Tax capacity in fragile states: Trends, challenges, and policy options

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- Achieving greater revenue mobilisation can be an effective strategy for countries to break out of fragility.
- Evidence suggests that tax revenue has a larger impact on fragility dynamics than non-tax revenue.
- This brief summarises research on tax revenue trends and key challenges in mobilising tax revenue in fragile states and explores avenues for policy reform.
- Given the complexity of raising tax capacity in fragile settings, there is no one-size-fits-all solution but localised approaches that combine administrative and tax policy reform with appropriate sequencing can result in positive, sustainable results.

POLICY BRIEF

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The tax and fragility nexus

Weak state capacity is a defining characteristic of fragile and conflict-affected settings and is often manifested in governments' inability to raise sufficient revenue for delivery of public goods and services.[1] **Low revenue capacity generates a vicious cycle**, where governments have insufficient revenue to invest in tax enforcement to mobilise greater revenues to fund public goods and, consequently, they continue to under-collect tax.

Achieving greater revenue mobilisation can be an effective strategy for countries to break out of fragility, and evidence suggests that tax revenue has a larger impact on fragility dynamics than non-tax revenue. A tax-to-GDP ratio of 13% is associated with a marked and sustained rise in real GDP per capita levels, and a 15% ratio is an accepted threshold for effective public service provision and economic development (Gaspar et al., 2016; IMF, 2017; Thompson, 2020). In contrast, non-tax receipts, especially those from the natural resource sector, are more limited in their contribution to broad-based prosperity and more prone to misuse (IMF, 2017).

Taxation impacts on state-building through a variety of channels. Greater tax mobilisation can increase provision of public goods, stimulate citizens' political engagement by creating a participation dividend, promote government accountability, and help rebuild the social contract. These impacts are evidenced in work from the Democratic Republic of Congo (DRC), where it was found that property tax raised citizen political participation and demands for more accountable government, improved the perceived performance and legitimacy of the government, and helped rebuild the social contract.[2] Citizens also had more positive perceptions of the provincial government, perceiving more revenue, less leakage, and a greater responsibility to provide public goods.

Tax revenue trends in fragile states: Weak performance and low diversification

Despite modest improvements in revenue mobilisation over the years, **fragile states have consistently underperformed other developing economies on revenue mobilisation by 4-6 percentage points on average**, remaining below the 13% tipping point for increased GDP per capita (Akitoby et al., 2020). Only a third of the OECD's classified 43 fragile states have reached 15% tax-to-GDP ratios (Thompson, 2020).

Significant variation exists between countries and over time. Tax performance collapses in settings undergoing conflict or having recently exited from it, with tax-to-GDP ratios being as low as 1-3% in countries

1 LSE-Oxford Commission on State Fragility, Growth and Development, 2018.
2 Citizens in taxed neighbourhoods were more likely to attend town hall meetings hosted by the government or submit evaluations of its performance.

such as Afghanistan, DRC, Timor-Leste, and Libya IMF, 2017; Mansour & Schneider, 2019). Exceptions do exist though: Liberia and Mozambique, for example, while remaining relatively fragile, have managed to double their tax revenue since the early 2000s, achieving ratios of over 20% today. Nonetheless, increasing tax revenue in a sustainable manner remains a formidable challenge for most fragile contexts.

Importantly, increased tax capacity alone is not a guarantee for greater stability and shared prosperity. Rather, the **type of taxes levied** and **how revenues are spent** also have key implications for state fragility (Fjeldstad et al., 2018).

Fragile contexts tend to rely on only a **few revenue sources**, resulting in **revenue structures that are poorly diversified and vulnerable to shocks**, especially compared to non-fragile developing countries (IMF, 2017). In particular, fragile states tend to rely heavily on:

- **Customs taxes**, which are comparatively easier to collect due to concentration at border posts, with customs tax comprising, on average, 19% of total taxes in fragile states compared to 15% in non-fragile states (Mansour & Schneider, 2019).

- **Revenue from the natural resource sector** makes up the bulk of revenue in many fragile settings, which poses many risks, including high revenue volatility (due to fluctuating commodity prices), lower government incentives to invest in fiscal capacity and institution-building, and a weaker social contract between government and citizens (Braütigam et al., 2008; Fjeldstad et al., 2018; Besley & Mueller, 2019).

Fragile settings usually exhibit **poorer performance** on:

- **Direct tax instruments**, such as personal or corporate income tax, property tax, or capital gains tax. These account for a small share of total tax revenue in fragile contexts, although they are significantly greater in resource-rich, fragile economies (IMF, 2017).

- **VAT, GST, and other indirect taxes**. For example, VAT and GST comprise 5% of GDP and 38% of total revenue for fragile settings, on average, against 8% and 46% in non-fragile countries (Mansour & Schneider, 2019.). This may be due to collection challenges or political economy dynamics, arising in part from their more regressive nature. These trends seem to hold regardless of the level of resource-intensity of the economy (Akitoby et al, 2020).

Critically, as states transition out of fragility, they tend to rely less on customs tax and more on VAT and GST and direct taxes (Mansour & Schneider, 2019).

Key challenges in mobilising tax revenue in fragile settings

Tax collection hinges on the social contract, a complementary relationship between governments and citizens. Public authorities need the capacity and infrastructure to develop and enforce tax policies and regulations; however, relying heavily on monitoring and coercion is ultimately too costly and government's ability to collect sufficient revenue ultimately depends on **citizens' voluntary compliance** (Besley & Mueller, 2019; Braütigam et al., 2008). Citizens' willingness to comply with tax obligations depends on tax morale, which is determined by several non-financial motivations for tax compliance (see **Box 1**).

BOX 1: FACTORS INFLUENCING TAX MORALE[3]

- Intrinsic motivation or privately held beliefs, perceptions, and feelings, such as the feeling of guilt or shame for failure to comply
- Social norms and peer behaviour, including the possibility of social recognition or sanctions from peers
- Reciprocity, or willingness to comply in turn for receiving something from government in the form of public goods and services.

Many advanced economies exhibit good state-citizen relationships, with growing levels of tax capacity due to a stronger tax apparatus and a more effective social contract between the state and citizens. **The state-citizenship relationship is weak or broken in most fragile states**: governments tend to lack the capacity and incentives to enforce tax collection and citizens are unwilling to pay tax unless coerced, resulting in low tax mobilisation. Government incentives to invest in tax capacity can be diminished due to numerous factors, including large post-conflict aid grants and low prioritisation of longer-term investments in fiscal capacity due to continued instability and uncertainty.

Low voluntary compliance arises from weak tax morale and civic culture, which is often the result of **a lack of state legitimacy**. Citizens do not expect the state to use revenues for the public benefit due to issues of corruption, weak checks and balances on power, and ethnic or elite favouritism (Besley & Mueller, 2019). A range of non-government entities, including NGOs and private firms, often to step into the gap to provide public services, often inadvertently further eroding state legitimacy and citizens' willingness to comply with tax obligations (Cantens & Raballand, 2021).

3 Luttmer & Singhal, 2014.

Parallel systems of informal taxation often arise in fragile contexts due to armed and opposition groups disputing government authority in areas not controlled by the government. This gives rise to complex rival taxation systems and, since non-government groups may enjoy higher levels of legitimacy on the local level (because they better address local needs, for example), they may also be more effective in tax mobilisation. Examples are seen in remote areas of DRC, Somalia, and Myanmar (Bandula-Irwin et al., 2021). Revenues collected by non-government groups can fund and fuel intrastate divisions and divert revenue from official channels, thereby reducing the tax capacity of the national government.

War and violence also have direct impacts on economic systems through, for example, a sharp reduction in formal economic activity and damaged infrastructure. The tax base is eroded through more widespread poverty and an expanding informal sector. Intrastate conflicts that affect economically important border regions are likely to have damaging effects on customs administration. Government is also constrained by destruction of public records and loss of data, inability to reach certain areas of the country, and shortage of manpower to administer and collect taxes (Fjeldstad et al., 2018).

In addition, due to structural differences in firm size and labor markets, fragile state governments face **informational barriers that limit their tax-raising potential**. In contexts where informal self-employment is pervasive in the economically active workforce, what can be observed of the income tax base is limited, making it difficult to enforce personal income tax. Instead, governments shift their limited enforcement capacity to **more readily observable tax sources**, such as customs taxes, thereby producing very different dynamics and outcomes than those observed in more developed countries.

Avenues for policy intervention

Given the complexity of raising tax capacity in fragile settings, **appropriate policy interventions need to look beyond purely technocratic approaches to factor in the broader issues that affect fiscal capacity**, including trust in the state, cohesiveness, civic culture, legitimacy, and formation of a social contract between citizens and the state. In addition, policymakers of fragile countries need to be open to using second- or even third-best options as optimal solutions for their contexts, at least in the short- and medium-term.

There is no one-size-fits-all solution to scaling tax capacity in fragile contexts and localised approaches that combine administrative and tax policy reform with appropriate sequencing – linked to opportunity and wider political factors – can result in positive, sustainable results, as demonstrated by Liberia, Malawi, and the Solomon Islands in **Box 2** below.

Effective tax administration and tax policy reform is likely to be dependent on the geographic scope of the intervention. **Local approaches** to policy intervention might be preferred to national-level approaches in certain fragile contexts. Local governments may be less likely than national governments to represent the interests of only part

of their constituent population, making it easier for them to overcome the legitimacy issues that often affect national governments in fragile states. Since transfers from the central government are typically limited in fragile contexts, local governments may also have stronger incentives to improve local revenue collection.

BOX 2: EXAMPLES OF COUNTRIES THAT HAVE SUSTAINABLY INCREASED THEIR TAX CAPACITY[4]

Liberia – Tax to GDP increased from 6.7% to 14.2% between 2003 and 2012. Tax policy reforms included expanding the taxable base for goods and services while utilising excise tax and reducing duty and tax exemptions.

Malawi – Tax to GDP increased from 9% to 20% between 2002 and 2013. The sequencing included tax policy reforms that contributed to initial gains (such as expanding the tax base, reducing fuel subsidies, and reforming tax exemptions), which were supported by administrative reforms (including establishing a revenue authority that merged the existing customs and excise departments).

Solomon Islands – Tax to GDP increased from 10% to 30% between 2001 and 2013. The government focused strategically on the high-yield logging industry, then tackled tax exemptions and undertook tax administration reforms.

Fiscal federalism and building fiscal capacity at the local level may help improve revenue collection and are associated with lower levels of conflict when **combined with strengthening local political and administrative structures**. In addition, local control over expenditure strengthens state legitimacy, especially in contexts of ethnic diversity and natural resource revenues (Siegle & O'Mahony, 2010).

Critically, policy interventions in fragile settings should aim to **strengthen the weak social contract by targeting both citizens**, by raising (ideally voluntary) compliance and the state, through both tax administration and tax policy reform. **Access to information** and accompanying **enforcement measures** are also critical.

(i) Citizens: Improving taxpayer compliance

Increasing citizen willingness to pay taxes can help increase revenue collection and feed into a positive reinforcement cycle: increasing visible service provision can raise citizen engagement and support willingness to pay.

Strategic communication from tax authorities can be leveraged effectively and at very low cost, with two broad kinds of messaging:

- **Deterrence messages**, whereby tax officials adopt direct communication, such as letter interventions, that remind citizens

4 Akitoby et al., 2020.

of their tax obligations, the likelihood of being inspected, or the penalties for evasion. Evidence suggests that this approach can increase taxpayers' perception of tax authorities' enforcement capacity and thereby lead to higher tax compliance. These messages are particularly effective when they are simple, have a credible threat of enforcement, and target areas with low state capacity where there have been recent investments in public goods (Cohen, 2020). It's vital, however, that information about enforcement threats is followed up by **actual and continuous enforcement efforts** for this to be effective. Findings also suggest that such communications have sizable spillover effects.

- **Messages to boost tax morale**, whereby government communication on tax rules and obligations target citizens' non-financial incentives to comply with taxes, i.e., their tax morale, which is influenced by intrinsic motives, social considerations, and reciprocity. Tax morale can be activated by communicating that paying taxes is the 'right thing to do' or is a 'civic duty', for example. Evidence is mixed on whether and what policy tools can meaningfully shift tax morale.

Messaging alone may not boost compliance, as suggested by the mixed evidence in this area. Rather, **undertaking messaging *after* improving provision of public goods and services could be more successful** in terms of increasing tax compliance and political stability. This is consistent with the largest increases in tax mobilisation seen in advanced countries during the world wars, when value of public goods – notably security – was high. Findings from fragile and developing settings confirms this, suggesting that when governments undertake actual, tangible changes in the delivery of public goods ***first***, taxpayers' willingness to reciprocate grows (see some successful examples of this in **Box 3**). It may be possible to peacefully shift to a new equilibrium of higher tax compliance with a sufficient initial investment to improve provision of public goods and services, perhaps financed through foreign aid or other transfers (Krause, 2020).

BOX 3: EXAMPLES OF PUBLIC GOODS PROVISION LEADING TO INCREASED WILLINGNESS TO PAY TAX

Haiti – An experiment showed that providing a valuable and visible public good (namely municipal garbage removal) **increased tax compliance** by 27% and **reduced localised political violence** by 85%. A cost accounting exercise suggested that providing the public good in this setting could pay for itself within the first year (Krause, 2020).

Pakistan – An ongoing study suggests that provision of local public goods can increase property tax compliance by 10%. Crucial to this idea is (i) **public goods must be observable** by the local communities (e.g., garbage collection, pothole repair, gutter clearing, streetlight repair) and (ii) **taxation must be direct** (Hussain et al., 2017).

Messaging and expanded provision of public goods and services appear complementary and jointly necessary. Ongoing research from Punjab, Pakistan is studying whether increasing urban services to match citizen preferences can improve the social contract and attitudes towards taxation. Early results show that despite an increase in service provision, citizens are unaware of having received greater local goods; hence, it has not affected citizen attitudes towards the state. The next stage of this work will involve **increasing public awareness of service delivery** and exploring whether greater public awareness results in improved attitudes towards the state through increased tax payments (Khan et al., 2022).

I**n more fractured societies and contexts of low government legitimacy, who delivers the tax-related message appears to be important**. For example, chiefs and other local leaders often enjoy greater legitimacy than the national government in many fragile settings. Evidence from Kananga, DRC shows that chiefs achieved higher tax compliance than state agents due to their superior local information about potential taxpayers – information that the national government lacked. Findings also reveal that working with local leaders increased revenue and trust in government and improved the accountability of chiefs.[5]

(ii) The state: Tax administration and tax policy reform

Tax administration reform

In lower-income contexts, administrative reform can be as critical as improving tax policy in terms of alleviating capacity constraints and **tax administration reform could be a more viable and immediate area of focus** for fragile state governments. Tax administration reform could focus on:

- **Increasing the capacity of tax offices through greater funding and staffing, for example**. Evidence from Indonesia shows that introducing large and medium taxpayer offices, with increased resources devoted to larger firms in the economy, increased collection capacity by several percentage points (Basri et al. 2021).

- **Optimising collector teams and assignments.** This can significantly increase tax revenue and compliance at little or no added cost. The optimal assignment teams the best collectors together and high ability teams are assigned to the neighbourhoods with the greatest revenue potential (Bergeron et al, 2021)[6].

- **Improving behaviour of tax collectors through use of monetary and non-monetary incentives**. Studies from Pakistan show that the introduction of **performance pay** for tax collectors had positive impacts on individual collection performance – provided that monitoring tools were in place to limit potentially adverse impacts, such as bribes (Khan et al., 2019). Additionally, ensuring

5 Chief collection raised tax compliance by 3.2 percentage points, increasing revenue by 44%. Chiefs collected more bribes but did not undermine tax morale or trust in government.
6 To maximise tax revenue, the government should (i) form teams of exclusively high- or low-type collectors (no mixed teams) and (ii) assign high-type teams to high-type households and low-type teams to low-type households.

that performance schemes account for tax officials' preferences in posting locations can also boost tax collection capacity, with findings from Pakistan indicating a 30-41% increase in tax collected when using such schemes Khan et al., 2019).

- **Regularising tax assessment and collection procedures**, such as through updated tax rolls and points-based assessments. For instance, updating property tax rolls in the DRC conveyed transparency to citizens and resulted in increased tax compliance, demonstrating that **perceived fairness** is crucial to increasing willingness to pay (Weigel & Ngindu, 2021). Introduction of a points-based assessment in Freetown, Sierra Leone reduced potential for revenue leakages and encouraged voluntary compliance by taxpayers (Grieco et al., 2019).[7] The appeal of the points-based methodology is that it combines the relative simplicity of implementation with significant accuracy and progressivity and a very high level of transparency.

Improvements to tax administration can increase collection – directly, as well as indirectly by improving the effectiveness of tax policies. Evidence from DRC where a study randomly assigned individual tax rates and enforcement letters to individual property owners found that improved enforcement and higher tax rates are complementary (Bergeron et al., 2021). The increase in tax revenues resulting from a higher tax rate is larger in a strong enforcement environment than in a weak enforcement environment. Administrative reforms are, therefore, key to expanding the feasible set of reform options that are available to governments.

Tax policy reform

Reforming and innovating tax policy in fragile contexts is undeniably ambitious due to the limited skills and human resources existing in public administrations. Nonetheless, as countries progress towards greater stability, certain areas of tax policy reform should be considered, including:

- **Adopting more progressive taxation**. Simplified tax instruments are often regressive and, consequently, can undermine tax morale and revenue collection. In contrast, more progressive tax instruments and tax rate structures have the potential to increase tax morale and revenue collection because they are perceived as more fair.

- **Scaling collection from property tax**. Property taxes are the most underutilised tax in low-income countries. There are large increases in urban land values going untaxed while demand for urban public goods is rising. As a direct tax, property tax is more likely to stimulate citizen engagement and strengthen the social contract. Property tax may also be less subject to leakage and waste as revenue tends stays at local government level. However, in settings where land rights are disputed – as is often the case in fragile contexts – property tax reform should be approached very carefully in order to avoid triggering land-related conflicts.

7 Points-based system is a simplified hybrid methodology that uses both surface area and easily observable characteristics to arrive at an estimated market value.

- **Increasing taxes from mining and high-net-worth individuals**. Income from mining and high-net-worth individuals make up most of the missing revenues in Africa. Personal income taxes contribute only 2% of GDP in sub-Saharan Africa, which is low when compared to the 10% collected in high-income countries. The creation of effective taxpayer units staffed with talented, well-paid people could contribute to changing this. For example, the Uganda Revenue Authority established a high-net-worth individual unit as part of the Large Taxpayer Office in the Domestic Taxes Department. Following this, many political candidates went to the URA to file tax returns and, in the process, made some payment towards their tax obligations (Kangave et al., 2018).

(iii) Access to information and enforcement measures

Improving available tax information. Information on taxable transactions is limited in fragile states, where informality is widespread. In these contexts, the tax base often shifts towards observable sources of tax and verifiable targets such as customs and tariffs and, to a lesser extent, sales. Improving access to information is essential if attempts to boost fiscal capacity are to be successful. This could be done by leveraging new technology to create paper trails, which may **boost transparency, trust, and perceived legitimacy**. For example, in DRC, hiring professional tax collectors and training them with clear and standard procedures and using mobile receipt printing technologies created a paper trail and instilled in citizens greater confidence that tax policies are being administered in a neutral and fair manner (Weigel & Ngindu, 2021).

Improving enforcement capacity and trust in revenue authorities is needed alongside greater access to information for better outcomes.[8] Work with the Liberian Revenue Authority examined the impact of building detection capacity for property tax liabilities. It showed a three-fold increase in taxes paid when information or detection capacity was combined with enhanced enforcement capacity in the form of penalty notices when compared to control groups (Okunogbe, 2021). This improvement in tax yields was sustained four years after the initial experiment. Information without enforcement is not effective in increasing tax compliance even in developed countries: a study in Denmark looking at the impact of prior auditing and threats of audits on self-reporting and third-party reporting groups found a 37% higher tax evasion rate in self-reporting groups, compared to a 0.3% rate of tax evasion in third-party reporting groups. This indicates that **access to information only increases compliance when combined with enforcement** (Besley & Mueller, 2021; Kleven, Khan & Kaul, 2016).

Research finds that a tax notice that includes the name of the property owner and photograph of the property, as well as information on penalties, triples tax registration and payment relative to a plain notice.

8 Data from the Afrobarometer April 2021 Survey on Sudan shows that 94% of the population do not fully trust the Sudan Revenue Authority, and 87% of respondents think Sudan Revenue Authority officials are involved in corruption.

Publicising how revenue is being spent – particularly spending on public services – supports positive encouragement of tax morale and motivation of taxpayers.

Improving compliance of *existing* tax obligations may be more effective than introducing new taxes. For example, when the Rwanda Revenue Authority introduced Electronic Billing Machines (EBMs) in 2012, total VAT payments increased by an average of 5.4% in two years, demonstrating the value of using technology to improve compliance of *existing* tax obligations (Eissa & Zeitlin, 2015). Findings also highlighted how such interventions could be implemented gradually, with less compliant industries targeted later.

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