

# The Fiscal Contract: States, Taxes and Public Services

by

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## **Abstract**

What explains the variation in public services and property rights protection around the world? Using a simple model of taxation, I posit that if enforcing tax compliance purely through force is costly and there is some probability that citizens respond to government demands for taxes based on their evaluation of government performance, states have incentives to trade services for revenue. Furthermore, if there are systematic variations in social preferences and the state has different tax instruments, it can cut separate deals with different groups, much like a discriminating monopolist. By acting as a discriminating monopolist, the state can maximize its revenue; in return, however, it accepts self-enforcing limits on redistribution to itself and between groups of citizens.

I test this hypothesis using data from approximately 90 countries from 1975-1999 based on the following assumptions: 1) lower income groups especially want the state to provide basic public services, while upper income groups covet property rights; and 2) “regressive” taxes are the best proxy for taxes paid by the poor, while “progressive” taxes are the best proxy for taxes paid by the rich. Controlling for per capita income and other relevant factors, I show that the more money a state raises from regressive taxes as a percentage of GDP, the more it spends on public health, the longer the average life

expectancy, the higher immunization rates, and the lower infant mortality. The more money a state raises from progressive taxes, in contrast, the better it protects property rights. The catch is that total revenue typically has no effect on public services or property rights, progressive taxes have no effect on social benefits, and regressive taxes have no effect on property rights. In other words, states cater to the people that pay for services. These findings hold for both democracies and non-democracies; the former tax more intensely and provide higher levels of services, suggesting that taxation and representation go hand in hand. My large-N findings are buttressed by a case study of Brazil, where I trace the evolution taxes and spending and show that earmarking has been essential for completing the fiscal contract.

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