The Fiscal Interest Approach: The Design of Tax and Transfer Systems

Caroline Pöschl, London School of Economics and Political Science

Barry R. Weingast, Stanford University

September 2013

Abstract

The design of the fiscal system vitally shapes subnational government institutions, policy choices, and economic performance. In this chapter we focus on the fiscal interest approach, the idea that the specific arrangements of tax and transfer systems directly affect the interests and incentives of subnational political officials. These incentives therefore affect these governments' policy choices and, consequently, the performance of their jurisdictions. This chapter reviews several ideas in the literature that show how precisely this occurs. When the taxation and transfer system has subnational governments rely on own revenue generation from broad based taxes, subnational governments tend to be responsive to their residents' needs, the overall health of their economies, and more willing to provide market-enhancing public goods. An excessive reliance on central government transfers, on the other hand, has a detrimental effect on subnational incentives to assist the production of wealth. We provide and overview of how the type of tax that is assigned and the specific formula used to divide central government funds among subnational governments either rewards or punishes subnational government efforts at promoting growth and prosperity; and, similarly, whether it encourages subnational government spending beyond their means or promotes prudent fiscal management.

INTRODUCTION

How can subnational governments be motivated to promote the prosperity of residents in their jurisdictions? According to modern scholarship on fiscal federalism and decentralization, one way is through the design of the fiscal system. Recent advances in the field emphasize that the specific arrangement of tax and transfer systems affects the incentives of subnational political officials. In this chapter, we focus on the fiscal interest approach. Because systems of taxation affect the incentives of subnational governments, they affect these governments' policy choices and, consequently, the performance of their jurisdictions (Faguet 2012, Faguet and Sánchez 2013, Wallis, Sylla and Legler 1997, Weingast 2009). The design of the fiscal system, in sum, shapes institutions and influences whether subnational government officials strive to create growth and prosperity or let their localities stagnate, and whether they rule in the interest of the ruled or not.[1]

This chapter reviews the literature and discusses *how* different tax and transfer systems are expected to affect incentives in decentralized settings. In particular, it discusses how their design can influence whether subnational political officials choose policies that foster markets and serve as a helping hand to their population or instead choose predatory and distortionary policies. It looks first at the different incentives created through reliance on different sources of revenue, comparing tax revenues with central government transfers. It then goes on to discuss specific taxes and different systems of intergovernmental transfers, assessing the effect these may have in shaping subnational government policymaking.

[1] The analysis in this paper thus falls into the category of "second generation fiscal federalism," which analyzes decisions by subnational government officials based on the incentives they face (Oates 2005, Weingast 2009).

Incentives of taxes versus transfers as a source of subnational government revenues

The fiscal federalism literature has long shown that different sources of revenues affect the incentives of governments differently (Moore 2004, 2007; Prichard 2009). At the subnational level, too, researchers see an important difference between governments that depend largely on own revenues, such as taxes and fees, and those that depend predominantly on central government transfers.

Subnational governments that depend on own revenues have incentives to be more accountable to citizens, to provide market-enhancing public goods, and to be less corrupt (Singh and Srinivasan, 2006; Rodden, 2003; Careaga and Weingast, 2003; Ambrosio and Borgignon 2006). While many of the arguments in support of these claims have been made with a view to the national level, they are applied to subnational governments as well. Dependence on taxes is said to create several incentives. First, it is believed to motivate governments to show that they are accountable and govern in the interest of their residents because they want to ensure compliance with tax payments. Beblawi and Luciani (1987, 73), for instance, write that a state that is dependent on taxation "must give credibility to the notion that it represents the common good". As Levi (1988) explains, tax payments are quasi-voluntary and depend on compliance of the taxpayers. And, as Timmons (2005) illustrates statistically at the local level, voluntary compliance with taxes is higher when citizens receive public goods and services they value in exchange for taxes. Thus, to motivate greater compliance and greater government revenues, governments that depend on taxes have the incentive to govern in the interest of their constituents and provide the services they require. Second, if a government is dependent on citizens and businesses for taxation, it has an incentive to increase productivity in its territory in order to secure or raise future earnings (Oates 1972, Olson 2000). This interest in turn provides the government with incentives to collect information about citizen needs and to respond to them, at least to the productive needs of those whom it sees as potential producers of taxable wealth. As Adam Smith (1776 [1904]: V.1.87) explains in *Wealth of Nations*, countries where "the revenue of the sovereign arises almost altogether from a land-tax or land-rent, which rises or falls with the rise or fall of the annual produce of the land […] the great interest of the sovereign […] is in such countries necessarily and immediately connected with the cultivation of the land, with the greatness of its produce and with the value of its produce. But in order to render that produce both as great and as valuable as possible, it is necessary to procure to it an extensive a market as possible, and consequently the freest, the easiest and the least expensive communication between all the different parts of the country; which can be done only by means of the best roads and the best navigable canals." Where this is not the case, "the sovereign does not feel himself so directly called upon to promote the increase, both in quantity and value, of the produce of the land, or, by maintaining good roads and canals, to provide the most extensive market for that produce" (*ibid*).

Shleifer and Vishny's (1998b) study of the differential local government support for the economy in Poland and Russia draws on this logic. Using survey techniques, they find that local governments in Poland are far more supportive of business than in Russia. Shleifer and Vishny attribute this difference to government officials' incentives. They explain that while local politicians have different electoral incentives in Russia than in Poland, their fiscal incentives also differ significantly. In Poland, local governments rely on local taxes and fees (particularly property taxes) so fostering local economic prosperity yields greater revenue. In Russia, by contrast, most local revenue comes from higher levels of government. What is more, the center reduces these transfers when cities increase their revenues. Studies of other countries reveal similar patterns (e.g., Diaz-Cayeros 2007 on Mexico; Singh and Srinivasan 2006 on India; and Zhuravskaya 2003). Although the first design provides incentives to foster local economic development as local governments are rewarded by this with the rise in revenues generated, the second has the opposite effect.

Third, governments are likely to be more prudent with their own income and more wasteful with 'unearned' income or "other people's money", such as revenue transfers from the federal government. As Bird (2002) notes, "So long as local governments are spending what they and their constituents view as 'other people's money,' they are unlikely to be under much local pressure to spend this money efficiently. Smith (1776 [1904]: V.1.76) deliberates that only when public services are directly paid for through user taxes, is it possible to avoid wasteful spending: "A great bridge cannot be thrown over a river at a place where nobody passes, or merely to embellish the view from the windows of a neighboring palace: things which sometimes happen in countries where works of this kind are carried on by any other revenue than that which they [the users] themselves are capable of affording" (also cited in Skinner, 1995). Bahl and Linn (1992: 428), in their authoritative study of local fiscal federalism in developing countries, observe that "grants can make local governments less accountable for their fiscal decisions (they may now increase spending without increasing taxes); hence there will be less incentive to improve the efficiency of local government operations and develop innovative methods of delivering public services".

Taxation also creates incentives for the government indirectly by influencing residents' behavior. If citizens are made to pay taxes, they are relatively more inclined to watch over or scrutinize the government's activities, and to demand representation in government and influence in policy decisions. As Bird (2010) posits, "local residents are more likely to hold officials accountable if local public services are financed to a significant extent from locally imposed taxes and charges as opposed to central government transfers" (p. 20). By contrast, as Ambrosio and Bordignon (2008: 316) write, "If everything were financed with money coming from outside the jurisdiction, citizens living in that jurisdiction would have very little incentive to check how that money was spent."

The reasoning behind this argument is the following. First, as Bird (2010) writes, "People care much more about how their 'own money' is spent than they do about the efficiency with which 'other people's money' -- such as transfers -- is used" (p.20). Thus, if people entrust their local government with their own earnings that they have worked for, they will be more concerned about how the government utilizes it and may also demand more transparency and influence over policy decisions (Ross 2004).

Second, taxation is intrinsically coercive and can be very burdensome on the taxpayers. This can lead to revolt, bargaining or other forms of collective action by citizens in attempts to resist it or control it. In this way, taxation provokes citizen engagement with the state through protest and “provides an opportunity for the creation of consensual and representative government through ‘revenue bargaining’ between states and organized citizens” (Bräutigam 2008, p.3). Di John (2010: 111), for instance, claims that “taxation is the main nexus that binds state officials with interest groups and citizens. Not only can taxation enhance government accountability, it also provides a focal point around which interest groups (such as producers groups, labor unions and consumer groups) can mobilize to support, resist and even propose tax policies.” Besides provoking collective action, a dependence of local governments on their citizens for taxes also gives citizens greater bargaining power to make demands. It may help to shift the balance of power in favor of residents.

The importance of taxation has also been expressed negatively in the literature on the “natural resource curse” and foreign aid. It has been frequently argued that poor governance and impeded development of resource rich states derives from the fact that large alternative sources of income free politicians from the need to tax their citizens. Referring to natural resource rents, Samuel Huntington (1991, 65), for instance, posits that because natural resource rents substitute for taxation, they "reduce the need for the government to solicit the acquiescence of its subjects to taxation" and hence reduce the incentives and necessity of governments to be concerned with the interests of citizens. Bräutigam and Knack (2004) consider foreign aid, another 'unearned' external source, to have an analogous effect and write that it takes away government's need to tax their own citizens and thereby takes away from the citizens´ bargaining power vis-a-vís their government in collective action problems.

Central government transfers have been regarded in the literature as a somewhat external source of revenue for subnational governments, which eliminates or reduces their need for taxation, and is also 'unearned' or at least 'less earned', much like natural resources and foreign aid at the national level. Gervasoni (2010), for instance, terms large central government transfers "fiscal federalism rents".

The connection between the source of subnational government revenue on one hand and the degree of representative, responsive and corrupt governance has been analysed statistically. Gadenne (2013) examines public expenditure in Brazilian municipalities and shows that as the proportion of tax revenue to transfer revenue rises, governments spend more on public goods and less on private rents. Similarly, Brollo, Nannicini, Perotti and Tabellini (2011) find that higher grants from the federal government lead to a rise in the incidence of corruption. In his analysis of Argentine provinces, Gervasoni (2010, 2011) uses both quantitative and qualitative evidence to show that central government transfers are negatively associated with levels of democracy. He argues that such rents allow the provinces to forgo taxation, and thus to restrict democratic contestation and weaken checks and balances.

Tax systems

If local taxes are important, how best should they be collected? Do different types of taxes and different ways of collecting them affect higher-order goals, such as economic growth and political inclusion? The literature differentiates how the type of taxation affects whether government officials choose to foster thriving markets or manipulate them – the difference between Shleifer and Vishny's (1998a) "grabbing hand" and a "helping hand". We discuss three ideas from the literature.

First, to provide the positive incentives outlined above, taxes require a relatively broad base of society. When government officials capture revenue based on broad taxes on economic activity, they have incentives to provide market-enhancing public goods and to create new market opportunities as a means of increasing the fiscal proceeds generated by markets. In contrast, a narrow tax base leads political officials to cater to the specific groups or sectors bearing the tax burden. For instance, when a jurisdiction raises revenue by selling monopoly rights, then officials will choose to restrict markets generating monopolies; further, officials have little fiscal incentive to foster competitive markets in other sectors (Wallis, Sylla and Legler 1997, Weingast, 2009).

Second, taxes need to be visible. If people see more clearly that they are being taxed by the subnational government, they are more likely to hold the government accountable for effective use of their tax money (Bird 2010). According to Grabowsi

(2008), when taxes are visible to taxpayers, they will be more likely to resist them, either directly (through protest or revolt) or indirectly (through evasion). As the government cannot entirely suppress such resistance through punishment or violence, it must reciprocate and provide services in return. One of the frequently cited arguments in favour of replacing indirect taxes such as tariffs with more visible direct taxes in developing countries -- a widespread policy furthered by the international financial institutions throughout the 1990’s and beyond -- was that the direct taxes would enhance the accountability of the government (Mahon 2009).[2]

Third, taxes should be tied to the growth or prosperity of residents, and subnational governments need to have the ability to affect that growth and prosperity. Tiebout (1956), as extended by Oates (1972), shows how the property tax incentivizes local governments to improve public goods in its jurisdiction. Because the value of public goods is capitalized into the value of local property, dependence on property taxation leads city managers to choose public goods that maximize local property values. Moreover, city managers facing intense inter-jurisdictional competition have incentives to maximize property values as a means of inducing scarce capital and labor to locate and remain in their jurisdiction. These specific taxes thus provide incentives for subnational political officials to design policies that foster markets and attract capital and labor (Bahl and Linn, 2002; Fischel, 2001; Glaeser 1996).

The theory that different types of taxes or tax systems affect government accountability, responsiveness and representation differently has also been applied to explain differences in development trajectories more generally. Grabowski

[2] Moore’s (2001) distinction between earned from unearned income is closely related to the idea of visibility discussed in this paragraph.

(2008), for instance, argues that different taxes (resulting from different agricultural models) influenced a divergence in long-run development paths between Latin America and East Asia. “The way a ruling elite raises revenue influences how state institutions evolve over time” (2008: 31). In Japan, Taiwan and Korea, the government relied on a broad based, ‘earned’, direct, and visible land tax that penetrated the countryside. The government repeatedly subdued resistance to tax rises by providing services in return for the tax revenue extracted. The government created, upheld and enforced property rights. It also established a research and extension system to the agricultural sector, and provided access to more productive technologies. In Latin America, by contrast, governments have relied heavily on export taxes. This is a narrow tax that is easy to collect and does not involve the same effort or outreach to the broad population. These governments therefore had few fiscal incentives to provide investment, services, and property rights to the broad population in the Latin American countries examined. Grabowski further shows how counter examples (Costa Rica and Philippines) in the respective regions equivalently fit the theory. Sokoloff and Zolt (2007) similarly argue that differences in inequality across the Americas can be traced back to tax systems (which in turn developed because of factor endowments and other pre-colonisation conditions).

Transfer systems

The scholarship generally views own revenues as superior to central government transfers as a source of revenues for subnational governments in terms of the incentives they create for growth and development. Yet the specific transfer design and how intergovernmental transfers relate to taxes is also important (Faguet and Wietzke 2006, Weingast 2009). Depending on their design, intergovernmental transfers to subnational governments can mitigate or magnify some of the incentive problems connected to transfers outlined above. They can encourage or destroy incentives for promoting growth directly and also indirectly by affecting incentives for tax collection.

Effect on promoting growth and development

Transfers to subnational governments are typically set by a formula that comprises a series of weights for different criteria, including economic and demographic characteristics, such as income and population. However, the attempt to correct horizontal imbalances by allocating more transfers to poorer regions often means that these transfer systems exhibit poor responsiveness to localities that foster local economic growth, and sometimes can even produce completely perverse incentives.

In Mexico, for instance, transfers have been tied to the poverty levels of subnational governments in an attempt to compensate poor regions. This has allegedly created perverse incentive for regional governments to keep poverty levels high in order to receive greater transfers (Diaz Cayeros 1997).

More generally, transfer formulas that are negatively related or only weakly positively related to income growth also provide poor incentives for subnational governments to foster growth and development. For example, in India the Finance Commission's transfers of revenue to states reflect a series of weights for different criteria: around two-thirds is negatively related to a state's income, so that poorer states receive greater funds; 10 percent on the basis of population; and the remainder is somewhat evenly divided among state area, an index of infrastructure, tax effort, and fiscal discipline.[3] This type of intergovernmental transfer system provides poor fiscal incentives for subnational jurisdictions to foster local economic growth: most of an increase in local revenue goes to the center (Singh and Srinivasan 2006).

In some countries, formulas have been fixed with reference to a given year so that the center allocates revenue using the same proportions each year, with the only variable across years being the size of the revenue pool to be divided among subnational governments. If there are *n* provinces, then the average province receives 1/*n* of the total revenue pool, no matter how good or bad its policies. Careaga and Weingast (2003) called the poor incentives of these transfer systems "fiscal law of 1/n."[4] In a country with even a modest number of states, this proportion is quite small. For instance, at times in Mexico revenue from all the states was put in a common pool and then divided by a sharing rule, which meant that for each newly generated peso in taxes, any one of its 33 states would receive only three *centavos* in return.[5] In contrast, fiscal systems that allow growing regions to capture a major portion of new revenue generated by economic growth provide far stronger incentives for local governments to foster local economic growth.

[3] These figures are for the 11th Finance Commission. See Rao and Singh (2005, ch 9, especially table 9.3) and Singh and Srinivasan (2006). The Planning Commission also transfers money to states based on different criteria.

[4] Following the results of Weingast et al. (1981) "law of 1/n"; see also Inman (1988).

[5] The data presented in Shah (1998,136-44) suggest that the figures for Pakistan are less than a third. The data in Rao and Singh (2005, ch 9) suggest that the figures in India are similar.

Zhuravskaya (2000) calculated the marginal revenue retention rate at only 10 percent for Russian cities. For every increase in local revenue, the regional government within which the city is located extracts most of the value of the increase by *lowering* transfers. In contrast, provinces in post-reform China were allowed to retain a high proportion of revenue above a fixed threshold. Jin et al. (2005) calculate that during the high growth period following the initial reforms (1981-92), Chinese provinces on average retained a marginal rate of 89 percent of additional tax revenue generated within the province and that 68 percent of all provinces faced a marginal retention rate of 100 percent. According to Ahmad, Rydge, and Stern (2013: 2), this reform, together with a reduction in the taxation of profits from state-owned enterprises and collectives, “laid the foundations for a remarkable period of economic transformation and growth” (see also Ahmad, this volume).

Courchere (1981) and McKinnon (1997) raise a related incentive problem with transfer schemes that are designed to provide substantial subsidies to the poorest regions in rich countries. McKinnon, for example, contrasts the huge subsidies by Canada to the Eastern Maritime Provinces and by Italy to the Mezzogiorno in Southern Italy with the lack of subsidies by the United States to the American South. McKinnon suggests that the revenue transfers in Canada and Italy create dependency and a soft budget constraint. Transfers allow these regions to finance ailing and inefficient enterprises, seeming to saddle Southern Italy with highly capitalized, loss-making enterprises. The regional economy is far less likely to adapt so that it becomes more like the vibrant national economy. In contrast, southern states in America faced a hard budget constraint and no national subsidies. The poorest region in the United States after the Civil War through mid-20th century, southern states were able to grow rich by redesigning their economies with low regulatory burdens relative to the industrialized North and to take advantage of lower labor costs. This adaptation fostered the booming sun belt economy of the late twentieth century. McKinnon argues that the economic rise of the American South is unlikely to have occurred had it been subsidized in the manner of the Canadian Maritimes and the Italian Mezzogiorno. For this reason, Courchere argues that these types of regional transfers are self-perpetuating.

Krueger (2006) uses similar logic to explain the difference between the vibrant economy in Poland just east of the border with Germany and the lackluster economic performance of the former East Germany just west of the border: massive transfers from the German government have deterred economic development.

Transfer systems may exhibit other perverse fiscal incentives. The intergovenmental transfer system may result in soft budget constraints for subnational governments (Bordignon, 2006; Haggard and Webb, 2004; Wibbels, 2003; Rodden et al., 2001; Dillinger and Webb, 1999; McKinnon, 1997; Sanguinetti, 1994; Kornai, 1986). A soft budget constraint arises when subnational governments believe they will be able to externalise some of their fiscal burdens, such as through a bailout by the national government or borrowing. Subnational governments facing a soft budget constraint have reduced (or no) fiscal incentive to make prudent financial decisions. Some transfer systems are explicitly "gapfilling," meaning that provinces with larger deficits receive larger transfers. Because these systems subsidize spending beyond revenue, they provide subnational governments with incentives to spend imprudently and with discretion.

Transfer systems may also provide poor incentives for subnational governments when they are not linked to clear responsibilities. Wiesner (2003,23) argues that decentralization in Latin America often emphasizes subnational government entitlements to revenue rather than linking them to spending needs or growth: "These frameworks tend to neglect market-based mechanisms and make the capture of large unconditional transfers an easy ride for public sector rent-seeking." For example, Bolivia, Brazil, and Ecuador considerably increased the transfer of revenue without increasing the policy responsibility, allowing subnational governments to use these funds for patronage rather than local public goods (Wiesner 2003).[6]

Effect on tax effort

While fiscal transfers tend to enhance the centralized control (and possible manipulation) of subnational governments, own revenues grant subnational governments independence. McLure (1998, 1) observes that "Subnational governments that lack independent sources of revenue can never truly enjoy fiscal autonomy; they may be –and probably are—under the thumb of the central government". However, raising revenues through taxation is also associated with political costs for subnational governments. Besides creating administrative costs,

[6] The opposite phenomenon is equally problematic – the devolution of authority and responsibility without the fiscal resources to implement it.

imposing taxes is unpopular and may compromise (re)election. It may also drive out residents or business or discourage settlement in the specific jurisdiction (Tiebout, 1956; Salmon 1986). As we argued above, these incentives require that subnational governments carefully devise policies and public goods provision so that taxpayers believe their taxes are worth paying. Between receiving transfers from the central government and raising taxes, subnational governments may thus prefer receiving transfers as a source of revenue. In receiving transfers, subnational governments draw from the common pool and can free ride on the tax effort of others.

Several authors have shown empirically how transfers “crowd out” taxation (Raich Portman, 2008; Cabrero Mendoza, 2006). Some transfer systems, however, include tax effort as a criterion in order to encourage subnational governments to maintain or increase tax revenues. That is, the more they increase their tax collection, the more transfers they will receive. These efforts may conflict with the equalization goals of transfers. Furthermore, subnational officials may still regard the political cost of collection higher than the economic cost of non-collection and simply leave potential government revenues uncollected. In Mexico, the central government collected the vehicle tax from the 1960s until 2007. In 2008 this tax was reassigned to the states. However, despite being a desirable subnational government tax in most other aspects, many states chose not to make use of this tax power and preferring instead to receive their revenues in the form of transfers. In part they are afraid of the political competition effect (See Salmon, 1986; 2013): if neighboring states do not tax or choose a lower rate, people move or will register their vehicles elsewhere, but mainly they are concerned with the political and electoral consequences of collecting the tax.

CONCLUSION

As Schumpeter ([1918] 1978) noted in his famous essay “The Crisis of the Tax State”, fiscal systems shape society and its institutions: “The spirit of a people, its cultural level, its social structure, the deeds its policy may prepare… all this and more is written in fiscal history”. Modern scholarship on fiscal federalism and decentralization continues to recognize that the design of the fiscal system can take a vital role in shaping institutions, and various scholars have since shown how specifically it can do so. In this chapter we have discussed some of the ways in which the design of the fiscal system affects subnational government policymaking and development.

First, when subnational governments are made to depend on own revenue generation rather than relying on central government transfers, they become, ceteris paribus, more responsive to citizens and more willing to provide market-enhancing public goods. This responsiveness is enhanced when the central government assigns subnational governments the power to levy broad taxes on the general economy rather than rely on revenue sources with a narrow base, and when the taxes are tied to the growth or prosperity of residents. As students of fiscal federalism have long known, subnational government reliance on the property tax, for instance, can act as a powerful motivator to improve public services, attract markets, and protect property rights in order to see land values and property tax payments rise (Oates 1972, Tiebout 1956).

Decentralizing taxation powers help ensure subnational governments' responsibility for their actions and give them a stake in the economic development of their jurisdictions. In so many developing countries decentralization processes have expanded fiscal transfers and spending powers to subnational governments, yet have stopped short of decentralizing powers of taxation. Increasing resource transfers to levels of government that are closer to the people, or to poorer regions within a country, may ostensibly appear as an attractive option to alleviate poverty and to help lagging regions catch up. However, as abundant evidence in the literature suggests, this brings with it the risk of poor subnational governmental incentives that perpetuate poverty and dependence on the center. Reliance on such external unearned resources robs subnational governments of the motivation to engage with its residents in order to find out how to help them to produce wealth. Reliance on transfers also dampens the impulse to be innovative in pursuing strategies that create growth from below and to use resources more efficiently and effectively. Evidence shows that this reliance also creates complaisant attitudes and disinterest amongst officials *and residents,* and lead to wasteful management of public finances and corruption. This can have a detrimental effect on growth and development.

Second, the specific design of transfer systems is important. Transfer formulas in particular can either reward or punish efforts at promoting growth and prosperity in subnational governments' jurisdictions. They can encourage spending beyond means or promote prudent fiscal management. By tying transfer formulas to revenue generation, or by allowing subnational governments to retain large portions of any new revenues they generate, for instance, transfer systems can serve as remarkable motivators for subnational governments to embark on wealth enhancing policies, as evidenced by the China in the 1980's and early 1990's. Designers of transfer systems should pay closer attention to the incentive effects inherent in transfer formulas so that transfers do not subsidize freeriding and stagnation but rather support the generation of wealth.

In decentralised settings, fiscal systems comprise a mixture of tax powers and transfers assigned to different levels of government. In designing these systems, central governments must balance various goals such as protecting the poor, ensuring equity among regions, maximizing administrative efficiency of collection and guaranteeing the provision of goods and services to all citizens. The fiscal incentives approach discussed in this chapter shows that the incentive effects that are created through different tax and transfer designs are not to be disregarded. They affect the approach taken by the government leaders that are closest to the people. They are a strong predictor of whether subnational governments tackle poverty and assist development and growth or choose not to.

References

Ahmad, Ehtisham, James Rydge and Nicholas Stern. 2013. "Structural Change Drives Tax Reform Drives Structural Change". Paper prepared for China Development Forum, London School of Economics and Political Science, March 2013.

Ambrosanio, Maria Flavia and Bordignon, Massimo. 2006. "Normative versus positive theories of revenue assignments in federations" in Ahmad and Brosio (eds.) Handbook of Fiscal Federalism. Cheltham: Edward Elgar.

Auty, R.. 2001. "The Political Economy of Resource Driven Growth", European Economic Review 45.4-6: 839-46.

Auty, R. and A. Gelb. 2001. "The Political Economy of Resource-Abundant States", in Auty (ed.) Resource Abundance and Economic Development. Oxford: Oxford University Press: 126-44.

Bahl, Roy W., Linn, Johannes, F., 1992. *Urban Public Finance in Developing Countries*, Oxford University Press, Oxford.

Beblawi, Hazem and Giacomo Luciani. 1987. *The Rentier State*. Croom Helm, Austrialia: Croom Helm Ltd.

Bird, Richard. 2010. "Subnational Taxation in Developing Countries: A Review of the Literature". Journal of International Commerce, Economics and Policy Vol. 2, No. 1 (2011) 139–161.

Bird, Richard. 2002. "Transfers and incentives in intergovernmental fiscal relations". *World Development* Vol. 30, No. 6, pp. 899—921.

Bordignon, M. 2006. "'Fiscal Decentralization : How to Harden the Budget Constraint' in EF. Wierts, S. Deroose and A. Turrini (eds.), Fiscal Policy and Surveillance in Europe. New York: Palgrave MacMillan, pp. 109-136.

Bräutigam, D. 2008. "Contingent capacity: export taxation and state-building in Mauritius". In: Bräutigam, Fjeldstad and Moore (Eds). Taxation *and State-Building in Developing Countries: Capacity and Consent. Cambridge*: Cambridge University Press.

Bräutigam, D. and S. Knack. 2004. 'Foreign aid, institutions, and governance in Sub-Saharan Africa', *Economic Development and Cultural Change*, 52, 255-285.

Brollo, Fernanda, Tommaso Nannicini, Roberto Perotti, and Guido Tabellini. "The political resource curse", January 2010. IZA Discussion Papers, No. 4706.

Cabrero Mendoza, Enrique (2006) "Los Retos Institucionales de la descentralización fiscal en América Latina", CIDE, división de Administración Pública Documento de Trabajo, No 181.

Careaga, Maite, and Barry R. Weingast. 2003. "Fiscal Federalism, Good Governance, and Economic Growth in Mexico," in Dani Rodrik, ed., *In Search of Prosperity: Analytic Narratives on Economic Growth*. Princeton: Princeton University Press.

Caselli, Francesco and Guy Michaels. 2011. "Do Oil Windfalls Improve Living Standards?" http://personal.lse.ac.uk/casellif/papers/brazil.pdf.

Courchene, Thomas. 1981. "A market perspective on regional disparities". *Canadian Public Policy 7*, 506–518.

Díaz Cayeros, Alberto. 1997. "Asignación política de recursos en el federalismo mexicano incentivos y limitaciones". Perfiles Latinoamericanos Vol. 6, no. 10 (jun. 1997).

Di John, Jonathan. 2010. "The Political Economy of Taxation and Resource Mobilization in Sub-Saharan Africa" in Padayachee, V. (editor) *The Political Economy of Africa*. New York: Routledge.

Faguet, Jean-Paul. 2012. *Decentralization and Popular Democracy: Governance from Below in Bolivia*. Ann Arbor: University of Michigan Press.

Faguet, Jean-Paul and Fabio Sánchez. 2013. "Decentralization and Access to Social Services in Colombia." *Public Choice*. DOI 10.1007/s11127-013-0077-7.

Faguet, Jean-Paul and Frank-Borge Wietzke. 2006. “Social Funds and Decentralization: Optimal Institutional Design.” *Public Administration and Development*, 26(4): 303-315.

Gadenne, Lucie. 2013. “Tax me but spend wisely: The political economy of taxes. Theory and Evidence from Brazilian local governments”. ULC Working Paper.

Gervasoni, Carlos. 2010. “Measuring Variance in Subnational Regimes: Results from an Expert-Based Operationalization of Democracy in the Argentine Provinces” In: Journal of Politics in Latin America, 2, 2, 13-52,online: <www.jpla.org>.

Gervasoni, Carlos. 2011. “A Rentier Theory of Subnational Regimes: Fiscal Federalism, Democracy, and Authoritarianism in the Argentine Provinces” World Politics 65, 302-40, April.

Grabowski, Richard. 2008. “Modes of long-run development: Latin America and East Asia”. Journal of Institutional Economics. 4: 1, 25-50.

Krueger, Anne, 2006. The role of freedom, openness and individual enterprise in economic development. Paper given at the Conference on “Freedom and Development,” London School of Economics, May 25–26, 2006.

Levi, Margaret. 1988. Of Rule and Revenue. Berkeley: University of California Press.

McKinnon, Ronald I., 1997. “Market-preserving fiscal federalism in the American monetary union”. In: Blejer, Mario I., Ter-Minassian, Teresa (Eds.), *Macroeconomic Dimensions of Public Finance*. New York: Routledge, pp. 73–93.

Moore, Mick. 2007. “How Does Taxation Affect the Quality of Governance?”. IDS Working Paper 280. Brighton: Institute of Development Studies.

Moore, Mick. 2004. “Revenues, State Formation and the Quality of Governance in Developing Countries”. International Political Science Review, Vol. 25, No.3, 297-319.

Moore, Mick (2001), “Political underdevelopment: what causes ‘bad governance’”. *Public Management Review*, Vol. 3 Issue 3, pp. 385–41

Oates, Wallace. 1972. *Fiscal Federalism*. New York: Harcourt Brace Jovanovich.

Oates, Wallace E. 2005. "Toward a Second-Generation Theory of Fiscal Federalism," *International Tax and Public Finance* 12, 349-373.

Olson, Mancur. 2000. “ In Mancur and Kähköhnen (editors) *A Not-so-dismal Science: A Broader View of Economies and Societies*. Oxford: Oxford University Press.

Prichard, Wilson. 2009. “The Politics of Taxation and Implications for Accountability in Ghana 1981-2008”. Institute of Development Studies. IDS Working Paper Volume 2009, No. 330.

Raich Portman, Uri (2004) “Impacto de la descentralización del gasto en los municipios mexicanos”, CIDE, Division de Economia, Documento de trabajo No.281.

Rodden, Jonathan. 2003. “Reviving Leviathan.” International Organization. (Fall) 57: 695-729.

Ross, Michael. 2001. “Does Oil Hinder Democracy?” World Politics 53 (April): 297-322.

Salmon, Pierre. 2013. “Horizontal competition in multilevel government settings”. Working Paper.

Salmon, Pierre (2006). “Horizontal competition among governments”, in: Ahmad and Brosio (eds), *Handbook of Fiscal Federalism*, Cheltenham: Edward Elgar, pp. 67-85.

Salmon, Pierre. 1986. “Decentralization as an incentive scheme”. *Oxford Review of* Economic Policy 3 (2), 24-43.

Schumpeter, Joseph. 1918. “Die Krise des Steuerstaates”. Reproduced in: Hickel, J.. 1978. (Ed): Die Finanzkrise des Steuerstaates. Beiträge zur politischen Ökonomie der Staatsfinanzen. Frankfurt/Marin, pp. 329-379.

Shleifer, Andrei, and Robert W. Vishny. 1998a. The Grabbing Hand: Government Pathologies and Their Cures. Cambridge, MA: Harvard University Press.

Shleifer, Andrei, and Robert W. Vishny.1998b. “Government in Transition,” ch. 11 in Shleifer and Vishny (1998a).

Singh, Nirvikar, and T.N. Srinivasan. 2006. “Federalism and Economic Development in India: An Assessment,” SCID Conference on the “Challenges of Economic Policy Reform in Asia,” Stanford University, June 1-3, 2006.

Skinner, Andrew S. 1995. “Adam Smith and the Role of the State: Education as a Public Service,” in Stephen Copley and Kathryn Sutherland, eds., *Adam Smith’s Wealth of Nations: New Interpretive Essays*. Manchester: Manchester University Press.

Smith, Adam. 1776 [1904]. An Inquiry into the Nature & Causes of the Wealth of Nations. London: Methuen & co., Ltd. 5th Edition.

Sokoloff, Kenneth L. And Eric M. Zolt. 2007. “Inequality and the Evolution of Institutions of Taxation: Evidence from the History of the Americas”. In: Edwards, Esquivel and Márquez, 2007. The Decline of Latin American Economies: Growth, Institutions, and Crises. NBER Books, National Bureau of Economic Research, Inc, number edwa04-1.

Tiebout, Charles, 1956. “A pure theory of local expenditures”. Journal of Political Economy 64, 416–424.

Timmons, Jeffrey F. 2005. “The Fiscal Contract: States, Taxes, and Public Services.” World Politics (July) 57: 530-67.

Weingast, Barry R. 2009. “Second generation fiscal federalism: the implications of fiscal incentives”. Journal of Urban Economics 65 (2009) 279–293.

Weingast, Barry R. 2013. “Second Generation Fiscal Federalism: Political Aspects of Decentralization and Economic Development”. http://dx.doi.org/10.1016/j.worlddev.2013.01.003