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## GOVERNANCE AND DEVELOPMENT IN AFRICA: THE ROLE OF TAXATION

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### ABSTRACT

*Despite decades of reform and foreign aid, the quality of public institutions in most African countries remains poor. Colonial powers did not leave behind strong, indigenous institutions that could tackle the development challenges of a modern state. Economic crises, wars and political instability have also taken their toll. Yet, Taxation which is one entry point for improving governance on the continent has received little attention. The paper highlights the problems of taxation in Africa, reviews some relevant literature and make some suggestions. These include well-designed tax systems to consolidate stable institutions, increase revenues, refocus government spending on public priorities and improve democratic accountability.*

**Keywords:** Governance, taxation, development

### INTRODUCTION

Africa has now embraced democracy process. In the last century when the rest of the world moved towards democracy and development, Africa was still ruled mostly by non-democratic and dictatorial governments. The effect of this undemocratic governance in the continent is poverty. African leaders either borrow huge sums of money or use foreign development assistance to finance domestic wars. Civil wars in Africa undermine the continent's productive capacity, destroy or severely weaken social structures, distort economic policy, pollute the value systems of the people and perpetuate prolong poverty (Elu, 2000).

The major aim of the African Union, formed in 2002 to replace the Organization of African Unity, is rigorous development of the continent through the New Partnership for Africa's Development established in 2001. To ensure development and a leap forward

from poverty, African Union hopes to adopt good governance across the continent.

Historically, the formation of accountable and effective states has been closely associated with the emergence of taxation systems (Moore, 2007). Taxes underwrite the capacity of states to carry out their goals; form one of the central arenas for the conduct of state-society relations, and shape the balance between accumulation and redistribution that gives state their social character. Without the ability to raise revenue effectively, states are limited in the extent to which they can provide security, meet basic needs or foster economic development. Bargaining between government and taxpayers has played a central role in state building and the emergence of democratic governance. We argue in the study that when governments depend on a large number of taxpayers for revenue, they have incentives to promote broad prosperity and to develop bureaucracies capable of collecting and administering taxes effectively. This makes

governments more responsive to their citizens and help build state capacity. Bargaining with citizens over tax makes governments more accountable, as taxpayers mobilize to resist or negotiate tax demands, monitor how tax is collected and used, and insist on having a greater say in public policy exchange for compliance with tax demands. As tax compliance increases, state capacity improves and the taxation process becomes more efficient and predictable. Better public policy results from debate and negotiation with citizens. However, taxes are obligatory and the services which they fund are generally provided to a different set of citizens from the tax payers. In broad terms, taxes should be paid by the richer members of society to fund services for the poorer members of society. In democracies governments should be accountable to their citizens. Citizens are not necessarily tax payers and tax payers are not necessarily citizens.

## LITERATURE

The link between taxation and governance is not immediately apparent, but in fact one is vital for the other. Taxation is a core governance function. It has the potential to shape relationship between state and society in significant and distinctive ways.

The history of state revenue production 'is the history of the state'. Taxes underwrite the capacity of states to carry out their goals; they form one of the central arenas for the conduct of state-society relations, and they shape the balance between accumulation and redistribution that gives states their social character (Moore, 2007).

In Europe, as Schumpeter noted, tax not only helped create the state, they 'helped to form it' (Brautigam, 1991). The origins of representative government are intimately bound with the evolution of taxation. There is a strong consistent connection between the ways in which governments are financed

and the ways in which they govern. In particular, this is foundational to mainstream Anglo-American interpretations of the emergence of representative government and democracy in Britain and America. Parliament in Britain, secured its long term dominance over the monarchy through wresting control of public finance and restricting the sources of funding for government bureaucracy, the armed forces and the monarchy itself to money raised through taxation which had been authorized by parliament (Braddick, 1996:13). The Americans rejected the British colonial authority in the 1770s after London violated a core principle of good government, and tried to tax the American colonists without asking for their consent through a legislature in which they were represented (the principle of no taxation without representation). Tilly argues that where, instead of simply taxing coercively, rulers were motivated to bargain over taxation, state financing and public policy with the people who controlled large amounts of capital, states tended to become more capable, especially in war, and more accountable and responsive to citizens (Tilly, 1992). There are several remarkable pointers to the universal importance of taxation for state-building. First, the state's capacity to raise taxes is closely linked to its ability to deliver good policies and it is suggested that tax-raising is a good proxy indicator of overall governance capability (ArbetmanRabinowitz and Johnson, 2007).

Second, tax levels remain surprisingly static in countries over long period of time, despite frequent tax policy reform. Third, differences in the treatment of taxpayers by tax authorities may be explained by differences in citizens' right to political participation (Feld and Frey 2002). Tax levels, in general, usually rise with increases in the gross domestic product (GDP). This implies that better governed people are more willing to pay more taxes, but more heavily taxed states are not necessarily more legitimate. As

taxation increases as a share of national economic output, conflict becomes less likely (Hendrix 2007)

Political governance, economic growth, and taxation create mutually reinforcing processes of state building. The 'fiscal social contract' is a key factor in delivering both political legitimacy and sustainable economic growth. A stable, transparent, even-handed tax system is perceived by investors as a sign of established 'rule of law'. In other words, tax is a key indicator of an institutionalized framework of political stability and fairness (Bird, Martinez-Vasquez and Torgler 2006).

The relationship between taxation and state building combines three critical, but complex dynamics:

- 1) taxes and political governance
- 2) taxes and economic growth
- 3) political governance and economic growth.

Taxation for state development therefore requires a clear understanding of tax as a system that needs to be administratively effective, economically efficient, and politically equitable. The ability to tax is closely associated with administrative capability and this is likely to improve with economic development (Burgess and Stern 1993:774-5). Public finance economists have long included a political dimension in their comments, saying that 'political will' was also a factor in revenue collection (Kaldor, 1963). An International Monetary Fund (IMF) study of tax effort in forty three countries in sub-Saharan Africa, for example, found a significant country specific effect, suggesting that 'the political system' and attitude toward government' might affect tax effort (Stotsky and Wolde Mariam 1997: 10, 29).

A government's ability to collect tax depends, in part at least on willingness to pay. People's perception of the risk of detection and punishment, and the impact of different penalties, occupied the first round of research on tax compliance (Allingham and Sandmo 1972). Later researchers added other social factors to their models: the sense of moral obligation; the perception of the tax system's fairness and in particular the perception that other taxpayers are also paying and the foundation for trust; the extent to which taxpayers believe the government is:

- (a) spending their tax money wisely, and
- (b) spending it on public goods that will benefit, the taxpayer (Frey and Feld 2002).

As Levi has noted, a society's 'publicspiritedness or normative conviction' can be motivating factors in the general willingness to pay taxes. People with a strong belief in a welfare state might thus be more willing to pay high rates of taxes (Levi, 1988:52). Religious traditions of 'Zakat' or 'tithing' might form a sense of moral obligation to hand over a percentage of one's income to the community (Hull 2000). This attitude is intrinsic and not conditioned by actions by the government, although they might well have been conditioned by state-society relations in the past (Cummings et al. 2004).

It is suggested that the level of compliance with taxation requirements is affected by perceptions of the government's legitimacy and the fairness of the tax system, as well as taxpayers expectations that their tax moneys will be spent on valued public services (Slemrod 1992). Recognizing the economic structure, some research has suggested that countries with sizeable shadow economies or informal sectors have lower tax morale (intrinsic motivation to pay tax) as people in the formal sector can more easily observe large numbers of others escaping the tax net

(Alm and Torgler 2004). The business tax culture and morale of the private sector are more complex. The complex relationship between tax authorities and tax payers reflect a country's tax culture (Torgler, 2007).

Therefore, how the tax authority treats different segments of the formal and informal economy shapes the business tax culture, at the same time, the attitudes of entrepreneurs in the different sectors of the economy to the legitimacy of the state, the extent of corruption, voice and accountability are critical to trust in the state on which economic growth depends. Tax effort and tax collection depend not just on the income base, but also on the political and institutional bases, specifically the extent to which taxpayers trust their governments (Bird, Martinez-Vazquez and Torgler 2006).

The elaboration of a general typology of tax deviance appears to include both legal and economic approaches. The more complex the tax law is, the more it leaves open possibilities for tax avoidance. Privileged taxpayers construct tax schemes which they defend as a category of tax avoidance (legal) while the tax administration may consider such schemes to be cases of tax evasion (fraud). Legal and illegal tax schemes (avoidance and evasion) may have similar economic effects, but different sociological effects. Tax evasion may be generally perceived rather negatively, tax flight neutrally, and tax avoidance positively (Kirchler et al 2003).

## TAXATION AND GOVERNANCE

The term governance is used variously to refer to:

- (a) outcomes (the effective provision of collective goods) and
- (b) the political processes that generate these outcomes; the manner in which

state elites acquire and use their power and authority.

The notion of statesociety tension and balance constitutes an important theoretical foundation for such political science (Gervasoni, 2006:5). The core proposition is that political regimes are the outcome of tension and conflict between:

- (a) elites who control the state, and wish to remain in power and to exercise that power as freely as possible, and
- (b) societal actors who want to place restraints on the power of a potentially overbearing state, either to protect themselves from despotism and depredation or as a strategy for obtaining power themselves.

Revenue is central to this conflict for two reasons. First, it represents a key strategic resource for state elites. If non-state actors can limit and control elites' access to revenue, they enjoy countervailing power in relation to the state. Second, if state elites need to depend on general taxation because they lack alternative, easier to collect revenue sources, they generally have to put considerable organizational and political effort into obtaining the revenue, and face strong incentives to bargain and negotiate, directly or indirectly, with at least some taxpayers, rather than simply to extract revenue forcibly. In other words, dependence on general taxation for a significant proportion of government revenue provides incentives for state elites and taxpayers to resolve their differences through bargaining. This is why the quality of governance may be poor in states rich in natural resources. In these states the government is freed from the requirement to negotiate with its tax payers.

Taxes as a percentage of national income have tended to rise over time, but not always in the same way, and not everywhere, states without much capacity tend not to collect

much in the way of taxes, and they also tend to be poor and non-democratic. Scholars in economics, political science, history and sociology have constructed at least five approaches to the political economy of taxation, all of which attempt to explain different levels of tax and by implication, state capacity and state society relations (Therkildsen 2001).

First, economists have emphasized economic stricture, the level of economic development and “tax effort”. The second approach emphasizes taxpayers' ideologies, value and culture in explaining compliance with the state's taxation demand. The third approach highlights the role of war and other threats in explaining the incentives for rulers to modernize their revenue systems, whilst the fourth set of theories seeks to explain the differences in state capacity and tax systems through the analysis of political institutions. The fifth set of theories, the fiscal contract model, frames taxation as a collective action problem: rulers wish to maximize revenue, taxpayers wish to minimize payments. These two sets

of wishes lead rulers to offer something (representation, accountability and/or services) in an exchange based on reciprocity.

In Western Europe and later in North America, bargaining between rulers and taxpayers helped to give governments an incentive to promote broad economic prosperity and improve public policies in ways that meet citizen's demands. The concept of a 'fiscal social contract' is central to explanations of how representative government and democracy emerged in Western Europe and the United States. Citizens accepted obligations to pay tax in return for rights to be represented in the processes of decisionmaking about how public money was raised and spent. American colonists in the 18<sup>th</sup> century captured this in their famous slogan “no taxation without representation”. However, this does not explain the move to significantly reduced rates of taxation in the 1980s in these two countries. Although the poll tax riot that led to the end of Margaret Thatcher's rule of the UK may be an acute example of this process.

**Table 1: The effect on governance of state reliance on broad taxation**

<b>Immediate effects</b>	<b>Intermediate effects</b>	<b>Direct governance outcomes</b>
<p><i>Effects on state</i></p> <p>The state becomes focused on obtaining revenue by taxing citizens</p>	<p>(1) The state is motivated to promote citizen prosperity</p> <p>(11) The state is motivated to develop bureaucratic apparatuses and information sources to collect taxes effectively</p>	<p>More responsiveness</p> <p>More bureaucratic capability</p>
<p><i>Effects on citizens</i></p> <p>The experience of being taxed engages citizens politically</p>	<p>(1) (Some) taxpayers mobilize to resist tax demands and/or monitor the mode of taxation and the way the state uses tax revenue</p>	<p>More accountability</p>



<p><i>Result of interaction</i></p> <p>States and citizens begin to bargain over revenues. Taxpayers comply with tax demands in exchange for some institutionalized influence over the level and form of taxation and the use of revenue (i.e. public policy).</p>	<p>(1) Taxes are more acceptable and predictable, and the taxation process more efficient</p> <p>(11) Better public policy results from debate and negotiation</p> <p>(111) Wider and more professional scrutiny of how public money is spent</p> <p>(1V) The legislature (assuming one exist) is strengthened relative to the executive</p>	<p>More responsiveness, political and bureaucratic capability</p> <p>More responsiveness and political capability</p> <p>More accountability</p> <p>More accountability</p>
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Source: Adapted from Moore (2007: 17).

Rulers have a stake in the prosperity of their citizens, and incentives to nurture that prosperity to generate more revenues. By using reliable tax-flows to leverage loans from domestic lenders, first the Dutch and then the British were able to turn their tax states into more powerful “fiscal states” (Tilly, 1992). The basic mechanisms involved are summarized in Table 1. Bargaining around tax simultaneously increased government capability, accountability, and responsiveness. Both governments and citizens benefit.

The links between taxation and the emergence of capable government can be illustrated with a wider range of historical experiences. In East Asian countries, developmental states had broadly based tax systems. These were not in the beginning associated with Western type of political democracy; but they did help to forge a relationship between governments and citizens that generated both widely spread economic growth and improved state

efficiency (OECD, 2008). Dependence on broad taxation gives governments incentives to extend their reach into rural areas. It also requires governments to develop a widespread taxation apparatus, including basic population registration systems and a tax collection administration that can become model for improving public services more generally.

In South Korea and Chinese Taipei (Taiwan), a strong tax system underpinned effective economic policies and government capability more broadly. In Chinese Taipei, a broadly based revenue system required government agencies to interact with, and keep records of, a wide range of enterprises and households (thereby largely avoiding the creation of an informal sector). In the 1950s, governments in South Korea paid considerable attention to tax, especially direct taxation (34% of its revenue came from direct taxes). This provided the basis for increasing broad based taxation under the first 'developmentalist' regime of President Park in the 1960s and

later the development of an information system that permitted the government effectively to target credits, subsidies and other interventionist measures towards individual firms (Shafer, 1997).

Both South Korea and Chinese Taipei made steady and stable transitions to something close to electoral democracy, as they became wealthier under governments that taxed relatively broadly and directly. Pioneers of good governance in Latin America, such as Costa Rica tell a similar story; tax is not the sole determinant of rapid development but it is one pillar of an effective state, and may also provide the basis for accountable and responsive democratic systems.

## THE NATURAL RESOURCE CURSE

The proposition that governments, which do not need to tax their citizens, have little incentive to be accountable, responsive or efficient-is well supported. Evidence of the relationship between bad governance and natural resource rents comes from an extensive literature on "rentier" states, including country case studies as well as strong quantitative evidence based on crossnational statistical analysis (Moore, 2007). Rentier states have limited incentives to build up institutions to collect and administer tax, or to extend the reach of government to poorer, more remote regions. In particular, large oil and mineral revenues are associated with low levels of democracy and states with low levels of law enforcement (OECD 2008).

Many states in the Middle East, the Caspian basin and Africa earn large surpluses from exporting oil to industrial countries. Because oil is a valuable, physically concentrated resource, the benefits accrue to a small number of big companies and central states, and individuals who control them.

According to the OECD (2008), evidence suggests that states dependent on oil tend to :

1. be independent of citizen taxpayers and therefore unresponsive to them
2. have few incentives to promote broad economic development
3. use oil revenue to buy off opposition, and to fund repressive internal security.
4. attract external military political support
5. lack incentives for tax payers to engage in the local political process, because there is no political bargaining over sources and use of public revenues
6. have non-transparent revenues, with little oversight from legislatures
7. have few incentives to establish effective bureaucracies to raise and manage taxes.

Rentier states represent the extreme case. Nigeria embodies the characteristics of a rentier state since oil resources constitute 80 per cent of government revenue. In addition, Nigeria had an unequal horizontal and vertical tax revenue distribution system and a large concentration of revenue in the Federal Government. But some countries such as Botswana; have managed their natural resource wealth with success. However, the association of bad governance with limited state reliance on taxes is found across a wide range of countries and regions (OECD, 2008). Those states that mainly depend on broad taxation of citizen have historically been the most democratic. Where provinces received more generous financial transfers from central government, or oil revenue, local politicians were better able to buy off or suppress democratic opposition (Gervasoni, 2006).

## WHY IS TAXATION IMPORTANT FOR DEVELOPMENT?

Today's poor developing countries, particularly in Africa, have a different history from those usually cited as examples of good



accountability and governance. It cannot be a question of simply replicating the experiences of other countries. Nonetheless, there are good reasons for thinking that the historical experience of taxation as the basis for state building is relevant for developing countries. Sustainable government finance is the key to sustainable development. The provision of social protection, infrastructure and basic services such as education and health care is crucial for development. Sustainability requires that the means to finance these public goods and services should come, as much as possible, from the government's own resources, that is, tax revenues. This explains the close link between taxation and development. For several reasons, developing countries, and African countries in particular have difficulty collecting these domestic revenue adequately.

If African countries were able to collect sufficient tax revenue, they might be able to increase their independence. The reason is that they would need less financing through foreign loans, which reduces debt problems, and they would be less dependence on foreign aid (Martens, 2008). This independence would increase stability of the government budget, as tax revenues are much less volatile and unpredictable than aid flows (Buli and Hamann, 2006). It could also increase the policy space for governments because of the economic policy conditions frequently attached to foreign aid and loans.

Furthermore, enhanced tax revenues could strength democratic accountability and provide opportunities for cuts in high marginal tax rates in many countries (Murphy et al. 2007). In brief, an effective tax system can serve four main goals:

1. revenue generation: to raise government revenues, as explained above.
2. redistribution: to redistribute income and reduce inequality. This is generally achieved through progressive taxes. This means that higher tax rates apply to those with a higher income.
3. re-pricing: to re-price economic alternatives, that is, the use of taxes and subsidies to ensure that market prices better reflect the full social costs and benefits.
4. representation: to strengthen political representation.

When governments are more dependent on tax revenue and less on income from natural resources, aid or debt financing, accountability to citizens regarding the use of government funds is stimulated. The effect is strongest for direct taxes on personal and corporate income. Aid dependence on the other hand, stimulates accountability to external donors.

## WHAT ARE THE PROBLEMS?

The challenge for poor countries in Africa and the developing world is not necessarily to tax more. How tax is raised matters, as well as how much is collected. The challenge is to tax larger number of citizens and enterprises more consensually. Broadly speaking, tax ratios tend to rise as incomes rise. The average tax to GDP ratio for low income countries is about 18%, compared to 29% for high income countries (Zolt and Bird, 2005). See Table 2 below.

The ability to obtain revenue from direct taxes, which are often progressive in nature and can be used for effective redistribution, is especially low; 2-6% of GDP in poor countries compared to 12-18% for developed countries (Cobham, 2005). This is due to features that characterize developing countries:

**Table 2: Tax Levels: tax revenues as a percent of GDP**

Country Groups	1970s	1980s	1990s	2000
Industrialized	30	34	36	33
Developing	16	17	17	17
Transition	n.a.	48	30	29

Source: Calculated from data in IMF (2003), as reported in Bahl (2006).

Notes: n.a. = not available

## THE LARGE INFORMAL ECONOMY

Most developing countries are said to have a large informal economy, which is undertaxed or completely untaxed at least in terms of direct taxation. The average size of the shadow economy as a proportion of official GDP was estimated for 2002-2003 at 43% in African countries, 30% in Asian countries, and 43% in Central and South American countries. In Organization for Economic Cooperation and Development (OECD) countries, the shadow economy is approximately 16% (Schneider, 2006). This data indicates that on average, the level of tax evasion due to the informal sector in developing economics is about twice that of developed countries.

## LIMITED CAPACITY OF REVENUE AUTHORITIES

Tax leakage in developing countries is often made worse by poor functioning tax authorities due to variety of reasons; underresourced or undertrained administrators, poor tax collection systems, failure of legal enforcement mechanisms for tax collection and small penalties for non-payment. These factors create opportunities for domestic and foreign entities to abuse the system since tax officials frequently lack the required technical skills to unravel complex international fiscal structures that are used

to escape taxation, and because penalties are insufficient to stop tax evasion.

## TAX COMPETITION

Tax competition describes countries that compete against each other by using tax related or financial incentives to attract Foreign Direct Investment (FDI). These incentives include: low tax rates on profit and capital, tax holidays, subsidies, absence of withholding taxes and so on. Urged-on by the major international financial institutions to adopt development strategies to attract FDI, and by multinational companies that use tax advantages as a condition for investment, many governments now routinely engage in tax competition by offering some or all of the above incentives. This leads to lower average corporate tax revenues for developing countries, resulting in a shift of the tax burden towards wages and consumption.

## TRADE LIBERALIZATION

The trade liberalization negotiated in the context of Economic Partnership Agreements (EPA) between the European Union (EU) and Africa, Caribbean and Pacific (ACP) economies may be expected to have a significant revenue effect. In the last two decades the World Bank and International Monetary Fund (IMF) have promoted a trade liberalization agenda, which involved the sharp reduction of import tariffs. High-income

countries, which derived only a small share of tax revenue from trade taxes, have been able to recover revenue from other sources, principally consumption taxes such as Value Added Tax (VAT). The situation has been dramatically worse, however, for low-income countries. They have only been able to recover about 30% of the tax lost from a reduction in the rate of trade taxes (Baunsgaard and Keen, 2008).

## WILLINGNESS TO PAY

Citizens' willingness to pay tax may be low for historical, political and cultural reasons, and also reflect a perception that governments consistently misuse public funds. The net effect of these various factors has been to weaken revenue mobilization. Half of sub-Saharan African countries still mobilize less than 15% of their GDP in tax revenues compared to an average of 29% for high income countries (Zolt and Bird, 2005).

**Table 3: Tax Revenue as a percentage of GDP**

Country	Year 2008
Benin	15.7
Cameroon	18.3
Egypt	15.8
Ethiopia	11.6
Sierra Leone	10.5
Kenya	18.4
Nigeria	6.1
Mozambique	13.4
Uganda	12.6

Source: Heritage Foundation (2009).

## CONCLUSION

There certainly are governance challenges in Africa, which must be addressed; fortunately action is in progress with respect to many of these. Weak administrative structures, poor financial management, corruption and impunity can only further impede the attraction of investment, the

provision of public services and alleviation of the plight of the bulk of the populace. Statebuilding approaches involve understanding tax as a system its morale, institutional and cultural determinants.

How a country collects taxes in totality influences its relations with its citizens. In most African countries where personal taxation is limited, the state's political development through taxation may critically depend on the medium and small enterprise business population and electorate. Harnessing this for state-building requires bringing tax policy and its administration explicitly together with political governance and economic growth to explore new ways for strengthening state through the political economy of the taxation of the private sector (both formal and informal) to deliver long term development.

## RECOMMENDATION

Paying taxes gives citizens a powerful incentive to engage with government and political process. Democracy is thus stronger and more effective in countries where a higher proportion of people pay taxes. Therefore, practical changes to tax design and improvements in tax administration is important in encouraging higher rates of tax payment.

Better tax relations can be fostered by designing incentives for compliance. Governments should take the path of 'fiscal pacts' to enhance tax relationships. Fiscal pacts are negotiated agreements between organized societal and political interests about public expenditures and how to finance them. These kinds of negotiations are useful not only for getting agreement on fiscal goals, but also for highlighting the political economy dimensions and the challenges of convincing citizens to accept tax reforms, especially when they involve tax rate increases.

One high potential revenue source for sub-national governments is taxing urban property. Property taxation is one of the potential sources of significant income for many municipal and metropolitan authorities. As property is relatively easy to identify, avoidance of property tax is relatively low. Digital databases make taxing urban property much easier now than in the past. The regulatory function of the government must be properly performed. Government through its institutions should enforce rules and regulations governing tax compliance. Those found to have defaulted

must face the sanctions. Special tax courts must be established to deal expeditiously with cases of tax non-compliance.

Sustained public education: the inculcation of a culture of tax compliance depends on changing attitudes and perceptions. Even though the revenue institutions have embarked on public education programmes either in the media or on posters and billboards, the approach is often ad hoc and piecemeal. Therefore, a more concerted and sustained approach needs to be put in place for the sensitization of the public.

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