

# 1 Introduction: taxation and state-building in developing countries

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## 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

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

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.<sup>1</sup> 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

<sup>1</sup> See Therikildsen (2001) for a detailed review of some of the seminal literature in this area.

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.<sup>2</sup> 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

<sup>2</sup> Mick Moore reviews this literature in Chapter 2.

(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

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

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.<sup>3</sup> 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.<sup>4</sup> 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

<sup>3</sup> This section draws on Brewer (1989) unless otherwise noted.

<sup>4</sup> 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.'

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.<sup>5</sup> 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

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

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,

parliamentary rather than presidential, and list-proportional rather than first-past-the post), could collect higher levels of taxes.

From the point of view of states still struggling to build effective institutions and constructive state–society relations, these studies offer some insight into the possible implications of different institutional choices, the way state institutions affect tax compliance, and the way state–society relations both affect and are affected by taxation. Yet for our purposes, much of this research raises as many questions as it answers. In much of the developing world, democracies either do not exist, or are new, fragile or impermanent. Institutions may have the same names, but they may not function in the same way. Several studies bear this out. For example, whereas Cheibub (1998) found no relationship between regime type and extractive capacity, researchers who examined this relationship among a subset limited to developing countries found opposite results: Fauvelle-Aymar (1999) determined that autocracies had higher levels of taxation than democracies, while Thies (2004) came to the reverse conclusion.<sup>6</sup> In another example, Boix (2001) found that high voter turnout was a factor in explaining the level of taxation in democracies, but that this effect only operated for countries at middle-income levels and above. Steinmo and Tolbert (1998) found that the level of taxation in OECD countries was significantly affected by partisan arrangements: countries with one large, majoritarian party, and countries with many small parties, would each (for different reasons) have fewer incentives to compromise than those in which the largest party held just under a majority of the seats.<sup>7</sup> However, when Gould (2001) included developing countries in the dataset, the effect of party size vanished. All of these suggest that we cannot assume that ‘institutions are institutions’ and that they will have the same effect in poor countries as in wealthy ones. On the other hand, Steinmo and others who have explored the *origins* of institutions emphasise the importance of historical legacies, critical junctures and path dependence. Several of our authors (Easter, Fjeldstad and Therikildsen, Strauss, and Bräutigam) use variations on this approach in their chapters for this volume.

<sup>6</sup> Each used different time periods, however: Cheibub: 1970–90, and Fauvelle-Aymar: 1980–9.

<sup>7</sup> One can certainly imagine situations where this would not be the case, but the logic is that large parties win elections, so they have no need to compromise and can restrain expenditures, and thus tax revenues. A system with several smaller parties is fairly equally balanced and would also restrain expenditures. Only those where the largest party holds just under half of the seats (44 to 49.9 per cent) were associated with higher tax revenues.

### 1.2.5 *Taxation and the fiscal contract*

The idea that taxes involve a kind of bargained exchange between governments and taxpayers has very deep roots (Moore 2004a). Mick Moore's chapter in this volume describes the historical origins of this exchange. In early modern Europe, monarchs seeking new sources of revenue to fight wars increased taxes on trade, on property and on ordinary citizens (through various head – 'poll' – or hearth taxes). Yet only the taxes on trade (customs duties), goods (excise duties) and fixed property had the potential to be increased significantly, and these increases were subject to consent, which in turn had to be negotiated. Assemblies of notables were formed to negotiate this consent. A primary aim of representation remained the bargain over taxing and spending. Taxpayers who believe that their interests are represented in a democracy may be more willing to pay taxes, but they also begin to believe that their payment of taxes gives them the *right* to representation. When the American colonists complained about taxation without representation, they were speaking to a colonial government that had long accepted this principle. Representation, however, is only one element of the fiscal contract. The bargain might also involve services: public goods (such as defence, schools or roads) or semi-public goods (benefits provided to producers or consumers). And it involves pressure on governments to be accountable to taxpayers for the use of their money.

There are two somewhat different approaches to the fiscal contract idea. One emphasises the broad societal, economic and state factors that are more or less conducive to revenue bargaining: Moore's chapter, for example, examines, among other things, war, mobile assets, political stability, the size and complexity of the state apparatus, economic modernisation and economic rents. The other approach is based primarily on an individual level of analysis and a framework emphasising rational choice: Margaret Levi's seminal study *Of Rule and Revenue* (1988) has shaped all subsequent work in this vein. Levi began with the assumption that rulers – as individuals – seek to maximise revenues. She hypothesised that their ability to do this is limited by (a) their relative bargaining power (who controls the economic, political and coercive resources that both the state and citizens require to meet their goals?), (b) transaction costs (costs of negotiating, measuring revenue sources, monitoring and enforcing compliance) and (c) rulers' discount rates (the degree of concern for current versus future revenues). These factors in turn are shaped by macro-level variables such as economic structure, changes in the means of production (such as technology), the international context and the form of government. Taxation, she argued, is a collective action problem,

a reciprocal contract of sorts that results in quasi-voluntary compliance by taxpayers: ‘quasi-voluntary’ because of the ever-present mix of norms, incentives and sanctions. Taxpayers pay taxes in part because they expect that the ruler will provide services (security and other public goods) in return for revenues. However, tax payment might be modelled as a prisoner’s dilemma: compliance is affected by assurances of fairness; the knowledge that others are also paying their taxes, but also by the threat of coercion. Bates and Lien (1985: 61) added an emphasis on the mobility/non-mobility of taxable assets, arguing that it was those with moveable property (traders and capitalists) who were compensated by being allowed an increasingly strong voice in government policy decisions.

Levi’s framework speaks directly to our concerns about state-building. Her goal was to refine the broad hypothesis that ‘taxation built states’ by specifying the mechanisms that lie between the need for revenue generation and the creation and evolution of state institutions. For Levi, representative government arose in part because it was useful to rulers: it reduced transaction costs, enabled the system to appear more ‘fair’ (building trust) and strengthened the link between the payment of taxes and the receiving of services. All of these enabled rulers to raise more revenue. Likewise, the organisational forms of the state change over time as economic development creates changes in the resources available to rulers and to taxed groups. Technological changes, ranging from the adoption of a money economy to the use of computers to track the flow of money, affect transaction costs such as the measurement of income and wealth. These changes make it possible for rulers to consider previously inconceivable policies such as the abandonment of tax farming, or the direct taxation of income. Over time, governments construct more sophisticated institutions that foster lower cost compliance. These institutions – starting with the tax agency, but including also the increasingly large array of services that are the government’s side of the fiscal contract – form the heart of governments’ bureaucratic evolution. They strengthen the state. With its emphasis on collective action problems and individual decisions, rational choice theory emphasises the relationship between states and societies in its approach to state-building.

A paper by Timmons (2005) lends some support to the fiscal contract idea. Using a dataset with ninety countries, Timmons found that, controlling for income levels, countries with a higher proportion of revenues from income and corporate taxes had stronger protections for property rights, a concern of citizens at higher income levels. Those relying more on regressive taxes (those that hit the poor relatively harder) had higher proportions of social spending. Timmons argued that these results represent a ‘credible commitment’ by governments to services that taxpayers

valued. This should not surprise us: if taxation is indeed part of an exchange, it is rational for governments to provide more benefits to the group of taxpayers who provide more revenue.

When Margaret Levi's 1988 book *Of Rule and Revenue* was reviewed in the *American Political Science Review*, the reviewer commented that 'taxation is probably the most significant political phenomenon that political scientists have left relatively unexplored' (Curtis 1989: 1424). The review above suggests that this exploration is now well under way. I introduced five sets of theories that have been used by social scientists to explore taxation and that offer some potential for an investigation of taxation and state-building. They emphasise, respectively, the autonomous working of economic development; values and culture; war and threat; the structure of political institutions; and the shaping of a fiscal contract and exchange as the key factors affecting extractive capacity (some have examined how taxation affects some of these factors, as well). These approaches have strengths, and they are not mutually exclusive; our authors sometimes use several of them in making their analyses. Yet we use them with caution. Like modernisation theory, these theories were developed from the specific experience of the advanced capitalist world. The discussion of political institutions in the preceding paragraph suggests something unsurprising: developing countries, in general, differ from advanced capitalist countries.

We can see these differences in four major areas. First, by definition, they are at lower levels of development. Their institutions are weaker, their economic structures are based more on agriculture than industry, their informal sectors and shadow economies are larger and they have fewer tax handles. Chapters 2, 4 and 5 in this volume emphasise that this combination of factors favours more coercive approaches to taxation, while Chapter 8 highlights other difficulties presented by large informal sectors. Second, as Moore points out in Chapter 2, many developing countries are highly dependent on one or a few natural resources; this was never the case in the Organisation for Economic Cooperation and Development (OECD) countries, even in their early histories (see Burgess and Stern 1993: 782–3). Gallo's case study of Chilean nitrates (Chapter 7) and Bräutigam's chapter on sugar exports in Mauritius (Chapter 6) are cases in point. Third, inequality is considerably higher in many developing countries than in the OECD, and this has been the case for quite some time (Kaldor 1963: 411). Finally, compared with the richer countries, developing countries face a different set of global pressures and influences. They are often recipients of aid, something that substitutes for taxes but that may have different political results. They have higher levels of debt, and weaker positions in the global political economy. As Chapters 9 and

10 both make clear: political pressures to raise or lower protective tariffs, export taxes and Value Added Tax (VAT) have often come from outside the country, such as from financial institutions with an interest in the fiscal health of a country (Gloppen and Rakner 2002; Mahon 2004). Whether democratic or not, these external relationships may exert far more direct political influence on a country's level of taxation than political institutions, rulers' discount rates or voter turnout. Levi signalled this (1988: 36–7) by adding 'international context' to her framework of macro-structural factors; however, she did not consider factors such as foreign aid as influences on the bargaining power of rulers or on rulers' incentives to bargain with taxpayers. All of these factors complicate the relationship between taxation and state-building and should cause us to pause before making the assumption that when it comes to the political economy of taxation, developing countries are simply poorer versions of today's advanced capitalist states.

We turn now to focus directly on taxation as it affects two of the key questions that matter so profoundly for social scientists: what leads some states to be so much more capable than others? What affects the ability of countries to build more accountable and responsive governance, and the constructive engagement on which economic growth and development depend? We argue that taxation is (or should be) a central part of the answers to both of these questions.

### 1.3 Taxation and state capacity

In 1963, as one country after another emerged from colonial rule, economist Nicholas Kaldor wrote an article for the journal *Foreign Affairs* with the title 'Will Underdeveloped Countries Learn to Tax?' Kaldor threw a spotlight on the link between state capacity and taxation: 'No underdeveloped country has the manpower resources or the money to create a high-grade civil service overnight. But it is not sufficiently recognised that the revenue service is the "point of entry"; if they concentrated on this, they would secure the means for the rest' (1963: 417). By state capacity we mean, first of all, a state with an effective bureaucracy. Our point of departure here is Weber's notion of the modern, rational-legal bureaucracy. As Strauss summarises in Chapter 9, a Weberian bureaucracy is structured along impersonal, technocratic, hierarchical lines. Its written records provide a strong institutional memory, and its personnel have formal salaries, rely on standard operating procedures and knowledge-based rules, and answer to superiors who (ideally) take decisions according to impersonal, technocratic criteria. In examining state capacity, I begin with an analysis of war, threat and natural-resource-based revenues as they

figure in rulers' incentives to establish 'good' extractive bureaucracies, and the institutional development that is the foundation of an effective state. This leads to the second concern: the impact of past institutional choices and 'critical junctures' on the structure of extractive capacity and related state institutions. Last, I briefly consider how the international context affects taxation and state capacity-building in developing countries today, a subject taken up at greater length in Chapter 10.

### 1.3.1 *Rulers' incentives to build tax capacity*

Theories of state-building in western Europe emphasise the central role of war and threats in the development of taxation and related institutions. Several of our authors (Moore, Gallo, Bräutigam, Joshi and Aye) elaborate in their chapters for this volume, that the specific characteristics of different sources or kinds of revenue have different political implications when it comes to building capacity (and state–society relations). (See also Hoffman and Gibson 2005; Snyder and Bhavnani 2005; Timmons 2005.) Both of these factors turn on the question: what gives rulers incentives to build tax capacity?

*War and threat* As the review above emphasised, a large body of literature points to war and threat as the incentive for the long process of state-building that began in Europe. As Tilly (1985) memorably put it, by stimulating demand for revenue: 'war made the state'. Researchers have now begun to explore the role of war in their analyses of state-building in Africa, Latin America and Asia. Jeffrey Herbst, for example, has argued (2000: 126) that African states lack the kind of external threats that prompted European rulers to bolster tax collection, and that this accounts in part for the weaknesses of institutions in Africa, a theme Mick Moore develops further in Chapter 2. Miguel Centeno (2002) made this question the centrepiece of *Blood and Debt: War and the Nation-State in Latin America*. Centeno found that wars did *not* push leaders to raise taxes in the eleven Latin American countries he studied; they resorted to debt to finance war. Cameron Thies (2004, 2005) reasoned that higher taxation might occur without an actual war; it might be the presence of significant rivals and the threat of war that would push states to expand their extractive capacity. His study of eighty-three post-colonial developing countries found a significant, positive effect of external threats and strategic rivalries on tax revenues and, by implication, extractive capacity.<sup>8</sup>

<sup>8</sup> There was also some evidence that taxation was higher in states with significant internal ethnic (but not political) rivals.

Applying the same model to Centeno's eleven Latin American countries, Thies found a similar, positive effect of war on the level of tax revenues over the course of the twentieth century. As in the early European experience, he concluded, 'Blood, debt, and taxes are dependably recurrent aspects of the long and painful process of building the modern state' (2005: 463).

Victoria Hui (2005) also made use of this theory in her analysis of state-building in ancient China during the Warring States period (656–221 BC). She made a strong case that the origins of the Chinese state's formidable bureaucracy could be traced to war, in particular, to the Qin Dynasty's unusual strategy of 'self-strengthening' (building extractive capacity and a meritocratic administration) as it strove to dominate the other warring states, eventually becoming the first dynasty of what we now call China. Julia Strauss's chapter in this volume suggests, however, that war acted only indirectly as a stimulus for building extractive capacity in China in the early twentieth century. Strauss shows how the Chinese leadership sought a large foreign loan in order both to consolidate a national debt perilously close to default, and to build the central government's army in order to counter rebel movements. The consortium that offered the loan demanded a lien on the salt tax in order to guarantee repayment. The strengthening of the Salt Tax bureaucracy (under a foreign director) thus came about not through 'self-strengthening' ordered by Chinese leaders, but as a condition for repayment of the loan. Threats were a factor, yes, but the link is not direct.

That threats might foster state-building efforts is a theme in research on the East Asian 'miracle' economies (Maxfield and Schneider 1997; Stubbs 1999). As early as the nineteenth century, for example, Thailand, which was never colonised, faced the threat of both French and British expansionism on its borders. In 1890, King Rama V invited fiscal advisers from England to oversee the country's revenue and expenditure accounts (Akira 1989: 79). These early moves helped to undergird the relatively high level of capacity in Thailand's economic ministries. Yet, as Moore points out in Chapter 2 in this volume, there are significant exceptions to this 'threat leads to capacity' thesis, particularly in sub-Saharan Africa, where internal and external threats have led in many instances to state collapse. Taxation may still be a factor here, but the road that leads from war/threat to taxation to capacity may be blocked by the nature of the taxable resources available in many weak states. For the 'wars make states' thesis to function, rulers facing threats need a source of revenue that they can actually tax. This leads to the second point: different kinds of resources have different implications for capacity.<sup>9</sup>

<sup>9</sup> This is also true for state–society relations.

*Resources, sectors and rents* One of the most significant differences between developing countries and today's advanced capitalist states is the fact that many developing countries rely heavily on one or several resources for their tax revenue. This fact has generated a large body of research. Rosser (2006) provides a comprehensive overview of much of this recent work. One group of researchers follows the lead of Shafer (1994) who has argued that a country's 'leading sector' shapes the boundaries of states' 'authority to tax' and its tax bureaucracy and related state institutions. 'Sectors differ in the level of taxable resources they generate, the ease with which such resources can be tapped, the institutions needed to do so, the availability of other revenue sources, and the state's ability to tap them' (Shafer 1994: 8). Shafer's framework can be challenged – it would not predict, for example, the capable states of Chile, also highly dependent on copper at an earlier stage, or Mauritius, almost totally dependent on its plantation economy at independence, but a diversified manufacturing economy now. But his discussion of Zambia, dependent on copper and unable to diversify, is reflected in many states (Nigeria with oil, for example). And Carmenza Gallo, in *Taxes and State Power* (1991), has shown that in an earlier period the case of Chile did fit the Shafer model: taxing a regionally concentrated export product, copper, led to an over-specialised and small bureaucracy and did little to facilitate the institutional penetration of the state throughout its territory. Other researchers have moved from this insight to note that even the same resource can be extracted and taxed in different ways, and that this might affect the ability of some states in Africa, for example, to avoid the 'resource curse'. Snyder and Bhavnani (2005) use the example of diamonds, pointing out that those that are widely dispersed, such as alluvial diamonds in Sierra Leone, are more easily 'looted' than those extracted by deep-mining industrial corporations. Rulers of countries that happen to have industrial diamonds (Botswana, South Africa) simply find them easier to tax. Facing threats, they are in a better position to use their resources to build capacity and maintain order. Gallo's chapter in this volume emphasises another aspect of resources: they are usually characterised by price instability. In her case, the instability of world market prices for nitrates 'undermined the incentives for state authorities to negotiate and consult with nitrate producers, and weakened collective action among producers'. In a relative sense, they strengthened the state.

A second, but related, theme linking resource-based economies and state capacity is the literature on the rentier state, which points to the characteristic weaknesses and the lack of accountability of states that depend heavily on revenues from mineral exports (particularly petroleum). The argument proceeds thus: reliance on natural resources and

other kinds of rents led to a truncated process of institution-building. With easy access to reliable revenues through taxing foreign corporations, resource-based states never needed to penetrate their outlying societies and organise them to raise revenues. They did not need to bargain with their producers over taxes, establish fiscal accountability towards taxpayers or build autonomous, capable bureaucracies that could make policy and direct resources to support autonomous producers. Rulers whose revenue arrived without much effort found themselves making decisions mainly about largesse, or the distribution of the 'national cake' as Nigerians put it. Terry Karl described petro-states as: 'weak giants that could be rendered ineffective by hundreds of rent-seeking Lilliputians' (1997: 60).

To date, the most compelling example of the 'resource curse' and how it can affect state capacity was produced by Kiren Aziz Chaudhry (1997) in her detailed account of these processes in two rentier states, Saudi Arabia and Yemen. Chaudhry documented how the institutions of tax states and national markets emerged together after 1918, through the expected processes of bargaining, conflict and the formation of a 'national community'. With the rise of a rentier economy in the 1970s (based on petroleum, in the case of Saudi Arabia, and on aid and labour remittances, in the case of Yemen), state-building took a drastic step backward. Yemen 'jettisoned' its extractive bureaucracy, and Saudi Arabia 'dismantled' its tax agency (Chaudhry 1997: 32). 'The decline of a tax bureaucracy has unintended consequences that bode ill for the long-term development of all parts of the bureaucracy' (*ibid.* 33), Chaudhry argued. Without an extractive bureaucracy, these states lost incentives to centralise their fiscal apparatus, obtain information about their producers and basic data on the economy, set fiscal priorities, establish effective regulation for their private sectors and foster the adoption of modern accounting and managerial practices (*ibid.* 33–4).

### 1.3.2 *Historical legacies and critical junctures*

The comparative historical approach used by Steinmo (1993) also provides leverage for unpacking the relationship between taxation and state capacity in developing countries. A number of researchers have noted that historical legacies shape taxation, state capacity and ultimately state–society relations in distinctive ways. In developing countries, colonial legacies are particularly salient, but there are other points at which critical junctures provide the foundations for new institutions and mark the start of different paths.

In many countries, as Fjeldstad and Therkildsen point out in Chapter 5, colonial systems of taxation had little to do with consent and everything to do with coercion. Their account of Uganda's tax system points out that one legacy of the colonial system was the fact that 'while it is a civil offence to default on income tax, defaulting on poll taxes continues to be a criminal offence'. Colonial powers differed in their own histories of developing extractive capacity, thus in the institutions that they brought with them to their colonies, and the models they offered for colonial revenue raising. Early modern Spain, for example, had access to gold, silver and other plunder from its conquest of much of the New World, but it also relied on domestic revenues from sheep herding. The reliance on state-controlled natural resource extraction and commodity exports also characterises many Latin American countries today. In Spain, as North and Thomas pointed out (1973), both sources of revenue provided little incentive to develop an efficient system of property rights or to stimulate more efficient domestic production. In 1562, interest costs on foreign loans drained more than 25 per cent of the annual budget, and Spanish rulers declared bankruptcy six times between 1557 and 1647 (North and Thomas 1973: 129). A cycle of natural resource plunder, foreign loans and repeated bankruptcy was the result of a failure of the Spanish crown to develop stable institutions of extraction or to stimulate more efficient domestic production. The parallels between this model and modern Latin America (Bolivia, Venezuela and Argentina, for example) are unsettling.

Korea under Japanese colonial rule provides another contrasting case. Before coming under Japanese rule, the Korean Choson state collected taxes in kind (through *corvée* labour and forced military service), and through the issue of prebends.<sup>10</sup> This system was not unlike those prevailing in Europe at the start of the early modern era. In ending this system, the Japanese built a formal tax collection bureaucracy with uniformed revenue collection officers, backed by police power (Kohli 2004). Professional collection raised revenues by 30 per cent in the first three years of the new system. The bureaucracy penetrated the villages, with local police, local tax collectors and local intelligence officers. The tax bureaucracy established by the Japanese served independent Korea well. Even before the 1961 coup that brought Park Chung-Hee to power, the Korean government was already collecting a much higher percentage of direct taxes than other countries at its level of development

<sup>10</sup> Where unsalaried officials in a particular district collected a set amount of taxes to deliver to the centre, keeping whatever extra amount they were able to squeeze from the peasantry.

(Shafer 1994: 121). The colonial state shaped the way independent Korea approached the question of revenue generation, the expectations of officials involved in tax collection and the compliance of a citizenry with long experience of being taxed directly.

Although numerous studies have identified a positive 'institutional effect' of British colonial heritage, with regard to democracy, better property rights and more developed financial markets (Bollen and Jackman 1985), there are many examples where the vaunted British institutions were not transferred. Nigeria formally came under British indirect rule in 1900. Four years later, the governor, Sir Frederick Lugard, issued a proclamation establishing a system of tax farming. This required chiefs to collect taxes directly from their population, but also allowed them to keep half of the amount. At first, as Okigbo (1965: 5–6) relates, chiefs handed taxes to the government treasury, which returned a portion to the chief. However, by 1913, the chiefs were allowed instead to split their tax take with the government. This spared the colonial government from having to develop tax bureaucracies that could penetrate deeply into the countryside. It also institutionalised a very different notion of accountability. In the north of Nigeria, the collection of taxes came to resemble 'plunder' (Kohli 2004: 307). The chapter by Fjeldstad and Therkildsen in this volume documents a similar institutional legacy left by the British: the poll taxes that paved the way for coercive rural tax collection in East Africa. In all three cases, this institutional heritage contrasted sharply with that left by the Japanese in Korea. The British left behind a more positive institutional heritage in Mauritius, but as Chapter 6 in this volume shows, this institutional capacity came about only in part by a process of institutional transfer. State capacity at independence was stronger in Mauritius because the sugar producers claimed successfully for well over half a century before independence that their payment of taxes legitimised their demands for employment in the colonial government. Decades before independence, most senior posts in the government had already been filled by nationals, smoothing the transition from colonial rule. In this sense, capacity was built from a state–society bargain over tax.

Colonialism also affected capacity when it introduced new institutions layered upon those that had evolved from bargains made by indigenous rulers and their taxpayers. Mette Kjær (2004) drew on Ugandan history to argue that extractive capacity in two districts in Uganda differed primarily because of tax practices that had been in place before British rule. In the more successful district (a former kingdom), the British built upon a pre-existing, relatively centralised and institutionalised system of taxation under the traditional king. In contrast, the other district (whose

boundaries had been patched together by the British) experienced a history of tax rebellions during the colonial period, and low levels of compliance thereafter. Kjær concluded that these different institutional histories at the sub-national level explain differences in extractive capacity today.

Much of the historical work also emphasises that decisions made at critical junctures can continue to define the shape of institutions and the relations between state and society. Evan Lieberman's research (2001, 2003) on income tax capacity and 'national political community' in Brazil and South Africa started with the critical juncture of new constitutions (1891 in Brazil; 1909 in South Africa) that defined how the national political community was to be constituted. Lieberman traced how these century-old decisions still shape the capacity of each state to tax its higher-income earners, affecting both 'quasi-voluntary' compliance and the administrative effectiveness and efficiency of the tax bureaucracy. In a similar manner, Gerald Easter's chapter in this volume considers how tax systems were restructured in the wake of the critical juncture of eastern Europe and the former Soviet Union's post-communist transitions. He argues that these critical junctures helped place regimes on different developmental paths. Compared to the states of the former Soviet Union, the East Central European states exhibit more democratic decision-making, more progress in developing efficient tax administration capacity and greater societal consent to taxation. Decisions made as market economies were first being constructed created alternative paths for these countries' revenue bureaucracies, affecting their capacity.

### 1.3.3 *International factors*

Tax reform in the countries examined by Easter provided an entrée for another set of influences that have shaped tax institutions in ways unlike those experienced in the advanced capitalist world: international experts, conditionality and foreign aid.<sup>11</sup> Julia Strauss's chapter for this volume provides a look at these processes in an era prior to the formation of the IMF and the World Bank. The Sino-Foreign Salt Tax Inspectorate was, as its unusual name suggests, a jointly operated bureaucracy established as the central condition for a large debt-consolidation loan made to the Chinese government in 1913 by a consortium of foreign banks. Strauss notes that the inspectorate had a 'preponderance of foreigners in positions of real administrative decision-making rather than simple advising'.

<sup>11</sup> There are exceptions to this. For example, Japan called on German experts to shape some of its state institutions during the Meiji Restoration.

It was headed by a foreigner, and he had the authority to restructure the bureaucracy and the protection that enabled the inspectorate to maintain a high degree of autonomy while transforming itself into a meritocratic, goal-oriented organisation.

This role of international influences in shaping tax capacity was noted as well by James Mahon (2004: 25) who found that specific IMF performance conditions were second only to inflation as a stimulus for Latin American governments to undertake capacity-building and other reforms of their tax administrations. 'The prominence of the IMF has no clear counterpart in the historical model', he noted. The ideas that shape tax reforms in developing countries today are heavily influenced by current norms held in the international financial institutions, as Fjeldstad and Moore note in Chapter 10. In some cases, these reforms are not creating a more Weberian state, but moving tax collection back to private management, as in the contracting out of customs authorities to private companies. They note as well the fact that, in the poorest countries, revenues lost through trade liberalisation (sometimes done under loan conditionality) have not been restored through other areas of tax reform of which the introduction of VAT has been most prominent in recent years (Baunsgaard and Keen 2005).

This brings us to a related set of studies reviewed by Moore in Chapter 2. These argue that countries highly dependent on foreign aid over long periods of time will also face difficulties in developing extractive capacity (Moore 1998). The evidence on this is fairly clear. Bräutigam and Knack (2004) found that large levels of aid reduce government revenue generation, even when controlling for the effect of economic decline and political violence; Remmer (2004) had a similar result. Research conducted at the World Bank found that aid to African countries reduced tax revenues by an average of 10 per cent; this average of course masked large variation among the countries in the study (Devarajan, Rajkumar and Swaroop 1999). These studies emphasise two aspects of aid dependence: (1) aid creates more financial autonomy as governments' prolonged reliance on 'unearned' income requires little bargaining with taxpayers, or construction of taxable capacity in society; (2) the aid system, with multiple uncoordinated donors and their independent project management units, can promote institutional destruction in what are already weak states.

Theda Skocpol's introduction (1985: 17) to *Bringing the State Back In* argued: 'A state's means of raising and deploying financial resources tell us more than could any other single factor about its existing (and immediately potential) capacities to create or strengthen state organizations.' We have seen in this section that the wide variation in the capacities of today's developing-country governments may in some measure be traced

to their sources of revenue and to patterns established by their colonial histories. States dependent on natural resources and other rents face different incentives from those that must tax a class of producers. The institutions that are fostered through these incentives serve as building blocks for different kinds of states. In countries rich in natural resources, state-building focuses on the mechanisms of distribution, the ways in which the ‘national cake’ is shared among the stakeholders. Foreign aid and ‘strategic rents’ may provide some of the same kinds of incentives. In contrast, states that rely for their revenues on taxation of producers face stronger incentives to ‘feed the goat’ that must be milked. Colonial histories provided a further set of influences that shaped the approach to revenue raising in newly independent states. This section has emphasised taxation as the leading edge of state capacity. I have considered how some countries came to have ‘better’ institutions than others, and how taxation figured in these outcomes. The next section turns the focus to taxation as a central nexus of state–society relations, affecting accountability, representation and bargaining.

#### **1.4 Taxation and state–society relations**

The national system of taxation, as Jane Guyer once said, ‘is a powerful moral, political, and economic theory of state and society’ (1992: 57). This theory is daily represented in practices vividly described by scholars as penetration, domination, compliance or disengagement. Taxation as the stimulus for rebellion is a theme that knows no geographic boundaries: witness the 1794 Whiskey Tax Rebellion in the United States; the 1898 Hut Tax War in the hinterlands of Sierra Leone; the 1908 Anti-Tax Rebellion among Islamic peasants in West Sumatra. The chapters for this volume by Bernstein and Lü and by Fjeldstad and Therkildsen show how coercive taxation is still stimulating rebellion in low-income countries. However, rebellion (as these authors note) is at the extreme end of possible responses by society to state efforts to tax. Exit, bargaining and ‘voice’ (representation) are more common. Chapter 2 considers in some detail the factors that might lead to revenue bargaining, and those that might foster more coercive relations. The fiscal contracts that Moore outlines form the moral basis of society’s demands for accountability and representation. This section emphasises four related aspects of state–society relations. The first has to do with the nature of society itself: societal characteristics and social organisation and the way these differences shape collective action and the state-building project. The other three are more directly affected by state action: revenues-for-services, fiscal decentralisation and embeddedness.

### 1.4.1 *Societies and social organisation*

State-building is shaped by societies, and taxation is a strategic nexus between the state and society. Macro-social factors such as power, class and race affect this nexus, and this makes these aspects of society central to the way taxation affects state-building and governance. States tax societies, but they do not tax all their citizens equally. Those that exit the tax net tend to be either at the top or the bottom of the income scale. Easter's chapter for this volume depicts powerful Russian elites as a case of the former, while Joshi and Ayee's chapter focuses on the informal sector as an example of the latter. Furthermore, powerful groups in society that do not seek to influence the state and its policy machinery can exit the tax relationship, as long as states have international sources of finance. Centeno (1997) argued that Latin American state-building contrasted sharply with the European experience in precisely this way. At independence, there was no Latin American 'class willing and able to ride [the state] to social and political dominance'. By the mid nineteenth century, Latin American nations could borrow in the global capital markets. This option allowed states to have sources of finance without having to negotiate with their elites, who chose exit rather than attempting to capture the state. The development of capacity in Latin America was thus 'not an absolute phenomenon but a relational one. It is not merely a question of strength but also of the potential of the relevant societies to resist (or welcome) intrusion' (Centeno 1997: 1570).

That tax structures would reflect the interests of the powerful is not surprising, though this concern does not often surface in the cross-national studies on determinants of tax.<sup>12</sup> Michael Best (1976) noted this when considering that Central American nations in the mid 1970s collected substantially less revenue than would be predicted by the structure of their economies. His research documented an increasingly strong relationship between the incidence of taxation and the preferences of the powerful, and the conclusion was unmistakable: despite ample 'tax handles', Central American governments were going into debt because they were unable to tax the propertied and the powerful. Mahon pointed out (2004: 25) in a review of tax reform experiences in Latin America that 'those who enjoy effective representation in fiscal matters are not always the ones who provide the most resources to the state, but rather those who provide resources at critical times and are already well organised'. This is

<sup>12</sup> See Timmons (2005) for an exception to this. His argument emphasises that tax structures can also follow the interests of the masses. Lieberman (2002b) provides a comprehensive discussion of taxation data as indicators of state–society relations.

not always the owners of capital. Carmenza Gallo (1997) pointed out that in the case of Bolivian tin, the mine-workers joined the state to strengthen its efforts to raise taxes on the mine-owners.

Lieberman's research (2001, 2003) has emphasised the different ways in which race and class meet in determining bargaining power and incentives for compliance. Although both South Africa and Brazil are high-capacity, high-tax states, only South Africa collects an unusually high level of income tax. Lieberman emphasised that cross-class alliances among whites in South Africa created a long-standing moral basis for nation-building and taxation, allowing a higher incidence of income tax with the understanding that this would benefit the white community, and greater compliance. Brazil's non-racial 'national political community' created a more adversarial relationship between property owners and the intended recipients of transfer payments from the state, leading to more contention over tax, weaker enforcement and higher rates of evasion. As Lieberman concluded, 'negotiated definitions of political community shaped the logic of interclass and intraclass relations in turn affecting the ability of the state executive to gain the cooperation of economically powerful groups. In other words, the authority and efficacy of the modern state is strongly influenced by how group identities get constructed and institutionalized within the political arena' (Lieberman 2001: 548).

In Chapter 2, Moore points out that British society was organised in a way that fostered tax bargaining: taxpayers were fairly independent of the Crown, homogeneous, and concentrated in a landlord-trading elite with a high capacity for collective action and the ability to hold rulers to their promises. Gallo (Chapter 7) emphasises the importance of taxed groups being able to secure support from other societal allies in their struggles with the state. This focus on societal strength also reminds us that the bargains that shape tax systems in developing countries today may be different from those available to the advanced capitalist states one hundred years ago, and that this may be because societies are organised differently today. Organised labour may be more powerful, for one example. Gerald Easter's chapter describes the shaping of tax capacity in Russia and Poland after the fall of communism as a reflection of the reshaping of power resources in the two countries, and the constraints this posed to post-transition state leaders. In Poland, specifically, transition empowered organised trade unions, and these became the main bargaining partners for the state, which based its extractive capacity on a 'social pact' with households and public sector workers. Alternatively, Russian leaders forged a far less sustainable system: they bargained with the elites, who had quickly gained control of formerly state-owned

resources. This leads us back to the role of natural resources and the tax base. Russian leaders' tax strategies shifted from bargaining to coercion in late 1997, when the falling price of oil and other commodities made elites reluctant to pay the taxes they owed. Gallo's chapter documents similar consequences of price instability in nitrate exports. The external shocks led to a breakdown in a system of price-setting based on effective collective action, weakened the owners of the nitrate mines and prompted the state to shift to unilateral taxation.

Finally, through its degree of progressivity, a system of taxation represents a state's 'official theory of inequality' (Guyer 1992: 57). Using taxation as a public vehicle for differentiating among taxpayers, and allocating burdens according to some societally determined ability to pay, draws attention to social duty and responsibility in a manner quite different from that of a regressive tax, such as VAT. It allows debates over taxation to be not simply between taxpayers and the state, but among taxpayers, over the allocation of their relative shares. There is a stark difference between the kind of regressive poll tax in East Africa discussed by Fjeldstad and Therkildsen (this volume) and the graduated property taxes that were the basis of the material links between state and society in Britain, as well as in Korea and Taiwan. These differences can have a qualitative impact on the relations between a state and its society. We can see an example of this in the case of Mauritius (Bräutigam, this volume), where the export tax was made into a progressive tax in the mid 1970s. This progressivity enabled the government to shift the burden for transfer payments and redistributive spending more squarely onto the shoulders of the middle class and the wealthy. A tax system that increases equality can affect the public sense of solidarity, fairness and trust, and therefore tax morale and tax effort (Bird, Martinez-Vazquez and Torgler 2004). It may even help consolidate new democracies, as the cases of Poland (Easter, this volume) and Mauritius both indicate.

#### 1.4.2 *Revenues-for-services*

Quasi-consensual taxation, as Levi (1988) emphasised, involves reciprocity: citizens understand that they need to pay for services, whether these involve security and protection from invading forces, or other public goods and services. How states spend their tax money can affect their legitimacy and their 'right' to demand revenues from taxpayers. This is an important theme in the literature on tax compliance and tax morale surveyed earlier in this chapter. However, as Kjær (2004) has noted, there is considerable controversy over the extent to which the payment of taxes in developing countries can be seen as a quid pro quo for better services.

Her research in Uganda did not support a fiscal contract conclusion. Hlophe and Friedman also contend (2002: 72) that the improved tax compliance following reforms of the South African Revenue Service (SARS) was more related to managerial reforms coupled with an earlier culture of compliance than to a sense of better social services. On the other hand, Fjeldstad (2004) argued in a study of local government, that payment *was* related to services: South Africans were more likely to pay local service charges if they felt that the government was providing services equitably, collecting revenue fairly and actually using the revenue to provide services. And a study of tax compliance in Botswana and South Africa reported that taxpayers in Botswana rated government fairness and efficiency considerably higher than did taxpayers in South Africa, and their self-reported tax compliance was also higher (Cummings *et al.* 2005).

The limited research that has been done on this in Latin America provides some support for the idea of a service-based fiscal contract. In a study that contrasted the high degree of tax evasion in Argentina with the low levels in Chile, Marcelo Bergman (2002: 290) found that taxpayers who expressed greater satisfaction with the performance of public services such as security, public education or infrastructure were also significantly more willing to pay taxes.<sup>13</sup> In other instances, the understanding is expressed implicitly: the Caracas Chamber of Commerce illustrated its understanding that the payment of taxes by its members would give them the ‘moral authority’ to demand in return that the state carry out its duties: ‘The current fiscal shortfall obliges all [taxpayers] to behave loyally, as real citizens, in order to be able to demand with moral authority that the public administration carry out the duties assigned to it by the laws and by the Constitution itself.’<sup>14</sup>

### 1.4.3 *Decentralisation, accountability and coercion*

Decentralisation is under way in many developing countries today, in part promoted by the donor community with the assumption that bringing service delivery closer ‘to the people’ will reinforce democracy and accountability. This fits with the fiscal contract notion as well. However, the evidence on this is decidedly mixed. As Moore points out in Chapter 2, the poorest countries – countries that are largely agrarian, with a wide

<sup>13</sup> For obvious reasons, the study could not measure actual payment of taxes, only the expressed willingness.

<sup>14</sup> Cámara de Comercio de Caracas, ‘La Cámara de Comercio de Caracas Ante la Reforma Tributaria’, (photocopy), Caracas, May 1994, cited in J. E. Mahon (n.d.).

variety of possible user charges and taxes, and without effective regulation by the centre – are fertile environments for coercive taxation when local governments are given the responsibility to raise revenues. This describes both rural China and the cases of Tanzania and Uganda (Chapter 5). Bernstein and Lü (in Chapter 4) document the political consequences of the dismantling of the central planning system in China, which left local governments in rural China seriously short of revenue, but burdened by new responsibilities for rural education and other social services. As they suggest, however, an increase in local taxes and fees to fund these mandates aroused local peasants to demand that the central government force local governments to respect their rights. The growth of new forms of elected representation at the local level and the recent abolition of some forms of local taxes are likely to have been, in part, a consequence of these tax protests. This suggests a link between democratic accountability and taxation, but not in the direction predicted by theory. Fjeldstad and Therkildsen (in Chapter 5) make a similar point in their story of decentralised local taxation in East Africa. As in China, local taxes were not conducive to state–society bargaining, but again, rural protest helped bring about the abolition of the poll tax. They emphasise the role of political liberalisation and democratisation in fostering an environment where rural people can mobilise politically to exercise various forms of ‘voice’ to combat a coercive practice and demand accountability from their governments. Taxation did not lead to representation in this case, but democracy helped bring about significant changes in the tax burden of the rural poor.

Decentralisation also highlights the role of local taxation in two more state-building debates: the revenues-for-services exchange discussed above, and the governance impact of dependence on foreign aid. In Uganda, the district with the lowest poll tax compliance was also one with very substantial donor funding (Kjær 2004). Yet as Fjeldstad and Therkildsen conclude in Chapter 5, donor demands that local councils raise matching funds for donor-assisted projects (something that is supposed to promote local ownership and accountability) seemed to intensify the incentives for local governments to use coercion; there was little evidence of reciprocity or ‘revenue bargaining’. On the other hand, a study by Hoffman and Gibson (2005) argued in favour of a revenue-for-services interpretation of local government budgets. Local governments in Tanzania and Zambia tended to budget significantly more funding for public services if they received relatively more funding from local taxes. Those with more funding from donors or from central transfers budgeted less money for services and more for their salaries and administrative expenses. Deteriorating public services can also be a

spark for tax resistance (Fjeldstad 2001: 295). This would suggest that local politicians do have an incentive to offer services in exchange for revenues. Joshi and Aye (Chapter 8) provide more evidence for this by noting that Peruvian street traders and informal transport operators were more willing to pay taxes to local governments when the government earmarked a portion of the revenues for a fund to pay for services for informal sector operators. Villagers in at least one Chinese county agreed that some taxes (particularly those earmarked for social support services) were legitimate, but they objected to others, such as those for infrastructure and the training of party members (Chapter 4). Chinese at the local level began to conclude that, as Bernstein and Lü put it: 'When citizens fulfil their duties as taxpayers, they have a right to make claims on the state for provision of public goods and public services.' Taxation might indeed be a pathway to a more legitimate and responsive state at the local level, but there is also a danger of increased coercion. Without a responsive state at the *central* level, the risk of local-level coercion can be high.

#### 1.4.4 *Embeddedness*

Finally, we draw attention in this volume to the fact that taxes build states, but they can also be used to build *society*, and in particular, to help cement 'embeddedness': strong, supportive relations binding states and business, allowing them to negotiate and bargain over policies and strategies (Evans 1995). Successful embedding of the state and business builds trust, eases monitoring and supports the exchange of information. It also fosters reciprocity (Maxfield and Schneider 1997), and it can enable states and societies to solve the collective action problems that accompany efforts to upgrade a sector: training, monitoring, research and development, etc. Evans did not focus on the impact taxation might have on embeddedness, but some of our authors and other researchers have done just this.

Rosemary Thorpe and Francisco Durand described the origins of the very successful coffee federation in Colombia, noting that 'From the start the federation had the right to collect taxes, which resolved a typical collective-action dilemma by providing resources. Hence, from the very beginning it reaped the rewards of political influence' (1997: 219). The case of Mauritius (Chapter 6 in this volume) also emphasised the organisational capacity of sugar producers in their successful negotiations with the state, a success that included state support (through a dedicated tax) for the strengthening of their producer association, including the private marketing syndicate that collected the tax on behalf of the government and used some of the tax to pay for research

and joint training. Chapter 7 shows a similar case: nitrate producers in Chile bargained with the Chilean state to use their nitrate tax revenues to solve their collective action problems, enforcing producer quotas among them, and facilitating their efforts to market their nitrate abroad. Joshi and Ayee's examples in Chapter 8 of innovative taxation of the informal sector in Ghana, Peru and Senegal suggest as well that efforts to tax this sector may depend on the strength and capacity of its associations, and the degree to which associations can demand benefits in exchange for their taxes.

Producers are likely to be more open to funding the state's capacity-building when that capacity is being used to strengthen their sector. As Easter shows in Chapter 3, this can work as well when the state constructs a corporatist social pact with workers: closer (embedded) relations lubricated by consent-driven taxation shaped the social democratic bargain in Poland. Dedicated taxes provide one means of ensuring that taxes are, indeed, being used to solve collective action problems that accompany efforts to build and restructure sectors. This alternative form of embeddedness shaped the nature of the fiscal bargain in Poland: social services in exchange for social security taxes. Having taxes collected by producer associations can serve as a powerful builder of mutual trust, legitimacy and accountability. This also qualifies some of the emphasis on autonomy in revenue collection (Strauss in Chapter 9).

## 1.5 Conclusion and organisation of the book

State-building as we have defined it involves an increase in the capacity of governments to pursue public goals, and to interact constructively with their societies. Some of our chapters focus on the strategies of taxpayers in their interactions with state power, highlighting the factors that foster the constructive engagement on which economic growth and development depend. Others emphasise how taxation shapes political bargains and accountability, and is in turn shaped by them. Others explain the sources of state capacity and effective institutions through the lens of taxation. All of the chapters emphasise a political dynamic of taxation in states still very much in the process of being built.

The themes discussed in this chapter are played out in the rest of the book. This essay and the following essay by Mick Moore provide conceptual and theoretical overviews of the topic and position our book in the context of current research on taxation and state-building. Chapter 2 emphasises the determinants of coercive taxation and of 'revenue bargaining', and it serves as well to introduce the next three chapters. Chapter 3, by Gerald Easter, on the contrasting state-building processes

in East Central Europe and the former Soviet Union, explores the politics of three sequential processes – the making of revenue bargains in the course of establishing new tax regimes; the consequent attempts to collect taxes; and the eventual remaking of revenue bargains in order to carry out tax reform. Chapters 4 and 5 analyse the dynamics of coercive local taxation in poor countries. Thomas Bernstein and Xiaobo Lü document how the end of central planning in China, and the rise in unfunded mandates, revived practices of coercive taxation at the local level. This generated considerable localised political unrest; however, this protest has begun to reshape the relationship between the local governments and the centre. Chapter 5, by Odd-Helge Fjeldstad and Ole Therkildsen, traces the history of local poll taxes in Uganda and Tanzania, a form of revenue raising left over from the colonial era but maintained by the independent governments. They show that in East Africa poll taxes have mobilised rural people politically to combat a tax practice that they have experienced as repressive.

Next, chapters by Deborah Bräutigam and Carmenza Gallo explore the historical evolution of tax bargaining and related institutional capacity in two export-dependent economies. In Chapter 6, Bräutigam shows how the colonial export tax on sugar acted as a stimulus for both an unusually high degree of state capacity and democratic accountability in Mauritius. Carmenza Gallo focuses in Chapter 7 on the history of tax bargaining before the First World War in Chile's nitrate export sector, an important mineral resource that nevertheless generated no 'resource curse'. She argues that the factor that most affected the scope for institutionalised tax bargaining was world market conditions for nitrates.

The last three chapters emphasise the politics and practicalities of tax reform in developing countries: building more capable bureaucracies, and more accountable relations between the state and taxpayers. In Chapter 8, Anuradha Joshi and Joseph Ayea address the dilemma of taxing the informal sector. How are low-income countries to avoid the coercive practices outlined in the chapters on China, Tanzania and Uganda, but still collect revenue from producers who are small-scale, scattered and heterogeneous? They identify innovative mechanisms used in Ghana, Peru and Senegal to suggest that states and societies may be able to solve these problems through unorthodox subcontracting arrangements with producer associations. Their chapter makes a point echoed in the chapters by Gallo, Easter and Bräutigam: strong societal organisations can shape the direction and outcomes of taxation, and help to produce a bargain that benefits both state and society. In Chapter 9, Julia Strauss provides an analysis of the deepening of extractive capacity in Republican China. This attempt to create an autonomous Salt Tax

administration in a hostile environment has some parallels to current efforts to establish autonomous tax administrations in developing countries. In the final chapter, Mick Moore and Odd-Helge Fjeldstad explore what a state-building perspective implies for tax policy in contemporary developing countries. Tax policy is now globalised. There is a powerful orthodoxy, promoted in particular by the IMF and transnational organisations of taxation professionals, that has helped animate an impressive process of tax reform virtually throughout the world. That orthodoxy is, however, driven by economic and fiscal considerations and by the perceived problems and needs of the richer parts of the world. A reform agenda focused on issues of state-building in the poorer countries would look substantially different.