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The Political Economy of Taxation and Tax Reform in Developing Countries

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Abstract

Taxation provides one of the principal lenses in measuring state capacity, state formation and power relations in a society. This paper critically examines three main approaches (economic, administrative and political economy) to understanding taxation. It also examines differences in tax composition across middle-income developing regions and finds that Latin American economies tax upper income groups much less than in East Asia and Eastern Europe, and explores the political economy and policy implications of these differences. The paper also examines issues of tax reform in low income/post-war economies and explores the problem that capital flight poses for less developed countries.

Keywords: taxation, tax reform, political economy, state capacity, developing countries

JEL classification: E62, H20, H24, O20

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Revenue is the chief preoccupation of the state. Nay more it is the state.

Edmund Burke[1]

1 Introduction: The problem of state capacity and taxation in less developed countries

Resource mobilization lies at the heart of economic development. And among various means of resource mobilization (e.g., forced savings, inflation tax, manipulation of terms of trade, etc.), tax is the most closely related to questions of state formation and capability. Tax also provides one of the principal lenses in measuring state capacity, power and political settlements in a society. In the wake of fiscal crises of the state in sub-Saharan Africa and Latin America, designing tax systems that can provide incentives for growth, can meet distributional demands and can increase revenue collection is central to state viability and effectiveness (Toye, 2000). In post-war economies, reconstruction of the revenue base is essential for the reconstruction of a viable state and sustained peace (Addison *et al*., 2002).

Surprisingly, taxation is not explicitly listed as a separate 'fundamental' task of a state (as spelled out in the *World Development Report* 1997).[2] This error of omission is indeed remarkable given the centrality of revenue production and resource mobilisation in the historical process of state formation (Schumpeter [1918], 1954; Tilly, 1990). As Schumpeter notes: 'the fiscal history of a people is above all an essential part of its general history' (quoted in Levi, 1988: 6).[3] The neglect of making tax central to understanding state capacity and governance reflects the decline in the political economy of resource mobilisation as a focal point of development theory and policy.

This is not to say that tax reform has not been a central part of World Bank and IMF operations in structural adjustment reform. However, tax reform has been largely couched in technical, non-political terms. This is part of the larger reform agenda where state capacity-building has been viewed largely as a 'technical' exercise in administrative reform (raising wages of civil servants, more training, greater meritocracy). According to the diagnosis of the capacity approach, 'poor governance' is the result of an over-extended state relative to its institutional capacity at a given moment in time (see World Bank 1997: 61-75). The analysis of governance crucially assumes that *inherited* capacity constrains and that this constraint is what should orient the shape of administrative, institutional and policy reform. The policy advice, therefore, for poorly performing economies generally advocates reducing the state's role in resource allocation decisions. The main message of the capacity approach is 'don't

1 Quoted in O'Brien (2001: 25).

2 According to the World Bank (1997: 41-60), the five 'fundamentals' that lie at the core of good governance for a state are: a) establishing a foundation of law, b) maintaining a non-distortionary policy environment, including macroeconomic stability, c) investing in basic social services and infrastructure, d) protecting the vulnerable and e) protecting the environment. While tax is not explicitly mentioned as a core function of governance, tax capacity is implicitly behind items [c] and [d].

3 Or as Rudolph Goldscheid notes: 'the budget is the skeleton of a state stripped of all misleading ideologies.' (quoted in Levi, 1988: 6).

try difficult interventions and reforms at home'. The technical and apolitical nature of the good governance agenda, however, limits an understanding of the political and institutional processes underlying the power and legitimacy a state requires to *enforce and change rights and institutions, and to extract and mobilise the resources* required to sustain development and growth.

Fiscal crises confronting many LDC's in Latin America and sub-Saharan Africa have necessitated bringing fiscal reform to the centre of macroeconomic stabilisation processes (Moore and Schneider, 2004). However, the tax component of the Washington Consensus follows along the lines of the capacity approach. The main policy proposals have been to simplify and broaden tax bases, lower income and corporate tax rates (that is, make taxes more pro-business), promote reduction in trade tax rates through trade liberalisation, and emphasize the widening and simplification of value-added taxes (VAT). Importantly, the latter is promoted on the grounds not only that it is less distortionary, but also that it is *administratively and politically easier* to implement than income and property taxes.[4] Because property and, particularly, income taxes are generally the most progressive taxes, equity concerns have been downplayed, which may have important implications for political stability in countries with very unequal levels of asset and income distribution.

The order of the rest of the paper is as follows. Section 2 considers the economic, administrative, and political economy approaches to analyzing tax and the policy implications derived from the insights of each approach. Based on the theoretical and historical insights developed in the critical examination of different approaches to tax, I argue that it is essential to consider the historical, political and institutional factors that have established durable tax collection capacity in some cases and not others. Section 3 provides an examination of the political economy underlying the extraordinary success of tax collection and, in particular, income tax capacity collection in South Africa. A brief comparison with the Brazilian experience is presented to highlight the importance of historical political economy analysis in understanding variations in income tax capacity across countries. Section 4 complements the Brazil-South Africa comparison by presenting a comparison of the structure of tax collection in East Asia, Eastern Europe and Latin America. The evidence suggests that the Latin American state relies to a much greater extent on indirect taxes, revealing both policy choices and a weakness of the state to extract resources from upper income groups. Section 5 examines the political economy of tax in low income/post-war economies and highlights the importance of the relationship of taxation to state-building and legitimacy and the need to consider gradual trade liberalisation as a policy to maintain tax revenues when the administrative and political capacity to collect alternative taxes are minimal. Section 6 briefly considers the magnitude of tax revenue losses due to capital flight and presents recent policy reforms to the international financial architecture to address this problem. The conclusion presents policy implications.

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4 The advocacy for tax simplifications and tax neutrality have been the result of disillusionment with progressive tax structures in enhancing vertical equity in the 1970s and 1980s (Tanzi, 1992); and the influence of neo-liberal ideas such as supply-side economics, which views state intervention, and direct taxes in particular, as providing disincentives for productive investment. Moreover, as a result of globalisation, the desire to attract foreign investment has created intense tax competition among states, which has created pressure to keep income taxes low.

2 Approaches to analysing taxation

The determinants of tax collection and tax reform have been the subject of extensive analysis. Several theoretical approaches inform debates on two main issues: first, why tax collection increases over time and, second, should the main concern be efficiency or equity when designing tax systems. There are three main approaches to these issues: the economic approach, the administrative approach, and the political economy approach. While the first two approaches have dominated theoretical and policy debates on tax in developing countries, the incorporation of political economy factors such as the role of threat, the perception of threat, and interest group formation and balances is essential to understanding the evolution of tax capacity.

2.1 The economic analysis of tax

Traditional tax analysis has focused on the design of tax systems that makes possible financing the 'necessary' level of public spending in the most efficient and equitable way (Stern, 1987; Tanzi & Zee, 2000). The neoclassical theory of public finance proceeds by describing the effects of taxation and then applying criteria (normally a social welfare function) to evaluate those effects (Stern, 1987: 24). This approach divides taxation into a logically-prior positive side and a subsequent normative side on which value judgements are introduced. Following Stern (1987), examples of positive issues include: a) the consequences of income or wealth taxation on risk-taking; b) the effects of corporate taxes on investment and distribution of profits; c) the effects of national debt and taxation on savings; and d) how different households or groups are affected or burdened by tax changes (the problem of incidence of tax). The basic problem in such a model is that the government wishes to raise revenue to distribute income without sufficient information on the preferences and endowments of citizens to do so by means of lump-sum taxes. Therefore, governments can achieve its goals only by raising taxes in some distortionary way. This gives rise to the standard neoclassical concern of the tension (or costs and benefits) between achieving equity and efficiency in a general equilibrium framework.

An important component of the applied literature on tax concentrates on why the level and composition of taxes in less developed countries differs from more advanced countries.[5] With respect to developing countries, the focus of the analysis centres on why their tax capacity is limited relative to more advanced countries. One set of factors concerns the economic structure of developing countries. For instance, developing countries are characterised by a large share of agriculture in total output and employment, large informal sectors and occupations; many small establishments, a small share of wages in total national income, a small share of total consumer spending made in large, modern establishments, and so on (ibid.: 3). These characteristics, it is argued, reduce the possibility of depending on certain types of taxes, such as personal income tax, and make them more dependent on indirect taxes such as foreign trade taxes and, result overall in a lower level of tax collection.

5 For reviews of economic theories of tax and the applied literature on developing countries, see, Gillis (1989); Burgess & Stern (1993); and Tanzi & Zee (2000).

Table 1: Resource mobilisation and poverty in developing countries: regional comparisons

Regions	GDP p.c. growth (1) (1985-2002)	Tax revenues (% GDP) (2) 1985-88	1997-2000	Gross savings (%GDP) (3) 1980-90	1990-2000	1990-2002
Sub-Saharan Africa	-0.4	21.7	16.3	13.9	12.5	12.7
South Asia	3.3	12.8	12.2	13.5	16.7	16.8
East Asia & Pacific	6.1	15.0	15.6	**30.8**	**31.6**	**31.2**
Latin America	0.8	15.2	15.9	21.7	18.9	18.9

Sources: (1) World Bank, *World Development Indicators*. (2) IMF *Government Financial Statistics* and calculations by the author. (3) World Bank (2004).

The mainstream economic literature on tax, however, does not consider the wider resource mobilisation question, which was a concern of earlier development economists (e.g. Lewis, 1954). As indicated in Table 1, while tax revenues in sub-Saharan African and Latin American countries from the mid-1980s to 2000 were collected at a similar proportion to GDP as in East Asia, there were dramatic differences in the savings rates between the regions.

The East Asian savings rate average is more than double as a percentage of GDP compared with South Asia and sub-Saharan Africa and two-thirds higher than in Latin America.[6]

The state's capacity to mobilise resources beyond taxation is one important feature of developmental success stories that the economic literature on tax misses. In particular, high levels of gross domestic savings have supported robust investment rates. The East Asian economies were in a class of their own in terms of savings rates. This was largely achieved through the coercive power of the state, which was deployed to mobilise resources through various forms of forced savings.[7] Among the coercive elements in East Asian economies were restrictions on consumer credit, financial restraint, mandatory provident pension contributions (used in Singapore and Malaysia) and encouragement of postal savings. Although state actions to increase savings are clear in East Asia, the high and sustained *growth* rates may have also had an important feedback effect on income growth and therefore on sustaining savings.

In sum, the economic approach to tax examines the trade-offs between efficiency and equity in a general equilibrium framework, and in the applied literature, examines the effects of levels of development and economic structure on tax takes and tax structure. The economic approach to tax does not consider the wider role of developmental states in mobilising savings. Also, this approach does not explain why tax structures differ in otherwise similar economies. Moreover, the economic approach abstracts from the political and institutional processes that determine the ability of the state to create tax policies and enforce them.

6 Kriekhaus (2002) argues that higher public savings as a percentage of GDP is correlated with higher growth rates in less developed countries.

7 See Wade (1990); Chang (1994); Kohli (1999); and Huff (1995).

2.2 The administrative approach to tax

The administrative approach focuses on the role institutional design and policy plays in enhancing the prospects of efficiency and effectiveness of the tax system. Efficiency refers to administrative costs in collecting different types of taxes, enforcing tax laws, and the costs of tax payers in complying with those laws (Lledo *et al.*, 2004: 6). Effectiveness refers to the extent to which taxes are predictable, transparent, and enforced by a fair judicial system (ibid.).

In line with the 'technical' view of institutions inherent in the above-mentioned capacity approach, administrative constraints are identified as the main constraint to the ability of states to collect revenues in general and direct taxes such as income tax in particular.[8] The detrimental factors commonly identified in developing country tax systems are: insufficient staff with appropriate skills, low public-sector wages, lack of up-to-date equipment and facilities, ill-defined and complex tax and related laws; poor enforcement of penalties for evasion and corruption; poor information collection and identification of taxpayers, and so on (see Kaldor, 1955; Bird, 1989: 315-46).[9] Based on this approach, the policy advice is to simplify tax rates and laws, make revenue authorities as autonomous from political pressure as possible, and form tax policy based on the implementation capacity of the tax administration.

There are many shortcomings to the administrative approach. First, the conception of capacity is static. There is no attempt to explain why and how administrative capacities *change*. Second, there is no explanation as to why tax capacities *differ* across countries. While much of the applied literature acknowledges political obstacles as the root cause of low tax collection (Bird & Oldman, 1964; Gillis, 1989; Burgess & Stern, 1993; Tanzi & Zee, 2000), there is no attempt to map which types of political obstacles matter more in some contexts as opposed to others. Third, there is little analysis as to why sound tax policies are not *enforced*. Although not often emphasised, low levels of legitimacy are often behind a state's inability to ensure compliance (Levi, 1988) and the genesis and variation in this legitimacy is not analysed in the applied literature. Finally, as in the case of the capacity approach, the emphasis on discouraging the collection of taxes with high information requirements (such as income tax) does not provide the impetus for countries to *improve* administrative tax collection capacity for such taxes.

Interestingly, the technical requirements of information collection and enforcement generally seem to be much *more* stringent in taxation than managing industrial policy, which is often dismissed on the grounds that it is too demanding for most developing countries. However, as seen in the case of East Asia, the conduct of industrial policy involves deliberative councils of a relatively small number of government bureaucrats and a relatively small number of medium and large firms or business conglomerates (see World Bank, 1993), and therefore has a much lower informational requirement than tax policy. The apparently sophisticated technical requirements of tax policy may be one of the principal reasons why the *World Development Report* 1997 neglects to discuss the political economy of taxation.

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8 As Bird and Casanegra (1992) argue: 'In developing countries, tax administration is tax policy.'

9 Because of these deficiencies, Bird (1989: 329), for instance, notes that 'there is no place for an income (or other general direct) tax in any developing country.'

One recent development within the administrative approach has been the advocacy of autonomous revenues authorities (ARA's). International financial institutions have developed the proposition that, in weak states, revenue collection authorities are more effective when they operate *autonomously* from the state (and particularly the finance ministry), and as a commercial entity at arms length from the government rather than as a department within the government administration (Taliciero, 2004). According to this line of thinking, autonomy protects revenue authorities from political interference and allows directors to circumvent the institutional obstacles of weak public sectors such as cumbersome regulations, low pay, antagonistic unions and so on (Therkilsden, 2003: 2). As a result, the creation of parallel agencies is favoured over the restructuring of existing tax institutions.

While there is some evidence in Africa and Latin America that autonomous revenue authorities may have been instrumental in *initiating* reforms, it is less clear that such arrangements are *sustainable*. Typically, where there have been initial successes in the efficiency and legitimacy of tax collection, these gains have proved ephemeral.[10] The Ugandan and Peruvian experiment with ARA's were directed by Presidents who governed on a political strategy of anti-party politics, which made the revenue authority vulnerable to shifting policies and electoral calculations of the President. In each case, Museveni (in Uganda) and Fujimori (in Peru) terminated support of their respective ARA's when the introduction of necessary taxes became unpopular.

Such a technical approach to tax policy abstracts from politics in at least three ways. First, the reasons why such reforms were politically feasible in the first place are not addressed. Second, there is little analysis of why such autonomy is acceptable to relevant political coalitions over time. Third, there is no accepted definition of autonomy. Since tax policy, which is the domain of finance ministries, can not practically be divorced from tax collection, which is the domain of newly created ARA's, it is not ultimately possible for the latter to operate in purely autonomous ways. In effect, autonomy can never be complete where there are inter-dependencies among agencies. Moreover, given the political nature of taxation, autonomy is always a contested notion (ibid.).

While the theoretical and applied literature has identified many common problems among developing countries, the focus on tax collection in technical terms abstracts from an analysis of where and how the power of the state originates. As importantly, the economic literature is unable to explain the wide variation and growth in the capacity of states to extract, mobilise and re-distribute assets for developmental and other aims. Simply put, the historically specific political coalitions underlying state support and particularly, the important roles of internal and external threat to political order and stability are not incorporated.

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10 On the Peruvian and Ugandan cases respectively, see Durand and Thorp (1998), and Therkildsen (2003).

2.3 Political economy approach to tax

The diversity of patterns of taxation and resource mobilisation among states is clearly a product of history. A brief look at the history of today's developed countries demonstrates why an assessment of taxation, good governance and institutional formation needs to incorporate an understanding of processes of conflict and bargaining. The institutional capacity of states to mobilise resources had to be *created*. War played a particular role in that process, not least because it created a context in which the wealthy in society felt threatened enough to allow the creation of capability and the centralisation of authority at the level of the state.[11]

Standard histories of European state formation underline the crucial contribution of external threat and war. Charles Tilly argues that 'war made the state and the state made war' (Tilly, 1990: 54). War caused states to be more efficient in revenue collection by forcing them to dramatically improve administrative capabilities (allowing states to fund administrations and economic systems). Most importantly, the effort to finance war and the military led to varying patterns of *bargains* between the state and interest groups, particularly merchants, landlords and in some cases, directly with the peasantry. In general, the distributional struggles between the state and societal actors (and between competing groups within civil society) led to uneven but mutually recognised rights: rights of citizens with respect to states as well as the rights of state officials (and corporate entities) with respect to citizens.

Of course, while Heraclitus argued that 'war is the father of all things', understanding the role of war in the history of institutional formation has its limits as a guide to policy. But it does allow us to ask whether there are conditions today that can replicate some of the incentives that historically emerged in times of warfare. Threat, which can provide 'windows of opportunity' for tax reform, may today be derived from domestic social movements, fiscal crises or the 'global economy' rather than imminent prospects of war.

This historical perspective also allows us to demonstrate that 'capability' is not simply an inheritance of history – entirely 'path dependent' – but has always been created by actors who are making history all the time. The formation of the state and its capacity to grow and survive was intimately related to its ability to tax. In turn, rights and institutions formed as the by-products of bargains, or settlements of conflict, in the course of struggle. This is consistent with some theoretical work on institutions that view institutional formation as a by-product of distributional struggles and power balances.[12]

A second important political economy factor in understanding taxation is the role played by political organisations that mediate the conflicts between interest groups, classes, and coalitions. Political parties are particularly important as they operate in the milieu that

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11 For an early and influential analysis of the relationship between war and state formation, and between state formation and taxation, see Schumpeter [1918] 1954. In Schumpeter's analysis, the 'most important cause of financial difficulties consisted in the growing expenses of warfare' (ibid: 13) and that 'without financial need the immediate cause for the creating of the modern state would have been absent' (ibid: 16). However, see Centeno (1997) and López-Alves (2001) for an analysis of why the potential stimulus of war did not transform Latin American states in the nineteenth century in ways similar to Western Europe.

12 See Knight (1992), Moore (1966), and Brenner (1976).

links state and civil society and they can provide political support necessary to legitimate state tax policies as well as organise demands on the state for social expenditure and tax breaks. That tax struggles are among the oldest types of class struggles (Goldscheid, 1958: 202) suggests that the power of classes and other interest groups are a key determinant of taxation (Campbell, 1993: 168). The historical evidence in the now advanced countries suggests that governments run by leftist parties mobilise and support higher tax levels (Cameron, 1978) and more progressive tax systems (Heidenheimer *et al*. 1983: 178-9) than those run by conservative parties. The well developed welfare states in Scandinavian countries in the second half of the twentieth century were controlled by social democratic coalitions. In less developed countries, countries with relatively historically high tax collection as a percentage of GDP, such as South Africa, Brazil, and Malaysia, are characterised by strong (though not always leftist or competitive) political party systems.

Third, the literature on the 'resource curse' in mineral abundant economies has made an important contribution to the political economy of tax. The main premise of this model is that when states gain a large proportion of their revenues from external sources, such as oil rents, the reduced necessity of state decision-makers to levy domestic taxes causes leaders to be less accountable to individuals and groups within civil society; more prone to engage in and accommodate rent-seeking and corruption; and less able to formulate growth-enhancing policies (Mahdavy, 1970; Karl, 1997). Although the literature has been an inadequate guide in explaining differential growth performance among oil states, and changes in growth rates in particular oil states over time (Di John, 2004), it has drawn attention to an important issue, namely that the type of taxes (and not just the level) and the manner in which the state appropriates resources is central to understanding the historical development of state capacity.

Finally, a historical perspective highlights the differential impact colonial legacies have had on tax structures. For instance, different patterns of English and Spanish colonialism and the institutions they left behind have influenced differences in tax policy between the Caribbean and Latin America (Thirsk, 1997). In particular, the British Caribbean countries inherited legal institutions that enabled the development of more *formal* labour markets which can explain, in part, the higher capacity of these countries to collect income tax compared to Central and South American economies (Stotsky and WoldeMariam, 2002). Additionally, Caribbean countries generally inherited parliamentary systems of governance, which may offer more feasible mechanisms of institutionalising pacts with elites to pay taxes than in the generally more presidential systems in Latin America (ibid.).

The differential impact of colonial economic development (and in particular the structure of labour markets and the historical process of the integration of indigenous populations into the colonial order) appears to have had an impact on the tax collection capacities in sub-Saharan Africa too.[13] One striking feature of African economies is the regional differences in the share of tax revenue in GDP, with countries of Southern African (South Africa, Zimbabwe, Botswana, Namibia) generally having higher tax takes and tax effort indicators than would be predicted on the basis of their per capita

13 This paragraph draws on a personal note from Thandika Mkandwire (2005).

incomes.[14] The reason for this difference owes to the greater formalisation of labour in the colonial period in the Southern African economies and Kenya compared with the rest of sub-Saharan Africa. Patterns of colonisation have turned out to have produced institutional arrangements and practices that have proved remarkably resilient.

In sum, the political economy approach offers an important complement to the economic and administrative frameworks to understanding taxation. In particular, such an approach, in providing historical and comparative analyses, can contribute to an understanding of why tax capacity differs across countries and changes over time. As importantly, this approach not only integrates economic and political processes, but specifically examines the interaction of taxation and state formation.

3 Political settlements and tax capacity in South Africa and Brazil

The highly successful income and overall tax collection capacity of the South African state since the 1960s is particularly instructive of the need to incorporate political analysis in an understanding of institutional and administrative reforms. In the period 1960-2000, South African tax collection as a percentage of GDP has consistently been the highest among middle-income countries. In the period 1997-2002, the tax take as a percentage of GDP in South Africa averaged over 25 per cent compared with the middle-income country average of 15 per cent of GDP. The South African state has been particularly successful in collecting direct taxes in the form of corporate and personal income taxes, which are generally the most progressive types of tax. In the period 1975-78, income tax collection averaged 12.9 per cent of GDP compared with the Latin American average of 5.0 per cent and the East Asian average of 5.7 per cent. In the more recent period 1997-2002, income tax collection averaged 14.6 per cent of GDP compared with the Latin American average of 3.9 per cent and the East Asian average of 6.9 per cent.

The factors that permitted this high level of income tax collection capacity have been the subject of considerable analysis (Lieberman, 2001; Friedman and Smith, 2004). First, there has been a high degree of cooperation between the state and upper-income white groups which supported state-led reforms. This challenges the idea that simply instituting and autonomous revenue agency is central to effective tax collection. Second, the introduction of computerisation in the 1960s greatly enhanced the ability of the Department of Inland Revenue to calculate and issue assessments, to record payments, and to register and monitor large tax payers, and maintain controls on tax payments more generally. Third, the introduction of a withholding pay-as-you-earn (PAYE) system also greatly enhanced tax collection. This system made employees responsible for withholding taxes on a monthly basis. The willingness of business owners to cooperate greatly reduced the transaction costs of implementing the PAYE system.

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14 Tax effort measures the relationship between actual and potential levels of taxation, the latter being the predicted value derived from the statistical relationship between the tax share in GDP and various combinations of explanatory variables, usually including levels of per capita income; the shares of agriculture, industry, and manufacturing in GDP; import shares; and levels of urbanisation. Tax effort is the residual of each country's equation. If it exceeds zero, then a country's actual level of taxation exceeds the predicted one while if it falls below then the country tax level is below its potential.

In the post-apartheid state, there have been several further reforms that followed from the Katz Commission which included representatives from the state, political parties, business chambers, labour unions, and national and international tax and legal experts. The Inland Revenue and Customs and Excise departments were integrated in 1995 and granted administrative autonomy under the new name South African Revenue Service (SARS) in 1997. The high degree of consultation within the state and between the state and interest groups were crucial to enhancing the legitimacy of the reforms. The key feature that marked the continued success of SARS in tax collection capacity was the high degree of administrative cooperation within the state, particularly between SARS, the Finance Ministry and the Central Bank. Such cooperation allowed for exchange in information that improved budget planning and tracking tax evasion. In sum, the mutually supportive ministerial relationships improved the resource mobilisation capacity of the state.

While the above discussion examined the technical means through which tax capacity developed in South Africa, such dynamic capacity-building can not be understood without examining politics, which is the terrain upon which these technical capacities are legitimated and rules of the game enforced. Historical political analysis contributes greatly to explaining *why* the tax capacity, in general, and the income tax collection capacity, in particular, of the South African state was high *relative to that in other middle-income countries*.

For Lieberman (2001), the historical process in which the national political community was constructed in the early 1900s contributes greatly in explaining the evolution of income tax capacity in South Africa. The 1909 Constitution defined the South African polity along two main lines. First, it created an exclusionary racial state that eventually manifested itself in the form of apartheid. Second, it created a unified central state. In terms of the first factor, the white supremacy that was embodied in the state's laws and codes legitimated the state for white-owned firms and white upper-income groups. The apartheid state influenced the calculations of upper income groups, who became assured that their income tax would benefit 'their own' group, and not 'the other'. At the same time, a racially defined project allowed lower income whites to demand progressive taxation by drawing on the shared identity of a cross-class white project. Importantly, the *centralised and national* structure of white-based unions and political parties helped lower the transaction costs of collective action that are more prevalent in decentralised and regionally-based party systems and unions.

The contrast of the South African experience with the Brazilian tax state in the twentieth century is instructive of the value of comparative historical political economy analysis in understanding *variations* in income tax capacity. The Brazilian state has indeed achieved among the highest tax takes as a percentage of GDP in Latin America (and indeed among all less developed countries) in the twentieth century, and in the period 1990-2004, has increased its take from 22 per cent of GDP to over 30 per cent of GDP. However, in comparison with South Africa, the Brazilian state tax system is much more regressive and is characterised by a more *adversarial* as opposed to cooperative relationship between the state and upper-income groups (Lieberman, 2001). As such, the Brazilian state collects less than one-third the South African rate of income tax and relies on a series of inefficient and regressive indirect taxes such as multi-tiered VAT, and financial transaction taxes (Schneider, 2005).

The comparison of South Africa and Brazil is interesting since both share many common features. Both are economies are upper middle-income, semi-industrialised economies that have followed a largely inward-looking state-led import-substitution regime for most of the second half of the twentieth century. Both also have among the most unequal income distributions in the world. The main difference, according to Lieberman, is that, in Brazil, the polity was defined as a non-racial federation where *regional* interests were much more salient than in the South African state, which developed a more centralised state along racial lines. As a result, race did not become an idiom along which upper-income white groups in Brazil could develop cross-class alliances and solidarity. The regional nature of the polity meant that both firms and white upper-income groups were less willing to cooperate with state as they were not confident that direct taxes would be used to benefit 'their' region. As a result, elites continued to challenge state efforts to increase income tax in the course of the twentieth century. Moreover, regionalism bred greater polarisation and fragmentation of political parties and labour unions which weakened the collective capacity of lower income groups to demand more progressive taxation.[15]

This comparative analysis highlights why focusing on technical capacity or structural economic factors (e.g. income distribution, per capita income) is insufficient in explaining the differential income tax collection capacity of South Africa and Brazil. Rather, this comparative analysis highlights the importance of considering the structure of political institutions and settlements, and the way in which the national political community is defined as critical to understanding the evolution of tax capacity of states.[16] As such, the political economy approach provides a lens of analysis that probes beyond issues raised by the economic and administrative approaches.

It is also important to highlight that state capacity to tax does *not* necessarily translate into equally effective state capacities to govern the economy in *other* policy areas. In other words, state capacity is not necessarily uniform across administrative functions. For example, while the South African state has been a champion income tax collector, its industrial policy has been far less effective. The record of the South African state promoting world-class industrial infant industries has been far less successful than, for example in South Korea or even Brazil. As in tax policy, detailed historical political economy analyses would be required to explain these differences of capacity both across states for a particular function (say, industrial policy) as well differences *within* state-society relations across several functions (e.g. tax, industrial policy, social service provision and so on). The policy implication is that designing reforms requires an historical and political understanding of the coalitions opposing and supporting reforms for specific policy areas within a country. There is no reason why the political economy dynamics and obstacles will be the same for each reform issue.

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15 Even in Lula da Silva's administration, income tax has remained off the agenda despite the fact that the Worker's Party (PT) has risen on a social democratic platform.

16 However, in a larger comparative perspective, the focus on ethnicity/race and regionalism does not explain why tax capacities differ within Latin America and differ across middle-income countries more generally.

4 Tax compositions in Latin America, East Asia, Eastern Europe and South Africa

There has been very little systematic comparison of the *composition* of tax across developing regions. As Lieberman's study comparing South Africa and Brazil suggests, overall take collection figures can mask important differences in developmental capacities of states. The capacity of states to collect direct taxes (income and property taxes) provides an important window into their power and legitimacy vis-à-vis upper income and middle-class groups. The aim here will be to underscore differences in the types of taxes collected between middle-income regions.

Consider the differences between Latin American and East Asian economies during 1997-2002 in terms of the share of direct taxes collected as a percentage of GDP. In this period, personal income and property tax collection in East Asia was, on average, 4 times higher as a proportion of national income than it was in Latin America as indicated in Table 2.

Moreover, the share of personal income and property tax as a percentage of GDP was six times higher in Eastern Europe compared with Latin America's average. This significant difference in personal income tax collection in 1997 is not due to any substantial differences in income per capita between the regions.

The very low personal income tax burden in Latin America is due to several factors, all of which point to states in the region with weak leverage over the elite economic classes. First, the average maximum personal income rate has fallen from an average of 50 per cent in 1985-86 to 38 per cent in 1991, and 34 per cent in 1997, a rate of decline 'that is considerably more rapid than in the OECD, where the top rates declined from 52.8 per cent in 1985-86 to 43.6 per cent by 1997' (Shome, 1999: 3-4). Second, poor administrative capacity and high level of tax evasion limit the productivity of tax collection (Shome, 1999). Third, while the top marginal personal income tax rate has been reduced in the 1990s, the top personal exemption level in terms of GDP per capita has risen from 1.29 in 1991 to 1.36 in 1997 (ibid.: 6). If one were to add that the significant levels of foreign savings held by Latin Americans (the result of several episodes of massive capital flight) are not taxed, it would not be unreasonable to argue that the economic elite in the region are the group least preyed on by their respective states.[17] These trends obviously imply that the tax burden of the upper income groups is negligible.

When one expands the category of direct taxes to include corporate income tax, East Asia still collects over 75 per cent more as a percentage of GDP than in Latin America in the period 1997-2002 as indicated in Table 3. The Eastern European economies in the sample had more than double the income tax collection as a share of GDP compared with Latin America. It is again worth highlighting the extraordinarily high income tax capacity of South Africa, which was discussed earlier.

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17 Tanzi & Zee (2000: 30) note that Latin American countries have virtually stopped taxing financial income to avoid chronic capital flight.

Table 2: Personal income and property tax burden: Latin America, East Asia, South Africa and Eastern Europe compared

(Ratio of personal income and property tax as a per cent of GDP, %)

	1975-78	1985-88	1997-2002	2000 GDP per capita (2000 US$)
Latin America				
Average	**1.7**	**1.2**	**1.0**	**$4,399**
Argentina	0.4	0.8	1.1	7,726
Brazil	0.2	0.2	1.4	3,537
Chile	3.3	1.1	na	4,964
Colombia	1.8	1.6*	0.6	1,979
Costa Rica	2.9	2.2	0.7	4,185
Mexico	2.7	2.0	na	5,935
Peru	1.5	na	1.5	2,046
Venezuela	1.0	1.0	1.0	4,818
East Asia				
Average	**1.8**	**2.3**	**3.9**	**3,716**
Indonesia	0.8	0.9	3.5	800
Korea	1.9	2.8	3.6	10,890
Malaysia	2.1	2.4	6.1	3,881
Philippines	1.6	1.1	2.6	990
Thailand	1.1	1.9	2.2	2,020
Taiwan	3.4	4.5	5.2	
Eastern Europe				
Average			**6.8**	**4,327**
Latvia			6.5	3,259
Estonia			7.7	3,987
Poland			6.7	4,309
Hungary			7.8	4,656
Czech Republic			5.2	5,422

Source: IMF *Government Finance Statistics*; Statistical Yearbook of the Republic of China 2002 for Taiwan.

Table 3: Income, profits and capital gains burden: East Asia, Latin America, South Africa and Eastern Europe compared

(Tax on income profits and capital gains as a per cent of GDP, %)

	Income, profits and capital gains burden		
	1975-78	1985-88	1997-2002
Latin America			
Average	**5.0**	**4.1**	**3.9**
Average (excluding Venezuela)	**3.2**	**3.0**	**3.8**
Argentina	0.7	0.8	2.2
Brazil	3.2	4.4	4.5
Chile	3.8	4.0	4.2
Colombia	3.7	3.1	4.7
Costa Rica	2.8	2.4	2.8
Mexico	5.6	4.4	4.9
Peru	2.7	2.0	3.5
Venezuela	17.6	12.0	4.7
East Asia			
Average	**5.7**	**6.0**	**6.9**
Average (excluding Indonesia)	**4.4**	**5.2**	**6.3**
Korea	4.2	4.8	5.5
Malaysia	8.3	9.6	8.4
Philippines	2.8	3.2	6.3
Indonesia	12.6	10.3	9.5
Thailand	2.1	3.2	5.0
Taiwan	4.0	4.8	6.6
South Africa	**12.9**	**13.1**	**14.6**
Eastern Europe			
Average			**8.3**
Latvia			7.5
Estonia			8.5
Poland			7.9
Hungary			9.3
Czech Republic			8.4

Source: IMF *Government Finance Statistics*, and International Financial Statistics; Statistical Yearbook of the Republic of China 2002 for Taiwan data.

Table 4: VAT in Latin America, East Asia, South Africa and Eastern Europe compared
(as a percentage of GDP)

	1975-78	1985-88	1997-2002
Latin America			
Average	**2.5**	**3.6**	**5.6**
Argentina	1.1	1.8	3.8
Brazil	0.0	8.7	12.1
Chile	6.5	8.1	8.2
Colombia	1.8	2.8	4.8
Costa Rica	1.6	2.8	4.8
Mexico	2.5	3.1	3.2
Peru	4.4	1.8	6.4
Venezuela	na	0.0	4.3
East Asia			
Average	**2.0**	**2.3**	**2.9**
Indonesia	1.6	2.8	3.5
Korea	2.6	3.5	4.1
Malaysia	1.2	1.5	2.0
Philippines	1.9	1.1	1.7
Thailand	2.7	2.8	3.4
Taiwan	na	na	na
South Africa	**1.2**	**6.1**	**6.1**
Eastern Europe			
Average			**7.4**
Latvia			7.4
Estonia			8.2
Poland			7.3
Hungary			9,0
Czech Republic			6.5

Source: IMF *Government Finance Statistics* and International Financial Statistics.

The lower levels of income tax collection has meant that the burden of structural change in tax falls relatively more on indirect taxes in Latin America than in East Asia, Eastern Europe, and South Africa. As seen in Table 4, ratio of VAT to GDP is significantly higher in Latin America compared to East Asia in the period 1997-2002.[18]

18 It is important to note here that standard analysis of tax incidence indicates that who bears the ultimate burden of the tax may be substantially different from who pays the tax in the first instance. For example, a corporation may not pay the full amount of a corporate tax if it can shift some of that burden to consumers via higher prices or if it can force workers to accept a lower wage (see Stiglitz, 1986: 411-55).

In the period 1997-2002, VAT-to-GDP ratios averaged 5.6 per cent in Latin America compared to 2.9 per cent in East Asia. While it is true that South Africa has a higher VAT-to-GDP ratio than both regions, VAT in South Africa represents a lower percentage of *total* taxes than in either region since income tax collection is, at 14.6 per cent of GDP, a much more significant component of total tax collection. The same story applies to Eastern Europe though to a lesser extent.

These patterns have several important implications. First, indirect taxes, and in particular VAT, which is generally one of the more regressive taxes, is occupying a relatively higher share within the overall tax burden in Latin America.[19] Second, as a result of the low levels of income tax collection, the region's tax collection is only 16 per cent of GDP when the international norm, given the region's average income per capita, should be 24 per cent of GDP (IADB, 1998: 6). Third, the poor tax effort and the reliance on generally regressive indirect taxes in Latin America are reflective of the weakness of the state vis-à-vis upper income groups. Finally, in comparison with East Asia and Eastern Europe, the tax effort in Latin America is further from achieving re-distributive goals. This is because the challenges of re-distribution are much greater in Latin America because income distribution is, on average, much more unequal than in the other two regions (IADB, 1998). Without an explicit political programme to redesign and enforce personal income tax collection, the level and progressiveness of taxation and hence poverty reduction strategies in Latin America would appear limited, particularly in the context of persistently high income and asset inequality.

5 Creating tax capacity in low-income/post-war economies

The challenges of tax collection are formidable in low-income and especially in low-income post-war economies. The ratio of government revenue to gross domestic product in war economies is, on average, well below the average for non-war economies with similar levels of per capita income (Gupta *et al*. 2004; Addison *et al*. 2004). In the post-war economies of Democratic Republic of the Congo (DRC), Rwanda and Uganda, for example, the most salient features are that the tax base is relatively low, dependent to a large measure on trade taxes, and is extremely narrow where 'large' payers (which are generally in the range of 300) contribute between 40 and 70 per cent of domestic revenue collection (Di John, 2005: 1). The need to widen the coverage of the tax base is urgent in these countries as is the need to examine the political economy of large taxpayer offices in the government.

The dependence on trade taxes in low-income/post-war economies presents specific policy challenges. Trade liberalization in these economies has led to reductions in trade taxes, which are the main source of revenue in weak and low income states (ibid.: 2). Moreover, alternative tax revenue (such as from VAT and income tax) have risen significantly less than the decline in trade tax revenue. The overall effect has been a decline in total tax revenues as a percentage of national income in low income countries. Evidence presented by the IMF (Baunsgaard and Keen, 2005) have found that

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19 In theory, the overall impact of VAT need not be regressive. This would be the case if luxury items are taxed at a higher rate than basic goods, and if public expenditure that is financed by VAT is targeted to lower-income groups.

low income countries typically recover only 30 cents on each dollar lost to trade tax declines.

The experience of Uganda provides an important exception to this trend. Under the Museveni regime, trade liberalization (that is the decline in import and export tariffs) was imposed *gradually* over the period 1986-98. Rodrik (2004) classifies Uganda as a case, not of shock therapy liberalisation, but one of moderate and gradual reform. Non-tariff barriers were removed for the first time in 1991; six years after Museveni took power. In 1995, there were still import quotas on beer, beverages, and auto parts. In 1999, all non-tariff barriers were eliminated. It was only in the early 1990s that the structure of trade taxes was switched from export taxation to import taxation, but import tariffs were introduced at a high level. There were few options available for alternative types of taxation, a characteristic of very poor economies with weak fiscal institutions. As a result, import taxes necessarily lead fiscal resource mobilisation in the 1990s. In 1996, ten years after the National Revolutionary Movement (NRM) regime took power, trade taxes still accounted for more than 50 per cent of total tax revenues.

This gradualism of trade liberalization proved crucial to maintaining fiscal revenues until the political and administrative problems of introducing VAT could be overcome. The tax revenues in Uganda increased from 7 per cent of GDP in 1986 to nearly 11 per cent by the mid-1990s. While this is still below the sub-Saharan African average, the fiscal consequences of more rapid trade liberalization could have been devastating. *The case against rapid tariff reduction as a means for maintaining and increasing fiscal resources, a key element in state consolidation and state-building, is one of the main lessons in the political economy of the Ugandan post-war reconstruction.*

Collier and Reinikka (2001) argue that the substitution of export with import taxes created greater inefficiencies because import taxes were subject to greater dispersion of tax rates since the latter were subject to more tax rates than the former. This is misleading in several respects. First, the replacement of export taxes was important in improving incentives for exports. Second, the substitution of export taxes with import taxes (however much dispersion) was essential for maintaining resource mobilisation, which was central to state-building. Third, a dispersion of import taxes allows the state to provide selective rents (and therefore incentives) for the development of particular sectors.[20] A uniform import rate provides much less scope for industrial and agricultural strategies. Finally, the argument that trade policy created static inefficiencies does not explain why Uganda achieved one of the fastest growth rates in the developing world over the period 1986-99.[21] Tariffs on commodity exports, for example, while potentially providing some disincentives to production, were the only mechanism to tax incomes of wealthy farmers. *Export tariffs thus can provide a functional substitute to weak income*

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20 Tariffs also provide a fiscally more sustainable mechanism to promote domestic industry in low income countries. The Museveni regime has used these tools to fuel infant industries such as the flower cutting industries whose exports have grown rapidly. While export subsidies may be less distortionary than tariffs, fiscal constraints in low income countries prevent the extensive use of subsidies as a tool of industrial policy.

21 By the mid-1990s, there were still five bands of ad valorem import tariff rates between 0 and 60 per cent, though more than 95 per cent of the imported items were between 10 and 30 per cent. During the latter half of the 1990s, the NRM regime implemented further trade reforms, which gave Uganda one of the lowest tariff structures in Africa. Since 1999, the maximum tariff was 15 per cent on consumer goods, 7 per cent on intermediate goods, and zero on capital goods.

tax capacity in low income/post-war economies. In the Ugandan case, such tariffs did not coincide with a decline in export growth, but rather were compatible with relatively rapid export and production growth in commodities (Di John and Putzel, 2005).

The Afghan case also highlights important political economy issues concerning tax reform in a low-income/post-war context. Afghanistan has one of the weakest tax collection capacities in the world. According to IMF estimates, government revenue as a percentage of non-drug GDP will be 5.4 per cent in 2005-06, the lowest figure for any country in the world (Rubin, 2006: 26). James Boyce (2003: 7-8; forthcoming) suggests that fiscal capacity has been crucial for the viability and sustainability of the state, particularly given the short attention span and shifting priorities of external donors. What seems clear in the Afghan case is that the state's command over legitimate force and legitimate fiscal capacities are closely interlinked, once again highlighting the limits of a purely technical approach to taxation.

There are several insights on the relationship between state-building and public finance that are highlighted in Boyce's work. First, there were three main principles that were important as foundations of sound revenue collections: a) the methods chosen should be easy to handle administratively; b) they should honour progressivity in order to reduce rather than exacerbate distributive tensions by taxing those with ability to pay; and c) they should be underpinned by legitimacy.

Second, there is a need to re-think the policy of exempting high-income expatriates from paying taxes despite the fact that they often earn 100 times the national average salary. This exemption creates a demonstration effect to high-income nationals that it is legitimate for upper income groups not to contribute to tax collection. Boyce points to three tax measures which would help the international community to play a catalytic role in the revenue area, analogous to its potential role in the expenditure and security arenas: a) the introduction of an income tax on high income expatriates, voluntarily paid and a measure of high symbolic value; b) the introduction of income and property taxes on high income citizens because the influx of external resources is a major source of a considerable increase in income for some well-placed Afghan citizens; and c) a customs duty on imported luxuries that is backed up by the willingness of international actors to forego exemptions and immunities. Such measures could easily be put into practice administratively and work as a nucleus of revenue collection capacity while at the same time would enhance legitimacy. It would also set the stage for state-elite bargains over tax collection to become an institutionalized feature of the polity.

Given the weak state capacity to collect tax in Afghanistan, trade taxes will inevitably be the most feasible source of tax collection. However, raising the level of import taxes is not simply a question of trade policy. The inability of the Afghan state to control much of the territory outside the capital, Kabul, including border areas impedes the collection of trade taxes. The presence of entrenched warlords weakens the state's monopoly not only on revenue collection but also on the legitimate exercise of force (Boyce, forthcoming). In this sense, raising trade taxes will require increased military and security presence of the central state in border regions, a feat unlikely to be achieved without international military assistance (Ghani *et al*., forthcoming: 26). Clearly, in post-war economies, capacity to collect even the 'easiest' taxes is closely linked to issues of security and the legitimate monopolization of violence on the part of the central state.

On the expenditure side, aid would do more to promote capacity to plan and execute policies if channelled through the *central government*. The current situation features a *dual public sector* where the bulk of expenditure (including procurement, the payments system and the delivery of services) is made directly by donors with only a small per cent of spending going through the parliament and the budget process. While international service provision is generally more efficient currently, the long-run consequences for state-building are likely to be negative. This is because foreign spending is not accountable and there is a lack of coordination of aid which wastes scarce resources. Most worrying is the high opportunity cost of not permitting the state to develop reciprocal relationships and mutual obligations with interest groups, which the fiscal system can enhance.

Both the Ugandan and Afghan case illustrate several important points. First, taxation is central to the prospects of state formation and legitimacy. Second, rapid trade liberalization can be de-stabilising to the tax collection capacity and state-building project in low-income/post-war economies. Finally, the exemption of high income foreign aid workers from paying income and consumption taxes signals that progressivity is not either feasible or desirable. This is creates a demonstration effect that regressivity is acceptable, which can undermine the process of building state legitimacy.

6 International obstacles to tax collection: the problem of capital flight

Another important concern for many countries, developed and less developed, is the extent to which international financial liberalisation has facilitated capital flight to onshore and offshore financial centres (for a discussion of the definitions and measurements of capital flight, see Beja Jr., 2005). The Tax Justice Network has estimated that capital flight from all countries, including funds undeclared in the country of residence, is approximately $US11.5 trillion (Spencer, 2006). Annual global income from such sources is conservatively estimated at $US860 billion, and the annual worldwide tax revenue lost is approximately US$255 billion, which equals the funds estimated to meet the UN Millennium Development Goals (ibid.).

Capital flight incurs many economic, political and social costs. Particularly when capital is scarce, capital flight results in a loss of resources to finance investments in infrastructure and social spending. Capital flight also lessens the resources available for investment more generally. This contributes to declines in growth rates which results in growing unemployment, informalisation of economic activity, and poverty. Declining investment also harms the technological upgrading required to keep exports competitive. In many countries, particularly in sub-Saharan Africa and Latin America, capital flight has been accompanied by increases in foreign borrowing – that is, increased indebtedness has been used, not to finance investment or even consumption, but to finance capital flight itself (Rodríguez, 1987; Boyce and Ndikumana, 2005). The resulting debt burdens are likely to most hurt the poor as social spending and infrastructural spending needs to be cut in the face of debt repayments.

Despite the global nature of the capital flight problem, there are important regional differences between developing regions. Consider Table 5.

Table 5: Capital flight as a share of private wealth in Latin America and East Asia (percentage)

	1980-89 (a)	1990-98 (a)	1980-89 (b)	1990-98 (b)
Sub-Saharan Africa	27.6	30.1	27.4	30.3
Latin America and Caribbean	8.5	9.0	7.5	7.9
East Asia and Pacific	4.5	5.0	2.0	2.7

Note: (a) all observations; (b) full data points only

Source: Collier *et al*. (2004: table 1A, p. 22)

Capital flight as a share of private wealth has been estimated by Collier *et al*. (2004) to be between two to three times higher in Latin America compared to East Asia in the 1980s and 1990s. For sub-Saharan Africa, the situation is even worse. In the region where capital is most scarce, capital flight as a percentage of private wealth was, on average, six times higher than in East Asia in the 1980s and over ten times higher than East Asia in the 1990s.[22] It is likely that capital flight both caused and was caused by lower growth, macroeconomic instability and political instability in Latin America and sub-Saharan Africa. Whatever the mechanisms, capital flight in both regions has severely lowered the tax base and with it, the domestic resources available to finance public investment in infrastructure and social services.

Policy proposals to address the tax revenues lost due to capital flight include selective use of capital controls, overriding bank secrecy in onshore and offshore financial centres, improvements in tax administration in less developed countries, and further implementation of tax information exchanges between countries (Spencer, 2006). Exchange of information on capital flight between governments was advocated by John Maynard Keynes and Harry Dexter White, the principal architects of the Bretton Woods institutions in 1944 (Heillener, 2005: 289-91). This proposal was opposed by the US financial community which had benefited from capital flight (ibid.: 291). Another more radical solution would involve selectively repudiating past loans, invoking the doctrine of 'odious debt' in international law as well as historical precedent (Boyce and Ndikumana, 2005).[23] The idea here is to repatriate funds that were illegally transferred out of the country by state leaders. Some analysts have also suggested that the IMF, World Bank and OECD should take the lead in implementing an international financial architecture to reduce the incentives and means for engaging in capital flight (Spencer, 2006). As in the past, the financial community in the advanced industrial countries as well as wealthier individuals and corporations in the poorer countries would likely oppose such policy proposals. Nevertheless, it would be possible to make the case that taxpayers in the OECD countries would shoulder less of the burden of financing international aid if tax revenues lost from capital flight (both from developed and less developed country residents) were re-captured and/or prevented.

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22 These estimates, of course, do not indicate variations within regions.

23 Boyce and Ndikumana (2005: 338) note: 'At the end of the 19th century, the US government repudiated the external debt owed by Cuba after seizing the island in the Spanish-American War. The US authorities did this on the grounds that Cuba's debt had not been incurred for the benefit of the Cuban people, that it had been contracted without their consent and that the loans helped to finance their repression by the Spanish colonial government.'

7 Conclusion

The main theme emerging from a historical perspective on taxation is that while technical aspects of tax reform are crucial, an understanding of the sustainability of reforms is not possible without understanding how reforms become legitimate. Because taxation affects incentives and distribution simultaneously, tax reform requires either a degree of social consensus that such policies are in the collective interest and/or it requires a state with the ability to coerce those who challenge its allocations. The focus on institutional designs (such as the degree of autonomy) and other technical issues of tax is incomplete since it ignores the political nature of taxation.

While the current focus on VAT and tax simplification have been useful to initiating tax revenue collection reforms, the more difficult administrative tasks of tax collection require further attention. The capacity approach of the World Bank and the IMF has been pragmatic in focusing attention on feasible revenue generation in the short- and medium-run. However, the long-run consolidation of tax states requires a diversification toward more direct and progressive income and property taxes. This is particularly the case in countries with very unequal income distributions.

The stakes of deepening the tax capacity in late developers are great. Tax contributes to making operational the social contract, and in particular, to creating the mutual obligations between state decision-makers and relevant political actors. Of critical importance to poor late developers is the development of bargaining mechanisms between the state and elite groups, who generally control much of the production and export sectors of the economy. Because direct taxes are more challenging to collect in both administrative and political terms, apolitical and ahistorical approaches to state capacity are inadequate. A major challenge of research for the development community is to develop a more strategic, historical, and politically informed basis to promote the more difficult tax reforms.

It is also important to *distinguish* low-income/post-war economies from middle-income countries when designing tax reform policy. The potential for revenue diversification toward direct taxes is higher in the latter set of countries since both administrative capacity and political stability are generally greater. Tax reform policies need to take account of context, and particularly the stage of development. An overarching policy blueprint is likely to be unhelpful in creating feasible tax capacity in historically specific contexts.

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