Rent-seeking elites, integration, and the coevolution of political institutions

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Taxing the moveables: an old problem

1225 Magna Carta: concession of liberties in exchange for a tax on moveables
Taxing the moveables: an old problem

1689 Bill of Rights: any new tax now requires the consent of Parliament
One of the most striking features of the evidence is that in both England and France it was the taxation of “moveable” property that promoted the conferral of political representation by revenue-seeking monarchs.
The success of the propertied and commercially minded interests led to institutions that [...] greatly constrained the behavior of the government.
Not only are governments losing control over money, but this newly free money in its own way is asserting its control over them, disciplining irresponsible policies and taking away free lunches everywhere.
[...] mobile capital as a virtual senate, a guardian of big property against unpredictable presidents and populist legislature.
Stylized facts

- no race to the bottom
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- waves / clusters of democratization, democratic spillovers
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- capital mobility $\implies$ market-oriented institutions
- tax havens exist alongside all big countries
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- capital mobility $\Rightarrow$ democracy in Europe
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Testable predictions

I account for the stylized facts in a testable framework

- whose asset is mobile is crucial
  - mobile elite, captive masses $\rightarrow$ extractive policies, polarized polities (patrimonial regimes, tax havens)
  - mobile population $\rightarrow$ efficient policies, inclusive polities

- PG provision and taxes are complementary policy tools
  - no race to the bottom
  - race to efficiency
Very selective literature

Mobile assets and political outcomes


The coevolution of institutions

▶ Cardoso Faletto (1979) *Dependency and development in Latin America*. University of California Press

▶ Acemoglu Robinson Verdier (2012) *Can’t we all be more like Scandinavians*, published as CEPR and NBER wp.
The model

Single country setup
Tax competition
Timing of one period

Within one period

Dynamics with mobile masses

Dynamics with captive masses

Appendix: public good provision
The economic structure of society

Individuals have a utility function $U(c_t, b_{t+1})$

They can work in either of two sectors:
- informal, with decreasing returns to labor $\phi(l_t)$
- formal, with constant returns $l_t$

They are organized in dynasties: at time $t$ they save $b_{t+1}$ as bequests for their heir in the next generation.
The political structure of society

To enter politics, an individual has to pay a sunk cost \( \pi \)

- capital market imperfections \( \implies \) an individual can only enter the elite if \( b_t \geq \pi \)

- \( 1 - z \) elite members jointly decide on the level of taxes \( \tau \)

- they share the product of the taxes. The elite’s individual political rent is therefore

\[
R = \frac{\tau}{1 - z} - \pi
\]

\( \implies \) an individual will only enter the elite if \( R \geq 0 \)
Tax competition

Individuals in a country can export their asset to work in the formal sector of the other country. Asset mobility applies to:

- migrations of workers
- brain drain
- capital flight
Exporting one’s labor has an ad valorem cost $c$. An individual in country $i$ can

- work locally in the formal sector, with a marginal return $(1 - \tau^i)$
- work abroad in the formal sector, with a marginal return $(1 - c)(1 - \tau^j)$
- work locally in the informal sector, with a marginal return $\phi'$; with $\phi' > 0$ and $\phi'' < 0$
Timing of one period

- Elite vote on $T$
- Decision on labor supply
- Decision on bequest for $t + 1$
- Production and consumption take place

- Receives bequest $b_t$
- Decision to enter politics

$t \quad \tau \quad t + 1$
Critical assumptions

- taxes as all kinds of costs of doing business
- rent-seeking state
- external constraint on the fiscal policy
- indiscriminate “source-based” taxation
- warm glow
- sunk cost to enter politics
Within one period

The model

Within one period
  Labor supply
  Tax policy
  Tax competition as an external constraint
  Elite size

Dynamics with mobile masses

Dynamics with captive masses

Appendix: public good provision
Stage 4: labor supply and bequest

The individuals’ program provides

- \( l = l(\tau) \rightarrow \text{decreasing} \)
- \( b_{t+1} \) as a function of \( b_t \)
Stage 3: Tax policy w.out inflows

The elite’s program provides
- $\tau = \tau(z)$ increasing until it is constrained
  - revenue extraction from the masses
  - economic distortion
- where $1 - z$ is the size of the elite
The elite’s program provides

- $\mathcal{T} = \mathcal{T}(z, n)$ increasing in $z$
- where $1 - z$ is the size of the elite
- and where $n$ is the relative proportion of the other country who inflows
To avoid an asset flight, the elite in $A$ is externally constrained

$$1 - \tau^A \geq (1 - c)(1 - \tau^B)$$

In equilibrium, when the assets of the masses are mobile

- no asset flow (bang bang tax competition)
- but fiscal policies affected (my object of study)
Stage 1: Size of the elite

Two conditions to enter the elite. One is binding:

- profitability: $z \geq z$ where political rents are 0
- liquidity: individually $b_t \geq \pi$
Mobile masses

The model

Within one period

Dynamics with mobile masses
  The autarkic / unconstrained case
  The constrained case: democratic spillovers

Dynamics with captive masses

Appendix: public good provision
The unconstrained system

\[ \begin{align*}
    b_{t+1} &= \frac{\rho}{1+\rho}(A(z_t) + b_t) \text{ in the elite, and} \\
    b_{t+1} &= \frac{\rho}{1+\rho}(B(z_t) + b_t) \text{ in the masses, and} \\
    z_t &= \max[q_t, \bar{z}] \text{ where } q_t \text{ agents can pay } \pi.
\end{align*} \]

A is the income of the elite, including a political rent if \( z > \bar{z} \), and \( B \) the income of the masses.

\( A = B \) if \( z = \bar{z} \) (ie. “democracy”, an outcome, not a process)
Low cost of entering the elite $\pi$
Intermediate $\pi$
High $\pi$
Baseline result: the case of one country

When the policy of the elite is **not** externally constrained

- democratiz.
- $\rho B(z)$
- $\rho A(z)$
- distortions
- elite

$\pi$
Since the constraint lowers the tax that the elite can impose,

\[
\begin{align*}
A(z, z^j) &< A(z) \\
B(z, z^j) &> B(z)
\end{align*}
\]
Example: $\pi$ over $B(z)$ but low

Without the external constraint: stable elite
Example: $\pi$ over $B_t$ but low

With the external constraint: democratization
When the policy of the elite is externally constrained

\[ \rho B(z) \quad \text{distortions} \quad \rho A(z) \]

In other words, a more democratic neighbor country has beneficial effects in terms of

- favoring **efficiency** over appropriation
- reducing tax and political rents
- reducing inequalities
- possibly accelerating or making democratization possible
Captive masses

The model

Within one period

Dynamics with mobile masses

Dynamics with captive masses
  Patrimonial regime
  Tax evasion

Appendix: public good provision
Patrimonial elite in a small country

Simplifying assumptions

- negligible cost $c \approx 0$ of investing from $A$ to $B$
- higher costs of doing business than elsewhere in the world
- tiny country $A$: $n \approx 0$

The elite in $B$ sets $\tau^B \approx \tau(z^B)$. The elite in $A$ allocates its wealth abroad iff

$$z^A \in \theta(z^B)$$

In particular, for narrow enough elites (high $z^A$), they will insulate their assets and maximize rent extraction from their population
$z^A \in \theta(z^B) \iff A$’s elite insulate their assets in $B$ from the taxes they impose in $A$
Result 2: patrimonial regime

If the masses of $A$ are captive and $z^A \in \theta(z^B)$

A big democratic neighbor country has negative spillovers

- it favors appropriation over efficiency
- increases taxes and political rents
- increases inequalities
- possibly slows down or prevents democratization
Result 3: patrimonial regime ➔ big country

Second order impact on the big democratic neighbor
▶ favors the extraction motive over the efficiency motive
▶ raises taxes, distortions, rents extracted
▶ may possibly slow down or prevent democratization

Real life scenario: foreign or occult party financing
▶ to avoid too much scrutiny from regulators abroad
▶ patrimonial elites want to benefit from lower costs
▶ and therefore agree to paying a bribe to the regulator

How to motivate Western elites to crack down on ill-gotten goods?
Tax evasion from a big country

Simplifying assumptions

- negligible cost $c \approx 0$ of investing from $B$ to $A$
- tiny country $A \ n \approx 0$

There is tax evasion whenever

$$\exists z, z^B \in \theta(z)$$

Whatever $z^A$! What happens in the small country is irrelevant. Flows from $B$ dwarf everything.
\[ \exists z, z^B \in \theta(z) \iff B's \text{ elite insulate their assets in } A \text{ from the taxes they impose in } A \]
Result 4: tax evasion

If the masses of $B$ are captive and $\exists z, z^B \in \theta(z)$

Tax havens
- favor appropriation over efficiency in big countries
- increase taxes and political rents
- increase inequalities
- possibly slow down or prevent democratization
Result 5: tax havens

Small country $A$’s elite would set any tax rate to attract assets from $B$’s elite, which dwarfs other domestic motives:

- a priori, a deal which favors mostly the receiving elite over the evading elite
- non-sovereign tax havens as a way for the evading elite to not be taxed by anyone else?
- competition between tax havens
- credibility of the official fight against tax havens?
Conclusion

Theoretical predictions

- Countries compete for mobile assets over their costs of doing business
- Competition $\implies$ spillovers \((\text{policy, inequalities})\)
- $\implies$ \((\text{rent extraction, inclusiveness})\)
  - positive if everyone is mobile, negative if only the elite is

Policy questions

- change the incentives of patrimonial elites?
- incentives to crack down on patrimonial elites?
- increase the cost of tax evasion? Coerce tax havens?
Appendix: public good provision

The model

Within one period

Dynamics with mobile masses

Dynamics with captive masses

Appendix: public good provision
  A basic setup
  Reinterpreting the race to the bottom
A new economic structure

Now the state provides a per capita amount of public good \( g \).

Individual can work in the same sectors

- traditional, with returns \( h(g) \phi(l) \)
- modern, with returns \( h(g)l \)

All the rest remains identical. Only one critical assumptions: individuals cannot work in the informal sector of one country and in the formal of another.
The elites now have to pay for \( g \).
The new constraint on the fiscal policy can be written

\[ Y(g, \tau) \geq Y \]
Result 6: race to efficiency

\[ \frac{d\tau}{d\gamma} < 0 \text{ and } \frac{dg}{d\gamma} > 0 \]

In other words, the more binding the external constraint,

► the less taxes
► and the more public good provision
► \( \implies \) the less appropriation by the elite, the more business-oriented / efficient policy
► taxes do not decrease to 0…