Tax and the Governance Dividend

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Summary

It is now widely believed that taxation contributes to the quality of governance. There are a number of variants of the broad argument. The most general proposition is that, if governments are dependent on broad general taxation for their incomes, they will, for reasons of self-interest, be more responsive to the needs of their citizens and more likely to allow citizen representatives to share in governance. From a broad historical perspective, that argument is probably valid. The political interactions between states and citizens over tax revenues are however considerably more complicated than this. Governments can proactively use their control over the revenue collection process to divide their citizens into different, competing groups, and thereby increase governments’ own bargaining power relative to their taxpayers. This dimension of the politics of taxation systems has received relatively little attention in the substantial literature on the topic. This paper summarises and illustrates the ways in which governments can use patterns of public spending and tax exemptions to protect themselves from the potential political influence of organised taxpayers.

Keywords: taxation; politics; public spending; tax exemptions.

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Introduction

It is close to two decades since I became infatuated with taxation. The relationship was premature and, on my part, distinctly adolescent. We barely knew one another. But this did not stop me from falling in love. I produced several publications arguing that more taxation was the way to improve the quality of governance, especially in those low-income countries whose governments were heavily dependent on aid or on the revenues from natural resource extraction.¹ I argued that case vociferously, in part because most staff of aid and development agencies seemed sceptical, and much more interested in how the governments of poor countries spent money than in how they raised it. I thought I could detect a whiff of self-interest in this position: the proposition that large volumes of aid might cause or exacerbate governance problems threatened to damage both the political case for aid and the morale of aid agency staff.

Two decades later, positions have changed. Within aid and development agencies, attitudes have been substantially reversed: tax now has a host of admirers. Claims that the greater dependence of governments on taxation will result in more accountability or democracy are now commonplace. Collecting public revenues is now presented not simply as a regrettable necessity – the least bad way of raising the money that governments need – but as a potential means of actively eliciting a ‘governance dividend’, that is, a more inclusive and accountable government.² Conversely, my own infatuation with tax has matured into a more critical affection. I still believe that there are potential governance dividends from the greater reliance of governments on taxation, but my expectations have become somewhat muted. I now envisage the governance dividends to be smaller and less reliable than I had previously hoped, and to emerge only in the relatively longer term.

Why have I revised my views? It is not principally because the evidence has changed. In respect of contemporary low-income countries, the evidence was never abundant. Like other people making similar arguments about tax and governance, I relied largely on a combination of deductive reasoning and evidence from history, mainly from Europe, and especially from Britain in the seventeenth and eighteenth centuries. To the extent that, in recent years, propositions about the positive impact of taxes on governance have been tested for their applicability to contemporary low-income countries, the evidence seems broadly supportive.³ There is also an

¹ The earliest and most strident versions of this argument are to be found in Moore (1998, 2004). For successively more nuanced arguments, see Moore (Moore 2008a, 2008b, forthcoming). Ole Therkildsen was the first colleague to alert me to the prevalence of exploitative and coercive taxation in some areas of the world. He referred me to the research of Odd-Helge Fjeldstad on the subject (Fjeldstad 2001; Fjeldstad and Therkildsen 2008), which led in turn to a very rewarding research partnership with the latter.

² Most OECD governments have been suffering from fiscal stress since 2009. Individually, they are ramping up their tax collection efforts. Collectively, they have made considerable progress in agreeing to changes that will decrease the scope for large transnational corporations to avoid most of their tax obligations. In this environment, any positive perspective on the potential benefits of taxation is likely to receive a sympathetic hearing. The institutions associated with large-scale bilateral development aid currently are receptive to the same arguments for a different reason. It is becoming increasingly clear that the era of large bilateral aid transfers is drawing to a close. An appealing narrative has been constructed around taxation: if donors could now help expand revenue-raising capacity in low-income countries, they can look forward to a satisfactory exit from the aid relationship; not only will former aid recipients be able to raise their own revenues, but the process of doing so is likely to stimulate better governance (e.g. OECD 2008, 2010).

³ I have recently reviewed that evidence elsewhere (Moore forthcoming), a review that was completed about a year ago. It does not take into account very recent research, notably that undertaken or stimulated by my colleague Wilson Prichard and based on a new and more reliable date series of national revenue statistics (Prichard et al. 2014a). This new research broadly supports the notion of a positive causal sequence running from tax dependence to improved governance (Prichard et al. 2014b). Note, however, that the weight of research evidence is now running strongly against the propositions that high levels of foreign aid lead recipient governments to reduce their tax efforts (Clist 2014; Morrissey et al. 2014) and that this might therefore damage governance through lower tax dependence.
accumulating weight of empirical evidence behind the mirror image argument: that the fiscal dependence of governments on revenues from oil, gas and mining damages governance (Bulte et al. 2005; Collier and Hoeffler 2005; Gervasoni 2010; Jensen and Wantchekon 2004; Neumayer 2004; Ross 2008; Torvik 2009; Tsui 2011; Vicente 2010; Weyland 2009; Williams 2011). My faith in the governance dividend argument has abated not because of the accumulation of contrary evidence, but mainly because I have become aware that its conceptual and theoretical bases are not sufficiently broad or robust. The possible political outcomes of interactions between governments and citizens over revenue collection are more diverse and open-ended than I used to believe.

1 Governance dividend theories

There is no space here to explore in any detail the range of arguments deployed by the governance dividend theorists. The core causal propositions are, however, relatively clear. In a manuscript that unfortunately was never published, James Mahon neatly called them revenues for regimes arguments:

- If states are dependent for their incomes on broad general taxation – rather than on direct control of land, manufacturing industry or natural resource extraction – then they will both be generally motivated to help promote the prosperity of their citizen-taxpayers and, more specifically, potentially willing to cut political deals with those citizens to stabilise or increase the tax take.
- Given that the experience of being taxed is also likely to mobilise citizen-taxpayers, there is a potential for institutionalised state-citizen political bargaining that essentially involves more citizen compliance in meeting legitimate tax demands in exchange for more influence, through more inclusive and accountable governance institutions, in the determination of those tax bills and in the use of public revenues.

It is unlikely that any governance dividend theorists conceived their arguments as anything other than probabilistic and dependent for their validity on context and a range of other variables. In particular, there seems to be a consensus that national fiscal institutions should be coherent and unified if they are to become the locus of the kinds of political bargains sketched out above (Brautigam 2008; Dincecco 2011; Gallo 2008; Herb 2003; Levi 1999; Moore 2008a; Timmons 2005). But what other variables might affect the validity of the governance dividend propositions? There is no space here to do a thorough review. I deal only with two complications to the core causal model that I believe are important and under-appreciated:

- More inclusive and accountable political institutions are not the only big political offer that governments can make to their taxpayer-citizens to induce tax compliance. Governments may also – or alternatively – offer targeted public spending, especially spending tailored to the interests of specific groups (Section 2).
- Governments have considerable scope to tax even more selectively and opaquely than is implied in the formal provisions of the tax code by giving ad hoc exemptions to individual

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4 For a wider range of references to literature in this tradition, and for a summary of the foundational ‘fiscal sociology’ ideas of Rudolf Goldscheid and Joseph Schumpeter, see Moore (forthcoming). The most influential recent social science contribution was that made by the late Charles Tilly (1992).

5 There are, however, a number of significant questions about how, in statistical testing of governance dividend theories, we might operationally define and measure such concepts as the degree of government dependence on broad general taxation and the size of the tax burden on citizens (Moore 2008b, forthcoming; Ross 2004).
taxpayers or narrowly defined groups of them. Far from being revenue maximisers, contemporary governments use this exemption power lavishly, especially in relation to investors (Section 3).

The common threads here are that, relative to the implicit assumptions of governance dividend theories, contemporary governments (a) have more latitude to shape the bargaining agenda around revenues, and (b) they may use this to divide citizen-taxpayers into distinct or even competing political groups. In the concluding Section 4, I suggest that governance dividend theorists have underestimated the degree to which governments are able to take initiatives to shape fiscal politics in part because they have been over-influenced by arguments that were more valid when governments’ fiscal activities were smaller and different than today.

2 From tax bargaining to fiscal bargaining

Governance dividend theories are founded on the notion that, especially at moments of perceived systemic political threat, governments might offer more inclusive and accountable governance institutions in return for greater tax compliance. The suggestion that they might in addition or instead offer particular patterns of public spending received a considerable boost with the publication in 2005 of Jeffrey Timmons’ article on ‘The Fiscal Contract’ (Timmons 2005). Timmons suggests the following basic model of state-society political interactions around fiscal policy:

- Governments tax but also make large recurrent distributional expenditures.
- Governments are likely to motivate compliance on the part of those citizen-taxpayers on whom they are most dependent through compensating policies that most directly address taxpayers’ interests.
- Citizen-taxpayers are potentially divisible into distinct interest groups.
- Strategically rational governments, which will normally seek both fiscal comfort and popular support, will act as ‘discriminating monopolists’, that is, they will segment the population of citizen-taxpayers, offer different compensating policies to different groups, and be more responsive to those groups that provide more of the total tax revenue.

From these broad theoretical propositions, Timmons derives some hypotheses for empirical testing: governments which rely relatively heavily on taxes paid by poor people (regressive taxation) will tend to motivate these relatively impoverished taxpayers through social spending; and governments that rely more heavily on taxing the rich (progressive taxation) will motivate them by providing relatively high levels of protection for property rights. Timmons finds support for these hypotheses through cross-country statistical analysis. His statistical tests are in fact quite blunt. He used a series of incomplete data sets covering between 18 and 100 countries over the period 1975-1999, and had to make some bold inferences from fiscal accounts about the division of tax burdens between rich and poor taxpayers respectively. The fiscal data that he used are anyway of poor quality. Relevant figures are often not available in the case of low-income countries (Prichard et al. 2014a). We cannot conclude that Timmons’ hypotheses about fiscal contracting are empirically valid. His underlying theory, however, is quite plausible, and has informed recent research about changing patterns of fiscal politics in the Americas by some of the most knowledgeable contemporary specialists in the subject (Bird and Zolt 2014). It is hard to believe that the theory does not accurately capture some of the reality of contemporary
fiscal politics. Offers of more inclusive and accountable governance institutions are not the only way for governments to induce tax compliance.

3 Revenue non-maximising and tax exemptions

Similar suggestions about the extent to which governments can (a) take political initiatives and (b) create political divisions among taxpayers emerge from the study of a topic to which Ole Therkildsen has recently made a major contribution: the politics of tax exemptions (Therkildsen 2012). I approach the topic a little obliquely here. Large-scale discretionary – and often opaque – exemptions for large (and mainly corporate) taxpayers are a modern phenomenon. But the broader phenomenon – special deals for ‘strategic taxpayers’ – is widespread. I begin therefore with a few contemporary examples:

- In produce markets in northern Ghana, the daily fees that are supposed to be levied on all sellers by market managers are sometimes not actually collected from the larger traders, who may end up paying lower fees each month than small traders (Prichard and Van den Boogaard 2014).
- At various sub-national levels in China, government agencies have long been levying relatively unregulated quasi-taxes (‘fees’) that are formally represented as service payments (education charges, security charges, etc.) but actually reflect mainly the extractive capacity of the organisations that collect them in relation to local businesses and residents. Research by Eun Choi showed first that larger firms generally paid lower fees relative to business turnover than did small firms. It also revealed that, while politically well-connected business owners generally paid higher fees than did the less well connected, they were more than compensated by receiving in exchange preferential access to loans and other publicly provided services (Choi 2009).
- Post-Soviet Russian governments found themselves very dependent for revenue on a small number of large firms. They responded with economic and industrial policies that preferentially channelled resources to those same large firms to try to keep public revenues buoyant (Gehlbach 2008).

Each of these observations exemplifies a general proposition about organisational behaviour that became encoded in what is known as resource dependence theory: organisations are more responsive to the agencies that control their critical external resources (Pfeffer and Salancik 1978). In the context of public revenue, this translates into the proposition that governments will tend to be more responsive to ‘strategic taxpayers’, that is, to large taxpayers that have the greatest capacity to trouble the tax collector by not paying in a timely and reliable way. To encourage strategic taxpayers to pay reliably, tax collectors will tend to find ways of motivating them, whether through reducing their tax bills below the ‘normal’ level or offering some other kind of inducement. To put it another way, divisive tax bargaining – doing deals with individuals and small groups – may to some extent be normal for governments and tax collectors. Contemporary tax exemptions may be regarded as divisive deals at scale.

Tax exemptions are a familiar topic for fiscal historians. For example, the inability of the French state to curb tax exemptions in the eighteenth century – and indeed the continual granting of them in exchange for up-front cash – has been a powerful theme in explanations for the weakness of that state and the outbreak of the French Revolution (Fukuyama 2012: Chapter 23). But such exemptions are very different in character from those that interest us here:
exemptions for capitalist investors, foreign or local, justified in terms of the need to provide incentives for capitalists to invest in a particular jurisdiction, and not in an adjacent country. These exemptions are characteristic of globalised capitalism and have become more widespread in low-income countries in recent decades (Keen and Mansour 2009: 18-20). Surprisingly, they have barely featured in the contemporary political science literature on tax and governance.

We do not know the actual incidence of tax exemptions for investors in low-income countries. Technical difficulties in defining and measuring exemptions are a small part of the explanation. A bigger part lies in the secrecy surrounding them. Exemptions are typically granted by politicians more than by public servants, and often in diverse, arbitrary and non-transparent ways. The literature on the subject is enormous. Economists and tax specialists are near-united in condemning the frequency of tax exemptions and the ways in which they are granted. The OECD recently assembled data relating to six countries in Africa that suggested that tax exemptions on average amounted to 33 per cent of taxes actually collected (OECD 2013). Other snippets of information indicate that this figure is probably typical.

Why do virtually all governments of low-income countries routinely give away a large fraction of their potential tax revenues through exemptions? We know that globalisation and competition among countries for investment is one of the motive forces. Strongly encouraged by potential investors and their advisers, many governments fear that, if they do not compete with their neighbours to attract investment by granting tax exemptions, their economies will suffer badly. But if that were most of the story, governments would adopt more coherent and formal procedures for granting exemptions, be more transparent about their decisions, and pay more attention to the possibility that they could generate more investment by not granting exemptions and instead spending the additional tax revenue on solving the kinds of problems about which potential investors are often very concerned, notably poor quality public infrastructure. There are motives other than competition for investment behind the high frequency of tax exemptions. As we understand in particular from Ole Therkildsen’s recent work on Tanzania, tax exemptions are a major source of political funding for individual politicians, factions and political parties (Therkildsen 2012). They are also a significant instrument of rule for governments that lack democratic legitimacy and/or strong and consistent support from stable political parties, organised interest groups or loyal public service cadres. The grant of tax exemptions, as well as the threat of withdrawing them, is a way to keep some powerful economic interests on side, or at least to deter them from active opposition. It is also, as Alexis de Tocqueville recognised in the mid-nineteenth century, a standard technique used by rulers to induce political divisions among their citizens: ‘of all the ways to make distinctions between people and classes, inequality of taxation is the most pernicious and most apt to add isolation to inequality’.6 My colleague Hubert Schmitz reports from field research in Vietnam that the granting of tax exemptions to large businesses is seen by small businesses as a significant obstacle to the creation of effective business associations that can interact and bargain with government. The interests of the larger businesses in seeking tax exemptions drive them into individualistic political strategies. Even if sectoral business associations are formed, they are politically weak because the big companies are not active members. Rather they pursue individualistic strategies in relation to government institutions (personal communication, 1 August 2012).

There are then three motives for contemporary governments to grant tax exemptions: the perceived threat of an investment famine if the exemptions offered by competitor governments are not matched; the side-payments that may be provided to powerful individuals and groups by

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grateful investors; and the creation or exacerbation of political divisions among citizens, taxpayers, business associations or any other category in a position to potentially challenge state elites. We do not know the relative weight of these motives, but one important consequence is likely to be the (partial) political demobilisation of the taxpayer interest. This is especially likely in contemporary low-income countries because a relatively small number of large companies tends to provide a high proportion of all actual revenues. These are the strategic taxpayers who are likely to exchange favours with government, including tax exemptions, in return for some mixture of making political contributions and paying their residual tax bills on time.

Tax exemptions are typically the outcome of interactions between individual companies and powerful individual political executives or small groups of them. On neither side do formal representative institutions – business associations or elected legislatures – play much of a role. The politics of exemptions are typically fragmented, individualistic and secretive. They are the very opposite of the kind of encompassing, public political exchanges between states and large categories of citizen-taxpayers that are conjured up in the governance dividend literature.

4 Concluding comments

I explained at the outset that I believe governance dividend theory to be substantially valid today. The purpose of this paper is not to justify my continuing faith, but to explore its limits. Let us assume that the reservations I have expressed here are also valid. Why have so many of us been over-eager to endorse and promote the rather simplistic version of the theory?

First, it is hard to marshal the statistical and other evidence needed to test governance dividend theories through contemporary social scientific methods. The evidence and methods are improving, but only slowly. We have therefore relied in part on historical argument and deduction.

Secondly, we have not fully appreciated the differences in the character and context of fiscal activities and fiscal politics in consolidated states of the contemporary world and those of, broadly, the seventeenth, eighteenth or nineteenth centuries. In the earlier period, fiscal politics were more likely to take the relatively simple form that underlies governance dividend theories. In particular:

- The public fiscal domain was generally considerably smaller. Except during occasional periods of intense warfare, governments raised only a few percentage points of GDP in revenue, as opposed to the figures of 15-35 per cent that are the norm today.
- As a proportion of the total population, actual taxpayers – i.e. people who actively handed over money to tax collectors – were relatively few.
- Raising taxes from a much less monetised and more agrarian economy where far fewer economic transactions were authoritatively recorded was a more challenging and conflict-ridden business (Moore 2014).

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7 There are two broad reasons for this. One lies in industrial structure: the relative economic dominance of large firms, many of them with foreign or state ownership. The other lies in the fact that, because the informality of employment relations means that governments obtain little revenue from personal income taxes, they depend relatively heavily on corporate profits taxes (IMF 2011).
• Taxes were raised predominantly for military purposes, and, especially at the level of central state institutions, mechanisms and personnel for spending public money on anything other than central administration and the military were rare.

Through mechanisms too numerous to explore in detail here, this combination of circumstances was, given other supportive factors,\(^8\) conducive to governance dividend outcomes. In particular, small numbers of taxpayers could more easily engage in collective action, and, when governments felt the urgent need for additional revenue, this was typically during actual or potential military emergencies when governance concessions to taxpayers might have seemed an acceptable price to pay for urgently needed revenues. Conversely, governments were not well placed to engage in the more complex kinds of fiscal politics, outlined in Sections 2 and 3 above, that make the core governance dividend theory appear a little over-simplified in the contemporary world. Governments did not have large routine programmes of public spending over which they could bargain with groups of taxpayers. Their grip on their main revenue sources was not so secure that they could risk giving selective exemptions to large taxpayers on a large scale.

Thirdly, the core narrative underlying governance dividend theory has become strongly naturalised within the political cultures of Great Britain and the United States over several centuries. What were originally political claims – that paying taxes generates an intrinsic right to political representation – have become accepted as if they were causal propositions, that is, that taxpaying generates more representative government and vice versa. It is not simply that historians tell us that attempts by British governments to raise taxes without granting adequate political representation to taxpayers sparked the English Civil War in the 1640s and American Independence in the 1770s. It is also that successive generations of British and American public figures have subsequently talked and acted as if the link between taxpaying and representative government (or democracy) were tight and binding (Daunton 2001). The apparent lessons of history seem all the more persuasive when articulated repeatedly by historical actors themselves, in addition to the academics who interpret their actions.

Finally, the governance dividend story is appealingly simple. It is therefore memorable, and attractive to those who are trying to shape public policy (Roe 1991).

In sum, the governance dividend theory does have historical validity and a strong analytical base, but we need to exercise care in translating it into contemporary contexts without qualification.

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\(^8\) These other factors include centralised and unified fiscal systems, the prior existence of some kind of representative political institutions, and large amounts of mobile mercantile capital that might easily relocate (Tilly 1992).
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