



Tax, Governance and Development

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Introduction

This paper outlines why taxation matters to Commonwealth developing countries, by not simply raising revenues to pay for development, but by shaping the governance context influencing that development.¹ In seeking to reduce poverty, promote growth and improve governance, the Commonwealth must pay more attention not just to how much revenue is raised through taxation or how it is spent in member countries, but also how taxes are generated. The paper concludes with ideas on how to promote tax reforms that improve governance.

There is overwhelming evidence of a strong association between effective governance and development, and between effective taxation and good governance.² Tax (meaning both domestic taxation and customs tariffs and excise) is a central concern to the Commonwealth because the ability to collect taxes is a core function of an effective democratic developmental state.

Tax collection is a core function of an effective democratic developmental state

The Importance of Taxation

Promoting better tax systems generally in the Commonwealth deserves priority because:

- Taxes, if designed well, can advance economic growth, lessen extreme inequalities, tackle climate change and fund the delivery of the Millennium Development Goals (MDGs), thereby significantly improving the lives of all citizens and especially poor people.
- Tax is a core part of state effectiveness and the most visible sign of the social contract between citizens and the state. Fair and transparent tax collection demonstrates good governance and shapes government legitimacy by promoting accountability to tax-paying citizens, and by stimulating effective state administration and good public financial management.
- Tax revenues that increase with economic growth ensure sustainable funding of essential public services ('public goods') such as security, health and education on which economic growth and social development depend.
- Rising tax revenues together with sustainable economic growth are the basis of an exit strategy to get developing countries out of aid dependency.

The way taxes are raised has profound effects on the type of state that develops

All countries, even the very poorest and most aid dependent, need to collect taxes. Yet, while low tax countries tend to have lower income per capita, higher per capita incomes are not necessarily associated with higher tax takes. For instance in 2003, Zambia with a per capita income of US\$785 collected 18.1 per cent of GDP in tax, whereas Uganda had a per capita income of US\$1,167 but collected only 11.4 per cent of GDP. What explains such differences?

The answer is complex. The tax 'system' comprises the politics, laws and regulations that set out a country's tax policy, combined with the administrative reality of how the policy is actually applied. Poor tax policies can undermine development. For instance, in Nigeria, persistent political uncertainty was reflected in the federal government estimation in 2004 that it collected only around 10 per cent of taxes due (with half the revenue collected then lost or embezzled).³ Examples from the French Revolution to contemporary Zimbabwe show declines in public revenues frequently inter-link with political violence and state failure.⁴ Levels of tax collection do not necessarily indicate that citizens perceive their state or government to be legitimate. Political violence in Kenya, a relatively highly taxed state, illustrates that collecting more taxes does not preclude violent challenges to the state's authority.

To raise taxes in a good way, tax systems should be:

- **Economically Efficient** – raising most revenue with the least cost and effort, and without creating a significant disincentive to work or invest;

- **Effective** – administratively capable of delivering the desired policy objectives at minimum administrative and compliance cost; and
- **Equitable** – offering fair treatment for taxpayers and promoting social cohesion. Tax systems and individual taxes should be as predictable, simple and transparent as possible, be internally consistent and be socially accepted as just.

These objectives are frequently in conflict. But difficult political choices must be made. The manner in which these policy choices happen is at the heart of the negotiated social contract, part of building a responsive state. Hence, the way taxes are raised has profound effects on the type of state that develops.

Tax and Governance

'Revenue is the chief preoccupation of the state. Nay more, it is the state'.⁵

Making tax systems efficient, effective and equitable is difficult everywhere, in particular in developing countries with weak political institutions, widespread corruption and poor administrative capacities. Too often this process of 'tax as state-building' does not happen: in many developing countries the tax base remains dangerously narrow, and its administration overly ineffectual or coercive. Different histories of taxation matter: in Western Europe taxes developed as a consequence of war and national mobilisation, whereas in many developing countries central taxes began as a colonial imposition.⁶ This has an important long-term influence on how people view the legitimacy of taxation.

Yet few governance challenges are as important as collecting taxes. As taxes supply the revenues to govern, establishing basic tax systems is a priority in even the most fragile contexts. Widespread corruption, tax avoidance and evasion by politically

influential businesses and access to tax havens by wealthy taxpayers all undermine efforts at taxation. The political challenge for building an effective state is not only *what* and *how* much to tax, but *how* to tax, *who* pays, and *why* – that is, the balance between degrees of ‘quasi-voluntary’ compliance⁷ and coercion. Below are four central aspects in the relationship between governance and taxation that matter in all countries.

Citizens, acting collectively, can be key in building checks and balances to provide oversight of the executive

Political settlement

Tax is always highly political. It is an expression of the ‘political settlement’ – the general understanding about how political power is organised and exercised – that defines the collective national interest. Taxes both fund public goods and help to entrench political authority.⁸ The political settlement for ‘elites to pay taxes’ is weak in many developing countries – too many politically powerful people are unwilling to pay their fair share of the tax burden to improve the effectiveness of the state.⁹ As a result, there is little political will to address huge inequalities by taxing easily identified assets such as property. In Kenya, for instance, the ‘tax gap’ of uncollected potential tax revenues by the last year of the Moi presidency in 2001 had reached at least 35 per cent, suggesting significant and increasing levels of tax evasion as taxpayer faith in the regime collapsed.¹⁰ This lack of ‘fiscal legitimacy’ exacerbates the doubts of ordinary citizens about whether governments will

spend tax revenues wisely. This can lead to an excessive use of coercion to raise tax, further alienating citizens from an already fragile state.¹¹

State legitimacy

Legitimacy strongly influences citizens’ willingness to pay tax.¹² State legitimacy emerges from the quality of governance institutions and the extent to which they deliver political stability, accountability, rule of law, the absence of violence, regulatory quality and control of corruption. An African state accepted as politically legitimate by its citizens is estimated to have annual growth rates up to 2.5 per cent higher than if the state’s legitimacy does not command popular support.¹³ The post-independence collapse in perceived legitimacy across Africa was reflected in tax evasion: in Malawi, for example, tax evasion increased seven-fold between 1972 and 1990.¹⁴ Trust in the government, in the justice system and in the legislature strengthens citizens’ confidence that government will spend tax revenues wisely and efficiently. This increases tax compliance, which in turn increases the efficiency of tax collection: for example, the widespread perception of government fairness and efficacy has built high tax compliance in Botswana.¹⁵

‘No representation without taxation’?

Tax has been central to the emergence of effective democracy at least since 1340, when the English Parliament for the first time explicitly linked its approval of taxation to the redress of public grievances over bad governance. Citizens as voter-taxpayers, acting collectively, can play a key part in building the constitutional checks and balances that provide oversight of the executive. This applies not only to the political evolution of all OECD countries¹⁶ but also in developing countries.¹⁷ In contrast, in the years immediately before the 1994 military coup in The Gambia, lost revenues rose to

9 per cent of GDP and income tax evasion expanded to 70 per cent of total revenue due.¹⁸

In democracies there is always a tension over fiscal discipline between citizens' interests as voters or citizens' concerns as taxpayers. In developing countries this relationship between the citizen as taxpayer or as voter is particularly difficult since most voters do not pay direct taxes. In Bangladesh, for example, less than 1 per cent of the population fall within the tax net, with 4 per cent of taxpayers (or less than 0.04% of the population) paying 40 per cent of the tax revenue while 50 per cent of taxpayers (less than 0.5% of the population) pay less than 1 per cent of the total tax revenue.¹⁹

The same 'social contract' is needed with the private sector. The informal sector is a major part of the economy in many developing countries in part because of low 'tax morale' (intrinsic willingness to pay taxes based on acceptance of the legitimacy and effectiveness of the state).²⁰ Business owners like all citizens do not want to pay taxes unless they feel the tax is legitimate, services will be delivered, and others are also paying their fair share.

Governments that finance themselves by persuasion rather than coercion are likely to be more democratic and provide more services

Tax morale

Creating high tax morale requires governments not just to compel but also to persuade. It is difficult to raise tax efficiently without 'bargaining' with citizens and building up their trust in

government.²¹ Tax levels reflect citizens' perception of the capability and responsiveness of the state. As a result, despite frequent tax changes, the government's share of national income usually remains remarkably constant, except where the political context changes. In Pakistan, for instance, as the legitimacy of the state collapsed from the early 1970s to 1995, tax evasion more than trebled, and continued thereafter in the climate of ongoing political turmoil and military rule that saw the tax/GDP ratio fall from 13.2 per cent in 1998 to 10.6 per cent in 2006.²² By contrast, the perception of a strong democracy creates consistently high tax morale in India²³ and in Botswana.²⁴

Fiscal Social Contract

Where governments must finance themselves by persuading rather than coercing their citizens, they are more likely to rule democratically and to spend money on providing services to citizens.²⁵ Progress will be most readily realised in a state that is already accountable, where taxpayers have representation and where the social contract already exists. These political economy dimensions shape the 'fiscal social contract', the implicit agreement between the state and its citizens that taxes are paid in return for good governance. A 'fiscal social contract' has two components:

- A high level of routine and institutionalised processes that enable citizens to be engaged in decisions about how public revenues are raised and spent;
- General acceptance that obligations to pay taxes ('contributive justice') and entitlements to the benefits of public expenditure ('distributive justice') are important components of citizenship.²⁶

These processes strengthen domestic accountability and encourage the emergence of civil society actors

State legitimacy and social cohesion are closely correlated with increasing tax compliance

and groups that can demand citizens' rights: 'No taxation without representation'.²⁷ That in turn promotes stronger oversight by parliaments, audit agencies and other oversight institutions, as well as business associations and the media that can scrutinise government revenues and expenditures. For example, taxation appears to be driving the emergence of a political 'voice' within the Commonwealth in the business communities in Uganda, United Republic of Tanzania, and Zambia.²⁸ Post-apartheid South Africa's strong 'fiscal social contract'²⁹ compares with the apparent lack of a 'fiscal social contract' delivering for the poor in Nigeria.³⁰

Strong political leadership also matters. The Rwanda Revenue Authority owes much of its success over the last 15 years to the country's president, who has led the campaign to change public attitudes to the importance of paying taxes for state building.³¹

Tax and Political Settlements

State legitimacy and social cohesion are closely correlated with increasing tax compliance.³² The tax/GDP ratio is strongly and negatively associated with the incidence of conflict: as taxation increases as a share of national economic output, conflict becomes less likely.³³ To achieve this, promoting tax systems that explicitly seek to build government legitimacy and effectiveness, creating in turn a culture of compliance among citizens, is particularly important for Commonwealth states like Sierra Leone that are fragile or emerging from conflict.³⁴

State legitimacy is built by delivering political order and core public services. The relative success of democratic legitimacy and state effectiveness in the Commonwealth therefore matters to taxpaying.³⁵ At the same time, the role of effective tax systems in creating better political representation, a stronger civil society 'voice' and a more effective bureaucracy means poor people are more likely to be better served by the government.³⁶ It is therefore possible to illustrate how taxation both shapes and reflects governance context (Table 1).³⁷

Reforming Tax Systems, Improving Governance

This paper has outlined why taxation matters for governance and development. How in practice can promoting better tax reform promote better governance?

The first step is to engage with the political process:

Politics matters!

- Understand the history and political context of taxation.
- Conduct 'tax morale' surveys of citizen attitudes to the legitimacy of the tax system at national and local level, and with the private sector.
- Strengthen the political rationale for broadening the tax base in ways that explicitly encourage citizen groups as taxpayers to seek political 'voice'.

The second step is to promote specific dimensions of governance:

Accountability

- Parliamentary and other institutional oversights of the tax authority.
- Media and civil society attention to tax, especially the importance of a sound tax system for poverty reduction and development.

Table 1. Political settlements shape the characteristics of tax systems³⁸

Type of Political Settlement	Politico-fiscal Dynamics	Indicative Tax System ³⁹
Fragile political settlements	<ul style="list-style-type: none"> Limited state legitimacy and political representation means tax policy very unstable. Tax base narrowly on trade; no direct taxes; excessive tax rates on the formal sector fuels corruption. Tax administration capacity extremely low and widely seen as corrupt. Tax collection relies on coercion further undermining very low compliance. Weak property rights, no credible growth strategy, limited political stability. 	<p>No or Low Tax Morale/Low Fiscal Social Contract/No Quasi-voluntary Compliance. Institutionalised Evasion. Low Tax Collection/Low Tax Effort. High Tax Rates/Low Social Spend/Regressive Taxation and Expenditure.</p> <p><i>Tax/GDP ratios:</i> e.g. Nigeria (6.1%) indicates non-tax revenues (i.e. oil); Bangladesh (9.3%); Pakistan (10.6%).</p>
Stagnant political settlements	<ul style="list-style-type: none"> Tax morale and compliance depend on support or opposition to regime, rather than to state. The 'fiscal social contract' is not evolving with changes in government capacity, economy and society. Tax administration capacity low, revenue collection stagnating or declining. Tax policy is unstable with a limited tax base. High tax effort achieved by enforcing indirect/trade taxes or imposing high taxes on the small formal sector. Personal direct tax mainly paid by government employees. 	<p>Low Tax Morale/Low Fiscal Social Contract/Limited Quasi-voluntary Compliance. Widespread Evasion. Low Collection/Low Effort/Low Rates/Low Social Spend.</p> <p><i>Tax/GDP ratios:</i> e.g. Uganda (12.2%); The Gambia (18.9%); Malawi (up from 13% in 1993 to 19.2% in 2002, 20.7% in 2010).</p>
Stable political settlements	<ul style="list-style-type: none"> The 'fiscal social contract' is weak, but tax morale strengthening and beginnings of quasi-voluntary compliance. Tax administration capacity low. Tax policy regime stable. Tax effort evolving from enforcing 'easy' indirect/trade taxes. 	<p>High Tax Morale/Low Fiscal Social Contract/Growing Quasi-voluntary Compliance. Contained Evasion. Low Collection/High Effort/Low Rates/Low Social Spend.</p> <p><i>Tax/GDP ratios:</i> e.g. Zambia (17%, with 93% effort)</p>

Strengthening political settlements	<ul style="list-style-type: none"> Increasing state effectiveness generates moderate tax morale, allowing ‘fiscal social contract’ to evolve; and growing quasi-voluntary compliance may be creating ‘democratic developmentalism’. Tax administration capacity improving. Tax policy regime stable and often progressive, with effort to tax incomes to reduce inequality; taxing property consolidating property rights helps in supporting economic growth and political stability. 	<p>Growing Tax Morale/High Fiscal Social Contract/Improving Quasi-voluntary Compliance. Limited Evasion. High Collection/Low Effort/Low Rates/High Social Spend/Progressive Taxation and Expenditure.</p> <p><i>Tax/GDP ratios:</i> e.g. Mozambique (rise from 8.5% in 1993 to 15% in 2010), Tanzania (rise from 9% in 2001 to 14.6% in 2010); India (16.4% but only 52.2% effort).</p>
Contested political settlements	<ul style="list-style-type: none"> High contestation of legitimacy polarised by coercion of political opposition, and consent from regime supporters. Tax policy regime may be relatively stable with broader tax base. Tax administration effective but often corrupt. High tax effort achieved by enforcement on the small formal sector, and relies more on effective coercion than consent. Weak property rights; limited growth strategy; poor political stability. 	<p>Low Tax Morale/Low Fiscal Social Contract/Low Quasi-voluntary Compliance. Widespread Evasion. High Collection/High Effort/High Rates/Low Social Spend.</p> <p><i>Tax/GDP ratios:</i> e.g. Kenya (18.4%) suggests that high tax collection does not preclude violent challenges to the political settlement.</p>
Effective/inclusive political settlements	<ul style="list-style-type: none"> High degree of state legitimacy creates high tax morale. The formal or informal ‘fiscal social contract’ is vibrant, by political process of persuasion and negotiation, leading to high rate of quasi-voluntary compliance. Stable tax policy in which direct taxes – personal, corporate, social contributions – significant. Competent, non-corrupt tax administration. Effective property rights; growth strategy; political stability. 	<p>High Tax Morale/High Fiscal Social Contract/High Quasi-voluntary Compliance. Limited Evasion. High Collection/Medium or High Effort/High Rates/High Social Spend.</p> <p><i>Tax/GDP ratios:</i> Effective and inclusive tax in evolving democracies, e.g. Ghana (20.8%), Namibia (26.1%) and Lesotho (42.9%); in more established democracies, e.g. Mauritius (20%) and Botswana (35.2%).</p>

Fair domestic taxation systems promote the effective democratic governance on which development depends

- Taxpayers associations to demand greater accountability.
- Greater visibility of direct taxation – income and property taxes – that appear to be particularly important in promoting political representation.
- Link taxes paid and benefits/services received – compliance rates go up when citizens and businesses know what they are getting in return for their payments.

Responsiveness

- Balance discretionary powers of the tax authority with taxpayer rights, a customer service attitude to taxpayers and a better appeals process to improve trust.

Transparency

- Private sector associations formally engaging with government over tax policy and its administration.
- Transparent laws, regulations and procedures.

Capacity

- International networks of tax administrators, to raise professional standards and ethics.
- The capacity, accountability and transparency of sub-national taxation.

Conclusion

These operational proposals are first steps; research on the complex relationship between governance and taxation is still in its infancy. But it is clear that sound and fair domestic taxation systems promote the effective democratic governance on which development depends. Tax reforms that advance better governance are also central to ending aid dependency, so improving taxation is essential for many Commonwealth developing countries. In the words of the Kenyan Revenue Authority, 'Pay your taxes and set your country free'.⁴⁰

Notes

- ¹ This Discussion Paper builds on earlier work by the author, Max Everest-Phillips, including 'Business tax as state-building in developing countries: applying governance principles in private sector development'. *International Journal of Regulation and Governance* 8 (2): 123–154; the Department for International Development, UK. 2009. 'Why Tax Matters for International Development'. Briefing Note; and, 2010. *State-Building Taxation for Developing Countries: Principles for Reform*. *Development Policy Review* 28: 75–96.
- ² See, for example, Rodrik, D, A Subramanian and F Trebbi. 2002. 'Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development'. *Journal of Economic Growth*, Vol. 9, No. 2, pp. 131–65.
- ³ OECD and African Development Bank. 2008. *African Economic Outlook*. Paris.
- ⁴ Bates, R. 2008. *When Things Fell Apart: State Failure in Late-Century Africa*. Harvard; Kwass, M. 2000. *Privilege and the Politics of Taxation in Eighteenth-Century France: Liberté, Égalité, Fiscalité*. Cambridge.
- ⁵ Edmund Burke quoted in P O'Brien. 2001. 'Fiscal Exceptionalism: Great Britain and Its European Rivals'. LSE Paper 65/01: p. 21.
- ⁶ Examples include the Hut Tax war in Sierra Leone in 1898.
- ⁷ Compliance is always the combined outcome of the intrinsic and the instrumental willingness to pay tax, along with taxpayer acceptance of the level of tax burden and the effectiveness of enforcement.
- ⁸ Besley, T et al. 2007. 'The Origins of State Capacity: Property Rights, Taxation, and Politics'. CEPR; DFID. 2007. *State-building*.
- ⁹ Stotsky, J and A WoldeMariam. 1997. 'Tax Effort in Sub-Saharan Africa'. IMF WP/97/101, Washington, DC.
- ¹⁰ Kenya Institute of Public Policy Research and Analysis. 2004. *Tax Compliance Study*. Tax Policy Unit, Macroeconomics Division, Nairobi. The Kenyan Revenue Authority seems to believe it to be higher, over 40 per cent – see www.revenue.go.ke/speeches/cgspeechtax100304.html
- ¹¹ For example, Juul, K. 2006. 'Decentralization, Local Taxation and Citizenship in Senegal'. *Development and Change* 37.4: 821–46.
- ¹² Torgler, B et al. 2007. 'Tax Compliance, Tax Morale and Governance Quality'. Working Paper 2007/17; Feld, L et al. 2007. 'Tax Compliance as the Result of a Psychological Tax Contract: The Role of Incentives and Responsive Regulation'. *Law & Policy* 29 (1): 102–120; Scott, J. 1987. *Resistance without Protest and Without Organisation*.
- ¹³ Englebert, P. 2002. *State Legitimacy and Development in Africa*. Cambridge.
- ¹⁴ As a percentage of actual total tax revenue and of potential tax revenue, tax evasion declined between 1972 and 1974, thereafter rose rapidly and was about 60 per cent of actual tax revenue and 37 per cent of potential tax revenue in 1990, representing seven-fold and four-fold increases, respectively. Chipeta, C. 2002. 'The second economy and tax yield in Malawi'. African Economic Research Consortium.
- ¹⁵ Cummings, R et al. 2005. 'Effects of Culture on Tax Compliance: Experimental and Survey Evidence'. Georgia State University Working Paper.
- ¹⁶ North, D. 1990. *Institutions, Institutional Change, and Economic Performance*. Cambridge. High-income countries have high tax 'take' that

pays for public services and ‘public goods’ such as effective legal systems that help to generate and maintain the state’s high legitimacy.

- ¹⁷ For example, Clapham, C. 2000. War and State formation in Ethiopia and Eritrea; Fjeldstad, O-H. 2004. To Pay Or Not to Pay? Citizens’ Views on Taxation in Local Authorities in Tanzania. IDS.
- ¹⁸ Dia, M. 1993. A Governance Approach to Civil Service Reform in Sub-Saharan Africa. World Bank Technical Paper. 225. Washington, DC: World Bank.
- ¹⁹ Sarker, T and Y Kitamura. 2006. Technical Assistance in Fiscal Policy and Tax Administration in Developing Countries: The State of Nature in Bangladesh. Keio University Tokyo.
- ²⁰ Torgler, B and F Schneider. 2007. Shadow Economy, Tax Morale, Governance and Institutional Quality: Panel Data. IZA Discussion Paper No. 2563.
- ²¹ An increase in the trust in government by one unit increases tax morale by over 5 per cent. Torgler, B. 2001. What Do We Know about Tax Morale and Tax Compliance? *International Review of Economics and Business*, 48: 395–419.
- ²² Saeed, K. 1996. Principle of Taxation: Taxation System of Pakistan. *Pakistan Journal of Public Administration*, January–June 1996.
- ²³ Torgler, B. 2004. Tax Morale in Asian Countries. CREMA working paper.
- ²⁴ Cummings, R. et al. 2005. Effects of Culture on Tax Compliance: Experimental and Survey Evidence. Georgia State University Working Paper.
- ²⁵ Ross, M. 2004. Does Taxation Lead to Representation? *The British Journal of Political Science*, 34: 229–249.
- ²⁶ Moore, M. 2006. How Does Taxation Affect the Quality of Governance? IDS.
- ²⁷ For example, Levi, M. 1988. *Of Revenue and Rule*. Berkeley; Di John, J. 2006. The Political Economy of Taxation and Tax Reform in Developing Countries. WIDER.
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- ³¹ World Bank/FIAS. 2006. Rwanda country study. Washington DC: p. 89.
- ³² Torgler, B. 2007. Tax Compliance and Tax Morale: A Theoretical and Empirical Analysis. Cheltenham.
- ³³ Hendrix, C. 2007. Leviathan in the Tropics? Environment, State Capacity, and Civil Conflict in the Developing World.
- ³⁴ Bird, R et al. 2006. Societal Institutions and Tax Effort in Developing Countries. In Alm et al (eds.), *The Challenges of Tax Reform in the Global Economy*. New York. The size and nature of tax systems largely reflects the political context. See also Acemoglu, D. 2005. Politics and Economics in Weak and Strong States. NBER.
- ³⁵ The World Bank’s World Governance Indicators, for instance, give the Commonwealth high average scores on all its six indicators.

³⁶ For example, Brautigam, D. 2007. Contingent Capacity: Export Taxation and State-building in Mauritius.

³⁷ See also Di John, J. 2008. Political Economy of Taxation. IFC. Washington DC; Fox, W and T Gurley. 2005. An exploration of tax patterns around the world. *Tax Notes International* 28 February: 793–805.

³⁸ Inspired by Le et al (2008) who compare tax collection capacity and tax effort in the different countries: i) taxable capacity as the predicted tax-GDP ratio taking into account a country's specific economic, demographic, and institutional features; and ii) tax effort as an index of the ratio between the share of the actual tax collection in GDP and the potential or predicted taxable capacity. Le et al (2008) then classified countries by their level of actual tax collection and attained tax effort.

³⁹ Tax/GDP ratios taken from IMF. 2010. Statistical Appendix 2005–2009. Washington DC.

⁴⁰ Kenyan Revenue Authority slogan, 2007.



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