WILTON PARK TAX CONFERENCE APRIL 2010 SPEECH

Domestic Resource Mobilisation [DRM] as an emerging issue on the African policy agenda

The international community increasingly realises that there is no exit from aid dependency without effective tax systems that both encourage economic growth and have a 'handle' on that growth. I of course use the term 'Tax' as short-hand in its broadest DRM context to mean all forms of state incomes - domestic revenue, customs tariffs and excises, within the broad base of resource mobilisation – eg. licenses and fees at local government.

We need to work on all aspects of DRM in a much more integrated fashion – tax policy with administration, tax exemptions not just taxation, not just tax but DRM in broader context. We need to understand the sequencing of reforms around DRM in Africa – for instance, it is clear that the sequencing of support is crucial. There are clear lessons that reforming tax policy in advance of creating an adequate administrative capacity is dangerous.

We need also to put DRM in the broad development objectives – of delivering broad based economic growth and political stability.

We therefore urgently need to help partner countries in Africa and generally deliver better tax systems for sustainable international development.

I therefore want to focus my remarks on the importance of tax research and better induce for achieving this.

Let me start with my belief that tax reform programmes in low income countries deliver a significant positive outcome. **There is strong evidence o**n impact, that the mobilisation of domestic revenue has been used in many low-income countries in Africa and elsewhere to increase expenditures for health and education. **There is also substantial evidence that many tax**

reform programmes not only succeeded in difficult circumstances but galvanised the political support to sustain the improvements in governance.

The goal of tax reform programmes must however be widened. There needs to be a new focus on broader impact that encapsulates the developmental goals of improving the investment climate, state building and direct poverty reduction. The long-term nature of DRM requires looking beyond revenue generation as a measure of success. The narrative of 'increasing revenues' must be replaced by 'optimising revenues' as a prelude to understanding better what is being achieved.

Currently, tax regimes in many developing countries constrain economic growth, and undermine governance. Excessive tax rates (theoretically upto 200% of profits in some countries) reduce incentives for investment and expansion and force companies to operate in the informal sector. Informal companies must remain small to avoid detection.

Excessive and non-transparent tax rules increase incentives to remain informal, and force companies to negotiate tax liabilities with officials, raising the likelihood of corruption. A large informal sector and low levels of taxation from the formal sector combine to severely limit the amount of revenue available to the government to invest in equality, growth and development. Developing countries typically only raise 10 to 20% of GDP in tax, compared to over 40% in most developed countries. The problem is critical in fragile low-income countries such as Yemen where only 7% of GDP is raised.

In many countries in Africa a large informal sector and massive tax exemptions for politically influential businesses combine to also undermine democracy. Governments in such situations raise relatively little revenue from the majority of citizens and businesses, but rather from the politically less influential - particularly medium-sized businesses, natural resources, or, indeed, aid. This weakens the state-citizen relationship, undermining the need and demand for accountability, and participation in the political process. The situation provokes a 'devil's deal', whereby politicians promise not to raise taxes from the poor majority in return for getting their votes.

The rationale for supporting the types of research that we are discussing this week is that there is general recognition that more evidence is needed on what 'really works' – not just for revenue raising, but for promoting economic growth and also political stability and legitimacy.

This is because particularly in Africa and especially in low-income countries ***improving tax systems matters for a wide range of developmental objectives. These include that:***

i) Increasing tax revenues combined with sustainable economic growth are the **eventual exit strategy** for developing countries from aid dependency.

ii) Taxes, if designed well, can **promote economic growth, lessen extreme inequalities, tackle climate change and fund the delivery of the MDGs**, significantly improving the lives of all citizens and especially poor people.

iii) Tax is a core part of **state-building**. Fair and transparent tax collection demonstrates good governance and shapes government legitimacy by promoting accountability of governments to tax-paying citizens, and by stimulating effective state administration and good public financial management.

iv) Taxes shape **investment** and **economic growth**: tax revenues that increase with economic growth ensure sustainable funding of essential public services for poor people: 'public goods' such as security, health and education on which economic growth and social development depend.

v) Tax is central to the **'Monterrey Consensus'** agreed in 2002 and reaffirmed in 2008, by which developing countries committed themselves to deliver 'effective, efficient, transparent and accountable'

vi) Evidence of partner countries' 'tax effort' matters for sustaining **public support in OECD countries for international development**.

vii) **Aid effectiveness** concerns that **aid can become a 'resource curse'**, undermining the accountability between state and taxpaying citizens.[1]

viii) Improving tax systems is essential to maintain **public finances** during the current financial crisis.

ix) **Gender** issues around taxation are poorly understood;[2]

x) **Anti-corruption**, rent-seeking and tax evasion are closely inter-connected with weak governance; anti-corruption strategies only work well in contexts where states can effectively tackle tax avoidance and evasion, and corrupt tax expenditures, through building the 'social contract' of accountability between citizen and the state.

Research

So better evidence is required to understand the best fiscal ways to promote development. Research ought therefore to be making an important general contribution to strengthen taxation reform in developing countries.

Research on the importance of taxation for state-building has been particularly influential on development policy in recent years. Research at three Development Research Centres - the Development Research Centre on the Future State, the Centre for Research on inequality and Social Exclusion at Oxford, and the Crisis States Research Centre - have produced the evidence that tax is a core part of state building and the most visible sign of the social contract between citizens and the state. This research has proved particularly influential in some African low-income countries seeking to enhance their revenue capacities while strengthening the legitimacy of the

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[1] See e.g. Professor Adrian Wood of Oxford university, article in the Financial Times of 3 September 2008 'How Donors should Cap aid in Africa' and subsequent blog discussion, at http://blogs.cgdev.org/globaldevelopment/2008/09/adrian_woods_ft_proposal_to_ca.php

[2] WB. 2008: Report of International Conference on Taxation and gender equality

state. It helped to shape the thinking of the foundation fo the African Tax Administrators Forum in 2008, and has recently been reflected in the EU's paper on **Tax and Development: Cooperating with Developing Countries on Promoting Good Governance in Tax Matters.** This notes that

Efficient and fair tax systems are crucial for growth, poverty reduction, good governance and state-building. They tend to result in higher and more stable revenues, more sustainable investments, and improved competitiveness of economies. In particular, the nexus between tax reform and the improvement of the business environment is critical by making it easier for business to invest, trade and create jobs. … Efficient and fair tax systems are also essential for promoting democracy and state legitimacy since tax payers tend to hold their governments accountable. They help build a strong fiscal social contract between citizens and their government at all levels that encourages tax compliance, leads to improved democratic and economic governance, higher revenues through higher economic growth and broader tax bases, and allow for combating tax evasion and avoidance, fighting money laundering, corruption and the financing of terrorism.

So the international community seems now increasingly to realise that fair and transparent tax collection demonstrates good governance and shapes government legitimacy by promoting accountability of governments to tax-paying citizens, by encouraging political debate about how to address inequality and promote economic growth, and by stimulating effective state administration and good public financial management.

We also all increasingly recognise that the foundation for all sustainable international development outcomes is politics. Governance structures on which poverty reduction depends will only be legitimate, effective and lasting when built – at national and sub-national levels - by local people in local context in accordance with their own political process.

The evidence for this requires all development agencies to recognise that creation or strengthening of public institutions is not simply technical, still less a transfer of blueprints from another country or the developed world.

So the key operational message from the research is that we all need to understand that the politics of taxation are central to the exit from aid dependency. We need good research and evidence on what incentives can be improved for governments to engage in political bargaining over taxation with organised interest groups to achieve the positive political accountability and political responsiveness through the institution building effects of taxation.

We now seek to build on this success, by supporting operationally focused research that supports the effective, efficient and equitable tax systems[3] needed for states to deliver development.

Such research on the political economy realities of improving effective tax systems in low-income countries' political economy contexts, including the work we are discussing here this week, also delivers on our collective responsibility to investigate how to strengthen governance, social cohesion and economic growth in developing – particularly low-income and fragile - countries by improving the capabilities and legitimacy of tax systems, as needed to fund MDGs.

Building on research findings and this programme, it is important for Africa and other developing contexts to support research on practical ways for strengthening of tax systems. This means finding practical means to support tax systems that legitimate the state, strengthen transparency and accountability in state-citizen relations and promote economic growth and development, including by improving the state's capacity and funding core public services.

[3] 'Tax' meaning all forms of state incomes - domestic revenue, customs tariffs and excises, within the broad base of resource mobilisation – eg. licenses and fees at local government.

I hope the international community can support new research that is able to offer cost-effective flexible research structure able to combine the necessary range of expertise, while building capacities among southern partners.

Specifically, such research should offer:

- Improved conceptual and empirical understanding of tax systems within public finances that promote economic growth and social inclusion, and capable and accountable states responsive to the needs of their populations, including poor people.
- Improved engagement in and better support for state effectiveness through policy relevant tax research.
- Better results for tax reform initiatives through stronger and clearer evidence of 'what works'.
- Greater uptake of new and existing research findings through more effective synthesis, channelling and communication of conclusions.

To deliver this **new knowledge providing a high-quality evidence base for reform in developing countries**, tax research should be:

➢ **Cross-disciplinary skills and approaches,** combining technical competence in tax policy and administration with expertise on socio-political economy dynamics around taxation;

➢ **Coherent vision** across the research and all related DFID-funded research;

➢ **Original insight** on dynamics and processes (at the sub-national, national, regional and global levels, of the state, citizens, society and markets) whilst building constructively on existing research;

➢ **Policy and operational relevance,** including striking a balance between generating new knowledge and getting knowledge in to use, and

- Effective **synthesis** of new findings and related to **existing knowledge** are essential to effective up-take.
- **Effective collaboration** with existing and future relevant DFID research programmes (including on fragile states) as well as the research of key partners (e.g. World Bank and other multinational, bi-lateral, and international donors; governments, the private sector and not-for-profit Foundations) to ensure synergy and value for money is essential.
- **Uptake of relevant research findings**.

The most important aspect of research is that it actully delivers an excellent output of the highest international quality which answers questions useful to policymakers and practitioners to help reduce poverty or the impact of poverty. The purpose is to build a stronger evidence base that is used by development actors to build more effective and legitimate institutions that deliver improved outcomes for poor people.

All this hugely matters for Africa and delivering development there. I am therefore delighted that we have the chance this week to consider how we are developing the evidence to help the African continent deliver poverty reduction, economic growth and sustainable international development goals.