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TAX SYSTEMS AND TAX REFORMS IN SOUTH AND EAST ASIA: DEMOCRACY AND WELFARE WITHOUT WELFARE STATE

by

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Abstract

This paper is part of a wider research on South and East Asia countries' taxation, carried on at this Department, under the direction of L. Bernardi, A. Fraschini and P. Shome, and the supervision of V. Tanzi. South and East Asian countries typically have a "light" welfare state. Enterprises and family ties have traditionally substituted public spending on welfare. Under the challenges of the current economic, demographic and political trends, public spending on welfare are increasing and/or expected to increase. This paper analyzes the role of the democratization process in the development of the welfare state in South and East Asian countries. We argue that, although initially not essential, as suggested by the experience of China, which is introducing major reforms in welfare areas without entering a democratization process, democracy may play an important role in the final social and economic development of these countries.

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1. Introduction

South and East Asian countries have a "light" welfare state, characterized by low public spending on welfare (Jacobs 1998). Enterprises and families have traditionally played a major welfare role and have partially compensated for the low public spending. In some countries, such as Japan, enterprises have adopted a variety of flexibility measures to keep workers who are not necessarily profitable, while in all South and East Asian countries three-generation families substitute the public welfare system by pooling income between workers and economically inactive people. The absence of the welfare state is based on the common assumption that women are the main providers of personal care for children and the elderly at home.

However, these forms of enterprise and family welfare are currently being challenged by the economic conditions (a recession in Japan, which will make enterprises not able to avoid massive layoffs any longer), the financial crisis (which has substantially raised unemployment in Korea), the falling fertility and aging process (in China and Thailand, but also in Korea and Japan), as well as by some common trends, such as urbanization, family nuclearization, the raise of female employment (which imply a reduced readiness of women to care for their parents or children). As a consequence, welfare public spending is expected to increase in South and East Asian countries.

Some countries have already introduced important reforms in the last decade to strengthen their social welfare systems (Japan, Korea), while others have them in their agenda (China).

The World Bank (1999) identifies the "social protection" as a strategic sector for the structural long-term development of South and East Asian countries. This sector includes three areas, strictly interrelated: social safety nets (including social funds), labor market policies (including child labor) and pensions. This last area, pensions, is crucial, especially for countries in which the demographic transition is well advanced, such as China and Thailand, Korea and Japan.

Current pension schemes are characterized by a general low level of coverage (in 1996 17.6 percent of labor force in China and 25.1 percent in Thailand), the absence of social safety nets for the needy elderly, retirement schemes still in evolution and not mature, a large funded private component. In 1994 total pension expenditure represented 6.12 percent of GDP in Japan and in 2002 it only accounts for 3.5 percent of GDP in China. These factors introduce ample opportunities to design changes and reforms, which are best seized early while the schemes are still young and the aging process at the beginning. China emerges as a critical country, due to its additional problems, such as the differences between local and provincial levels, a fragmented and non unified system (Holzmann *et al.* 2000).

In this paper, we explore whether in addition to economic and demographic trends, political factors may also represent a crucial challenge for the development of a welfare state in South and East Asian countries. Many of these countries show a trend towards increased democratization and participation of civil society, which raise demands for government to assume more responsibility for the unemployed, sick, poor and the elderly. This political transition towards greater democracy and participation has already increased the government role in key social protection areas, for instance in Korea. Again, China represents an interesting case, since it seems not to fit this pattern, because no democratization process is combined with the starting process of reforms aimed at raising the welfare state.

This paper contributes to the analysis of the relation between the democratization process and the emergence of a welfare state in South and East Asian countries. We argue that, although it seems not to be essential to have democracy in order to start reforms aiming at raising the welfare programs (e.g. in China), the interrelation between economic and political liberalizations may be important to characterize the outcome of the final stage of the reform process, with the best performances arising when political and economic development go hand by hand.

The paper is organized as follows: next section provides evidence on democracy indicators in the six East Asian countries analyzed in this book. Section three focus on the case of pensions in China. Section four introduces the political economy of democracies, by reviewing the existing literature and providing some conclusions for China.

2. Democracy in South East Asian countries: Some evidence

Are economic and political outcomes related? In particular, may a specific economic outcome which broadly characterizes South East Asian countries, mainly the absence of a comprehensive welfare state, be explained on political grounds?

In this section we collect data from the Polity dataset (2002) on the political characteristics of the countries analyzed in this book. The Polity dataset provides indicators of democracy, autocracy and other specific political characteristics for the period 1800-2003 for a large sample of countries. This dataset is widely used in political economy studies, in particular in a recent strand of the literature devoted to democracies and economic development (see Acemoglu *et al.* 2004-5 and Mulligan *et al.* 2004).

We focus on the indicator called “democracy,” which represents an annual measure of institutionalized democracy. This measure is constructed based on three essential elements: *(i)* the presence of institutions and procedures through which citizens can express effectively their preferences about alternative policies and leaders, *(ii)* substantial instituzionalized constraints on the exercise of power by the executive, *(iii)* the guarantee of civil liberties to all citizens in their daily lives and in acts of political participation. The rule of laws, systems of checks and balances, freedom of the press, and other aspects of democracies are included, because they are considered specific means of these three elements. The democracy indicator ranges from 0 (minimum democracy) to 10 (maximum democracy).

Figures 1 and 2 show the values of the democracy indicator for the period 1800-2003[1] for China, Korea,[2] India and for Japan, Thailand and Malaysia respectively. Two results emerges: *(i)* China is characterized by the lowest absolute levels of the Democracy indicator (scoring 1 from 1800 to 1950 and 0 from 1950 to 2003), Japan and India have a tradition of high democracy and Korea, Thailand and Malaysia have recently reached high levels of democracy; *(ii)* China is characterized by the more stable trend with almost no variation (or a small negative variation) in the democracy indicator of the last two centuries, while the other countries, especially the ones which entered the mid-1990s with low levels of democracy, have experienced a certain variation of this

[1] The missing years are interruption, interregnum or transition years.

[2] From 1948 we consider South Korea.

indicator over time, mostly an ascendant path (see for instance Korea, Thailand and Malaysia).

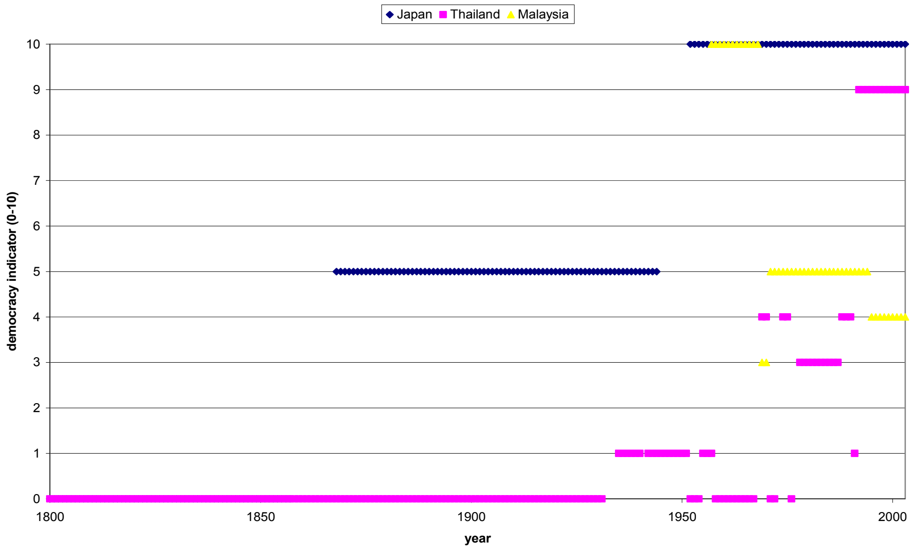

Figure 1 Democracy in South and East Asian countries: Japan, Thailand and Malaysia

Source: Polity dataset (2002)

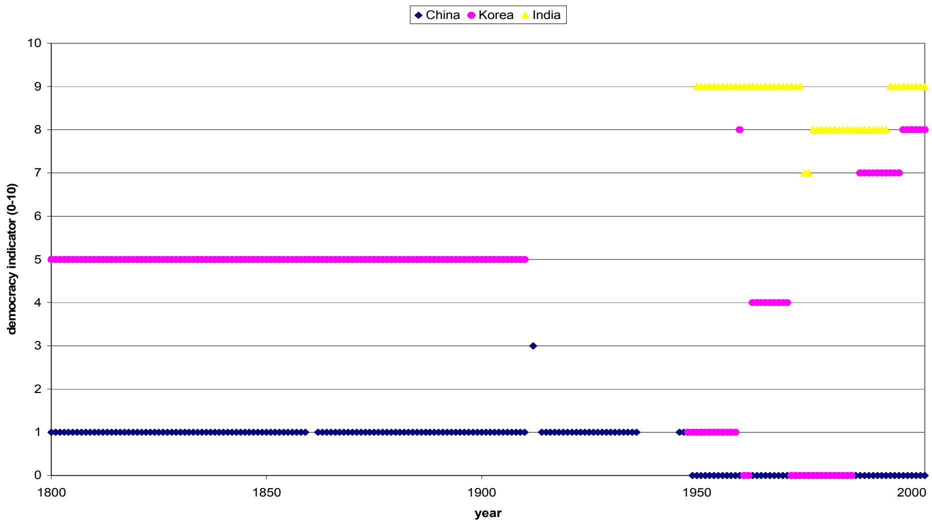

Figure 2 Democracy in South and East Asian countries: China, Korea and India

Source: Polity dataset (2002)

These simple graphs suggest two directions to explore. First, China is experiencing deep economic changes, while at the same time it is characterized by a stable non-democracy. At first sight, it seems that the economic development in China is unrelated to its democratic evolution, which is far to begin. The next section is thus devoted to China, with a particular focus on its pension system, as a main category of a potential welfare system.

Second, the development of a stronger welfare state in South and East Asian countries seems to follow the democratization process, with the exception of China.

What are the determinants of democracy? Is there any relation between democracy and the level of welfare expenditures? These questions are essential to understand the future of the social and economic development of South and East Asian countries. A growing political economy literature is devoted to this topic. Section four, after reviewing the main results of the literature, explore some consequences of the relation between democracy and welfare for the future of China.

3. Welfare without welfare state: The case of pensions in China

China represents the more relevant example of a country "without welfare state." In particular, the public pension system, which typically represents the larger share of the welfare state in developed countries, is a very modest share of the economy, 3.5 percent of GDP in 2002. Official statistics report that only a small fraction of Chinese workforce is currently part of the pension program: 55 percent of urban[3] workers and only 11 percent of the rural[4] workforce are covered by the public pension system and only 6 per cent of workers in the private sector are covered by a pension scheme. However, these few pensioners receive a quite generous benefit: the replacement rate is about 80 percent of wages and it increases up to 90 percent for civil servants.

[3] 10 of this 55 percent is part of a separate and more generous pension system for civil servant. Jackson and Howe (2004) estimate that only 45 percent of the urban workforce participates in the basic public pension system.

[4] The pension scheme for rural workers is extremely small and almost entirely beneficiary-financed.

The expansion of pension coverage, together with the unification of the program at a provincial level and the reduction of enterprise contribution share (Chen 2004), is at the centre of the reform of the Chinese pension system. This reform is a critical component of China's overall economic reform and one of the main challenges for the development of its economy. This challenge is exacerbated by additional risky circumstances, in particular a rapid aging of the population, the inability of state-owned enterprises (SOEs) to cover the pensions of current retirees, the underdevelopment of China's capital market and deep social transformations. How China will meet with these problems will determine whether it becomes a prosperous developed country.

One of the more relevant aspects of the Chinese pension reform concerns the implementation of a multipillar scheme, composed by three pillars: *(i)* a PAYG public pillar with flat rate benefits, financed by a 13 percent of contribution from enterprises that goes into a municipal or provincial pooled fund, *(ii)* a mandatory funded defined contribution pillar with individual accounts for each worker, financed by a payroll tax of 11 percent, *(iii)* a voluntary supplement pension pillar managed by each individual firm or private insurance company. The combined expected replacement rate of the first two pillars is 58.5 percent for a typical average-wage earner with 35 years of contributions. Currently, only the first pillar is at work and the implementation of the three-pillar scheme represents one of the most critical aspect of the reform process. This implementation implies a transition cost, which has not been fully addressed yet by the Chinese government (Chen 2004). The state council simply grouped benefit formulas into three main categories: *(i)* new workers, entered the labor force after 1997, who fully participate into the new three-tier system, *(ii)* middle workers, who started work before 1997, receiving an additional transitional benefit, *(iii)* old workers, retired prior to 1997 and entitled to benefits defined by the previous system. Although the implicit pension debt is small, due to the reduced size of the pension system, and thus the costs of the reform are expected to be low, the government has to provide a definite set of guidelines in order to implement effectively the pension reform.[5] In particular, it has to address the transition problem, by recognizing that the cost of the transition cannot be supported only by new workers participating in the system.

[5] For an analysis of the financing options of the transition see Li and Li (2003) and Zhao and Xu (2002).

One of the main challenges for the future of the Chinese pension system and the overall economy is represented by the demographic transformation: “China is growing older” (Jackson and Howe 2004), as a combination of a falling fertility (due in part to the modernization policy and in part to the government control policy) and a rising longevity (due to the improvements of living conditions, especially in the urban areas). The United Nation (2003) assess that by 2050 the number of elderly aged sixty or more will exceed thirty percent of the population and that in 2050 there will be 18 percent fewer working age adults than today. In practice, each retiree in 2050 will be supported by 1.5 workers (today the ratio is one to three). Given that the current pension system covers only a small fraction of the population and that the modernization process is reducing the family support in old age (which represents the unique financial support to the elderly overall in the countryside), a reform of the pension system which introduces a substantial role of the public sector is inevitable. This reform should provide a decent standard of living for the elderly, without imposing a heavy burden on the young generation. Otherwise, China will be the first country to “grow old before to grow rich” (Jackson and Howe 2004). In other words, China cannot continue to grow without developing a welfare state.

The Chinese pension reform is strictly related to the SOEs reform (Chen 2004). The ratio of contributing workers to retired beneficiaries is dropped from 5.4 in 1989 to 3 in 2003. On one hand reforming the pension system will help the SOEs reform process, since the creation of effective, and not just nominal, pension individual accounts can facilitate the choice of workers to move from the state to the private sector; on the other hand reforming the SOEs will help the pension reform process, since when SOEs reduce their redundant workforce, it becomes urgent the extension of pension coverage to non-state workers.

Another reason for an urgent reform is the financial distress of the current Chinese social security system. According to the China’s ministry of social security the deficit in social pooling funds was 18.7 billion RMB in 1999, 35.7 billion RMB in 2000 and it is expected to reach 50 billion RMB in 2005. Several factors have contributed to this situation: *(i)* non-compliance and tax evasion, *(ii)* fragmentation of the pension system at local levels, *(iii)* lack of capital market. As argued by Zhao (2004), non compliance means that business traditionally excluded from pension system, which typically have a relatively young workforce and a small number of retirees, refuse to agree to the program and the government cannot force them to do it (for several reasons, such as the fact that social bureau is not able to collect levied administrative penalties, employment data are not available etc.). This refusal is mainly due to the lack of incentives they receive from the government, due to the prohibitive cost of the system, the large redistribution operated at first pillar level and low rates of return on contributions to personal accounts. The second element concerns the fragmentation of pension pools at local levels, which is an obstacle to guarantee financial stability to the overall system. In fact, local governments have the systematic distorted practice to borrow from personal account contributions to cover cash shortfalls in the social pools and use individual accounts to cover current expenses. Thus, pooling pensions at provincial levels is an inevitable solution. But pooling contributions is going to create a vicious circle, increasing moral hazard and principal agent problems and discouraging the participation in the system (Chen 2004), because if the center will cover any deficit or take away any surplus, the local units have incentives to under perform on collection and over perform on benefit expenditure ("soft budget constraint"). The third element contributing to the financial crisis of the pension system is the underdevelopment of the capital market. This implies that only a limited amount of pension assets in the individual accounts is available for capital market investment and that the opportunities and returns from contributions investment are reduced. Wang (2004) argues that a virtuous interaction between pension scheme and capital market is essential, especially if a funded component of the Chinese pension system will finally be implemented.

To conclude, we expect the introduction of a welfare state, through a broad public pension program, to represent a major measure of the Chinese economic development process. Several factors make this process particularly difficult, such as aging, the reform of the SOEs, fragmentation and the underdevelopment of the capital market. Since at the same time we do not observe any ongoing democratization process, we ask whether this may represent an additional factor which affects the final economic outcome of the country. We explore this direction in the next section.

4. The Political Economy of democracies and non-democracies

The existing political economy literature on democracies deals with two important questions: *(i)* what are the economic determinants of democracy (if any)? *(ii)* does democracy affect public policy? In this section we provide a short review of the current theoretical and empirical findings on these two issues from which we can draw some lessons for China.

4.1 The economic determinants of democracy

The first question, i.e. the identification of the economic determinants of democracy, is addressed by several contributions related to the "modernization theory", which studies the link between democracy and economic development. Recent contributions in this tradition include Boix (2003), Barro (1996), Giavazzi and Tabellini (2005), Acemoglu *et al.* (2004-5), Acemoglu and Robinson (2005).

The modernization theory argues that markets can prosper only in a political framework characterized by constitutional liberties and democratic practices. In this sense, developed economies and political democracies should emerge and survive together, especially in the long run. According to Lipset (1959) only in a wealthy society the mass of population can intelligently participate in politics and avoid succumbing to irresponsible demagogues. Countries should become more democratic as they become richer. The process of economic modernization generally results in both the reduction of income inequality, which is a source of political conflict and brings to authoritarian solutions, and the growth of a broad middle class, who acts as a moderating political force. Moreover, the raise of education levels and the creation of a labor force required to make its own decision in the production process (that is an autonomous labor force) should increase the toleration of different values and options and the recourse to liberal democracy as the mechanism to settle disagreements. Education promotes democracy either because it enables a culture of democracy to develop or because it leads to greater prosperity.

A recent complete theory of political transition and economic development is provided by Boix (2003). The author finds that democracy prevails when economic equality and capital mobility are high in a given country. First of all, economic equality promotes democracy. As the distribution of income becomes more equal among individuals, redistributive pressures from the poor on the rich diminish and the probability of a peaceful transition from an authoritarian regime to universal suffrage increases. The ultimate level of taxes becomes smaller than the cost of repression. Secondly, a reduction in the cost of moving capital away implies that government must curb taxes. As a consequence, the extent of political conflict among capital holders and non-holders declines and the probability of democracy rises. On the contrary, authoritarianism predominates in those countries in which both the level of inequality and the lack of capital mobility are high. The redistributive demands of the worse-off citizens on the rich are particularly intense and, as a result, the latter strongly oppose the introduction of democracy that would allow the majority of population to establish heavy taxes on them. The presence of immobile capital makes the authoritarian solution worse. Given that they cannot escape the threat of high taxes shifting assets abroad, capital owners want to block democracy. In this sense, the association between economic development and democracy comes from the transformation that capital experiences with economic modernization: from an economy based on fixed assets to an economy based on highly mobile capital in which the accumulation of human capital, harder to expropriate than the physical one, increases.

Boix (2003) examines also how changes in the economy may affect the chances of democracy. The author underlines that economic growth is a necessary, but not sufficient condition in order to secure a democratic outcome. The poor can commit themselves to moderate levels of redistribution according to the fact that low taxes stimulate faster economic growth. This reduces the opposition of the rich to universal suffrage and increases the probability of democracy. But if an organizational capacity of the poor to credibly commit to observe their promises is needed, then left-wing parties and unions may be instrumental to the success of democracy. Moreover, social mobility across classes fosters democracy by easing social conflict, that is by tending to equalize the income of individuals over time. Trade openness and democracy are also related. However this relationship depends on the distribution of factors in a given economy. In countries where the poor are the abundant factor, trade openness equalizes conditions and favors the introduction of democracy. On the contrary, if the poor are the scarce factor, trade openness intensifies social conflict and raises the probability of authoritarianism.

In order to assess the validity of his theoretical model and analyze the probabilities of transition to democracy and democracy stability, Boix (2003) refers to two different samples of countries, one from 1950 to 1990 with direct measures of inequality and the other from 1850 to 1980 with indirect measures.[6] With reference to the first sample, the author takes different proxies for asset specificity such as per capita income, the average years of education, the share of agriculture as a percentage of GDP, the size of the oil sector and the level of economic concentration. Using the first measure of asset specificity, that is per capita income, Boix finds that a decline in income inequality is associated with both an increase in the likelihood of democratization process and a lower probability of democratic stability. However, this latter conflicting result holds only with reference to very low level of income. As pointed out by modernization theory, the author also finds that per capita income positively affects the probability of a democratic transition and in particular the stability of a democratic regime.[7] Even when he comes to consider the second broader sample, Boix shows coefficients of the independent variables in line with his theoretical expectations, but it seems that per capita income is simply a proxy for other more important factors. In short, highly unequal countries remain authoritarian and whenever they go through a democratic phase, it is only a temporary phase. At the same time, countries with a limited share of mobile assets are unlikely to become democratic unless they show a particularly equal income distribution.

Another contribution on the relation between income and democracy is Barro(1996). In his econometric study, Barro (1996) finds that an improvement in the

[6] Data on inequality are taken from Deininger and Squire (1996). In the second sample, inequality refers to two indicators that are well correlated to the Gini index: the distribution of agricultural property and the quality of human capital.

[7] Boix (2003) also finds that higher levels of human capital contribute to the democratization process. Agricultural societies do not seem to affect the democratic transition but they increase the probability of democratic breakdowns. The presence of an oil economy reduces the possibilities of democratization, in this way accommodating the paradox of wealthy dictatorship, and finally the diversification of productive activities either raises the likelihood of a democratic transition or reduces the one of a democratic breakdown.

standard of living, measured by different indicators such as per capita GDP, infant mortality rate and education attainment, affects positively the probability of democratization over time. As in Lipset's theory, prosperity stimulates the development of democratic institutions. Moreover, representative regimes are more likely to arise in a non-colony rather than in a colony, especially when it was not a British or Spanish possession. The religious traditions are also relevant in the sense that Protestant and Muslim countries are the most and the least democratic respectively. However, when Barro simultaneously controls for both the level of standard of living and the colonial status (or religious affiliation), the latter stops being a key element for democracy. This means that the main effects on democratic regime apparently work indirectly through influences on the standard of living indicators. In this way, developed countries would export their economic systems rather than their political regimes. Democracy would catch on after reasonable standards of living have been attained, whereas would seem not to last without strong economic bases.

This is also the idea of Giavazzi and Tabellini (2005). They find positive feedback effects between economic and political reforms even if it is difficult to know the correct direction of the causality relationship. Furthermore, the interaction effects allow to say that countries which undertake both reforms have better economic performance as compared to countries which undertake only economic or political liberalization. In other words, the effects are not additive and moreover the sequence matters. Following the "easy path," that is first becoming a democracy and then opening up the economy, leads to poorer economic payoffs in terms of growth, investment, trade volume and macro policies. It is less likely that an authoritarian regime opens up the economy but when it happens it is because interest groups opposing free trade and the market system have been crushed. Consequently, liberalization is more effective and devoid of compromises. On the other hand, it could be that better democracies arise in an open economic environment. Redistributive conflicts could weaken a young democracy characterized by a closed economy whereas openness to trade, competition and growth, which come from the economic liberalization, provide the resources for the redistribution that a democracy requires.

In line with the modernization theory, the correlation between income per capita and democracy as well as the one between education and democracy are recurrent in many other cross-country analyses. But, according to Acemoglu *et al.* (2004-5) these works do not establish causation in the sense that, first of all, it could be that democracy causes income or education rather than the reverse and, in the second place, there is no relationship between changes in income or education and changes in democracy. Moreover, existing empirical results may suffer from omitted variables biases, i.e. factors determining both the political regime and the income per capita or the level of education could drive the findings. Because these omitted characteristics are either country-specific or time-invariant, Acemoglu *et al.* (2004-5) include country fixed effects in the regressions in order to improve inference on the causal relationship. The first and main measure of democracy is the Freedom House Political Rights Index, according to which a country gains a higher score if political rights are closer to the ideals coming from a checklist of different questions. By introducing fixed effects, the positive correlation between income and democracy as well as the one between education and democracy disappear: income and education are not determinants of democracy. These results hold with both indicators for democracy, with different econometric specifications and estimation techniques and in various subsamples. In order to explain the strong cross-sectional relationship between income and democracy, Acemoglu *et al.* (2005) refer to historical factors which have influenced either the economic or the political development path of societies.[8]

Furthermore, contrary to the predictions of modernization theory, Acemoglu *et al.* (2005) show that economic crises, defined as a sudden and significant reduction in the growth rate, increases the probability of democratization. As a matter of fact it seems that economic crises do not affect transitions away from democracy but lead to dictatorships collapse. This empirical result fits in with the theory of democratization and democratic consolidation of Acemoglu and Robison (2004). They suggest that some degree of development in civil society, some level of industrialization, a greater inter-group inequality, the middle class and the globalization process as well as economic or political crises are key factors for democratization. This latter can be thought as a

[8] With reference to the sample of the former European colonies, Acemoglu *et al.* (2005) show that fixed effects explaining the mentioned cross-sectional correlation are related to these historical variables such as settler mortality rates, the density of the indigenous population before colonization, the constraint on the executive at independence and the date of independence.

credible promise by the elite endowed with *de jure* political power and faced with a serious revolutionary threat or significant social unrest from the citizens endowed with *de facto* political power of the majority.[9] In this sense, when the citizens are not well-organized, the transition to democracy can be delayed or avoided. If social and political conflicts can be damaging to physical and human capital owners, then democracy is more likely to arise when the elite are industrialists rather than landowners. Greater inter-group inequality leads to democratization because it makes revolution a chance to increase the citizens income. Democratic politics tend to be more conflict-ridden where there is not a middle class acting as a buffer between the elite and the citizens. International financial integration, international trade and increased political integration are also important for democracy given that they discourage the elite from using repression. Finally, shocks and crises make revolutions easier and less costly and then force the elite on representative regimes.

4.2 Democracy and public policy

The second question, i.e. how democracy affects public policy, is addressed in Mulligan *et al.* (2004) and Boix (2003).

Mulligan *et al.* (2004) underline that there are two very different perspectives on constructing positive theories of the public sector. The first one comes from the formal voting literature whereas the second one relates to the "Chicago Political Economic School." In the formal voting literature three tenets of democratic decision-making would imply democratic-non democratic policy gaps. In other words, it would be possible to predict public policy starting from a measure of democracy and holding constant economic and demographic variables. The first tenet says that in many formal models the voting process mitigates the expression of strong policy preferences which determines inefficient policy outcomes. The second tenet concerns the distribution of political power. This is more equal than the distribution of income or wealth and, as a consequence, democracy would massively redistribute from rich to poor. On the

[9] The identity of the elite is not important.

contrary, under authoritarian regimes the level of redistributive spending should be minimal. At last, the third tenet of the formal voting theory emphasizes the importance of "the form of the voting game."

At the other extreme, there are positive theories of public policy such as those of Barro (1979) and Wittman (1989) that focus on efficiency considerations as the main determinants of public policy. There is no room for political factors. These theories are also related to Stigler (1971), Peltzman (1976, 1980) and Becker (1983), that is to the "Chicago Political Economic School."

When dealing with the link between democracy and the public sector, Boix (2003) initially specifies that as the choice of a political regime depends on its distributive implications, the economic and fiscal consequences coming with a democracy or an authoritarian system must be different. In other words, his analysis is consistent with the results of the formal voting literature rather than the ones of the Chicago School. Under a non-democratic regime the size of the public sector should be small, a substantial part of the electorate being excluded from the decision-making process. So, independent of the type of economy, the level of redistributive spending should be minimal. A transition to democracy, on the contrary, should raise taxes and public spending. Under the same level of inequality ex ante, the level of inequality ex post has to be lower in a democracy than in a non democracy, i.e. is the extent of redistribution increases according to the second tenet of the formal voting theory. However, even on the basis of its findings about the determinants of democracy, the author links the amount of redistribution to the underlying economic and social structure. Given that inequality is more limited in a democratic system, the public spending directed to redistribute actually remains small. Moreover, the electoral turnout plays a fundamental role since only when the number of low-income voters that vote is significant, the level of taxes and transfers is high. In this way, structural basis of democracy can reduce its redistributive inclinations and, in the limit, the size of public sector in this political system can be the same as in non democracy. In representative regimes redistribution takes place also depending on the extent of economic development, that is modernization. Democratic institutions can take root in farmer economies characterized by little differences among individuals. In this case, public sector does not grow being the redistributive tensions practically non-existent. But democracies can also develop in industrialized societies where income equality and capital mobility are high. By creating an urban working class and the bases for an older population which cannot receive any longer informal family help, the industrialization process rises stronger pressures for intragenerational but also intergenerational transfers, that is for an increasing public spending. Development grows the size of the public sector, because it stimulates demands for public programs that in turn foster the economic modernization process. Finally, the volatility of the income also affects the magnitude of the welfare state. If the fluctuation of income increases then voters which are averse to risk may want to stabilize their economic position by rising public spending. This will happen either in a democracy in which the risk is concentrated among the worse-off or in an authoritarian system in which the risk is concentrated among the well-off.

Empirical evidences are not uncontroversial. In order to know the empirical importance of economic and demographic variables relative to the political institutional ones in determining public policies, Mulligan *et al.* (2004) focus on a sample of 142 countries and on the democracy index from the Polity IV data set. The timeframe of the cross-country analysis goes from 1960 to 1990 and, among the other control variables, the most important from our point of view seems to be the dummy for whether a country has been communist for more than a few years.[10] This dummy allows the authors to try to separate non democracy from central planning. In their comparison of democratic and non democratic public sectors, they consider the spending policy group consisting of government consumption, education spending and social spending (pension and non pension programs) as a percentage of GDP. None of these three variables are statistically different in democracies and non democracies. However if one refers to the communist dummy it seems that totalitarian countries spend more of their GDP on education but also on pension and non pension programs.

Though there are no significant economic or social policy differences between democracies and non democracies, the results change when Mulligan *et al.* consider as dependent variables different policies that might affect public office competition, erecting political entry barriers. Following Tullock (1987) five policy steps are important for blocking entry: torture, death penalty, press censorship, regulation of

[10] This variable takes a value of 1 if the country is considered communist by Kornai (1992) and 0 otherwise. China is one of the 26 communist countries in the sample.

religion and maintaining an army. Democracies are less likely to use these anticompetitive policies than non democracies.

A different result is reached by Boix(2003). The author shows that at low levels of per capita income, i.e. low levels of economic development, the public sector appears small. If per capita income increases, then public revenue also raises both in a democratic and in an authoritarian political systems. However, under an authoritarian regime the public sector expands at a slower rate than under a democracy, perhaps because the latter has to satisfy the increasing needs of the modernization process. In other words, under the same level of per capita income, government is larger in a democracy, but only when modernization starts. This is due to the interrelation of economic development and political regime, but also to the one of economic development and democratic participation.[11] The economic development can also be associated with a reduced importance of the agricultural sector as a percentage of GDP and an aging population. In this sense, the industrialization process and an increasing proportion of old population raise public revenue at a higher rate under a democracy. On welfare state expenditure, such as pensions, health care and unemployment benefits, Boix finds a growth only after the introduction of a democratic system. Showing the strong effect of democratization on core programs of the welfare state, this result rejects the theory according to which poor countries cannot sustain a strong state whereas the rich ones can. To conclude, differently from Mulligan *et al.*, Boix empirical study underlines that a significant share of the public sector varies with the political regime in place.

4.3 Lessons for China

[11] The nature of political regime does not affect on its own the size of the government because the public sector is not larger under a democracy at all income levels. Starting from the lowest level of per capita income the public revenue is higher in an authoritarian system because for example the latter has to finance its repressive apparatus.

This section aims at drawing some conclusion about the possible interrelations of economic development and political democratic transition in China, an interesting country study in East Asia, due to its stable absence of democracy and a raising path of economic development. Are these phenomena related to the rise of a welfare state?

On one side an optimistic view suggests that if a country is characterized by a steady economic growth, based on a deep process of industrialization and urbanization, a peaceful political democratic transition is possible. For instance, Barro (1996) suggests that economic liberalization leads to political liberalization. In the long run, we should thus expect a democratic transition in China.

However, there are fundamental problems in China which may affect this outcome and make a democratic transition more difficult:

1. The existence of massive internal differences, in particular huge income disparities between coastal areas and interior regions, which may lead to territorial conflicts and fragmentation (Boix 2003). The risk is that coastal areas may oppose democracy because this would lead to interregional redistribution towards the rural interior regions. However, it may also happen that an authoritarian regime will expropriate coastal areas. A pessimistic view would thus predict a separation of areas. Boix (2003) identifies the historical roots of non democracy in China with the existence of a unified empire, characterized by non mobile capital, high taxes and inequality of income. Thus, provided that income inequality will not substantially change, together with fragmentation of areas, a democratic transition will be difficult to implement.

2. China is characterized by several barriers to political competition (torture, death penalty, press censorship, regulation of religion) which makes its political regime highly non democratic and very stable (Mulligan *et al.* 2004). Thus, economic liberalization may not be sufficient if political competition is not pursued, through the elimination of these constraints. An additional transition is necessary, namely the abolition of these constraints to the political competition, to make outcome in democracies and non democracies comparable. Only after that, a democratic transition may be possible.

In other words, China seems to follow a “hard way” of development, by introducing economic liberalizations while still being autocracy. According to Giavazzi and Tabellini (2005), if the process will be successful, better final outcomes are expected, but the process itself is very challenging.

To conclude, we argue that, as suggested by Mulligan *et al*. (2004), in the first phase of the economic development, i.e. after modernization, a rising welfare state (public expenditures and revenues) in China, such as the development of the public pension system, does not need a democratization process. However, in the long run this democratization process may be important for the economic development of the country.

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