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The politics of what works for the poor in public expenditure and taxation: a review

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Abstract

The paper examines the questions of which fiscal (public expenditure and taxation) options work in terms of poverty reduction, and how they can be made implementable in practice. The point of departure is that although the poor, acting on their own, are politically weak, nonetheless there are ways in which they can make themselves essential to the elite, and this in combination with relevant policies and institutions has enabled poverty, in some countries and regions, to fall dramatically. Yet others have been excluded from this process. Our review identifies the following areas of policy and institutional development as requiring further exploration and testing through the life of the RPC:

(1) The distributional impact of public expenditure and taxation, with emphasis on the sectors of agriculture and social protection, and on the instruments of input subsidy and 'progressive' export taxation;
(2) The politics of forming pro-poor coalitions, with emphasis on reforms of distributive justice as an instrument for achieving this;
(3) The politics of escaping from the low-tax trap, with emphasis on the role of aid donors.

Within each of these territories, an agenda for future research is specified.

Keywords

Taxation, public expenditure, effective state, fiscal policy, service delivery

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1. Making states developmental and pro-poor: the evolution of thinking

Introduction

The Effective States and Inclusive Development (ESID) research centre seeks to understand 'what forms of state capacity and political commitment are required to underpin sustainable levels of growth and employment' (University of Manchester 2011: i). This paper is concerned with the state's *fiscal* capacity,– its ability to raise revenue and to spend it in a way that sustains growth and eliminates poverty - which is certainly one of the key functionings required to enable a state to work. We are concerned, in particular, with the political feasibility dimension of fiscal policy.

Section 1 of this report presents a brief historical review of approaches to these issues. This section exposes three key building-blocks related to the construction of the fiscal component of an effective state on which our knowledge is still insufficient. These building-blocks, examined in sections 2 through 4, are, first, how to make public expenditure and taxation pro-poor, second, how to build effective pro-poor coalitions, and finally, how to build tax structures which facilitate escape from a low-tax, weak-state equilibrium. In these sections, we seek to highlight the research which needs to be done, and in section 5 we make suggestions for how such research could fit into the programme of the proposed new ESID Centre.

The politics of pro-poor fiscal policy: the evolution of thinking and policy priorities

During the second half of the nineteenth century, we see for the first time fiscal policy being used, particularly in what were then the newly industrialising countries of Germany, Russia and Japan, not just to meet government's financial requirements, but as a developmental instrument designed to transform the structure of the economy, and specifically to overcome market imperfections which prevent the economy from evolving in the way desired by the government. Amongst the activist fiscal policy instruments used to achieve this objective, four are particularly are particularly important : government investment in strategic sectors, especially infrastructure; subsidy for specific inputs (notably loanable funds) for which markets are missing or at any rate not providing the necessary support for re-equipping the economy; development of new sources of finance to overcome a government financing constraint, such as the tax on the value of unimproved land implemented by the Japanese government in 1870, which financed much new infrastructure construction; and not least, infant-industry protection, first given its developmental rationale by the German political scientist Friedrich List in 1841[1] and since then possibly the commonest and certainly the most controversial instrument of pro-developmental fiscal intervention. An important rationale for this more interventionist stance after 1850 was the belief that, in the new world where many players were competing for control over the global economy, the old laisser-faire

[1] A good account of List's political economy is provided by Payne and Phillips (2010: 37-43)

approach to policy and to finance could, in the absence of such purpose-built intervention, no longer deliver industrialisation in the manner that had worked for Britain and the United States (Gerschenkron 1959).

After the First World War, indeed from the 1920s right through to the 1970s, this activist approach to fiscal policy-making in emergent countries received considerable support from comparative economic development experiences. During the inter-war depression Brazil under President Vargas, notably, joined the group of countries practising activist fiscal policies for industrial development, and as a consequence was able during that period to record higher rates of economic growth than any country except Russia, now itself implementing five-year plans within a completely socialised economy (Hilton, 1975). After the second world war, in defiance of a liberalising General Agreement on Tariffs and Trade agreed within the Bretton Woods agreement of 1944, what has become known as the *dirigiste* ('controlling' or 'directive') approach to economic policy (Lal, 1983) was expanded to encompass a majority of developing countries. Especially in the fields of input subsidy and export taxation, as well as orthodox protectionism, we see the state's fiscal role being expanded in pursuit of faster development.

By the mid 1970s it was clear that this pattern of interventionist fiscal policy was impacting on developing countries in two radically different ways. In one group of countries, principally the 'tigers' of south-east Asia (South Korea, Taiwan, and later Malaysia, Thailand and Indonesia), but also including Brazil and arguably northern Mexico, non-traditional, and in particular manufacturing, exports expanded rapidly through the 1950s and 60s, and this fed through into a rapid growth in the economy as a whole. In these countries and also northern India, a green revolution was also beginning, enabling these countries to achieve self-sufficiency in food. And as a consequence of both these trends, tax revenue was able to grow in a broad-based manner and escape the strait-jacket imposed on all poor countries by the dominance of taxes on foreign trade[2], revenue from which is unstable and constrained by the long-term adverse trend in the terms of trade of primary commodities. In these countries, a positive interaction between policy-making and the diversification of the economy had become visible which led their governments to become celebrated as 'developmental states'[3] – most of at them, at this stage, not democratic, still less corruption-free, but nonetheless able to manage a break-out into autonomous self-sustained development such as Japan and their other nineteenth-century predecessors had achieved. In the

[2] In the 1970s, revenue from taxes on foreign trade in developing countries averaged about 40% of total domestic revenue (World Bank, *World Development Report 1979*, appendix tables). But in many countries the proportion was far greater than this. In Uganda, export taxes on coffee alone accounted through the 1970s for more than 80% of total domestic revenue (Bowden and Mosley, 2011, using Uganda *Annual Trade Reports*)

[3] The idea of a 'developmental state' is attributed to the American political scientist Chalmers Johnson (1982), who used Japan, South Korea and Singapore as his exemplars. As presented by Johnson, the essence of a developmental state is a partnership between the state and the private sector to achieve rapid economic growth, with the state providing financial support (and in particular selective, performance-based subsidies) to the private sector, and the private sector being expected in return to co-finance the costs of health, education and social protection. Developmental states are sometimes characterised as 'hard states', by contrast to the 'soft states' whose softness was seen by Gunnar Myrdal(1967) as a cause of poor developmental performance in south Asia. In the 2000s the president and finance minister of South Africa have openly sought to identify a 'developmental state' as a model for where they are seeking to go (see Bond(2010), and this idea is also embedded in the Latin American idea of *neodesarrollismo*, or neodevelopmentalism (see section 2 below). 'Building developmental states' is of course the second main theme of this research programme consortium; for further writing on developmental states, see in particular Woo-Cummings (1999).

other group, comprising at this stage all other developing countries including India and China, neither a break-out into the development of manufactured exports nor the development of a fiscal base which would enable this break-out to take place, was occurring. There were numerous reasons for this bifurcation, but one of them – the tendency for state intervention to be used in many countries not to promote development but to protect the special interests of ‘rent-seekers’ – emerged from the shadows at this point, notably in the work of Little, Scitovsky and Scott (1975) and Krueger (1979).

At this point, we become able to fit poverty, on which we are beginning to have usable data, into the picture. Policy-makers had always been aware that objectives other than growth of output, and in particular individuals’ standard of living, were relevant to development; but in early global development policy manifestos, such as the very first (United Nations 1951), low standards of living are equated with unemployment, and the assumption is made that a combination of policies which achieve high growth and policies which will achieve low unemployment will be enough. By 1973, however, it was clear that they were not enough. In Ethiopia and Bangladesh, after a quarter of a century in which the world had hoped that it might have been freed from starvation[4], famine had once again recurred, and in many parts of the world growth was leading to inadequate, indeed in some places near-zero, increases in productive employment. The World Bank’s chief economist, Hollis Chenery, estimated that ‘a decade of rapid growth in underdeveloped countries has been of little benefit to perhaps a third of their population (Chenery et al 1975: xiii)

This awareness brought about a reappraisal of development policy – in the Bank under its new president, Robert MacNamara; amongst like-minded donor agencies, and amongst governments and, incipiently, NGOs in developing countries. This reappraisal (much of the intellectual substance of which is to be found in the World Bank/IDS document *Redistribution with Growth* (Chenery et al 1975) had two main axes, which correspond to the two dimensions of pro-poor action delineated earlier. In terms of the *optimality* criterion, we encounter through the 1970s a shift towards ‘pro-poor spending policies’, especially in favour of agriculture and in particular smallholder agriculture, implemented through new modalities such as integrated rural development projects, - but also, in urban expenditure policies, a recognition of the economic importance of the informal sector and a shift towards policies for the benefit of low-income people such as site and service housing schemes. However the Bank, correctly acknowledging the importance of the political economy dimension, also took the further step of asking under what circumstances pro-poor expenditures and tax policies would be *feasible* (Bell 1975). Bell noted two important channels, beyond altruism, why a self-interested elite might wish to adopt pro-poor policies, namely the desire to buy off a rebellion of the dispossessed and the need of an insecure elite to bolster its position by finding allies – who might in some cases be found amongst the poor (Bell 1975: 54-55). In practical terms these ideas were embodied into the Bank’s spending programmes through measures such as land reform, especially in Latin America, and financial support for the informal sector (Chenery et al 1975: especially chapters 4,6 and 7). These ideas have abiding relevance to the construction of an inclusive, pro-poor fiscal research programme.

[4] The horrifying Chinese famine of 1958-62, which killed between 30 and 50 million people, was not known to the world until the 1990s.

Much, though not all, of the pro-poor thrust of the 1970s was aborted by the global recession of the 1980s, and by the tide of liberalisation and retrenchment that stemmed from it. But the retreat from the 'poverty focus' policies of the MacNamara era, of course, proved to be only temporary. What began in the 1980s as a protest against the social costs of adjustment (Cornia, Jolly and Stewart, 1987) was to grow into one of the most influential of *World Development Reports* (World Bank, 1990), which rested its analysis of poverty on a 'three-legged stool' – labour-intensive policies, investment in the human capital of the poor and social safety nets. This was no ordinary humanitarian manifesto, but eventually grew, through the Millennium Development Goals, into a global anti-poverty crusade (Hulme 2010). The idea of poverty reduction, or putting it more positively 'inclusive development' remains, twenty years later, the primary goal of international development efforts.

Within this territory, where are the gaps which most need researching? In the remainder of this section, we shall seek to identify questions which need special attention because:

- they represent promising ways forward which have seized the imagination of a number of developing countries, however
- they are under-researched in the sense that no clear and robust answer to the question identified has emerged, in spite of
- the existence of a number of research activities and centres, several of them funded by DFID, which speak to this range of questions.

Other criteria for inclusion of an issue in our list of focus questions are: linkage to the other overarching themes of this research programme consortium (RPC)-i.e. state non-fiscal capacities and issues related to elite accountability and responsiveness; and the existence of a knowledge gap identified by DFID in its recent review of politics and governance RPCs (DFID 2011) .

Pro-poor expenditure priorities

One still under-researched dimension of fiscal policy is the role of *subsidies* in counteracting market failure. If the market for an input feeds into a product or service which has the ability to relieve poverty, but for which the market is fragile or has collapsed – fertiliser, microfinance and irrigation equipment are good examples – there is a case for subsidising it, which is analogous to the case for protecting infant industries by means of a subsidy on the input. In Section 2, we make the case for investigating the scope for making such subsidies 'smart', i.e. efficient and equitable at the same time, within the context of the ESID Centre.

Discussion of pro-poor *taxation* is also a generally under-researched area of development policy. Most of the extensive literature on taxation emerging from the IMF, for example, is concerned with allocative and revenue issues, (DFID 2011: chapter 8, Brautigam, Fjeldstad and Moore, 2008). One new way of doing this is particularly fascinating. As the Washington Consensus has fragmented into 'Washington Confusion', so countries with the room for manoeuvre to be able to defy the Washington institutions, mainly middle-income countries, have felt free to reintroduce many policy instruments associated with the first wave of activist developmental policies : not only capital controls and protectionist tariffs but also price controls and even export taxes – for the World Bank at least, the epitome of anti-developmental policy (World Bank 1981, 1989). Since the early 2000s, export taxes have not only been an important part of the leftward drift of Latin America but, as we shall illustrate in the next section, have also penetrated into

Africa as well. What is especially fascinating is that these export taxes, especially on mineral rents, have often been bundled together with pro-poor expenditures (especially elements of the social safety net, such as pensions, unemployment allowances, and rural decentralisation programmes) so to produce a package which is as politically attractive as it is distasteful to liberal economic opinion. The potential of these taxes for pro-poor action has not been researched, and in section 2 we elaborate how it could enhance the work of the Centre.

Building pro-poor coalitions

There is a tradition in the literature of scepticism about the feasibility of pro-poor policies, on the grounds that elites and their actions are always dominated by the not-so-poor. As a recent OECD publication puts it, 'the politically most active groups are not usually the poorest' (Haggard et al 1996:120). The poor are nowhere a class with the ability to organise in their own interest, and they have little leverage in their own right. But as discussed above in relation to the pro-poor movement of the 1970s, they can still exercise influence if able to present a credible threat to the elite, or to present themselves as a credible partner to the elite, typically at a moment of crisis. In section 3 below, we shall examine the politics which underlay these realignments.

Escaping from the 'low tax trap'

A fiscal base confined to taxation imposed through import and export taxes on primary products, as is the situation in many bottom-billion countries, has acted as a major structural constraint inhibiting development and perpetuating the fragility of the state. (Moore 1999; Braeutigam, Fjeldstad and Moore, 2008); and aid aimed at relieving this constraint may make the problem worse, because it disincentivises efforts by governments to reinforce their tax base. Noting this, DFID (2011, p.81) argue that 'There is a need to consider the relationship between foreign aid and domestic taxation'. We concur. Whether this negative interrelationship in fact holds, and whether aid can be configured so as to achieve not only possible escape routes from this part of the 'tax trap' but an increase in the institutional effectiveness of aid as a whole, represents an obvious priority for research.

In the next three sections we illustrate what role the ESID centre might fulfil in expanding the body of existing research findings on these themes in complementarity with existing research activities.

2. What types of expenditures and taxation will have the strongest effect on poverty reduction?

Public expenditure

Appended to the World Bank's 1990 *World Development Report* was a new wave of analytical work on poverty reduction, of which a particularly significant component was Ferroni and Kanbur's paper (1990) on *Poverty-Conscious Restructuring of Public Expenditure.* Ferroni and Kanbur divide the 'poverty impact' of a specific anti-poverty initiative, or expenditure on a specific sector, into three elements: gross impact, poverty focus (the proportion of persons affected who are poor) and the social valuation (the assessor's weighting between different criteria of well-being). Ferroni and Kanbur's work signals a new stage in the analysis of distributional impacts of expenditure, with gross impact decomposed into production and consumption components, the pathways of impact formally specified and, even at the beginning of the 1990s, sensitivity shown to the existence of multiple poverties each of which might require a different response. The commonest way of developing this approach has been not to look at public expenditure as a whole, but to focus on a particular anti-poverty idea, from malaria eradication to agricultural extension to village savings and loan associations, or a particular expenditure programme, or sector of the economy, and applying some variant of the Ferroni-Kanbur analysis to that. In what follows we shall concentrate on studies of the developmental and poverty impact of four sectors of expenditure: agriculture; human capital (health and education); social protection and subsidy; and military expenditure. In conclusion we shall summarise the studies which compare across different categories of public expenditure. The main findings from each of the studies which we examine are collected together in Table 1.

Agriculture

Because most of the poorest people live in rural areas and derive livelihoods only from agriculture and from agriculture-related labour, it follows almost axiomatically that the major route to poverty reduction in most areas (excepting Latin America, where much poverty is urban rather than rural) is an increase in agricultural productivity, and expenditures which will make that possible. This was acknowledged by the first great development economist, Arthur Lewis (1952), in a report on the industrialisation of Ghana which can be read as a forewarning of the flaws in Ghana's own import-substituting industrialisation strategy[5] ; it was reiterated in Ferroni and Kanbur's review of poverty-conscious expenditure strategies, which argues that 'agriculture is a key sector to be promoted, since no other sector is capable of comparably participatory growth' (1990:5); and more recently it has been given quantitative teeth by a series of studies mounted under the auspices of the International Food Policy Research Institute (IFPRI), which focus on India and China (Fan, Hazell and Thorat 2000; Fan, Zhang and Zhang 2004; Fan 2008). The IFPRI study of India by Fan et al. (2000) finds that investment in rural roads and in agricultural research achieve far and away the most significant impacts on poverty, with education in a fairly distant third place and 'other investments, including irrigation, soil and water conservation, health, and rural community development, achieving only modest impacts on growth and poverty per additional rupee spent' (Fan et al 2000:1038). Feeder roads and agricultural research, Fan et al. argue, achieve big impacts because they impact on poverty through multiple channels: by increasing food production, by reducing the price of foodgrains to urban consumers, and by improving the distribution of income (Fan et al: 1040). In China (Fan et al 2004) the results similarly show that the impact of agricultural research on poverty is crucially important, especially in the remote western areas where the worst poverty still persists. However, by contrast with India, they find education to be an even more powerful way of reducing poverty in rural areas. As In India, investment in irrigation and in dedicated area-based poverty reduction programmes are found to have an insignificant effect on

[5] 'The surest way to industrialise the Gold Coast would be to multiply by four or five the resources available to the [Agriculture] department for fundamental research into food production',(Lewis 1952: para.24)

poverty. The only African country investigated by the IFPRI studies is Uganda, and there also (Fan and Rao 2008) agricultural research is the dominant poverty-reducing influence, with feeder roads and education once again significant negative influences on poverty, although with a much less dramatic effect than research spending[6]. Because of data problems, studies of the impact of public expenditure in Africa are relatively sparse by comparison with Asia and Latin America. However, across four case-study countries of Africa (Uganda, Ethiopia, Malawi and Zimbabwe), Mosley and Suleiman (2007) find, in similar vein to the IFPRI studies, that infrastructure and education are an important influence on rural poverty in addition to direct spending on agriculture . In addition, the Mosley and Suleiman study finds that the stability of pro-agriculture expenditure, as well as its level, is a significant influence on rural poverty levels.

Health and education

Since the *Redistribution with Growth* studies of the 1970s the World Bank has been enthusiastic about human capital spending as a potential route out of the 'Baldwin trap', providing, in principle, both a way of increasing the productivity of the rural poor in the short term and, in the medium term, paving the way for the possibility of small-scale-based industrialisation for export (e.g. Chenery et al 1975: Chapter IV). Reflecting this, aid donors have moved a large part of their incremental disbursements in pursuit of the Millennium Development Goals away from project aid (physical capital) and towards human capital, in the shape of technical assistance expenditures designed to build the human capital of the poor. Both in relation to education and health, however, the Bank has warned that in order to achieve maximum rates of return, as well as in order to reduce poverty, it is necessary to slant the pattern of public spending towards primary education and health, and away from universities and referral hospitals (e.g. World Bank 1990, 1991, 1995[7]). Health and education also were included in the IFPRI comparative review of public expenditure and poverty (Fan et al 2004), which finds that the Bank's warnings were well-founded. 'The distributional effect of expenditures is low', they report (Coady 2008: 125).'The benefits of public expenditures were found to be progressive in only 3 or 4 out of 12 countries analysed (i.e Argentina, Uruguay, Malaysia and Chile). However, where education and health were administered, as especially in Latin America, through means-tested conditional cash transfers (e.g. *Oportunidades,* formerly PROGRESA, in Mexico and *Bolsa Familia* in Brazil), the results have been promising (Coady 2008: 128, 136); de Britto 2008)[8]. The impact of conditional cash transfers in Latin America is also considered in detail by Haggard and Kaufman's comprehensive study of welfare spending in middle income countries (Haggard and Kaufman 2008: 216ff.) The inference seems to be that in a number of developing-country environments,

[6] The number of poor reduced per million Ugandan shillings of public expenditure is given as follows: agricultural research and development, 58.39; feeder roads, 33.77; education, 12.81. Fan and Rao, 2008: 82-83.

[7] The World Bank's 1990 *World Development Report* (World Bank 1990: Box 5.2) found the rate of return to primary education to be 26% across the developing world as a whole, compared with a return of 16% to secondary education and 14% to tertiary education. Across a sample of two industrialised and ten developing countries, the Bank's 1991 *World Development Report* (table 3.2) finds that an additional year of schooling raises male wages by an average of 9% and female wages by an average of 13%.

[8] In recent years a specialised literature has emerged on the form of the conditional cash transfer, with a particularly lively advocacy of school feeding programmes (Powell et al. 1998, Daelmans et al. 2003 .De Britto emphasises that, although conditional cash transfers are a valuable expedient, they do not reduce poverty on their own, and complementary actions to stabilise the macroeconomy and remove deeply rooted inequalities are often also necessary (2008:191))

as in industrialised countries (where the principle is known as 'Director's Law'[9]), political pressures cause the benefits of health and education spending to be concentrated on the middle class and the poor to remain marginalised, *unless* effective targeting procedures are implemented. How these pressures arise and can be circumvented is of course central to the theme of the RPC, and we consider them further in section 3.

Social protection and subsidy

Here we consider three kinds of public expenditure on subsidy, or transfer payment. *Food subsidies,* as shown by the Ferroni and Kanbur study and also by Coady (2008) emerge as not only an inefficient but not even an equitable instrument of social protection, which have a deterrent effect on food production, and generally fail to reach vulnerable groups, partly because as in Cote d'Ivoire they are awarded principally on commodities such as wheat and rice which are not salient in the consumption of the poorest people. *Other instruments of social protection expenditure* are also examined by Coady, Grosh and Hoddinott (2004), Barrientos and Hulme (2008) and Coady (2008), including social funds, cash transfers and rural public works. In Coady's sample, the average degree of targeting effectiveness, or poverty focus, which as we have seen was 0.93 for food subsidies, is measured as 1.2 for social funds, 1.4 for cash transfers and 1.85 for public works. Thus in these cases, social protection expenditures were at least doing their fundamental job of redistributing from richer to poorer, and in the case of cash transfers some of the reasons for this relative success have been examined above. But the most successful of all are an ancient expedient, *public works*, used indeed by industrialised countries to avert famine in the nineteenth century[10]. An important reason for the targeting effectiveness of such schemes is that they make abundant use of what is often the only thing which poor people are able to sell – labour. Because the wage offered on such schemes is low, they are able to 'self-target' – only the poor wish to take up such employment offers, and therefore no expensive arrangements are required to achieve effective targeting. Public works programmes are particularly useful in addressing vulnerability and at times of emergency. As Coady (2008b:153) notes, 'community involvement has been found to be important in increasing overall effectiveness' , and this of course raises issues of intra-community political motivation and incentives which lie at the heart of the ESID programme. These will be further taken up in Section 3.

[9] After the American political scientist Aaron Director, who. 'almost a decade ago … proposed a law of public expenditures: Public expenditures are made for the primary benefit of the middle classes, and financed with taxes which are borne in considerable part by the poor and rich'. Stigler 1970:1.

[10] For example, several of the main roads of northwest Scotland such as that from Dingwall to Ullapool were 'destitution roads', built in the late 1840s, in extension of those built by Thomas Telford in the earlier part of the century, to obviate the risk of a famine amongst rural subsistence cultivators such as had occurred in Ireland in 1846. See Devine(1995) and Richards (2002).

Table 1: Findings on effectiveness and poverty leverage of government expenditure

	Sample description, study period and methodology	**Summary of findings**
Agriculture and rural infrastructure only		
Fan, Hazell and Thorat 2000	14 states of India 1970-93. Multi-equation model estimating headcount poverty as a function of expenditure and non-expenditure causal factors	Within the rural sector, spending on rural roads and agricultural research were the main contributors to poverty reduction.
Fan, Zhang and Zhang 2004	China 1978-2000. Multi-equation model estimating headcount poverty as a function of expenditure and non-expenditure causal factors.	Across the whole of China, spending on education, agricultural research, rural roads and telephones, in that order, were the main contributors to poverty reduction. In poorest (western) regions, agricultural research has most impact on poverty, followed by education. Spending on irrigation and on loans specifically targeted for poverty reduction had an insignificant impact.
Fan and Rao 2008	Uganda, 1994-2008	Agricultural research and extension and rural infrastructure are the expenditures making the biggest poverty impact.
Health and education only		
World Bank 1991	12 developing and industrialised countries	Significant positive relationship between education and real wages
Coady 2008	Bangladesh,Sri Lanka, Egypt, Tunisia, Cote d'Ivoire, Honduras	Insignificant impact of health spending *as a whole* on well-being indicators. Findings on targeting (e.g. Britto 2008) suggest that link between wellbeing and primary healthcare, and especially conditional cash transfers, is stronger.
Social protection and subsidy only		
Ferroni and Kanbur 1990	Cote d'Ivoire (Living Standards Measurement Survey). Multi-market model, late 1980s	Food subsidies as a whole had little redistributive impact. Subsidies on foodgrains other than rice were more effective in reducing poverty than subsidies on rice.
Haggard and Kaufman 2008	20 countries in Eastern Europe, Latin America and East Asia (mostly middle-income), 1980s to mid 2000s. Mixture of qualitative enquiries and regressions exploring the political and economic causes of social expenditures	Mostly a study of causes rather than impact of social expenditure (see further Section 2 below); but argues that targeted cash transfers of the PROGRESA/OPORTUNIDADES type (see text) achieved greater political impact partly through being better targeted than previous social protection programmes.
Coady, Grosh and	Bangladesh, Sri	*Comparative study of several instruments of*

Hoddinott 2004; Coady 2008	Lanka, Egypt, Tunisia, Cote d'Ivoire, Honduras	*social protection:* food subsidy (whose degree of targeting effectiveness is measured as 0.93, or not even progressive), social funds (targeting effectiveness 1.2), cash transfers (targeting effectiveness 1.4) and public works (targeting effectiveness 1.85).
Military expenditure		
Knight, Loayza and Villanueva 1996	Panel data regressions, 1980s and early 90s	There is a significant 'peace dividend', in other words cuts in military expenditure significantly increase GNP growth.
Davoodi, Clements et al 2001	Panel data regressions, 130 countries 1974-92	Confirms the existence of a significant peace dividend, and divides it into global, regional and country-specific factors.
Nafziger and Auvinen 2002	Panel of c.60 developing countries, 1980-92. OLS regression	'Military centrality' (a composite of share of military expenditure in GDP growth and role of military in government) has a significant negative impact on GNP.
Multi-sector studies		
Baldwin 1963	Various developing countries, mostly late 1950s. Secondary evidence on employment coefficients	(Public expenditure on) Agriculture is better than extractive industries at employment creation (and by extension, poverty reduction)
Mosley, Hudson and Verschoor 2004	Panel of 54 developing countries, 1980-2000. Instrumental-variables regression	In low-income countries (not in middle-income countries) 'pro-poor expenditure'(education+health+agriculture-military) as share of GDP, has a negative effect on infant mortality (ie a positive effect on poverty reduction)
Fan 2008	India, China, Uganda only, 1980s and 90s	Rural roads, agricultural research and development, and (especially in the case of China) primary education are the most pro-poor forms of public expenditure.

Input subsidies have, as discussed in our historical review, been used since the nineteenth century both as an instrument for accelerating the rate of industrial development and, indeed, for rebalancing the whole pattern of growth from consumption towards investment. Rigorous studies of the specific developmental effectiveness of input subsidies are surprisingly scarce, but it appears likely that, especially among smallholders, they played an important part both in accelerating the rate of adoption of new technology by smallholders and thereby in reducing rural poverty in south-east Asia[11]. In Africa, growth has been less than in Asia, fiscal constraints bite more tightly and subsidy is a less feasible option failing the possibility of collusion with aid donors, and largely for this reason[12] less use has been made of agricultural input subsidy as an instrument of raising productivity and reducing poverty. Two places where this instrument, exceptionally, has been employed (coincidentally both research partners

[11] On the role of subsidies in bringing about growth with equity in south-east Asia see World Bank (1990); on subsidies and agricultural development strategy in China, see Lin(1998); on South Korea, see Moore(1985); on Indonesia, see Djurfeldt and Jirstrem(20052004?, chapter 4); specifically on BIMAS, the programme of multiple input subsidies adopted by the Indonesian government in the 1970s, see Barker et al(1985) and Timmer(2007) not in biblio.

[12] But also for political reasons, including the greater persistence of 'urban bias' (South Africa is a notable example, but Ghana is also a case in point).

within ESID) are Ghana and Malawi, and we believe that a great deal can be learned from both experiences. In both cases the input subsidised has been fertiliser, a key element in agricultural productivity.

The political and economic contexts differ greatly between the two cases. In Ghana, fertiliser subsidy is only available for growers of the country's main cash crop, cocoa. Cocoa productivity, especially during the middle 2000s, has increased sharply; and poverty during the period 1990-2005 has halved, in large part because of increased labour demand driven by this expansion of cocoa production (Nsowah-Nuamah et al 2010). However, even though fertiliser subsidies in Ghana are now targeted through the use of a voucher system, with the intention of progressivity[13], and even though Ghana has been spectacularly successful in making the transition to democracy and reducing many dimensions of corruption, some observers see the allocation of fertiliser vouchers as having been politicised[14] and, as a consequence, still inefficient (Branoah-Banful, 2011).

In Malawi, by contrast, subsidised fertiliser is applied principally to maize, the country's main foodcrop, again in the form of vouchers which entitle the user to one 50kg bag of 23:21:0 (nitrogen: phosphate: potassium) basal fertiliser and one 50kg bag of urea, as part of a 'Starter Pack' input package, comprising new seeds as well as fertiliser, and designed to launch the smallest-scale and most vulnerable farmers into the market (Harrigan, 2003). The introduction of Starter Pack, prima facie, was highly effective, as it led to a sharp increase in production (table 2 below); the three-year average of maize yields has now risen to around 2 tons/hectare, or about twice the African average (Mosley 2012: chapter 5). The need to import maize has diminished greatly, with an export surplus in 2006/2007, providing additional food security; however, at the same time, the price of maize has increased, which has altered the profile of poverty, decreasing it for producers but increasing it for consumers, especially consumers who do not have jobs or assets to draw on[15] (Dorward and Chirwa 2011: 232). At the time of writing, Malawi experienced major governance problems in 2010 and 2011 which put aid flows, and thus the continuance of the fertiliser subsidy, at risk , but there is hope, with the election of a new president in 2012, that these problems may have been resolved.

In both these cases, there is nonrigorous evidence that even the subsidies currently in position have had an important role in raising productivity and, thereby, reducing poverty (Table 2). However, in both cases political factors have a had a leading role in the design of the subsidy package and some commentators have stated outright that the new, targeted, systems of input allocation by voucher are still politically tainted. We therefore believe that there is a strong case for including within the ESID programme a study of the political and economic rationale for agricultural input subsidies, which examines the possibilities for increasing the effectiveness of input subsidies by making them 'smarter' and in particular by making them performance-based in a way that is conscious of the distortions which have entered the new voucher systems. Just as performance-based subsidies helped to create the developmental states of South Korea

[13] 'Almost all …fertiliser subsidies of the 21st century pronounce goals of being targeted to poor farmers' (Banful 2011: 1168).

[14] In particular, Branoah-Banful (2011:16) not in biblio alleges that 'more vouchers were targeted to districts that the ruling party has lost in the previous presidential elections and more so in districts that had been lost by a higher percentage margin'

[15] Especially this has caused suffering in the south of the country in districts such as Ngabu, where a quasi-South Asian problem of landlessness is beginning to emerge.

and Indonesia in the second half of the twentieth century, so we feel that the proto-developmental states of Africa in the twenty-first could be assisted by a better understanding of what this instrument of economic policy has achieved and could achieve.

Table 2. Input subsidies and literature on their impact

	Studies	**Sample, study period and methodology**	**Summary of main findings**
Asia:			
Malaysia			
India	Djurfeldt and Jirstrom (2004)	1960s through 1990s	
South Korea	Moore(1985)	Late 1960s to early 1970s	Sharp increase in productivity in late 1970s after subsidies introduced
Indonesia	Djurfeldt and Jirstrom (2004)	1960s through 1990s	Sharp increase in productivity in 1970s after subsidies introduced (they were scaled back and became more targeted in 1980s for macro-economic reasons)
Africa:			
Malawi	Harrigan(2003)	Review of fertiliser policy in the context of overall agricultural policy 1981-2000	In years when subsidies have been (re) introduced, there has been a significant increase in smallholder production (e.g. by 16% in 1991, and by 27% in 1998-99 following the introduction of Starter Pack)
	Dorward and Chirwa(2011)	Makes 'high', 'medium' and 'low' estimates of incremental maize production induced by subsidy over years 2005/6 to 2008/09	Medium estimate suggests that production is, on average, about 600,000 tons above the 2002 level. Although it can be inferred that subsidy has something to do with this, how much this is the case is not formally analysed.
Ghana	Branoah-Banful (2011)	Regression of number of fertiliser vouchers issued on region where issued and control variables.	Accepts that subsidies have become more focussed on lower income groups, but shows that more vouchers were issued in regions which were politically marginal between the ruling and the opposition party.

Taxation

The incidence of taxation on the poor has been very thinly studied: a 2001 report to DFID (Gemmell and Morrissey, 2001: 1) records that 'poverty and/or inequality considerations have received little if any attention in LDC tax reforms'[16], and indeed there exists something of a conventional wisdom, with which we disagree, which suggests that fiscal redistribution should only be carried out on the expenditure and not on the tax side[17]. Some of the few studies of this issue that have been done, both officially by the IMF (e.g. Cubero and Hollar, 2010, on Central America) and by NGOs (e.g. Lashari and Sharpe, 2011, on Pakistan) suggest that the incidence of taxation as a whole is regressive, for familiar political reasons: the rich in developing countries, because of their control over power-structures, global reach, and knowledge, are very good at tax evasion, and more broadly at manipulating governments so that they are not even required to pay taxes. The valuable work on taxation of the two DFID RPCs so far established, CFS and Crisis States Research Centre, does not get to grips with this research gap. Here, we take a case-study approach to five countries comparatively: three African cases within the ESID programme (Ghana, Uganda and Zambia) and two Latin American cases (Bolivia and Argentina). The thrust of the argument is that although, indeed, there is a tendency for LDC tax systems to be regressive, this tendency has been successfully resisted in a number of countries through the application of a number of imaginative ideas which suggest that, here as in other parts of our argument, it may be good politics to be pro-poor.

African cases: Uganda, Ghana and Zambia

In Uganda, Ghana and indeed all the African countries developed on a basis of African smallholder exports[18], the colonial authorities originated in the 1930s and 1940s, as described earlier (page 3 above) the practice of diverting a portion of the on-farm price of export crops away from farmers and into the country's treasury to finance development – a practice which was continued after independence in the 1960s. The proportion thus retained varied according to the state of the markets but in some boom years rose to over 90% of the export price. It was never described by governments of the time as a tax, rather as a 'development levy' or equivalent phrase[19], but so effectively did it function as one that, in Uganda at the end of the 1980s, three-quarters of the government's total public revenue was accounted for by export duties on coffee alone. All exports other than coffee were wiped out by this export taxation [20], which at the same time, being targeted on labour-intensive and mostly low-income rural producers, was highly regressive.

[16] A referee has suggested that this is because of lack of data, rather than because of lack of interest by practitioners and researchers in the issue.

[17] This was suggested to us by a referee as follows: '(The) accepted wisdom says that it is very difficult to raise progressive taxes in developing countries owing to the weakness of tax administration, and the relative informality of business, and as such distributional concerns should be managed primarily on the expenditure side of the budget.'

[18]'Peasant export economies' as described by Myint 1976; this economic structure also developed in Malaysia, Indonesia, and other countries of South and Southeast Asia.

[19]Governments still using this system of taxation in the 1980s included, in addition to Uganda and Ghana, Cameroon, Benin, Togo, Nigeria, Cote d'Ivoire, Congo, and Congo DRC; see Mosley and Chiripanhura 2009.

[20] 'For example, tea production fell from a peak of 20,000 tons in the early 1970s to around 2,000 tons by the early 1980s, and cotton production fell from 87,000 tons to 2,000 tons.' Collier and Reinikka 2001:31.

In 1991, Uganda grasped the nettle of eliminating the export tax and creating in its place a structure of import duties, initially at high rates which were then gradually lowered over the later part of the 1990. In the process, the structure of taxation has been shifted from one almost exclusively targeted on smallholder rural producers, the majority of whom were poor at the beginning of the 1990s, to one much more oriented towards urban consumers, a good number of whom are well off. Thus not only has the 'tax trap' been sprung, but sprung in a pro-poor manner: Chen et al(2001) show that the tax changes of the 1990s led to an increase in the progressivity of the tax system in Uganda[21]. In Ghana, the process of liberalisation, again by contrast with Uganda, has involved not the total removal of the export tax but rather its gradual easing to a level of about one-third of the export price, by comparison with 80% at the beginning of the 1980s.Notwithstanding this, there has been a distinct reduction, since the end of the 1980s, of Ghana's dependence on primary exports for its revenue and a reduction in particular of the fiscal pressure on the cocoa producer, which suited well the political imperatives bearing on the PNDC (later NDC) governments of Ghana in the 1990s, namely above all to capture and retain support in rural areas [22]. Much more than in Uganda, the diversification of tax revenue has been not just into the building up of VAT revenue but also into collections of direct tax from individuals as well as companies [23]. There has even been a broadening of taxation into previously untapped bases such as the informal sector (Joshi and Ayee 2008).

By contrast with Uganda and even Ghana, *Zambia's* economy and therefore its tax system is much more heavily dependent on mining. The President, Levy Mwanawasa, imposed a new windfall tax in 2008 on the profits of the copper companies, explicitly earmarked to be spent on social protection expenditures (Cheeseman and Hinfelaar 2009:65; Lungu 2009), which was suspended in 2009 and then restored in 2011 in the form of a 3% duty on mineral royalties . Proceeds from this tax were earmarked 20% for government spending on health and education[24] and 20% for local councils, with the balance going to community development. In other words, Zambia, having embarked on a promising quasi-Latin American path (some Latin American cases are considered below) of linkage between windfall export taxes and social protection, now appears to be experiencing a 'mineral taxation political business cycle'. It would clearly be to the advantage of investment and poverty reduction if this cycle could be stabilised., and we believe that a great deal can be learned from the experience of Latin American countries, including Argentina, Bolivia, Venezuela and Ecuador, which have also experimented with export taxation partly or wholly earmarked for progressive expenditures and in particular social protection. Taxes of this sort have for the last

[21] See Chen et al (2001) Liberalisation of taxes on smallholder exports has in other African countries with a similar productive structure (in particular Cameroon, Benin, Togo, Madagascar and Cote d'Ivoire) had a much lesser impact on poverty. We investigate this difference in poverty impacts in Mosley and Chiripanhura (2009) and give, provisionally, three reasons for it: better infrastructure, enabling the benefits of crop price liberalisation to be transmitted to small-scale producers; better chemistry with the aid donors, enabling a more stable and productive flow of aid money; and, deriving from this, a more pro-poor expenditure pattern, which built upon a pro-poor asset structure inherited from colonial times (Bowden and Mosley 2012).

[22] 'The NDC… was aware that it was not especially popular in the cities where structural adjustment had produced the greatest pain, but it also knew that the elections would be won and lost in the countryside.' Nugent 2001:410.

[23] In 2003, tax collections from the personal sector in Uganda were 19 billion shillings out of total direct tax revenue of 276 billion shillings, or 6.8 %. In Ghana they were 1535 million cedis out of total direct tax revenue of 3401 billion, or 45 %. (Mosley 2012 table 5.6)

[24] *The Courier*, issue no. XXIII (May/June2011);www.acp-courier.info/taxing-the-mining-in.1497.0.html.

decade been an important element in providing an economic and social basis for the anti-neoliberal, left-of-centre political movement known in Latin America as *neodesarrollismo:* of course they represent a direct challenge to the 'Washington consensus' which is based on the opening of closed economies and , since exports are seen by the Consensus as the key to growth, on the removal rather than the imposition of taxes on exports. Much more covertly and with less use of anti-Washington rhetoric than Latin America, several African countries have also experimented with earmarked export taxes of this sort, again with progressive and sometimes also with decentralising intentions. These countries include Zambia, as discussed above; Ghana, whose attachment of cocoa export duties to 'new-style' import subsidies was described on page 12; and Mauritius, where taxes on sugar exports until the 1990s[25] played a major part in achieving the transition from a primary product-based economy and tax system to a more diversified economy (Bräutigam 2008: chapter 6)

Bräutigam describes the political and governance advantages of the Mauritian export taxes as follows:

Although the sugar industry benefited from extensive rents…these rents never became a resource curse, because they were *earned* by the tens of thousands of sugar planters, collected by the government through the export tax and used to build capacity in the state and in society. The export tax helped the private sector to organise, and it built their capacity to interact with the government. It helped both state and society to solve some of the collective action dilemmas they faced in building skills and supporting research on sugar. It served to underpin the demands by taxpayers for voice and for state employment, leading to a state that was unusually democratic and with an unusually high proportion of local officials at independence.' (Bräutigam 2008: 158; emphasis in original)

The significance of this achievement, of course does not relate to tax structures only. Mauritius is of course the closest thing to a developmental state in Africa: much closer than the more analysed cases of Botswana and South Africa, neither of which has been able to achieve a breakout into export-based manufacturing. These results have not been achieved by adherence to the Washington consensus, but through a structure of performance-based protection which closely approximates the model of the East Asian developmental states (Gulhati and Nallari 1990). Indeed, although most progress towards the remaking of the 'Washington consensus' has consisted of a broadening of the range of policy instruments rather than of new theory, we believe that if it turns out to be possible, under this programme, to design 'smart' export taxes which deal with the revenue problem, the distributional problem and the incentive problem at the same, orthodox trade theory, which outlaws export taxes, will have to be remade. Of course, the politics associated with export taxes on minerals, as in Zambia and Latin America, differs from the politics associated with export taxes on primary exports, as in Ghana and Mauritius. We develop this point further later.

Although the general political advantages of export taxation of this sort have been discussed by a number of commentators[26], no study of any country, to our knowledge,

[25] In 1994, the sugar export tax was replaced with a value-added tax on consumption.
[26] In particular, the IMF has become very interested in the issues associated with export taxation of minerals including oil (Hossain 2003, Sala-i-Martin and Subramaniam 2003, Daniel et al 2010, IMF 2011: appendix VII). But in general, its analysis is of taxation only, and not of taxation linked to public expenditure; nor are

has yet analysed their distributional impact, nor has any study examined the potential trade-offs between short-term political and distributional impact and long-term impact on distribution and growth, and whether this trade-off can be finessed in any way. These issues represent important priorities for the ESID consortium, the more so since two of our partner countries, Ghana and Uganda, have as described pioneered interesting initiatives in earmarked pro-poor taxation.

We may summarise this discussion of pro-poor expenditure and taxation options as follows:

1. The main sectors of public expenditure where there is evidence of high leverage on poverty globally are agriculture (and specifically agricultural research and development), rural infrastructure (and specifically rural roads, including emergency social protection expenditure) and primary education. Increases in military expenditure have a negative impact on poverty.
2. Putting these things together, pro-poor expenditure has a positive impact on poverty and aid effectiveness. Research is needed within the ESID centre to understand the way in which input subsidies can be configured in a 'smart' manner so as to reduce poverty in a targeted manner whilst at the same time maximising investment.
3. The instability of expenditure, as well as its composition, impacts on the well-being of the poor. Research is needed on how elements of public expenditure and the influences on it, such as overseas aid, impact on expenditure instability, and on how such instability could be mitigated.
4. Information on the distributional impact of taxation is particularly thin. In some cases, precisely because the political thrust of taxation in colonial and post-colonial times was urban-biased and anti-poor, the reforms of the 1990s can be seen even without elaborate analysis as pro-poor.
5. The imposition of taxes on large-scale corporations, and the removal of exemptions, is, providing that it does not damage investment, good for poverty reduction; reductions in poverty consequent on amendments to the export tax regime both in Africa (Ghana, Uganda and Zambia at least) and Latin America (Argentina, Bolivia and Ecuador). In the case where these corporations deplete non-renewable natural resources, such taxes provide an environmental as well as a poverty dividend.
6. Building on (5), the ESID centre should research the impact of linkages between export taxation on large companies and the kind of targeted pro-poor payments described above, and the implications of 'smart' export taxes of this sort for trade and development theory.

3. How do pro-poor coalitions form and hold together?

The very idea of 'pro-poor political action' is a little paradoxical because, as individuals, poor people have little ability to change the world by influencing others; nor, as we have discussed, do they anywhere form a coherent or united class with an idea of their common interests and the ability to advance them as a group (Bell 1975: 53; Haggard et

the political consequences of different incidences of taxation and expenditure, and their political impacts on political stability, factored in. It is in particular in this area that the ESID centre can hope to add value.

al 1996:120). Often, indeed, as recent surveys have pointed out, the interests of different groups within the poor are in fact opposed[27]. And yet, political action on behalf of the poor has often been successful, witness the dramatic fall in poverty that has occurred over the last twenty years[28], which has benefited not only the urban groups where development theories of the 1960s and 70s assumed that power in developing countries was concentrated (Lipton 1977), but poor rural people also. How has this happened?

Our story emerges from the two answers originally given by Bell (1975:53)

1. *The elite may fear that, unless they incorporate the poor in their policy-making, they will be pushed out of power*. As DFID note (2011:13) 'exclusionary politics are associated with high levels of violence and poor development outcomes', and the elite, perceiving this, may choose to pre-empt such outcomes by means of inclusive policies. However, if inclusion is wise and exclusion is foolish, even from the point of view of self-preservation, the question then arises why so many elite leaders opt for exclusion rather than inclusion (amongst 21st century examples, Indonesia under Suharto 1997-2000, Bolivia under Sanchez de Losada 2003, and now Libya and Syria 2011 are relevant cases): thus the decision to be inclusive is a gamble, and we need to understand why those who take the conciliatory rather than the hawkish option choose to do so.

2. *The elite may be weak, unable to govern on its own without support, and look to the poor for support.* In cases where (1) does not apply, a weak elite may nonetheless decide that a coalition is the best bet[29], and this focuses our attention on when it is a low-income group that is sought out to be a member of that coalition, and what enables coalitions with low-income groups to endure rather than collapse.

Most of the literature which speaks to these hypotheses is of a case-study, rather than a globally comparative, nature[30] – there is still very little material on what causes weak elites to look to poorer groups to consolidate their position, and what factors successfully enable them to do that[31].

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[27] The most eloquent demonstration of this is by Anirudh Krishna (2009), who shows, with the help of data from Andhra Pradesh, that the entrepreneurial poor who expect to escape from poverty soon tend to make fiscal demands on the state which correspond to their expected future livelihood (including demands for education, transport and other infrastructure such as irrigation), whereas the newly poor make different demands, in particular for better healthcare, whereas the chronic or persistent poor make demands which are different again, in particular wage labour. Krishna(2009):954.

[28] See Hulme(2010)

[29] As noted by DFID (2011:p64) 'It is usually broad based coalitions, not just 'the poor' or 'civil society' that bring about change.' The remarks by Krishna about variations in motivation amongst the poor (note 50 above) are also relevant here.

[30] Case-study literature which examines the scope for forming pro-poor coalitions includes the essay on Tanzania by Therkildsen(2008) which argues that the ruling party, CCM, can be regarded as 'a pro-poor distributional coalition', and this author's *The Politics of Poverty Reduction* (Mosley 2012).

[31] Studies which have attempted to generalise concerning the factors which cause weak elites to look to the poor for support remain uncommon. One study which does attempt this is the paper by Moore and Putzel(2001), which insists that there is scope to increase the political capabilities of the poor at the macro (central government), meso (sectoral or regional) and micro (project) levels, and in particular emphasises that the poor and middle income strata often have common interests. This point has been taken up by observers especially in Latin America, such as Schneider (2004) , who additionally argues that innovation in

In Mosley (2012) we show that elites, even if they do not directly identify with the interests of lower income groups, may still see them as enough of a threat (Indonesia and Russia) or a potential asset (Uganda, Bolivia, Argentina, Ghana) to implement policies which have those lower income groups' interests in mind. We also know that, in some cases, recent experience of conflict (Uganda, Bolivia, Argentina, Indonesia) or simply of economic underperformance and political turbulence (Ghana) can serve as a salutary shock which crystallises a decision by the policy authorities to work within a more inclusive institutional and decision-making framework. However, the sample from which our observations are drawn is quite small, and biased towards countries who have been successful in learning from experience, which argues for caution in making inferences.

However, one gap in our knowledge is pretty clear. This is that, although Argentina, Bolivia, Uganda, Ghana and Indonesia may have learned effectively from misery in the 1990s and 2000s, other countries confronted with identical shocks have not done so, and we do not yet know why. Within the fiscal area, we therefore need to research why elites, confronted with a challenge to their authority:

- sometimes 'take the risk' of sending tax and expenditure signals which are intended to be inclusionary; and sometimes not;
- sometimes send institutional signals (e.g. the creation of the Argentinian *Mesa de Dialogo*, and the Bolivian *Asemblea Constituyente*) which are intended to be inclusionary, and sometimes not.

To send a signal, of course, is not a guarantee that it will be accepted, and if we are to understand why coalitions form, we also need to understand not only why representatives of low-income groups, on receiving such a signal, decide to accept it or reject it. In other words, our research needs to try and understand the bargaining process which leads to a political settlement, and thereby to frame workable generalisations about what kind of atmosphere leads to an inclusive political settlement in which fragile coalitions can become stronger. In terms of likely explanatory variables, this requires us to investigate the role of

(1) Inequality, "especially horizontal" , as stated by DFID's review of politics and governance research (DFID 2011, p34). Langer (2009: 544-545) shows that the possibility of violent political mobilisation in Northern Ghana was obviated by the efforts made by successive (southern-based) regimes to conciliate the north and in particular to encourage the political inclusion of the northern elites. He draws an explicit parallel with Cote d'Ivoire, where the northern elites were excluded rather than coopted and where there has been severe conflict from 2002 to the beginning of the current year (Langer 2009: 545).

(2) democratic political institutions;. Ghana and Mozambique are the prime African illustrations of this, and the theme connects in an obvious way to the component of the RPC which is concerned with institutions and legitimacy[32].

the formation of coalitions is more likely to come about in circumstances of economic crisis 'because the status quo is seen as intolerable', an observation borne out by our discussion of the cases of Argentina, Bolivia and Uganda below. On Latin America, see also the papers by Birdsall et al (2011) and Lopez-Calva and Lustig (2010).

[32] DFID however warn (p14) that 'elections may not be an effective vehicle to achieve lasting elite bargains'.

In terms of methodology, we advocate a two-part approach. In the first place, we believe that in cases where there is a useful institutional lesson to be learned, the universe for case-study analysis needs to be extended beyond the six developing countries (India, Bangladesh, Ghana, Zambia, Malawi) which are currently included within the RPC. In particular, just as there is much to be learned from Latin America in framing pro-poor export tax policies (section 2) so also there is much to be learned from that continent in designing inclusionary political institutions which will improve the relational atmosphere in which fiscal and political discussion takes place. Within Africa, however, the experience of Ghana is also an important beacon here, from which we hope it will be possible to diffuse ideas within the ESID centre. The emphasis in this part of the research should be in understanding what makes an effective pro-poor signal and what institutions constitute good practice which it is desirable to diffuse.

In selected countries within this expanded sample, however, we believe that there is also scope for explicit modelling of the game which causes inclusive political settlements (or 'social contracts') to be reached and to endure, or alternatively to fall apart. The concept of trust is useful here, as the degree of trust between buyers and sellers is certainly an important element in the cost of doing business and thence investment and growth, and by extension trust between the elite and the hitherto politically excluded may well be an important determinant of the interpretation which receivers of signals such as changes in the structure of tax and expenditure, and proposed constitutional changes, put on the signals themselves. There exists experimental evidence which suggests that trust is not a 'primitive' but rather a variable which responds to appropriate incentives, in particular variations in the sanctions available against those who breach a contract, and to variations in the risk efficacy, or assets-to-risk ratio of the truster (Charness et al 2008; Lenton and Mosley 2011) We therefore feel that in a subset of ESID partner countries, it would be valuable to investigate not only the externals of the process by which political settlements were achieved or not achieved, but to conduct experiments and attitudinal surveys on the beliefs and attitudes which determine the bargaining environment which underlies such processes.

4. How can bottom billion countries escape from the low-tax, low-income, weak state trap? (and the role of aid in this trap)

We conclude by examining the politics of the 'tax trap', which is the problem that weak states have weak tax systems, and so cannot easily afford the spending which is required to strengthen the state. As shown by Moore(1998) the lowest-income ('bottom billion') group of countries have not only the lowest tax ratios but also, very possibly because they dare not embark on the politically risky measures required to increase them, the lowest rate of increase of tax revenue. Without escape from this trap, of course, there is no possibility of building a developmental state.

However, escape from the trap is possible. We have seen this in Section 2, in our discussion of Ghana and Uganda. These countries, in spite of being low-income countries with an average per capita income of around $500, nonetheless managed to more than double their tax ratios between 1990 and the present[33], and then to convert that into a pattern of public expenditure which yielded rapid pro-poor growth (Osei et al. 2005, Stotsky and Woldemariam 1997, Gupta 2007). What enabled them, and other such exceptional cases, to do this? In particular, did they confront the political risks associated with increasing the ratio of tax revenue to national income, or did they find a way of finessing those risks?

In Table 3, we categorise developing countries by income and tax ratio. The poorest countries, on average, have the lowest tax ratios (about 13%, by contrast with almost twice that in the upper-middle-income category) , but the dispersion around the average tax ratio in the bottom income group is considerable, and we now focus on the 'outliers' in the lowest income-group: the ones who have although poor been able to escape from the low-tax trap. These include, in addition to Ghana and Uganda, Kenya and Zambia. In the right-hand columns of table 3 we state some hypotheses concerning how they have escaped.

A key determinant of success for the poorest countries has been *ability to escape from a limited tax structure dominated by trade taxes.* In colonial times, the revenue base of developing countries was derived mainly from duties on exports and imports, which were the simplest revenue source to administer. Forty years after the end of colonialism, revenue from trade taxes still accounts for around half of all state income in many bottom billion countries, and this has been a major constraint on development, as the commodities which are most salient in the trade of developing countries have low income elasticities, hence revenue from them cannot be expanded rapidly as the economy expands; also, because their prices are volatile, tax revenue derived from this source is unstable, which is damaging both for the effectiveness of public expenditure and for political stability (Greenaway and Milner 1993). Therefore, a crux for expanding the tax base is the ability to diversify out of trade taxes into a broader mix of revenue sources, in particular taxes on sales, income and capital. This structural shift, as we can see from Table 3, was more effectively achieved by the four 'outliers' than by low-income countries as a whole (It still has a long way to go: for example, in most of low-income Africa and Latin America, taxation on capital assets has made very little progress).

The 'outliers', of course, like the rest of the world, had to find a way round political opposition to the introduction of new taxes, and the fascinating question for this research programme is how this was achieved. We have already observed three ways in which this was done:

- *sequencing* of new taxes so that they were brought in at times when taxpayers were, as much as they would ever be, in a receptive mood because they have just received broad-based cuts in real income, some of them consisting of cuts in trade taxes. Thus, there was little political opposition to the wide diffusion of value added tax (VAT) in Uganda and Ghana in the 1990s, because at the beginning of the decade producers of export crops (cocoa in Ghana and coffee and cotton in Uganda) had received a substantial dividend from an increase in on-farm prices consequent on reduction in export taxation on those crops.

[33] The tax ratio of Uganda was just under 5% in the late 1980s, but increased from this to a stable level of about 12% by the mid-2000s, at which point it has stalled (as discussed further below). In Ghana, the tax ratio increased from 11% to 22% between 1990 and 2007. Data from IMF *Government Expenditure Statistics.*

- *Earmarking* of taxes to expenditure, in particular to social security (Argentina, Bolivia, Zambia, also Mauritius (page 16 above), which made the link between tax payment and the receipt of benefits visible and justifiable to taxpayers;
- *Introduction of a progressive rhetoric and ethos* into the tax system which encouraged compliance. (the approach previously described as 'tax signals', in which the link between tax payments and the benefits derived from expenditure is publicised and illustrated, and the social contract between taxpayers and the state is presented as a necessary part of the construction of a developmental state).

In addition to these three approaches, experiments have been made in tapping new taxes by initiating a dialogue between taxpayers and government, as described for the case of the Ghanaian informal sector by Joshi and Ayee (2008) Beyond changes in tax rates and bases, complementary policies are relevant to explaining these levels of tax effort, for example exchange rate flexibility: African countries with flexible rates have been much more successful than countries with fixed rates in generating increases in tax revenue (Nashashibi and Bazzoni IMF Staff Papers 1992?). Equity is also as a background factor which encourages compliance, just as it encourages the achievement of political stability (section 3 above).

In many cases, the heavy lifting that made possible an increase in tax effort was achieved by reforms of *institutional structure* rather than by changes in policy. For example, the creation of independent revenue authorities, as we saw from our Latin American cases in Section 2, have been associated with increases in tax ratios. In Africa, the introduction of internal revenue authorities is more recent but is also making progress especially in 'outlier' cases (Zambia, Uganda, Ghana; see Table 3) In addition, where closing of loopholes permitting rich people and corporations to go tax-free has been politically feasible (Kenya since 2002, Ghana), that has been very important not only in increasing revenue but in building a pro-compliance ethos (or social contract) that has facilitated further governance reforms.

Table 3. Tax ratios by income category (with 'outstanding performers' separately listed)

	Per capita GDP($) 2009	Tax ratio (average 1980-2009)	Trade taxes share of tax revenue (average 1980-2009)	Independent revenue authorities	Aid/GDP% (average 1980-2009)
Upper middle-income (per capita income>$4000)(n=5)	5456	23.4	10.4		1.8
Lower middle-income (per capita income $1000-$3000) (n=5)	2394	15.2	12.7		6.1
Low income(per capita income<$1000) (n=21)	500	13.2	22.1		11.1
Low income outliers:					
Ghana	670	17.1	24.4	yes	9.0
Kenya	770	18.3	12.0		7.0
Uganda	420	11.0	17.0	yes	12.2
Zambia	950	18.7	16.3	yes	19.5

Source: World Bank, *World Development Indicators.*

So, on the evidence of Table 3, a part of the story is that in the countries we have identified as outliers, governments have escaped from the tax trap by finding it in their long-term interest to vary both the structure of taxation and its administrative environment. As part of the strategy used to achieve this, some agricultural taxation, as in Ghana, Uganda and other countries based on smallholder exports, was radically *cut*. The pill of an increased average tax burden was sugared both by policy and administrative devices, and in both cases the establishment of an ethos of fairness was, we argue, of great importance.

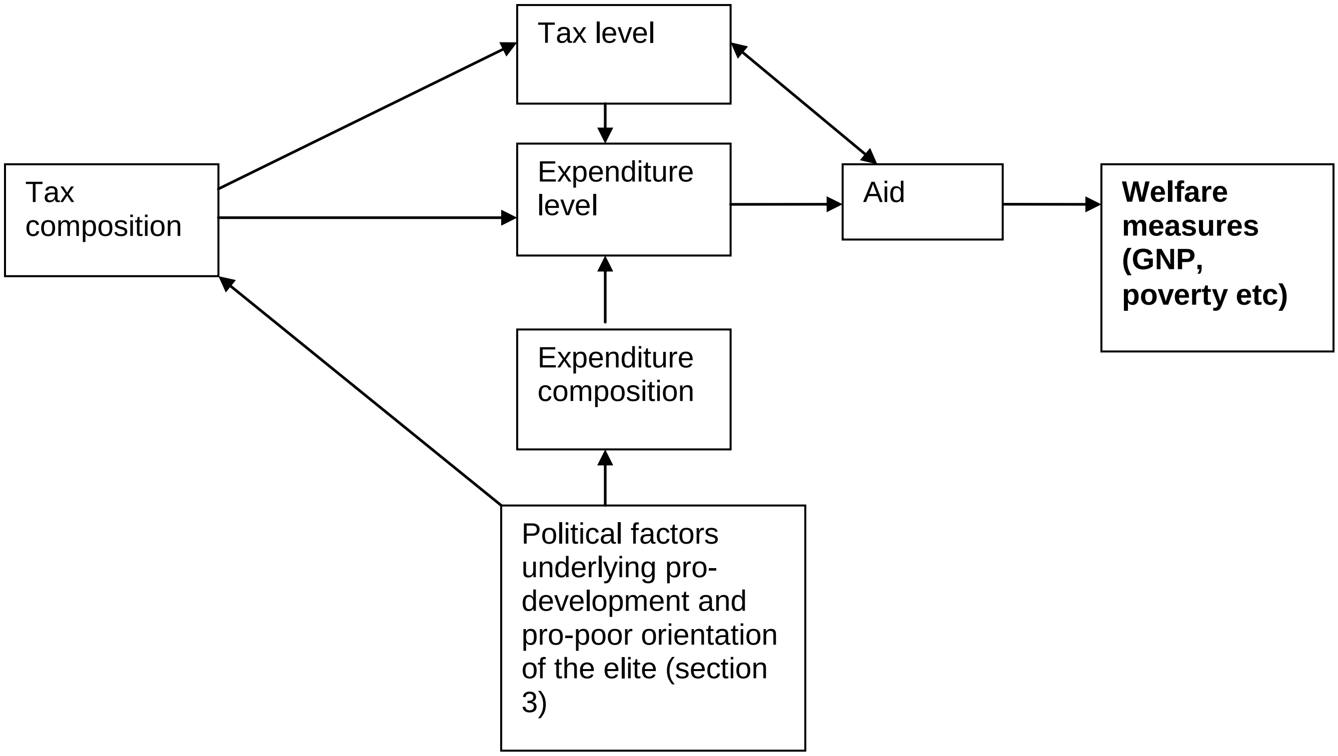
But the question remains, why did some countries find it in their interest to broaden the tax base in this way, and others not? Underlying this question are two political developments of great importance of the last thirty years: the ability of some states (the ones conventionally treated as developmental states) to adopt a long-term time perspective, which acknowledges for example the value of building up a domestic tax base to finance development expenditure rather than depending on aid flows; and the ability of these same states to build broad-based coalitions which, being broad-based, are able to stand up to rather than surrender to the special, often urban-based, interests whose dominance makes the state weak. These issues have been investigated on a case-study basis by, for example, by Bräutigam et al(2008), di John(2008) and Mosley(2012). However, there exists as yet no general story concerning the politics of building developmental states out of weak low-income states, and we argue below that the ESID centre would be an ideal vehicle for doing this.

Part of this process of course is the transformation of aid donors from a liability into an asset for the government revenue base, and this is by no means easy. In Brautigam and Knack (2004) it is suggested, that increased aid flows are associated not only with lower tax receipts but also with worse levels of another indicator of state capacity, namely the ICRG index of corruption. Grossman (1992) has also suggested that 'by making control of the government a more valuable prize, aid may even increase political instability' (quoted in de Haan and Everest-Phillips 2007: 10).The line of thought that emerges from all this is that aid flows, whatever good they may do in the short term, may do harm in the long term by undermining institutions. An argument of this sort can be used to underpin some disturbing recent findings about aid impact, for example the contention of Rajan and Subramaniam(2008) that aid and growth are not correlated, whatever the length of lag that is used[34]. Indeed, the whole horizon of aid-effectiveness studies has recently become clouded, in part by this suggestion that aid may in some inescapable way undermine governance.

Does aid in fact undermine long-term fiscal capacity in this way? If this question could be answered this would contribute not only to our understanding of what determines tax capacity but to our broader understanding of the causes of poverty. In our background paper, Mosley (2011) we begin from one of the fundamental insights of the Haggard and Kaufman (2008) study – that tax capacity determines the ability of governments to finance social programmes and thus reduce poverty. To that idea we add two findings from earlier on in this paper, namely that expenditure composition is important in determining poverty impact (pages 6-12) and that, as just discussed, the composition of taxation and in particular the ability of governments to diversify out of their traditional dependence on trade taxes may be important for determining governments' ability to expand public revenue. These ideas can be assembled to generate Figure 1:

[34] We stress that Rajan and Subramaniam do not use this argument to explain their findings. In Rajan and Subramaniam (2009) they suggest instead a Dutch-disease causal mechanism.

Figure 1: Causal links in a model of aid, expenditure and taxation



In common with de Haan and Everest-Phillips (2007) we see it as important to see donors as political agents, and we would add on the basis of the preceding discussion that it is important to see taxpayers also as political agents in order to understand the possibilities for escape from the tax trap and in particular the reasons why some very poor countries, in spite of the temptation to substitute aid for tax effort, spurn that temptation and manage to escape. We find that various political-economy factors, including the shock of recent conflict, the inclusiveness of the elite (as previously discussed) and the quality of the technical-assistance relationship with the IMF and other parties, help to determine tax effort, which in turn determines expenditure possibilities, which determines growth and the effectiveness of aid as in Figure 1. Our analysis, still highly provisional, indicates the following preliminary conclusions (Mosley 2011: tables 2-4).

(1) Growth and poverty reduction capacity are influenced by the composition, as well as the level, of expenditure flows (following the argument of section 2 above).
(2) Expenditure capacity is influenced by revenue generated, holding constant other determinants of expenditure ceilings including macro-budget constraints, democracy and strategy factors determining the ability to government to chart a palatable way around the inevitable opposition to increased taxes (pp52-53 above).
(3) Tax revenue is determined, following the argument of this section, by tax composition and administrative capacity. It is also influenced by aid; however, the impact of aid on tax is much more complex than the simple crowding out effect

visualised by Brautigam and Knack. The relationship is a two-way, interactive one, and its outcome is determined not only by the Knack-Brautigam 'crowding-out' effect, but also by the magnitude of two more positive impacts, namely the direct effect of technical assistance by donors into tax design, the strategy factors discussed in (2), and the indirect effect of aid on tax revenues via growth.

(4) Therefore the size and composition of taxation and their consequent impact on public expenditure are crucial to understanding the impact of aid on growth, including that part of the impact which works through the link from aid to tax revenue. As it happens, we arrive, using plausible lag-structures, at a more optimistic estimate of the impact of aid on growth than do Rajan and Subramaniam. In common with other commentators such as Arndt et al(2009) and Minoiu and Reddy(2010), we find a mildly positive long-run effect of aid on growth.

However the crucial issue is not this soundbite, but the dependence of the size of the impact on fiscal behaviours. We hope that our exploration of these behaviours can help make aid donors, including DFID, more effective in their operations.

5. Conclusion

As stated in the prospectus to the ESID programme, our aim in this research is to identify the political processes which will enable developing countries to achieve improved access to services, and more committed and accountable states. This paper has focussed on the fiscal element of those processes, and has identified three major territories needing to be researched: effective targeting of public expenditure, the creation of coalitions which include the poor, and ways of exiting from the 'low-tax, weak-state' trap.

Within these territories we have identified, having regard to ongoing complementary research, eight pieces of work which fill gaps in that research, and would assist the ESID centre in its task of reinforcing low-income states through evidence-informed policies. In Table 4 below we list these tasks in the form of propositions needing to be tested, and show how they emerge from the existing literature.

In the first territory, *making public expenditure and taxation more pro-poor in their impact,* we have seen that where markets for critical inputs fail, subsidies which make those inputs available have been a critical tool in creating the developmental states, first of Japan and Brazil in the first half of the twentieth century, and then in the Far East in the second half. In bottom billion countries, subsidies have been less effective; but they are now proving their worth. The challenge for the future (task 1) **is to design them in forms which strengthen the state by allocating subsidy in forms which are 'smart', that is, improve equity and efficiency at the same time**. Another strand we have observed in the expenditure literature is that, as noted in the Malawi case above, expenditure instability damages effectiveness and indeed may make the state itself more fragile. A part of making the state more stable in a political sense, indeed, consists (task 2) of **making it more stable in an economic sense by reducing the volatility of government expenditure**. Since, in bottom billion countries, a large part of public spending is financed by aid, this task inevitability brings the issue of controlling aid volatility into play.

In the last ten years there has been a great upsurge of literature on taxation and its role in securing the state and making it developmental. However, very little of this literature has been explicitly devoted to the redistributive role of taxation. The recent experience of Latin America in particular, has shown that export taxes, however, can both be revenue-increasing, progressive and at the same time 'smart', by introducing appropriate efficiency incentives. **A main research challenge facing this research consortium (task 3) is to find out whether this can in fact be achieved**. If that can be done, the possibility on the horizon is that contributions can be made not only to political economy but to development economics, by defining a set of principles by which export taxes can contribute both to equity and to a more competitive economy.

In the second proposed research territory, *reinforcing pro-poor coalitions,* the literature has profusely observed that poor people, not anywhere constituting a cohesive interest group with its own strategy for advancing the interests of the poor, risk being politically marginalised. The experience of the last twenty years suggests in fact that pro-poor coalitions do often form. But we have few systematic findings on what initial conditions cause such coalitions to form, and our first recommendation within this territory (task 4) is that **research of this kind, to explain the ways in which pro-poor coalitions form is needed as a precondition for good policy design**, probably involving a larger sample of study countries than simply the case-studies contained within this RPC.

The next question is what (fiscal) incentives can be provided to encourage pro-poor coalitions to form, and here also we are on uncertain ground. However, one possible way forward is to focus on the *composition of public expenditure.* Our companion paper, Hudson, Lenton and Mosley (2011) argues that every variation in the composition of public expenditure changes the balance between those who gain and those who lose from the continuance of current policies – and thereby the likelihood of both conflict and poverty reduction. This yields the concept of the *social efficiency wage* – the rate of social wage, or public spending, which most effectively buys off the risk of conflict and political instability – and the related concept of *pro-poor expenditure* – the level and mix of public spending which maximise the poverty-reducing impact of public expenditure[35].

This raises the issue of the mechanisms through which variations in the expenditure, or taxation, mix can be used to deliver changes in well-being and in state cohesion. To make a preliminary distinction, a change in the fiscal mix (say a shift from spending on military purposes to spending on agricultural research, or a change from taxation on the rich to taxation on the middle class) has an obvious economic impact, through its influence on demand, employment and thence on well-being, and at the same time a political impact by altering the balance between interest groups. **We believe that the impact of expenditure and tax mixes, both through economic impacts (task 5) and through political and institutional signals (task 6), on state capacity represents an unexplored territory for development research, and would hope to investigate it further under this programme,** using not only standard qualitative and quantitative methods but also experimental methods. These have proved valuable in explaining the influence of conditional cash transfer programmes on trust and intracommunity

[35] As the political leverage of the poor increases, so the level of the social efficiency wage converges on pro-poor expenditure.

relationships in Colombia (Attanasio et al. 2009). A particular way in which they add value is by showing that conventional incentives (providing more money) are often ineffective and may be counter-productive as fiscal incentives intended to change behaviour (Bowles 2008).

In the third research territory, *Escaping from the low-tax trap,* we build on ground broken for us by, in particular, the Centre for the Future State (CFS) and the Crisis States Research Centre (CSRC). It happens that two of the partner countries within the ESID centre, Ghana and Uganda, are both 'positive outliers' from the general pattern of state weakness and low tax capacity within bottom billion countries. We wish to build on this experience, and indeed use it for capacity-building purposes. **We propose (task 7) to examine the role of institutional changes (such as independent revenue authorities), sequencing of tax and expenditure reforms, equity-based reforms (such as closing of tax loopholes) and innovative new tax bases in escaping from the tax trap, using both case-study evidence from escapees and cross-country evidence.** This research strategy has not been used, in the form of comparative quantitative analysis, by either CFS or CSRC.

Finally, aid donors have been argued by some studies (including one from CFS) to contribute to the 'low tax, weak state' problem, by reducing the incentive to governments to build up tax revenue, because aid flows with lower political costs are always there as an alternative. Some commentators have expanded this approach into a broader critique of the 'institutional damage' done by aid flows to the recipient country state, arguing that aid increases corruption as well as weakening the tax base. This may connect with recent empirical work which suggests an insignificant correlation between aid and growth. **Our proposal (task 8) is to tackle these ideas head-on by examining the relationship between tax structure and level, expenditure composition and level, aid and ultimate development indicators (growth and poverty).** This brings together the fiscal work proposed to be done by the ESID centre on tax, expenditure and aid.

Table 4. Summary of findings and recommendations for action

Area of research	Findings so far	Testable propositions to be researched within this RPC
Making public expenditure and taxation more pro-poor:	*Public expenditure:* rural roads, agricultural extension and research in smallholder areas are almost always pro-poor; primary education and health are usually pro-poor but vary by region in their degree of targeting effectiveness; military expenditure is generally regressive and often conflict-producing.	
	Specifically in the form of subsidies, public expenditure has often had a crucial role in	1.*Smart input subsidies:* assess effectiveness of existing input subsidies as applied in Malawi and

	removing market imperfections; but its effectiveness has often been diluted by inefficient special interests, including in our case-study countries. Ways need to be found of targeting subsidies and making their disbursement performance-related. (Where subsidies are self-targeting, as with a number of public expenditure schemes, the first problem solves itself.) Instability in public expenditure is often productive of political instability as well as low expenditure productivity. *Taxation:* much recent research has demonstrated the importance of building the tax base in order to strengthen the state. In several cases, notably in Latin America but more recently extending to Africa, export taxes linked to pro-poor expenditures have involved middle-income taxpayers as stakeholders, as well as simply raising revenue.	Ghana, having regard to the political pressures described in this paper (pages 12-13 above) and the trade-off between political (state-building) and economic (productivity maximisation) motives for subsidy. Then use these studies as a platform for designing 'smart subsidies' which more effectively combine equity and efficiency objectives. 2. *Measures for reducing expenditure instability:* Investigate, in with reference to case-study countries, political and economic costs and benefits of making public expenditure more stable, highlighting the link between instability of aid and of public expenditure, and illustrate modalities by which it can be made more stable. 3. Assess the pro-poor impact of earmarked natural resource taxes of this sort. Building on this, examine whether *smart export taxes linked to social protection expenditures, especially on natural resource exports,* can introduce appropriate incentives to competitiveness, as well as simply be revenue-increasing; and the implications of this for the orthodoxy of development economics.
Reinforcing pro-poor coalitions:	Although poor people on their own have little political leverage, they can derive leverage, either directly by combining with others to threaten to undermine the state, or indirectly and more positively by presenting themselves as credible partners in a coalition which helps to sustain a weak elite. 'Learning from misery' has been	4. Investigate on a case-study basis how coalitions involving the poor form, and what keeps them stable. In particular, examine the role of 'environment' variables such as inequality and democratic rights in determining the outcome of the bargaining process by which political settlements are determined.

	a powerful force inducing coalition-building settlements incorporating the poor in this way (e.g.Uganda, Argentina, Bolivia, Ghana). Pre-emptive fiscal (e.g. social expenditure)measures may be valuable to prevent contagion (e.g. Indonesia, and Russia in Caucasus) Changes in the tax and public expenditure mix influence well-being both through economic channels and through 'political signals' which define the interests with which the elite is identified. Institutional signals to advance the rights and interests of disfavoured regions and groups may be crucial in counteracting horizontal inequality (CRISE and others).	5. Examine impact of expenditure mix (possibly also tax mix) on sending pro-poor signals, using both 'conventional' (qual/quant) methods in all case-study countries and experimental methods – involving the collection of new interview data - in a smaller sample. 6. Examine the impact of institutional reform on signals sent by fiscal reform – using the same mix of methods indicated under 5 above.
Escaping from the tax trap:	Low income and low tax receipts are strongly correlated; many commentators (notably CFS) have interpreted this as a causal relationship, arguing that the weakness of the state in low-income countries discourages tax effort. One additional factor in deterring the build-up of the tax base is argued by some (including CFS) to be aid flows. Some empirical work of the mid to late 2000s suggests aid has no impact on growth; some commentaries interpret this in terms of a positive short-term impact of aid being undermined by a negative medium-term institutional impact. Our own pilot research (Mosley 2011) suggests that tax *structure* and expenditure composition, as well as the levels of these variables, are important in determining aid effectiveness.	7. Examine characteristics of outliers who escaped from this vicious circle (notably Ghana and Uganda, within this research partnership, but in relation to a comparison group of other bottom billion countries). 8. Apply robustness tests to the experimental analysis of the aid-tax link presented here, and derive implications for fiscal policy.

We therefore recommend these eight activities for inclusion in the ESID centre's work programme. In most cases this work can be done by collaborative work between partners within the RPC, but in two cases (proposal 3, on 'smart export taxes' and proposal 6 on institutional signals) many of the initiating ideas are from Latin America and it may be desirable to carry out some case-study work there also.

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