UNU-WIDER development conference

Fiscal states in Developing Economies

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UNU-WIDER's Fiscal States project

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This project is part of the 'Domestic Revenue Mobilization' programme.

16 PEACE, JUSTICE AND STRONG INSTITUTIONS

TEAM

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This project will combine country case studies, cross-country econometric analysis and comparative historical analysis to examine the effects of fiscal states in low- and middle-income countries and its economic, political and historical determinants.

A central aspect of institutional development in developing economies is building tax systems capable of raising revenues from broad tax bases, i.e. acquiring fiscal capacity. While it is recognised that fiscal capacity is pivotal for state-building and economic development, it is less clear what its origins are and what explains its cross-country differences.

This research will combine qualitative country case studies with microeconometrics and cross-country econometric analysis to examine the economic, political and historical determinants of fiscal (taxation) capacity in low- and middle-income countries. Facilitating a new collaborative discussion

Project background

- Modern states: complex organizations, have an important role in economic and human development
  - Provide crucial public goods and services (universal education, public health systems, and an effective administration of justice).
- But how do we finance state activities?
- Understanding the process of transformation of public finance institutions, or the emergence of *fiscal states*, a fundamental part of becoming an effective state.
- Not only an academic question…
  - SDG 17.1, 'strengthening domestic resource mobilisation' to finance development goals.

The relevance of the fiscal question

- Consider taxation: central to finance state activities. Yet…
- Stylised facts suggest that developing economies collect, on average, a significantly smaller share of taxes compared to advanced market economies.
- What explains this?
  - Is it (only) the organisational performance of national revenue administrations?
  - Or should we instead also look at the economic, political and historical conditions that help consolidate taxation?

Total revenues/GDP, 1995-2020

Figure 1 - Total non-resource taxes/GDP, by level of economic development, 1995-2020

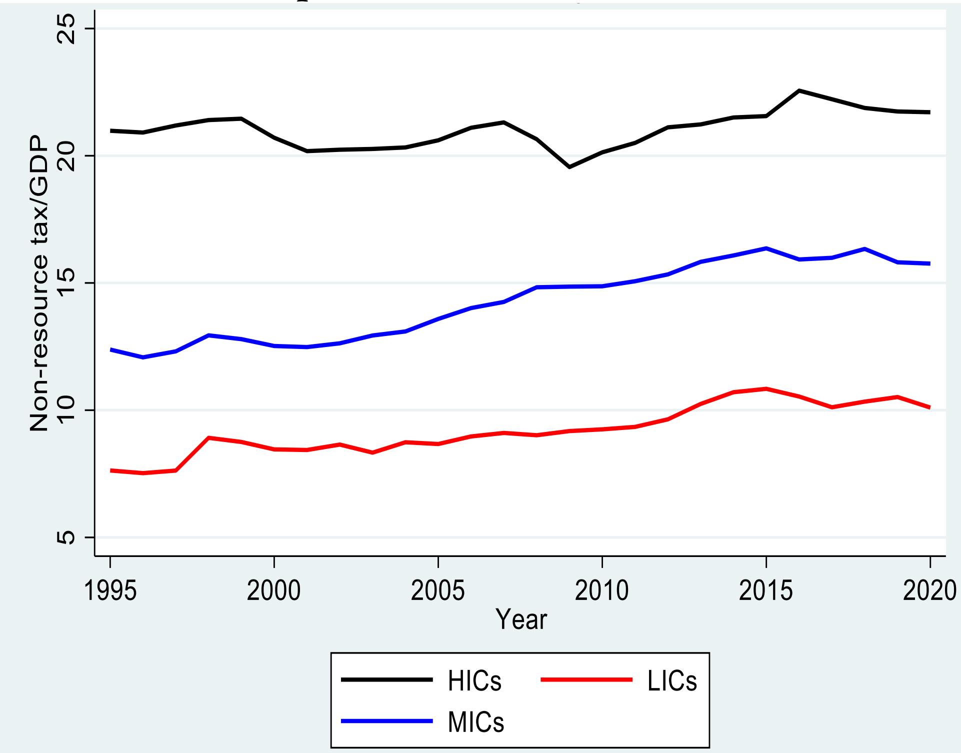
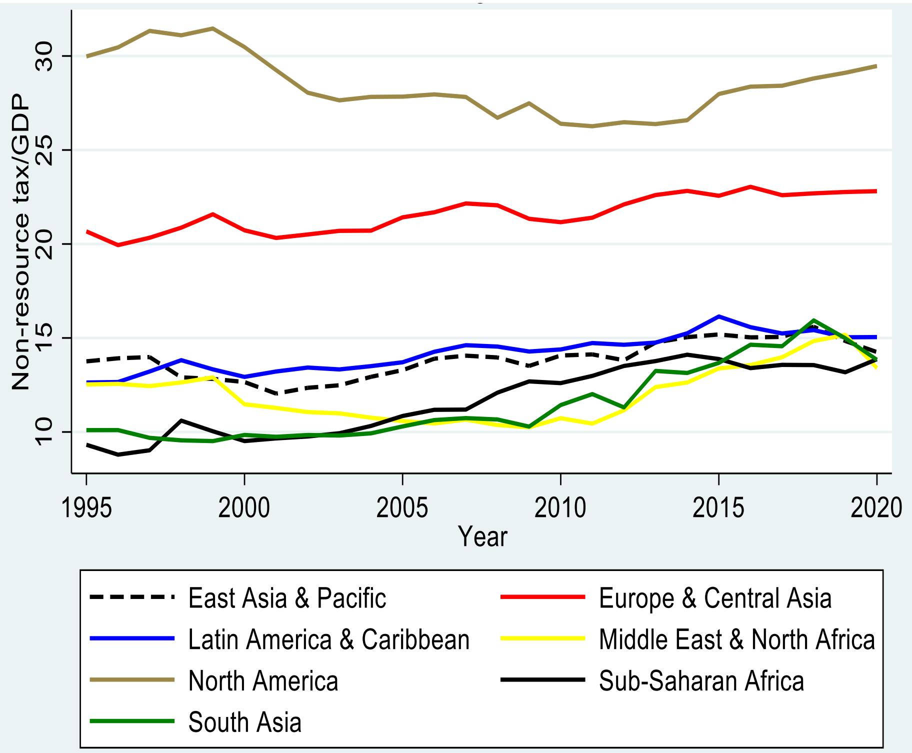


Figure 2 - Total non-resource taxes/GDP, by region, 1995-2020



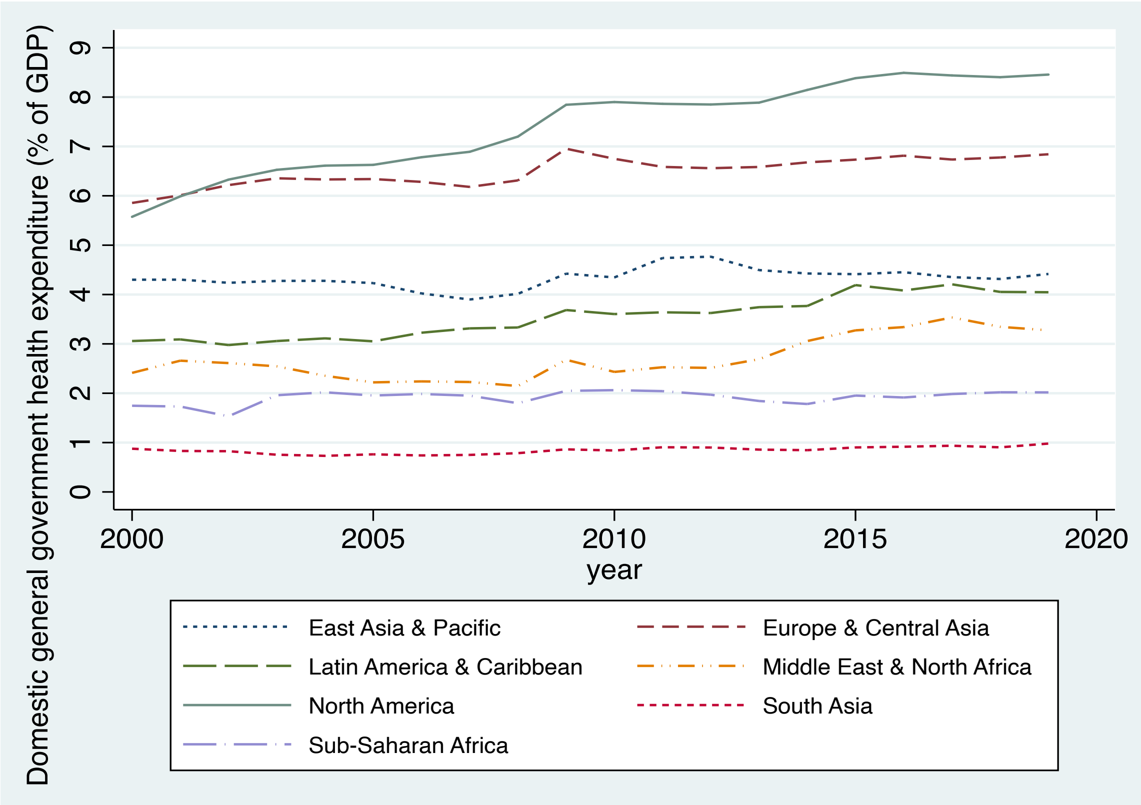
Source: UNU-WIDER Government Revenue Dataset'. Version 2022. https://doi.org/10.35188/UNU-WIDER/GRD-2022.

The relevance of the fiscal question, ctd.

- And what are the developmental consequences?
- Three reasons why the emergence of fiscal capacity matters for economic and social development…
  1. Governments that are able to obtain more tax revenues are more likely to spend more on both education and health.
  2. Fiscal capacity may provide developing countries with access to tax and spending instruments with significant distributional impacts (e.g., progressive tax systems, income taxation).
  3. The rise of taxation should come with a 'governance dividend': the quality of government should improve, as a result greater government accountability, because the taxpaying citizenry will subject the ruler to increased scrutiny.

Gov. Expenditure on Health, 2000-2021

Government Expenditure on Health as a percentage of GDP, 2000-2021



Source: World Bank, World Governance Indicators 2022, https://info.worldbank.org/governance/wgi/.

Voice and Accountability, 1996-2021

Voice and Accountability, High- versus Low-Income Countries, 1996-2021

Source: World Bank, World Governance Indicators 2022, https://info.worldbank.org/governance/wgi/.

Special issue: *Journal of Institutional Economics* Open access!

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What are the origins of fiscal capacity?

Political determinants

- Executive constraints are a structural condition for fiscal development, as well as the emergence of broad-based taxation (Savoia, Sen and Tagem)
- Role of legislatures in non-democratic states: institutional oversight through legislature is positively related to the adoption and expansion of income taxes in non-democratic regimes (Andersson)

Institutional determinants

- Complementarity between formalisation of property rights on land and taxation (Nistoskaya and D'Arcy).
- States' ability of gather salient information on the territory they administer (*information capacity*) as a necessary condition for fiscal capacity (vom Hau, Peres Cajias and Soifer).
- Non-tax revenues and vertical accountability associated with higher tax capacity in Africa (Tagem and Morrissey)

Historical origins

- Pre-colonial centralization (Ali and Fjelstad), long-run effects of pre-colonial institutions on tax compliance norms in Uganda.
- Using Rwanda as a case-study, Heldring and Robinson argue that local political institutions predating the establishment of African states were based on a social contract that did not allow the emergence of centralised tax systems.

Lessons for development policy

1. Rome wasn't built in a day.
   – Developing fiscal states is a long-term process. Countries do not go straight from old to new forms of public finance. There are intermediate steps to becoming a modern fiscal state.

2. History matters.
   – Historical conditions cast a long shadow and shape today's possibilities. Understanding of how such mechanisms work explains why tax reforms work in some contexts, but not others.

Lessons for development policy, ctd.

3. Politics matters.
   - Important to understand the politics behind the fiscal contract between state and citizens. Developing effective and accountable political institutions is key to the emergence of fiscal states. This implies that there are significant interlinkages between SDG 17 and SDG 16.
4. Do not look at fiscal capacity in isolation.
   - Invest in other dimensions of state capacity that support tax system development, such as information capacity and property rights protection. Developing fiscal capacity hinges on simultaneous institutional reforms in other areas. Complementarities are important.