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A THEORY OF FEASIBLE TAXATION IN ADVANCED DEMOCRACIES

A grayscale photograph of a large, multi-story building with a classical facade, featuring arched windows and a prominent entrance. The image is slightly tilted and serves as a background for the authors' names.

LEONARDO BAGGIANI
ENRICO COLOMBATTO

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A theory of feasible taxation in advanced democracies

Leonardo Baggiani* and Enrico Colombatto**

Abstract

Tax pressure is usually considered the result of the policymakers' efforts to maximise public expenditure, possibly by resorting to populism in order to alleviate tensions among the taxpayers. This paper offers a different and more articulated approach, following which populism is exogenous in the short run, but may change in the long run; taxpayers are sensitive to the quality of public expenditure; and 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 illustrates the categories of outcomes that the taxpayers' reactions may generate.

Keywords: Fiscal strategies, populism, rent-seeking

JEL Codes: H10, H11, H26, P17

* Independent Scholar (dottLBaggiani@hotmail.com)

** Professor of Economics, Università di Torino (enrico.colombatto@unito.it)

A theory of feasible taxation in advanced democracies

Leonardo Baggiani and Enrico Colombatto

1 What defines the feasible tax pressure?

This paper investigates the determinants of the rate of taxation (tax pressure). In this context, the traditional literature argues that policymakers aim at maximising tax revenues, to finance large amounts of public expenditure, and create privileges (rent-seeking). In particular, the basic principle of tax-revenue maximisation is captured and visualised by the so-called Laffer curve, which describes the causal correlation between tax rates, taxable incomes and tax revenues. Following from Colombatto (2015), we claim that the Laffer-curve approach is incomplete. In particular, we deny that the main purpose of the tax authorities is to maximise tax revenues. As a consequence, we also deny that their action is restrained only by the size of the tax base. Instead, we develop a graphical model in which the electorate indirectly determines tax pressure, while policymakers aim at prestige (vanity), the quest for power, and rent-seeking. As a result, policymakers look for solutions to please the electorate and meet their own personal goals. As will be shown in the paper, sometimes a compromise is feasible. Under different circumstances, however, tensions emerge and reactions follow, both in a short-run and in a long-run perspective.

In this light, this paper explores the legislators' action within a democratic context by drawing attention to four variables that are usually ignored by the traditional Laffer-curve literature: populism, the political pressure applied by voters and constituencies, the policymakers' own preferences, and the quality of public expenditure. The outcome

of the policymakers' action is “lawmaking”,¹ the working of which is illustrated in sections 2 and 3. Section 4 explores the connection between people’s preferences and lawmaking, and identifies the conditions that guarantee equilibrium (absence of tensions). Sections 5 and 6 examine what happens when tensions do arise, while sections 7 and 8 conclude.

2 Populism, tax pressure and growth

In our analysis, populism relates to 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. This desire stays constant in the short-run, but can change in the long-run if political tensions induce individuals to modify their beliefs in the face of reality and/or become more tolerant to avoid conflict. Since taxation plays a critical role in funding redistribution, we assume that taxation is increasing 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 has a choice. He can give priority to economic performance, which requires a relatively low level of taxation and regulation.² 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

¹ In this paper, the terms “policymaker” and “lawmaker” are used interchangeably.

² See Pejovich (2008: chapter 8) and Bergh and Henrekson (2011) on the causality between taxation, regulation and growth.

course, the greater is the extent of rent-seeking, the worse economic performance (Cole and Chawdhry 2002, Del Rosal 2011).

Within this broad framework, our simplified model presents a number of key features. First, the policymaker acts to meet the current demand for populism and to obtain the expected economic performance. Second, actual 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. Third, public opinion accepts that higher taxation and government expenditure create inefficiencies and rent-seeking opportunities, and that economic performance suffers. Yet, taxpayers object – tensions emerge – when rent-seeking is excessive, i.e. when it leads to a growth rate lower than expected.

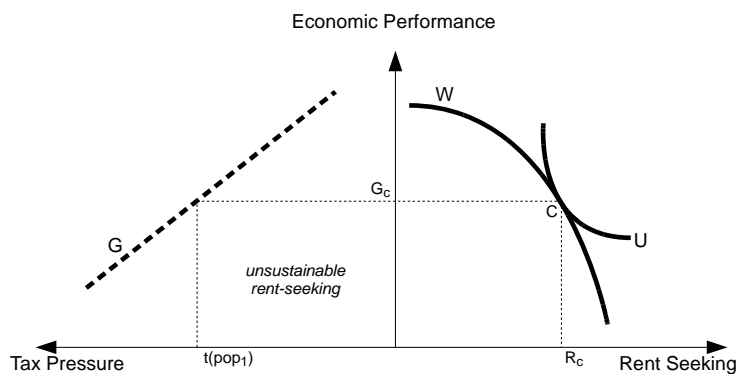
When they emerge, tensions originate different reactions, which define the short-run and long-run scenarios. In the short run, disgruntled taxpayers oust the incumbent policymakers, and replace them with candidates supposedly more concerned with economic performance and less inclined to rent-seeking. If tensions persist, taxpayers realise that replacing the incumbent policymakers is pointless, and the short-run electoral reaction develops into long-run scenarios. From a long-run perspective, taxpayers respond by migrating or engaging in tax evasion; or by realising that the desirable mix between populism and growth is in fact unsustainable. In this 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

Figure 1 offers a visual account of how populism and the policymaker's preferences affect economic performance. The dotted line G in the left-hand quadrant illustrates the relationship between populism, tax pressure, and the economic performance expected by the taxpayers: the exogenous degree of populism pop_1 elicits tax pressure $t(pop_1)$, which 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. This explains the negative slope of the G line. Since we assume that taxpayers realise and accept that populism comes at the expense of growth,³ and that some degree of rent-seeking is inevitable whenever government expenditure increases, the economy is free from tensions when the policymaker does not exceed in his rent-seeking activities and economic performance meets the expectations described by G . In our example – the level of taxation involved by pop_1 elicits growth expectations equal to G_c – 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



The right-hand side of the figure illustrates how the policymaker chooses to engage 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 shape and position of the W frontier account for the fact that a rise in rent-seeking creates inefficiencies (competition is weakened and resources are misallocated), and that inefficiencies reduce growth. The U curve illustrates the lawmaker's preferences, which feature a trade-off between self-enrichment through rent-seeking, and prestige through compliance with the rule of law and economic performance. In our example, the policy

³ See the survey of the literature in Laffer and Arduin (2013, appendix 1).

maker maximises his satisfaction at C . At C , rent-seeking equals R_C , which is consistent with people's expectations regarding growth (G_C).

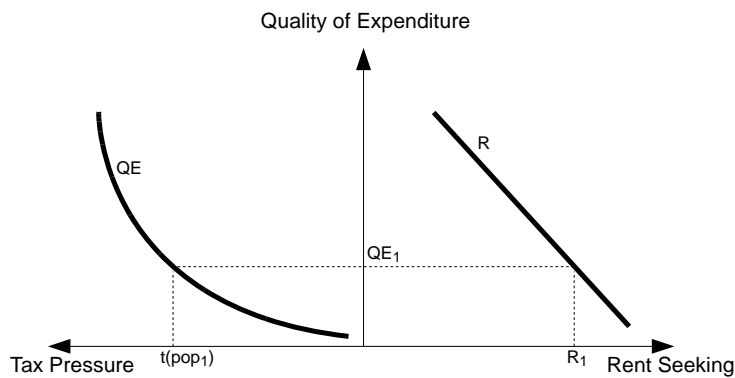
It is reasonable to assume that people's expectations about economic performance tend to be rather optimistic. In particular, competing policymakers tend to make buoyant promises about what they can deliver, and the voting taxpayers are usually receptive to such promises, possibly at a discount. When so, the G line describes both expectations and (at best) the highest possible economic performance associated with a given degree of populism and taxation. Under this "rational-expectations" assumption, therefore, all points above the G line describe situations in which growth is attainable only if boosted by substantial government expenditure funded by external creditors. By contrast, all points below the G line relate to situations in which growth is disappointing because of excessive rent-seeking. Public indebtedness can provide a solution in this case as well, since debt gives people access to resources that under normal circumstances would be generated by growth. Put differently, since public debt reduces the need to tax and enhances people's disposable income, voters are living beyond their means: they behave as if they were on G , even if the economic performance is actually poor. 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.

As mentioned in the previous section, populism justifies taxation and 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.⁴ We refer to the way taxes are used as the quality of public expenditure. 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 higher quality of public expenditure. In particular, the slope of QE increases because of the increasing opportunity cost of public expenditure.

⁴ See for instance Hofmann et al. (2008), who offer an in-depth account of the determinants of people's attitude towards taxation.

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 taxpayers and in 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.⁵

Figure 2: The quality of public expenditure and tax pressure



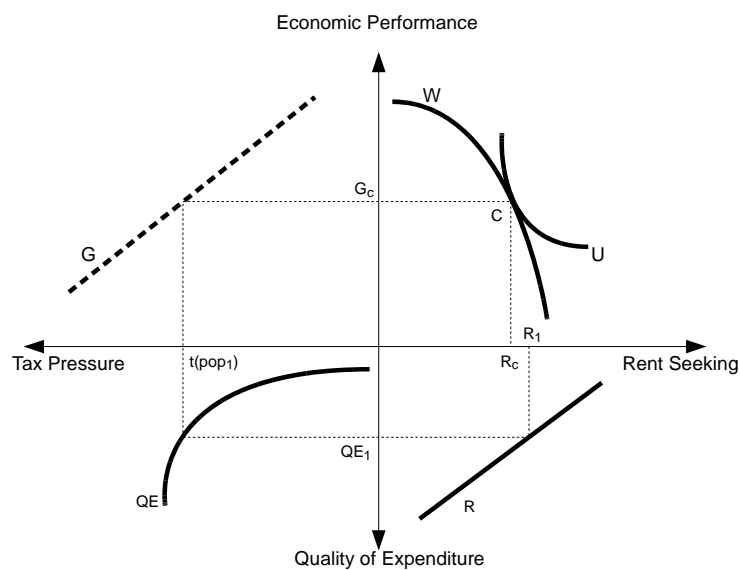
The right-hand side of Figure 2 relates to the trade-off between the quality of public expenditure and rent-seeking. As described by the R schedule, insofar as the lawmaker uses the government sector in order to pursue rent-seeking activities, the quality of public expenditure deteriorates (Tanzi and Davoodi, 1998). For example, the figure above 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 .

⁵ 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.

4 Defining political equilibrium

In brief, 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 allow 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 level required by the population, given the amount of taxes they pay. The economy is thus in equilibrium (no tensions) when populism, the quality of expenditure, and rent-seeking are mutually compatible. This is summarised in Figure 3, in which quadrants I and II reproduce Figure 1, and quadrants III and IV reproduce Figure 2.

Figure 3: Political equilibrium

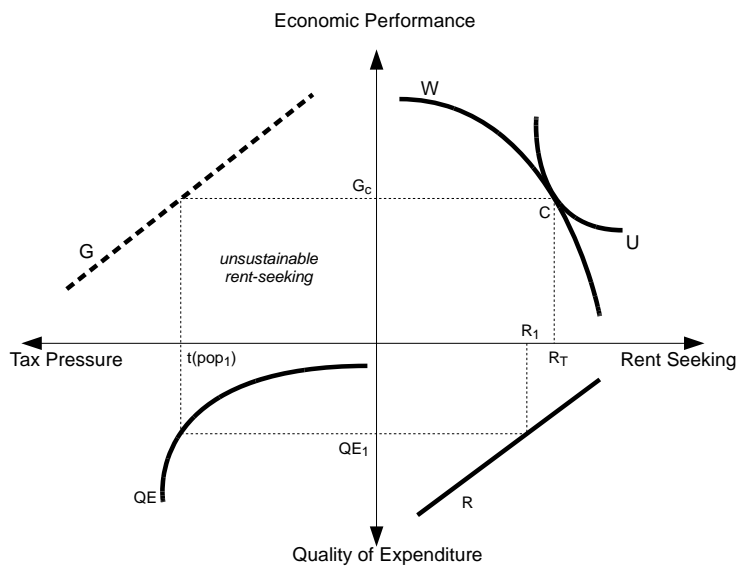


For example, the presence of a pop_1 degree of populism leads to a demand for taxation equal to $t(pop_1)$. This level of taxation, however, is tolerable as long as the quality of expenditure is at least QE_1 , which is attainable if rent-seeking does not exceed R_1 . In order to assess whether this 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. Moreover, one can observe that at C rent-seeking is R_C , which in Figure 3 is lower than R_I . Thus, the situation is (politically) sustainable.

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_T , which are still consistent with the economic performance G_C expected by taxpayers featuring a pop_1 degree of populism. However, R_T turns out to be an intolerable burden for the quality of public expenditure ($R_T > R_I$). The system is then in disequilibrium, and tensions follow.

Figure 4: Political disequilibrium



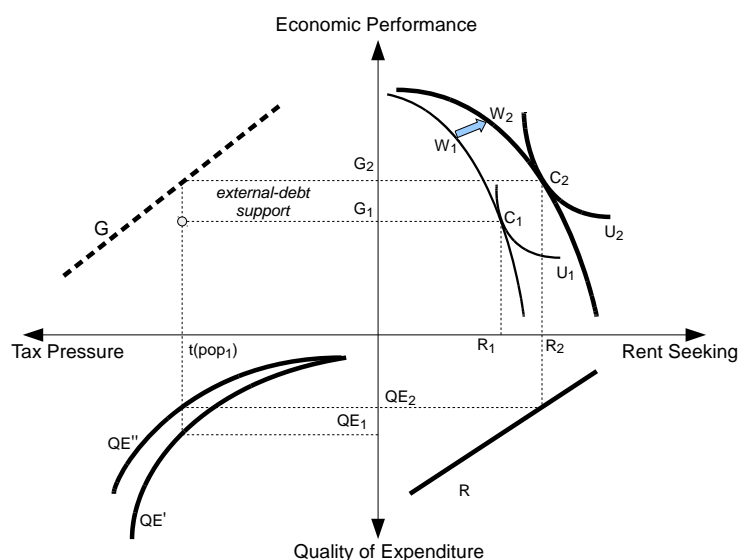
5 The short-run scenarios

In our simplified world, tensions elicit reactions. In the short-run, either incumbent politicians hold on to power by resorting to external creditors, who thus allow the

country to live above its means; or voters oust the current lawmakers. We examine these possibilities in turn.⁶

Figure 5a shows what happens when rent-seeking leads to disappointing growth, and tensions are defused through indebtedness. As a result of foreign credits, the rent-seeking opportunities expand: the W frontier moves upwards, and a new rent-seeking equilibrium C_2 obtains. Economic performance is now satisfactory, but new rent-seeking opportunities have emerged. Under these circumstances, taxpayers are (temporarily) happy as long as the quality of public expenditure is high enough, and the expanded rent-seeking activities are tolerated. For example, if the quality requirements are described by QE' , debt is not enough to defuse tensions ($QE_2 < QE_1$). Actually, tensions might even become more acute. By contrast, if the quality requirements are described by the QE'' schedule, the new-rent seeking level is still acceptable. Of course, even if indebtedness succeeds in offering a short-run solution, tensions will resume when government expenditure is no longer sustained by foreign creditors; and sharpen when debts must be reimbursed.

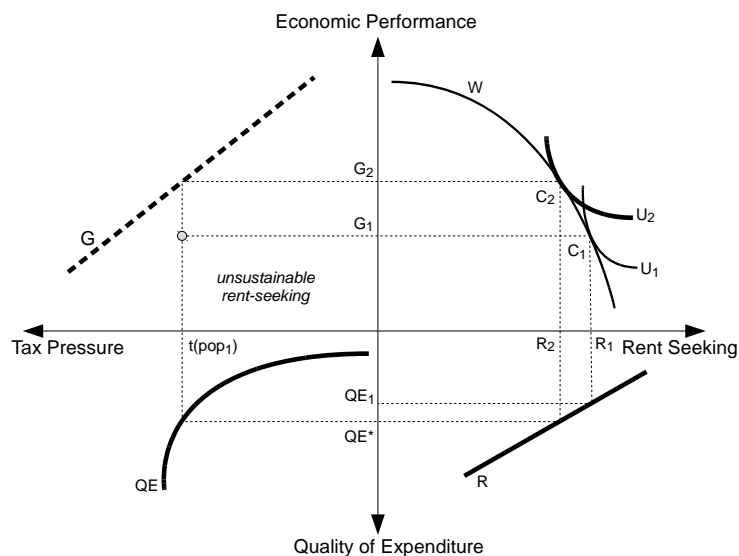
Figure 5a: Public debt (temporarily) defuses tensions



⁶ There is actually also a third possibility: money printing is likely to 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.

The second 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 below, 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. If voters succeed in replacing the incumbent policymakers with less greedy individuals with preferences U_2 , rent-seeking drops from R_1 to R_2 , and the quality of public expenditure rises to QE^* .

Figure 5b: Less greedy policymakers win the elections



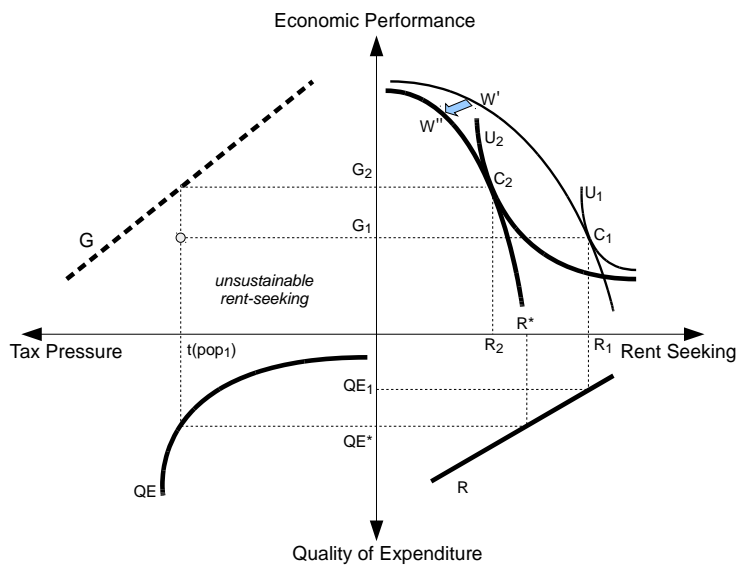
6 The long-run scenarios

However, it may also happen that the taxpayers' efforts to improve the quality of lawmaking are vain, and that the new leaders are as bad as their predecessors. Under

these circumstances, disillusioned taxpayers might react by cheating or opting out – tax evasion and migration, respectively.

This 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 *pop1*. 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 . However, G_1 is not enough to meet the voters' expectations G_2 . The quality of expenditure is also less than satisfactory, since the actual level QE_1 is lower than the minimum acceptable level QE^* . Hence, tensions emerge, and tax evasion and/or migration follow.

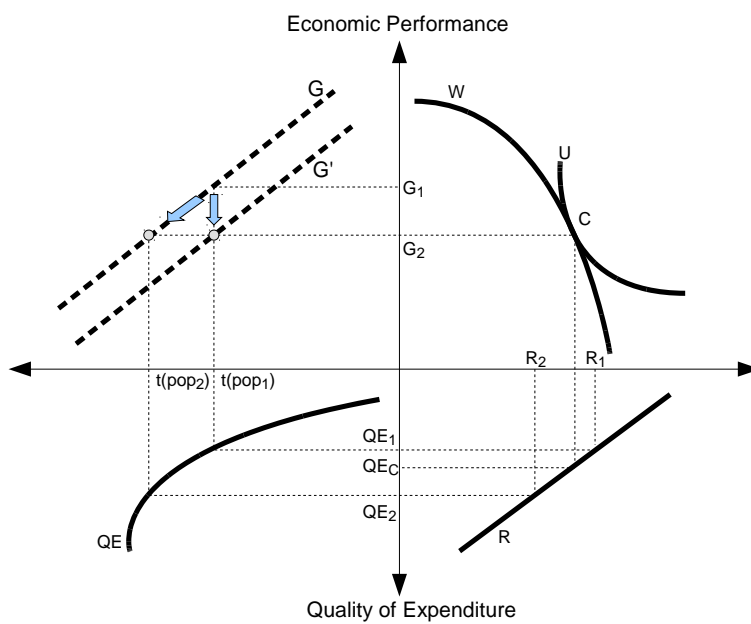
Figure 6a: Migration or tax evasion



Tax evasion and migration imply that tax revenues drop, and the policymaker has fewer resources available for rent-seeking. This is equivalent to 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.

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 effective in cutting rent-seeking, but failed to boost economic performance.⁷

Figure 6b: New taxpayers' preferences



In this light, Figure 6b describes a situation in which taxpayers initially feature a degree of populism equal to pop_1 and expect performance G_1 . Yet, rent-seeking is relatively intense and performance is only G_2 . Moreover, we are assuming that voting out the old politicians proves ineffectual, and growth continues to be disappointing. Under these circumstances, the population adjusts its preferences, and accepts lower growth for the sake of fairness, or trades more fairness for lower growth. In the former case, the G line shifts downwards; in the latter, we experience a movement to the left along the G line. In other words, in the former case (lower growth for the sake of constant fairness), tax

⁷ 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.

pressure stays the same and the required quality of public expenditure also remains constant. In the latter case (lower growth compensated by more fairness), tax pressure increases and the quality of public expenditure is also expected to increase.

7 The main results in one page

The line of reasoning we have been following in this work rests on two sets of critical assumptions. Taxation is defined by the degree of populism that characterises the electorate, which expects to obtain fairness, growth and good-quality public expenditure. Lawmakers tend 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) Growth expectations and quality of expenditure – affected by rent-seeking decisions – are crucial for political sustainability.
- (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 electoral process succeeds 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 resources available for rent-seeking. However, this scenario sows the seeds of future tensions, since 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 is poor; and they might even sharpen, if populism increases.

8 What about the real world?

How does the story outlined in the previous paragraphs fit the real world? This paper has offered a theoretical framework within which one can better appreciate the economics and dynamics of taxation in economies in which taxpayers can express their wishes at the ballot box, or react with their feet – migrating to another country or diving underground.

As the reader has noticed, equilibrium is not granted. As a matter of fact, one may easily understand why tensions are the normal state of affairs, although their origins may differ. In some cases, they are triggered by disappointing growth, in other cases by the inadequate quality of public expenditure. Furthermore, one can also appreciate why the economics of tensions differs across countries. As illustrated by the figures, countries can present different fairness-growth trade-offs (the G schedules), different categories of rent-seeking (so that the W schedule varies), and different expectations about the quality of public expenditure (QE). Of course, the features of the political classes are not necessarily constant across countries, either. And in each country all these variables can vary with time. For example, tolerance with regard to the quality of public expenditure can become more generous (people give up hope and accept whatever comes) or more stringent (people look at other countries and realise they can have better services). Last but not least, reactions unfold at different speeds, especially when cultural variables play a significant role. This is certainly the case with taxpayers' preferences.

For example, one could suggest that since the expected quality of public expenditure in a country like Italy is significantly lower than – say – in Scandinavia, the same degree of rent-seeking activities would be considered acceptable in Italy, but scandalous in Sweden. In a similar vein, one might suspect that in some low-income countries growth tends to be more important than redistribution, while in richer countries the opposite applies. Hence, the *G* line would be relatively flat in the former groups for countries, and relatively steep in the latter group. As a result, all efforts to compensate for poor economic performances in developing countries 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.

A cursory look at the recent experience in Western Europe further illustrates how the analysis presented in these pages could be applied. In Western Europe, taxation is generally high, and reflects the voters' widespread propensity to sustain populist visions (income equality and a generous welfare state to the benefit of the low-income earners). Yet, in some countries people do complain about tax pressure. They 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. 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 suggest. Nonetheless, they have 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.⁸

⁸ One may observe that the efforts to reduce tax evasion and the presence of so-called “brain drain” are stronger where tax pressure is most resented and the quality of public expenditure disappointing.

By contrast, 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 has dropped significantly), or is being perceived as a variable outside the lawmaker's control (an almost flat G line), and voters have thus focused on enhanced populist demands. In this case, therefore, voters aim at obtaining greater fairness trade, aware of the fact that the sacrifice in terms of growth is limited. Of course, tensions may still arise if rent-seeking is relatively high, and the quality of expenditure turns out to be inadequate.

Time will tell whether the flattening of growth expectations is enough to guarantee equilibrium, or whether preferences and perceptions will change (again), and bring about new needs for adjustment.

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DEPARTMENT OF ECONOMICS AND STATISTICS
UNIVERSITY OF TORINO
Corso Unione Sovietica 218 bis - 10134 Torino (ITALY)
Web page: <http://esomas.econ.unito.it/>
