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Political Institutions, State Building, and Tax Capacity: Crossing the Tipping Point

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Political Institutions, State Building and Tax Capacity: Crossing the Tipping Point

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Abstract

An empirical finding by Gaspar, Jaramillo and Wingender (2016) shows that once countries cross a tax-to-GDP threshold of around 12¾ percent, real GDP per capita increases sharply and in a sustained manner over the following decade. In this paper, we attempt via four case studies—Spain, China, Colombia, and Nigeria—to illustrate that the improvements in tax capacity have been part of a deeper process of state capacity building. We discuss the political conditions that supported tax capacity building, highlighting three important political ingredients: constitutive institutions, inclusive politics and credible leadership.

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CONTENTS

I. INTRODUCTION

Building tax capacity is closely linked to the process of economic development and growth. There is a long intellectual history behind this conception of the role of taxes and the state. Joseph Schumpeter, in his famous paper "The Crisis of the Tax State" (Schumpeter, 1918), links state and tax so closely that he stresses that his qualification "tax" in "tax state" can be regarded as almost redundant. He emphasizes that taxes are not only associated with the historical origin of the state, they are also active in shaping it. In his view the organic development of taxation was associated with the organic development of other dimensions of the state. For Schumpeter, the analysis of the consequences of taxation requires a long run perspective that allows for structural and self-reinforcing evolutionary dynamics to play out in full. Those are not only economic but also social and political. We interpret Besley and Persson (2011, 2013, 2014a, 2014b) as bringing a similar perspective to contemporary research.

In a recent study (Gaspar, Jaramillo, and Wingender, 2016) we argue that there is a minimum tax-to-GDP threshold associated with higher sustained growth. We investigate the existence of a tipping point in tax revenue levels. Tipping points are characterized by sharp changes occurring around some threshold. We show that once the tax-to-GDP level reaches around 12¾ percent, real GDP per capita increases sharply and in a sustained manner over the following decade. The effect of the tax tipping point on real GDP per capita after 10 years is of the order of 7.5 percent, i.e. the average country that went from 12.5 percent of GDP to 13 percent of GDP in taxes was likely to be 7.5 percent larger than an otherwise similar country that remained below the threshold.

Of particular note is that the tipping point occurs for both developing economies, in a contemporary dataset, as well as for advanced economies, in a historical dataset spanning a much longer period starting in the early 19th century. These results raise the possibility that tax thresholds and tipping points are an inherent feature of the development of modern economies and the state and institutions that facilitate their emergence.

Far from demonstrating the effect of a single variable, tax tipping points indicate the presence of much deeper and broader changes in institutions and state capacity to sustain such effects on economic growth. This raises an important question:

What political conditions and institutions facilitate the shift to greater state and tax capacity?

This chapter attempts via case studies to illustrate the nature of political conditions and institutions that accompanied countries as they crossed the tax-to-GDP threshold. It illustrates that the improvements in taxation have been a part of a deeper process of state capacity building in these countries. Countries were chosen on the basis of their levels of development both at the time of their crossing of the tax-to-GDP threshold as well as their subsequent experience in economic development to this day. Care was also given to select a group that provides different insights, both from a regional and a historical perspective. We therefore focus on the following cases: 1) Spain crossed the 12¾ percent tax-to-GDP threshold in 1983; 2) China last crossed the tax threshold in 2001; 3) Colombia saw its tax-to-GDP level exceed the threshold for the first time in 2001; and finally 4) Lagos State in Nigeria, which saw a substantial increase in tax capacity although at the national level Nigeria is still below the 12¾ percent tax-to-GDP threshold.

The case studies illustrate the enabling political conditions that supported the building of state and tax capacity. In particular, we highlight three important political ingredients: constitutive institutions, inclusive politics and credible leadership. Constitutive institutions are evident in the cases of Spain and Colombia, where an explicit political settlement between political elites and citizens embodied in the enactment of new Constitutions preceded tax capacity building. In both these cases, it was recognized that greater levels of taxation were essential to meet the emerging spending pressures associated with the economic, social, and institutional demands prompted by the new Constitutions. Inclusive politics facilitated new center-periphery agreements crucial to build new tax collection schemes, as discussed in the cases of China and Lagos State.

Credible leadership was also clearly manifest. Across the four case studies, there was a deliberate decision by policymakers to implement a shift in the economic model, taking advantage of opportunities offered by economic or political crisis. In Spain, transition to democracy created the opportunity to build broader coalitions around the issue of building tax capacity. In Colombia, the economic crisis of the late 1990s helped foster the political consensus needed to implement several fiscal reforms. Efforts to mobilize internal tax revenues in the case of Lagos State can be linked to its political rivalry with the Federal government, following the transition from military rule. In China, the main driver for greater tax capacity was the collapse in SOE revenues associated with the transition out of patrimonial state toward a market-oriented economy.

In this chapter we do not try to present any general theory about the institutions and politics behind state capacity. Rather our goal is to illustrate with a few case studies the political conditions that have supported broader changes in state and tax capacity. Our aim is that our insights into these cases can serve as useful input for the process of developing a more general theory that integrates politics, institutions, and tax capacity.

II. POLITICAL INSTITUTIONS ENABLING STATE AND TAX CAPACITY BUILDING

What political conditions and institutions facilitate the shift to greater state and tax capacity? This question remains unanswered, and is subject to considerable debate. The literature is vast, but most scholars point to a number of institutional features that can be grouped in three sets of political conditions that underpin state and tax capacity building (Figure 1):

- *Constitutive Institutions*: According to Fritz and Menocal (2007) at the core of constitutive institutions is the political settlement that binds together state and society, ruling elites and citizens, public service providers and taxpayers. This political settlement (typically an explicit agreement) provides the necessary legitimacy for those who govern over those who are ruled. It is a key element in creating a social pact and the sense of shared public realm that leads to an effective state capable of collecting taxes and delivering public goods. To be considered legitimate, a political settlement must be acceptable to the majority of actors who need to be brought on board a state-building process, especially in post-conflict settings, democratic transitions (Haggard and Kaufman, 1995) and/or deeply divided societies (Hesselbein et al. 2006). Key constitutive institutions include a written Constitution, free competitive elections, security and justice mechanisms, and a functioning meritocratic civil service.

- *Inclusive Politics*: For Acemoglu (2005, 2016) and Acemoglu and Robinson (2016) the presence of inclusive political institutions is a key determinant of state capacity building. Inclusive politics are made of two main components: pluralism and centralization. Pluralism implies a broad distribution of political power and participation, constraints and checks on politicians, and the rule of law. Centralization requires the Weberian monopoly of legitimate violence over a territory and the ability of the state to regulate economic activity, impose taxes, and provide public goods. In state-building situations there are often various tensions between the center and the periphery. According to Dobbins and et al. (2007) the center should be strengthened until it develops a good degree of control over general resources before engaging in horizontal redistribution among regions. At the same, inclusive politics means that excessive centralization should be avoided, by growing local capacities that work in synergy with the center (Lister and Brinkerhoff, 2007).

- *Credible Leadership*: The 2008 Commission on Growth and Development Report—under the chairmanship of Nobel laureate Michael Spence—attempted to draw lessons about strategies and policies that produced high levels of sustained growth in developing countries. A crucial ingredient identified by the Commission was a "capable, credible and committed government." By this it meant a system of governance and leadership with the flexibility to adjust policy and institutional structures to changing circumstances and opportunities, but doing so in a manner that is credible and commands broad support. Underscoring the role of leadership, Brady and Spence (2009) draw on the evidence from high-growth countries studied by the Commission on Growth and Development (2008). They identify two key stages in successful economic leadership. The first stage is the process by which the political leadership chooses an appropriate economic model and builds a political consensus to support the model. The process of choosing a new model is often associated with opportunities offered at times of economic or political crisis.[2] The second stage is concerned with ensuring enough political stability for the economic plan

[2] Several authors have argued the connection between crisis and reforms. In their seminal paper, Alesina and Drazen (1991) show in their model that a change to the status quo is more likely when the economy is in crisis. Weyland (2002) studied the circumstances under which the Washington Consensus reforms in the 1990s were implemented in Peru, Brazil, Argentina, and Venezuela, confirming the hypothesis put forth earlier by Kahneman and Tversky (1979) that in times of crises, reforms are more likely to happen.

to work. This implies that leaders have the capacity to adapt growth strategies—and to retain support for such changes—as circumstances change. Jones and Olken (2005) support this hypothesis. They study the effects of leadership on growth by looking at 57 cases in post-Second World War economies where there was an exogenous change in the country's leader (sudden death, resignation, etc.). They find that the change of national leaders is related to economic growth.

These political conditions are key ingredients to enable the building of state and tax capacity. We follow Besley and Persson (2011, 2013, 2014a, 2014b) and argue that state capacity is shaped by the interaction between tax capacity, legal capacity, and public administration capacity. Tax capacity not only provides a stable and elastic source of revenue for the government to finance government activities. Also, a government with a larger stake in the economy through a developed tax system has stronger motives to play a productive role in the economy. Public administration capacity refers to the government's effective and efficient use of public money. This directly impacts the ability of governments to implement policy and deliver public services, which in turn influences citizens' trust in government. Legal capacity refers to the government's ability to secure private property rights.

We further argue that the strength of tax capacity depends crucially on social norms of compliance. Kiser and Levi (2015) emphasize that the more a government is effective and trustworthy, the more legitimacy it is likely to attain, and the more it will be able to elicit compliance without excessive monitoring or punitive action. Similarly, as proposed by Levi (1988), the government can achieve a high degree of quasi-voluntary compliance with the taxation system when citizens comply with taxation out of a combination of strategic and normative considerations. Strategic considerations refer to the calculation of the probability of being caught and the punishment involved. Normative considerations refer to a sense of fairness: the citizen believes that sufficient public goods are being provided in return for tax payments, and that others are also paying their fair share. A variety of other authors have also argued that creating a culture of compliance is central to raising revenue. For example, Gordon (1989) refers to individual morality, Posner (2000) to tax-compliance norms, and Torgler (2007) to tax morale. Social norms of compliance are in turn closely associated with a higher demand by citizens for accountable and transparent government, as argued by Moore (2007), Brautigam et al. (2008) and Ross (2004). These relationships are illustrated in Figure 2. In a similar vein, studies have found strong correlations between taxation and democratization (Ross, 2004), public goods provision (Timmons, 2005); and quality of governance (Moore, 2004).

Figure 1. Complementarities in State Capacity

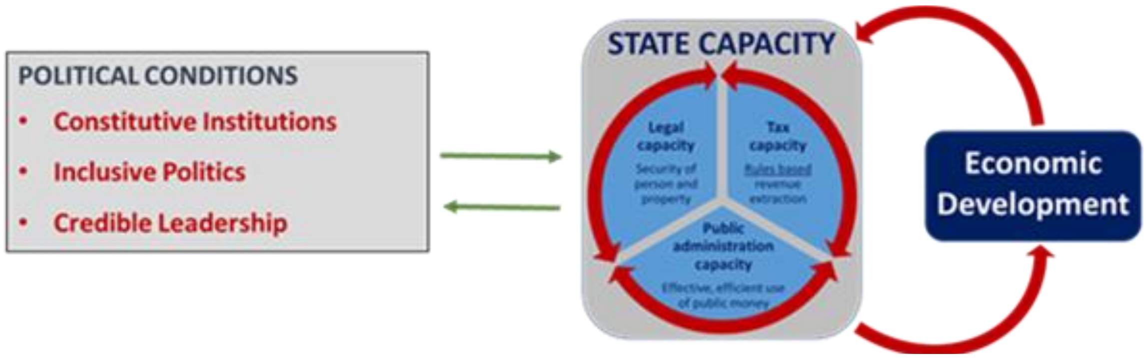


Figure 2. Tax Capacity, Social Norms, and Accountability

III. State Capacity and Growth After Crossing the Tax Tipping Point

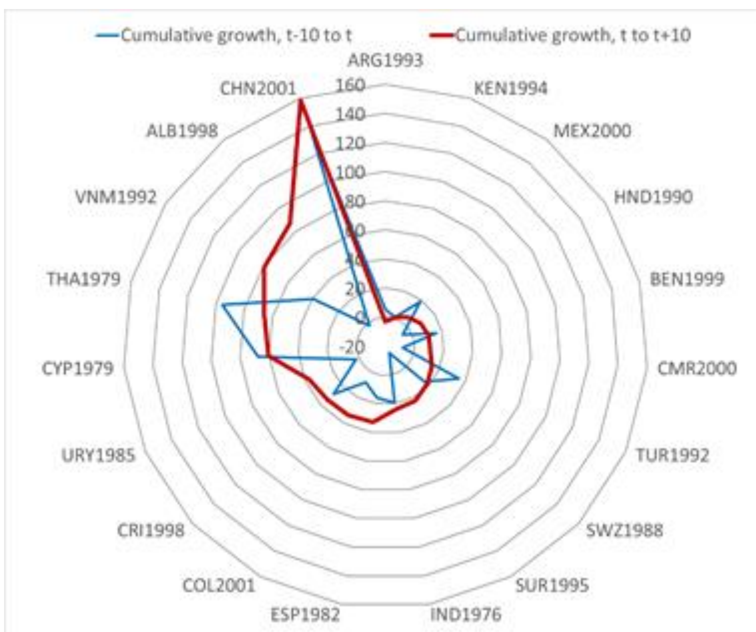
To provide a more granular perspective of the findings Gaspar, Jaramillo and Wingender (2016) described above, this section contrasts the growth and institutional performance of individual countries before and after they crossed the tax threshold.

Using the contemporary dataset of the abovementioned paper, which assembles a panel for 139 countries from 1965 to 2011, we find 60 developing countries that crossed the tax threshold of 12.88 percent of GDP without reversal (see Appendix 1). Among these episodes, the median year for crossing the tax threshold is 2002, without clustering around any specific time periods. Figure 3 shows the cumulative real GDP per capita growth 10 years prior and 10 years post crossing the 12.88 percent of GDP tax threshold. Only 19 episodes are displayed, out of the 60 identified, based on the availability of 20 years of consecutive data around the time the tax threshold is crossed. Of these 19 cases, two thirds saw higher ensuing cumulative real GDP per capita growth, by an average of 12 percent.

Using the historical dataset of Gaspar, Jaramillo, and Wingender (2016), consisting of a panel for 30 advanced countries between 1800 and 1980, we find 17 countries that crossed the tax threshold of 12.65 percent of GDP without reversal (see Appendix 1). Interestingly, several of the countries crossed the threshold around World War II. In most cases, 10-year cumulative real GDP per capita growth was considerably higher after the country crossed the tax threshold, by an average of 19 percent (Figure 4). Exceptions are Australia, Japan, the United Kingdom, and the United States. However, if we were to exclude the Great Depression in the case of the U.K. and the peak of the war buildup in the U.S., then for these two cases one would also see higher real GDP per capita growth after crossing the tax threshold.

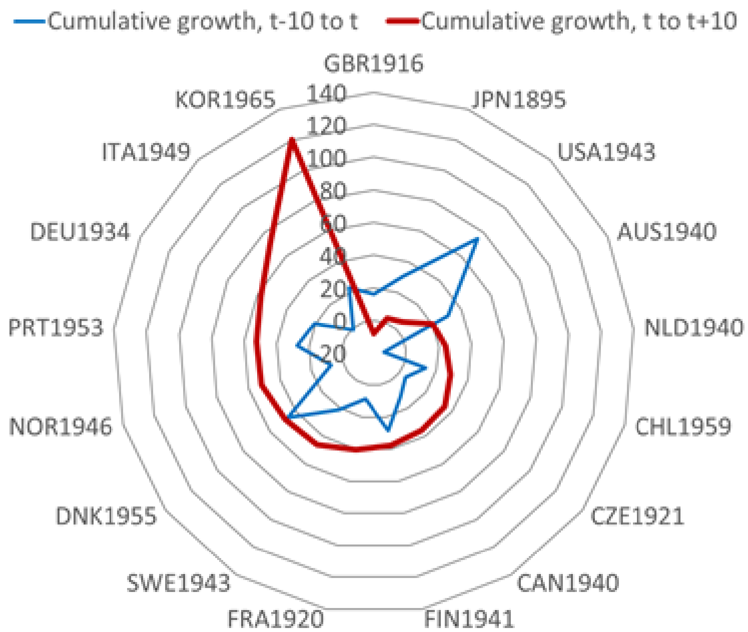
Looking beyond cumulative real GDP per capita growth, we find improvements in other indicators of state capacity after countries crossed the tax-to-GDP threshold. Using the contemporary dataset, Figure 5 shows that countries saw lower volatility in tax revenues after crossing the threshold. This suggests that the increase in tax capacity was associated with greater stability of revenue, which in turn would support less volatility of government spending. Figure 6 shows that for many countries, the prevalence of corruption declined after crossing the tax threshold. This is consistent with the expectation of greater transparency and accountability demanded by citizens when tax compliance increases. In terms of legal capacity, countries also saw an improvement in indicators that are expected to be supportive of sustained economic development, in particular protection of property rights (Figure 7) and regulatory quality (Figure 8).

Figure 3. Contemporary Dataset: Cumulative Real GDP Per Capita Growth Before and After Countries Cross the Tax to GDP Threshold (percent)



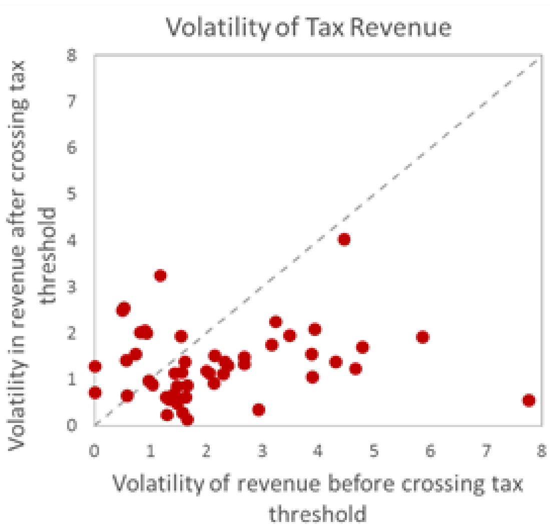
Source: Gaspar, Jaramillo, Wingender (2016)
Note: Includes only 19 episodes (out of 60) for which 20 years of consecutive data is available. Cumulative growth of real GDP per capita at constant national prices.

Figure 4. Historical Dataset: Cumulative Real GDP Per Capita Growth Before and After Countries Cross the Tax to GDP Threshold (percent)



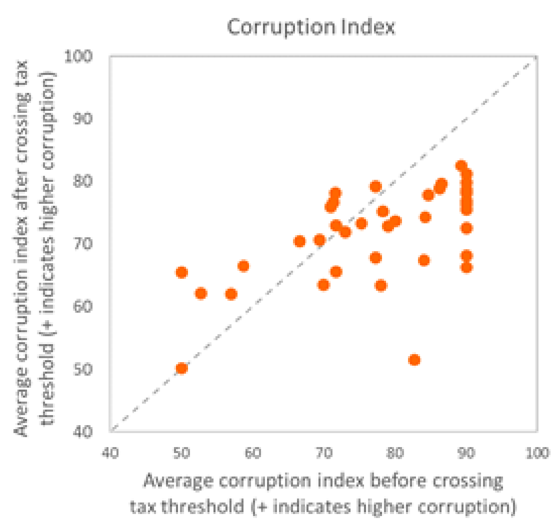
Source: Gaspar, Jaramillo, Wingender (2016)
Note: Cumulative growth of real GDP per capita in GK$ 1990.

Figure 5. Volatility of Tax Revenue



Sources: Authors' estimates
Note: Volatility calculated as the standard deviation of tax to GDP taking into account the underlying trend.

Figure 6. Corruption Index

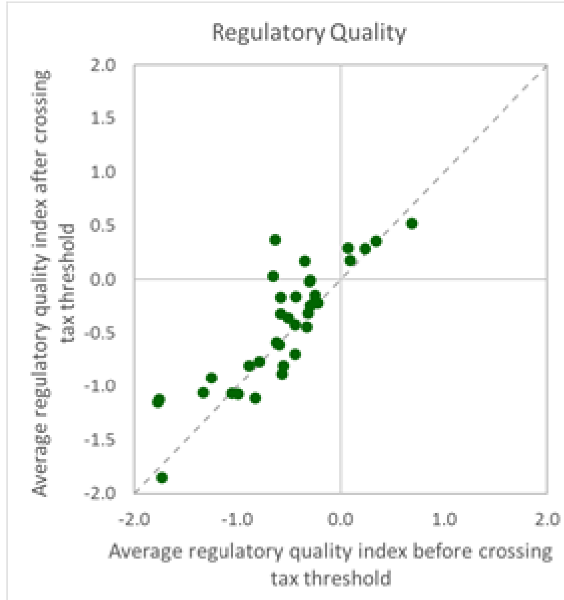


Sources: Freedom House, and authors' estimates
Note: Freedom House index was transformed so that a higher index indicates higher corruption.

Figure 7. Protection of Property Rights

Sources: Fraser Institute and authors' estimates
Note: Indicator is defined as: "Property rights, including over financial assets, are poorly defined and not protected by law (= 1) or are clearly defined and well protected by law (= 7)".

Figure 8. Regulatory Quality



Sources: World Governance Indicators and authors' estimates
Note: Indicator reflects perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.

IV. Case Studies

This chapter attempts via case studies to illustrate the nature of political conditions that accompanied countries as they crossed the tax-to-GDP threshold. The discussion that follows illustrates that the improvements in taxation have been a part of a deeper process of state capacity building in these countries. Note that the aim of this chapter is not to offer a general model that would encompass these cases. Rather, our goal is to provide an overview of the political context that fostered the implementation of reforms to increase tax capacity in four selected countries. For each case, we discuss the political conditions that have accompanied state and tax capacity building, noting the role of constitutive institutions, inclusive politics, and credible leadership. We then discuss growth performance around the time that the country crossed the threshold. Where available, we document the associated changes in social norm of tax compliance. We also discuss the behavior of other indicators that suggest that tax capacity moved in conjunction with improvements in other aspects of state capacity, in particular legal and public administration capacity.

We choose four cases: Spain (crossed in 1983), China (2001), Colombia (2001), and Lagos State in Nigeria, which saw a substantial increase in tax capacity although at the national level Nigeria is still below the 12¾ percent tax-to-GDP threshold.[3] Countries were chosen on the basis of their levels of development both at the time of their crossing of the tax-to-GDP threshold as well as their subsequent experience in economic development to this day. Care was also given to select

[3] Discussion of the political economy of state building in countries with natural resources is beyond the scope of this chapter. See Collier (2010) for a comprehensive analysis of this issue.

a group that provides different insights, both from a regional and a historical perspective. It is important to note that for each of these cases, the tax reforms discussed below do not imply that further improvements in the tax system were not needed. Indeed, most countries subsequently implemented additional tax policy and administration reforms to improve fairness, increase efficiency, and reduce administrative complexity.

Across all four case studies, constitutive institutions, inclusive politics, and credible leaderships played a role in the process of state and tax capacity building. First, important constitutive institutions were in place in the cases of Spain and Colombia, where an explicit political settlement between political elites and citizens preceded state and tax capacity building. In the case of Spain, the transition to democracy and the new Constitution of 1978 paved the way to economic modernization and welfare state development. Similarly, in Colombia the Constitution of 1991 facilitated a new distribution of power between the center and the subnational governments, increased checks and balances within the political system, and mandated more public services. In both these cases, it was recognized that greater levels of taxation were essential to meet the emerging spending pressures associated with the economic, social, and institutional demands prompted by the new Constitutions. Second, inclusive politics facilitated new center-periphery agreements which were crucial to build new tax collection schemes, as discussed in the cases of China and Lagos State.

Credible leadership was also clearly manifest across the four case studies. In all the cases, there was a deliberate decision by policymakers to implement a shift in the economic model, taking advantage of opportunities offered by economic or political crisis. In Spain, transition to democracy created the opportunity to build broader coalitions around the issue of building tax capacity. In Colombia, the economic crisis of the late 1990s helped foster the political consensus needed to implement several fiscal reforms. Efforts to mobilize internal tax revenues in the case of Lagos State can be linked to its political rivalry with the Federal government, following the transition from military rule. In China, the main driver for greater tax capacity was the collapse in SOE revenues associated with the transition out of patrimonial state toward a market-oriented economy. The case studies also illustrate that in all these episodes, policymakers needed to build broader coalitions to ensure enough political stability for the economic plan to work.

A. Spain

Political context of reforms to increase tax capacity

The improvement in the tax revenue performance observed in Spain during the early 1980s reflected the social and political consensus that emerged after the death of General Francisco Franco in 1975. The political transition to democracy needed to take place in the context of intense social conflict and a deep economic crisis—including high inflation and unemployment rates, and significant balance of payments and public sector deficits. In the face of these challenges, a wide public consensus emerged that the country needed to greatly improve its basic public services, welfare programs, and public infrastructure, and at the same time modernize its economic institutions, a consensus embodied in the new Constitution of 1978.

There was also recognition that a significant increase in public spending had to be financed through greater levels of taxation. Spain's reform efforts during this period were further encouraged by the ambition to join the European Economic Community (EEC), the application for which was made in 1977.

The Unión de Centro Democrático (UCD) government, elected 1977 with 34.4 percent of the vote, managed to build a national political consensus in 1977–79, during which all political parties signed the Moncloa Pacts. Early in office, the UDC government presented an economic program that included economic adjustment measures together with fiscal structural and financial system reforms. However, when negotiations with social organizations stalled, the government decided to seek an agreement across all political parties in Parliament. Enrique Fuentes Quintana, Vice President of Economic Affairs, convinced political parties to negotiate and to use his Economic Reparation and Reform Program as a basis. The agreements signed were called the Moncloa Pacts. Success of the Moncloa Pacts was based on the subordination of collective negotiations to price stability and the use of progressive taxation and public expenditure policies as instruments of income distribution (Comin, 2007).

The Moncloa Pacts provided the blueprints for fundamental tax system reform. The tax system under the Franco regime exercised a low and regressive tax burden, with widespread tax evasion. The Pacts addressed both tax policy and tax administration. On tax policy, they included five main elements: (i) a personal income tax, with a comprehensive tax base and progressive tax schedule, to replace the existing income tax; (ii) a permanent personal net wealth tax, properly harmonized with the personal income tax, applicable on real wealth bases and with a progressive tax schedule; (iii) a corporate income tax, without the exemptions that had been frequent in the previous corporate income tax; and (iv) the introduction of a value added tax (VAT) to align indirect taxation with the system of the EEC.

The UDC government took the first steps at strengthening tax compliance, but did not advance fully the reforms outlined in the Moncloa Pacts. Early on, the government managed to pass Law 50/1977 of Urgent Tax Reform Measures. A personal net wealth tax was introduced in 1978. The main objective of the new tax was not to increase revenues but rather to obtain information on all sources of income, in order to adequately apply the new personal income tax (IRPF) to be introduced in 1979. Conscious of the pervasive tax evasion, the government coupled the introduction of the net wealth tax with a tax amnesty in order to motivate taxpayers to reveal hidden sources of income. Other measures implemented during this period included the abolition of bank secrecy and the introduction of criminal sanctions for fiscal offences (Sánchez Maldonado and Gómez Sala, 2007). However, little progress was made in modernizing the tax administration.

Reforms stalled following the approval of the new Constitution in 1978. Party differences became significant in the context of the 1979 elections. Disagreements among the social and business groups with regard to details of fiscal reform eroded the previous consensus. The various UCD governments that followed did not reach the majority in Parliament needed for the passage of reform, which prevented the implementation of the tax reforms set out in the Pacts. Moreover, fragmentation within the UDC itself further weakened the government.

Political clout to implement the tax reforms outlined in the Moncloa Pacts was only achieved in the early 1980s. The momentum for tax reform gained support with the Socialist Party's ample win in the 1982 elections (with 48.1 percent of the vote), as well as Spain's preparations for joining the EEC in 1986. The VAT was introduced through Law 30/1985, a condition for entering the ECC. The government took decisive steps to reorganize the tax administration. It substantially increased human resources and invested in information systems. Measures were put in place to fight tax fraud. It introduced the New Tax Management Procedure, which increased the use of self-assessment for collecting the main taxes, and established a unique taxpayer's personal identification code. Territorial deconcentration was a further important change in the organizational reform of the tax administration (see Onrubia, 2007).[4]

Performance of growth and indicators of state capacity

Following 1983, cumulative growth of real GDP per capita was above that observed in earlier years, and remained relatively higher until the Global Financial Crisis (Figure 9).[5]

During this period, the increase in tax revenues can be attributed both to changes in the tax system, and also to greater compliance rates. The change in the overall social norms of tax compliance can be illustrated using the response to the question "Is it justifiable to cheat on taxes if you have a chance?" from the World Values Survey (Martinez-Vazquez, 2007). The social norm of compliance is measured by those that answer that "it is never justifiable to cheat on taxes." The sharp increase in this measure for Spain from 1981 to 1994, shown in Figure 10, suggests that there was a significant improvement in citizens' willingness to voluntarily comply with taxation. Furthermore, available government data confirms the improvement in tax compliance over the period. In 1990, the Commission for the Study and Prevention of Tax Evasion quantified personal income tax compliance during the period 1979–1987, to illustrate the extent of tax evasion and avoidance. Table 1 shows that in the early 1980s there was notable improvement in tax filing as well as income reporting.

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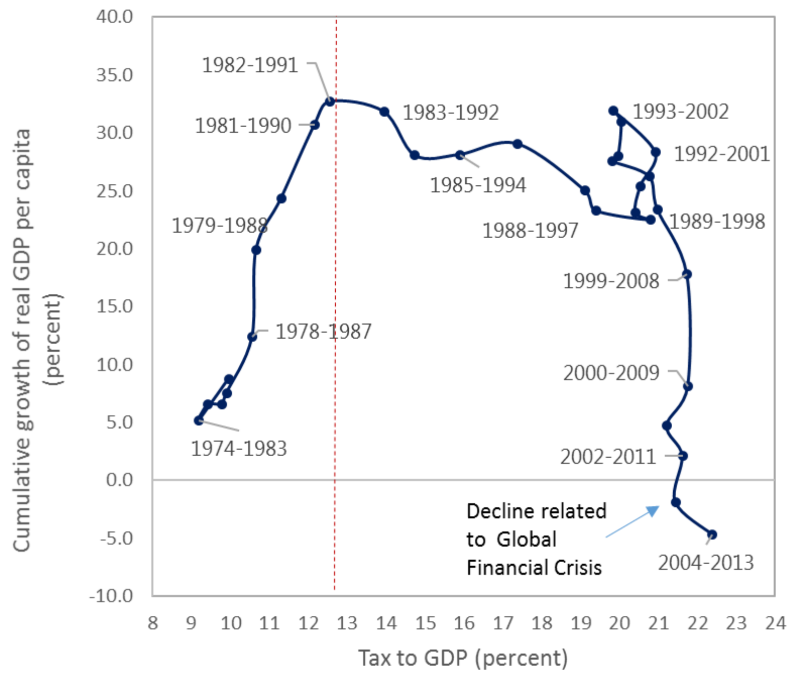
[4] Decentralization of the public sector brought about by the 1978 Constitution required that both spending competencies and public revenues be transferred from the central to the regional governments.

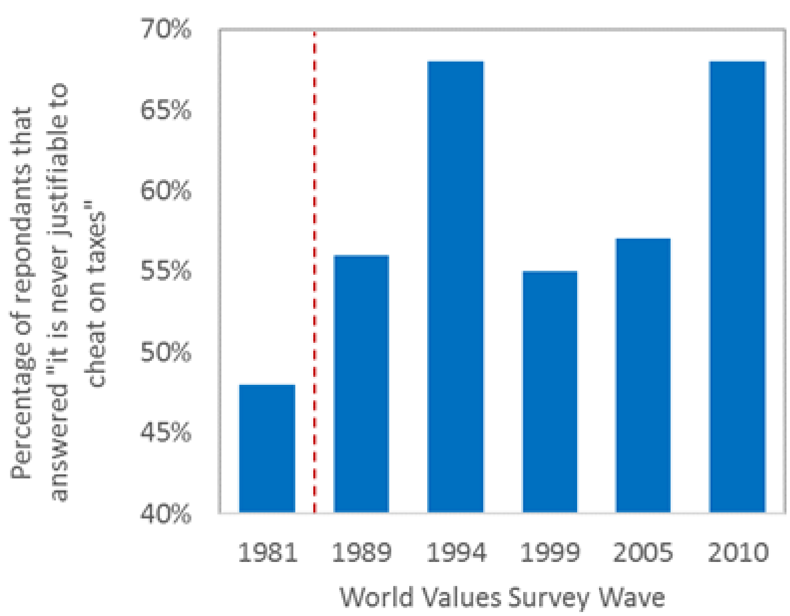
[5] Other indicators of state capacity (such as regulatory quality, corruption, and protection of property rights) are only available starting in the mid-1980s, therefore we are not able to show changes in these indicators around the time that Spain crossed the tax to GDP threshold in 1983.

Figure 9. Spain: Taxation and Cumulative Growth of Real GDP Per Capita Over Ensuing 10 Years (percent)



Source: OECD, World Economic Outlook, and authors' estimates
Note: Tax to GDP figures do not include social security contributions.

Figure 10. Spain: Social Norms of Compliance



Source: World Values Survey

Table 1. Spanish Personal Income Tax Compliance (1979–1986)

	1979	1980	1981	1982	1983	1984	1985	1986
Filing (percent of potential tax returns)	52.2	56.9	56.2	56.1	59.4	58.7	61.0	64.1
Tax base reporting								
Percent of true taxable income	42.9	47.8	48.9	49.6	50.8	50.5	52.0	55.1
Percent of true labor taxable income	54.0	62.1	63.4	64.8	66.6	66.7	68.9	71.3
Percent of true non-labor taxable income	22.3	23.3	24.6	25.2	23.4	24.6	26.2	30.4

Source: Onrubia (2007)

B. China

"Tax is the foundation of state governance. It plays an important role in social and economic life." Mr. Jun Wang, Commissioner State Administration of Taxation of the People's Republic of China, March 2016

Political context of reforms to increase tax capacity

In the late 1970s, China embarked on a path toward a market-oriented economy. While maintaining the overall framework of predominant public ownership, China adopted a policy of opening up trade and investment with the rest of the world and restructured its domestic economy. The government gradually relaxed mandatory planning, decentralized economic decision-making, and allowed market forces to influence an increasing number of prices. For example, more investment was channeled from capital goods to consumer goods production. The government raised the purchasing prices for agricultural products by more than 20 percent in 1979 and significantly increased grain import. Steps were taken to decentralize foreign trade and give more fiscal autonomy to provincial governments. Preferential policies were conferred on special economic zones to attract foreign investment. Importantly, reforms were launched to incentivize state owned enterprises (SOEs).[6]

China initiated its reform process in the wake of a major political transition. Following the death of Mao Zedong in 1976, the ultra-left faction (referred to as the "Gang of Four") was ousted from power by a coalition of moderate forces consisting of senior veterans of the Communist Party and younger cadres that had emerged during the period of the Cultural Revolution (Bell et al., 1993). Initially, the party was led by Mao's designated successor, Hua Guofeng. During this time, the economy was partially recentralized and the planning apparatus strengthened. An ambitious 10-year development plan was launched, focused on investment in heavy industry and strong reliance on imports of capital equipment. However, the plan was soon abandoned, as the surge in capital imports resulted in serious balance of payments problems.

[6] See Bell et al. (1993) and Coase and Wang (2013).

By late 1978, reformist views gained dominance within the party, spearheaded by Deng Xiaoping. At the Third Plenum of the Central Committee of the Communist Party in December 1978, the leadership resolved to focus the party's work on reforming those aspects of the economic system that had impeded economic development. There was, however, no unanimity in views on the pace and nature of reform, particularly the role of the market versus planning. Conservatives favored retaining a central role for planning in a reformed economic system, whereas the more radical elements envisaged a greatly diminished and reformed role for planning (Bell et al., 1993). Despite periodic shifts in the emphasis of policy, the more radical views prevailed. In 1992, a decisive ideological change occurred when the party called for the establishment of a socialist market economy.

As part of its reform efforts, the Chinese authorities sought to increase their tax capacity rather than rely solely on the profits from SOEs. Before 1978, state enterprises were required to turn in all of their profits to the state, which was the main source of government revenue (Lin, 2009). Tax reform efforts began in 1979. State enterprises were allowed to keep part of their profits in order to expand production and to issue bonuses and awards to workers. In 1983, SOEs became subject to income taxes, instead of contributing profits. However, widespread evasion prompted the government to shift to a "contract responsibility system" (CRS). Rather than trying to monitor each company's sales and profits, the government instead signed a contract with each one specifying its tax liability over the next several years. In some of these contracts, tax payments were set ex-ante, usually based on the previous year's profits plus an increment. In other contracts, there was a base payment with a supplementary tax imposed on profits earned above a set level. In 1989, the government launched a new tax reform where SOEs were required to submit a portion of their profits to the government after paying corporate income taxes.

The sharp decline in the tax-to-GDP ratio during the early 1990s exposed the weaknesses in China's tax administration. Some studies estimated that up to 30 percent of state-owned enterprises, 60 percent of joint ventures, 80 percent of private enterprises, and 100 percent of individual street vendors failed to comply with their tax obligations in the mid-1990s (Brondolo and Zhang, 2016). China's impending accession to the World Trade Organization—application for which took place in December 1995—increased the urgency for tax reform.

The sharp drop in revenues limited the ability of the central government to conduct macroeconomic or redistributive policies (Ahmad, 2011), which prompted the Chinese government to undertake comprehensive reform of the tax system. The 1994 tax reform included four main elements.

- Simplification and standardization of the tax structure. The government lowered the income tax rate from 55 percent to a universal rate of 33 percent. A new value-added tax was enacted at 17 percent on most goods and services, and a reduced rate of 13 percent on agricultural products and inputs, energy and minerals.

- Change in revenue-sharing between the central and local governments. In the previous system, local governments collected taxes and then remitted a negotiated amount to the central government. The reform divided taxes into three distinct categories: central, local, and shared. The central government was assigned all revenue from consumption (excise) taxes, customs duties, and import-related VAT and consumption taxes. Shared taxes included domestic VAT, enterprise income tax, and personal income tax. All remaining taxes were allocated to local governments including the business turnover tax on services, social security contributions, and stamp duties on real estate transactions. In general, harder to collect taxes were assigned to local governments, which presumably had an information advantage over the national government (Wang 1997).

- Centralization of the tax administration. The central government established its own revenue collection agency, the State Administration of Taxation (SAT). The SAT was charged with collecting central and shared taxes, while the local tax system collects local taxes. This reform was crucial for enforcement. Local governments could no longer game the tax sharing mechanism by strategically lowering their tax effort or reclassifying revenues in order to reduce remittances to the center (Wang, 1997).

- Curbing the ability of local governments to grant tax breaks. In the previous system, local governments held the discretion to grant reduced tax rates and tax exemptions. They had often used this discretion to channel budgetary funds into extra-budgetary funds, thereby reducing the revenues shared with the center. The reform now required local governments to obtain approval by the State Council in order for any tax exemption to be effective.

To strengthen tax administration, the Tax Collection Law was enacted in 1992. The law set out the procedures for each tax administration function, vested the tax authorities with powers to enforce the tax laws, and defined the rights and obligations of taxpayers. In 1994, the government launched the "Gold Tax Project" to establish a computerized database of the records of both taxpayers and tax collectors (central and local).

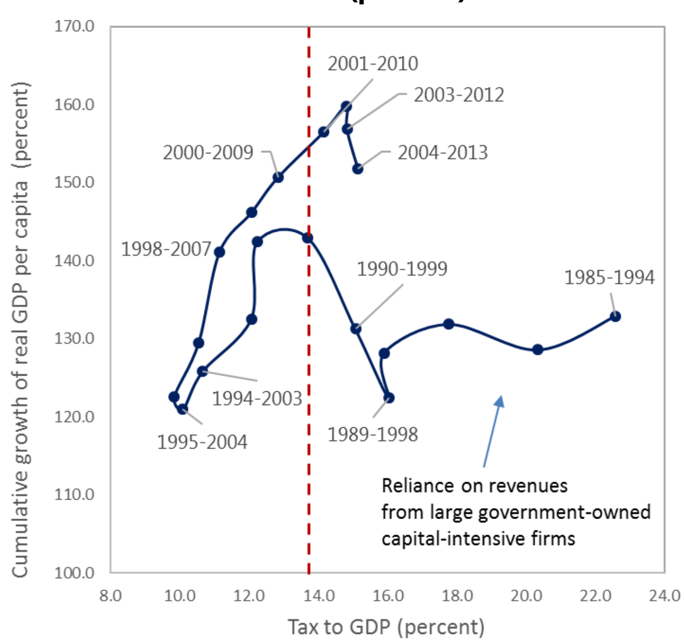
In order to garner political support for the reform and persuade provinces to relinquish tax space to the SAT, the center agreed to three main concessions. The first concession by the center was to agree to a lump-sum to each province to assure that revenue after 1993 would not be lower than that in 1993. Of course, local governments also wanted a share in the revenues of the new taxes (especially the VAT). Therefore, the second concession by the center was to increase the central compensation to provinces by 30 percent of the average growth rate of VAT and consumption tax collections. A third concession was to allow a two-year "transitional period" in which tax breaks authorized by local governments in years prior to the reform would continue to be effective, and lower corporate income tax rates would be applicable to some enterprises with low profitability (Wang, 1997). The first concession was geared to obtaining political support from the richer provinces. The second concession was a lure for all the provinces. The last concession was geared at obtaining political support from the poorer provinces, which collectively were large in number.

Performance of growth and indicators of state capacity

China last crossed the 12¾ percent of GDP tax threshold in 2001. Tax to GDP had been above the threshold already in the 1980s, but this was the result of great reliance on revenues from large, capital intensive, state-owned enterprises. By the early 1990s, tax to GDP had dropped below the threshold. Brondolo and Zhang (2016) attribute the decline in the tax-to-GDP ratio to a number of structural factors, including: (1) the decreasing share of profits from relatively highly taxed SOEs to more lightly taxed non-SOEs; (2) a relative shift in value-added from goods to services, with the former having higher effective tax rates than the latter; and (3) an increase in the trade surplus which reduced the tax base as exports are excluded from the VAT base. It is important to stress that the drop in the contribution from SOEs has a deep structural interpretation. State dependence on revenues from state property or entrepreneurial activities is, from the viewpoint of the development of the tax state, a characteristic of an earlier stage of developments. From this viewpoint, it is only after shifting away from overreliance on SOE taxation that China built tax capacity on a sustained basis.

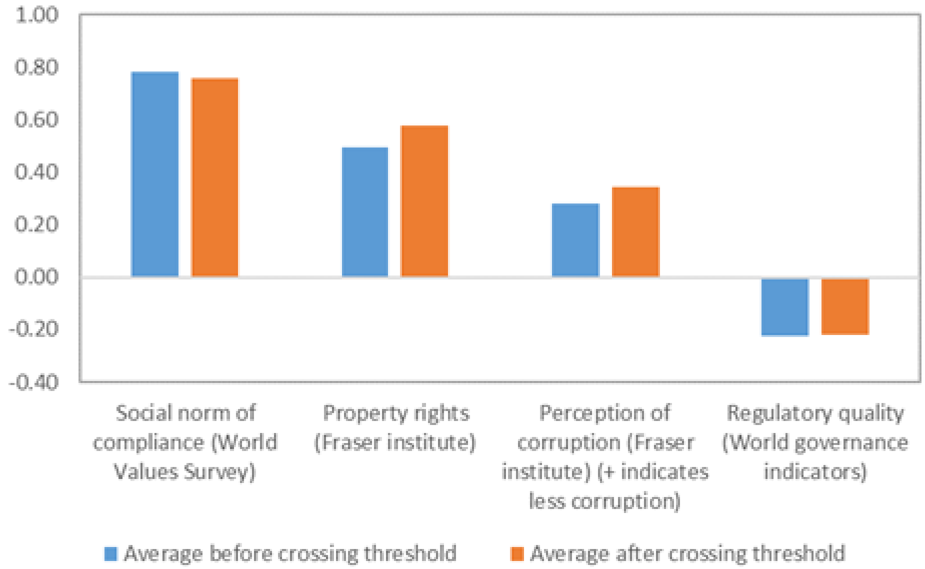
As illustrated in Figure 11, since 2001 cumulative growth of real GDP per capita over the ensuing 10 years was considerably higher than that observed in earlier years. Furthermore, there were noticeable improvements in several indicators related to legal capacity and accountability after crossing the threshold, such as protection of property rights, regulatory quality, and corruption (Figure 12). However, the World Values Survey does not capture improvements in the social norms of compliance, as the willingness to pay taxes remained basically unchanged.

Figure 11. China: Taxation and Cumulative Growth of Real GDP Per Capita Over Ensuing 10 Years (percent)



Sources: National bureau of statistics China: China statistical yearbook 2014, World Economic Outlook, and authors' estimates.

Figure 12. China: Social Norms of Compliance and Other Institutional Indicators



Sources: World Values Survey, Fraser Institute, Freedom House, World Governance Indicators, and authors' estimates.

C. Colombia

"Strengthening our tax, budget, and planning institutions is an essential part of progress towards development. Achieving this requires substantial improvements in all our institutions and in politics."
Mr. Guillermo Perry Rubio, Minister of Finance and Public Credit 1994–1996, February 2014

Political context of reforms to increase tax capacity

The increase in tax capacity in Colombia can be seen as a response to the new political, economic, and social demands that emerged from the 1991 Constitution. The 1991 Constitution sought to increase State presence by devolving fiscal and political power to subnational governments. This entailed giving subnational governments an increasing proportion of central government revenues. The Constitution extended the coverage of basic social services, and strengthened the judiciary. The new constitution also increased checks and balances within the political system. The President lost some capacity as an agenda-setter relative to the previous period, while Congress and the Constitutional Court gained relative power (Cárdenas et al, 2006).

These reforms gave rise to significant spending pressures. Furthermore, independence of the Central Bank, approved as part of the Constitution, restricted its capacity to finance the government. Simultaneously, the country was embarking on a series of economic liberalization policies. Increased spending linked to the new constitution was coupled with other expenditure pressures, particularly those related to the financial imbalance in the pension system and increased resource demands from the defense sector. Higher tax revenue was therefore crucial to finance the sharp increase in spending and offset the decline in revenue from the reduction in trade tariffs.

Several structural economic and fiscal reforms were implemented in the early 1990s. Cesar Gaviria was elected as a candidate of the Liberal Party, with 48.2 percent of the vote. The government had a majority coalition in Congress, thus facilitating the enactment of difficult reforms. Structural reforms to liberalize the economy included the reduction of trade barriers, privatization, labor market reform, and opening of the capital account. In 1990, tax changes were introduced mainly with the aim of encouraging savings and deepening capital markets through the repatriation of capital, among other measures. The authorities reduced the corporate tax rate, introduced a much lower rate for income from repatriated capital, and exempted stock market income from taxation. As spending pressures continued to mount, in 1992–93 tax reform was introduced with the objective of lowering the fiscal deficit. The VAT rate was increased to 14 percent and the base broadened. An income tax surcharge was introduced to fund national security expenditure. Public enterprises, public funds, and financial cooperatives were made the subject to taxation. Tax administration reforms included: (i) implementation of audit plans; (ii) introduction of computerized audit management; (iii) improvement of the monitoring and recovery of tax arrears; and (iv) introduction of stiffer sanctions for tax evasion and contraband (IMF, 2001).

The ensuing Administration had the intention of advancing structural tax reform, but lacked political backing. Ernesto Samper, from the Liberal Party, began with a majority coalition in Congress, but suffered a deep political crisis following allegations of illicit campaign contributions. The Administration proposed a tax reform in 1995 to eliminate VAT and income tax exemptions, and strengthen tax administration. However, the government was unable to garner support, even from its own party members in Congress. Weak party discipline was further fueled by the willingness of individual Congress members to protect the narrow tax interests of their campaign finance contributors (Salazar, 2013). To increase revenues, the government ended up relying mostly on the increase in the general VAT rate to 16 percent.

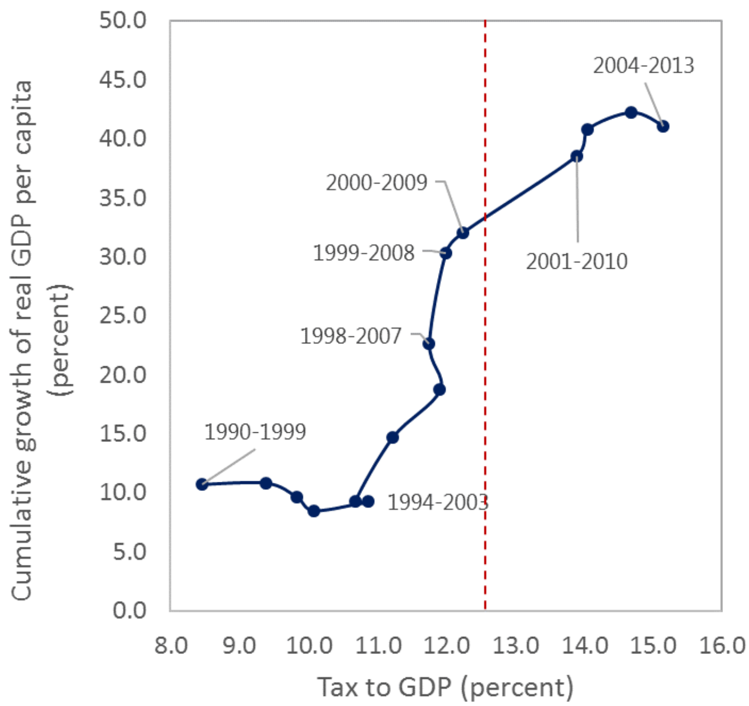
Further reform was achieved in the late 1990s, with political support facilitated by the need to respond quickly to the economic and financial crisis. Andres Pastrana took office in 1998, without a congressional majority. He won 51.9 percent of the vote in the run-off election as the candidate for the Great Alliance for Change party, a multiparty coalition made up of heterogeneous political groups. However, soon after elections, Colombia faced deep crisis. Following the Asian and Russian crises, Colombia saw high pressure on the exchange rate, the economy entered recession, Colombia lost its investment grade rating, there was a mortgage crisis, and several banks had to be intervened. The magnitude of the economic and financial crisis, however, helped to foster the political consensus needed to implement several fiscal reforms (Olivera, Pachón, and Perry, 2006). A temporary 2x1000 financial transactions tax was created to finance the financial sector rescue operations. The 1998 tax reform increased the VAT tax base, eliminated some exemptions, and mandated the subscription of public bonds in proportion to net wealth. The 2000 tax reform made permanent the financial transactions tax and increased some VAT bases.

The reform also contributed to a reduction in tax evasion and strengthening of tax administration by introducing heavier penalties and supporting improvements in collections through electronic filing (see González and Calderón, 2002).

Performance of growth and indicators of state capacity

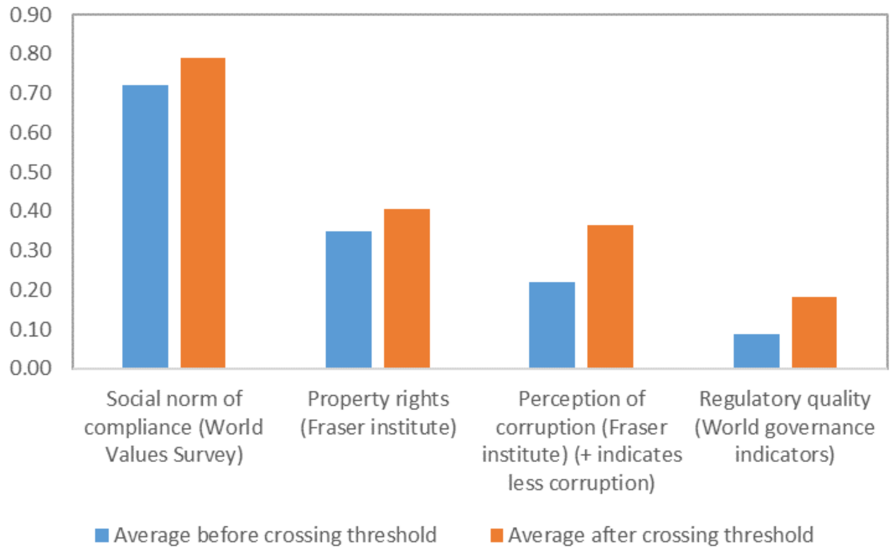
After crossing the tax threshold in 2001, Colombia saw higher cumulative growth of real GDP per capita over the ensuing 10 years that observed in earlier years (Figure 13). The increase in tax revenues was accompanied by an improvement in several indicators associated with willingness to pay taxes, legal capacity, and accountability (Figure 14). The social norm of compliance, as measured by the World Values Survey, increased noticeably after crossing the threshold, suggesting that the increase in collections was linked in part to greater voluntary tax compliance. Corruption was perceived to be less prevalent, which suggests that higher taxation prompted a greater demand for government transparency and accountability. There was also an improvement in the measures of protection of property rights and regulatory quality, suggesting that the increase in taxation was accompanied by strengthening of the country's legal capacity.

Figure 13. Colombia: Taxation and Cumulative Growth of Real GDP Per Capita Over Ensuing 10 Years (percent)



Source: OECD, World Economic Outlook and authors' estimates.
Note: Tax to GDP figures do not include social security contributions.

Figure 14. Colombia: Social Norms of Compliance and Other Institutional Indicators



Sources: World Values Survey, Fraser Institute, Freedom House, World Governance Indicators, and authors' estimates.

D. Lagos State, Nigeria

"As we improved tax administration and revenues grew, the citizenry became more interested in government's developmental programs, literally insisting on seeing the benefits of their contribution." Mr. Ade Ipaye, Special Adviser for Taxation and Revenue in Lagos State 2007–2011, May 2016.

Political context of reforms to increase tax capacity

Despite strong growth performance since the 1990s, Nigeria faces large weaknesses in its economic and human development. Nigeria's real GDP per capita has doubled since 1995. However, when compared to countries with similar income levels, Nigeria falls behind across many human development indicators, such as life expectancy, infant mortality, and educational attainment indicators. Importantly, a central driver of Nigeria's growth performance has been the oil sector (Akinlo, 2012), which makes the country vulnerable to oil price volatility and calls into question whether growth rates can be sustained. Indeed, following the sharp decline in oil prices since 2014, the Nigerian economy fell into recession in 2016. This situation is not uncommon for resource-rich countries. On average, countries that have an abundance of natural resources often show a record of relatively poor economic performance compared with non-resource-rich countries, as showed by Torvik (2009), Arezki et al. (2011), and IMF (2015). Furthermore, Collier and Goderis (2007) find that although in the short run an increase in export prices of commodities raises growth, in the long run growth is substantially reduced.

Heavy reliance by the government on oil revenue has prevented Nigeria from building its own tax capacity. Non-oil tax revenues have averaged about 4 percent of GDP over the last 10 years, which puts it among the countries with the lowest tax collections in the world. This is also well below the levels of taxation in countries with similar income levels. Unsurprisingly, the weak tax capacity is associated with weak indicators of legal and public administration capacity.

Despite very weak tax capacity at the national level, the experience of Lagos State illustrates how it is possible to improve tax capacity and voluntary tax compliance, which in turn can foster greater legal and public administration capacity. Since the early 2000s, the Lagos State government has succeeded in boosting tax revenues to develop basic infrastructure, expand public services, and improve law enforcement.

Efforts to improve tax capacity in Lagos State can be traced back to the early 2000s. Nigeria began a transition away from military rule following the death of General Sani Abacha in 1998. National and State elections were held in 1999. Bola Tinubu was elected governor of Lagos State as the candidate of the Alliance for Democracy (AD), the opposition party to the Nigerian President's People's Democratic Party (PDP). Governor Tinubu was reelected in 2003, again as a candidate from the opposition party to the President. His successor, Babatunde Fashola, elected in 2007 and reelected in 2011, was also from the opposition party to the PDP-controlled national government. As prominent opposition leaders, Lagos politicians were eager to demonstrate that they could deliver more benefits to their constituents than the PDP. Building tax capacity was crucial for their objectives, as resource allocations (including revenue sharing of oil receipts) received by Lagos State were insufficient to meet their spending needs. For example, according to De Gramont (2015), in 2002, the state government's personnel costs alone exceeded its statutory allocation from the federal government.

Governor Tinubu made taxation an early priority. In the late 1990s, the Lagos State government lacked basic tax capacity. Taxes were paid in cash to revenue officials who gave out handwritten receipts. The State finance ministry was not able to clearly track payments made into state bank accounts. State revenue staff were ill-equipped to effectively audit businesses. Tax evasion was pervasive. During Tinubu's first term, tax collection was shifted from cash transactions toward electronic payments through banks. Taxes could now be paid directly into government coffers at a number of bank branches. Greater attention was also placed on enforcement.

Tax administration in Lagos State saw a turning point in 2005. Political rivalry added further impetus to the ongoing reform process to increase internal revenues, when in 2004 the President cut off federal funding for local governments in Lagos State due to a dispute over the creation of new local governments. As a first step, the management of the existing internal revenue board was replaced with a new team and it was given greater autonomy. The revenue board was then transformed into a new agency, the Lagos State Internal Revenue Service (LIRS). LIRS came into full force in 2007. LIRS was able to pay higher salaries and use greater flexibility in hiring and internal management than the ordinary civil service. As a result, it was able to attract better-qualified staff and offer better training (Asaolu, Dopemu, and Monday, 2015).

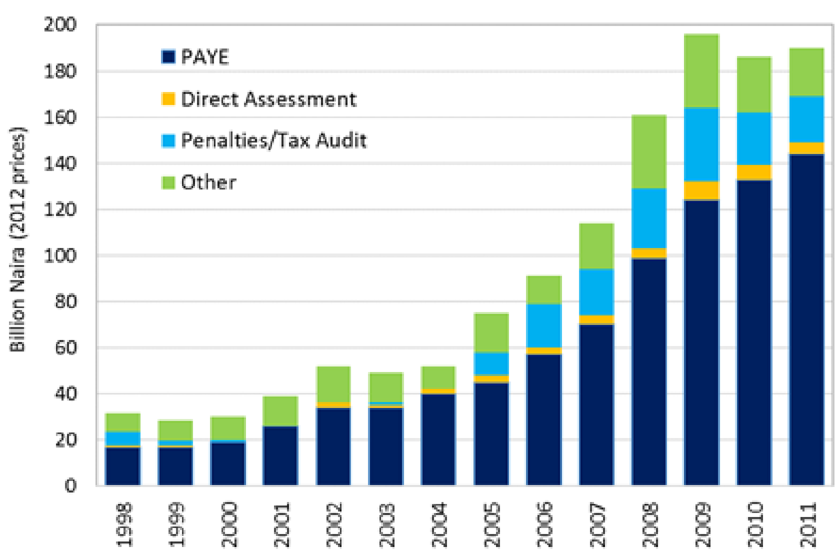
Governor Fashola continued to make taxation a central focus of his administration. LIRS increased its monitoring capacities. In-house audit capacity was increased. A self-assessment filing system for individuals was introduced. Efforts were made to bring informal sector workers into the tax net through payment of a flat tax. Meanwhile, infrastructure construction and public service reforms accelerated, in order to be able to clearly display to citizens the benefits of their tax contributions.

As part of the reform process, important efforts were made to increase voluntary tax compliance. Since 2007, regular tax stakeholder conferences are convened with representatives from the private sector, labor unions, civil society groups, and informal sector associations to discuss tax payment and their expectations from the government. Public works projects in Lagos display large signs urging people to pay their taxes. LIRS has enlisted public figures to record messages about the importance of tax payment, and runs a tax essay competition for youth. Media campaigns underline the link between paying tax and developing Lagos as a cosmopolitan city, Also, legal enforcement actions are publicized.

Public perceptions that the state government has been doing its job well appear to have influenced individuals' readiness to pay taxes. De Gramont (2015) reports a 2010 survey where 74 percent of respondents said they were somewhat or very satisfied with the State government's use of tax revenues. Bodea and Lebas (2014) report that residents of Lagos expressed the highest support among all residents of urban centers in Nigeria for the statement that "citizens should always pay their taxes."

The impact of these tax system reforms have been remarkable. Between 1999 and 2010, internal tax revenues increased almost 8-fold, as shown in Figure 15. Both revenues and tax audit penalties increased markedly after the 2005 tax administration overhaul. As a result of these efforts, in 2014, about 70 per cent of Lagos State government revenue was derived from internally generated tax revenue.

Figure 15. Lagos State Tax Revenue by Source



Source: De Gramont (2015)

V. Conclusions

This chapter complements our recent study (Gaspar, Jaramillo and Wingender, 2016) on the determinants of economic growth and development of state capacity. While the aforementioned study uncovered a robust and significant statistical threshold effect of the level of taxes on subsequent growth, the current chapter attempts to document the political environment that supported broader changes in state capacity that accompanied the tax threshold crossing in the four countries analyzed.

In this chapter, our goal is not to present any general theory about the institutions and politics behind state capacity. Rather our aim is to illustrate with a few cases studies the political conditions that have supported broader changes in state and tax capacity. We hope that our insights into these cases can serve as useful input for the process of developing a more general theory that integrates politics, institutions, and tax capacity.

Across all four case studies, constitutive institutions, inclusive politics, and credible leaderships played a role in the process of state and tax capacity building. Constitutive institutions were in place in the cases of Spain and Colombia, where an explicit political settlement between political elites and citizens preceded state and tax capacity building. Inclusive politics facilitated new center-periphery agreements that became a central element of the building of tax capacity, as discussed in the cases of China and Lagos State. Credible leadership was also clearly manifest across the four case studies. In all the cases, there was a deliberate decision by policymakers to implement a shift in the economic model, taking advantage of opportunities offered by economic or political crisis.

In our analysis, we also make the case that improvements in tax-to-GDP levels can only be sustained when accompanied by changes in social norms of tax compliance. This in turn entails greater demand by citizens for an effective, trustworthy, and equitable government. Spain and Colombia saw sustained increases in taxpayers' compliance norms after crossing the 12¾ percent tax-to-GDP threshold. This suggests that the improvement in tax collections was not only due to stricter tax enforcement but also the result of greater voluntary compliance. The cases studies also showed lower perceptions of corruption, suggesting that higher taxation generated a greater demand for government transparency and accountability. In the case of China and Colombia, stronger tax capacity was also accompanied by improvement in legal capacity, such as the protection of property rights and regulatory quality. The case of Nigeria illustrates that sustained economic and human development does not follow suit when growth is not accompanied by a building of state and tax capacity.

As in the quote that serves as epigraph to the section on Nigeria, the evidence here collected is suggestive of the importance of a double-sided accountability social contract. As tax administration and tax capacity improve, social norms of behavior change, leading to quasi-voluntary compliance on the part of taxpayers. Tax revenues become more important and elastic, allowing government revenues to become more stable. Public governance improves as citizens demand (and the administration delivers) accountability. As the process deepens, public administration increasingly focuses on the public good and acquires the capacity to deliver on it.

It is from such deep social, institutional, and political dynamics that we find the explanation for a tipping point in tax–to-GDP levels that delivers a significant acceleration in the process of growth and development.

Appendix 1. Year in Which Countries Crossed the Tax to GDP Threshold Without Reversal

Contemporary dataset (12.88 percent of GDP threshold)				Historical dataset (12.65 percent of GDP threshold)	
Albania	1998	Liberia	2006	Australia	1940
Argentina	1993	Malawi	2004	Canada	1940
Armenia	1997	Maldives	2011	Chile	1959
Bahamas, The	2006	Mexico	2000	Czechoslovakia	1921
Benin	1999	Mali	2002	Denmark	1955
Bolivia	2004	Mozambique	2009	Finland	1941
Burkina Faso	2011	Nepal	2010	France	1920
Cabo Verde	1992	Nicaragua	2010	Germany	1934
Cameroon	2000	Papua New Guinea	1978	Italy	1949
Chad	2010	Peru	2003	Japan	1895
China	2001	Philippines	2005	Korea	1965
Colombia	2001	Portugal	1976	Netherlands	1940
Costa Rica	1998	Solomon Islands	2003	Norway	1946
Cyprus	1979	Spain	1982	Portugal	1953
Dominica	1977	Sri Lanka	2010	Sweden	1943
Dominican Republic	2004	South Africa	1973	United Kingdom	1916
El Salvador	2010	Suriname	1995	United States	1943
Ethiopia	2010	Swaziland	1988		
Gambia, The	2006	São Tomé and Príncipe	2004		
Georgia	2004	Tajikistan	2002		
Ghana	2010	Thailand	1979		
Greece	1966	Togo	2003		
Guinea	2005	Tonga	1993		
Honduras	1990	Turkey	1992		
India	1976	Uruguay	1985		
Kenya	1994	Vanuatu	1984		
Kiribati	1987	Vietnam	1992		
Korea	1974	Zambia	2010		
Kyrgyz Republic	2002	Zimbabwe	2010		
Lao P.D.R.	2009				

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