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# Feasible taxation in advanced democracies

Leonardo Baggiani\* and Enrico Colombatto\*\*

## Abstract

One usually considers tax pressure as the result of the policymakers' efforts to increase public expenditure, while populism is resorted to in order to alleviate tensions among the taxpayers. This paper takes a different view. It assumes that populism is exogenous in the short run and defines the tolerable degree of tax pressure required to bring about redistribution; however, taxpayers also resent disappointing economic performances and low-quality public expenditure. Within this context, therefore, policymakers try to find a compromise between their desire to engage in rent-seeking and their electoral ambitions.

This paper shows under which circumstances compromise is obtained, how tensions arise, and what outcomes the taxpayers' reactions may generate.

**Keywords:** Fiscal strategies, populism, rent-seeking

**JEL Codes:** H10, H11, H26, P17

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## Feasible taxation in advanced democracies

### 1. What defines feasible tax pressure and tolerable rent-seeking?

During the past decades, the general perception of the role of government in Western societies has moved away from the classical liberal vision typical of the 19<sup>th</sup> century.<sup>1</sup> Certainly, nowadays governments are still expected to provide defence against foreign aggression, define and protect property rights and enforce contracts. However, they are also required to produce a wide range of merit goods, to correct undesirable outcomes of the market process, and to pursue social fairness and income equality through redistribution.<sup>2</sup>

This paper focuses on this last aspect (redistribution) and addresses important issues so far ignored by the literature: It investigates under which circumstances a given level of tax pressure, consistent with the electorate's desire for redistribution, can provoke imbalances; how such imbalances can be redressed; and what happens if they are not. In order to pursue our analysis, we imagine an economy in which the population chooses the desirable amount of redistribution in favour of those in need, and charges the politicians with the power to collect the resources required (tax revenues). However, in this economy the politicians do not restrict themselves to carrying out the task assigned by the taxpayers. They also pursue their own self-interest through fund misappropriation and various forms of rent-seeking.<sup>3</sup> Sometimes, misuse and rent-seeking are relatively moderate, and are tolerated by the electorate when economic performance and the quality of expenditure are considered adequate. But it may also happen that the electorate strongly deplores the policymakers' misbehaviour. Under such circumstances, tensions emerge. In this latter case, therefore, policymakers must decide whether to strike a balance between their own self-interest and people's expectations, or ignore public opinion and carry on and run the risk of being voted out.

Certainly, redistribution, taxation and rent-seeking have been the object of a huge literature. Yet, their interaction has not been studied, and the analysis of the tensions that might emerge has been ignored. In order to fill this gap, we examine a context within which various phenomena are analysed simultaneously: the relationship between tax pressure and tax revenues, which harks back to Dupuit (1844/1969) or earlier; the intensity and features of rent-seeking, which depend on culture, constitutional arrangements, formal and informal controls; and the very goals of the lawmakers, who might pursue long-term visions, or focus on short-term electoral deadlines, or be captured and held hostage by powerful interest groups.

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<sup>1</sup> See Humboldt (1969 [1852]).

<sup>2</sup> According to Maddison (1995), between the end of the 19<sup>th</sup> century and the end of the 20<sup>th</sup> century, the share of government expenditure as a percentage of GDP in the Western economies rose from 10% (1880) to almost 46% (1992).

<sup>3</sup> See the Federalist Papers (Maddison, no. 10) for an early warning regarding the lawmakers' self-interest, and McChesney (2001) on lawmakers, rent-seeking and regulation.

In particular, we assume that the electorate's leaning towards redistribution defines the limits to the tolerable tax pressure, while policymakers aim at prestige (vanity), rejoice in the quest for power, and engage in rent-seeking. Within this framework, the policymakers end up looking for solutions to please the electorate and meet their own personal goals. Sometimes a compromise is feasible. Under different circumstances, however, tensions emerge and reactions follow. In the short run, these reactions aim at producing a different political context. When this context fails to materialise, long-run scenarios emerge, within which taxpayers modify their beliefs, or try to evade taxation or consider leaving the country.

Our analysis considers the legislators' action within a democratic context and makes use of three variables in order to define the actors' behaviour: populism, the policymakers' own preferences, and the quality of public expenditure. The outcome of the policymakers' action is "lawmaking".<sup>4</sup> With this goal in sight, sections 2 to 4 illustrate the basic working of the model (taxpayers' preferences, economic performance and rent-seeking). Section 5 examines the connection between people's preferences and lawmaking, and identifies the conditions that allow equilibrium (absence of tensions). Sections 6 and 7 discuss what happens when tensions arise, while sections 8 and 9 interpret the results and conclude.

## 2. Populism, tax pressure and growth

In our analysis, we define populism as the desire to obtain a distribution of income and/or wealth according to a pattern shared by a large portion of the population. In other words, populism identifies a shared desire for income redistribution.<sup>5</sup> This desire stays constant in the short-run, but we allow it to change in the long-run if political tensions induce individuals to modify their beliefs and/or become more tolerant (resignation) for the sake of peace and quiet.<sup>6</sup> Since taxation plays a critical role in funding redistribution, it follows that taxation increases with populism, and that most tax revenues are devoted to bringing about (partial) income equalization both directly (wealth transfers) and indirectly (discretionary spending).

In accord with a substantial body of literature, we also assume that taxation and redistribution provoke wastage and deadweight losses, and discourage entrepreneurship (Baliamoune and Garelo 2014). As a consequence, economic performance (growth) suffers. Thus, the lawmaker faces a trade-off. He can give priority to economic

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<sup>4</sup> In this paper, we use the terms "policymaker" and "lawmaker" interchangeably.

<sup>5</sup> Our definition of populism differs from the one usually adopted in politics, where this term identifies "a political movement based on a mobilized but not yet autonomously organized political sector led by an elite rooted among the [anti-status-quo] middle and upper echelons of society" (Di Tella, 1997: 196). Instead, in our paper, populism is a preference shared by a large portion of the society.

<sup>6</sup> Fong (2001) shows that the preference for redistribution is deeply rooted in the beliefs about the roles of effort, luck and opportunity, and poorly linked to income level. In accord with this literature, therefore, we shall consider the attitude towards redistribution as a cultural trait of the electorate.

performance, which requires a relatively low level of taxation and regulation;<sup>7</sup> or he can follow populist pressure, engage in redistribution, and also make use of a combination of tax revenues and ad hoc regulation to create privileges (rent-seeking) to his own benefit and/or to the benefit of his constituency (supporters and *clientèles*). Of course, the greater is the extent of rent-seeking, the worse economic performance (Cole and Chawdhry 2002, Del Rosal 2011, Shleifer and Vishny 1993).

Economic growth is negatively affected by both tax pressure and rent-seeking. To keep our analysis simple, we make two reasonable assumptions. First, we suppose that economic performance corresponds to the lowest growth rate between the rate allowed by the tax pressure elicited by populism and the rate allowed by the policymaker's choice on rent-seeking. Second, we postulate that public opinion accepts that higher taxation and government expenditure create inefficiencies and rent-seeking opportunities, and that economic performance suffers.<sup>8</sup> Yet, taxpayers object – tensions emerge – when rent-seeking is excessive, i.e. when it leads to a growth rate lower than expected.

When they emerge, tensions provoke different reactions, which define the short-run and long-run scenarios. In the short run, disgruntled taxpayers oust the incumbent policymakers, and replace them with candidates supposedly more concerned with economic performance and less inclined to rent-seeking.<sup>9</sup> Of course, new elections do not guarantee that the newly appointed policymakers meet the preferences of the electorate. Thus, if policymakers still engage in excessive rent-seeking, growth remains disappointing and tensions persist, taxpayers realise that replacing the incumbent policymakers is pointless, and the short-run electoral reaction develops into a long-run perspective. From a long-run perspective, taxpayers respond by migrating or engaging in tax evasion.<sup>10</sup> They can even realise that the desirable mix between populism and growth is in fact unsustainable. In the latter case, taxpayers adjust their preferences: they accept a lower growth rate for the sake of fairness (populism), or change their views on the growth-fairness trade-off.

### 3. Taxpayers' and policymakers' preferences at work

We now analyse the simple story outlined in section 2 by resorting to a set of figures that allow us to examine some hidden features that the narrative fails to clarify and from which one can develop further insights. In particular, the figures in this section and in

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<sup>7</sup> See Pejovich (2008: chapter 8) and Bergh and Henrekson (2011) on the causality between taxation, regulation and growth.

<sup>8</sup> See the survey of the literature in Laffer and Arduin (2013, appendix 1).

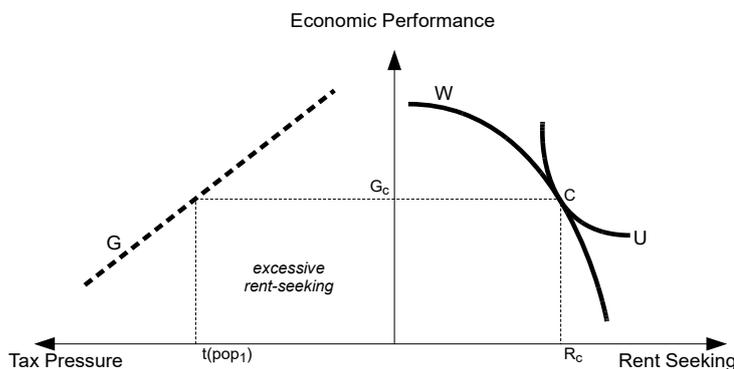
<sup>9</sup> This is not the only reason why the electorate might dislike the incumbent policymakers. For example, voters might react to legislation about capital punishment, abortion, defence, censorship or human rights. In this paper, however, we focus on the reactions triggered only by disappointing economic performances.

<sup>10</sup> “The more severe the bureaucratic corruption in a country, the more difficult it is to collect formal taxes. As a result, the government has to rely more on capital controls/financial repression” (Bai and Wei, 2000: 17).

section 4 discuss the conditions that define consistency between the voters' preferences and expectations on the one hand, and the lawmakers' choices and responses on the other.

Figure 1 offers a visual account of the interactions outlined in the previous section. It illustrates how taxpayers and lawmakers choose – see the left-hand side and the right-hand side of the figure, respectively -- and how solutions emerge. In particular, the dotted line  $G$  in the left-hand quadrant illustrates the relationship between populism, tax pressure, and taxpayers' expectations regarding economic performance: the exogenous degree of populism  $pop_1$  determines the tax pressure  $t(pop_1)$  that taxpayers believe will allow an economic performance no less than  $G_C$ . As the demand for redistribution (populism) increases, the required tax pressure also increases, and the expected economic performance drops. As mentioned earlier, taxpayers realise and accept that populism comes at the expense of growth: this explains the negative slope of the  $G$  line. The economy is free from tensions when the policymaker does not exceed in his rent-seeking activities and economic performance meets or beats the expectations described by  $G$ . In our example the level of taxation involved by  $pop_1$  elicits growth expectations equal to  $G_C$ . Hence, in order to avoid tensions, the policymaker must ensure that his rent-seeking activities do not depress economic performance below  $G_C$ .

Figure 1: Populism, economic performance and tax pressure



When expectations are rational,<sup>11</sup> the  $G$  line does not identify the minimum tolerable performance, but rather the feasible performance. In other words, expectations, tolerance and feasibility coincide: voters tolerate the economic performance shown by the  $G$  line, and they know that under normal circumstances they can't have more. Within this framework, therefore, all points below the  $G$  line relate to situations in which growth is disappointing because of excessive rent-seeking. All points above the  $G$  line describe situations in which growth is attainable only if boosted by substantial

<sup>11</sup> For the sake of simplicity, we assume that taxpayers are characterised by rational expectations: they know what the lawmakers can deliver, given the voters' mandate regarding taxation. Yet, this is by no means the only possible hypothesis. For example, one could follow Caplan (2007), and claim that voters are rationally irrational, so that they end up assessing performance by considering both the lawmakers' compliance with the voters' irrational preferences expressed in the ballot booth, and the objective results actually obtained, regardless of what the ballot booth reveals.

government expenditure funded by external creditors; or if public indebtedness encourages voters to live beyond their means.<sup>12</sup>

The right-hand side of the figure illustrates the extent to which the policymaker engages in rent-seeking. In particular, the  $W$  frontier describes the maximum economic performance that the policymaker can obtain for each level of rent-seeking. The slope of the  $W$  frontier accounts for the fact that a rise in rent-seeking creates inefficiencies (competition is weakened and resources are misallocated). Hence, economic performance deteriorates as rent-seeking increases. The shape and position of the  $W$  frontier are determined by specific features of the economy,<sup>13</sup> such as the presence of institutional checks on the use of public funds, the size of public spending, and the perception of the actual cost of public expenditure (for example, public debt often gives the impression that government expenditure is a free lunch).

By contrast, the  $U$  curve illustrates the lawmaker's indifference curve, which reflects his preferences: self-enrichment through rent-seeking, and prestige through compliance with the rule of law and economic performance. In our example, the policy maker maximises his satisfaction  $U$  at point  $C$ . At  $C$ , rent-seeking equals  $R_C$ , which is consistent with people's expectations regarding growth ( $G_C$ ). Hence,  $R_C$  is not excessive and solution  $C$  is sustainable, i.e. it does not generate tensions.

#### 4. Populism and the quality of public expenditure

As mentioned earlier, populism justifies taxation. Furthermore, taxpayers tolerate a moderate amount of inefficiencies and rent-seeking, which are considered all but inevitable. However, people also expect that tax revenues are used appropriately.<sup>14</sup> We refer to how taxes are used as the quality of public expenditure perceived by the taxpayers. This is reproduced by the upward-sloping curve  $QE$  in the left-hand quadrant of Figure 2: given taxpayers' expectations, a heavier tax pressure must be matched by a (perceived) higher quality of public expenditure. In particular, the slope of  $QE$  increases because of the increasing opportunity cost of public expenditure: the marginal sacrifice taxpayers undergo when financing public expenditure increases with expenditure (and the tax revenues it requires).

Of course, the shape and position of the  $QE$  curve change when taxpayers' preferences change. For example, if people want better services for their money, the  $QE$  curve in figure 2 moves upwards. By contrast, if the policymakers succeed in deceiving the

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<sup>12</sup> However, one should keep in mind that public debt provides only temporary relief, since debt servicing and debt repayment will eventually make their impact on taxpayers' welfare.

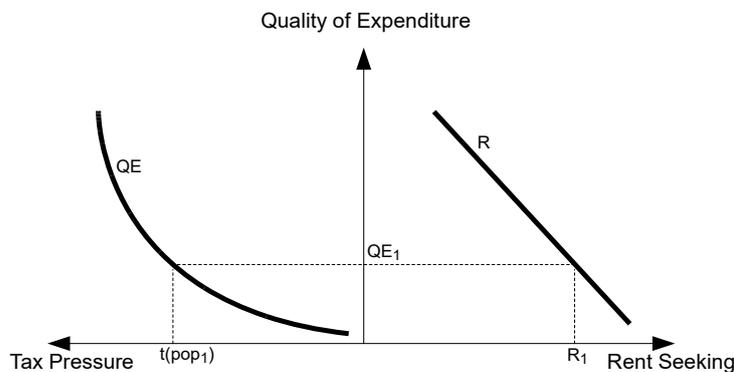
<sup>13</sup> For example, Ahlin (2001) shows that different kinds of decentralization allow for different (but always positive) levels of corruption. See also Lederman, Loayza and Soares (2001).

<sup>14</sup> See for instance Hoffmann et al. (2008), who offer an in-depth account of the determinants of people's attitude towards taxation.

taxpayers and making them believe that the quality of expenditure has improved while in fact it has remained the same, then the  $QE$  curve moves to the left.<sup>15</sup>

The right-hand side of Figure 2 relates to the trade-off between the quality of public expenditure and rent-seeking. As described by the  $R$  schedule, insofar as the lawmaker uses the government sector in order to pursue rent-seeking activities, the quality of public expenditure deteriorates (Tanzi and Davoodi, 1998). For example, the figure below depicts a situation in which tax pressure  $t(pop_1)$  is tolerated when the quality of expenditure is at least  $QE_1$ , which is attainable only if rent-seeking does not exceed  $R_1$ . Excessive rent-seeking can therefore drive the quality of expenditure below its tolerance threshold. This is another source of political instability the policymaker must face.

Figure 2: The quality of public expenditure and tax pressure



## 5. Defining political equilibrium

To summarise, Figures 1 and 2 show that the taxpayers' attitude towards taxation follows populist sentiments, and is also sensitive to how the money is spent. These two drivers could generate tensions. Since the policymaker has his own preferences, his rent-seeking behaviour could lead to an economic performance inferior to the performance expected by the taxpayers and defined by their populist feelings. Moreover, the quality of expenditure might be below the minimum level required by the population, given the amount of taxes they pay.

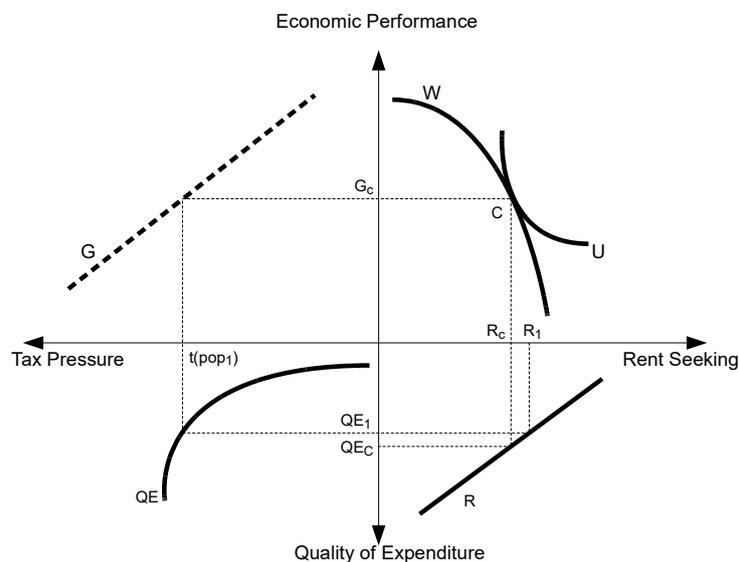
The economy is thus in a political equilibrium (with no tensions) when populism, the quality of expenditure, and rent-seeking are mutually compatible. This is shown in

<sup>15</sup> Of course, deception differs from the so-called "spending review". A spending review means that a given amount of rent-seeking yields public expenditure of better quality, or that the opportunities for rent-seeking are reduced. By contrast, deception corresponds to a situation in which the policymaker induces people to spend more for the same goods/services supplied by the government.

Figure 3, in which quadrants I and II reproduce Figure 1, and quadrants III and IV reproduce Figure 2.

For example, the presence of a  $pop_1$  degree of populism leads to a demand for taxation equal to  $t(pop_1)$ . This level of taxation, however, is tolerable as long as the quality of expenditure is at least  $QE_1$ , which is attainable if rent-seeking does not exceed  $R_1$ . In order to assess whether this is indeed the case, one needs to consider the policymaker's choice. In the example presented in the figure, policymakers operate at  $C$ , which obtains economic performance  $G_C$  – consistent with the taxpayers' expectations. One can observe that at  $C$  rent-seeking is  $R_C$ , which is lower than  $R_1$ ; hence, the quality of expenditure is  $QE_C$ . Since  $QE_C$  is higher than  $QE_1$ , it defines a (politically) sustainable situation.

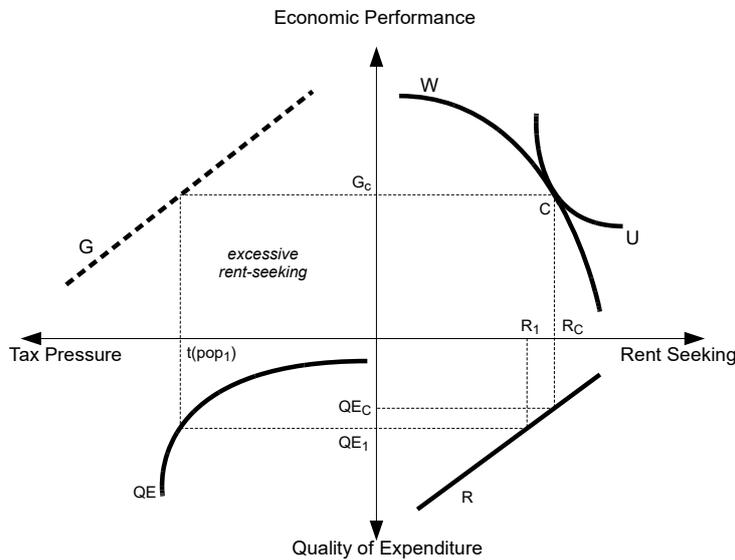
Figure 3: Political equilibrium



A different outcome would materialize if rent-seeking was less harmful to growth (see Figure 4, where the  $W$  frontier is further away from the origin than in Figure 3). Here the policymaker engages in rent-seeking activities  $R_C$ , which are still consistent with the economic performance  $G_C$  expected by taxpayers featuring a  $pop_1$  degree of populism. However, rent-seeking turns out to be an intolerable burden ( $R_C > R_1$ ) for the quality of public expenditure ( $QE_C < QE_1$ ). The system is then in disequilibrium, and tensions follow.<sup>16</sup>

<sup>16</sup> In brief, the political situation is sustainable when  $R_C < R_1$ ; it is not sustainable when  $R_C > R_1$ .

Figure 4: Political disequilibrium



## 6. The short-run scenarios: public debt or better politicians

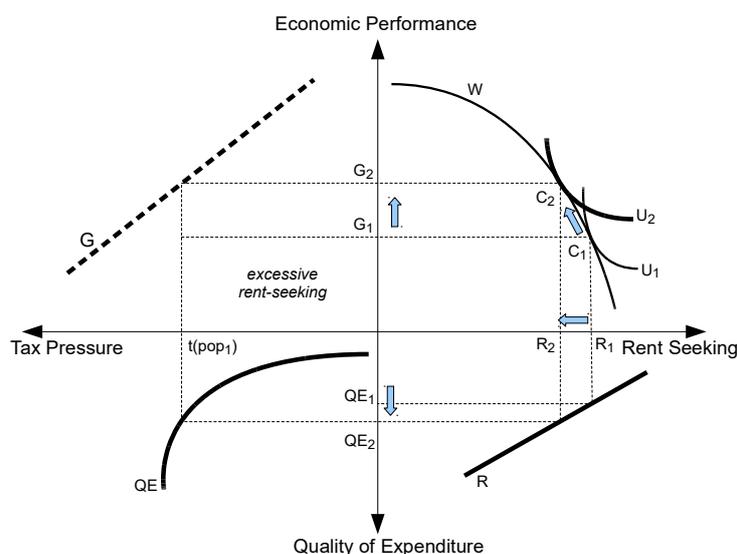
Let us now examine what happens when tensions emerge. In our simplified world, tensions elicit reactions. In the short-run, either incumbent politicians hold on to power by sweeping under the rug bad economic performances and resorting to external creditors, who thus allow the country to live above its means (see also section 3); or voters oust the current lawmakers. We examine these two possibilities with the aid of figures 5a and 5b.<sup>17</sup>

Consider the initial state of economy described in Figure 5a by curves  $G$ ,  $R$ ,  $W_1$  and  $QE'$ . Here, preferences  $U_1$  lead the policymaker to choose  $C_1$ . This allows for growth at  $G_1$  (below the taxpayers' expectations  $G_2$ ) and rent-seeking at  $R_1$ . Thus, although rent-seeking involves a satisfactory quality of expenditure  $QE_1$ , tensions are fuelled by disappointing growth.

<sup>17</sup> There is also a third possibility, since by resorting to money printing, the policy maker can boost economic performance with relatively little resistance in the short-run, and with consequences in terms of rent-seeking, redistribution, and fairness. For the sake of clarity, however, in this paper we neglect to analyse the inflationary option.



Figure 5b: Less greedy policymakers win the elections



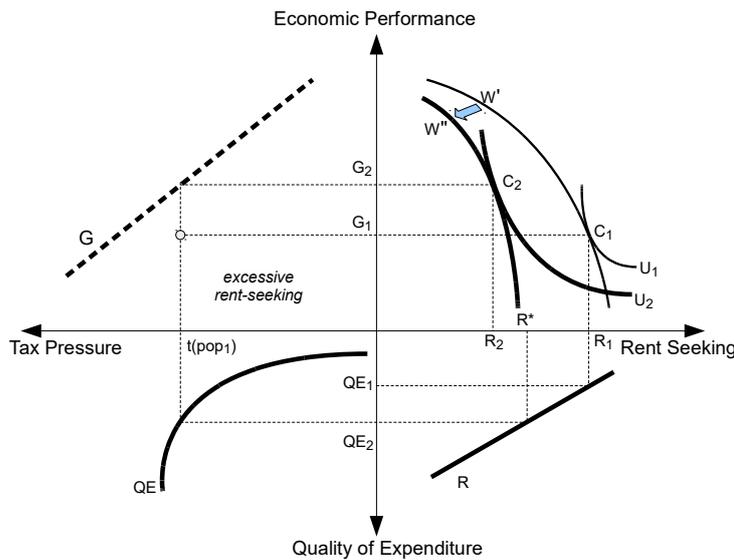
The second short-run scenario materialises when taxpayers react by voting out the incumbent politicians, and the newcomers feature different preferences and generate a new equilibrium. As shown in Figure 5b, in an economy characterised by populism  $pop_1$  and tax pressure  $t(pop_1)$ , taxpayers expect growth to be  $G_2$ , while the incumbent politicians feature preferences  $U_1$ . Economic performance is thus no greater than  $G_1$ , and the quality of public expenditure is also less than satisfactory (the actual level of rent-seeking  $R_1$  is greater than  $R_2$ , the amount of rent-seeking consistent with the expected quality of public expenditure expected). If voters fail to elect a less greedy policymaker, then the economy enters a long-run scenario. If voters succeed in replacing the incumbent policymakers with less greedy ones characterised by preferences  $U_2$ , then rent-seeking drops from  $R_1$  to  $R_2$ , which allows public expenditure of quality  $QE_2$ .

## 7. The long-run scenarios: tax evasion, migration and ideology

Debt and/or new elections define the short-scenarios discussed in the previous section. However, it may also happen that the possibilities of fooling the taxpayers by increasing public indebtedness are limited and that the voters' repeated efforts to improve the quality of lawmaking are vain, since the new leaders turn out to be as bad as their predecessors. Under these circumstances, disillusioned taxpayers might react by cheating or opting out – tax evasion and migration, respectively. We label these two options as long-term scenarios.

This context is described in Figure 6a, in which we have assumed that taxpayers' expectations regarding growth do not change (the  $G$  line remains constant), and that populism is  $pop_1$ . The policymaker initially operates along the  $W'$  frontier and maximises utility by engaging in rent-seeking activities  $R_1$ , which allow economic performance  $G_1$ . As shown in the figure,  $G_1$  is not enough to meet the voters' expectations  $G_2$ . The quality of expenditure is also less than satisfactory, rent-seeking  $R_1$  leads to a quality of expenditure  $QE_1$ , which is lower than the minimum acceptable level  $QE^2$ . This explains the presence of tensions.

Figure 6a: Migration or tax evasion

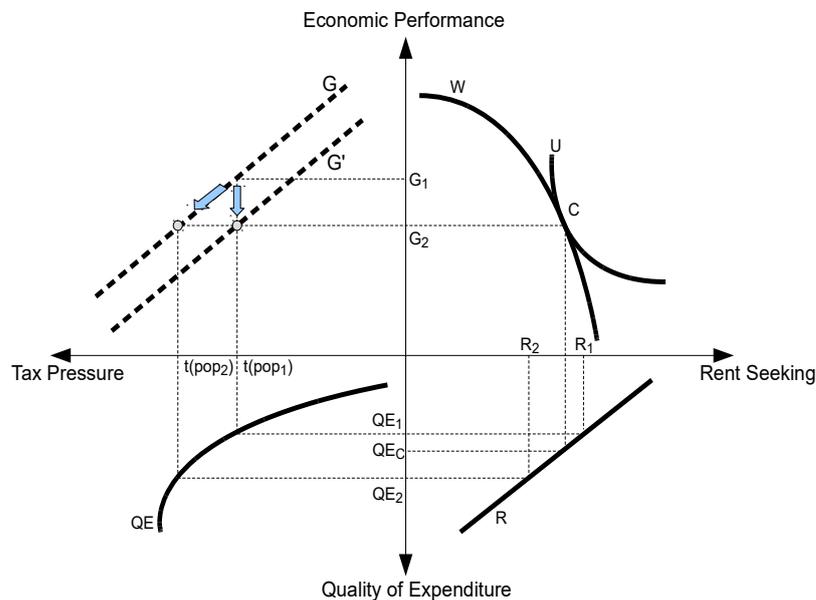


From a long-run viewpoint, tax evasion and/or migration follow. Tax evasion and migration imply that tax revenues drop, and that the policymaker has fewer resources available for rent-seeking. This is rendered by an inward shift of the rent-seeking frontier from  $W'$  to  $W''$ . In our example, the new point of equilibrium for the policymaker is  $C_2$ : rent-seeking drops to  $R_2$ , and economic performance rises to  $G_2$ , consistent with the voters' expectations. The quality of expenditure also improves and tensions disappear. Put differently, in our context tax evasion and/or migration could be a satisfactory answer to the tensions provoked by excessive rent-seeking and greedy politics.

Finally, a different mechanism applies when the ongoing tensions provoke changes in the taxpayers' preferences. For example, this is what would happen if tax evasion and migration were ineffective in cutting rent-seeking, e.g. because they fail to boost economic performance.<sup>19</sup>

<sup>19</sup> In figure 6a, this would be the case if the new equilibrium point in the second quadrant fell below  $C_2$  on the  $W''$  schedule.

Figure 6b: New taxpayers' preferences



To illustrate this last long-run scenario, we refer to Figure 6b, a situation in which taxpayers initially feature a degree of populism equal to  $pop_1$  and expect performance  $G_1$ . Yet, in this economy, rent-seeking happens to be relatively intense and performance is only  $G_2$ . If voting out the old politicians proves ineffectual, and growth continues to be disappointing, taxpayers may end up adjusting their preferences (resignation), and accepting lower growth for the sake of fairness; or trading more fairness for lower growth.<sup>20</sup> In the former case, the  $G$  line shifts downwards (see  $G'$ ); in the latter, we experience a movement to the left along the  $G$  line. As a result, in the former case (lower growth for the sake of constant fairness), tax pressure and the required quality of public expenditure remain constant. In the latter case (lower growth is accepted only if compensated by more fairness), tax pressure increases and so does the quality of public expenditure.

<sup>20</sup> We would obtain the same effects in the case of migration. Migration would change the composition of the electorate following some kind of “Curley Effect” (Glaeser and Shleifer, 2005). This alternative, however, would not alter our conclusions.

## 8. What about the real world?

This paper has offered a framework within which one can appreciate situations in which taxpayers can express their wishes at the ballot box, react with their feet – migrating to another country or diving underground -- or change their views about growth and redistribution.

In this section, we try to figure out whether the story outlined in the previous paragraphs can be a useful guide to understand the actual world. As we have tried to show throughout the paper, tensions can emerge rather easily. Although one can hardly downplay the importance of the differences across regions and countries (e.g., culture and localised shock matter), frictions have two origins. In some cases, they are triggered by disappointing growth, in other cases by the inadequate quality of public expenditure.

In this light, our model helps understand the nature of the mechanisms at work, which depend on the presence of different fairness-growth trade-offs (the  $G$  schedules), different ways through which rent-seeking affects growth (the position and shape of the  $W$  schedules), and different expectations about the quality of public expenditure ( $QE$ ). Likewise, the preferences and skills of the policymakers are also variable across countries, as shown by the shape and position of the  $U$  schedules. Finally, in each country all these variables can vary with time. For example, if people get used to inefficiencies and bad lawmaking, tolerance with regard to the quality of public expenditure can become more generous. Under such circumstances, taxpayers despair of ending up with a better ruling class, and accept whatever comes. By contrast, it may also happen that voters look at other countries, and realise they can have better services for their money. As a result, their resolve to change the economic and political environment would strengthen.

In this section, we present two simple examples that may illustrate the explanatory power of our model: the first example examines how different advanced economies react to a deterioration in economic performance, and briefly extends the analysis to the case of developing countries; the second example regards the ongoing drift towards the long-term scenarios we described in section 7.

Let us assume that in two countries – call them Italy and Sweden – taxpayers have different views about the quality of public expenditure they can expect from their policymakers. In particular, in Italy the expected quality of public expenditure is significantly lower than in Sweden. It follows, therefore, that a given degree of rent-seeking would be tolerated in Italy, but rejected in Sweden. Let us then start from an initial situation in which voters are reasonably happy and tensions are absent. What happens if the economic performance deteriorates?

According to our predictions, within the Italian context, taxpayers realise that their expectations have not been met, and grumble. At first, a budget deficit (an increase in public debt) or a shift towards enhanced populism could defuse tensions and avoid turmoil and drastic reforms. However, should the authorities find it difficult to increase public debt or intensify the demagogic rhetoric, tensions erupt: either a new political class emerges or the country enters a period of political instability with numerous and

short-lived governments. Eventually, it drifts towards the long-run scenarios described in section 7 (migration and /or taxation). By contrast, since in Sweden rent-seeking is limited by the need to guarantee high-quality public expenditure, growth actually tends to be systematically higher than the rate required to meet people's expectations. As long as the growth buffer is large enough, slow growth in Sweden is hardly a source of tensions.

These differences are consistent with what we currently observe. What is perhaps less obvious – and our model emphasises – is that the key to the difference between countries like Italy and Sweden is in fact the taxpayer's attitude – expectations and tolerance – towards the quality of public expenditure.

More generally, tensions are modest in areas in which the quality of public expenditure is considered adequate. Apparently, in these countries growth does not matter much (the  $G$  schedule that figures prominently in our graphs is relatively low), or is perceived as a variable outside the lawmaker's control (an almost flat  $G$  line). Thus, voters tend to focus on obtaining greater fairness, aware of the fact that the sacrifice in terms of growth is limited. Of course, tensions may persist if rent-seeking is relatively high, and the quality of expenditure turns out to be inadequate.

In a similar vein, let us assume that in some low-income countries growth tends to be more important than redistribution, while in richer countries the opposite applies. Under such circumstances, the  $G$  line would be relatively flat in the former group of countries, and relatively steep in the latter group. Thus, in developing countries all efforts to compensate for poor economic performances by intensifying redistribution would be vain and possibly counterproductive: the required redistributive policy would be very substantial, and trigger great expectations in regard to the quality of public expenditure. The lower tensions one may obtain by increasing fairness would then be eclipsed by the tensions provoked by the inadequacies of public expenditure. These considerations apply also to the previous comparison between Italy and Sweden: if the  $G$  line is all but flat, the required quality of expenditure is prohibitive, and may lead taxpayers to simply accept lower growth with no request for more fairness.

The second example applies to Western Europe, where taxation is generally high, and reflects the voters' widespread propensity to argue in favour of income equality and a generous welfare state to the benefit of the low-income earners. Taxpayers are indeed ready to accept economic performances that would have been defined miserable in the past decades, and are reluctant to advocate lower public expenditure. At the same time, however, they lament that they do not get enough for what they pay (low quality of expenditure) and tensions build up. The short-run solutions have generated large public debts, as our model would predict. Nonetheless, indebtedness has failed to produce better generations of lawmakers: the increasingly frequent cries advocating "direct democracy" (as a substitute for the ballot box) can be interpreted as a symptom of frustration. It seems, therefore, that at least some Western European countries are now

in what we have defined as “the long-run scenarios”: migration and the efforts to evade taxation have intensified, and voters have revised their growth expectations.<sup>21</sup>

## 9. Summary and conclusions

The line of reasoning we have been following in this work rests on two sets of critical assumptions. First, we have defined taxation by considering the degree of populism that characterises the electorate, which expects to obtain fairness, growth and good-quality public expenditure. Second, lawmakers tend to resort to rent-seeking in order to pursue their own goals (vanity, the quest for power and material rewards), which may or may not be compatible with taxpayers’ desires. Within this framework:

- (1) Expectations about growth and tolerance towards and the quality of expenditure are crucial for political sustainability (absence of tensions).
- (2) Tensions are more likely to arise when the policymaker is particularly greedy and short-sighted. He might take advantage of populism, which reduces people’s expectations about economic performance, and creates more tolerance for rent-seeking. Yet, intensive rent-seeking affects the quality of public expenditure and triggers taxpayers’ reactions even when the electorate is happy with growth.
- (3) When the voters succeed in ousting the worst rent-seeking politicians, tensions are defused with relative ease.
- (4) Tensions provoked by disappointing growth may also be alleviated through public indebtedness, which gives voters better living standards (the illusion of satisfactory economic performance and of improved expenditure) and makes more resources available for rent-seeking. However, this scenario sows the seeds of future tensions, since the temptation to use the additional resources for rent-seeking increases (at the expense of the quality of expenditure), and debts must be serviced and ultimately reimbursed.
- (5) When the new policymakers replicate the bad habits (preferences) of their predecessors, tax evasion and migration can help restore equilibrium by subtracting resources to the rent-seekers. Under these circumstances, both economic performance and the quality of public expenditure necessarily improve.
- (6) In the long-run, if tax evasion and migration are not feasible or fail to defuse tensions, it could also happen that the voters/taxpayers revise their views on the fairness-growth trade-off. In particular, taxpayers would settle for lower growth with constant fairness, or in exchange for more fairness. Under both circumstances, however, tensions might persist if the quality of expenditure remains poor. Tensions might even sharpen, if populism increases and the quality of public expenditure does not.

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<sup>21</sup> One may observe that the efforts to reduce tax evasion and the presence of the so-called “brain drain” are stronger where tax pressure is most resented and the quality of public expenditure disappointing.

Briefly, public expenditure plays a key role in our analysis. Taxpayers might be ready to tolerate lower economic performance either as a temporary phenomenon or as the price to pay for greater fairness. Yet, they are reluctant to accept poor services for their money: by relating the quality of public expenditure to the quality of their lawmakers, they identify the culprits of their disappointment and tensions have clearer focal points. The taxpayers' cultural traits and their experiences with lawmaking then determine the economy's long-run scenario.

Certainly, our hypotheses about populism, taxpayers' behavior and policymakers' preferences are subject to refinements and possibly significant changes. For example, we have assumed that the voters have a distinct preference for income redistribution (populism). By contrast, one could imagine that the taxpayers are not a homogenous group, that different groups of voters follow different rent-seeking objectives, and that the policymakers' promises and actions contribute to defining and redefining the voters' objectives, as well as the size and features of the rent-seeking coalitions.

In a similar vein, one may question the way we framed the policymakers' behaviour. We have assumed that the policymakers pursue either self-enrichment through rent-seeking, or fame and self-esteem by operating in the common interest. Furthermore, we have presupposed that the electorate is relatively well informed and evaluates the lawmakers' performance with reference to economic growth and to the quality of public expenditure. This is possibly an oversimplification of the real world. As an alternative, one could argue that voters are in fact ignorant, or perhaps irrational. In the former case, the politicians end up being accountable to a subset of the electorate (the informed elites), while in the latter situation the notion of economic performance would be much more nuanced, as explained in Caplan (2007, chapters 6 and 7). If these hypotheses turned out to be realistic enough, the model would change accordingly, and different outcomes would emerge.

In order not to obscure the central contribution of this paper – the mechanisms that connect the economic origins of political tensions and the voters' reactions – we have ignored the analysis of the scenarios generated by alternative assumptions with regard to political choices. Likewise, we have neglected the examination of further issues that certainly play an important role in our context: the role of regulation, of monetary policy (inflation), of public indebtedness. We hope that future works will soon fill these gaps.

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