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Private vs. public collection in enhancing local tax revenues

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November 2017

DIRECTED BY LSE University of Oxford

FUNDED BY UKaid from the British people

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Summary

The development of productive and livable cities is key to national growth strategies in developing countries. But for cities to become engines of growth, public policy is needed enhance the positive effects of interaction between firms and individuals in cities, and to tackle the potential downsides of density. In many developing cities, municipal revenues are insufficient to finance the necessary investments in public infrastructure, services and well targeted policies that can deliver long term growth and rising living standards for a city. In this context, local governments are increasingly looking to outsourcing tax collection to private companies to improve the efficiency of tax collection. However, while there are potential arguments for privatization, and some successes do exist, these **successes depend on a range of very particular conditions** that may not be met by local authorities in many developing cities. Outsourcing to private collectors instead risks undermining the very government capacity that would be needed to effectively monitor and enforce private collection contracts.

There are a number of potential advantages to local governments to outsourcing tax collection to private sector companies. With private management of tax collection, there are greater incentives and potential means with which collectors can be motivated to expand tax revenues. If private firms have greater staffing and financial capacity, this can also expand tax collection potential. If tax collection is implemented under ‘tax farming’ contracts, which specify a particular level of revenue to be paid to governments by private partners each month regardless of actual collection revenues, outsourcing collection also comes with more predictable streams of revenue for governments.

However, privatising tax collection also comes with significant disadvantages. There may be inflated or uncompetitive costs of private collection, particularly if there are significant sunk costs associated with switching to new systems of collection, or if private collectors have a strong monopoly position in providing collection services. Over and above stated costs, private firms will also charge a private premium on collection in the form of retained revenues, which can far exceed costs. In addition, corruption in the form of collusion between local governments and firms contracted to can increase as a result of outsourcing. Alongside limiting potential for local government capacity development, private collection may undermine the legitimacy of local government and damage the necessary social compact between citizen and state for tax compliance.

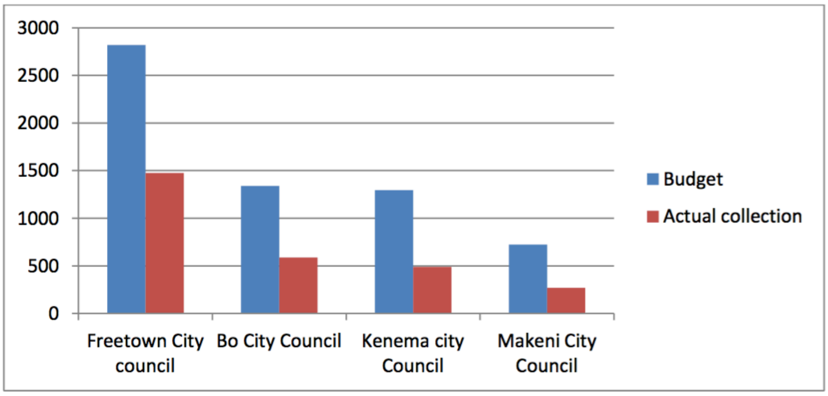
Private outsourcing of collection is only likely to be effective in expanding local government revenues and enhancing tax compliance under very specific conditions. Local governments need to implement competitive and transparent tendering processes to reduce opportunities for corruption, invest in detailed revenue projections, effective design and enforcement of contracts, and implement systems to reduce overzealous collection, inefficiency and corruption of private collection. Without these enabling conditions, capacity development to facilitate tax collection by local government departments is likely to be the best option for developing cities. Outsourcing collection of taxes to private firms will not necessarily improve compliance with taxation on the part of taxpayers – key to improving tax compliance is instead active policy to increase transparency of tax collection, expand revenues, and, crucially, spending these revenues effectively on public investments.

The importance of improving tax collection

Urban development is key to national growth strategies. In both developed and developing countries, millions have been lifted out of poverty by structural transformation away from agricultural labour to high productivity jobs in urban manufacturing and services. Cities are responsible for 80% of global GDP[1]. Rapid urbanization now represents the developing world's biggest growth opportunity for the 21st century. But for cities to become engines of growth and economic transformation, coordinated public policy is needed, both to enhance the positive effects of interaction between firms and individuals in cities, and to tackle the potential downsides of density.

The problem for many developing cities is that **municipal revenues are insufficient** to finance the necessary investments in public infrastructure, services and well targeted policies that can deliver long term growth and rising living standards for a city. In some cases, low levels of revenue collection mean that a large percentage of revenues are spent on recurrent expenditures. Most development related projects are largely financed either by central government or development partners. As urban populations in sub-Saharan Africa and South Asia rapidly grow, demands on public investment will only continue to rise. In this context, strategies to enhance municipal revenues are a vital precondition for productive and livable urban development.

A significant source of limited municipal resources for city governments is **limited collection of potential tax revenues.** Poor administration of tax collection alongside strong political resistance to payment result in extremely low collection rates. In South Africa, for example, the 'tax gap' between actual and potential tax revenues collected is estimated to be between 15-30% of revenues[2]. Similar problems are faced in Sierra Leone, where city councils frequently collect significantly less than budgeted targets.



Actual revenue collection vs. budgeted targets in City Councils in Sierra Leone, 2007

(Source: Jibao and Prichard, 2013)

Note: It has not been possible to access budgeted collection targets for earlier years.
Source: Local Government Finance Department, Ministry of Finance, Government of Sierra Leone.

Efficient and effective tax collection is key to raising revenues from taxation, preventing unfair distribution of the tax burden and allowing taxation to be seen as legitimate to the public at large.

[1] World Bank, "Urban Development."
[2] Steyn, "Clampdown on Tax Avoidance."

Private vs. public tax collection

In this context, local governments are increasingly looking to outsourcing tax collection to private companies to improve the efficiency of tax collection. Private outsourcing of tax collection has been seen across a number of different revenue sources, including property taxes, parking fees and market fees. In Mwanza, Tanzania, for example, over a third of council revenues in 2006 were privately collected[3].

However, while there are potential arguments for privatization, and some successes do exist, these **successes depend on a range of very particular conditions** that may not be met by many local authorities in developing cities.

Why would local governments want to outsource tax collection?

There are two potential advantages to local governments to outsourcing tax collection to private sector companies:

- ✓ **Potentially higher revenue collection (and lower corruption at collection).** This is both due to profit incentives and higher capacity of private firms[4]. As the profits and incomes of those managing tax collection depend directly on maximizing revenue collection and minimizing costs of collection, private firms are more incentivised to maximise revenue collection. Private firm managers are also likely to have lower political incentives to collude with those liable for taxation than government officials, reducing revenue leakages from corruption. This is coupled with the fact that private managers are better placed to incentivise collectors through performance related pay contracts and the threat of termination for poor performance[^]. However, because of this, outsourcing of tax collection can be resisted by local government staff who have a vested interest in maintaining internal tax collection. In Mwanza and Kinondoni, Tanzania, for example, ward officials have resisted supplying private collectors with the necessary data to effectively collect property tax.

  At the same time, private firms may in many cases have greater staffing and financial capacity to undertake large scale tax collection as compared to local governments. As such, where local governments face credit constraints in expanding collection internally, outsourcing tax collection can significantly expand revenues.[5] In Lagos, for example, limited resources of state revenue staff to collect and monitor tax payments in 2000 compelled the finance ministry to hire an external company, ABC Consulting, to manage tax payments using an electronic billing and payment system in exchange for a commission on these payments[6].

[3] Fjeldstad, Katera, and Ngalewa, "Outsourcing Revenue Collection: Experiences from Local Government Authorities in Tanzania."
[4] Edgar Kiser and Kathryn Baker, "Could Privatization Increase the Efficiency of Tax Administration in Less-Developed Countries?," *Policy Studies Journal* 22, no. 3 (September 1, 1994): 489–500.
[^] However, the benefits of higher revenue collection are highly dependent on private firms choosing to structure contracts in this way.
[5] de Gramont, "Governing Lagos: Unlocking the Politics of Reform."
[6] Ibid.

- ✓ **Potentially lower costs of collection.** By outsourcing collection, administrative and staffing costs of tax collection are incurred by the private sector rather than by local governments. However, it is important to note that these costs will be passed on to local governments in the form of retained revenue collection by private firms to cover their costs. One potential benefit of private tax collection is the possibility of lower costs of collection due to greater flexibility in short-term employment, if there are greater constraints on hiring practices for government collectors. This can be valuable as many revenue sources are variable over the year, such as taxes on agricultural products, and staffing requirements can vary widely. In Mwanza City Council, Tanzania, staff numbers by private collectors of fish market fees varied from 25 collectors in peak season to 10 collectors in low season. Private collectors may also be more flexible in their ability to rapidly adopt new technology such as internet or M-pesa mobile money transfers, with digitised collection reducing costs of collection and opportunities for corruption.

  However, the benefit of lower costs to local governments depends on these reduced costs being translated into lower retained revenues by private firms – and on the cost reductions associated with flexible labour outweighing the benefits of greater learning on the job from permanent employees.

Tax farming and the allocation of collection risk

Some private revenue collection contracts also have the added benefit of providing **more predictable revenue streams** to governments. Under 'tax farming' contracts, a collection contract specifies a particular level of revenue to be paid to governments by private partners each month regardless of actual collection revenues. This is in contrast with private outsourcing of collection that instead specifies a particular percentage of tax revenue collected to be paid to governments.

However, 'tax farming' contracts create more predictable government revenue flows for budgeting and planning by shifting the entire risk associated with the amount of tax collected onto the private sector. Regardless of the amount collected, a fixed fee must be paid to governments. As such, it is likely that tax farming contracts will come with a **higher premium** to incentivise private firms to take on the risk of collection.

At the other extreme are contracts where private collectors collect taxation for a fixed fee. Though this is likely to reduce the premium demanded by private collectors due to lower risk, such contracts are problematic as there are limited incentives for private collectors to maximise revenue collection.

Disadvantages of private tax collection

However, outsourcing tax collection also comes with potential disadvantages:

- **Inflated or uncompetitive (stated) costs of private collection.** Privatised tax collection will not automatically lead to reduced costs of collection. For example:

    - As part of the costs of private tax collection, the sunk costs associated with any changes in collection system must also be considered. The costs associated with new systems that may be passed on to local governments will need to be weighed against the projected additional revenues from this system to local governments. In Kampala, for example, costs of collection were approximately 27% higher than current levels when capital expenditures were made for new systems and software^.

    - If tax collection is contracted to one private firm, this firm can take advantage of its monopoly power in contract negotiation to demand higher premiums for collection. This is particularly likely to be the case when private firms own the initial capital investments, data and systems needed to collect property taxes even after the contract has ended. As a result, without sufficient competitive pressures, cost efficiencies may fall and costs may actually become higher than the costs associated with public tax collection.

    As such, *ex ante* estimates of the costs of collection of contracted firms with detailed breakdowns are extremely useful in helping guide decision making by local governments. These can be compared with estimates of the cost of collection if collection were to be done by local government internally and cost estimates from comparable tax collectors in other cities in determining the value of privatising collection to local governments.

    Experience of the Internal Revenue Service in the United States reveals that in some cases private collection may be less efficient than when collected by government departments. Between 2006 - 2009, the IRS contracted out the collection of some undisputed past due taxes to private collection agencies (PCAs), before recalling these contracts for internal collection. Data on tax collection reveals that the IRS was significantly more effective at collecting tax liabilities than PCAs, collecting 62% more than PCAs in the first two years of case assignments[7]. In Sierra Leone, private contracting of the development of property tax cadaster and valuation systems to expand revenues in Kenema City Council was achieved with lower levels of transparency and compliance than similar in-house reforms by Bo City Council. The reform programme in Kenema was also associated with greater initial challenges with data quality that were harder to resolve, making updating property rolls over time more difficult[8].

- **High private premiums in the form of retained revenues.** If contracts are poorly designed, private outsourcing of collection can come with an excessive private premium

^ ^ This is an estimate, based on discussion with the KCCA's Revenue Department

[7] Beck et al., "The IRS Private Debt Collection Program — A Comparison of Private Sector and IRS Collections While Working Private Collection Agency Inventory."

[8] Jibao and Prichard, "Rebuilding Local Government Finances After Conflict."

in terms of the percentage of revenues retained by the private firm (over and above costs incurred by private firms). In the case of the Ubungo Bus Terminal in Dar es Salaam, for example, 56% of revenues collected from entry fees were retained by private collectors in 2006, despite limited evidence of high collection costs[9]. These retained revenues can be far higher than private costs of collection. For comparison, in Kampala, for example, the cost of collection for property tax is approximately 10 – 12% of gross collection rates[^].

- **Opportunities for corruption between local governments and private firms**. Though corruption at the level of collection may be reduced through private collection, evidence from local governments in Tanzania and Uganda suggests that opportunities for corruption at the level of contract tendering are enhanced[10]. Both the firm selected to collect taxes and the amount agreed on as a private premium can be subject to corruption, with collusion between government/council officials and private firms to capture excessive profit margins. This has been a key factor limiting the effectiveness of private outsourcing of tax collection.

- **Undermined local government legitimacy and capacity.** As private collection allows tax collection firms to profit from taxes, and limits government accountability for tax collection, this can undermine the legitimacy of taxation as the price of public goods and services, making citizens less willing to comply with payment. At the same time, private firms have limited incentives to implement taxation in such a way that builds public support – and can therefore implement overzealous collection strategies to maximise profits. In many cases, a lack of legal provision for enforcement of taxation by officials outside of government results in unofficial or informal tax enforcement. This further undermines the legitimacy of the tax system. Historical experience of private tax collection in France and the Netherlands shows that overzealous private collection can lead to heightened social discord and revolt[11].

  In addition, by outsourcing collection of taxation, local governments are less able develop internal collection capacity. This limits the potential for long term cost effectiveness of collection that does not require paying a private premium.

As a result, in Tanzania, for example, the impact of private collection of local government revenues since 1996 has been mixed – whilst in some councils, revenues from tax collection increased and became more predictable, in others, outsourcing collection was accompanied by high levels of corruption and large profit margins for private collectors at the cost of government revenues[12].

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[9] Fjeldstad, Odd-Helge, Katera, Lucas and Ngalewa, Erasto, "Outsourcing Revenue Collection to Private Agents: Experiences from Local Authorities in Tanzania."
[^] This is an estimate, based on discussion with the KCCA's Revenue Department
[10] Fjeldstad, Odd-Helge, Katera, Lucas and Ngalewa, Erasto, "Outsourcing Revenue Collection to Private Agents: Experiences from Local Authorities in Tanzania"; Iversen et al., "Private Tax Collection—remnant of the Past or a Way Forward?"
[11] Peter Stella, "Tax Farming: A Radical Solution for Developing Country Tax Problems?," *Staff Papers (International Monetary Fund)* 40, no. 1 (1993): 217–25,
[12] Fjeldstad, Katera, and Ngalewa, "Outsourcing Revenue Collection: Experiences from Local Government Authorities in Tanzania."

Enabling conditions for effective private tax collection

As such, effective use of private firms for tax collection is only likely to improve revenue outcomes if some key enabling conditions are in place:

1) **Competitive and transparent tendering processes to reduce opportunities for corruption.** This involves making public information on the tendering processes and bids received for collection contracts, as well as monitoring of the tendering process by independent government agencies with the resources to effectively identify corruption.

2) **Detailed revenue projections, including estimates of the number and value of the properties in the administrative remit of collection** so that local governments are able to effectively contract the appropriate revenues expected from private collectors. Detailed, inflation adjusted projections are necessary to limit the extent to which the private sector is able to profit at the expense of government revenues. As a result of a lack of realistic assessments of revenue potential for markets in rural Uganda, a recent study has shown that local districts lose between 25 - 74% of total revenues collected to private collectors[13]. More sophisticated projections may require outsourcing modelling to independent agencies. Independent projections can in turn also act to improve transparency of tendering and remove opportunities for collusion between government officials and private firms to capture excessive profit margins. These revenue projections can also help in the selection of realistic contracts. In some rural districts in Uganda, private contract bids that offer to collect over 10% of the 'reserve price', i.e. the estimated revenue potential from a market or site, are not considered as they are seen as likely to default.

3) **Shorter term, smaller scale and enforceable contracts to encourage competitive performance.** In Tanzania, for example, many councils require private collection applicants to provide, alongside a detailed tender proposal, a bank guarantee to prevent contractors from defaulting on revenues owed. Similarly, a number of councils require regular weekly or fortnightly payment installments to prevent defaulting.

   By designing shorter term yearly collection contracts that can be renewed based on performance, local governments can incentivise private firms to provide competitive services in terms of coverage and revenues retained. Contracts that specify local government ownership of capital can play an important role in limiting monopoly power of private collectors. In addition, policymakers can reduce bargaining power of private collectors by limiting the percentage of total government revenues they are responsible for collecting.

4) **Systems for monitoring private collection to prevent inefficiency, overzealousness and corruption.** These include:

   a. **Ensuring contracts allocate adequate payment to private collectors to incentivise collection.** However, this should be accompanied with monitoring and penalty procedures for collectors. Experimental evidence from Punjab,

[13] Iversen et al., "Private Tax Collection—remnant of the Past or a Way Forward?"

Pakistan, suggests that performance pay can allow for a 46% increase in growth rates of property tax revenues collected, but that in the majority of cases higher wages simply meant a higher bribe paid because of higher bargaining power of collectors[14].

b. **Electronic payment systems.** In Lagos, private tax collectors developed and used electronic software to track payments and issue receipts to tax payers, to eliminate opportunities for human error and corruption between collectors and taxpayers[15]. A similar system in Malaysia of electronic tax filing and payment was implemented in 2004 to improve taxpayer services by reducing the time and cost of tax compliance. This was associated with an increase tax collection from 14.5% of GDP to 15.3% between 2006 - 2011[16]. However, it is important to weigh the potential benefits of electronic payment systems with the possibility that this will exclude some of the tax base.

c. **Monitoring of the collection tax base**, to ensure that revenue collection is obtained from a wide tax base, rather than predominantly from easily accessible taxpayers.

d. **Adequate monitoring capacity and effective complaints procedures** to address taxpayer concerns can help overcome the problem of overzealous collection by private contractors.

These enabling conditions in turn depend strongly on **local government capacity** as well as **strong political commitment.**

Without these enabling conditions, capacity development to facilitate tax collection by local government departments may be the best option for developing cities, particularly as this comes with the long run benefit of eliminating the private premium paid to collectors. Outsourcing to private collectors instead risks undermining the very government capacity that would be needed to effectively monitor and enforce private collection contracts. In Kampala, with the introduction of the Kampala Capital City Authority (KCCA) came an overhaul of the existing tax collection system. Tax collection was previously outsourced to private collectors, but high levels of corruption and wide private profit margins meant that limited revenues reached the government. As a result, after tax collection was brought back in house, revenues from “road user fees” from minibus taxis, for example, doubled in one year[17]. Partly as a result of these reforms, revenues at the KCCA have dramatically expanded by 89 percent after inflation, from US$9 million to $24 million between 2010 and 2015[18].

[14] Khan, Khwaja, and Olken, “Tax Farming Redux.”
[15] de Gramont, “Governing Lagos: Unlocking the Politics of Reform.”
[16] World Bank Doing Business, “Implementing Electronic Tax Filing and Payments in Malaysia.”
[17] Taylor, “How One African City Is Flipping the Script on Urban Development.”
[18] Ibid.

What circumstances and revenue sources are best suited to private tax collection?

If the costs of collection from the private sector that are passed on to local governments are higher than the costs of collection by local government staff, local governments should not outsource private collection but should instead undertake collection in house - allowing local revenues collection at the lowest cost and avoiding payment of a premium to private firms.

If the cost of collection for private firms is less than that of local governments, it is still not clear that governments should outsource collection. Outsourcing tax collection to private firms is most appropriate for cities where efficiency gains from private collection are estimated to outweigh the costs of monitoring collectors to prevent overzealous collection, corruption in tendering, contract enforcement and other enabling conditions for effective tax collection. As such, private collection may make more sense if:

- **Taxpayers have political influence.** Outsourcing of taxation to private firms may make more sense in cases where taxpayers liable for collection have sufficient understanding of their tax liability and adequate channels of communication with government to report overzealous collection. These channels of communication can come from the political power of these groups. At the same time, politically powerful groups are likely to be those most likely to be able to collude with government collectors to avoid tax payment. As such, collection of customs tax, for example, may be more appropriate to outsource to private firms, as customs taxpayers tend to be better organised and have more influence over policymaking than those liable for sales or excise taxes[19].

- **Tax amounts are non-discretionary**. The collection of revenues such as known tax arrears, where the amount to collect has already been decided by government departments, may also be more amenable to private collection, as there is limited potential for overzealous collection.

Finally, even where there are adequate enabling conditions to allow outsourcing of tax collection to private firms at a lower cost in the short run, if the primary reason for outsourcing tax collection is financial and staff tax collection capacity, local governments should weigh this against the revenues saved over the long run if initial investments are made in internal capacity building for collection. This capacity development may be in an existing local government revenue department or a dedicated local government collection agency.

[19] Kiser and Baker, "Could Privatization Increase the Efficiency of Tax Administration in Less-Developed Countries?"

Collection and compliance

It is important to note that outsourcing collection of taxes to private firms will not necessarily improve compliance with taxation on the part of taxpayers – in fact, as discussed, private collection can serve to erode the social compact on which tax compliance is based. In many circumstances citizens may feel that private firms profiting from taxes paid undermines the link between taxes paid and services provided by the government. In Kampala, for example, despite the use of private property tax collectors by the KCCA, collection rates in 2013 were approximately 50% of projected revenues[20].

There are many reasons why people do not comply with paying taxes, including the system being too cumbersome, low tax morale or because those liable do not understand their obligations. Each of these reasons will require a different remedy and this will be something that will have to be in the local council's remit to improve.

Key to improving tax compliance is active policy to increase transparency of tax collection, expand revenues, and, crucially, in spending these revenues effectively on public investments. Rigorous process for tendering are necessary to ensure privatisation of tax collection is accompanied not only by stable but also expanded revenues for government, to allow governments the capacity to invest in a city. At the same time, linking taxation to visible public investments, alongside awareness campaigns, can help build public support by linking taxation to the tangible benefits they provide.

- In Fashola's first term in office, annual capital spending in Lagos rose from $600 million in 2006 to $1.7 billion in 2011 (in inflation adjusted 2012 figures)[21]. These investments played an important part in maintaining support for further tax collection reforms in the city.

- In Liberia, tax administrators encourage tax compliance by using printed communications to explain tax obligations. At the same time, tax payments are directly connected to services; property owners are obligated to pay all outstanding tax liabilities before they are able to register their property, use property for a loan, and to use their property as proof of address for visa applications[22].

- In Bo City Council, extensive efforts to improve public outreach and transparency of spending whilst investing in small scale public services has been associated with a property tax compliance rate of 93 percent of those surveyed[23].

When collection of revenues is outsourced to private firms, governments may need to make additional provisions to improve tax compliance. In Lagos, for example, compliance was enhanced by outsourcing tax collection to market associations with strong existing ties to civil society groups in an effort to enhance social pressures for tax compliance[24].

[20] Olima, "Property Tax Regimes in East Africa."
[21] de Gramont, "Governing Lagos: Unlocking the Politics of Reform."
[22] Olabisi, "Optimizing Real Estate Taxin Liberia: Implications for Revenue Performance and Economic Growth."
[23] Jibao and Prichard, "Rebuilding Local Government Finances After Conflict."
[24] LeBas, "This Research from Nigeria Shows Us How a Government Can Build a Tax Base."

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