UNRISD

UNITED NATIONS RESEARCH INSTITUTE FOR SOCIAL DEVELOPMENT

DRAFT

Fiscal Reforms, Developmental State Capacity and Poverty Reduction

Jonathan Di John, School of Oriental and African Studies (SOAS), University of London

background paper commissioned for the

UNRISD Flagship Report on Poverty

September 2008 ▪ Geneva

The **United Nations Research Institute for Social Development** (**UNRISD**) is an autonomous agency engaging in multidisciplinary research on the social dimensions of contemporary development issues. Its work is guided by the conviction that, for effective development policies to be formulated, an understanding of the social and political context is crucial. The Institute attempts to provide governments, development agencies, grassroots organizations and scholars with a better understanding of how development policies, and processes of economic and social change, affect different social groups. Working through an extensive network of national research centres, UNRISD aims to promote original research and strengthen research capacity in developing countries.

Research programmes include: Civil Society and Social Movements; Democracy, Governance and Well-Being; Gender and Development; Identities, Conflict and Cohesion; Markets, Business and Regulation; and Social Policy and Development.

A list of the Institute's free and priced publications can be obtained by contacting the Reference Centre.

UNRISD, Palais des Nations
1211 Geneva 10, Switzerland

Tel: (41 22) 9173020
Fax: (41 22) 9170650
E-mail: info@unrisd.org
Web: http://www.unrisd.org

Introduction

"Poverty reduction is currently high on the agenda of international development. Most countries today have wide-ranging anti-poverty programmes, irrespective of whether they have signed on to the Least Developed Country (LDC)-focused Poverty Reduction Strategy Papers (PRSP) of the international financial institutions. There are concerns, however, that many countries will be unable to make meaningful dents in their poverty, let alone meet the targets set in the Millennium Development Goals. At the centre of these concerns is the question of whether countries are following the appropriate development paths. Critics affirm that the deflationary adjustment model that gained prominence in the 1980s still imposes constraints on the types of anti-poverty strategies that countries can adopt, and that lessons have not been drawn from the experiences of late industrializers that have been successful in reducing poverty in very short periods" (UNRISD 2007: 1).

There is a general consensus that sustained economic growth is a necessary condition for sustained reduction in poverty (Ravallion, 1997; Page, 2005). Sustained economic growth and structural transformation is a necessary condition for sustained increases in salaried employment, which historically is the main source of increases the incomes of low-income groups as well as improving the empowerment of women (Sender, 2008). While there is considerable debate about the types of state capacities and policies that are necessary to achieve sustained growth (Rodrik, 2003, 2004), recent research indicates that a wide variety of policies and institutions can be compatible with sustained growth. This suggests that what matters for growth is not so much the implementation of a 'correct blueprint', but the development of institutions and policies that are compatible with political settlements over property rights, which are in every instance, a historically specific process (Khan, 2006). In sum, there are many institutional forms that provide developmental functions (Qian, 2003; Rodrik, 2004).

At least since the work of Thomas Hobbes, a necessary condition for sustained economic growth is the construction of a centralised state that has the authority and legitimacy to secure property rights over growth-enhancing activities, maintain public order and mobilize resources. Much of the literature on the developmental state examines *how* successful late developers have intervened to promote growth, but has neglected where the power and legitimacy of a state (to *enforce and change the rights and institutions, and to extract and mobilize the resources* required to sustain development and growth) comes from in the first place (Kohli 1999).

In particular, the developmental state literature has neglected the processes through which a state develops its capacity to collect tax. This is a serious lacuna since tax is intimately related to questions of state formation and capability. Douglass North, for instance, *defines* the state in terms of taxation powers: "… an organization with a comparative advantage in violence, extending over a geographic area whose boundaries are determined by its power to tax constituents" (North 1981:21). Much earlier, Edmund Burke remarked: "Revenue is the chief preoccupation of the state. Nay more it is the state."[1] Tax also provides one of the principal lenses in measuring

[1] Quoted in O'Brien (2001:25).

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).[2] 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).

A recent IMF (2005) assessment sets a revenue-to-GDP ratio of 15-20 percent as a reasonable minimum "threshold" for developing countries. While the majority of LDCs are above this threshold, many countries fall below this cut-off point (Bird, 2008: 5). In West Africa in 2003, for example, Guinea, The Gambia, Liberia, Togo and the Democratic Republic of Congo (DRC) all had tax ratios below this threshold (IMF 2005a). Fox and Gurley (2005) find that 44 out of 168 countries examined had tax ratios less than 15 percent in the 1990s, with 18 of those that failed the "threshold" test being in sub-Saharan Africa. While the UN Millennium Project (2005) advised that most developing countries should mobilize up to an additional 4 percent of GDP, only South Korea has been able to do so in the past fifteen years (Bird, 2008:5); and many low-income countries have seen their tax shares as a percentage of GDP decline in recent years (Baunsgaard and Keen, 2005). Thus, the challenge to mobilize tax revenues is a pressing issue in many LDCs.

Remarkably, there is little attention within the 'good governance' agenda of incorporating discussions of tax. Taxation is not even explicitly listed as a separate "fundamental" task of a state (as spelled out in the World Bank Development Report, 1997).[3] This error of omission is indeed remarkable given the centrality of revenue production and resource mobilisation in the historical process of state formation (Schumpeter [1918], 1954). While the goals of transparency and accountability are stressed, much less emphasis is placed on *how governments will finance* the social services that citizens demand of them.

This paper provides a survey of the variations in taxation systems and processes of tax reform in less developed countries. The purpose of the survey is to shed light on how different tax systems and tax reform policies contribute to processes of state-building and how changes in tax policies present specific challenges for LDCs in mobilising the resources necessary to both finance growth and reduce poverty, and meet the Millennium Development Goals.

The organisation of the paper is as follows:

---

[2] Or as Rudolph Goldscheid notes: "…the budget is the skeleton of a state stripped of all misleading ideologies." (quoted in Levi, 1988:6).

[3] According to the World Bank (1997:41-60), the five "fundamentals" that lie at the core of good governance for a state are: a) establishing a foundation of law, b) maintaining a non-distortionary policy environment, including macroeconomic stability, c) investing in basic social services and infrastructure, d) protecting the vulnerable and e) protecting the environment. While tax is not explicitly mentioned as a core function of governance, tax capacity is implicitly behind items [c] and [d].

Section 1 provides a descriptive of the general features of tax systems in developing countries, and attempts to assess how differences across countries and regions can be linked to differences in policy regimes, level of development, crises and external threats.

Section 2 investigates the links between tax reforms and building state capacity in low income countries, both in terms of consolidating the territorial reach of the state and developing the contract between the state and its citizens. In particular, an analysis of the various types of tax reforms being implemented in diverse sets of countries, and the extent to which increased tax efforts have improved the territorial, administrative and social reach of the state will be assessed. The section will identify which are the most successful countries in these efforts and why.

Section 3 examines the implications for the policy autonomy of developing countries of taxation and foreign aid as alternate revenue sources, looking at the potential of tax reforms to address problems related to aid dependency. We assess emerging evidence that some aid-dependent countries that had implemented orthodox managerial reforms recommended by donors are rejecting aspects of these reforms and asserting autonomy in the policy field as their tax yields improve. The tax challenges in mineral abundant countries will also be assessed. This section will also analyze the extent to which tax efforts are improving policy spaces in aid-dependent countries, and what patterns are emerging.

Section 4 briefly explores the extent to which the tax system contributes to economic goals like efficiency, stabilization and growth. In particular, an examination of how tax collection can be linked to production strategies will be examined.

Section 5 explores the social goals of tax policy, and in particular, the theoretical relationship between tax policy and social policy in terms of redistribution, equity, and equality. It also explores the links between tax reform, poverty and inequality. The section assesses whether, in practice, a tax system can contribute to social goals of equity, cohesion, accountability and democratization. It assesses if there is evidence on the specific effects of recent reform trends in tax systems in developing countries on poverty and inequality; and what the effects on public revenues in general are. It also reflects on whether a "pro-poor" tax policy framework (i.e., one that effectively redistributes) exists.

1. Tax Systems and Tax Policies: Trends and Regional Variations

This section provides a descriptive of the general features of tax systems in developing countries, and attempts to assess how differences across countries and regions can be linked to differences in policy regimes, level of development, crises and external threats.

The determinants of tax collection and tax reform have been the subject of extensive analysis. There are two main questions which drive analyses of tax collection and reform: first, why does tax collection increase over time, and second, should the main concern be efficiency or equity when designing tax systems?[4]

The applied economic literature focuses on the *structural reasons* why the tax base is lower, and particularly why direct taxes (personal and corporate income taxes) are lower as a share of total taxes, the lower is the level of economic development.[5] The main reason why the development of 'tax handles' is lower at lower levels of economic development revolves around the economic structures in such economies. For instance, developing countries are characterised by a large share of agriculture in total output and employment, large informal sectors and occupations; many small establishments, a small share of wages in total national income, a small share of total consumer spending made in large, modern establishments, and so on (Burgess and Stern, 1993:3). As well, the demand for public services may rise faster than income (that is, the income elasticity for public services is greater than one), particularly in lower-income countries. For example, urbanization tends to rise with income and the demand for public services is generally higher in urban areas. It is also usually easier to collect taxes in urbanized areas. [6]

These characteristics, it is argued, reduce the possibility of depending on certain types of taxes, such as personal income tax, and make LDCs more dependent on indirect taxes such as foreign trade taxes and, result overall in a lower level of tax collection. *The main message of this literature, and one that is relevant for considering issues of financing social services, is that the tax base tends to be low and narrowly based on a small percentage of asset-owners and workers the lower is income per capita.* Not only do low-income countries collect a lower *share* of taxes as a percentage of GDP, the amount they collect is based on *levels* of income per capita that is several magnitudes lower than in wealthier countries. *As a result, foreign aid contributes a significant portion of government expenditure, especially in low-income countries.*

Indeed, there is robust evidence (see Figure 1) that increases in economic development improve the share of taxes as a percentage of GDP, as traditional tax analysis would suggest.[7]

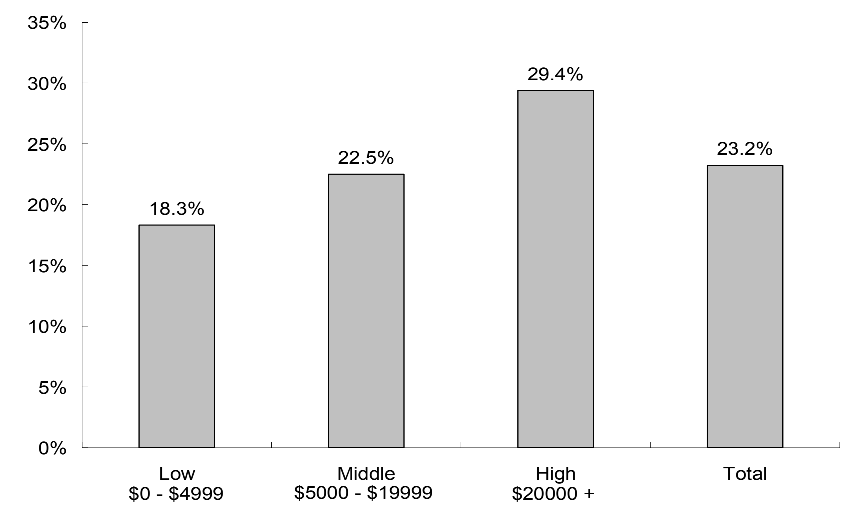
Figure 1. Tax Revenue as a Percentage of GDP by GDP/Capita Category

[4] With respect to the second question, there is considerable debate as to whether designing a tax system that promotes growth necessarily must sacrifice equity considerations (see section 4).

[5] For reviews of economic theories of tax and the applied literature on developing countries, see, Gillis (1989); Burgess & Stern (1993); and Tanzi and Zee (2000).

[6] While the capacity of countries to collect taxes appears to rise as income levels increase, more detailed analysis suggests that the relationship between rising income levels and higher taxes is significant only for the poorest countries (Fox and Gurley 2005).

[7] Earlier studies (Tanzi 1987) also found, that on average taxes tend to rise as per capita incomes rise. The tax ratio rises from about 17 percent in the low-income group to 22 percent in the medium-income group and 27 percent in the high-income group. Figure 1, although based on a somewhat different data set, shows much the same picture: the average tax-to-GDP ratio for low-income countries (in this sample, those with per capita GDP less than USD5,000) is 18.3 percent, for medium-income countries (per capita GDP between USD5,000 and USD20,000 US) it is 22.5 percent, and for high-income countries (per capita GDP greater than USD20,000) it is 29.4 percent.



Source: Bird and Zolt (2005).

It is important to note that there is substantial variation of tax collection within each category. Within the OECD, countries dominated by social democratic parties and labour unions have tax shares over 45% of GDP (e.g. Sweden, Netherlands), while countries with weaker left-centre parties and labour unions have shares below 40% of GDP (e.g.United States, Japan). Within LDCs, there is also substantial variation for both low-income and middle-income countries. South Africa and Brazil collect over 35% of GDP in taxes while Colombia and Mexico collect less than 15% of GDP in taxes. Mineral and fuel abundant LDCs such as the Gulf States, Algeria, Zambia, Chile, Botswana, and Malaysia also tend to have higher tax takes than would be predicted by their income per capita levels (although other such as the DRC tax ratios below 10% of GDP).

An example of the variation of taxation can be seen within sub-Saharan Africa, as indicated in Table 1

Table 1: Tax Collection and Composition in selected Sub-Saharan African countries

	Years	**Tax Revenue**	**Trade Taxes**	**GDP/cap**
lower tax countries		(as % of GDP)	(as % of total taxes)	(market prices*)
Congo (DR)	1998-2002	4.5%	32.0%	$600

Central African Rep.	1992-96	6.1	39.0	1,055
Chad	1994-2000	6.5	34.0	801
Niger	1994-2000	7.9	57.0	678
Rwanda	1993-99	9.3	18.0	931
Tanzania	1992-99	9.6	35.0	524
Uganda	1998-2003	11.4	16.0	1,167
Mozambique	1993-99	11.4	18.0	799
Ethiopia	1993-97	12.9	40.0	814
Mali	1991-2000	12.9	30.0	784
Malawi	1993-2000	14.2	15.0	583
average		**9.7**	**30.3**	**814**
higher tax countries				
Botswana	1993-98	32.5%	18.0%	$8,347
South Africa	1998-2002	25.5	13.0	8,764
Zimbabwe	1992-97	22.5	19.0	2,498
Kenya	1992-2001	23.1	17.0	1,033
Zambia	1990-99	18.1	12.0	785
Cote d'Ivoire	1991-99	18.0	40.0	1,582
Senegal	1992-98	16.0	28.0	1,427
Nigeria	1992-2000	15.2	18.0	854
average		**21.4**	**20.6**	**2,420**
average (excl. Botswana, S. Africa)				**1,363**

Note: * at $US 2000, market prices

Source: IMF, Government Finance Statistics; Fox and Gurley (2005)

There are several points worth considering with respect to the data in the table. First, as standard theory predicts, low tax countries tend to have much lower income per capita and tend to be much more reliant on trade taxes which means that the fiscal consequences of trade liberalization can be devastating if alternate forms of tax are not quickly increasing. However, income per capita is not necessarily associated with higher tax takes. For instance, there are many countries with a lower income per capita than the Central African Republic and Uganda that collect a much higher share of taxes as a percentage of GDP. Second, the level of tax collection does not necessarily indicate that the state has the capacity to promote rapid economic growth. Uganda, Mozambique and Tanzania have been among the fastest growing African economies in the period 1900-2005 yet have relatively low tax capacity. South Africa and Zimbabwe have higher tax capacity but have not had nearly as impressive growth