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Fiscal Reforms, Developmental State Capacity and Poverty Reduction

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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:

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[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]

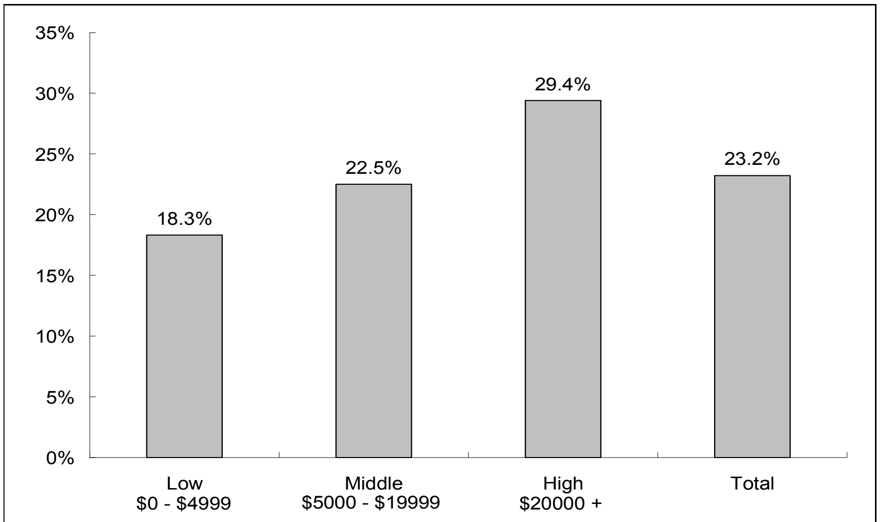
Figure 1. Tax Revenue as a Percentage of GDP by GDP/Capita Category

[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 rates over the same period. Finally, high tax levels do not necessarily indicate that a state or government is legitimate. Recent episodes of political violence in Kenya and Zimbabwe, two relatively high tax states, are examples that relatively high tax collection does not preclude violent challenges to state authority. In these two cases, further research is needed to explain if high tax rates were the result of compliance/consent, administrative effectiveness, or unsustainable levels of coercion.

Levels of economic development and the economic structure (e.g. size of the informal economy, factor endowments) tell us only part of the story of differential tax capacity across countries and over time in one country. Changes in tax policy have also been decisive, particularly as it relates to the *composition* of tax revenues. Traditional tax analysis tells us much less on why the composition of taxation differs across

developing regions. There is substantially more variation in the composition of taxes than in overall tax take per se.

In the past decade, fiscal crises confronting many LDC's in Latin America and sub-Saharan Africa have necessitated bringing fiscal reform to the centre of macroeconomic stabilization processes (Moore and Schneider, 2004). The main policy proposals advocated by the IFIs (especially the IMF and World Bank) have been to simplify and broaden tax bases, lower income and corporate tax rates (that is, make taxes more pro-business), promote reduction in trade tax rates through trade liberalization, and emphasize the widening and simplification of value-added taxes (VAT). VAT in fact has driven the majority of tax reforms in most LDCs.[8] Importantly, the latter is promoted on the grounds not only that it is less distortionary, but also that it is *administratively and politically easier* to implement than income and property taxes.[9] Because property and, particularly, income taxes are generally the most progressive taxes, equity concerns have been downplayed, which may have important implications for political stability in countries with very unequal levels of asset and income distribution.

Despite these general trends, there is substantial differentiation in tax composition across developing countries. Consider first the case of middle-income countries. The share of income tax in total tax collection differs substantially between Latin America and the other middle-income regions, namely, East Asia, Eastern Europe, and South Africa. Consider the differences that have emerged in the period 1997-2002 between Latin American and other middle-income economies in terms of the share of direct taxes collected as a percentage of GDP. In the period 1997-2002, personal income and property tax collection in East Asia was, on average, four times higher as a proportion of national income than in Latin America as indicated in Table 2:

Table 2: Personal Income and Property Tax Burden: Latin America, East Asia, South Africa and Eastern Europe Compared

[8] See Norregaard and Khan (2007) for a discussion of recent trends in tax policy in OECD and LDC economies

[9] The advocacy for tax simplifications and tax neutrality have been the result of disillusionment with progressive tax structures in enhancing vertical equity in the 1970's and 1980's (Tanzi, 1992); and the influence of neoliberal ideas such as supply-side economics, which views state intervention, and direct taxes in particular, as providing disincentives for productive investment. Moreover, as a result of globalization, the desire to attract foreign investment (or to avoid that capital/investors leave the country) has created intense tax competition among states, which has created pressure to keep income taxes (esp. on capital) low.

(Ratio of Personal Income and Property Tax as a percent of GDP, %)

	1975-78	1985-88	1997-2002	2000 GDP per capita
Latin America				**(2000 US$)**
Average	**1.7**	**1.2**	**1.0**	**$4,399**
Argentina	0.4	0.8	1.1	7,726
Brazil	0.2	0.2	1.4	3,537
Chile	3.3	1.1	na	4,964
Colombia	1.8	1.6*	0.6	1,979
Costa Rica	2.9	2.2	0.7	4,185
Mexico	2.7	2.0	na	5,935
Peru	1.5	na	1.5	2,046
Venezuela	1.0	1.0	1.0	4,818
East Asia				
Average	**1.8**	**2.3**	**3.9**	**3,716**
Indonesia	0.8	0.9	3.5	800
Korea	1.9	2.8	3.6	10,890
Malaysia	2.1	2.4	6.1	3,881
Philippines	1.6	1.1	2.6	990
Thailand	1.1	1.9	2.2	2,020
Taiwan	3.4	4.5	5.2	
Eastern Europe				
Average			**6.8**	**4,327**
Latvia			6.5	3,259
Estonia			7.7	3,987
Poland			6.7	4,309
Hungary			7.8	4,656
Czech Republic			5.2	5,422

Source, Government Finance Statistics, IMF; Statistical Yearbook of the Republic of China 2002 for Taiwan.

The share of personal income and property tax as a percentage of GDP was six times higher in Eastern Europe compared with Latin America's average. This significant difference in personal income tax collection in 1997 is not due to any substantial differences in income per capita between the regions.

The very low personal income tax burden in Latin America is due to several factors. First, the average maximum personal income rate has fallen from an average of 50 percent in 1985-86 to 38 percent in 1991, and 34 percent in 1997, a rate of decline 'that is considerably more rapid than in the OECD, where the top rates declined from 52.8 percent in 1985-86 to 43.6 percent by 1997' (Shome, 1999: 3-4). Second, poor administrative capacity and high level of tax evasion limit the productivity of tax collection (ibid.). Third, while the top marginal personal income tax rate has been reduced in the 1990's, the top personal exemption level in terms of GDP per capita has risen from 1.29 in 1991 to 1.36 in 1997 (ibid.: 6). If one were to add that the

significant levels of foreign savings held by Latin Americans (the result of several episodes of massive capital flight) are not taxed, it would not be unreasonable to argue that the economic elite in the region are the group least preyed on by their respective states.[10] These trends obviously imply that the tax burden of the upper income groups is negligible.

When one expands the category of direct taxes to include corporate income tax, East Asia still collects over 75 percent more as a percentage of GDP than in Latin America in the period 1997-2002 as indicated in Table 3.

Table 3: Income, profits and capital gains burden:
East Asia, Latin America, South Africa and Eastern Europe Compared

(Tax on income profits and capital gains as a percent of GDP, %)

	Income, profits and capital

[10] Tanzi and Zee (2000: 30) note that Latin American countries have virtually stopped taxing financial income to avoid chronic capital flight.

	gains burden		
Latin America	**1975-78**	**1985-88**	**1997-2002**
Average	**5.0**	**4.1**	**3.9**
Average (excluding Venezuela)	**3.2**	**3.0**	**3.8**
Argentina	0.7	0.8	2.2
Brazil	3.2	4.4	4.5
Chile	3.8	4.0	4.2
Colombia	3.7	3.1	4.7
Costa Rica	2.8	2.4	2.8
Mexico	5.6	4.4	4.9
Peru	2.7	2.0	3.5
Venezuela	17.6	12.0	4.7
East Asia			
Average	**5.7**	**6.0**	**6.9**
Average (excluding Indonesia)	**4.4**	**5.2**	**6.3**
Korea	4.2	4.8	5.5
Malaysia	8.3	9.6	8.4
Philippines	2.8	3.2	6.3
Indonesia	12.6	10.3	9.5
Thailand	2.1	3.2	5.0
Taiwan	4.0	4.8	6.6
South Africa	**12.9**	**13.1**	**14.6**
Eastern Europe			
Average			**8.3**
Latvia			7.5
Estonia			8.5
Poland			7.9
Hungary			9.3
Czech Republic			8.4

Source: Government Finance Statistics, and International Financial Statistics, IMF; Statistical Yearbook of the Republic of China 2002 for Taiwan data.

The Eastern European economies in the sample had more than double the income tax collection as a share of GDP compared with Latin America.[11] . One of the main reasons behind the declining corporate tax capacity in Latin America owes to declines in the tax rate on corporations falling from 41 percent in 1985 to 29 percent in 2003 and the top rate on personal income from 51 to 28 percent (Lora and Cardenas 2006).

[11] It is again worth highlighting the extraordinarily high income tax capacity of South Africa (see Lieberman, 2001 for a discussion of the political origins of this income tax collection capacity).

The lower levels of income tax collection has meant that the burden of structural change in tax falls relatively more on indirect taxes in Latin America than in East Asia, Eastern Europe, and South Africa. As seen in Table 4, ratio of value-added taxes to GDP is significantly higher in Latin America compared to East Asia in the period 1997-2002. [12]

Table 4: Value-Added Taxes in Latin America, East Asia, South Africa and Eastern Europe Compared

(VAT as a percentage of GDP, %)

[12] It is important to note here that standard analysis of tax incidence indicates that who bears the ultimate burden of the tax may be substantially different from who pays the tax in the first instance. For example, a corporation may not pay the full amount of a corporate tax if it can shift some of that burden to consumers via higher prices or if it can force workers to accept a lower wage (see Stiglitz, 1986:411-455).

	1975-78	1985-88	19972002
Latin America			
Average	**2.5**	**3.6**	**5.6**
Argentina	1.1	1.8	3.8
Brazil	0.0	8.7	12.1
Chile	6.5	8.1	8.2
Colombia	1.8	2.8	4.8
Costa Rica	1.6	2.8	4.8
Mexico	2.5	3.1	3.2
Peru	4.4	1.8	6.4
Venezuela	na	0.0	4.3
East Asia			
Average	**2.0**	**2.3**	**2.9**
Indonesia	1.6	2.8	3.5
Korea	2.6	3.5	4.1
Malaysia	1.2	1.5	2.0
Philippines	1.9	1.1	1.7
Thailand	2.7	2.8	3.4
Taiwan	na	na	na
South Africa	**1.2**	**6.1**	**6.1**
Eastern Europe			
Average			**7.4**
Latvia			7.4
Estonia			8.2
Poland			7.3
Hungary			9,0
Czech Republic			6.5

Source: Government Finance Statistics and International Financial Statistics, IMF. Statistical Yearbook of the Republic of China 2002 for Taiwan data.

In the period 1997-2002, VAT-to-GDP ratios averaged 5.6 percent in Latin America compared to 2.9 percent in East Asia. While it is true that South Africa has a higher VAT-to-GDP ratio than both regions, VAT in South Africa represents a lower percentage of *total* taxes than in either region since income tax collection is, at 14.6 percent of GDP, a much more significant component of total tax collection. The same story applies to Eastern Europe though to a lesser extent (see also Figure 2 for a comparison of tax structures across regions).

Figure 2. Tax Structure by Region, Percentage of Total Tax Revenue, 1975-2002

	Income Tax			Domestic Goods and Services			
	Total	Individual	Corporate	Total	General Consumption	Excises	International Trade
North America							
1975-1980	78.4%	56.9%	20.5%	15.0%	7.7%	6.5%	6.6%
1986-1992	78.8%	63.5%	14.4%	17.0%	9.8%	6.3%	4.3%
1996-2002	83.3%	66.3%	15.8%	14.8%	8.8%	5.1%	1.8%
Latin America							
1975-1980	32.7%	11.1%	17.6%	40.4%	17.1%	19.3%	26.8%
1986-1992	31.1%	8.5%	17.6%	47.3%	20.9%	21.0%	21.5%
1996-2002	30.4%	6.2%	18.5%	56.3%	34.0%	16.1%	13.3%
Western Europe							
1975-1980	42.7%	33.3%	8.5%	50.6%	28.6%	16.5%	6.7%
1986-1992	43.4%	32.9%	9.3%	53.4%	33.4%	14.9%	3.2%
1996-2002	47.2%	32.8%	13.0%	52.4%	31.8%	15.0%	0.3%
Asia							
1975-1980	38.8%	22.9%	20.5%	37.2%	14.3%	18.3%	24.1%
1986-1992	39.3%	20.8%	19.2%	39.5%	17.4%	16.7%	21.2%
1996-2002	46.9%	24.2%	21.4%	40.2%	19.6%	15.3%	12.9%
Africa							
1975-1980	32.1%	14.6%	16.1%	29.7%	18.4%	13.5%	38.2%
1986-1992	27.4%	14.6%	11.4%	31.9%	18.3%	11.9%	40.7%
1996-2002	30.7%	17.7%	11.6%	36.2%	21.8%	11.3%	33.2%

Sources: Bird and Zolt (2005), cited in Bird (2008)

These patterns have several important implications. First, indirect taxes, and in particular VAT, which is generally one of the more regressive taxes, is occupying a relatively higher share within the overall tax burden in Latin America. In theory, of course, the overall impact of VAT need not be regressive. This would be the case if luxury items are taxed at a higher rate and basic goods (such as food, medicine, public transport, and agricultural inputs) are exempted (or zero rated), and if public expenditure that is financed by VAT is targeted to lower-income groups.[13]

Second, as a result of the low levels of income tax collection, the region's tax collection is only 16 percent of GDP when the international norm, given the region's average income per capita, should be 24 percent of GDP (IADB, 1998:6).

Third, the poor tax effort and the reliance on generally regressive indirect taxes in Latin America are reflective of the weakness of the state vis-à-vis upper income groups. Finally, in comparison with East Asia and Eastern Europe, the tax effort in Latin America is further away from achieving re-distributive goals (?). This is

[13] See Bird (2008) for a discussion of the evidence on the extent to which VAT proves to be regressive in practice as well as a discussion as to how progressive income taxes have been in LDCs. See also Lindert (2004) on the role that indirect taxes, high excise taxes (on alcohol and tobacco), and direct taxes on the working and middle class (and not particularly high corporate income taxes) played in the construction of Nordic welfare states. High-budget welfare states in Scandinavia tend to have a more pro-growth and slightly regressive mix of taxes. These countries have been careful to keep net taxes on corporations low, and have avoided the double taxation of dividends.

because the challenges of re-distribution are much greater in Latin America because income distribution is, on average, much more unequal than in the other two regions (IADB, 1998). Without an explicit political programme to redesign and enforce personal income tax collection, it is virtually impossible to make the tax system in Latin America more progressive, which is of particular concern in the context of persistently high asset and income inequality in the region. Moreover, the failure to make the tax system more progressive limits the extent to which resources can be re-distributed to finance poverty reduction strategies. As such, only high and sustained levels of economic growth are likely to reduce absolute levels of poverty.

For low-income countries, the main challenge has been how to replace trade taxes as a result of trade liberalization. As indicated in Figure 2, trade taxes are a main source of revenue in weak and low income states. 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) shows 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. Moreover, a VAT base broadening with a revenue-neutral reduction in trade taxes may also reduce welfare' (ibid: i).

It is important to note that recent research has challenged the validity of the claims made by Emran and Stiglitz (2005) and thus have questioned the extent to which trade taxes may be preferable to trade taxes (VAT?) in the context of low-income countries with large informal sectors. One objection is that the introduction of VAT may be preferable from the standpoint of building tax capacity over time because it is a tax that requires more information and administrative skills to administer effectively than trade taxes (Boadway and Sato, 2007; Ebrill et al. 2001). *The continued reliance on trade taxes does not present the incentive for the government to diversify and build tax collection capacity over time.* Improved tax capacity over time may also help the state increase its administrative coverage of the informal economy and potentially increase its economic and political contact/relations with informal sector firms. This can in turn increase the possibilities of a more institutionalized milieu in which problems of the informal sector can be solved.

Second, the development of domestic forms of taxation at an early stage of development may reduce the incidence of 'blanket protection' that reliance on trade taxes generates. Effective industrial policy relies on selective, rather than blanket protection because selectivity means that only a few sectors provide high profit

opportunities and thus focuses scarce entrepreneurial effort more efficiently. (Amsden, 2001). Blanket protection fails to provide focal points around which scarce entrepreneurial effort can be organised. Indeed, countries that have historically been able to develop direct forms of taxation at an early stage of development (e.g. Britain, Japan, Korea), were able to limit the scope and depth of blanket tariff protection (Hobson, 1997).. Similarly, the ability of countries to effectively collect VAT may reduce the reliance on trade taxes which generates ineffective forms of 'blanket protection' for domestic firms. Whatever the merits of infant industry protection may be, effective industrial policy coincides with very 'selective' protection which provides a focal point of investment around a limited number of sectors (Aoki et al. 1997). The reliance on trade taxes makes such 'selective' protection a remote possibility. The only way 'selective' protection could take place, in a context of 'protection for everyone', is if a few sectors are given even higher protection. Not only is this not feasible under WTO rules, but the levels of effective protection would become so high as to create incentives for growth-restricting rent-seeking and capture on the part of the domestic firms.

Third, at a theoretical level, it is not necessarily the case that the substitution of VAT for trade taxes will reduce tax collection from the informal sector (Keen, 2008). This is because a value-added tax functions, in part, as a tax on the purchase of informal firms from formal sector firms, and, on their imports.

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[14]:

First, in sub-Saharan Africa trade taxes accounted, on average, for about one-third of total tax revenue in the early 1980s; now 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.

Second, trade liberalization does not necessarily reduce revenue from trade taxes. This is most likely to be the case when liberalization involves: a) reducing non-tariff barriers, by converting them to explicit tariffs; b) reducing distorting exemptions, or raising low tariffs to establish a more uniform structure; c) 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; d) reducing most favoured nation tariff rates towards preferential rates, tending to shift import demand towards more heavily tariffed items.

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.

[14] This section draws on Ter-Minassian (2005).

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.

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**,** many of which were highly aid-dependent. 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: first, *those countries which did recover total tax revenue also increased domestic consumption tax revenue*, often by an amount broadly corresponding to the loss of trade tax revenue; second, t*he 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); third, 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; and finally, r*eductions 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.

In sum, trade liberalization needs to be purposively *sequenced* with domestic tax reform and donors need to focus on this issue. This is especially the case since high levels of informality in low-income countries(and in particular, low-income, post-conflict economies) *may* make the collection of taxes from value-added taxes particularly difficult in the short-run (Emran and Stiglitz, 2005; though see Keen, 2008 for an opposing view).[15] While tariff protection may not necessarily create much productive capacity given the weak state of domestic business capacity, the role of moderate tariffs in preventing a collapse in fiscal revenues may be a reasonable 'second best' solution to the problem of tax collection in post-war/low-income contexts, at least in the short- to medium-run. As discussed above, further research is needed to explain why low-income countries find it difficult to replace lost trade taxes with domestic revenues, and the condition under which VAT is potentially more conducive to tax capacity-building in LDCs.

Finally, it should be pointed out that the construction of tax systems is a by-product of more than just policy initiatives and economic structure. The economic approach is limited in explaining why some states developed tax systems before others. War played a particular role in that process, not least because it created a context in which

[15] See also Section 2 for further discussion of these issues.

the wealthy in society felt threatened enough to allow the creation of capability and the centralisation of authority at the level of the state.[16]

Standard histories of European state formation underline the crucial contribution of external threat and war. Charles Tilly argues that "war made the state and the state made war" (Tilly, 1990: 54). War caused states to be more efficient in revenue collection by forcing them to dramatically improve administrative capabilities (allowing states to fund administrations and economic systems). Most importantly, the effort to finance war and the military led to varying patterns of *bargains* between the state and interest groups, particularly merchants, landlords and in some cases, directly with the peasantry. In general, the distributional struggles between the state and societal actors (and between competing groups within civil society) led to uneven but mutually recognised rights: rights of citizens with respect to states as well as the rights of state officials (and corporate entities) with respect to citizens.

Of course, the role of war in the history of state formation (and in particular tax collection capacity) has its limits as a guide to policy. But it does allow us to ask whether there are conditions today that can replicate some of the incentives that historically emerged in times of warfare. Threat, which can provide 'windows of opportunity' for tax reform, may today be derived from domestic social movements, fiscal crises or the 'global economy' rather than imminent prospects of war. There is little doubt that renewed interest in tax reform in the past twenty years is a by-product of the macroeconomic crises, and in particular fiscal crises, that were widespread in sub-Saharan Africa and Latin America in the 1980s and 1990s. As a result, initiatives to improve taxation capacity have gradually become more central to fiscal adjustment policies advocated by IFIs, bi-lateral donors, and LDC governments. This does not necessarily mean that elites have either lobbied for or agreed to tax reforms; but it does mean that macroeconomic crises have given leverage to central governments to initiate such reforms.

Two major areas for further research emerge out of the above discussion. The first is to understand the political economy origins of why tax collection capacity differs in otherwise similar economies. Second, more case study work is required to understand why some low-income countries are able to diversify their tax revenue sources more quickly than others.

2. Tax Reforms, and the Territorial and Social Reach of the State

In low-income countries, and especially post-war economies, the tax base generally has a limited reach both in terms of territory and in terms of the number of taxpayers. The ratio of government revenue to gross domestic product in war economies is, on

[16] For an early and influential analysis of the relationship between war and state formation, and between state formation and taxation, see Schumpeter [1918] 1954. In Schumpeter's analysis, the "most important cause of financial difficulties consisted in the growing expenses of warfare (ibid: 13) and that "without financial need the immediate cause for the creating of the modern state would have been absent." *(ibid*: 16). However, see Centeno (1997) and López-Alves (2001) for an analysis of why the potential stimulus of war did not transform Latin American states in the 19th century in ways similar to Western Europe. See also Leander (2004) for a discussion as to why wars have coincided with the unraveling of some states in contemporary Sub-Saharan Africa

average, well below the average for non-war economies with similar levels of per capita income (Addison et al. 2002). 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.[17]

There are, however, several examples of low-income countries improving the territorial and social reach of the state. One neglected policy for low-income countries is the maintenance of export taxes which can contribute to revenue collection, the construction of state-society relations and developing the territorial reach of the state. Tariffs on commodity exports, while potentially providing some disincentives to production as emphasized by IFIs, are often the only mechanism to tax the incomes of wealthy farmers. *Export tariffs thus can provide a functional substitute to weak income tax capacity in low income/post-war economies.*[18] 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 (ibid.). Indeed, 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 (ibid.).

In the case of Mauritius, export taxes on sugar, the main export commodity in the 19th and most of the 20th century had several positive effects on state-society relations and in increasing the productive capacity of the sugar sector (Bräutigam, 2008). First, the tax was an effective substitute for income taxes, and was generally progressive as it shifted the burden of taxation and redistributive spending on the wealthy and middle classes. This contributed to the public sense of fairness and solidarity and thus enhanced state legitimacy. Second, the tax was used by the state to finance research and development, infrastructure, and marketing which enhanced production and productivity growth in the sugar sector. An often neglected aspect in tax analysis is to explain *how tax reform can be linked to productive strategies* (a theme explored further below). Third, the export tax helped the private sector organize, and it built their capacity to interact with the government over time. As well, it helped both the state and society to solve collective action problems they faced in building skills and in supporting research on sugar. Finally, the export tax helped develop the territorial reach of the state since the tax affected the main employer in the countryside and

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

[18] Of course, the imposition of export tariffs on commodities, such as in Argentina since 2005, is often very controversial and not always effective. The idea of the export tax, which brought in $US 12 billion in 2007, was to increase incentives to process commodities, such as soya, into higher value-added processed goods. However, in the first few months of 2008, the tax has led to disruptive strikes among soya farmers and to domestic food shortages.

promoted mutually beneficial rights and obligations between the state and farmers, both large and small.

The Colombian experience with its national coffee federation also provides evidence that the state can use taxation of agriculture to solve collective action problems in production (such as the provision of funds for storage, distribution, and marketing for thousands of dispersed smallholder producers) and help forge strong state-society negotiations and mutual obligations (Thorp, 2000).[19] Since the 1930s, the state delegated the right to collect taxes to the private National Coffee Federation (NCF) and gave the fund the right to spend the collected funds on rural infrastructure, technical agricultural assistance and provide local social service delivery in health and education. For over eight decades, it has developed into one of the developing worlds most successful examples of collective action. Financed by a small surcharge on members' coffee sales, the Federation has been instrumental in organizing improvements in quality, pest-control, technical advice, credit and international marketing and branding for nearly 400,000 smallholder producers. The Coffee Fund under its auspices guaranteed internal minimum prices for coffee, acting as a buyer of last resort, which reduced the risks of production. The political influence of the Federation was also influential as a powerful lobby historically to demand prudent macroeconomic management, particularly the avoidance of exchange rate overvaluation.

Apart from the important economic functions played by the NCF in the economy, the potential for the Federation to influence at the grassroots level has grown as a result of the direct election of mayors in 1988 and the increased transfers of state funds to the municipal level.[20] The lack of adequate institutions to help channel funds effectively have resulted in coffee committees, where they exist, playing an unexpectedly large role in local governance. In Callas, for example, the federation's departmental committee_requires the municipal coffee committee to go out and seek funding for public works with the municipality. If successful, the federation will match the funds raised. This gives them leverage with the municipality. If the local mayor does not want to collaborate, local producers are encouraged to lobby the mayor. The collective riles of lobbying and monitoring projects, developed over decades gives the federation legitimacy, effectiveness, and mobilizing capacity at the local levels in technical issues concerning coffee and in local governance generally. Interestingly, coffee regions generally have the lower levels of violence and guerrilla penetration than other departments in Colombia.

In terms of policy lessons, donors should tap the institutional capacity of the NCF, and there should be serious reflection on the importance of production and producer groups as focal points of political capacity. Often, discussions of governance are divorced from the realities of the economic development strategies and the challenges of late development generally

History also provides several examples of the importance of *land and property taxes* in enhancing the territorial, social and economic reach of the state.[21] In the case of

[19] See Gallo (2008) for a discussion of a similar experience with nitrate export taxes in 19th century Chile.
[20] This paragraph draws extensively on Thorp (2000).

Taiwan and Korea, the role of Japanese colonialism from the early 1900s to 1940 was central to understanding the capacity to collect direct taxes in the post-colonial period. An understanding of the role of Japanese colonialism first requires a brief discussion of Japan's own experience with land taxation. Through much of the 19the century, Japan relied much more heavily on land taxes than trade taxes (Bird, 1977), which contrasts with the conventional wisdom that countries at lower levels of development necessarily have to rely on indirect taxes (especially trade taxes) as their main sources of domestic revenue mobilization.

With emergence of the Meiji elite in the 1860s, there was concerted effort to reduce the power of feudal landowners in an attempt to centralize state power and mobilize more resources for development, which was seen as essential in the face of external threat of Western colonisation. In the period 1868-1872, the state derived 87 percent of all taxes from land taxes (ibid.). Reform of land taxes included the introduction of land taxes to be paid in cash, which helped monetize transactions in the economy. The land tax reform was accepted because the state offered two important things in return: a) the Meji leaders terminated feudal rights and strengthened the property rights of tenants, and b) the state provided services in the form of a research and extension system for the agricultural sector (Grabowski, 2008: 37-39). Tenants were favoured overwhelmingly in conflicts with landlords. As a result, the landlord system was significantly weakened which paved the way for land reform which the US government promoted in the post-World War II period (ibid*.*). *Another important feature of the land tax was that it was introduced as part of a production strategy to help improve agricultural production.* The link between tax collection strategies and production strategies is, as mentioned above, often lost in contemporary discussion of tax collection.

Similar policies were followed by the Japanese colonial administration in Taiwan and Korea. The Japanese colonial authority dramatically increased the level and diversification of tax revenues in Korea, where historically the state had been incapable of collecting much revenue due to the power of landowners. The most substantial increase occurred, as in Japan, in land taxes. Two factors were instrumental in this increased state capacity to collect tax. First, the colonial state developed the coercive power to break the political stranglehold the landowning elite had in during the old Yi state. Traditional elites, which had close connections with landowners, were pensioned off and replaced with Japanese career bureaucrats. Second, colonial administrators used the newly created civil and police bureaucracy, to collect taxes. Extensive land surveys were undertaken which mapped all plots of land in the territory and classified it according to type, productivity, and ownership. Land taxes increased 30 percent in the period 1905-1908, and total revenues increased 300 percent in the period 1905-1911.

As a result of the survey, the colonial state secured a revenue base, and enhanced its control over the Korean agrarian sector by bringing in the landowning class as ruling partners. What the Korean landlords lost in terms of autonomy from and influence over the Yi state, they made up for by securing legal private property rights and later by gaining increased profits from land. As Kohli (2004) observes, the relatively successful penetration by the Japanese colonial state of the agrarian periphery stands out as fairly unique display of state effectiveness in the comparative history of

colonialism. The more typical colonial legacy was one of ‘indirect rule’, which left landed elites with significant power to resist taxation and to capture the state.

As in Meiji Japan, land tax policy was linked directly with a production strategy for agriculture. In return for increased land taxes, the colonial state made significant investments in rural infrastructure (especially roads and irrigation) and provided subsidised fertilizer and improved seeds. The economic outcomes were impressive. The percentage of land paddy under improved seeds doubled between 1915 and 1940, reaching 85 percent; fertilizer input expanded 10 times in the same period. Rice production grew at 3 percent per annum in the period 1920-1935, and between one-half and two-thirds of this growth was due to improvements in land productivity. Grabowski (2008) describes a similar set of Japanese colonial policies and outcomes in Taiwan. During the Syngman Rhee administration (1948-1961), the tax capacity of the Korean state, inherited from the Japanese colonial period, was maintained. In sum, the legacy of Japanese colonialism led to a decline in landlord power, the development of smallholder agriculture, the deep penetration of the state in the countryside, and significant reliance on land taxes in return for state services to enhance agricultural productivity growth.

The North American experience in the 19th century also provides an example of how land taxes can contribute to the territorial reach of the state. While the US and Canada did rely significantly on trade taxes to finance central government expenditures, local governments played a much more important role in tax collection than, for example, in Latin America where almost no land taxes were collected as a result of the political power of large landowners (Sokoloff and Zolt, 2005). And local governments relied heavily on direct taxes, particularly land and property taxes (ibid.). Moreover, local governments made significant investments in infrastructure and local education.

The role of land taxes is especially important as local governments seek to raise revenues in the context of decentralization reforms.[22] The same is true for local governments in urban areas. However, in this case, the relevant tax would be the *urban property tax*. There are three main reasons why governments, particularly at the local levels should focus on this tax.[23] 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

[22] The search for different types of taxes (such as land taxes) is, in part, the result of declines in trade taxes as a result of economic liberalization.

[23] This paragraph draws on Fjeldstad and Moore (2008: 245-6).

property tax reform requires long-run investments in capacity which is often downplayed compared to the quicker returns initiating VAT can provide. To the extent that tax capacity is an investment in the long-run capacity of the state, and to the extent that decentralization 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.[24] Currently, there are no comparative data sets on urban property tax levels at the municipal level. The IMF, however, is well placed to generate data on urban property taxes across the world.

Finally, and most controversially, the role of agricultural marketing boards have played in some countries an important role in expanding the territorial reach of the state and in linking rural interest groups to the state. Marketing boards were also an important source of state resource mobilisation through the mechanism of monopolising the purchase of cash crops at below world market prices and selling such crops abroad at world market prices. The surplus generated was often of similar magnitudes to formal total tax collection levels, particularly in Sub-Saharan African economies in the 1960s and 1970s. Marketing boards were effective in some countries such as in Taiwan, South Korea, Indonesia, and India because the state gave something in return to producer groups: services, infrastructure, research, price stability, and so on.

By the 1980s, however, an extensive critique of marketing board developed in the wake of worsening agricultural performance, particularly in Sub-Saharan Africa (see Bates, 1981). The dominant view was that the system worsened the terms of trade by paying farmers less than what the state received for the products at the world market. This often created disincentives for farmers to produce, and/or led to smuggling—both of which reduced the resource mobilization capacity of African states. Economic liberalization of agriculture was promoted as the cure for the growth-retarding effects marketing boards had in many contexts.

The dominant neoliberal view of marketing boards has, however, some important shortcomings. First, there was much less analysis as to why some marketing boards performed better than others. The historical evidence suggests that the political power of the state and the nature of the political coalitions underpinning the central state are significant factors determining the effectiveness of marketing boards. For instance in Taiwan during the 1960s, the ability of the state to undertake land reform removed the power of large landowners who historically resisted state penetration of the countryside (Amsden, 1985). This state penetration allowed the state to tax rice farming in return for financing inputs that improved the productivity of rice production. To take a Sub-Saharan African comparison, Bates (1995) argues that the Kenyan coffee board was, in the 1970s and 1980s more effective than the Tanzanian coffee board because the nature of the political coalition in power differed in the two countries. In Kenya, large and medium-sized coffee farmers were a powerful interest group; whereas in Tanzania, coffee farmers were not a powerful group in the national

[24] It should be pointed out that increased territorial reach of the state does not necessarily translate into greater state legitimacy, even at the municipal level. As Fjeldstad and Therkildsen (2008) point out in the case of East Africa, and Bernstein and Lü (2008) point out in the case of China, local taxation, and in particular, land taxes, have been collected through relatively coercive means. Thus, the *way* taxes are collected may tell us more about state legitimacy than the levels of tax collection per se.

government's support base. As a result, policies were in Kenya were developed in ways that extracted much fewer *net* resources from coffee producers than in Tanzania.

Even where marketing board policies were relatively ineffective such as in Tanzania and Zambia, they have played an important role in increasing the territorial reach of the state, developing state-rural interest group links, and in providing social infrastructure and services. In these two countries, the reach of the state was a by-product of the development of *nationally-based political parties* which developed an inclusive system of patronage across all agricultural regions (see Hesselbein, Golooba-Mutebi and Putzel, 2006 on Tanzania; and Di John, forthcoming on Zambia). There is also evidence that the inclusive reach of marketing boards contributed to the maintenance of political stability and nation-building in both these cases. Further comparative historical work is required to assess the differential impacts marketing boards have had in state-building and in enhancing the territorial reach, and legitimacy of the state.

3. Do Capital InFlows Limit Domestic Tax Effort and Host Government Policy Space?

The Case of Aid

In countries reliant on foreign aid, there is substantial concern that aid will crowd out domestic efforts of tax collection. If this is the case, then the long-term prospects of aid dependence would be slim. Recent work on the potential dangers of scale-up aid has highlighted this potential (Gupta et al, 2003; Brautigan and Knack, 2004).[25] Another claim is that increases in central government transfers will crowd out tax mobilization at the state or municipal level. This is an empirical question and the evidence does *not* 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 mobilization. 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.[26] The other main result of the Gutpa et al study is that aid in both grant and loan versions, has a negative impact in countries with higher corruption indices.[27]

[25] On the magnitude of scaled-up aid, see Killick and Foster (2005) and Moss, Peterson and van de Walle (2004).

[26] What these authors do not consider is that debt repayments loans have often led to decreased social expenditures and to decreases infrastructure investment, both of which may reduce the prospects of poverty reduction strategies and of economic growth.

[27] 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

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.

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 these 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 and political and economic contexts that influenced the response of tax revenue to the inflow of aid after 1990.*

In any case, since 1990, there is little evidence that scaled-up aid is reducing policy space in terms of domestic tax effort in LDCs (see Heller, 2005 on the concept of fiscal space in LDCs). As mentioned above, comparative evidence suggests that there has been substantial variation in the ability of low-income, aid-dependent countries to increase and diversify their tax bases (Ter-Minassian, 2005). The aid-dependent countries that have been most successful in this regard are Ghana, Kenya, Zambia, Malawi, and Senegal.[28] The tax policies that have been most important include the increase and consolidation of income taxes and value-added taxes. The case evidence on Zambia and Kenya, at least, indicates that despite substantial donor advice and technical assistance, there has been significant government 'ownership' on how tax collection can be diversified. This is not to say that aid conditionality and structural adjustment loans have not reduced the policy space of LDC governments in terms of macroeconomic and trade policy (Weeks and McGinley, 2007; Pollin, Epstein, and Heintz, 2008). More case study work is required to examine the extent to which policy space has been restricted in LDCs more generally.

The dominant policy directed at increasing the tax capacity in low-income, aid-dependent countries has been the initiation of autonomous revenue authorities. International financial institutions and aid donors have developed the proposition that, in weak states, revenue collection authorities are more effective when they operate *autonomously* from the state (and particularly the finance ministry), as a commercial entity at arms length from the government rather than as a department within the government administration (see Taliciero, 2004). This is the reasoning behind the

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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.

[28] On the Kenyan case, see Cheeseman and Griffiths, (2005); and Njuguna Karingi and Wanjala, (2005). On Zambia, Ghana, and Uganda, see von Soest (2008).

promotion of the so-called autonomous revenue agencies (ARAs). This line of thinking follows much the line of New Public Management, which stresses that agencies be run on business principles, where directors can circumvent the institutional obstacles of weak public sectors, which include multiple layers of principles and agents, cumbersome rules and regulations, low pay, antagonistic unions and so on (Therkildsen 2003:2). According to this argument, autonomy protects revenue authorities from political interference. In short, the creation of parallel agencies is favoured over the restructuring of existing tax institutions.

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 (ibid.).

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* (for a review of case evidence, see Kidd and Crandall 2006; Di John 2006). Overall, there is no evidence that ARAs have performed better at modernizing tax administration or improved long-run revenue collection. As such, differences in ARA policy across countries do not account for variations in tax capacity across LDCs. As Bird (2008: 46) notes "any country that has the will, strategy, and resources to reform tax administration probably does not need an independent revenue authority -- and a country in which these critical ingredients are lacking is unlikely to be successful even if it creates such an authority." This is generally the case regarding technocratic solutions like autonomous agencies and rules-based policy-making.

More research is required to as to why ARAs have been more successful in initiating rather than sustaining reforms. Also, there is little known as to why Anglophone countries in sub-Saharan Africa have been much more willing to initiative ARAs relative to Francophone countries in Africa, although the relatively successful experience with ARAs in Rwanda offers an interesting case that may mark a lessening in this regional variation (on Rwanda, see Kloeden et al. 2004).

In the case of post-war economies and low-income economies, the manner in which donor aid is delivered has an important impact on the policy space of low-income countries, and in particularly post-war economies. There are two important dimensions that matter in this regard. First, 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 and O'Donnell, 2007: 278-280). There are 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 domestic citizens; and c) a customs duty on imported luxuries that is backed up by the willingness of international actors to forego exemptions and immunities (ibid.). 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.

Second, on the expenditure side, aid, would do more to promote capacity to plan and execute policies if channelled through the *central government*. The current situation in many countries, 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 (ibid.: 287-289). Afghanistan would be a clear example of this. 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 lower incentives state leaders may have to develop reciprocal relationships and mutual obligations with interest groups, which the fiscal system can enhance.

The Case of Mineral Booms

The case of mineral abundant economies presents particular challenges to both expanding the reach of the state and in affecting the degree of policy space. As the literature on the resource curse has highlighted, there is a danger that leaders, by relying on 'unearned" income (in the form of mineral rents and/or aid), do not develop a set of reciprocal obligations with citizens via the nexus of domestic taxation. As a result, mineral rents (particularly oil and gas) can, in lower-income countries, coincide with weak or illegitimate state institutions which may trigger conflict.

'Unearned' income through mineral resource rents can allow elites to purchase security through corrupt patron-client networks, rather than with the establishment of a 'social contract' based on the exchange of public goods financed through domestic taxation. Such arrangements, according to this model, can reduce a regime's legitimacy and relative military, administrative, political and economic power, which, in turn, can render the regime vulnerable to rebellion (Reno, 2002; Le Billon, 2003). Fearon and Laitin (2003) drawing on the work of rentier state theorists (e.g. Karl, 1997), Fearon and Laitin (op. cit.), argue that oil states are more likely to have weak state structures because they have less need to create strong bureaucracies to raise revenue.

While the degree of mineral abundance does not determine politics or the prospects of effective governance (see Di John, 2007a), there is some evidence in transition economies that mineral abundance does affect the incentives leaders have in broadening the tax base. In the former Communist countries, two trends of tax states are 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 programmes.

Easter’s (2002) comparative analysis highlights differences in the trajectory of tax structure in Poland and Russia and incorporates the role of the degree of mineral abundance. Poland, which has limited revenue options from mineral rents, developed a social pact with labour over household income, and was able to institutionalize 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) created explicit deals linking wage increases to productivity gains which paved the way for union leaders to accept income tax reforms. The corporatist arrangement also provided the milieu from which future disputes could be settled. 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 1990s 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.[29] 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.

More research is needed to understand why some mineral abundant states have developed more diversified tax systems. Chile, Malaysia, Botswana, South Africa, Norway, and Australia would provide useful case studies on how and why political settlements in these countries prevented a narrow reliance on mineral taxes.

Notwithstanding the potential danger of oil boom for growth and governance, recent commodity booms do offer an important opportunity for mineral abundant countries to generate significant tax revenues, and increase their policy space. The potential revenue capture from such booms far outweighs aid flows. However, recent experience suggests that, in Sub-Saharan Africa, at least, this potential is not being realized. Take the case of Zambia. Taxes as a percentage of GDP *declined* from 18.4 percent in 1996 to 17.0 percent in 2005. Although Zambia is a relatively high tax state, one of the main reasons for what? is the extraordinarily 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 a royalty rate of 3.0 percent. In 2006, the government received just $25 million in copper royalties out of a $US 2 billion turnover in copper sales. This substantially hampers the extent to which the government can finance improvements in physical infrastructure which are essential

[29] The power of private business groups meant prevented the state from re-nationalizing much of the mineral sector, which would have increased mineral revenues even further. However, the option of sharing mineral rents with private business groups provided a *faster* route to increasing revenues compared with the longer-run and administratively more difficult challenge of setting up value-added or personal income taxes.

for reviving productive capacity and growth in non-copper sectors in agriculture and light manufacturing.[30]

A similarly disappointing experience has occurred in Mozambique. The main 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 Mozal, a large aluminium smelter (completed in 2000) on the outskirts of the capital city, Maputo. Mozal cost $2.4 billion to build and 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, Mozal 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.[31] Mozal 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 governments 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 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 a project can generate (ibid.). This limits the extent the government can invest in social policy and in developing productive capabilities and infrastructure elsewhere in the economy.

There are several policy implications that are 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 minerals can provide a valuable source of

[30] Weak taxation capacity of mineral countries has also been a recent feature in the Democratic Republic of Congo, where in 2006, the government collected a mere $86,000 in mineral royalties (Collier and Spence, 2008).

[31] The availability of extensive hydro-electric power has also been central to Mozal's economic viability. Mostraco, a joint venture of three electricity corporations, EDC (Mozambique), ESCOM (South Africa) and SEB (Swaliland) supplies Mozal's energy needs. This energy source is in effect part of the South African power grid (Castel-Branco, 2004, 17).

financing of infrastructure investment which is much needed to enhance non-mineral productive capacity. Second, 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. Finally, 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 to benefit from the willingness of Chinese investors to finance infrastructure as part of these deals.

4. Tax Policy and Economic Growth Strategies

This section examines the extent to which a tax system contributes to productive capacity-building. This is a vast topic, so the treatment of this subject will inevitably be selective.[32] There are two features of the relationship between tax systems and growth that stand out. The first is that there is no robust evidence to suggest that tax ratios as a percentage of GDP has any systematic relationship with economic growth. (Easterly and Rebelo, 1993).

The difficulty of establishing any relation is due to the complexity in disentangling both the effects of the absolute and marginal rates of taxation, and nominal and effective tax rates 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, the capacity of the state to tax does not necessarily translate into similar capacities such as undertaking industrial policy. For instance, South Africa and Brazil have among the two highest tax ratios among developing countries yet their growth rates since 1980 have been far from stellar. 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.

It is worth mentioning, however, that high tax ratios do not necessarily generate disincentives for investment and growth as many neoliberals argue. Advocates of more statist intervention point to the fact that taxes are necessary to finance public goods (education, health, and infrastructure), which are 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 (Barro and Sala-I-Martin 1992).

As well, high tax and budget welfare states can be growth- and productivity-enhancing. There are two mechanisms that may explain why large welfare states can be good for growth. The first is the productive role that conflict resolution can play in reducing political resistance to institutional change.[33] The second is the role state

[32] For discussion of long-run trends on the relationship between taxation, social spending and economic growth in OECD, but also in less developed countries, see Lindert (2004).
[33] See Calmfors and Driffill (1988), and Chang and Rowthorn (1995).

subsidy and transfer spending plays in socializing risk by providing social insurance in smaller open economies subject to higher external risk.[34] Without taking into account the potential and, in many cases, real, productive and enabling role the state can play in socializing risk, it would be hard to use the neoliberal model's logic ('low taxes, and a minimal state is best for growth') 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. [35] Consider Table 5:

Table 5: Government Revenues, Government Expenditure and Productivity Growth

	Average Gov. Revenues 1980-97 (% GDP)	Government Expenditure 1990 (% GDP)	Real GDP/Hour Worked, 1973 and 1996 (thousands 1990 dollars, PPP-based) 1973		1996	
Sweden	60.1	>50%	USA	21.2	Norway	32.5
Norway	51.3	>50%	Netherlands	18.4	Netherlands	31.3
Netherlands	49.4	40-50%	Sweden	18.0	Belgium	29.8
Belgium	49.1	40-50%	Belgium	16.5	Germany	29.7
France	48.3	40-50%	France	16.5	France	28.5
Germany	44.3	40-50%	Germany	16.1	USA	25.5
UK	37.7	<40%	Norway	14.1	Sweden	25.4
Japan	31.3	<40%	UK	13.9	UK	22.7
USA	31.0	<40%	Japan	10.0	Japan	20.1

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.[36] 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 reason to believe that there is a robust causal relationship between tax

[34] Rodrik (1998) demonstrates there is a positive relationship between the degree of openness and size of government in high-income and low-income countries.

[35] On the contribution that social policy plays can make to economic growth in late developers, see Sen (1999), Mkandawire (2004), and Kangas and Palme (2005).

[36] In the case of Norway, GDP per hours worked is likely to be inflated by an appreciated exchange rate due to high oil revenues.

rates and economic growth. When one compares the tax levels as a percentage of GDP across regions, there is no discernable relationship between tax levels and subsequent growth (see Table 6).

Table 6: Tax Levels and Economic Growth: Regional Comparisons

	Average Tax Revenues, 1975-1997 (as % GDP)	**Average GDP/Capita Growth 1965-98** (annual average growth, %)
OECD	35.3	2.3
Sub- Saharan Africa	15.5	-0.3
South Asia	12.0	2.7
East Asia & Pacific	15.0	5.7
Latin America & Caribbean	17.4	1.3

Source: IMF, Government Financial Statistics; IMF, International Financial Statistics World Bank, World Development Indicators 2000

Furthermore, 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.

What seems to matter much more for growth in LDCs is the mobilization of national savings which is necessary to finance high levels of investment without incurring foreign debt. Indeed, the traditional tax literature does not generally consider the important role that *non-tax* forms of resource mobilization (including national savings) plays in financing economic development.[37] 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 (see Table 7).

Table 7: Resource Mobilization and Growth in Developing Countries: Regional Comparisons

	GDP p.c. growth (1)	**Tax revenues (% GDP) (2)**		**Gross Savings (%GDP)(3)**		
Regions	**(1985-2002)**	**1985-88**	**1997-2000**	**1980-90**	**1990-00**	**1990-2002**

[37] The wider resource mobilization question was, of course, a concern of earlier development economists (e.g. Lewis, 1954). For Lewis, 'the fundamental problem of economic development is to explain how a low income country can increase its national savings rate from 4-5% of GDP to 15-20% of GDP'.

Sub-Saharan Africa	-0.4	21.7	16.3	13.9	12.5	12.7
South Asia	3.3	12.8	12.2	13.5	16.7	16.8
East Asia & Pacific	6.1	15	15.6	**30.8**	**31.6**	**31.2**
Latin America	0.8	15.2	15.9	21.7	18.9	18.9

Sources: (1) World Bank, World Development Indicators.
(2) IMF Government Financial Statistics and calculations done by the author.
(3) World Bank (2004), Partnerships in Development.

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.[38] Moreover, the public savings component of national savings is particularly important for the growth prospects in LDCs. Kriekhaus (2002) finds that higher *public* savings as a percentage of GDP is correlated with higher growth rates in less developed countries. [39]

The very high savings rates achieved in East Asian economies were largely the result of the coercive power of the state, which was deployed to mobilize resources through various forms of forced savings.[40] Among the coercive elements in East Asian economies were restrictions on consumer credit, financial restraint, mandatory pension contributions (used in Singapore and Malaysia) and the encouragement of postal savings. Although state actions to increase savings are clear in East Asia, the high and sustained *growth* rates may have also had an important feedback effect on income growth and therefore on increasing savings rates.

The extent to which tax systems may a play a role in improving productive capacity is neglected in the literature. However, *there is evidence that there may be growth returns for linking tax reform and policy to productive strategies*. We have already seen that this was the case with land taxes in East Asia, the export tax on sugar in Mauritius, and the role of the Colombian Coffee Federation. Evidence from North East Brazil also suggests that 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 was central to improved economic performance of the leather and shoe industry (Tendler, 2002).

Given the prominent role of aid in government revenue in low-income countries (see Foster and Killick 2006 for evidence), it is also relevant to consider how aid policy could contribute to economic growth. Historically, there is little evidence that increased aid necessarily translates into higher economic growth (Easterly 2006). However, this may 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 (op. cit.)

[38] This difference in national savings was much less pronounced in the 1970s across the regions.

[39] Public savings contribute to growth because such savings represent budget surpluses which contribute to macroeconomic stabilization.

[40] See Wade (1990); Chang (1994); Kohli (1999); and Huff (1995).

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 instability.

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 (e.g. health, education, governance). OECD-DAC data on sector-specific aid from all sources 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).[41] Second, the attention placed on fiscal tightening in the 1980s and 1990s has led to widespread deterioration of infrastructure throughout Latin America and Africa.[42] 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 donor community has not responded to these growth-restricting falls in infrastructure investment.[43] 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 in poverty are so difficult to achieve. *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. Second, there is substantial evidence that physical

[41] While social spending can contribute to growth (see reference in footnote 37), there is no evidence to suggest that it matters so much more to growth than direct investment in economic activity to justify the dramatic shift in aid toward social service delivery that has occurred. What is true is that aid flows in general have taken place in the context of structural adjustment loans and structural adjustment programs. Such programs have forced reductions in fiscal spending and therefore reduced spending in potentially growth-enhancing investments such as in infrastructure and social services.

[42] Structural adjustment programmes sought to achieve stabilisation - interpreted as price stability - by taming inflation. However, the World 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.

[43] 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).

infrastructure investment is correlated with growth rates (UNCTAD 2006; Calderón, Easterly and Servén 2003). Third, investments in electricity contribute to the competitiveness of manufacturing exporters (UNCTAD 2006).

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.

This does not mean that investments in social sectors do not contribute to growth. As Killick and Foster (2007) 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." (p. 182).

In sum, the role of aid can contribute more to growth if it is re-allocated more towards directly enhancing production, particularly in agriculture. For this to be effective, the *time-frame of aid needs to lengthen* as many infrastructure projects are long-gestating. As well, it may make sense to introduce a matching funds approach to budget support (Carnahan, 2007). If leaders know that aid flows will increase if they increase domestic tax effort, then this provides incentives for leaders to develop tax states which in turn would contribute to state- building and state capacity, and ultimately the increased possibility of greater public investment. Finally, aid flows need to be made more predictable [44] 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). This makes macroeconomic planning difficult and thus can undermine the prospects of macroeconomic stabilization.[45]

5. The Social Goals of Tax Policy: Taxation, Inequality and Poverty Reduction

[44] Eifert and Gelb (2005) provide a summary of this topic as well as suggestions on how improved predictability might be achieved.

[45] It is also important to note that aid does also have price effects like any capital inflow and therefore affects stabilization beyond volatility of revenues.

This section considers the social goals of tax policy, and in particular, the relationship between tax reform, inequality, and poverty. The challenge for the design of any tax system is to keep the costs of collection as low as possible while also achieving revenue, growth, and distributional goals as effectively as possible (Bird 2008:31). Indeed, traditional tax analysis focuses on the design of tax systems that makes possible financing the "necessary" level of public spending in the most efficient and equitable way (Stern, 1987; Tanzi and Zee, 2000).[46]

The main tension identified in this literature is the potential trade-offs that tax collection can have on growth and equity. While taxation is necessary to finance public goods and re-distribute income, the process through which a government collects tax can entail substantial costs in terms of efficiency. [47] The most obvious cost is that higher tax rates on business and labour can reduce incentives of labour effort, investment and risk-taking since post-tax wages and profits would decline (Stern, 1987). The basic problem identified in traditional tax models is that the government wishes to raise revenue to distribute income without sufficient information on the preferences and endowments of citizens to do so by means of lump-sum taxes. Therefore, governments can achieve its goals only by raising taxes in some distortionary way. This gives rise to the standard neoclassical concern of the tension (or costs and benefits) between achieving equity and efficiency in a general equilibrium framework.

Given the inherent trade-offs between efficiency and equity, it is difficult to assess the extent to which a fiscal system is pro-poor. *The first important factor is the extent to which a tax system is progressive*, which requires that those taxpayers with greater ability to pay to pay relatively higher taxes. Generally, personal and corporate income taxes, along with property taxes are progressive while indirect taxes (VAT) and excise taxes tend to be less progressive, and are often, regressive. In the case of VAT, they can be made less regressive by exempting (or zero-rating) basic goods and taxing luxury items at a higher than average rate.[48] The *second important factor determining the extent to which a fiscal system is progressive is the extent to which fiscal spending*

[46] See Olson (1965: 98-102) for brief discussion on the historical evolution of the theory of "public goods". The collective action problem inherent in the financing of public goods implies that taxation requires coercion, a factor that is implicitly assumed in the mainstream literature on tax. The power to coerce thus is exogenous in the neoclassical theory of tax. Olson (ibid.: 173) points out that the provision of collective goods can generate divisiveness and conflict in a society. This is because the coercive provision of a collective good does not necessarily align with individual preferences which are likely to be diverse.

[47] In a world of rational expectations, an additional theoretical problem for the design of tax systems concerns the issue of dynamic inconsistency (Fischer, 1980). The problem of dynamic inconsistency occurs when an optimal policy calculated at time zero transforms into less efficient solution when re-evaluated at a later time. For example, an optimal policy is to plan for an exam at the end of a course. However, on the day of the exam, it would be optimal to cancel the exam to save students the trouble of writing and the teacher the trouble of marking. However, a consistent policy of optimizing backwards, would result in recognizing that the exam would not be held. This outcome, is however, clearly sub-optimal as there would be no incentive for students to master the course material. The problem of dynamic inconsistency has generated debates as to the importance of credible commitment-or the use of rules versus discretion-under different economic conditions.

[48] For a discussion of the complications in assessing the incidence of different types of taxes, see de Ferranti et al. (2004: Box 9.1, pp 253-4).

and transfers are pro-poor. Thus, a first approximation of the extent to which a fiscal system is progressive is to compare income distribution before and after taxes and transfers.

There are two other considerations relevant to understanding the extent to which a tax system is pro-poor. The first is the *level* of tax collection. A nominally progressive tax system can be achieved through a low level of tax collection (by, for instance, taxing wealthier individuals at a higher rate than poorer individuals, but doing so at a very low tax rate in general). In this case, there will be very few resources available for social spending, which limit the provision of social services to the poor.

The second factor is how the tax system affects investment incentives. If a tax system (whether progressive or regressive), provides major disincentives for investment, then economic growth will likely suffer. As a result, the demand for jobs will decline, which will inevitably increase poverty levels as employment levels and real wages decline.[49] Even in the high-budget welfare states (such as in Scandinavia) there is generally a pro-growth and slightly *regressive* mix of taxes, along with highly progressive social spending (Lindert, 2004). These countries have been careful to keep net taxes on corporations low, and have avoided the double taxation of dividends.

In sum, theory generally predicts the following: a) a regressive tax system is unlikely to improve income distribution unless social spending is particularly pro-poor; b) a progressive tax system is likely to improve income distribution unless social spending benefits the rich disproportionately; c) any type of tax system will not result in poverty reduction if it does not provide incentives for investment and growth; and d) even progressive tax systems are unlikely to affect income distribution or poverty reduction if the tax effort is below average. Only when low tax levels coincide with high levels of economic growth will poverty reduction take place.

Keeping in mind the limitations of tax incidence analysis (see footnote 36), the trends that seem to emerge from such studies are as follows. In all OECD countries, income distribution before taxes and transfers is significantly more unequal than income distribution after taxes and transfers (de Ferranti et al. 2004, Table 9.1, p. 248). Thus, the tax and expenditure systems in OECD countries are generally progressive. This is because income taxes (which are generally progressive) comprise a relatively large share of total tax revenue.

For less developed countries, the evidence is more mixed, but generally suggests that tax systems are at best mildly progressive, but in many cases are either neutral or slightly regressive. Chu, Davoodi, and Gupta (2000) surveyed 36 studies of tax incidence in 19 different developing countries: 13 found the tax system progressive, and 7 each found the tax system proportional and regressive; the others had mixed findings or insignificant effects. Most of the reported progressivity came from income taxes.[50] In general, the evidence suggests that expenditure policies (particularly on

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[49] In the context of a growth slowdown, or recession, real wages decline because a decline in the demand for labour (even in the context of constant supply) will result in a decline in the price of labour, and thus a decline in real wages.

[50] To the extent income taxes do not impinge on the poorest people – those outside the market sector – they are bound to be progressive (Bird, 2008: 34). Even within the taxed sector, progressive rates mean that the impact of the tax is progressive at least within the group of those who must pay tax on

education) have a greater impact on the distribution of income than tax systems (Harberger, 2006).[51]

In Latin America, where tax incidence studies have attracted the widest coverage, Chu, Davoodi, and Gupta (2000) find that the tax system has relatively little distributive impact because of the increasing reliance on indirect taxes (see also Tables 2,3 and 4 above). The influence of IFIs in pushing VAT, and the fact that Latin American countries have followed this advice most consistently is one of the main reasons why tax systems in the region do not generate much re-distributive impacts.[52] However, earlier studies on Latin America, before the VAT became the driver of tax revenue increases, also found that the tax system had little distributive effect (Bird and de Wulf, 1973).

Overall, the picture in Latin America is that the tax system has generally not been progressive, and is likely to be slightly regressive. This is due to several factors. The first is that overall levels of tax collection, is on average, low in comparative terms. The evidence suggests that the overall tax burden in most of the countries in the region is about a third lower than it should be given per capita income levels in the region (ECLAC 2007:134). Second, the greater reliance on indirect taxes limits the extent to which even the comparatively low tax collection is progressive, and thus likely to have a pro-poor re-distributive effect.[53] The evidence provided above (Tables 2, 3, 4) would suggest that, among middle-income countries, most countries in Eastern Europe, East Asia, and South Africa, possess more progressive tax systems because the share of income taxes in total revenues is greater. If the region is to change this situation, a much greater reliance on income taxes and property taxes needs to be developed (de Ferranti et al., 2004: 256). Thus, the main ways countries in the region develop a mildly progressive stance is through relatively progressive social spending on education and health (ibid.: 257-283; Barriex et al., 2007), and through conditional case transfers.

income-- for example because they receive it in the form of wages from a public sector employer. In most developing countries, however, little if any tax is collected from capital income or self-employment (mixed) income and that little is most unlikely to be distributed very progressively (ibid.).

[51] As Engel et al. (1999) demonstrate, even in a relatively advanced country like Chile with an unusually well-developed and effective tax administration the progressivity of an income tax that captures only some of the income of some people is unlikely to have any significant influence on distributional outcomes.

[52] The extent to which the VAT itself is regressive does vary across countries (Bird and Gendron, 2007). In cases where basic food items are exempted, VAT tends to be slightly progressive.

[53] The 'Plato Index' developed by Fitzgerald (2006) captures the extent to which Latin American tax systems are particularly regressive relative to most middle-income countries in other regions. The Plato Index is defined as the ratio of direct tax revenue (personal, corporate and property tax) as a share of GDP to the income share of the top quintile of households. This proxies for the direct tax incidence for the top quartile since this group provides most of the direct tax base. The 'Plato Index' is far lower in Latin America than in other middle-income countries. This is because the share of direct taxes as a share of GDP in relatively low in Latin America, and the income share of the top quartile is relatively high.

Even if it is the case that social spending (apart from spending on pensions) in Latin America tends to be progressive [54] there is little evidence that the quality of that spending is necessarily benefiting the poor as much as it might. This is because the composition of taxes can also play an important role in determining the extent to which upper income groups exercise their 'voice' in the face of deteriorating public services. Di John (2007b) finds that the relatively poor quality of public education in Latin America compared with other middle-income countries in East Asia and Eastern Europe is closely related to differences in the degree to which upper income groups pay income taxes. As mentioned above, Latin America has a much lower income tax collection compared with other middle-income regions. The paper applies Albert Hirschman's exit-voice framework to the problems of education coverage and quality in Latin America. The combination of relatively low direct taxation and high levels of private primary enrolment in Latin America is argued to provide exit options for the wealthy and reduce their incentive to exercise voice in the face of poor education performance. It also argues that fragmented and clientelist political party structures limit the provision and monitoring of public education, and thus reduces the political capacity of the poor to exercise their 'voice' regarding public education coverage and quality.[55] The main policy implication is that good governance in education can not be realistically addressed without analysing how the structure of power and voice and conflicts of interest within civil society affect the actual political pressures that state institutions face. These issues are often avoided in discussions of good governance by donors because they require one to make more explicit political judgments that donors are not comfortable doing.

Since indirect taxes dominate tax revenue increases in most LDCs), there is little scope for tax reforms to be address income inequality. This is of particular concern in Latin America since it has the most unequal income distribution in the world, which has a complex set of reasons, but began with the very unequal distribution of land assigned in the colonial period (Grabowski, 2008). The failure of agrarian reform to change the structure of property rights in almost all countries in the region throughout the 20th century is a large part of the reason why income distribution has remained so unequal. In countries where there has been successful asset redistribution, there is less need or temptation for the state to undertake progressive forms of taxation in the form of income tax in order to address economic and social inequality. As well, to the extent that more egalitarian structures of agrarian property rights create political stability, the growth prospects of the state may be high even without a substantial change in tax levels or composition, provided the state is able to mobilize savings to finance high levels of investment.[56] In this sense, *it is important to assess the tax challenges and growth prospects of a state in the context of the initial conditions of*

[54] If one includes pensions in social spending, then public spending in Latin America would, in general be regressive. The evidence suggests that pension expenditures in Latin America are highly regressive because low-income individuals tend to work in the informal sector, and therefore are not eligible for the benefits provided by the formal social security system (World Bank, 2004).

[55] Elite avoidance of tax and exit from public service also reflect on the Investment Climate through the perpetuation of vested interests who capture the state to produce growth-restricting regulatory ecomomic policies.

[56] While much investment is financed through credit (except in countries where the financial system is particularly weak), high savings rates both allow a higher level of domestic investment without incurring foreign debt, and contribute to the creation of a stable financial system.

income distribution. The consensus view that VAT is preferred over income taxes may not be appropriate in all contexts, particularly in Latin America where the need for progressive taxation is central to addressing durable inequalities in the region.

Poverty reduction, on the other hand, depends much more on sustained economic growth. Since neither tax levels nor tax composition determines economic growth, one needs to look at non-tax forms of resource mobilization in assessing the extent to which growth accelerations will be generated. Here, increased FDI, aid and increased in national savings are likely to matter much more. Sustained economic growth is the main mechanism through which the poor can increase their incomes through acc[57]ess to wage employment. This is especially important as an escape route from poverty for women (Sender, 2008). Far more attention is needed by donors on developing effective policies to promote large-scale investments in agri-business and rural infrastructure required to increase the demand for female labour in rural Africa (ibid.). Recently, the World Bank in the World Bank Development Report (2008) has acknowledged that 'making the rural labour market a more effective pathway out of poverty …is a major policy challenge that remains poorly understood and sorely neglected in policy making" (quoted in ibid.)

For low income countries, the prospects of a pro-poor tax system are remote. This is mainly due to the limited number of 'tax handles' that exist at low levels of development. 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. These structural factors do not disappear just because we would like to see tax systems in poor countries resemble more closely those of developed countries.

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 current 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 weak fiscal base of many less developed countries. The most likely way that a state, at low levels of development, becomes legitimate is through delivering an institutional structure that provides incentives for growth-enhancing activities. This is not to say that pro-poor expenditure is impossible in low-income settings (e.g. Kerala, China, Sri Lanka, Cuba, as discussed in Sen [1999]). However, but the prospects of improving social service delivery are greatly enhanced by sustaining high levels of economic growth, which greatly facilitate the prospects of increasing the tax base.

In a general sense, improved tax collection capacity can be constitutive of social cohesion and democratization, and increased state legitimacy. Taxation is generally

[57] There is no evidence that any country in Latin America has achieved anything approaching a progressive tax system.

considered one of the main ways in which to assess the extent to which a state is legitimate. Low levels of legitimacy are often behind a state's inability to ensure compliance, which is necessary to reduce the transaction costs of collecting tax (Levi, 1988).[58] When the state requires greater degrees of coercion in extracting tax resources, this is a general sign that the tax policies of a state are less legitimate.

There is a long tradition in the social sciences that links patterns and levels of taxations with the way in which societies are governed (for a summary see Moore, 2007). One of the main links drawn from history is that taxation is the nexus that binds states and citizens. The mainstream Anglo-American understanding on the emergence of representative government and democracy is that 'there can be no legitimate taxation without representation' (ibid.). In British history, several scholars have emphasized that the ability of Parliament (representing landlord and merchant capital interests) to limit the how and to what extent the monarchy could raise taxes was central to reducing arbitrary rule and necessary for the emergence of representative (albeit limited) democracy (e.g. North and Weingast, 1989). In US history, the general narrative links the declines of British colonial authority in the 1770s to the attempt of the colonial power to impose taxes without the consent of the American settlers.

The salience of taxation as a source of legitimacy does, however, depend on the initial distribution of income and assets. In countries with high levels of income inequality, the pressure to secure progressive taxation and expenditure is likely to be greater.[59] For example, the consensus view that VAT is preferred over income taxes may not be appropriate in all contexts, particularly in Latin America where the need for progressive taxation is central to addressing durable inequalities in the region. It may be tempting to argue that , in many East Asian economies, where substantial asset redistribution has taken place in the form of agrarian reform, there has been less of a need or temptation for the state to undertake progressive forms of taxation in the form of income tax in order to address economic and social inequality. This would hold for the case of Malaysia which is the country with the highest levels of income inequality in East Asia, and which also has the highest rates of income tax collection (see Table 2).[60] However, it does seem to be the case generally that countries with more egalitarian distributions of income also seem to have more progressive tax systems. Both Eastern European and East Asian economies, on average, have more egalitarian patterns of income distribution *and* more progressive tax systems, compared with the Latin American pattern. Clearly, more research is required to uncover why the general evidence goes against predictions of standard neoclassical theory.[61]

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[58] It is also conceivable that a state may be legitimate precisely because it does not tax powerful elites. This legitimacy is not likely to last as the ability of the state to finance social services and public goods would be limited.

[59] Which is not to say that such pressure translates into the progressive tax reform as the Latin American experience, in general, suggests.

[60] Similarly, South Africa, which has among the most unequal levels of income distribution, also has the highest levels of income tax among developing countries.

[61] Standard neoclassical theory applies the median voter theorem, which, in its simplest (and most common) form, is based on democratic determination of tax rates. The basic logic of the standard model (e.g. Meltzer and Richard, 1981) is that the more unequal the income distribution, the more that the median voter will tend to support re-distributive taxes that are assumed to be financed by taxes on

In recent years, there are several political and institutional arrangements, particularly in Latin America, that have helped enhance the role taxation can play in promoting social cohesion. The first is the rise in participatory budgeting, where the case of the municipality of Porto Alegre, Brazil is the most promising example (see Schneider and Baquero, 2006). Such institutions brought together local political party leaders, neighbourhood associations, and the business sector where public assemblies were set up to discuss the public budget. The local government secured support for progressive property taxes in meetings that mobilised support mostly from poor neighbourhoods.

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.

The second major institutional arrangement that has re-enforced the link between democratization and tax policy is the emergence of fiscal pacts. The most well known example took place in Chile in 1990, during the transition to democracy after seventeen years of military rule.[62] The reforms comprised four major elements: corporate income tax was increased from 10 to 15%; the standard VAT rate was raised from 16% to 18%; marginal personal income tax rates were increased for taxpayers in intermediate income brackets; and various tax exemptions for the private sector were eliminated. The tax reforms were at best neutral, but the overall effect was redistributive since the various parties involved in the pact agreed to use increased tax revenues to increase pro-poor social spending.

Two factors specific to the recent history of Chile enhanced the prospects of fiscal pact-making. One was the widespread notion that there was a 'social debt' to the poor, arising from their previous experience under the military regime that should now be

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capital income. More formally, in terms of income distribution, the poorer the median voter in relation to the average income, the higher the equilibrium tax will be.

[62] The Chilean example draws on Schneider, Lledo, and Moore (2004: 16-18).

compensated. Second, the tax increases could be represented as a dimension of restoring the country to normality: the military regime had cut the government's tax take by 5% of GDP between 1980 and 1990.

Importantly, the use of indigenous political traditions were drawn upon to drive tax reform; in this case the pact drew upon the Latin American corporatist tradition, in the sense that it was the result of extended negotiations between various organized groups both inside the legislature and outside it. The governing five-party coalition, "La Concertacion", included most of the political spectrum from Left to Centre. As well, the coalition sought and gained support from right-wing parties.

A similar pact was reached in Guatemala. Guatemala's *Pacto Fiscal* signed in 2000, brought together government, private sector, and civil society groups to develop a package of tax and spending proposals that would help the government carry out social and economic reforms promised in the country's Peace Accords.[63] It not only set targets for total revenues to be allocated for this purpose (8–12 percent of GDP), but also for expenditures on specified goals for social sectors; for fiscal balance (the average deficit was not to exceed 1 percent of GDP), and for tax administration efficiency. Further, it articulated a consensus that in order to improve the quantity and quality of public expenditures, the government would need to launch major tax reforms. While the reforms have not reached the stated targets by 2006, participatory discussion created a space for government to negotiate with business, civil society organizations, and citizens in determining how best to use the country's resources.

In the long-run, however, the consolidation and/or revival of effective national political parties are central for sustaining progressive tax reforms. Political parties are important since 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 organize 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 mobilize and support higher tax levels (Cameron, 1978) and more progressive tax systems (Heidenheimer et al. 1983: 178-9) than those run by conservative parties.[64] The well developed welfare states in Scandinavian countries in the second half of the twentieth century were controlled by social democratic coalitions.[65]

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[63] The Guatemalan example draws on Gallagher and Rozner (2007).

[64] Steinmo (1993) and Lindert (2004) have, in fact, argued that countries dominated by social democratic parties such as Sweden, do not have more progressive tax systems than the United States, where electoral politics is not dominated by left-centre parties. What distinguishes Sweden is not high levels of corporate income tax, but very high and stable levels of income tax collection (mostly on salaries), and more progressive social spending.

[65] In developing countries, it should be noted that it is often difficult to place parties on a definitive left-wing/right- wing scale. This is, in part, because, many of these parties developed along more populist lines where social class cleavages defining parties are more blurred (see Roberts, 2002).

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. The relatively well developed welfare state in Costa Rica is also the by-product of dominant centre-left political parties that have developed a widespread penetration and legitimacy in the countryside (Yashar, 1997). 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 centralized 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).

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