This revised GOVNET paper reflects comments made at the DAC Meeting on 14th November 2007 and subsequent written submissions from Australia, Denmark and the United States. As agreed during that meeting, it has now been circulated to the DAC under written procedure. It is now considered approved.

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EXECUTIVE SUMMARY

The quality of a country’s governance is recognised as a critical factor in its ability to develop. It is therefore surprising how little attention is given to one of the most fundamental drivers of the relationship between a state and its citizens—the way public revenues are raised.

Taxation systems can contribute significantly to shaping accountability relationships and strengthening state capacities. This remains true and becomes more of a concern when countries receive large volumes of external assistance. This paper summarises the substantial evidence supporting this proposition. It describes ways in which developing countries can make their tax systems more supportive of good governance and how donors can help, based on a proposed forward agenda.

Taxation and governance: the evidence

Historically, the formation of accountable and effective states has been closely bound up with the emergence of taxation systems. In Western Europe and later in North America, bargaining between rulers and taxpayers helped to give governments an incentive to promote broad economic prosperity and improve public policies in ways that meet citizens’ demands. In East Asian countries, too, developmental states had broadly based tax systems. These were not in the beginning associated with Western-type political democracy but they did help to forge a relationship between governments and citizens that generated both widely spread economic growth and improved state efficiency. Pioneers of good governance in Latin America and Africa, such as Costa Rica and Mauritius, tell a similar story: tax is one of the keys to an accountable and effective state.

The negative proposition—that governments which do not need to tax their citizens have little incentive to be accountable, responsive or efficient—is equally well supported. The most striking examples are those showing the malign effects on governance of abundant natural resource rents, particularly those from oil and minerals—the so-called “resource curse”. Rentier states represent the extreme case, and some countries have managed their natural resources successfully. However, there are a number of examples where bad governance is associated with limited state dependence on taxes.

Today’s poor developing countries have a different history than countries in the North usually cited as examples of effective and accountable governance. It cannot be a question of simply replicating the experiences of other countries. Rather, it is a matter of applying the same logic to the different circumstances prevailing today. A notable feature is that there is little bargaining between governments and citizens, and that existing interactions tend to be focused on spending, not taxation.

Taxation and aid

The combined effects of the donor countries’ commitments to scale-up development assistance and the new demand for raw materials generated by China’s economic growth are putting poor countries in Africa and elsewhere in a position they have not faced for a generation. Such countries are now quite likely to be both aid-dependent and recipients of substantial natural resource revenues. This combination of circumstances poses a substantial challenge to the improvement of governance in the affected countries.

Aid is in several important respects not the same sort of external resource inflow as a resource rent since aid has a less damaging effect on governance than oil if it is provided in “purposive” ways, and
accompanied by mechanisms of scrutiny, expertise and management techniques that can add value, and create some pressure for accountability. Nonetheless, it has some of the same effects on the incentives of governments, freeing them from the imperative of raising taxes from a wide range of economic agents and from the scrutiny of tax-paying ordinary citizens and thus from an important kind of pressure to improve general economic and social conditions. Donors’ preoccupations with pro-poor expenditure may also take attention away from the longer term challenge of domestic resource mobilisation. It is not clear, however, to what extent aid dampens domestic resource mobilisation.

**This situation calls for a deliberate and coordinated response.** There is already international recognition of the need to address ways in which the global system contributes to corruption and weak accountability in developing countries, notably by initiatives to promote greater transparency in regard to natural resource rents. These include the Extractive Industries Transparency Initiative (EITI) and the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (OECD Anti-Bribery Convention). These initiatives need to be matched by a renewed focus on the positive drivers of enhanced domestic accountability, with broadening the tax base as a central issue.

**What can developing countries do?**

The challenge for poor countries is not necessarily to tax more, it is to tax a larger number of citizens and enterprises more consensually. This is not easy for various reasons, including economic structure and history. In many poor countries, the informal sector is quite extensive and hard to tax. Nonetheless, recent experience suggests that taxpayers’ behaviour can be transformed by reforming the tax system, leading to both a greater willingness to pay and an increased propensity to mobilise demand for better public services.

The relative decline of trade taxes (as a result of tariff liberalisation) and the introduction of consumption taxes such as VAT or energy taxes, has made tax more visible and transparent in a number of countries. This represents an important first step towards making the tax relationship a focus for constructive bargaining between taxpayers and the state. While VAT is not an ideal instrument, it works to some degree like a direct tax applicable to most consumers and may in some cases provide a practical way forward in widening the tax base in economies with large smallholder and informal sectors.

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

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

**Donors can do more to support revenue-raising efforts in partner countries in ways that are likely to improve governance.** Nonetheless, donors should not assume any automatic link between tax dependence and better governance, and acknowledge the complexities involved. Tax reforms in developing countries have been supported by external actors like the IMF and World Bank with macroeconomic and trade concerns primarily in view. While potential governance improvements should be taken into account when considering tax reforms, they must be balanced against possible fiscal costs and benefits and the trade-offs involved.

Over the last twenty years, tax reforms worldwide have exhibited three main elements: i) a shift away from reliance on trade taxes, and the introduction of broad-based consumption taxes (VAT); ii) simplified tax design; and iii) giving less discretion to tax officials and improving tax administration.

Bilateral assistance has focused mainly on improved tax administration, with a heavy reliance on the establishment of semi-autonomous revenue authorities. In this area, important early gains have sometimes proven difficult to sustain. Experience suggests that rather than advocating autonomous organisational models as a panacea, donors should examine each context on a case by case basis. For instance, political commitment to reform is crucial.

Experience from support to tax reform echoes lessons learned from support to capacity development in other policy areas. These include the importance of local leadership, locally designed solutions and donor approaches that are sensitive to each country specific socio-economic environment. A significant feature of the more successful aspects of recent tax reform efforts is that they have not just been externally driven. Tax officials from developing countries increasingly participate in an organised global community of tax professionals. This has supported the emergence of a consensus about the key technical elements of reform.

As in other fields, donors need a more consistent and strategic approach. This implies combining high-level international efforts with work to improve the enabling environment for improved revenue generation and more coordinated direct support to organisational changes which have the potential to spark off positive dynamics of change. The following specific actions should be considered.

**At the international level:**

- As a follow up to the 2002 Monterrey Consensus on Financing for Development, construct a compact between developed and aid dependent countries in which more—and more predictable—aid is provided in the short term while partner countries commit to enhancing domestic resource mobilisation efforts.

**In respect of the enabling environment:**

- Think more carefully about the political incentives for taxation and the impact of different aid modalities on domestic accountability and tax. This means looking more systematically into the political economy of taxation, and respecting the diversity of different country situations and different tax arrangements.

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- Facilitate dialogue with international tax specialists on how the reform agenda can take more account of the governance aspects highlighted in this paper as a means to foster a consensus between tax professionals about the key technical elements of reform.
- Place more emphasis on professional networking, including more support for technical training and networking within international communities of practice.
- Give special priority to regional initiatives and South-South learning on tax reform for improved governance.

**In providing more coordinated direct support:**

- Review existing support to civil society with a view to identifying partners, issues and debates with strong linkages to the revenue side of public policy.
- Provide more collective and harmonised support to tax reform and tax and customs administration, including greater efforts to document and evaluate current experiences and their impact on governance.
INTRODUCTION

1. The quality of a country’s governance is critical to its ability to develop and make effective use of aid. It is also recognised that a central factor in governance and state-building is the pattern of interaction between state and society. It is surprising, therefore, how little attention is given to one of the most fundamental drivers of the relationship between a state and its citizens—the way public revenues are raised.

2. Taxation systems can contribute significantly to shaping accountability relationships and strengthening state capacities. State-society bargaining around tax makes a unique contribution to building more effective, accountable states and public institutions. This paper summarises the substantial evidence supporting this proposition. It highlights the potential for taxation to provide the stimulus for effective mobilisation of citizens, and the importance of a “social contract” centred on taxation in establishing better governance. It describes ways in which countries can make their tax systems stronger and more supportive of good governance.

3. The importance of taxation is increased, not reduced, when countries receive large volumes of external assistance. One reason for this is that aid can inadvertently undermine the foundations of a tax-based bargain between the state and its citizens. This is not an argument that outweighs the case for increased aid to meet urgent gaps in basic services and investment programmes in very poor countries. But it does underline the need for donors to focus on the drivers of improved governance, within the longer-term perspective of progressively phasing out aid. The paper therefore considers ways donors might assist tax reform efforts in a more coherent and strategic way, including through a targeted set of proposed actions for the GOVNET.

TAXATION AND GOVERNANCE: THE EVIDENCE

The historical experience

4. Historically, the formation of accountable and effective states has been closely bound up with the emergence of taxation systems. In Western Europe and later in North America, bargaining between rulers and taxpayers helped to give governments an incentive to promote broad economic prosperity and improve public policies in ways that meet citizens’ demands. The concept of a “fiscal social contract” is central to explanations of how representative government and democracy emerged in Western Europe and the United States. Citizens accepted obligations to pay tax in return for rights to be represented in processes of decision-making about how public money was raised and spent. American colonists in the eighteenth century captured this in their famous protest, “no taxation without representation”.

5. The more detailed historical story is less well known. Under constant threat of interstate warfare, some governments (notably in Britain and the Netherlands from the mid-17th Century) negotiated with taxpayers, especially holders of mobile capital, in ways that created joint gains to both rulers and taxpayers. The fact that tax was negotiated meant that tax collection became less costly to administer, less

2 State building has been defined as “increasing the capacity of governments to interact constructively with societal interests, to obtain support and resources from those interests, and to pursue consistent lines of action” (O.-H. Fjeldstad and M. Moore, “Tax Reform and State Building in a Globalized World”, in D. Bräutigam, O.-H. Fjeldstad and M. Moore (eds.), Capacity and Consent: Taxation and State Building in Developing Countries, Cambridge University Press, forthcoming).

onerous and more predictable. This encouraged governments to undertake better long-term planning, and businesses were encouraged to invest. Rulers had incentives to strengthen the bureaucracy to collect and administer taxes, and to extend its reach. Systems for recruiting, training and managing revenue-collection cadres became the models for civil service efficiency generally. Taxpayers in parliament adopted mechanisms to oversee revenue-raising and public expenditure management. Rulers had a stake in the prosperity of their citizens, and incentives to nurture that prosperity to generate more revenues. By using reliable tax flows to leverage loans from domestic lenders, first the Dutch and then the British were able to turn their tax states into more powerful “fiscal states”.

6. The basic mechanisms involved are summarised in Table 1. Bargaining around tax simultaneously increased government capability, accountability and responsiveness. Both states and citizens benefited.

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<th>Table 1. The effects on governance of state reliance on broad taxation</th>
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<td><strong>Immediate effects</strong></td>
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<td>Effects on the state</td>
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<td>The state becomes focused on obtaining revenue by taxing citizens</td>
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<td>Effects on citizens</td>
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<td>The experience of being taxed engages citizens politically</td>
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7. The links between taxation and the emergence of capable government can be illustrated with a wider range of historical experiences. In East Asian countries, developmental states had broadly based tax systems. These were not in the beginning associated with Western-type political democracy; but they did help to forge a relationship between governments and citizens that generated both widely spread economic growth and improved state efficiency. Dependence on broad taxation gives governments incentives to

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extend their reach into rural and peripheral areas. It also requires governments to develop a widespread taxation apparatus, including basic population registration systems, and a tax collection administration that can become the model for improving the public service more generally.

8. In South Korea and Chinese Taipei, a strong tax system underpinned effective economic policies and government capability more broadly. In Chinese Taipei, a broadly based revenue system required government agencies to interact with, and keep records of, a wide range of enterprises and households (thereby largely avoiding the creation of an informal sector). In the 1950s, governments in South Korea paid considerable attention to tax, especially direct taxation (34% of its revenue came from direct taxes). This provided the basis for increasing broad-based taxation under the first “developmentalist” regime of President Park in the 1960s, and later the development of an information system that permitted the government effectively to target credits, subsidies and other interventionist measures towards individual firms.5

9. Both South Korea and Chinese Taipei made steady and stable transitions to something close to electoral democracy as they became wealthier under governments that taxed relatively broadly and directly. Pioneers of good governance within the Latin American and African regions, such as Costa Rica and Mauritius,6 tell a similar story: tax is not the sole determinant of rapid development but it is one pillar of an effective state, and may also provide the basis for accountable and responsive democratic systems.

The natural resource curse

10. The negative proposition— that governments which do not need to tax their citizens have little incentive to be accountable, responsive or efficient—is equally well supported. The most striking examples are those showing the malign effects on governance of abundant natural resource rents, particularly those from oil and minerals—the so-called “resource curse”. Evidence of the relationship between bad governance and natural resource rents comes from an extensive literature on “rentier” states, including country case studies as well as strong quantitative evidence based on cross-national statistical analysis.7 Rentier states have limited incentives to build up institutions to collect and administer tax, or to extend the reach of government to poorer, more remote regions. In particular, large oil and mineral revenues are associated with low levels of democracy and states unbound by law.

11. Many states in the Middle East, the Caspian basin and Africa earn large surpluses from exporting oil to rich countries. Because oil is a valuable, physically concentrated resource, the benefits accrue to a small number of big companies and central states, and the individuals who control them. Evidence suggests that states dependent on oil tend to:

- Be independent of citizen-taxpayers, and therefore unresponsive to them.
- Have few incentives to promote broad economic development.
- Use oil revenues to buy off opposition, and to fund repressive internal security.

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6 In Mauritius throughout the 19th and 20th centuries, sugar was the principal export. The export tax on sugar stimulated the organisation of producers (notably through the establishment in the mid-19th century of the Chamber of Agriculture). They bargained with government over tax and policies affecting the sugar industry. Interaction between government and producers contributed to solving a range of collective action problems, including research and investment. It also underpinned demands by taxpayers for the Mauritius legislature to have a “voice”, and for government to employ local people, leading to a state that was unusually democratic and with an unusually high proportion of local officials at independence (D. Bräutigam, ‘Contingent Capacity: Export Taxation and State-building in Mauritius’, in Bräutigam et al., op. cit.).

• Attract external military and political support.
• Lack incentives for taxpayers to engage in the local political process, because there is no political bargaining over sources and use of public revenues.
• Have untransparent revenues, with low oversight from legislatures.
• Have few incentives to establish effective bureaucracies to raise and manage taxes.

12. Rentier states represent the extreme case and some countries, such as Botswana, have managed their natural resource wealth with success. However, the association of bad governance with limited state reliance on taxes is found across a wide range of countries and regions.

13. Russia’s government continues to depend for revenue on a relatively small number of large enterprises working on natural resource extraction in the energy sector. There is little political debate around taxation and no ‘social contract’.

14. Comparisons of provincial governments in Argentina show that those most dependent on broad taxation of citizens have historically been the most democratic. Where provinces received more generous financial transfers from central government, or oil revenue, local politicians were better able to buy off or suppress democratic opposition.

Taxation and governance in developing countries today

15. Today’s poor developing countries, particularly in Africa, have a different history than those usually cited as examples of accountable governance. It cannot be a question of simply replicating the experiences of other countries. Nonetheless, there are good reasons for thinking that the historical experience of taxation as the basis for state building still has relevance for developing countries today. It is a matter of applying the same logic to the different circumstances prevailing today.

16. In many developing countries, governments have little incentive to bargain with organised groups of citizens. This is a major part of the explanation for poor governance. A complex set of historical factors, including state formation through colonisation, has resulted in the concentration of political and economic power in the hands of elites. These elites often represent the major tax payers, resist tax reform and are relatively unrestrained by organised societal interests.

17. The state tends to be powerful in relation to citizens (and accountability is lacking), but weak in relation to its capacity to make or implement policy (so competence or capability is lacking). The need for states to bargain domestically with organised groups of citizens over tax is further weakened by the global context. A combination of high levels of inequality with increasingly close interaction between rich and poor countries provides unprecedented opportunities for political elites to gain access to large, non-tax sources of income from a range of legal and illegal activities. The availability of external military support, especially in heavily aid dependent countries, may further reduce the need for states to tackle difficult tax reforms and to mobilise internal political support for change.

18. In today’s developing countries, some bargaining does take place over spending. Unlike taxation, issues of spending and the illicit use of these resources feature prominently in public political debates. But

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bargaining tends to be confined to narrow political and elite circles, and without any link to taxpaying, which means citizens have little incentive to mobilise or use leverage to influence outcomes.

19. The lack of organised bargaining on the revenue side is understandable but nonetheless unfortunate. Even when the bargaining relationship between the state and groups of citizens is very unbalanced by historical standards, taxation has the potential to mobilise social groups with genuinely countervailing power and a shared interest in holding governments accountable. Most importantly, it can bring together members of business and trade associations that have common concerns around taxation. Even in economies with quite small formal sectors, the representative bodies of small and medium-sized enterprises (SMEs) are potentially a key group for increasing mobilisation around tax. Unlike other typical forms of social protest, such mobilisation is likely to be sustained (because taxation is an ongoing process), and it is potentially constructive, because the concerns typically raised are susceptible to bargaining and compromise.

20. Mobilisation of citizens around taxation issues may be a good avenue into their engagement with public policy more generally because tax policy decisions are central to public policy and particularly to public expenditure decisions. Such mobilisation can help, over time, to move the focus of debate over public expenditure from patronage concerns to more broadly based, interest-group bargaining and the provision of public goods. This in turn has the potential to strengthen democratic institutions, for example by giving elected representatives the incentive and leverage to gain more influence over fiscal matters.9

**TAXATION AND AID**

21. The combined effects of donor countries’ commitments to scale-up development assistance and the new demand for raw materials generated by China’s economic growth are putting poor countries in Africa and elsewhere in a position they have not faced for a generation. Such countries are now quite likely to be both aid-dependent and recipients of substantial natural resource revenues. This combination of circumstances poses a substantial challenge to the improvement of governance in the affected countries for both partner countries and donors.

22. Aid is in several important respects not the same sort of external resource inflow as a resource rent. It has been persuasively argued that aid has a less damaging effect on governance than oil if it is provided in “purposive” ways, and accompanied by mechanisms of scrutiny, expertise and management techniques that can add value, and create some pressure for accountability.10 Nonetheless, aid can have similar disincentive effects on governments, freeing them from the imperative of reforms to broaden the tax base, and thus from an important kind of pressure for the provision of economic and social services. Even in countries that are not highly aid dependent, donors need to be alert to the possibility that a substantial increase in aid flows over a sustained period without a complementary effort in domestic resource mobilisation could have a harmful effect on institutional development.11

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9 The focus on taxation is not a substitute for understanding better the structures of political and social power in partner countries or for doing what is possible to strengthen the effectiveness and accountability of public institutions in other ways, as discussed previously by GOVNET (COWI/IDS, ‘Lessons Learned on the Use of Power and Drivers of Change Analyses in Development Co-operation’, Paris: DAC GOVNET, Room Document 5, 20-21 Oct 2005). Taxation is obviously not the only entry point into improving state accountability and effectiveness, or one that can be used successfully on its own. It is, however, a pivotal issue and one that has been insufficiently explored in recent thinking about improving governance.


23. **How far aid dependency is a concern depends on a) how far donor commitments to increase aid are met, and b) whether, as has happened in Africa in the past few years, rates of economic growth and increases in domestic revenue mobilisation outpace increases in aid. It seems likely that very high levels of aid dependency (i.e. 20% or more of GDP)¹² may be quite rare. A relatively small group of countries in Africa¹³ is likely to be affected, in addition to a significant number of very small countries, and countries emerging from crisis. On the other hand, if countries avoid the extremes of aid dependency thanks in part to enhanced natural resource revenues, the governance implications are potentially severe.**

24. **It is not clear how far high aid levels actually depress domestic revenue mobilisation.** The statistical evidence is inconclusive. Some research indicates a depressing effect, but a review of the evidence for sub-Saharan Africa suggests that the case is not proven, and this is confirmed by a recent study for the French government.¹⁴ This study observes an overall positive effect of aid, both loans and grants, on the tax effort in developing countries. Moreover, the 2006 Evaluation of General Budget Support found no evidence of a reduction in revenue mobilisation effort in response to increases in this form of aid.¹⁵ However, it should be noted that the results of any statistical research on this topic are likely to be contentious. It is hard to find reliable fiscal data for very low income (aid dependent) countries. Overall, donors and partner governments need to be alert to the risks of aid dependency, particularly if and when aid levels to some countries rise significantly. As a most recent IMF working paper concludes, revenue-raising capacity is essential to guarding against aid volatility and preparing an orderly exit from long-term reliance on aid¹⁶. Moreover, programmes financed by scaled up aid flows will give rise to future recurrent spending, which will need to be financed by domestic resources.

25. There are reasons to expect that different types of aid may have different effects on revenue raising and domestic accountability. One suggestion is that while concessional loans are associated with higher domestic revenue mobilisation, the opposite is true of grants. However, the cited French study finds no such variation, so much more research is needed if useful policy recommendations are to be drawn.¹⁷

26. **Donor behaviour also matters.** Although the primary responsibility for improving governance rests with leaders in developing countries, scaling-up aid without giving attention to the possible effects of certain donor behaviour risks exacerbating existing problems of weak engagement between governments and their own citizens. Such behaviour may include overloading already weak administrations with multiple demands and overambitious advice; reducing the scope for local experimentation with policy options; weakening the voice of legislatures; and emphasising spending rather than sources of income.

27. **These issues call for a deliberate and coordinated response.** There is already international recognition of the need to address some of the ways in which the global system contributes to corruption and weak accountability in developing countries, notably around the OECD Convention on Combating

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¹² This is the threshold suggested in the 2006 DAC Chair’s report; some commentators see 15% as constituting high aid dependency. At 20% of GDP, in a country that raises only 10% of GDP in taxes, aid accounts for two thirds of government spending. (2006 Development Co-operation Report – Volume 8, No 1, OECD 2007).

¹³ The 2006 DAC Chair’s report identifies these as Madagascar, Malawi, Rwanda, Mozambique, Burkina Faso, Ethiopia, Ghana, Guyana, Niger, Tanzania and Uganda.


¹⁶ IMF working paper WP/07/222, September 2007, IMF.

Bribery of Foreign Public Officials in International Business Transactions (OECD Anti-Bribery Convention). Initiatives have been taken to promote greater transparency in regard to the spending of natural resource rents, including innovative ventures such as the Extractive Industries Transparency Initiative (EITI), the special fund created for managing oil revenues in Chad and the Oil Fund supported by Norway in Timor Leste. These initiatives need to be matched by a renewed focus on the positive drivers of enhanced domestic accountability, with the raising of broadly based taxes as one central issue.

WHAT CAN DEVELOPING COUNTRIES DO?

The scale of the challenge

28. The challenge for poor countries is not necessarily to tax more. How tax is raised matters, as well as how much. The challenge is to tax a larger number of citizens and enterprises more consensually. This is not easy for various reasons, including economic structure and history.

29. Broadly speaking, tax ratios tend to rise as incomes rise. The average tax to GDP ratio for low income countries is about 18%, compared to 22.5% for medium income countries, and over 29% for high income countries. In the short to medium term tax ratios tend to be “sticky”. Despite repeated attempts at tax reform, the overall tax take changes little from one year to another.

30. Citizens’ willingness to pay tax may be low for historical, political or cultural reasons, and also reflect a perception that governments consistently misuse public funds.

31. It is difficult to collect tax from low income, agrarian economies, and to do so without resorting to coercion. Taxable units are small, so the costs of collection are high; and incomes are seasonal and unstable. Records are lacking, and there is limited use of banks. Collection depends on face-to-face interaction, where assessment and collection are done by the same people (thus increasing discretionary power and facilitating extortion). Poor farmers are highly immobile, and therefore especially vulnerable to predatory tax collection, which is more prevalent at a local level. It is also difficult, and costly, to tax the large informal urban sector that exists in many developing countries.

32. Economic structure also influences the tax mix. Income tax (corporate and personal) plays a much smaller role in developing countries (24.3% as opposed to 38.6% of total tax revenues in developed countries), and personal income tax accounts for a smaller proportion of the mix. Compared to OECD countries, a low proportion of citizens in poor countries pay the kind of direct income, wealth, property or social security taxes that are most conducive to taxpayer mobilisation.

33. Problems of domestic revenue-raising have been exacerbated by a global shift away from trade taxes as a principal source of revenue. This has been one of the consequences of trade liberalisation.

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18 The Revenue Management Law required 80% of oil revenue to go into a special fund, which could only be spent on a specified set of social priorities, with the agreement of a “college” which included representatives from civil society. To ensure that such spending was incremental, government was required to sustain its own spending from non oil revenue at agreed levels in priority sectors.

19 It is estimated that 94% of Timor Leste’s state revenues will come from oil and gas sales by year 2010. The bulk of the income from the Timor Sea currently flows into a Petroleum Fund, modeled on a comparable Norwegian mechanism, the Oil Fund. Norwegian support is helping to build capacity for the sound management of the fund.


21 Bird and Zolt, op. cit.
policies over the last 20 years. It has posed particular problems for low income countries. IMF research shows that, whereas rich countries have managed to offset the decline with other sources of revenue, notably VAT, the poorest countries have at best replaced about 30% of lost trade taxes.\textsuperscript{22}

34. **Poor countries may lack resources and capacity to build comprehensive tax collection systems.** Despite aspirations to broaden the tax base, revenue authorities tend to focus their efforts on a very small number of large taxpayers, who generate most revenue, to the exclusion of many other groups, including professionals and the large numbers working in the informal sector.\textsuperscript{23} This makes sense from the point of view of containing administrative costs of collection, but has perverse outcomes for governance.

35. **Globalisation may also exacerbate fiscal problems, as internationally mobile capital becomes more difficult to tax.** Controllers of capital have increased their bargaining power over governments, and can take advantage (legally or illegally) of lower tax rates payable in offshore financial centres and tax havens. Governments may have limited powers to resist this trend even if they achieve a sensible domestic policy balance combining a fiscal environment favourable to foreign direct investment and means of securing a fair share of the tax base from such investment. Evidence of the actual impact on poor countries is as yet mixed, and incomplete.

36. The net effect of these various factors has been to weaken revenue mobilisation. After remaining basically unchanged between early 1990 and early 2000, total government revenue as a share of GDP has been steadily improving in most sub-Saharan African countries over the last few years.\textsuperscript{24} However, most of this improvement is attributed to more effective tax administration and collection, rather than to broadening the tax base. In some cases, it has been achieved from a very low base. *Half of sub-Saharan African countries still mobilise less than 15\% of their GDP in tax revenues* compared to an average of 18\% for low income countries, and an average of over 29\% for high income countries.\textsuperscript{25}

**Encouraging trends**

37. **Despite these difficulties, recent experience suggests that taxpayers' behaviour can be transformed by reforming tax systems.** This can lead to both a greater willingness to pay and an increased propensity to mobilise demand for better public services.

38. Over the last twenty years, several distinct trends have emerged in tax reform worldwide. In addition to a general move away from using the tax system actively to pursue socio-economic goals, tax reform programmes have exhibited three main elements: i) a shift away from reliance on trade taxes, and the introduction of broad-based consumption taxes (VAT); ii) simplified tax design, including abolition of some taxes, simplification of others, reducing the number of different tax rates, widening the tax net, reducing high marginal tax rates; and iii) giving less discretion to tax officials and improving tax administration.

39. This agenda has been led by the IFIs, in particular the IMF, with an emphasis on efficiency and revenue collection. The evidence indicates that this agenda broadly serves state-building as well as economic policy objectives.\textsuperscript{26} For example, the simplification of tax systems can encourage political

\textsuperscript{22} Baunsgaard and Keen, op. cit.
\textsuperscript{23} In Tanzania, for instance, 286 large firms contribute 70\% of the total tax take; in Rwanda, 80\% of total taxes are collected from 13 large companies.
\textsuperscript{24} Africa Partnership Forum, Report prepared for the 7\textsuperscript{th} meeting, Moscow, 26-27 October 2006, APF/MOS-2006/15; Bird and Zolt, op. cit.
\textsuperscript{25} Africa Partnership Forum, op. cit.; Bird and Zolt, op. cit.
\textsuperscript{26} Fjeldstad and Moore, op.cit.
mobilisation of taxpayers. Tax systems become more transparent and accessible to ordinary citizens, and the temptations and opportunities to seek exemptions or cut personal deals with the tax authorities are reduced. Building on this positive record provides an opportunity to investigate how donor assistance in these areas can contribute to better governance.

40. **The shift from trade taxes to more visible taxes on consumption also appears to help.** VAT has the disadvantage of being harder to collect than the trade taxes it has replaced. On the other hand, recent research does not support the widely held perception that it makes tax systems more regressive. Furthermore, although VAT is an indirect tax (i.e. it is paid by the consumer to the government via an intermediary when purchasing goods or services), it has a certain degree of visibility and therefore capacity to mobilise taxpayers, mainly because of the burden of book-keeping that it imposes on small businesses. For example, VAT has been highly visible in Ghana and Uganda, where its introduction was contentious, and where recurrent political debate about VAT rates suggests that its political effect has been quite direct. This represents an important first step towards making the tax relationship a focus for constructive bargaining between taxpayers and the state. Another relevant example of the introduction of visible consumption taxes includes energy taxes which can offer environmental benefits (since they are likely to lead to reduced energy consumption), can have a pro-poor effect, especially if linked to the reduction of payroll taxes, and are relatively easy to implement.

41. An important challenge is to avoid relying on taxes that are widely perceived as unfair or as liable to be collected in unfair (corrupt or coercive) ways. Such taxes have been relatively common, contributing to poor collection rates and blocking the emergence of any kind of “social pact” around taxation in many countries. Coercive taxation can be a source of bad governance, and can undermine the potential for constructive political bargaining over tax. This is a particular problem in poor, agrarian economies, and at local level, although its negative impact should not be overstated.

42. **Recent efforts to change the attitudes of tax administrations towards taxpayers have been promising in this regard.** Actual practice often falls far short of the rhetoric, but the aspirations are summed up in the mission statement of the Tanzania Revenue Authority: “to be an effective and efficient tax administration, which promotes voluntary tax compliance by providing high-quality customer services with fairness and integrity through competent and motivated staff”. In the case of the successful South Africa Revenue Service, a more user-friendly approach is balanced by the establishment of special investigative units that work in collaboration with a tough national crime investigation unit (the Scorpions) to pursue high-profile defaulters.

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29 There are likely to be trade-offs in all cases, e.g. the possibility of regressive effects from these taxes leading to higher prices of public transports.

30 Even coercive taxation can bring benefits if it mobilises people to demand more of their governments. For example the introduction in 1988 of elections for village governments in China was in large part a response to rural unrest sparked principally by the spread of coercive local taxation after the transition from collectivised agriculture. Rural politicians competing for seats in parliament within the ruling parties of Uganda and Tanzania used the abolition of coercive local taxation as a policy platform (T. Bernstein and Lu Xiabo Lu, “Taxation without Representation in Contemporary China”, Cambridge University Press, 2002; O.-H. Fjeldstad and O. Therkildsen, ‘Mass taxation and state-society relations in East Africa’ in Bräutigam et al., op.cit.). This is not to suggest that aid donors should support or encourage coercive taxation. But constructing better government inevitably involves some conflict, and taxation that provokes opposition and ultimately more constructive engagement between the state and its citizens could be a powerful part of the process.
Opportunities for change

43. Quite small, practical changes to tax design and improvements in tax administration can be important in encouraging taxpayers to mobilise. A climate for better tax relations can be fostered by designing incentives for compliance. As the Malawi case in Box 1 illustrates, these can have benefits for taxpayers and revenue authorities alike.

**Box 1. Tax Compliance Certificates in Malawi**

In 2004, the Malawi Revenue Authority decided to reward tax compliant taxpaying businesses by giving them tax compliance certificates on an annual basis at the end of their accounting period if their legal requirements and liabilities are met. In return, certificate holders are assigned Revenue Officers who are in charge of all issues affecting the taxpayer, including all reminders, tax information and notices for audits to be carried out. A key aspect of broader significance is that local banks have unilaterally started using such certificates as a requirement for businesses seeking loan finance as an index of overall credit worthiness.

The Government of Malawi reports that this initiative has led to an increase in tax compliance for large and medium taxpayers and there has been a motivational effect on other smaller taxpayers, who are keen to qualify for the certificates. Overall, incentives on both sides have resulted in a climate of improved relationships between the Malawi Revenue Authority and businesses, based on the principle of reciprocity, and the way in which this initiative has been used by the banks has considerably reinforced its practical effect.

Source: Adapted from Government of Malawi, 2007.

44. In some countries, efforts to enhance the tax relationship take the form of “fiscal pacts”. Fiscal pacts are negotiated agreements between organised societal and political interests about public expenditures and how to finance them. These kinds of negotiations are useful not only for getting agreement on fiscal goals, but also for putting crucial discussions—debates over big social, political, and economic issues affected by fiscal policy—onto the public agenda. They also highlight the political economy dimensions and the challenges of convincing citizens to accept tax reforms, especially when they involve tax rate increases. Box 2 provides an example from Guatemala.

**Box 2. Guatemala’s Pacto Fiscal**

Guatemala’s *Pacto Fiscal* signed in 2000, brought together government, private sector, and civil society groups to develop a package of tax and spending proposals that would help the government carry out social and economic reforms promised in the country’s Peace Accords. It not only set targets for total revenues to be allocated for this purpose (8–12 percent of GDP), but also for expenditures on specified goals for social sectors; for fiscal balance (the average deficit was not to exceed 1 percent of GDP), and for tax administration efficiency. Further, it articulated a consensus that in order to improve the quantity and quality of public expenditures, the government would need to launch major tax reforms.

Seven years after inaugurating the *Pacto Fiscal* in Guatemala, government, business, and civil society groups are still discussing it, and it continues to play an integral role in deliberations about where the country is headed. Some of the reforms may get watered down and rolled back over time—Guatemala’s pact set a goal of raising the country’s tax ratio to 12 percent of GDP by 2000, a date later pushed back to 2002 but never reached. Nonetheless, participatory discussion creates a space for government to negotiate with business, civil society organizations, and citizens in determining how best to use the country’s resources.


45. While some tax reforms have mainly focused on the national level, local level revenue mobilisation has been a key element in decentralisation efforts over the past twenty years. Tax reforms at the local level have in some cases proved easier than at the national level. Focussing on sub-national tiers of government is an important component of tax reform to achieve improvements in governance. Donors
need in particular to guard against the tendency of central governments to off-load responsibilities to lower levels of government without adequate funding or capacity. It is important not to push revenue mobilisation responsibilities down to too low a level, where there may be no realistic prospect of raising significant amounts of revenue (e.g. from taxes on the agrarian economy or marketing). Australia’s experience with cash hand outs and performance grants at the local level in Africa suggests donors should also be alert to the possible disincentive effects on local revenue generation.

46. **One high-potential revenue source for subnational governments is taxing urban property.** Property taxation is one of the potential sources of significant income for many municipal and metropolitan authorities. Digital databases make taxing urban property much easier now than in the past. Another useful mechanism is charges of various kinds for the provision of collective services, such as water, electricity and markets. Such charges have the potential to enhance pressure from service users for accountability and efficiency. Much can be learned about such mechanisms from decentralisation efforts in Latin America and Asia.

47. Improved tax relations at the local level depend critically on ordinary people being able to see that they are getting something in return from taxation. This can become the focus of special measures, as some recent French research highlights (Box 3).

### Box 3. Tax compliance in Africa: the importance of reciprocity

A 2006 study by the French Ministry of Foreign Affairs (MAE) on strengthening local taxation in Africa, based on surveys in Benin, Cameroun, Ghana, Mali and Mauritania, showed that people often refused to pay tax because they could see little in return in terms of government services or investments.

The study showed that this circle of non-compliance is hard to break. Lack of resources and a lack of capable local administration staff resulted typically in low quality goods and services to citizens. Moreover, local tax administrations often lacked the motivation to pursue the collection of taxes from which services could be provided.

However, the study concluded that some actions can improve attitudes towards taxation. For example, in some cases local authorities made efforts to communicate and explain actions they had taken to provide services. Exchanges between local authorities and people took place during public meetings or through local radio broadcasts, for example to inform citizens of a market renovation which was carried out with public funds coming from local taxes. Experience showed that these awareness-raising measures only succeed when a link could be established between taxes and a concrete project considered useful by citizens.

*Source: Ministry of Foreign Affairs, France, 2006.*

48. Finding equitable and efficient ways of taxing the informal sector is not entirely to be excluded in the light of experience in some countries. This is difficult, and sometimes dangerous; and costs of collection are high in relation to revenue raised. So it holds little attraction for tax officials. Donors worry that taxing the informal, urban sector could place additional burdens on poor people who already pay for some services in the form of bribery and informal fees. However, transitioning from the informal to the formal sector can give small business owners access to bank loans and government subsidies, and can contribute to stabilising their business in the longer run. In addition, experience in Ghana suggests there may be scope for innovative approaches to taxing the informal sector that could bring benefits to poor people, replacing rather than adding to informal impositions (Box 4).
Since 1987 the government of Ghana has effectively franchised taxation of incomes in the large private road passenger transport sector to one of the major unions. This has generated revenue for the government, income and authority for the union, and protection against a range of potential illegal levies for the vehicle operators. However, much of the tax levied was not reaching the public Treasury, and other, less visible sectors, such as manufacturing were still hardly captured by taxation. In response, the government introduced two new instruments: the Vehicle Income Tax (VIT) for commercial drivers, and the Tax Stamp for small-scale enterprises. The VIT, which operates with stickers on the windscreen of buses and taxis controlled by the police, has shown noteworthy results. However, the Tax Stamp has not yet had any notable effect on revenue.


49. Looking ahead, therefore, there appear to be considerable opportunities to build on the existing tax reform agenda, with a view to: i) making it more responsive to the particular challenges faced in poorer countries; and ii) seeking to engage a broader range of citizens in politics by mobilising them as taxpayers. In all of the areas considered, there may be limited government interest in reform at first, but small changes can tip the balance of incentives and begin to create virtuous circles of change in which the payment of taxes and state responsiveness to taxpayers become mutually reinforcing over a period of years.

HOW CAN DONORS HELP?

50. Donors can do more to support revenue-raising efforts in partner countries in ways that are likely to improve governance. The IMF has been the major source of expertise and support on tax policy and administration in poor countries for several decades. In the context of a huge international effort to support Public Expenditure Management in the developing world, some bilateral donors have been less active in the field of tax policy and administration. Of the $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. The figures for 2004, 2003 and 2002 were 2.7%, 2.2% and 3.5% respectively. Poverty Reduction Strategy Papers, Medium Term Expenditure Frameworks, and technical assistance to strengthen procurement and budgeting systems all put the spotlight on spending, unmatched by equivalent attention to sources of revenue. There seems to be a strong case for donors to make a collective effort to redress this balance by complementing urgent spending priorities with a focus on taxation with particular attention paid to design and programme quality. In doing so, donors should not assume any automatic link between taxation and better governance and should acknowledge the complexities involved. Simplistic assumptions that virtuous circles between taxation, demands from ordinary people for better services, and responsive government, can easily be established must be avoided. The task is to identify practical entry points to improve tax relationships, whilst being aware of potential threats to better governance, such as coercive tax collection. In addition, when considering different tax reforms (e.g. the merits of VAT versus income tax), potential governance improvements must be balanced against possible fiscal costs and benefits and the trade-offs involved.

31 These figures do not include expenditures to support decentralisation efforts which may include taxation and revenue components.
Lessons learned

51. *The bilateral assistance that has been concerned with taxation has mainly focused on improving tax administration with the aim of raising revenue through better collection.* Some of this has been facilitated by the spread of digital information and communication technologies which have made possible significant changes in working practices, including the introduction of unique identification numbers for each individual taxpaying unit, and separation of tax assessment and auditing functions from actual collection (to reduce the scope for extortion and bribery). In addition, there has been significant progress in moving from a system organised around different taxes to one organised around localities and/or industries, so that individual taxpayers have to deal with fewer tax officers. Revenue authorities have been establishing different offices and procedures for different categories of taxpayer, typically starting with the creation of a Large Taxpayer Unit focusing on big companies.

52. Organisational changes and capacity development investments of these kinds can have significant impacts even in unfavourable governance environments, as the Rwanda case in Box 5 shows.

**Box 5. Tax reform: the governance dimension in Rwanda**

In Rwanda, DFID’s support to the Rwanda Revenue Authority (RRA) has resulted in a dramatic increase in domestic revenue: revenue as a percentage of GDP increased from 9% in 1998 to 14.7% in 2005. Costs of collection have also been reduced. This success is attributed to both the strengthening of RRA’s internal organisational structures and processes, and the building of accountable relationships with external partners – such as central and local government, a newly growing tax consultancy profession and taxpayers themselves. The RRA now plays an important role in strengthening relationships between citizens and the state, building a “social contract” based on trust and co-operation.

*Source: DFID, 2007.*

53. The most high-profile innovation, and a particular focus for donor support, has been the formation of independent or (semi-) autonomous revenue authorities. There are now some 30 of these in the developing world, mostly in Africa and South America, and they take a variety of forms. They are in many cases new and still evolving, and evidence about their effectiveness is inconclusive. For example, the performance of the South African Revenue Service has been impressive in many ways, but the history and context probably make this unique. In other cases, early gains have been hard to sustain. Examples are SUNAT in Peru and the Uganda Revenue Authority, both established following periods of serious political instability and major falls in revenue collection. Revenues initially increased rapidly, as the economy recovered, but then stagnated once they had reached pre-collapse levels.

54. *Overall, experience to date suggests that the formal status of revenue authorities may be less important than other factors.* Integration of all tax departments under one common leadership/management body facilitates coordination, sharing of data and so forth. This is probably one of the major benefits of the semi-autonomous revenue authorities. (By contrast, tax departments located within Ministries of Finance have struggled to achieve good coordination.)

55. On the other hand, “autonomy” per se does not guarantee insulation from political interference. Revenue authorities given “semi-autonomous” status may not enjoy much more independence from the Ministry of Finance than they did before. The concept is superficially attractive, particularly when civil service procedures and conditions of service are inadequate. However, complex modern tax systems require the exercise of some discretion, so complete autonomy without adequate safeguards for taxpayers’ rights could expose taxpayers to extortion. Tax collection cannot be entirely divorced from making tax and budget policy, so relations between tax authorities and Ministries of Finance have to be carefully managed.
While managerial autonomy is desirable, complete autonomy from the Ministry of Finance may leave the revenue authority answerable only to the President. In some cases, this is addressed by the presence of the Minister of Finance on the board of the tax authority. The lesson is for donors to acknowledge the dangers of advocating autonomous organisational models as a panacea, and to examine each context on a case by case basis.

56. **The extent and nature of political commitment to reform is also crucial.** High-level political support is critical for success. This is a general finding, illustrated by the experience of Rwanda, where personal support from the President has contributed to the success reported above. It is too early to say whether this represents a distinctively new experience. However, the principle of a fiscal contract has been well understood by Rwanda’s political leadership. Instances of fluctuating political support leading to setbacks are unfortunately more common (e.g. Uganda).

**Developing capacity**

57. **Experience from support to tax reform echoes lessons learned from support to capacity development in other policy areas.** These include the importance of local leadership, locally designed solutions and donor approaches that are sensitive to each country’s specific socio-economic environment. And as with other areas, support to the demand side and to checks and balances (appeals systems or independent ombudsman offices) is as important as support to the executive or agencies of the executive.

58. Efforts to diagnose and improve the performance of an organisation require an understanding of external forces that can facilitate or inhibit that performance, as well as internal factors. This is particularly the case with tax reform, which needs to take account of local economic conditions, institutional constraints and administrative capacity, but also local culture and history. Taxation is not just a technical issue which can be transferred from one context to another without taking account of local realities. Political analysis can help get a better understanding of the possible impact of power structures and traditional forms of governance on new policy initiatives, as the Ghana case in Box 6 shows.

**Box 6. The importance of the socio-economic context: traditional chiefs in Ghana**

In Ghana, traditional forms of governance which survived colonial rule play a crucial role in the success or failure of fiscal policy. Since more than two thirds of the country is still jointly owned by various tribes, the chieftaincy system can limit the power of central government and offset the effects of national fiscal policies. Each policy decision affecting local conditions, such as imposing new taxes on the local population, requires informal approval by the chief in question. Thus, the chieftaincy system can have significant impact on tax compliance at the local level and any attempts at reform which conflict with traditional authorities are unlikely to be successful.

*Source: Adapted from GTZ, 2006.*

59. In other words, **donors need to look much more systematically into the political economy of taxation, and respect the diversity of different country situations and different tax arrangements.** While many countries operate conceptually similar tax systems, they differ considerably in the relative size of the government sector and in the specifics of tax policy, thresholds, rates, and administrative practices.

60. One approach to capacity development that warrants further discussion by donors is the extensive use of international personnel as direct providers of services and core policy functions. An example is a DFID-funded programme of support for Mozambique Customs, under which the Crown Agents, under the direction of the Mozambique government, took over full operational management of the customs authority in order to modernise the service, tackle corruption, and increase revenue. Some of the short-term results
looked impressive, including raising revenue by more than 350%, reducing fraud and corruption, and significantly reducing clearance times. However, this approach raises big questions about how to balance the urgent need for improved revenue and service delivery with longer-term concerns about building legitimate, sustainable public institutions. Critics claim that reforms of the Mozambique Customs service have achieved few lasting results – the transfer of skills by foreign contractors has been limited, and the contract has been very expensive for the government. The recently launched Partnership for Democratic Governance, whose Advisory Unit is located at the OECD, will provide urgently needed expertise to bolster core government functions, including taxation, while ensuring long-term capacity development and sustainability issues are addressed.

61. Experience from elsewhere, for example the Zambia Revenue Authority, suggests that expatriate senior advisers and top managers who are in place for a predefined and limited period of time can contribute to effective change by building integrity and professionalism in the organisation through systemic changes. Placing expatriates in key management positions may help to deal with patronage, and to confront political and bureaucratic pressures, thus providing a “buffer zone” within which systemic changes and new forms of staff behaviour can become implanted. However, experience with expatriate top management in other countries, such as Uganda, has been mixed.  

62. **A significant feature of the more successful recent tax reform efforts is that they have not just been externally driven.** Tax officials from developing countries increasingly participate in an organised global community of tax professionals, which includes employees of national tax administrations as well as international organisations like the IMF, and economists, accountants and lawyers specialising in tax in academia and in consultancy organisations, including, increasingly, the big transnational consultancy companies. Key organisations include CIAT (Centro Interamericano de Administraciones Tributarias), founded in 1967, and the more recent global professional forum, CIOTA (the Committee of International Organisations of Tax Administrations) of which CIAT and other regional groupings are members. Extensive professional support for training of tax administrators is offered by the Commonwealth Association of Tax Administrators, the OECD’s Centre for Tax Policy and Administration, and (within Africa) by the South Africa Revenue Service, among others. The International Tax Dialogue provides an important network for discussion between national tax officials, international organisations and other key stakeholders. Tax is a specialist subject, within which governments of rich and poor countries alike freely borrow ideas and institutional arrangements from each other. **This dialogue and exchange of ideas has supported the emergence of a consensus between tax professionals about the key technical elements of reform.**

63. **This community of tax professionals offers donors an unusually useful entry point into a politically sensitive policy area.** Alignment with locally-owned policy agendas is particularly important in the case of tax, since ideas, interests and institutions play a central role in shaping tax policy. It is therefore good news that there is already a flourishing global network, which engages in extensive cross-national lesson learning, with active participation of tax experts from both developed and developing countries. It has been recommended that donors should focus their efforts on helping to develop local capacity to make wise fiscal choices. Existing professional networks could provide a good place to start.

33 The African Association of Tax Administrators (AATA), the Caribbean Organization of Tax Administrators (COTA), the Centre de Rencontres et d’Etudes des Dirigeants des Administrations Fiscales (CREDAF), the Commonwealth Association of Tax Administrators (CATA), the Intra-European Organization of Tax Administrations (IOTA), the Organisation for Economic Co-operation and Development (OECD), and the Study Group on Asian Tax Administration and Research (SGATAR).  
As in other fields, donors need a more coherent and strategic approach. For example, an evaluation for BMZ of donor-supported tax reform in Ghana, Tanzania, Uganda and Zambia emphasises the need for much better donor coherence; the importance of a long-term, comprehensive approach; the need for much greater sensitivity to each socio-economic environment; and the importance of supporting locally designed solutions.35

As with most sectors, there are opportunities for multi-donor approaches to revenue and taxation reform. An example from Uganda is described in Box 7. More coherent technical support can be extended to the dialogue and advice provided by the donor community.

Box 7. Multi-donor support for revenue reform in Uganda

The Uganda Revenue Authority (URA) was established in 1991 as a central body for the assessment and collection of specified tax revenue, to administer and enforce the laws relating to such revenue and to account for all the revenue to which those laws apply. In 2006, the URA developed a Modernisation Plan (2006-2009) to improve revenue collections by the URA to enable the Government of Uganda to achieve and sustain the targets set out in its Poverty Action Eradication Plan. The purpose of this Modernisation Plan is to adopt modern, efficient and effective processes and systems to collect tax and customs revenues and achieve a high level of voluntary compliance from taxpayers.

The Modernization Plan is supported by the Netherlands, the UK, Belgium and Denmark under an integrated technical cooperation and basket funding framework for an amount of US$12.24m, to allow URA to better focus management effort and resources on targeted priorities, implementation of reforms and results achieved. The proposed arrangements, which are in line with the Paris Declaration on Aid Effectiveness (2005) also aim at supporting the Government of Uganda in progressing towards budget support, which is its preferred development assistance modality.


Strategic priorities for donors

66. Being more strategic implies that donors should combine high-level international efforts with work to improve the enabling environment for improved revenue generation and more coordinated direct support to organisational changes which have the potential to spark off positive dynamics of change. Areas for specific donor action at each level are suggested below:

A. At the international level:

- As a follow up to the 2002 Monterrey Consensus on Financing for Development, serious consideration should be given to establishing a compact between developed and aid dependent countries in which more – and more predictable – aid is provided in the short term while partner countries commit to enhancing domestic resource mobilisation efforts.36

B. In respect of the enabling environment, donors can:

- Negotiate and implement tax treaties with developing countries to ensure that multinational enterprises pay a fair share of taxes. This is important because it sets a consistent pattern for

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35 von Soest, op. cit.

accountability between the state and the rest of civil society. If the rules are not applicable to entities at the top of the pyramid, it is much more difficult to persuade other taxpayers to take their tax compliance responsibilities seriously. The International Tax Dialogue are currently examining the tax treatment of aid projects and programmes from the same perspective of consistency.

- **Do more to address the problem of tax havens** where illegally acquired funds from the developing world often end up.

- **Take account of political economy aspects of and political incentives for taxation and the impact of different aid modalities on domestic accountability and tax.** The Guatemalan example (Box 2) illustrates the type of political economy issues that may arise. Regarding political incentives for taxation, the French government has commissioned research on this topic, but more is needed. Questions include whether different approaches to transferring aid (e.g., grants versus loans) could help to limit or offset the potentially negative effects of aid on revenue raising; whether specific mechanisms for managing aid flows might help to make aid work more like tax; and whether budget support and related improvements in transparency and effectiveness of public expenditure management contribute over the longer term to increased willingness of citizens to pay tax.

- **Facilitate dialogue with international tax specialists on how the reform agenda can take more account of the governance aspects highlighted in this paper**. This might involve exploring the opportunities identified above, such as taxing urban property and the informal sector in carefully designed ways. It could also include a more explicit focus on ways in which changes to seemingly technical issues such as the tax mix, the tax base and different approaches to tax collection could encourage taxpayers to mobilise and engage in potentially constructive political bargaining with the state. In collaboration with the OECD’s Centre for Tax Policy and Administration (CTPA), GOVNET can feed in lessons on governance issues—the next opportunity is a CTPA outreach event in Chile in April 2008.

- **Emphasise professional networking**. This could include more support for technical training, networking within international communities of practice. Existing communities of practice could be connected more systematically with relevant international organisations such as the tax working groups of SADC (Southern African Development Community), ECOWAS (Economic Community of West African States) and the EAC (East African Community); other regional tax organisations including the CREDAF (Centre de Rencontres et d’Etudes des Dirigeants des Administrations Fiscales), AATA (the African Association of Tax Administrators), CATA (the Commonwealth Association of Tax Administrators) and ATI (the African Tax Institute); and institutions such as the World Customs Organisation (WCO).

- **Give special priority to regional initiatives and South-South learning on tax reform for improved governance**. The international donor community could play a role by encouraging peer-to-peer development and learning, especially between practitioners from the South. Such efforts as already exist (for example, the IMF Technical Assistance Tax Centres in Gabon, Mali and Tanzania) should be encouraged. The OECD CTPA and the GOVNET are looking at ways of collaborating with the South African Revenue Service (SARS), in particular to support the launch of a South African International Tax Centre (SITC), building on, not duplicating, other initiatives. This could serve as a basis for multilateral dialogue, capacity development and

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37 For instance by establishing dialogue with the National Tax Association and the International Institute of Public Finance.
targeted technical assistance to support tax reform from a governance perspective in the sub-Saharan region.

C. To provide more coordinated direct support donors could:

- Review existing support to civil society with a view to identifying partners, issues and debates with stronger linkages to the revenue side of public policy. There may be opportunities to engage with partners (for example, taxpayer and business associations, trade unions, professional groups and political parties) with a particular interest in tax. With those partners, donors might support access to better public information about tax and sources of revenue (including under-taxed sources), and stimulate public debate about links between taxation and spending, and governance. Links could also be made to a broad range of national and international NGOs (such as the International Budget Programme and the Tax Justice Network) which are taking a growing interest in taxation and governance issues.

- Provide more collective and harmonised support to tax reform and tax and customs administration. This includes greater efforts to document and evaluate current experiences, such as sector-wide approaches, which benefit from potential synergies with other aspects of Public Financial Management (PFM) and their impact on governance. The International Tax Dialogue is preparing a database of existing interventions, but more systematic efforts are also needed to evaluate different approaches, including their impact on governance.

D. The DAC’s Network on Governance (GOVNET) can assist donors in the above areas by:

- Providing support in 2008 for work on political incentives for taxation.

- Supporting key international meetings (South Africa and Chile in 2008) for senior tax officials as opportunities to disseminate, and consult on, the messages in this paper.

- Reviewing existing donor support for civil society aimed at increasing public pressure for improved accountability and sharing information about ongoing efforts.

- Documenting successful experiences in strengthening tax and customs administration and supporting tax policy reform, as well as identifying good practice and entry points for donor harmonisation.

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38 Donors tend to be wary of collective action by relatively wealthy taxpayers, wondering whether this will increase their influence at the expense of poorer people. This is a risk, but in many poor countries with bad governance, the major problem is that governments are barely responsive to anyone. Charles Tilly argues that where governments face little constraint or challenge from society, almost any issue that mobilises groups of citizens against the state is likely to contribute to the construction of democracy in the long term (“Democracy”, Cambridge University Press, 2007).