This study was prepared for UNCTAD as a background paper for the Least Developed Countries Report 2009: The State and Development governance. The views in this paper are those of the author and not necessarily those of UNCTAD or its member states. The designations, terminology and format employed are also those of the author.
Introduction

Resource mobilisation lies at the heart of economic development. And among various means of resource mobilization (e.g., forced savings, inflation tax, manipulation of terms of trade, etc.), tax is the most closely related to questions of state formation and capability. Tax also provides one of the principal lenses in measuring state capacity, power and political settlements in a society. As Schumpeter notes: “the fiscal history of a people is above all an essential part of its general history” (quoted in Levi, 1988: 6). In the wake of fiscal crises of the state in sub-Saharan Africa and Latin America, designing tax systems that can provide incentives for growth, can meet distributional demands and can increase revenue collection is central to state viability and effectiveness (Toye, 2000). In post-war economies, reconstruction of the revenue base is essential for the reconstruction of a viable state and sustained peace (Addison et al., 2002).

Much of the work on taxation, and particularly economic and administrative approaches, has been couched in technical, non-political terms. The focus of these approaches has been concerned with how economic structures and levels of development, on the one hand, and administrative capacity, on the other, affect the capacity of states to mobilise tax resources (see Di John, 2006, Brautigam, Fjeldstad and Moore, forthcoming for a review of these approaches). The technical, non-political approach to taxation is prevalent in IMF and World Bank advice on tax reform. This is part of the larger reform agenda where state capacity-building has been viewed largely as a “technical” exercise in administrative reform (raising wages of civil servants, more training, greater meritocracy). As well, these approaches how and why tax collection can be improved in LDCs (see Di John, 2006 for a review). However, the mainstream discussion on tax promotes the idea that improved taxation will generate greater legitimacy without asking the question: legitimacy to do what and for whom? While the economic, administrative, and political economy approaches to taxation approach these problems from different angles, none of these frameworks adequately examine how taxation and tax reforms affect the prospects of capital accumulation, productive capacity, and economic development.

1 Or as Rudolph Goldscheid notes: “…the budget is the skeleton of a state stripped of all misleading ideologies.” (quoted in Levi, 1988: 6).
If LDCs which to finance infrastructure (which is essential for enhancing productive capacity) and do so in a way that reduces aid dependence, then improved tax collection capacity is necessary. However, it should also be kept in mind that improved tax collection does not necessarily enhance the growth prospects of the economy. For instance, South Africa and Brazil have among the highest tax ratios as a percentage of GDP among middle-income countries, yet neither economy has achieved impressive rates of economic growth in the past twenty years. Indeed, it is well known that cross-country regressions do not find a statistically significant relationship between tax collection capacity and economic growth. The main argument of this paper is that analyses of taxation and tax reform in LDCs, if they are to contribute to promoting sustained economic development, need to focus more on the relations between revenue generation and the construction of productive capacities. A more developmental approach would link tax reform (and aid policy) to economic production strategies in order to provide political and economic elites the incentives to engage in bargaining over tax reform.

The paper is organised as follows. Section 1 considers the relationship between taxation and growth in advanced industrial economies and in less developed countries. The evidence suggests that there is not a significant relationship between tax levels and economic growth. One of the reasons for this is that the traditional tax literature does not consider, non-tax forms of resource mobilisation, including national savings rates, which may matter more for sustaining high levels of growth.

Section 2 considers the problem of taxing the informal sector in LDCs and suggests that widening the tax base to include informal sector firms has been most successful when it is linked to a productive strategy that provides incentives for firms to register. The experience of footwear producers in Northeast Brazil illustrates how this strategy works in practice.

Section 3 examines the role that political parties and business associations can play in both improving the tax capacity of the state as well as providing organisational support to improve productive capacity. The case of the transport sector in Ghana is one of the cases presented to illustrate the role of political parties in this process.
Section 4 examines the fragility of tax systems in low-income and post-war economies. In particular, it points to the fiscal challenges that such economies face when trade liberalisation removes the one type of tax states in such economies can collect effectively. Cases studies from Uganda and Afghanistan suggest gradual liberalisation of trade (as opposed to rapid liberalisation) helps maintain tax revenue generation as well as provide policy instruments for the government to undertake selective industrial strategies.

Given the fragility and low-levels of tax collection in most LDCs, high levels of aid dependence will be a feature in most low-income/post-war economies for the foreseeable future. The reality for most LDCs is that aid will provide a substantial part of the resource mobilisation effort. As such Section 5 considers the relationship between aid and growth. While there is not a statistically significant relationship between aid and growth, it is argued that this may be due to the declines in the share of aid directed toward economic activities, and particularly physical infrastructure, in favour of aid dedicated to social service delivery and governance, and humanitarian assistance. One important policy implication is that the generation of productive capacity will require a shift back in the share of aid funding physical infrastructural investment.

Section 6 considers one of the central issues of resource mobilisation in the donor community, namely the extent to which increased aid crowds out the domestic tax effort in LDCs. This issue is important since the prospects of reducing aid dependency depend in part on the ability of economies receiving aid to increase domestic taxation. Contrary to the predictions of the ‘resource curse’ literature, the evidence suggests that, at least since 1990, aid has not systematically crowded out domestic revenue generation. The reasons for this are discussed.

Section 7 considers the fiscal and productive impact of attracting mineral investment, and natural-resource-based industrialization in sub-Saharan Africa. The cases of copper in Zambia and aluminium Mozambique suggest that, while export growth has been substantial, the extraordinarily low corporate taxes and royalties charged to multinationals not only limit the fiscal linkage of such investments (which limits
resource mobilisation for infrastructure investment in agriculture) but also concentrate production in sectors that have few production linkages. The main policy recommendation in these cases is that royalty rates need to be re-negotiated, as even the IMF suggests in the case of Zambia, but also that mineral development needs to be part of a wider industrial strategy geared toward developing domestic supplier firms.

The Conclusion considers more general policy implications of placing tax within the wider problem of resource mobilisation and production strategies in LDCs.

1. Taxation and Economic Growth

In LDCs, the importance of increasing domestic revenue collection is central to the long-run capacity of the state to finance physical infrastructure and social service delivery.\(^2\) It is well known in the growth literature, however, that there is a weak statistical relationship between growth rates and taxation (see Easterly and Rebelo [1993] for a review of the literature). The difficulty of establishing any relation is due to the complexity in disentangling both the effects of the absolute and marginal rates of taxation on economic growth as well as isolating the growth effects of different types of taxes (trade, income, consumption). It is also difficult to disentangle the tax regime from other macroeconomic (such as monetary policy) and microeconomic policies (such as industrial policy) that affect the growth path. Moreover, as mentioned earlier, the capacity of the state to tax does not necessarily translate into similar capacities such as undertaking industrial policy (e.g. South Africa). Finally, there is the issue of endogeneity. Taxes may not only affect growth, but growth may affect the capacity of the state to tax because sustained growth involves the growing formalisation of the economy and the development of a manufacturing sector both which make tax collection easier.

There are two opposing views on the relationship between taxes and growth. The proponents of neo-liberal economic policies argue that taxes, especially income taxes,

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\(^2\) Foreign aid contributes to this aim as well, but without increases in domestic tax collection, aid dependency has little chance of declining over time.
provide a disincentive to growth (North, 1990; Olson, 1993). Here the lower and less distortionary the tax regime, the better the prospects for economic growth. These authors will also posit that how taxes are collected affect growth prospects. Thus, if tax extraction occurs under an arbitrary, predatory regime, then the confiscatory nature of taxation weakens the security of property rights which in turn provides a disincentive to long-run productive investment. These models posit that democratic regimes are more likely to create checks and balances on arbitrary, predatory rule and thus will result in more legitimate, business-friendly tax regimes. The evidence on this, however, is weak as there is no clear relationship between regime type and economic growth among less developed countries (Clague, Keefer, Knack, and Olson, 1997; Przeworski and Limongi, 1993).

Proponents of more statist policies, on the other hand, argue that taxes are necessary to finance the public goods (education, health, and infrastructure) necessary for physical and human capital accumulation. Indeed, the potentially positive contribution of taxation to growth is a standard result in many endogenous growth models that incorporate public finance and public services (see for example, Barro and Sala-I-Martin, 1992). The more statist view will considers the productive role that conflict resolution can play in reducing political resistance to institutional change or the role state subsidy and transfer spending plays in socialising risk by providing social insurance in smaller open economies subject to higher external risk. Without taking into account the potential and, in many cases, real, productive and enabling role the state can play in socialising risk, it would be hard to use the neo-liberal model’s logic to explain why some of the highest tax countries, such as the Nordic countries, Germany, France and the Netherlands, have achieved among the highest levels of GDP/capita in the second half of the twentieth century. Consider Table 1:

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3 For a more neutral consideration of the role taxes play in providing the incentives for investment, particularly in the African context, see Ruhashyankiko and Stern (2006).


5 See Rodrik (1998) where it is demonstrated there is a positive relationship between the degree of openness and size of government in high-income and low-income countries.
Table 1: Government Revenues, Government Expenditure and Productivity Growth

<table>
<thead>
<tr>
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<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>1973</td>
</tr>
<tr>
<td>Sweden</td>
<td>60.1</td>
<td>&gt;50%</td>
<td>USA</td>
</tr>
<tr>
<td>Norway</td>
<td>51.3</td>
<td>&gt;50%</td>
<td>Netherlands</td>
</tr>
<tr>
<td>Netherlands</td>
<td>49.4</td>
<td>40-50%</td>
<td>Sweden</td>
</tr>
<tr>
<td>Belgium</td>
<td>49.1</td>
<td>40-50%</td>
<td>Belgium</td>
</tr>
<tr>
<td>France</td>
<td>48.3</td>
<td>40-50%</td>
<td>France</td>
</tr>
<tr>
<td>Germany</td>
<td>44.3</td>
<td>40-50%</td>
<td>Germany</td>
</tr>
<tr>
<td>UK</td>
<td>37.7</td>
<td>&lt;40%</td>
<td>Norway</td>
</tr>
<tr>
<td>Japan</td>
<td>31.3</td>
<td>&lt;40%</td>
<td>UK</td>
</tr>
<tr>
<td>USA</td>
<td>31.0</td>
<td>&lt;40%</td>
<td>Japan</td>
</tr>
</tbody>
</table>

Source: Vito Tanzi & Ludger Schuknecht (Public Spending in the 20th Century, Table III.1, p. 52-3); Nicholas Crafts (‘East Asian Growth Before and After the Crisis’, IMF Staff Papers, vol. 46, no. 2, June, 1999: Table 8, p. 153)

By 1996, some of the countries with the highest levels of tax collection and government expenditure such as Norway, Germany, and the Netherlands had levels of productivity (as measured by GDP per hour worked) higher than some of the lower tax and spend countries in the sample, such as Japan, the United States and the United Kingdom. In the same year, Sweden, the country with the highest tax collection in the sample, had the same level of productivity as the United States, the country with the lowest level of tax collection.

While attention to the tax-growth relationship has focused more on OECD countries, there is little evidence to suggest that there is a robust causal relationship between tax rates and economic growth among less developed countries. If one compares the tax levels as a percentage of GDP across regions, there is no discernable relationship between tax levels and subsequent growth. Consider Table 2:
Table 2: Tax Levels and Economic Growth: Regional Comparisons

<table>
<thead>
<tr>
<th>Region</th>
<th>Average Tax Revenues, 1975-1997 (as % GDP)</th>
<th>Average GDP/Capita Growth 1965-98 (annual average growth, %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>OECD</td>
<td>35.3</td>
<td>2.3</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>15.5</td>
<td>-0.3</td>
</tr>
<tr>
<td>South Asia</td>
<td>12.0</td>
<td>2.7</td>
</tr>
<tr>
<td>East Asia &amp; Pacific</td>
<td>15.0</td>
<td>5.7</td>
</tr>
<tr>
<td>Latin America &amp; Caribbean</td>
<td>17.4</td>
<td>1.3</td>
</tr>
</tbody>
</table>


Moreover, the composition of taxation does not seem to affect subsequent growth prospects. In the 1970’s and 1980’s, the tax composition between East Asia and Latin America was very similar (see Di John, 2006, Tables 2-4), yet East Asian economies, on average, grew three times faster in the period 1980-2005. While this is a presentation of very rudimentary evidence, it nevertheless suggests that finding a strong correlation between taxation and growth among less developed countries is likely to prove fruitless as has been the case among OECD countries.

One of the weaknesses of the mainstream taxation literature is that it does not consider the important non-tax forms of resource mobilization, particularly the mobilization of national savings, which have proved central to growth. Indeed, the wider resource mobilisation question was a concern of earlier development economists (e.g. Lewis, 1954). As indicated in Table 3, while tax revenues in Sub-Saharan African and Latin American countries from the mid-1980s to 2000 were collected at a similar proportion to GDP as in East Asia, there were dramatic differences in the savings rates between the regions.
The East Asian savings rate average were more than double as a percentage of GDP compared with South Asia and sub-Saharan Africa and two-thirds higher than in Latin America.\(^6\)

The state’s capacity to mobilise resources beyond taxation is one important feature of developmental success stories that the economic literature on tax misses. In particular, high levels of gross domestic savings have supported robust investment rates. The East Asian economies were in a class of their own in terms of savings rates. This was largely achieved through the coercive power of the state, which was deployed to mobilise resources through various forms of forced savings.\(^7\) Among the coercive elements in East Asian economies were restrictions on consumer credit, financial restraint, mandatory provident pension contributions (used in Singapore and Malaysia) and encouragement of postal savings. Although state actions to increase savings are clear in East Asia, the high and sustained \textit{growth} rates may have also had an important feedback effect on income growth and therefore on sustaining savings. The economic approach to tax does not consider the wider role of developmental states in mobilising savings. This is important to note because much of the taxation literature assumes that a state’s legitimacy is enhanced when there is a consensus around tax collection. However, \textit{economic growth and employment creation are also important sources of legitimacy for a state}. Since there is no clear relationship between tax levels and composition and economic growth, it is important consider the role of

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\(^6\) Kriekhaus (2002) argues that higher public savings as a percentage of GDP is correlated with higher growth rates in less developed countries.

\(^7\) See Wade (1990); Kohli (1999); and Huff (1995).
taxation in the context of the wider resource mobilization challenges of late developing economies.

2. Taxing the Informal Sector as a part of a Production Strategy

Despite the lack of any systematic relationship between tax and growth, there is one important initiative donors and governments should consider: linking 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. Much of the tax literature points to the benefits for governance of widening the tax base to incorporate informal sector producers. The standard approach emphasizes both reducing the costs of compliance with government regulation, and improving the technical capacity of tax administrations. This emphasis is inadequate since there are strong incentives for producers to remain in the informal sector, not least of which is that it provides a competitive advantage for firms by lowering the costs of production.

The growth and upgrading of productive capacity of informal sectors firms remains limited in most LDCs. There are several reasons for this. One, informality significantly reduces the prospects of obtaining credit from the banking system since banks require tax receipts to process loans, and property rights deeds as collateral for loans (both which are absent in informal sector enterprises). Second, the insecurity of property rights of informal sector firms reduces the incentives for long-run, asset-specific investment (North, 1990). However, simply legalizing informal sector firms is unlikely to improve the growth prospects of such firms.\(^8\) This is because the main constraints to growth for even formal sector small and medium-sized firms (SMEs) in many LDCs is precisely the low access to formal sector credit, training, and output markets. For many small producers, the lack of physical infrastructure (including electricity provision and roads) is also major constraint to growth.

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\(^8\) Even in more advanced developing countries, such as South Africa and Peru, there is little evidence that formalizing informal sector firms had led to increase in market access (Kenyon, 2007: 9).
The rationale for linking tax policy vis-à-vis the informal sector and production strategy is illustrated in Judith Tendler’s (2002) work on Brazil. Her story involves small footwear producers in the northeast Brazilian state of Pernambuco. Tendler’s argument is as follows. In Pernambuco, the challenge was to create a growth pole around a 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. Tendler argues that much of the policy advice on this subject focuses on the ‘burdens’ themselves as sources of the problem—particularly the costs of formalising and observing tax, environmental and labour codes. It advocates reforms, in turn, that grant special relief from these burdens to small firms in the form of exemptions from or reductions of taxes and other costs associated with environmental and labour regulation.

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 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. This frees policy makers to dedicate their economic-development attention elsewhere, by reducing for them the political cost of the job losses that ensue from the modernisation of industry and economic-policy reforms. 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.9

9 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.
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 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. This is not a new insight since the success of industrial policy more generally is based on selective support for some sectors as opposed to blanket support for all sectors. As Tendler notes:

“Before any significant support is rendered, they often require or elicit broad involvement of the sector in a process of discovering exactly what the problem is and what to do about it. And they may benefit directly – at least at first – only those firms most capable and most interested in upgrading their production, which, in turn, often leads to their formalisation. The histories of dynamic small-firm clusters often reveal this particular kind of strategic public support which, in turn, has been central to the formation of strong local economies and the reduction of unemployment” (pp. 99-100).

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 leftwing 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.

There are several important policy implications for donor and governments. 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. Third, micro credit schemes need to be part of a wider sectoral strategy that involves technological upgrading. Micro credit for its own sake generally creates low productivity firms. If taxing the informal sector is to become a viable policy the links between tax policy and firm incentives needs to be studied systematically.

3. Tax Capacity, Production Capacity, and the Role of Political Organisations and Business

An important political economy factor in understanding taxation is the role played by political organisations that mediate the conflicts between interest groups, classes, and coalitions. Political parties are particularly important as they operate in the milieu that links state and civil society and they can provide political support necessary to legitimate state tax policies as well as organise demands on the state for social expenditure and tax breaks. That tax struggles are among the oldest types of class struggles (Goldscheid, 1958: 202) suggests that the power of classes and other interest
groups are a key determinant of taxation (Campbell, 1993: 168). The historical evidence in the now advanced countries suggests that governments run by leftist parties mobilise and support higher tax levels (Cameron, 1978) and more progressive tax systems (Heidenheimer et al. 1983: 178-9) than those run by conservative parties. The well developed welfare states in Scandinavian countries in the second half of the twentieth century were controlled by social democratic coalitions. In less developed countries, countries with relatively historically high tax collection as a percentage of GDP, such as South Africa, Brazil, and Malaysia, are characterised by strong (though not always leftist or competitive) political party systems. In Porto Alegre, Brazil, the support of the Workers Party has been central to the success of participatory budgeting initiatives which have raised the legitimacy of local government among the poor and middle classes, created more and better pro-poor expenditure and raised local tax collection from wealthier groups (Schneider and Baquero, 2006). Moreover, even in low-income settings, such as the state of Kerala in India, the presence of well developed and centralised programmatic political parties with a strong political support basis among the poor has been central to the collection of state taxes and pro-poor state expenditure (Sen, 1999).

*Taxing the Informal Sector in Ghana: The Role of Political Party Support*

The role of political party support in improving taxation is clearly seen in the case of Ghana’s ability to successfully increase its taxation of the informal sector, and in particular the transport sector. The case is not only relevant for assessing the political conditions necessary for tax collection to improve but also points to the pressing need in many poor countries to widen the tax base to formalise much of the informal sector, which makes up over 60-70 percent of GDP in the poorest countries. Moreover, in political terms, the more the informal sector is incorporated into the tax system, the wider the relationship between state and citizen becomes. The creation of a wider fiscal social contract (Moore, 2004) is essential since tax helps construct state-citizen relations and the mutual obligations between the two.

Taxing the informal sector is difficult for economic, administrative and political reasons; and there is little in the literature that provides a useful guide on how to
widen the tax base to incorporate the informal sector. First, cash transactions dominate which makes data collection and tax registry difficult. Second, poor countries lack the resources to cover a sector where the administrative costs of tax collection tend to be high and where tax productivity of collection is likely to be low. Thirdly, politicians often purposefully do not tax informal activities as these prove politically unpopular. In fact, there are often implicit contracts made by politicians that allow tax burdens to be low on informal activities in exchange for political support (Tendler, 2002). Finally, 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.

The success that Ghana has had in creating the institutions necessary to tax the informal transport sector provides a rare example of how administrative, economic and political constraints can be overcome.  

10 This episode of “tax farming” began under President Rawlings but has continued under the current of the New Patriotic Party (NPP). In 1987, the government delegated responsibility of collecting tax from (largely) informal transport providers to their unions, principally the Ghana Road Transport Union (GPRTU), which organises the operators in the sector (which is totally private) and negotiates tariffs with the Ministry of Transport. The characteristics of the sector—the absence of public transport, widespread coverage, and the strong and centralised nature of the union and the organisation of all transport units around lorry parks are central in understanding how the union was able to establish a close relationship with the ruling party over the period 1981-2000.

Prior to the election of Rawlings, the role of the GPRTU in national politics was minimal. However, the emergence of Rawlings’s Provisional National Defence Council (PNDC) and its close links between the GPRTU enhanced the possibilities of cooperation in tax between the state and the informal sector. The GPRTU helped mobilise support for Rawlings’ campaign, and was one of the few organisations in the county with presence in most villages and thus was an enormous source of political capital for the ruling party. The collaboration was further enhanced by the government’s macroeconomic recovery program which included the lifting of

10 The remainder of this section synthesizes the main points in Joshi and Ayee (2002).
controls on passenger transport fares, reconstruction of road infrastructure and the increased availability of spare parts. Liberalisation and economic growth contributed to the growth in union membership, as the transport sector grew 20 percent per annum in the period 1984-1991. The growing political importance of the GPRTU was such that the government gave it monopolistic control over lorry parks. The GPRTU supported most of Rawlings political and economic policies in return.

The main innovation in tax reform was the state’s use of the union to assist in tax collection of the informal sector. The state was in need of increasing resource but, budgetary restrictions curtailed the possibility of expanding the tax administration in the mid-1980s. The informal sector was targeted as potential source of untapped income. As with any scheme that involves tax sharing, the state had to handle both the agency problem with its partner, the union. The union, in turn, had to create a viable mechanism of ensuring compliance of tax payments among its members.

The main institutional reforms were as follows. In 1985, the Ministry of Finance was restructured to strengthen revenue collection. The main revenue collectors, the Internal Revenue Service (IRS) and the Customs Excise and Preventive Services (CEPS) were created as autonomous institutions—that is, autonomous revenue authorities outside the civil service under a newly created National Revenue Secretariat (NRS). The goals of the new agency were to identify taxable parts of the informal sector, decentralise operations in order to increase taxpayer identification, increase compliance and bring the tax revenue service closer to the taxpayer.

The main problem in achieving compliance was a reform in the sequencing and timing of tax payments. The existing tax system imposed a yearly tax, payable in a lump sum up front, and thereafter, quarterly. This was unaffordable to lorry drivers and led to large-scale evasion and corruption. Moreover, the administrative delays in paying the tax to the state directly were financially costly to drivers as they lost days of work paying taxes. Many also considered the tax unfair as it did not take into account work days lost due to illness or work repair This enhanced the incentive to evade the tax.
The IRS, GRPTU and rival unions convened to reform the system, which entailed creating the Identifiable Group Taxation (IGT). This system improved tax collection for several reasons. First, the unions now collected tax for the state. The advantage of this is that the union has more knowledge of the situation of drivers and would not overtax them for lost work days. Second, the union’s tax effort allowed for tax collection in a sector where the state’s presence was weak. Finally, the tax was collected daily and only on days drivers earned, which made it affordable.

While corruption still remains an important issue, the state in Ghana has been relatively successful in taxing the informal sector. Tax collection increased significantly (from 6.7% of GDP in the 1980 to nearly 14% of GDP by 2002). The experience of the informal sector partly reflects this success. While Taliceiro (2004) argues that the reason for this is that the ARA in Ghana remained more autonomous, there is no explanation of why the NRS was allowed to remain autonomous. In fact, this case suggests that the more stable political party system and tight relations between the ruling party and the unions were crucial to the success of tax revenue collection. The political and institutional factors surrounding the construction of tax reform has proved in this case to be much more relevant to improved performance than creating autonomy of the tax administration per se.

Apart from the North-East Brazilian and Ghanaian examples, city of Johannesburg provides another example of the role that linking production strategies with tax policies can play in formalising the informal sector and improving the productive capacity of its firms. The city of Johannesburg attempted to formalize a cluster of enterprises in the garment sector into the formal economy by providing them with storage and office space in a specially designated ‘fashion district.’ The city government also provided them training and advice on marketing and business development. A controlled comparison found that these interventions led not only to higher levels of output and employment, but also to product diversification and competitive upgrading (Rogerson, 2004, 422).

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Finally, it is worth considering the role that business associations can play both in increasing the capacity of governments to tax the informal sector as well as enhance the productive capacity of informal sector firms. It is well documented that business associations can contribute to economic development by providing a wide range of functions that enhance efficiency. Among these functions are the strengthening of property rights of member firms, facilitating vertical and horizontal integration, reducing information costs, and upgrading worker training (Doner and Schneider, 2000). Business associations can also in a position to package information about their members and provide it to commercial banks or other service providers at a lower cost than if small and/or informal firms tried to undertake these tasks themselves (Kenyon, 2007: 11). Formal private sector associations can also persuade entrepreneurs to formalize (and thus increase the tax base) by making the benefits of membership contingent on regulatory compliance (ibid.). One of the best examples of the fiscal and productive roles business associations can play come from Northern Italy, where producer groups offered technical assistance and administrative support to help businesses comply with tax rules. These services were also bundled with access to finance and product market certification, which meant that firms had a strong incentive to participate. Over time, this led to the generation of a ‘compliance culture’ and the graduation of large parts of Italian industry to the formal economy (Criscuolo, 2003).

There are some examples of the fiscal and productive role business association play in LDCs as well. In Kenya the association of small tea-growers helped its members’ compliance with national product standards by acquiring inputs, such as pesticides and fertilizers, in bulk and selling them at a discount to producers. Business associations in the Moroccan textile industry have played a similar role with respect to equipment and machinery. An association of handicrafts entrepreneurs in Madagascar has done the same with regard to tax compliance. In Senegal, locally-owned fish wholesalers selling to European markets have worked closely with informal suppliers to help them meet export standards – for instance, by providing

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12 The examples in this paragraph and the following one draw on Kenyon (2007).
them with ice so that their catch does not spoil en route to the processing plant and by issuing invoices on their behalf to keep track of production. The issuing of invoices had the beneficial side effect of helping the state tax the sales of fish production. Despite these examples, there is still limited knowledge of the role business associations can play in both enhancing tax collection and productive capacity. Further research is required on this issue.

Is tax authority autonomy necessary to improve taxation?

The previous examples stress the importance of creating linkages between tax authorities and political organisations (the case of Ghana) and between tax authorities and development planning ministries (the case of North East Brazil). The main idea developed in those cases is that improving taxation capacity cannot be separated from other political and economic institutions within the state and within political society. This view contrasts with much of the prevailing wisdom on tax reform in LDCs advocated by international financial institutions and aid donors. These organisations 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 (see Taliciero, 2004). This is the reasoning behind the promotion of the so-called autonomous revenue agencies (ARAs), which have been promoted in many sub-Saharan African counties including Uganda, Ghana, and Tanzania.

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 (see Di John, 2006: 5-6 for a review). Such a technical approach to tax policy abstracts from politics in at least three ways. First, the reasons why such reforms were politically feasible in the first place are not addressed. Second, there is little analysis of why such autonomy is acceptable to relevant political coalitions over time. Third, there is no accepted definition of autonomy. Since tax policy, which is the domain of finance ministries, cannot practically be divorced from tax collection, which is the domain of newly created ARAs, it is not ultimately possible for the latter to function in purely autonomous ways. In effect, autonomy can
never be complete where there are inter-dependencies among agencies and thus is always a contested notion.

A more sustainable approach to reform would be to encourage cooperation between the central bank, the finance ministry, the development ministry and tax authorities. There are several advantages of this more coordinated approach, one that has been followed by the South African Revenue Service (SARS). First, it would allow for ministries to coordinate tax policy with tax collection feasibility. It makes no sense for the finance ministry to develop tax policies that have no chance of being implemented. Second, cooperation enhances the exchange of information between ministries which is essential if efforts to reduce tax evasion are to be realized. For instance, the central bank often has information on the scale of imports, exports and capital transactions which can help trace the transactions of large tax payers. Third, cooperation between the planning ministry and tax authority can enhance the ability of the state to develop tax policies in conjunction with production strategies so as to provide incentives for those evading tax to register their businesses or more of their transactions, as was the case in the North East Brazilian shoe industry. The success of a more integrated and cooperative approach (as followed by SARS) suggests that focusing on the autonomy of the tax revenue authority is unlikely to either improve tax capacity or link tax policy to productive capacity-building.

4. The Fragility of Tax Revenues in LDCs: Creating Tax Capacity in Low-Income/Post-War Economies

The challenges of tax collection are formidable in low-income and especially in low-income post-war economies. The ratio of government revenue to gross domestic product in war economies is, on average, well below the average for non-war economies with similar levels of per capita income (Addison et al. 2002). Moreover, low-income countries, particularly in sub-Saharan Africa experience a higher degree of tax revenue volatility due to their dependence on a narrow set of commodity exports (Bleaney, Gemmell, and Greenaway, 1995). In the post-war economies of Democratic Republic of Congo (DRC), Rwanda and Uganda, for example, the most
salient features are that the tax base is relatively low, dependent to a large measure on trade taxes, and is extremely narrow where ‘large’ payers (which are generally in the range of 300) contribute between 40 and 70 percent of domestic revenue collection (Di John and Putzel, 2005: 1). The need to widen the coverage of the tax base is urgent in these countries as is the need to examine the political economy of large taxpayer offices in the government.  

The dependence on trade taxes in low-income/post-war economies presents specific policy challenges. Trade liberalization in these economies has led to reductions in trade taxes, which are the main source of revenue in weak and low income states (ibid: 2). Moreover, alternative tax revenue (such as from value-added (VAT) and income tax) have risen significantly less than the decline in trade tax revenue. The overall effect has been a decline in total tax revenues as a percentage of national income in low income countries. Evidence presented by the IMF (Baunsgaard and Keen, 2005) have found that low income countries typically recover only 30 cents on each dollar lost to trade tax declines.

One of the reasons for the reasons why the introduction of VAT as a substitute for trade taxes results in declines in total tax revenue in low income countries is related to high levels of informal economic activity in such economies. Emran and Stiglitz (2005), while acknowledging that the current consensus is for exactly this shift of indirect tax incidence, they question the reliance of the underlying analysis on unrealistic assumptions of markets’ performance. In particular, they demonstrate that when the existence of an informal sector is accounted for given the relatively pervasive presence of informational constraints, this result can be reversed: ‘Once the incomplete coverage of VAT due to an informal economy is acknowledged […] the standard revenue-neutral selective reform of trade taxes and VAT reduces welfare under plausible conditions’ (p.i).

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13 It is important to note that the goal of widening the tax base is at odds with much current policy (Brautigam, Fjelstad and Moore, forthcoming). 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.
There are some other important trends with respect to the relationship between trade liberalization and tax revenue in low-income countries that are important to consider:\textsuperscript{14}

\textit{First, in sub-Saharan Africa trade taxes accounted, on average, for about one-third of total tax revenue in the early 1980s; by the early 2000s, they account for about one-quarter.} As a consequence, even countries persuaded that they would enjoy substantial growth or other benefits from further trade liberalization—whether unilateral, in the context of regional agreements, or within a prospective multilateral Doha round—may fear a substantial cost in terms of lost revenue, and hence be reluctant to pursue trade reform beyond the point at which it poses no risk to trade tax revenues.

\textit{Second, trade liberalization does not necessarily reduce revenue from trade taxes. This is most likely to be the case when liberalization involves:}

\begin{itemize}
  \item Reducing non-tariff barriers, by converting them to explicit tariffs;
  \item Reducing distorting exemptions, or raising low tariffs to establish a more uniform structure;
  \item Cutting tariffs that are initially set, for protective reasons, at such high levels that a reduction will cause trade volumes to increase by more than enough to offset the direct revenue loss from lower rates;
  \item Reducing most favoured nation tariff rates towards preferential rates, tending to shift import demand towards more heavily tariffed items.
\end{itemize}

\textit{Third, the presence of a VAT does not in itself appear to enhance the ability to recover revenue. Baunsgaard and Keen (2005) find that the degree of revenue recovery is not systematically related to the simple fact of whether or not a country has a VAT.}

\textit{Fourth, excises also play an important role in the transition from trade taxes to domestic consumption taxes, since excisable goods are often a large part of the import base.}

\textit{Fifth, although past experience thus indicates that many low-income countries have experienced real difficulty in dealing with the revenue consequences of trade liberalization, there are others that have managed to cope.}

Ter-Minassian (2005) examines the experience of a sample of eight low-income countries. These countries have in common a decline in the collected tariff rates over the past twenty years, but differ in the extent of revenue recovery. In Kenya, Sri Lanka, Egypt and Cote d’Ivoire lost trade tax revenues were not replaced. In Malawi, Uganda, Senegal and Jordan, they were. The conclusions of this study were as follows:

\textsuperscript{14} This section draws on Ter-Minassian (2005).
a) Those countries which did recover total tax revenue all also increased domestic consumption tax revenue, often by an amount broadly corresponding to the loss of trade tax revenue.

c) The presence of a VAT does not in itself appear to enhance the ability to recover revenue, a result similar to the econometric evidence provided by Baunsgaard and Keen (2005).

d) In those countries with high recovery, there has also been a strengthening of income tax revenues, suggesting that the burden of adjustment has not been borne solely by shifting to taxes on consumption. This result is important since it contradicts the conventional wisdom that consumption taxes are the main source offsetting trade tax revenue.

e) Reductions in tax/GDP ratios in low- and middle-income countries are not confined to those undertaking trade reform. Of the 14 low-income countries in which collected tariff rates did not decline over the past two decades, 9 experienced a decline in the tax ratio. This suggests that while trade liberalization poses particular challenges to maintaining revenue collection, there are other political economy factors that need to be researched.

There are three other issues that can provide scope for increasing tax collection:

The first concerns urban property tax. There are three main 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 (during the recent wave of decentralisation) 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

15 This paragraph draws on Fjeldstad and Moore (2008: 245-6).
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. Moreover, urban property tax provides one of the few mechanisms through which progressive taxation can be developed in LDCs.

Second, there is a need to improve the capacity and legitimacy of Large Tax Payer Offices (LTOs). In LDCs, usually less than 500 companies and individuals account for over two-thirds of tax collection. Reducing evasion among these large tax payers is essential and will require coordinated efforts of the central bank, planning ministry and the tax authority. As emphasized throughout, production strategies (such as selective tariff protection) that benefit large tax payers may be needed to provide the ‘carrots’ to induce them to declare more of their taxable income. IMF (2002) surveys also suggest that establishing an LTO helped them address major operational weaknesses in tax administration and improve core tax administration functions. In addition, in many countries the LTO has been a pilot for the tax administration to test reforms later extended to the rest of the taxpayers. These include the self-assessment of taxpayer liabilities, single taxpayer master files, unique taxpayer identification numbers, an organizational structure based on the main tax administration functions, electronic filing, and new computerized information systems (ibid.)

Finally, for low-income countries, membership in regional trade associations (which have been promoted for countries to reap the benefits of specialization and widen local markets) also presents specific challenges to revenue mobilization. The lowering or elimination of tariffs on trade with regional partners can lead to a reduction in trade taxes, which as we have seen, is significant source of taxes in low-income countries. In this context, policy-makers need to consider the introduction of revenue loss compensation mechanisms (RLCMs) into regional trade agreements (see Walkenhorst, 2006 for a discussion of policy options). Although such initiatives are recent, initial evidence suggests that RLCM regional funds should be generated from domestic tax sources in member countries in order to avoid the economically more costly trade taxes as the preferred means of raising revenues for compensation purposes. Moreover, funds should be reduced gradually over time and be of limited duration (4-5 years) [Walkenhorst, 2007: 384]. This would be consistent with the revenue-enhanced effect of trade-induced growth, and would maintain the incentives for governments to continue with revenue-enhancing tax reforms over time (ibid.). In sum, trade liberalization needs to be purposively sequenced with domestic tax reform and donors need to focus on this issue.
The experience of Uganda provides an important exception to the trend of low income countries experiencing a reduction in tax revenues. As one of the more aid-dependent LDCs, it also does not support the rentier state argument that increased aid leads to a reduction in domestic tax effort. Under the Museveni regime, trade liberalization (that is the decline in import and export tariffs) was imposed gradually over the period 1986-1998. Rodrik (2004) classifies Uganda as a case, not of shock therapy liberalisation, but one of moderate and gradual reform. Non-tariff barriers were removed for the first time in 1991; six years after Museveni took power. In 1995, there were still import quotas on beer, beverages, and auto parts. In 1999, all non-tariff barriers were eliminated. It was only in the early 1990’s that the structure of trade taxes was switched from export taxation to import taxation, but import tariffs were introduced at a high level. There were few options available for alternative types of taxation, a characteristic of very poor economies with weak fiscal institutions. As a result, import taxes necessarily lead fiscal resource mobilisation in the 1990’s. In 1996, ten years after the National Revolutionary Movement (NRM) regime took power, trade taxes still accounted for more than 50 percent of total tax revenues.

This gradualism of trade liberalization proved crucial to maintaining fiscal revenues until the political and administrative problems of introducing VAT could be overcome. The tax revenues in Uganda increased from 7 percent of GDP in 1986 to nearly 11 percent by the mid-1990s. While this is still below the sub-Saharan African average, the fiscal consequences of more rapid trade liberalization could have been devastating. The case against rapid tariff reduction as a means for maintaining and increasing fiscal resources, a key element in state consolidation and state-building, is one of the main lessons in the political economy of the Ugandan post-war reconstruction.

Collier and Reinikka (2001) argue that the substitution of export with import taxes created greater inefficiencies because import taxes were subject to greater dispersion of tax rates since the latter were subject to more tax rates than the former. This is misleading in several respects. First, the replacement of export taxes was important in improving incentives for exports. Second, the substitution of export taxes with import taxes (however much dispersion) was essential for maintaining resource mobilisation,
which was central to state-building. Third, a dispersion of import taxes allows the state to provide selective rents (and therefore incentives) for the development of particular sectors.\textsuperscript{16} A uniform import rate provides much less scope for industrial and agricultural strategies. Finally, the argument that trade policy created static inefficiencies does not explain why Uganda achieved one of the fastest growth rates in the developing world over the period 1986-1999.\textsuperscript{17} Tariffs on commodity exports, for example, while potentially providing some disincentives to production, were the only mechanism to tax the incomes of wealthy farmers. \textit{Export tariffs thus can provide a functional substitute to weak income tax capacity in low income/post-war economies.} In the Ugandan case, such tariffs did not coincide with a decline in export growth, but rather were compatible with relatively rapid export and production growth in commodities (Di John and Putzel, 2005).

The Afghan case also highlights important political economy issues concerning tax reform in a low-income/post-war context. Afghanistan has one of the weakest tax collection capacities in the world. According to IMF estimates, government revenue as a percentage of non-drug GDP will be 5.4 percent in 2005-6, the lowest figure for any country in the world (Rubin, 2006: 26). James Boyce (2003: 7-8; Boyce and O'Donnell 2007) suggests that fiscal capacity has been crucial for the viability and sustainability of the state, particularly given the short attention span and shifting priorities of external donors. What seems clear in the Afghan case is that the state’s command over legitimate force and legitimate fiscal capacities are closely interlinked, once again highlighting the limits of a purely technical approach to taxation.

There are several insights on the relationship between state-building and public finance that are highlighted in Boyce’s work. First, there are three main principles that

\textsuperscript{16} Tariffs also provide a fiscally more sustainable mechanism to promote domestic industry in low income countries. The Museveni regime has used these tools to fuel infant industries such as the flower cutting industries whose exports have grown rapidly. While export subsidies may be less distortionary than tariffs, fiscal constraints in low income countries prevent the extensive use of subsidies as a tool of industrial policy.

\textsuperscript{17} By the mid-1990’s, there were still five bands of \textit{ad valorem} import tariff rates between 0 and 60 percent, though more than 95 percent of the imported items were between 10 and 30 percent. During the latter half of the 1990’s, the NRM regime implemented further trade reforms, which gave Uganda one of the lowest tariff structures in Africa. Since 1999, the maximum tariff was 15 percent on consumer goods, 7 percent on intermediate goods, and zero on capital goods.
are important as foundations of sound revenue collections: a) the methods chosen should be easy to handle administratively; b) they should honour progressivity in order to reduce rather than exacerbate distributive tensions by taxing those with ability to pay; and c) they should be underpinned by legitimacy.

**Second, there is a need to re-think the policy of exempting high-income expatriates from paying taxes despite the fact that they often earn 100 times the national average salary.** This exemption creates a demonstration effect to high-income nationals that it is legitimate for upper income groups not to contribute to tax collection. Boyce points to three tax measures which would help the international community to play a catalytic role in the revenue area, analogous to its potential role in the expenditure and security arenas:

a) the introduction of an income tax on high income expatriates, voluntarily paid and a measure of high symbolic value;

b) the introduction of income and urban property taxes on high income citizens because the influx of external resources is a major source of a considerable increase in income for some well-placed Afghan citizens; and

c) a customs duty on imported luxuries that is backed up by the willingness of international actors to forgo exemptions and immunities. Such measures could easily be put into practice administratively and work as a nucleus of revenue collection capacity while at the same time would enhance legitimacy. It would also set the stage for state-elite bargains over tax collection to become an institutionalized feature of the polity.

Given the weak state capacity to collect tax in Afghanistan, trade taxes will inevitably be the most feasible source of tax collection. However, raising the level of import taxes is not simply a question of trade policy. The inability of the Afghan state to control much of the territory outside the capital, Kabul, including border areas, impedes the collection of trade taxes. The presence of entrenched warlords weakens the state’s monopoly not only on revenue collection but also on the legitimate exercise of force (Boyce, forthcoming). In this sense, raising trade taxes will require increased military and security presence of the central state in border regions, a feat unlikely to be achieved without international military assistance. Clearly, in post-war economies, capacity to collect even the ‘easiest’ taxes is closely linked to issues of security and the legitimate monopolisation of violence on the part of the central state.
Carnahan (2007) argues that it makes sense for donors to enter into a multi-year compact with post-conflict host government to provide matching funds for direct budget support purposes. The current arrangement in many post-conflict countries is that donors provide budget support when the government specifies its expenditure needs and calculates what its financing gap is. Donors then promise-with varying degrees of commitment, promises to finance the revenue shortfall. This system can create several problems. First, the incentive for the government to raise revenue may be diminished. Second, the capacity of the government to identify and assess macro-level expenditure revenue trade-offs as ministers are not forced to prioritise spending based on what revenues they can collect; instead they simply present a wish list. Third, there is considerable uncertainty and volatility in the actual aid flows that are dispersed creating problems for macroeconomic management and planning.

The matching funds approach can address these concerns if donors could agree to match a percentage of the funds collected by the government up to a fixed limit. The matching percentage could be reduced over time, reflecting the increased capacity of the government to raise revenue. The main advantage of this approach is that it increases the incentives for revenue collection since state officials will know that raising extra revenue will result in additional inflows of donor resources. The matching funds approach can: tighten the link between revenue raising and increasing expenditure, provide greater certainty to facilitate building stronger cash-flow skills in the treasury, and reduces the time spent by ministers in pursuing donors and persuading them to turn promises of aid into disbursements.

For this system to work, it is necessary that donors commit for the medium- and long-term through development of trust funds. The major challenge involves the willingness of donors to make their aid flows predictable and reliable- putting into practice agreements on good donor practice made in such statements as the 2005 Paris Declaration. The matching funds approach will mean that donors need to find a higher level of coordination, planning and discipline than has been demonstrated in post-conflict situations than has been demonstrated in the past.

On the expenditure side, aid, as Boyce (2003) points out, would do more to promote capacity to plan and execute policies if channelled through the central government.
The current situation features a *dual public sector* where the bulk of expenditure (including procurement, the payments system and the delivery of services) is made directly by donors with only a small percent of spending going through the parliament and the budget process. While international service provision is generally more efficient currently, the long-run consequences for state-building are likely to be negative. This is because foreign spending is not accountable and there is a lack of coordination of aid which wastes scarce resources. Most worrying is the high opportunity cost of not permitting the state to develop reciprocal relationships and mutual obligations with interest groups, which the fiscal system can enhance.

*Both the Ugandan and Afghan case illustrate several important points.* First, taxation is central to the prospects of state formation and legitimacy. Second, rapid trade liberalization can be de-stabilising to the tax collection capacity and state-building project in low-income/post-war economies. Finally, the exemption of high income foreign aid workers from paying income and consumption taxes signals that progressivity is not either feasible or desirable. This is creates a demonstration effect that regressivity is acceptable, which can undermine the process of building state legitimacy.

*Finally, it is important for donors to assess more systematically how revenue policies affect the prospects for peace-building.* International aid agencies increasingly recognize the need for “conflict impact assessment” as an input into policymaking and project appraisal, and some have begun to put this recognition into practice. However, as Boyce and O’Donnell (2007) point out, little has been done to bring these insights to bear on revenue policies to date. *The starting point for any effort to address this lacuna must be careful documentation of the distributional incidence of revenue instruments both vertically and horizontally.* Collecting the necessary data will be a nontrivial task, for today there is a paucity of such information even in “normal” developing countries, let alone in war-torn societies. As mentioned above, one option that would be likely to receive much more attention, once revenue is seen through the distributional lens, is luxury taxation. Taxes on items such as private automobiles and private aircraft can combine the attractions of administrative ease, distributional progressivity, and substantial revenue. Yet remarkably, they rarely feature in discussions of post-war revenue policies (ibid.).
5. Aid and Growth in low-income countries

Given the fragility and low-levels of tax collection in most LDCs, high levels of aid dependence will be a feature in most low-income/post-war economies for the foreseeable future. The reality for most LDCs is that aid will provide a substantial part of the resource mobilisation effort. Thus, it is useful to examine how aid will affect the prospects of improving productive capacity and growth. There is little evidence that the level of aid resources as a percentage of GDP matter for the long-run growth rates of less developed countries (Easterly, 2006). The lack of any correlation provides problems not only for the resource curse argument, which argues that increases in unearned income generates poor governance and therefore low growth, but also for the recent revival of the idea that a big push in aid will help poor economies overcome the poverty trap (Sachs 2005).

The idea that poor countries are stuck in a poverty trap has become influential in recent years. Yet, there is little evidence to support this view. First, in the period 1950-2001, the poorest fifth of countries in 1950 grew at similar rates to the other four-fifth of richer countries (Easterly, 2006). Second, in the same period, countries that received above average aid grew at similar rates to countries with below average aid. Third, the identity of the poorest fifth of countries changes dramatically over time. Eleven of the poorest fifth countries in 1950 were not in the poorest fifth in 1950, suggesting that these countries became poor by declining from above rather than being stuck from below. This is hardly evidence that sustained stagnation is the result of a poverty trap.

A second line of inquiry has argued that aid can contribute to growth but only in cases where aid recipients had “good policies” (defined by low budget deficits, low inflation, and free trade) [Burnside and Dollar, 2000]. There are some important problems with this study. First, one of the criteria, low inflation, is not a policy but an outcome of policy. More importantly, subsequent empirical studies (using Burnside and Dollar data) have found that aid does not have any systematic impact on growth whether or not countries have “good policies” (as defined by Burnside and Dollar) [see Easterly, Levine, and Roodman, 2004; and Rajan and Subramanian, 2005].
The weak relationship between aid levels and growth could also be due to the fact that much recent aid has been deployed for geo-political reasons (much of which goes to military spending) or for post-conflict humanitarian assistance. In the latter case, aid may be increasing in places because countries have fallen into violent political conflict, which itself is generally associated with low or even negative rates of economic growth. More generally, Easterly argues that *it is unlikely that increased aid causes economic decline, rather the fall in growth rates in many poor countries caused an increase in aid, which subsequently failed to reverse growth declines in many countries because of profound economic and political stability.* This is another important reason why the claims of proponents of the resource curse/rentier state model may be mis-specifying the causal effects of aid on governance and growth in low-income countries. It is of course important to point out that the structural adjustment programs (which have focused on reductions in fiscal deficits) have been deflationary in many contexts, particularly in many countries in sub-Saharan Africa (Mkandawire, 2005). As a result, increases in programme aid may be coinciding with stagnant or even declining growth, which of course also limits tax collection. *It is an area for further research to uncover why countries undergoing such programmes have achieved such varied growth performances.*

While the aid-growth relationship may be weak, one piece of good news is there is no conclusive evidence to suggest that aid is causing low growth because of Dutch Disease effects (see Killick and Foster [2005] for a review of the evidence). The Dutch Disease model posits that foreign exchange windfalls (such as from oil or aid) can generate an appreciation of the real exchange rate, thus rendering the non-mineral tradable sector (agriculture and manufacturing) less competitive, thus hindering export growth and diversification. Because agriculture and manufacturing are labour-intensive in most low income economies the decline in the viability of these sectors can have serious consequences for poverty since these two sectors employ the bulk of the labour force. Moreover, the extent to which manufacturing is the source of substantial technological development, Dutch Disease effects can slow down the long-run productivity growth rate of the economy. However, despite the absence of strong evidence, Killick and Foster (op. cit.) caution against discounting Dutch Disease as a potentially important disadvantage of an aid scaling-up.
There are two important factors related to donor policy that may have weakened the aid-growth relationship. First, there has been a shift in donor priorities away from providing aid for economic sectors and particularly infrastructure in favour of social sectors (health, education, governance). Government leaders, responding to the priorities set by donors and IFIs have also shifted spending priorities in a similar way. Killick (2005) estimates the proportion of British aid to Africa devoted to ‘directly productive’ activities (the economic plus rural livelihoods sectors), expressed as a percentage of aid for ‘social’ spending (education, health, social and governance), to have fallen from 371% in 1988/9-1989/90 and 208% in 1993/4-1994/5, to only 45% by 2003/4. More general evidence is provided by OECD-DAC data on sector-specific aid from all sources. This shows the ratio of assistance to ‘social’, as against ‘economic’, sectors to have changed in a continuous - and continuing - trend from 1:4 in 1978 to 4:1 in 2004 (Killick and Foster, 2005).

Second, the attention placed on fiscal tightening in the 1980s and 1990s has led to widespread deterioration of infrastructure throughout Latin America and Africa. According to Calderón, Easterly and Servén (2003), cuts in infrastructure investment (in power, roads and telecommunications) in Latin America accounted for more than half of the total fiscal belt-tightening between the early 1980s and the late 1990s. The growing infrastructure gap in Latin America accounted for one-third of the increase in the output gap relative to more successful economies in East Asia (Calderón and Servén, 2003). The growing infrastructure gap in Africa is of even more concern (UNCTAD, 2006). Beginning in 1980, infrastructure spending as a share of GDP declined, on average, in Africa from about 4% to less than 2%. Expenditures on

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18 Structural adjustment programmes sought to achieve stabilisation - interpreted as price stability - by taming inflation. However, the Bank's interim report concedes that: "The success of fiscal policy in relation to its stabilisation objective may have come at the cost of long-term economic growth.” According to Bank vice president for Poverty Reduction and Economic Management Danny Leipziger, "the key issue is that fiscal adjustment biased against infrastructure accumulation can be largely self-defeating” as the effect of spending cuts diminishes output growth and competitiveness. Indeed, growth rates in the developing world sharply declined in the period 1980-2000 compared to 1960-1980. See Alexander (2007) for a brief discussion of these issues.
education and health rose during the same period to more than 5% and 2% of GDP, respectively (World Bank, 2005). Closing the resulting infrastructure deficit in Africa has been estimated to require between 7 and 12 billion dollars per year of new investment (Estache, 2005).

The donor community has not responded to these growth-restricting falls in infrastructure investment.19 The growing infrastructure divide between LDCs and other developing countries has widened recently partly because private sector investment has not compensated for the decline in public sector investment in infrastructure and partly because less Overseas Development Assistance (ODA) has been spent on infrastructure—50 percent less in real terms in 2003 compared with 1992 (UNCTAD, 2006).

The lack of adequate physical infrastructure is central to understanding why reductions why reductions in poverty are so difficult to achieve. The central problem of poverty reduction in LDCs is raising the income of rural households. This can only be achieved if the costs of producing products for domestic and international markets drop. In this perspective, there are severe infrastructure gaps in Africa. For instance, more than 30% of Africa’s population lives in landlocked countries in contrast to about 2% of the world’s population. A landlocked country in Africa has 50% higher transport costs and 60% lower trade volumes than a typical costal economy (Page, 2005). Moreover, Africa has 7 km of navigable roads per 100 km2 of land when compared with 170 km in Europe. In Burkina Faso and Zambia, the road density is 5–7% that of India in 1999. Because of poor market access, more than three-fourths of African farmers are isolated from national and world markets. Kelly and Byerlee (2004) estimate that 60% of the rural population in Africa lives in areas of good agricultural potential but poor market access.

19 This is not to say that increased aid has not contributed to growth in some cases. Uganda and Mozambique are two of the most aid-dependent countries in sub-Saharan Africa and have achieved relatively rapid growth rates. In fact, where poverty has been reduced such as in Uganda, aid dedicated to infrastructure has been central to improvements in agriculture and light industry performance (see Di John and Putzel, 2005).
The consequences of high transport costs and limited infrastructure are particularly severe for exporters. For a widespread agricultural export push to succeed in Africa, better integration of its economies is essential. For landlocked economies, effective integration with their coastal neighbours is imperative if the benefits of growth in Africa are to be broadly shared across national boundaries as well as within them.

There is also evidence that the prospects of labour-intensive manufacturing depends on the on the provision of electricity. As many low income countries are potentially competitive in labour-intensive manufacturers, the provision of electricity is likely to improve manufacturing employment and contribute to poverty reduction. The UNCTAD Report 2006 estimates that only 16 percent of the LDC population have access to power. World Bank surveys of private investment decisions find that, in Africa, 50% of firms identify electricity as a ‘very severe’ obstacle to business operations, while a quarter cite transport and telecommunications (Killick and Foster, 2005).

The important policy implication of this is that aid needs to be focused more on infrastructure investment to both improve growth rates and reduce poverty. There are several reasons for this. First, physical infrastructure in the form of transport, energy, and telecommunications, is necessary to enhance productive capacity. Adam Smith argued this point by noting that transport is central to developing the size of the market which in turn creates the possibility of a greater division of labour, the source of productivity improvements (Thirlwall, 2007). Second, there is substantial evidence that physical infrastructure investment is correlated with growth rates (UNCTAD, 2006; Calderón, Easterly and Servén (2003). Third, as mentioned above, investments in electricity contribute to the competitiveness of manufacturing exporters (UNCTAD, 2006).

20 Because of, primarily, high transport margins, African coffee producers receive a farm gate price that is 30% below the price received by Vietnamese producers (Diao et al., 2005).

21 This is not to say that investments in social sectors do not contribute to growth. As Killick and Foster (2005) note: “it is not our position that expenditures on education and health are purely ‘consumption’. Both add importantly to actual and potential productivities and, to this extent, should be viewed as essential productive investments, alongside improvement of the physical infrastructure. However, such investments need to be kept in reasonable balance with other forms of productive investment. In the absence of accelerated economic growth, massive improvements in educational standards are apt merely to lead to qualification inflation, under-employment and frustrated aspirations. The issue is about balance in the composition of investment, a balance which is not being well achieved at present.”
In light of these reasons, there is a need, as Page (2005) argues, for a joined up approach to infrastructure investment which includes:

1) rural infrastructure and district level links between rural areas and small towns;
2) large-scale national infrastructure (trunk roads, electricity, and port facilities); and
3) cross-border regional infrastructure.

Increased public investment in the first is important for agricultural productivity growth and the development of a market economy in rural areas as well as the creation of non-farm employment. Increased public investment in the second is important for diversification and structural change as well as international trade integration. Increased public investment in the third is important for regional integration.

There are three other donor policies that could contribute to the effectiveness of scaled-up aid contributing to economic growth.

The first involves *lengthening the time-frame of aid commitment*. This is especially important for making the matching funds approach to budget support work as discussed in the section on public finance in post-conflict countries. If leaders know that aid flows will increase if they increase domestic tax effort, then this could provide incentives for leaders to develop tax states, which in turn would contribute to state building and capacity.

Second, *donors need to ensure that aid flows become more predictable*. The volatility of aid significantly exceeds that of other macroeconomic variables, such as GDP or fiscal revenue and is pro-cyclical, that is, it tends to be disbursed in periods when output or domestic revenue is high (Hamann and Bulíř, 2005). The consequences of aid volatility for aggregate growth and consumption are also very high, approximately equivalent to the impact of the Great Depression (Lensink and

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22 Eifert and Gelb (2005) provide a summary of this topic as well as suggestions on how improved predictability might be achieved.
Morrisey, 2000). The coefficient of variation of net aid disbursements to sub-Saharan Africa is five times more volatile than the GDP of sub-Saharan Africa, which has the highest volatility of GDP of any region in the world.\(^{23}\) Moreover, the relative volatility of aid has increased in the late 1990s and remained high in the early 2000s. For sub-Saharan African countries, the variation in aid receipts is twice the variation in tax revenue receipts. Even more disturbing is the finding that unpredictability of aid is negatively correlated with the level of development as measured by GDP per capita. The poorest countries have received a smaller share of promised aid than countries with higher incomes. Finally, the volatility of aid is higher in countries that are more aid-dependent (Eifert and Gelb, 2005).

*This volatility and unpredictability of aid disbursements exacerbates problems of macroeconomic instability and makes macroeconomic planning and management even more challenging than it already is in countries with weak fiscal and monetary institutions.*\(^{24}\) One proposal would be to encourage the development of stabilisation funds, possibly on the model of Chile’s copper stabilization fund. In this arrangement, reserves would be built up to cushion aid disbursement shocks. A second proposal, not mutually exclusive with the first, would be to develop a more incremental or gradual approach to scaling-up aid. This would lessen the volatility of aid inflows. It seems the most prudent approach would be for a combination of incremental scaling-up that donors commit to for a long-time horizon (though see Eifert and Gelb, 2005 on the types of results-based criteria that would need to be met for donors to continue providing aid).

Third, *improving aid data flows is important for improving the coordination of aid and making fiscal and monetary policy more feasible.* Killick and Foster (2005) point out that there are at least two major problems here: (a) the poor past record of donor agencies in providing recipient authorities with comprehensive, reliable and up-to-date statistics on actual and intended levels of support and (b) the limited ability (and perhaps interest) of recipient governments in processing data and feeding it into policy decision processes. They further argue that problem (a) reflects past donor

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\(^{23}\) The data presented in this paragraph draws on the results of Hamann and Bulíř (2005).

\(^{24}\) See UNCTAD Least Developed Country Reports 2000, 2002 on the problems volatile and uncoordinated plays in generating macroeconomic instability.
reluctance to channel assistance through domestic budgetary processes. In the end, there is little prospect for a sophisticated matching-up of fiscal and monetary responses if a significant amount of additional aid remains ‘off-budget’ and goes unreported to government.

6. Does scaled-up aid substitute for domestic tax mobilisation?

One of the central issues on tax concerns in the academic and donor community is the extent to which increased aid crowds out domestic tax effort. This issue is important since the prospects of reducing aid dependency depend in part on the ability of economies receiving aid to increase domestic taxation. The literature on the ‘resource curse’ in mineral abundant economies, and particularly the rentier state model, has made an important contribution to the political economy of tax and has been an important intellectual pillar behind the idea that aid reduces domestic tax effort.

The main premise of the rentier state model is that when states gain a large proportion of their revenues from external sources, such as oil rents, there is a reduced necessity of state decision-makers to levy domestic taxes which causes leaders to be less accountable to individuals and groups within civil society; more prone to engage in and accommodate rent-seeking and corruption; and less able to formulate growth-enhancing policies (Mahdavy, 1970, Karl, 1997; Brautigam, Fjeldstad and Moore, 2007; IDS Policy Briefing 2007; Moore, 2004). In addition, it is posited that the greater abundance of unearned income makes such economies more prone to violent political conflict, including civil war. Although the literature has been an inadequate guide in explaining differential growth performance among oil states, and changes in growth rates in particular oil states over time (Di John, forthcoming), it has drawn attention to an important issue, namely that the type of taxes (and not just the level), and the manner in which the state appropriates resources are central to understanding the historical development of state capacity.

Comparative work both across and within countries provides some valuable insights into how the so-called ‘resource curse operates. In the former Communist countries, two trends of tax states seem to be emerging. One consists of those Central European,
Baltic and Balkan countries that have developed a diversified and ever increasing tax take. The pressure to meet European Union admission criteria played a role in this success. The other group broadly forming is countries that appear to be suffering from the ‘natural resource curse’: characterised by narrow taxes based on minerals, and the failure to spend mineral rents on broad-based welfare programs.

Easter’s (2002) comparative analysis highlights differences in the trajectory of tax structure in Poland and Russia. The former state, which has limited revenue options from mineral rents, developed a social pact with labour over household income, and was able to institutionalise a well developed personal income tax, and avoid punitive taxes on corporate profits. While there was substantial union resistance to these taxes, the negotiated settlements through tripartite commissions that involved the state, unions and industrial managers were able to forge acceptable reforms to all parties. The Russian situation differed. The revenue base was narrower, based on large mineral, oil and gas exports, which came under the control of private conglomerates. These groups were strong enough in the 1990’s to resist state attempts to fully tax mineral rents, and so the state resolved its revenue shortfalls by focusing on sharing its claim on mineral/oil rents with a small group of business groups. As a result, the tax base remained narrow, and as a result, the social contract between state and citizen was less developed. Moreover, the inability of the state to tax the conglomerates at a sufficient level to meet its fiscal needs meant that the state raided less powerful and smaller businesses in an arbitrary manner.

Further evidence in support of the rentier state model is developed in analyses that compare governance patterns within countries. A study that compares provincial governments in Argentina shows that those most dependent on broad taxation of citizens has historically been 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 (Gervasoni, 2006). While these studies provide some important insights, the extent to which they support the idea that abundant levels of ‘unearned income’ necessarily lead to ineffective governance and political instability is less certain. This is important to assess since many of the initiatives of scaling up aid would be counterproductive if the resource curse logic were generally valid. As we shall see this is not the case.
The rentier state model has influenced ideas on the relationship between aid and taxes. In particular, this line of thinking has generated concern that the scaling up of aid will crowd out domestic tax efforts and thus generate patterns similar to what supposedly occurs in ‘petro-states’ (Gupta et al., 2003; Brautigan and Knack, 2004) [on the magnitude of scaled-up aid, see Killick and Foster, 2005 and Moss, Peterson and van de Walle, 2004] Another claim is that increases in central government transfers will crowd out tax mobilisation at the state or municipal level. This is an empirical question and there is not robust evidence to support the claim that aid or central government transfers crowd out domestic tax effort.

The most influential study on the question of the effect of aid on domestic tax mobilization is the cross-sectional time-series analysis conducted by Gupta et al. (2003) who separately examine the impact of grants and loans on government revenue in a large sample of developing countries between 1970 and 2000. Their results suggest that net aid has a negative impact on government revenue, which seems to be driven by a negative impact of grants on revenue, whereas loans are associated with increased domestic revenue mobilisation. One potential explanation they offer for why this might be the case is that loans may imply the need of a repayment, which serves as an incentive to increase the domestic tax effort. The other main result of the Gutpa et al study is that aid had in both grant and loan versions, has a negative impact in countries with higher corruption indices.25

A more econometric recent study has arrived at the opposite conclusion. Gambaro, Meyer-Spasche, and Ashikur (2007) find evidence that there is a positive association between aid inflows and tax revenue, which is primarily driven by the positive relationship between grants and tax revenue over the period 1990-2000. The authors also do not find any evidence for the hypothesis that the marginal impact of aid on tax revenue is different in countries with low corruption compared to more strongly corrupted countries.

25 It is important to point out that the Gambaro et al (2007) specification is slightly different from the one used by Gupta et al., as they use tax revenue as dependent variable rather than total government revenue. Total revenue is a more aggregate variable, as it also includes income from, for example, state assets and rents from mineral resources. It is therefore less apt to capture the factors directly linked to the tax system, which is essentially what they are interested in.
Gambaro et al (2007) emphasize that their conclusions only hold for the period 1990-2000, which is both a more recent and shorter time frame that the Gupta et al (2003) study. One possible reason for the Gambaro et al results may be that the role of development policy post 1990 has had a stronger focus on institutions. The positive correlation between grants and tax revenue lends some support to the interpretation that development aid since the 1990s, through its stronger focus on institutions, may have led to an improvement in the tax administration and revenue collection in recipient countries. An important conclusion Gambaro et al highlight is that both donors and recipient countries should try to identify the pivotal set of policies that influenced the response of tax revenue to the inflow of aid after 1990.

Participatory Budgeting in Porto Alegre: A case of central government transfers coinciding with increased municipal revenues

The successful experience with participatory budgeting in Porto Alegre, Brazil provides three important lessons with respect to the predictions of the rentier state model, and by extension, the idea that aid or other forms of unearned income will reduce local tax efforts and/or result in ineffective governance. First, it provides an example of how increased central transfers to local governments do not necessarily reduce the incentives of local politicians to raise local taxes. Increases in so-called ‘unearned income’ have not created a rentier state effect. Second, it highlights the importance of the role local politics, political innovation and bargaining can play in how increases in external resources can affect governance outcomes. The rentier state model assumes that increases in external/unearned resources will negatively affect governance without examining the mechanisms and processes through which politics is conducted in historically concrete situations. Finally, the Porto Alegre case shows how a local government can provide for the poor while securing the voluntary compliance of middle- and upper-income groups.

The evolution of municipal governance in Porto Alegre since the 1980’s is as follows. The participatory budgeting project began in the context of very fragile finances manifested in chronic municipal deficits and poor service delivery. The

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26 This section summarizes the main insights of Schneider and Baquero (2006).
public administration in 1988 was characterised by ‘bloated mayoral office, low salaries, dissatisfied employees, decayed equipment, old vehicles, obsolete machinery, investment capacity around zero; in sum, absolute incapacity of municipal authority to attend to the minimal needs of maintaining services, investment, and renewal. Within five years, the city had turned itself around, including a rationalisation of expenses and inherited debts; refinancing of the deficit; administrative restructuring; and recuperating receipts.

To understand how this path change took place, it is important to identify how, in fiscal terms, the municipal authority survives. Own-sources of funding in Porto Alegre include taxes on several bases (services, income retained at source on salaries, transfer of property, and property), fees on services like garbage, sewage, and lights; profits on public companies (which were few); and financial gains (which were significant until the end of inflation in 1994). In the late 1990s, municipalities gained an additional boon to their finances with the transfer of health service funds (SUS). For Porto Alegre (like other many cities in Brazil), the largest sources are constitutionally-mandated transfers from higher levels of government, which were greatly increased following the 1988 Constitution.

This increase in central government funding, contrary to rentier state predictions, coincided with greatly increased municipal tax receipts. Total receipts increased 269 per cent from 1988 to 2004. Significantly, the increase in tax effort far outpaced what one might expect simply as a result of economic growth, which was only 18 per cent in the city. In particular, a close look at the kinds of taxes the municipality mobilised tells the story of a city seeking to raise money from particular segments of society. At 27 per cent of total taxes, the two main municipal taxes are the taxes on services (ISQN) and the tax on property (ITPU).

Several means of raising property tax were utilised. The city closed exemptions and loopholes, re-valued properties, published a list of large debtors as an ‘invitation to pay,’ made the rate more progressive, and when progressivity was declared illegal by the Supreme Court in the late 1990s, recuperated revenue in 2003 with new rates on specially classified properties. All of these efforts followed a common underlying principle that ‘those who had more should pay more’. A key factor in this process was
the role the national governing party, the Workers’ Party (PT) played at the level of the municipality. 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. The effective role of a main national political party was absent in the case of participatory budgeting efforts at the municipal level in Argentina and may explain why such initiatives have failed to become institutionalised there.

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. Participatory budget institutions were associated with this shift in two ways. First, participatory budgeting included a decision-making process in which poor citizens had privileged access as a result of their higher levels of participation. Second, the formula used to distribute funds and to make other institutional decisions, such as the boundaries of different regions, gave preference to the poorest neighbourhoods that had the weakest infrastructure.

Equally important are the factors that contributed to an increase in voluntary compliance among the middle- and upper-income groups to pay local taxes. First, some wealthier areas did receive direct benefits in the form of improved street lighting and roads. Second, most of the public employees were from the middle classes who were now receiving better salaries and were paid on time. Finally, middle sectors valued the international fame associated with being the home of participatory budgeting. Despite some complaints among wealthier groups for having to pay higher taxes, the Workers’ Party governed in Porto Alegre with impressive middle sector support. The best evidence of this is that the degree of tax evasion declined substantially at the municipal level.

In sum, the Porto Alegre case provides an example of how internal political dynamics can shape the use of so-called ‘unearned income’ whether in the form of aid or natural resources. First, the role of an effective, programmatic political party (the Workers’ Party) was central to improving democratic participation where an increasing number
of citizens participate in public decisions, and different groups, especially the poor, have been incorporated. Second, the legitimacy of the municipal government and the Workers’ Party was based on progressive public spending in which investment in poor neighbourhoods increased both in absolute terms and in relation to rich neighbourhoods. Finally, effective and progressive governance resulted in perceptions that corruption has decreased, and clientelist administrative structures have been reformed.

7. Mineral-Based Growth, Mineral Taxation and Economic Development in LDCs: The Cases of Zambia and Mozambique

The fiscal and productive impact of attracting mineral investment and natural-resource-based industrialization is also of central concern for many low-income countries, particularly in sub-Saharan Africa. Two recent examples that illustrate the challenges of mineral-based development are Zambia and Mozambique. Consider first the case of Zambia.

Zambia

Zambia is one of the poorest countries in Sub-Saharan Africa. It is a land-abundant but sparsely-populated country of 11 million inhabitants. Copper is the dominant export industry and the development of export diversification has been further hampered by the fact that the country is landlocked and is surrounded by five countries which have experienced civil wars and political disorder. By any conceivable measure, the growth performance of Zambia has been dismal, a chronicle of decades of relentless economic decline as indicated in Table 4.

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<td>African Average</td>
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<td>Zambia’s rank:</td>
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Source: World Development Indicators.

The reasons for the decline in Zambian economic performance are complex, but include a combination of the disruption of regional trading routes, the nationalisation
of the copper industry before the development of skilled workers and managers emerged on the domestic scene, and mismanagement of the state-owned copper industry (see Weeks et al. 2004). Copper production declined from 600,000 tons in the 1960’s to just over 300,000 tons by the end of the 1990s.

The response of the government in the late 1990s was to privatise the copper industry and lower mineral royalties in order to attract foreign investment. This was undertaken in the context of desperation, namely historically low world copper prices, declining copper production, and an unsustainable debt burden.\textsuperscript{27} Its privatisation strategy for copper included the a reduction in the corporate tax rate from thirty-five to twenty-five percent; exemption from customs duty on inputs up to US$ 15 million; \textit{reduction of the mineral royalty from 2.0 percent to 0.6 percent}; exoneration from excise duty on electricity; an increase in the period for which losses could be carried, from ten to twenty years; and, exemption from the withholding tax on interest, dividends, royalties and management fees. In sum, the mining companies effectively paid almost no income taxes in the period 2000-2006. The effect of these so-called incentives was that it would be decades before the government received substantial revenue from the new mining companies.

There is indeed evidence of renewed growth in Zambia in the period 1999-2005, as in indicated in Table 5. Much of this has been driven by the growth in copper after three decades of decline.\textsuperscript{28}

\begin{table}[h]
\centering
\begin{tabular}{|l|c|c|c|}
\hline
 & GDP & Agriculture & Manufacturing \\
\hline
1990-1998 & -0.5 & 0.5 & 1.5 \\
1999-2002 & 3.5 & 2.5 & 4.0 \\
2003-2005 & 5.3 & 4.2 & 4.5 \\
\hline
\end{tabular}
\caption{Recent Growth in Zambia: 1990-2005}
\end{table}

Source: Central Bank of Zambia.

\textsuperscript{27} The government received substantial debt reductions under the HIPC initiative which reduced its debt burden.

\textsuperscript{28} Copper export volume has increased by more than 10 percent per year in the period 2000-2006. Much of the copper export revenue, however, owes to a boom in copper prices which increased from less than $2,000 per ton in 2000 to over $8,000 per ton in 2006 (data from IMF country reports on Zambia).
Despite this renewed growth, there are several reasons for concern. On the fiscal side, tax revenues have not increased. Taxes as a percentage of GDP declined from 18.4 percent in 1996 to 17.0 percent in 2005. One of the main reasons is the ludicrously low royalty the Zambian government set to attract copper mining investment. The royalty of 0.6 percent is one of the lowest mining royalty taxes in the world, and even the IMF has suggested that the government consider re-negotiating the royalty rate of 3.0 percent. In 2006, the government received just $25 million in copper royalties out of a $4 billion turnover in copper sales. This substantially hampers the extent to which the government can finance improvements in physical infrastructure which are essential for reviving productive capacity and growth in non-copper sectors in agriculture and light manufacturing.

Moreover, there is little evidence that the current increase in growth can be sustained in absence of continued buoyancy of mining sector exports. More worrying is that, even in spite of this boom, growth rates in agriculture and manufacturing are well below the growth rates in more successful countries in the region such as Uganda, where growth in manufacturing is not sustained by high mineral prices. Another inauspicious feature of the recent growth acceleration is that it has not been accompanied by significant infrastructure investment, particularly in agriculture where most poor people work. Rural infrastructure in particular has suffered from macro-stabilization policies. The importance of rural infrastructure in determining the participation of poor households in agricultural growth is well established. In 1998, only 18 percent of rural households were within five kilometres of input markets, and few remote households had access to education and health facilities. Therefore missing and deteriorating infrastructure, especially in remoter rural areas remains a major constraint to achieving pro-poor growth.

Mozambique

Mozambique is considered one of the success stories of post-war reconstruction. A turbulent post-independence period and long civil war coincided with declines in economic activity. In the period 1974-1986, real GDP per capita declined by one-third. Economic reforms, begun in 1987, and the end of the civil war in 1992, helped revive
the economy. In the decade from 1987, annual growth averaged 5.3 percent, and accelerated further to over 8 percent per year in the period 1996-2006. Growth has been fuelled by substantial levels of foreign aid, which has financed approximately one-half of government expenditures over the period 1985-2005 (Virtanen and Ehrenpreis, 2007: 17), which has coincided with an increase in the tax take, which has risen from 11.7 percent of GDP in 1995 to 14.6 percent of GDP in 2004 (USAID 2004: Table I-1, p. I-13).  

The main growth pole of growth and exports has been generated through foreign-owned mega-projects in mining and natural-resource-based industrialization. The leading project in this is Mozał, a large aluminium smelter (completed in 2000) on the outskirts of the capital city, Maputo. Mozał cost $2.4 billion to build produces 512,000 tons of aluminium ingots. South African mining interests control two-thirds of the project, as is the case in most mega-projects in Mozambique. As of 2004, Mozał contributes 75% of manufacturing exports, and 42% of total export revenues of Mozambique (Castel-Branco, 2004). Aluminium represents nearly half of total manufacturing output.

Tax policy has been central in attracting foreign investment in mega-projects. Mozał was given Free Industrial Zone (FIZ) status. This means that it is exempted from paying duties on imports of material inputs, and equipment. It is also exempted from valued-added taxes, and corporate income taxes are limited to 1 percent of sales! The failure of the government to develop a more revenue-enhancing tax package was the result of it not seriously considering the offers of rival aluminium producers (Kaiser, a US multinational, made initial offers in the late 1990s but was rejected by the Mozambican government on the grounds that it did not have enough of an influence on world markets to succeed) [ibid, 18]. Irrespective of the reasons of rejecting the Kaiser bid, an important policy lesson is that government’s can use competition among multinationals to produce more lucrative tax packages out of mineral-based investments. The increased interest of Chinese corporations in mineral development in

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29 In this perspective, the Mozambican case does not corroborate the argument that increases in foreign aid reduce the domestic tax effort.
30 The availability of extensive hydro-electric power has also been central to Mozał’s economic viability. Mostraco, a joint venture of three electricity corporations, EDC (Mozambique), ESCOM (South Africa) and SEB (Swalland) supplies Mozał’s energy needs. This energy source is in effect part of the South African power grid (Castel-Branco, 2004, 17).
Africa may provide an opportunity for governments to reap the fiscal rewards of competitive bidding among multinationals.

While Mozal has undoubtedly contributed to the export and production capacity of the Mozambican economy, there are several issues that are of concern for the prospects of long-run economic development and productive capacity-building. First, the negligible tax payments Mozal makes to the government limits the fiscal linkage such projects can generate (ibid.). This limits the extent the government can invest in developing productive capabilities and infrastructure elsewhere in the economy. Second, the mega-projects have focused FDI and manufacturing production around the capital city has induced a substantial regional concentration in manufacturing production (in 2003, 81% of industrial activity was generated in Maputo Province [USAID 2004, Table 12-3, p. 3]). Manufacturing production outside the capital is negligible. Third, most of the economic linkages of Mozal are with firms in South Africa, not in Mozambique. This is mostly because Mozambican firms do not have the technical capacity to provide inputs that Mozal needs, but also because there is not wider industrial strategy to provide either carrots or sticks for Mozal to develop important supplier contracts with Mozambican firms.

There are several policy implications that it is possible to draw from the Zambian and Mozambican cases:

First, there is an urgent need for mineral abundant states to enter into a renegotiation of mining contracts which even the IMF agrees is necessary. Commodity rents are temporary and this period represents a window of opportunity that can not be missed. This is of vital importance if the fiscal linkage of mineral rents is to be realized. Tax revenues from mineral can provide valuable source of financing of infrastructure investment which is much needed to enhance non-mineral productive capacity.

Second, the increasing interest of Chinese investment in mineral production offers an opportunity for African states not only to bargain for better tax deals but also offers an opportunity for such states to benefit from the willingness of Chinese investors to finance infrastructure as part of these deals.
Third, there is a need for governments to develop productive strategies that exchange mineral rights for local content conditions, whereby foreign investors are obligated to use domestic suppliers on an increasingly greater scale. Local content management has been one of the main ways in which FDI can be utilised for the benefit of national productive capacity. The increasing interest of the Chinese offers an opportunity for African states to leverage Chinese interests against South African, Japanese, European and North American investors.

Finally, capacity-building in the geological survey capacity in sub-Saharan Africa needs to be developed in order to improve the bargaining power of states vis-à-vis multinationals. No African states, apart from South Africa, have any survey capacity at present. This is an area where the international financial institutions can play a leading role.

**Conclusion**

Inherent in much of the recent work on taxation is that a broader-based taxation system will consolidate state-interest group bargaining which will, in turn, generate a greater degree of legitimacy which supposedly will generate more effective governance. Good governance, in turn, is seen as central for sustained rapid economic growth (World Bank, 1997, 2002). The usefulness of much of the new refocusing on tax is that it brings back discussions of politics and state-building into the discussion on governance which many international financial institutions neglect.

The problem with much of the new literature, however, is that it identifies the tax nexus as the main source of a state’s legitimacy. This is problematic in the context of economically underdeveloped countries. To re-iterate, economic growth, employment creation and poverty reduction are important source of state legitimacy in less developed and developed countries. Because tax rates and composition are not systematically correlated with economic growth, it is not helpful to focus on taxation in isolation of other factors that affect capital accumulation, the efficiency of investment and economic growth. For instance, national savings and particularly
public savings (which in part come from the efficient operation of state-owned enterprises) may be as if not more important to the growth prospects of an economy.

Also, the focus on taxation as a way to finance social service delivery, while important, may distract attention away from the political economy factors that matter for the construction of a dynamic capitalist class in the context of primitive accumulation processes (Khan, 2006). For instance, the new consensus is on providing broad-based neutral (especially consumption) taxes. This leaves little room for using the tax system as a tool of production, including industrial strategies. The decline in tariff rates makes industrial policy even more challenging—particularly since tariffs are a much less expensive way to encourage infant industry development than subsidies given the weal fiscal base of many less developed countries.

The traditional economic approach to tax focused on the structural reasons why the tax base is low and why direct taxes are relatively low in the context of underdevelopment (e.g. Burgess and Stern, 1993). Such factors include low incomes generally, a large subsistence agriculture sector, a large informal sector and so on. This literature does not engage with the political economy implications of limited tax collection potential, but the structural factors do not disappear just because we would like to see tax systems in poor countries resemble more closely those of developed countries.

The implication is that while improving tax capacity in less developed countries is important, one should not expect state-society relations to resemble OECD countries. The evidence also suggests that the wider resource mobilisation capacity of states is as if not more important to the expansion of the tax nexus. Donor and government policy needs to link tax reform with productive strategies and aid policy needs to focus much more on facilitating capital accumulation. One suggestion already mentioned is that aid needs to shift back toward the financing of directly productive economic activities and particularly physical infrastructure. The advocacy of improving tax capacity as a way to help construct states and state legitimacy is well placed, but such advocacy needs to be done in a way that is more informed by history and political economy dynamics that accompany low levels of per capita income. It is
important not only to bring politics back into issues of taxation and governance but also the realities of the stage of economic development.

**Summary of Policy Recommendations:**

1) Rapid trade liberalization is not recommended for LDCs as it is difficult for low income countries to recover lost trade tax revenues with VAT and income tax in the medium-run.

2) Tariffs not only provide an important source of tax revenue but are the most feasible way, in fiscal terms, for states to promote domestic firms. Subsidies, while potentially less distortionary, are often too expensive for low-income countries.

3) Widening the tax base (to include informal sector firms and to avoid evasion among large tax payers) will require a 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.

4) Donor support for improving Large Taxpayer Offices (LTOs) can provide a focal point for testing the administrative capacity of the tax authority.

5) There is a need to re-think the policy of exempting high-income expatriates from paying taxes despite the fact that they often earn 100 times the national average salary. This exemption creates a demonstration effect to high-income nationals that it is legitimate for upper income groups not to contribute to tax collection.

6) Aid has does not generally substitute for domestic tax effort. However, it makes sense for donors to enter into a multi-year compact with low-income and post-conflict host government to provide matching funds for direct budget support purposes. This The main advantage of this approach is that it increases the incentives for revenue collection since state officials will know that raising extra revenue will result in additional inflows of donor resources. For this system to work, it is necessary that donors commit for the medium- and long-term through development of trust funds.
7) It is not advisable to advocate autonomous revenue authorities (ARAs). This is because tax policy, which is the domain of finance ministries, cannot practically be divorced from tax collection, which is the domain of newly created ARA’s, it is not ultimately possible for the latter to function in purely autonomous ways. A more sustainable approach to reform would be to encourage cooperation between the central bank, the finance ministry, the development ministry and tax authorities.

8) Urban property tax is one of the most underutilised 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. Urban property tax also can provide one of the few potential sources of taxation for municipal governments which have received increasing responsibilities in the delivery of services (during the recent wave of decentralisation) but so far have been unable to generate sufficient local revenue collection.

9) Donors need have a historically and politically more informed view of the role that political parties and business associations play in legitimating tax reforms and in helping national and local governments collect tax.

10) LDCs need to appropriate a greater level of mining taxation. Tax revenues from mineral can provide valuable source of financing of infrastructure investment which is much needed to enhance non-mineral productive capacity. The IMF and other donors can use their influence to make the case that higher levels of mining taxation will not deter mineral investment, and can have a positive developmental impact. There is also a need for governments to develop productive strategies that exchange mineral rights for local content conditions, whereby foreign investors are obligated to use domestic suppliers on an increasingly greater scale. Local content management has been one of the main ways in which FDI can be utilised for the benefit of national productive capacity.
11) Taxation policy is only of a wider set of resource mobilisation challenges in LDCs. Policies to improve public enterprise efficiency, and national savings need to accompany taxation reforms.

12) If international aid and expenditure from taxation is to become more growth-enhancing, then greater emphasis needs to go to both national and regional infrastructure investment (particularly in power, roads and irrigation).
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