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Sovereign rents and quality of tax policy and administration ☆

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ABSTRACT

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Windfall revenues from foreign aid or natural resource exports can weaken governments' incentives to design or maintain efficient tax systems. Cross-country data for developing countries provide evidence for this hypothesis, using a World Bank indicator on "efficiency of revenue mobilization." Aid's negative effects on quality of tax systems are robust to correcting for potential reverse causality, to changes in the sample, and to alternative estimation methods. Revenues from natural resources are also associated with lower-quality tax systems, but results are somewhat sensitive to the choice of resource dependence indicators, and to a few extreme values in the data. Disaggregating by resource type, revenues from fuel exports are found to be more strongly associated than revenues from metals and ores exports with inefficient tax systems. *Journal of Comparative Economics* **37** (3) (2009) 359–371. The World Bank, MSN MC3-313, 1818 H St. NW, Washington, DC 20433, USA.

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1. Introduction

Access to windfall revenues from foreign aid and natural resource rents can reduce the dependence of governments in less-developed countries on their own taxpayers. Such governments have weakened incentives to broaden their tax base, improve collection rates, and eliminate inefficient exemptions and corruption. Cross-country data for developing countries provide evidence in this paper that rents from aid and natural resource revenues reduce the quality of tax systems. Aid's negative effects are robust to correcting for potential reverse causality, to changes in the sample, and to alternative estimation methods. Natural resources also show evidence of negative effects, but results are somewhat sensitive to the choice of indicators for resource intensity and to a small number of extreme values in the data. Disaggregating by resource type, revenues from fuel exports are found to be more strongly associated than revenues from metals and ores exports with inefficient tax systems.

The stronger findings for aid in comparison to natural resources presented here appear to contradict Collier (2006), who argues that donors' leverage over aid recipients can prevent or at least partially counteract some of the damaging effects of windfall revenues typically associated with oil exports. However, Collier's (2006) analysis is concerned with development outcomes such as growth, and not with the quality of tax systems. Moreover, a stronger effect for aid is consistent with a distinction in the resource curse literature regarding the "appropriability" of rents from different natural resources (Boschini et al., 2007; Isham et al., 2005). Aid revenues are relatively "appropriable," as most aid goes directly from donors to central governments.

☆ The conclusions of this paper are not intended to represent the views of the World Bank, its Executive Directors, or the countries they represent.

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Section 2 below presents the basic theoretical arguments regarding the impact of windfall revenues on developing countries' tax systems. It also summarizes the related literature on the "resource curse," which mostly addresses growth, conflict and democratization as outcomes rather than tax systems. Section 3 describes the data used in the analysis, with a particular focus on measuring dependence on resource revenues. Results from the data analysis are presented in Section 4. The concluding section discusses findings in the context of related work by Collier (2006) and others, and briefly summarizes implications for development and aid policy.

2. Taxation, governance and sovereign rents

How governments mobilize public revenues has important implications for other aspects of its quality of governance. Taxation is a key shaper of accountability relationships between citizens and government (OECD, 2008).

Historically, democracy and the rule of law in Western societies evolved from bargaining between monarchs and economic elites over tax revenues and political and economic rights (e.g. Tilly, 1990). In European warfare, rulers relying only on coercive taxation tended to fare more poorly in military conflict than their rivals who granted more rights to some of their subjects in exchange for additional revenues. Survival of the state or regime was facilitated by broadening the revenue base, which in turn often required granting more rights in return for the new revenue sources. England is the prototypical example: the Magna Carta and the Glorious Revolution are two of the most prominent events in the process of increasing accountability of monarchs to elites, followed eventually by gradual extension of the suffrage (North, 1990, pp. 113–114). Spain is an example of the opposite case. While the powers of England's Parliament expanded dramatically in the 16th and 17th centuries, Spain's Cortes had little power throughout this period (North, 1990), which coincided with enormous windfall revenues accruing to its monarchs from New World gold and silver.

In contemporary societies with broad-based tax systems, the implicit fiscal contracts between rulers and subjects take different forms. However, it remains the case that paying taxes is part of an implicit exchange in which taxpayers gain political representation or other forms of voice over public policies and provision of public services (Levi, 1988). Satisfaction with the quality of public services, and trust in government more generally, tend to improve taxpayer compliance (e.g. Bergman, 2002; Scholz and Lubell, 1998).

Conversely, governments less reliant on domestic tax revenue are less accountable, responsive, and efficient (OECD, 2008, p. 4). This argument is a major theme of the large and growing "resource curse" literature (e.g. Ross, 1999). States benefiting from oil and other natural resource rents tend to be less democratic (e.g. Ross, 2001; Karl, 1997), more corrupt (e.g. Treisman, 2007; Leite and Weidmann, 1999), and less interested in building state capacity for collecting taxes or providing services.

Many of these arguments associated with the "resource curse" literature also apply to official development assistance (ODA). Like resource rents, aid revenues can reduce government's dependence on taxes from its own citizens, weakening its accountability to them. Collier (2006) calls aid and resource revenues "sovereign rents" that generate dysfunctional rent-seeking behavior and tend to receive less scrutiny from legislators and citizens than other revenues (also see Auty, 2007).

Fig. 1 depicts a simple theoretical framework on the effect of sovereign rents (or "windfall" revenues) on tax systems. Tax revenues (exclusive of sovereign rents) increase from left to right on the horizontal axis, while tax exemptions for favored constituents increase from right to left. Increasing exemptions – i.e. moving from right to left on the horizontal axis – is associated with dollar-for-dollar reductions in tax revenues. Benefits to the regime from tax revenues and tax exemptions (net of other costs) are measured on the vertical axis. Tax revenues can be used by the regime to provide public goods

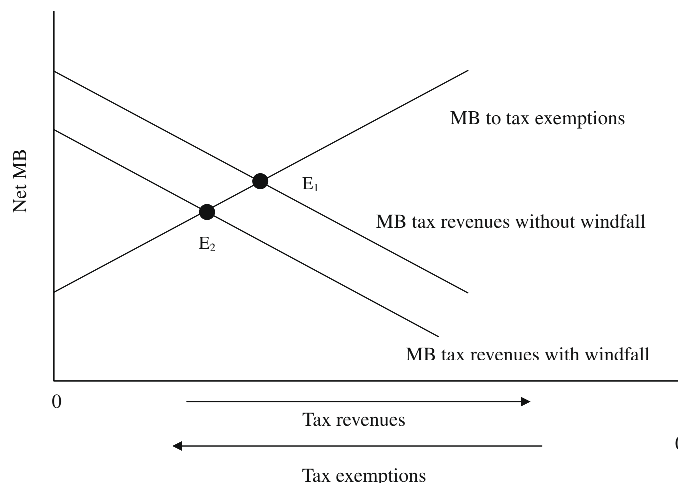

Fig. 1. Regime's optimal combination of tax revenues and exemptions.

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