Taxation and state-building with a (more) human face

Push for broader-based taxation in fragile states – and tax the aid machinery operating in them too.

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Four advantages arise from this: better, more sustainable and less donor-dependent funding of core state functions in security and service provision; new organizational lessons on how to increase the capacity to tax that can be used in other parts of the public sector; improved state-society relations around revenue bargaining that increase people’s say over government tax and spending in exchange for tax compliance; and practical donor support to build broad-based and fair tax systems, with fewer tax exemptions for the powerful and influential.

State-building is strengthened in this process, as the hearts and minds of people will be more favourably disposed towards a state which is more responsive and accountable to their needs because the state’s own survival depends on the willingness of people to pay taxes.

These are the simple (and grossly simplified) suggestions of this brief.

War made the state and the state made war, says a well-known and now widely accepted account of European state-making. It was brutal process with an inhuman and violent face.

State-building in present-day fragile states is different. War is no longer an internationally accepted way of state-making. Failure to deliver services and internal uprisings against illegitimate power are more likely to affect state-building in fragile states than wars against external enemies. Consequently, mobilising resources from internal sources (and aid) are especially central to present-day state-making.

But can more reliance on taxation in fragile states really be called ‘state-building with a human face’? The answer is yes if taxation actually helps to build states, and if collection is not too brutal. The arguments to support these propositions are:

State-building involves increasing the capacity of governments to interact constructively with societal interests, to obtain support and resources from those interests, and to pursue public goals. Taxation by consent promotes state-building in three ways:

1. by providing revenues without which key state functions (such as providing security and services) cannot be carried out
2. by encouraging constructive state-society relations around taxes
3. by creating more effective tax administrations whose bureaucratic practices may (eventually) spread to other public-sector organisations

Such arguments are neglected in the recent literature on state-building. Most fragile state literature neglects the potential state-building impacts of taxation too.

POLICY RECOMMENDATIONS

- Taxation issues should be dealt with up front in post-conflict states, even if revenue yields may be modest to start with
- Taxes that suit local circumstances should be identified and tapped, even if they may not fit the current global ‘best practice’ advice
- Reduce/abolish tax exemptions for donors and their contractors/NGOs

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TAXATION ENCOURAGES POLITICAL MOBILISATION AND BARGAINING

The potentially positive effects of taxation on state–society relations can best be illustrated by the negative effects that arise when states do not tax much, and by the potentially positive effects when they do.

If a government fails to tax, or if the revenue-raising machinery of the state is allowed to decay so that the bulk of the population escapes the reaches of civilian bureaucracy, people may become exposed to more committed and organized predators and competitors: guerrillas, private armies based on the narcotics and arms trades, and non-state movements of various kinds, including faith-based Christian and Islamic movements.

Another situation arises when fragile states have access to large non-tax incomes from oil, gas and mineral exports. This often reduces efforts to tax citizens – and may aid, although this is still disputed. Moreover, substantial income from natural resources may affect expenditure: more money may be spent on patronage, on undermining independent social groups demanding political rights, or on repressive measures to ‘enhance internal security’ and block aspirations for better accountability.

Contrast this with the potentially positive impacts of active revenue-raising as shown by historical experience, cross-national analyses and case studies. First, taxation may be an important means of keeping the state machinery alive and active at the grassroots level and in preventing rebellions and predators from tapping into revenue sources to fund further conflicts. Secondly, taxation may reduce dependence on income from unpredictable and conditional aid and natural resources. Thirdly, taxation is a ‘strategic nexus’ between state and society. Being taxed provides incentives for citizens to become active in the political processes – what incomes and assets should be taxed; what constitutes just and fair tax rates and acceptable methods of tax collection; and what are the best uses of the revenue mobilised. Tax revenue-dependent states become motivated to bargain with taxpayers about these issues and to accept institutionalised influences by citizens on public policy in exchange for tax compliance.

Obviously, brutal and coercive taxation will undermine this type of revenue bargaining, although taxation generally involves some ‘threat of’ compulsion in case of failure to pay legitimate taxes. Raising revenues through fair taxation that encourages compliance and consent – not through coercion and force – is therefore important.

TAXATION CONTRIBUTES TO STATE CAPACITY

Taxing the bulk of people requires both administrative capacity and systematic information about companies, asset-owners and income-earners. Building up such capacities is central to effective and fair taxation and to state-building as well – both in terms of strengthening public-sector organisations and institutions, and in preventing predators and rebellions from having access to the national tax base.

Moreover, revenues are central to building capacity in the rest of government. This is not only because this requires sustainable funds, but also – and this is a bit more speculative – because the lessons about how to build effective tax-extraction capacity may be used to improve capacity and performance in other parts of the public sector through a diffusion of ‘best practices’ from an emerging tax bureaucracy to the public sector at large. Effective taxation also requires detailed information about who earns and owns what. This may stimulate a welcome state interest in economic growth.

TAXATION IN POST-CONFLICT FRAGILE STATES

The box below shows some of the key features of taxation in fragile states. Revenues are relatively low, resulting in a very weak fiscal basis for the provision of security and services. Trade taxes are very important, but vulnerable to international attempts to reduce tariffs and other customs revenues. Such attempts are driven more by a concern for liberalisation than for revenue generation in fragile states.

Donor dependency is another typical feature of revenue generation. However, if donor funding leads

KEY FEATURES OF TAXATION AND GOVERNANCE IN POST-CONFLICT FRAGILE STATES

• Low tax/GDP ratio (typically below 15% but only 5% in Afghanistan).
• High dependence on trade taxes (60% of total government revenues in Sierra Leone; 35% in the Democratic Republic of Congo).
• Very high aid dependence (donors fund around 2/3 of government operating expenditures in East Timor and Afghanistan. Recent security-sector spending by donors in Afghanistan was almost 500% of the government’s revenue, roughly one-third of the country’s GDP).
• Dual government (donors fund a large proportion of government directly, outside the recipient budget).
• Private contractors increasingly used in security operations, development activities, and to service donor operations.
to visible improvements in security and services, this helps to improve domestic tax compliance and thereby strengthen the government’s own revenue mobilisation, even in post-conflict situations that are not particularly conducive to taxation.

Tax exemptions for donors, and for organisations contracted by donors, is also a significant feature. The box above shows that such states are often forced to administer a myriad of exemptions, which typically vary from donor to donor. This places unnecessary burdens on the already weak tax authorities and promotes corruption. Even worse, it fuels a tax-exemption culture, and sends a wrong signal that the powerful may succeed in escaping taxation.

THREE PROPOSALS FOR TAXATION IN POST-CONFLICT STATES

What are the policy implications of these broad generalisations about the relationship between state-building and taxation in post-conflict states?

First, taxation is an issue that should be dealt with up front, for the challenges of building an effective state, a robust economy and a durable peace are closely related. Deciding on them early in the post-conflict situation is critical, even though taxation measures may not yield significant revenues in the short run, and their ‘state-building’ effects may be modest to start with. Thinking about the three challenges together is equally important because difficult trade-offs are involved. Experience shows that a single-minded focus on economic development rather than on security may have damaging consequences for state-building in the medium term, and vice versa. Moreover, since donor fund-
Finally, reduce and do away with tax exemptions for UN organisations, donors, NGOs and donor-funded foreign contractors. Present exemptions for UN organisations are based on a 60-year-old and now outdated convention, but have been extended to the international community more broadly over the years. While donors typically push very hard to get recipient governments to reduce tax exemptions that fuel patronage and political corruption and burden weak tax administrations, donors still insist on tax exemptions for their own staff and operations – sometimes even including the foreign companies they contract. Such exemptions are especially problematic in countries where donors fund a large proportion of the public sector and the economy. If donors are serious about state-building they should agree to pay part of their contribution to the recipient countries by paying taxes and duties just like everyone else. While this will not affect the net flow of funds (if double taxation agreements exist and agents are law-abiding), it will reduce the negative effects of the tax exemptions for donors. More importantly, it will signal, and be a practical demonstration of, the principle that the economically privileged should also contribute significantly to the provision of public goods. Finally, it will be a practical demonstration of the willingness of donors to subject themselves to the duties of taxpaying that they so strongly urge on domestic taxpayers.

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THIS BRIEF IS BASED ON THE FOLLOWING:


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