April 2017

Briefing note

Taxation and the Sustainable Development Goals

Do good things come to those who tax more?

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Key messages

- Linking the delivery of the Sustainable Development Goals to an increase in domestic resource mobilisation is a good idea in principle. More taxation is associated with benefits beyond the finance it raises, including more accountable and effective institutions and more social spending.
- Some developing countries collect taxes at levels commensurate with their level of economic and institutional development. In many cases, these levels of tax collection are higher than the levels recorded in today's developed countries when they were at a similar level of development.
- Trying to squeeze too much tax out of the poorest economies has risks. High tax rates can impede private investment. Tax and spending policies are often regressive rather than progressive.
- Blind adherence to a push for more taxation is likely to have adverse consequences unless the international community prioritises *support for better tax systems, rather than more tax collection*. The two are not always compatible. Good things come to those who build tax systems that are compatible with economic growth.

Purpose of this briefing note

This briefing note has three objectives. These are to discuss:

- the reasons for the renewed interest in domestic resource mobilisation in developing countries
- the reasons why tax revenues tend to be lower in the poorer countries, and
- the potential risks associated with trying to squeeze too much taxation out of the poorest economies.

The purpose is not to argue the merits of more versus less taxation, but rather to provide food for thought on the management of expectations around taxation and the development agenda, as articulated in the Sustainable Development Goals (SDGs).

Why taxation?

The idea that good things come to those who tax more has been around for a long time. It was certainly on the mind of the economist Nicholas Kaldor when he wrote:

> *Whatever the prevailing ideology or political colour of a particular government, it must steadily expand a whole host of [..] services [..] as a prerequisite for the country's [..] development. These services must be financed out of government revenue. Besides meeting these needs, taxes [..] provide the most appropriate instruments for increasing savings for capital formation out of domestic sources* (Kaldor, 1963).

This train of thought prompted Kaldor to ask the question 'Will under-developed countries learn to tax?' In posing the question he was pointing to the fact that, as a percentage of GDP, taxes are much lower in under-developed countries than in developed countries. This observation remains as relevant today as it was back in 1963 (Genschel and Seelkopf, 2016).

Contemporary narratives on taxation and development

There is today a renewed interest in domestic resource mobilisation (DRM) and development. DRM topped the list of action areas in the outcome document that emerged from the 3rd Financing for Development conference held in Addis Ababa in July 2015 (UN, 2015a). In addition, a number of donor countries established the Addis Tax Initiative to support developing partner countries in strengthening their tax systems, in line with the commitments made at the conference.

International actors have put forward three key arguments for investment in strengthening tax systems in developing countries: a financing argument, a spending argument and a governance argument.

A financing argument

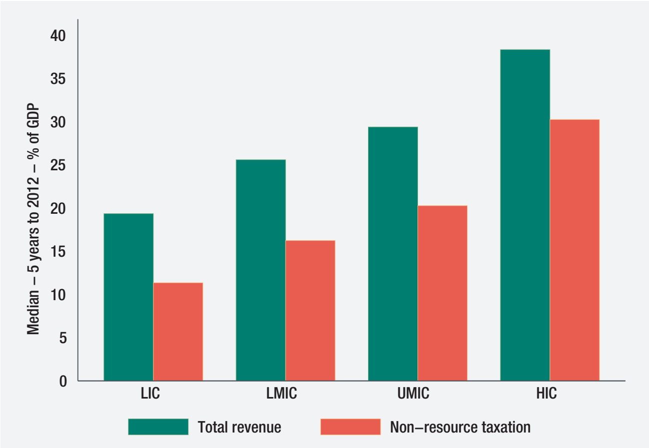
Developing countries have enormous unmet needs in terms of infrastructure, social protection and the delivery of services. As such, it has been suggested that the achievement of the SDGs requires an escalation of development finance 'from billions to trillions' (World Bank and IMF, 2015). Donor financing, which had started to plateau before the adoption of the SDGs, was never going to be enough to meet the scale of their aspirations. The SDG Agenda, therefore, required a rethink of financing for development.

Greater DRM is widely championed as a way to fill the gap between the lofty ambitions of the SDGs and available development finance. The IMF and World Bank (2016) describe domestic resources as the 'largest untapped source of financing to fund national development plans'. The idea of 'untapped sources' of financing partly derives from the observation that poorer countries draw a larger proportion of their much smaller public purses from non-tax sources of revenue, including from both natural resources and aid (see Figure 1).

A spending argument

Poorer countries also lag behind richer countries in terms of social spending (see Figure 2). Like Kaldor (1963), many today view the lack of resources from taxation as a key constraint to more spending on areas like health, education and social protection and the achievement of the SDGs.[1]

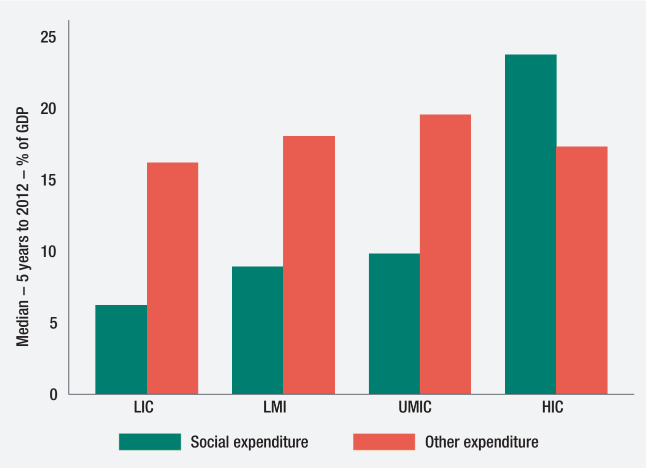
Figure 1. Poorer countries collect less tax than richer countries



Source: IMF Government Finance Statistics; ICTD Revenue Database. Note: Country categories are per the World Bank income classifications for low-income countries (LIC), lower-middle-income countries (LMIC), upper-middle-income countries (UMIC) and high-income countries (HIC).

1 At the Addis Ababa Financing for Development Conference in 2015, the UK's then International Development Secretary, Justine Greening, said that '*strong tax systems […] will enable developing countries to reap the benefits of growth and build stronger health and education systems*'. See: https://www.gov.uk/government/news/greening-tax-generation-key-to-ending-poverty

Figure 2. Poorer countries spend less on social sectors than richer countries



IPFRI SPEED Database; Social expenditure defined as the sum of spending on health, education and social protection.

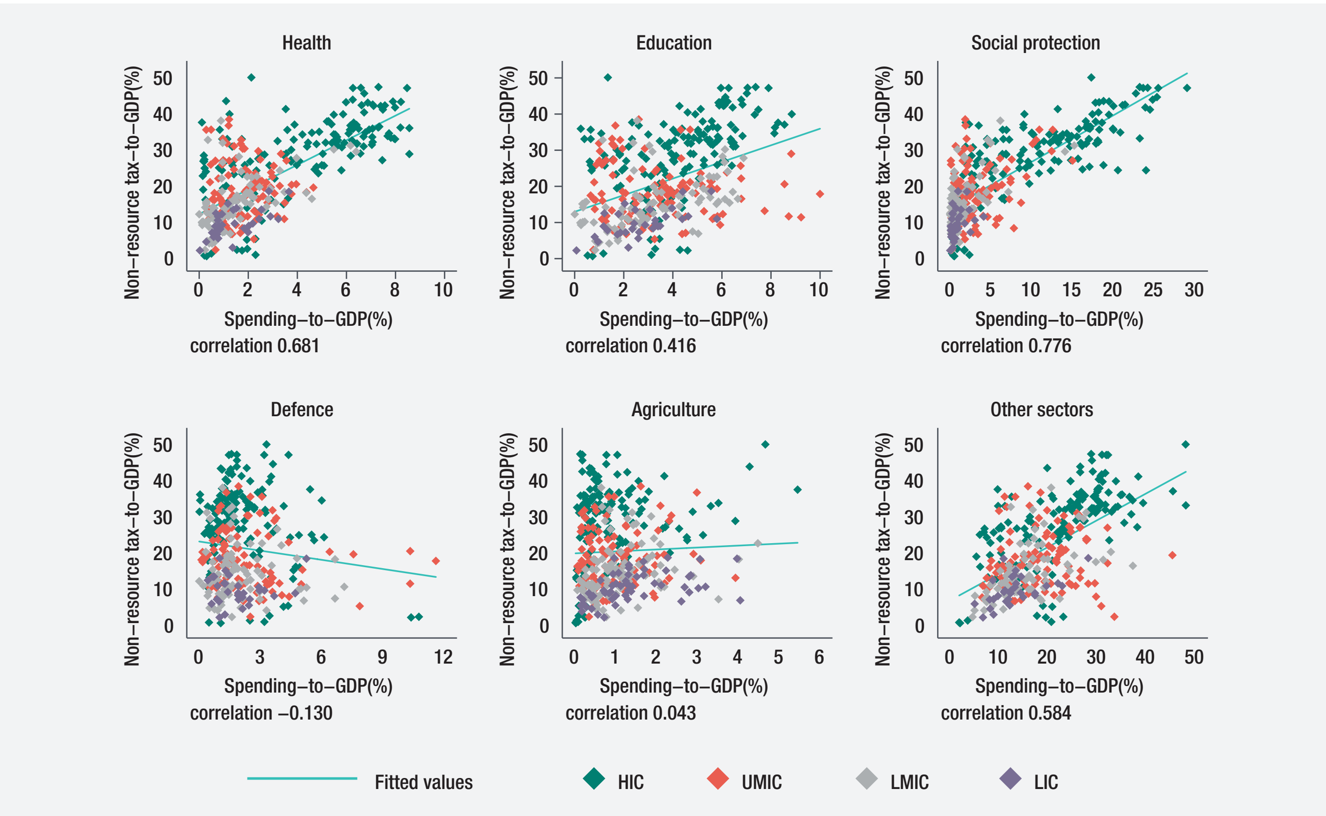
Finance alone is of little use: its impact depends on how it is allocated and used. As attention has shifted towards DRM as a source of development finance, there has been greater interest in whether increases in taxes support increases in allocations for social spending (a particular focus for donors).

A recent USAID study, for example, estimates that a 10% increase in taxation leads to a 17%, 4% and 3% increase in public health expenditure in low-income countries (LICs), lower-middle-income countries (LMICs) and upper-middle-income countries (UMICs) respectively (Tamarappoo et al., 2016). Similarly, Reeves et al. (2015) have attributed progress towards universal health care to additional tax revenues, estimating that every $100 per capita raised in additional tax revenue leads to a $10 per capita increase in health spending.

Figure 3 illustrates positive correlations between non-resource taxation[2] and spending on health, education and social protection for all country income groups. These results are not particularly surprising: you would expect greater availability of revenues to be associated with greater spending. While spending across all other sectors tends to increase, these sectors tend to benefit more from additional non-resource taxation than sectors like agriculture and defence.

However, Carter and Cobham (2016) note that the results of estimates that do not specify and test causal mechanisms can have many potential explanations, and can generate only tentative policy conclusions. Nevertheless, they note that their own results, which confirm some of the statistically significant relationships

Figure 3. More taxation is associated with more social spending, 1980 to 2012, 10-year averages



Source: ICTD Revenue Database; IPFRI SPEED Database. Other sectors is calculated as total spending less spending on the other five sectors displayed.

2. Taxation that is not derived from the extractive sectors i.e. fossil fuels and mining

between more direct taxation and health spending found by others, '*provide reasons to be cautiously optimistic about the benefits of greater international attention to the obstacles to raising direct taxes in developing countries*' (Carter and Cobham, 2016).

A governance argument

According to Bird (2015), '*the tax system constitutes one of the major interfaces between citizens and state in any country so how taxes are administered may affect […] public trust in government. Tax administration may thus play a critical role not only in shaping economic development but in developing an effective state*'. Moore (2007) sketches a set of steps whereby greater state reliance on taxation, as opposed to revenues from aid and natural resources, can lead to the emergence of a more responsive, accountable and capable state (Table 1).

Looking at observations across countries, it can be seen that non-resource taxation is much more closely associated with measures of accountability (Figure 4) and with government effectiveness (Figure 5) than revenues more generally.

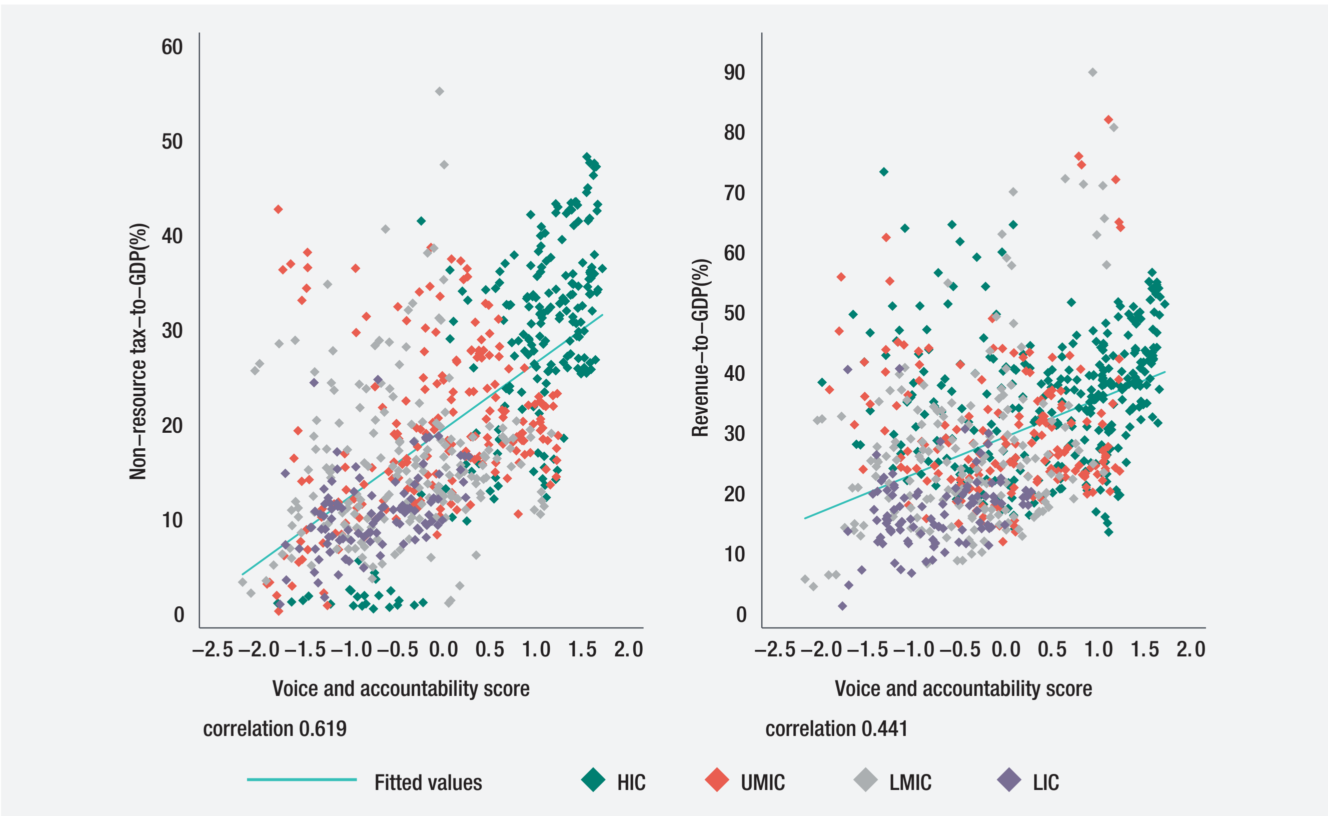
Again these relationships do not show cause and effect, but some recent literature has attempted to establish causal linkages between revenue sources and the quality of spending. Gadenne (2016) finds that increases in taxation

Table 1. The effect on governance of state dependence on taxation

Immediate effect	Intermediate effects	Governance outcomes
State focused on taxation	State motivated to promote greater prosperity to stabilise or increase the tax take	More responsive
	State motivated to improve tax administration	More capable
Taxpayers become more politically engaged	Taxpayers organise themselves to: 1. resist taxation 2. monitor taxation 3. monitor spending	More accountability
Fiscal bargaining ensues	Taxation becomes more acceptable, predictable and efficient	More responsive and capable
	Better public policy based on debate and negotiation	More responsive and capable
	More scrutiny of spending	More accountability
	Strengthening of legislature relative to executive	More accountability

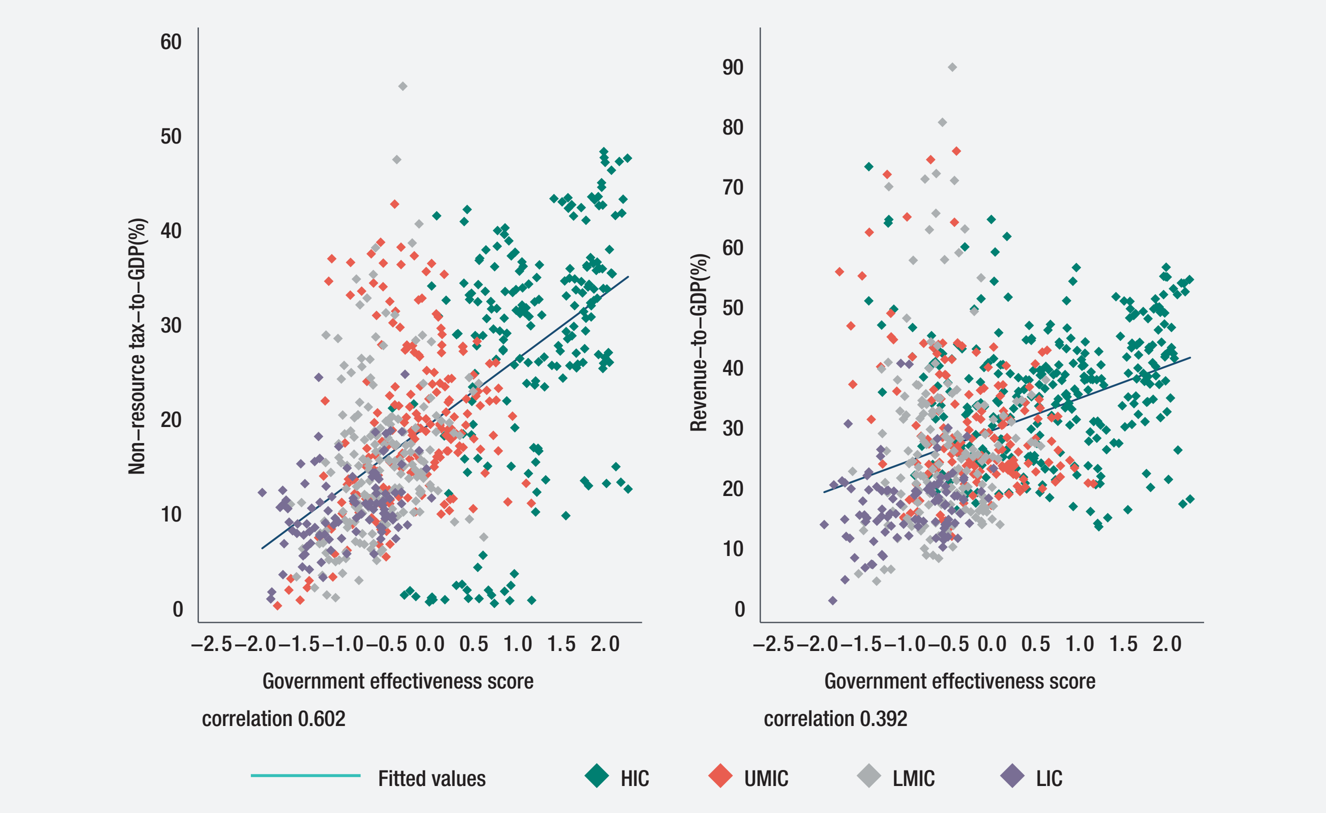
Source: Authors' elaboration of Moore (2007 and 2015).

Figure 4. Non-resource taxation is more closely associated with accountable states than revenue more generally: five-year averages, 1996 to 2014



Source: IMF Government Finance Statistics; ICTD Revenue Database; World Governance Indicators.

Figure 5. Non-resource taxation is more closely associated with effective states than revenue more generally: five-year averages, 1996 to 2014



Source: IMF Government Finance Statistics; ICTD Revenue Database; World Governance Indicators.

by Brazilian municipalities were used to improve both the quality and quantity of education infrastructure, while increases in federal grants had no impact on infrastructure spending at all. From the opposite perspective, Edwards (2016) finds that countries with large mining sectors have lower levels of general health and educational attainment than would otherwise be expected for their income level.

Summary

- Taxation is perceived as an 'untapped resource' for financing development.
- There are also associations between more taxation, more social spending, and better governance
- But there is a need to be wary of attributing causation at the risk of ignoring other factors underlying these relationships.

Why are tax revenues low in developing countries?

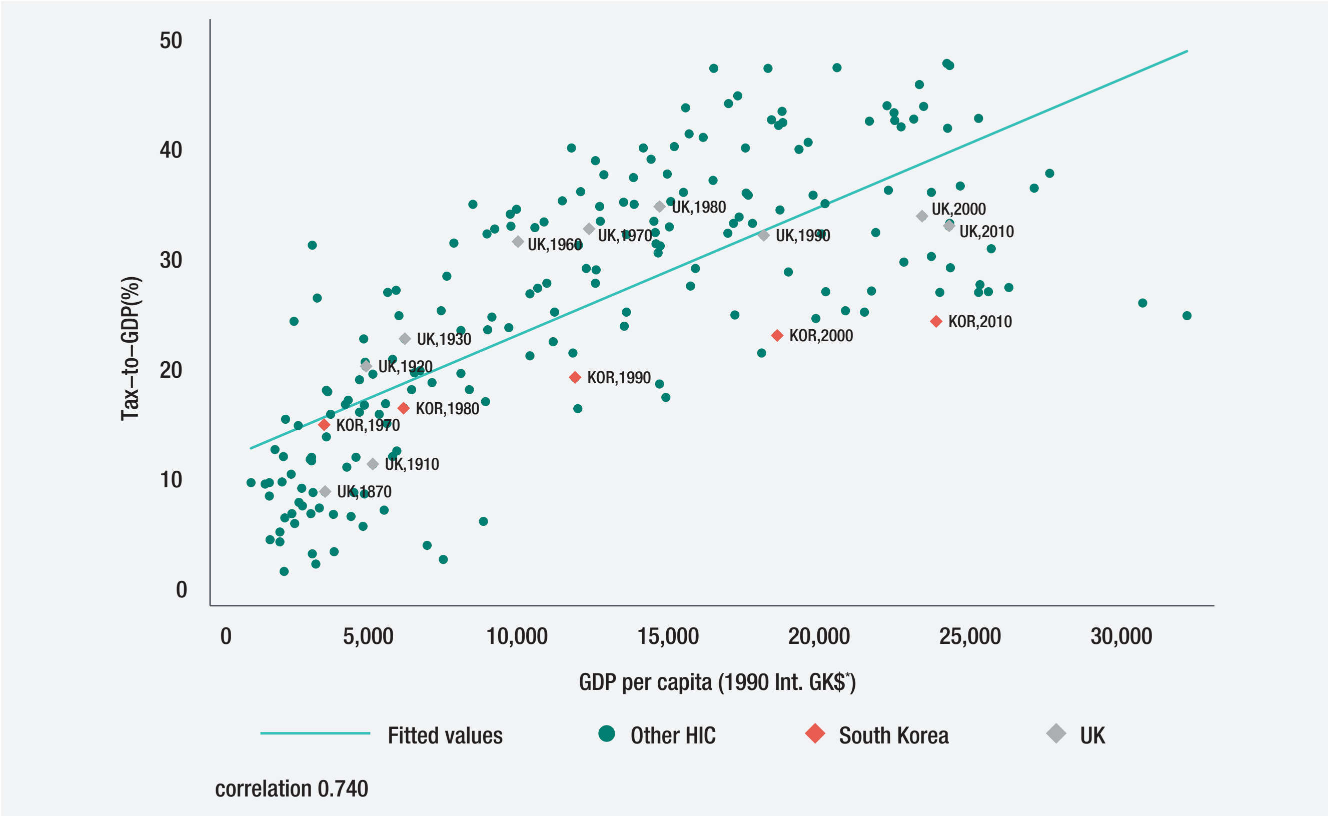
The lack of capacity to tax is a symptom as well as a cause of under-development. As Besley and Person (2014) note, *'poor countries are poor for certain reasons and these reasons can also help to explain their weakness in raising tax revenue'*. They cite the following reasons:

- Economic structure: low-income countries tend to have large informal sectors that are administratively difficult to tax.
- Aid and resource dependence: to the extent that such dependence diminishes the actions that would increase taxation.
- Lack of government action: despite the tendency for accompanying formalisation of the economy, rising income levels do not mechanically translate into a higher tax take without some deliberate government action to modernise the tax system and provide incentives to transition into the formal economy.

A historical perspective

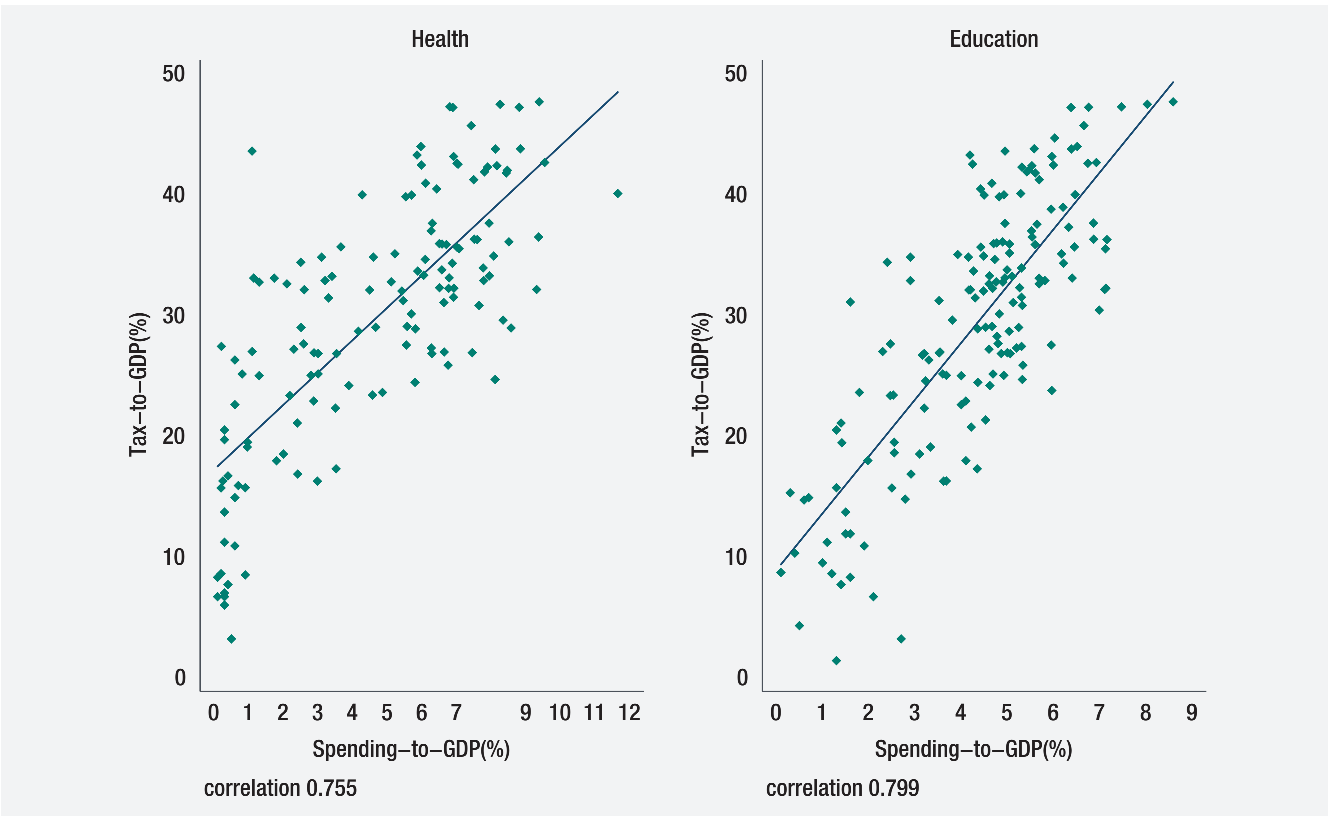
Over the past century, many of today's high-income countries (HICs) have experienced sustained growth in both income and taxation (Figure 6). This has been the experience of both early movers like the UK, and later developers such as South Korea. Increases in taxation have been used to expand state provision of services, as shown in Figure 7, which illustrates the expansion of public spending on both education and health (Tanzi and Schuknecht, 2000). This co-evolution of economic development and an increase in the share of public spending in national income is often referred to as Wagner's Law (see for example Peacock and Wiseman, 1961).

Figure 6. Wagner's Law, 27 high-income countries, 1870 to 2013, 10-year averages



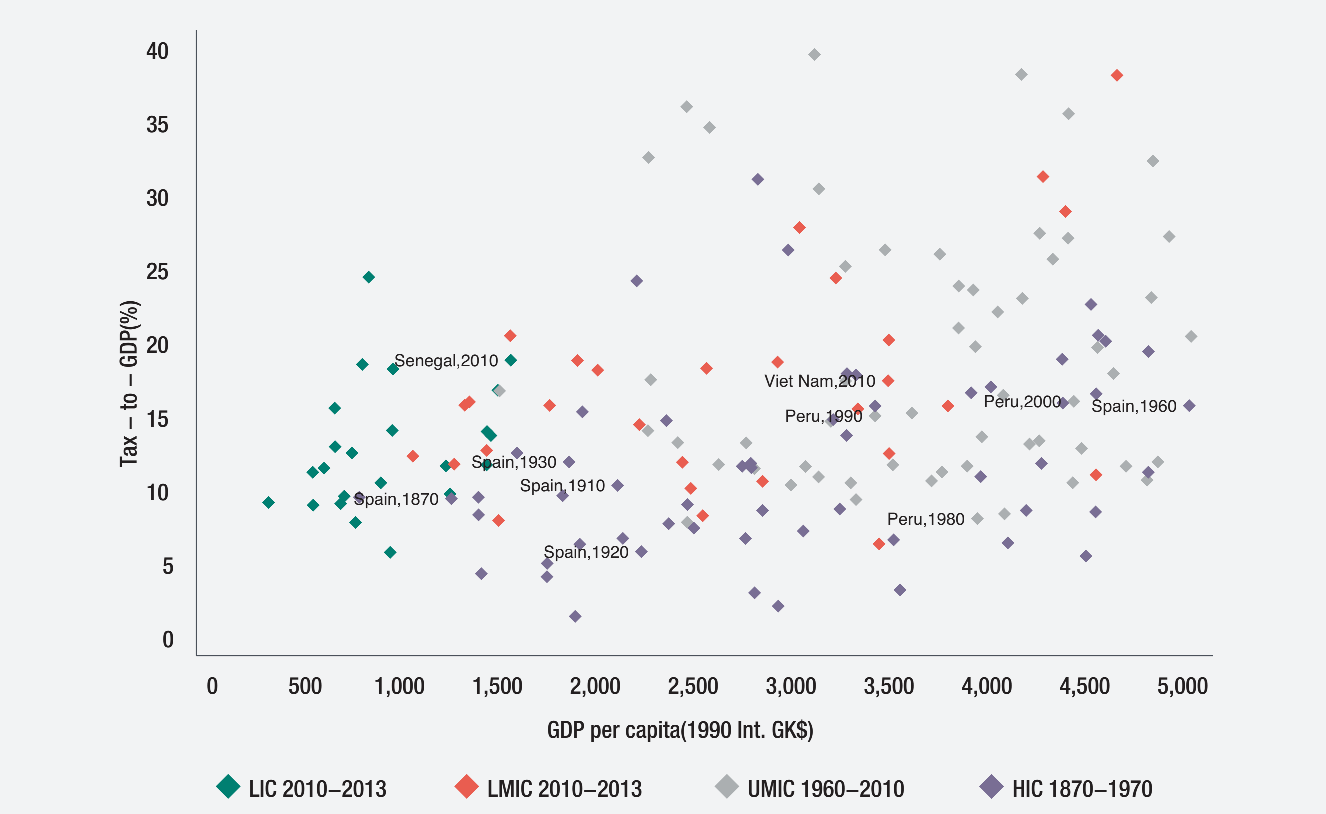
Source: Tanzi and Schuknecht (2000); OECD; ICTD Revenue Database; the Maddison-Project (2013).
**Geary-Khamis dollar*

Figure 7. Taxation and spending on health and education, 27 high-income countries, 1870 to 2013, 10-year averages



Source: Tanzi and Schuknecht (2000); OECD; ICTD Revenue Database; the Maddison-Project (2013).

Figure 8. Tax-to-GDP ratios in some developing countries are high by historical standards



Source: Tanzi and Schuknecht (2000); OECD; ICTD Revenue Database.

Looking at the tax-to-GDP ratios of developing countries today, they are not that different from those of today's higher income countries when they were at a similar stage of development (Besley and Person, 2014; Picketty, 2014). Figure 8 compares current tax-to-GDP ratios in LICs and LMICs with historical observations for UMICs and HICs when they were at similar income levels. Though there is quite a bit of variation, tax-to-GDP ratios of less than 10% were actually quite common for HICs when they were at this level of development, while tax-to-GDP ratios of less than 15% were quite common for UMICs. A good number of LICs and LMICs already have tax-to-GDP ratios between 15% and 20%.

Though influenced by aid flows, many contemporary LICs and LMICs also allocate a much higher proportion of spending on capital, health and education than HICs did when they were at a similar level of development and at levels comparable to UMICs (Figure 9).

A perspective on 'tax effort'

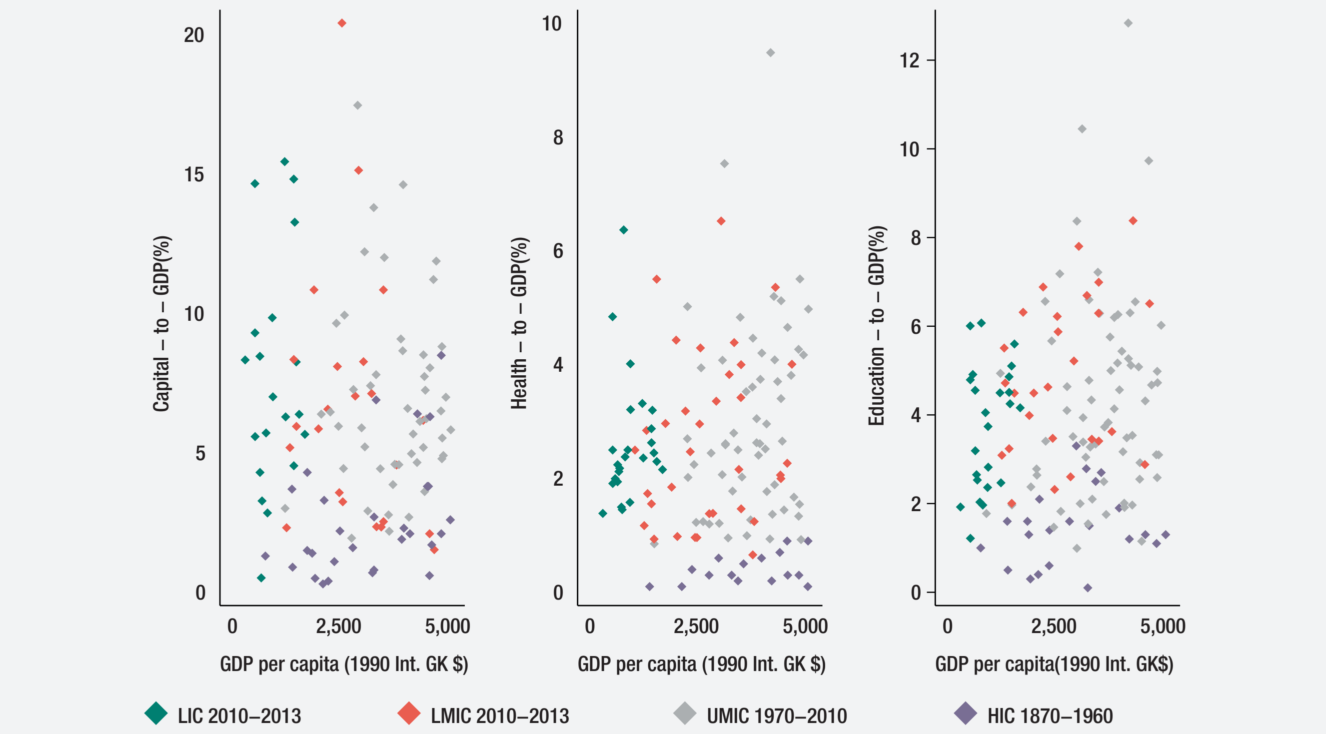
The comparatively low tax-to-GDP ratios of poor countries may, simply, be down to the fact that their economic and institutional conditions limit the amount of taxes they can realistically raise (Langford and Ohlenburg, 2016). Cross-country studies of tax effort (Box 1) highlight variation across income groups (Gupta, 2007; Fenochietto and Pessino, 2013; Langford and Ohlenburg, 2016). While there is a close correlation between tax-to-GDP ratios and tax effort, some poor countries, particularly LICs, collect less tax but exert more tax effort than richer countries (Figure 10).

There is also a regional dimension to this observation. The average tax effort in sub-Saharan Africa is higher across all income categories than in other regions (Figure 11). In particular, some sub-Saharan African LICs appear to exert a great deal of effort in pursuit of higher tax-to-GDP ratios. South Asian LMICs, meanwhile, exert the least amount of tax effort on average.

Summary

- Today's HICs saw increases in their share of public spending in national income as they developed.
- Looking at the tax-to-GDP ratios of many developing countries today, they are not that different from those of today's HICs when they were at a similar stage of development.
- Given the economic and institutional constraints faced, tax effort in many under-developed countries, particularly in sub-Saharan Africa, looks reasonably high (even if the amounts collected are low).

Figure 9. Spending-to-GDP ratios in some developing countries are high by historical standards



Source: Tanzi and Schuknecht (2000); ICTD Revenue Database; World Development Indicators; IPFRI SPEED Database.

Box 1. What is tax effort?

Tax effort is a way of measuring the difference between what a country could potentially collect, and what it actually collects:

$$\textit{Tax effort} = \frac{\textit{Tax-to-GDP ratio}}{\textit{Tax capacity}}$$

Thus if a country has a tax-to-GDP ratio of 25% and a tax capacity of 35% its tax effort is 71%, which illustrates a gap of 29% to full tax collection potential. By measuring the difference between actual tax collections and tax capacity, tax effort captures both:

- public policies (e.g. differences in tax legislation and tax collection rates), i.e. countries may choose to be lower tax jurisdictions, and
- technical inefficiencies (e.g. compliance failures), i.e. countries may be unable to enforce tax collection to a level similar to other countries facing similar economic and institutional constraints.

While tax-to-GDP is the ratio of two actual numbers – actual tax collections as a percentage of GDP – tax capacity requires estimation. Tax capacity is estimated based on economic and institutional characteristics. These economic characteristics might include levels of income, trade and education. On average, as these things improve, so too does a country's tax capacity. Institutional characteristics might include levels of inflation, inequality, informality and corruption. On average, tax capacity is lower when these are higher. In summary, tax capacity is a prediction based on the economic and institutional characteristics of a country. There are different approaches to estimation.[2] As such one should be cautious about making comparisons of tax effort scores across studies.

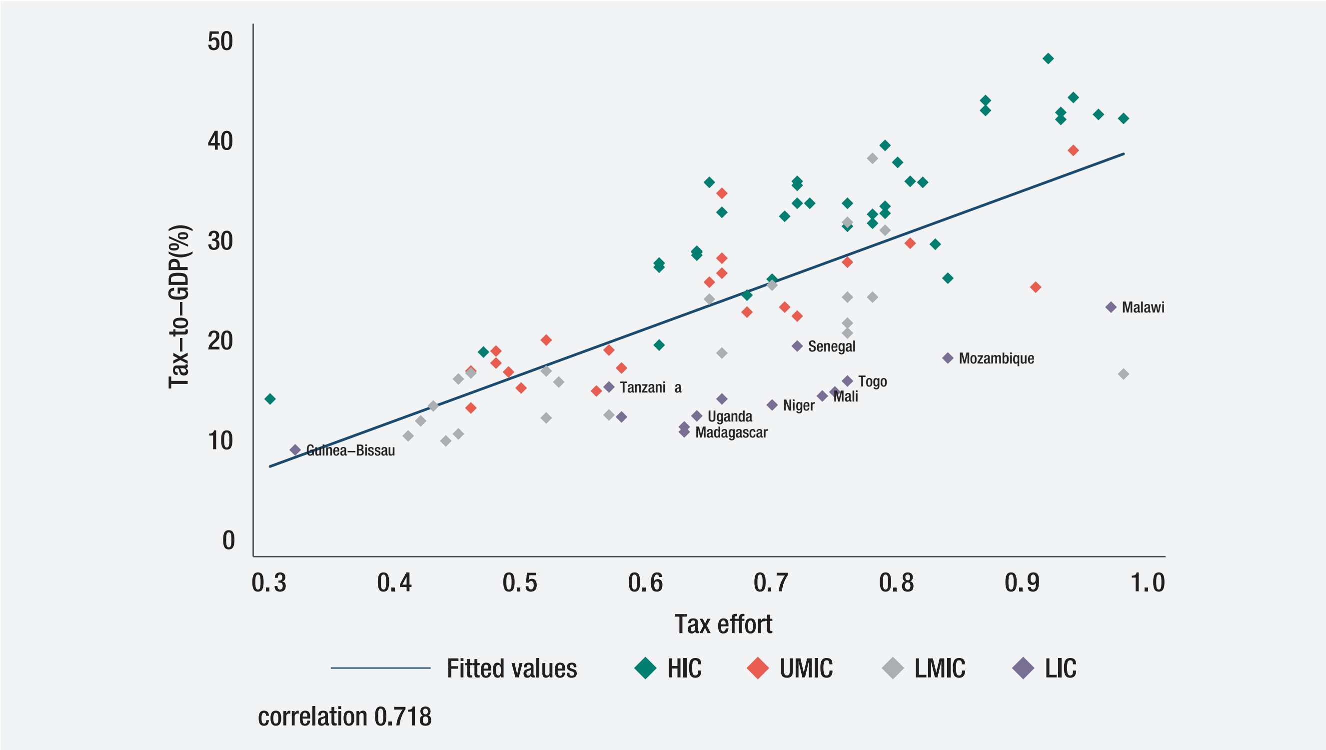
Tax effort is a useful departure point for discussions on a county's revenue-raising potential because if a country is:

- far from its tax capacity, but its tax rates/exemptions are in line with its peers, then technical inefficiency can be identified as the problem
- far from its tax capacity, and its tax rates are below its peers, tax policy changes can be proposed.

Coming to a coherent conclusion about what a country should best do to increase its tax effort requires cross-examination with other available evidence. In some cases the most appropriate course of action may be to do nothing. If tax rates are already high and the political economy is blocking progress on exemptions and evasion, the most appropriate course of action may be to look at removing the constraints to increasing tax capacity.

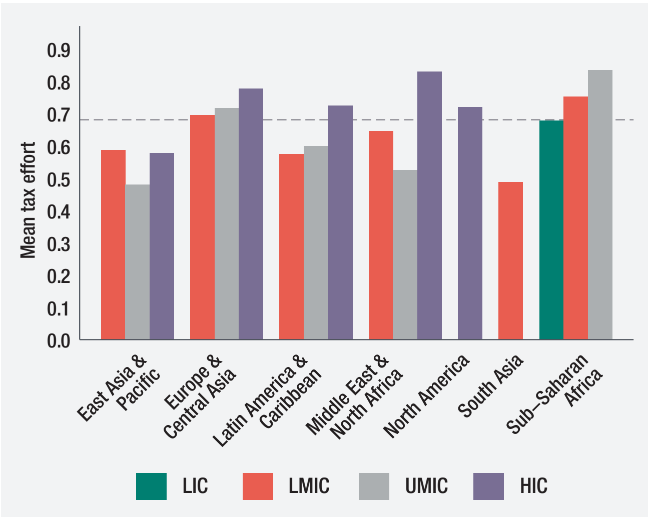
3. For a somewhat different approach see Le et al. (2012).

Figure 10. Some poor countries collect less tax but exert more tax effort than richer countries



Source: Fenochietto and Pessino (2013). Observations are for 2011 and 2012.

Figure 11. Tax effort is already high in sub-Saharan Africa



Source: Fenochietto and Pessino (2013). Observations are for 2011 and 2012, for a sample of 96 countries.

What are the risks of always and everywhere targeting more taxes?

While the development of fiscal capacity is likely to play a key role in a country's economic development, caution is required in pushing for too much tax, too quickly. A recent study by the International Monetary Fund (IMF) suggests a minimum tax-to-GDP ratio of 12-13% is associated with significant acceleration in growth and development (Gaspar et al., 2016). But it is not uncommon to see recommendations pushing poor countries to raise tax-to-GDP ratios further (see Box 2). The IMF's standard recommendation for LICs is to aim for 15% (Gaspar et al., 2016) despite the fact that it is an admittedly arbitrary benchmark (IMF, 2011). The World Bank is supporting reforms in Burkina Faso intended to increase the tax-to-GDP ratio to 17.5%[4] despite the fact that assessments of tax effort suggest its current ratio of 15% is relatively high (Fenochietto and Pessino, 2013). In assessing good financial governance across seven sub-Saharan African countries, GIZ (2016) gives a 'green' rating to those countries with government revenue above 20% of GDP.

This is not to say that targeting higher tax collection is a bad thing in and of itself. However, reforms that target higher tax collection may not necessarily be what are required in a given country at a given point in time. External actors often recognise this need to go beyond

4 http://documents.worldbank.org/curated/en/961171482462153531/pdf/1482462144438-000A10458-BF-DPO-PD-11292016.pdf

Box 2. Revenue-to-GDP targets and Financing for Development

The zero draft for the Addis Ababa Financing for Development (FfD) conference in 2015 called on 'countries with government revenue below 20 per cent of GDP [to] agree to progressively increase tax revenues, with the aim of halving the gap towards 20 per cent by 2025, and countries with government revenue above 20 per cent of GDP [to] agree to raise tax revenues as appropriate' (UN, 2015b)

In the run up to the FfD conference, no doubt influenced by the zero document, the then Dutch Minister for Foreign Trade and International Cooperation, Lillianne Plouemen, wrote that 'in order to be able to finance their share of the SDGs, developing countries will have to increase tax revenue collection to about 20% of GDP'[5]

In contrast, many experts rejected the use of 'uniform tax targets of any kind'[6] and they were ultimately dropped in favour of 'efforts by countries to set nationally defined domestic targets and timelines for enhancing domestic revenue as part of their national sustainable development' (UN, 2015a).

Though dropped as a target, revenue-to-GDP was retained as an indicator under SDG 17, the rationale being that it 'enables easy comparisons across countries…facilitate[s] transparent policy dialogue and provide[s] policy makers with an important tool to assess alternative fiscal reforms and to undertake relevant policy actions'.

basic measures like tax-to-GDP ratios, but yet they often fail to do so (European Court of Auditors, 2016). This risks missing the big picture in terms of building better tax systems in developing countries.

Too much tax can impede private investment

Not all of the SDGs relate to social-sector spending. The achievement of SDG 8 – on decent work and economic growth – will require more private-sector investment. The Addis Ababa outcome document recognised this by stating that '*private business activity, investment and innovation are major drivers of productivity, inclusive economic growth and job creation*'.

The World Bank's most recent *Paying Taxes* report notes that for many businesses in developing countries the tax burden is already quite high (Figure 12). In sub-Saharan Africa, effective tax rates facing medium-sized companies are 7 percentage points higher than the world average (World Bank, 2017).

These observations suggest that the targeting of higher tax-to-GDP ratios by some developing countries may be counterproductive to creating an 'enabling environment' for investment and growth, and could be inconsistent with other elements of the SDG Agenda.

The benefits of more taxes depend upon how money is used

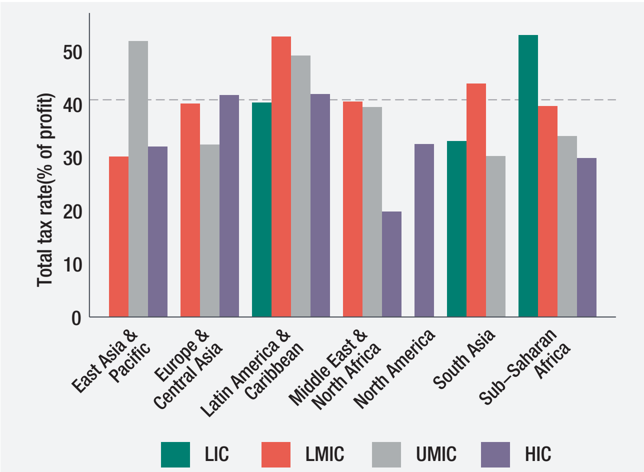
The benefits of collecting more taxes depend on how money is allocated and used. Even if the tax system is progressive, it does not necessarily mean that the net fiscal impact will promote greater equity.

Pritchett and Aiyar (2015) distinguish between taxes that are the 'price' of better public goods, and those that are 'tribute' to the inefficiencies and rent-seeking of politicians, bureaucrats, civil servants and private-sector contractors. In doing so, they also make a distinction between the accounting cost of delivering public goods (as reported in national accounts, and indeed in Figure 9 above) and the economic cost (e.g. the cost of producing one year of education of a given quality). Using this framework they estimate that some 60–80% of the budget for basic education in India is simply 'tribute'.

Similarly, South Africa spends a significant share of GDP (6.8%) on education, but lags behind poorer countries on the continent in terms of educational attainment.[7] In other cases, identifying poor allocation of resources is more straightforward. In Zimbabwe, which has the highest LIC tax-to-GDP ratio, approximately 85% of total revenue is spent on the government wage bill (IMF, 2016a).

A related point is that the quality of public goods has implications for taxpayers 'willingness to pay' taxes. Using

Figure 12. Tax rates are higher than average in some poorer regions



Source: World Bank Paying Taxes Database. Observations are for 2015.

5 https://www.theguardian.com/global-development/2015/jul/07/why-developing-countries-need-to-toughen-up-taxes-sdgs

6 http://ictd.ac/blogs/entry/the-sustainable-development-goals-reject-tax-targeting

7 https://www.economist.com/news/middle-east-and-africa/21713858-why-it-bottom-class-south-africa-has-one-worlds-worst-education

examples from urban India, Pritchett and Aiyar (2015) note that, at lower levels of quality relative to income, taxpayers begin to opt out of using public services. This in turns shifts their view of the taxes they pay from 'price' to 'tribute'. Pritchett and Aiyar also argue that, in the case of India, social insurance programmes that strike the right balance between insurance and redistribution are more likely to attract broad based support. This appears to be an argument the Government of India is taking seriously. Its most recent economic survey lists a universal basic income as a means to addressing the 'exclusion errors' associated with targeted social programmes (Government of India, 2017).

On a similar point Bird and Zolt (2014) point to recent declines in income inequality and poverty levels in Latin America, made possible by economic growth and the emergence of a middle class that was more willing to pay taxes in exchange for a 'fiscal contract' that provided for relatively universal programs. However, countries like Brazil, which were to the forefront of this decline in income inequality and poverty, are currently struggling through protracted fiscal crises as a result of what have been described by the IMF as 'unsustainable expenditure mandates' (IMF, 2016b).

These observations raise concerns around the type of expenditures that developing countries are being urged to undertake as part of the SDGs, as well as their sequencing, and the taxes that can be realistically raised to finance and make them sustainable.

Taxation can be divisive rather than inclusive

Recognising the multitude of political outcomes that are possible in modern developing states, Moore (2015) admits that his own expectations of the potential governance dividend from taxation are now 'somewhat muted', and he expects them to be smaller, less reliable and likely to emerge only in the relatively long term. Using taxation as a way to promote an inclusive fiscal contract between state and citizens is not a given. Taxation can also be used as a means to promote divisions between different groups in a society. As Moore (2015) argues, governments have the ability to:

- tax opaquely or selectively, particularly with regard to the use of exemptions
- offer targeted public spending tailored to specific interest groups.

There may be different motivations for these kinds of behaviours, including:

- attracting investment in a more globally competitive environment
- corruption in the form of side payments from grateful investors
- the creation or exacerbation of political divisions among taxpayers perceived as a threat to political elites.

According to Bird (2015), '*the single most important ingredient for effective tax administration is clear recognition at the highest levels of politics of the importance of the task and the willingness to support good administrative practices, even if political friends are hurt*'. Politicians are more likely to pursue a more equitable tax system if a more progressive developmental model and broad-based economic growth is in their interest.

In many poorer countries, these circumstances do not exist. Encouraging and incentivising 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. According to Slemrod (2016), the international community '*must 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?*'.

Summary

- Putting in place a better tax system may not necessarily be consistent with achieving a higher tax-to-GDP ratio in the short term.
- Businesses already face high effective tax rates in some of the poorest countries.
- The ability to raise taxes and the impact of taxation is inextricably linked to how well governments spend those resources.
- While taxation can *potentially* support the development of a fiscal contract, taxation can also be used divisively.

Do all good things come to those who tax more?

The historical record suggests they do. Countries with higher tax-to-GDP ratios are among the most developed countries in the world (Besley, 2016). As such, linking the delivery of the SDGs to DRM is a good idea in principle. The evidence base suggests that rising levels of taxation are associated with more social spending and more effective and accountable states in the long run, which are likely to contribute to meeting SDG targets. This is also in line with Kaldor's intuition that good things come to those who tax more.

However, following this intuition blindly has the potential to lead to adverse consequences. The relationships between tax and development are complex, and it should not be forgotten that the Addis Ababa outcome document correctly recognises that '*domestic resources are first and foremost generated by economic growth, supported by an enabling environment at all levels*'.

The development of this enabling environment should consider the governance arrangements related to the effectiveness of current spending and the adequacy of existing resources. From the perspective of a middle-class earner in a developing country being asked to make up the difference between a current 14% tax-to-GDP ratio and a target 15% ratio, the most relevant question may be, 'What are you doing with the 14%?'.

On this point, the international community should heed the advice of Slemrod (2016) and '*banish soft thinking, like "more revenue is always good"*'. Tax reforms should focus on building better tax systems rather than collecting more taxes.

Sometimes these objectives are mutually consistent, but often they are not. Some developing countries do not collect enough taxes and this is a risk to their sustainable development. Others collect close to their capacity and need to consider the impact this has on the ability of their economy to undergo the necessary transformation to generate higher levels of taxable income. In both cases these countries need better tax systems, but for different reasons. New measures and estimation techniques[8] present a far better departure point for assessing the taxation needs of developing countries than the setting of revenue targets.

8 Beyond noted measures of tax effort, the IMF is introducing new tools for assessing tax administration including RA-FIT and TADAT, while Keen and Slemrod (2017) have introduced a new measure they call the 'enforcement elasticity of tax revenue'.

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