed its tax administration and granted the revenue authority greater autonomy. Tax collection has been very successful as well as being very progressive. In the period 1997-2002, the tax take as a percentage of GDP in South Africa averaged over 25 percent compared with the middle-income country average of 15 percent of GDP and income tax collection averaged 14.6 percent of GDP compared with the Latin American average of 3.9 percent and the East Asian average of 6.9 percent (Di John, 2006).

While there has been a coincidence of impressive revenue collection with increased autonomy, there are several historical and political factors underlying this success. First, the highly successful income and overall tax collection capacity of the South African state is not a new feature of the state's tax capacity. In the period 1960-2000, South African tax collection as a percentage of GDP has consistently been the highest among middle-income countries. In the period 1997-2002, the tax take as a percentage of GDP in South Africa averaged over 25 percent compared with the middle-income country average of 15 percent of GDP.

The factors that permitted this high level of income tax collection capacity have been the subject of considerable analysis (e.g. Lieberman, 2001). First, there has been a high degree of cooperation between the state and upper-income white groups which supported state-led reforms. This challenges the idea that simply instituting an autonomous revenue agency is central to effective tax collection. Second, the introduction of computerisation in the 1960's greatly enhanced the ability of the Department of Inland Revenue to calculate and issue assessments, to record payments, and to register and monitor large tax payers, and maintain controls on tax payments more generally. Third, the introduction of a withholding pay-as-you-earn (PAYE) system also greatly enhanced tax collection. This system made employees responsible for

withholding taxes on a monthly basis. The willingness of business owners to cooperate greatly reduced the transaction costs of implementing the PAYE system.

Policy Lessons

In the post-apartheid state there are several key political and institutional features that marked the continued success of SARS in tax collection capacity.

First, there has been a high degree of administrative cooperation within the state, particularly between SARS, the Finance Ministry and the Central Bank. Such cooperation allowed for exchange in information that improved budget planning and tracking tax evasion. While SARS has been successful in widening the number of tax payers for personal income and corporate tax over the period 1998-2002, it has been much less successful in taxing the informal sector (Smith, 2003). This reflects the difficulty of taxing the informal sector even in the context of a middle-income country with one of the best tax administrative capacities among developing countries.

Second, the state has historically maintained a cooperative relationship with upper-income groups, including large firms, which helped reduce the transaction costs of collecting income taxes.

Third, the reforms were introduced with substantial consultation with representatives from the state, political parties, business chambers, labour unions, and national and international tax and legal experts. This allowed for the design of policies that were technically and politically feasible.

Fourth, SARS was formed in the context of a strong national political party, the African National Congress (ANC). The ANC as the governing party provided an important platform of wider legitimacy for the reforms. Moreover, The ANC also possessed substantial amounts of political capital as it was the leading political organization in the struggle to end apartheid rule. Its leading role in the

liberation struggle is where it largely derives its legitimacy.

Fifth, tax compliance is aided by the fact that most business leaders agree that there must be some redistribution from the top down given the legacy of apartheid and the very unequal distribution of income; there is little political room to contest progressive taxation as fundamentally unfair; or to complain that a particular sector or region is being overtaxed at the expense of other. The tax system thus has become one of the central institutions targeted for righting past wrongs. By equating corporate taxation with the taxation of whites, and VAT payment disproportionately burdening the poorer blacks, unions and community leaders have managed to generate a national discourse which has in turn produced a nationally distinctive interpretation of democratization that emphasizes equitable development.

Finally, South Africa's enhanced revenue collection performance is the result of a sustained campaign by SARS which emphasizes in its campaigns that its task effective tax collection is central for 'the protection of the national economy'. These campaigns have effectively communicated three aspects which form the pillar of the legitimacy of SARS:

- a) **Compliance:** This is tackled in two ways. One is to encourage taxpayers to voluntarily pay their dues to SARS. Workshops are organised to determine the reasons for not complying with tax obligations, while encouraging people to pay. The other relies more on coercion. SARS uses investigators and auditors to lay criminal charges against those who fail to comply, and to use publicity to embarrass and deter defaulters. This has involved the publication of the names of high profile individuals and corporations and an attempt to encourage media coverage of arrests and court appearances.
- b) **Taxpayer service:** This offers the tax paying public a means to interact with

SARS offices, establishing easy means of communications between the two. The service is meant to address queries and act sympathetically to taxpayers who voluntarily comply with their obligations.

- c) **Processing centres:** These seek to develop a business technology capable of handling the tax process from beginning to end. Rather than tax queries, for example, having to be transferred to the head office, the aim is to decentralise through relevant technology such that a query can be handled in any part of the country from its beginnings to the end. The aim is to develop a similar system to that in banks. Taxpayers are meant to be able to visit any SARS processing centre anywhere in the country, and have their entire enquiry dealt with completely and effectively.

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