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To Render Unto Caesar: Tax Policy for Developing Countries

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It's a little unusual to base an economic presentation, and certainly one about taxes, on a scriptural reference from the Bible, but I thought Jesus' dialogue with the Pharisees on the subject of taxation raised issues that are still of paramount importance to us today.

For those of you who might not know the story, Jesus was preaching in Jerusalem, and the Pharisees, strict adherents of religious law, were trying to trap him, and they asked him whether it was lawful or not to pay tribute—taxes—to Caesar. Jesus asked to see a coin and noted that it had Caesar's image on it, not God's. He then said (Matthew Chapter 22), "Render unto Caesar the things which are Caesar's; and unto God the things that are God's."

What I want to talk about this evening are the things which are Caesar's. What are they? What should they be? Is there a genuine consensus in society about what things properly belong to Caesar, or the state? Or, to put it more prosaically, do we all agree on the things that we want the state to do? And do we have a collective understanding of the things a state cannot do well, or should not do at all?

Taxation

Taxation in all countries, and certainly in developing countries, and most certainly here in East Africa, is a subject filled with contradictions and perverse incentives. Some of the questions we must deal with are entirely practical: Are we promoting good economic practice and efficiency? Will we actually be able to collect the revenue we need? Others are acutely moral and ethical: Do we tax the right people? Do

Talking Points

- No tax policy is likely to succeed—certainly not in a democracy—unless basic questions of fairness and justice are answered to the satisfaction of the population as a whole.
- What government does and how it does it is far more significant than tax rates or the size of government in determining economic prosperity. On the other hand, higher government spending, while it might boost growth in the short run, seems to do so at the expense of long-term growth.
- In poor countries, rendering unto Caesar may not be an easy or simple matter. Governments that make the process as simple, as honest, as transparent, and as fair as possible will bring benefits both spiritual and economic to their people.

This paper, in its entirety, can be found at:
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we tax fairly? Are we encouraging corruption or law breaking?

The tax policy of King George III of England, a tax policy regarded as unjust by the people of the 13 American colonies, was a prime cause of the American Revolution. The Boston Tea Party was a tax revolt to protest tariffs on tea that were designed to give an unjust advantage to the East India Company.

I'm not advocating tax revolt or revolution, but I do want to emphasize that no tax policy is likely to succeed—certainly not in a democracy—unless basic questions of fairness and justice are answered to the satisfaction of the population as a whole. Assuming that you have a genuine consensus in society on what a state should do, and how the burden of paying for it should be distributed, can you actually devise systems to collect the money you need in the amounts required from the people who should pay?

The answer, in a highly developed country like the United States, is maybe. We have entire industries in my country devoted to tax avoidance and major political debates about the proper degree of progressivity for an income tax and the extent to which taxation should fall on income, consumption, trade, property, people, or businesses.

Responding to the Informal Economy

In developing countries, the problem is even more daunting. First you have to find the money. That is relatively easy for money flowing through the banking system, but as little as 20–30 percent of estimated African GDP may actually be captured by the banking system. The rest, flowing through the informal economy, is no less real or important, but it may be invisible and uncountable (and thus, untaxable) to the government.

Table 1 shows one recent estimate of the size of the informal economy on the African continent.

Table 1 HL 1056

Size of the Informal Economy in Africa

Informal economy as a share of:	
• Non-agricultural employment	78%
• Urban employment	61%
• New jobs	93%

Source: Jantjie Zaba, Pat Horn, and Shirin Motala, "The Informal Sector in Sub-Saharan Africa," International Labour Office, 2002.

Typical government responses to the challenges of economic informality are problematic, to say the least. Governments will tend to tax the income or wealth they can see, or perhaps not even income or wealth but just any flows of money they can identify and somehow tap.

In developing countries, many or perhaps even most of the workers may be employed in agriculture or informal commercial activities that are either not properly monetarized or not institutionalized through the legal or banking sectors. We do not actually know what the true gross domestic product is in most developing countries, and therefore we do not know what the actual tax base is.

Table 2 shows some recent estimates of uncounted and untaxed economic activity.

When you don't know what levels of income are, it is difficult to extract meaningful income from an income tax. The attempt to tax incomes provides major incentives for individuals and firms to remain outside the formal economy, or to hide and under-report their income. If meaningful revenue is to be extracted through an income tax, from an equity point of view, it will almost always be the case in developing countries that too few people are taxed and that they are taxed at rates—nominal rates at least—that are too high. Of course the rich, who in every society enjoy more political power, may be able to use that power to avoid paying all or part of what they owe.

Economic informality also creates problems for that other great source of revenue in developed countries: consumption, sales, or value-added taxes.

- Consumption taxes depend on transactions that flow through organized channels of commerce with firms that keep records of sales and inventories.
- A value-added tax requires even more records because of its elaborate reimbursement processes to prevent double taxation.
- Property taxes are problematic too. Where land titles or registration practices are weak, and

where landholders may enjoy disproportionate influence on government, the use of property taxes to generate significant revenue will face formidable legal, administrative, and political problems.

Streams of Income

There are two readily identifiable streams of income available for taxation in developing countries, and these form the bedrock of government revenue in most developing countries. The first is revenue from mining or other extractive industries. Such industries are generally large, capital-intensive, and likely to deal in a product that will cross a border to be sold: easy pickings for a tax official. Likewise, goods coming into a country provide an easy target for taxation, or a tariff in this case.

Not surprisingly, developing countries rely far more than developed countries on revenues from tariffs in support of government. The costs of this in terms of lost efficiency and equity are tremendous. Tariffs distort prices and misallocate resources. As for equity, it is hard to imagine an ethical system in which it is possible to justify why a government should be able to impose an additional cost through tariffs on average consumers for the benefit of a select group of producers, who are likely to have far more income and wealth.

Table 2 HL 1056

Growth of the Informal Economy

	Central Africa
Cameroon	In 1992, 80% of all jobs created were in the informal economy.
Democratic Republic of the Congo	No figures available.
	East Africa
Tanzania	In 1990, the informal economy contributed 33% of GDP.
Kenya	In 1995, the informal sector employed 2.2 million people, compared with 1.6 million employed in the formal economy.
Uganda	Employment in the informal economy exceeds employment in the formal economy.
	Southern Africa
Angola	By the 1990s, 26% of all non-farm employment was believed to be in the informal economy.
Mozambique	In the 1990s, 30%–40% of urban households were dependent on the informal economy.
South Africa	Employment in the urban informal economy increased from 1 million people in 1996 to 1.9 million in 1999.
Swaziland	By the 1990s, the informal sector contributed 22% of national employment compared with 10% in the 1980s.
Zambia	43% of urban employment is in the informal economy.
Zimbabwe	In 1996, the informal economy employed 1.5 million people, compared with 1.26 million people in the formal economy.
	West Africa
Ghana	The informal economy employs 89% of the labor force.
Nigeria	The informal economy employs one-third of the urban labor force.

Source: Jantjie Zaba, Pat Horn, and Shirin Motala, "The Informal Sector in Sub-Saharan Africa," International Labour Office, 2002.

The best thing a country can do for itself is to set its tariff rates to zero. There is no need for negotiation. Unilateral action is faster and surer. There is no reason to delay the improvements in one's own economy that flow from free trade or to make them contingent on policy improvements in another country. Just get rid of the tariffs. Phase them out if you must, but get rid of them.

Where does that leave developing countries in terms of generating tax revenue? In a very hard place. Income tax is problematic. Consumption and value-added taxes are problematic. Property taxes are problematic. Taxing extractive industries is problematic. Tariffs are problematic. I haven't mentioned excise taxes or seignorage, the printing of money.

Excise taxes are levies designed to discourage behavior or consumption of certain products. Since these taxes can be significant revenue raisers in certain areas—taxes on tobacco or alcohol come to mind—we cannot dismiss them from the discussion. They do, however, have the same distorting economic and welfare impacts as any tax on consumption. One needs a strong societal consensus behind such taxes if they are actually to reduce consumption of the product that is taxed rather than foster the creation of a black market in it.

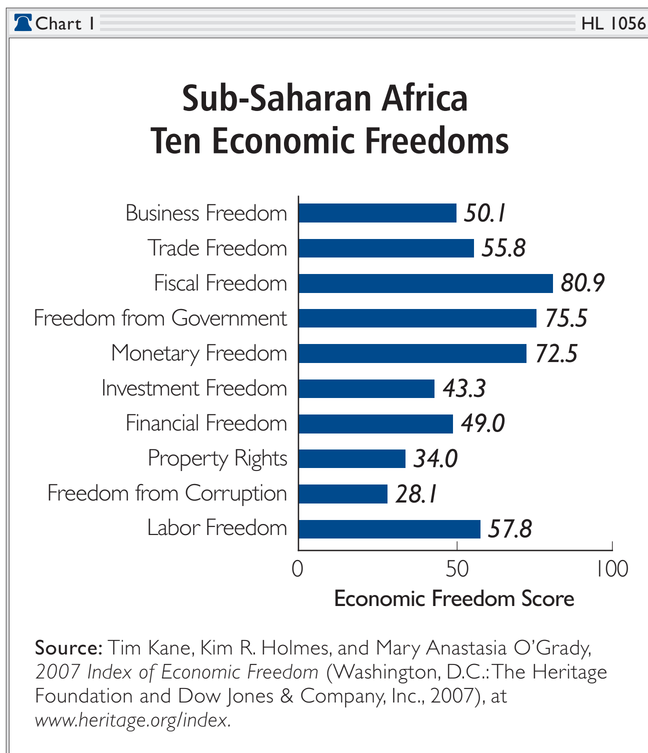
Some estimate that seignorage income—the money that countries earn by printing money—may account for almost 25 percent of government revenue in poorer countries. The risk, of course, is inflation.

The bottom line is that taxation is much harder to do in developing countries than in developed countries. And the real bottom line: Tax revenue as a percentage of GDP is approximately half in developing countries what it is in developed countries.

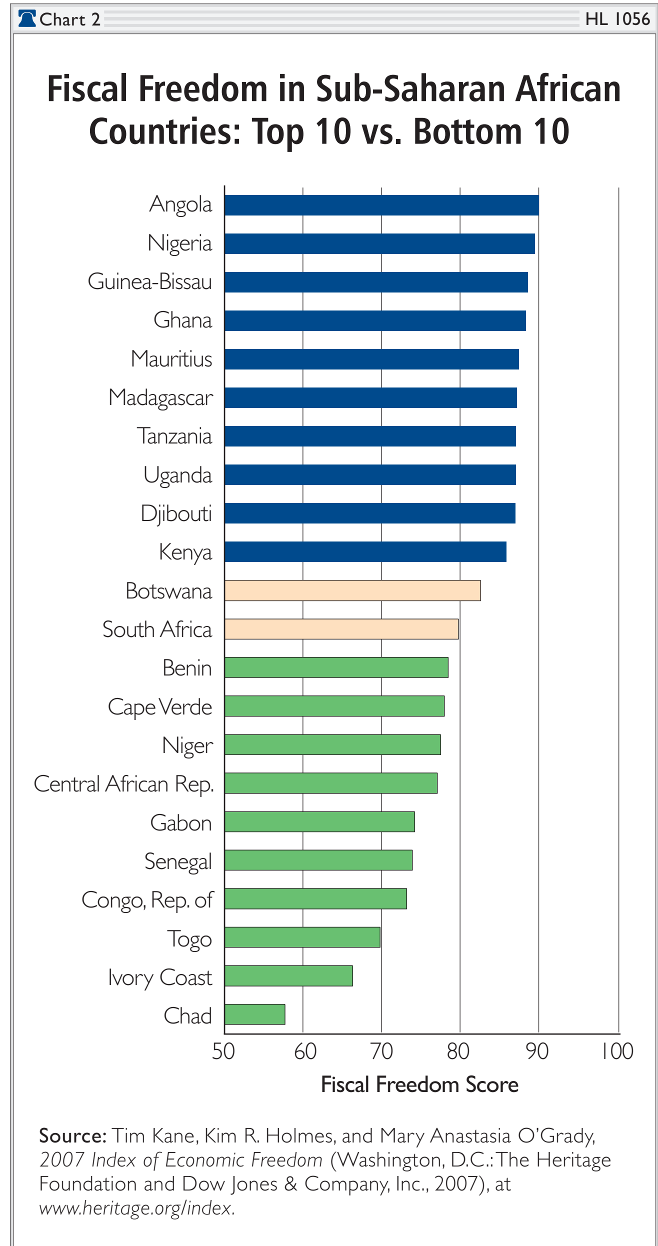
Economic Freedom and Growth

Most of the literature and most of the speakers on tax policy in developing countries regard this fact—the difficulty of raising government revenue through taxation—as a big problem. I have a different perspective. The Heritage Foundation's *Index of Economic Freedom* shows conclusively the link between economic freedom and economic growth.

Vital components of the overall economic freedom score are fiscal freedom, representing tax rates, and freedom from government, representing the percentage of economic activity for which the government is responsible. Chart 1 shows the 10



Source: Tim Kane, Kim R. Holmes, and Mary Anastasia O'Grady, *2007 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2007), at *www.heritage.org/index.*



Source: Tim Kane, Kim R. Holmes, and Mary Anastasia O'Grady, *2007 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2007), at *www.heritage.org/index.*

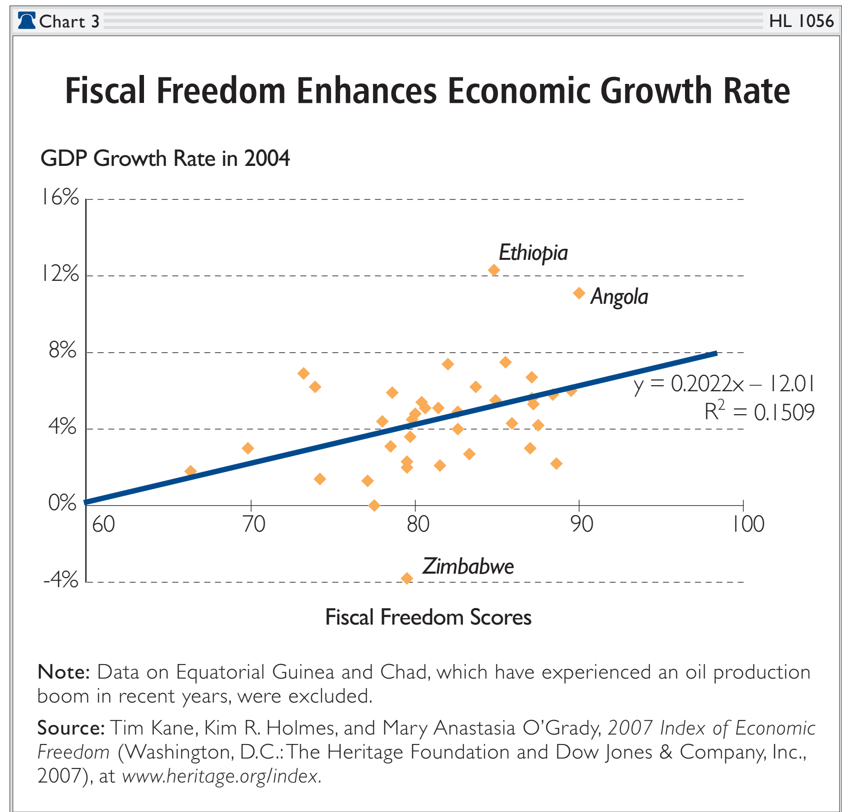
economic freedoms we measure and how African countries did.

When one looks at Africa and other poor countries, the picture can be a little confusing. Africa, which scores lowest overall in economic freedom, actually scores rather well on the two indicators relating to tax levels and government size.

Chart 2 looks just at taxes and what we call fiscal freedom. It's hard to see too much of a pattern.

This puzzling picture is borne out in a remarkable recent study by Leon Louw of the South African Law Review Project.[1] According to Louw, the clear correlation between lower taxes and higher growth that data show for the rich countries of the Organisation for Economic Co-operation and Development (OECD) was not statistically significant for poorer countries.

Using our data from the *Index of Economic Freedom*, and excluding Equatorial Guinea and Chad, two countries whose high rates of oil-induced growth skew the results, we at The Heritage Foundation do find a clear correlation, but those of you who are statisticians can see from the low *R*-squared here that there is a lot more going on in the observed growth rates than just tax policy. (See Chart 3.)



Note: Data on Equatorial Guinea and Chad, which have experienced an oil production boom in recent years, were excluded.

Source: Tim Kane, Kim R. Holmes, and Mary Anastasia O'Grady, *2007 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2007), at *www.heritage.org/index.*

It appears that what government does and how it does it is far more significant than tax rates or the size of government in determining economic prosperity. On the other hand, higher government spending, while it might boost growth in the short run, seems to do so at the expense of long-term growth.

Louw determined that a number of our most cherished preconceptions about the causes of economic growth are simply not true. For example, many believe that government spending on education is a key to growth. Louw found instead that spending on education lags economic growth. In other words, the causation goes the other way: Economic growth leads to better levels of education. One could certainly hope that this starts a virtuous cycle in which better education might then contribute to even higher future growth.

Louw looked at foreign aid and found what so many other economists have found—no statistically significant link between official development assistance and development. Chart 4 shows the relationship between aid flows and economic growth. As you can see, it is virtually an inverse relationship.

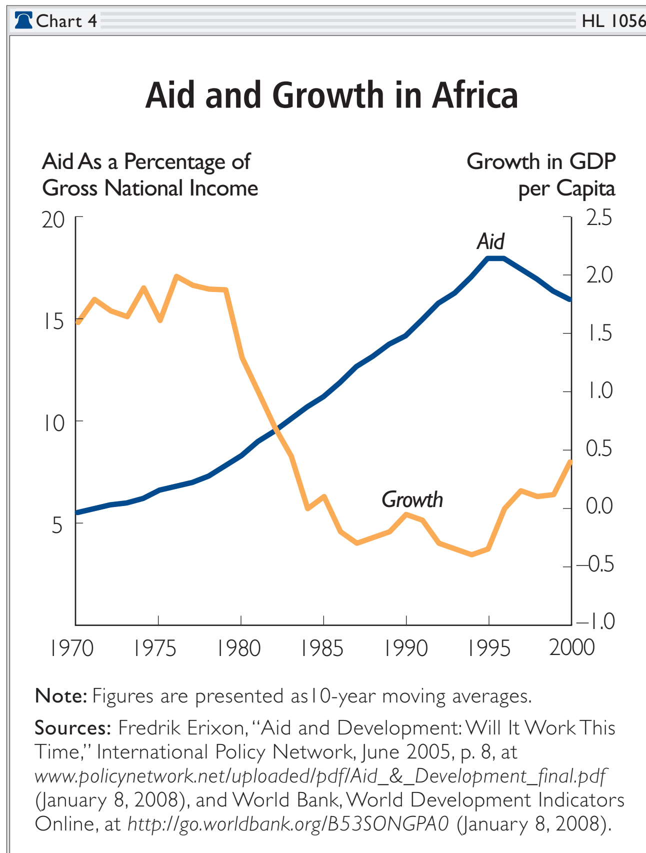
Louw looked at access to land and found that reforms that encourage small holders to remain on the land impede growth. The conversion of rural and agricultural land to agribusiness, with farming regarded as simply another form of enterprise, was the path to prosperity.

Louw looked at natural resources, and while challenging the widely held idea that they are a curse, he acknowledges that, in the end, rent-seeking behavior and, I might add, corruption take away much if not all of the advantage that resource endowments might otherwise have provided.

My own solution to both the land and the natural resource problem would be for governments to disperse ownership, but not direct control, of both kinds of resources by distributing freely traded shares of stock to their citizens. It would be collec-

1. Leon Louw, *Habits of Highly Effective Countries: Lessons for South Africa*, The Law Review Project, October 2006.

tive ownership through a corporate structure rather than the state. Individuals could sell their shares, borrow against them, or buy more. I don't expect to see any governments leap to this solution. Governments themselves are generally rent seekers in such situations.



Note: Figures are presented as 10-year moving averages.

Sources: Fredrik Erixon, "Aid and Development: Will It Work This Time," International Policy Network, June 2005, p. 8, at *www.policynetwork.net/uploaded/pdf/Aid_&_Development_final.pdf* (January 8, 2008), and World Bank, World Development Indicators Online, at *http://go.worldbank.org/B53SONGPA0* (January 8, 2008).

What Should Be Done?

Given all of these things that don't seem to matter, or at least don't matter much, what should policymakers do? Two factors stand out as driving economic growth.

- The first is dispersion of power within government. In the United States, we call this the separation of powers: The executive, the legislature, and the judiciary are independent of one another. We also have a federalist system in which governmental power is separated between the national, state, and local levels. This kind of dispersion of power is good for developing countries too.
- The second is the integrity of the judicial system and the rule of law. Favoritism, corruption, and lack of property rights virtually destroy any chance for economic advancement.

Both are key components of economic freedom. However you define it, economic freedom is the key to growth and development. (See Chart 1.)

So, given the uncertainties we've discussed, the problems inherent in taxation where the informal element of an economy is large, and the clear linkage between growth and economic freedom, of which freedom from excessive taxation is an important component, what advice could we offer African policymakers? There are many options. I would suggest three broad guidelines.

- Concentrate on what government should do rather than how big it should be. Don't ask government to do things that individuals or enterprises can do for themselves. Make sure that government activities truly involve public goods. A public good, by definition, is a good whose enjoyment by one does not detract from its ability to be enjoyed by another. It is not good public policy to tax the many to pay for benefits for the few.
- Err on the side of too little taxation rather than too much. Poor countries cannot afford to make the same mistakes that rich countries do. The downside risk that government intervention in an economy, whether through taxation or regulation, will impede efficiency and retard growth is far higher than the likelihood that it will do good. Markets are better sources of information about people's desires and needs than government planning ministries. People left free to make their own economic decisions and control their own income are likely to make better decisions for themselves than a government bureaucrat.
- Pick a tax, any tax, and make adherence to it as simple and as widespread as possible. We've seen that every kind of tax poses problems of equity or efficiency, some more than others. We've also seen that there is no strong correlation between the amount of taxes and growth for poorer countries. There is, however, a correlation between growth and tax friendliness—that is, the ease of

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compliance and simplicity. Most important of all may be to tax in a manner and at levels that encourage compliance and entry into the formal sector of the economy. A tax system that promotes the rule of law rather than evasion will have economic benefits far beyond any revenue that might be raised.

Conclusion

When Jesus told his followers to render unto Caesar that which is Caesar's, he had in mind a distinction between the things of this world and the things of the spirit. In poor countries, rendering unto Caesar may not be an easy or simple matter. Governments that make the process as simple, as honest, as transparent, and as fair as possible will bring benefits both spiritual and economic to their people.

—Ambassador Terry Miller is Director of the Center for International Trade and Economics at The Heritage Foundation. These remarks were delivered at the 5th Africa Resource Bank Meeting on "Positioning Africa in the 21st Century," which was held in Dar es Salaam, Tanzania, on November 12, 2007.