



# Taxation, non-tax revenue and democracy: New evidence using new cross-country data

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## ABSTRACT

A large body of econometric research has generated growing support for the existence of a political resource curse, but has nonetheless continued to be regularly punctuated by research contesting those conclusions. This continuing disagreement can be explained in significant part by problems associated with low-quality government revenue data: it has undermined the robustness of many existing findings, while leading other researchers to rely on alternative measures of resource income as their primary explanatory variable – a highly imperfect measures of the underlying relationship of interest. We re-examine the relationship between taxation, non-tax revenue and democracy by employing dramatically improved data developed specifically for this research. We find the strongest evidence to date of a political resource curse, and provide evidence about the specific details of the underlying relationship: (i) natural resource wealth is anti-democratic, rather than merely stabilizing; (ii) it is driven primarily by changes in the composition of government revenue; (iii) it is best understood as a long-term relationship, rather than short-term changes in resource wealth being quickly translated into major political changes; and (iv) it is driven primarily by oil wealth, rather than mineral wealth, because governments are comparatively effective at translating oil wealth into the government revenues that drive the political resource curse.

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## 1. Introduction

Most research into the political resource curse proposes that governments that rely more heavily on revenue from non-renewable natural resources<sup>1</sup>, and which are less reliant on national taxation, are less likely to be democratic and accountable to their citizens. Building on this research, resource dependence has become a prominent feature of accounts in political science and economics about the long-term drivers of state building, institutional change and democracy. This argument has been based largely on cross-country econometric studies, which have proliferated over the past 15 years, with most cross-country econometric research reporting the expected negative relationship between natural resource wealth and democracy.

However, among the studies investigating “whether the resource curse is real or illusory”, a significant group have contin-

ued to contest these results (Ross, 2015: 240). Some have argued that findings of a political resource curse are simply not robust (Haber & Menaldo, 2011). Meanwhile, recent work by Morrison (2009, 2015) – building on earlier work by Smith (2004) – has proposed an alternative interpretation: that natural resource wealth, and non-tax revenue more generally, is not anti-democratic, but tends to stabilize democracies and non-democracies alike, while taxation has the opposite effect. This divergence within existing results is puzzling: Why have multiple researchers, asking a consistent and well-defined research question, over almost two decades, failed to arrive at more consistent findings?

In this paper we argue that a significant part of existing disagreement can be explained by a combination of low quality data and correspondingly mis-specified tests of the relationship of interest. We demonstrate that after correcting for these two problems there is far more consistent and persuasive evidence of the existence of the political resource curse.<sup>2</sup> Furthermore, we are able

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<sup>1</sup> Primarily oil and, to a lesser extent, other mineral resources.

<sup>2</sup> Some of the findings of this paper have been previously described in Prichard (2016a), which referred to an earlier Working Paper version of this paper.

to add clarity about underlying mechanisms that have remained debated in the literature. First, that the effects of natural resource revenues are anti-democratic, rather than merely stabilizing. Second, that the political resource curse is driven by *changes in the composition of government revenue*, rather than alternative mechanisms linking resource extraction more broadly to reduced democracy. This is important in its own right, and helps to explain recent evidence that the political resource curse is driven primarily by oil wealth rather than mineral wealth (Ross, 2012): oil wealth tends to be much more effectively translated into expanded government revenue. Third, that the political resource curse is best understood as a long-term relationship, rather than one in which levels of democracy are highly sensitive to short term fluctuations in resource revenues (Ross, 2015).

The starting point for our analysis is a return to the theory underpinning the political resource curse. The most compelling and commonly cited version of the political resource curse hypothesis focuses on the impact of changes in the *composition of government revenue* on political outcomes.<sup>3</sup> Stated most broadly, government reliance on non-tax revenue – that is, government revenue from comparatively captive sources, and primarily (but not exclusively) from non-renewable natural resources<sup>4</sup> – is expected to reduce democracy and accountability by weakening state-society links, facilitating government investments in patronage and repression, and driving expanded political corruption (Ross, 2001). Meanwhile, reliance on tax revenue – that is, revenue raised from relatively broad-based taxes on individual taxpayers and businesses – may have a conversely positive impact on governance by providing the state with stronger incentives to “bargain” with their citizens over how public revenue is used and the broader extent of political representation (Moore, 1998; Prichard, 2015).

However, owing to data limitations there has yet to be a study that convincingly and directly tests the relationship between the composition of government revenue and democracy. A handful of studies have set out to test this relationship directly, but have been undermined by severely inadequate government revenue data (Ross, 2004; Mahon, 2005; Morrison, 2009, 2015). This data, primarily from the IMF and World Bank, has suffered from extensive missing observations and has failed to distinguish effectively between tax and nontax revenues. Owing to these data limitations, most studies of the political resource curse have instead tested the relationship between *resource income*<sup>5</sup> and democracy. However, while this is an intuitive proxy for changes in the composition of government revenue, it is highly imperfect, and thus fails to precisely test the key mechanism underpinning the most persuasive version of the resource curse hypothesis (Wiens, Poast & Clark, 2014).

In what follows we address these longstanding problems by drawing on dramatically improved data from the ICTD Government Revenue Dataset (GRD), which was constructed explicitly, though not exclusively, for this project (Prichard, Cobham, & Goodall, 2014).<sup>6</sup> These improved data are pivotal. Table 1 lists the

<sup>3</sup> Natural resource wealth – and oil wealth in particular – may also affect democracy through alternative channels, detailed most completely in Ross (2012). However, our contention is that revenue related channels are the primary mechanisms linking resource wealth to autocracy.

<sup>4</sup> As described in detail later, this definition is rooted in the political economy literature, and differs from a purely accounting definition.

<sup>5</sup> Defined as the total annual value of resource production, either per capita or as a share of GDP.

<sup>6</sup> We employ the May 2016 version of the data, available at <http://www.ictd.ac/datasets/the-ictd-government-revenue-dataset>. Future updates of the data will be hosted by UNU WIDER, and are available here: <https://www.wider.unu.edu/project/government-revenue-dataset>. An earlier working paper version of this paper reported results employing the original 2014 version of the ICTD data, while the 2016 version of the data, used here, is significantly improved in terms of coverage, accuracy and the length of the time series.

33 resource dependent states that collect at least 10% of GDP in non-tax revenue<sup>7</sup> and for which any data is available. It then compares data coverage here to data coverage in the two most high profile papers to have previously run similar tests linking the composition of government revenue to levels of democracy (Ross, 2004; Morrison, 2009).<sup>8</sup> The table notes countries for which there was either (a) no data in earlier studies, (b) extremely limited data, or (c) data that was analytically problematic owing to a failure in earlier international datasets to adequately distinguish between normal tax revenues and resource revenues.<sup>9</sup>

The limitations of those early papers are immediately apparent. A seminal paper by Ross (2004) exploring the connections between tax reliance and democracy contains no data for nine of the 33 countries, limited data for six countries, and contains data that is analytically problematic – and often severely so – for an additional fourteen countries. Data is relatively complete, and entirely free of problems, for only four of 33 countries. More recent work by Morrison (2009) rightly excludes the most analytically problematic data, but at the expense of extremely limited data coverage: His dataset contains no data for fifteen of these countries, very limited data for an additional five, and analytically problematic data for seven more countries. Relatively complete and accurate data is available for only seven of 33 resource-dependent countries. While these data problems merely reflect the limits of earlier datasets, and efforts by the authors to ask important questions while employing the best available data at the time, they raise serious concerns about the reliability of earlier results.

With access to this new data we implement three distinct sets of econometric tests: Generalized Method of Moments (GMM), Mean-Group Estimators (MG), and Random and Fixed-Effects Logit estimators. All of the estimators yield clear support for the existence of a political resource curse that is both statistically significant and large in magnitude. In turn, we are able to explicitly demonstrate that, consistent with theory, all of the results are stronger when focusing on the *composition of government revenue*, rather than *resource income*, while the results are similarly stronger when employing estimators that focus on the long-term relationship between revenue and democracy, rather than focusing exclusively on short-term changes.

The paper proceeds in seven parts. The next section presents a brief review of the relevant literature. The second section presents the new data and the construction of the revenue variables. The third section presents the empirical strategy, reviewing the rationale for a range of alternative econometric models. The fourth section presents the core results and the fifth section presents robustness checks. The sixth section offers a discussion of the core results. The final section concludes.

## 2. Going back to basics: Model specification and data

Most studies of the political resource curse propose that natural resource wealth – and other forms of non-tax revenue – are likely to undermine the quality of a country's governance by disconnecting governments from their citizens, supporting the expansion of corruption, patronage and repression, and increasing the risk of conflict (Ross, 2015). Beginning with Ross (2001), a wide array of cross-country econometric studies have reported support for such

<sup>7</sup> Of which the majority is from non-renewable natural resources.

<sup>8</sup> Haber and Menaldo (2011) construct a similar fiscal reliance variable, but it covers only 14 of the 33 countries listed here. Morrison (2015) provides a more recent version of his 2009 results. It was unfortunately not possible to access that data, but the sample sizes are almost identical to those from the 2009 paper.

<sup>9</sup> This issue is discussed at length later in the paper. Data is labeled “analytically problematic” if the share of tax revenue in total government revenue reported in the original source is at least 50% larger than the level reported in the more accurate ICTD GRD.

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