

# INVESTMENT CLIMATE IN PRACTICE

## BUSINESS TAXATION

### LINKING BUSINESS TAX REFORM WITH GOVERNANCE

#### HOW TO MEASURE SUCCESS

Why should business tax reform aim for better governance? This note highlights the significance of firms' willingness to pay taxes in the context of state-building—both as an end in itself and also as an essential component of sustainable investment climate reform. State legitimacy, taxpayers' willingness to pay (based on their intrinsic "tax morale" and the translation of taxes into public goods and services), and the effectiveness of tax administration are integral to any tax system. This note suggests diagnostic steps to measure key influences on taxpayers' willingness to pay, offering a baseline for judging progress on the sustainability of all tax reforms.

#### BUSINESS TAXATION AS GOVERNANCE

Governance and taxation are mutually reinforcing. Governance shapes tax systems, while how taxes are raised influences the creation of effective state institutions and the dynamics of the investment climate and economic growth. Investment climate reforms of the tax system should aim explicitly at a virtuous circle: taxation that reinforces both state legitimacy and institutional effectiveness, which in turn improve tax compliance by increasing taxpayer consent and reducing the costs of tax coercion.

The linkages between governance, taxation, and the investment climate are reflected in three key dynamics:

#### **Good governance delivers good tax systems.**

Revenue collection depends on efficient administration, trust in government, and political stability. Without these pre-conditions, fair, effective, and efficient tax systems are difficult to develop.

#### **Better tax systems deliver better governance.**

How states obtain revenue affects the quality of their governance. Sound and fair domestic taxation systems promote good governance because raising tax efficiently requires the consent of the tax-paying population. The process of political bargaining between government leaders and taxpayers legitimizes taxes and the state in the eyes of citizens, increases the state's capacity to collect and administer taxes, and strengthens the accountability of government to its citizen-

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## FACTORS IN ANALYZING QUASI-VOLUNTARY COMPLIANCE

### Structural

- ❑ Fiscal constitution: legitimacy as consent to pay tax.
- ❑ Trust in government: perceived justice and fairness.
- ❑ Cultural and social norms: attitudes to rule of law.
- ❑ Corruption: informal tax substitutes for the formal.
- ❑ Systemic factors: for example, high tax rates, the total amount of the tax take, and compliance costs.

### Individual

- ❑ Norms and values: these shape the citizen's view of the state.
- ❑ Perceived risk of detection: cost/benefit ratio of evasion.
- ❑ Skill base: formal employment opportunity.

### Private Sector

- ❑ Labor market: ease of work in informal economy.
- ❑ Sector-specific: for instance, degree of competition.

taxpayers. Governments then have the incentive to promote broad economic prosperity. Negotiation with taxpayers leads to better public expenditure policy.

### Governance and tax systems shape the investment climate.

Developing country governments often depend on narrow tax bases and coercive tax collection. The often small formal sector typically bears heavy financial and time burdens in complying with tax obligations. These burdens create a strong disincentive to investment and participation in the formal economy. Dominant enterprises may be politically powerful vested interests with the capacity to secure tax exemptions. Micro and small firms can disappear into informality. As a result, medium-sized businesses may emerge as the most politically crucial constituency for fair and effective tax reforms. Middle-sized companies, in environments where they shoulder a disproportionate share of the tax burden, are potentially most concerned about effective public services and have the capacity to mobilize politically. However, where they suffer the disproportionately heaviest tax burden, middle-sized firms have little incentive to grow the economy and every incentive to break up and try to disappear. This undermines growth prospects and broad-based political mobilization by the private sector.

### STATE LEGITIMACY MATTERS TO THE PRIVATE SECTOR

State legitimacy is a fundamental influence on intrinsic willingness to pay tax, also called “tax morale.” Business-owners as citizens will actively seek to avoid paying tax to a state they do not believe in. The more legitimate a state is in the eyes of its citizens, the less a regime requires coercion to raise tax. An increase in trust in government increases citizens’ tax morale. Business tax reform programs can too easily focus on technical fixes; that is, they target the detailed design of taxes rather than the political attitudes toward paying taxes. These links between legitimacy and business tax morale matter for the sustainability of any tax reform.

Tax is at the institutional roots of legitimacy for four key reasons:

**Representation.** Paying taxes encourages collective participation in and oversight of government through participatory democratic institutions.

**Fiscal social contract.** Acceptance of the obligation to pay tax empowers parliaments, civil society (including business associations), and the media to play an essential role in scrutinizing government revenues and expenditures.

**Accountability.** Tax compliance depends on the confidence of the taxpayer that tax revenues will be used fairly. Confidence is built through transparency.

**Politics.** Unless the political process creates citizens’ willingness to pay tax, politicians have no incentive to broaden the tax base to non-taxpaying voters (called the “Devil’s Deal”).

The state also creates an instrumental willingness to pay tax by delivering the services needed by its citizens. Tax compliance is low in many developing countries where citizens neither believe governments act in their interest, nor trust the state to use revenues wisely. In Latin America, for instance, less than 25 percent of the population believes taxes are well spent. Such lack of trust perpetuates a vicious circle—low trust undermines a weak legitimacy of the state in the eyes of citizens, making tax collection less cost effective, necessitating more coercive tax collection that further undermines trust and reduces the likelihood of the efficient provision of public goods and public services.

“Quasi-voluntary tax compliance” extends the concept of legitimacy from both the intrinsic and instrumental willingness to pay tax to the taxpayer’s overall perception of fairness of the tax system. Taxpayers will evaluate taxation: i) in providing public goods that benefit the citizen efficiently (at a reasonable cost); ii) in legitimately and effectively exercising state power; and iii) in reflecting legitimacy in the tax authority’s powers of enforcement (not unaccountable coercion) and capacity to make all taxpayers shoulder their fair burden. The actual level of tax compliance is the combined outcome of the intrinsic and the instrumental willingness to pay tax, along with taxpayer acceptance of the level of tax burden and the effectiveness of enforcement.

### HOW TO TACKLE BUSINESS TAX REFORM AS STATE-BUILDING

The following six steps address the operational implications of applying the tax-as-state-building

approach to improving governance, growth, and the investment climate.

**1. Understand the politics of taxation.** Tax is always highly sensitive, and it draws attention to the political power of vested interests. Tax structures represent the outcome of the political process—good technical solutions are not enough. For instance, political choice limits tax simplification; the more advanced democracies have the most complex tax systems.

**2. Analyze quasi-voluntary compliance.** This analysis should include relevant factors at the structural, individual, and private sector levels (see sample list of factors, opposite page). The factors can be based on taxpayer perceptions (such as trust in government and perceived risk of detection), systemic characteristics (such as the tax rate), and actual market dynamics (such as the degree of competition).

**3. Diagnose the potential willingness to pay tax.** How taxpayer attitudes to the state influence willingness to pay tax is the least understood but most fundamental dimension of compliance. This dimension emerges from taxpayers’ assessment of the overall quality of governance at the instrumental and intrinsic levels (see figure).

*At the instrumental level.* Taxpayers assess government capacity to deliver the fiscal social contract—the instrumental side of governance in providing essential public goods such as security and core services such as infrastructure, health, and education.

*At the intrinsic level.* Taxpayer perceptions of the legitimacy of the state, called tax morale, combines political acceptance of state authority, the perceived fairness and effectiveness of state institutions, and trust in public institutions and officials.

The development of the fiscal social contract depends on the tax relationships with small and medium-sized businesses. How SMEs and the informal sector develop social responsibility to pay taxes will shape their political incentives to mobilize around taxation and compliance. Broadening the tax base means politicians must tackle the “Devil’s Deal.”

**4. Diagnose quasi-voluntary compliance.** As shown in the figure, the degree of actual

compliance is also shaped by governance capacity in the tax authority’s enforcement capability, which has two dimensions: i) taxpayer acceptance of enforcement as a legitimate and effective exercise of state power (tax morale), and ii) perceived fairness and effectiveness of the tax authority based on the taxpayer’s experience and perceptions of the extent of other taxpayers’ levels of compliance. These factors can create a virtuous circle of mutually reinforcing trends towards consent and higher effectiveness, or a vicious circle

## DIAGNOSING QUASI-VOLUNTARY COMPLIANCE

### Step 1: Assess Instrumental or “Cost-Benefit” Willingness to Pay Taxes

Taxpayer perceptions of utility of public goods and services	high	Limited consensual compliance; ineffectual enforcement	Effective and consensual compliance
	low	No voluntary compliance; ineffectual enforcement	Effective but coercive compliance
		low	high
Taxpayer perceptions of costs of evasion/risks of coercion			

### Step 2: Measure Intrinsic or Voluntary Willingness to Pay Taxes (Tax Morale)

Taxpayer perceptions of state legitimacy	high	Limited voluntary compliance	High voluntary compliance
	low	No voluntary compliance	Limited voluntary compliance
		low	high
Taxpayer perceptions of the fairness of the tax authority			

For each step, determine a low/high level along each axis in the grid, and then locate the quadrant that reflects the intersection of these scores:

Step 1 determines the taxpayer cost-benefits of compliance (the likely benefits from the resulting provision of public goods) and the possible risks (detection/fines) from an effective tax authority;

Step 2 measures taxpayer perceptions of the fairness of the tax authority combined with general acceptance of the legitimacy of the state.

The overall outcome (the combined outcome of Steps 1 and 2) is the level of quasi-voluntary tax compliance.

## OBJECTIVES OF TAX REFORM DESIGN TO STRENGTHEN GOVERNANCE

### Transparency

- ❑ Constrain the discretion of tax collectors and reduce corruption by publishing consistent and accessible tax regulations, rates, and procedures.
- ❑ Foster public-private dialogue on tax through a formal process of private-sector engagement with government on tax policy.
- ❑ Create visible links between taxes and expenditure; compliance rates increase when citizens and firms know how taxes are used.
- ❑ Conduct taxpayer education and outreach—including to small business and the informal sector—on the benefits of working in the formal economy, and strengthen incentives to do so.
- ❑ Change perceptions through improved outreach, services, and public-private dialogue to engage the private sector in the reform process from the outset.

### Accountability

- ❑ Ask business and taxpayer associations, along with parliament, the media, and civil society, to participate in tax policy formulation and implementation.
- ❑ Make tax administration accountable through a complaints and appeals procedure.

### Fairness

- ❑ Broaden the tax base and reduce exemptions to increase sense of justice.

### Effectiveness

- ❑ Simplify law, regulations, and administration where possible.

The World Bank Group's Investment Climate Department (ICD) is a joint department of the International Finance Corporation (IFC), the Multilateral Investment Guarantee Agency (MIGA), and the World Bank. ICD is the operational center for IFC's Business Enabling Environment Advisory Services and FIAS, the multi-donor investment climate advisory service of the World Bank Group. The findings, interpretations, and conclusions included in this note are those of the authors and do not necessarily reflect the views of the Executive Directors of the World Bank or the governments they represent.

of increasing coercion, higher collection costs, and declining effectiveness of the tax system.

### 5. Conduct taxpayer perception surveys.

Understanding attitudes towards the level of tax morale, the effectiveness of the tax authority, and the resulting extent of compliance provides an essential diagnostic of the political realities for reform. It also offers a baseline for measuring progress on all aspects of tax reform success, not least on tax morale and state legitimacy. Attitude and perception surveys of current and potential taxpayers identify perceived weaknesses in the

fairness of the tax system. Survey results clarify the extent of quasi-voluntary compliance, revealing the governance issues underlying tax reform and offering a baseline for measuring progress. When higher compliance strengthens effective enforcement, a virtuous circle of mutually reinforcing taxation and governance emerges, enabling tax authorities to focus attention efficiently on high-risk categories of taxpayers. These types of surveys are well established for Organisation for Economic Co-operation and Development countries, but are nascent in developing country contexts. However, surveys may be controversial in countries where the political contest is oppressive and tax authorities are unwilling to invite criticism of their integrity, public acceptance, and effectiveness.

### 6. Pay attention to micro and smaller enterprises.

Small and medium-sized enterprises are the missing link from narrow tax bases with widespread informality and weak citizenship to effective, legitimate democracies constructed on broad-based tax systems. The development of the fiscal social contract depends on the tax relationships with smaller firms. How these firms and the informal sector develop social responsibility to pay taxes will shape their political incentives to mobilize around taxation and compliance. Broadening the tax base means politicians must tackle the "Devil's Deal."

## CONCLUSION

Effective, efficient, and equitable business taxation requires the private sector's willingness to pay taxes. Business tax reforms depend on governance context and contribute to improving it. Measuring perceptions affecting the governance aspects of taxation is an important diagnostic, offering a baseline for building a culture of tax compliance. Based on the diagnostics and survey results, tax reform design should promote transparency, accountability, fairness, and effectiveness (see box, above left).

