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## Building tax systems in fragile states

Challenges, achievements  
and policy recommendations

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## Summary

The purpose of this study is to systematise and analyse existing knowledge on taxation in fragile states. Efforts to support domestic revenue mobilisation in conflict situations require a different approach and other means than in the more stable developing countries. On that basis, the study discusses possible entry points for Norwegian support to domestic revenue mobilisation in ways that may contribute to strengthen state-building and improve government legitimacy.

Complexity, limited experience and security concerns suggest that one should be cautious to adopt bilateral technical assistance programmes of the kind implemented in other developing countries. Instead, the study argues in favour of engagement via multilateral institutions, including multi-donor trust funds and other forms of pooled resources.

Nine entry points are recommended for Norwegian support to taxation in fragile states:

1. Do no harm
2. Safeguard donor coordination, but ensure a certain humility
3. Support customs administration
4. Capacitate management and taxation of natural resources
5. Support the United Nations Tax Committee
6. Improve taxpayer-tax administration relations
7. Remember the sub-national tax system
8. Support civil based organisations
9. Develop research capacity

Viable entry points are likely to differ substantially from country to country depending on context and demand. Fragility has many features and the challenges facing different states differ.

## Keywords:

Fragile states, state building, domestic revenue mobilisation, taxation, capacity building, development assistance

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The *Terms of Reference* defines the assignment as a short-term desk study. Part of the work involved reviewing and synthesising existing literature, including published academic studies and reports and documents from the MFA, Norad and other development agencies, in particular the OECD, IMF, and the World Bank. The study also draws on the involved researchers' own research and advisory work on taxation in low-income countries and research on the political economy of fragile states.

The study team consisted of Professor Odd-Helge Fjeldstad (CMI and ATI, project leader), Research Professor Morten Bøås (NUPI), and Research Assistants Julie Brun Bjørkheim (CMI) and Frida Margrethe Kvamme (NUPI).

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Bergen/Oslo, 2 March 2018

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## 1. Introduction

In recent years, there has been growing attention from international development agencies to contribute to stability and sustained development in fragile states. A fragile state can be defined as a state that has weak capacity to carry out basic governance functions, including security and basic service provision, and lacks the ability to develop mutually constructive relations with society (OECD 2014). It is also more vulnerable to internal or external shocks, such as economic crises or natural disasters. Political unrest, war, and years of economic turmoil have caused the collapse of state revenue collection systems. Yet, fragility has many features and the challenges facing different states differ. Fragile states include countries that are recovering from conflict and embarking on state-building processes (e.g. Liberia and Myanmar), and countries that experience long-term insecurity, recurrent crises or localised conflicts (e.g. the Central African Republic and Yemen). They also include cases where governments have relatively strong administrative structures, but where political exclusion combined with lack of economic opportunities are fuelling political tension and violence. This is the situation across regions such as the Sahel and Maghreb. In Zimbabwe, these characteristics are reflected by weak institutions and in Mali by an armed rebellion.

The international development community recognises that it is required to invest more in the capacity of fragile states to mobilise their own revenue to support state building and peace (OECD 2014, 2016; IMF 2017a). The importance of strengthening domestic revenue mobilisation was emphasised by the G20-leaders at recent summits and affirmed in international fora held at Monterrey and Busan. Support for domestic revenue mobilisation is also reflected by the commitment of the signatories to the 2015 Addis Tax Initiative (ATI)<sup>1</sup> to double their assistance to developing countries to strengthen their tax systems and their administration by 2020 (ATI 2015). This commitment has yet to be translated into action. A very small share of all development assistance is targeted toward developing tax systems in partner countries. In 2015, official development assistance (ODA)-funded activities for these purposes accounted for only 0.13% of the total ODA spend worldwide (ITC 2017: 15).<sup>2</sup>

The commitment to support domestic revenue mobilisation in poor countries is partly based on the recognition that the establishment of tax regimes and state-building efforts are closely connected (Acemoglu and Robinson 2012; Besley and Persson 2011, 2013; Braütigam *et al.*

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<sup>1</sup> For more details about the Addis Tax Initiative, see:

<http://www.un.org/esa/ffd/ffd3/commitments/commitment/addis-tax-initiative.html>

<sup>2</sup> OECD's Development Assistance Committee (DAC) has measured resource flows to developing countries since 1961. ODA, or foreign aid, is a key measure for aid given by governments and other agencies to support the economic, environmental, social, and political development of developing countries:

<http://www.oecd.org/dac/stats/officialdevelopmentassistancedefinitionandcoverage.htm>

2008; Collier 2007).<sup>3</sup> There is a strong argument in the literature that a substantial ‘governance dividend’ can be gained from mobilising domestic financial resources through the tax system (Moore 2008; Prichard 2015). Robust fiscal institutions are essential for state-building and economic growth. From this perspective, building, or re-building, fiscal institutions in fragile states and strengthening their fiscal capacity is of particular concern, given their key role in the functioning of the state and the economy (IMF 2017a). However, increased domestic revenue generation will only lead to improved development outcomes if the revenue is translated into productive public expenditure. If tax reform is undertaken in a way that promotes greater responsiveness and accountability, alongside improvements in the state’s institutional capacity, then tax reform can become a catalyst for broader improvements in government performance.

Using taxation as a way to promote a fiscal contract between the state and citizens is not a given. Taxation can be used as a means to promote divisions between different groups in a society (Moore 2015: 9). Taxation may also leave large segments of the poor population worse off, in terms of less cash for food and other essential goods (Lustig 2016: 4). Predatory taxation has produced revolts and widespread resistance by citizens (Fjeldstad 2001; Fjeldstad and Therkildsen 2008; Meagher 2016). Thus, as argued by Long and Miller (2017: 11), encouraging extractive governments to collect more taxes, and “keeping one’s fingers crossed for a governance dividend from taxation, is likely to be naïve at best and harmful at worst”. The international community should, as argued by Joel Slemrod, “*consider whether our best advice will make the intended beneficiaries – often desperately poor people – better off, or will it make corrupt bureaucrats and politicians better off?*” (Slemrod 2016: 7).

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<sup>3</sup> State-building can be defined broadly as “increasing the capacity of governments to interact constructively with societal interests, to obtain support and resources from those interests, and to pursue consistent lines of action” (Moore 2008).



**Box 1: Tax for development has a long history**

Development agencies have supported domestic resource mobilisation in developing countries for decades (Fjeldstad 2014). In the 1960s, when a number of African countries gained their independence from the colonial powers, leading economists argued that the new states should give the development of effective tax systems priority (Kaldor 1963). In the 1980s and 1990s, the reform of trade taxes was a major component of donor-funded structural adjustment reforms (Bird and Oldman 1990; Thirsk 1993). The impetus for tax reform in this period did not come from those responsible for assessment and collection of tax, but rather from a donor government or from the ministry of finance in the specific country advised by the International Monetary Fund (IMF) and/or the World Bank (Goode 1993; Gillis 1990). The general advice was to abolish export taxes and lower import duties. Governments were urged to desist from using taxation to try to mobilise savings or to transfer resources from agriculture to non-agriculture, and to place less emphasis on using high marginal tax rates in the effort to reduce income and wealth inequality. After a period of declining funding beginning in the latter part of the 1990s, funding for tax-related development assistance appears to have increased recently, although it remains relatively modest as a share of total donor programmes.

How can Norway assist in building, or re-building, tax systems in fragile states and contribute to strengthen their fiscal capacity? The Norwegian Ministry of Foreign Affairs has developed a “Strategic framework for Norwegian efforts in fragile states and regions” (MFA 2017a), which is aimed at countries that are directly or indirectly affected by conflicts.<sup>4</sup> The framework emphasises that efforts in conflict situations require a different approach and other means than in more stable countries. This is the point of departure for this study. The purpose of this study is to systematise and analyse existing knowledge on taxation in fragile states. On that basis, the study discusses possible entry points for Norwegian support to domestic resource mobilisation in ways that may contribute to strengthen state-building and improve government legitimacy in fragile states.

The report is organised as follows: Section 2 describes features of fragile states and discusses the diversity of challenges they are facing with respect to (re-)building tax systems. Section 3 discusses the links between taxation and state-building, followed by Section 4 which examines why fragile states are struggling to raise taxes. Approaches to domestic revenue mobilisation in different contexts and types of fragility are addressed in Section 5. Thereafter, in Section 6 we present possible entry points for Norwegian support to developing tax systems in fragile states in ways that may contribute to strengthen state-building and improve government legitimacy. Section 7 concludes the study.

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<sup>4</sup> Increased Norwegian efforts in countries with a high degree of vulnerability (fragile states) is rooted in two recent White Papers to the Parliament: Meld. St. 24 (2016-2017) *Felles ansvar for felles fremtid [Shared responsibility for a shared future]* (MFA 2017b); and Meld St. 36 (2016-2017) *Veivalg i norsk utenriks- og sikkerhetspolitikk [Roadmaps in Norwegian foreign and security policy]* (MFA 2017c). These white papers constitute an important basis for the Norwegian contribution to the fulfillment of the UN sustainable development goals (SDGs) towards 2030.

## 2. Features of fragile states

Fragile states are associated with instability, chronic violence, humanitarian crises, and large-scale migration or displacement. Fragile states pose huge challenges for the international community as the lack of an institutional response capacity in such countries makes it difficult for such interventions to succeed. In general terms, we know what is required: fragile states need order and institutions that can extract revenue from taxes, fees and duties to deliver economic development and services (Fukuyama 2014). The problem is how to achieve this in fragmented, conflict-prone societies. The challenge that this constitutes is obvious when we consider the track record of the international community in assisting state-building efforts in fragile states. Most often, these fall short of achieving their stated objectives and at times even make a difficult situation worse leaving countries such as Afghanistan and Mali on an artificial international life-supporting system. International intervention may prevent a total state collapse, but it does not represent a sustainable path to recovery, stability, reconciliation and development. This can only be achieved through a process of institution building based on an ability to extract domestic revenues. Such a process must be based on a combination of increased administrative enforcement capacity in tandem with an attempt to achieve legitimacy through public service provision and security. International assistance in such a process must be knowledge-based, and it must be based on a grounded reading of what fragile states actually are and how they work. The first step would be to acknowledge what we call the ‘fragility dilemma’ (Bøås 2017a).

In theory, weak state capacity and general fragility might indicate that donors can impose their will and the programmes they believe are needed in such states. However, this is not necessarily the case as a state’s fragility combined with an insurgency that is defined as a regional and/or global threat can strengthen the bargaining position of the government in question. This is particularly pertinent for at least four of the ten fragile states with a need for stabilisation and conflict prevention that have been targeted as focus countries for Norwegian aid.<sup>5</sup> It may be hard to find anyone who is impressed by the governments in Bamako, Kabul,

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<sup>5</sup> The ten countries with a need for stabilisation and conflict prevention that Norwegian support will particularly target are: Afghanistan, Haiti, Jordan, Lebanon, Mali, Niger, Palestine, Somalia, Syria, and South Sudan (MFA 2017d: Prop. 1 S (2017–2018)). In this report, we do not cover the cases of Jordan, Lebanon and Syria. With regard to Jordan and Lebanon, the most visible dimension of their fragility is not internal, but external. Lebanon is very much based on the historical compromise that emerged after the end of the Lebanese civil war. Seen from a narrow Western liberal democracy point of view, this may be far from perfect. However, the ‘compromise’ is holding and has kept Lebanon stable throughout the influx of more than two million Syrian refugees. This is not fragility, but a remarkable achievement of regime stability and elite compromise. This feature also applies to Jordan, the other Arab state that harbours a large number of Syrian refugees. The country has not been brought to its knees by this influx. This does not mean that these countries do not need assistance from the international community to deal with this huge burden, only that the main reason for their fragility is the Syrian war, and not necessarily any internal issue. With regard to Syria, our opinion is that as much as post-war Syria will need huge amounts of international assistance, we are not there yet. The war is not over and could drag on for a considerable time. Daesh (the Islamic State) is not defeated. It could morph, it can be resurrected, and as the recent round of fighting in Northern Syria

Mogadishu or Niamey. However, as few can identify any credible alternatives to these governments, most donors are reluctant to press too hard for deep structural reforms. They fear, if not outright collapse, at least a further implosion and subsequent erosion of the state.

This means that if progress is to be made on the establishment of sustainable tax regimes in fragile states, this dilemma must be acknowledged and utilised to build grounded country strategies concerning how these states actually work and the potential for identifying ‘change’ agents within them. Such agents of change must have a combined will to change and the power potential to initiate change. In this regard, we believe that the recent political economy analyses commissioned by the Norwegian Ministry of Foreign Affairs is a useful start point to develop the knowledge base needed to work more effectively in fragile states environments.<sup>6</sup> Such a knowledge-based approach is also in-line with the ministry’s strategic framework for Norwegian contributions in fragile states and regions (MFA 2017a).

Unfortunately, a grounded knowledge-based approach is still at odds with the dominant perspective for understanding these challenges. States defined as ‘fragile’ typically are defined as ‘lacking’ what modern states are supposed to have: control of borders, monopoly on violence, procedures for taxation and dispute settlement, and a legitimate design for transfer of power from one ruler or regime to another (Bayart 1990; Mamdani 1996; Eriksen 2011; Bøås 2015). Obviously in states defined as ‘fragile,’ such as Afghanistan, Haiti, Mali, Niger, Palestine, Somalia and South Sudan, we find, albeit to different degrees, low scores on most of these indicators (Fund for Peace 2017). However, such a checklist approach to statehood cannot tell us more than that they simply lack things that a modern state ideally should have. As the making of such lists does not adequately cover this knowledge gap in research and policy, the question is how we can start to close it. The premise for this report is that we need to analytically unpack the ‘black-box’ these states have become to investigate how revenue extraction takes place, and how transparent and legitimate regimes for taxation can be established, exercised and maintained over time. Here, we attempt to address this challenge by rigorously reviewing what the embryonic literature on fragile states and taxation can inform us.

There are number of definitions and approaches to fragile states. OECD (2014) identifies fragility as challenges to societal cohesion, political processes and decision-making, and challenges to the economy, environment, climate and security that the states in question cannot handle based on their present state capacity. IMF (2017a) on the other hand defines fragile states as having either weak institutional capacity as measured by the World Bank’s

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on the border to Turkey only proves all too well that a number of successor conflicts are likely to emerge. This makes questions concerning support to developing the tax system in the Syrian case premature right now.

<sup>6</sup> Several country reports have been published, including on Afghanistan (Strand, Borchgrevink and Harpviken 2017), Mali (Ba and Bøås 2017) and South Sudan (Rolandsen and Kindersley 2017).

Country Policy and Institutional Assessment (CPIA) score (average of 3.2 or lower) and/or experience of conflict (signalled by presence of a peace-keeping or peace-building operation in the most recent three-year period). These definitions are useful, but they are also quite general, and we believe that they fail to offer the nuance and analytical depth needed to really understand the complexity of fragility.

Most fragile states are very poor. However, poverty is not a precondition for fragility as there are just a small number of poor countries that also are defined as fragile. Fragile states are, therefore, states whose monopoly on violence is either undermined or at considerable risk of being undermined. Everything else equal, the weaker the state is, the larger the risk that armed non-state group(s) will either operate or start to operate in the territory of the state. This means that fragile states are states that lack control of its own borders as well as run the risk of losing its monopoly on violence. In such situations, the state is no longer the dominant actor for service provision and security to local populations, but one among several actors that compete for this position (Bøås 2016). In extreme cases of fragility, such as in Afghanistan, Somalia, South Sudan, and parts of Mali and Niger, an armed non-state group can be just as relevant for people's livelihoods as the bureaucratic machinery of the state. These insurgents are also involved in extraction, but also at times in some form of crude taxation (Bøås 2015; Hoffmann, Vlassenroot and Marchais 2016; Baaz, Olsson and Verweijen 2018). This means that as much as fragile states share important commonalities, they also consist a category of quite different states.

The International Monetary Fund suggests differentiating fragile states in accordance with the country's state of fragility: (i) middle of conflict/disaster; (ii) fragile, but post-conflict or disaster; and (iii) stable, but vulnerable (IMF 2017a: 19). The duration of each stage generally differs substantially between countries. This categorisation is useful in some contexts, but it does not capture key features of the states with a need for stabilisation and conflict prevention that have been targeted as focus countries for Norwegian aid (see note 4). All seven countries targeted (and covered in this report) are in some stage of conflict, but their state of fragility differs between ongoing open conflict/war and a situation characterised by "no peace, no war".<sup>7</sup> None of the targeted countries are post-conflict states or states that are included in the IMF-category "stable, but vulnerable". It can be argued that some of the eight countries categorised by Norway as "countries for long-term strategic partnership" fit into IMF's category "stable, but vulnerable", including Liberia, Mozambique, Myanmar and Uganda.<sup>8</sup> These countries all need support to develop their tax systems. Norway has already contributed

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<sup>7</sup> In note 4 we clarify why it does not make much sense to include taxation as an element in Norwegian assistance to alleviate the humanitarian crisis facing Jordan and Lebanon, which is rooted in the influx of refugees from Syria. For obvious reasons, Western support to the tax system in Syria is not an issue in the current situation.

<sup>8</sup> The eight "long-term strategic partnership countries" are: Ethiopia, Liberia, Malawi, Mozambique, Myanmar, Nepal, Tanzania, and Uganda (MFA 2017d).

through the *Tax for Development Programme* in Mozambique and Tanzania, and through the *Oil for Development* in several more countries.<sup>9</sup> However, the challenges and approaches for support to states with a need for stabilisation and conflict prevention are of a different character.

We therefore suggest differentiating the states that we discuss from (A) semi-fragile ‘no peace, no war’ situations (see Richards 2005) where certain key tasks are still performed by the state; and (B) ‘fragile in-conflict states’ where state authority is directly challenged or has collapsed (see Table 1). Everything else equal, it is easier to get aid and support to establish tax regimes to work in the countries in group A than in group B, but also group B type countries require this type of assistance as all pathways out of fragility and conflict include an ability to gather revenue. Without this, the state in question not only will remain hooked on an artificial international life-supporting system, but will also by necessity fail to establish a sustainable social compact that can be the basis for new social contracts to minimise the risk of new violent conflict.

**Table 1: State of fragility, resource dependency, tax to GDP and informal sector employment in selected countries**

	State of fragility		Resource dependent	Tax in % of GDP	Share of total labour force in the informal sector
	Conflict	No peace-no war			
Afghanistan	✓		✓	6.5%	–
Mali	✓		✓	15.3%	90%
Somalia	✓			1.9%	Large, approx. 90%
South Sudan	✓		✓	4.2% (nonoil tax revenue)	Large, approx. 90%
Haiti		✓		13.2%	92,6%
Palestine		✓		–	57%
Niger		✓	✓	15.5%	93%

*Sources: Tax to GDP ratio: Afghanistan, Haiti, Mali and Niger: Heritage Foundation (2017); World Bank (2017b); South Sudan: IMF (2017b). Informal sector: Mali: Verick (1996); Haiti and Palestine: Charmes (2012); Somalia: World Bank (2017b); South Sudan: Munive (2014); Niger: Ulandssekretariatet (2014). Please note that all these figures should be seen as indicative as almost all statistical material from fragile states tend to be inconsistent and contains several missing elements. This is due to a combination of administrative weaknesses and conflict that often make parts of the country inaccessible for surveys.*

<sup>9</sup> Measures on how to strengthen the tax systems in low-income countries have been addressed in a number of studies in recent years, e.g. von Soest (2008); IMF (2011); Drummond *et al.* (2012); Keen (2012); Bird (2013); Fjeldstad (2014); Moore and Prichard (2017); World Bank (2017a); and Forstater (2018).

When we examine the seven fragile states with a need for stabilisation and conflict prevention that are the focus of Norwegian aid, we see both commonalities and significant differences. This suggests to us that Norway needs to develop both a general policy on taxation in fragile states and detailed country-specific strategies. All seven countries lack proper control of their borders and none of them can be said to have a firm monopoly on violence. However, not all are in conflict. Haiti and Palestine exist in an environment of ‘no peace, no war’, experiencing occasional outbursts of violence, but not to the extent that it threatens their very existence as states. This also applies to Niger, which offers an interesting comparison to neighbouring Mali. The two countries share many of the same background statistics and variables. Both are poor and suffer from weak state administrations. They are heavily dependent on natural resources extraction for export revenue (gold in the case of Mali, uranium in Niger). Climate change is taking its toll on local livelihoods, and both countries have populations that are fragmented between different ethnic groups, in particular between an Arab and Moorish population in their northernmost territories and a black majority population in the central and southern parts of both countries. Despite a number of attempts by a string of insurgencies based in Mali and elsewhere in the Sahel to spread battlefronts to Niger, this has not happened. There is a remarkable level of resilience in the state of Niger, but not much is known about it.

On the other hand, in Afghanistan, Mali, Somalia and South Sudan considerable parts of the territory are under the control of various insurgent groups. This does not necessarily imply that programmes aiming to build credible tax regimes are useless. Only that one - based on grounded local knowledge - needs to examine what is possible and what is not. The World Bank (2017), for example, claims to have made some progress in this regard in Somalia (we will return to this example later in the report). The less formal the institutional environment of the state is, the greater the need local populations will have for non-state figures of authority to navigate life and livelihoods. We see this clearly from the almost non-existent state of South Sudan to varying degrees in Afghanistan, Mali and Somalia. The way that non-state actors combine institutions, resources and legitimacy may represent a mimicking of state practices, but it may also be based on different configurations of these bases of political authority that result in the emergence of new hybrid forms of political authority. This can briefly be illustrated by experiences from Afghanistan (Bøås 2017b).

In Afghanistan, the Taliban have recently made certain advances. The group controls a larger territory than in a long time. They are now involved in 14 of Afghanistan’s 34 provinces. They also seem to be better organised. The Taliban are obtaining revenue from the country’s large mineral reserves by issuing licenses for mineral extraction in the areas under their control and taxing both extraction and transport. It is estimated that the group makes between 200 and 300 million US dollars a year from minerals (Bøås 2017b). This contributes greatly to the Taliban’s ability to wage war. However, with such large-scale operations and taxation come

obligations. New types of social contracts are emerging between the Taliban and economic interest groups. New institutional forms of political authority within the Taliban arise from this, such as *Dabaro Comisyoon* (the Taliban's mineral and mining commission). Taliban's comprehensive involvement in the Afghan mineral sector seems to give rise to another type of institutional organisation of the group – a more bureaucratic structure. Many questions emerge from this brief snapshot of Afghanistan in 2017. Is this simply about the Taliban mimicking state practices or are we witnessing the evolution of a new hybrid form of political authority in areas under Taliban control? This example raises many important issues and questions that have relevance far beyond the case of Afghanistan. For example, how and to what extent is political authority perceived as legitimate? To provide novel ways of addressing the many pertinent questions that derive from this brief illustration, we must take the debate beyond the current situation, as this has become a debate that is not sufficiently linked to what takes place on the ground in fragile states.

This is important as the introduction of any tax regime rests on the combination of legitimacy and enforcement capacity. Tax regimes, particularly in fragile states where state legitimacy is generally very low, must be implemented with some levels of coercion. Without this people will simply not pay tax since they have little trust in the government's promises that they will see anything in return. Thus, enforcement capacity is needed, but it cannot be too heavy-handed, and emerging taxpayers will have to see quite immediate effects based on taxes paid. The question is how to strike a balance between enforcement and legitimacy. However, donors themselves cannot achieve this. They can assist, they can help fund, but if they want to venture this way, they need to think hard about who the agents of change are and how they can be identified within governments. Agents of change must be within the government, otherwise there is no change potential in settings that commonly are plagued with corruption and illicit practices. The obvious consequence of this would be to change policy from 'zero tolerance on corruption' (which is impossible today in countries such as Afghanistan, Haiti, Mali, Niger, Somalia and South Sudan) to a policy aiming at reducing corruption through facilitating autonomous spaces for 'change agents' with a will and potential to orchestrate processes of reform.

In the next section, we discuss how taxation and state-building are linked based on Western historical experiences. We argue that it is unlikely that contemporary low income and fragile states can adopt a similar process with similar outcomes. We argue, however, that taxation is a necessary condition for state-building and for countries to move out of fragility.

### 3. Building state capacity in fragile states

The functioning and survival of a political system depends on state capacity. State capacity can be defined as the ability of a government to administer its territory effectively or implement official goals, especially over the actual or potential opposition of powerful social groups or in the face of unruly socio-economic circumstances (Skocpol 1985). The literature distinguishes between four basic state capacities:<sup>10</sup>

1. Extractive capacity that enables the state to mobilise resources from society to pursue the ‘national interest’.
2. Steering capacity, which guides national socio-economic development.
3. Legitimation capacity, which is the capacity to dominate by creating consensus.
4. Coercive capacity, which involves dominating through threat of force.

State capacity can be measured in terms of tax extraction or extractive capacity. Extractive capacity is often measured by the tax-to-GDP ratio or by the structure of the tax system, i.e. whether taxation is based on direct income and wealth taxes or on indirect taxes on consumption, import duties etc. (Bizhan 2018: 16). It requires capacity to extract taxes, and successful tax extraction is a way for governments to create fiscal space, provide essential public services, and reduce foreign aid and single resource dependence (Fukuyama 2013: 353). These capacities are absent or in very short supply in fragile states.

The average tax-to-GDP ratio in fragile states was below 15% during the period 2005-14 (IMF 2017a: 12). Recent studies suggest that ensuring basic public service provision requires a revenue-to-GDP ratio safely above 15% (ibid.). Countries emerging from conflict may have an even greater need. Yet, the benefits of collecting more taxes depends on who pays the taxes and how tax revenues are spent. Based on a comparable fiscal incidence analysis, Nora Lustig (2017) finds that many developing countries have regressive policies and practices both on the revenue and expenditure side. In some countries, fiscal policy increases poverty, meaning a significant number of the poor are made poorer by the tax system. This is mainly the consequence of high consumption taxes on basic goods. Moreover, increasing tax as a proportion of GDP, without improving the way that taxes are spent, will not improve the well-being of citizens if the collected revenue simply ends up as tribute for a small elite (Pritchett and Aiyar 2015). Thus, Joel Slemrod (2016) argues that the international community should “banish soft thinking, like ‘more revenue is always good’”.<sup>11</sup> The overall challenge is not to tax more, but to tax better, i.e. more consistent, simple, transparent, fair, predictable, efficient and honest.

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<sup>10</sup> See Bizhan (2018) for a more elaborate discussion of state capacities.

<sup>11</sup> Cited by Long and Miller (2017: 12).



If taxation is undertaken in a way that promotes greater responsiveness and accountability, alongside improvements in the state's institutional capacity, then the tax system can become a catalyst for broader improvements in government performance (Braütigam 2008; Fjeldstad and Moore 2008). Historical evidence from state-building processes in Western countries suggests that a substantial 'governance dividend' can be gained from mobilising domestic financial resources through the tax system (Levi 1988; Tilly 1990). In Western countries, the tax system contributed to improved governance through three main channels (Moore 2008). First, fiscal bargaining and negotiation between the state and citizens over taxes was central to the development of a social fiscal contract. In this perspective, taxpayers have a legitimate right to expect something in return for taxes paid and are more likely to hold their government to account if it underperforms. Second, governments have stronger incentives to promote economic growth when they are dependent on taxes and therefore on the prosperity of taxpayers. Third, dependency on taxes requires states to develop a bureaucratic apparatus for tax collection. This can also motivate reforms in other public institutions and stimulate the development of state capabilities, for instance by building business and property registers for urban planning. On this basis, Di John (2010) argues that tax collection capacity is a useful (but neglected) indicator of state performance and provides important clues as to where polities lie on the spectrum between fragility and resilience.

One important question these historical studies raise is whether the idea of 'revenue bargaining' is helpful in thinking about how political authority and order are created (and re-created) in poor countries today. Some recent country case studies suggest that it may be. Prichard (2015) argues that in some cases, taxation has been a catalyst for demands by citizens for greater accountability in Ethiopia, Ghana and Kenya. Eubank (2012) shows that the formation of a government in Somaliland – a state that has never been internationally recognised - was deeply intertwined with the process of building a viable tax base. This position is partly supported, though somewhat modified, by Moore (2016). He argues that the balance of 'bargaining power' in Somaliland generally lies with larger companies and wealthy individuals. They can block tax initiatives to which they object by using their connections to senior members of government or organising strikes or other forms of public dissent. In that regard, the Somaliland revenue system is a reflection of the national political system: authority is widely dispersed, and changes have to be negotiated with care.

The links between taxation and state authority is explored by Varming (2017) in the semi-autonomous Puntland State of Somalia. She finds that Puntland, in the absence of an effective central government, has had some success in creating a political identity among its citizens. People recognise the right of the state to collect taxes. Thus, taxation is not just a source of revenue for the Puntland government, but also a claim to state authority as part of the state building process. In everyday practices, however, taxes are often collected by force or the threat of it (ibid. 16). Campos (2016) documents a similar link between taxation and Somaliland's

state-building project. He explains how taxes collected by force and at the recognition of power, construe collectors as the authority of the sovereign state: “[T]axes construe collectors as agents of a common collective project” (ibid. 5).

It is, however, important to acknowledge that the pattern of state formation in Western Europe was unique to a particular context and time. Therefore, one should be cautious in expecting similar state-building outcomes in the contemporary developing world, particularly in fragile states. Based on research from the Middle East, Waterbury (2001: 29) argues that there is no guarantee that taxation leads to representation:

*...neither historically nor in the twentieth century is there much evidence that taxation has evoked demands that governments account for their use of tax monies. Predatory taxation has produced revolts, especially in the countryside, but there has been no translation of tax burden into pressures for democratization.*

Nematullah Bizhan (2018) supports this argument in his commendable book *Aid paradoxes in Afghanistan: Building and undermining the state*. He argues (p. 18):

*Although the literature claims that the demand for “no taxation without representation” led to democratization, taxation does not unilaterally lead to representation. The outcome of this process depends on how societies are organized and how the state interacts with society. For example, post-1979 Iran does not support the notion of “no taxation without representation”. Taxation was declared a religious duty that would not entitle the taxpayer to have a voice in state affairs.*

Using taxation as a way to promote a social fiscal contract between state and citizens is not a given. The country context and specifics on the ground matter (Byiers and de Weijer 2014). The causality between representation and taxation is also blurred. Does taxation lead to

## **Box 2: Does democratisation foster effective taxation?**

Benin was born out of decolonisation, with a fragile economy and a heritage of administrative weakness. The country has undertaken a fairly successful transition to democracy. If the hypothesis of the existence of a ‘virtuous circle’ between effective taxation and representative government is correct, democracy may have helped the country in overcoming a negative historical legacy. The case of Benin suggests that democracy can have a positive impact on taxation in two ways. First, democratic legitimacy can help a government to push ahead a package of potentially controversial fiscal reforms. Second, the climate of civil freedoms and open debate generated by democracy can help with putting on the agenda issues that previously received little attention, such as the impact of taxation on equity and economic development or the role of the informal sector. Thus, a democratic environment can create the preconditions for effective fiscal reforms.

*Source: Piccolino (2015)*

demand for representation or does representation create the preconditions for effective tax reforms, as the experiences from Benin suggest (see Box 2)? There at least seem to be correlations. A recent study of a property tax collection campaign in the city of Kananga, D.R. Congo, finds that citizens in taxed neighborhoods were more likely to attend government townhall meetings or submit a suggestion card evaluating the government (Weigel 2018). Participating individuals demanded more public goods and more accountability from the government, consistent with a process of tax bargaining.

The tax system may not only be relevant for the relationship between state and citizens, but also for the relationship between citizens. Based on Afrobarometer data, D’Arcy (2011) finds that the way the state treats individuals or groups relative to their fellow citizens is an important factor in determining taxpayer compliance attitude.<sup>12</sup> If the state treats certain groups preferentially, this may colour the citizen’s relationship with the state and the group receiving favors. A crucial variable is then not just what a person gets from the state, but how the state treats the person *relative* to those who are in the person’s wider national community (Ali *et al.* 2014). Thus, making a tax system more fair, accountable and responsive addresses some of the root causes of fragility and might contribute to greater societal resilience (OECD 2014).

Although these tax-governance linkages are complex and context-specific, and much of the evidence is anecdotal, there are many indications of synergies between tax reforms and governance, though they might only emerge in the relatively longer term (Moore 2015). Seen in this light, taxation is not just an administrative task for governments and citizens. It is also about politics and power, and the way that authority is exercised in a country through its formal and informal institutions.

The matter of political power in fiscal reforms was emphasised by Nicolas Kaldor more than five decades ago. In an article published in *Foreign Affairs* with the title “Will underdeveloped countries learn to tax?” he writes (Kaldor 1963: 418):

*To the detached observer, fiscal reform undoubtedly appears as the most appropriate instrument for transforming the feudal or quasi-feudal régimes which inhibit the*

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<sup>12</sup> Afrobarometer (AB) measures Africans’ views towards democracy, economics, and civil society with random, stratified, nationally representative samples. Because the instrument asks a standard set of questions, countries can be systematically compared. The surveys are conducted in more than a dozen African countries and are repeated on a regular cycle. The fieldwork in each country is conducted by national research institutions affiliated with the Afrobarometer project. Mali and Niger are covered by the surveys. AB plans to conduct a survey in South Sudan when the political situation permits. Afrobarometer covers all the six African countries targeted for long-term strategic partnership with Norway (see section 2). For more on the AB, see [www.afrobarometer.org](http://www.afrobarometer.org)

*healthy evolution of so many of the underdeveloped countries and prevent them from following the path toward the kind of mass-prosperity civilization which has evolved in Western Europe and North America. But the advocacy of fiscal reform is not some magic potion that is capable of altering the balance of political power by stealth. No doubt, expert advice on tax reform can be very useful in making men of good will - ministers or officials - conscious of the precise nature of the legislative and administrative changes that are required. But what can actually be accomplished does not depend merely on the individual good will of ministers or on the correct intellectual appreciation of the technical problems involved. It is predominantly a matter of political power.*

In the next section, we will discuss major challenges facing fragile states in raising tax revenues.

#### 4. Why fragile states are struggling to raise domestic revenue

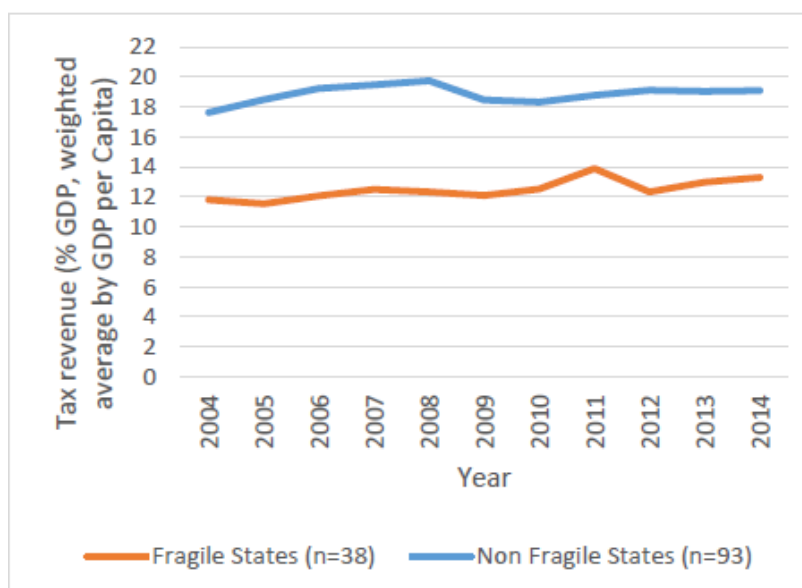
Intrastate conflicts tend to substantially reduce formal tax collection due to the disruption of economic activity and erosion of the tax base. Damage of infrastructure and administrative capacity generally prevents tax collection in conflict-affected regions. Destruction of public records and the loss of control of important economic centres contribute to the revenue decline (Gupta *et al.* 2005, 2007). Localisation of the conflict also matters. Conflicts that largely remain in peripheral regions have generally a much smaller impact on tax revenues than conflicts that reach capital cities (van den Boogard *et al.* 2016: 20). Conflicts that affect economically important border regions are likely to have damaging effects on customs administration. Intense conflict is also likely to cause major challenges for post-conflict tax reforms due to infrastructural damage and sustained weak tax bases, as well as greater disruption to the bureaucratic capacity (*ibid.* p. 19).

Economic, political and social turmoil have, in many cases, led to collapse of the revenue systems. There is a general shortage of skilled manpower to draft tax legislation and administrate tax collection. Revenue statistics and data are in short supply. Accurate revenue statistics are an important part of an administration's capacity to collect and manage revenue (Jerven 2013). However, roughly two-thirds of fragile states lack revenue data, double the proportion for other developing countries (OECD 2014: 56). Lack of such capacities facilitates tax evasion and capital flight, as well as other criminal activities such as smuggling. Generous tax exemptions, especially granted companies operating in natural resource extraction, are part of this picture and contribute to undermining public revenue generation.

It is well documented in the literature that high levels of foreign aid during, and in the immediate aftermath of conflicts, may generate incentives that discourage policy makers to invest in tax collection (Boyce and Forman 2010; Carnahan 2007). Bizhan (2018) argues that

while western economies-built states and the social contract around taxation, modern Afghanistan has been built around aid. Although intended to support state-building, the way aid has been delivered in Afghanistan has distorted the state and stunted the longer-term development of a social fiscal contract. In a similar vein, Vijaya Ramachandran of the Center for Global Development, argues that “*Haiti remains the ‘Republic of NGOs.’ Five years and \$9 billion later, Port-au-Prince does not have decent roads, clean water, or a reliable supply of electricity*” (Ramachandran 2015). These problems are partly the result of the excessive number of donors present in fragile settings, their diverse interests and the different aid modalities adopted. This complex environment creates risks of duplication or fragmentation and drains the already poor administrative capacity. In 2004, 60 governmental donors, many international organisations and about 2000 local NGOs operated in Afghanistan (Bizhan 2018: 83). The many international actors with diverse and sometimes conflicting interests made aid coordination a major problem. Exacerbated by the use of off-budget mechanisms, bypassing the state and national systems, many overlapping systems emerged. Major bilateral donors and multilateral agencies prepared their own strategies and policies that were poorly aligned with Afghanistan's needs and the Afghan government's priorities. In a study from 2007, the World Bank concluded that “the widespread use of uncoordinated and non-strategically targeted technical assistance is neither fiscally nor politically sustainable” (World Bank 2007: 2).

The IMF has estimated that the average annual tax-to-GDP ratio in fragile states was less than 15% during the period 2004-14 (Figure 1). In comparison, the average for other developing countries was 19% and for OECD countries 34% (OECD 2014).

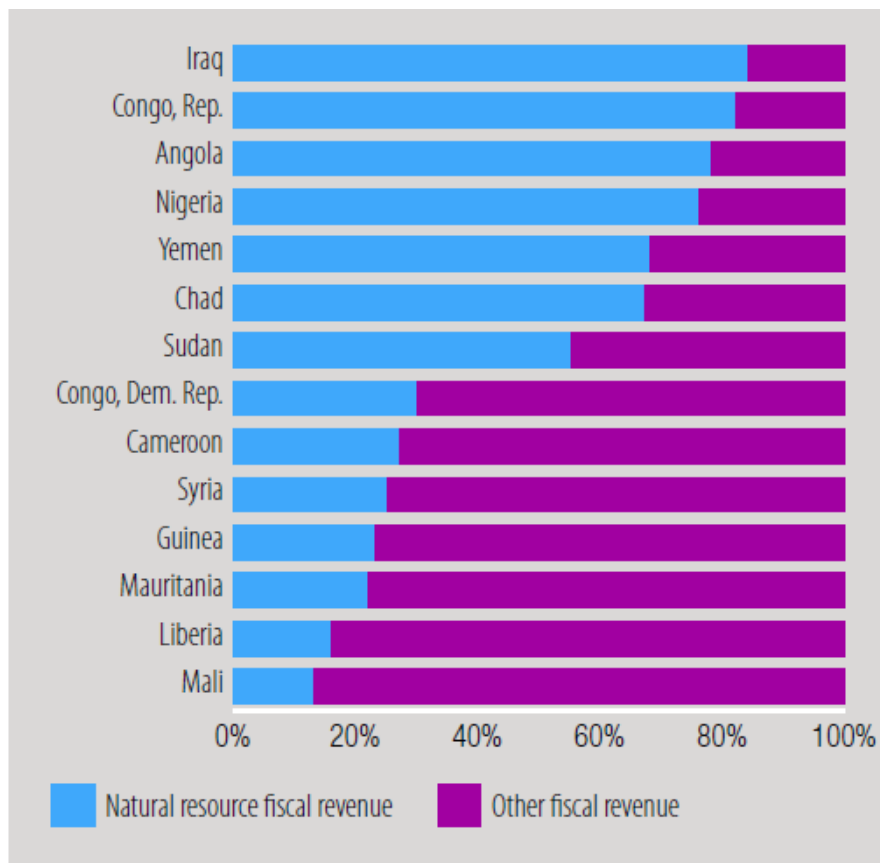
**Figure 1: Tax revenue in % of GDP in fragile and non-fragile states (2004-14)**

Source: IMF (2017a)

Many fragile states rely heavily on only one or two types of resource, rather than on a diverse composition of revenue sources (OECD 2014). Revenues from natural resources and trade related taxes account for a much larger proportion of revenue in fragile states than other countries. This is exemplified by Mali and Niger, that both rely heavily on revenue from mining and customs. Direct taxes, such as personal income tax and corporate tax on profits, account for small shares. This implies that global trade liberalisation has a larger negative impact on public revenue generation in fragile states than in other countries. We will discuss this further in Section 5.

Non-renewable natural resources generate a large share of total fiscal revenue in some fragile states: 84% in Iraq, 82% in the DRC, 68% in Yemen, 67% in Chad and 55% in Sudan (see Figure 2). In South Sudan, 98% of fiscal revenue in 2011 came from oil (OECD 2014: 54). Revenues from natural resources are generally much more volatile than tax revenues. Dependency on natural resources makes fragile states vulnerable for commodity price shocks, such as the dramatic drop in commodity prices in 2014. High dependency on revenues from extractive industries and trade is not only a challenge from a revenue perspective. Research finds that these revenue sources do less to build a social fiscal contract than direct taxes (Braütigam *et al.* 2008; Moore 2004, 2008).

**Figure 2: Natural resource fiscal revenue in fragile states (in % of total revenue, average, 2006-10)**



Source: OECD (2014).

Decreased formal tax collection during periods of conflict, and especially during periods of conflict intensity, is not surprising. This does not mean that people do not pay taxes. During conflict, parallel systems of informal taxation frequently emerge, ranging from relatively institutionalised and coordinated extractions by rebel groups to *ad hoc*, coercive extractions by armed individuals (van den Boogard *et al.* 2016: 20). Informal payments are among the key issues that distinguish fragile states from other developing countries (OECD 2014). Outside of the formal, national-level tax systems and policies, people often have to pay simply to engage in trade and business, travel, educate their children, and get health care. Informal taxes comprise both illicit formal taxes in the form of payments illegally collected under the guise of formality by official tax collectors and other state officials, and not remitted to the government treasury (e.g. bribes and embezzlement), and ‘gifts’ and ‘donations’ collected by a wide range of non-state agents and organisations (see Box 3). In South Sudan, for instance, non-monetary ‘taxes’ such as grain were collected by rebel administrations during the civil war (Rolandsen

2005). Companies in the small formal sector are often taxed disproportionately highly and may lead to closures and/or businesses moving from the formal to the informal sector to avoid extortive taxation. Many end up being exposed to a combination of formal and informal taxes in the form of bribes, fees and charges levied by both state and non-state agents (see Box 4).

### **Box 3: Informal taxation in the DRC**

The French economist Remy Prud'homme has studied informal taxation in the Democratic Republic of Congo. DRC (previously Zaire) has never been ruled by an effective central political authority and has suffered recurrent and sometimes acute internal conflict since independence in 1960. Congolese public servants have routinely functioned as unofficial tax collectors simply to collect their salaries. Prud'homme (1992) distinguished six categories of informal taxation: *pinch* (misappropriation of money by authorised tax collectors), *extortion*, *requisition*, *contributions*, *gifts* and *donations* (to schools). He estimated that informal tax collections amounted to about 85% of total tax collections. Recent evidence from other countries, including Sierra Leone (Jibao *et al.* 2017), suggests that the picture on informal taxation painted by Prud'homme is common in many poor countries.

*Source:* Moore, Prichard and Fjeldstad (2018)

### **Box 4: Taxes on fuel transport in Puntland State of Somalia**

Most goods available in the markets of Garowe, the administrative capital of Puntland, arrive by truck, either from Ethiopia or Somaliland, or from the port of Bosaso. Fuel is one of the most important items. Truck drivers pick up the fuel at the port, some carrying barrels others in tanker trucks. Most of the drivers are individual entrepreneurs, owning one or two trucks, while others work for the big fuel companies who own truck fleets. Many fees are levied between Bosaso port and the market in Garowe.

After loading their trucks, drivers undergo a check by customs and pay the 'port tax'. As they leave Bosaso town, they pay a 'transportation tax' or exit fee. Between Bosaso and Garowe there are somewhere between three and seven checkpoints collecting payments. These are official checkpoints, manned by police officers from the local municipality. The fees they charge from the trucks are considered to be socially accepted, but they are not legal. The checkpoints are only supposed to collect offloading tax from trucks having their town as their final destination. After a ten-hour drive on the narrow mountainous road, the fuel arrives in Garowe, where an offloading tax is paid at the checkpoint before entering the town.

*Source:* Varming (2017)

Poor governance and systemic corruption are features of fragile states (Acemoglu and Robinson 2012; Lavallée *et al.* 2008). According to Transparency International's Corruption Perception Index, two thirds of the fragile states were among the countries with the highest levels of corruption in the world in 2015 (TI 2015). Corruption is common in contracts between the government and companies in the extractive sectors, and often involves ministers and senior government officials. Corruption in revenue administration is also widespread. Surveys



repeatedly find that the most discredited institutions are the police and the tax administration, including customs. Distrust and poor state-citizen relations are the outcomes. To break out of this circle and to (re-)build a working tax system is challenging. It requires enforcement capacity and state legitimacy. As argued in Section 2, tax systems in fragile states where state legitimacy generally is low, must be implemented with some levels of coercion. Without this, people will simply not pay tax as they have little trust in the government delivering anything in return. Nevertheless, there are lessons that point at possible directions forward. For instance, experiences from Afghanistan suggest that a change in the political leadership was essential to establish credibility of the tax reform. A strong leadership ('agent of change') took concrete action and fired 40 corrupt officials in 2015. This sent a powerful signal to the public. Tighter monitoring of government officials, stabilisation of (imperfect) government, and improvement of technical systems in addition to relatively strong human capital have been important in building the Afghan tax collection system (World Bank 2017a: 29). In the next section, we will discuss experiences with tax reforms in fragile states, including how and what revenues are collected in different countries.

## 5. Domestic revenue mobilisation in fragile states

Engagement on taxation in fragile states in principle should be broadly similar to that in low-income countries. However, as discussed above, there are several unique features of conflict-affected settings that require specific attention. While there are huge variations between conflict-affected countries, there are certain common challenges that necessitate distinctive policies (Addison *et al.* 2002; Gupta *et al.* 2005; Di John 2010). The legacies of conflict, related to economic and administrative destruction, and to political power and divisions, implies that great attention must be paid to identifying entry points and priorities for reform, as well as to possible threats to successful implementation of the reform (van den Boogard *et al.* 2016: 20). It is crucial to understand the political economy of the country in question. How are revenues mobilised? What are the most important sectors, and what is the nature of power and the decision-making processes? Is decision-making based on vertical patron-client relationships rather than being integrated in the formal decision-making process?

There is an ongoing debate among development practitioners and tax experts on what would be the best approach to assist fragile states to strengthen their own revenue system (OECD 2014: 66). Many issues remain contentious, and each argument has its strengths and weaknesses. For instance, should tax reform start by focusing on improving customs first, and thereafter move on to indirect sales taxes? How should enterprises be taxed? Should the reform focus on larger companies from the outset, or should all taxpayers be included, independent of size? What about sub-national taxation, including property taxes? A related debate is whether tax reform in fragile states should aim to strengthen existing administrative systems and tax legislation or establish new ones. There are no 'correct' answers to these questions. It depends

on the specific context. The chosen approach will have implications for the effects of taxation on state-citizen relations and state-building.

The International Monetary Fund suggests a three-pronged strategy to build tax capacity in fragile states (IMF 2017a: 19). First, define and implement the required tax policies, along with basic arrangements for administering revenues and managing public finances. Second, establish a proper legal and regulatory framework for fiscal policy. Third, establish an effective central fiscal authority (usually the ministry of finance) and a mechanism to coordinate donor assistance. The challenge is how to implement such a strategy in fragmented, conflict-prone societies, including the states that have been targeted as focus countries for Norwegian aid (see Section 2). The windows of opportunity are context specific and often unpredictable. For instance, the state collapse in **South Sudan** offered limited entry points, except from in the capital Juba where something that appears like a state structure is still in place. In **Somalia**, the government has recently made progress in establishing government institutions and supporting community stabilisation. In this setting, there is demand for and opportunities to developing the tax system. Taxation in **Palestine** is largely governed by the principles of the Paris Protocol (PP), signed in 1994.<sup>13</sup> The PP limits the role of the Palestinian Authority (PA) in designing its own fiscal and trade regimes.<sup>14</sup> This of course also limits the entry points for donor support to taxation. However, within its restricted room of manoeuvre, the PA, with external technical assistance, has managed in periods to raise significant domestic revenues. This is also the experience of other conflict-ridden states, including **Afghanistan, Haiti, Mali** and **Niger**.

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<sup>13</sup> The full title of the Paris Protocol is *Protocol of Economic Relations between the Government of the State of Israel and the PLO, Representing the Palestinian People*. The title indicates that it was drawn up between two equal partners, despite one contract partner being a state and the other an organisation (see Arnon and Weinblatt, 2001: 295). Kanafani (2001) provides an insightful discussion of the strengths and weaknesses of the PP from both Israeli and Palestinian perspectives.

<sup>14</sup> Formally, the Palestinian Authority (PA) is entitled to collect taxes from the Palestinians in the Palestinian territories, but some 75% of the total tax revenue was, as of 2014, collected by Israel on behalf of the PA and transferred on monthly basis. Israel has occasionally withheld the taxes it owes the Palestinian Authority (Fjeldstad and Zaghera 2004; UNCTAD 2015).

In the following paragraphs, we present lessons from reforms that have contributed to building tax capacity in countries that are the focus of Norwegian support to fragile states. Although the reforms and technical assistance cover a range of issues, we have grouped the efforts into five sub-categories: (a) (re-)building tax administration; (b) customs reforms; (c) broadening the revenue base; (d) tax exemptions; and (e) sub-national taxation. As a starting point, it is important to emphasise that tax capacity does not depend solely on tax administration (see Box 5). Tax policy units within ministries of finance are equally important.

#### **Box 5: Tax capacity does not depend solely on tax administration**

It is important that donors do not view revenue administrations as the only relevant bodies for targeting capacity building efforts. Tax policy units within ministries of finance are equally important. The responsibilities of these units are significant: evaluating the impacts of tax policies on the economy and proposing reforms, making revenue projections and setting collection targets. Building capacity in the judiciary is also important, as any disputed tax cases will end up in the courts. Donors should consider measures to inform and empower parliamentarians, parliamentary committees and citizens to promote the passing of better legislation and greater accountability. In contexts where tax collection is characterised by coercion and corruption, increased popular and legislative scrutiny can encourage better collection processes, which in turn may increase compliance and lead to higher and more sustainable revenue streams.

*Source: Moore et al. (2015)*

#### **(a) (Re-)building tax administration**

Security constraints impose major constraints on technical assistance (TA) to countries that experience major political instability and insecurity, or inaccessibility due to natural disasters or public health crisis. Yet, there are examples where such countries are supported through the use of different aid modalities (IMF 2017a: 19). For instance, the **Liberia** Revenue Authority (LRA) was launched in July 2014, in the middle of the Ebola crisis. Travel restrictions meant that the IMF provided TA through video conferencing, telephone, e-mail, and off-site meetings. This suggests that major crises, such as natural disasters or public health crises, does not necessarily imply inactivity from donors. This also applies to some countries in severe intra-state conflict.

Lessons from **South Sudan** suggest that establishing basic tax administrative procedures can have high revenue impact in a short time. In South Sudan, this meant introduction of basic rules and procedures in key compliance areas such as registration, filing, and payment of taxes for the major taxpayers (IMF 2017a: 23). It also included strengthening of the large taxpayer office and customs operations at the largest port. In **Myanmar**, the administrative reform

from the start also focused on larger taxpayers to secure the largest proportion of tax revenue and lay the foundation for further strengthening of the tax administration (ibid.).

In **Afghanistan**, the Ministry of Finance in Kabul has received substantial technical assistance (TA) from the IMF, the World Bank and bilateral donors for developing new revenue systems and policies (Bizhan 2018: 107). The ministry received 60 foreign advisors by 2011, the largest number of international technical assistants among the state civilian institutions. Foreign and local consultants both provided TA. Foreign consultants helped drafting new policies and legislation, while the local consultants engaged with local civil servants and translated the policies and laws from English into Dari and Pashtu. The TA improved the speed of the reforms.

### ***(b) Customs reforms***

Revenues from trade related taxes account for a large proportion of revenues in fragile states (see Section 4). Thus, improving the customs administration and containing corruption are likely to support overall revenue growth. For instance, the main component of **Haiti's** revenue consists of taxes from international trade (IMF 2013). The country's dependence on international trade is particularly high (4.6% of GDP in 2011), much higher than the regional average (2.5%). The second largest component of taxes is the turnover tax on goods and services, followed by taxes on income (2.5% of GDP). Important reforms of the revenue administration have taken place. Revenue-to-GDP rose from 10.7% of GDP in 2008 to 13.1% in 2011 (ibid. p. 2). According to the IMF (2013), these improvements in the revenue-to-GDP ratio are associated with a more efficient collection chain, and improved controls over the collection chain. Yet, tax and customs administrations still suffer from weak technical capacity, and an organisational structure where policy direction, monitoring and operational delivery are not separated.

Between 2003 and 2009, the tax-to-GDP ratio in **Afghanistan** was about 7%, among the lowest in the world. The reliance on trade-related taxes was substantial and much higher than in other conflict-ridden states such as Burundi, DRC and Sierra Leone. A large share of domestic revenue was collected at the borders in the form of customs duties, fixed taxes on imports and exports and administrative fees. The revenue system also included income taxes withheld from salaries (PAYE), dividends, royalties etc. However, personal and corporate income taxes were as low as 3% of GDP annually during the period 2003-2009. A number of factors undermined revenue mobilisation (Bizhan 2018: 106). These included a very narrow tax base, associated with a very low level of development, a large informal sector and a large small-scale agriculture sector, weak public administration and massive corruption. By 2010, domestic revenue generation had increased to around 10% of GDP (ibid. p. 105). This trend seems to have continued. In the first eight months of 2017, government revenues grew by nearly 13% compared to the same period of 2016 (Byrd and Payenda 2017). This followed

strong revenue performances in 2015 and 2016. According to Byrd and Payenda, this is “*one of the few positive trends in the Afghan economy, in contrast to its continuing weak overall showing in terms of economic growth and employment*”. The revenue increase in the first half of 2017 was not due to rises in tax rates. On the contrary, Afghanistan was forced under the conditions of its entry into the World Trade Organisation to reduce some import tariff rates. The major contributing factors appear to have been customs units managing to reduce the incidence of mis-declaration of goods (falsely labelled in order to pay a lower tariff rate) and under-valuation of goods (declared at below the actual import price to lower duties).

In addition to raising revenue, import tariffs can also be an instrument, if used carefully and in moderation, for protecting and nurturing the development of domestic production. While high tariffs would be ineffective and most likely encourage smuggling, it does not make sense to cut tariffs to a minimum and provide no protection at all for goods which a fragile state is producing domestically, where it has some potential comparative advantage, and where the economy has a capacity for a supply response (i.e. the right incentives would stimulate greater production). Many agricultural products fit this bill. Moreover, many fragile states currently import large volumes of agricultural goods, goods which often are subsidised by the exporting country.

### ***(c) Broadening the revenue base and tax simplification***

In addition to trade related taxes, many fragile states rely heavily on revenue from natural resources. In **Mali** and **Niger**, for example, income from mining and customs are the major revenue sources. A key objective of tax policy is to reduce the dependence on volatile natural resources by broadening the revenue base, in addition to strengthening the efficiency of customs administrations (IMF 2017c, 2017d). Such measures are required to address macroeconomic imbalances and to develop a more reliable revenue system to finance the most urgent government activities, such as paying civil servants and delivering basic public services (Gupta *et al.* 2005). Due to widespread destruction caused by conflict and limited administrative capacity, simple taxes that require low administrative capacity from both the revenue administration’s and the taxpayer’s perspectives are recommended. This could be custom tariffs and turnover taxes on companies, such as *ad-valorem* royalties in the natural resource sector. Income-based taxes are far more vulnerable to avoidance than royalties and pose substantial administrative challenges to manage by weak states (Durst 2016). Taxes should be raised in ways that minimise their disincentive effects on economic activities. Simple taxes are generally more transparent than complex ones and may reduce opportunities for corruption. Thus, even though such taxes may be distortionary, their benefits may exceed the costs in fragile settings (IMF 2017a: 22).

Experiences from **Somalia** suggest that simple reforms in the short to medium term can possibly have large effects on tax collection. Even though Somalia has an extremely low

absolute tax-to-GDP ratio of 1.9%, the government managed to increase its tax revenue by more than 22% from 2013 to 2015 (World Bank 2017b). This change has taken place without undertaking large reforms and with minimal efforts to increase revenue mobilisation. It shows that simple, short-term reforms may have large impacts on revenue generation. One of the reforms was to switch from manual to electronic tax collection in 2015. Automation of a property transfer tax was piloted, which increased revenue by 74% in the four first months after the implementation, as compared to the previous four months. According to the World Bank (*ibid.*), this reform increased efficiency and transparency of the tax system. It provided information to the authorities relevant for future planning and tax reform. Through increased public awareness, it also has potential to support the building of a more trustworthy state-citizen relationship.

Relatively easy tax handles include restaurants, hotels, and car rentals. The large influx of expatriates in fragile settings, has often lead to a surge in spending at a small number of hotels and restaurants (Gupta *et al.* 2005: 13-14). These provide an easily identifiable tax base that could be exploited in a simple and straightforward manner through sales and turnover taxes. Since the burden of these taxes would fall on expatriates, they are often politically attractive (*ibid.*). These taxes could also be confined to a few larger enterprises. When administrative capability has developed, the coverage of the taxes could be broadened to cover areas such as private health services, legal and accounting services. Measures to improving collection of tax arrears and management of tax exemptions should then also be prioritised.

The International Monetary Fund argues that some of these reforms can provide the basis for implementing value added tax (VAT) later (IMF 2017a: 22). **Benin** is an example of a relatively successful VAT implementation in a fragile setting. In 1992, Benin's tax-to-GDP ratio was 10.8%. In 2011, it had risen to 17.1% (Piccolino 2015). The most important component of the tax reform was the introduction of VAT in 1993. Other reforms addressed the way taxes were collected. However, for most fragile states VAT is not an immediate option since it requires a reliable accounting system in both the private and public sector. In highly corrupt environments, fabricated VAT reclaims may skyrocket and undermine revenue collection (Moore, Prichard and Fjeldstad 2018). A simple sales tax could be an option. For example, **Afghanistan** has implemented a sales tax that allows some deductibility of tax on input - mainly imported intermediate goods (IMF 2017a: 22).

#### ***(d) Tax exemptions***

Many countries provide tax incentives to encourage private investments - both foreign and domestic - and reduce the tax burden of certain sectors (such as agriculture) and the poor (IMF, OECD, UN and the World Bank 2011). In developing countries, international development agencies, NGOs and religious organisations are often exempt too. These exemptions come at a cost since they tend to reduce the present value of taxes the country can collect from taxpayers

(Oppong and James 2016). Some tax expenditures are a normal part of the tax system, such as capital allowances and import tax refunds for exporters (Forstater 2018). In countries with large informal sectors and tax evasion pressures, tax incentives can be a means of preventing firms from shifting into the informal sector or evasion-prone activities (Jun 2017). However, tax experts have argued for many years that overall tax exemptions are ineffective to attract investments (see Box 6). In addition, exemptions may create room for bribery and corruption, and increase the appearance of loopholes for tax evasion (Zee *et al.* 2002). There are also examples where tax exemptions are used as tools to reward political allies and control potential opponents (Moore and Prichard 2017). The recommendations are that where tax exemptions are used, they should be based on clear criteria, transparently granted and monitored, and with a clear time limit.

Tax exemptions are often extensive in fragile states. Reliable data on revenues foregone through the granting of tax exemptions is patchy, but overall they appear to be non-trivial amounts of money. For **Haiti**, the IMF estimates a level of tax exemptions equivalent to about 4% of GDP for the fiscal year 2010/11 (IMF 2013: 5). In comparison, the tax-to-GDP ratio is around 13%. Thus, the exemptions constitute an important loss in revenue. However, in contrast to what is observed in many other countries where exemptions are largely granted to investors (both foreign and domestic) the major source of this tax expenditure in Haiti, and other conflict prone countries, comes from exemptions granted on the imports of international organisations and diplomatic missions. Many of these exemptions go beyond the boundaries set by international treaties (*ibid.*).

Among the items exempt from customs duties, the largest share of tax expenditure often relates to vehicles. Only a minor share refers to food, construction materials and medical items. Poor countries are often forced to administer a myriad of exemptions that typically vary from donor to donor. This places unnecessary burdens on already weak tax administrations. Even worse, it may fuel a tax exemption culture and promote corruption (Fjeldstad 2014: 185). Efforts to tax aid – including tariffs on aid-financed imports, taxes on the incomes of national and expatriate aid agency employees and private contractors, and taxes on rental incomes of the owners of housing and offices leased to aid agencies and their staff – could contribute to widening the revenue base, simplifying the tax system and increasing domestic revenue collection (Boyce and Forman 2010: 37). Taxes paid in relation to project assistance should be included in measured official development assistance (ODA), and thus contribute to meeting donors' targets in this area. Yet, there is strong resistance from international donors and NGOs to abolish these exemptions.

**Box 6: Do tax incentives encourage investments?**

Proponents of tax incentives often argue that it is imperative to provide tax incentives to attract investors, given the generally poor investment climate in poorer countries. This position is disputed. In a study using data from a cross section of 80 countries, Van Parys and James (2010) found that it is ineffective to lower the tax rate to compensate for a bad investment climate. Instead, they argue that countries should focus on improving the basic investment climate, such as the time required to start a business, register property and deal with construction permits, as well as protection of investors, the quality of infrastructure and so on. A report by the IMF *et al.* (2011: 19) reaches the same conclusion: where governance is poor, corporate income tax exemptions “may do little to attract investment”, and when they do, “this may well be at the expense of domestic investment”. In addition to distorting competition, tax incentives may lead to large revenue losses.

**(e) Sub-national taxes**

Donor support to tax reform in fragile states has largely focused on national tax systems. Due to the overall fiscal constraints, the reform of the sub-national tax system has not been a priority over the mobilisation of central government revenues. In the peace building literature, strengthening local government through decentralisation reforms is often considered a solution to state capacity restraints. This may seem quite neat in theory. The problem, however, is that local governments often have more severe capacity constraints than central governments and are given little attention from international donors after the decentralisation process has been carried out. Decentralisation of tax administration could therefore potentially be an important factor in broadening the capacity to collect taxes. However, it ought to be approached from both sides: strengthening the local government at the same time as increasing the fiscal responsibility of central government (Fjeldstad 2015, 2016; van den Boogaard *et al.* 2016).

**Mali** offers some lessons in this regard. In the 1990s, the conflict in the northern part of the country was ‘solved’ temporarily through a National Pact that included a large-scale Governance and Decentralisation Programme. In 2017, a conversation along solutions to the current crisis took place along similar lines. Giving more power to authorities that are closer to people may seem like the right thing to do. However, experiences from Mali indicate that conducting combined political democratisation, economic liberalisation and decentralisation within such a weak and fragile state runs the risk of being hijacked by a combination of national elites and regional ‘big men’ (Bøås 2012). This is precisely what happened in Mali in the 1990s, and the turmoil that surfaced in 2012 is an unintended consequence of that (Bøås and Torheim 2013). If they want to tie support to building tax regimes to decentralisation programmes, external actors should ask themselves: How can a state that is politically and socially



fragmented, economically impoverished, and administratively very weak, become any stronger if it is divided into smaller entities? Much work needs to be done at the sub-national level, but it should be seen in line with how one can strengthen state capacity in general and not undermine it further. Here, as elsewhere, the first-priority ambition must be ‘do no harm.’

This does not mean that reform of existing sub-national tax systems should not be looked into. In particular, there is a revenue potential from property taxation. Poor countries are urbanising fast, driven by a combination of population growth, poverty and - in fragile states - by conflicts (Fjeldstad, Ali and Goodfellow 2017). It is estimated that between 2015 and 2050 the share of the population living in towns and cities in Africa will grow from 38% to 55% (Freire, Lall and Leipziger 2014). More than 50% of Africa’s poor are likely to live in urban slums by 2025 (UN Habitat 2014). These developments imply huge challenges for urban governance, service delivery and stability (Nugent 2010). Property tax is a potential cornerstone for the efforts to finance the development of urban infrastructure. Along with the huge increases in urban populations, investments are pouring into the real estate sector in cities. Investors are increasingly drawn towards high-value, high-security property development, which promises much better returns and lighter taxation than other investment options (Zinnbauer 2017). If taxed effectively, these property developments could potentially generate substantial public revenues for urban services and infrastructure.

Weigel (2018) studies an apparently successful property tax reform in a fragile setting. In 2017, a door-to-door property tax collection campaign was initiated in the city of Kananga, in the **Democratic Republic of Congo**. The DRC is a particularly difficult context in which to raise tax compliance because extractive colonial practices, economic decline (the country has lower per capita GDP today than in 1960), and civil war have weakened state capacity and propagated corruption. Before the reform, citizen payment of formal taxes was near zero. Less than 6% of the population knew of the property tax. Despite the difficult circumstances, the campaign raised citizen payment of the property tax by 11 percentage points. In this case, the successful approach to widening the base of property tax started with a very simplified assessment of property values followed by a door-to-door tax collection campaign. The institutional responsibility for tax collection was in the hands of local authorities with strong incentives to collect substantial revenues. The sustainability of this reform partly relies on whether the local economic and political elites continue to support the reform, or whether they will prevent the reform to being enforced. Experience from other countries also show that the main barrier to effective property taxation is largely political.

Based on the above analysis, in the next section we will discuss possible entry points for Norwegian support to domestic revenue mobilisation in fragile states in ways that may contribute to strengthen state-building and improve government legitimacy.

## 6. Norwegian support to domestic revenue mobilisation in fragile states

Norway is a signatory of the Addis Tax Initiative (ATI 2015) and has committed to doubling the support to technical co-operation in the area of domestic resource mobilisation by 2020. Existing Norwegian expertise on taxation in developing countries is scarce, though recognised internationally. The current expertise has developed over time in the form of technical assistance to revenue administrations, research and advisory work, and civil society engagement. Norad and the Ministry of Foreign Affairs have been actively engaged on tax issues over many years in selected partner countries, and in international fora on taxation and development. Norway supports IMF's tax related trust funds, including the *Revenue Mobilization Trust Fund* and the *Managing Natural Resource Wealth Trust Fund (MNRW-TF)*. The *Norwegian Tax Administration* (NTA) has provided technical assistance to the revenue authorities in Mozambique, Tanzania and Zambia on advanced tax audits of companies in the extractive sectors. The *African Tax Administration Forum (ATAF)* was established in 2009 with Norwegian support (among others), and Norway was instrumental in the establishment of the *International Centre for Tax and Development (ICTD)*. These, and other initiatives, have contributed towards developing tax administrative capacity in some countries, as well as increasing the knowledge base on taxation and development. Support to civil society organisations has generated awareness and public engagement on the links between taxation and development.

So far, these initiatives have only to a limited degree focused on fragile states (as defined in Section 2 of this report). How can Norway assist in building, or re-building, tax systems in fragile states and contribute to strengthen their fiscal capacity? Although some of the approaches that have been applied in other developing countries are relevant, the challenges of fragile states require different approaches, in particular regarding technical assistance. Complexity, limited experience and security concerns suggest that one should be cautious when adopting bilateral Norwegian technical assistance programmes of the kind implemented in, for instance, Mozambique, Tanzania and Zambia (Fjeldstad and Heggstad 2012, 2013). Instead, we envisage increased engagement via multilateral institutions, including multi-donor trust funds and other forms of pooled resources.

Based on insights from this study, our own expertise on taxation and fragility, and dialogue with relevant officials in Norad and the Ministry of Foreign Affairs, in this section we outline nine possible entry points for Norwegian support to domestic revenue mobilisation in fragile states. Our recommendations come with an important caveat: entry points for donor support are likely to differ substantially from country to country depending on context and demand. The recommendations are tentative and should be considered as issues for further discussion and elaboration by Norad and the Ministry of Foreign Affairs in their effort to operationalise Norwegian assistance to fragile states.

***Recommendation 1: Do no harm***

Tax systems in fragile states where state legitimacy generally is low, must be implemented with some levels of coercion otherwise people will simply not pay tax. Enforcement capacity is needed, but it cannot be too heavy-handed, and taxpayers will have to see fairly immediate effects based on taxes paid. The ‘right’ balance between enforcement and legitimacy cannot be achieved by donors. They can assist through technical assistance and policy advice. Donors need to think hard about who the agents of change are and how can they be identified within governments often are plagued with corruption and illicit practices. This means, as argued in Section 2, that if progress is to be made in establishing sustainable tax regimes in fragile states, these insights must be utilised to build grounded country strategies concerning how states actually work and the potential for identifying ‘change agents’ within them. Such agents of change must have a combined will to change and the power to initiate change. The practical question for Norway and other development partners in this context is: What can be done in countries where state legitimacy is low, and in the face of opposition from interest groups of various kinds, and through tax administrations that are corrupt, inefficient and resistant to change? The first-priority ambition must be ‘do no harm.’ This implies more and better donor coordination together with an established process of in-depth country analysis.

***Recommendation 2: Safeguard donor coordination, but ensure a certain humility***

Government ownership is a prerequisite for any policy reform, but it is particularly important for politically sensitive tax reforms. In fragile settings, characterised by widespread corruption and ineffective public institutions, there is a real danger that donors establish parallel systems outside the public sector to ‘make things work’. It is common that external tax experts in TA-projects become gap fillers, not capacity builders, in revenue administrations. Further, the large number of bilateral and multilateral donors that often are present in fragile settings, their diverse interests and the different aid modalities adopted create risks of duplication and/or fragmentation (see Section 4).<sup>15</sup> It is also likely to drain the already poor administrative and managerial capacity in the recipient countries. Multi-donor trust funds and other forms of pooled funding have resulted in greater collaboration among donors and recipients (Boyce and Forman 2010: 41). However, lack of agreement on strategic goals and competition among donors with diverse national and institutional interests continue to impede coordination and progress on the ground. These challenges should be followed up by Norway as a contributor to several multilateral trust funds (see the introduction to this section). There is also a need to minimise duplication and inconsistencies between the work funded by different tax related multilateral trust funds and tax initiatives, such as the IMF’s *Revenue Mobilization Trust Fund*

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<sup>15</sup> In some countries, there are as many as 35 different donors working with technical assistance on increasing tax revenue (IMF 2017a: 39).

and the *Managing Natural Resource Wealth Trust Fund* (MNRW-TF), and the World Bank's *Global Tax Program*. Through the *Global Platform for Cooperation on Tax*, established in 2016, the World Bank, IMF, OECD and the United Nations aim to collaborate more effectively in the area of tax and capacity development in development. The platform also aims to be a venue for discussing tax and expenditure assistance among development agencies and recipients of tax assistance. Norway's standing in tax and development, makes this platform a possible venue where Norwegian experiences can be communicated to influence priorities.

Countries differ substantially in their resources, capacities, opportunities, and histories, causing diverse responses to policy choices and practice (Grindle 2010: 24). This is not least the case for conflict-ridden countries. In fragile contexts, international actors are particularly influential when it comes to ideas about what needs to be done. Thus, if greater donor coherence and cooperation is achieved it comes with an obligation to keep ideas within reason, to ensure a certain humility in the design and implementation of the approaches to domestic revenue mobilisation, and to exercise caution in championing perspectives that have not had time to face the test of practice (ibid.). Development is a process in which learning and change occur. Movement toward international coherence and cooperation should therefore incorporate means for learning from practice, flexibility, and adaptation to changing circumstances.

### ***Recommendation 3: Support customs administration***

Revenue from customs (i.e. import duties, excises, sales taxes on import goods and, in some cases, export fees) are one of the major revenue sources in fragile states (see Section 5). Reforming and strengthening customs should be a priority for donor assistance. Due to low capacity, customs and tax administration should be able to rely on simple regulations, short tax forms, and minimum information requirements from traders (importers and exporters). Simplification also requires that the extensive tax exemption regimes must be addressed, including exemptions granted donor funded activities.

The IMF is involved in work to strengthen customs administration in some fragile states. Norway should also consider supporting the *World Customs Organization*. WCO has 182 members, three-quarters of which are developing countries. All ten countries with a need for stabilisation and conflict prevention that Norway has targeted are members of the WCO (see Section 2). We will recommend Norad/MFA to consult the *Directorate of Norwegian Customs* ('Tolldirektoratet') on opportunities and obstacles connected to such an initiative.<sup>16</sup>

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<sup>16</sup> See: <https://www.regjeringen.no/contentassets/a51e3fb5c0b1446f8a1fd5aa9548553d/tolletaten2016.pdf>

#### ***Recommendation 4: Capacitate management and taxation of natural resources***

Revenues from extractive sectors, especially mining, are prominent in several of the countries targeted by Norway, in particular Afghanistan, Mali and Niger. One possible entry point for Norwegian support is the *Managing Natural Resource Wealth Trust Fund*. The IMF launched the MNRW-TF in 2011 with several development partners to help countries build capacity to manage their natural resource wealth effectively. The support programme includes five modules: (1) tax policy; (2) tax administration; (3) financial management; (4) management of revenue produced by the resources; and (5) statistics systems to monitor natural resources (e.g., tax revenue and national accounting system). The fund has also assisted countries to create a more stable macroeconomic environment for exploration and exploitation of natural resources. Mali and Niger are among the beneficiaries so far, but results on the ground are still negligible, suggesting that better and more fine-tuned approaches are needed (see also Ba and Bøås 2017).

Norway should aim to influence the trust fund to improve the implementation of legal frameworks for more effective incorporation of environmental and social issues in the fiscal regimes. In some cases, it might be relevant to link IMF and initiatives like the *Oil for Development* (OFU) programme and the *Extractive Industries Transparency Initiative* (EITI). EITI has 51 member countries, including [Afghanistan](#) and [Mali](#).

#### ***Recommendation 5: Support the United Nations Tax Committee***

We are reluctant to recommend that Norway should support building advanced, transfer pricing and tax audit units in conflict-ridden states. Instead, the priority should be to assist in developing the basic tax system.<sup>17</sup> However, looking forward, there is a need for fora that to a larger degree than today serve the interests of developing countries when it comes to tax base erosion through profit shifting and transfer mispricing by multinational companies. We recommend that Norway contributes to scaling up the funding of the *United Nations Tax Committee*. The UN Tax Committee plays a potentially important role as a forum for developed and developing countries to address tax issues, beyond and in complement to the OECD processes. However, it is severely constrained by lack of resources (Forstater 2018). There is a need to evolve the committee into a more effective forum to serve the needs of developing countries, alongside the OECD and other international bodies.

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<sup>17</sup> This is a concern not only relevant for fragile states, but applies to many low-income countries. Logan Worth, ATAF's Executive Secretary, expressed his concern at the First Global Conference of the Platform for Collaboration on Tax, 14-16 February 2018. UN Headquarters, New York: "There is a balance between participating in BEPS and building basic tax administration. But, BEPS is absorbing all of our time. Participation in BEPS is correct, but the challenge is to get the balance right."

***Recommendation 6: Improve taxpayer-tax administration relations***

Tax officers in many fragile states have discretion over important decisions: tax liability assessments, selection of audits, litigation, etc. (see Sections 4 and 5). Many administrative procedures, including reporting tax revenues, should be more transparent. Business people report that over-assessment of tax liabilities is common, followed by ‘negotiations’ with the tax officer(s).

An important element of administrative accountability is the rights of taxpayers vis-à-vis the tax administration. Though either absent or in their infancy in the countries which are part of this study, tax appeals boards and tax tribunals are important institutions for securing taxpayers’ rights and in establishing fair and transparent procedures to addressing tax disputes. To make these institutions relevant for a wider segment of taxpayers, there is a need to simplify the procedures for instituting appeals, and to disseminate more accessible information to the general public on the roles and functions of the appeals board. Norway should consider supporting measures to strengthening taxpayers’ rights through the World Bank’s *Global Tax Program* and/or the IMF’s *Revenue Mobilization Trust Fund*.

A large proportion of the economic active citizens in fragile states belong to the informal sector (see Section 2 and 4). Understandably, ‘tax literacy’ is generally poor and many people are not able to comprehend the technical issues of paying taxes. In some contexts, it might be a demand for taxpayer education interventions, especially in urban centres. Norway should consider supporting taxpayer education campaigns and measures that aim to improving taxpayer-tax administration dialogue, through the *Global Tax Program* and/or the *Revenue Mobilization Trust Fund*. Since the *Norwegian Tax Administration* (NTA) has extensive experience in designing and implementing so-called ‘soft compliance’ methods, involvement of the NTA in the World Bank and/or IMF initiatives should be considered.

The *African Tax Administration Forum* (ATAF) is also engaged in taxpayer education programmes. ATAF has 38 member-countries, including [Niger](#). If there is a demand from ATAF to scale up its activities in fragile states, Norway should consider to provide financial support to the organisation.

***Recommendation 7: Remember the sub-national tax system***

Due to the overall fiscal constraints, the reform of the sub-national tax system has not been prioritised by donors over the mobilisation of central government revenues. As documented in Section 5 of this report, local government taxation is often a major constraint for small and micro enterprises, and thus for income generation and growth. Multiple taxes, fees, charges, licenses etc. make it difficult to establish new businesses and enter new markets. Generally, various levels of government do not co-ordinate well regarding issues of taxation. This is partly

to do with lack of capacity at all levels of government. Norway should, through support to multilateral tax initiatives and trust funds, use its influence to give higher priority to reforming local government tax systems and to strengthening intragovernmental fiscal relations. One ‘dangling fruit’ with substantial revenue potential in urban areas is property tax. However, as argued in Section 3, increasing tax revenues without improving the way that taxes are spent, will not improve the well-being of citizens. Better synchronisation between revenue and expenditure reforms should be inherent elements of fiscal reforms.

### ***Recommendation 8: Support civil based organisations***

The lack of peace and security in fragile states is a major obstacle to economic, social and human development. Any development cooperation strategy for these countries needs to consider the interconnections between peace, security and development. A genuine and sustainable peace requires the involvement of local populations, and participation of civil society. There is a need in most fragile states to strengthen the capacity of civil society actors to generate increased knowledge and understanding of the conflict dynamics, and to develop a strategy for civil society contributions to peace, security and development.

Debates on tax policy and administrative reforms in developing countries generally focus on technical issues and are often dominated by experts, donors and business people. The majority of citizens perceive tax issues as technical and very complex. Yet, it is vital for the legitimacy of the tax system to secure a broad-based citizen engagement around taxation. Civil based organisations, including business associations, can help broaden the debate and bring a new focus to the discussion of tax policy, for instance on fairness, and thus influence the policy decisions that are being made. Norway should consider supporting civil based organisations that aim to broaden the public’s interest on tax issues in fragile states. There is a need to map which civil society organisations are operating in the targeted countries, how they work and on what topics.

### ***Recommendation 9: Develop research capacity***

There is a need for research that produces concrete, contextualised and policy-relevant insights on whether and how taxation can contribute to broader state building goals in fragile countries. In addition to generating and disseminating knowledge to policymakers, knowledge should be mobilised in ways that will contribute to widen and deepen public debate about tax issues in countries suffering intra-state conflicts. Addressing these challenges requires research that points to feasible reform goals and strategies and, importantly, informs stakeholders. Norway should consider financing such applied and policy-oriented research. Such funding should aim to (a) develop Norwegian research capacity, (b) strengthen international research on taxation in fragile states, and (c) build domestic research capacity in fragile states.



There is substantial Norwegian expertise to draw on when it comes to understanding the political economy of countries in intra-state conflicts from institutions such as *Chr. Michelsen Institute* (CMI), the *Norwegian Institute of Foreign Affairs* (NUPI), the *Peace Research Institute Oslo* (PRIO), and *Noragric at the Norwegian University of Life Sciences* (UMB). Many of the studies conducted by researchers from these institutions have been implemented in collaboration with researchers from the countries studied and have contributed to build local research capacity. At present, expertise in Norway on fiscal reforms and taxation in fragile countries is scarce and largely located at CMI. The *TaxCapDev network* is an initiative that aims to build a wider engagement by Norwegian researchers on tax and development.

Applied research on tax and development by CMI has been partly conducted in collaboration with the *International Centre for Tax and Development* (ICTD). The centre was established in 2010 with funding from Norway and the United Kingdom. In 2015, Norway ended its support to the ICTD. It is time to consider whether Norway should again contribute to financing ICTD's activities. Norway would then be in a position to influence the research agenda of the centre with the purpose of strengthening the focus on issues considered to be of particular relevance for the tax agenda in fragile countries.

Building domestic research capacity in fragile states is challenging, but feasible through joint studies with international researchers. There is also a need to strengthen the more general analytical capacity within revenue administrations and ministries of finance. Depending on demand, an entry point here could be through the *African Tax Administration Forum* (ATAF). A possible extension of this would be to build regional and in some cases national academic courses or degrees in public economics, including fiscal reforms, taxation and public expenditures. This could be done by the *African Tax Institute* (ATI) at the University of Pretoria, and regional research institutions like the *African Economic Research Consortium* (AERC) in Nairobi.

## 7. Concluding remarks

Taxation is not an end in itself, but a means towards development and improved welfare. Public revenues ought to be raised in a way that promotes development. There are trade-offs that need to be carefully considered in country analysis of taxation. Tax and fiscal policies should be assessed on a range of indicators such as private sector investments, business environment, growth, poverty, and income distribution. In fragile states in particular, this will imply that a more diverse and local context adapted set of fiscal policies, including tax instruments, and TA modalities need to be developed.



We conclude this report by sharing some reflections on taxation and state-building by Byiers and de Weijer (2014): Rather than assuming that tax reform can achieve all the positive things for state building, it is important to look at whether the preconditions exist for these theories of change to hold. And if not, what space for manoeuvring exists? What could be a way to catalyse this virtuous circle of public spending, government legitimacy, and willingness to pay taxes? Who are the possible agents of change? Is it possible to design tax reforms that align with elite incentives, or can one think of domestic reforms that would help shift the interests of the elite towards a more ‘developmental’ system? With tax reform, as with many other issues on the state-building agenda, it is the politics that matter. The focus on institutional designs and other technical issues is incomplete if it ignores the political nature of taxation. It is therefore essential for donors to integrate politics and the space for political manoeuvring in their approaches to supporting tax systems. Development agencies need to move beyond their common approach to incorporate political theory without changing the technocratic approaches they are so used to advancing.

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The purpose of this study is to systematise and analyse existing knowledge on taxation in fragile states. Efforts to support domestic revenue mobilisation in conflict situations require a different approach and other means than in the more stable developing countries. On that basis, the study discusses possible entry points for Norwegian support to domestic revenue mobilisation in ways that may contribute to strengthen state-building and improve government legitimacy.

Complexity, limited experience and security concerns suggest that one should be cautious to adopt bilateral technical assistance programmes of the kind implemented in other developing countries. Instead, the study argues in favour of engagement via multilateral institutions, including multi-donor trust funds and other forms of pooled resources.

Nine entry points are recommended for Norwegian support to taxation in fragile states:

1. Do no harm
2. Safeguard donor coordination, but ensure a certain humility
3. Support customs administration
4. Capacitate management and taxation of natural resources
5. Support the United Nations Tax Committee
6. Improve taxpayer-tax administration relations
7. Remember the sub-national tax system
8. Support civil based organisations
9. Develop research capacity

Viable entry points are likely to differ substantially from country to country depending on context and demand. Fragility has many features and the challenges facing different states differ.

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