Democratic spillovers—rent-seeking elites, mobile capital, and the coevolution of political institutions

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Research purpose

Democracy spills over to other countries, through coercion, emulation, information, and competition for the location of capital. This paper proposes a mechanism.

> *Sharp declines in the ability of governments to control cross-border movements of goods, services, and capital are thought to have forced countries to compete with each other for investment and market share by enacting political and economic reforms that reduce governmental constraints on finance and firms.*
>
> *(Simmons, Dobbin, & Garrett 2006)*

I show that the spillover is positive or negative, depending on the concentration of capital

Key idea

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- Geographic mobility begets influence over institutions
  - indirectly: the elite tends to the interests of a homogeneously mobile group of individuals
  - directly: favorable policies help members of that group enter the elite
  - exit buys you a way into voice

Key idea

- Geographic mobility begets influence over institutions
  - indirectly: the elite tends to the interests of a homogeneously mobile group of individuals
  - directly: favorable policies help members of that group enter the elite
  - exit buys you a way into voice
- Co-evolving institutions
  - capital $\notin$ elite: good institutions spread across borders
  - capital $\in$ elite: good institutions abroad encourage rent-seeking and support patrimonial regimes
  - $+$ tax havens, vote-buying, foreign-party financing etc.

The spillovers of rent-seeking

As the polity becomes more inclusive // the elite becomes wider

- rent-seeking loses ground to the efficiency motive
- the rate of rent-seeking decreases

The fiscal policy is more likely to be externally constrained in the case of a narrow elite.

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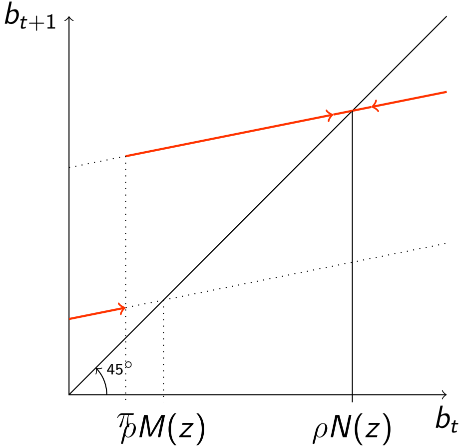
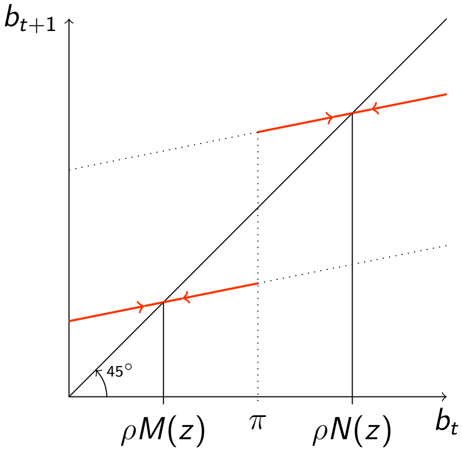
- the constraint on other jurisdictions becomes stronger

An inclusive jurisdiction constrains the policies implemented in less inclusive neighbors

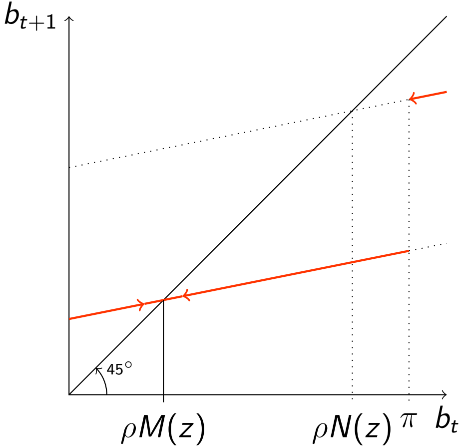
Low cost of entering the elite π



Intermediate π

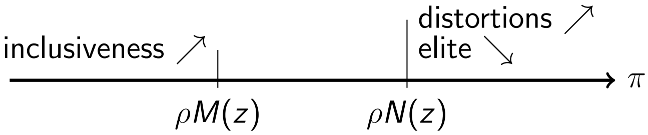


High π



Baseline: the case of one country

When the policy of the elite is not externally constrained



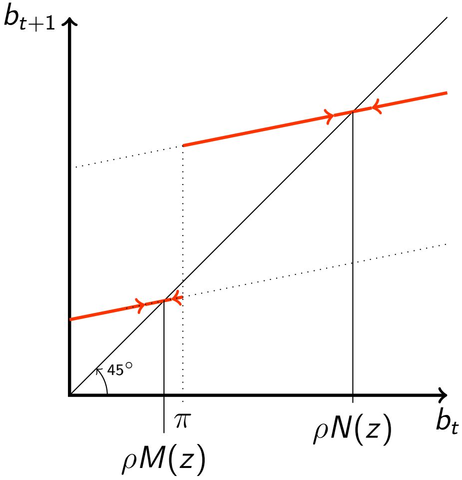
The constrained system

If rent extraction is constrained by the presence of a jurisdiction competing for the assets of the masses

- the income of the masses increases
- the income of the elite decreases

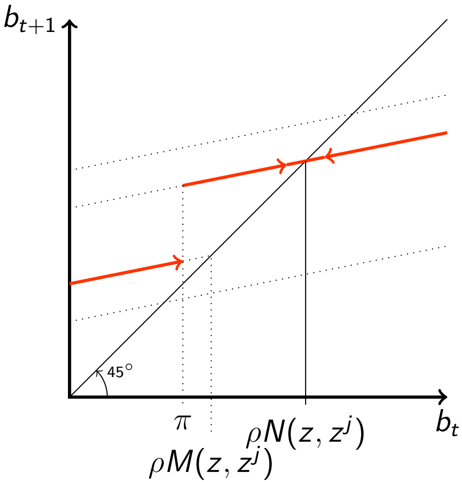
Example: lower-intermediate entry cost

Without the external constraint: stable elite



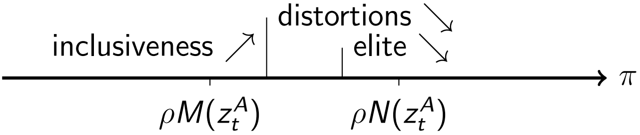
Example: lower-intermediate entry cost

With the external constraint: inclusiveness $\nearrow$



Result 1: democratic spillovers (mobile masses)

When the policy of the elite is externally constrained



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

- favoring efficient policies over rent-seeking
- favoring inclusiveness, undermining elite control

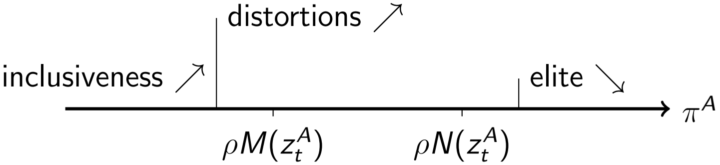
Captive masses 1: Patrimonial regime

New setup

- negligible cost of investing from A to B for the elite only
- high costs of doing business in A, higher than elsewhere
  - cf. Dharmapala Hines (2009) Which countries become tax havens, *JPubE* 13(02): 15-24.
- small country A

Result 2: patrimonial regime (captive masses)

If the masses of A are captive



A big democratic neighbor country has negative spillovers

- it favors rent-seeking over efficiency
- it facilitates elite control. It may slow down, or even avoid altogether increasing inclusiveness

Further predictions

Tax havens (captive masses 2)

- capital inflows dwarf domestic motives for small countries
- tax havens and elite control benefit each other

Benefit sharing between elites:

- competition between tax havens
- quasi-non-sovereign tax havens
- patrimonial regimes go through tax havens

Reciprocal impact on liberal democracies

- foreign-party financing
- vote-selling at the UN

Conclusion

In a general equilibrium setup, competition in the costs of doing business yields cross-border spillovers

- on policies and inequalities
- and, as a result, on rent extraction and inclusiveness
  - positive if everyone is mobile, negative if only the elite is: tax havens, patrimonial regimes, and reciprocal effects

Prediction 4.1: competition between tax havens

A priori, a deal which favors mostly the receiving elite over the evading elite, but:

- competition between tax havens

So the evading elite can still benefit from evasion.

Prediction 4.2: non-sovereign tax havens

A way for the evading elite to not be taxed by anyone but themselves?

Prediction 4.3: patrimonial regime $\Longrightarrow$ 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 #1: foreign party financing
Real life scenario #2: vote-selling at the UN...

How to motivate Western elites to crack down on ill-gotten goods?

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 new formal program of the elite

The elites now have to pay for g.
The new constraint on the fiscal policy can be written

$$Y(g, \tau) \geq \mathcal{Y}$$

Result 4: race to efficiency

$$\frac{d\tau}{d\mathcal{Y}} < 0 \text{ and } \frac{dg}{d\mathcal{Y}} > 0$$

In other words, the more binding the external constraint,

- the less taxes
- and the more public good provision
- $\Longrightarrow$ the less appropriation by the elite, the more business-oriented / efficient policy
- taxes do not decrease to 0...