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# TAXATION, DEMOCRACY AND STATE-BUILDING: HOW DOES SEQUENCING MATTER?

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## **Taxation, Democracy and State-Building: how does sequencing matter?**

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## **ABSTRACT**

What is the relationship between democracy and taxation, under conditions of ‘reverse’ sequencing? Existing theories about taxation and democracy have presumed this relationship to be positive, but they have largely been predicated on the West’s historical evolution where the state became strong before it became democratic. The ‘reverse’ sequencing most developing countries are experiencing – democratizing before they consolidate their statehood – may have important implications for their ability to tax. The paper argues that taxing in a context of weak state capacity necessitates state-building with intrinsically coercive elements, as citizens have few incentives to voluntarily comply. The paper hypothesizes that democracy reduces the ability of the state to coerce and that this has implications for how it can tax. The empirical section uses a most similar systems design to compare a democracy, Lesotho, with an autocracy, Rwanda, demonstrating how the mechanics of this process operate: how governments incentivize bureaucracies into certain kinds of tax collection, depending on regime type; how this then affects the different levels of state-building activities the tax authority engages in; and how this cumulatively impacts on tax outcomes.

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## Introduction

Research on the relationship between democracy and taxation has yielded some of the most rich theoretical insights within political science. Raising tax has been shown to create a fiscal contract between citizens and state, mirroring the democratic compact and giving it substance. The idea that tax gives citizens a degree of power over their rulers, and a chip with which to bargain, is deeply embedded. Tax is thought to lead to demands for democracy, and democracy to legitimate and enhance the efficiency of tax collection. They are seen to be mutually reinforcing processes.

Although the historical evolution of Western states has provided ample empirical evidence to support the positive relationship between democracy and taxation, recent work has produced ambiguous results. A number of quantitative studies have sought to establish the impact of regime type on taxation using a sample of developed and developing countries, but they have found contradictory results (Cheibub, 1998; Fauvelle-Aymer, 1999; Boix, 2001; Thies, 2004; Ross, 2004). This lack of empirical confirmation constitutes the puzzle this paper tries to address: why is there so little evidence for a positive impact between democracy and taxation today?

One of the reasons why this critical relationship may not be operating as we expect could derive from the fact that most developing countries are currently experiencing a process of 'reverse' development. A number of authors have pointed out the fact that developing countries today are democratizing before they consolidate their statehood, and hence are following a 'reverse' institutional sequence to the one which unfolded in the West, with implications for outcomes (Huntington, 1968; Mansfield & Snyder, 2007; Fukuyama, 2007). The importance of the timing of democracy in state-building has so far received little analytical attention, especially in research on the relationship between democracy and taxation. This prompts the key research question addressed in this paper: What is the relationship between democracy and taxation, under conditions of 'reverse' sequencing?

In trying to answer this question the paper draws on a central insight of the sequencing argument, by seeing taxation firstly as a function of state-building and only latterly as a function of state society relations. In a developing world context, where states are generally weak and the tax net small, citizens have few incentives to voluntarily comply, as free-riding is easy and the services received in return are poor. As this is the case, the state must first acquire the coercive capacity to force everyone to pay before it can convince them to do so consensually. When taxation is seen in

this way, as being firstly about extending the reach and control of the state, it becomes clear that democracy, which gives citizens a greater capacity to resist these processes, may have an important impact on taxation, though not the positive one that we have come to expect. The paper hypothesizes that democracy reduces the ability of the state to coerce and that this has implications for how it can tax.

The paper proceeds as follows: the next section gives an overview of the existing literature on the relationship between democracy and taxation. It emphasizes how this literature, mostly predicated on the West's historical experience, has predominantly seen taxation as a function of state-society relations, rather than state-building. The next section advances an initial theoretical discussion of how democracy might impact on the mechanics of tax collection, under conditions of reverse sequencing. It argues that democracies seek to maximize tax collection, with minimal coercive state-building. The empirical part of the paper presents a comparison between one democratic African state, Lesotho, and one autocratic one, Rwanda, to show how differences in regime type impact on the operations of tax authorities and resulting tax outcomes. The paper concludes by considering the implications of the findings.

## **Democracy and Taxation**

The existing literature on democracy and taxation has primarily considered one direction of causality – that from taxation to democracy – and done so on the basis of the historical trajectory of countries in the West. Tilly traced the origin of the revenue imperative, and the development of the state, to the need to go to war (Tilly, 1992). Rulers, needing revenue to fight, had to raise tax, which necessitated the construction of the extractive infrastructure of the state. Brewer showed exactly how the need to collect tax led to the expansion of state capacity in early modern Britain, as the King began developing a Weberian bureaucracy in order to collect excise taxes (Brewer, 1988). This expansion of power increasingly brought the state into conflict with citizens, who demanded concessions, in the form of representation and services, in return for taxation. They wanted a say in how their money was spent and how this emerging bureaucratic power related to them. The link from taxation to representation has been clearly theoretically explored through these historical processes, and neatly summed up in the demands of American revolutionaries that there be ‘no taxation without representation’.

Useful as this literature is in outlining the mutually constitutive character of taxation and state-building, the relationship between these variables and representation is embedded in a particular historical trajectory of institutional sequencing followed by states in the West, but arguably very different from that being followed by developing countries today. As a number of authors have noted, most states in the developing world are following this sequence in reverse: they are democratizing before they have fully consolidated their statehood (Huntington, 1968; Mansfield & Snyder, 2007; Fukuyama, 2007). While in the West the emergence of representative institutions were in many ways a response to the expansion of the state, both in bureaucratic and fiscal terms, and so came after, many developing countries are democratizing first, before they have constructed 'an orderly administrative powerbase' (Mansfield & Snyder, 2007, p. 59). This sequencing prompts questions about the reverse causality – from representation to taxation.

Many authors have argued for a positive relationship between tax and democracy as they have seen tax as a function of state-society relations. The existence of a fiscal bargain at the heart of the relationship between citizens and rulers has been demonstrated in cross country regression analysis (Ross, 2004); using citizen surveys (Fjeldstad, 2004); and experimental methods (Cummings et al, 2005). As democracy alters state-society relations, and taxation is a function of this relationship, it is hypothesized that democracy should have an effect on tax outcomes. Since the changes wrought on state-society relations by democracy are positive – opening political space for opposition, giving citizens more voice, creating mechanisms of accountability, and placing constraints on rulers - its impact on taxation should also be positive. It should, as Levi argues, reduce the transaction costs of taxing by making compliance 'quasi voluntary' and by building 'tax morale' (Levi, 1988; Pommerehne, Hart & Frey 1994). Citizens should be more willing to enter into a fiscal contract with the state, as they have more control over its actions and greater belief in its legitimacy (Levi, Sacks & Tyler, 2009).

However, the theoretical case for a positive relationship between tax and democracy has not received emphatic empirical confirmation. A number of quantitative studies have sought to establish the effect of regime time on the overall level of taxation. In one of the earliest studies, Cheibub found no significant evidence that regime type had any effect (Cheibub, 1998). A later study focused only on developing countries, found that democracies were better at taxing (Thies, 2004), while another found the opposite result (Fauvelle-Aymer, 1999). Boix did find support for the suggestions that democracies tax more, but only for countries above a certain income threshold

(Boix, 2001). The empirical literature provides no clear answer on what the relationship between democracy and taxation is, but confirms that a straightforward positive relationship cannot be assumed.

Emerging qualitative evidence from contemporary developing world contexts also raises questions about the assumption that working out a fiscal contract either necessitates democracy, or that increased taxation is always the outcome of democratic bargaining. As Bernstein and Lu have shown, increases in local taxes in China sparked protests that led to changes in how local government operated and the abolition of certain forms of tax, but within the context of an autocratic state (Bernstein & Lu, 2008). In East Africa, onerous local taxes, in a context where democratic opening had created an increased space for mobilization, sparked protests that led to the abolition of controversial poll taxes (Fjeldtad & Therkildsen, 2008). In this example, the positive changes brought about in state-society relations by the emergence of democratic institutions had a negative impact on tax outcomes. Rather than strengthening the fiscal contract, it enabled people to opt out of it altogether.

At both the macro and micro level there is a paucity of evidence to support the contention that democracy has a straightforwardly positive impact on taxation. This is theoretically surprising to those who have seen taxation as a function of state society relations. However, this result is more understandable if taxation is seen as, primarily, a function of state-building. The literature on the evolution of the West emphasizes how taxation firstly led to state-building, and only secondly – as the state became more powerful – to improved state-society relations. In accentuating how democracy leads to ‘voluntary’ aspects of compliance, existing accounts often skim over the fact that it is still *quasi-voluntary*. The capacity to force citizens to pay still lies at the bottom of the fiscal contract. This is even more the case in developing countries, where most people are outside the tax net, and the compliance issue is about bringing them within the net, and into the control of the state.

This paper attempts to address the lacunae in the existing literature in a number of ways. Firstly, most studies on the relationship between democracy and taxation have downplayed the role of state-building in taxation and consequently paid little attention to the tax authority as a key actor in this process. They have focused on rulers, and their motivations; societies, and their cleavages; and the relations between the two. Secondly, as a result of leaving out the bureaucratic institutions, and

seeing taxation primarily as a function of state-society relations, they have overlooked the mechanics of what you must do to collect tax, and so too the character of that process – as inherently coercive and often conflictual. Thirdly, they have been primarily concerned with the overall levels of taxation – how much tax is collected - rather than its structure – where tax is being derived from. This paper attempts to address these weaknesses by focusing specifically on *how* democracy impacts on the way in which tax authorities go about the process of collecting tax and how this then maps onto the overall structure of taxation that result. The next section outlines the main theoretical arguments.

## **Taxation and the Political Constraints on State-building**

In order for a tax authority to be able to collect tax from its citizens it must; know who is eligible to pay tax; register them; ensure they know how to pay; secure the borders – both external and internal – so no one can slip through the net; acquire the capacity to monitor and enforce compliance. In other words, they need to consolidate their knowledge of and control over citizens. It is not coincidental that we use the term ‘tax net’: to function effectively, the tax authority must have the ability to catch people and must be able to minimize their chances of escape.

These tasks, the mechanics of tax collection, are very challenging in a developing world context, not only because of a context of underdeveloped economies, but also unconsolidated statehood. The low reach of the state, and its inability to broadcast power, has been singled out as one of the key characteristics of weak states (Herbst, 2000). Large territories, with low population densities, long and porous borders, and very large informal sectors, means that the ‘net’, in a developing world context, has many holes, and bringing people within it is a significant challenge. This results in a situation where only a tiny fraction of the population is actually registered with the tax authority. In Namibia, for example, there are 200,000 individuals and 15,000 companies registered to pay tax, which is a relatively high figure compared to other less developed African countries, but less than 10% of the Namibian population (Hansohm, Schade & Nephembe, 2002).

In this context, where states are weak and the tax net small, citizens have few incentives to pay tax. On the tax side of the fiscal contract, the fact that so few people are within the tax net and the state has a low ability to enforce compliance, means the opportunities to free-ride will be high. Rational individuals will therefore choose not to pay (Allingham & Sandmo, 1972). On the services side of

contract, a poor capacity state has a lower ability to deliver effective services in return for taxation. Again, a rational individual will try to avoid paying tax and instead seek services in the private sector. On both sides of the equation, then, poor capacity states are trapped in a low efficiency equilibrium where the incentives to pay tax are very low.

Seeing tax in these terms – as a classic collective action problem – highlights how the route to revenue raising is through state-building: the state must first have the ability to coerce everyone to pay, before it can convince them to do so consensually. In this sense, the collection of taxes in developing countries is not ‘quasi voluntary’ but rather ‘quasi coercive’ and the key task of the revenue authority is as much to extend the control of the state as it is just to collect taxes.

This paper hypothesizes that democracy reduces the ability of the state to coerce and extend its control by increasing the ability of citizens to resist these processes. If you increase the ability of citizens living in such a low capacity state to bargain over tax, the rational choice for them is not to negotiate how much tax to pay, but rather to choose not to pay at all. Democracy increases the space for citizens to bargain with the state: improvements in civil liberties enable protest and contestation; competitive elections make politicians responsive to the preferences of voters; constraints on the executive curtail the power of the state. If they have a greater ability to bargain, but cannot trust the state to have the power to make everyone pay then, regardless of the state’s own character, they have few incentives to consent and more to resist or opt out completely.

The advent of democracy before states have consolidated their ability to control will then have serious implications for how that state can collect tax. Governments in democracies will be more constrained in their ability to target taxes that are more politically sensitive and that involve higher degrees of state-building. In other words, their preference will be to maximize tax collection, with minimal state building. Governments in autocracies will face lower constraints in undertaking state-building activities, and in fact may even have incentives to do so. They can maximize tax collection, with maximum state-building.

If these are the political realities that governments face, how do they transfer these incentives and constraints to the tax authority? Much of the existing literature assumes that this is an automatic process, where the bureaucracy is the agent of government, directly translating their will into reality. This paper does not make that assumption. Instead it proposes that, although most tax authorities

are nominally autonomous from the rest of the civil service (Fjeldstad & Moore, 2009), governments have devised ways to incentivize them into specific modes of tax collection. As well as the ad hoc interference by governments to use tax authorities to reward allies and harass opponents that has been noted in some countries (Therkildsen, 2004), governments take long-term measures to inscribe their own objectives into the incentive structures within which revenue authorities operate. Democracies design incentive structures to constrain the state-building impulses of revenue authorities, and autocracies design ones to enable it. Although they are not straightforward puppets, tax authorities are malleable, especially in the early years after their establishment, and governments in both democracies and autocracies mould them towards their own ends.

If governments have effectively transferred the constraints they face in engaging in coercive state-building to tax authorities, then they should be observed to be taxing in different ways. Tax authorities in autocracies should be observed to be more aggressively active in expanding the reach of the state; controlling borders; expanding operations into the periphery; penetrating the informal sector; setting up capable enforcement mechanisms – in both auditing and prosecution; increasing taxpayer registration; and using taxpayer education as a tool of broader state-building projects. Tax authorities in democracies should be observed to be less active in these activities, and more focused on extracting the maximum revenue from the least politically sensitive areas.

These operational differences should also then map onto differences in overall tax structure. Some forms of taxation, such as direct taxation need more intensive state-building activities. Indirect taxes also require high levels of activity, especially where there are multitudes of small businesses, often with poor literacy and book keeping capabilities. These are also the most politically sensitive kinds of taxation as both are highly visible<sup>i</sup>. In contrast, taxes on trade, natural resources or tourism, for example, are not as visible to citizens, and they are more ‘lootable’ – they require less intensive state-building efforts. Putting these pieces together it should be the case that democracies will try to maximize revenue collection from the least politically sensitive taxes and will have a lower ability to change their tax structure over time towards direct and indirect taxes. Autocracies will not be similarly constrained and can maximize revenue across tax types and change the tax structure over time.

**TABLE ONE: SUMMARY OF THEORETICAL ARGUMENT**

	<b>Democracies</b>	<b>Autocracies</b>
<b>Ability to engage in coercive state-building</b>	Lower	Higher
<b>Incentive Structures</b>	Designed to constrain state-building	Designed to enable state building
<b>Observable Indicators</b>	Less aggressive taxpayer recruitment Lower penetration of the informal sector Lower efforts to extend reach into the periphery Weak enforcement mechanisms	More aggressive taxpayer recruitment Higher penetration of informal sector Higher efforts to extend reach into the periphery Clear enforcement mechanisms
<b>Impact on Tax Structure &amp; Levels</b>	Higher dependence on 'lootable' taxes Lower rates of increase in direct and indirect taxes	Lower dependence on 'lootable' taxes Higher rates of increase in direct and indirect taxes

Table One summarizes the theoretical propositions thus far. Democracies have a lower ability to engage in coercive state-building than autocracies. Governments consequently create incentive structures for Tax Authorities designed to to either constrain or enable state-building. These different incentives then create different kinds of operational behavior: Tax Authorities in democracies can be observed to be engaging in less coercive state-building than democracies, as measured by the indicators listed below. This cumulatively has an effect on tax outcomes, creating higher dependence on 'lootable' taxes and lower rates of increase in direct taxes in democracies than in autocracies. The next section uses this table the template for testing the propositions put forward with a case comparison of Rwanda and Lesotho.

## **Revenue Authorities and State-building: Comparing Rwanda and Lesotho**

To test the effect of democracy on how tax authorities operate and resulting tax outcomes, the empirical section of the paper uses a 'most similar systems' comparison between Rwanda and Lesotho (George & Bennet 2005; Tarrow 2010). The claim that these two countries are most similar requires some justification. The following section compares Rwanda and Lesotho in terms of key economic, administrative and political variables to show that, in as much as possible, they are similar in terms of the usual explanations of tax structure and collection, and different in terms of the key political variable of interest – levels of democracy.

Both Rwanda and Lesotho are small, landlocked African countries that are broadly comparable in terms of the size and structure of their economy. Their GDP per capita, US\$334 and US\$470, mean that both countries are classified by the World Bank as Least Developed Countries. They are also broadly comparable in terms of employment diversity and sectoral structure, although Lesotho is somewhat more diversified. In Rwanda in 1989, 90% of the population was employed in agriculture, 3% in industry and 7% in services<sup>ii</sup>. In Lesotho in 1999, 72% of the population was employed in agriculture, 9% in industry and 18% in services. Although there is an 18% difference between the two countries, in both cases it is clear that the great majority of people are employed in agriculture. Neither country has significant natural resources. However, there is a very big difference in terms of levels of trade. Lesotho is over three times as reliant on trade as Rwanda. The implications of this are discussed further in footnote 11. At this point, it is fair to say that Rwanda and Lesotho are broadly comparable in terms of the size and structure of their economies, other than the fact that Lesotho has much greater levels of trade.

Other variables matter for taxation, particularly how the tax authority is organized. Both the LRA and the RRA are autonomous revenue authorities, established within the last fifteen years: the RRA was set up in 1998 and the LRA in 2003. They both have very similar governance structures and internal organization. This, in a large part, reflects the diffusion of best practices and New Public Management principles throughout the newly established tax authorities in Africa (Fjeldstad & Moore, 2009; Hirschman, 2011), and is a result of the fact that both have received significant financial and technical support from DfID. These factors combined mean that the administrative structure of both authorities is very similar. They both have a board of governors composed of four representatives from the relevant ministries, three representatives from the private sector, and one from the central bank. They have both reformed their internal operational structure to conform more closely to the international norms, with departments based on functions rather than tax heads.

Rwanda and Lesotho may be broadly comparable in terms of economic and administrative variables. Where they do differ significantly is in terms of the key independent variable of interest: regime type. Lesotho is a constitutional monarchy, deemed by Freedom House to be ‘partly free’ and with a Polity IV score of 8. Democracy in Lesotho is far from fully institutionalized, and has not delivered a change in government, but elections are regularly held, are deemed free and fair, and the opposition is strong and active. The aspects of democracy that matter for the theoretical

argument, electoral competition and civil liberties, are present. Rwanda is a presidential republic, classified by Freedom House as ‘not free’, and with a Polity IV score of -4. Since the Genocide, Rwanda has been ruled by the Rwandan Patriotic Force<sup>iii</sup>. All other serious opposition parties have been banned, opposition candidates arrested and even, in one case, assassinated (Freedom House, 2010). Although elections are regularly held, the widespread suppression of the opposition means that Rwanda is very far from democratic.

The empirical analysis which follows assesses the extent to which these differences in political institutions have impacted on how the tax authorities go about collecting tax. It begins by showing how governments incentivize bureaucracies into certain kinds of tax collection, depending on regime type; then demonstrates the ways in which this affects the different levels of state-building activities the tax authority engages in; finally it shows and how this cumulatively impacts on tax outcomes. Within each section the analysis triangulates evidence from interviews with senior officials and experts, in both the RRA and LRA, conducted in 2009, with detailed process tracing using primary documents, most particularly the annual reports of both authorities, as well as independent evaluations.

## **Explaining Different Levels of State-Building: The Incentive Structures of Revenue Authorities**

Both the Rwandan and Lesothan governments have created incentive structures for their revenue authorities that bring these institution’s objectives in line with their own. In Lesotho, where the government has been anxious to maximize revenue collection, while minimizing coercive state-building, the LRA has been incentivized away from collecting taxes in the more politically sensitive area of direct taxes and VAT, and into relying heavily on trade taxes. In Rwanda, the government has the objective of maximizing revenue collection with maximum state-building, and has incentivized the RRA into maximizing revenue collection across tax types, rather than solely by focusing on the most lucrative tax handles, such as large taxpayers or trade taxes. The incentive structures can be seen at both the macro level, the incentives of the institution as a whole, and the micro level, the incentives of individual officials.

The key tool used by governments at the macro level to mould incentive structures has been the issue of how the revenue authority is funded. In Lesotho, in the initial years after the LRA's foundation in 2003, a clear tension was evident between the government and the LRA over how the Authority would be funded. The government's preference was for the funding to come from the central budget and to be based on the estimates of overall tax collection, which were voted on by parliament. The Authority, however, wanted to be funded in a different way; retaining an agreed percentage of direct and indirect tax collections: 'a long term funding mechanism which is based solely on a percentage of the Income Tax and VAT remittances that are generated by the Authority is preferred by both the Ministry and the LRA' (LRA, 2005, p. 7). Unlike the government, the LRA wanted their funding to be based on what they actually collected, rather than estimates, and on direct rather than total tax take.

The rationale for this preference was clearly stated: 'it is important to ensure that, for the future, the Authority is incentivized to maximize income tax and VAT collection efforts and, by extension, recoup its own share of such revenue' (LRA, 2005, p. 8). The LRA was worried about the high dependence on trade taxes and in particular the annual remittance they received from the Southern Africa Customs Union (SACU). Under the terms of SACU, Lesotho received a share of all the trade taxes collected in the customs area union, determined by a revenue sharing formula that was not based on the actual amounts of tax which they collected<sup>iv</sup>. However, the terms of the formula changed after 2005 to be more directly based on actual collections. This was anticipated to lead to a drop in the remittance, as it was a measure designed to boost trade liberalization in the region. The LRA expressed persistent concerns about the very high levels of dependence on SACU: in 2008 the annual report stated that any change in the remittance would require a 'greater than proportionate increase in collections from other sources of revenue to offset it' (LRA, 2008, p. 17). They wanted to be specifically incentivized into the collection of direct and indirect taxes, in a way that would enable them to change the tax structure. They expressed the hope that the issue would be resolved by 2006/7.

However, by 2006, the issue was still unresolved. The Authority seemed to have realized that their call for a switch from funding based on estimates to a retention fee had no traction with the government. They switched to calling for their budget to be based on estimates, but only those for direct and indirect taxes: 'it is hoped that from 2006/7 onwards the Authority will receive an equivalent amount of funding but based solely on the estimates of Income Tax and VAT collection'

(LRA, 2006, p. 25). Although a weaker incentivizing strategy than a retention fee, the Authority was again asking to be allowed to focus more on direct and indirect taxes.

These requests were never realized. From the 2007/8 Annual Report onwards, there was no further mention of the funding issue. The LRA continued to be funded on the basis of overall estimates of total tax revenue, rather than actual collections of direct taxes. The government had rejected their preference to be incentivized both into increased general revenue collection, by allowing them to keep some of the revenue collected, and into changing the tax structure, by focusing on direct and indirect taxes.

The situation in Lesotho contrasts markedly with that in Rwanda. From 2003 onwards, the RRA was funded from a retention fee of 2.6% of total revenue collected. The Authority credited this with having 'significantly increased the RRA's operational efficiency' (RRA, 2005, p. 3). In 2005 they asked for the percentage to be increased and in 2007 the cabinet sanctioned an increase to 3.5%. The RRA, in contrast to the LRA, has been directly incentivized into increasing tax collection in all tax categories.

In Rwanda, at the micro level, individuals within the RRA have been incentivized collectively into attaining the RRA's overall revenue targets. All RRA staff members receive a bonus when the total revenue collected is in excess of the targets agreed by the Ministry of Finance (ADB, 2010). This bonus can amount to as much as 80-100% of their salaries. Given that everyone has a strong incentive to ensure that the targets will be met, constant monitoring processes are in place to achieve that end. Weekly departmental meetings are held to ensure that targets will be reached and to devise corrective action if not: 'the key purpose of the monitoring process was to identify any instances where targets weren't being met and then identify corrective action that is needed to get back on track' (RRA, 2005, p. 22).

The incentive structure at the micro level within the RRA is based on a collective principle: when the organization as a whole meets its revenue targets, everyone benefits. Officials are not assessed on their individual revenue raising capabilities, meaning that there are no incentives to concentrate solely on large and lucrative taxpayers to get big revenue wins (FIAS, 2006a, p. 87). The structure of incentives ensures that the RRA can balance both its revenue maximizing and state-building

functions; it incentivises staff to collectively meet revenue targets, but not at the expense of other objectives, such as widening the tax net into the less lucrative informal sector.

The LRA, by contrast, does not have a micro incentive structure that rewards all staff for meeting overall revenue targets. Instead, it has individual targets focused on particular kinds of tax. The Performance Management Development System (PMDS), was introduced in 2004/5, and linked personal performance indicators to set revenue collection targets for individual staff members, but only those in customs units on the borders. Ensuring that staff were maximizing and accurately recording customs revenue transactions had become particularly important after 2004, as the SACU revenue sharing formula changed to being more specifically based on actual recorded collections. When the PMDS was rolled out to the whole Authority in 2007/8, individual indicators were not linked to revenue collection but with the LRAs broad objectives which, as discussed below, had been steadily moving away from a narrow focus on revenue collection and towards voluntary compliance.

The difference in macro and micro level incentive structures can clearly be seen to have an effect on how each authority behaves. The LRA, at the macro level, is incentivised to exaggerate its estimated revenue collection, as its funding is a proportion of these estimates. It is not incentivised to actually meet them. From 2003 to 2008 the LRA missed its targets once, and met it three times, but on two occasions this was after the targets had been revised to a lower level. When targets have been exceeded it has been by a margin of between .4 and 12% (LRA, 2009, p. 7). By contrast, the RRA is incentivised at the macro level to set low targets, as staff members receive a bonus if the target is exceeded, and to exceed it by as much as possible, as the overall budget is based on actual revenue collected. The RRA has exceeded its targets every year since 2000, by a margin of between 5 and 25%.

Each government has incentivised its tax authority into modes of revenue collection that mirror its own political imperatives and constraints. The democratic government in Lesotho has provided no incentives for the LRA to move away from relying on 'lootable' trade taxes and towards increasing politically sensitive direct taxes. At the micro level, there is no collective incentive to staff to maximize revenue, except in one area – customs. In Rwanda, the government has not been so constrained and has incentivised the RRA into maximizing tax collection across tax types. How

these differences in incentive structure affect the different levels of state-building activities the tax authority engages in, is the subject of the next section.

## **The Mechanics of Tax Collection: Differences in Operations**

There are clear differences between the LRA and the RRA in terms of their stated commitment to, and operational use of tax for the task of state-building. The RRA has explicitly listed widening the tax net as one of its strategic objectives; consistently linked taxation to broader projects of development in the creation of its public image and their actions; targeted the informal sector; extended their reach into the periphery; and established clear enforcement mechanisms. In contrast to this, the LRA has shifted away from the goal of widening the tax net towards voluntary compliance; undertaken few activities in targeting the informal sector; done little to extend their reach into the periphery; and failed to establish strong enforcement mechanisms.

The LRA's emphasis on the state-building aspects of their operations has steadily decreased over time. While in the first two years after their foundation, widening the tax net was listed as one the five key strategic objectives in their Annual Report, this was dropped in subsequent reports. The move away from this aspect of their role accelerated after an organizational review in 2007, when the LRA adopted a new direction that focused on 'promoting voluntary compliance as opposed to rigorous enforcement strategies that had a detrimental effect on taxpayers perceptions about the role of the LRA' (LRA, 2009, p. 4). The emphasis on voluntary compliance, ensuring that those already registered were compliant, was allied to a de-emphasis on increasing the number of people registered and widening the tax net.

This shift away from the state-building aspects of tax collection was made explicit in October 2007, where the LRA changed their motto from 'Pay Taxes and Build Lesotho's Future' to 'Serving You, Serving the Nation'. The move was seen to 'reflect the Authority's strategic focus on the provision of a facilitative service, rather than focusing solely on the collection of revenue' (LRA, 2008, p. 22). The Authority was attempting to decouple taxation, in the minds of taxpayers, from the broader project of national development, and instead emphasizing its responsive, service orientated approach to its task, in which tax payers were seen primarily as clients rather than citizens.

In Rwanda, by contrast, the RRA has continued to explicitly link taxation to the tasks of state-building and national development. Every year the RRA holds 'National Taxpayers Day' when the largest compliant taxpayers are honoured publically. This Day is one of the two most important public events of the year that is always attended by the President (ADB, 2010). As the themes of the Day demonstrate, the RRA consistently tries to draw a link between taxation and national and economic development; 'Be a compliant taxpayer, build you nation' (2008); 'Partnership for business growth' (2009); 'Choose development, be compliant' (2010).

This difference in the stated objectives and symbolic language which the two Authorities use, maps onto significant differences in the concrete actions they have taken in relation to extending the tax net into the informal sector, penetrating the periphery and establishing enforcement mechanisms.

Bringing more and more of the informal sector into the tax net has been one of the core objectives of the RRA. A World Bank survey of the informal sector in 2004 noted that of the estimated 70,000 micro and small enterprises in Rwanda, only 1000 of these were registered with the RRA (RPSF, 2005). In their 2005 Annual Report, the RRA listed this situation as being one of their major constraints, as it 'dwarfs the registered formal business activities and narrows the tax base' and because 'in spite of our rigorous pursuits in taxpayer identification and registration throughout the year, many potential taxpayers remain outside the tax net' (RRA, 2006, p. 24).

Specific policies to tackle registration and compliance in the informal sector emerged in 2008. RRA launched the Block Management System (BMS), under which Kigali was divided into blocks and sub-blocks, and revenue officials went door-to-door checking that all businesses eligible to pay tax were registered with the Authority. The explicit aim of the BMS was to 'widen the tax base by reducing the informal sector through proper registration of all those engaged in taxable activities' (RRA, 2008, p. 3).

The BMS was seen by the Authority to have been a major success, and in the years after its introduction led to quite dramatic increases in the numbers of small and medium sized taxpayers registered with the RRA. The year before the BMS was introduced, there were 9662 registered small and medium taxpayers (RRA, 2007, p. 15). The following year, this increased by 51% to 14,580, of which 13,305 were small taxpayers and 1,275 were medium taxpayers (RRA, 2008, p. 14).

By 2010, there were 42,210 registered, a 337% increase from 2008 (RRA, 2010, p. 13). Of these 40,295 were small taxpayers and 1,715 were medium taxpayers.

It is hard to argue that the actions of the RRA in extending the tax net into the informal sector were driven primarily by revenue imperatives. Although the link between widening the tax base and increasing tax as a percentage of GDP is made by the RRA (RRA, 2010, p. 4), the actual revenue return for the significant investment of time and personnel resources is questionable. Firstly, the figures indicate that that of the 3,248 businesses surveyed in the first year of the BMS, only 754 (23%) of these were eligible to pay tax but not registered (RRA, 2008, p. 18). Furthermore, even when registered compliance rates among small taxpayers were relatively low, at 54.4%. This is unsurprising, given the low levels of literacy, and poor accounting practices usually found in the sector. Finally, these are by definition small enterprises, with a limited taxable income. Taken cumulatively, it is not clear that adding a couple of thousand extra small, low compliance taxpayers would be worth, in revenue terms, the quite considerable transaction costs of finding and registering them. It seems more plausible that extending state control into the informal sector was at least as strong a motivation.

In contrast to Rwanda, the LRA has made no significant attempts to widen the tax net into the informal sector. Although some organizations, such as Stockvels (rotating credit unions) have been targeted, there has been no systematic campaign comparable to the BMS in Rwanda. Rather, small businesses, most of which are located in the informal sector, have largely been ignored by the LRA. They have not implemented a small business tax regime, such as those adopted in other countries which make it easier for small enterprises to pay tax by making the burdens of compliance easier and more affordable<sup>vi</sup> (FIAS, 2006b). The LRA has left most small businesses out of the tax net.

The reasons for this are, according to interviews with a senior LRA official, largely political. Targeting the informal sector would be deeply unpopular, as those in that category – the majority of the population – see themselves as ‘strugglers’<sup>vii</sup>. The interviewee went so far as to say that no politician would allow the LRA to do this. When probed as to whether extending the tax net into the informal sector might be desirable, despite political resistance, as part of a broader state-building function, the official replied that this was not part of their mandate. Although it is difficult to prove that the LRA has come under political pressure to avoid targeting the informal sector, it is clear that no political pressure has been applied to them to do so. Without that pressure, and given

the low returns in additional revenue from any efforts, the LRA has been relatively inactive in its activities in relation to the informal sector.

As well as the informal sector, there is a difference between the extent to which the RRA and LRA have tried to penetrate the periphery, beyond the capital and major urban areas. The RRA has taken a number of steps in extending their reach into the provinces. In 2004, coordinators were appointed for each province. In 2005, provincial offices had their mandates extended so that they could carry out most of the services provided at headquarters in Kigali. The same year they also carried out a study about how best the RRA could fit in with the new structures of local government, leading to the establishment of new offices in four regions. In 2008, 2237 new taxpayers were added in the provinces, a third of the total that year. This brought the total number of taxpayers to 13,861. In 2009, the RRA took part in the training of local government administration on fiscal decentralization. They have built a number of border posts, even though they have reduced collection from trade taxes, as part of the broader project of extending reach and consolidating control within and at the frontiers of the state.

In contrast the activities undertaken by the LRA in extending their reach beyond the capital Maseru have been minimal. They opened two new advice centres in Leribe and Mohale's Hoek in 2005/6 and they embarked on a project to refurbish border posts in 2007/8. Other than these actions, there is little evidence of concerted attempts by the LRA to state-build in the periphery.

In terms of enforcement, the RRA has been very proactive in putting in place auditing and enforcement mechanisms. In the words of one expert, they see themselves as 'the third force after police and army'<sup>viii</sup>. Enforcement is seen as a critical means of improving direct tax collection: in the 2006 Annual Report the improved performance in direct tax collection is seen to 'indicate improvements in the effectiveness of the tax administration through enforcement and audit activities, coupled with improvements in taxpayer identification, registration and education' (RRA, 2007, p. 18). The introduction of Law 25 in 2005, strengthening enforcement procedures, enabled the RRA to develop its enforcement procedures. This is reflected in the number of audits undertaken the following year – 746 (RRA 2007, 24). They were in fact so tough on evasion that the Ministry of Finance and Economic Planning had to step in to restrain them on occasion (ADB 2010) – showing that even in autocracies, the latitude for coercion is not limitless. The challenge, according to one expert, was to 'turn a blunderbuss into a sniper'<sup>ix</sup>: to make enforcement

mechanisms more effective by targeting them more precisely. By 2009, the number of audits had dropped to 333, but the number of prosecutions had risen (RRA, 2010, p. 14).

The strenuous activities by the RRA in the area of enforcement contrast strongly with the rather lackluster efforts of the LRA. In the initial years after its foundation, a tax amnesty was introduced, under which people could have their tax obligations for the preceding years dropped, if they became registered. Eight hundred and fifty people applied, but the scheme was not deemed a success by external observers (FIAS, 2006b). The use of more voluntaristic mechanisms, such as amnesties, signaled a less coercive attitude towards enforcement that is also reflected in the levels of auditing. Although the annual reports do not detail year on year the number of audits, in 2005 the reports states that 132 businesses had been identified for audit. It is not clear if this number of audits, much lower than that of the RRA, ever took place. There was also lower visible commitment to ensuring the institutional infrastructure for prosecuting was in place: in 2004 the LRA expressed the hope that a Revenue Appeals Tribunal would be established (LRA, 2005, p. 20). As of December 2009 this tribunal had not been established<sup>8</sup>.

Nowhere is the differing intensity with which the two authorities engage in state-building more clearly summed up than in relation to their activities with schools. While the LRA has organized debating competitions around tax issues, offering a laptop as a prize, the RRA has begun working with the National Curriculum Development Centre to design a curriculum for secondary schools on entrepreneurship and taxation. The RRA sees taxation not just as a means of collecting revenue, but also as a tool in the broader project of building the state and developing the nation. The LRA has been far less fervent in its use of tax towards such ends. They have instead shifted to seeing their role as being that of a service provider – to both taxpayers and the government – facilitating, rather than building the state.

## **Tax Structure and Outcomes in Rwanda and Lesotho**

The imprint of the differences in operations detailed above can clearly be seen in the resultant tax structure and outcomes in both countries. As Table Two demonstrates, Rwanda's tax structure is very different to Lesotho's and has changed significantly over time. In Rwanda, where the RRA has specifically focused on direct and indirect taxes, widening the tax net, improving enforcement and increasing the reach of the state, these taxes constitute the main sources of tax revenue, and

dependence on trade taxes has diminished over time. Rwanda's main source of tax revenue is indirect taxes (47% in 2009), followed by direct taxes (35%). The share of direct taxes in Rwanda has increased by 17% over the last six years. This has compensated for the fall in trade taxes, which accounted for only 11% of overall revenue in 2009, down 42% from 2003.

**TABLE TWO: TAX STRUCTURE IN RWANDA & LESOTHO, 2003-2009**

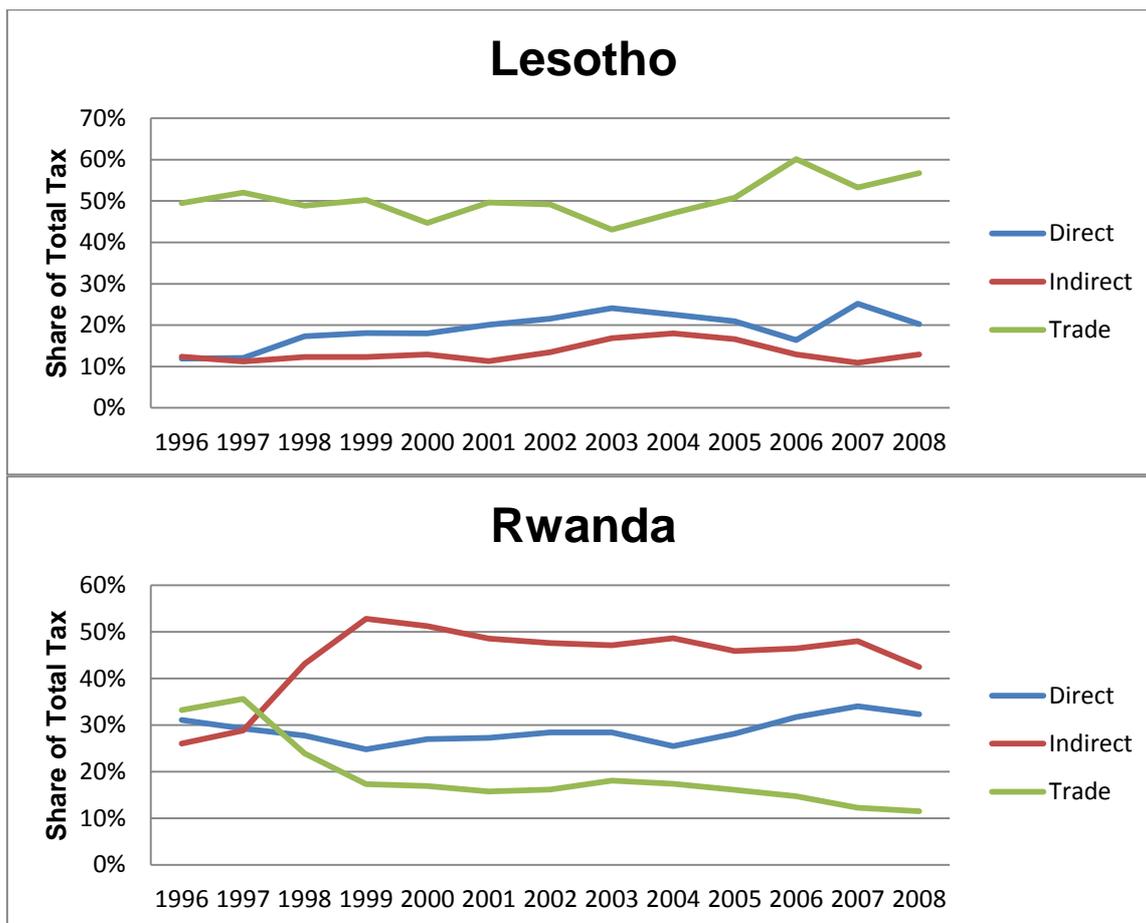
Tax Type	Indicator	Rwanda			Lesotho		
		2003	2009	% Change	2003	2009	% Change
Direct	% Tot. Rev	30	35	17	23	21	-9
Indirect	% Tot. Rev	50	47	-6	15	14	-7
Trade	% Tot. Rev	19	11	-42	43	57	33
<b>Total Tax</b>	% GDP	12	15	25	46	63	37

*Source: OECD's database on African Fiscal Performance*

By contrast, in Lesotho, where the LRA has shied away from expanding the tax net and targeting politically sensitive sectors such as informal workers, trade taxes are the largest source of tax and dependence on them has increased over time. Trade taxes constituted 57% of overall tax revenue in 2009. This dependence has increased by 33% since 2003<sup>xi</sup>. The share of both direct and indirect taxes has been falling since 2003, 9% and 7% respectively.

To lend further weight to the proposition put forward here that it is democracy that has been driving these changes, Figure One shows trends in tax structure over a longer time period, from 1996-2008. As can be seen, Rwanda began with a high dependence on trade taxes but has been consistently reducing its reliance on trade taxes and increasing the share of direct taxes. In Lesotho, the opposite has been the case, and this trend accelerated after the first fully free and fair elections in 2002. As can be seen in the graph the upward trend in trade taxes and the downward trajectory of direct and indirect taxes began the year after the election in 2003.

**FIGURE ONE: STRUCTURE OF TAXATION IN RWANDA & LESOTHO, 1996-2008**



The data illustrates two main points; that there is a difference between Rwanda and Lesotho in terms of tax structure; and that this difference has emerged recently, coinciding with changes in regime type. Rwanda has been able to change the structure of taxation away from trade and towards direct and indirect taxes, while Lesotho has not. Particularly since the introduction of democratic elections, Lesotho has reduced its share of direct and indirect taxes and become increasingly reliant on trade.

## Conclusion

This paper has argued that the reverse sequencing process that most developing countries are experiencing, democratizing before they have reached a point of substantial state consolidation, has important implications how they collect tax, and challenges our existing theories about the relationship between taxation and democracy. As taxation in developing countries is primarily a function of state-building, and many aspects of state building are inherently coercive, democracy gives citizens the ability to resist, forcing states into lower intensity state-building activities, in the least politically divisive areas. In the context of taxation, this means that it constrains the ability of the revenue authority to widen the tax net and consolidate its ability to coerce, focusing their attention instead on the least visible forms of taxation. Democracies try to maximize taxation, with minimal state-building, while autocracies can maximize taxation, with maximum state-building. The empirical case comparison shows how governments have incentivized revenue authorities into these modes of behavior, in ways that meaningfully impact on their daily operations.

The limitations of this argument should be clearly articulated. Firstly, this is an argument about the way in which regime type creates different levels of constraint on governments and state institutions. It does not discuss in detail motivations, and the impact of regime orientation through this channel. Just because autocracies can state-build more easily does not mean that they will, as most of post-Independence African history so clearly demonstrates. Nor is it the case that democracies never work to overcome their constraints. Although we have some theories about how regime type impacts on motivation, there is far more to say on this topic than can be accomplished within the scope of this article. Secondly, emphasizing the importance of political constraints, should not come at the expense of the economic variables that matter, as the two are inherently interactive. The prevailing economic structure will have a very big impact on where democracies seeking to maximize tax with minimal state-building will focus their attention.

Nonetheless, there are a number of important implications stemming from the findings reported here. The impact of reverse sequencing needs to be taken more seriously, not as a normative prescription but as an analytic reality with meaningful consequences. If it is acknowledged that there are aspects of state-building that are inherently coercive, then it is clear that democracy in many ways can impede state-building tasks, such as bringing people within the tax net, by giving them a greater voice and ability to resist. This negative relationship, the opposite of existing

theories based on the West's historical experience, underscores the uniqueness of that history, and the danger of assuming that the same ingredients in a different order, will lead to the same results. The paper echoes the emphasis on the importance of the formative stages of state-building for later outcomes, by showing how state institutions are, at least in their initial stages, somewhat malleable, and come to bear the imprint of the objectives of early governments in ways that may then become locked in and path dependent. It is precisely for this reason that we need to think more questioningly about how democracy impacts on important state functions, like taxation, and adapt our theories to the context within which developing countries exist today.

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<sup>i</sup> Even though indirect taxes are sometimes argued to be less visible, this is not the case in most developing countries, as it imposes heavy and visible administrative burdens on small businesses. The introduction of VAT sparked protests in India, Uganda and Ghana (Moore 2007, 25).

<sup>ii</sup> This is the last available data on employment structure for Rwanda. It is likely that, although the broad proportions are the same today, the differences in level between Rwanda and Lesotho have decreased.

<sup>iii</sup> It has to be admitted that the genocide in Rwanda makes it, in many ways, an exceptional case. It has had a profound effect on subsequent political development, ethnic relations, and relations with the rest of the world (Hintjens, 2008). However, it is not clear that the genocide should be treated as a variable, in and of itself, so long as its effects through the channels of relevance to the main theoretical argument are acknowledged and controlled for, a comparative approach should be defensible.

<sup>iv</sup> The size of the SACU remittance is the main factor accounting for Lesotho's very high overall level of taxation, which is one of the highest in Sub-Saharan Africa. However, the high levels of dependence on trade taxes which it creates is not exceptional, with trade taxes being the largest single category of trade taxes in most African countries.

<sup>v</sup> Other African countries, including some democracies, also hold such days, Kenya being one example. Again, the argument is not that all autocracies want to state-build and no democracies do, but rather that autocracy removes many of the constraints for doing so, while democracy maintains them.

<sup>vi</sup> By means of, for example, having fewer annual filing deadlines for small businesses, or levying tax on presumptive rather than actual turnover.

<sup>vii</sup> Interview with senior LRA official, 07/12/2009

<sup>viii</sup> Interview with expert, 21/11/2009

<sup>ix</sup> Interview with expert, 21/11/2009

<sup>x</sup> Here, as in a number of other areas, there is the suggestion that the LRA wants to be doing more, but is being held back from doing so. As with the issue of funding, they often use the Annual Reports as a forum for publically expressing their position on certain matters. They ask for a tribunal to be established, and they ask for auditors to be incentivized into completing quotas. But, as on the funding issue, they often do not seem to be met, and the issue is dropped.

<sup>xi</sup> As has been noted earlier, the Lesothan economy is heavily dependent on trade. Although the higher level of trade in Lesotho may explain why the *levels* of trade taxes are higher than in Rwanda, it does not explain why this dependence has increased over time. The argument in the paper is that this has been a deliberate choice of the government to focus on less politically sensitive taxes, and that, in the Lesothan context, trade is the most 'lootable' source of tax revenue.