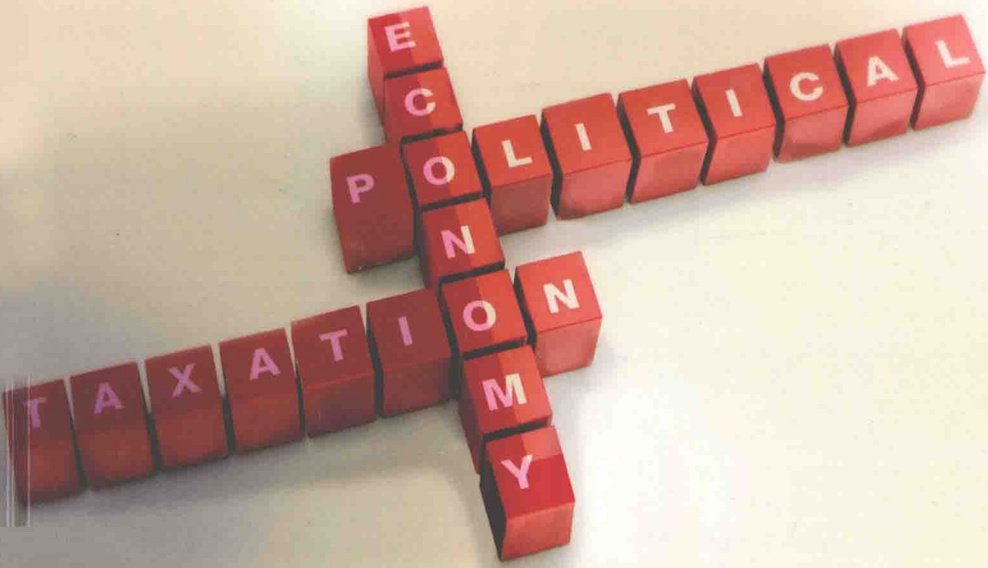
The Political Economy of Taxation

Lessons from Developing Countries



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Preface

The initial idea to develop this project was born when we were working together on a series of contributions focused on political economy issues of taxation in different areas of the world. Our task was to describe the main political factors which played a major role in the design of the tax system and in the implementation of tax reforms in some specific countries. These works increased our interest towards developing countries, in particular those which have recently experienced an economic transition toward a market economy and/or a political transition toward democratic institutions. We found that in these countries the foundation of democracy and its consolidation over time, as opposed to the presence of autocratic regimes, as well as other political elements, such as the role of lobbies or interest groups, are important factors in the analysis of tax level and tax design. They may interact with the main macroeconomic variables, such as the level of GDP per worker, the openness of the economy, the level of debt and the share of agriculture, and with other socio-economic factors, such as the age of the population, female labour force participation, urbanization, population density, schooling enrolment and the extension of the shadow economy.

Many rigorous empirical studies have analysed developing countries and their political regimes with the objective of explaining their development and growth. The analysis of tax systems and in particular the tax composition of these countries has instead received much more limited attention from the applied political economy literature. We thus decided to start this project as an attempt to develop a detailed and comprehensive empirical analysis. Such a quantitative approach implies a collection of political, fiscal, macroeconomic and socio-demographic data for a large set of countries and for a certain time span. We decided to narrow our attention to two critical world areas, Asia and Latin America, and collect data for as many countries as possible in these two areas. We also decided that it would be useful to collect data for new EU member countries and use them for comparisons. Finally, owing mainly to the availability of comparable data, we restricted our attention to the time period starting in the 1990s. We had this idea in the back of our minds when we met Matthew Pitman, who encouraged us to submit our project to the Editorial Office of Edward Elgar Publishers.

The collection of data has not been an easy task, especially for those countries where the official international statistics do not provide organized or online information. We are grateful to several people who helped us during this process, in particular Maria Victoria Espada from CEPAL and Roberta Gatti from the World Bank.

We gratefully acknowledge Luigi Bernardi and Vito Tanzi for encouraging us to develop this big project and for their useful comments. We also benefited from discussions and contacts with many researchers at several stages of this project: Alberto Barreix, Matteo Cacciatore, Angela Fraschini, Vincenzo Galasso, Luca Gandullia, Anna Marenzi, Riccardo Puglisi, Parthasarathi Shome and Stanley Winer.

Some of the ideas developed in the book were presented in preliminary forms at national and international conferences, in particular at the annual meetings of the Italian Society of Public Economics and the annual meetings of the International Institute of Public Finance of recent years, as well as seminars at the University of Pavia, OECD, Stockholm University and the University of Tallinn.

Financial support from the Italian Ministry of University and the University of Pavia is gratefully acknowledged.

We are indebted to our editor, Matthew Pitman, for his great incentives and support.

Special thanks go to Paola Salardi for excellent research assistance with the manuscript, tables and figures.

Although we are grateful for all the help received, we are responsible for any errors that may have remained in the book.

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1. Introduction

Taxation is a major issue in economics and politics. Tax design and the implementation of tax reforms are at the core of economic policy. They are also among the more debated issues in the political arena. In modern democracies tax reforms need the support of voters in order to be implemented, while at the same time policy makers try to design a tax system and propose tax reforms to attract and please as many voters as possible. The issue of taxation can attract and alter votes, in particular those of uncertain citizens (who may be a large part of the electorate) who decide which party to vote for by computing the advantages, even (and, in some cases, mainly) fiscal ones, that they could enjoy from this party as opposed to the opponents (Hettich and Winer, 1999; Profeta, 2007).

In traditionally non-democratic countries the process underlying tax decisions is much more difficult and less clear to predict. Lobby groups and interest groups that are economically and politically powerful have a dominant role. And when these countries experience a democratic transition it is very likely that these influences will remain strong and interact with voters' preferences in determining tax policy outcomes.

Democratic and economic transitions are generally strictly related (Boix, 2003). In many areas of the world the economic transition goes hand-in-hand with a political transition towards a modern concept and organization of democracy. Although it is difficult to establish the correct direction of a causal relationship, there may be positive feedback effects between economic and political reforms (Giavazzi and Tabellini, 2005).

The interplay between economic and political factors may prove crucial to understanding public policies and reforms. Taxation is a central issue. The transition towards a free market crucially affects the economic status of a country and the push towards a modern design of tax system through the implementation of several reforms. Thus, both economic and political transformations have an impact on the fiscal decisions, the design of tax systems and the implementation of tax reforms in developing countries.

Taxes (and public spending) are expected to increase under a democratic regime, to satisfy the needs of the electorate. However, the empirical evidence is not uncontroversial. Moreover, what should happen to the structure of taxation is much less clear and typically neglected by the existing empirical analysis.

This book develops a unified applied political economy analysis of taxation with reference to two key areas of developing countries: Asia and Latin America. We also look at new EU member states in a comparative perspective for the time period between 1995 and 2004. We are constrained to this time interval since 1995 is the first available year for homogeneous fiscal data of the new EU member countries and 2004 is the last available year for fiscal data of Asian countries.[1] These countries share some common trends in their transitions towards a free market and/or a modern democracy. However, the history and pattern of development in these areas show different features and timing: in Latin American countries the democratic transition is a quite recent event, while Asian countries show a recent fast economic transition, but are still in trouble with the democratic one. This justifies our approach, which will first analyse each area separately. Then we make a comparison with new EU member countries, which have almost completed their transition both in economics and in politics.

We develop an integrating framework to study the economic and political issues related to taxation in these economies. To do this, we build a unified dataset including political, fiscal, macroeconomic and socio-demographic data for a large set of countries of each area. Data are collected from different comparable sources (see Chapter 7 for the details) and are used in a set of cross-country regressions. We pay particular attention to the political variables, that is measures of democracy, which are collected by the most used datasets available, Polity IV and Freedom House. Using different indicators does not change our results, which is a robustness check of our findings.

Our analysis shows that fiscal pressure is still very low in transition countries with respect to developed ones. We argue however that it is reasonable to expect that this fiscal pressure will rise, for instance in Asia, under social transformations and the related rising demand for government to assume more responsibility towards the unemployed, poor, sick and elderly. We find that more democratic countries generally show a higher level of tax revenue, even when a certain number of control variables are included and robustness checks are performed. The results on the structure of taxation are much less clear, and more democratic countries are not necessarily associated with more personal income taxes, which are typically more redistributive, than autocratic ones. This happens for instance in the Latin American area, where we argue that this result depends on the role played by vested interests and the financial sector.

The book is organized as follows. After this brief introduction, Chapter 2 reviews the main findings of the theoretical and empirical political economy literature on democracies. We first analyse the socio-economic conditions that could favour the foundation and the consolidation of a democratic system and then focus on the two-way relation between democracy and growth. Finally, we study the impact of democracy on redistributive policies, mainly taxation.

Chapter 3 provides an overview of the main economic (GDP per worker, share of agriculture on GDP, sum of exports and imports on GDP, central government debt on GDP, Gini index), socio-demographic (the secondary school enrolment, the share of over 65s in the population, the female labour force participation rate, urbanization, population density, the size of the shadow economy on GDP) and political (different measures of democracy) variables which may play a role in explaining the level of tax revenue. We look at data of the complete sample of Asian, Latin American and new EU member countries and we provide correlations, which are plotted in graphs. We then look at the relation between our measures of democracy and the level of specific taxes.

Chapters 4 and 5 are devoted to our two critical areas of analysis: Asia and Latin America. For a selected sample of countries in each area we perform cross-country regressions to understand the determinants of the level of taxation and of the structure of taxation. Our attention is focused on the role played by political variables, in particular the level of democracy, which turns out to be positively and significantly associated with the level of tax revenue. The relation with the structure of taxation however, mainly direct versus indirect taxes, and the level of social security contributions, is not unambiguous.

Finally, Chapter 6 develops a comparison between Asian, Latin American and new EU member countries and provides some conclusions.

NOTE

1. Our source of fiscal data for new EU members is Eurostat. From 1995, national accounts data are generally available in the ESA95 (European System of Accounts 95) format.

2. The political economy of democracies: a review of the literature

The existing political economy literature on democracies deals with two important questions: (i) what are the socio-economic determinants of democracy, if any? (ii) does democracy affect public policies, mainly in terms of growth and redistribution?

In this chapter we provide a short review of the current theoretical and empirical findings on these issues within the political economy literature. In the first section we focus on the socio-economic conditions that could favour the foundation and consolidation of a democratic system,[1] following the analysis of the structural approach as well as the strategic approach to the political change. Then, in the second section we consider the two-way relation between democracy and growth. Finally, in the third section we deal with the impact of democracy on redistributive public policies with a specific focus on taxation.

2.1 DEMOCRACY AND ITS DETERMINANTS

Following Acemoglu and Robinson's (2006) theory, democracy is a situation of political equality,[2] implying a transfer of the *de jure* political power from the elites (the rich) to the citizens (the poor). Starting from a non-democracy, in which the elites have *de jure* political power, a revolutionary threat by the citizens, who have the *de facto* political power[3], could lead to repression, which will be really attractive only in particular cases, mainly if it is neither too risky nor too costly for the elites.[4] In all other cases, the threat will wring promises by the elites to future pro-citizen policies. To make these concessions credible, a formal transfer of the *de jure* political power from the elites to the majority of citizens is needed, meaning that democratization has to happen. In this way, the majority of the population will be allowed to vote and express their preferences about policies and the government will represent the preferences of the whole population. In other words, being a regime more beneficial to the majority, democracy will result in policies relatively more favourable to it (i.e. redistribution)[5].

Obviously, democratization is a complex historical process. It starts with the decline of an authoritarian regime and the beginning of a new representative political system which, through its consolidation, reaches its full maturity (Shin, 1994). The transition stage is characterized by great political instability, which generally ends with the promulgation of a new constitution and free and fair elections, that is when elite consensus on procedures goes hand-in-hand with extensive mass participation in elections and other institutional processes (Higley and Gunther, 1992). This consolidation stage usually takes decades to complete its course. It could also be hindered by the nature of political institutions, which may allow the elites to influence democracy's choices to avoid radical majoritarian (populist) policies (this is what happens in a formal democracy). In other words, although there exist democratic institutions, actual policies may be constrained by anti-democratic provisions in the new constitution, and the voices of some people may be louder thanks to lobbying, bribery and other types of persuasion which aim at protecting the interests of the most powerful groups in the society (O'Donnell, 1988). As a consequence, the vertical conflict between politicians and their constituencies should be considered, not only because of the risk of corruption, but also because policy makers may be self-interested and may want to pursue their own agenda. However, given the credible threat of losing power in the next election, in a democratic system political accountability will generally be high (Boix, 2003).

Can the transition process to democracy and its subsequent consolidation be favoured by particular socio-economic circumstances?

Certainly, economic crises and macroeconomic shocks determine fluctuations in *de facto* political power. By raising discontent and undermining the legitimacy and survival of the authoritarian regime, they can effectively help to promote democracy (Haggard and Kaufman, 1995).

Moreover, following 'modernization theory' (Lipset, 1959), economic development, and in particular the rise of the level of per capita income, would induce citizens to no longer tolerate repressive regimes.[6] Countries should become more democratic as they become more modern and more complex, urbanization rises, the importance of industry increases, agriculture commercializes and is no longer characterized by feudal or semi-feudal labour relations, the *bourgeoisie* becomes strong and education attainment improves. Developed economies and political democracies should consequently emerge and survive together, especially in the long run. Markets would thus prosper in a political framework characterized by constitutional liberties and democratic practices. In fact, income growth and industrialization lead to a wealthy, well-organized and pluralistic society in which the mass of the population can intelligently participate in politics and avoid succumbing to irresponsible demagogues, repression becomes more difficult, power is widely distributed and the cost of toleration of the opposition by the incumbent in the policy-making process becomes low (Dahl, 1971).[7] In such a context, democratization can more easily occur.

In addition, the process of economic modernization generally results in both enlarging the middle class, who act as a moderating political force, a buffer between the opposite interests of the elites and the citizens, and reducing income inequality, which is a source of political conflict that may even lead to authoritarian solutions. As the distribution of income becomes more equal among individuals, redistributive pressures from the poor on the rich diminish and the probability of a peaceful transition from an authoritarian regime to universal suffrage increases. The ultimate level of taxes becomes smaller than the cost of repression. On the contrary, when the redistributive demands of the worse-off citizens on the rich are particularly intense, the latter will strongly oppose the introduction of democracy, which would allow heavy taxes to be levied on them. Thus, inter-group inequality should be at an intermediate level to make redistribution suitable and avoid repressive non-democracies or revolutions. In this sense, the opposition of the rich to universal suffrage would also reduce with the credible commitment of the poor to moderate levels of redistribution according to the fact that low taxes stimulate faster economic growth (Boix, 2003).

Moreover, social mobility across classes would foster democracy by easing social conflict, that is by tending to equalize the income of individuals over time.[8] The nature of the assets owned by the elites would also matter, given that for example land is easier to tax