Journal of Comparative Economics 41 (2013) 684–718

Contents lists available at SciVerse ScienceDirect

Journal of Comparative Economics

journal homepage: www.elsevier.com/locate/jce

Does democracy affect taxation and government spending? Evidence from developing countries

Paola Profeta [a,*], Riccardo Puglisi [b], Simona Scabrosetti [b]

[a] Università Bocconi, Econpubblica and Dondena, Via Roentgen 1, 20136 Milan, Italy
[b] Università di Pavia, Strada Nuova 65, 27100 Pavia, Italy

ARTICLE INFO

Article history:
Received 11 May 2011
Revised 8 October 2012
Available online 25 October 2012

JEL classification:
H20
O53
P16
P35
P50

Keywords:
Comprehensive dataset on taxation and public expenditure
POLITY2 index
Civil liberties
Tax structure
Public spending composition

ABSTRACT

Profeta, Paola, Puglisi, Riccardo, and Scabrosetti, Simona—Does democracy affect taxation and government spending? Evidence from developing countries

Focusing on developing countries in three geographical areas (South-East Asia, Latin America and European Union), we explore the relation between political variables and tax revenue, public spending and their structure. We build a new dataset for the 1990–2005 period with fiscal, political and socio-economic variables. Since democracy is a complex and multidimensional concept, we measure it using two variables, the political strength of democratic institutions, and the protection of civil liberties. We perform three sets of estimates: (i) cross-country pooled OLS regressions with region fixed effects, (ii) country fixed effects regressions and (iii) region specific regressions with country fixed effects. While the first model delivers some significant correlations between political variables and tax items, when controlling for country fixed effects we find that tax revenue and tax composition are in general not significantly correlated with the strength of democratic institutions and the protection of civil liberties. The only exceptions are indirect, trade and property taxes. A similar result applies to public spending, with the exception of defense expenditure. Overall, our findings cast some doubt on the exact public policy channels through which political institutions affect economic development. *Journal of Comparative Economics* **41** (3) (2013) 684–718. Università Bocconi, Econpubblica and Dondena, Via Roentgen 1, 20136 Milan, Italy; Università di Pavia, Strada Nuova 65, 27100 Pavia, Italy.

1. Introduction

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. On one hand a higher level of economic well-being – which entails higher rates of literacy, education, urbanization, and also a larger middle class – would be necessary, though not sufficient, for democracy to be widely supported and then introduced (Lipset, 1959; Boix, 2003; Acemoglu and Robinson, 2006). On the other hand, stable democracies are likely to promote economic liberalizations and reforms, which in turn would have a positive effect on overall economic performance (Persson and Tabellini, 2007). Democratization may thus deliver positive effects on subsequent growth (see Papaioannou and Siourounis, 2008). However, the way in which democracy promotes economic development can depend on the details of the democratic reform process (Persson and Tabellini, 2006).[1]

* Corresponding author.
E-mail addresses: paola.profeta@unibocconi.it (P. Profeta), riccardo.puglisi@unipv.it (R. Puglisi), simona.scabrosetti@unipv.it (S. Scabrosetti).

[1] Although it is difficult to establish the true direction of a causal relationship between democratic and economic transitions, several authors have emphasized the existence of positive feedback effects and their advantages for growth (see among the others, Giavazzi and Tabellini, 2005; Persson and Tabellini, 2007; Papaioannou and Siourounis, 2008; Rodrik and Wacziarg, 2005; and the criticisms of Barro, 1996 and Fernandez and Rodrik, 1991).

0147-5967/$ - see front matter
http://dx.doi.org/10.1016/j.jce.2012.10.004

If successful democratic transitions are subsequently associated with a higher growth rate of real per capita income (Papaioannou and Siourounis, 2008), what is the channel through which democratic transitions affect economic outcomes?

The interplay between economic and political factors suggests a potential role for public policies and reforms, mainly on the side of redistribution through taxation and public spending.

In this paper we empirically investigate the relation between redistributive public policies and indicators of democracy. Our goal is to understand whether taxation and public expenditures, their level, structure and composition, are associated with democratic indicators. Is a democracy associated with higher taxes and/or higher public spending? Which categories are mostly affected? The results will be informative about the impact, if any, of a democratic transition on economic outcomes, which goes through changes in public policies.

The relation between democracy and public policies has been largely investigated in the literature.[2] Democratization might induce higher taxes and higher spending to satisfy the needs of redistribution of a large electorate, as explained by, among the others, Meltzer and Richard (1981), using a median voter framework and, more recently, by Acemoglu and Robinson (2006). However, probabilistic voting models, which are more suitable to incorporating a multidimensional policy (Hettich and Winer, 1999; Profeta, 2002) and the role played by the political influence (Tridimas and Winer, 2005), do not necessarily predict a positive association between democracy and redistributive public policies. The link between democratization and the structure of taxation and public spending remains an empirical question.

Being aware of this lack of clear theoretical predictions, in this paper we turn to the data. Previous empirical studies have tried to test these relations by making use of different approaches. Again, the results are not uncontroversial. Many cross-country studies find support for the theoretical prediction of the median voter model: democratization is positively related to both the size of the public sector (Lindert, 1994, 2004) and the level of tax revenue (Boix, 2003), as well as the one of direct taxes (Kenny and Winer, 2006). Mulligan et al. (2004) however do not confirm these relations.

Cross-country studies are known to be subject to criticism, since any correlation may depend on unobservable country-specific characteristics. Moreover, the political economy analysis of taxation and public outlays should focus specifically on the composition of taxes and expenditures, since different taxes and public expenditures tend to have a different impact on various economic and administrative outcomes, such as redistribution and tax compliance (see in this direction Aidt et al., 2006 and Aidt and Jensen, 2009a). Furthermore, taxes and public expenditure should be jointly investigated, in order to check whether the democratization process affects them differently.

For all these reasons, to contribute to the empirical analysis of the relation between redistributive public policies and indicators of democracy, this paper (i) adopts country fixed effects regressions, (ii) analyzes both taxes and public spending and (iii) investigates their composition, in addition to their total amount.

We focus on a sample of developing and low-income countries of three geographical areas: South-East Asia, Latin America and European Union during the 1990–2005 period. These countries have recently experienced a democratic and economic transition and hence represent an ideal laboratory for the study of the relationship between political regimes and tax and expenditure systems. We build a new dataset where we collect data on fiscal and spending variables from different sources.[3] In addition to the main macroeconomic indicators and several socio-economic and demographic variables, we include data on political indicators. In particular we refer to a measure of the strength of democratic institutions and to an index of civil liberties protection from the PolityIV dataset and Freedom House respectively, two well-known sources in political economy studies. These two aspects of the political landscape allow us to capture two different dimensions of the concept of a liberal democracy, which broadly correspond to the concepts of positive and negative liberty. According to Berlin (1969), positive freedom, in its political form, is the liberty that can be achieved through participation in the political process. As a consequence, a democratic country is free to the extent that its citizens actively participate in the decision making. On the other hand, negative freedom is related to the degree to which individuals or groups suffer some kind of interference from external bodies. In other words, this concept of liberty refers to the absence of obstacles, barriers or constraints to individual actions. We explore whether these two concepts have a different relationship with public finances.

Our dataset is a first attempt at collecting in a comprehensive and homogeneous fashion all the essential data for the study of taxation and public expenditure in these geographical areas. In fact, especially fiscal data for these countries are typically sparse across different sources, are not directly available for researchers, and are often not homogeneous, thus making it difficult to compare and analyze them jointly.

We investigate the link between political variables and the structure of taxation and public spending using three different empirical models: (i) cross-country pooled OLS regressions with region fixed effects, (ii) country fixed effects regressions and (iii) region specific regressions with country fixed effects. To make our results comparable with previous studies, we begin with OLS cross-country pooled regressions. Interestingly, this specification confirms some of the results obtained in previous contributions. However, these findings do not typically survive to a more demanding fixed effects specification, with the only exceptions of indirect, trade and property taxes. Also, the two different aspects of the political landscape on which we focus turn out to be differentially correlated with tax and spending and their composition. This result may be driven by the fact that the civil liberties index is associated with factors, such as freedom of association or freedom of press, which may also facilitate the emergence of lobbies and interest groups which exert pressure for a specific public policy outcome. Finally, in some cases the relationship between redistributive instruments and political variables appears to be region-specific. This last result is particularly interesting, since it suggests that redistributive policies may reflect specific patterns of economic and

[2] See next section for a detailed review of the relevant theoretical and empirical literature.

[3] See the Data Appendix for details.