

No representation without taxation

Governments that depend on taxes need the consent of their citizens. They must establish trust-worthy systems of revenue collection, and design policies responsibly. In historical terms, parliaments' budgetary rights were the base for democracy.

[By Mick Moore]

➔ Governments need money to pay for health services, education, roads, agricultural research and other public goods. Therefore, they have to raise funds at a massive scale. If one compares the effects alternative sources of revenue have on governance, taxation is clearly the best choice. Basically, there are only two other relevant sources: foreign aid and income generated from controlling the extraction and export of natural resources.

In theory, there are several reasons for preferring taxation over the other two. It makes sense to spell them out step by step. First of all, there are effects on the governments themselves.

- The prosperity of any tax-collecting government depends on having prosperous citizens and enterprises. Accordingly, these governments have a self-interest in development and growth, which makes them responsive to the needs of their economies and people.
- To raise taxes reliably, moreover, governments need efficient, accountable and honest revenue services. It is a productive challenge to invest in creating, training and sustaining such agencies, which then tend to constitute the core of good civil services in general. In contrast, it does not require much competence to raise money from aid donors or oil wells.

Second, taxes engage citizens. Taxpayers want to know what is happening to "their" money. Many are prepared to organise in attempts to hold governments to account. The knowledge that their government is funded from oil or aid does not engage citizens in the same way.

Finally, taxation affects the way governments and citizens interact. There is great scope – though no guarantee – for productive bargaining and deal-making between the two sides.

- If the government and taxpayers can reach agreements on what taxes will be levied, how, and at what levels, then tax demands become more predictable and compliance more likely. Business will be more secure in making investments, and governments can undertake long-term fiscal planning. Aid, on the other hand, is the least predictable

source of governmental revenues, and commodity prices are very volatile.

- Government officials and citizen-taxpayers representatives who sit down to bargain about taxes will normally also discuss the policies the state will pursue in return for taxes. Doing so makes mutually beneficial decisions more likely and improves policy-making in general.
- Representatives of citizen-taxpayers will demand public scrutiny of how public money is spent, forcing governments to act more transparently.
- Accordingly, the elected legislature will be strengthened in relation to the executive.

Supportive empirical evidence

These theoretical considerations are supported by three kinds of empirical evidence. The first is historical, especially rich for Europe in the past three centuries. Typically, rulers' need for money was the driving force behind extending the power of representative legislatures. This connection was widely recognised at the time. Parliaments' budgetary powers thus became the cornerstone of democracy.

The second kind of evidence is contemporary and abundant, but a bit indirect. It has become quite evident that governments, which largely depend on revenues from oil and gas, for example, rule badly. They are especially prone to act in undemocratic, militaristic and exclusive ways. Dependence on aid, moreover, obviously undermines a country's sovereignty.

A third kind of practical evidence stems from comparing sub-national administrations within the same country. For instance, Carlos Gervasoni (2006) looked at the recent political history of Argentina's provinces, which depend on taxes, substantial transfers from the central government and, in a few cases, local oil revenues. He found that the provinces that relied most on broad taxation of their citizens had also been the most democratic ones historically. In a similar vein, Barak Hoffman and Clark Gibson (2006) found that district governments in Tanzania spend higher proportions of



◀ Dissatisfaction with taxes triggered the American Revolution. On 16 December 1773, Bostonians protested against taxes that England, the colonial power, was raising without paying attention to local needs. Men dressed up as American natives dumped tea shipments into the harbour.

the revenues they generate on services for the citizens (rather than on themselves) if local populations are economically mobile and can thus avoid coercive local taxation.

The question may arise, whether taxation systems make wealthy segments of any given population more influential, simply because they pay more taxes. However, this is not a crucial matter. After all, the principal problem in countries with bad governance is that governments are barely responsive and accountable to anyone at all. If concern for making taxpayers part with their money more willingly were to restrain their behaviour and make them less repressive, that would be more than welcome. It seems unlikely that poorer sections of the population would not benefit, too. In any case, they are very unlikely to be worse off.

If one accepts that engaging citizens is an important aspect of taxation, it makes sense to raise those taxes that taxpayers are most aware of. These are normally "direct" taxes on income, property, wealth et cetera. However, the old distinction between direct and "indirect" taxes (on sales or turnover) is blurring. The fastest growing tax in the world is VAT (value-added tax). It exists in most developing countries today. While formally an indirect tax, VAT is a direct tax from a political perspective because it impacts very perceptibly on enterprises.

Its introduction has been resisted strongly in some developing countries, mainly because of the visible, continuing book-keeping burden it imposes on small businesses. Once VAT is introduced, however, business managers and tax authorities tend to be in continual negotiation over precise procedures and coverage and, in the case of exporters, repayment of VAT export re-

bates. In sum, the "direct-indirect" issue does not matter very much.

Reconsidering budget support

Donor governments should bare in mind that taxation is not only a matter of finances, it is also a precondition of good governance. Negotiations about budget support gives them a real opportunity to talk to recipient governments about raising revenues locally. So far, we probably do not have enough convincing evidence about the bad effects of high aid levels on governance to use this alone as an argument to reduce aid. But aid donors would act irresponsibly if they did not take the issue seriously by seizing this opportunity to talk about replacing aid.

Fortunately, some are doing so. There are interesting developments within the Development Assistance Committee of the OECD. Germany could use its position as Chair of the G8 this year to advance this agenda. It is high time to use the enthusiasm among senior African tax administrators who want to use their expertise to end what they see as humiliating, frustrating, endless aid dependence. ←

References:

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VAT triumph

Value-added tax (VAT) systems are sweeping the globe. Introduced in Europe as long ago as the 1960s, some form of VAT has now been adopted by virtually every country in the world – with the notable exception of the United States. Since the early 1990s, the spread of VAT has accelerated. For one thing, the model has been adopted by many countries of the former Eastern Bloc; for another, the International Monetary Fund has pushed for its introduction in many African countries.

VAT generates high revenues at comparatively little administrative cost. That is why it regularly figures in the debate on development financing. But VAT is not without its problems. In effect, it taxes consumption, and thus the hardest-hit are poor people who have to spend a large share of their income on essentials.

VAT is basically levied on the sales invoiced by companies and the self-employed. All VAT expenses for goods and services accrued before in the course of business are deducted. Accordingly, the system precisely taxes the value added at every stage of production. Even though enterprises and entrepreneurs transfer VAT payments to the fiscal authorities, it is the consumers that bear the true burden as VAT is included in consumer prices.

The basic VAT model is almost the same everywhere, but the way it is implemented varies from one country to another. Governments can apply different VAT rates. Moreover, they grant exemptions to different product groups or types of businesses. Typically, exports are exempt from VAT, whereas imports are taxed. VAT has been adopted on such a large scale that there are only few countries left that might still consider introducing it. Around the world, two trends are striking.

- Almost everywhere VAT has been introduced, it accounts for a substantial amount of total tax revenue.
- One reason regularly given for its introduction is that it does not distort markets.

In sub-Saharan Africa, VAT generally accounts for 20% to 35% of tax revenues. It typically affects important imports. In some places today, tax on imports makes up as much as two-thirds of all the VAT collected. Where a large part of an economy is informal, ratios that high are not unusual. Often, VAT was introduced at the same time as tariffs were scrapped.

Many governments seem to consider VAT a useful cash cow. However, its redistributive effect is relevant from a development viewpoint. Unlike taxes on income, VAT does not lend

itself to progressive or graduated taxation, where the better-off are taxed more heavily than those with small incomes. However, this does not mean that income taxes are always preferable. What matters is how the system as a whole impacts on the poor. If tax revenues are used for transfer payments to the disadvantaged, the result can be progressive even if a tax itself is regressive. Implementing such a progressive system, however, is something that only reform-minded governments committed to poverty reduction as well as to good financial governance will be capable of. In many cases, governments exempt essential goods (like basic foodstuffs) from VAT.

In countries where VAT is already successfully established, action in the future will focus on eliminating shortcomings. For trade blocs like ECOWAS and SADC, regional tax coordination will be at stake. And in most developing countries, capacity building will continue to be necessary in order to strengthen tax administrations. However, one of the greatest challenges in the decades ahead will be organised VAT fraud, especially "carousel" fraud, where bogus claims for VAT deductions are made on business transactions. So far, even EU members have not managed to find a satisfactory solution to this problem.

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Number of countries in different regions with a VAT system in place in the years indicated (Total numbers of countries in brackets)

	Sub-Saharan Africa (43)	Asia and Pacific (24)	EU 15 and Norway, Switzer- land	Central and Eastern Europe (27)	North Africa and Middle East (21)	North, South and Central America (26)	Small island states (27)
2005	33	18	17	27	9	23	9
1989	4	6	15	1	4	16	1
1979	1	1	12	0	1	12	0
1969	1	0	5	0	0	2	0

Sources: Ebrill, L et al., 2001: The modern VAT, IMF and Background paper for International Tax Dialogue, Rome, March 2005