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Dictators don't compete: autocracy, democracy, and tax competition

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ABSTRACT

It pays to be a tax haven. Ireland has become rich that way. Why do not all countries cut their capital taxes to get wealthy? One reason is structural. As the standard model of tax competition explains, small countries gain from competitive tax cuts while large countries suffer. Yet not all small (large) countries have low (high) capital taxes. Why? The reason, we argue, is political. While the standard model assumes governments to be democratic, more than a third of countries worldwide are non-democratic. We explain theoretically why autocracies are less likely to adjust to competitive constraints and test our argument empirically against data on the corporate tax policy of 99 countries from 1999 to 2011.

KEYWORDS

autocracy; democracy; globalization; tax Competition; corporate Taxation; tax policy-making.

1. WHY ARE NOT ALL COUNTRIES TAX HAVENS?

Tax havens are rich. On average, the GDP per capita of tax havens (i.e. countries that make a sustained effort to attract mobile foreign capital by low or zero tax rates) is twice as high as that of non-tax havens (Dharmapala and Hines, 2009, p. 1061). Why do not all countries cut their capital taxes and get wealthy?

Economic theory provides a partial answer. The economic baseline model of tax competition suggests that the incentives to compete vary with country size (Keen and Konrad, 2013; Wilson, 1999). Small states can gain from tax competition: Poaching foreign tax base is potentially welfare-enhancing for them. Large states, by contrast, lose in welfare terms. They are better off farming domestic tax resources. According to this logic, we should expect small countries to engage in aggressive tax competition but not large ones. Indeed, tax havens are generally small.

The largest country on most tax haven lists is Switzerland with a population size of 7.5 million. Yet, most countries are small. The global median country size is just 6 million, i.e. slightly smaller than Switzerland and considerably smaller than the global average size of 32 million (data is based on the year 2010 from World Bank (2013b)). But not all small countries adopt low tax strategies. And not all large countries keep their capital taxes up even though economic theory predicts low international competitive pressure. Why?

The answer, we argue, is politics. Governments' incentives to adjust to tax competition are conditioned by domestic institutions. Democratic governments are institutionally constrained to be sensitive to the welfare implications of their tax policies. Hence, they tend to cut taxes if their country is small enough to potentially profit from tax competition and tend to keep rates up (or cut them by less) if their country is large. Autocratic governments, by contrast, have fewer incentives to adjust to their competitive environment because their governments are less concerned about the general welfare of their populations and less able to lure in foreign capital by low taxes.

We use panel data on the corporate tax rates of 99 countries over the period 1999–2011 to test our theory. The results are in line with the expectations: tax level and country size are closely associated in democracies but not in autocracies.

The rest of the paper is organized into four sections. The following Section 2 reviews the economic baseline model of tax competition. It explains why country size matters for competitive incentives. Section 3 introduces domestic institutions. It explains why democratic governments are generally more responsive to competitive incentives than autocratic governments. Section 4 tests our argument against evidence on global corporate tax competition. Section 5 summarizes our findings and discusses theoretical implications.

2. THE ECONOMICS OF TAX COMPETITION

While the economic literature on tax competition is extensive (for recent reviews, see Genschel and Schwarz, 2011; Keen and Konrad, 2013), most of it starts from the same baseline model. In its simplest form, this model is about two identical countries sharing one internationally mobile tax base, capital (Wilson, 1999; Zodrow and Mieszkowski, 1986). The tax policies of both countries are interdependent because one country's capital tax revenue depends on the other country's capital tax rate: higher taxes in country A swell country B's revenues by pushing a larger share of mobile capital towards B; lower taxes in A depress B's revenues by poaching capital from B. This interdependency triggers a 'race to the bottom' in taxation as each country tries to attract capital from the other. In equilibrium, capital tax rates are lower in both countries than they would otherwise be.

The normative implications of the baseline model are controversial (see Edwards and Keen, 1996 for a summary). Some argue that the competitive race to the bottom undermines efficiency by constraining the ability of benevolent governments to supply optimal levels of tax-financed public goods (Wilson, 1999; Zodrow and Mieszkowski, 1986). Others insist that tax competition enhances efficiency by limiting the ability of predatory 'Leviathan' governments to over-tax domestic society (Brennan and Buchanan, 1980; Weingast, 1995). The causal logic of the baseline model is uncontroversial though. There is general consensus that governments of all stripes are forced to compete under conditions of economic integration.

The baseline model has been extended in various ways. Perhaps the most important extension concerns the influence of country size (Bucovetsky, 1991; Kanbur and Keen, 1993). In a symmetric setting of same-sized countries, the baseline model predicts that both countries face the same incentives to cut taxes and suffer equal welfare losses in the non-cooperative equilibrium. In an asymmetric setting, however, the smaller country faces stronger incentives to cut tax rates than the larger country and suffers a smaller welfare loss in the competitive equilibrium. Indeed, if the difference in country size is large enough, the smaller country is better off under tax competition than in its absence (Wilson, 1999, p. 288).

Why is small size a competitive advantage? Intuitively, in pondering capital tax cuts governments have to weigh the costs in terms of lost revenue from domestic capital against the benefits associated with capital inflows from the other country. In the small country with a narrow domestic capital tax base and lots of foreign capital to attract, the cost−benefit ratio is more likely to be favorable than in the large country with lots of domestic capital to lose and little foreign capital to win (Bucovetsky, 1991; Keen and Konrad, 2013, pp. 6−8; Wilson, 1999, pp. 278−9).

In the non-cooperative equilibrium, the small country undercuts the large country's tax rate and ends up with a disproportionately large share of the internationally mobile capital tax base. This does not necessarily imply higher capital tax revenues (because the small country's capital tax rate is low and possibly close to zero). But it pushes up the capital-labor ratio, fuels labor demand and thus leads to higher employment, higher wages and, eventually, to higher tax revenues from labor and consumption. In this way, not only capital profits from tax competition but labor

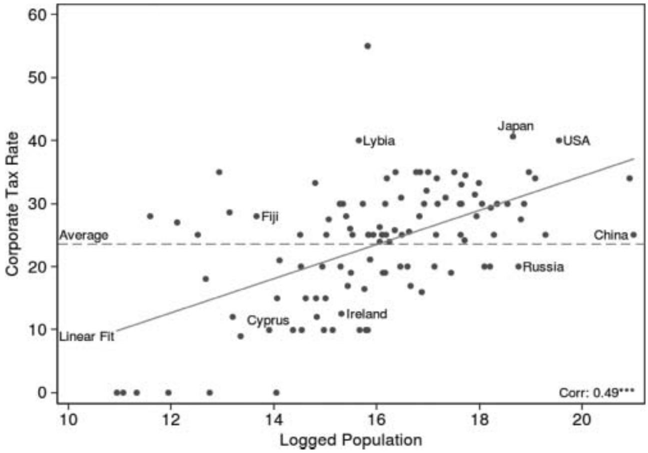

Figure 1 Country size and corporate tax rate of 112 countries, 2010. Sources: KPMG (2007–2011) and World Bank (2013b).

as well – in the small country. The bill is paid by labor in the large country. It suffers twice from the tax-driven outflow of capital to the small country: first in terms of less tax financed redistribution from the reduced domestic capital stock and, second, in terms of depressed labor demand, employment levels and wages due to the fall of the capital–labor ratio.[1]

As a first empirical cut, Figure 1 compares the corporate tax rates of 112 countries in 2010. The rates are significantly related to country size as the baseline model predicts: small countries like Cyprus and Ireland undercut the rates of large countries such as Japan and the United States.[2] However, the correlation is far from perfect because some small countries such as Fiji and Libya have substantially higher rates than much larger countries such as China and Russia. Why do not all countries follow the logic of the baseline model? The answer we propose in the next section is politics: countries' reactions to tax competition are conditioned by domestic political institutions.

3. THE POLITICS OF TAX COMPETITION

It is a well-established finding in international political economy that domestic institutions shape the dynamics of international tax competition and often slow down the race to the bottom (Basinger and Hallerberg, 2004; Ganghof, 2006). Yet the literature has focused on the institutions of advanced capitalist democracies and has largely ignored the potential effects of autocratic institutions. This is problematic because the difference between democracy and autocracy greatly influences governments' incentives to compete. As we will argue next, it affects not only the *ability* of governments to attract foreign tax base, as is sometimes argued in the literature on foreign direct investment (for exceptions, see Cao, 2010; Li, 2006) but also the *willingness* of governments to do so.

3.1 The willingness to compete

Following conventional wisdom, we assume power-seeking governments (Acemoglu and Robinson, 2006; Bueno de Mesquita et al., 2003): Governments want office; they need political support to gain and maintain office; and they use their policy-making power to pay off their supporters. The policies they choose vary in the preferences and needs of the support groups on whom they depend for political survival.

Democracies depend on mass support because all citizens have a say in government selection and formation primarily through free and fair elections but also through the freedom of expression and the freedom of association. The dependence on mass support forces democratic governments to target their policies at the interests of a broad majority of citizens as represented, under a range of plausible assumptions, by the median voter. The median voter is typically poorer than the national average, and relies mostly on wage income (Rudra and Haggard, 2005, p. 1018). Her interests are often best served by efficient policies that increase mass incomes before taxes and by broad-based redistributive programs that increase mass incomes after taxes and transfers.

Autocracies depend on minority support because only a select few have a say in government formation such as the members of the royal family, military officers, bureaucratic elites, or domestic business elites. All other citizens are formally or factually excluded from politics because there are no elections as in Saudi Arabia, because voting rights are restricted as in Apartheid South Africa, because elections are rigged as in Tajikistan, or because opposition groups are repressed as in Qatar. Obviously, autocrats cannot afford to be completely indifferent to majoritarian preferences if they want to avoid the threat of a general revolution ('revolution constraint') (Acemoglu and Robinson, 2006, p. 120). But usually this is a secondary concern. The primary concern is to keep the elites happy on whose support the government's survival immediately and directly depends. The elites are typically richer than the majority. They often rely on domestic capital income as, for instance, the Russian oligarchs, or enjoy privileged access to public rent-income as managers of state owned-enterprises (China), as members of the security forces (Fiji), as public bureaucrats (Singapore), or as members of privileged ethnic groups or religious sects (Syria). The best way to serve the interests of the elites is often by targeted discrimination and redistribution in their favor.

The implications for tax competition are straightforward: democratic governments have an incentive for competitive tax cutting if this benefits the majority, i.e. the median voter; autocratic governments have an incentive to compete if this benefits their elite supporters.

Consider democracies first. According to the baseline model the welfare effects of tax competition vary with country size. In *small* democracies, the median voter gains because the disadvantage of competitive constraints on fiscal redistribution from domestic capital is more than compensated by the positive effects of tax-induced inflows of foreign capital: higher employment, higher wages, buoyant tax revenues. This creates an incentive for governments to cut capital taxes that often dominates ideological preferences for high capital taxation. The Irish Labour Party, for instance, has been a staunch supporter of low Irish corporate tax rates since the onset of the European Single Market in 1993: 'Labour in government introduced the 12.5 percent corporation profits tax rate, and we will insist that it remains in place' (Labour, 2011, p. 15). In the same vein, Denmark's social-democratic government promotes cutting the Danish corporate tax rate well below the level of neighboring countries as part of its 2013 'Growth Plan DK' (Bomsdorf, 2013).[3] Rhetoric aside, this is the same strategy, Paraguay's conservative President Nicanor Duarte used in 2004 to give his country a competitive edge (NOTIMEX, 2004) or that Austria's right-wing coalition, supported by the social democratic opposition, used in 2005 to gain an advantage over its large neighbor Germany (News, 2003).

In *large* democracies, the median voter loses from tax competition because the negative effect of less redistribution from a shrinking domestic capital tax base is compounded by the economic disadvantages of capital outflows: depressed labor demand, stagnating wages, shrinking revenues. These negative effects create an incentive for governments to go slow on tax competition and restrict capital tax cuts. Tellingly, all initiatives to reign in 'harmful' tax competition in Europe and worldwide have come from large countries such as Germany, France, the United Kingdom, and most importantly the United States (Genschel and Schwarz, 2011, pp. 359−63). Also, the left-right divide on corporate tax issues is often more pronounced than in small democracies. Think, for instance, of Francois Hollande's bid during the French Presidential elections 2012 to shift the tax burden from small business to large corporations (Hollande, 2012). Another example is the decision of Mexico's left-leaning government in 2013 to suspend the mild corporate tax cuts adopted by its conservative predecessor and to increase other capital taxes to consolidate the budget (Day, 2013). The reactions of autocratic governments to tax competition depend on the ruling elites' preference for capital inflows. These preferences are not systematically related to country size. Small autocracies will exploit their structural advantage of smallness if this serves the interests of their rulers, as arguably in Singapore where the government relies heavily on foreign capital and multinational corporations to gain autonomy from domestic society (Khondker, 2008; Verweij and Pelizzo, 2009). But autocracies will ignore the advantage of smallness, if capital inflows are politically irrelevant or detrimental for the government. Military dictatorships, for instance, are often more concerned about short-term increases of the defense budget than about long-term growth prospects (Albertus and Menaldo, 2012, p. 975): the first priority of Fiji's military regime upon usurping power in 2006 was a 39% pay raise for the armed forces, not tax-induced capital inflows (Narsey, 2008). Small autocracies may also want to keep capital taxes high because they lack mass loyalty and therefore depend on easily administered tax handles like the corporate tax (Winer and Kenny, 2006, p. 187) or because high tax rates are a handy instrument to reward loyal supporters through selective tax exemptions (Dharmapala and Hines, 2009, p. 1063).

Likewise, large autocracies lack systematic incentives to keep their capital taxes up. Russia, Kazakhstan, and China are examples of large autocracies with corporate tax rates substantially below what the baseline model would seem to suggest. One reason to set a low corporate rate may be the government's dependence on the support of domestic capital or foreign investors. Chile under Pinochet provides a textbook example. Depending on the structure of the winning coalition, efficient taxation may simply be politically unattractive for autocratic governments. Hopes that tax competition could impose an efficiency-discipline on the wasteful tax policies of autocratic Leviathans (see Edwards and Keen, 1996) appear ill-founded in light of this argument.

In summary, democratic majorities are more sensitive to the broad welfare implications of tax competition than the minorities on which autocratic governments rely for political support. As a consequence, democratic governments are generally more willing to adjust to tax competition than autocracies.

3.2 The ability to compete

In line with the previous literature we assume capital to be risk-averse (Cao, 2009; Jensen, 2003; Li and Resnick, 2003; Schultz and Weingast, 2003): Capital owners will only invest if they have credible guarantees against future expropriation both by illegal means including confiscation, corruption or embezzlement and by legal policy changes including tax hikes. While governments usually have an incentive to promise investment friendly policies ex ante, the credibility of these promises varies in the institutional constraints on governments' ability to renege on them ex post. Two types of constraint are crucial: the rule of law and political checks and balances (Keohane et al., 2009; North et al., 2009; Olson, 1993; Schultz and Weingast, 2003).

The rule of law provides insurance against the arbitrary violation of property rights by the government or by third parties. It is an integral element of democracy because respect for the law, an independent judiciary, and an effective court system are essential preconditions of the constitutive openness and inclusiveness of the democratic system (Li, 2006, p. 64; North et al., 2009, p. 26; Olson, 1993, p. 571; Przeworski, 1991, p. 14). The rule of law prevents incumbent governments from dodging elections, from manipulating electoral institutions, or from repressing the opposition through selective infringements of individual and collective rights including property rights.

The rule of law is inherently in tension with autocracy because autocracy implies that different rules apply to the government and the governed. While various autocracies including Imperial Germany in the nineteenth century or contemporary Singapore have achieved high levels of property rights protection, the credibility of legal guarantees is generally lower than in stable democracies because ultimately the law remains at the discretion of the government (e.g. North et al., 2009, p. 75).

While the rule of law prevents illegal expropriations, political checks and balances decrease the likelihood of expropriation by legal means including tax increases. Democracies generally score high in checks and balances. First, they provide for the electoral accountability of the government to voters. This constrains the government's ability to renege on popular policies (Alesina, 1988). Hence, to the extent that capital inflows are popular with voters, electoral accountability is likely to increase the credibility of government guarantees to investors. Second, democratic constitutions provide for institutional separations of power such as federal structures, bicameral legislatures, coalition agreements, or constitutional courts. In this way, they force the government to accommodate various veto players in the policy process. This makes policy change difficult in general (Mattes and Rodríguez, 2013, p. 3), and makes wasteful and inefficient policy change difficult in particular. For policy proposals that do not appeal to a broad range of interests are particularly likely to be blocked by veto players. Of course, democratic governments can still renege on their policy promises to investors – but only if the breach of promise enjoys broad political support among voters and interest groups.

Autocracies score low on political checks and balances. By definition, the electoral accountability of the governments is weak or non-existent, and the separation of powers is underdeveloped. To be sure, autocratic governments need to accommodate their support base. This may involve concessions and compromises and thus constrain government discretion. Yet, the constraint lacks institutionalization and therefore contributes little to policy credibility and predictability: The government may be toppled by a competitor relying on a different support coalition or it may decide to reshuffle its own coalition out of its own volition. Just think of the rapid disempowerment of the Russian Oligarchs under Putin (Appel, 2008). In either way, the change in support base and policy preference can be radical and abrupt (Olson, 1993).

The rule of law and political checks and balances matter for international tax competition because tax competition involves risky investments: direct investments in location-specific production facilities in low-tax countries (Jensen, 2003; Li, 2009); direct investments in management and service operations (holding companies, headquarter services, sales centers, financial services companies) that serve as receiving ends of international profit-shifting into low-tax countries[4]; portfolio investments that investors conceal from tax authorities at home and therefore cannot easily repatriate.[5]

Given the risky investments involved, democracies enjoy a general advantage in tax competition. The rule of law ensures tax-driven investors against tax policy abuses such as Russia's arbitrary use of tax evasion charges for undercutting BP's grip on Russian oil companies (Belton, 2008). Political checks and balances ensure investors against abrupt and controversial policy reversals such as, for instance, Fiji's 5000% tax hike on foreign water producers in 2013 (Lester, 2010) or Kazakhstan's creative use of environmental regulation to extract extra-concessions from foreign oil firms (*The Economist*, 2014).

The rule of law and political checks and balances enable democracies to attract (or retain) more capital at any given tax rate than autocracies (Dharmapala and Hines, 2009, p. 1065): they pull in more capital at low rates, and lose less capital at high rates. Autocracies have to offer more in terms of tax concession in order to achieve the same effect in terms of capital investments (Jensen, 2003; Li, 2006). Even capricious dictators usually prefer keeping their loot in sober democracies like Switzerland over entrusting it to another capricious dictator.

While all democracies enjoy a general 'democratic advantage' (Schultz and Weingast, 2003) in tax competition, the strength of this advantage varies in country size: Small democracies are better able to credibly commit to low-tax policies than large democracies. In small democracies the inbuilt bias of political checks and balances towards centrist policy choices favors tax cuts because, according to the baseline model of asymmetric tax competition, the majority will benefit from relatively low capital taxes. This makes a reversal of low-tax policies unlikely. Not by accident, the corporate tax is the only major tax the Irish government never considered raising during the recent fiscal crisis. In large democracies, by contrast, the centrist bias of checks and balances reduces the credibility of low-tax guarantees because the median voter is less likely to gain from a low-tax policy. Tellingly, the only OECD country with a higher corporate tax rate in 2013 than in 1993 is large: France.

In summary, democracies enjoy a general advantage in tax competition: At any given tax level they can attract more capital than autocracies because their constitutive rule-of-law system and checks-and-balances arrangements provide investors with more credible guarantees against expropriation and adverse policy change. Yet, small democracies can commit to low tax rates even more credibly than large democracies because they have fewer domestic actors who could potentially gain from a tax rise. The ability to compete is higher in democracies than in autocracies, and higher in small democracies than in large democracies.

3.3 Empirical implications

According to our model, tax competition induces democracies but not autocracies to follow the logic of the economic baseline model. Autocracies are less *willing* to adjust to competitive constraints because the low inclusiveness of their political institutions makes them largely insensitive to the welfare penalties of non-adjustments. Also, autocracies are less *able* to adjust because the relative lack of rule of law guarantees and of constitutional constraints undermines the credibility of long-term policy commitments and lessens the supply of tax-sensitive international capital at any given tax rate.

The empirical implications of the model are straightforward. Under conditions of tax competition we should observe, first, that capital tax rates are associated with country size in democracies: small democracies have systematically lower rates than large democracies (in line with the economic baseline model). Second, tax rates in autocracies should be unrelated to country size: small autocracies should not have systematically lower rates than large autocracies (in contrast to the baseline model). Third, the responsiveness of intermediate regimes ('anocracies'), in between pure democracy and pure autocracy, should vary with the relative inclusiveness and openness of their political institutions: the tax rates of more inclusive and institutionally constrained regimes should be more responsive to differences in country size than the rates of less inclusive and constrained regimes.

4. EVIDENCE: CORPORATE TAX COMPETITION WITH DIFFERENCES IN REGIME TYPE

The spread of multinational companies since the 1950s and 1960s, the liberalization of capital controls since the 1970s and landmark US tax reforms in the 1980s have ushered in an era of international tax competition (Genschel and Schwarz, 2011; Swank, 2006; Tanzi, 1995). Did national tax rates adjust as predicted by our model? We use data on corporate tax rates in 99 countries, 1999–2011 (see Table A1) to investigate this question. We first introduce our variables and estimation strategy (Section 4.1), then turn to the regression analysis (Section 4.2), and finally discuss the robustness of our findings (Section 4.3).

4.1. Research design

4.1.1. Dependent variable

Our dependent variable is the statutory corporate tax rate.[6] While governments have various instruments of capital taxation, the corporate tax rate is arguably the most important. On the one hand, the corporate tax is a main revenue raiser in its own right and a crucial backstop to the revenue raising capacity of personal taxes on income and wealth.[7] To many voters it is 'a linchpin of any progressive tax system' (Slemrod, 2004, p. 1172). On the other hand, the statutory rate is an important determinant of the effective corporate tax burden,[8] and the single most powerful tax incentive for cross-border FDI and profit-shifting.[9] While other variables including the corporate tax base and the tax system also matter, big accounting firms such as KPMG or PwC focus on the statutory corporate tax rate when comparing the business-friendliness of national tax systems (e.g. KPMG, 2007–2011; PWC, 2013–2014).[10]

We checked five data sources on corporate tax rates: the OECD tax database (OECD, 2013), the KPMG corporate tax survey (KPMG, 2007–2011), the World Tax Database (WTD, 2012), the IMF (2013) and World Development Indicators (Cao, 2010). The OECD data is the most detailed and sophisticated but is limited to OECD member states. We used it as a benchmark for checking the reliability of the other sources. The KPMG data correlates almost perfectly (0.98) with the OECD data, whereas the other three sources correlate below 0.75. We thus choose the interpolated KPMG corporate tax rate as our dependent variable.

A more comprehensive analysis would also include so-called special corporate tax regimes, i.e. selective tax reductions for specific corporate forms, functions, and investments. Arguably, special tax regimes constitute a powerful alternative to low corporate tax rates in the competition for foreign companies and profits (Keen, 2001; Kemmerling and Seils, 2009). Yet comparative time series data on special tax regimes is not available. We use Li's cross-sectional dataset on selective tax incentives in 53 developing countries to triangulate our results. We find that autocracies generally provide more incentives than democracies (Li, 2006). But we find no relationship between the number of incentives and country size (see Figure A2). Hence, if small autocracies have higher statutory corporate tax rates than small democracies, as our model predicts, this is not because they compete by other means (i.e. by incentives rather than rates). We are confident, therefore, that the omission of special tax regimes does not bias our results.

4.1.2. Independent variables

The most common indicator of *country size* is population because the size of the population reflects the size of a country's labor endowment (e.g. Bucovetsky, 1991). Since arguably the effect of national labor endowments on corporate taxation is subject to diminishing returns, we follow the standard practice in the literature and use the natural logarithm of population as our measure of country size (Dharmapala and Hines, 2009). The data is from the World Bank (2013b). A possible objection to the population size measure is that it systematically overrates the size of population-rich but capital-poor countries such as India or China. As a robustness check, we also measure size by GDP (see e.g. Li, 2006). The results remain unaffected (see Table A5).

The most common indicator of *regime type* stems from the Polity IV Project (Marshall et al., 2011). Rather than treating democracy and autocracy as a binary distinction, Polity conceptualizes it as a gradual scale ranging from purely democratic to purely nondemocratic and purely autocratic to purely non-autocratic regimes. Country scores on this scale reflect the inclusiveness of selection institutions and the constraints they impose on executives. We convert the Polity scale to exclusively positive values running from zero (fully autocratic) to 20 (fully democratic). We use the Polity2 score, which interpolates transition periods, treats interregnum periods as neutral (10), and codes foreign interruptions as missing cases.

Unfortunately, Polity excludes micro-countries with populations of 500,000 inhabitants or less. Yet, if this exclusion should bias our results at all, the bias is downwards, i.e. against our expectations because it excludes many notorious low tax havens such as the Cayman Islands (54,000 inhabitants) or Liechtenstein (37,000 inhabitants). Hence, Polity provides a hard test for our argument. Yet, as a robustness check, we use two alternative measures of regime type that include smaller states: the 'voice and accountability' variable from the World Bank's good governance indicators (Kaufmann et al., 2012) and Freedom House's political rights variable (FreedomHouse, 2013). Again, our results remain unaffected (see Table A5).

4.1.3. Controls

In our robustness checks, we enter a number of control variables that previous studies identified as potential determinants of corporate tax rates. First, we include the Chinn-Ito-Index (2008) of *capital account openness* as more open economies are likely to be more susceptible to international tax competition: countries with fewer barriers should have lower corporate tax rates. Second, we bring in a yearly lag of the row-standardized distance-weighted *spatial lag* of the corporate tax rate as the competition for inward investment is likely to be more intense among neighboring than among distant countries. Third, we control for GDP per capita because wealthy countries tend to have higher taxes and a more effective tax administration (World Bank, 2013b). Fourth, we enter *health care spending* as a percentage of GDP and GDP *growth* as indicators of expenditure requirements and revenue buoyancy (World Bank, 2013b). Health care spending should increase the corporate tax rate, growth should decrease it. Fifth, we include the share of *agriculture* in national accounts as a proxy for the monetization and, hence, taxability of the economy (World Bank, 2013b). Low monetization implies a high dependence on corporate taxation because there is little else to tax. Hence, high shares of agriculture should be associated with high corporate tax rates. Sixth, we enter the share of tax revenue in total government revenue (*tax/government revenue*) (IMF, 2013) to control for the availability of non-tax sources of revenue such as, for instance, oil and gas extraction or foreign aid (Burgess and Stern, 1993; Tanzi and Zee, 2000). High shares of tax revenue in total government revenues (indicating low non-tax revenues) should be associated with higher corporate tax rates.

We also include two institutional controls – *investor protection* (World Bank, 2013a) and *regime durability* (Marshall et al., 2011) – that could potentially influence corporate tax rates independently of the political regime type. Higher levels of investor protection (in terms of legal remedies for minority shareholders) should allow governments to extract a higher tax price from investors and, hence, to charge higher corporate tax rates. Likewise, more durable regimes (in terms of years since the most recent fundamental regime change) should have higher tax rates than less durable regimes because, all else equal, they have higher policy credibility with investors.

We test our argument by a random effects GLS model with splines to control for the temporal downwards trend in corporate taxation. As a robustness check we run an AR1 model to account for temporal dependence. Given our interest in the effects of one slowly changing variable (country size),[11] our main model neither includes fixed effects nor first differences. Yet, even taking out the averages by including country dummies in our robustness section does not change our main findings. The model is very robust to different specification and measurements.

4.2. Findings

Table 1 shows the regression results for four different model specifications.

The first model (1) estimates the additive effect of country size (i.e. population size) and regime type (i.e. Polity score) on corporate tax rates. The findings support the economic baseline model: larger countries have higher corporate tax rates. Regime type, by contrast, does not seem to matter for taxes. The picture changes, once we include the interaction effect of country size and regime type in the main model (2): regime type becomes significant and changes signs, while country size does the opposite. The interaction effect on tax rates is positive and significant. Since the interaction effect is difficult to interpret by coefficients alone, we graph it in Figure 2.

Figure 2 plots the marginal effect of a change in regime type (i.e. a one-point change on the Polity scale towards more democracy) on the corporate tax rate for all relevant country sizes. It shows that the sign and the magnitude of the effect crucially depend on country size. The effect switches signs at a population of around 14 million, i.e. a country roughly the size of the Netherlands. The smaller a country is from this point downwards, the stronger becomes the negative effect of regime type, i.e. the lower is the corporate tax rate as countries become more democratic.[12] Take small Tunisia (10 million inhabitants): Before the Arab Spring it had a corporate tax rate of 30%. Almost immediately after the

Table 1 The effect of country size and regime type on corporate tax rates

	(1) No interaction	(2) Main model	(3) Fixed effects	(4) AR1
Country size	2.21***	−0.26	0.14	0.56
	(0.44)	(0.66)	(1.87)	(0.70)
Regime type	0.067	−2.98***	−3.35***	−1.77***
	(0.071)	(0.62)	(0.84)	(0.68)
Interaction		0.18***	0.21***	0.100**
		(0.037)	(0.049)	(0.040)
Observations	1166	1166	1166	1166
Countries	99	99	99	99
R^2	0.24	0.25	0.24	0.17

Note: Standard errors in parentheses. Constant and splines not reported. Standard errors in parentheses. Constant and splines not reported. $^{***}p < 0.01$, $^{**}p < 0.05$, $^{*}p < 0.1$.

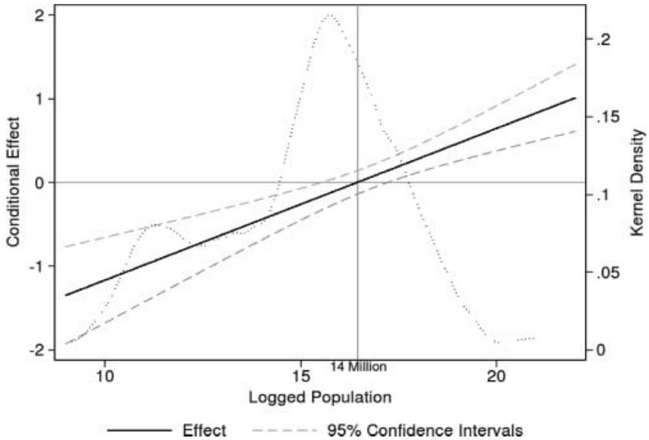

Figure 2 Conditional effect of regime type on the corporate tax rate depending on country size.

Arab Spring it decided to cut this rate to 25% (OECD, 2013). The opposite applies to countries larger than 14 million. Here, the larger and the more democratic a country is, the higher is the corporate tax rate. Take large Indonesia (220 million inhabitants): Following its dramatic democratization in 1999, the corporate tax rate went up from 30% to 39% (KPMG, 2011). In sum then, our empirical finding is in line with our model: democracies react more strongly to tax competition than autocracies at both, small and large, country sizes. Figure 3 further illustrates this finding.

Figure 3 compares the predicted corporate tax rates of four hypothetical countries. The small democracy (1 million of population, Polity score

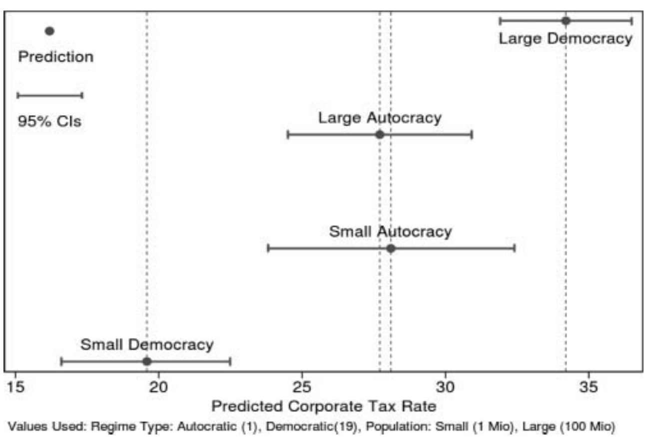

Figure 3 Predicted corporate tax rates for small and large autocracies and democracies, holding all other variables at their mean.

of 19[13]) has the lowest and the large democracy (100 million of population) has the highest predicted rate. The rate difference is large and significant. The predicted rates of the small and the large autocracy (1 million and 100 million of population, respectively, Polity score of 1) are in between both extremes, i.e. significantly higher than those of the small democracy and considerably lower than those of the large democracy. Yet, they hardly differ from each other. Conclusion: Democracies are responsive to the structural constraint of country size, autocracies are not.

Figure 3 focuses on cases of pure democracy and pure autocracy. But, pure autocracies are empirically rare. Only 11 countries in our sample of 99 countries were full autocracies (Polity scores of 5 or lower) in 2010. All other non-democratic countries were anocracies with moderate Polity scores (5−15). What do our regression results say about their responsiveness to competitive constraints?

Figure 4 graphs the marginal effect of country size on corporate tax rates for different regime types. As before, country size has no significant effect on corporate tax rates in autocracies (Polity score of 5 or less) but a strong and significant positive effect on tax rates in democracies (Polity score of 15 or more). Yet, country size also has a significant effect on anocratic regimes with Polity scores larger than 7. While non-democratic regimes are, on average, less able and willing to adjust to tax competition than democracies, most anocracies do adjust to some degree. Singapore is a prominent, if rather singular, example of a non-democratic country successfully competing as a low tax haven for multinational companies (KMPG, 2011).

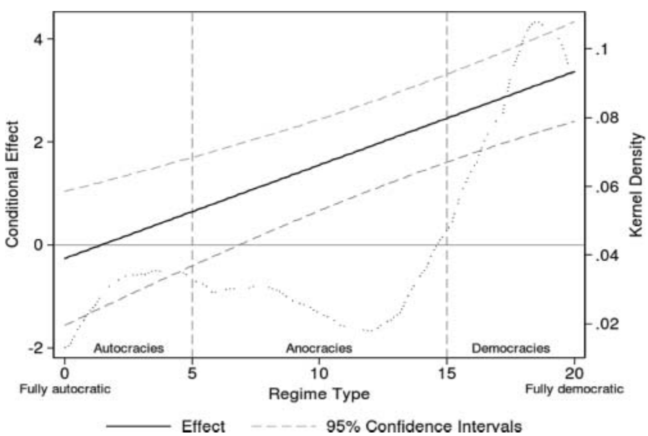

Figure 4 Conditional effect of country size on the corporate tax rate depending on regime type.

4.3. Robustness

Our regression results suggest that a country's propensity to adjust its tax rate to its country size increases steadily as the country moves from being autocratic to being more democratic. This is a striking result given widespread concerns about a possible curvilinear relationship between regime type and public welfare. There is an important body of research arguing that anocratic regimes in between pure autocracy and democracy are more susceptible to government irresponsibility and policy mayhem than pure autocracies. Some authors find, for instance, that intermediate regimes are more conflict-prone than either pure autocracies or pure democracies (Fearon and Laitin, 2003, p. 85; Hegre et al., 2001; Mansfield and Snyder, 2005, p. 273). Others claim that intermediate regimes are more conducive to predatory government than pure autocracies (Bueno de Mesquita et al., 2003, p. 68; Zakaria, 2003, p. 15). In this perspective, we should expect intermediate regimes to be less responsive to international tax competition than autocracies, not more. Is our finding of a linear regime effect a methodological artifact? To investigate this question we separate our sample into three subsamples (full autocracies, full democracies, and anocracies) using the usual cut-off points on the Polity scale. Figure 5 plots corporate tax rates against country size separately for each subsample.

The picture that emerges from Figure 5 is compatible with the linear regime effect graphed in Figure 4. Among the autocracies, corporate tax rates vary widely and are essentially unrelated to country size. Among the democracies, tax rates correlate strongly with country size. The tax policies of the intermediate group are in between: the range of tax rates is more restricted than among the pure autocracies but the association with country size, while weakly significant, is less pronounced than among democracies.[14] This supports our claim of a linear regime effect in tax competition.[15]

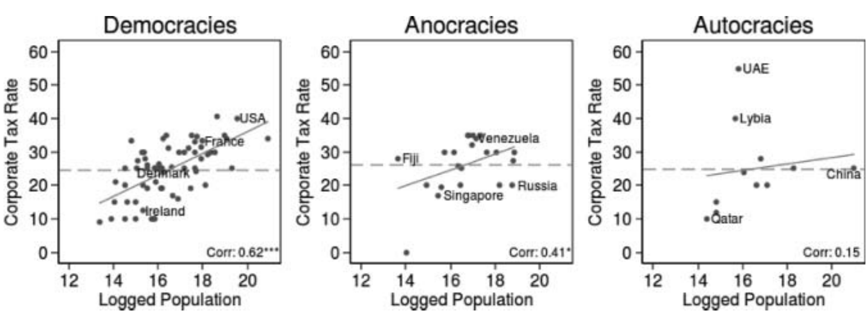

Figure 5 Country size and corporate tax rates in 99 countries by regime type, 2010. Sources: KPMG (2007–2011), World Bank (2013b), and Marshall et al. (2011).

Our regression results are also robust to a whole range of different modeling strategies. As Table 1 illustrates, including fixed effects instead of random effects (model 3) or using an auto-regressive model rather than splines (model 4) does not change the interaction effect of country size and regime type on the corporate tax rate. The effect is also robust to different samples (Table A4) and with different measurements of country size (GDP) and regime type (the World Bank's 'voice and accountability' index and Freedom House's political rights variable) (Table A5).

Table A6 shows the main model with additional control variables. Again, the key findings remain unchanged. Most controls have the expected sign but are not consistently significant or completely insignificant (openness, growth, agriculture, tax/government revenue, health spending). Perhaps most importantly, the two institutional controls (regime durability and investor protection) have no significant effect on corporate tax rates, supporting our notion that the credibility of legal guarantees does not vary independently of regime type. The only control variables consistently and significantly affecting the corporate tax rate are GDPpC and the spatial lag. Wealthy countries with high GDPpC tend to have larger public sectors and hence higher taxes overall. The spatial lag demonstrates that the corporate rate varies in the rates of neighboring countries: it tends to be high if neighbors have high rates as generally in South Asia, and low if neighbors have low rates as generally in Eastern Europe and Central Asia. There are regional equilibria in global tax competition which, however, all exhibit the same patterns with respect to country size and regime type (see Table A4).

5. THEORETICAL IMPLICATIONS

We have argued that regime differences matter for tax competition. Autocracies are generally less *willing* to adjust their tax policies to international competitive constraints because the low inclusiveness of their political institutions makes them insensitive to the welfare penalties of non-adjustments. At the same time, they are also less *able* to adjust because the relative lack of institutional constraints (rule of law and checks and balances) on government discretion undermines their ability to make credible long-term policy commitments: at any given tax rate they attract less capital than democracies. Our argument is supported by the evidence. Based on a sample of 99 countries, we found that the corporate tax rates of democracies vary systematically in country size, as predicted by the welfare-theoretic economic baseline model of tax competition, while the corporate tax rates of autocracies are insensitive to country size. We also found that the sensitivity of tax rates to country size increases steadily, as countries become relatively more democratic.

Our findings contribute to the political economy literature in two ways. First, they show that domestic institutions matter not only for tax competition among advanced Western democracies but also, more fundamentally, for the competition between democracies and autocracies. Our empirical analysis suggests that the general distinction between democracy and autocracy dominates the effect of more fine-grained institutional differences within each regime type. This has two important implications. On the one hand, it suggests that democratic governments are more sensitive to the welfare implications of their tax policies than autocracies: Democratic governments set the corporate tax rates to maximize the welfare of the median voter. On the other hand, the analysis indicates that tax competition has no disciplining effect on the wasteful tax policies of autocratic rulers. Contrary to what is sometimes suggested in the economic literature (Brennan and Buchanan, 1980; Edwards and Keen, 1996; Weingast, 1995), tax competition cannot simulate by external pressure the tax policy constraints of domestic democracy. People looking for means to tame autocratic Leviathans have to look elsewhere.

Second, our findings show that similar domestic institutions can have dissimilar policy effects depending on a country's structural position in the international economy: While democratic institutions exert downward pressure on capital taxation in small countries they are associated with relatively high capital taxes in large countries. Considering this interaction between country size and regime type adds nuance to the literature on FDI and portfolio investments in developing countries. Most of this literature assumes that democracy will generally increase countries' attractiveness to foreign investors (Cao, 2009; Jensen, 2003; Li and Resnick, 2003). Our analysis suggests, by contrast, that the willingness and ability of democratic governments to compete for foreign investors varies in country size: Large democracies have fewer incentives to lure in foreign investors by low general rates *and* they are less able to credibly commit to such. Hence, even if a right-of-center government implements a low tax reform, the likelihood that the reform is repealed by a successor left-of-center government is higher than in a small democracy.

In conclusion, our paper shows that tax competition means something different inside and outside the OECD simply because a large share of non-OECD countries is non-democratic. While the corporate tax rates of democracies are largely driven by international competitive constraints, the rates of autocratic countries reflect the specific details of the 'fiscal contract' between the government and its domestic elite supporters.

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NOTES

1. All predictions of the baseline model depend crucially on the assumption that capital generates labor demand in its country of (source) taxation. This assumption is unproblematic as long as countries compete over real investment in productive assets. Yet, even competition for financial capital, i.e. capital that is not directly and physically tied to real activity (bonds, bank claims, equity, corporate paper profits, intangible assets, etc.) has employment effects because it generates demand for financial services and often bring real investments in its wake. According to Keen and Konrad (2013, p. 277) the insights of the baseline model 'seem reasonably robust to the mix between real and paper shifting of tax bases'.
2. Measuring country size by GDP rather than population does not change the picture. See Table A5.
3. On the general issue of low capital taxation in high-tax Denmark, see Ganghof (2007) and Martin (2015).
4. Multinational companies engaging in profit shifting from subsidiaries in high-tax countries to subsidiaries in low-tax countries are vulnerable to tax increases in the latter because these would put the profitability of the entire multinational group at stake. This gives the governments of low-tax countries some leverage for extortion (Bucovetsky, 2014).
5. Efficiency-driven investors (i.e. capital owners investing abroad for the purpose of exploiting non-tax locational advantages) can usually rely on the assistance of their home country if the host country defrauds them. Tax-driven investors (i.e. capital owners investing abroad in order to minimize taxes at home) usually cannot. Since the very purpose of their investment is to deny revenue to the home country, the home country has little reason to defend these investments against encroachment by the host country (Keen and Lighthart, 2006).
6. For summary statistics, see Table A1.
7. In the absence of a corporate tax, individual income owners could use corporations as tax shelters for instance by retaining profits in companies or by reclassifying labor as capital income. By preventing such abuse, the corporate tax backs up the personal income tax. The effectiveness of this function hinges on the statutory corporate tax rate, for as long as the corporate tax rate is lower than the top personal income tax rate there is an incentive to shift personal income into the corporate sector (Ganghof and Genschel, 2008, p. 61).

8. Effective average tax rates (EATRs) indicate the statutory tax burden of a hypothetical investment project taking all relevant laws on the tax rate and base into account. The EATR depends crucially on the profitability of the investment. With rising levels of profitability, it converges on the statutory corporate tax rate (Devereux et al., 2002, p. 465; Swank, 2015, p. 17). Usually, high profitability is a precondition for firms to engage in foreign direct investment in the first place. Hence, the loss of information caused by the lack of data on the EATRs of non-OECD countries is slight.
9. In deciding where to declare taxable profits, multinational companies seek to use all allowances and deductions available in any jurisdiction. Having done so, any excess profit is taxed at the statutory rate. Hence it is the statutory rate which is central in determining the location of profit (EuropeanCommission, 2001; Devereux and Sørensen, 2006; Ruiz and Gerard, 2008).
10. Many political scientists feel uneasy about neglecting the tax base and use revenue-based measures of the tax burden (Quinn, 1997; Garrett and Mitchell, 2001). These measures calculate the effective tax burden by scaling corporate or capital tax revenues by GDP or total tax revenues (so-called tax ratios) or by the share of capital income in national income (average effective tax rate on capital, AETR). The major problem with these measures is that corporate tax revenues depend not only on the statutory corporate tax system (i.e. legal provisions on rates, bases, etc.) but also on the level of corporate profits. If tax competition affects both the statutory tax system and the level of corporate profitability, it is hard to infer anything about national policy reactions to international competitive constraints by looking at revenue-based measures of the tax burden (Devereux and Loretz, 2012, p. 14).
11. There is considerable variance in the two other main variables of the model. Regime type: the polity score changed in roughly one-third of the countries in our sample (37 out of 99) over the sample period, and in 16 states it has changed more than once. The majority of changes were by two points or more and they went in either direction (more or less democratic). Corporate tax rate: the majority of countries has undergone more than one rate change (21 none, 15 one, and 63 more than one). Again, changes go in both directions, even though we observe four times more decreases than increases and also more substantial decreases in rates.
12. Please note from the kernel density pictured in the graph that the majority of countries is smaller than 14 million. Thus, more countries (but not people) are in a structural position to benefit from tax competition.
13. All polity scores refer to the transformed 0−20 scale. Polity scores for full autocracies range from 0 to 5, for full democracies from 15 to 20, and for intermediate regimes from 6 to 14 on our transformed 0−20 scale.
14. As an additional check, we regress the corporate tax rate on country size separately for each of the three sub-samples for all available country-years 1999−2011 (see Table A2). The same pattern emerges as in Figures 4 and 5: tax rates in intermediate regimes are more responsive to country size than in autocracies but less responsive than in democracies.
15. Following some authors we also investigated the influence of different autocratic regime types (party, personal, monarchic, and military) on corporate taxation (Hadenius and Teorell, 2007; Geddes et al., 2012). We found that autocratic regime types do indeed matter but only because, and to the extent that, they represent different ranges of polity scores. For instance, limited multi-party systems tend to be relatively more inclusive and more institutionally constrained than monarchies or military dictatorships. As a

consequence, they usually have higher polity scores and corporate tax rates that are more closely aligned to their country size. In the end, we decided to drop these differences from our analysis because it did not substantially increase our explanatory leverage.

SUPPLEMENTAL DATA

Supplemental data for this article can be accessed http://dx.doi.org/10.1080/09692290.2016.1152995.

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