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Taxation and Democratization

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Summary. — Anecdotal evidence from pre-modern Europe and North America suggests that rulers are forced to become more democratic once they impose a significant fiscal burden on their citizens. One difficulty in testing this "taxation causes democratization" hypothesis empirically is the endogeneity of public revenues. I use introductions of value added taxes and autonomous revenue authorities as sources of quasi-exogenous variation to identify the causal effect of the fiscal burden borne by citizens on democracy. The instrumental variables regressions with a panel of 122 countries over the period 1981–2008 suggest that revenues have on average a mild positive effect on democracy.
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Key words — taxation, democracy, democratic transition, tax innovations

1. INTRODUCTION

One defining feature of a state is its capacity to raise revenues. Whether a state is strong or weak, whether it is determined or yielding, even whether it survives or disintegrates depends ultimately on its balance sheet. Public finances are thus more than a purely economic phenomenon. Following Joseph Schumpeter's conception of a *fiscal sociology* they are essential determinants of social and political developments, in fact "…public finances are one of the best starting points for an investigation of society, especially but not exclusively of its political life" (Schumpeter, 1991, p. 101).

The level and composition of public revenues, in particular, are likely to have a decisive influence on the character of the state. Rulers who depend on revenues from taxation will rule differently than rulers who rely on their own estates or on the exploitation of natural resources. Taxation implies a direct and noticeable transfer of resources from citizens to the state. Most other revenue sources affect citizens less or not at all. Given this critical distinction between tax and non-tax revenues, it can be conjectured that rulers who impose a large fiscal burden on their citizens must offer them in return a voice in policy making. Once citizens feel the fiscal weight of the state, they are less likely to tolerate an autocratic and unaccountable government. [1]

Historical evidence appears to be consistent with this argument. There are several famous examples where attempts to increase taxation by autocratic rulers resulted in revolution and eventually more accountable government. During the early conflicts between Parliament and the Crown in England, the former rebelled against repeated attempts by the kings to expand taxation and simultaneously model the English state into an absolutist monarchy. The French Revolution began as a revolt against the large tax burden imposed by the Ancien Régime to fund its costly wars and sumptuous court life. The American Rebellion even had as its seminal demand that there should be no taxation without representation.

The "taxation causes democratization" hypothesis has recently reemerged in the context of development policies. [2] According to some authors, improvements in the state's capacity to tax could lead to more democracy in developing countries (Di John, 2009; Moore, 2007). Yet while the case for the hypothesis appears strong in view of the historical evidence, it is ultimately based on a few admittedly dramatic but perhaps unrepresentative cases.

I study in this paper whether taxation has a casual effect on democracy with a panel dataset consisting of macroeconomic data for 122 countries over the period from 1981 to 2008. [3] As sources of quasi-exogenous variation, I rely on two tax innovations that have seen wide-spread adoptions in the last three decades: the value added tax (VAT), and autonomous revenue authorities (ARA). I argue that countries adopted these two tax innovations primarily for fiscal and economic reasons, i.e., reasons unrelated to their level of democracy. Dummy variables indicating the year of their adoptions can therefore serve as quasi-exogenous instruments for levels of taxation.

The closest methodological predecessor to this paper is the study by Keen and Lockwood (2010) on the causes and consequences of the introduction of value added taxes. These authors explore why countries adopt a VAT and whether revenues increase after the adoption. In terms of the research question, the closest precedent is Ross (2004) who studies the link between taxation and representation for a large panel of countries. However, since his results rely on pooled cross-section regressions, there remains doubt whether he has identified a causal effect. Subsequent contributions on the taxation–democracy link devote more attention to identification, but have a narrower geographical focus. Berger (2009) studies whether regional differences in the investment in administrative capacity by the British colonial authorities in Nigeria affect the contemporaneous quality of government. Baskaran and Bigsten (2013) investigate with panel data from 23 sub-Saharan Africa how fiscal capacity affects the quality of the government. McGuirk (2011) tests with micro-level public perception data from 15 sub-Saharan African countries whether natural resource rents incentivize rulers to reduce taxation, and whether this effect in turn diminishes the demand for democratic accountability.

A related literature focuses on how natural resource wealth in general and oil abundance in particular—sources of public revenue that do not require the participation of citizens—

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Table 1. *Countries and adoption dates*

Country	VAT	ARA	Country	VAT	ARA	Country	VAT	ARA
Algeria	1992	–	Gabon	1995	–	Nigeria	1994	–
Angola	–	–	Gambia	–	2005	Norway	1970	–
Argentina	1975	1988	Germany	1968	–	Oman	–	–
Australia	2000	–	Ghana	1998	1985	Pakistan	1990	–
Austria	1973	–	Guatemala	1983	1999	Panama	1977	–
Bahrain	–	–	Guinea	1996	–	Papua New Guinea	1999	–
Bangladesh	1991	–	Guinea-Bissau	–	–	Paraguay	1993	–
Belgium	1971	–	Guyana	–	2001	Peru	1973	1991
Benin	1991	–	Honduras	1976	–	Philippines	1988	–
Bhutan	–	–	India	2005	–	Portugal	1986	–
Bolivia	1973	1987, 2001	Indonesia	1985	–	Rwanda	2001	1998
Botswana	2002	2005	Iran	–	–	Saudi Arabia	–	–
Brazil	1967	–	Ireland	1972	–	Senegal	1980	–
Burkina Faso	–	–	Italy	1973	–	Sierra Leone	–	2002
Burundi	–	–	Jamaica	1991	1981	Singapore	1994	2001
Cambodia	1999	–	Japan	1989	–	Solomon Islands	–	–
Cameroon	1999	–	Jordan	2001	–	South Africa	1991	1997
Canada	1999	–	Kenya	1990	1995	Spain	1986	–
Central African Republic	2001	–	Korea, Republic of	1977	–	Sri Lanka	1998	–
Chad	2000	–	Kuwait	–	–	Sudan	2000	–
Chile	1975	–	Laos	–	–	Swaziland	–	–
China	1994	–	Lebanon	2002	–	Sweden	1969	–
Colombia	1975	1991	Lesotho	2003	2003	Switzerland	1995	–
Comoros	–	–	Liberia	–	–	Syria	–	–
Congo, Dem. Rep.	–	–	Libya	–	–	Tanzania	1998	1996
Congo, Republic of	1997	–	Madagascar	1994	–	Thailand	1992	–
Costa Rica	1975	–	Malawi	1989	1995	Togo	1995	–
Cote d'Ivoire	1960	–	Malaysia	–	2001	Trinidad & Tobago	1990	–
Cyprus	1992	–	Mali	1991	–	Tunisia	1988	–
Denmark	1967	–	Mauritania	1995	–	Turkey	1983	–
Djibouti	–	–	Mauritius	1998	2005	Uganda	1996	1991
Dominican Republic	1983	–	Mexico	1980	1997	United Arab Emirates	–	–
Ecuador	1970	1999	Mongolia	1998	–	United Kingdom	1973	–
Egypt	1991	–	Morocco	1986	–	United States	–	–
El Salvador	1992	–	Mozambique	1999	–	Uruguay	1968	–
Equatorial Guinea	2005	–	Namibia	2000	–	Venezuela	1993	1993
Eritrea	–	–	Nepal	1997	–	Vietnam	1999	–
Ethiopia	2003	2002	Netherlands	1969	–	Yemen	–	–
Fiji	1992	–	New Zealand	1986	–	Zambia	1995	1994
Finland	1994	–	Nicaragua	1975	–	Zimbabwe	2004	2001
France	1948	–	Niger	1986	–			

This table lists the countries included in the sample and notes the years in which they introduced a VAT or an ARA. For Ghana and Vietnam, the two countries included in the sample that have abolished a VAT and subsequently reintroduced it, only the second introduction is noted (the first VATs in these countries were short-lived). Bolivia introduced an ARA in 1989, abolished it in 1989, and reintroduced it again in 2001. Both introduction dates are noted for Bolivia.

affect democracy and the quality of government. Notable studies are Ross (2001), Herb (2005), Treisman (2007) and Tsui (2011). Another related literature investigates whether aid has the same consequences as natural resource income for democracy (Bermeo, 2011; Collier, 2006). This paper is also related to the extensive empirical literature on the determinants of democracy. A seminal contribution that explores different channels is Barro (1999). Much of the subsequent literature studies specific causes. For example, Acemoglu, Johnson, Robinson, and Yared (2005) explore the role of education, Acemoglu, Johnson, Robinson, and Yared (2008) study the link between income and democracy, and Persson and Tabellini (2009) study the effects of past experiences with democracy.

The remainder of this paper is structured as follows. In Section 2, I provide a short description of the elementary features of value added taxation and autonomous revenue authorities and discuss the causes of their spread during the last three decades. I introduce the empirical model in Section 3 and discuss the data in Section 4. The results are collected in Section 5. I conclude in Section 6.

2. VATS AND ARAS AS TAX INNOVATIONS

The main idea of this paper is to use quasi-exogenous variation in the efficiency of the revenue collection technology to identify how the fiscal burden imposed on citizens affects the level of democracy in a country. Two remarkable developments in the field of taxation over the last three decades can provide such quasi-exogenous variation: the spread of value added taxes and the increased adoption of autonomous revenue authorities.

The value added tax, first introduced in France in 1948,[4] is in principle a tax on sales. In contrast to retail sales taxes which are charged on the final sale of a product, the VAT is

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