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.