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978-0-521-88815-8 - Taxation and State-Building in Developing Countries: Capacity and Consent

Edited by Deborah A. Brautigam, Odd-Helge Fjeldstad and Mick Moore

Excerpt

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1 Introduction: taxation and state-building in developing countries

Deborah A. Bräutigam

1.1 Introduction

Taxation is the new frontier for those concerned with state-building in developing countries. ‘The history of state revenue production’, as Margaret Levi declared, ‘is the history of the evolution of the state’ (1988: 1). Taxes underwrite the capacity of states to carry out their goals; they form one of the central arenas for the conduct of state–society relations, and they shape the balance between accumulation and redistribution that gives states their social character. Without the ability to raise revenues effectively, states are limited in the extent to which they can provide security, meet basic needs or foster economic development. Yet the political importance of taxation extends beyond the raising of revenue. We argue in this book that taxation may play the *central* role in building and sustaining the power of states, and shaping their ties to society. The state-building role of taxation can be seen in two principal areas: the rise of a social contract based on bargaining around tax, and the institution-building stimulus provided by the revenue imperative. Progress in the first area may foster representative democracy. Progress in the second area strengthens state capacity. Both have the potential to bolster the legitimacy of the state and enhance accountability between the state and its citizens.

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This claim – that taxation is a central component of state-building – unites the contributions to this volume. We do not argue that taxation is a unilaterally positive force; much depends on the way in which states and societies negotiate (or fail to negotiate) revenue raising. Chapters 4 and 5 in particular emphasise the perils of coercive taxation. Yet we do contend that it is an exceptionally important force, and that it may affect governance in direct but perhaps unexpected ways. This idea is largely missing from the new scholarship on state-building (Chesterman, Ignatieff and Thakur 2005; Fukuyama 2004; Levy and Kpundeh 2004; Rueschemeyer 2005). It is also largely missing from the practical concerns of those working in the aid community, who tend to focus far more attention on cutting expenditures than on raising revenues (Therkildsen 2002a). The ‘Washington Consensus’ has converged around the economic outlines of a ‘good’ tax regime (broad-based, with low marginal rates) and there is growing diffusion of an administrative model for revenue raising in the independent or autonomous revenue authority; Mick Moore and Odd-Helge Fjeldstad discuss this further in Chapter 10. However, the lack of attention to the relationship between revenue raising and governance is surprising, especially given the long-standing linkage between taxation and governance assumed by students of European and American history.

We define state-building as the process of increasing the administrative, fiscal and institutional capacity of governments to interact constructively with their societies and to pursue public goals more effectively. In Europe, as Schumpeter noted, taxes not only helped create the state, they ‘helped to form it’ (see Swedberg 1991: 108). The origins of representative government are intimately bound with the evolution of taxation. The oft-told narrative begins with war: the costs of warfare led European monarchs to increase direct taxation, which they were able to do only through bargaining with their societies’ elites. This had two political outcomes: it prompted the rise of parliaments, and it led to larger, more capable and more professional state bureaucracies. The argument about taxation and representation is a familiar one, and studies of political development in low-income countries are beginning to focus more closely on these relationships. Less familiar is the argument about taxation and state capacity. It proceeds thus: revenue demands fostered reform of tax systems, shifting from tax farming to permanent, modern bureaucracies. These set the standard for the evolution of bureaucratic structures in Europe’s new states. The needs of these bureaucracies for a literate and numerate workforce helped stimulate the rise of systems of formal education. The bargain between taxpayers and monarchs encouraged a rule of law protecting private property rights. Backed by taxation, rulers were able to raise bonds on private capital markets. Formed originally to

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finance wars, these institutions became essential supports for European economic development. If this reading of the European experience is correct, there may be a governance dividend in more explicit attention to the political dimension of taxation in today's developing world.

This book addresses three main questions across two broad themes of taxation and representation, and taxation and institutions:

1. *How do taxation and sources of public revenue affect state–society relations and governance in contemporary developing countries?* A major axis of debate is whether the taxation relationship either (a) is intrinsically coercive and therefore inimical to consensual governance, or (b) provides an opportunity for the creation of consensual and representative government through ‘revenue bargaining’ between states and organised citizens.
2. *When (if at all) does the revenue imperative begin to create a virtuous circle of institutional development?* As shown in this volume, the revenue imperative can produce a variety of institutional outcomes. In some countries (and in some historical periods) revenue and related institutions are developmentally ‘better’ than in others. What is the origin of more effective and credible state institutions, and tax systems that are able to elicit higher levels of consent?
3. *What are the key political considerations involved in enabling governments of contemporary developing countries to tax more effectively, more equitably and more sustainably?* Few developing countries have yet succeeded in creating tax systems with high levels of both capacity and consent. Their tax systems are often regressive and distortionary, and lack legitimacy. Tax administration is usually weak and characterised by extensive evasion, corruption and coercion. In many cases overall tax levels are low, and large sectors of the informal economy escape the tax net entirely. How can tax reform strengthen states and at the same time contribute to accountability and better governance?

Although the concern with taxation and state-building in developing countries is still quite new, we build on a foundation of historical and contemporary research that takes taxation as central to the state–society relationship in what are today's advanced capitalist countries. Some of this research uses large, cross-national datasets, while some have studied these issues using comparative case studies, often historical. State-building is a social process that unfolds over long periods of time. As researchers as diverse as Barrington Moore (1966), Sven Steinmo (1993) and Atul Kohli (2004) have shown, it lends itself well to methods emphasising the effect of history, and to those that illuminate the role of power holders and state–society alignments. Detailed case studies emphasise context and the enduring influence of history in interpreting the factors

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that affect the design and effectiveness of tax systems, the willingness of societies to pay taxes, the role played by taxation in state–society bargaining and the stimulus taxation may provide to develop the capacity of the state in other areas. This is the approach we have taken in this book.

This introduction has four parts. I begin with a discussion of recent scholarship on the political economy of taxation, asking what this might contribute to our concern with state-building. The review situates our book in the context of a burgeoning literature, but a literature that for the most part focuses on the advanced capitalist countries, and that addresses two narrower questions: what explains the level of taxation, and what explains the design of tax systems? These questions are not irrelevant for our concern with state-building, and the review highlights promising pathways laid out by this scholarship. It has much to say for one of our central concerns: what factors affect states' ability to tax? Yet much of this literature tackles the issues that concern us only indirectly. For our purposes, it has strengths, but also weaknesses; I discuss these briefly in the second part of this chapter. The third and fourth sections draw on the contributions of our authors, as well as on a selection of recent studies, to highlight how taxation relates to the political economy of state-building in contemporary developing countries. Here my focus is on two of the central themes introduced above: (1) taxation as a factor in the building of institutions and state capacity; (2) taxation as a factor in state–society relations, particularly in the expansion of representation, bargaining and accountability. The third theme, implications for tax policy in contemporary developing countries, is the central concern of Chapter 10.

1.2 Political economy theories of taxation

Historically, taxes as a percentage of income have tended to rise over time, but not always in the same way, and not everywhere. States without much capacity tend not to collect much in the way of taxes, and they also tend to be poor and non-democratic. How do we untangle these various strands? Scholars in economics, political science, history and sociology have constructed at least five approaches to the political economy of taxation, all of which attempt to explain different levels of tax and, by implication, state capacity and state–society relations.¹ First, economists have emphasised economic structure, the level of economic development and 'tax effort'. The second approach emphasises taxpayers' ideologies, values and culture in explaining compliance with the state's taxation

¹ See Therkildsen (2001) for a detailed review of some of the seminal literature in this area.

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[More information](#)

demands. The third approach highlights the role of war and other threats in explaining the incentives for rulers to modernise their revenue bureaucracies, while the fourth set of theories seeks to explain differences in state capacity and tax systems through the analysis (often historical) of political institutions. The fifth and final set of theories, fiscal contract models, frames taxation as a collective action problem: rulers wish to maximise revenue, taxpayers wish to minimise payments. These two preferences lead rulers to offer something (representation, accountability, services) in an exchange based on reciprocity. Although I discuss these separately, it is important to note that individual scholars often employ two or more of these approaches simultaneously.

1.2.1 Level of economic development and economic structure

The structure of taxation, the general shape of tax systems and the overall level of taxation tend to change over time and with economic development.² Though countries differ, there is a stylised pattern to these changes: from tax farming to professional bureaucracies; from particular excise taxes on products such as salt and rum to general value-added taxes; from ‘head’ or ‘poll’ taxes to income and employment taxes, and so forth (Hinrichs 1966). These varied patterns of taxation have long been an important concern for public finance economists (Bird 1992; Musgrave and Peacock 1964; Newberry and Stern 1987). A standard economic approach to framing the relationship between taxation and state-building is to explain the level of taxation (and, by implication, the capacity of the government) through a combination of the level of economic development and other aspects of economic structure. Countries with higher incomes have higher tax ratios as a percentage of national income. This higher ratio accompanies other factors that also rise with development: literacy, industrialisation, economic openness, debt, formalisation of the economy and urbanisation. New ‘tax handles’ (foreign trade, oil wells, a formal manufacturing sector) as well as new technologies ease the process of collecting revenues. In these views, the relationship between taxation and state capacity is a simple, evolutionary process, a function of modernisation captured by this quotation: ‘Ability to tax is closely associated with administrative capability and this is likely to improve with economic development’ (Burgess and Stern 1993: 774–5).

Public finance economists long ago included a political dimension in their comments that ‘political will’ was also a factor in revenue collection

² Mick Moore reviews this literature in Chapter 2.

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(Kaldor 1963). This recognition also finds expression in the literature on ‘tax effort’, or the degree to which countries actually make use of the potential for revenue generation afforded by a given economic structure (Hinrichs 1966; Musgrave 1969). However, even these examinations usually stopped with a determination that tax effort was high (or low), and that governments were ‘unwilling’ to use their available tax capacity. An International Monetary Fund (IMF) study of tax effort in forty-three countries in sub-Saharan Africa, for example, found a significant country-specific effect, suggesting to the researchers that ‘the political system’ and ‘attitudes toward government’ might affect tax effort (Stotsky and WoldeMariam 1997: 10, 29). This recognition that tax ‘effort’ and the effectiveness of a revenue-raising system vary because of political factors that affect the relative power of states and taxpayers is helpful for our state-building concern, but it is helpful more as a starting point than as a fully-fledged theory or as a path forward. As one recent group of economists remarked, ‘If this is the story, then economists, who do not readily take to the revolutionary barricades, have a problem in suggesting a viable solution’ (Bird, Martinez-Vazquez and Torgler 2004: 3). On the other hand, the emphasis on attitudes led to a second set of theories that economists and others have used to model tax compliance as a function of taxpayers’ social values, sense of moral obligations, ideologies and norms.

1.2.2 *Societal factors: culture, values, trust and ‘tax morale’*

Governments’ abilities to collect taxes depend on people’s willingness to pay them. People’s perception of the risk of detection and punishment, and the impact of different penalties, occupied the first round of research on tax compliance (Allingham and Sandmo 1972). Later researchers added other social factors to their models: the sense of moral obligation; the perception of the tax system’s fairness and, in particular, the perception that other taxpayers are also paying; and the foundation for trust: the extent to which taxpayers believe governments (a) spend their tax money wisely, and/or (b) spend it on public goods that will benefit the taxpayer (Andreoni, Erard and Feinstein 1998; Frey and Feld 2002). As this suggests, the focus on societal attitudes has two strands. The first emphasises ideology, values or culture as something that affects attitudes independently from the current state–society relationship (Levi 1988; Putnam 1993; Webber and Wildavsky 1986). As Levi has noted, a society’s ‘public-spiritedness or normative conviction’ can be motivating factors in the willingness to pay taxes. People with a strong belief in a welfare state might thus be more willing to pay high rates of taxes (Levi

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Excerpt

[More information](#)

1988: 52). Religious traditions of ‘*zakat*’ or ‘tithing’ might form a sense of moral obligation to hand over a percentage of one’s income to the community (Hull 2000). The attitudes in this case are intrinsic and not conditioned by actions by the government, although they might well be conditioned by state–society relations in the past (Cummings *et al.* 2004). The second strand of research emphasises attitudes formed through experience with government. It suggests that compliance will be affected by perceptions of the government’s legitimacy and the fairness of the tax system, as well as taxpayers’ expectations that their tax moneys will be spent on valued public services (Slemrod 1992). Economic structure figures here: some research suggests that countries with sizeable shadow economies or informal sectors have lower tax morale, as people in the formal sector can more easily observe large numbers of others escaping the tax net (Alm and Torgler 2004). The government’s capacity to provide services also matters. In this sense, tax compliance is based on an exchange, or a ‘fiscal contract’; we return to this theme in Section 1.2.5.

1.2.3 *War and taxes: bureaucratic modernisation as a response to threat*

In searching for the starting point for state capacity and bureaucratic modernisation, one set of theories emphasises war, threat and taxation (Henneman 1971; Prestwich 1972). These theories have their deepest roots in the same European story that provided the basis for ideas of a fiscal contract. Intense military competition created a rising demand for revenue. European citizens accepted that war required extraordinary tax levies. Hobbes outlined this understanding in *The Leviathan* (1615) when enumerating the right of the sovereign to make war and peace, ‘judging when it is for the public good, and how great forces are to be assembled, armed, and paid for that end, *and to levy money upon the subjects to defray the expenses thereof*’ (emphasis added). However, as Charles Tilly (1985: 180) pointed out, up until the rule of Henry VIII, ‘the English expected their kings to live on revenues from their own property and to levy taxes only for war’. This changed, as war stimulated the parallel development of a permanent and professional revenue infrastructure. Because of the growing importance of a steady and reliable source of revenue, rulers began to professionalise tax collection. From systems based on the farming out of excise, customs and land taxes, or raising revenue through the sale of offices or ‘prebends’ to private individuals, they turned to an increasingly professional civil service.

This process happened first in Britain. Tax revenue constituted one of the central ‘sinews of power’ supporting the early rise of the British state (Brewer 1989). By the time of the Napoleonic Wars, British taxes were

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[More information](#)

triple those levied by the French, rising to 24 per cent of national income from an already high base of 15 per cent (Tilly 1985). Legislatures in Britain used their power of the purse to hold governments accountable for the use of citizens' tax revenues. But accountability brought with it new demands for capacity. Parliaments demanded reports and information to document the legislative proposals, and government departments became more skilled and sophisticated in collecting the information they needed to respond to legislative demands for accountability.

John Brewer (1989) has given us the seminal account of this process.³ In the late seventeenth century, the British state ended tax farming and established permanent bureaucracies to collect excise and customs taxes. These were staffed by full-time, salaried employees who were recruited by examinations or apprenticeships, promoted on merit through steps in a hierarchy and retired with a pension. With its standard operating procedures and staff training, the British Excise Office in particular rapidly became the model for the administrative revolution taking place across Europe. It was the largest and the most competent part of the government, closer 'to Max Weber's idea of bureaucracy than any other government agency in eighteenth-century Europe' (*ibid.* 68). Moreover, the growth of the revenue bureaucracy and its technical approach to assessment and collection created a demand for clerks: literate and numerate employees.⁴ Employees of the excise were required to know algebra and calculus. Although compulsory primary education would wait in Britain until late in the nineteenth century, municipalities, private groups and individuals were sponsoring schools to meet this demand long before the passing of the national education acts.

The needs of the revenue department also stimulated other areas of capacity-building. Statistics on imports and exports began to be collected in 1696 and the government began to calculate its balance of trade. The government also started to undertake studies of economic activities with revenue potential. As Brewer noted, a 'good' government began to be seen as one with 'technical knowledge and expertise' (*ibid.* 224). The existence of a professional tax bureaucracy allowed Britain and other countries to develop a sophisticated system of bond finance. Knowing that their governments had access to reliable sources of revenue, investors and financiers could accept lower rates of interest for these bonds, allowing the government to invest not only in weapons and manpower for wars, but, many

³ This section draws on Brewer (1989) unless otherwise noted.

⁴ Brewer (1989: 105) notes: 'They learnt how to use decimals, square roots and cube roots as well as the geometry of cones, spheres, rhomboids and cylinders. They were also instructed in bookkeeping and accounting, the use of the slide rule and the art of gauging.'

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[More information](#)

decades later, in the construction of systems of sanitation and water that would boost living standards for the increasingly urban populations. The issuance of bonds and the rise of a system of national debt helped establish the City of London as a global financial centre. As Tilly (1985: 180) memorably put it: ‘war, state apparatus, taxation, and borrowing advanced in tight cadence’. By the time of the industrial revolution, Britain had the ‘vital preconditions’ of education, strong property rights, stable credit and deep financial markets (Ferguson 2001: 16). In this view, the stimulus for state capacity and the institutions of a modern economy lies in the revenue imperative, but as the professionalisation of taxation proceeds, it pushes additional changes that build states, as a response to legislative demands for accountability, as a way to nurture sectors of the economy with tax potential and as a way to make revenue raising more efficient and effective.

1.2.4 *Political institutions and tax systems*

A fourth set of theories focuses on the question of tax systems and tax policy. They begin with the observation that the structure, goals and effectiveness of revenue-raising systems differ even in countries with similar economic structures, with established democratic governance and with modern, capitalist economies, and they argue that this is due to the structure of political institutions. Steinmo’s *Taxation and Democracy* (1993), a study of the politics of tax policy in Sweden, the United States and Britain, set the pattern for much of this work. Steinmo gave credit to periods of war in all three countries for raising the overall tax take. However, he argued that their tax systems differed in systematic ways that could be explained by differences in the design of democratic institutions (constitutions, electoral rules, parliamentary committees, etc.). These institutions affected the relative bargaining power of those most interested in tax outcomes, the information available to them and their incentives for seeking particular kinds of tax policies.

With the expansion of datasets that code a variety of political institutions in an increasing number of countries, scholars have explored the impact of a range of institutions on the ability of states to raise revenue.⁵ These studies primarily address state-building from the perspective of tax bargaining (factors that affect relative bargaining power), the incentives for cooperation and compromise, the impact of other political factors as they intervene to shape decisions over taxing and spending, and (perhaps most basically) the relationship between taxation and

⁵ The Database on Political Institutions (DPI) is one prominent example of a new database.

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Excerpt

[More information](#)10 *Deborah A. Brautigam*

representation. They focus both on elections, and on post-election politics, in models emphasising the ‘median voter’, partisan competition, veto players and agenda setters (Gould and Baker 2002).

In a test of the idea that democracies exchange taxation for representation, scholars have asked how regime type affects taxation (and vice versa). Cheibub (1998) found that whether a government was democratic or a dictatorship had no independent effect on the government’s ability to tax, once he controlled for other factors such as the level of economic development. Boix (2001) challenged this, concluding that levels of taxation *grew more rapidly* in democracies than in authoritarian regimes, as elections allowed changing societal interests to better express their preferences, and redistribution became an important societal goal. Although a decade ago John Waterbury (1997: 394) could lament that the ‘venerable’ taxation-leads-to-representation hypothesis was nearly impossible to confirm, in 2004 Michael Ross tested this hypothesis. Ross reasoned that the relationship could work in two possible ways: (1) rulers raise taxes, causing citizens to protest and seek representation (democracy) in order to lower their tax burden; alternatively, (2) citizens use a cost–benefit approach when reacting to a tax increase. If the increased burden comes without a commensurate increase in desired services (or even a drop, as in many cases of economic crisis and fiscal reform), there is pressure for representation. His study found support for the latter hypothesis: ‘When citizens are faced with an undemocratic government that is charging unreasonably high prices for its services, they tend to demand democratic reforms’ (Ross 2004: 248). The impact is relatively rapid; however, merely increasing taxation had little effect on demands for democracy. As Moore notes in Chapter 2 in this volume, work by James Mahon (2005) confirms and extends these findings, which lend support to the fiscal contract idea.

Other scholars have focused on how institutional differences within democratic systems might affect extractive capacity, again, largely through the incentives they provide for cooperation or compromise. Boix (2001: 15) found that controlling for the level of economic development, constitutional arrangements had ‘a marginal effect’ on tax revenues. Parliamentary systems were able to raise more revenues than presidential systems, but whether the state was federal or unitary, or what type of electoral system it had, was far less significant than factors related to the structure of societal interests, and, in particular, the interests of the median voter. On the other hand, Gerring, Thacker and Moreno (2005) found that countries with what they term ‘centripetal’ constitutions, those with incentives for ‘voice’ rather than ‘veto’ (political systems that were unitary rather than federal,