



Report

# Fiscal governance and state-building

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Cover photo: Museum of The Asian-African Conference: flags of the 29 newly independent countries at the museum. © Gwmb2013 | Dreamstime

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# 1. Introduction

The interest in state-building in post-colonial development thinking is relatively new. Historically, the need to ‘build states’ has received less attention than the need to build effective markets to generate wealth, or build effective political institutions to deliver democracy and respect for individual rights.

State-building has often been seen as a sub-field of European history (e.g. Tilly, 1990) or as part of the early study of public administration (e.g. Weber, 1978). Early post-colonial development thinking assumed that a well-functioning state was available to implement the ‘correct’ economic policies (e.g. Rostow’s 1962 theories of stages of economic growth or Lewis’ 1954 dual markets approach). Later debates assumed that the state was inherently detrimental and needed to be restrained if the private sector was to flourish (e.g. the stereotypical ‘Washington Consensus’ model of economic development).

Since the 1990s, however, there has been a stronger focus on the role of the state in development. There is, for example, a wider recognition – perhaps even a general acceptance – that ‘governance matters’ for development, and that patterns of state/society interaction will shape overall development outcomes (e.g. Kaufmann et al., 1999). More recent thinking has, therefore, aimed to ‘bring the state back in’ to questions of development (World Bank, 1997).

As part of this discussion, some commentators have tried to reconceptualise what ‘development’ means to emphasise that it must include an increasingly sophisticated bureaucratic capability alongside traditional conceptions of greater economic output and more inclusive political institutions (Pritchett et al., 2010; Fukuyama, 2011).

‘State weakness’ – an inability of the state to deliver basic public goods or undertake essential functions – is increasingly seen as a key challenge for global development (e.g. Ghani et al., 2005; Besley and Persson, 2011a). The problem of ‘state weakness’ is often expressed in the concept of a ‘failed’ or ‘fragile’ state. There are many definitions of what constitutes such an entity, and the term itself is not without controversy (Hagmann and Hoehne, 2009).

In general, fragility is defined as states that are unable – or unwilling – to protect their populations from insecurity, to foster economic development or deliver basic public goods (World Bank, 2011). For some thinkers, fragile states represent the central problem of development in the modern era. By many measures, widespread and enduring income poverty will increasingly be concentrated in such states (e.g.

Collier, 2007; Kharas and Rogerson, 2012). Furthermore, conflict and/or political instability can be key determinants of the significant differences in long-term growth rates between low-income countries that are in other respects fairly similar (Salinas et al., 2015; Fofack, 2010).

State-building is seen as critical to resolving state fragility: indeed, the OECD (2007) has suggested that state-building is the central objective of engagement in fragile states.

State-building refers to ‘the set of actions undertaken by national and/or international actors to establish, reform and strengthen state institutions where these have seriously been eroded or are missing’ (Fritz and Rocha-Menocal, 2007: 13). State-building means both building state institutions capable of performing certain functions and strengthening the legitimacy of the state by supporting more constructive relationships between state and society (DFID, 2010).

This emerging interest in state-building has focused attention on accounts of how states were built in today’s developed economies. A number of authors (Bonney, 1999; Ertman, 1997; Glete, 2002; Brewer, 1990) recount the evolution of modern European states whose survival depended on military prowess. Where ‘states’ were not able to protect themselves from invasion, they ceased to exist. At the centre of this narrative is the role of fiscal governance – the institutions, rules and norms that structure how public money is raised and spent (Anheier, 2013) – in state formation. Today there is growing interest in understanding whether fiscal governance reforms might play a similar role in supporting state-building, particularly in fragile settings.

This report aims to provide practitioners with an accessible guide to the existing academic and policy literature on the relationship between fiscal governance and state-building. More specifically, the report:

- provides a summary of how changes in fiscal governance played a central role in the development of modern European states
- shows how these historical relationships underpin contemporary arguments for supporting fiscal governance reforms as a way to build more capable and legitimate states
- outlines key reasons why state-building in fragile states today has followed a very different path to that taken in early modern Europe, and the effects on fiscal governance
- concludes by outlining the implications for external actors looking to support state-building.

# 2. The role of fiscal governance in building European states

## 2.1. Introduction

The idea that taxation and spending shaped the development of states has a long history. It was Schumpeter who first gave rise to a body of literature often referred to as fiscal sociology (Moore, 2004). He believed that the drivers of social, economic and political change could only be understood by appreciating how states had grappled with the challenges of raising and spending public funds: ‘the fiscal history of a people is above all an essential part of its general history’ (Schumpeter, 1991: 100).

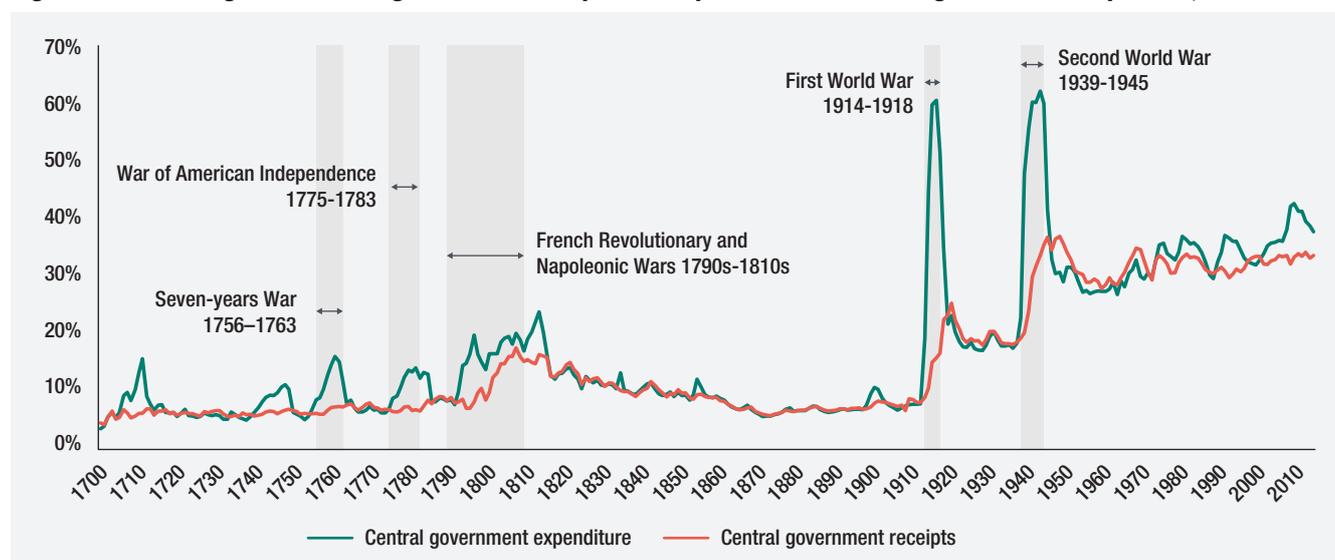
Much of our understanding of contemporary state-building, therefore, rests on our understanding of the ‘fiscal history’ of European states during the 16th to 18th centuries and how this reshaped both states and societies. This chapter provides an overview of the literature on the history of fiscal governance and state-building in Europe; drawing primarily from Tilly (1990), Moore (2004), Brautigam (2008) and Krause (2013).

## 2.2. The threat of war and the transformation of fiscal institutions

During the early modern period, interstate competition threatened the very survival of European states. To prevent the invasion and loss of territory under their control, states needed to finance their war-making capabilities, while ever-more sophisticated warfare required ever-greater financing (Bonney, 1999; Ertman, 1997; Glete, 2002; Brewer, 1990). The threat to survival posed by interstate competition placed significant demands on the public purse (see, for example, the sharp rise in receipts and expenditure in the UK during periods of war, as shown in Figure 1).

The need to secure financing to wage war successfully led to a transformation in the way European states collected and used public monies (Tilly, 1990). Pre-modern European states relied upon wealthy individuals to collect taxes under a system often referred to as ‘tax farming’. In practice, this

Figure 1. United Kingdom\*: central government receipts and expenditure as share of gross domestic product, 1700-2015



\*Up until 1801, Great Britain, thereafter United Kingdom.

Source: Bank of England, 2015.

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meant that rulers relied upon wealthy landowners to collect funds, predominantly from peasant farmers, on their behalf.

Under this system, revenue flows tended to be unpredictable and large amounts of the funds collected were appropriated by tax collectors. The states that established larger and more predictable sources of revenues gained a considerable advantage over their competitors (Moore, 2004).

### 2.3. Fiscal reforms as a spur to bureaucratic modernisation

As the cost of financing military operations rose, permanent bureaucracies began to emerge that were responsible for the collection of ever-larger amounts of tax revenue. This required the development of a formal administrative apparatus that allowed a coordinated network of civil servants to collect taxes across a state's territory and channel the funds raised to the public purse (Brautigam, 2008).

The structures put in place to collect public funds began to bear the hallmarks of modern bureaucracies that Weber characterised as the basis of 'rational rule' (Weber, 1978). Systems were put in place to promote impersonal processes that limited the discretion of tax collectors and increased the state's oversight. Brewer (1990) describes the case of Great Britain, where the British Excise Office was one of the first permanent bureaucracies set up to promote the efficiency of revenue collection. Key innovations included: the introduction of salaried staff; the emergence of organisational hierarchies; recruitment and promotion based on merit; and the introduction of standard operating procedures.

The modernisation of institutions to manage spending ran in parallel to changes in the apparatus for raising funds. Historically, monarchs and landlords had their own private treasuries that were responsible for funding their activities, and these tended to be highly chaotic (Webber and Wildavsky, 1986).

However, as the requirements of war drew in more resources, the processes for managing and controlling spending became increasingly formal. Systems were required to reduce the uncontrolled leakage of funds and increase the ability of the state to direct resources towards ever-more complicated military operations. The historical account of the British and Prussian finance ministries provides one example: the ability of these institutions to establish expenditure systems with 'hierarchical, centralised oversight based on impersonal norms' (Krause, 2013) ensured greater availability of resources to fight wars.

As such, the evolution of fiscal institutions was the 'entry point' to wider bureaucratic modernisation (Kaldor, 1963). Changes in the institutions that collected and spent money were at the forefront of a broader 'administrative revolution' in the rest of government (Brautigam, 2008). The modernisation of fiscal institutions contributed to the development of a more capable public administration, albeit primarily for the purposes of war.

### 2.4. Fiscal reforms as precursors for more representative government

Pre-modern systems of tax farming relied primarily upon coercive means to raise funds. These were costly to administer, partly because of the resistance of taxpayers, but also because much of the money collected was appropriated by tax collectors.

Levi (1989) describes how it was in the self-interest of rulers to come up with more consensual mechanisms to collect taxes as a way to reduce the loss of revenue. This is because effective revenue collection requires 'quasi-voluntary compliance' by taxpayers. Comparative analysis of the development of European fiscal institutions (Tilly, 1990) shows that where countries had institutions in place to promote consensual tax regimes, they stood to benefit from larger and more predictable revenues.

The move towards more 'consensual' revenue collection required that taxation became a more formalised and public endeavour. Tax became regulated by rules-based procedures that were negotiated and agreed upon in the public domain, rather than subject to individual negotiations in private.

This helped to address the collective action problem, whereby any individual taxpayer is reluctant to pay taxes if they believe that others might be paying less, or not paying anything at all (Levi, 1989). Moving away from private negotiation to a more public discussion of tax obligations had the effect of requiring and reinforcing a greater sense of 'fairness' in the relationships between taxpayers and the state.

Sustaining consent to pay taxes also required mechanisms to ensure that taxpayers (or creditors) could demand accountability for the use of money raised. The first assemblies of notables in modern Europe were formed to negotiate consent on tax and spending policies (Brautigam, 2008). These assemblies became places where the revenues provided by nobles were exchanged for mutually beneficial policies (Moore, 2004).

In the case of medieval Holland, for example, the Habsburg rulers became increasingly accountable to the estate owners who issued debt to finance their military operations. In return for financing, estates were given the right to audit and control accounts, ensure money was actually spent on the intended purposes (military operations) and given the right to appoint treasurers (Tracy, 2008).

Over time these practices evolved into the accountability and oversight mechanisms we recognise today. The budget came to be a cornerstone of the system of democratic oversight of public finance in European states. Legislative oversight of the executive's budget proposal provided elected representatives with the opportunity to ensure that executive spending was in line with the preferences of citizens (Krause, 2013).

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## 2.5. Summary

Much of the theory that underpins our understanding of the relationships between fiscal governance and statebuilding draws from the emergence of states in Europe between the 16th and 18th centuries. The financing requirements of states grew in response to the threat of war. The states that flourished were those that shifted the administration of fiscal affairs away from personal and informal systems and towards institutional bureaucracy.

This transformation of fiscal institutions led the way to a broader administrative revolution.

Over time, as financial management moved from a largely coercive private matter to a more consensual public one, checks and balances emerged to control the executive's use of public funds, culminating in modern institutions of financial oversight and accountability. Emerging from the need to finance warfare, these changes to fiscal institutions were the catalyst for the creation of more capable and legitimate states.

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# 3. The links between fiscal governance and state-building objectives

## 3.1. State-building and fragility

In today's development debates, state-building is commonly viewed through the lens of fragile states. Indeed, the OECD (2007) has suggested that state-building is the central objective of engagement in such countries. Naturally, this leads to questions about the relationship and interactions between fragile states and state-building.

One characteristic of fragile states is their chronic lack of even the most basic capacities (World Bank, 2011). This undermines the ability of their governments to carry out certain core functions that are expected of the state. While the expected core functions might vary from state to state, there is consensus that, at a minimum, a state should provide a safe and secure environment in which to live (Haider, 2014) as well as basic services and macroeconomic management (see, for example, Ingram, 2010). The state's ability to perform these core functions can be thought of as its 'capability' or 'capacity' (see Dressel and Brumby, 2012, Tilley et al., 2015 and Krause et al., 2016 for more detailed discussions on issues of capacity and capability).

As well as lacking capacities, fragile states tend to lack legitimacy. Fundamentally, a state is legitimate when its monopoly on the use of violence is accepted by citizens (Weber, 1966). Its legitimacy matters, therefore, 'because it provides the basis for rule by consent rather than by coercion' (OECD, 2010a).

Where state institutions are seen as legitimate, they are better able to generate the commitment, coordination and cooperation necessary to carry out their functions (Nixon et al., 2017). Without such legitimacy, there is always a risk that political conflicts will be settled by force, rather than institutional forms of arbitration. When states are not seen as legitimate, they are unable to form constructive relationships with their societies or manage change through peaceful political processes.

States derive their legitimacy from different sources, with Scharpf (1997) distinguishing between 'output legitimacy' and 'input legitimacy'.

- *Output legitimacy* involves building consent between state and society based on what the state delivers to its citizens. This might, for example, include the provision of security and the delivery of basic services such as health and education. It is, therefore, closely related to the capability of the state to perform its functions effectively.
- *Input legitimacy* depends on the processes through which the state takes decisions. It requires that 'political choices should be derived, directly or indirectly, from the authentic preferences of citizens'. It is, therefore, closely linked to ideas of how states are to be held accountable for ruling in the interests of their citizens.

The history outlined in the previous section demonstrated the central role that changes to fiscal governance played in the development of capable and legitimate states in Europe. Contemporary academic and policy literature on state-building has revisited this literature to determine whether improved fiscal governance could support such developments in fragile states.

## 3.2. Fiscal governance and the capability of the state

### 3.2.1. Fiscal capacity and the performance of core functions

As noted above, bureaucratic modernisation of the mechanisms to collect taxes is seen as a key contributor to Europe's historical experience of increasing revenue collection to finance war. Today, reforms to increase tax administration capacity are recommended as a way to increase resources to finance development (IMF, 2017; OECD, 2014).

The capability of the state to perform its core functions is affected by the availability of revenue: this is often referred to as the state's fiscal capacity (see, for example, Besley and Persson, 2009). Without sufficient fiscal

capacity, states are unable to pay for the soldiers, schools and roads needed to meet even the most basic expectations of what a state should do.

From a financing perspective, non-resource tax revenues (those that are not derived from the extraction and sale of natural resources) are seen as a particularly useful source of funds because of their relative predictability and ‘sustainability’ compared to other revenue sources (OECD, 2014). Where countries rely on natural resources or overseas development assistance, the revenues available to finance the state’s core functions tend to be more volatile. For example, South Sudan – the world’s youngest country – depends heavily on oil revenues which have been subject to fluctuating supply and price changes, as shown in Figure 2. This can disrupt its ability to pay for the core functions of the state.

Weaknesses in tax administration capacity are seen as one reason why domestic revenue collection in fragile states tends to be low as a percentage of GDP. For example, the OECD (2014: p. 55) states that ‘weak technical, technological and institutional capacities in many fragile states also make it harder to levy taxes.’

Fiscal capacity also depends upon the state’s ability to channel the revenues generated to their intended purpose. Governments need infrastructure to make payments across their territory (Boyce and O’Donnell, 2007). Where they are unable to control or limit spending, the revenues that are generated are liable to be wasted. Many fragile states also rely on funding from donors. Having systems in place that give donors ‘fiduciary confidence’ can also enhance fiscal capacity (Fritz and Rocha-Menocal, 2007).

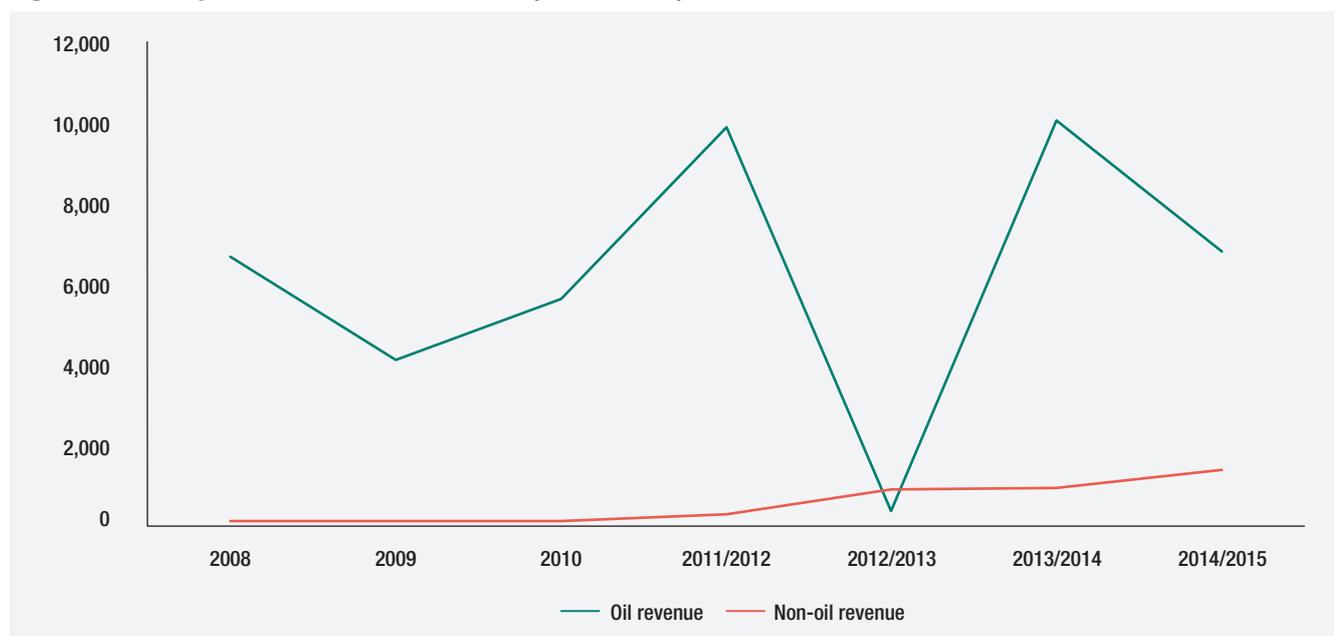
Two recent studies by the IMF (Gelbard et al., 2015; Deléchat et al., 2015) find positive correlations between fiscal capacity and the ‘resilience’ of states (with resilience measured via by a combination of the World Bank’s Country Policy and Institutional Assessment (CIPA) index and the prevalence of conflict in the preceding period). They find associations between the measure of resilience and both tax as a percentage of GDP and fiscal space (measured by the size of the deficit and the level of current spending).

### 3.2.2. Spillovers on wider bureaucratic capability

Not all financing is equal from a state-building perspective. The ability to collect taxes, in particular, is seen in the literature as a sign of wider state capability (Di John, 2010). It signals state capability because the collection of taxes requires administrative effort. Direct taxes (e.g. income tax) are seen to be particularly relevant to questions of state capability. Where states can collect taxes directly across their territory (rather than simply erecting border posts to collect import duties), it is a sign that the government has the power to administer, monitor and enforce the payment of taxes (Besley and Persson, 2011b).

Strengthening the collection and administration of tax is also seen as a way to motivate wider improvements in the overall capability of state bureaucracies. The OECD (2014) suggests that reforms to tax and revenue administration ‘have been shown to catalyse reforms in other public sector institutions’, citing the work of Fjeldstad and Moore (2008). Prichard and Leonard (2010) find a positive correlation between improvements in tax administration (as measured by indicators of tax effort) and measures of

**Figure 2. Volatility of revenues in South Sudan (US\$ millions)**



Source: Ministry of Finance and Economic Planning, South Sudan, accessed at <http://grss-mof.org/docs/historic-budgets-and-budget-outturns-2005-2015/>  
 Note: Data for the first six months of 2011 are excluded. At this time the country moved the fiscal year from Jan-Dec to July-June.

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government capacity five years later (as measured by the International Country Risk Guide (ICRG). With caveats, they interpret this as offering some support to the idea that improvements in tax administrative capacity precede wider improvements in government capability.<sup>1</sup>

Prichard (2010) suggests a number of specific channels through which improvements in tax administration can benefit the wider capability of the state.

- They expand the reach of government services through investments in the presence of tax administration in remote areas. In Bolivia, for example, the expansion of customs administration to remote areas required improvements in the telecommunications network, which later became the backbone for other government agencies.
- Information from tax authorities can be used to inform and support other policy processes. In Chile, for example, the municipal government agencies, civil and company registries and even private banks all use the unique tax identification numbers managed by the revenue authority.
- They contribute to innovation elsewhere in government through ‘demonstration effects’.
- Tax collection agencies may also demand innovation from agencies who they depend upon to collect funds effectively (e.g. modernising processes for business and land registration).

The links between changes in expenditure administration and broader state capability have not been explored to the same extent in the literature. There are, however, certain parallels that can be drawn with above discussion on taxation.

- Building the institutional architecture a state needs to make payments throughout its territory is central to the expansion of a government’s reach. Fritz and Rocha Menocal (2007) note the central importance of a reliable and monitorable payment system to support a functional civil service as the basis of state administration.
- Information produced routinely to manage public expenditure is used to support other functions of government. Expenditure information is critical for the policy-making process, with recruitment decisions, for example, dependent upon the payroll records used to process salary payments. Tracking how much is being

budgeted for and spent on government projects is a key input for any kind of performance monitoring system.

- The ability to make salary payments on time and in full is also a critical foundation for a motivated civil service. A public expenditure tracking survey in Nigeria, for example, showed a positive correlation in Kogi province between the facilities where staff were paid on time and the likelihood of essential drug availability from those facilities rather than private providers (Das Gupta et al., 2004).

There is some evidence that the quality of institutions that manage expenditure is also associated with state capability. Gelbard et al. (2015) find a positive association between an index on the quality of budgetary institutions<sup>2</sup> and (Country Policy and Institutional Assessment (CPIA) scores, which capture certain elements of government capability. A World Bank study on public finance reforms in eight fragile states also found a weak association between improvements in public financial management systems (as measured by Public Expenditure and Financial Accountability (PEFA) indicators) and measures of government effectiveness (as assessed by Worldwide Governance Indicators) (Fritz et al., 2012).

### 3.3. Fiscal governance and state legitimacy

#### 3.3.1. Fiscal governance and ‘output legitimacy’

*Output legitimacy* involves building consent between state and society based on the outputs or public goods that the state delivers to its citizens (Scharpf, 1997), including security and health or education services. From a fiscal governance perspective, this means that governments mobilise revenues on the understanding that those funds will be used to deliver things that taxpayers care about. This is often referred to in the literature as a ‘fiscal contract’ (for example, in Moore, 2004).

Taxation is particularly important for legitimacy because it requires the consent of citizens. As Di John puts it ‘taxation is a nexus that binds together state and citizens’ in a way that funds raised through other means (e.g. natural resource revenues, aid or the profits made by governments for issuing currency) do not (Di John, 2010).

Timmons (2005) provides some evidence for the existence of this ‘fiscal contract’. Comparing 90 countries, he shows that the more a state taxes rich people (as a percentage of GDP), the more the state tends to invest in the protection of property rights; and the more a state taxes poor people, the more the state invests in basic public services. The implication is that taxpayers get what they pay for.

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1 Interestingly, their data point to a structural break since the mid-1990s, where the relationship no longer holds. They speculate whether this might be related to the introduction of semi-autonomous revenue authorities, which may limit capability spillovers from the tax administration to other parts of the bureaucracy.

2 Quality of budgetary institutions is measured using an index compiled by Gollwitzer (2011) that provides rankings based on certain features of an effective budget process, such as ‘top down processes’, ‘comprehensiveness’, ‘transparency’, ‘rules and controls’ and ‘credibility and sustainability’.

On the expenditure side, well-functioning financial management systems can be thought of as a ‘process for systematically relating the expenditure of funds to the accomplishment of planned objectives’ (Schick, 1966: 244). The use of fiscal institutions to deliver certain public goods is expected to strengthen the state’s legitimacy on the basis that it delivers what its citizens want and expect (OECD, 2010a). The ability of the state to garner output legitimacy is, therefore, linked closely to its fiscal capacity and the quality of its bureaucracy.

The outputs that should be delivered by states is, however, subject to some debate. While European states were expected to provide protection and promote prosperity, today’s policy literature often assumes that states derive legitimacy not only from keeping societies safe and secure, but also from providing basic services and macroeconomic stability (Ingram, 2010).

Recent research by the Secure Livelihoods Research Consortium across five fragile states shows that access to services alone does not seem to be linked consistently with people’s perceptions of government (Nixon et al., 2017). In fact, it is the engagement of community members in the provision of services that seems to consistently improve their perception of government. This points to the importance of ‘input legitimacy’, as described below.

### 3.3.2. Fiscal governance and ‘input legitimacy’

*Input legitimacy* depends upon the processes through which the state takes decisions (Scharpf, 1997). It is, therefore, linked closely to ideas of how states are held accountable for ruling in the interests of citizens. In terms of fiscal governance, this means that perceptions of the legitimacy of the state are derived not just from what is delivered with public money, but also from how that money is mobilised, spent and accounted for. The state is seen as more legitimate where mechanisms are in place to raise revenues and manage spending in a way that responds to the preferences of citizens and interest groups.

Taxation is particularly important for building input legitimacy because the development of effective, consensual tax systems has, historically, required governments to talk to citizens about taxation (Levi, 1989; Tilly, 1990). Citizens accept and comply with taxes in exchange for outputs (e.g. the provision of services), but also for greater state accountability.

This process of tax bargaining is seen as a key entry point for the political engagement of taxpayers (Moore, 2007). Prichard (2010) cites the example of Chile, which has been more successful in growing its revenue base than neighbouring countries. In addition to a number of technocratic tax reforms, he points to processes dating back to the transition from dictatorship, where representatives from across the whole political spectrum were invited to establish ‘an inclusive fiscal pact’ with ‘broad agreement on the contours of tax and expenditure policy’.

In terms of expenditure, the budget process is seen as a key mechanism to build input legitimacy. Ghani et al. (2007)

suggest that the budget is the ‘linchpin of the state’. As a result, a budget process that is perceived as transparent, fair and inclusive can yield a legitimising – and therefore state-building – benefit.

In his analysis of state-building in Iraq, Savage (2014: X) suggests that ‘a politically legitimate budgeting process may also serve as a dispute resolution mechanism that offers a source of political and institutional stability through which claimants for public funds can reach nonviolent agreements on the division of these resources.’ Indeed, the very idea behind modern parliamentary budgeting is that officials who have been elected democratically represent the interests of citizens when approving how public money is to be raised and spent.

In recent decades, budget transparency and participation have come to be seen as pillars of more accountable states. The basic premise is that when they have greater access to reliable information on the use of public monies, citizens are empowered to hold the executive to account in its fiscal procedures. This strengthens trust in the state and confers greater input legitimacy (Carlitz, 2013). A systematic review of the evidence on fiscal openness shows consistent associations between ‘fiscal openness’ and measures of governance, but only a few studies identify causal effects (De Renzio and Wehner, 2015).

## 3.4. Summary

The discussion in this section has highlighted links between aspects of fiscal governance and state-building.

- Most immediately, states cannot exert the monopoly of violence upon which their survival depends without access to revenues (also called fiscal capacity). In contemporary development discourse, fiscal capacity is also seen as critical for financing development needs.
- It has been suggested that the modernisation of fiscal institutions has the potential to spur wider improvements in the administrative capabilities of states.
- Improved fiscal governance can also support more legitimate states. Where funds are used to deliver outputs that citizens care about and want, states can derive ‘output legitimacy’. Systems of accountability for how public funds are allocated, raised and spent also influence a government’s input legitimacy.
- Taxation is seen as particularly beneficial from a state-building perspective because it requires the state to be capable of collecting taxes and to be legitimate enough for citizens to willingly pay their taxes.

It is not clear, however, that causality runs in one direction: does improved fiscal governance cause more capable and legitimate states? or are there other factors

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contributing to the capability and legitimacy of states, which then lead to more effective fiscal governance? Besley and Persson (2011b: 5) suggest a much more complex picture: '[h]istorical accounts demonstrate vividly that state authority, tax systems, court systems, and democracy coevolve in a complex web of interdependent causality. Simplistic stories that try to paste in unidirectional pathways are thus bound to fail.'

In European states, this 'complex web of interdependent causality' seems to have been mutually reinforcing. By contrast, it is rare to see robust fiscal institutions in fragile states: weak fiscal governance has tended to co-evolve with limited bureaucratic capacities and a lack of legitimacy. The next section explores why this is so, before the final section reviews the implications for external actors looking to support state-building efforts in today's fragile states.

# 4. Fiscal institutions have developed differently in fragile states

Current arguments for supporting fiscal governance reforms as part of state-building draw heavily on the role played by fiscal institutions in the development of modern European states. However, today's fragile and conflict-affected states face a very different set of circumstances to those found in Europe. The dominant narrative in the literature on European state-building is that interstate competition provided the conditions for the shared interest of mercantile and political elites in financing a centralised state that provided protection from external threats.

This section explores how two key departures in the external environment faced by today's fragile states have contributed to an evolution of fiscal institutions that differs markedly to the evolution seen in Europe.

## 4.1. Reliance on external revenues to finance state functions

The first key departure from the European state-building story is the differences in the incentives to mobilise domestic revenues. Today's fragile states are on the periphery of a global economy, where states can generate revenues externally, rather than having to look inwards for funds (Moore, 2004).

Moore (2004) identifies 'political pathologies' that stem from a dependence on the extraction and sale of natural resources to mobilise revenues.

- *Autonomy from citizens*, with the state and those who control natural resources having a guaranteed source of income that allows them to operate without reference to citizens.
- *Vulnerability to external military intervention and coups* because of the strategic importance of commodities and oil.
- *Weak financial transparency* because of the greater oversight challenges associated with the financial operations of state-owned oil companies rather than the central budget.

- *Limited incentive to modernise the bureaucracy.*

Where states can access funds from external sources, the returns to investment in the capability to generate revenues across their territory become less attractive, and there is less incentive to spend money in a way that responds to the needs of citizens. This, in turn, can undermine wider bureaucratic capabilities.

These factors help to explain why, on average, states that are more reliant on non-resource taxation tend to be more accountable and effective (see Figures 3 and 4).

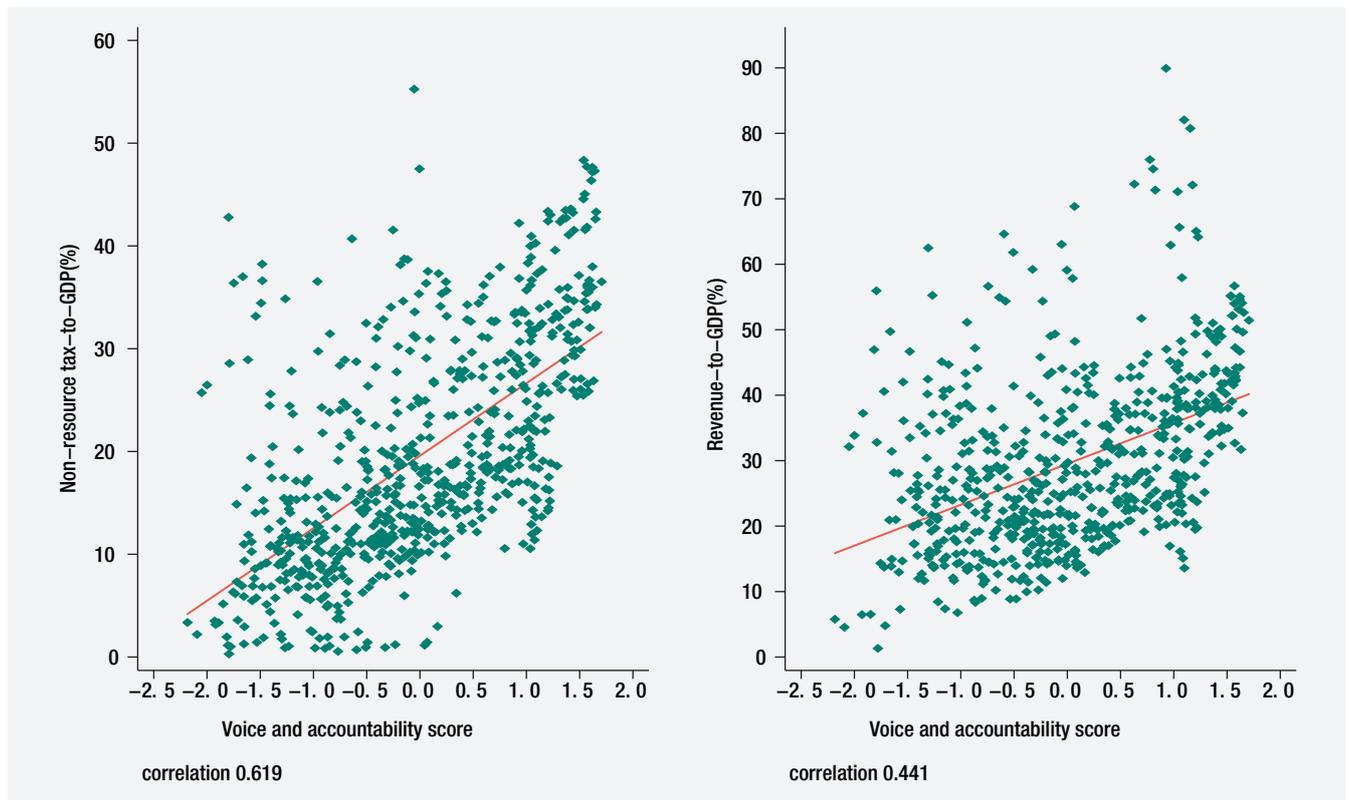
Chaudhry (1997) provides some evidence of causal linkages between a reliance on natural resources and state weakness. She documents how the effects of moving away from a reliance on taxes in Saudi Arabia (towards a reliance on oil) and Yemen (towards remittances from migrants working abroad) eroded not only the capacity of the domestic tax authority, but also more broadly the ability of bureaucracies to undertake independent verification and information gathering on other state functions.

There is also an ongoing debate on whether financial assistance from foreign governments can undermine the building of accountable government. Financial assistance may be in the form of aid or, in countries seen to be of strategic importance, military aid.

Bates (2010: 63) asserts that in the newly formed nations in the 1960s 'public officials and technocrats, who might have otherwise traversed local districts seeking ways to strengthen the local economy found it more profitable instead to tour the capitals of the advanced industrial nations, seeking donations from abroad'. This has given rise to concerns of 'an aid institutions paradox' (Moss et al., 2006): where states that mobilise a significant proportion of their revenues from abroad are less accountable to their own citizens. Legitimacy is sought internationally, rather than domestically.

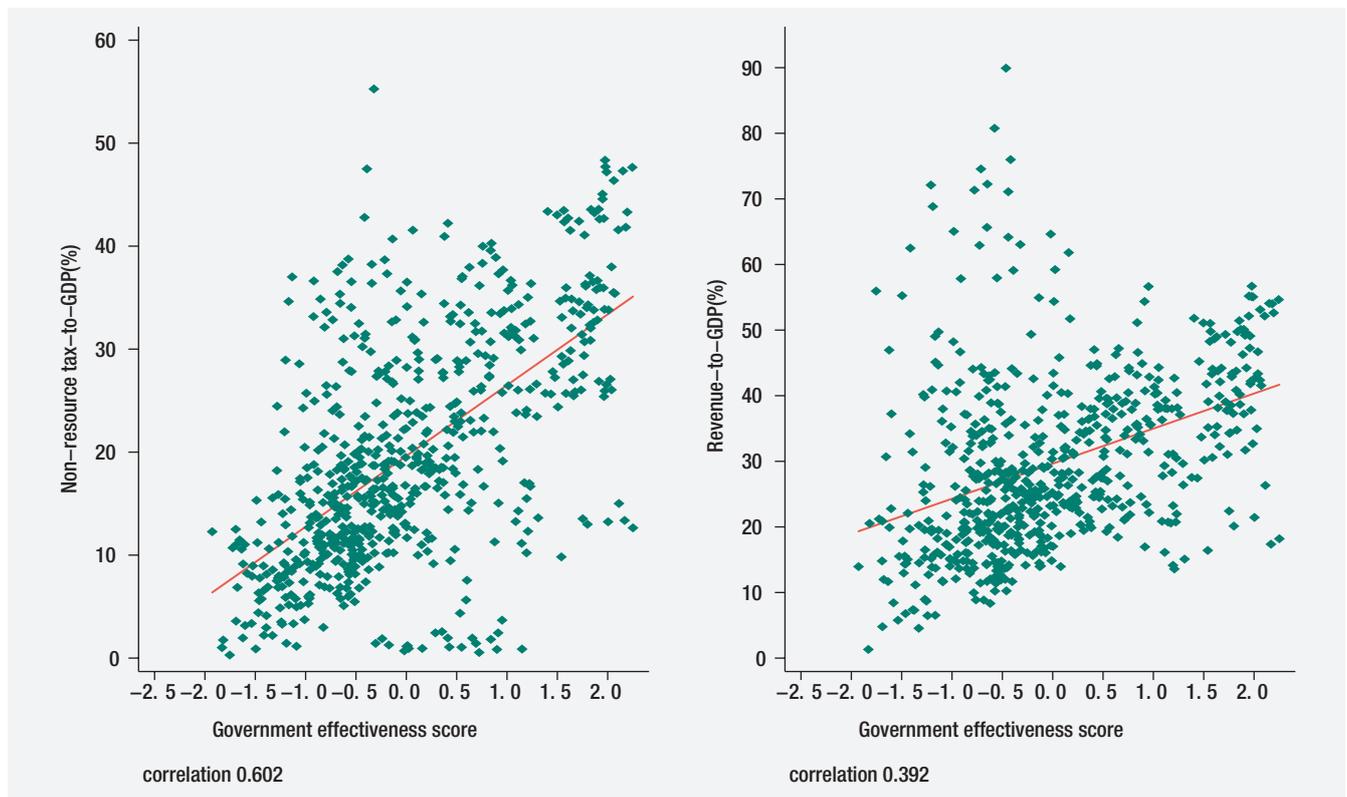
There is some evidence that governments spend taxes 'more wisely' than money received in the form of grants. A recent study by Gadenne (2017) uses variation in the introduction of a programme to enhance tax capacity

**Figure 3. Non-resource taxation is more closely associated with state accountability than revenue more generally: five-year averages, 1996 to 2014**



Source: ICTD Revenue Database, IMF Government Finance Statistics and World Governance Indicators (adapted from Long and Miller, 2017)

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



Source: ICTD Revenue Database, IMF Government Finance Statistics and World Governance Indicators (adapted from Long and Miller, 2017)

in Brazilian municipalities to compare the way in which resources from grants and locally raised tax revenues are used. She shows that locally raised taxes are used to improve both the quantity and quality of municipal education infrastructure, while increases in grants have no impact. Eubank (2012) argues more speculatively that the dependence of the Government of Somaliland on domestic revenues (as a result of ineligibility for overseas development assistance) has fostered more responsive and inclusive forms of government than are seen in many other low-income countries that are aid-dependent.

Concerns have also been raised about whether the provision of aid might undermine incentives to build the capacity to mobilise revenues domestically. Aid could discourage governments from levying taxes on citizens as a politically less costly source of revenue. However, aid can also promote increased revenue collection: either directly through support for tax policy and administration reforms, or indirectly through promoting growth (Morrissey, 2015). The most recent empirical papers on this topic point to a modest but positive relationship between aid and domestic revenue collection (Clist, 2014).

## 4.2. The formation of nation states and ‘competing authority’ within states

The second key departure from the history of European state-building is the way in which today’s nation states have been formed and the implications for the authority of the state. The European states seen in a contemporary map can be thought of as the survivors of a long period of interstate competition. The ‘enormous majority’ of European states failed as a result of wars (Tilly, 1990) and were absorbed by the victors. The national borders of European states, therefore, evolved through successive wars as the victorious states expanded the territory under their control. As part of this process, states emerged as dominant political authorities, having defeated alternative, lower-level political institutions, such as fiefdoms or areas controlled by large landowners (Khan Mohmand, 2016).

In other regions, the formation of states in the wave of decolonisation that began in the late 1950s followed a very different path. The boundaries of new states mirrored the arbitrary lines put in place during colonialisation. The British Prime Minister Lord Salisbury summarised the 1884-85 Scramble for Africa in the following terms: ‘we have been engaged in drawing lines upon maps where no white man’s feet have ever trod; we have been giving away mountains and rivers and lakes to each other, only hindered by the small impediment that we never knew exactly where the mountains and rivers and lakes were’ (Michalopoulos and Papaioannou, 2017).

The *direct* administrative reach of these new nation states rarely spanned the territories of the nation shown on a map. Post-colonial governments found themselves facing the very same problem in building states as their colonial

predecessors: namely, how ‘to project authority over inhospitable territories that contain relatively low densities of people’ (Herbst, 2014: 11). In such circumstances, the relative costs of extending the reach of a formal state across a territory are that much higher.

To overcome this problem, colonial authorities relied upon the authority of alternative, lower-level political institutions of the kind that were once pushed aside in Europe. Power was often delegated to an array of ‘devolved authorities’, such as local chiefdoms.

Although the colonial governments are long gone, these patterns of overlapping authority have persisted. ‘Informal governance institutions’ such as local chiefs, traditional leaders, religious groups and neighbourhood groups tend to exercise an authority over defined areas that often overlaps with the reach of the formal state (Khan Mohmand, 2016). As a result, the greater threat to contemporary fragile and conflict-affected states comes from contested authority *within* states; rather than from outside.

This pattern of multiple authorities has affected the development of fiscal institutions in fragile states.

- The formal state does not always have a monopoly over the collection of taxes. Using household data from 11 countries, Olken and Singhal (2011) demonstrate that community-based informal tax systems are widely used in rural areas to finance public goods, such as schools or roads, where there is an absence of formal state provision. A study on ‘ungoverned spaces’ in Nepal found just 10% of respondents paying formal taxation, while 45% paid taxes to non-governmental actors – particularly religious organisations (Mallett, 2016).
- The reach of formal tax and expenditure institutions across the state is often limited. Herbst (2014: 126) suggests that in many African countries ‘the spatial structure of revenues, and thus of the state itself, is very much as during the colonial period: concentrated in the capital and the few other areas of the country where it is easy to tax.’
- Where authority is contested, taxation may also be used to erect divisions rather than to bind state and citizens together in a common fiscal contract. Moore (2015) suggests that the emergence of a fiscal contract is not a given. Indeed, tax can be used to exacerbate political divisions among taxpayers perceived as a threat to political elites.

## 4.3. Summary

Contemporary fragile states have evolved under a very different set of circumstances to those found in early modern Europe. Today’s states are more likely to face the threat of contested authority within them, rather than

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threats from external sources. The availability of revenues from natural resources and aid also mean that control of these funding sources delivers major returns. Unlike the accounts of Europe, governing authorities and economic elites in fragile states do not have the same aligned incentives to invest in an inclusive fiscal contract that secures a stable source of revenues for shared stability and prosperity. As a result, fiscal institutions in today's fragile

states are very different to the impersonal bureaucracies developed in Europe.

What does this mean for external actors looking to support state-building processes in fragile states? How might their actions affect fiscal governance and state-building? Can they hope to support state-building through fiscal governance reforms? These questions are explored in the final section.

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# 5. The role of external actors in fiscal governance and state-building

This final section considers how international organisations might influence fiscal governance as part of wider state-building efforts. It examines:

- approaches to fiscal governance reform
- the contents of fiscal governance reform
- the management of aid and natural resource revenues
- the research agenda on fiscal governance and state-building.

## 5.1. Approaches to reform

One common view in the policy literature is that although fiscal governance reform is hard, it is both possible and indeed easier than influencing other aspects of governance. Gelbard et al. (2014: 47) suggest that ‘[w]hereas broad-based institutions, as defined by Acemoglu, Johnson and Diamond (2004), are deeply rooted in history and highly persistent, fiscal institutions can be bolstered and policies implemented over a relatively shorter period.’

They suggest that the content of fiscal reform should, in broad terms, be consistent across countries, but that external supporters should manage their expectations on the scale and speed of results when supporting fiscal governance reform in fragile states. Calculations by Pritchett and de Weijer (2010) for the 2011 *World Development Report* suggest that even under the most optimistic scenarios, where institutions improve in line with the average pace of the best 20 performing countries, it takes 20 to 30 years to reach thresholds of average state capability.<sup>3</sup>

In practice, there is still a discrepancy between the stated need for modest ambition and the actual reforms supported by external actors. Case studies of public financial management (PFM) reform in fragile states (Fritz et al., 2012) suggest that while progress is possible across different dimensions of PFM, the greatest progress was made on the indicators of budget execution. External actors also tend to introduce quite advanced technical reforms. For example,

Afghanistan, Liberia and Sierra Leone have, at some point, tried to introduce medium-term fiscal frameworks and programme-based budgeting.

Where reforms are overambitious, there is a risk that they may hinder, rather than support, the development of capable and legitimate states. Pritchett et al. (2010) suggest that donors have often been guilty of supporting reforms that contribute to ‘premature load-bearing’. Where targets are, in reality, beyond reach, states may imitate the organisational forms of advanced countries (how systems look) without necessarily changing the underlying functions (how systems work). This is because the look of an organisation is easier to change over a short period of time than its functions.

Indeed, a study of PFM reform in 31 countries in sub-Saharan Africa shows that countries have made much greater progress on measures of institutional form than on function (Andrews, 2010). This ‘isomorphic mimicry’ runs the risk of overburdening systems with unnecessary complexity, given the limited available capabilities. It also focuses fiscal reform on garnering legitimacy from external actors, rather than domestic constituents.

In the wider literature on institutional development, critical voices have questioned the ability of external actors to design and orchestrate a sequenced reform path. Here, the debate on donor engagement in improving capability in fragile states has moved away from ‘best practice’ transfer towards frameworks that support: ‘good enough governance’ (Grindle, 2007); ‘going with the grain’ of local politics (Booth, 2011); searching for small-scale practical answers to immediate problems (Easterly, 2006); using iterative reform approaches that build in experimentation and tolerance for failure (Andrews 2013); and ‘starting with problems and opportunities, not comprehensive solutions’ (Williamson, 2015).

### 5.1.1. Recommendations on approaching reform

- Ultimately, sustainable fiscal governance reform means institutional development, and the new thinking on this

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3 If bureaucratic quality were to improve at the same average pace as other non-fragile countries, then the time taken for fragile states to reach a threshold measure of state capability would be 116 years according to ICRG indicators and 2,646 years using World Bank measures of government effectiveness.

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agenda should be taken on board. For improvements in fiscal governance to be sustainable, they need to coalesce into functioning institutions. Recent thinking on institutional reform in low-income countries provides a number of clear lessons about how external actors can best support genuine institutional development. These emphasise long-term support to a country-led agenda of incremental and iterative change. Each context will be different, but this learning should inform the manner in which external support is delivered to support fiscal governance reform.

- There is a need for serious thought about the time frames for what can, realistically, be achieved, given that the processes by which capable European states developed took several centuries. The key fiscal governance reforms that contributed to capability in particular states took many years to fully institutionalise, and major reforms may have happened only once in every few decades. However, many reforms to PFM systems in today's fragile states aim for a level of sophistication far beyond those found in European states at a comparable stage of economic development. External actors should, therefore, review their expectations for the magnitude and speed of results when supporting state-building processes through fiscal governance.

## 5.2. The content of fiscal governance reforms

An emerging body of literature, particularly on taxation and state-building, questions whether the *content* of standard tax-reform recommendations are appropriate for the achievement of state-building objectives (see, for example, Brautigam et al. 2008; Prichard, 2010, 2015). Doubts are raised about whether an approach to taxation built primarily around 'economistic' notions of efficiency about tax collection will capture the potential benefits to building capable and legitimate states outlined earlier in this report.

Fjeldstad and Moore (2008), for example, review systems of taxation in Tanzania. They suggest that a focus on strengthening the large taxpayers office has resulted in just 286 firms paying 70% of domestic taxes, while many members of the professional classes pay no tax at all. While such an approach may be 'efficient', the authors worry that a focus on this narrow group overlooks opportunities to foster a social contract between state and citizens.

Prichard (2010) summarises possible alternative approaches to tax reform that maximise opportunities for tax bargaining, including recommendations that run counter to 'standard public finance theory'. For example, he champions earmarking of revenues as a way to strengthen the links between revenues raised and the 'outputs' delivered by the state in return.

Earmarking requires that revenues earned from one source be solely dedicated to specific expenditures (Welham et al., 2015). From a state-building perspective, it is justified as it can support 'tax bargaining' between state and citizens, although it limits flexibility of finance ministries to reallocate resources. The idea is that states can build consensus over changes to tax policy by linking revenues to particular expenditure programmes. Prichard cites the example of an increase in value added tax in Ghana (from 10% to 12.5%), which faced strong public opposition. In addition to an impressive public relations campaign that helped to generate greater acceptance for the reform, the increased collection was earmarked for a new Education Trust Fund.

Joshi and Aye (2008) have explored approaches of *associational taxation* as a way to bring the informal sector into the tax net. Citing examples from Ghana, Peru and Senegal, they argue that prospects for sustainable taxation are improved by negotiation between the state and associations that represent parts of the informal sector. In each of these countries, the government has brought parts of the informal sector into the tax net by delegating responsibility for the collection of certain fees to trade associations. Joshi and Aye suggest that the effectiveness of such measures depends on the revenue imperative facing a government (i.e. is central or local government facing a fiscal crisis that requires potentially unpopular reform) and the ability of trade associations to bargain collectively with a government.

Kiser and Sacks (2009) argue that centralised, bureaucratic tax administrations may be a poor fit for the economies of many states in sub-Saharan Africa because limited fiscal capacity and poor transportation and communication limit the ability of states to monitor and sanction tax collectors. They contend that under certain conditions, the systems of tax collection used in early modern Europe may be more suitable. This might include options to decentralise or delegate responsibilities for tax collection; or contracting out certain tax collection responsibilities.

Less has been written on the expenditure side, but similar concerns for the appropriateness of standard public expenditure reforms could be valid. There is, for example, a tendency to push for the centralised management of all government bank accounts on the grounds of efficient cash management. There could, however, be situations where allowing service providers to retain and manage their own revenues might have benefits from an accountability perspective.

Similarly, many PFM reform programmes have promoted a centralised finance ministry to manage the performance of line ministries. In Rwanda, however, systems of performance management have been built around the moral rewards and sanctions of the *imihigo* system, whereby local officials pledge publicly to achieve certain objectives (Chambers and Booth, 2012).

Given weaknesses in the fiscal capacity and capability of prevailing fiscal institutions, there may also be situations where ‘privatising’ responsibility for expenditure management could work. During a recent roads project in Liberia, the World Bank contracted out responsibility for both construction and maintenance of road building to address the persistent pathology of under-budgeting for maintenance in a weak institutional environment (World Bank, 2015).

### Recommendations on the content of reform

- Empirical evidence to support possible alternatives to standard reforms is based largely on individual case studies. This raises obvious questions about the external validity of the findings. None of the examples provide a blueprint for a distinct approach for reform that supports state-building. What they do highlight, however, is that there could be more room for experimentation than is often acknowledged. Piloting alternative approaches and measuring their effectiveness could reap dividends. It would also be useful to state more explicitly how planned reforms are likely to interact with state-building goals.
- A standard package of fiscal reforms may not always be appropriate. A number of examples of country reform challenge some of the received wisdom on fiscal reform: associational taxation; earmarking revenues to gain popular support for tax policy changes; contracting out certain fiscal functions; and incorporating informal governance institutions (e.g. *imihigo*) into processes of fiscal governance. There is a need, however, for more rigorous evaluation of the effectiveness of these interventions and the conditions under which they are likely to succeed.
- Promoting the reform of fiscal governance means thinking about the interactions between fiscal institutions and other actors in government. The literature identifies how improvements in fiscal institutions have spurred wider improvement in bureaucratic development, but also how this may be less apparent in recent years. While ‘core’ institutions of fiscal governance (e.g. the ministry of finance; accountant general; tax collection agencies; audit institutions) are the natural candidates for fiscal governance reform support, other agencies with financial management responsibility (such as major line ministries, or agencies responsible for the public sector payroll) also have key roles in PFM, particularly on expenditure. External actors should consider how and when programmes should reach beyond the core institutions of fiscal governance, and how targeted improvements in core fiscal institutions could have benefits in other parts of government.

### 5.3. Mitigating the impacts of aid and natural resources revenues

This report has highlighted that the capacity to collect taxes has a much greater return from a state-building perspective than the collection of revenues from other sources. Concerns have also been expressed that a reliance on external resource flows can undermine the development of responsive, domestic political institutions. In the short term, however, there may be little that can be done to diversify the revenue base.

External actors may, however, be able to influence the way in which resources from other sources are managed. A number of initiatives have emerged in the extractive industries sector to bolster the institutional mechanisms that hold governments to account for the extraction and use of natural resource revenues (Meijía Acosta, 2013). Examples include Publish What You Pay and the Extractive Industries Transparency Initiative, which advocates a global standard for transparency among business and governments. The CONNEX initiative agreed by the G7 aims to help developing country governments secure better deals from contracts with extractive companies by providing support for negotiations.

There are also debates on how aid can best be provided to mitigate potentially negative impacts on the accountability of states to their citizens. In a background paper to the 2017 *World Development Report*, Devarajan and Khemani (2016) suggest that external actors should provide not only lump-sum transfers to governments (i.e. budget support), but also research products and associated knowledge that build the capacity of citizens ‘to select and sanction leaders who have the political will and legitimacy to deliver the public goods needed for development.’

It has also been suggested that where aid uses country systems for financial management and procurement, it can reduce the risks of undermining the long-term development of administrative capacities (Hart et al., 2015). Setting up separate systems to manage donor funds is thought to divert scarce institutional capacity away from strengthening the management of governments’ own systems. It also sends a clear and negative message to domestic taxpayers about the quality of government financial systems.

Creating parallel systems of higher capability can stop any positive spillovers reaching other parts of the bureaucracy (OECD, 2010b). There is also a risk that a ‘dual public sector’ emerges that is ‘run parallel to, and often in competition with, national state structures’ (OECD, 2010b: 69). The use of existing country systems can help to mitigate these risks. There is, however, a tension here: those countries in greatest need of support to improve fiscal governance are also those where the fiduciary risks tend to be greatest.

#### Recommendations on mitigating risks:

- Donor country governments can use regulation to influence behaviours of the extractive companies domiciled in their jurisdiction. The Natural Resource

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Charter (Natural Resource Governance Institute, 2014) recommends that governments promote and enforce public disclosure requirements in the extractive industry and ensure that extractive industry projects comply with social and environmental standards.

- Hart et al. (2015) propose a number of concrete recommendations that donors can consider when deciding whether to use country systems when providing aid, including: '(i) understanding the country context and political economy, (ii) understanding objectives of overall programme and the time-frame of expected results (e.g. long-term state building or rapid basic services delivery), (iii) identification of key trade-offs, including the risks of not engaging with country systems and (iv) taking decisions on the level of acceptable risk tolerance to inform the degree of use of country systems.'

#### 5.4. Advancing the research agenda on fiscal governance and state-building

More needs to be done to unpick the different elements through which fiscal institutions affect state capability and legitimacy. Indeed, the literature on PFM and state-building can be criticised for concluding that because it involves a 'complex web of interdependent causality' it means that 'all good things go together'. Much of the empirical work looks at broad associations between fiscal institutions and measures of government effectiveness, but does not tease out the mechanisms through which change happens.

A future research agenda on this issue could, therefore, be structured around the following changes in approach.

- *Considering longer time periods in research and evaluation work.* Many evaluations of the impact of donor-supported change in fiscal governance are linked to a donor programming cycle of three to five years. However, the tax and state-building literature points to change that occurs over a far longer period. Shifting to longer-term evaluation of multiple external interventions would improve understanding of sustainable change.
- *Looking seriously at examples where improved fiscal governance has not made a positive contribution to state-building.* A future research agenda should be bold enough to research cases where seemingly sustainable changes in fiscal governance have *not* led to any appreciable improvement in state capability and legitimacy in fragile contexts. These 'negative results' will provide useful material that can provide greater depth to the hypotheses set out in this report.
- *Looking beyond the usual core fiscal governance institutions.* Identifying where and under what circumstances change occurs means looking at how reforms filter out from finance ministries and associated

institutions to other state actors. Within government, this can include understanding how financial operating procedures have an impact (formally and informally) on other administrative behaviours; the role, management and impact of cadres of financial management staff working outside the finance ministry; the impact of disseminating financial information outside the finance ministry; and the motivations faced by financial management, in particular.

- *Considering the role of non-state actors more seriously.* It would be useful to look in more detail at how different groups of taxpayers (private individuals; wealthy elites; small businesses; transnational businesses; informal sector workers, etc.) engage with the issue of taxation and state legitimacy. The research agenda could look at historical examples of how competing political authorities have been incorporated into systems of fiscal governance as part of peace processes. It could also consider how civil society groups of different kinds have supported or worked against changing perceptions of the state's legitimacy in the context of fiscal governance reform.
- *Increasing the financial resources dedicated to impact evaluation in fiscal governance reform.* There is a dearth of impact evaluations that look at the effectiveness of interventions to strengthen fiscal governance, using both conventional and non-conventional approaches. Much of the evidence for fiscal reform comes from cross-country analyses that in their very nature do not deal well with issues of 'best fit' for reform.

#### 5.5. Conclusions

The literature is clear: there is a 'complex web of interdependent causality' surrounding relationships across fiscal governance, overall institutional development and state-building. It may, therefore, be impossible to pinpoint one single, linear relationship or approach based on the experience of single interventions. Even in the absence of strong *causal* evidence of the positive effect of fiscal governance on state-building or service delivery, the simple fact remains that there is no evidence, or any persuasive theory, that suggests the opposite. In other words, we cannot conceive of a state-building model and broader development agenda that does not involve strong fiscal institutions. There is not a single prosperous and stable society today that did not, at some point, develop capable fiscal institutions.

Many questions about fiscal governance and state-building remain unanswered. These questions are not easy, but then neither is the process of state-building. Given the importance of this process to supporting development in fragile contexts, and the ubiquity of fiscal governance institutions across all states, a better understanding of the role of the fiscal governance in supporting capable and legitimate states seems essential.

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