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Taxes, Peacebuilding and Stability

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- *Elizabeth Kariuki*

1. Background and context

The long-term stability of any nation is predicated on the legitimacy of its government and other public sector institutions. According to many political economy scholars, for example, Zakaria (2007) “the key test of a government’s legitimacy is tax collection”. When taxes “are raised and managed responsibly, they can have a significant impact on people’s trust in state institutions” (DFID, 2010).

Following conflict, affected country governments are confronted with both the challenge of securing resources for development as well as legitimacy. Governments have the huge challenge of reconstructing their nations’ infrastructure, political and social systems. This feat is particularly problematic given that their civil services and public administration systems no longer or barely function. Moreover, in post-conflict environments the public resources needed to finance reconstruction are in short supply because: tax bases are narrow; the legal and regulatory fiscal framework is weak; and the revenue administration system and its supporting infrastructure are inefficient (IMF, 2004).

Against this backdrop, a recurring trend is for the governments of post conflict countries (e.g. Afghanistan, Burundi, East Timor, Gaza, Sudan and West Bank), has been to collaboratively prioritise medium and long term reconstruction needs for presentation to international development partners in conference settings. The aims of such conferences are to secure bilateral and multilateral institutions’ commitment to priorities, promote “a good interface between donors and the government agency responsible for aid management”, and mobilise external resources primarily in the form of aid and concessionary loans (Schiavo-Campo, 2007).

The process described above suggests that once external resources become available, governments in post conflict countries tend to focus on public expenditure on investment projects geared towards reconstruction and building the necessary institutional and human capacity in their public sectors. On the other hand, perhaps due to the constraints above, efforts to mobilise domestic revenue through taxation may take a back seat. Yet, consistently large flows of external assistance are said to adversely affect institutional development particularly when insufficient attention is accorded to mobilising domestic resources ((Moss et al., 2006); (Everest-Phillips, 2010)). This situation is exacerbated when post-conflict countries begin to exploit their natural resources.

However, neither aid nor natural resource revenues can necessarily be sustained in the long-term. This policy brief therefore examines strategies to overcome poor tax effort and emphasises the centrality of a durable and effective taxation system to both peace building and stability.

2. Taxation and the fiscal contract

Over and above the urgent need to restore services and rebuild infrastructure, countries coming out of conflict are faced with the challenge of repairing their fragmented societies by promoting democracy, a sense of nationhood, solidarity and trust through greater accountability by government. These aspects are likely to be undermined when a government is financed almost entirely from external resources as it is more accountable to international partners than to its citizens. As a result, “it may simply not be possible to also expect a credible fiscal contract to develop between the state and its citizens” (Moss et al., 2006).

A fiscal contract is negotiated on the premise that the government protects and serves the interests of the public. It evolves as citizens gain confidence that over and above delivering goods and services, the state keeps its side of the bargain by: consulting them when developing a shared national vision and development goals; being accountable for the management of public resources; addressing their grievances; and treating them fairly ((Levi, 1988); (Kariuki and Kiragu, 2011); (Muggah et al., 2012)). In this regard, it is argued that businesses and citizens “who believe that their interests are represented in a democracy may be more willing to pay taxes,…[and] also begin to believe that payment of taxes gives them the right to representation” (Brautigam, 2008).

When a fiscal contract is in place, a government can expect higher levels of voluntary tax compliance or tax morality. When compliance is high a government spends less on collecting taxes as taxpayers do not need to be coerced to pay. To this end, governments “can – and do – invest in rituals, symbols, and propaganda meant to encourage compliance” (Levi, 1988). In this regard, the tax authority in Liberia displays images which depict the message “see what your taxes are doing for Liberia”. Some other revenue administrations have coined up mottos which they incorporate in all their communications to taxpayers (Kariuki and Kiragu, 2011). For example, Kenya Revenue Authority’s motto is “pay your taxes and set your country free”. Also, politicians in Rwanda, a post-conflict country, have over the years at annual taxpayers’ days, reminded taxpayers of the value of paying taxes, and thanked them for their contributions (see **Box 1**).

Box 1: Excerpts from speech at Rwanda's 11th National Taxpayers' day

On 1st September 2012 Rt. Hon. Prime Minister Dr. Pierre Damien Habumuremyi officiated a Taxpayers' day in Musanze District Northern Province where he thanked Rwandans for their commitment to…the country's development. The Prime Minister thanked taxpayers for their contribution to the country economic development reminding [them that through] tax revenue much has been achieved by the country. He called Rwanda Revenue Authority to go beyond its target as was [achieved] in fiscal year 2011/2012 when it collected Rwanda Francs (RwF) 640 billion up from the RwF 532 billion targeted. The Premier reminded [those present] that 52% of the 2012/13 national budget will be funded by local revenue, and called everyone to play a significant role in the home grown solution.

Source: Office of the Prime Minister[1]

3. Overcoming weaknesses in the tax system

For a fiscal contract to be realised a post-conflict country government must also revamp its tax system (encompassing laws, policies and administration) to make it fair and easy for firms and individuals to comply. In this regard, it is noteworthy that at the commencement of their reconstruction, countries such as Afghanistan, Iraq, Liberia, Sierra Leone and South Sudan, were faced with tax systems that displayed one or more of the following weaknesses: a complex, antiquated or ambiguous legislative environment; inadequate staffing; weak systems; regressiveness; corruption; and high levels of smuggling and/or evasion; politicisation; and inequity ((Tafuri, 2009); (Prichard, 2010); (Benson, 2011); (Danishju, 2011); (Fallah, 2011)). For example in the case of South Sudan, Benson (2011) reports that US$ 36.7 million worth of exemptions were awarded in one state alone – what is more, there is anecdotal evidence that "elected officials [used] the funds to sponsor the construction, and purchase, of personal homes and vehicles".

To ameliorate the problems above, the IMF's Fiscal Affairs Department recommends that post conflict country governments focus on introducing new policies to increase domestic revenues and simplify administrative arrangements (IMF, 2004). For instance, with respect to tax policy, a gradual shift from reliance on international trade taxes to direct taxes such as income tax and value added tax is common (see **Box 2**). So are measures to simplify the tax regime by removing exemptions and minimising the number of tax brackets.

Box 2: Select changes to tax policies in Burundi

In the years of political instability and violence, there was no proactive tax policy stance by successive governments. In 2005 the Government of Burundi initiated the reform of its tax systems with a focus on lowering and streamlining the tax regime as a means of raising domestic revenue, "reducing smuggling, simplifying administration and boosting trade". On 1 July 2009, the government introduced the Value Added Tax (VAT) at a standard rate of 18% except for exports which are zero rated, and imports for diplomatic and certain international organisations which are exempt. The VAT replaced the transaction tax (Decree Law No. 1/04 of 1989 and 1/005 of 1994) which was levied at rate of 17%. The rationale for its introduction was twofold: "to raise the efficiency of tax collection, and offset potential losses on customs revenue due to [Burundi's] accession to the East African Community" (IMF, 2008). The government also prepared an action plan to phase out the transaction tax.

Source: African Development Bank Group (2010a)

Another key reform measure has to do with strengthening revenue administration. This will usually be in two stages. First, within the first 12 months following the conflict, "starting revenue collection and registering/controlling the flow of goods across borders" (IMF, 2004). Second, for the medium-term in line with international practice in tax administrations, governments are encouraged to develop and implement a reform programme. In this regard, it is now a conventional practice for "tax administrators…to diagnose the tax administration's principal problems, design a strategy for actions to be taken, and agree on…scope and timing" (Silvani and Baer, 1997). **Box 3** illustrates some of the measures taken by the Government of Rwanda to address the weaknesses pinpointed above.

Box 3: Some of the tax administration reforms in Rwanda

The establishment of the Rwanda Revenue Authority (RRA) as an autonomous agency in 1997, and the wide-ranging policy and legislative measures effected since 2001 have gone a long way to transforming and modernising the institutional environment for tax revenue mobilisation in the country. RRA enjoys strong political support for both its mandate and administrative autonomy. Government has provided an ultra-modern building for RRA to share with the National Electoral Commission and the Auditor General. RRA is allowed to retain 3% to 3.5% of its total revenue collection to meet its administrative costs.

RRA has also made noteworthy strides in modernization and efficiency improvements of the tax administration system. Results include: a major initiative to formalize businesses and widen the tax base by establishing the Small and Medium Taxpayers Office; improved administration of collection and cash management - over 90% of revenue is collected by banks; the implementation of an Automated System for Customs Data ++ which allows for direct trader input; and the launch of a 24/7 one-stop border service at Gatuna.

Source: African Development Bank Group (2010b)

4. Gauging the effectiveness of the tax system

Reforming tax systems can be an expensive undertaking, hence the case for a system to measure the effects of actions taken. Both research and lessons of experience from public sector organisations from around the world suggests that the use of tools such as performance measurement systems are useful in monitoring and improving the tax system ((Behn, 2003); (Van Dooren et al., 2010)). Furthermore, from a principal-agent perspective, taxpayers can be viewed as the principals with a right to demand for accountability and improved performance by tax administrations (the agents) (Verhoest et al., 2010).

Against this rationale, tax authorities should collect, analyse and disseminate some basic performance measurement data. The cheapest data source is the revenue administration's routine administrative records. However, this data source is not comprehensive. Moreover, a growing practice by both tax administrations and 'international statistical institutions' such as the World Bank is to solicit feedback from external stakeholders (e.g. taxpayers and tax practitioners) as a means of gauging their attitudes, perceptions and behaviours. In this regard, a recently completed study concludes that:

> *"More systematic and coherent information on taxpayer attitudes and behaviour are required for better analysis and more informed tax policy design...Understanding how taxpayers think about and*

experience taxation may provide an essential diagnostic of the political realities for tax reform" (Fjeldstad et al., 2012).

The body of literature on public sector performance also suggests that external stakeholders are particularly keen for feedback on "outcomes and in citizen perception of service quality, responsiveness,… services, intra-jurisdictional equity, transparency and effectiveness in public communication" (Ho, 2011). In this regard, exploratory research covering external stakeholders in three countries, confirms that they are particularly keen to obtain performance data on the priority indicators shown in Table 1.

A review of publically available documents of 10 tax authorities from around the world indicates that they commonly report on several of the Key Performance Indicators (KPIs) listed above. Actual revenue compared to forecast revenue is a universal KPI. However, three KPIs that are not prominent in tax authority strategic plans and annual reports are: (1) equity indicators; (2) tax expenditure/exemptions; and (3) governance/corruption indicators. It is argued that these three indicators of fairness and legitimacy of the tax system affect taxpayers' compliance behaviour. Specifically, a taxpayer's compliance is influenced by the actions of others – "no one prefers to be a 'sucker'" (Levi, 1988). Therefore, where high tax expenditures/exemptions are targeted at particular taxpayer groups, those that do not benefit are likely to consider the system to be unjust and evade taxes, thus undermining the fiscal contract (Fjeldstad et al., 2012).

Table 1: Priority performance indicators demanded by external stakeholders

Key performance indicator (KPI)
1. Actual revenue compared to forecast revenue
2. Expansion/contraction of the tax base - no of registered taxpayers disaggregated by sector/industry and gender and compliance levels
3. Results of taxpayer surveys
4. Tax gap/ growth projections
5. Average processing turnaround time for tax returns and refunds (during filing season)
6. Equity indicators which show the extent to which the tax system is progressive and pro-poor
7. Cost of collection
8. Percentage reduction in error rates
9. Tax expenditure/ exemptions
10. Governance/corruption indicators
11. Measures which indicate the extent to which the ARA has strengthened its capacity in terms of staffing and ICT
12. Statistics on the handling of service queries

Source: Kariuki (2012)

5. Concluding remarks

This policy brief sought to demonstrate how a durable and effective taxation system is vital for both peacebuilding and stability, as well as indicate what steps can be taken to develop it. As part of reconstruction, the governments of post conflict countries need to accord the necessary attention to overcoming the specific weaknesses in their tax systems, making taxpayers aware of the importance of domestic resources to sustainable development, and engaging them by soliciting their views and reporting performance especially with respect to areas of concern and interest. In the latter perspective, disseminating performance data on a select number of KPI is one way for governments to nurture the building of a fiscal contract.

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