Recensione del volume:

The Political Economy of Taxation. Lessons from Developing Countries◊

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a cura di

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1. - Introduction

S. Winer, one of the most notable world experts in the field of the *Political Economy* of taxation (see Hettich and Winer, 1999), wrote about this book: "*Anyone who wants to know how contemporary empirical models can be used to study the political economy of the tax mix in developing and transition economies will want to read this book*". In fact, this book deals with the relationship between political institutions and both the level and the structure of taxation, a very important topic not only in the "Italian school" of the beginning of the past century, but also in the more recent *public choice* literature (*i.e.* Buchanan). However, the normative approach, in the form of both the *Equitable Taxation à la* Musgrave and the *Optimal Taxation à la* Diamond and Mirrlees, contributed to cast a shadow on this important research area.

This book instead belongs to the recent field of the new *Political Economy* and to positive analysis. It focuses a relationship so far only partially investigated. In particular, this research project, which is based on econometric evaluations of the determinants of the level and the structure of taxation, devotes particular attention to the political variables, such as the degree of

◊ Cheltenham - Northampton, pages XI-191, 2010, Index and Historical Notes.

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democracy and civil liberties protection, while all the economic variables generally used to estimate the fiscal burden (see Tanzi, 1992) are included: the *per capita* income (+), according to Wagner law; the level of economic development, measured by the share of agriculture over GDP (–); the trade openness (+) and the public debt (+). Then, in order to check the robustness of the basic model, and especially of the coefficients related to the political variables, other controls are included in the empirical analysis. They are: the share of elderly people over the total population (+); the female labor force participation rate (+); the education level (+); the urbanization rate (+); and finally the weight of the underground economy (–).

The research rightly refers to developing and transition countries where also in recent times (the period investigated goes from 1990 to 2004) one can still observe the co-variance between the introduction and consolidation of democratic institutions and the growth of fiscal systems, although with systematic differences among the three areas of the world selected for the analysis. In particular, the study refers to 11 Asian countries (which are well representative of the three main Asian regions: Far East, South and East, and the Indian sub-continent) and to 19 Latin American countries. Moreover, the 2004 new EU member countries are taken into account as a control group given that they have recently (almost) completed their political and economic transition in a satisfactory way. To perform the econometric analysis, the authors have built a new and unique dataset, which represents by itself a relevant output of this research project, also available for further studies. This was not an easy task, because especially fiscal data are not always available from homogeneous sources. As for the econometric model, the authors run pooled OLS regressions with and without fixed effects. They interpret the results always in a balanced way and the text is written in a clear, essential and elegant English. Two historical appendixes (on the democratization process in Asian and Latin American countries), a huge bibliography and the index complete the book.

2. - A Discussion of the Various Chapters

In this paragraph we discuss the contents of the book by chapters, adding our comments on its main findings. The book has to be red step by step, given the relevance not only of its general theses, which could be presented just in a heuristic way, but also of their rigorous and well-constructed checks. In the *Introduction*, the authors focus on the main hypothesis which the research wants to investigate, that is, as already said, how different political institutions relate to the different composition of fiscal systems. In democratic countries fiscal systems are built on the basis of the electoral process (without hiding its shortcomings and the presence of self-interests of the politicians, which refer to the Leviathan as modeled by the *public choice*). On the contrary, in the autocratic systems, the level and the structure of the taxation would be determined according to the preferences of the *elites* in power and the strong influences of the lobbies, which in these country are more powerful than in democracies. The interrelation between economic and political variables is thus essential to understand the evolution of the fiscal systems. After democratization the *a priori* hypothesis is the growth of the welfare state. This implies an increase in the taxation level and the change in the composition of the fiscal burden to go through a more progressive system thanks to the increase in the share of direct taxes.

The *second chapter* focuses on a crucial argument for the logic construction of the research: the link between modernization (economic development) and the introduction of democratic institutions. This is an essential point, because it allows creating a logic chain between economic development, democracy and fiscal reforms. Thus, the chapter contains a rich and critical analysis of the *Political Economy* literature on democracy and economic development. The authors start discussing a relevant research field (among the others, Boix, 2003), in particular the so called "*modernization theory*", which identifies the socio-economic variables that can contribute to the introduction and the consolidation of democratic institutions, albeit along neither short nor linear historical paths: income growth, social development, the role of the middle class, the redistribution requests raised by the poor, education, and social mobility. The correlation between democracy and economic development seems to have robust foundations, even if some contrasting opinions remain (for example Acemoglu, 2004, 2005 and Barro, 1996), but the direction of causality seems not easy to identify. This last topic is at the centre of the point of view of Persson and Tabellini (2007) (and previously of Hayek, 1960). They assume a virtuous circle existing between economic and political development. Moreover, and more specifically, after the introduction of democratic institutions, and the resulting electoral relevance of the preferences of the poor, public policies would have to change, at least according to the theoretical literature. However, the empirical evidence is not uncontroversial and a debate has started since then. The most recent conclusions, with some exceptions, seem to be in line with the fact that welfare programs are more relevant in the presence of democratic institutions: as financial needs increase, the share of direct taxes becomes greater, given that they are easier to accept in a political context that becomes representative also of the (poor) individual preferences (Kenny and Winer, 2006).

The *third chapter* starts with a set of plots showing the relations between the above mentioned different explanatory variables and the level and the composition of taxation. Keeping in mind the specification of the model to estimate, these plots show first of all the correlations between tax revenue and socio-economic variables and then the ones between tax revenue and political variables. As for the structure of the fiscal system, the same is done for the personal income tax, the corporate income tax, direct and indirect taxes. Here the data are referred to all the three areas of the world considered in the analysis. Among the economic variables one can observe the positive role of *per capita* income (in line with Wagner law, probably to be verified with PPP data), the negative role of the share of agriculture over GDP (tax collection is more difficult and public services are generally concentrated in the urban areas), and the less clearer role of the openness of the economy and of the level of the public debt. The political variables taken into account are a democracy index and two indicators of civil liberties and political rights protection. They are correlated with both the *per capita* income and the share of tax revenue over GDP, while there is not a robust interaction between the political variables and the income distribution. Then, the control variables are introduced. The education level is related with the political variables, but not with the tax burden. The latter is on the contrary influenced by both the demographic structure of the population (share of the elderly people), except for Asian countries – in which public pension systems are almost absent – and (everywhere) the female labor market participation rate. Moreover, the correlations between tax revenue and the urbanization rate (+) and the underground economy (–) respectively are very clear. As for the structure of the tax system, both direct taxes (especially PIT) and indirect taxes seem to be directly (+) correlated with political variables. The authors will turn back to this finding later on in the book, but this first evidence seems to be in contrast with the Musgrave's hypothesis (1969) on the evolution of the tax mix which should follow the changes in the possible tax bases ("*tax handles*") and the increase in the fiscal administration abilities.

The *fourth chapter* is dedicated to Asian countries, which are now quite integrated, while the *per capita* income levels are still very different[1]. Traditionally these countries have been characterized by a not heavy tax burden (5-10% of GDP in 1990) and three-generation families which substitute for a 'light' welfare state. However, the interrelated low fiscal pressure and light welfare state are under challenge. The urbanization and the ageing process as well as the increase in the female labor participation rate will determine growing social expenditure and tax revenue, as well as a change in the tax mix, with a more relevant role for personal taxation. As a consequence, the authors try to investigate the role of political institutions in addressing these expected changes in welfare and fiscal policies starting from the fact that Asian countries are very different in terms of political regimes: new democracies and old democracies come together with persistent autocracies.

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[1] For a general overview of taxation in South and East Asia, see BERNARDI L. *et* AL. (2006).

The estimates underline a positive and statistically significant relationship between tax revenue and the introduction and consolidation of democracy, while a negative coefficient refers to the autocracy index. Among the other variables of the basic model, only the openness of the economy is positively and significantly related with the tax burden. Focusing on the control variables, the significant relationships concern female labor force participation rate (+), the share of the shadow economy (–) and the income inequality (+), while they do not concern *inter alias* the share of elderly people over total population. More important, the introduction of these controls acts as a robustness check because it does not alter, while sometimes increasing, the significance of the political variables. The relation between the different tax sources and all the explanatory variables is also investigated. The results are not uncontroversial and they seem to underline a more relevant relation of the tax mix with economic rather than the political variables. More specifically, the Personal income taxes – it is not correlated with the degree of democracy and civil freedom, but only with the protection of the political rights, while the Corporate income tax – CIT and the taxes on good and services appear to be lower (higher) in a democratic (autocratic) context.

Latin American countries show a different situation[2], as explained in the *fifth chapter*. They are typically younger democracies, built on previous military regimes or populist liberal regimes that are still full of inheritances. The economic transition has been led by external agents, in particular IMF and WB, which have imposed Western models of taxation. The overall level of taxation (on average 16.6% of GDP in 2004) is again far from EU and US (with the exception of Brazil, that experiences a high level of social contributions), but generally higher than Asia (although this area is characterized by a high heterogeneity). Latin American countries are experiencing a general increase in fiscal pressure, particularly in Colombia. Political changes have been substantial, although since the '80s a sharp transition toward democracy has started, well accepted by the population. Similarly to Asia, but not

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[2] For a general overview of taxation in Latin America, see BARREIX A. *et* AL. (2008).

necessarily for the same reasons, direct taxes, PIT in particular, have a secondary role with respect to indirect ones, which are still increasing: VAT has reached a level similar to the average European one and has substituted trade taxes almost everywhere. Social contributions vary in size across countries and are stable over time.

The main equation of the model is confirmed and so the relationship between fiscal revenue and political variables, with coefficient similar to the ones estimated for Asia. In this case economic variables are more influential, in particular the share of agriculture (in a continent dominated by large land properties estates and their powerful owner) and the level of public debt, one of the main features of Latin American countries. Control variables play a more important role than what is found in Asia: the share of the elderly and education in particular (together with female labour force participation and the shadow economy), which crowd out the coefficients of political variables. A clear result, even more than in the Asian area, unexpected if we look at the theoretical implications of the median voter model, is that direct taxes do not depend on the level of democracy. This puzzling evidence is explained by the authors following two arguments: *(i)* the quality of democracy in Latin America is low, vested interests and lobbies of the richest groups of the population play a crucial role and *(ii)* the disintermediation of the banks in systems characterized by a relevant share of the shadow economy reduces the efficiency of the tax collection process.

The *last chapter* (chapter 6) compares Asia and Latin America with new EU member countries[3]. The comparison with an area that has (almost) satisfactorily completed the economic and democratic transition aims at checking the results obtained in the other two areas. In New EU member countries the transition process has required a radical change of the tax system which is now close to the western European one, including a change in taxpayers' habits and the building of a modern tax administration,

[3] For a general overview of taxation in these countries see BERNARDI L. *et* AL. (2006).

almost *ex novo*, two processes yet to be completed, which also explain the high level of tax evasion and the low level of tax compliance. All New EU member countries have parliamentary systems, but the influence of old and new pressure groups is still high. Fiscal pressure is still heavy with respect to *per capita* income, as a consequence of a generous welfare system inherited from communism. As in Asia and Latin America, indirect taxes prevail, while a flat rate personal income tax is present together with a very generous corporate income tax, aimed at attracting direct foreign investments and at stimulating internal ones[4].

The estimation of the benchmark pooled model[5] confirms the previous results, that is the evidence of a robust relationship between the level of tax revenue and the political variables, which include democracy, civil liberties and political rights. This is a strong result: along the transition path the emergence of a democracy is associated with a higher level of taxation. As for the other fundamental variables, the results do not confirm the Wagner law, nor the dependence of fiscal pressure on the level of debt (very low in New EU members), while the openness of the economies results to positively influence the degree of taxation. The inclusion of additional control variables does not alter the significance of the political ones, nor of the dummy areas. Population age, female labour force participation and the share of the shadow economy influence the level of taxation. The results hold in a general equation with all variables, although with a different significance of the coefficients.

Finally, the issue of the effects of democracy on the structure of taxation is addressed. The disaggregation between direct and indirect taxes necessarily implies a lower covariance with the set of exogenous variables, but the political ones are still relevant and significant in both cases, without crucial changes of the coeffi-

[4] Marginal tax rates of the personal income flat tax (adopted in all New EU member countries with the exception of Hungary) are around 20%, as those of the corporate income tax. In Estonia only distributed profits are taxed, in Lithuania only the retained ones (BERNARDI L., 2009).

[5] *Per capita* income is expressed in levels and dummies for Asia and Latin America are included.

cients and their significance, with respect to the aggregate estimation. Thus, both direct and indirect taxes increase during the transition and we cannot identify a trade-off between direct and indirect taxes. The authors mention, as an explanation for that, the redistributive nature of indirect taxes (due for instance to higher tax rates for goods typically consumed by high income groups, or auto-consumption among the poor) and the larger set-up difficulties for personal taxes. One can add the following arguments: *(i)* many personal incomes are exempt, since they are below the poverty line; *(ii)* development of firms is considered a crucial issue and *(iii)* high-income groups may exert a high pressure against progressivity. As a consequence, taxation during transition is less redistributive than in developed countries[6].

3. - Concluding Remarks

The main lesson we can draw from this important and innovative research can be summarized as follows: we cannot forget the role of political variables and the evolution of institutions in the process of the rise of fiscal pressure that has typically characterized the transition from under-developed or planned economies towards a market structure and a democratic government. This result is not a specific feature for a single country, since the analysis is performed for a large number of countries in different areas of the world. The econometric model is precise and the analysis is rigorous. However, the empirical analysis shows that the structure of the taxation system (direct *vs.* indirect taxes) does not seem to be related with the evolution of democratic institutions. As already said, political reasons justify this result, and, in addition, the greater administrative difficulties in managing direct taxes have to be considered, especially in the case of the personal income tax, which requires to assess the total in-

[6] Social contributions are typically not correlated with democracy. Yet they are almost absent in all Asian countries and in many Latin American ones. Wealth taxes, the old *tax handle* of these countries, play a secondary role almost everywhere.

comes and the permitted allowances for a very large number of tax payers. In fact, the introduction of a progressive personal income tax came after the economic development in developed countries too. For example in the United States, at the beginning of the past century, the Supreme Court had to assess the introduction of the personal income tax because this tax was considered to excessively violate the privacy of taxpayers. In most European countries, the personal income tax's spread dates back only to the period after World War II, when the poor started to pretend its introduction as a compensation for their war effort. In Italy, as known, a high revenue personal income tax was introduced only at the early of the '70s. Moreover it has never had a really general character because it always concerned only some large, but at the same time specific, income categories and taxpayers (employees, self-employed (aside from those evading) and retirees).

The analysis performed is already comprehensive and the arguments are well developed. It is therefore not easy to suggest future steps for this research project. On the methodological side, additional econometric robustness checks are possible, such as including a larger sample of countries, using a wider set of income measure, performing a disaggregation of indirect taxes. The lesson of this study has public policy implications that may affect the design and size of future tax and welfare systems in a relevant way. This is certainly true for the countries covered by the study, among which we find countries crucial for the world economy – China, for one, which is facing the issue of the introduction of a wider tax system and of a more comprehensive welfare state. Political variables will matter in this policy implementation.

There are also relevant implications for developed countries. This book contributes to bridge the gap between the theoretical studies on the interaction between economic and political variables in determining the level and structure of taxation (Profeta, 2004; Galli and Profeta, 2009) and the empirical assessment of tax systems. As a consequence, the approach suggested here can be useful in the current policy debate on how to structure the tax systems of developed countries and how to reform them, a debate which, instead, seems to be dominated almost exclusively by a normative approach (*e.g.*: Ifs, 2010). A framework similar to the one here developed by Profeta and Scabrosetti could also in its turn be used, with all the necessary adjustments, to study some of the present critical issues of the fiscal systems of developed countries (and in particular of the Italian one), such as the level of tax evasion, the tax composition and the degree of progressivity and redistribution, besides to the relation between the level of the fiscal burden and the dynamic of the economic development. We are confident that researchers following this striking methodological direction would also receive by V. Tanzi comments similar to that he devoted to this book, by affirming that the book has produced *"highly interesting results"*, which *"will attract the attention of many experts interested in taxation"*, and, finally, *"will be cited often"*.

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