

# Taxation and State-Building: Lessons from tax reforms in poor countries

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# Motivation

- Has the recent global wave of tax reform contributed to state-building in poor countries?

# Outline of the presentation

- I. How tax reforms may contribute to state-building in poor countries
- II. Does the current tax reform agenda encourage constructive state-society relations around taxation in poor countries?
- III. Implications for policy
- IV. Challenges for donors/Norway

# **I. Tax reforms may contribute to state-building in poor countries through four main channels:**

1. Providing revenue
2. Shifting towards more appropriate revenue sources
3. Creating more effective tax administrations
4. Encouraging constructive state-society relations around taxes

## IV. Encouraging constructive state-society engagement around taxes

### Two main challenges:

1. Mobilising citizens by taxing them
    - Engage the attentions and political energies of a substantial fraction of the citizens in taxation issues
  
  2. Levy taxes as consensually and as transparently as possible
    - Put an end to arbitrary assessments, forcible collections, and extortion
    - Increase the extent to which taxation becomes a predictable, negotiated process, securing taxpayers' rights
- 1 & 2 not always fully consistent with one another
- Always an element of compulsion in taxation

## **II. Does the current tax reform agenda accommodate a constructive state-society engagement around taxes in poor countries?**

1. Simplification of complex tax systems
2. Strengthening taxpayers rights
3. Broadening the tax base
4. Reducing tax exemptions
5. Revenue targets: The rule of the game

# 1. Simplification - not always simple

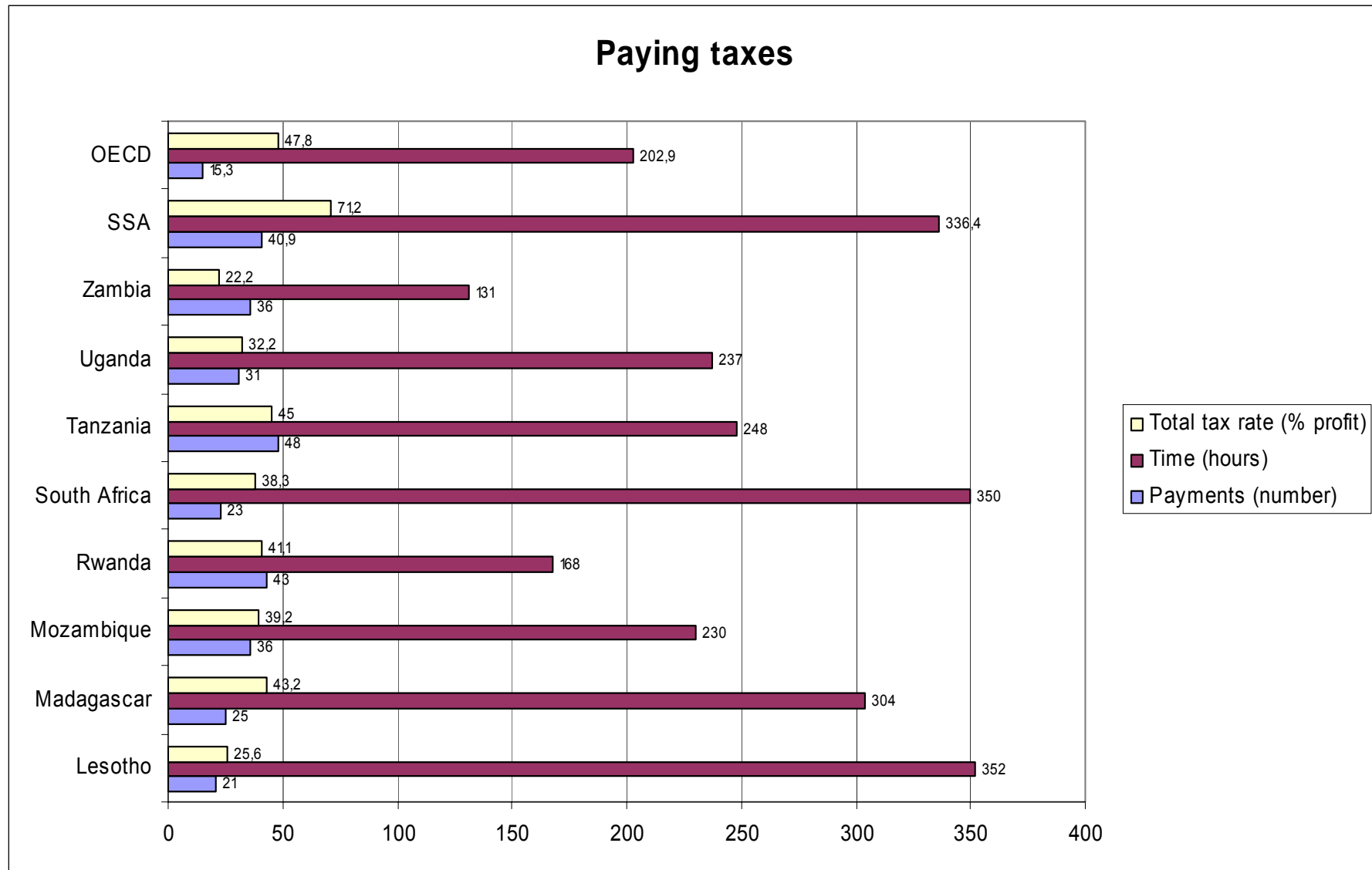
Central government tax system has become more predictable and transparent

- Encourage political mobilisation of taxpayers around tax issues
- Opportunities to pursue corrupt deals with tax officers reduced
- Compliance costs reduced
- Administrative costs reduced

Local gov. tax system requires more attention

- Often complicated and non-transparent
- Disincentives for small- and micro enterprises
- Oppressive revenue raising
- Duplication and inconsistencies between LG taxes & CG tax policies

# Compliance costs: OECD – sub-Saharan Africa compared (Doing Business 2006)





## 2. Taxpayers rights – some improvements

### Large corporate taxpayers' rights strengthened

- Customer friendliness - rational for tax adm. to be on good terms with LargeTaxpayers
- Tax Appeal Tribunals (TATs)

### Small and medium sized enterprises

- TATs not yet a real option for small and medium sized enterprises
- Tax administration often indifferent – sometimes hostile
- Ending coercion implies more attention to local government tax system

## Tanzania: Number of tax appeals filed

	2002	2003	2004	2005
Income tax	40	23	28	25
VAT	11	16	14	25
Customs	13	9	13	10
<i>Total</i>	64	48	55	60

Citizens' changing views on 'Why people pay tax'?  
 Survey data – Tanzania (Nov 2003 & Nov 2006)

	<b>2006</b> (in % of resp)	<b>2003</b> (in % of resp)
They will avoid disturbances	14	46
They anticipate public services	50	23
They have no opportunity to evade	12	10
They feel obligations towards the gov't	12	10

Major problems in tax collection  
Citizens' changing views in Tanzania (2003 & 2006)

	<b>2006 (in % of resp)</b>	<b>2003 (in % of resp)</b>
Tax revenues not spent on public services	36	58
Too high tax/fee rates	26	48
Dishonest collectors	39	46
Too many taxes/fees	24	39

# Citizens' views on how to improve the tax system in Tanzania

- More information to the public on collection and allocation of revenues
- Stronger punishment of civil servants when misappropriation is detected
- Stronger punishment of corrupt politicians

### 3. Broadening the tax base – not achieved

Likely that the number of registered taxpayers has been reduced in many poor countries in recent years

- Thresholds for income taxation and VAT registration increased
- Justified in terms of reducing administrative and compliance costs, but...

The political arguments for a broad tax base not heard

- Shaping state-society relations
- Fiscal contract
- A broader set of performance criteria than Tax-to-GDP required

Narrow tax base:

- Relative high tax burden on those who pay
- Incentives to split businesses to avoid tax registration

## Narrow tax bases: Examples

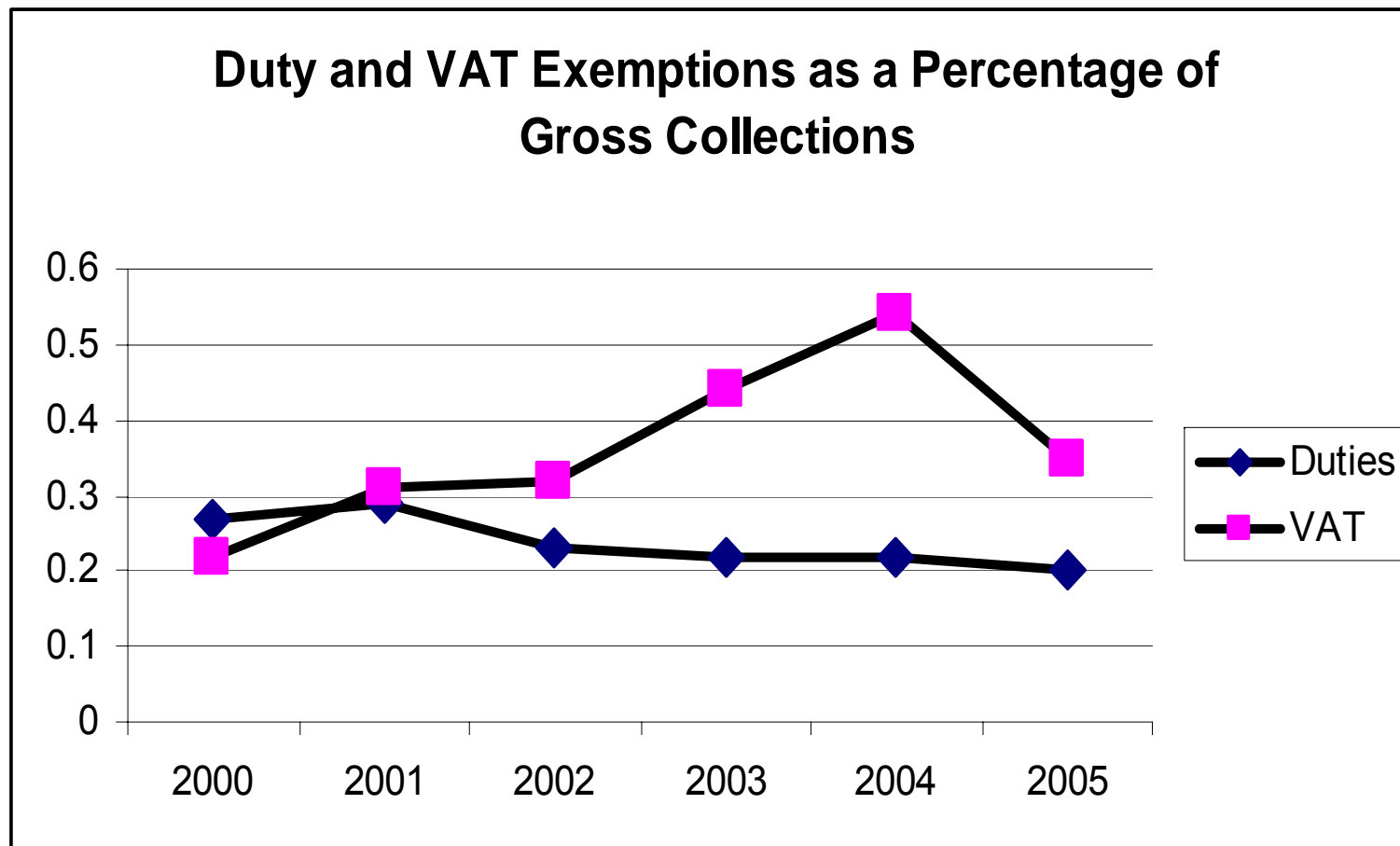
- Rwanda (2005)
  - 13 companies pay  $\approx$  80% of total taxes
  - 3,000 registered companies pay national taxes
  - 280 covered by LTD pay  $\approx$  90% of total taxes
  
- Tanzania (2005)
  - 286 large firms contribute 70% of total taxes
  - 10,000 medium sized firms  $\rightarrow$   $\approx$  30% of revenues
  - 100,000 small taxpayers  $\rightarrow$   $\approx$  2% of revenues
  
- 'Small' taxpayers little voice in the creation of tax policy

## 4. Reducing tax exemptions – not achieved

- Extensive – and sometimes increasing
  - Discretionary
  - Firm specific
  - Donors
  
- Exemption regimes
  - Distort investments
  - Divert resources into unproductive rent-seeking
  - Facilitate corruption
  - Undermine the revenue base
  - Erode the credibility of the tax system
  - ‘Legitimate’ tax evasion
  
- Exemptions used as a political tool
  - Positive discrimination of political supporters (granting tax exemptions)
  - Negative discrimination against opponents (tax audits and harassment)



Tanzania: Discretion in application of tax laws & political interventions → Tax exemptions erode the revenue base



## 5. Revenue targets - the rule of the game

- Strong pressure from IMF (and donors) to meet revenue targets
  - Tax-to-GDP ratio
  - Reduction of trade taxes & Introduction of VAT
  
- Tax administrations respond with a combination of:
  - A tighter squeeze of registered and easy accessible taxpayers
  - ‘Hunting in the zoo’
  
- Attempts to meet externally set Tax-to-GDP targets may undermine democratic accountability if legal processes and taxpayers’ rights are set aside in response
  
- ❖ Narrow tax base and tax exemptions major parts of the problem

### III. Implications for policy

- There are a large number of good things to report from the global tax agenda
  - Simplification of the tax system
  - Improved tax administrations at the central government level
  
- but also worrying problems in the poorest and most dependent countries
  - Lost revenues due to rapid reduction in trade taxes
  - VAT faces substantial implementation problems
  - Narrow tax bases
  - Extensive/increasing tax exemptions
  - Local government tax systems often ignored

- The contemporary global tax reform agenda is least appropriate to those countries most in need of the state-building
  
- but, considerable opportunities to build on the existing tax reform agenda with a view to:
  - Making it more responsive to the needs of poorer countries
  - Engaging a broader range of citizens in politics by mobilising them as taxpayers, and so contributing to the legitimacy of the state
  
- How:
  - Finding more effective ways to tax the informal sector
  - Taxing urban property
  - Pay more attention to local (sub-national) taxation

## IV. Challenges for donors/Norway

### **Policy dialogue in joint donor-government fora:**

- *Broaden the debate on taxation and development*
- *Attention on how to enhancing taxpayers' compliance*
- *Measures to enhance citizens' engagement in debates on public finances*
  - *Accessible and relevant information*
  - *Transparency*

## IV. Challenges for donors/Norway (cont.)

### **Technical assistance:**

1. Reforming the rates & tax structures
2. Administrative reforms
3. Legal reforms
4. Assessment of the revenue base
5. Assessment of who actually pays taxes, what, where and when

## IV. Challenges for donors/Norway (cont.)

- Donors should start paying taxes (ref. ITD)
  - Import tax/duties
  - VAT
  - Income tax
  
- Secure better links (political, administrative etc) between natural resource taxation and the 'ordinary' tax regime