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The Taxation Tango: State Capacity in Argentina's Provinces

A dissertation submitted in partial satisfaction of the  
requirements for the degree Doctor of Philosophy

in

Political Science

by

Melissa Ziegler Rogers

Committee in Charge:

Mathew McCubbins, Co-Chair  
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2010

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2010

## **DEDICATION**

Dissertations do not come easily or quickly. I appreciate the patience of my family, friends, and husband from whom I sought advice and support. I also thank them for helping me by editing drafts, offering constructive criticism, and taking care of business on the home front while I trekked through Argentina. My advisors have given me funding, opportunities for research and publication and invaluable guidance in my academic pursuits.

I thank my parents most of all for pushing me to succeed in academia and for encouraging me at my most doubtful moments. They are my favorite people in the world and I only wish that my Mom were still in this world to celebrate with us.

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**FIELDS OF STUDY**

**Major Field: Comparative Politics**

**Secondary Field: American Politics**

## **ABSTRACT OF THE DISSERTATION**

The Taxation Tango: State Capacity in Argentina's Provinces

By

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Doctor of Philosophy in Political Science

University of California, San Diego, 2010

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Most states of the world are ineffective at implementing policy. State capacity to perform these tasks is dependent both on the will of politicians who make laws and the technical capabilities of bureaucracies who carry them out. Existing measures of state capacity do not effectively separate these two sources of capacity failures, leading to uncertainty about the condition of policy implementation in most states. I develop a measure of state capacity based on types of taxes that better captures the theoretical foundations of state capacity. Additionally, in two empirical chapters, I build research designs that enable us to identify politicians' efforts at encouraging policy implementation and observe the weaknesses of bureaucracies to collect revenue and deliver services. Most studies of state capacity understand the problems of bureaucracies to be rooted in politics but do not consider that the reverse might be true—that weak

bureaucracies could themselves affect the political system. I theorize about the role of bureaucracies in the operation and design of political institutions. Specifically, political parties are not able to impose collective discipline and provide inducements for their members in the absence of a quality bureaucracy able to come through on their promises. Parties are thus unable to encourage individual politicians to overcome incentives to behave in short-sighted or localized ways. These innovations in the measurement of state capacity and the analysis of feedback from technical capabilities to party systems are examined in the context of Argentina during its reform era in the 1990s.

## **Chapter 1**

### **Introduction**

As the twentieth century draws to a close, the state will remain center stage, but increasingly it will be the state's difficulties in achieving conformity and obedience that should attract the interest of comparative political scientists. If we are to understand the yawning gap between state rhetoric and performance, our old ideal-typical images of states as successfully imposing uniformity, as building an iron cage, need to be replaced by theories that start with the limitations of actual states. (Migdal 1988; 211)

### **Introduction**

Many states of the world are very ineffective at implementing policy. A quick study of comparative policymaking and comparative bureaucracy clearly reveals that some states cannot or will not implement the policies they claim to want. The reasons for this weak state capacity are not always clear. We can dismiss some underdeveloped states as too poor to have the resources to implement policy. In other places, and even in most underdeveloped states, many of the problems of policy implementation are not easily attributed to resource constraint. Rather, politics and weak administrative capabilities plague states, making them ineffectual governors.

Most policymakers at the head of governments in Latin America, for example, claim to genuinely desire economic development and higher government revenue but they are unable to change either the effectiveness of state agencies at producing these results or the resistance they face from political subordinates. The reasons for this stem from the institutional incentives for politicians to implement tax policy and invest in tax bureaucracies. For instance, provincial governors in Argentina quite reasonably look to the national government to transfer resources into their coffers rather than pressing for

provincial taxation that will only leave them hated by constituents. Even those Argentine politicians that might want to implement such reforms realize that using these resources in the short term will only pay off in the long term and thus will not help their own political careers. Furthermore, Latin American governments, including those at the national and provincial levels in Argentina, do not know enough about the activity of their citizens to effectively extract resources and deliver services to citizens. What is unclear in Argentina, and many other countries, is whether these political causes or administrative challenges, or both, are the true drivers of weak policy implementation. The root causes of policy failures are mysterious in most developing countries due in large part to challenges in the measurement and conceptualization of state capacity.

My dissertation explores these difficulties in the development of state capacity. My central contributions are, first, to parse out the theoretical interaction between will and capabilities and to show how these factors might be separated and measured for research designs in comparative analysis. Second, I develop a theoretical framework to examine an effect of weak state capacity that has not been explored in previous literature. Most works on capacity assume that politicians' poor investment in bureaucracies result in low state capacity. This is true, but weak bureaucracies themselves have a causal effect on politicians' incentives and their policymaking environment. Without the ability to implement policy effectively, the institutions that can enable beneficial policy outcomes, such as political parties, cannot provide politicians with enough positive incentives to promote good policy choices.

Overall, I seek to explain the effectiveness of states at policy implementation by attributing causal weight to both the political origins of capacity development and the

technical capabilities required of a state. I integrate both of these factors into my theoretical framework and measurement of state capacity. I use the testing ground of Argentina's provinces and the reform environment of the 1990s to evaluate my claims

### **Contributions to Political Science**

My dissertation offers several important contributions to the study of comparative politics. Unlike previous literature, I explicitly recognize the role of political will and technical capabilities in state capacity and I theorize about how these factors interact with each other. In particular, I suggest that state capacity can have effects on the operation of political institutions, such as political parties, by limiting the benefits to politicians for sacrificing personal gain in pursuit of collective aims.

The conceptualization of state capacity has also been muddled by the dual causes of political will and technical capabilities. Economists' theories of state capacity recognize that states have difficulty implementing policy and place the onus upon bad bureaucrats. Political scientists argue that politicians are the real reason for poor policy implementation since they do not invest in good bureaucracies and often use them for patronage payoffs. Importantly, measures of the concept do not try to separate these causes. My dissertation provides an innovative methodological approach to evaluate and separate political will and technical capabilities in policy implementation. I identify the links between will and capabilities that flow in both directions. I also demonstrate inventive research designs to locate the source of bureaucratic change. This helps us to know better how to approach and assess capacity development.



Another important contribution of my research is in the measurement of state capacity. I measure state capacity as effectiveness at tax collection. By evaluating provinces on how well they collect the most demanding taxes, I am able to fine-tune an indicator that is often used in comparative literature. I link tax types to the requirements they place on states' technical capabilities so that I can tell, in a much more precise way than in other measures, that I am capturing the effectiveness of the state at implementing policy.

I place information at the center of explanations of effective governance and state capacity. While access to resources, the quality of employees, and the organization of bureaucracies are all important components of policy implementation, information is the input necessary for any policy to be administered. Before a state can get better at policy implementation (such taxes, services, and controlling violence) it needs to know "who is who" and "who does what." I demonstrate that even the most reform-oriented politicians cannot transform their bureaucracies in the absence of quality information about citizens. Information will not be collected unless politicians devote considerable resources and effort toward it.

Political institutions are crucial to state capacity development and reform. I address the consequences of institutional design for politicians' motivations to invest in capacity and, down the line, for policy implementation. Political institutions that structure the time horizons of politicians and press them to invest in a powerful state have strong effects on their efforts to improve bureaucracies. The institutional design of bureaucracies, including the incentives they give to collect, manage, and share information within and across agencies, determines how effectively states can implement

policies. But there is also feedback from technical capabilities to political institutions; poor bureaucracies make reform seem impossible even for politicians with very long tenures.

Related to institution-created time horizons, I highlight the important role of political stability in state capacity. Bureaucracy is a long-term investment; politicians must feel that their project of state improvement will be rewarded in the long term. In countries that have had political and economic upheaval, including regime change, dedication to state institutions can become less important than maximizing returns for politician's immediate political future. Political stability, therefore, is a condition in favor of state capacity development.

This project focuses on understanding and identifying issues of state capacity in sub-national governments. State capacity is nearly always studied at the national level. Many of the policy outcomes that interest scholars, such as security, taxation, healthcare, and education take place primarily at the sub-national level in federal countries. Understanding state capacity in states or provinces, I argue, is vital in federal countries with considerable devolution. This characterizes many of the largest and most influential countries of the world.

These chapters explore the consequences of mismatches between spending and revenue in sub-national governments. Most federal countries have in place a system of federal transfers. In some cases, such as the United States, transfers are primarily used by the national government to influence state policy. In the federal countries in Latin America, transfers are a collective good for which sub-national governments fight to get their share. Their share is largely based on political power, not effort or ability to

produce government revenue. Fiscal federalism creates strong incentives for sub-national politicians to acquire these resources rather than develop the capacity of their own government to extract and administer resources to citizens. Fiscal federalism of this type is a political institution that hinders state capacity.

### **My Theoretical Framework**

State capacity is effectiveness at implementing policy. The chain of causality in developing state capacity, in short, is this. Depending on their incentives, politicians legislate policy and provide resources and direction for the bureaucrats who implement it. Bureaucracies, for their part, must possess the administrative skills and have the tools to put policy into place. Politicians' incentives are shaped by the institutions that guide their political careers, and by the effectiveness of the bureaucracy itself. Accordingly, state capacity demands both political will to implement policy and the technical capabilities of bureaucrats to put it into place, and these causal factors interact within the process of policy making and implementation.

Political institutions structure political will through the incentives they give to politicians. In particular, politicians need to have inducements to invest in long-term goals to see the value of bureaucracies. Political institutions drive politicians' will to implement policy. Bureaucracies do not become effective overnight, so politicians must anticipate rewards for devoting scarce resources toward this project. Thus political institutions which incentivize long time horizons, such as the possibility for reelection, long terms in office, institutionalized political parties, and a stable regime all make investment in bureaucracies more likely. Moreover, institutions must orient their

politicians to develop and maintain a high quality state. Politicians' will to implement policy determines the quality of bureaucracies.

Once policy moves from the legislation to the implementation stage, it becomes the domain of bureaucracies. Bureaucracies rely on information about society to implement policies. Every type of policy, from taxation to education to healthcare, requires extensive information about citizen demographics and behavior to implement. Information is the crucial component to technical capabilities of bureaucracies; they must have the means to collect information through interactions with citizens and manage it with a good organizational structure.

Political will and technical capabilities also have a feedback mechanism that reverses the causality of these factors. Once bureaucracies are in place, politicians factor in the effectiveness of their bureaucracy in policy decisions. Politicians invest more in their bureaucracies if they believe that those resources are likely to help their political careers. A weak bureaucracy harms the policy environment because legislators and other policymakers do not have a wide range of policy options or faith in the process of implementation.

In the chapters that follow, I trace the roles of political institutions and information in the development and reform of bureaucracies in Argentina's provinces. In every province, some of these conditions are lacking and in all of them, politicians struggle with incentives to invest in good policy. I demonstrate that, with changes in politicians' will to implement policy, policy implementation improved. I show how both a change in the orientation of politicians toward investing in their provincial states and allegiance to political parties influenced politicians' motivations and the existing level of

provincial bureaucracies weighed in governors' choices on whether to attempt capacity-oriented reform. Moreover, I show that the quality of information collected and managed by a province had strong effects on their ability to implement policies.

### **Concepts in the Dissertation**

My dissertation addresses four large concepts in comparative politics: state capacity and bureaucracies, taxation, federalism and presidentialism. Each of these concepts reflects directly on the functioning of the state.

#### State Capacity and Bureaucracies

Nearly everything political scientists care about, including such outcomes as war, economic growth, and modernization, depends on the state's ability to implement policy. More specifically, all policy is implemented through bureaucracies. In political science, bureaucracies are often overlooked in favor of legislatures and presidencies. Bureaucracies are at least as important to consider as these policymakers since they only pass bills and then look to the bureaucracies to implement them. Even in the sparsest of states, bureaucracies are important in the lives of citizens and the longevity of the regime because of their important role as collector of revenue and deliverer of services.

Moreover, state capacity is a "hot topic" amongst policy scholars and international organizations. As Heredia and Schneider (1998) explain:

In the 1990s the need for capacity-building reform and "good government" rapidly became a focal point in analyses of development. Administrative reform also became part of a new Washington consensus, especially among the World Bank, Interamerican Development Bank, and the International Monetary Fund. The World Bank devoted the *World Development Report* for 1997, *The State in a Changing World*, to demonstrating how important bureaucratic capacity is (4).

State capacity is thus an important topic to examine to ensure that the interventions by international organizations are taking the correct approach and, once they are in place, to measure their effects.

### Taxation and State Capacity

Taxes are the foundation for the modern and ancient state. Every single function of a state requires money that usually comes from taxes. Even the earliest recorded states and civilizations collected taxes to fulfill their common tasks. Taxation is highly intertwined with state capacity and a powerful measure of overall policy performance.

In theory, the effectiveness of a state at implementing policy might be measured with indicators of any policy a state pursues. However, states vary widely in the kinds of policies they seek to administer, in their dedication to those policies, and in their comparability. Taxes are the best indicator of whether the state can implement policy because if it wants to do anything, it should want to secure revenue. States have the unequivocal motivation to secure revenue and thus should show their best effort at doing so. Weyland succinctly describes these important qualities of taxation:

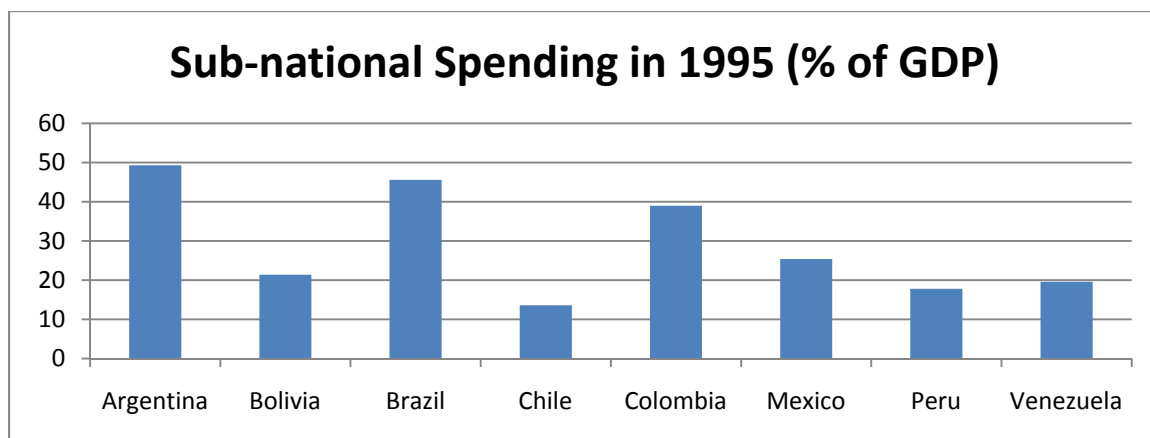
State capacity is visible through taxation and taxation is fuel that allows states to exercise and develop capacity. Taxation is thus a core task of the state; all states should devote a high level of effort to fill their coffers even during economic crisis or social disturbance. If a state has capacity to implement policy, this should be visible in the effective collection of taxes (Weyland 1996).

Taxes also reveal the importance of the causes of state capacity, including political institutions and information. Taxes are based upon interaction with citizens. Political institutions structure state-society interaction. The information they collect through interactions enables bureaucracies to collect revenue. An extensive literature in political science and economics has demonstrated the importance of taxation as a crucial

linkage between state and societal actors. States must provide services to citizens in exchange for tax resources and states must therefore interact with citizens to monitor economic behavior, collect and spend tax resources.

### Federalism and Sub-national Politics

Sub-national governments are important policymakers in federal states. If we care about policy outcomes, in a federal country we must look to sub-national governments. In Argentina, for example, nearly 50% of policy spending takes place at the sub-national (provincial or municipal) level (Schwartz and Liuksila 1997). National policy outcomes in Argentina are so intertwined with provincial government action that the two cannot be easily separated.



Source: International Monetary Fund Government Finance Statistics Yearbook 1996.

**Figure 1.1: Sub-national Spending in Latin American Countries**

Argentina is not unique in the importance of sub-national governments in governance and spending. In Figure 1.1, sub-national spending is listed as a percentage of GDP for the largest countries of Latin America. Argentina is shown to be on the high

end for sub-national spending in Latin America, but it is comparable to other federal countries like Brazil and the United States. Even though Argentina spends more than its Latin American counterparts at the subnational level, the chart reveals the broad importance of finances outside the capital, even in unitary countries. Colombia spends nearly 40% of its GDP at the sub-national level despite being a unitary state; Bolivia and Venezuela also have levels of sub-national spending comparable to a federal state. In sum, sub-national spending is an important factor in comparative governance and in national macroeconomic conditions.

Sub-national governments are important in every area of policy implementation; they are responsible for security, taxing, education, health and more in federal countries and often in unitary, centralized countries. Essentially every policy we care about, besides external defense and international trade, are conducted in significant part by sub-national governments. Even those policies that are specifically national in scope must often interact with sub-national governments in federal countries.

### Presidentialism and State Capacity

The case of Argentina and its provinces reflects strongly upon the role of presidents in state capacity. Studying Argentina offers an examination of state capacity in a strong presidentialist system. Strong presidentialism means this office has significant constitutional (policymaking) and partisan authority (Mainwaring and Shugart 1997). Constitutionally, the president is the head of executive agencies in Argentina, including tax authorities, making her critical to any discussion of policy implementation in the country. Also, presidents have strong effects on macroeconomic trends through the



policies set by their economic ministers. Presidents are primary actors in provincial affairs as well, since most policy between the federal and provincial levels of government are negotiated through her. As the head of her party, the president also has some tools to impose capacity-oriented reforms upon co-partisans. This is apparent in the trends of compliance with the 1993 Fiscal Pact examined in Chapter 5. The political institutions that impact Argentina's state capacity, such as fiscal federalism, political career paths, and party allegiance are intimately connected with the power of the president. Importantly, my research suggests serious constraints to the constitutional and partisan powers of even the strongest president in a state with weak capacity.

### **Why Argentina is a Testing Ground for My Theoretical Approach**

The aim of my dissertation is to explore my theory of state capacity, institutions and information using a strong research design. The basic theory should be generalizable to all nations and the research design is particularly applicable to federal nations, Latin American countries and the developing world. Argentina is a developing nation with administrative difficulties that hinder state capacity. Argentina shares problems of poor information about citizens and weak capabilities to implement policy with most nations across the world. Related to this, many of Argentina's institutions hinder political will to implement certain policies, particularly those that would create a more efficient state. These challenges of political will for good policy are common to nearly, if not all, countries in the world.

The choice of a federal nation makes the study broadly comparable to both large, federal nations and smaller federal or unitary nations. Argentina's provinces are

independent political jurisdictions with great responsibilities in policy making for the nation. Particularly following decentralization in 1990s, provinces are tasked with duties that require strong capacity to implement public policy. The diversity across Argentina's provinces is great enough that some provinces could be usefully compared to developed nations and others to developing or underdeveloped nations. The structure of their economies varies quite widely as well. Some provinces are heavily industrialized, some are largely service-based economies, many are agricultural, and a few garner much of their productivity from natural resource extraction. The province of Buenos Aires, in particular, has greater population, economic activity, and diversity than most Latin American nations. I argued earlier that sub-national governments are highly consequential to comparative politics in their own right. Moreover, they have political institutions and policymaking responsibilities similar to countries. The lessons of sub-national governments' experiences with state capacity are broadly comparable to those of national governments.

Sub-national comparisons are particularly useful for the type of historical politico-economic analysis I perform in this dissertation. The provinces experienced a common political and cultural history but have important variation in provincial governance, economic development, and the structure of their economies. The variance across nations on these processes may be quite large over time, and vary considerably with differences in institutions and economic experiences. By comparing provinces of the same country, I am able to hold constant the effects of changes to national institutions, regimes and economic experiences on provinces, making them more comparable than cross-national studies.

At the national level, Argentina may be dismissed as a special case in state capacity, particularly in regards to tax collection. Argentina is considered to be poor at collecting taxes relative to its level of development (Bergman 2003). Accordingly, it may not be considered a generalizable case for other upper-middle income countries. I argue that the generalizability of the Argentine case should not be dismissed, however, for two primary reasons. First, Argentina's development has been very uneven; to lump all of Argentina under the same development category belies considerable differences in economic structure between provinces. The divergence between the industrialized provinces surrounding the federal capital and the remote province of the north is clear. These provinces can be taken separately and compared to countries with similar development.

Second, the other federal nations of Latin America have similar difficulties taxing because of disincentives in state-federal tax collection and sharing. Argentina is broadly comparable to these cases and federal systems in other regions. In either case, I suggest that the dynamics that challenge Argentina's ability to tax are common to all countries. Although Argentina may be on the weaker end of the taxation spectrum it is still comparable to those countries with better or worse capacity. Even more, Argentina is a "hard case" for political will and state capacity since institutions give short time horizons, considerable political and economic instability, and fiscal federalism provides little incentive to invest in bureaucracies. Thus, it is useful to observe changes in capacity here to see how reform might come about in similarly challenging environments.

This study focuses on the 1980s and 1990s in its empirical analysis, though much of the data reaches back to 1959. The cross-provincial and case study chapters draw data

from Argentine government sources that are not readily available for extending the study further in time. Historical discussion and data are infused throughout the dissertation, however, to better understand the developments that led to the current economic and institutional situations. Although the data are somewhat limited, the nearly 50 years covered in the statistical analysis contain notable diversity in regime type and economic fortune. Argentina's history is marked by change in regimes and leaders and fluctuation in growth and debt rates. The recent decades are a good example of this instability.

Economic and political instability have strong effects on the operation of Argentina's political institutions. Politicians are often reluctant to invest in bureaucracies because they cannot be sure that they would reap any rewards. Immediate political survival became focal over long-term planning in the face of threats to the regime and the ever present threat of economic collapse.

In sum, Argentina is a fruitful area of study because of its internal diversity and dynamic policy environment. The policy changes that I document in the empirical chapters, along with the interviews and observations captured during field research, lend considerable support to my theoretical framework.

### **Roadmap of the Dissertation**

My dissertation will proceed as follows. I will begin with a theory chapter entitled "Politicians' Incentives and Bureaucratic Quality" where I argue that the state capacity literature is generally scattered and divided between those who find political will consequential and those who see technical capabilities as all important to policy implementation. Few scholars combine these two factors and none show how they

interact in real world situations or provide measures that separate them for their effects. Moreover, absent in the literature is a discussion of the feedback between these two factors in capacity, particularly how weak technical capabilities can further stifle capacity development through their effects on political institutions. I argue that political institutions and the collection and management of information about citizens strongly affects these components. I ground my theoretical arguments in academic literature about political institutions, state access to information, bureaucracies and time horizons of leaders.

In the chapter entitled “Identifying and Measuring State Capacity,” I lay out the methodological tools I use for the subsequent empirical chapters. I explain the taxation measures that I employ throughout the dissertation. These are unique in comparative literature, so I weigh them against existing measures and explore their theoretical validity. With these theoretical and methodological frames in mind, I detail the conditions for each of these factors in Argentina. I show that Argentina’s leaders have, in most cases, short time horizons because they do not often expect reelection and fear for the stability of the regime itself. Also, the design of institutions, such as fiscal federalism, discourages politicians’ investment in developing the capacity of the state. Where politicians do invest in capacity, they are encouraged by institutions such as long-standing parties, or by policy changes at the national level, such as the Convertibility Reforms, that give them no choice but to attempt to strengthen the state’s policy implementation. These institutions, however, are constrained in important ways by existing capacity.

In my large N, cross provincial chapter entitled “When the Well Dries,” I deeply explore the will and capabilities dichotomy and show an innovative way to measure these components. Argentina’s provinces have very little incentive to collect provincial taxes because they get most of their revenue from the national government and rely on inflation and debt to cover their other expenses. These motivations changed markedly in 1991 when President Carlos Menem introduced the Convertibility Reforms which stifled inflation and eliminated important sources of loans to the provinces. I use an interrupted time series design to measure changes in tax revenue that resulted from changes in provincial politicians’ will. Argentina’s provinces, once they were forced to collect more of their own revenue, devoted more effort toward collection and tax revenue went up in all provinces. The technical capabilities of the provinces mattered in how much they improved and on what taxes. Some taxes, such as those on real estate and contracts, require much greater technical capabilities than easier taxes such as those on automobiles. The provinces with better access to information about citizens showed much more improvement in these difficult taxes than less informed provinces.

My second empirical chapter entitled “Governors’ Calculations” focuses on the institutional and informational origins of state capacity and the feedback between bureaucratic performance and politicians’ incentives. In 1993, Argentina’s provinces and the national government agreed on a fiscal pact to reform the tax system of the provinces. The national government pressed for these reforms in exchange for a minimum guarantee on federal transfers. Provinces’ responses to these capacity-oriented reforms varied in predictable ways depending on their institutional incentives and access to information. The most important institutional determinant of compliance with the Fiscal Pact of 1993

was allegiance to the Peronist party. Even though the tax reforms were painful in the short term, the long-term incentives of the Peronist party and politicians' desire to stay in their party's good graces pressed them to change their tax systems. Technical capabilities mattered in crucial ways and interacted strongly with political institutions. Even some Peronist-led provinces were not able to reform their taxes, however, because they could not make up lost revenue. These reforms required provinces to eliminate inefficient yet easy taxes to enforce. The provinces with low technical capabilities, even if pressed by their party, would not reform because the benefits provided by national government were not enough to make up for their weak provincial revenue collection. My field research in Argentina's provinces also showed that bureaucrats were strained by politicians, politicians were reluctant to invest in bureaucracies because of their weak access to information, and political parties have limited means to encourage collective outcomes.

In the conclusion chapter, I sum up the lessons I learned in my field work and in the theoretical and methodological explorations of my dissertation. I use these lessons to elaborate on the policy implications of my work. I argue that many extant reform initiatives to improve state capacity in developing states are too narrow or their locus of activity is misplaced. Neither isolated focus on bureaucracies' technical capabilities nor politicians' incentives to improve policy implementation will be sufficient to drive changes in states. Both areas need to be improved simultaneously so that politicians see an incentive to invest in bureaucracies and bureaucracies are skilled enough at the collection and management of information to deserve politicians' efforts. Of course, tremendous challenges to capacity remain. It is not easy to change the time horizons of politicians or establish responsible parties. It is likewise difficult to make a previously

uninformed, out-dated bureaucracy newly effective. Hopefully, even small approaches can build upon each other to eventually tip states out of a low-capacity equilibrium.

## **Conclusion**

During my field work in Argentina, I experienced the implications of weak state capacity. One funny incident in the province of Catamarca brought this home for me.

Argentina has weak credit markets and few citizens regularly use credit cards other than for large purchases. Cash, therefore, is a necessary part of nearly every transaction made on a daily basis for Argentine citizens and this can make lines for the ATM incredibly long. In my informal survey of ATM lines in Argentina's provinces, I found that the weaker the provincial bureaucracy, the longer the line. The lines in the province of Catamarca were unconquerably long on Friday paydays.

On a Saturday morning, after giving up on the day before in Catamarca, I found an ATM line with only four people waiting. I rushed to get in the line, seizing the rare opportunity. I was in the line for around 30 seconds before I heard a woman beneath a tree nearby yell to me "la cola está aquí"—the line is over here. I looked under the tree to find 14 more people waiting underneath in the shade on that very hot day. I decided to get in the back of the line to get cash because any line fewer than 20 people seemed pretty good in Catamarca. While I was in the line for 20 minutes, I saw no fewer than three cars come to a screeching halt to have their passengers exit to get in what appeared to be a four person line for the ATM. Five people that I counted came at a full sprint, one with a baby in her arms, to get in this short line. Several more people, arriving at a



normal cadence, made the same mistake I did and were directed to the queue under the tree.

This incident shows just one of the complications of poor state capacity. Argentina's bureaucracies' weak access to information about citizens makes banks unwilling to offer credit to private citizens. After all, if banks do not know much about prospective clients, they cannot assess the likelihood that they will pay back debt. Since Argentina's political institutions do not encourage investment in quality bureaucracies that collect and manage information about citizens, the state is not effective at policy implementation and both citizens and the state suffer. In the chapters that follow, I show theoretical origins of weak state capacity and offer theories and measures for why we see this condition in modern states.

## **Chapter 2**

### **Politicians' Incentives and Bureaucratic Quality: A Theoretical Framework for Understanding State Capacity**

“Unlike most premodern political structures, the state has aimed to impose uniform and ultimate conformity on social life within far-reaching (but still circumscribed) boundaries: Its leaders have sought obedience in even the most personal realms of social interaction, from whom one might sleep with to how one must bury the dead. Compliance to these sorts of social norms was not new, but the claims of a single centralized organization to enforce such norms over huge territorial expanses were novel almost everywhere they were made. And, indeed, one can point to real cases in which this kind of micro-regulation has been successfully achieved. Astonishingly, some states have been able to garner from people’s yearly earnings a share equivalent to all their work performed through April or May or, sometimes, even June of that year and to sequester their children for 30 or so hours a week in a state institution.” (Migdal 1988, 209)

#### **Introduction**

State capacity provides a key to understanding policy outcomes. Well-meaning attempts to reform or transform a policy environment are only as valuable as a state’s means to carry through its programs. State capacity, therefore, is important to understand conceptually and theoretically. The theoretical argument of my dissertation is that state capacity is driven by both political will and technical capabilities and the interaction between these two factors. Political institutions structure politicians’ incentives and thus their will to invest in the technical capabilities of their bureaucracies. Once in place, the quality of bureaucracies shape political institutions, thus having their own causal effect on politicians’ motivations. My contribution to the literature on state capacity are in the measurement of these concepts, discussed in the next chapter, and in the explicit theorizing about the feedback from technical capabilities to political will, the focus of this chapter.

To begin, I lay out my assumptions about the role of political will and technical capabilities in state capacity. Next, I lay out two primary hypotheses that guide my understanding of state capacity. My first hypothesis is that institutions, such as those that extend politicians' time horizons and promote collective goods, give politicians incentives (will) to improve their state, particularly by investing in the technical capabilities of bureaucracies that implement policies. The technical acumen of these agencies depends on how well they collect and manage information. My second hypothesis is that where bureaucracies have long been established, this arrow of causality may also be reversed. Politicians' will to improve bureaucracies can be influenced by their technical capabilities because politicians make choices about investing in their bureaucracies based on their extant capabilities. This hypothesis is new to the literature on state capacity. Political scientists have not explicitly theorized about the possibility that poor bureaucracies can themselves improve or degrade political institutions, such as party systems.

### **Place in the Literature**

Almost all theorizing on politicians' delegation to bureaucracies assumes state capacity. Huber and McCarty (2004) argue:

The main problem is that existing theories typically assume that bureaucrats are "Weberian" – they are a highly professionalized cadre of state officials who can usually take actions that will further their goals. In developing countries, bureaucrats hardly fit this mold. The problem for politicians in such places is not how to create appropriate incentives for high-powered bureaucrats. Instead, the problem is how to make policy when bureaucrats are known to lack capacity (481).

The assumption of high quality bureaucracies leaves the scholar of the developing world at a loss to explain their environment for policy implementation. We must go back to the beginning, to make variables of what are constants in the developed world.

Politicians respond to incentives in their pursuit of policy. They work hard to better their political prospects, aggressively seeking reelection or their next political office (Mayhew 1974; Samuels 1998). The policies that they support and those in which they invest their scarce political resources must help them to achieve these goals. This can happen directly, such as when an implemented policy translates directly into votes from constituents, or indirectly, such as when voting with a political party leads that group to support their campaign (cf, Snyder 1990; Cox and McCubbins 1993). Similarly, investment in policy implementation comes about because it is helpful to the politicians.

Politicians cannot implement policies themselves; they must delegate to bureaucracies to get the job done. Bureaucracies depend almost entirely on their political principals for the funding they need, their organizational structure, and the quality of the employees they attract. In this way, politicians, guided by the incentives of their political institutions, decide whether and how much authority and resources to delegate to bureaucracies. These structuring institutions may include political parties (cf. APSA 1950; Kiewiet and McCubbins 1991), rules for reelection (cf. Ames 1995; Jones et al. 2002), fiscal federalism (Tommasi and Spiller 2007; Weingast 1995), and the size of districts (cf. Carey and Shugart 1995; Cox 1987), among many others.

In the developed world, the bureaucratic delegation problem for politicians is whether their bureaucrats will faithfully represent their interests (cf. Epstein and O'Halloran 1994; Bawn 1995; Huber and Shipan 2002). The chain of causality I have

just described stops here in most bureaucracy literature. However, the absence of state capacity adds a new link to the chain that is much less discussed in comparative literature on political institutions. Most scholars of the developing world have recognized that, in addition to concerns about agents' loyalty, its politicians must fundamentally be concerned with whether the bureaucracy is competent enough to implement the policy (cf. Rauch and Evans 2000; Geddes 1990). Few scholars have acknowledged that this weak bureaucratic environment might flow back to the political institutions that spawned it. Going back to Huber and McCarty's quote, it is not just theories of bureaucracies that assume they are Weberian. Theories of parties and most other political institutions presume the same without consideration for how their absence could shape the policymaking environment. My contribution to the theoretical literature on state capacity is to recognize this feedback from technical capabilities and political institutions, especially political parties, in the process of capacity building.

### **Theoretical Assumption and Hypotheses**

Policy implementation requires the action of many actors, most importantly politicians and bureaucrats. Both of these actors must have incentives to implement policy and the tools to do so. This is a primary assumption of my theory and one that I focus on here and operationalize in the cross-provincial chapter.

*Central Assumption: Political will and technical capabilities are both necessary for state capacity*

Political will, as it relates to state capacity, is incentive to invest in high quality bureaucracies. While it may seem obvious that politicians should want their

bureaucracies to be capable agents, their efforts are highly conditioned by the institutional environment in which they operate. Politicians may either not invest in bureaucracies because they lack resources to devote to them or because those bureaucracies will not further their political goals. Since bureaucracies are dependent upon the resources and the structures imposed by politicians, in the absence of political support, bureaucracies will not be able to effectively implement policies.

On the other side, politicians cannot implement policies without bureaucracies that have the administrative skill to follow through on their wishes. Thus, bureaucracies need to be technically capable of putting politicians' plans into action. This requires bureaucrats skilled in their trade, organizational structures that reward good performance, and coordination across agencies. Therefore, I assume that poor policy implementation can be the result either of lack of political will or of deficiencies in technical administration, or both. Good implementation requires both of these inputs.

Since political will and technical capabilities are both necessary for policy implementation, it is crucial to understand how they come about and how they are related. In Hypothesis 1, I suggest that, in their initial formation, political will drives the creation and maintenance of technical capabilities. Once bureaucracies are in place, their technical capabilities have a causal effect on political will as well, as I argue in Hypothesis 2.

*Hypothesis 1: Institutional Incentives → Political Will → Technical Capabilities*

My basic theory of policy implementation is shown in the diagram above. Simply described, institutional incentives structure politicians' will to implement policy.

Politicians' will to implement policy drives their investment in their bureaucracies. I elaborate on each link in this chain of causality, in turn.

Sub-hypothesis 1: Institutional Incentives → Will

The first stage requirement is for politicians to find it in their interest to invest in policy implementation. In other words, politicians must have incentives to support state action. These incentives usually relate to their career goals; politicians use their time and resources toward the activities that will get them reelected or increase their chances of gaining the next political office they seek. So, only politicians that connect effectiveness at policy implementation to their futures will likely support high quality bureaucracy.

Accordingly, we must look at the conditions and institutions that influence politicians' incentives. These are the institutions they work within and the stability of their political environment. Put simply, politicians must have reasonable expectations that their investments in the state will pay off for them in the long run. The institutions that promote investments in the state are ones that extend the time horizons of politicians and that connect state effectiveness to political success. The primary institution that promotes these incentives in most polities is political parties. Many institutions can undermine these incentives, including fiscal federalism, certain electoral institutions, and the very instability of regime institutions.

Sub-hypothesis 2: Will → Technical Capabilities

When politicians see the value of policy implementation and feel that they can affect its success, they will invest in the bureaucracies that produce these results. The

ways that politicians do this are by devoting resources to fund their activities, monitoring hiring practices to ensure quality and merit, structuring the organization to align their interests with managers and employees, and promoting cooperation across agencies.

Devotion of resources toward good agencies is an investment in quality information gathering. Cultivation and management of information is the primary task of bureaucracies because it is the foundation for the implementation of all state policies. The more a state knows about its citizens and their activities, the better the state will be at implementing policy. Better state information means greater volume, accuracy, detail and organization of knowledge about citizens. With quality information, bureaucrats are able to identify the needs for policy, locate the recipients, and evaluate the effectiveness of policy. This is critical to understand, in particular, for the purpose of measuring state capacity, as I describe in the next chapter.

The chain of causality I have described above attributes political origins to technical capabilities. This, in general, is the way I argue that capacity is built. Politicians see a need for their state to implement policies and they devote the resources and effort to build bureaucracies to make this happen.

Once bureaucracies are in place, however, the causal connection of political will leading to technical capabilities becomes more complicated. Specifically, the existing technical capabilities of a bureaucracy itself become a factor in politicians' will to invest in bureaucracies. Since politicians are not endowed with unlimited resources, they must decide if what they could offer a bureaucracy could make it more effective. Moreover, politicians must have a reasonable expectation that they will see improvements in a bureaucracy in the time span of their political career or that of their patron party



organization. The ability of the state to deliver services are crucial carrots and sticks available to the political institutions that promote collective outcomes in democracies. The absence of a state able to implement policies severely constrains the functioning of these political institutions, especially political parties, to promote collective goods and long term policies. This leads to hypothesis 2, technical capabilities affect political will.

*Hypothesis 2: When bureaucracies are in place, technical capabilities affect political will*

This hypothesis may be seen as an addendum to the first. Political will continues to drive investment in bureaucracies in the present, but as bureaucracies are established, their technical capabilities become a confounding factor affecting political will.

Expectations about bureaucracies' ability to implement policy affects the range of policy choices available to policymakers and thus determines some of the tools available to political parties to lengthen politicians' time horizons and promote collective outcomes. Low technical capabilities, in particular, can feed back into the operation of political institutions, thus further undermining the development of quality bureaucracies.

With these theoretical hypotheses in mind, in the next sections I elaborate upon the definition of state capacity and I use supporting literature to expand upon the causal chain I have just described. Where possible, I provide concrete examples of how these processes work in developing nations.

### **State Capacity**

My definition for state capacity is the ability of a state to effectively implement the policies they pursue. This definition is dense with terms and components, so I will explain each in turn. First, state capacity refers to the capabilities of a state, especially

the administrative skill and coordination of their bureaucratic agents. Laws passed in the policy process are only as effective as the bureaucracies instructed to carry them through. If bureaucracies cannot handle the technical process of implementation, including managing the distribution of state goods and coordinating implementation across geographic and bureaucratic jurisdictions, this state lacks in capacity.

Effectiveness at implementation is an assessment of the outcomes of policy. If agencies meet self-imposed or objective standards of quality, this is effective policy implementation. Put concretely, policy outcomes that reach the desired number of people, give the desired quantity and quality of product and do so with minimal waste of government resources is considered effective. Of course, no truly objective rubric of policy implementation is possible for most countries or policies. However, most countries internally assess their policy outcomes, within the implementing bureaucracy itself or an oversight agency (such as the U.S. Government Accountability Office) and they know whether a policy has been successful at meeting goals.

Importantly, I specify capacity relative to the policies that the states themselves pursue. This means that a state should not be considered to have low capacity if it does not aggressively pursue policies that we might see as universally good, such as public education or health care.

Policy goals vary by country, depending on societal and cultural preferences. Moreover, a disconnect between laws passed and policies implemented is certainly possible and even likely. For example, some developing states have passed laws to appease international development organizations or banks. Some of these laws do not meet the electoral incentives of the politicians that passed the laws or the preferences of

their constituents. As such, bureaucrats that did not execute those policies were being faithful agents to their political principals. This “political will” of policy implementation is critical to all concepts of state capacity but it is rarely confronted in policy literature, particularly in measures of state capacity.

State capacity is defined in many different ways in political economy, economics, and policy literature. Within the diversity of definitions and focus, all are centrally concerned with effective policy implementation (Weller and Ziegler 2009a; Ziegler and Wallack 2009). My definition of capacity is thus inclusive of other works in the field but also neutral, in a normative sense, and it usefully complicates the notion by addressing the role of political will in any policy implementation.

Many alternate definitions of capacity focus on administrative capabilities of the state. Their theories of capacity depend upon the skill of the bureaucrats themselves, the control of the bureaucracy by politicians, and the incentives for bureaucrats to implement policy (c.f., Geddes 1994, Huber and McCarty 2004). State capacity, in these formations, is effective policy implementation that is caused by well-funded, highly trained and structured bureaucratic agencies. This is an important component of state capacity, but I find it too narrow to understand policy implementation at a macro level. I incorporate these theories into my broader theoretical framework by relating the institutional incentives of politicians to technical capabilities.

### **Central Assumption: Political Will and Technical Capabilities are Both Necessary**

State capacity is an elusive concept because it is very difficult to distinguish a state incapable of implementing policy from a state unwilling to do so (Geddes 1994;

Acemoglu and Robinson 2006). Below is a table detailing the theoretical relationship between will and capabilities in state capacity. In the column axis, states are separated based on their desire to implement policy and divided by their technical ability to do so in the rows. Table 2.1's entries highlight the conceptual challenge to identifying weak states. Because both will and capabilities can derail capacity, three out of four conditions result in low capacity. States that lack either will or capabilities, or both, will appear equivalent when compared based on policy outcomes.

**Table 2.1: State Capacity Outcomes Depending on Capabilities and Will**

<b>Technical Capabilities</b>	<b>Will</b>	
	<i>Yes</i>	<i>No</i>
<i>Yes</i>	High State Capacity	Low capacity
<i>No</i>	Low capacity	Low capacity

In reality, poor policy implementation that results from bad bureaucrats or bad politicians will appear the same, from the outside. Barbara Geddes' works provide examples of these two situations. She shows the failure of political principals when she demonstrates that the leaders in the Chilean bureaucracy in the 1970s certainly had the policy expertise to nationalize the copper mines but the incentives for politicians to use related posts as patronage lead to their mismanagement (Geddes 1994). She juxtaposes this to Brazil in the 1930s when bureaucrats could not find the documents they needed to determine how much money their country owed to foreign lenders (Geddes 1990). Good principals and good agents are both needed for effective policy implementation. The crucial role of political will must always be considered when evaluating policy implementation.

State capacity literature typically addresses the challenges of will and capacity separately. Economics literature tends to focus on the challenges of bureaucracies' technical capabilities (e.g., Rauch and Evans 2000; Weber 1968; Milgrom and Roberts 1992; Rose-Ackerman 1997) as the source of bureaucratic failings. Political science literature usually attributes poor policy implementation to political institutions (Cox and McCubbins 1997; Putnam 1993; Spiller and Tommasi 2007; Cheibub and Przeworski 1999). This dichotomy has long been recognized, but scholars have not considered how these factors influence the measurement and analysis of the concept. They have also failed to consider the ways that these two factors interact, in theory, to influence state capacity.

### **Institutional Incentives → Will**

Politicians, like all people, respond to the incentives of the institutions under which they operate. In particular, politicians' incentives to invest in state capacity depend on their time horizons and on the benefits they see from policy implementation. Politicians' motivation to implement policy should be clear. Politicians, we often assume, want to implement the policies that they prefer because this is how they will further their policy goals and please their constituents. Simple observation of any nation's politicians shows that policy implementation is not so easy as this, however. Tremendous political and technical barriers exist to implementing even the most basic public policies.

To explain institutions' effects on the will of politicians to implement policy, I draw upon theories that seek to explain politicians' behavior. In particular, I examine

those institutions thought to shape their behavior toward providing collective goods. The broad assumption of political economy research is that politicians pursue the courses of action that they believe will further their career goals (Mayhew 1974). Accordingly, when we see good policy outcomes, such as balanced budgets and effective service delivery, we expect to find them consistent with furthering the careers of politicians.<sup>1</sup> When we see failures in provision of public services, we must consider the logic of politicians and bureaucrats which results in this outcome.

The primary institutional barriers to the effective delivery of services are time inconsistency problems and localism (cf. Olson 2000, Geddes 1994; Cox 1987). Politicians prefer policies that produce quick gains so that they can take credit for these benefits. For politicians who are reelected every 2, 3 or 4 years, especially those who do not have good reason to believe they will be reelected, policies that only pay off in the future are not attractive. Policies that improve capacity, like investments in bureaucracies, are continuing projects. Like any investment, the initial outlay of capital is only rewarded after a period of time. Importantly, the development of bureaucracies, including the hiring and training of quality employees, the organization of agencies, and the collection of a critical amount of information about citizens is a (very) long-term project.

The institutional arrangements that will encourage investment in state capacity are those that extend the time horizons for politicians. These include the possibility for long terms in office and nationally-oriented political parties, among others. Moreover, the

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<sup>1</sup> “Good” public policy is loosely defined as policy that benefits a broad sector of constituents. This is juxtaposed to corruption or clientelism, which serve only a few individuals in the former and a limited group of political loyalists in the latter.

stability of the regime and the political institutions themselves factors into politicians time horizons.

Reelection and long terms in office offer politicians time to see results from their investments in capacity. Since they are in office for more time, or have the possibility of being in office for longer, they might reasonably expect to reap rewards from their pro-capacity policies. In most political environments, however, this institutional feature is static and often the reelection incentives promote very short-sighted behavior, as we see in the United States House of Representatives (Cox and McCubbins 1993) or in the Argentine Chamber of Deputies (Levitsky 2003; Jones et al. 2002).

In the absence of long terms or opportunities for reelection, parties can incentivize long-term thinking in politicians. Parties, unlike politicians, can exist indefinitely in politics. They have greater incentive, therefore, to press for improvements that will only pay off in the long term. Parties also have broader scope of interests than individual politicians; they often have nationwide constituencies vote on the basis of the party's "brand-name." (Cox 1987; Shugart 1999). This brandname depends on how they handle the major issues a country faces. Parties can engage in long-term strategies, built on the collective policies they implement, to address these issues.

Investment in bureaucracies has the property of an inter-temporal contract (Tommasi and Spiller 2007). Politicians in Argentina, for example, even when they seek to make long term changes in the quality of their bureaucracies, are not able to make credible commitments and settle contracts to get this work accomplished in the future. The difficulty of passing and implementing these policies that require long-term commitment is evident in Argentina where reelection is not likely for many national

offices, political (even regime) turnover is frequent, and province-specific “flash” parties win office in many provinces. Many politicians in Argentina may be considered “roving bandits” that have little incentive to focus on the long term outcomes of policies (Olson 2000; Spiller and Tommasi 1997). Nearly every politician in Argentina, at any level of government, would tell you that they desire more effective bureaucracies. Nonetheless, those same politicians are reluctant to devote substantial resources to improving bureaucracies or devote political capital toward reform because they recognize that these changes could not be realized in their political careers. These time inconsistency problems span all levels of government in Argentina: national, provincial and municipal.

Difficulties of time horizons can be directly related to investment in policy implementation with the example of ribbon cuttings. Politicians love to attend ribbon cuttings on new projects such as roads, bridges and hospitals. A politician invests in this infrastructure and significant progress can be realized in a few months. They take lovely pictures cutting the ribbon of this shiny government-provided service and reap the reward of goodwill from constituents. The fate of those roads and hospitals after the ribbon cutting is another matter entirely. Politicians get little cache from devoting money to fill potholes. Paying for new equipment to modernize the hospital does not make for the neat picture of a ribbon cutting. There is a much lower value assigned by a short-sighted politician to the long term projects of maintenance and improvement than to those policies that produce short-term gains. This opinion may be even further reinforced by outside influences. Tanzi and Davoodi (1997) have shown the international lenders punish countries for current spending that may be used to maintain and grow capacity in bureaucracies. Capital investments, particularly in infrastructure, are encouraged.



Time inconsistency problems emerge not just from the design of institutions but also the very stability of them. Politicians may fear for the longevity of their careers in the short-term because of regime turnover. If their political regime is shaky or has been unstable in the past, politicians would rationally pause before making continuing investments in state capacity that will only be dismantled by the next regime. Morisset and Izquierdo (1997) argue that regime change helps to explain Argentina's weak tax capacity. They say: "The efficiency of the tax administration and the tax payers' compliance level are closely related to the stability of the political system (10)." Whatever the source, politicians' incentives to invest in long term projects have strong effects on state capacity. Political parties, again, can help to overcome these time inconsistency problems.

In addition to concerns with longevity, politicians may not have incentives to strengthen the state. Some political institutions do not orient their politicians toward investing in the quality of their bureaucracies (e.g, Tomassi and Spiller 2007). One example of this is fiscal federalism which disconnects tax effort from the rewards of taxation. If money comes to a province via the efforts of another state apparatus, provincial politicians will not have reason to improve their taxation bureaucracy. Similar to this, when states fund policy through natural resource extraction, they will not devote scarce resources toward tax capacity. When politicians see that resources do not need to come from their own citizens, the focus becomes securing the resources from these places

and protecting that institution, rather than developing the technical capabilities of their own state.<sup>2</sup>

Similar to this, when politicians face collective action problems in the advancement of state capacity, they will not feel inclined to work towards its improvement. State capacity requires the efforts of many individuals and institutions that must devote resources and energy (Hardin 1982; Olson 1971). If institutions are designed in a way that does not align the incentives of the group, self-interested behavior will produce sub-optimal collective outcomes.

High quality government administration may be thought of as a public good (Geddes 1994). Citizens cannot be easily excluded from all of its benefits and including more people in the administrative system does not usually take away from it but rather can add to its effectiveness. Good administration, accordingly, can be compared to the provision by government of other public goods. Shortsightedness and concern for individual politicians' constituencies often discourage politicians from investing in such public goods. Certain political institutions have been theorized to encourage these types of collective outcomes, in particular political parties (cf. APSA 1950; Aldrich 1995; Cox and McCubbins 1993).

Cohesive national party systems also press politicians to act nationally when their constituents demand local attention (Shugart 1999). National parties use carrots and sticks to orient their members to national issues, including financing campaigns, controlling access to national policymaking, and influencing career trajectories for national and provincial positions. Parties can compel politicians to consider long-term

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<sup>2</sup> Fiscal federalism has similar properties to natural resource extraction in the incentives it gives politicians

outcomes and work to overcome collective action problems (APSA 1950). By forcing politicians to care about national outcomes, parties can broaden the scope and improve the quality of public policy. Parties can make politicians care about building state capacity and be forced to use their scarce resources toward this end.

### **Political Will → Technical Capacity**

In the previous section, I have argued that politicians determine their investment in bureaucracy based on their institutional incentives. In this section, I explain how policy is implemented once it is given from politicians to their bureaucracies and how this is shaped by politicians' actions. In order to understand capacity we must, therefore, know what makes for good (or bad) bureaucracies. To begin, I address the reasons why bureaucracies are said to have poor technical capabilities. These include lack of resources, unskilled employees, inefficient organization, and poor enforcement. I reveal the roots of these problems in difficulties in collecting and managing information.

Economic and political science literatures often focus exclusively on the design of policy in explaining poor policy outcomes. They are not as concerned with how bureaucracies are themselves influencing these outcomes. Morisset and Izquierdo (1993) argue,

In the economic literature on taxation, policy reveals little concern for weakness in tax administration. A good tax policy proposal and technological progress is thought to unambiguously improve the tax system. However, administrative constraints may prevent the establishment of an optimal tax system, particularly in countries suffering from a scarcity of trained administrators (10).

Similarly, Bird argues, “In short, there may well be too much preoccupation with what to do and too little attention on how to do it” (1992, 189). This literature demonstrates how important it is for scholars to consider the political origins of administrative strength and weakness, and evaluate how the conditions within the bureaucracy influence policy outcomes.

For policy to be well-implemented by a bureaucracy, several conditions must hold. First, bureaucracies must be good agents for political principals who made the policies. Second, bureaucracies must have the resources and skill to carry out policy directives. They could be lacking in this regard because politicians have not invested in capacity, because resources for that particular policy are scarce, or because the bureaucracy overall is weak in collecting resources and managing policies.

Politicians decide how much to invest in and monitor bureaucracies, thereby influencing their technical capabilities. For legislation to translate into good policy implementation, bureaucrats must be good “agents” for lawmakers. Most bureaucracies are beholden to an executive or legislative branch for their policy directives, their funding and their structure. Their principals, executive and legislative politicians, avoid agency loss by selecting good bureaucrats, monitoring their work, creating rules of procedure, and eliminating funding in cases of insubordination. No bureaucracy perfectly carries out its political principals’ wishes, however, as much literature on the developed and developing world has discussed at length (cf. Lowi 1969; Moe 1989; McCubbins and Schwartz 1984; Rauch and Evans 2000)

Most work on bureaucratic capacity has assumed that bureaucrats are capable and skilled, but they may not be good agents for politicians. This highlights a central tension

in the principal-agent relationships in modern states—a skilled bureaucrat may be a good implementer but not a good agent. The reason for this is hidden information; bureaucrats may feel that they better understand the approach necessary to solve the social problem that they address (Lowi 1969; Huber and McCarty 2004). The way to keep bureaucrats in check is to align their incentives with their political principals. This includes linking advancement to performance (with loyalty to statute rewarded), by imposing pre and post accountability measures via hiring standards and monitoring, and by agenda control—establishing procedures for implementation (Rauch and Evans 2000). The reverse could also be true. A good agent may be a loyalist but not a skilled implementer. Another way is hiring political loyalists with less concern for skill. This suggests a possible tension between the goals of bureaucracy to be good at implementing policy or good at promoting the careers of politicians, if these things conflict.

In addition to monitoring and selection, politicians determine whether their bureaucracies are effective implementers of policy by conferring resources to them and influencing their structure. The ways to attract high-quality bureaucrats are seen to be good pay (Evans and Rauch 1999), bureaucratic prestige (Besley and McLaren 1993), and training (McCourt and Sola 1999). Skill, resources, and technology are vital components to a successful bureaucracy.

An investment in technical capabilities for policy implementation is a dedication to the pursuit of collecting information for the state. Politicians understand that information about citizens is critical to the implementation of policy. Therefore, the institutions that give politicians incentive to invest in their state's capacity prompt them

improve the agencies that collect information about citizens. All state activity requires information to execute and bureaucracies are the agents that carry out state activity.

Institutions have strong effects on the collection of information. Citizen information comes from the interaction between state actors and citizens. These interactions can take many forms, including face to face meetings, mailings, forms that citizens fill out, and registration of people and property. These interactions can happen with any government agent, from tax officials to census takers to teachers to police officers. The number and type of interactions could be quite large, as it is in most states with developed bureaucracies. State institutions are the primary factor explaining how, when, why, and where state actors (both politicians and bureaucrats) interact with citizens.

Information is only useful once it is collected and organized for effective use. The design and staffing of institutions of the bureaucracy is thus critical to the handling for information within a state. The ways that institutions are designed, in this case bureaucracies, make them more or less conducive to effective policy implementation. Bureaucracies organized for the effective cataloging and sharing of information within their agency and across agencies will facilitate technical capabilities. Given the large number of government agents that interact in some way with citizens, the burdens of information management and sharing are very high in a modern state. "Street-level" bureaucrats such as police officers can offer very important information to tax officials given their observation of a neighborhood, for example. The information registered in police officers' reports will only be useful if it is cross-referenced and available to other agencies.

State capacity depends on collection, understanding, and management of information about society. Information is the foundation for technical capabilities of bureaucracies since every policy requires extensive data to implement. This role of information in capabilities becomes crucial when I address the measurement of state capacity in the following chapter.

### **Hypothesis 2: Technical Caps → Political Will**

In the previous sections, I have described how institutions shape political incentives to invest in technical capabilities. The causal arrow went from political will to technical capabilities. In this section, I show where this effect can be reversed so that technical capabilities can have serious implications on the operation of political institutions such as parties.

The feedback between will and capabilities is rarely discussed in state capacity literature and it is never fleshed out for its theoretical implications. The closest description of feedback I have found in the literature is Spiller, Tommasi and Bambaci's (2007) description of a "vicious circle" in Argentine political and bureaucratic relationships at the national level. They say "The quality of the bureaucracy is an important component of the quality of the environment for political transactions... a poor bureaucracy worsens the policy-making environment, and a poor policy-making environment is unlikely to create a quality bureaucracy (156)." This has not been discussed in most literature on state capacity even though it should be a central concern for those trying to explain either weak policy implementation or poor policymaking environments.

Those few scholars who have recognized the importance of feedback from poor state capacity to the functioning of policymaking have not addressed the implications for political parties. Spiller, Tommasi and Bambaci (2007) mention the possibility of feedback from weak bureaucracies to political institutions but do not expand upon the idea. Huber and McCarty (2004) also argue that low capacity influences the policy environment, but that it mostly affects how politicians decide to delegate to bureaucracies. Neither has considered how weak technical capabilities might hinder the operation of political parties.

Political parties force politicians to pursue long-term, collectively-oriented policies through the carrots and sticks they have available to impose discipline. In strong parties, party members behave in a disciplined manner when they work toward policies that further party goals. When bureaucracies do not have strong technical capabilities, both the tools of the party to impose discipline are weakened, and the means by which party members can pursue collective policies are hindered.

Political parties have resources available to make their members comply with their collective goals. Many of these resources are related to campaigning, including endorsement, organization, and monetary support. The other value of a party is in its programmatic reputation—its policy stances and its ability to deliver widespread collective goods. In a state with low technical capabilities, political parties do not have the same type of access to the latter. Parties cannot deliver on many collective goods because they do not have a bureaucracy able to implement those policies. This results in a party that must base its policy platform on delivering those policies that it *can* give and reform only as far as their bureaucracy can reach. In most cases, those are directed,



limited interventions such as pork or party-based patronage. It is very difficult for strong parties with programmatic platforms to exist in such an environment.

On the other side, parties are not able to impose strict discipline on their members because it is unrealistic for politicians to be expected to deliver on many promises of policy implementation. For example, leeway must be given to those politicians, governors, mayors or legislators, with low capacity bureaucracies to stand outside many reform initiatives. This creates tremendous pressure on the party apparatus, since some geographic zones and policy areas with higher quality bureaucracies are punished for their efficiency. A “strong” party able to enforce compliance with party mandates will be unlikely in country where state capacity is low and uneven across jurisdictions and policy arenas.

In this way, among others, technical capabilities can reverse the direction of causality to shape the political institutions in a country. Political parties will find it difficult to provide the collective goods to establish themselves as programmatic parties. They also find enforcement of their mandates difficult when their members cannot implement the policies that will support their collective aims. The environment where parties are weak also reinforces the low capacity equilibrium and creates an environment where incentives to reform or bolster the bureaucracy are low (Huber and McCarty 2004). This can have serious implications for the quality of democracy in developing states.

## **Conclusion**

In this chapter I have described my theoretical framework for state capacity development. I assume that both political will and technical capabilities must be present for policy implementation to be effective in a state. Politicians must desire that a policy be executed and see value in investing resources in their bureaucracies for them to be adequately funded, staffed and managed. The institutions of government that structure their incentives, mainly their time horizons and their orientation toward developing a strong state, account for their investment in bureaucracies. Bureaucracies need to have the technical capabilities to administer policies as well. They must possess the information about citizens necessary to deliver services and extract from citizens. Finally, the quality of the bureaucracy feeds back into the operation of political institutions to render political parties more or less effective at achieving collective outcomes.

The dependent variable throughout this dissertation is state capacity. In the chapters ahead, I operationalize state capacity as effectiveness at tax collection. I demonstrate new methodology to measure aspects of state capacity and compare my measures to existing measures in the literature. I show how political will and technical capabilities drive outcomes in tax collection in the provinces of Argentina. In the cross-provincial empirical chapter, I isolate the dichotomy of will and technical capabilities. I am able to separate these two causes of tax collection to show the effects of a change in will. Given this change in will, I show that some provinces are better able to improve their tax collection because of superior extant technical capabilities.

In my study of Argentina's Fiscal Pact of 1993, I show evidence of the important role of institutional incentives and technical capabilities, and the feedback between the two, in policy implementation. In particular, I identify the effects of party allegiance and technical capabilities on province's decisions to make capacity-improving reforms. The Peronist party was able to impose some compliance with their tax reforms, but many provinces (especially Peronists) did not fulfill important components of the reform. The Peronist party had to sacrifice the reach of their reform because of the technical constraints of many provinces in the coalition. In the two empirical chapters, I show clear evidence of information's role in state capacity through examination of taxes that require considerable knowledge of citizens and through field interviews and personal accounts of information's part in policy implementation.

## **Chapter 3**

### **Identifying and Measuring State Capacity**

#### **Introduction**

A central contribution of my dissertation is in the research design and measurement of state capacity. As such, I devote an entire chapter to explaining the ways that I use taxes to measure the concept and how this compares to existing indicators of state capacity. I explain the validity of taxation measures and how they fit into the theory that information drives policy implementation. I also further justify my focus of study on Argentina's provinces in the 1990s.

In the first section, I explain how I measure state capacity using taxation indicators. The way that I use these measures is unique in the literature. I examine individual types of taxes separately because different taxes are more or less demanding on the state. Some taxes require considerable bureaucratic organization and intrusive activity; others are easily collected at the point of sale. I argue that my measure is more valid from a research design and theoretical perspective than other indicators of capacity.

After my discussion of measurement, I relate the application of my study to Argentina and specifically to the provincial politics of Argentina. My work is unique in its application of state capacity theories to sub-national governments, so I use supporting literature to show the precedence for such a research design. I also review some of the existing literature on state capacity in Argentina.

In the final section, I relate my theoretical framework to the political environment in Argentina in the 1990s. Only through understanding the basics of Argentina's background conditions, including its institutions, the incentives they create, and its

political history can we reflect upon how these factors influence current policy outcomes. In the institutional setting in Argentina and the data I collected during field research, I found considerable support for my assertions about capacity development.

### **Measuring State Capacity**

I measure state capacity using effectiveness at tax collection. Tax measures for capacity exist in the literature, but they are usually restricted to national-level data and broad indicators of total tax revenue. I add to the methodological literature on state capacity by using constructs which separate the types of taxes a state collects to provide more detail about how the state is implementing policy. These measures are highly integrated into my theoretical framework in the previous chapter where I link information to technical capabilities. In the following section, I justify my use of taxation measures, in theory, and show that they are an improvement upon current measures of state capacity.

#### Tax Capacity

When conceptualizing or measuring capacity it can be overwhelming to imagine all of the things a state does or could do. Capacity for policy implementation varies both across countries and sub-national governments, but also differs within a state, across bureaucratic agencies and policy arenas. Rather than conquer the concept with all of its levels of complexity, I focus on one policy area, taxation, that I consider both representative of capacity for other policies and necessary for any state capacity.

Tax capacity is a viable proxy for state capacity because it is the foundation for all other policy (Lieberman 2003; Weyland 1996). Without revenue, governments cannot

perform any of their desired tasks. Taxation is primary source of revenue for nearly all nations. Taxation, as compared to other policies, is the best indicator of capacity because it is not optional. Unlike education or health policies that some states can ignore or leave to the private sector, taxation must be handled by the state and it is in the state's interest to collect revenue. All states collect taxes and all states want to do this well, barring alternative revenue sources. Taxation, moreover, lends itself to quantitative analysis, cross-national and sub-national comparisons.

Tax types vary in their utility as a measure for state capacity overall. All taxes require some level of capacity, but some suggest much more administrative skill and state reach. Income taxes, for example, are technically challenging for a state to implement because they require access to financial information for and extraction from all members of society (Weller and Ziegler 2009a). Excise taxes, on the other hand, can be applied at the point of sale for a restricted number of goods, making them much easier to execute and collect. Accordingly, when I examine tax capacity, theoretically and empirically, I distinguish between tax types and what they each reveal about state capacity.

### Tax Capacity and Information

Capacity to tax is entirely dependent upon information available to a state. Information is required for the two major actions of a state: delivery of services and extraction. Crucially, resources are required for any government action; for most states these resources must come primarily from domestic taxation. Resources precede government action and resource collection depends on the information a government has about its citizens. I argued in the previous chapter that the information required for

governance, especially taxation, comes from interactions between citizens and state actors. These interactions provide information about the actors involved in taxable activities and the value of them. This section explains how taxation is related to information and leads me to my construct of using different tax types.

In order for a government to tax effectively, three (challenging) conditions must be met by that state. For all taxes, these conditions are:

- 1) The actors involved must be known
- 2) The value of the taxable activity must be known
- 3) The state must be able to extract, given information from conditions 1 and 2

The first two conditions are highly information-dependent and the third condition relies crucially on the first two. These conditions highlight the importance of the quality of state information and means of force for taxation. It should also be noted that these conditions are agnostic to the type of taxation employed. Even where only small sub-sectors of a state are taxed, as in so-called Petrostates, those governments have good knowledge of the actors involved in oil extraction, the value of the oil extracted, and are able to enforce compliance with those taxes imposed. Behind the tax bureaucracy is an implied or explicit capability to apply force.

These conditions, despite their seeming simplicity, are not easily met by states. For instance, taxes on trade, despite their distortion of efficiency, are predominant in developing nations since all three conditions can be met for trade taxes with relatively little information. For a state to collect a tax on international trade, little more is needed

than a customs house at the borders and ports.<sup>3</sup> Since trade must flow through these critical “gates,” government interaction with the actors that must use them provides the information required for conditions 1 and 2 to be met. Condition 3, enforcement and collection, is also relatively easy since the force can be concentrated at these “gates.” The demands on a state to collect trade taxes in the modern era are relatively small.

Trade taxes may be “easy,” but they can be economically “inefficient” in an increasingly globalized economic system. All else equal, most governments would prefer to tax from the widest base possible and to do so in the least distortionary manner. Of course, all else is not equal, and political concerns weigh heavily into these decisions. Nevertheless, if they were possible, most governments would want to garner more from lucrative, efficient taxes, which are usually the hardest to enforce. The taxes with the widest, most stable bases are those on income and property from individuals and businesses.<sup>4</sup> These are effectively applied in developed nations; once these governments were able to tax harder to observe activities, such as services and income, a reduction of the emphasis of trade taxes was observed in all nations (Weller 2008). This suggests a preference for more difficult but lucrative taxes should they be feasible to enforce. These taxes, however, require extraordinary amounts of information to meet the three necessary and sufficient conditions for taxation.

The kinds of state activities that I suggest provide this information for effective taxation are numerous. One group of examples includes issuance of licenses, permits and

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<sup>3</sup> Of course, the existence and maintenance of borders and ports comes before this. Part of the motivation for governments to assist, develop or control these infrastructures comes from their desire to tax them.

<sup>4</sup> This might also include VATs as applied in many nations.



deeds. These documents, often considered “rents” that are worth only their issuance fee, provide much more to the state. Deeds, in addition to imparting “property rights” to citizens, tell governments who owns land and the value of that land. Automobile registrations tell the government who owns a car and the value of that car. These types of interactions with citizens, it is clear, assist states in meeting conditions 1 and 2 of taxation. Similarly, state access to or provision of centralized collections of financial information, such as credit and bank clearinghouses, involve the state in private financial transactions. This allows state actors to know who is involved in these transactions and their value, making them more easily taxable. Related to this, government involvement in the issuance of credit cards allows activity on these cards to be traced to citizens and their value is obviously known.<sup>5</sup> This information is available to state actors and can be employed in tax collection.

Tax returns are the most obvious type of information-providing interaction in taxation. In these, citizens report the income they have received from their employer, the amount of money they have gained from capital holdings, the value of their property, the number of dependents, the value of items they purchased or sold, and much more. Importantly, in effective income tax systems, citizens are not taken “at their word” on these activities. Their taxable income, for example, must come from a form provided by their employer, who has incentives to be factual on these numbers. Individuals’ capital gains are reported by financial institutions that must also report to government institutions. The value of property is listed in deeds held by government authorities. The

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<sup>5</sup> Linkage of credit cards to social security numbers in the United States is a primary way that governments are involved in these interactions and the information from credit-issuing bodies is shared with the United States government.

holdings in bank accounts are known by many states. The tax returns I have just described are an “ideal type” to provide maximum information to state actors. Such returns are closely approximated by developed states.

The necessary and sufficient conditions for taxation are difficult for most governments to meet on most types of taxes. Different tax types vary widely in their information required and their enforcement demands; most governments lack the capacity to impose these taxes. The developed nations only established the means of collecting sufficient information and “reaching” citizens to enforce their laws for the most difficult taxes in the last century. These theoretical conditions for taxation reveal the reasons why most modern governments cannot effectively tax their citizens and shows the considerable progress required to dramatically improve taxation and governance in most of the world. Crucially, this improvement will require governments to know more about their citizens and be able to apply force (or implicitly threaten force) to gain compliance with laws.

### **My Tax Measures**

My argument about the diverging demands placed on the state by different types of taxes is the foundation for my measurement of state capacity. Throughout my empirical chapters, I employ measures of taxes collected by the provinces of Argentina. I use two different types of measures: total tax revenue and revenue from individual taxes. In both cases, I calculate these measures as a percentage of Gross Provincial Product to control for the size of the provincial economies.

Argentina's provinces collect four primary taxes: real estate, gross business taxes, automobile taxes and stamp taxes. These taxes vary on the amount of effort and information required of the state to enforce them. The most difficult taxes are the real estate and stamp taxes because, in the case of the former, they are very difficult to assess and few provincial governments have good data on the ownership of property. For stamp taxes, citizens approach the government to guarantee contracts. Though not difficult to enforce, this tax suggests a state that people believe can implement policies. On the other side, automobile taxes require very little information or effort on the part of provincial governments. I assess the capacity of provinces based on these measures. For example, those provinces that are able to do a good job of collecting the more difficult real estate taxes should have higher overall capabilities than those who have low revenue on this tax or get most of their revenue from automobile taxes.

In the following section, I compare my taxation indicators to existing measures of state capacity. I argue that my measure offers a more complete and complex picture of states' ability to implement policy.

### **Comparison to Existing Measures of State Capacity**

The existing measures of state capacity can be classified in two categories according to their method of procuring data. The first group of indicators relies upon survey research from country experts, firm owners or potential investors in the country. The second group uses indirect measures (such as taxation) to measure capacity. The measure I use throughout my dissertation builds on the measures in the second group,

with important improvements that are more descriptive about the information available to the state and the quality of implementation.

#### Examining survey-based measure of state capacity

Survey-based indicators are commonly used measures of state capacity in academic and policy research. In these survey designs, country experts, bureaucrats or business people are asked their opinions about the policy environment in a country. Researchers use data from selected survey responses or they develop a composite indicator of questions across several surveys. The most popular surveys are the Business Enterprise Environment Survey published by the World Bank, the International Country Risk Guide published by Political Risk Services, and Transparency International's Corruption Perceptions Index.

These surveys are inappropriate as measures for capacity. The surveys are intended to gauge the business climate of a country, which is conceptually distinct from the ability of a state to implement public policy. Surveys provide information about the business climate by collecting opinions on the likelihood of bureaucratic red tape or bribery, or failures in basic public services such as utilities, for example. A state can be very effective in implementing policy that harms the business environment and be said to have strong state capacity. The standards of global capital, in other words, may differ from theoretical conceptions of governance and state capacity. Moreover, these surveys are not designed to measure policy implementation, but rather other concepts such as state capture or corruption that may be related to capacity but are not equivalent to it.

### Survey-based *Indices* of State Capacity?

State capacity scholars have recognized a variety of problems with existing surveys (World Bank 2000, Knack 2006). In an effort to improve upon the results from a single survey, several widely-used indexes have been developed that combine the results of capacity-related surveys. The most commonly used indexes of this type are Kaufmann, Kraay, and Mastruzzi's *Governance Indicators* and the regional "Barometer" series. The justifications for indexing are clear under some conditions, but the means of transformation are not grounded in theory and the combination of several biased surveys is unlikely to produce indexes with reduced "error."

The rationale for creating an index is that existing surveys of business environment, corruption, bureaucratic delay and other questions are, by themselves, incomplete portrayals of state capacity. By combining the survey questions to include all of the theoretical components of capacity, the index collapses multiple data points into a single data point. Using only one indicator for state capacity has clear advantages, but also adds problems (Knack 2006).

For an index to be useful the many data points combined must all be related to each other – that is there must be a single dimension or construct that underlies the data points. If not, it will still be possible to calculate an index, but the index itself will not be meaningfully related to the construct defined by the researcher. The result may be a number or series of numbers with an unclear relationship to the construct of interest.

Another reason for an index is a concern that any one survey has statistical errors or bias. Since the respondents or questions for any one survey may be biased by country-specific peculiarities or poor wording, the hope is that by averaging or otherwise

combining the results of surveys that errors will “wash out” and a “true” measure of capacity will emerge. There is no guarantee that aggregating biased data will result in an accurate indicator of a given construct. Combining biased data to develop an unbiased measure can only occur if each component of the index is biased in such a way that aggregation eliminates the bias. This implies that the various biases cancel out each other. This is an empirical claim that is often neither claimed nor supported by researchers who develop these indexes.

The reasons I outlined in this section suggest that survey-based measures do not capture my construct for state capacity. It is also not clear that creating an index escapes the flaws in the surveys and it may introduce other types of errors into the measure.

#### How do my Measures Compare to Other Taxation-based Indicators of Capacity?

Another class of indicators for state capacity uses taxation data as a proxy for policy implementation. Unlike surveys, taxation-based capacity measures are indirect, and they exploit objective data to capture evidence of successful policy implementation. My measure follows in the tradition of these taxation-based indicators. The most common of these is total tax revenue as a percentage of GDP (Peters 1991; Cheibub 1998; Steinmo 1998). In these formulations, the ability to collect a large proportion of revenue would provide solid evidence that a state is able to extend its authority over economic activity in the state.

I use a similar measure of capacity when I assess provinces taxes as a percentage of Gross Provincial Product (GPP). I add to this literature the separation of tax types according to their difficulty of collection. Any form of taxation reveals some amount of

state capacity, but some tax types reveal greater state capacity than others. Total taxation is a coarse measure of capacity; much more can be learned by parsing out states' effectiveness at collecting different types of taxes.

My measure of state capacity is unique not only in its theoretical foundations but also in its application to sub-national governments. In the empirical chapters that follow, I will use the measures to reveal existing capacity in the provinces and identify when they improve on capacity using these tax indicators. In the next section, I address my selection of Argentina as a testing ground for my theoretical framework.

### **Argentina and its Provinces in Comparative Perspective**

In the introduction chapter, I explained why I selected Argentina to test my theoretical framework of state capacity. Briefly, Argentina can be usefully compared to other federal countries, to other developing nations, and other Latin American countries. Bergman's (2003) work compares Argentina's tax collection to that of Chile, for example. Argentina, Brazil and Mexico are frequently compared because they are similar on all three of these dimensions (cf. Kaufman 1989; Montero 2001; Haggard and Webb 2001).

My empirical analysis examines Argentina's provincial governments, not the country as a national unit. I argued in the introduction that these subunits may be usefully compared to other developing nations and to other states or provinces in federal states. Studying the provinces is not just important because of their relevance to national politics; they are also a valuable "laboratory" for examining political hypotheses. In most comparative politics, research is cross-national. Examining countries, however, raises

many concerns about the confounding factors in individual countries that may make those countries difficult to compare, such as different histories, economies and cultures.

Research on sub-national units, however, eliminates many of the threats to validity in cross-national research. For example, in the United States, comparisons of the states have long been considered a powerful way to examine policies and political institutions. The provinces of Argentina share a common political and economic history and culture. However, they differ on many variables of interest, making them useful for theory testing.

The idea of comparing the performance of the Argentine provinces is not new in comparative literature. For example, Remmer and Wibbels (2000) look at the fiscal performance of the Argentine provinces during the period of economic adjustment in the 1980s and 1990s. They argue that sub-national governments are important to study because they have significant impacts upon the economic performance of national governments. They also show that sub-national governments are a testing ground for examining the role of party competition in structuring the public sector. Many other authors (cf. Sawers 1998; Gibson and Calvo 2000) examine the provinces as important actors in the developments of national politics.

Argentina is frequently examined as a case of state capacity. It is compared to other Latin American countries in Geddes (1994) work and is often featured in cross-national examinations of state capacity such as Heredia and Schneider (1998). The general conclusions in these studies are that Argentina's state capacity is surprisingly weak given the level of economic development in the country. Argentina's tax system is the subject of Bergman's (2003) and Berensztein's (1996) work, and many publications



by the World Bank. Again, Argentina is shown to be poor at taxing, given the economic factors thought to be associated with tax revenue. Thus Argentina is a case to be explained in comparative development and state capacity. Given the importance of the provinces in the functioning of the country, they need to be examined for their role in these outcomes.

### **Argentina- Application of the Theoretical Framework**

My dissertation applies my theoretical framework of state capacity to the case of Argentina. In this chapter, I provide an overview of the political history and major institutions in Argentina that relate to policy implementation to provide context for the evidence I present in the empirical chapters.

#### Political and Economic History

Argentina has a long, well-documented history of political instability. Regime change flip-flopped between democracy and dictatorship frequently in the 1900s, culminating in the current democracy in 1983. During these periods, politicians had very good reasons to believe that their time in office would be short-lived and their regime might succumb to pressure very rapidly. Even more volatile than the political system has been the economic system. Argentina's economy has experienced periods of both rapid growth and much quicker depression in the twentieth century. These are not good conditions for the investment in long term projects such as the development of a high quality, meritocratic bureaucracy to implement policy.

Argentina's politicians have made several rational adjustments to the political and economic instability they face. They have rigged certain institutions to be very difficult to change, no matter the regime, or the consequences for economic or social outcomes. Most Argentine politicians admit to thinking in terms of the immediate, rather than long-term, effects of policies. They never know for sure where their party, their institution, or their political position will be in the future. Their electoral institutions, moreover, encourage short-term thinking and their fiscal federalism presses provincial politicians to delegate capacity to the national level. Their parties offer some hope of overcoming time inconsistency problems but fail in many important ways. The combination of these factors ensures that all levels of government, provincial and national, have relatively weak state capacity.

### **Argentine Institutions and their Incentives**

As a federal country, Argentina's institutions span the national, provincial and federal levels. I cannot address every institutional set-up in Argentina, so I will outline the basics of the national and provincial systems and demonstrate the systematic effects of these institutions on incentives for politicians. Specifically, Argentina's institutions lead politicians to be short-sighted and province-oriented in their careers but national-oriented for the acquisition of resources.

Argentina is a federal nation headed by a president and a bicameral legislature. Members of the Chamber of Deputies are elected in 24 multimember districts, composed of the 23 provinces and the federal capital. Deputies are chosen from closed party lists using the D'Hondt form of proportional representation. The number of deputies is

determined by the population of the jurisdiction, with a minimum of five deputies. Even the smallest provinces have five deputies, resulting in strong overrepresentation of the least populated provinces. Every two years, one half of the members from each district are up for reelection. The Senate is directly elected with three Senators per province. Given the large disparities in population between Argentina's provinces, the Senate is highly malapportioned. In three different indexes and in every indicator of malapportionment in twelve modern federal democracies, Stepan (1999) found Argentina to be the worst case.

Provinces are run by governors who act as the chief executive of the province. Governors are, for all intents and purposes, the actor that represents the provinces in their dealings with the national government. National-provincial interactions are critical to explaining provincial efforts to develop capacity, so I will provide more detail about the influence of provinces, and provincial governors in particular, on the political system in Argentina.

### **Sub-National “Drag”**

Argentina's politicians, including its national legislators are influenced by “sub-national drag”—their careers are oriented toward their province because their future career path must go through the province (Jones et al. 2002). This holds true for national as well as provincial politicians. Reelection rates are very low for national legislators because of voluntary career change or because provincial party leaders (governors) replace them with new candidates. National legislators have little concern for the health of the national government or national fiscal accounts beyond their effects on their home

provinces. They are “roving bandits” interested in immediate outcomes that will further their careers when they return home to their province. Presidents, the only elected figures with a truly national focus, along with their cabinets, are the usual source of investment in national government capacity. As heads of their party, they also try to orient their members toward national outcomes.

Aside from the President, provincial governors are the most powerful actors in Argentine politics. They have considerable powers to exercise authority within their province but their national authority comes largely from their instrumental role in their party organizations. De Luca (2004) argues, “while the president and governors’ supremacy is partially based on the use that they have made of their constitutional powers, above all it comes from their ability to depose and use their partisan powers.” Governors control the party lists for national legislators from their province, sway the fates of those interested in pursuing the presidency, and control the party machines in their provinces. Specifically, a governor’s dominion “derives from an important group of political and institutional resources, such as the governors’ control over jobs in the provincial public sector, the provincial budget and the provincial party organization” (ibid).

Although the governors have significant political power at the national level, their authority can be limited by the weakness of individual provinces relative to the national government and by the power held by the national president. The president can influence (or pressure) them in several ways. First, presidents can distribute positions in the national government in ways that reward or punish particular provinces. Second, presidents have discretion over certain budget funds corresponding to each province.

Third, under certain circumstances the president can exercise national control over a province through a federal intervention. Finally, the president can back a rival candidate in the next governor election. These tools are not enough, however, to overcome the deleterious effects of weak state capacity on governors' cooperation with party mandates.

### **Party System and Structure**

The effects of federalism and sub-national drag are felt strongly in the party system in Argentina. Party organization and political careers are formed at the provincial level. All elective political careers begin at the provincial level and, with the exception of President, no office is more powerful than governor. De Luca (2004) argues,

In Argentina, the recruitment process of presidents and governors is concentrated in the political parties and, within these, in their provincial sections. This centrality of the parties in the recruitment process is strongly related to a particular combination of key party and electoral variables: an institutionalized party system and a moderate party identification among voters, party monopoly of candidacies, control by the provincial party leaders of the candidate selection process, and mixed and decentralized party financing (2).

The political parties in Argentina have built themselves around this federated structure.

The Partido Justicialista (Peronist or PJ Party) and the Union Civica Radical (UCR or Radicals) have dominated politics since World War and have had a national presence backed by a dense network of provincial political machines based on clientelism and patronage relationships (Calvo and Murillo 2004, Levitsky 2003). The Peronists have strong identifiers but not much formalization and weak organization; the UCR is a more organized institution with stronger commitment to liberal democracy than to the leadership of charismatic individuals. Peronist candidate selection is not too formalized compared to that of the UCR (Levitsky 1998, 2001). Both parties, due to the institutional

pressures of federalism, have their base in the provinces not in the national party organization.

Province-based parties are important actors in the national legislature and hold the governorships in several provinces at any given time. Their organizational structures are exclusively provincial and thus we should expect even more sub-national drag with provincial-party politicians. De Luca finds two general characteristics of the provincial parties: (1) their relative lack of organizational structure (small membership, absence of a physical presence at the neighborhood level), particularly compared to the PJ and UCR, and (2) their tendency to be dominated by a single person or small clique (2004). These parties are not oriented toward long-term goals and are just as concerned with acquiring federal transfers as the national parties. The provincial parties have even less concern for maintaining national fiscal accounts than the national parties. Neither the longstanding parties nor the provincial parties are widely considered to be programmatic parties able to deliver collective goods.

Sub-national drag might suggest that provinces would therefore be strong relative to the national government. However, the system of fiscal federalism shifts provincial politicians' attention from their own states toward securing federal transfers. These pressures often trump the longer time horizons that parties could give them and direct their efforts away from developing provincial capacity.

### **Fiscal federalism**

Argentina's fiscal federalism discourages development of provincial state capacity. Its incentives lead provincial politicians to chase national resources and avoid

collecting their own revenue. Fiscal federalism was originally put in place to protect provinces' autonomy yet they have had the opposite effect as provinces are beholden to the resources of the national government. However, given the institutional design and incentives of Argentina, this situation is unlikely to change.

Fiscal federalism in Argentina is built upon the Law of Co-Participation (also known as the Federal Tax Sharing Act) which distributes national tax revenue to the provinces. The national, provincial and municipal governments have divided duties, with little overlap in taxation authority. The established laws place primary taxing authority in the national government, especially on income, capital assets, sales taxes (VAT) in addition to trade taxes. Provinces receive almost 60% of these funds in direct transfers. Nearly every province relies heavily on transfers to pay their bills; only 5 of 24 provinces provide more than 30% of their own revenue. Importantly, this distribution of national resources is *not tied to taxation effort of any kind*. Provinces receive funding according to an assessment of need. The incentive for provinces, especially the least economically developed provinces, to collect their own revenue is very low and the “progressivity” of the Co-participation regime stifles most the effort of the least developed provinces.

Co-Participation works like a common pool resource, creating a collective action problem that hinders effective collection of national taxes (Saiegh, Tommasi, Spiller 1999). Since tax effort is not related to distribution, provinces shirk this unpleasant task and expect the other provinces to contribute. This gives perverse incentives for all provinces not to improve their own tax capacity, thus leaving this common resource in shorter and shorter supply. It also drives the national government to focus effort on collecting the taxes they can keep for themselves rather than give to the provinces.

Fiscal federalism's staying-power can be attributed in part to malapportionment in Argentina's national Chamber of Deputies and, in particular, its Senate. The smallest and most economically weak provinces are highly advantaged by the vote distribution in the Senate which gives every province 3 Senators. In the Chamber of Deputies, every province has a minimum of 5 deputies. These efforts to create parity in representation across the provinces do not reflect the distribution of population in Argentina. The majority of the population resides in three metropolitan areas, and around 40% lives in Greater Buenos Aires alone. The distribution of national resources highly advantages those provinces that are overrepresented in the Argentine houses of congress and this is highly unlikely to change since any amendment requires their consent.

Why would such an institution as Co-Participation persist over time? First, Argentina's federalism is highly valuable to the underdeveloped provinces of the interior that are heavily overrepresented in the Senate. Also, these provinces have been crucial to the success of the Peronist party as part of the urban labor- clientelistic rural support base (Gibson 1997). National Peronist leaders have consistently reaffirmed this Law to bolster support for their coalition. Military dictators, moreover, found the strongest base for their brand of politics in these same, less populated provinces. They, too, bolstered the malapportionment of the Congress and negotiated federal transfers in favor of the smallest, least populated provinces. The result of these fiscal arrangements has been strong incentives not to invest in provincial state capacity because those resources could come more easily from the national level.



## **Bureaucracies in Argentina**

Bureaucracies at all levels of government are considered poor administrators in Argentina. This is attributable to their weak technical capabilities, due to unskilled employees, staffing bureaucracies with patronage employees, disorganized agencies, and other problems. The political environment in Argentina has contributed to this weakness. Moreover, the bad situation in bureaucracies hinders political actors' ability to make policy. Spiller, Tommasi and Bambaci (2007) argue, "Political actors do not have a quality bureaucracy onto which to delegate policy implementation, and the weaknesses of the bureaucracy are themselves the result of the poor quality of the overall policy-making environment in Argentina (156)." The story of bureaucratic capacity in Argentina is one of ebbs and flows in the political commitment to bureaucracies and in the development of their technical capabilities. In the end, bureaucracies at all levels remain weak.

The national, provincial and municipal levels of government in Argentina maintain bureaucracies to implement policy. Most academic work on the bureaucracies in Argentina has focused on the national level. The descriptions of these bureaucracies have not been flattering. For example, Rauch and Evans (1999) ranked Argentina's bureaucratic "coherence" as near the bottom of their measure. Their index attempts to capture adherence to "Weberian" standards for effective bureaucracy, including competitive salaries, meritocratic criteria in the selection and promotion of employees, and the existence of a civil service career path. Argentina was ranked between Zaire and Syria, with only Guatemala, Nigeria, the Dominican Republic and Kenya ranked lower.

Argentina's weak bureaucratic capacity is particularly stunning considering it is housed within a relatively well-off nation with an educated citizenry. Argentina was once

characterized as “one of the clearest instances on record of an institutionalized, non-performance-oriented bureaucracy in a society with ample numbers of skilled human resources in which the primary interest within the state apparatus is survival, through securing one’s future through a limited by sufficient salary to live on” (Graham 1998: 221-2). In sum, it is a relatively developed country with very poor bureaucracies at all levels of government.

Bureaucracies in Argentina’s provinces are considered by everyone within the nation to be far worse-off than their national counterparts. If Argentina’s national bureaucracies are at the bottom of the rankings in bureaucratic quality, we can deduce that their provincial bureaucracies are all the worse. I will not address all of the problems with the Argentine bureaucracies, but I will discuss several challenges with them that relate directly to my theory. I evaluate the role of politicians in creating bureaucratic capacity, in particular in the way that they staff their offices and monitor their bureaucratic agents. Bureaucracies in Argentina do not have principals interested in the long-term development or invested in their long term success. Bureaucrats themselves are rational actors that respond to the incentives given by their political principals.

Argentina’s provincial bureaucracies are a political tool available to provincial governors to reward party loyalists. Bureaucracy is very important in Argentina’s party system because it is run on patronage, particularly the dominant Peronist Party. This patronage often comes in the form of provincial bureaucratic jobs (Levitsky 2003). Even when provincial bureaucratic posts are assigned based on merit, the pay is so uncompetitive with private pursuits that few skilled employees are interested in them

(Carlsson and Payne 2003). Politicians, in their hiring practices and in their assignment of resources to bureaucrats, make Argentina's bureaucracies administratively weak.

Argentina's provincial bureaucracies also lack principals that invest in long-term improvements in capacity. Governors and provincial legislatures are primarily concerned with using the posts for political gain or with securing revenue from the national level. Executives assigned to lead bureaucracies fill temporary posts that leave them unable to make lasting changes in the functioning of their bureaucracy. Executives, moreover, have strong incentives to do as their principals, the governors, want them to do. They will not expect to see their political career flourish should they decide to defy the interests of their bosses.

Argentina has, at times, invested in improving their bureaucracies, but these have been start-and-stop efforts that ultimately reflect the short time horizons of their political principals. For example, in the early 1930s, the national government installed an income tax bureaucracy that produced similar outcomes as other federal countries such as the United States and Australia (Mitchell 2006). The political and economic upheaval that began in the 1930s and has continued today have limited politicians' abilities, much less their desires, to invest in developing their bureaucracies (Weller and Ziegler Rogers 2009b). However, we do see reforms at times to improve bureaucracies. I show evidence of these changes in my chapter about provincial politicians' capacity-oriented response to the Convertibility reforms. Also, Menem placed tax reform and improved tax collection very high on his policy agenda for the national bureaucracy. In the early 1990s, they made dramatic reforms in the national tax collection agency, the DGI, and reorganized the economic ministry to give more attention and resources to tax collection

(Eaton 2003).<sup>6</sup> However, the result of this and most other attempts at bureaucratic reform has been the creation of a “parallel bureaucracy” where small groups are brought into the bureaucracy to fulfill a particular task without efforts to reform the agency as a whole (Spiller, Tommasi and Bambaci 2007).

For their part, bureaucracies have not shown themselves to be effective implementers of policy despite their limited resources. Indicators of policy outcomes and of information available to the bureaucracies show that they are not doing well by any standards. To demonstrate the challenges of interacting with provincial bureaucracies in Argentina, I explain how provincial are paid by citizens. This example reveals not only the dearth of resources available to bureaucracies and their poor organization but also provides explanations for why many citizens rationally avoid interacting with bureaucracies.

Provincial taxes are generally paid, in person, at the provincial palace or main office building. Citizens that owe taxes and wish to pay them must stand in line or sit in a waiting room for their number to be called. This experience is akin to waiting at the DMV to someone from California. It is time consuming, unfriendly, and generally unpleasant. First they wait in line to get the proper form necessary for the tax in question. At that point, they get a number and sit in provided chairs while they complete

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<sup>6</sup> The reforms of the DGI were successful, if short-lived. They created a “pocket of efficiency” of specially-selected collectors and auditors. This group competed with the rest of the DGI and, through their performance indicators, showed what a properly funded tax agency with a mandate could accomplish. The entire agency was given much wider legal leeway to conduct business, including placing some of the tax appeals courts within the DGI rather than the judicial branch (Eaton 2003).

their forms and wait a long time for their number to appear on a counter above the heads of tax officials.<sup>7</sup>

In many provinces, government office buildings work “siesta” hours. That is, administrative matters can only be handled between 8:30am and 1:15pm. To pay taxes requires a citizen to take a morning off from work to sit in the provincial office building. Taxes, moreover, are usually paid in cash. All provincial office buildings have Automatic Teller Machines with long lines of people collecting the proper payment for their dues.

Taxes are not paid by mail because the mail system is not commonly used and it is expensive. In the larger cities, people receive mail such as bills, but they also pay them in person at the respective office, such as telephone and mobile phone bills. Online payment is a growing industry in Argentina but it is not yet available for paying taxes. Even if available, most Argentines use the internet at work or in internet cafés (locutorios) but not in the home. Bill payment at internet cafes comes with significant risks of identity and password theft. And, like in all nations, the internet is the terrain of the young. Provincial tax bureaucracies thus demonstrate what is generally true of provincial bureaucracies. They are understaffed, they lack resources, and they appear inefficient.

Some provinces have better bureaucracies than others, however, as I show in my empirical chapters. They have invested more in capacity because of political motivations to do so in the past and currently maintain higher technical capabilities. The interaction

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<sup>7</sup> I observed this in Mendoza, Córdoba, and Salta.

between political will and technical capabilities is very important in their successful development of capacity.

### **The Menem Years in Comparative Perspective**

In my empirical chapters, I examine two policy reforms that took place in Argentina in the early 1990s. In this section, I argue that this period is a valuable one to study and it is broadly comparable, in its institutional environment, to other periods in Argentina. I also show how, despite the close temporal proximity of these reforms, their effects do not bias or undermine the results seen in both empirical chapters.

The 1990s in Argentina were the decade of Carlos Menem. He took office in 1989, several months before his scheduled inauguration, at the request of troubled outgoing president Raul Alfonsín. Alfonsín was the first democratically elected president following the military dictatorship of 1976-1983. Despite significant strides on issues of civil liberties and domestic peace, he left office with Argentina in considerable financial trouble. Menem, although he campaigned on a traditional Peronist platform that emphasized protection of wages and labor rights, introduced radical neoliberal reform. The 1990s were a period of flux for the Argentine economy, as Menem eliminated state industries, opened the country to foreign trade, and placed strict controls on the money supply. The political institutions I have described in Argentina are broadly reflective of their patterns from the twentieth century to the present. The Menem years are often characterized as a time of political change, but this does not extend to the operation of its basic political structures.

The characterization of the 1990s as a transitional period does not suggest that it cannot be compared to other periods in Argentina. Rather, this period is typical of Argentina's dramatic policy shifts throughout the twentieth century and beyond. Argentine politics has always been exemplified by change, rather than stability, yet the basic institutional structures remain rather constant, including in the 1990s. The institutions under examination, political parties and fiscal federalism, were not changed during the period except in the ways that I inspect in my empirical chapters. The party system, dominated by the Peronist and Radical parties along with a sprinkling of province-based parties, was institutionally the same during this period. Fiscal federalism's institutional structure was also not altered, though the amount of federal transferred varied over the years.

My empirical chapters look particularly at policy interventions in 1991 and 1993. In 1991, Menem introduced the Convertibility Reforms to stabilize the macroeconomic condition in the country. These reforms took away resources from all of the provinces that they previously garnered from economic instability, in particular inflation and ill-advised lending from the federal government and provincial banks. This was a policy imposed on high from the national government and the provinces were forced to respond to this new fiscal environment. This policy change is quite different than the 1993 Fiscal Pact, where the provinces negotiated the terms of changes to their fiscal environment. In this pact, provinces agreed to reform some of their taxes in exchange for a minimum guarantee of federal transfers. The 1993 pact was a strongly political process where provinces were able to debate the changes and make deals with the federal government to get the most out of the bargain.

Although the 1991 and 1993 policy changes both affected provincial tax systems, I argue that they are separate interventions and one did not bias the results of the other. Although Convertibility changed the dedication of provinces to collecting taxes, it did not change which taxes were implemented by the provinces, it only affected how hard the provinces tried to collect them. The reforms of 1991 did not alter the institution design of taxes in the provinces. In 1993, the national government negotiated with the provinces to change the structure of certain taxes that they collected. Thus, it is possible that the change in 1993 could affect the tax revenue data seen in the cross-provincial chapter. I need to be concerned that the trends I observe after 1991 are not being caused by the reforms of the Fiscal Pact of 1993. I argue that this is not the case, and that in fact, the results of the cross-provincial chapter are in fact stronger because of the changes at 1993.

The provinces that complied with 1993 were, generally, the provinces with high technical capabilities. The expected effect of compliance with the pact in the short term would have been to *reduce* receipts in those taxes (Schwartz and Liuksila 1997; Tommasi 2002). Thus, the effect in 1991 of the complying provinces should be underestimated. In the cross-provincial chapters, we see that the high capabilities group has the biggest increase in tax revenue in 1991 and the highest sustained growth in revenue. The results for the high capabilities group should have been even bigger (in the post-1993 period) if the Fiscal Pact had not taken place. The changes made in response to the Convertibility reforms were likely underestimated due to the 1993 pact.

The 1993 pact also changed the size and reliability of federal revenue transfers to the provinces. It is certainly possible that the increased floor on federal transfers should make provinces less likely to collect provincial taxes. Again, this is a way that the 1993



reforms might underestimate the results of changes in provincial tax collection. However, the tax revenue in the provinces remains stronger after 1993 than they were in the post-Convertibility period. This is so because of the underlying reasons for the changes in provincial behavior at the Convertibility reforms—low inflation, no provincial banks or national bailouts—remains the same after 1993. The change in federal transfers in the 1993 pact did not dramatically increase the money received by each province, it only guaranteed that the provinces would receive a minimum level of transfers.

## **Conclusion**

In this chapter, I explained why my taxation indicators are a contribution to the literature on state capacity. I showed how tax indicators reveal effort on the part of states, thus showing their ability to implement policy. I also describe the theoretical basis for separating the types of taxes so that we can see much more about the states' capabilities. Finally, I compared my measure to existing indicators of capacity to show that tax types are a more theoretically-sound way to capture state capacity in comparative research.

In the second section, I have demonstrated the persistent weakness of state capacity in Argentina's provinces. These weaknesses emerge from political sources, in particular politicians' reluctance to invest in the long-term project of capacity building. Once bureaucracies have shown themselves to be inefficient and unable to be helpful to the career goals of politicians, they are further marginalized, and limit policy options for decision-makers. They lack high quality information about citizens and citizens, in turn,

see little value in engaging their bureaucracies. I based these assessments on theories of state capacity, bureaucratic quality, and institutions.

In the chapters that follow, I detail two important efforts at bureaucratic reform in the provinces. The first, the Convertibility Reforms that cut significant sources of provincial revenue, were forced upon the provinces. Provinces were made to sink or swim—either improve their provincial tax bureaucracies to meet their revenue demands or default on debts. In the second, provinces negotiated tax reform measures with the national government in exchange for secure access to federal transfers. In both chapters, I show how the responses of the provinces to these reform efforts depended on the will of provincial politicians and their existing technical capabilities to make the needed reforms.

## **Chapter 4**

### **When the Well Dries: State Capacity in Argentina's Provinces**

#### **Introduction**

Studies of state capacity suffer from a critical flaw. Capability of state action is inseparable from “will” to perform those tasks. Where states are observed to be weak at implementing policy, they may lack the administrative resources for effective governance or politicians may prefer that policies flounder. Simple observation of policy implementation cannot distinguish between the capability and will components of capacity.

The goal of this chapter is to examine capacity where political will is clearly present so that state capabilities may be isolated. Specifically, I explore a case where will to implement policy was previously absent but incentives to develop capacity were dramatically altered by a policy change. Argentina's provinces prior to the Convertibility reforms of 1991 seemingly had weak capacity, evident in their apparent inability to collect provincial taxes. The provinces had very little incentive to collect these taxes, however, and many even had a disincentive to do so. Convertibility cut off easy money to the provinces—this generated will for all provinces to collect own-source taxes, resulting in observable capacity development. The provinces, with shared national history, shared national (fiscal) policies, and very similar tax policies, provide a laboratory for examining the differences between high and low capacity states, and incentives that drive capacity-building.

The research design of this chapter integrates the theoretical argument of my

dissertation. Capacity, I argue, is a function of the information available to a state that may be used to administer policy and enforce compliance. In this chapter, I show a clear change in provincial capacity that came from increased political will to collect and manage information to implement policy. I also show that variation in information results in different levels of capacity and rates of capacity development. Argentina's provinces all responded to the hardened budget constraints of the Convertibility reforms but some did so much more effectively, evident in their total collection and improvements in "high capabilities" taxes. The provinces that were successful at improving their fiscal situations were those with greater information about their citizens.

### **Will versus Capacity**

The political and economic implications of lack of will are conceptually distinct from weak technical capabilities. An important contribution of this chapter is to demonstrate a way to distinguish states that simply have low technical capacity from those that have little incentive to implement policy. Since the interventions of international organizations and the classification of states will fundamentally differ based on these conditions, the type of state capacity challenge is crucial to identify.

The Convertibility reforms provide a way to isolate the political will and technical capabilities of Argentina's provinces. These reforms created the political incentive to implement tax policy that did not exist prior to this time. Table 4.1, below, refers back to Table 2.1 from the Theory Chapter. After Convertibility, all provinces should be on the left side of the table as having political will. Where we observe provinces that do not improve their tax collection after these reforms, we can attribute this in large part to weak

capabilities. Jumps in provincial collection after 1991 identify provinces with stronger capabilities.

**Table 4.1: State Capacity Outcomes After Convertibility**

<b>Capabilities</b>	<b>Will</b>	
	<i>Yes</i>	<i>No</i>
<i>Yes</i>	High State Capacity	<del>Low capacity (in some policy areas)</del>
<i>No</i>	Low capacity	<del>Low capacity</del>

### **Micro-foundations of Capacity: Information-Producing Interactions**

I argue that state capacity is built upon effective collection, distribution, sharing and use of information gleaned by the state. This information comes from citizens' interaction with the state. State and society interaction is extremely common in modern states. Some interactions between state and societal actors are clearly aimed at generating information for the state. These include registration of people (birth certificates, driver's licenses, identification cards, passports) and property, filing taxes, among others. In exchange for this information, states provide citizens with goods, such as free education, welfare services, or security. Other interactions are less visible to citizens themselves. Bank and credit information are usually known to states because of linkage of accounts to the registration of people or property. Tickets purchased at the bus station that require a DNI (National Identification Document) or use of a passport at the airport tell the state something about its citizens' travel habits and access to money.

Interactions between states and citizens also include dealings with "street level" bureaucrats. Police that walk a beat learn who lives in a neighborhood, who owns the

shops, and where the crime commonly occurs. This is valuable information to a state interested in controlling crime and social unrest, but it is also useful for state taxation. Knowing who lives where, who owns a shop and an approximation of how many people frequent that establishment is relevant information to a state interested in taxing property and income. Citizens also come in contact with teachers, trash collectors, and public works officials on a regular basis, in addition to those who may see and talk to local, provincial or national elected officials. These interactions can also be used to inform states about societal preferences and to collect information usable for taxation and the provision of state services.

The amount of information available to the Argentine state is clearly observable in some cases. Argentina conducts a reliable census every 10 years and this information is promptly available on the internet. The census is not the only information collected by state agencies in Argentina. The national government has several major data collection bodies, including INDEC (National Institute for Statistics and Censuses), for social statistics and MECON (Economic Ministry), for economic statistics. These are the primary information stores in the country. Every province has a statistical agency, created by provincial law, and ministries of economy and social agencies that collect information. The economic data provided by the provincial websites are usually the PBG or Gross Provincial Product, and price indexes, along with budget information copied from the federal data agencies. In general, however, the Argentine state is weak at information collection relative to its wealth and social development. Much better information is available in some parts of the country than others, however, because of greater frequency of and higher quality state-citizen interactions.

Aggregate socioeconomic data, census information, and macroeconomic statistics are only the start to the information needed by a modern state. Taxation of income, property, profits, and sales require extensive knowledge of the economic actors and taxable activity that takes place within a state. Also, expenditure, not just revenue collection, requires an informed state. In order to dole out welfare and pension checks, fund public schools and hospitals, and build and maintain infrastructure, states need to know who receives services and the appropriate amount to allot to them. Information is therefore critical to the functioning of an effective state, including bureaucracies and political institutions.

### **Research Design**

The ability of Argentina's provinces to tax their citizens has been difficult to observe for most provinces. Since the majority of provinces receive over 80% of their funding from central government transfers without any linkage to provinces' contribution to the communal "pot," most, quite reasonably, exert little tax effort. The marginal gains to rigorous pursuit of provincial taxes are very low. Accordingly, few provinces collect a significant portion of their revenue from their own taxes.

Some provinces are notable exceptions to this tax shirking. These provinces are the widely recognized as economically developed provinces, the hubs of industry and economic growth for the country. Central transfers are progressive; less is provided to those provinces that are wealthier. Since the relatively well-off provinces receive relatively little from central transfers they are forced to collect their own resources. Capacity to tax is more evident in these provinces. In fact, these provinces have strong

incentives to collect provincial taxes in particular because, contrary to federal taxes, these funds are not put into the central “pot” to be redistributed to poorer provinces.

A simple cross-sectional comparison of these wealthier provinces to the poorer provinces with little incentive to collect provincial taxes would be a poor test of state capacity. The obvious result that the rich provinces of Buenos Aires, Santa Fe and the capital city, for example, are more effective tax collectors than the underdeveloped Jujuy, Santiago del Estero and Tucúman would surprise few observers of Argentina. The research design featured in this chapter does not rely on the economic differences between provinces but rather on an event study that reveals their latent capacity. Since central transfers and historically high inflation stifle incentives to collect provincial taxes, I examine the differences in provincial collection when these resources were not so readily available. In particular, I show how a critical event in Argentina’s recent history, the Convertibility policies of 1991, necessitated provincial tax collection because they cut the flow of “inflation tax” that came from monetary instability. Those provinces with latent capacity to collect taxes were able to increase provincial revenues to fill the void in their finances. Those lacking capacity had to develop it, cut spending, or default on their expenses to survive in difficult times.

The result is a pooled interrupted time series research design. In these designs, we expect predictable changes in the dependent variable of interest as a result of a treatment event. I focus on Convertibility “treatment” with multiple pre and posttest observations of the outcome variable, provincial tax collection, measured at multiple evenly-spaced intervals. This is a strong research design because, even though there is not random selection of provinces to receive the Convertibility treatment, the numerous



observations of pre and post Convertibility levels of tax collection and the multiple groups of provinces (sorted by levels of capabilities, explained later) allows for a valid test that can capture both the onset (abrupt or gradual) and duration (permanent or temporary) of the treatment effects (Duncan and Duncan 2004). The pretest provides a baseline for comparison of the post-treatment observations. This is analogous to using basic medical information, such as body temperature, blood counts, blood pressure and other statistics to assess the health of a patient. With people we know, after years of observations, the normal range of body indices that we can compare to those who are or may be sick. For the provinces of Argentina, the baseline taxation level (measured relative to Gross Provincial Product) must also be known so that the existence or extent of changes in revenue and taxation following these events can be assessed. The posttest observations are the years after Convertibility. I predict a visible pattern of change in revenue and taxation following these events.

The Convertibility Reforms of 1991 hardened provincial budget constraints by eliminating inflation “taxes” and federal bailouts. Importantly, this treatment is not endogenous to specific provinces but was a national economic event that imposed effects on all provinces. Although many scholars blame the provinces for the economic mismanagement that drove decision-makers to Convertibility, this crisis was not produced by specific provinces but was a series of national economic events with multiple economic as well as political causes: national, provincial and municipal, and international.

I predict noticeable changes in size and content of revenue for the provinces following these events. First, I expect all provinces to improve provincial-source taxes

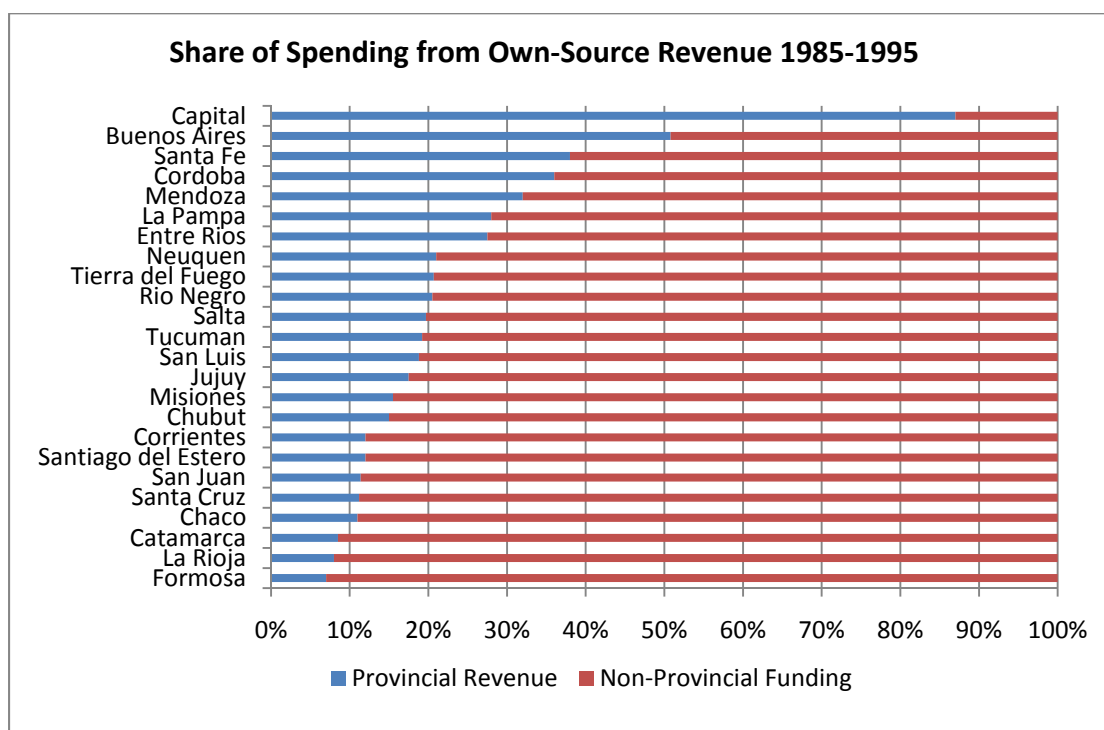
through increased tax effort. The extent of improvements in taxation will depend critically upon provincial capabilities. I explore trends both in total taxation and across taxes that vary in difficulty of collection. Second, the pattern of change predicted for the remaining revenue is what I call the “beg, borrow or steal” hypothesis. With the cut-off in national funding, I anticipate noticeable differences in the revenue choices of provincial governments depending on their information about citizens. This is a non-equivalent dependent variable aspect of the research design because I expect to see three different outcomes depending on the quality of provincial information.

### **Convertibility as Fiscal Constraint**

Argentina’s fiscal federalism has taken the brunt of the blame in recent years for the country’s poor macroeconomic performance (Saiegh and Tommasi 1999; Jones, Sanguinetti, and Tommasi 2000; Tommasi, Saiegh, and Sanguinetti 2001). The revenue sharing arrangements between provinces, established in 1853 and under continuous review and retrenchment to this day, provide notable disincentives to strong and independent provincial accounts. The large majority of the provinces, except for the most economically developed and productive, rely almost exclusively on national transfers for funding, totaling up to 97% of provincial revenue. The motivation to collect own-source revenue has been almost entirely absent in Argentina’s history.

The Law of Co-Participation, outlined in the previous chapter, is the federal tax sharing law. These national resources are distributed without any connection to the tax effort of the provinces. It provides perverse incentives to develop the capacity of the provincial bureaucracies. Co-Participation not only dampens incentives to collect taxes,

it also heightens incentives to overspend. National taxes act as a “common pool resource” for provincial officials and local legislators who receive the full benefit of provincial spending without having to incur the full political cost of collecting that revenue (Tommasi, Saiegh, Sanguinetti 2001). Moreover, provincial spending is highly pro-cyclical—they increase spending rather than savings in boom times—because provinces understand that they could receive less federal funding if their fiscal situation improves. This would include a reduction in national transfers, which are at least partially “progressive” or failing to cash in on national “bailouts” that reward fiscal profligacy. Not surprisingly, the fiscal situation in Argentina has been continuously plagued by provinces that do not devote political or economic resources to developing taxation capacity.



Source: Ministry of the Economy, in Saiegh and Tommasi, 1999

**Figure 4.1: Own-Source Revenues, Percentage of Total Provincial Spending**

The 1980s were a fiscal disaster for Argentina. Slow economic growth, coupled with high inflation (over 300% per month in 1989), high unemployment rates and mounting national and provincial debt, resulted in a macroeconomic time bomb in the Southern Cone. Provinces were racking up debt, borrowing from the national government and province-owned banks and relying on the (exceedingly high) “inflation” taxes that monetized their debts to local lenders. Argentina lost its credibility as a site for foreign investment or foreign loans; it was economically devastated. The president at the time, Raul Alfonsín, the first democratically elected president in decades, was forced to step down due to economic ruin in 1989 and he was replaced by Carlos Menem along with his innovative Economic Minister Domingo Cavallo. Cavallo took drastic action to control Argentina’s explosive inflation and restore confidence in its economic regime.

Cavallo’s policies were centered around the peg of Argentina’s currency to the U.S. Dollar; a strictly fixed exchange rate that would stifle inflation. This “Convertibility” initiative was paired with firm controls on lending to provinces, previously a source of provincial “bailouts” and an encouragement of provincial extravagance. Finally, these initiatives changed laws to strictly limit borrowing from provincial banks. Convertibility had profound effects on Argentina’s provincial finances. First, the provinces previously relied heavily on inflation for the financing of their initiatives, in particular wages for provincial employees and loans from province-owned state banks. Specifically, provinces would establish wage rates at the beginning of a year and inflation would dramatically reduce the value of these salaries. Also, loan values not

fixed to inflation became significantly cheaper over time.<sup>8</sup> This so-called monetization of debt was a primary source of “funding” that was eliminated by Convertibility.

Second, provinces could no longer count on the federal government to bail-out provinces with troubled finances. In the past, provinces were assured that if they got too far in the “red,” the central government would come to their aid. The larger provinces knew they were valuable to the federal government and thus “too big to fail”; a cushion of federal money would be available if they stumbled. The smaller provinces knew that their debts, taken individually, were a trivial amount to the federal government and they could secure help without tremendous difficulty. Convertibility policies were intended to remove this “safety net” for the provinces so they could manage on their own.

Importantly, the federal government partially backed out of this agreement and aided some provinces in trouble after the Convertibility reforms, such as the loan given to the province of Córdoba in 1994 and the absorption of several municipal pension systems in 1994-1996 (Nicolini, Posadas, J. Sanguinetti, P. Sanguinetti, Tommasi 2002). While these incidences undermined, to some degree, the assertion that the federal government would no longer bail out the provinces, such financing was much less common, bailouts were unlikely, and provinces found a clear difference from before Convertibility in their debt negotiations with the federal government (Sturzenegger and Werneck 2007).

Finally, the “captive” financing of provincial banks was cut off by these changes.<sup>9</sup>

Prior to Convertibility and the “Fiscal Pact of 1992,” provincial banks were frequently

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<sup>8</sup> Of course, inflation also decreased the value of collected taxes, but since the provinces collected very little of their own taxes, this was not a primary concern.

<sup>9</sup> Provincial banks had a legal status that made them dependent on provincial executives. Tommasi (2002) describes, “the provincial government banks were considered to be akin to the central bank of the province:

given loans to keep afloat when they overextended their credit. Province governors held sway over these province-owned banks, so the provincial credit rating mattered very little in the assessment of loans and loan rates. These bad loans were covered by national treasury contributions or bonds from the federal government; these bonds, if paid, dramatically improved the rate of interest on existing debt, effectively lowering provincial debt.<sup>10</sup> With the reforms of the early 1990s, federal assistance for provincial banks was no longer available. This change is apparent, in the privatization of all but a few provincial banks in the mid 1990s. Without federal bailouts, provincial banks did not have the resources to fund provincial projects or pad provincial budgets.

**Table 4.2: Changes to Provincial Finances After Convertibility**

<b>Before Convertibility</b>	<b>After Convertibility</b>
Federal Transfers	Federal Transfers
Inflation Financing	<i>No</i> Inflation Financing
National Bailouts	<i>No</i> National Bailouts
Province-owned Banks	<i>No</i> Provincial Banks <sup>11</sup>

The intended and actual result of many of the Convertibility and Fiscal Pact reforms was to eliminate the “easy” money available to provinces. A summary of Convertibility’s changes to provincial finances is shown in Table 4.2, above. Without “bailout” funding and inflationary monetization, provinces had to be more careful about their financing. This could be accomplished by increasing own-source revenue

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they provided funds to the provincial governments upon demand and, in turn, received rediscounts from the Central Bank” (of the Nation) p.7.

<sup>10</sup> National treasury contributions (ATNs) are distributed by the Ministry of the Interior at the discretion of the national executive. Their distribution has been shown to be highly political; provinces of the same party as the president (and in the case of Carlos Menem, his home province) are much more likely to be the recipients.

<sup>11</sup> Most provincial banks were shut down in this time period but a few banks remained open. The remaining banks were not those lending exorbitantly to their own provinces.

(especially provincial taxes), reducing spending, both, or neither. Jones, Sanguinetti, Tomassi (2001 p.20) and Rezk (2000) find strong evidence that Convertibility resulted in the improvement of provincial tax collection. They found much weaker evidence that Convertibility hastened provincial spending. The purpose of the following data section is to examine the extent and causes of this increase in provincial tax collection.

### **Data Analysis**

The Convertibility and “Fiscal Pact” reforms should have created a stronger incentive for all provinces to increase provincial tax revenue to cover costs previously handed off to the federal government. This drive should have been particularly strong in the provinces that historically relied on inflation financing and central bailouts. In general, those provinces dependent on large-scale assistance from federal sources are also those with the weakest provincial economies and the lowest provincial tax collection. While all provinces had incentive to increase taxes because of the hardened budget constraints generated by these reforms, their ability to do so was conditioned by their state capacity, which I argue is a result of the information gleaned from interactions between states and citizens. Changes in taxation efficacy in the period under examination, both in total tax collection and among the different types of provincial taxes, should vary according to these interactions and resultant information. The following analysis presents hypotheses and results for these changes in tax collection.

### Data Description

The primary dependent variables in this study are total provincial tax collection and collection separated according to type of tax: property, automobile, business and stamp. I use provincial revenue data for all provinces except the federal capital of Buenos Aires from 1959-2001. In nearly all of the results (except those expressed per capita) I have controlled for changes in the economy of the province by examining the ratio between taxes and Gross Provincial Product. These data were collected and coded by Juan Porto and his colleagues at the National University of La Plata. All figures in money values are expressed in 2001 Argentine pesos.

#### *Dependent Variable: Provincial Tax Collection / Gross Provincial Product*

The capital city of Buenos Aires (GCBA) is at this time an autonomous province of Argentina. The federal capital was divorced from the province of Buenos Aires in 1880, but only became an autonomous political zone with its own elections in 1996. The fiscal status of GCBA has changed often in the last century, making consistent collection of provincial level revenue and spending data very difficult.<sup>12</sup> The strong role of the federal government in its political affairs also precludes it from being a comparable case to provinces that were self-governed throughout the period in question. For these reasons, GCBA is excluded from this analysis. It is clear to all observers of Argentina, however, that the federal capital is strongest of provincial economies, has the most

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<sup>12</sup> GCBA was at times included in national level tax collection and spending and tax collection in the city has been directed at times by the federal government.



informed bureaucracies, by most accounts, and is the area most likely to have high tax collection.<sup>13</sup>

### Basic Model Description

The foundation model for this study is listed below:

$$\text{Totaltaxrev} / \text{GPP} = \alpha + \beta \text{PostConvert} + \beta \text{GPPpercap} + \beta \text{Indust} + \beta \text{GovParty} + \epsilon^{14}$$

The dependent variable is total tax revenue for each province. This value is divided by Gross Provincial Product to control for the different sizes of the provincial economies as well as changes in the economic fortunes of the provinces. Dividing by GPP ensures that the improvements we see in tax collection are not due simply to an improved provincial tax base.

The independent variables are predictors of changes in tax collection. First, *PostConvert* is the primary independent variable, coded 0 before 1991 and 1 after 1991 to represent the timing of the Convertibility reforms. The control variables are both political and economic. For economic variables, I have included *GPPpercapita* to control for level of development and wealth. The variable *Indust* represents the level of industrialization in a province, measured as the percentage of industrial production in a province divided by the provinces' percentage of the national population. Finally, the political variable I include is *GovParty*, coded 1 if the Governor of the province is

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<sup>13</sup> Other indicators of bureaucratic quality, such as tax collection in more recent periods, support experts' opinions that the federal capital of Buenos Aires would be in the "High Information Provinces" category.

<sup>14</sup> Taxes in 2001 Constant Pesos. GPP is 1986 Constant Pesos.  $\text{PostConvert} = 0$  if  $<1991$  and  $1$  if  $\geq 1991$ .  $\text{GPPpercap} = \text{GPP} / \text{population}$ .  $\text{Indust} = \% \text{ of national industrialization} / \% \text{ of national population}$ .  $\text{GovParty} = 1$  if Peronist Governor;  $0$  otherwise

Peronist and 0 otherwise. The governor is the strongest political figure in the province and a very powerful political actor at the national level. I included this variable to see if partisan ties influenced politicians' actions to spur improved bureaucratic performance.

Bureaucracies do not exist in a political vacuum. The political impetus for policy implementation is a necessary condition for state capacity. It is possible or even likely, therefore, that the provinces responded to Convertibility differently. Convertibility was a drastic policy introduced by a Peronist president. The effects of Convertibility were, particularly in the short-term, a hardship to many provinces and created stress to provincial bureaucracies.

I include partisan effects in the model with a variable coded for the party affiliation of the provinces' governor between 1980 and 2001. For all intents and purposes, the governor is the political actor for the provinces, particularly in national-provincial affairs. The possible effects of partisan affiliation are not obvious. It could be that the provinces with administrations (particularly governors) sympathetic to Carlos Menem may have worked harder to improve their own provincial finances to prove that Convertibility was a success. On the other side, Peronist provinces might have resisted improving their bureaucracies because they expected Menem to make exceptions to his loan policies by granted his co-partisans resources to help with the change. I discuss these effects in the hypothesis and results section below.

### Provinces Grouped by Information

The extent of state and society information and interconnection cannot be directly measured. The number of times states interact with citizens, the quality of those interactions, the amount of information they generate, and their effect on loyalty and compliance can only be ascertained indirectly, by outcome variables. To group the provinces according to network connectivity, I employ data from the Central Bank of the Republic of Argentina (BCRA).

#### *Sorting Variable: Private Loans per Capita*

I use a proxy variable of state information, value of loans per capita given to private citizens in the province.<sup>15</sup> The goal of this division is to establish whether provinces that are better informed are in fact better at utilizing their capacity to increase taxation rates in the post-Convertibility period. With citizens seeking loans, state bureaucracies have quality information about their access to resources since this information is reported to provinces and linked to their national information number. It should correlate with other state information. Importantly, this variable is not endogenous to taxation; taxation itself does not cause high or low loan access since these resources are not taxed at the provincial or federal level. The provinces, grouped into high, medium and low information groups according to the Private Loan sorting variable, are listed below in Table 4.3.

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<sup>15</sup> Private loans per capita is not a proxy for wealth. It correlates with GPP per capita at .57 level

**Table 4.3: Private Loan Per Capita Groupings**

<b>Technical Capabilities Group</b>	<b>Provinces Included</b>
<i>Low Capabilities Provinces</i>	Catamarca, Corrientes, Formosa, Jujuy, Misiones, Salta, Santiago del Estero
<i>Medium Capabilities Provinces</i>	Buenos Aires, Chaco, Entre Ríos, La Rioja, Rio Negro, San Juan, San Luis, Tucumán
<i>High Capabilities Provinces</i>	Chubut, Córdoba, La Pampa, Mendoza, Neuquén, Santa Cruz, Santa Fe, Tierra del Fuego

I grouped the provinces in this way because I want to show, in a theoretically driven and helpful presentational way, observable differences in how provinces responded to Convertibility based on their level of capabilities. By grouping provinces in low, medium and high information capabilities, I can perform additional data analysis beyond the results of the full model on all cases.

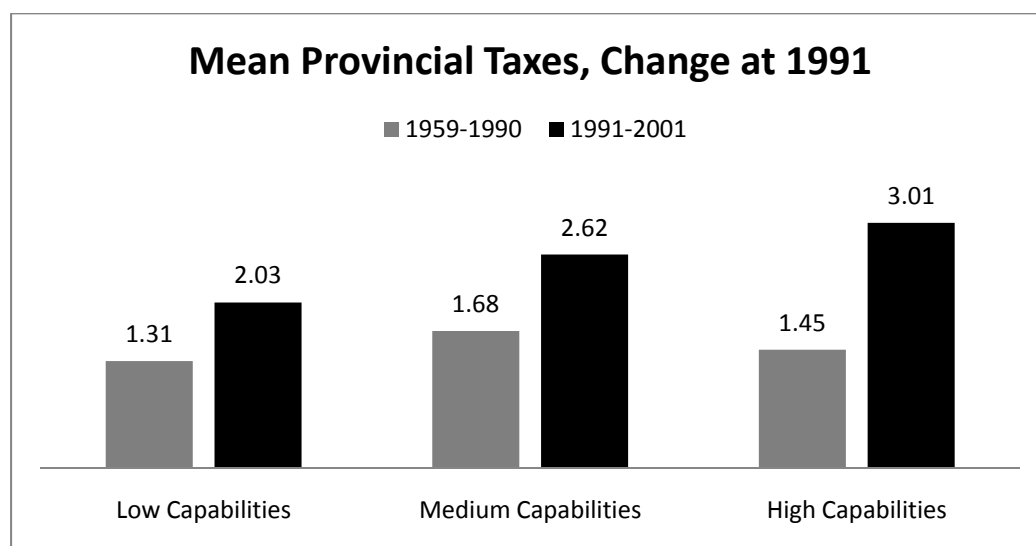
In the next section, I lay out hypotheses and present statistical results on provinces' effectiveness at taxation after the Convertibility reforms. Throughout, I separate provinces according to the information groupings.

### The Convertibility Effect

*Hypothesis 1:* Convertibility will create incentives for all provinces to increase provincial tax collection.

The first change that must be examined is whether the “treatment” of the Convertibility reforms had the effect that I have theorized. If provinces had incentives to increase provincial taxes, we should observe higher tax receipts for all provinces capable of collecting more taxes. That is, in theory, we should see a “jump” in tax collection after 1991.

I present strong evidence below that the year 1991 marked a substantial change in provincial tax collection for nearly every province. I argue this change was due to increased tax effort and, where possible, development of capabilities to collect more tax revenue. In Figure 4.2, the change in tax collection after 1991 is obvious and strong. For ease of examination, I show the mean tax collection for the network groups. Each group shows a noticeable increase in provincial tax collection. Also, importantly, the graph reveals a clustering of provinces prior to 1991 and separation, by information level after 1991. The groups distinguish themselves much more after 1991, with high information provinces going to the top. The high information provinces were actually lower than medium provinces prior to this change in will in 1991 but had the strongest growth after 1991.



**Figure 4.2: Mean Provincial Taxes (% of GPP), Change at 1991**

The graphical evidence supports my assertion that the Convertibility reforms drove increases in provincial tax collection. Below in Table 4.3, I present evidence that this “1991” effect holds up to statistical analysis as well. For the provinces as a whole,

and for each group, the variable *PostConvertibility* (labeled “Change in Taxation after 1991”) has a large statistical effect in a generalized least squares regression. This variable is coded 0 for pre-1991 and 1 for after 1991 to show the change at that year. These results hold when regressed with economic and revenue-related independent variables. Table 4.4 also shows that provinces improved collection in the years following the 1991 change. This increased rate is demonstrated in the variable *YearsAfterConvertibility*, a counting variable that starts from 1 at 1992 and goes to 10 at 2001. The positive and significant correlation shown in the right-hand column between tax collection and *YearsAfterConvertibility* (labeled “Rate of Change after 1991”) shows that provincial taxes are increasing over this period. This effect is not guaranteed to be related to Convertibility since the slope from 1959-1990 is also increasing overall, but it does provide support to the idea that incentives to increase collection were present after 1991.

**Table 4.4: Total Taxes, Before and After 1991**

	<b>Change in Taxation after 1991</b>	<b>Rate of Change after 1991</b>	<b>Difference in Per Capita Taxes</b>
Low Information	.691**	.103**	\$40.08
Medium Information	1.040**	.149**	\$88.58
High Information	1.631**	.213**	\$163.83

As expected, high capabilities provinces improve the most and at a higher rate than medium or low capabilities provinces. Nearly every individual province increased collection after 1991. In Table 4.5, I show whether each province had a statistically significant increase in tax revenue, and its mean per capita value. Even those without a statistically significant jump had a positive increase in mean collection.

**Table 4.5: Changes in Total Taxation, By Province**

	<b>Positive Change in Provincial Taxes Collection after 1991? (P Value)</b>	<b>Difference in Average Tax Collection Pre and Post 1991 (in Per Capita Revenue)</b>
<i>High Information Provinces</i>		<i>\$170.19</i>
<b>Chubut</b>	No (Insig.)	\$49.69
<b>Córdoba</b>	Yes (.01)	\$161.67
<b>La Pampa</b>	Yes (.05)	\$140.35
<b>Mendoza</b>	Yes (.01)	\$112.03
<b>Neuquén</b>	Yes (.01)	\$222.33
<b>Santa Cruz</b>	Yes (.01)	\$173.83
<b>Santa Fe</b>	Yes (.01)	\$126.71
<b>Tierra del Fuego</b>	Yes (.01)	\$374.92
<i>Medium Information Provinces</i>		<i>\$92.90</i>
<b>Buenos Aires</b>	Yes (.01)	\$138.75
<b>Chaco</b>	Yes (.05)	\$38.91
<b>Entre Ríos</b>	Yes (.01)	\$120.39
<b>La Rioja</b>	Yes (Insig.)	\$51.98
<b>Río Negro</b>	Yes (.01)	\$125.80
<b>San Juan</b>	Yes (.05)	\$68.72
<b>San Luis</b>	Yes (.01)	\$155.35
<b>Tucumán</b>	Yes (Insig.)	\$43.31
<i>Low Information Provinces</i>		<i>\$42.81</i>
<b>Catamarca</b>	Yes (.01)	\$72.42
<b>Corrientes</b>	Yes (Insig.)	\$28.78
<b>Formosa</b>	No (Insig.)	\$13.10
<b>Jujuy</b>	Yes (.10)	\$19.33
<b>Misiones</b>	Yes (.01)	\$62.00
<b>Salta</b>	Yes (.01)	\$48.94
<b>Santiago del Estero</b>	Yes (.01)	\$55.09
<i>Total (Average)</i>	<i>Yes (.01)</i>	<i>\$114.08</i>

The results of the full model are show in Table 4.6. In the full set of provinces, having a governor from the Peronist party improved tax collection to a statistically significant degree. When broken down by information groups, I show that this provincial effect is driven by the high information provinces. A Peronist governor in the high

information provinces made the province significantly more likely to improve their provincial taxes and to improve them more dramatically.

**Table 4.6: Full Model Results**

<b>Dependent Variable</b> Total Provinces/GPP	<b>All Provinces</b>	<b>Low Information Provinces</b>	<b>Medium Information Provinces</b>	<b>High Information Provinces</b>
<b>Treatment Variable</b>				
Post Convertibility	1.207**	.691**	1.040**	1.631**
<b>Economic Controls</b>				
GPP Per Capita	-1.426**	2.714**	-.527**	-1.022**
Industrialization	-.093**	-.841**	-.167**	.633**
<b>Political Controls</b>				
Governor's Party	.271**	.124	.076	.576**
<b>Grouping Variable</b>				
Private Loans per Capita	.429**			
<b>N</b>	943	287	328	328

I included figures for industrialization in the results because most theories of taxation suggest that industrialization helps tax collection. This is consistent with my theory because industrial activity is easily observable and monitorable by the state. However, I think this type of variable is limited on the national scale in Argentina because of that country's heavy concentration of industry in three provinces—Buenos Aires, Santa Fe and Córdoba. The industrialization results show a negative relationship to tax collection in the low and medium information groups and positive relationship in the high information provinces. Two of three important industrial provinces, Córdoba and Santa Fe, are high information provinces, supporting the idea that they could more easily tap new tax resources. The results of this variable are not particularly valuable, however, because industrialization did not change markedly in this period.



Hypothesis 1 was supported by the graphical and statistical evidence I presented above; the provinces clearly increased tax collection after 1991. The constraint placed upon the provinces because of the Convertibility reforms was the cause of this jump. Because provinces could no longer fund their expenditures with inflation financing or rely on federal bailouts, they were forced to find their own means to fund some of their initiatives. All provinces responded to this pressure to some extent, but I argue the variation in this growth depended on their capacity.

The statistical results show clear changes in bureaucracies' performance. The logical question thus becomes: what are the processes that result in better collection? In my field interviews, provincial tax officials and politicians said after Convertibility they put more tax officials in the field, staffed more in the tax collection bureaucracies, and held longer hours for filing. They also made efforts to simplify the process of filing some taxes and eliminated penalties on back taxes for first-time filers. Citizens also reported that officials looked the other way a little less often. The results show changes in what provinces could do once they had the motivation to do it.

The effect could, in theory, be attributed to some other factor that influenced every province in this time period. However, the driver of this change cannot be specific to individual provinces because these transformations are observed at the same time. The change cannot be ascribed to economic growth overall because the provinces varied in their economic success in this period and I present tax revenue relative to Gross Provincial Product. The change that explains these differences in tax rates must, accordingly, be national in scope and specific in time. Convertibility and the related

fiscal reforms are the most plausible source of these results (Jones, Sanguinetti, Tommasi 2001 and Rezk 2000).

*Hypothesis 2:* Better informed provinces will show a larger increase on “high capabilities” taxes

Capacity is apparent in ability to collect all taxes, but variation is more apparent where taxes are segregated by type. Argentine provinces collect four primary taxes: property (real estate), “gross” business, automobile, and stamp taxes. Of these revenues, property taxes require the greatest capabilities. Property tax collection demands a province collect quality information on who lives where and the value of the property, as well as have the means to enforce collection. Argentina has a very weak history of registering property; a nearly all real estate is deeded near market value and relatively few sales are transacted through official means.<sup>16</sup> Thus, property tax collection is the most challenging of the provincial taxes and most provinces collect very little. The mean collection for the entire period for all provinces is 0.27 % of GPP.

If capacity is related to tax collection and if information is an important predictor of state capacity, better informed provinces should perform better at collecting this difficult tax than less informed provinces. This hypothesis is shown to be supported in Table 4.7. The low capabilities provinces do not have a statistically significant increase in property tax collection after 1991 and they do not increase in the 1991-2001 period. Provinces with medium and strong network capacity both increase at 1991 and increase from year to year 1991-2001. The highest capacity provinces increase the most at 1991 and do so at a higher rate in the 1991-2001 period.

**Table 4.7: Property Taxes**

	<b>Change in Taxation after 1991</b>	<b>Rate of Change after 1991</b>
Low Information Provinces	.000	.001
Medium Information Provinces	.005	.031
High Information Provinces	.195**	.195**

Property taxes can be juxtaposed with two easier taxes to collect: automobile taxes and gross business taxes. Automobile taxes are low information taxes. Automobile taxes are paid to receive a license plate and the paperwork is initiated by car dealers upon purchase of the vehicle. Nearly all of the necessary information is gathered by the dealers, rather than the state, and administrators need only collect the forms and payment. Few have incentive to evade this tax because, first, it is not prohibitively expensive, and second, without a license plate they are targets for police. The rates of automobile taxation are very contingent on economic tides. When people are making enough money to buy cars, automobile sales will increase. All provinces should have the means to collect these taxes and the economic upturn in the 1990s (relative to the depressed 1980s) should have increased these taxes during this time period. The results in Table 4.8 show this to be true. All provinces increased this easy revenue, showing some level of capacity, and collected more over time.

**Table 4.8: Automobile Taxes**

	<b>Change in Taxation after 1991</b>	<b>Rate of Change after 1991</b>
Low Information Provinces	.000	.000
Medium Information Provinces	.098**	.097**
High Information Provinces	.075**	.075**

<sup>16</sup> Those registered with the state are often done so at a value much below the actual sale price.

Stamp taxes are an interesting type of tax for state capacity, especially in the post-1991 period. Unlike property taxes that have a clear, direct relationship to information collection and enforcement, stamp taxes are the easiest taxes to enforce. Stamp taxes are fees for contracts and paperwork registered with the state. By necessity, those who seek this service must present their taxable activity to the state, so the state need not devote any effort to identification and enforcement. On the other hand, stamp taxes offer an indirect measure of the information necessary for state capacity; those provinces with the means to enforce contracts are those with stronger state capacity. They are those provinces with the essential information and force to ensure that registration with the state is valuable. Better informed states should have higher levels of stamp taxes at all time periods, but they should also show an increase in stamp revenue as their capacity increases. Low capabilities provinces are not expected to be able, in this rather short time period, to develop the means to enforce nor change their reputation with those who might want a state contract.

**Table 4.9: Stamp Taxes**

	<b>Change in Taxation after 1991</b>	<b>Rate of Change after 1991</b>
Low Information Provinces	.001	-.036*
Medium Information Provinces	.031	-.033*
High Information Provinces	.136**	.136**

Table 4.9 shows the change in stamp tax collection after the 1991 period. Only the provinces with the highest level of information were able to improve, to a statistically significant degree, the collection of stamp taxes during this period. The low capabilities provinces did not improve, and may have regressed on this tax during this period. High

information provinces showed an increase in their credibility as enforcers of state authority; this evidence is consistent with increasing capacity in these provinces and a higher base level of capacity.

**Table 4.10: Difference in Means, Property and Sales Tax Per Capita Revenue**

<b>Expected Information Capabilities</b>	<b>Property Tax, Per Capita</b>			<b>Stamp Tax, Per Capita</b>		
	<i>Before 1991</i>	<i>1991-2001</i>	<i>Difference in Means</i>	<i>Before 1991</i>	<i>1991-2001</i>	<i>Difference in Means</i>
<i>Low</i>	\$7.85	\$9.53	\$1.68	\$10.97	\$11.83	\$0.86
<i>Medium</i>	\$16.49	\$26.35	\$9.86	\$19.13	\$22.94	\$3.81
<i>High</i>	\$18.57	\$31.29	\$12.72**	\$29.44	\$45.03	\$15.59**

Table 4.10 shows additional results of changes per capita revenue in high information taxes after 1991. In both taxes, the low capabilities provinces had the lowest revenue before and after 1991 and the smallest change at that year. Only the high information provinces changed markedly on these taxes after 1991, improving \$12.72 per capita in property tax revenue and \$15.59 in stamp tax revenue. These data showed the difficulty of collecting and transforming these difficult taxes. They also reveal the overall weakness of provincial tax collection; \$18.57 or even \$31.29 per capita in property tax revenue is quite low by any standard.

The Fiscal Pacts of 1991 and 1992 between the federal government and the provinces required provinces to “phase out” two inefficient taxes: the stamp tax and the gross business tax. Stamp taxes, they argued, lowered incentives to register contracts with the state because they increased the costs of doing so. Gross business taxes were regressive and imprecise and did not meet standards of fairness in taxation. Few provinces attempted to phase out these taxes because they are relatively easy-to-collect

(low information) and lucrative.<sup>17</sup> Rather, the evidence in Table 4.11 below shows that provinces substantially increased collection of gross business taxes in all information groups. Moreover, all provinces increased their collection of this tax over the 1991-2001 period, shown in the right-hand column.

**Table 4.11: Gross Business Taxes**

	<b>Change in Taxation after 1991</b>	<b>Rate of Change after 1991</b>
Low Information Provinces	.797**	.707**
Medium Information Provinces	.820**	.820**
High Information Provinces	1.246**	1.25**

Gross business taxes are a “medium difficulty” tax to collect because they require some information (though less than property taxes) about business transactions, locations and ownership and, unlike automobile taxes, require state officials to devote substantial effort toward enforcement. This is a fruitful tax to examine for increases in capacity because, unlike property taxes, it was possible for provinces starting from any base level of capacity to increase their capacity to collect gross business taxes in this short time period. This tax, and the dynamics of increase in this tax in the 1959-1990 and 1991-2001 time periods are examined in greater detail in a related article.

The results presented in this section strongly support Hypothesis 2. Better informed provinces were able to improve collection of high information taxes while more low capabilities provinces could only increase the easier types. In the next section, I explore other sources of provincial revenue according to their theorized connection to state capacity. Taxes are not the only way that provinces could respond to the hardened

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<sup>17</sup> In the next chapter, I explore the political decision-making behind provinces’ choices to keep gross

budgets constraints of the Convertibility reforms. Loans and payment defaults were also employed by provinces to make ends meet. The choice of revenue sources depend critically on state capacity.

### **Beg, borrow, or steal?**

Provincial governments have important expenditure demands. They are expected to fund state services such as education and health and pay government salaries, among many other tasks. For the majority of provinces, the bulk of these funds are transferred directly from the central government to provincial government coffers. In the absence of such funds, I expect the provincial governments to seek substitutes for this revenue so that they may continue to pay their bills. In particular, I predict three outcomes to meet revenue demands. These are:

- 1) Beg- raise provincial taxes to earn more money for expenditures
- 2) Borrow- seek and acquire loans to meet expenditure demands
- 3) Steal- default on expenditures

Of course, most provinces will attempt a mixed strategy to fund expenditures. Every province will attempt to beg, borrow and steal but the ratio of revenue gained from each source will depend on the capacity of that province. I assume throughout that the attractiveness of the beg, borrow and steal options and the theoretical difficulty in acquiring such funds, can be ranked as follows:

beg > borrow > steal

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business and stamp taxes despite federal mandates.

Raising taxes to pick up the slack in expenditures is the most attractive revenue option for a provincial government. Tax money, if it can be collected from citizens, need not be paid back, with interest, to creditors. It is a grant rather than a loan.<sup>18</sup> I assume that provinces will seek to fund their finances this way if they have the means to do so. The ability to tax, however, is the most difficult of these options for provinces to achieve and it can be harmful to politicians' goals.

Borrowing money from lenders is the second-most attractive option for provinces to fund their expenditures. Acquiring loans is inferior to taxation because it must be paid back at a future date. It is better than defaulting because it builds, rather than destroys, the creditworthiness of the province for future financial transactions. It is, however, not a simple thing for provinces to achieve, particularly following the government reforms of the early 1990s. Prior to these economic reforms, many provinces borrowed money from their own provincial banks and rarely repaid the loans. They also borrowed from foreign and domestic sources with expected future central transfers as collateral. This option was not readily available following Convertibility and, especially, economic crisis. Rather, they waited on inflation to erase their debts or extended the payment schedule of the loan.

With the Fiscal Pacts of 1991 and 1992, most provincial banks were shut down and provinces were prohibited from acquiring foreign debt. After 1991, therefore, borrowing became much more difficult and required provinces to demonstrate creditworthiness. Co-Participation revenue and natural resources afterward became the basis for collateral. Importantly, however, the time horizons and credibility of their debt must be considered to ensure that this is really the second best option for provinces. Many

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<sup>18</sup> This "grant" comes with some expectation of performance, of course.



provincial politicians may not expect to have to pay for the debts they incurred because their time in elected office is limited. These politicians may push off for the future the expenses of today. However, the same reforms that cut off easy money from provincial banks should also limit the creditworthiness of provincial administrations with short time horizons. Taxation in this case should still be the most attractive option.

The final option for provinces is spending the money and failing to pay those owed. This typically means arrears for government employees and defaulted loans. Every Argentine province has failed to meet expenditure demands at some point in history, but the incidence differs widely across provinces and no province prefers this option. Failure to pay destroys credit, leads to walkouts and likely protest by government employees, and hurts the electoral chances of politicians. Given the option of raising tax revenue or borrowing money they intend to repay, provinces will prefer not to steal if they can substitute other revenue methods. The following hypotheses predict the resource-replacement behavior of provinces, depending on their level of state capacity.

*Hypothesis 3:* To replace lost federal resources, high capabilities provinces will gather more revenue from taxes than from loans and will rarely default on payments.

Tax Revenue > Loan Revenue > Default “Revenue”

*Hypothesis 4:* To replace lost federal resources, medium capabilities provinces will gather more revenue from loans relative to taxes than higher capabilities provinces, and will default more often than higher capabilities provinces.

Loan Revenue > Tax Revenue > Default “Revenue”

*Hypothesis 5:* To replace lost federal resources, low capabilities provinces will default more often than provinces with higher capacity, take more loans relative to tax collection than high capabilities provinces, but will not be able to attract as much loan revenue as the medium capabilities provinces.

Default “Revenue” > Loan Revenue > Tax Revenue

The results of a ratio analysis for Hypotheses 3-5 are presented in Table 4.12. As predicted, high capabilities provinces have the highest tax/loan ratio, showing they collect much more revenue from taxes than they borrow in loans. They are “beggar” provinces because they seek revenue by asking it from their own citizens. The tax/loan ratio for medium capability “borrowers” provinces is higher than the low capabilities provinces. The network grouping of low capability provinces has the lowest tax/loan ratio, meaning that these provinces collect relatively more revenue from loans than taxes in this period. The difference between the provincial groups on this variable is marked. The high capabilities provinces had nine times greater tax revenue than loan value, while the lowest provinces had more loans than taxes.

**Table 4.12: Tax to Loan Ratios**

	<b>Total Tax / Total Provincial Loans</b>
Low Information Provinces	.75
Medium Information Provinces	5.91
High Information Provinces	9.10

Loan behavior for the provinces is also worth discussing in more detail.

Importantly, the total value of loan revenue in higher capabilities states may be higher than that for medium or low capabilities provinces even though the latter are more reliant on this type of income. Higher capabilities provinces should have greater access to resources of all kinds; that is why this study focuses on the ratio of loan to tax revenue. Also, even low capabilities provinces were able to secure some loans in this period, despite low state capacity. This is due to the possibility of securitizing their guaranteed Co-Participation funds into loans. The flow of Co-participation funds (federal transfers)

has no relationship to high state capacity, and likely is a better predictor of low state capacity, so these loans are not indicative of investors believing the state is capable of repayment through its own revenue.

The value of provincial “defaults” is not widely available from government revenue reports. These numbers are not easily quantified across the wide variety of revenue types included in defaults. The defaults on payments that are relevant include: payment cancellations or arrears to government employees and defaults on bank loan payments. These revenue lapses have not been systematically documented and their total monetary value is not known; but the national government attempted to collect information about this “floating debt” (unpaid obligations) after the economic crisis 2001.<sup>19</sup>

I measure default with provincial credit ratings. After the fiscal reforms of 1991, provinces could not borrow from their own “central banks.” In order to secure loans, provinces without sources of revenue to demonstrate credit-worthiness, had to use their Co-Participation funds as collateral. The Banco de la Nación, a semi-autonomous federal agency, distributes Co-Participation revenue and also works with lenders to collateralize provincial debt with Co-Participation funds. The Banco handled the collateral process differently depending on the credit-worthiness of the provinces. Tommasi describes: “Provinces with a weak credit position have to give irrevocable instructions for Banco de la Nación to deduct the debt-service payments upfront from their Co-Participación. Provinces with a stronger credit rating are able to satisfy their creditors with a less onerous pledge, namely that the creditor can collect from the Banco de la Nación only if

there is a default in payment.” Table 4.13 show the percentage of Co-Participation revenues withheld from each provincial group for this purpose (from Tommasi 2002).

**Table 4.13: Coparticipation “Collateral” for Network Groups**

	<b>Average Co-Participation Funds Withheld (1997-2000)</b>
Low Information Provinces	52.2%
Medium Information Provinces	44.7%
High Information Provinces	18.4%

The low capabilities provinces had to withhold a much greater amount of their Co-Participation revenues to meet these loan conditions, evident in the high (52%) level of collateral. The high capabilities provinces had a sharply lower deduction. This is an important indicator that the information groups are not a simple function of economic development. The amount of the loans secured by the provinces depended on economic development; more developed provinces had bigger economies and larger expenses that required more revenue. It was cheaper, therefore, to lend to less developed provinces because the loans were relatively small and they could charge higher interest rates. Most importantly, the noticeable differences in credit-worthiness, an indicator of ability to collect revenues in the provinces, across the information groupings suggests that these types of connections point to real differences in state capacity.

## **Conclusion**

Argentina’s provinces responded to the Convertibility reforms of 1991 with changes in revenue collection. Provinces that were better informed about citizens showed systematically higher state capacity, measured in the amount and type of revenue

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<sup>19</sup> I have not yet been able to access the floating debt data from MECON.

they were able to collect, than less-informed provinces. This improvement was seen in higher tax collection, increasing tax collection over time, higher collection of “high capabilities” taxes, higher ratios of tax to loan revenue, and lower risk of “default” on revenues.

The Convertibility reforms present an opportunity for a strong research design for state capacity, since provinces experienced a clear and strong change in incentives to collect own-source revenue. Prior to Convertibility, most provinces did not have the “will” to collect their own taxes but some had the capabilities. With this reform, the extent of capabilities was more easily observable because all provinces had the required will to exercise and build state capacity. No longer could provincial officials afford to under-invest in this type of policy implementation.

This empirical study of capacity strongly supports my theoretical claims that information is the critical connection between states and citizens. It also shows the importance of separating, in theory and research design, the contributions of technical, administrative capabilities from political will to implement policy. This is a valuable contribution to academic and policy research that has largely ignored this distinction and muddled measures of capacity.

**Chapter 5**  
**Governors' Calculations:**  
**State Capacity and Provinces' Compliance with the Fiscal Pact of 1993**

**Introduction**

This chapter focuses on one fiscal pact to explore how political will and technical capabilities help to explain policy implementation across the provinces of Argentina. This study focuses to a greater extent than the previous chapter on variation in political will and the impact of technical capabilities on political will. The motivations of politicians to improve their own-source revenue in response to the Convertibility reforms were assumed to be uniform—everyone needed money so everyone should have tried harder. In the case of the Fiscal Pact of 1993 in Argentina, however, political will is a much more contested issue and much less likely to be the same across provinces.<sup>20</sup> I show how political motivation and technical capabilities both contributed to governors' choices in provinces' response to the fiscal pact, and feedback from the technical capabilities of the provinces shaped their political incentives.

The Fiscal Pact of 1993 was an agreement between the national and provincial governments to reform inefficient and harmful taxes at the provincial level in exchange for a guaranteed minimum level of federal transfers. These changes, however, placed greater technical demands on provincial bureaucracies that not all of them were able to meet. I examine the responses to the pact through the lens of the political logic of a partisan provincial governor. I use hypotheses to predict the patterns of provincial compliance. In explanations of my quantitative findings, I provide qualitative evidence about several provinces and the politics that guided their behavior during this period.

My expectations for provincial compliance are driven by my theoretical framework of political will and technical capacity and their interaction. I expect only those provinces with both political will and technical capacity to comply with the majority of the pact. Where provinces have political will but not technical capacity, I expect them to try to comply by eliminating the taxes that they had difficulty enforcing in any case. Provinces with technical capacity but not political will comply only with reform of taxes that were proving harmful to their economic productivity. When provinces have neither situation, I expect very little or no compliance. Overall, I expect governors' beliefs about their provinces' capacity to shape the environment for negotiation and agreement with the pact. Provinces' responses to the pact reveal these patterns of compliance.

### **Why Pacts?**

The event under examination in this chapter is the Fiscal Pact of 1993, signed by the national government of Argentina and the provinces. This pact included the following terms: provinces committed to standardize automobile valuation and utilities taxes, eliminate stamp taxes on checking accounts, and, most importantly, phase out the gross business tax.<sup>21</sup> In return, the federal government offered participating provinces: a floor on minimum guarantee on federal transfers, an option to shift their social security systems for provincial government employees to the national system, and reduced federal payroll taxes levied on employers. All of the provinces signed the pact (some negotiated

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<sup>20</sup> The Fiscal Pact of 1993 is known in Argentina as the Pacto Federal para el Empleo, la Producción y el Crecimiento (Decreto 1807/1993).

<sup>21</sup> Schwartz and Liuksila 1997. The gross business tax is also known as the provincial turnover tax and the gross receipts tax.

for longer than others) yet none fully complied and most strayed significantly from major components of the agreement. Given the shaky history of compliance with pacts in Argentina and the non-compliance with this pact in particular, one may wonder why pacts are a worthwhile topic of study.

The study of pacts has proven valuable in the past because, first, they are a visible promise between political actors. In most cases, this commitment can be expected to endure for some period of time since it is in the interest of both parties. Barring coercion, pacts should not be signed if both parties are not made better off by the changes sought in the pact. Second, pacts reveal preferences of political actors. Often political scientists must assume or deduce the preferences of actors, without knowing for certain their priorities and what they are willing to give up for their choices. Pacts, on the other hand, place a value on the preferences of political actors and give a general idea of incentives for actors at the national and provincial levels.

Pacts are also good indicators of political change. If we can assume that two parties signed a pact because that agreement was in all parties' interest at time  $t$ , we can also know that when parties break the pact, it is not longer in their interest. Pacts are thus a good way to clearly demonstrate a change in political cost structure. Furthermore, should pacts fail without obvious changes in the conditions of the agreement, as was the case for Argentina's 1993 pact, we are given an arena to investigate commitment problems in government institutions.

For Argentina, with weak legislatures and dominant executives at the national and provincial levels, pacts are often better at showing the politics of lobbying and legislating than is national congressional legislation. The primary political game in Argentina is



played out between presidents and governors, rather than presidents and Congress (De Luca 2004). Pacts are the usual mechanism for decision-making between these two actors and are thus a vital tool in the Argentine federal system. Pacts are particularly interesting in the case of Argentina because of their frequency of use. Pacts, it stands to reason, are subject to complicated political negotiation outside of the official agreement.

The Fiscal Pact of 1993 is a very good example of national-provincial negotiation and provincial response to national incentives. Studying compliance with a pact that was forced upon provinces by a strong-arming national government would not tell us much about the politics of provinces. This pact, brought forth by the president in conjunction with a majority of governors, held the possibility of eliminating economically deleterious taxes while at the same time stabilizing national revenue into the provinces. This is a very good pact to examine because the tax reforms were considered by most to be mutually beneficial (at least in the long term), it dealt with matters of vital importance to both parties, and it was a central policy issue to all involved.

### **Central Question**

The goal of the chapter is to understand patterns of compliance with the Fiscal Pact of 1993. I want to know which provinces are complying and on which aspects of the pact. From this I can evaluate qualitative and quantitative evidence of why these provinces transformed their taxing system. For those that failed to comply, we can separate the political from the technical reasons for their decisions. The central question of the chapter is: can we distinguish weak (or strong) technical capabilities from political

intransigence (or cooperation)? To answer this question, I explore provincial self-interest, provincial-national party connections, and provinces' technical capabilities.

The most obvious questions for pacts with low levels of compliance is: why are provinces defecting from these agreements? Is enforcement weak? Is the national government failing to hold up its end of the deal? The more apt questions for Argentina are: why do *any* provinces comply with national accords? Given the history of national renegeing, policy instability, political turnover, weak tax enforcement and lax attitude toward past provincial defection, provinces could rightly assume that they need not comply with the pact but they will likely still reap the rewards of federal transfers.

Failure to comply with the Fiscal Pact of 1993 could have come from two primary sources. The first is political will. Put succinctly, some provinces may not comply with the pact because of political, especially partisan, disagreements with the national government. They could defy the mandate to undermine the success of the Peronist executive branch. On the other hand, provinces may not be able to comply because of their weak tax administrations. I argue that provinces look out for themselves, following party lines when it suits them and they are able, and ignoring them when it does not or they cannot. Related to this, the negotiation of the pact itself was shaped by governors' assessment of their own capabilities.

The role of both political will, technical capabilities, and the feedback between the two is evident in the negotiation of and compliance with the pact. I can sort the differences in these qualities in provinces based on their response to the pact. I expect only those provinces with political motivation, evident in Peronist party affiliation of the Province's governor, to comply on the removal of taxes that are significant sources of

revenue for them. Within the Peronist party, only those provinces with strong technical capabilities will comply with tax reform on the lucrative yet easy to enforce taxes.

### **Theoretical Foundations**

In this chapter, I am primarily concerned with demonstrating the role of political will in capacity development and with the feedback mechanism whereby technical capabilities shaped political will. Political will is driven by politicians' incentives to invest in improving their bureaucracies. Technical capabilities are founded upon information known to the state; to get this bureaucracies require politicians' resources and monitoring. Politicians' expectations about bureaucracies' existing technical capabilities also impacts politicians' willingness to invest in bureaucracies. In Argentina's response to the Fiscal Pact of 1993, we can see all of these factors at work.

The political institutions that shaped governors' choices were their political career paths, political parties and fiscal federalism. Politicians do not invest in their bureaucracies because of time inconsistency problems and because fiscal federalism in Argentina provides a disincentive for provincial revenue collection and reform. They seek political gain in the short-term but bureaucracies are an investment that only pays out in the long run (Spiller and Tommasi 2007). To overcome these problems, parties can provide longer term incentives (cf. North and Weingast 1989; Schepsle 1989; Mayhew 1974). Parties can impose discipline and use carrots and sticks to achieve collective outcomes *when they have to tools to do so*.

Institutions can also dissuade politicians from pursuing good collective outcomes. Institutions such as federalism and district-based representation can give politicians incentives to favor a small jurisdiction above the national good. Cohesive national party systems may also press politicians to act nationally even when their constituents demand local attention (Shugart 1999). Fiscal federalism, even though it creates perverse incentives to collect provincial revenue, gives the federal government tools with which it can shape governors' behavior. Federal control over provincial resources can also act as an instrument to impose collective outcomes. Argentina's has both of these institutions to sway provincial behavior.

In Argentina, a longstanding two party system dominates political activity. These parties—the Peronists (PJ) and the Radicals (UCR) are broad-based parties with appeal throughout the nation. The president is the head of the party and is imbued with strong constitutional and partisan powers. In the time of the Fiscal Pact of 1993, Peronist Carlos Menem held relatively strong sway over his co-partisans and was complemented with co-partisans in a majority of provinces. We can see in the pact that partisanship mattered in the fiscal pact of 1993 but the models of *strong* party discipline do not explain provincial behavior.

The negotiation of the federal pact takes place between the President and his cabinet, and provincial governors. The President is the only elected actor in Argentina with a national constituency. He is interested in what will improve the federal government's fiscal accounts. Provincial governors are concerned with what is best for their province. These two groups of actors often conflict, therefore, because what is best for the national government is often not the same as what is best for a given province. To

overcome this frequent source of conflict, political actors are brought together in the common interest of improving and maintaining the reputation of their political party. Partisanship and conflicting interests shaped the political background to this federal pact. Nonetheless, the provincial-based incentives of governors created by Argentina's institutions and concern about their own weak bureaucratic environment often trumped the desires of presidents.

Technical capabilities strongly affect states' ability to implement policy (Weber 1968; Rauch and Evans 2000). Bureaucracy must have the tools, including quality employees and good information about citizens and their behavior to do the business of the state. Politicians consider the quality of their bureaucracies when making policy decisions. The environment for political negotiation is affected by politicians' beliefs about the likelihood that policies can be carried out effectively by states (Spiller and Tommasi 2007).

The Fiscal Pact of 1993 was aimed at enhancing the quality of taxation in Argentina's provinces. The federal government traded some of their resources to alter the incentives of provincial politicians to make these tax reforms politically attractive. It was based on virtually unanimously agreed upon economic principles that know these taxes to be detrimental to the development of provincial economies, in particular the development of financial markets.<sup>22</sup> Provincial governors could not implement many of these reforms, however, due to technical constraints. Moreover, concerns with their weak

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<sup>22</sup> I do not claim that the Fiscal Pact of 1993 was perfect from an economic or social standpoint. I also do not claim that it Menem had the provinces' best interest at heart in all of the pacts' elements. Many of Menem's policies contributed to increasing income inequality and worsened conditions for Argentina's poor (Rock 2002). The pact was a political accord negotiated by self-interested actors on both sides. However, economists have universally decried the harm of the provincial taxes addressed in the pact.

bureaucracies affected the pact negotiations themselves, as weaker Peronist parties were allowed to skirt many of the pact's objectives.

## **Pact Background**

### Federal-Provincial Revenue Connection

The provinces are in a weak position, relative to the central government, in revenue collection. Argentina has experienced periods of both centralization and decentralization since the beginning of the republic, but these changes have almost always directly influenced the jurisdiction of expenditures, not revenue. All changes in revenue collection have been toward centralization, towards the delegation to the national government of revenue responsibilities.

The provinces have been very supportive of most, if not all, of the revenue centralization mechanisms. If they are able to get a satisfactory allocation of Co-participation funds from the national government, federal transfers are highly advantageous to provincial politicians. They get the revenue they need to pay for provincial programs, they get the benefits of providing services (and patronage) at the provincial level, and they do not have to pay the political costs of collecting the taxes.<sup>23</sup> Provinces like it this way. For example, in 1998, the governors killed a proposed shift to distribution criteria that would reward provincial tax effort (*El Economista*, 6 February 1998, 3). They paint the national government as the enemy—it is the evil force that robs constituents of their hard-earned money yet withholds revenue from the provinces. Co-Participation is easy money for the provinces, and thus provincial officials devote

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<sup>23</sup> Federal transfers have also frequently been used for patronage positions (Levitsky 2003; Eaton and Dickovick 2004)

extraordinary time, effort and political capital to securing their share from the national government.

The consequence, for most provinces, of this delegation of revenue collection to the federal level has been the persistent weakness of provincial administrative capacity. Many provinces have scattered, inefficient bureaucracies that are unable to effectively collect tax revenue and do not perform much better on delivery of services. They do not invest in revenue collection bureaucracies because they want revenue to come from the federal level. They prefer to expend political capital to the politically preferable, and the easier and shorter term, option of negotiating larger transfers with the federal government rather than work to build better bureaucracies.

### Pact Components

The Fiscal Pact was first signed on August 3, 1993 between the national government, represented by Peronist Economic Minister Domingo Cavallo, and all of the Peronist governors. After this meeting, Cavallo pledged to reach out to UCR and provincial party governors to earn their cooperation with the pact's terms. Cavallo announced, on the day of the signing, that "it is the harmonization initiative that reflects the efforts of the nation and the provinces, aimed at supporting productive activities in order to create more jobs and increase production, thus promoting economic growth"

*(Noticias 3 Aug 1993).*<sup>24</sup>

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<sup>24</sup> Cavallo could never be described as "diplomatic" in his dealings with the provinces, particularly those with governors from other parties. He said, speaking somewhat pointedly to the UCR Córdoba province, "What advice can we give to these provinces and those that still have a debt problem? We suggest that they read, over and over again, the Fiscal Federal Pact on 12<sup>th</sup> August 1993."

Provinces tax what they are allowed by law and what they are able to, given the constraints of their bureaucracies' technical capabilities. National law allows provinces to tax automobiles, real estate, contracts, and business profits (gross business taxes). The pact's major tax reforms were the following: rates on real estate taxes should be reduced to a maximum of 1.5 percent on urban real estate, 1.35 on suburban, and 1.2 percent on rural real estate. Gross business taxes (provincial turnover tax) should be repealed and replaced with a general consumption tax by 1995. Also, stamp taxes on the contracts for institutionalized financial or insurance operations for certain sectors of the economy should be repealed. The full description of the tax reforms and all of the other components of the Fiscal Pact of 1993 are listed in Table 5.1a in the Appendix.

**Table 5.1: Fiscal Pact of 1993- Major Components**

<b>National Government Agrees to:</b>	<b>Provincial Governments Agree to:</b>
Provide a minimum of federal transfers of the provinces of \$740 million Argentine Pesos	Eliminate the gross business tax and replace it with a general consumption tax
Accept the transfer of provincial social security systems to the national government	Repeal the stamp tax on financial and insurance transactions for the agricultural, industrial, mining or construction sectors
Reduce federal payroll taxes in certain regions and sectors	Average real estate tax rates should not exceed, for rural real estate, 1.2 percent; suburban real estate, 1.35 percent; and urban real estate, 1.5 percent The real estate taxable base valuation should not exceed 80 percent of the market value of urban and suburban real estate or the value of undeveloped land in case of rural real estate

The changes required for the gross business tax were the most controversial. They were very lucrative to the provinces even though nearly everyone agreed that they distorted economic activity. "While the provincial turnover tax constitutes the largest source of provincial own tax revenue, it is a cascading tax, constitutes a drag on



enterprise costs, benefits imports over domestic products and increases the cost of exports, has a tax base that overlaps with the federal VAT, and makes it difficult to audit interprovincial transactions” (Saiegh and Tommasi 1999).

The national government understood that the pact was asking a lot of provincial governors and bureaucracies. Schwartz and Liuksila (1997) describe:

Initially, the provinces were slow to join this second pact, largely because of the revenue implications of the tax reforms, particularly the initial stipulation to abolish the provincial turnover tax before June 1995. The announcement in December 1993 that federal payroll taxes levied on employers would be reduced, depending on region and sector, in those provinces participating in the second pact, increased pressure on provincial governments to join. By May 1994, all but one provincial legislature had ratified the second fiscal pact, and most had taken at least some initial steps toward implementation. Also the provinces were given a minimum revenue guarantee and some other guaranteed fixed payments that provided a floor of federal transfers equivalent to about 4.5% of GDP annually (p.408-410).

The Pact was made very attractive to provinces by providing the minimum guarantee of federal transfers and its reductions in the federal employer payroll tax rates. The federal government had been inconsistent in providing transfer revenue in the past. The provinces won significant concessions from the federal government, in part because they argued how difficult it would be to give up these taxes, given their bureaucracies.

Schwartz and Liuksila (1997) explain:

The second fiscal pact clearly shows the “horse-trading” that is involved in implementing structural reforms of the system of fiscal federalism...An example is the reduction in federal employer payroll taxes, which reduced enterprise costs...but came at the expense of making payroll taxes an explicit instrument of regional and sectoral policies and contributed to the growing social security deficit (p. 412).

Prior to the pact, the tax was 33 percent in all provinces but three, where it was 28.5 percent. The new rates, introduced in early 1994, reduced the taxes up to 80%, depending on region and productive sector. Provinces in weak economic regions

received larger reductions that were restricted to agriculture, industry, construction, mining, and scientific and technological research sectors (see Appendix). Tourism and service sectors, much more common in the economically well-off regions, received no reductions. Around 50 percent of the labor force was affected by these changes (ibid.)<sup>25</sup>

The pact was signed as a mutually-beneficial agreement: the national government would gain improved economic activity and government revenue while the provinces got a guaranteed minimum for federal transfers. Both sides would gain if they held up their ends of the bargain. Not surprisingly, the costs of implementing those tax changes varied across the provinces and the potential benefit of the floor on transfers was also uneven.<sup>26</sup> The differences in benefits and the challenges they create to the administration of provincial bureaucracies are a primary reasons for non-compliance by the provinces, especially Peronist provinces.

### **Political Background**

Taxation is an exceedingly political operation, influenced much more by its potential effects on constituencies than on economists' views of efficiency. As such, the transformation of provincial taxes proposed in the Fiscal Pact of 1993 involved powerful political actors, most notably parties, governors and the president.

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<sup>25</sup> The employer tax that resulted from this tax was "excessively complicated and distortive, as it meant that different industries in the same province could have different employer payroll tax rates, and the same industry in different provinces could have different tax rates. Even within the same province, employer payroll contributions were differentiated according to rural and urban location. For example, in the province of Entre Ríos, the new employer payroll tax rate was 18.2 percent in the capital city, 13.2 percent in the district of Feliciano y Federación, and 16.5 percent in the rest of the province." (Schwartz and Liuksila 1997 p.413)

<sup>26</sup> The Fiscal Pact contained more provisions than the tax changes. Importantly, it allowed provinces to transfer their social security systems to the federal government and privatize provincial industries. The privatization of industries was far more controversial than changes to provincial taxes.

Partisanship is extremely important in Argentina at all levels of government. Parties control candidate nominations and elections and they have considerable bases of support throughout the country. Ascension to political careers in the important positions in government, including the President, governors, national senators, deputies and mayors almost invariably necessitate close affiliation with their party. The Peronist party dominated during the 1990s at all levels of government except the Chamber of Deputies where small or provincial party votes were required to make a majority. Governors' stances of the Fiscal Pact of 1993 were closely tied to allegiance to Menem and the Peronists; not surprisingly, all provinces with Peronist governors quickly signed onto the pact.<sup>27</sup> Only two (UCR) provinces delayed signing the pact and expressed clear reservations to its components—Catamarca and Córdoba. Córdoba held out for the longest and only gave in once its fiscal accounts deteriorated significantly and made politicians fear they would not be given the minimum Co-Participation revenue.

At the national level, Argentina is largely a two-party system. In the governor races, the majority of provinces are won by the Peronist and UCR candidates but some (four in 1993) were held by province-specific parties. In 1993, the majority of governorships were Peronist (15)<sup>28</sup>, four provinces had UCR governors, and five governors were members of provincial parties.

Governors are the most powerful actors in provincial politics and highly important players in the national game. Same-party governors work closely with presidents to secure benefits to their provinces. Opposition party governors expect to be

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<sup>27</sup> Governor's opinions were not the only ones that mattered. Provincial legislatures had to ratify the Fiscal Pact. However, no governor face legislative resistance to the pact.

frozen out from the perks of presidential distribution and try hard to thwart her policy program. Provincial-based Governors bargain hard with the party in power, hoping to trade their votes for perks for their province. For all intents and purposes, governors are the political representatives of Argentina's provinces.

The distribution of governorships does not follow any clear patterns of region, economic structure, level of development or administrative capacity. The UCR-held governorships in 1993 were Catamarca, Córdoba, Chubut and Rio Negro. Both Catamarca and Córdoba are UCR strongholds where the governor had been Radical since the return of democracy in 1983. Catamarca is a relatively poor province on the border with Chile with little industry and an economy based largely on agriculture and mining. Córdoba is the primary manufacturing province in the country; it is the historic base of UCR operations. Chubut is a wealthy province that relies on natural resources, particularly oil, for revenue. Rio Negro, in the Patagonian region, is a middle-class agricultural province.

Provincial Parties' governors in 1993 held office in economically diverse provinces, primarily in the north. They governed economically weak Corrientes in the Northeast and neighboring Chaco, a cotton-farming hub.<sup>29</sup> Salta, Chaco's agricultural and oil-producing neighbor to the west, had Roberto Ulloa of the Salta Renewal party as its governor. Finally a provincial party governor ruled Neuquén and Tierra Del Fuego in the South, two of Argentina's most prosperous provinces, which rely heavily on natural resources for revenue. The provinces that were governed by Province-specific parties did

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<sup>28</sup> The leader of the Federal Capital is a mayor (intendente), not a governor, but he has the powers of a governor.

not follow any predictable pattern, nor did were these provinces particularly inclined to elect provincial parties in future elections. Chaco elected a UCR governor in 1995 and Salta opted for a Peronist governor in the same year. Tucuman, Salta's neighbor, chose a provincial party in 1995.

Provincial party governors are not tied to the national government or any national constituency in the same way as the major parties. Unlike Peronist and Radical governors who care about their party "brandname" and worry about the carrots and sticks available to the national party organization, provincial parties are usually independents on the national scene. As governors, however, they are intimately tied with the national government because of their need for Co-Participation revenue.

### **Technical Capabilities Background**

The technical capabilities of provincial bureaucracies are discussed at length in other chapters, so I will only provide a brief description in this section. Put simply, Argentine provincial bureaucracies are considered administratively weak in comparative perspective. Even the most effective provincial bureaucracies are not the close to the types of organizations that Weber (1968) imagined in his classic treatise on bureaucracy. Moreover, their capabilities often deteriorated during times of economic or political upheaval. For example, speaking about the national bureaucracy in 1987-1989, Morisset and Izquierdo (2003) say:

The capacity to administer efficient taxes was eroded by inattention to management and systems development, frequent legislative changes and the imposition of new levies greatly complicated the work of the General Tax Board (DGI), resulting in the accumulation of inconsistent bureaucratic procedures (10).

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<sup>29</sup> At the time of the signing of the pact, Corrientes was headed by a federal intervenor. This was the governor of neighboring Formosa, headed by Peronist Vicente Joga (Eaton and Dickovick 2004).

The basic concerns with provincial bureaucracies have to do with their resources, staffing, organization, and coordination across agencies. Provincial bureaucracies regularly cite resource constraints as the cause of poor performance. This is a valid concern, particularly given the economic instability in Argentina's history. Inflation, economic downturns and fluctuations in global prices have all impeded their ability to establish stable, efficient organizations. Staffing high quality employees is a challenge for nearly every provincial bureaucracy. Two major phenomena contribute to this. First, provincial bureaucracies are the primary source of patronage for provincial governors (Levitsky 2003). Thus, merit-based hiring may be the exception rather than the rule for many agencies. Second, Argentina's provinces suffer from a high degree of "brain-drain" since people with education tend to move to the federal capital. Over 40 percent of the population, and nearly all professionals, live in the greater Buenos Aires area. Many provincial bureaucracies may not have enough skilled personnel in their population.

Provincial bureaucracies struggle with management and organizational challenges (Tommasi and Spiller 2007). Given the high number of patronage hires at both the staff and management levels, the commitment to effective management practices and organizational structure is low. Provincial agencies are often described as "scattered" and "unaccustomed to operating as a functional unit" (Personal communication 2008).<sup>30</sup> Similarly, coordination across bureaucracies is not common in most provinces. Even though the sharing of information between policy areas would seemingly benefit all

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<sup>30</sup> Personal communication with a bureaucrat manager in Salta Province, February 2008.

agencies, bureaucrat managers cite laziness (on the part of the other agencies) or jurisdictional battles as the barriers to coordinated bureaucracies (ibid).

### **Why Would Provinces Comply?**

Given the seeming benefit of the pact for all parties involved, motivation for compliance may seem obvious. The clear evidence that many provinces did not comply, however, makes it worth explaining the logic behind compliance or non-compliance for the provinces. Provinces had strong motivation to comply and significant barriers to compliance, as I explain in the following sections.

#### Political Reasons to Comply

Provincial motivation to comply comes from three primary sources—partisanship, fear of punishment and provincial self-interest. The importance of cooperation to maintain a party's reputation and push through policy makes some provincial governors willing to impose tough measures. Governors seeking reelection or with national aspirations (usually presidential or ministerial) see the importance of keeping the party reputation healthy and staying in good graces with other leaders of the party (the president and other same-party governors). The president and that national party organization seek national public goods, such as strong national fiscal accounts and economic growth. In pursuit of these goals, governors tied to their (president's) party would wish to cooperate to achieve these outcomes.

Fear of punishment from the federal government might also push provincial leaders to comply with the pact. The provinces are often accused of leeching off the federal government. While this suggests that the provinces hinder the success of the

federal government, it also means that, when the federal government withholds its relatively vast resources, the provinces are helpless to meet their revenue demands. Provinces could read the pact as a commitment to transform the provincial transfer system or risk their federal transfers. The credibility of this punishment, however, was certainly in doubt given Argentina's history of ignoring provincial disobedience. Nonetheless, all provinces and particularly UCR provinces, worried about Menem's punishments.

Provinces' fear of reprisal was justified. Some provinces (but not all) paid the consequences of non-compliance. Montero (2001) describes:

Governors refusing to sign the 1992 fiscal pact were selectively punished with no payments. Support for the 1993 fiscal pact was generated with similar strategies. Selective debt relief, tax abatements on firms located in cooperative provinces, and federal infrastructure investments added to the repertoire of side payments Menem used to curry sub-national support. Although these monies were intended to ameliorate the transition costs of reforms at the sub-national level, they also served the political purpose of preempting provincial opposition to increasing federal discretion over revenue shares and subnational policy responsibilities (p. 58).

Argentina's presidential system gives strong powers to the executive office, including both partisan and formal powers (Carey and Shugart 1992; Mainwaring and Shugart 1997). Menem had many tools at his discretion to ensure compliance, most notably control over budgets and national bureaucratic resources. Eaton and Dickovick (2004) argue that strong partisan presidential powers make pacts more likely to come about and be complied with, while formal powers such as decree matter less, except where they push through constitutional amendments. Menem had strong formal power and partisan powers, making compliance more likely. Eaton and Dickovick (2004) show that he used them:



Menem aggressively wielded his partisan powers on behalf of this more difficult second pact. For example, having intervened in the Peronist party organization in Corrientes in 1993, he named as intervenor the governor of a neighboring province (Vicente Joga of Formosa) who agreed in exchange to sign onto the second pact (p.108-109).

He also needed to rely upon members of other parties including national legislators and governors. Accordingly, Menem used his access to resources to “buy” cooperation from members of other parties, especially members of provincial parties.

Aside from punishment, self-interest also motivated many provinces to sign the pact and it helps to explain their selective cooperation. Peronist governors negotiated the pact with Menem’s administration to their mutual satisfaction. Many would comply with the pact because it was in their interest, from a revenue and governance perspective, to do so. Some of these taxes were not beneficial to the provinces and they would do well to eliminate them. Moreover, the package of benefits given by the federal government to the provinces was valuable to the provinces and it was in many provinces’ self-interest to comply to get them.

Some provinces would also comply with (parts) of the pact because cooperation is cheap. “Cheap” cooperation happens for several reasons. First, politicians like to claim credit for reducing taxes, particularly for eliminating those perceived as toxic and inefficient. Related to this, eliminating some of these taxes, that produced little revenue anyway, could be politically beneficial and would not greatly affect provincial finances.

#### Technical Reasons to Comply

Provinces had to weigh the political costs and benefits of compliance with their technical capabilities to meet their revenue demands. The major reason why provinces would comply with these changes to their taxing system is that the taxes they were asked

to eliminate were not good ones. The national government asked the provinces to eliminate the most distortionary taxes. These included taxes that double-charged for activities already taxed by the national government, those that obviously impeded economic activity, and those that encourage black market activity. Each province recognized these taxes to be toxic, from an economic point of view, and in a perfect world, most if not all of the provinces would have chosen to eliminate them on their own.

Given the overall weakness of provincial taxing systems and provincial technical capabilities, the attractiveness of the guaranteed minimum on Co-Participation revenue inspired all provinces to consider reforming their taxes. Every Argentine province relies on federal funding to cover its expenses. The benefits of the “floor” on federal transfers were particularly important to the poorer provinces that garnered the large majority of their revenue from this source. These provinces did not have viable substitutes for the income from federal transfers. In previous years, the national government had withheld federal transfers from the provinces, claiming financial distress, or diverted them to national policy priorities. These episodes devastated the financial situations in the transfer-dependent provinces. Even those provinces that generate much of their own income, such as Buenos Aires, still depend on federal transfers since their budgets are very large and transfers constitute a significant portion of revenue.<sup>31</sup> If for no other reason, the minimum on federal transfers inspired provinces to want to comply with the reforms.

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<sup>31</sup> The province of Buenos Aires, for example, has an economy similar in size to the country of Colombia.

### **Why Would Provinces Not Comply?**

On the other side, provinces had many incentives not to comply with the federal mandate. Radical and provincial party legislators had the greatest incentive to defect since they were not included in the negotiation of the pact. Provinces were justifiably concerned about potential lost tax revenue, the costs of the effort to transform the tax system, and their ability to substitute “better” tax revenue for the taxes they eliminated. Moreover, provinces questioned how severely they would be punished for non-compliance. They might have hoped to get the national governments’ rewards without the costs of reform.

#### Political Reasons

The pact was negotiated by and for Peronist governors. Governors from the Radical party were rightly skeptical that they should comply with a pact written by a Peronist president and the Peronist governors was in their interest. Thus, their political motivation to comply with the pact could not be party cooperation but fear of punishment by Menem.

Provincial parties have likewise little reason to support the programs of national parties and little invested in the success of national policy. Like the Radicals, they worried that the pact would benefit Peronists more than other parties despite Cavallo’s assurance that “this is a proposal for everybody” (*Noticias Argentina* 3 Aug 93). Provincial party governors signed on quicker than Radical governors, however, most likely because of concessions received from Menem and Cavallo. Complying with its terms is different than signing the pact, however, and provincial party governors did not

have party loyalty to keep them committed. Like Radicals, they had motivation to comply to avoid reprisal, but they also received material benefits from Menem to make compliance worth their while.

For Governors from any party, short time horizons, particularly when reelection is unlikely or impossible, make short term gains more attractive than long term reform. The tax changes required by the pact had the possibility to pay off for the provinces in the long term, by making their taxes more attractive to investment and by helping to build their information infrastructure, but these changes required considerable time and investment. Even Peronist governors that designed the pact had incentive to stray from it because of these political calculations and the Peronists' often weak inter-party enforcement mechanisms.

Argentine politicians must always be concerned with collective action problems in fiscal matters. Governors no doubt wondered about the likelihood that their fellow provincial leaders would comply with the pact. No governor wanted to be the "sucker" who complied while the others reaped the rewards without costs. Only if the national government could be a credible threat to punish the provinces, or if provinces would comply voluntarily, would this concern be mitigated.

The best result for any of the provinces, all else equal, was to selectively comply to eliminate inefficient taxes and gain the minimum for federal transfers. This grants them protection from federal withholding and assures them a stable source of revenue to fund their programs. Provinces had legitimate concerns about their ability to recover lost revenue from the tax changes and reason to believe they could still get the rewards of the pact without paying the costs.

### Technical Reasons for Non-Compliance

Many provinces lacked the technical capabilities to comply with the pact and still collect enough tax revenue. Many provinces lacked quality information about citizens to reform their taxes in compliance with the pact. The other problems of technical capacity follow from this information deficit. Many do not have good cadastral information, particularly about property, they do not utilize up-to-date technology to aid in collection and management of information, they have weak enforcement, and their bureaucracies are poorly organized and have little coordination across agencies. Given this situation, citizens collude against tax compliance.

The difference between political and technical reasons for non-compliance can be illustrated with a comparison of two very different provinces. The first is Chubut, a Patagonian province, is one of the country's most economically prosperous, with a specialization in mining. During the 1990s, Chubut's governor, Carlos Maestro, was from the Radical party. The second is Santiago del Estero, a poor, agricultural province in the northeastern part of the country. Santiago del Estero, since the return to Democracy in 1983, has elected Peronist governors. Neither province complied with most of the 1993 Pact. It is unsurprising, in different ways, that neither province complied. Chubut lacked the political motivation and Santiago del Estero did not have the technical expertise to substitute more efficient taxes. When Chubut complied, they did so with changes to businesses taxes that hurt their climate for investment. Santiago del Estero's compliance was with the stamp tax and taxes on financial transactions, neither of which Santiago del Estero collected in the first place. Chubut could have complied but chose to "cherry-pick" the parts of the pact they preferred since they were

not beholden to the party leadership at the national level. Santiago del Estero wanted to comply, to support their Peronist president and Congress, but did not have the technical capacity to make these changes while maintaining provincial revenue.

## **Research Design**

### Dependent Variable

The dependent variable of this study is compliance with the Fiscal Pact of 1993. These data come via Argentine Economist Mariano Tommasi from the Argentine Ministry of the Economy.<sup>32</sup> He collected this information for his chapter in Srinivasan and Wallack's (2006) book. Tommasi's table is shown in the appendix, Table 5.5a.

Compliance with the reforms is coded as "full," "partial," or "none" by the Ministry of the Economy. For my figures and tables, I treated both full and partial as "compliance" and none as non-compliance. I understand that variation exists within the partial category and between full and partial but these distinctions were not made clear in the data. Even more than this, the attempt at compliance suggested by the "partial" designation does say something about those provinces' incentives to reform. However, nearly all data points were coded "full" or "none" so there's good reason to believe that the distinction between compliance and non-compliance was very significant. It is important to recognize the limitations of these data. These are a snapshot of the compliance of the provinces, taken years after the 1993 pact. They do not give a textured account of efforts by the provinces to introduce or implement these reforms.

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<sup>32</sup> Specifically, it was published in the "Pact Federal para el Empleo, la Producción y el Crecimiento", UNLP, Lics. L.M.Monteverde, R. Ruiz del Castillo, S. G. Tarragona y H. Terán y Dres. T. Perez Balda y J.M. Prada sobre la base de información de la Dirección de Coordinación Fiscal con las Provincias

The dependent variables are general compliance with reforms and compliance with reforms of individual taxes. Argentina's provincial taxes vary considerably in their difficulty of collection. As I explained in previous chapters, provinces have easy (automobile), medium (gross business/turnover tax), and most difficult taxes (real estate, stamp).<sup>33</sup> I utilize the difficulty of these taxes to show that provinces with higher technical capabilities are better able to comply with these reforms, when they have incentive to do so.

### Independent Variables

The primary independent variables in this study are political will, operationalized as the party of the provincial governor, and technical capabilities, proxied by the loan variable groups used in the previous chapter.

**Table 5.2: Partisan Composition of Provincial Governors**

<b>Party of Governor 1992-1995</b>	<b>Total</b>	<b>Provinces</b>
Peronist Party (PJ)	15	Buenos Aires, Capital City, Entre Rios, Formosa, Jujuy, La Pampa, La Rioja, Mendoza, Misiones, San Juan, San Luis, Santa Cruz, Santa Fe, Santiago del Estero, Tucumán
Radical (UCR)	4	Catamarca, Córdoba, Chubut, Rio Negro
Provincial Party	5	Corrientes, Chaco, Neuquén, Salta, Tierra del Fuego

The provincial party governor represents the provinces' political motivation to adhere to the pact. The partisan composition of the provinces is shown in Table 5.2. As explained above, the pact was negotiated by the Peronist governors with the Peronist

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<sup>33</sup> Stamp taxes are easy to collect, as I explained in the cross-provincial chapter, but they imply good state capacity when collected. Since they are taxes on business contracts conducted through the province, only those provincial bureaucracies perceived to have good enforcement powers will see many registration of contracts.

president, Carlos Menem. Accordingly, the Peronist governors should have wanted to implement this reform. The governors from the Radical (UCR) party and the provincial parties resisted this pact initially and were not subject to intra-party pressure by Menem. All provinces, and especially the UCR and provincial parties, had to be concerned about the carrots and sticks available to Menem in the form of national resources.

The technical capabilities of the provinces are operationalized by the value of loans per capita given to private citizens in the province. With citizens seeking loans, state bureaucracies have quality information about their access to resources since this information is reported to provinces and linked to their national information number. This is the same variable used to group provinces in the previous chapter.

### **Hypotheses and Results**

My theoretical framework suggests that policy implementation is not a simple matter of political allegiance or of technical capabilities alone. The strength of parties is conditioned by the technical capabilities of the state. Accordingly, I do not expect to find perfect partisan cooperation with the pact or an exact match between technical capabilities and compliance. Rather, I expect a hybrid of these results, with clear patterns based on both party and technical capabilities. This is the first hypothesis I explore in this chapter.

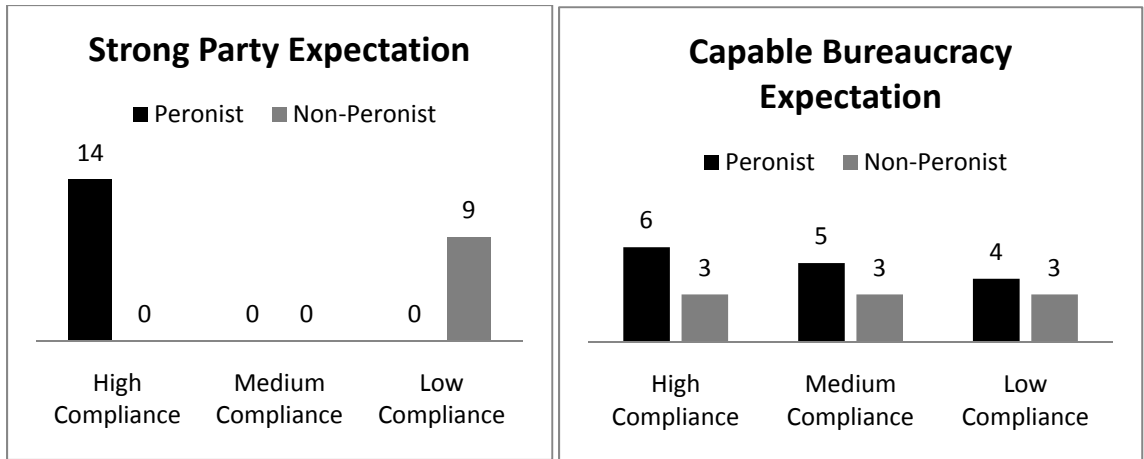
*Hypothesis 1: Political will and technical capabilities are both necessary for policy implementation*

To illustrate the roles of political will and technical capabilities in compliance with the Fiscal Pact of 1993, I first illustrate a “strong party” explanation versus a



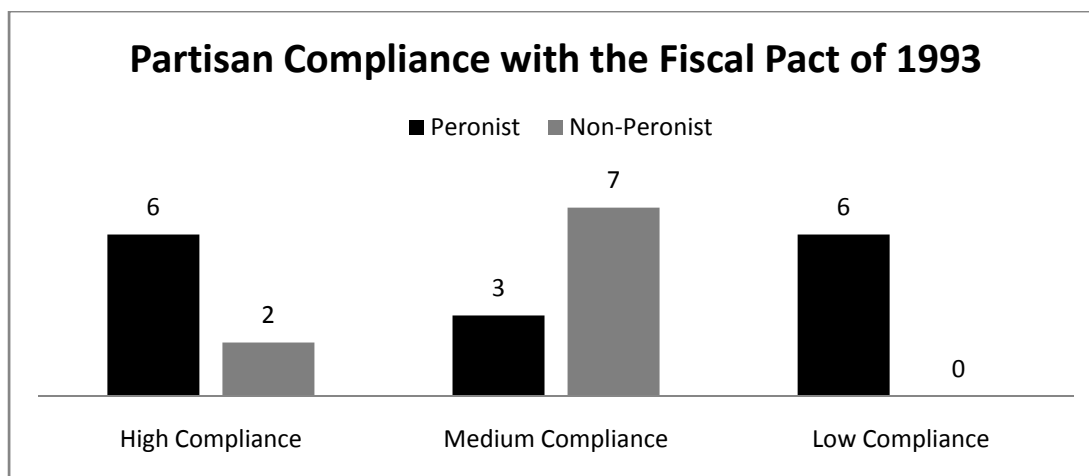
“capable bureaucracy” explanation to show the theoretical expectations for compliance with the pact. If the parties in Argentina are strong—they are able to impose discipline on co-partisans—then all Peronists should comply with the pact. If partisanship is the only explanation for compliance and discipline only occurs within the party, all provinces with governors from other parties will not comply. Such a result would look like the bar graph on the left in Figure 5.1. This bimodal distribution reflects pure partisan allegiance.

If provinces technical capabilities perfectly explain compliance with the reform, the results would be those found on the chart on the right in Figure 5.1. The bars represent the number of provinces in each capabilities group. Thus the nine provinces in the high capabilities group are in the high compliance group. The eight medium capabilities provinces are in the medium compliance group and the seven low capabilities provinces are in the low compliance group. This chart represents what would happen if compliance was driven purely by the provinces’ ability to reform their taxes and shows no role for the party. The high capabilities provinces would comply because they have knowledgeable bureaucracies and are able to collect taxes from a variety of sources. The low capabilities provinces could not comply because it would hurt their base level of taxation.



**Figure 5.1: Strong Party vs. Capable Bureaucracy Theoretical Expectations**

The actual pattern of compliance with the pact is shown in Figure 5.2. The influence of parties is supported by these data, but not in the way that strong party theories might suggest. This chart shows the level of compliance for each province based on an index of all of the Pact's components. Of course, this is a very rough indicator of compliance with the Pact. This index counts all components of the pact equally without consideration for the theoretical importance of compliance with some components over others. I only use this chart to give a general sense of compliance and I break down the pact's components in the next several sections. The important differences between the different taxes and the reforms required show much more textured accounts of provincial compliance.



**Figure 5.2: Compliance with the Fiscal Pact of 1993, by Party**

In Figure 5.2, we see that pure strong party explanation is not supported in the data. Provinces with Peronist Governors did not comply at the highest level in the majority (9 out of 15) cases. The UCR and Provincial Party-led provinces all complied at medium or high levels, contrary to expectations that they would comply at the lowest level. However, there is a clear and prominent partisan trend apparent in these data. Peronists were almost exclusively in the highest and lowest categories of compliance and the non-Peronists were all, except two, in the medium compliance group.

These data suggest something that we have long known about Argentina—that their parties (or at least the Peronist) party do not live up to the standards of a strong party. Their parties are not able to fully overcome the significant barriers to inter-temporal cooperation. They also do not appear able to impose perfect discipline, or at least they do not exercise this option. Their party cooperation looks different than strong party theories suggest.

The data shown in Figure 5.2 do, however, reveal the important role of the party in explaining compliance with the Fiscal Pact. The Peronists were bifurcated—either

they complied at a high level or they skirted the pact almost entirely. The non-Peronists neither embraced nor ignored the pact but reformed enough to appear compliant. What Peronists chose to reform can be explained, again, by looking at the partisan and technical capabilities aspects of capacity. For Peronists, those capable of reform were leaned upon to carry it out. Those Peronist provinces that would suffer from the reforms because they lacked the capabilities to keep the same level of tax revenue were allowed to selectively comply. This reveals evidence of intraparty negotiation and the flexibility that holds the Peronist coalition together. It also shows how feedback from technical capabilities shapes the political environment. The Peronist party made choices knowing compliance would be limited in some cases, and worked around this reality.

Party does not capture all of the political motivations in this case. Governors from the UCR or Provincial parties were much more concerned than the Peronists with the possibility of punishment by the Menem and the Peronist Congress. They could expect to get away with some level of non-compliance, at least in certain policy areas, but they could not blatantly defy the pact in the way of some of the Peronists. We see that all of the Non-Peronists complied at least at a medium level.

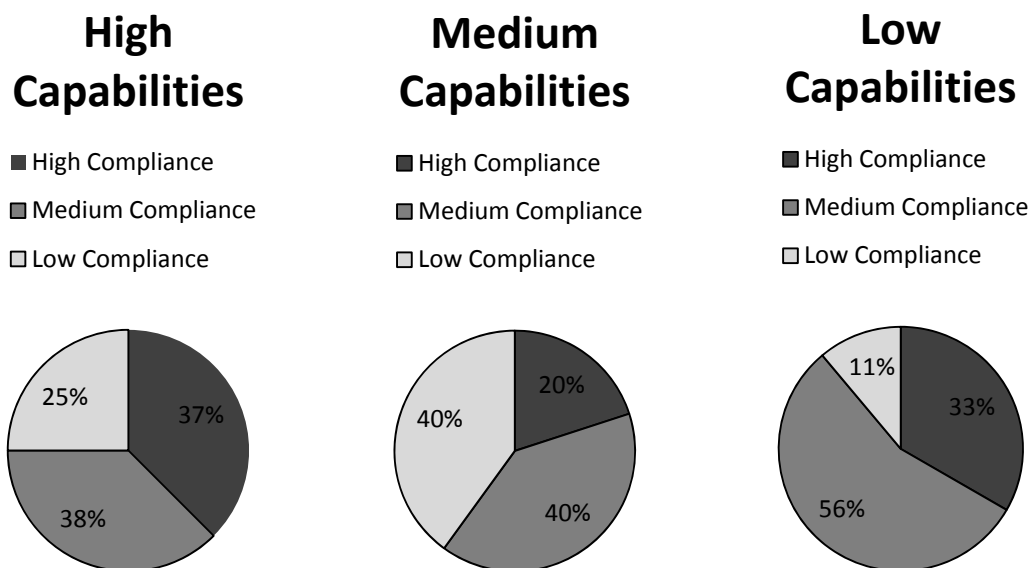
These trends become even more apparent when the pact is broken down into its components. The Peronists provinces did not fully comply with any aspect of the Fiscal Pact. In some cases, however, the UCR provinces and the Provincial Party provinces all complied with the reform. This is true of compliance with reform of the automobile tax, for example, as I show in the next section.

A provincial governor's aide in Catamarca explained compliance with the federal government when your governor is from a different party. "Our governors are Radicals.

This makes it difficult to work with the President. He, or she, is usually a Peronist.”<sup>34</sup>

Opposition party governors do not have much leverage at the national level to fight the president and they are not rewarded with perks of the presidency.

Technical capabilities also help to explain the differences in cooperation with the pact. In Figure 5.3, the level of compliance is plotted according to provincial capabilities. The provinces again show a bifurcation in these data. Seventy-five percent of high capabilities provinces and 89% of low capabilities provinces complied with the pact at a medium or high level. The medium capabilities provinces, despite their relatively higher level of capabilities than the low capabilities provinces, had low compliance in 40% of provinces.



**Figure 5.3: Compliance with the Fiscal Pact of 1993, by Capabilities**

Technical capabilities do not perfectly explain compliance, either. In my description of the “Capable Bureaucracy” theory above, I made several assumptions that

<sup>34</sup> Personal Communication, February 2008. All quotes are translated. The aide used the feminine pronoun

do not hold true for the Fiscal Pact of 1993. In particular, low capabilities do not lead a province to reject all tax reforms. On the contrary, low capabilities provinces are willing to comply with changes to taxes that they could not collect effectively in the first place. High capabilities provinces are able to collect revenue from all types of taxes, so reform of them would not dramatically undermine their revenue. The medium capabilities provinces are in the most difficult position to carry out these reforms. They do collect significant revenue from the taxes as levied prior to the fiscal pact but they may not be able to maintain those levels if they comply with the reforms. The reforms were too costly for many of the medium capabilities provinces to implement.

A bureaucrat I met from Buenos Aires (a medium capability Peronist province) was very forthcoming about the challenges his province faced in complying with these reforms. He understood the importance of Buenos Aires to the nation as the most populated and economically productive province. Buenos Aires props up the economically weak provinces but suffers from significant technical challenges. Nonetheless, the internal incentives of the bureaucracy in Buenos Aires are not resulting in high quality bureaucracy. He said, “Most of the people here think that they shouldn’t work hard to make our work better. The problem is that nobody else works hard so why should they?” (Personal Communication, Buenos Aires, June 2007).

Compliance with the full Fiscal Pact of 1993 supports my theory that political will and technical capabilities have strong effects on policy implementation. The pattern of compliance reveals a mixture of these factors; clear partisan trends but not perfect party discipline and technical capabilities revealed through the lens of party allegiances.

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because the current president, Cristina Fernández de Kirchner, is a woman and a Peronist.

Partisanship's influence on compliance with the pact was conditioned on provincial capabilities since provinces that would struggle to enact the reforms were allowed to avoid many of them.

In the next sections, I break the pact into component parts to see how partisan effects and technical capabilities impact provincial decisions to reform their taxes. The first reform element I examine is the automobile tax.

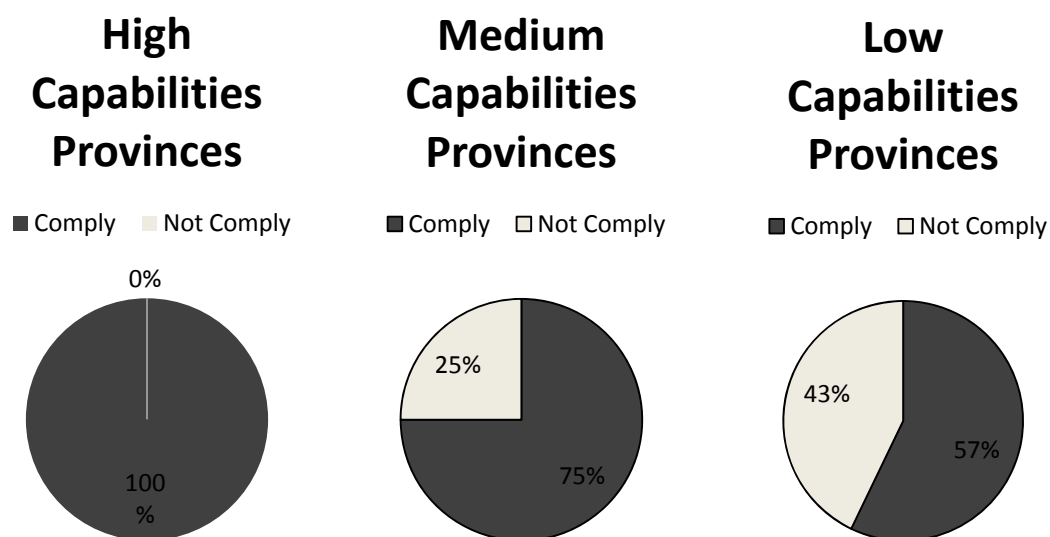
### Automobile Taxes

In the previous chapter, I ranked the provincial taxes based on their “order of difficulty” or the information requirements necessary to collect the tax. Provinces collect four primary taxes: real estate, stamp, gross business, and automobile taxes. The easiest of these taxes to collect is the automobile tax. Provinces require citizens to approach the bureaucracy with information about their car in order to receive a license plate. Non-compliance is very obvious—cars do not have official tags. The most difficult of these taxes is the real estate tax. Provinces must have quality, detailed information about their land and their citizens to know whether they are taxing at an appropriate level. In this section, I examine the role of technical capabilities in compliance with reforms to these two taxes. Technical capabilities play an important role in both reforms, but party differences work differently in the two taxes.

### *Hypothesis 2: Technical capabilities impact politicians' decisions about policy implementation*

I operationalize this hypothesis through compliance with automobile taxes. The pact required provinces to “ensure the uniformity of valuations...among all jurisdictions

as of 1994. Valuations published by the General Directorate of Taxation (DGI) are to serve as reference” (Decreto 1807/1993). I expect provinces with higher technical capabilities to comply with valuation reforms on this “easy” tax. They can acquire revenue from many different types of taxes and do not need to rely heavily on automobile taxes. Low capabilities provinces will be less willing to comply with reforms of easy taxes. These provinces depend on revenue from easy taxes because they cannot effectively collect more difficult taxes. I predict that capabilities, not party allegiance, will best explain compliance with the automobile tax.



**Figure 5.4: Automobile Tax Compliance, by Capabilities**

Figure 5.4 shows the level of compliance with the reform of the valuation of the automobile tax for each capabilities group.<sup>35</sup> The groups show a clear progression of compliance based on their level of capabilities. The high capabilities provinces all complied with the reforms. The medium capabilities provinces mostly complied (6 out of



8 provinces). The low capabilities provinces complied at the lowest rate with 3 of the 7 provinces failing to change their valuation. Capabilities appear, on their face, to be influencing the choices of provinces to comply with the tax. Reducing the revenue from this easy tax seems too costly for the weakest capabilities provinces.

Only examining the capabilities groups, however, would hide important variation in the partisan compliance with the reform. *Every single province* that failed to comply with the automobile tax was headed by a Peronist governor. This holds true for the provinces in both the medium and low capabilities groups. Every UCR and Provincial Party province complied with the pact, regardless of their level of technical capabilities.<sup>36</sup> Again, this suggests that a strong-party characterization of the Peronist party would not explain provincial behavior. Rather, being in the Peronist coalition seems to allow more leeway for their weaker provinces. The importance of those extremely overrepresented weak capabilities provinces in the National Legislature might also help to explain the concessions made to them by the Peronists.

The automobile tax shows the important role of technical capabilities in policy implementation. The provinces with the lowest technical capabilities would not comply with the reforms of their automobile valuation because it threatened a source of revenue that they could not easily collect from other sources. Political will was clearly present in this case, however. The only provinces that did not comply with the automobile valuation were Peronists. One economist I spoke with in the federal capital spoke of this very dilemma in the negotiations of the pact. He said that the Peronists governors all

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<sup>35</sup> No provinces complied with the automobile tax rate reform at the provincial level.

knew, during the negotiations, that the small Peronist provinces would not comply with reform to the “irreplaceable” automobile tax (Personal Communication, June 2007, Federal Capital). Unlike many parties where discipline is essential to party functioning, Peronists allow leeway for weaker provinces to skirt collective responsibilities in exchange for cooperation on policymaking.

### Real Estate Taxes

The real estate tax is the most difficult for the provinces to collect and the high capabilities provinces collect this at the highest levels. The provinces do this poorly by nearly any standard and even the best province at collecting this (Córdoba at 31% of total taxes) did so only at a rate of 1.33% of Gross Provincial Product in 1992. The average for all provinces was 0.33% of Gross Provincial Product in 1992. The information and enforcement demands of this tax are very high.

Evidence from Santa Fe (a high capabilities province) and Buenos Aires (a medium capabilities province) show the difficulty of collecting this revenue even amongst reasonably capable, urban provinces. The challenges of collecting and managing the information necessary to levy these taxes is more than most provinces can handle effectively. Schwartz and Liuksila (1997) quote:

In the city of Santa Fe, a recent survey showed that two-thirds of the lots that were vacant according to the tax roll actually had buildings on them, and 56 percent of all properties were underrecorded in the sense that the extent of the construction that was recorded was less than what was actually on the lot. A similar survey in the municipality of Santo Tome found 52 percent of all properties to be underrecorded. Also, a 1994 tax amnesty in the province of Buenos Aires led 400,000 taxpayers, including 170,000 whose land was vacant

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<sup>36</sup> One UCR provinces, Chaco, and three provincial party provinces, Corrientes, Neuquén, and Salta, carried out the automobile reforms at the municipal level. This was the only reform with municipal involvement.

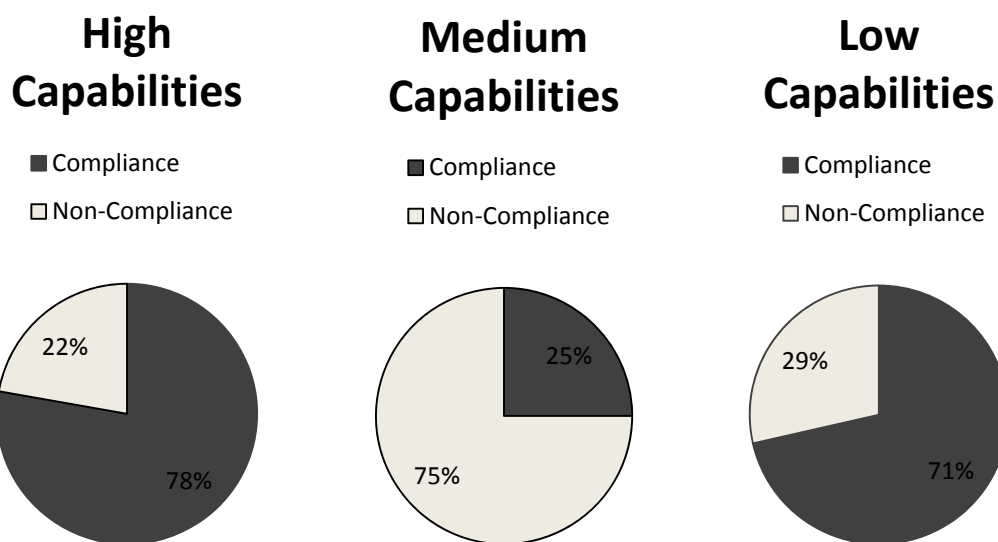
according to the tax roll, to report 30 million square meters of construction previously unknown to the tax authorities (Provincia de Buenos Aires 1994).

The observations in Santa Fe and Buenos Aires are particularly telling because these are provinces that collected a significant portion of their total revenue from real estate (24% and 17%, respectively). This is a very difficult tax to collect and no province does this perfectly. That being said, some provinces do this much better than others and for some the real estate tax is a significant tax in their revenue. Compliance with these reforms, accordingly, can tell us something about the role of technical capabilities in the reform efforts.

*Hypothesis 2- Technical capabilities are necessary for state capacity*

I operationalize through compliance with the real estate reform. Again, Real Estate Valuation involved standardization of rates for urban, suburban and rural property. I expect a bifurcated result—the provinces with the highest and the lowest levels of capabilities will be willing or able to implement this reform. The real estate tax requires the highest levels of technical capabilities to implement effectively. Thus the highest capability provinces tend to be the ones that get the most revenue from it. However, these same provinces are able to collect revenue effectively from all sources, including the stamp, gross business and automobile taxes. The weakest capabilities provinces will comply with this reform because it is not very costly to them. They did not get much revenue from the real estate tax in any case.

Compliance with the real estate valuation is shown in Figure 5.5.<sup>37</sup> Compliance with this reform reveals very different patterns than those observed with automobile taxation. The high capabilities provinces and the low capabilities provinces nearly all complied with these reforms. Very few of the medium capabilities groups, on the other hand, reformed their real estate valuation.



**Figure 5.5: Compliance with Real Estate Valuation**

The data shown in Figure 5 supports the idea that the provinces with the lowest and highest capabilities would be compelled to change their behavior, but for different reasons. The high capabilities groups had the sophistication to reform their real estate valuation while still collecting enough revenue to keep their finances afloat. The low capabilities provinces reformed their valuation because their revenue systems were not dependent on it. This stands in contrast to the automobile valuation where the low capacity provinces had much to lose from reforming that tax.

<sup>37</sup> The compliance pattern on real estate valuation and rate reforms were very similar. The real estate rate table is shown in the appendix.

The medium capabilities provinces were put in a difficult spot by these reforms. These provinces collected the real estate tax with some success and relied on it for their revenue. Reform to the real estate valuation had the distinct possibility of either reducing the amount of revenue they collected or disorganizing the existing system of collection, or both. The provinces with very serious concerns about their revenue collection were wary of disturbing their real estate collection.

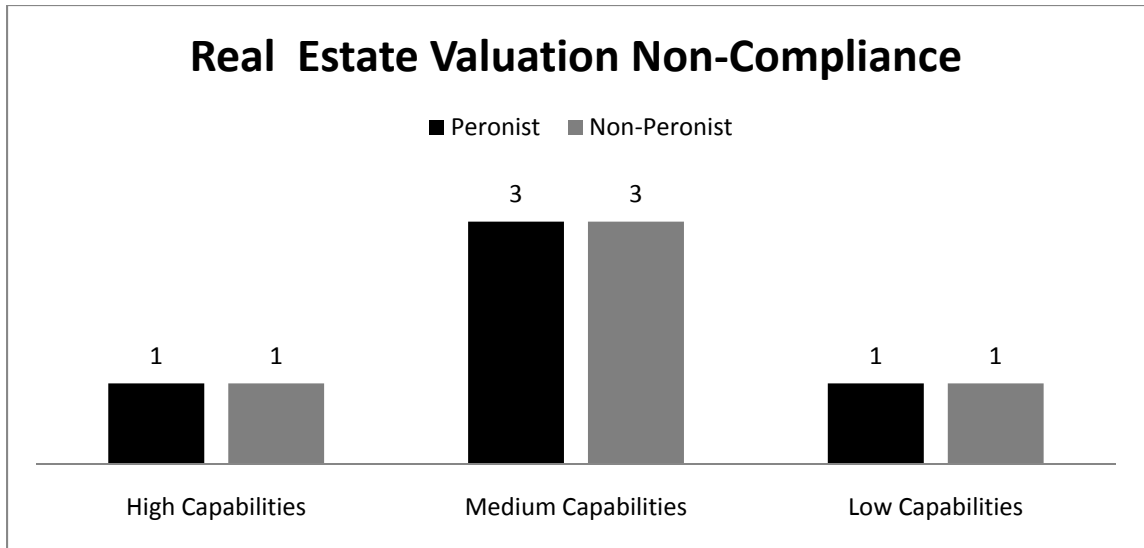
Buenos Aires provides an example. Buenos Aires was the only medium capabilities province that did not comply with either automobile or real estate tax reforms. They can do a lot more than the weakest provinces but they are large and weak enough to have real concerns about rearranging their bureaucracy. An official in Buenos Aires' economic ministry told me, "we are a big province with a big bureaucracy. It is hard for us to reorganize quickly" (Personal Communication, June 2007 Buenos Aires). Fortunately, as part of the Peronist coalition, they were given leeway to comply selectively. Most importantly, they had some ability to do this because of the province's importance to the federal government overall. Buenos Aires is practically a country in itself, with much of the population and productive economic activity in the country. Its fate is so tied to the country's that all actors in Argentina realize that this province must stay afloat. This aspect of power is not easy captured by partisanship but is also a factor in the calculations of provinces' motivations to invest in their bureaucracies or pursue long-term efforts to improve their institutions.

The provinces that defied my hypothesis are also interesting. Córdoba, a high capabilities province, should have been able to maintain their revenue system even as

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they reformed their real estate valuation. However, Córdoba leaned on this tax far more than the other provinces, even those in the high capabilities group. In 1992, their level of real estate revenue collection was 9% higher, as a percentage of Gross Provincial Product, than the next highest province, Santa Fe. In several of my interviews, I was told that the real estate tax was simply too valuable to change in Córdoba. Party also might have played a role in the compliance decision of Córdoba, which initially fought the pact and was headed by a UCR governor. The officials I spoke with in Córdoba, however, emphasized only the importance of the tax to their coffers.

The pattern of non-compliance with the real estate reform is not well explained by simple party allegiance. Unlike automobile taxes or the general compliance with the pact, real estate non-compliance was exactly the same across parties. This is shown in Figure 5.6. In all capabilities groups, the same number of Peronist as non-Peronist provinces rejected these reforms. These results reinforce the importance of considering province's capabilities to implement policy, not simply their political will to do so when evaluating the pact.



**Figure 5.6: Non-Compliance with Real Estate Tax Reform**

Despite this evidence, it would not be safe to assume that party played no part in calculations of compliance with the real estate tax. Salta, a low capabilities province headed by a governor from the Salta Renewal Party, did not reform their real estate valuation. If hypothesis was correct, Salta should have been willing to comply with real estate changes because they were not getting much revenue from it anyway (6% of total provincial revenue). The official in Salta said they did not change their real estate valuation (or rate) because it would have involved “too many changes” to the standard operating procedures of the tax officials. They do not get much revenue for the tax, he said, but the reform of the tax would have taken more time and effort than the short-staffed bureaucracy could give (Personal Communication, February 2008 Salta). Partisanship may have played a role in these efforts, as we see in an examination of the nearby UCR province of Catamarca.

A tax official in neighboring Catamarca, which faces similar challenges to technical capabilities, responded differently to the reform of the real estate valuation.

They made the change precisely because they do not get much revenue from that tax. The changes were an administrative headache, he said, but they were imposed from on high (Personal Communication, March 2008 Catamarca). The difference in partisanship of Salta's governor and Catamarca's governor may help to explain these divergent paths. Salta's provincial-based party, in theory, has less interest in the national issues and worries less about punishment by national-level Peronists than Catamarca's national UCR party. In general compliance patterns, the provincial parties were very similar to the UCR provinces and for this reason I have grouped them in much of this chapter. The micro-level decisions of some individual provinces, however, were likely shaped by their relationship with the national party system.

The evidence from real estate valuation reforms suggests that technical capabilities of the provinces are a factor in provinces' compliance. Party affiliation does not explain the broad patterns of compliance observed in this case. Political will is certainly relevant in these cases however. What we observe as provinces' non-compliance can be a matter of political will of governors *informed by the technical capabilities* of their own provinces. This would be consistent with Spiller and Tommasi's (2007) argument about Argentina's bureaucracies. They say:

Thus, a poor bureaucracy worsens the policy-making environment, and a poor policy-making environment is unlikely to create a quality bureaucracy (p. 156).

The technical capabilities in this case drove the motivations of politicians, and not just the other way around.



### Gross Business Taxes

The most consequential of the tax reforms for the provinces were on the gross business tax. Every province collected more than 45% of provincial taxes from this source and one collected 82% of total provincial taxes (1992 figures). Perhaps not surprisingly, the provinces as a whole failed to comply with almost all of the reforms to the gross business tax. The reforms placed too high a burden on the provinces to transform their tax system; the provinces were not able to collect enough revenue from other sources to offset losses in the gross business tax.

The national government desired the reform of the gross business tax above all other changes. These taxes were universally believed to be detrimental to economic productivity. Economic minister Domingo Cavallo understood the challenges of eliminating the gross business tax but assured governors that they would not suffer from these reforms. He said, “We are confident that economic expansion will facilitate increased tax revenues with the existing taxes, and this will compensate for the revenues lost from tax exemptions granted to productive sectors” (speech August 3, 1993).

I do not present figures or tables for the gross business tax for several reasons. First, the theory behind compliance with this tax is highly complicated by other inputs in the economy. For example, some provinces might comply with reforms to the industry or the agricultural reform of the tax because they have very little of these activities in their province. Similarly, the capital city, for example, might not comply with the reforms to tourism taxes or insurance taxes because their economy is highly reliant on those. The small number of data points available to assess compliance, including these economic factors that have strong effects on provinces’ compliance decisions, would make the

analysis too complicated and the results too province-specific to yield useful information. Instead, I discuss the very low level of compliance across all of the provinces.

The biggest reform in the pact was to replace the gross business tax with a consumption tax by 1995. The national government's data show that no province, of which they are aware, adopted the consumption tax. The national government knows that five provinces did not adopt the consumption tax, but for 18 other provinces they *do not have enough information to say whether the province transformed their business tax* (Tommasi 2006). The lack of communication between the national and provincial governments on these large policy issues demonstrates the poor quality of information sharing across branches in the Argentine government. The federal government was also unaware if most of the provinces had reformed their tax agencies to meet the terms of the pact.<sup>38</sup>

The provinces would have found it very difficult to comply with the elimination of the gross business tax. Efforts to improve their tax system bumped up against politicians' time horizons. Schwartz and Liuksila (1997) explain:

Overall, there is no easy short-term alternative for replacing the provincial turnover tax... Other alternatives for improving provincial revenue would be beneficial in the long run, but would not yield short-term results... Similarly, improving real estate taxation would require substantial initial efforts, including, for example, improving property mapping and property registries; providing better and more consistent application of valuation techniques; improving the exchange of information between local tax offices, property registries... (p. 408, 410)

Despite their obvious failings, without those taxes, many provinces would be unable to collect much revenue at the provincial level of government. Eliminating them thus

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<sup>38</sup> Granted, the pact's language make it difficult for the national government to judge compliance. The pact asked provinces, "As far as possible, strengthen the tasks of auditing and supervising compliance with tax

imposed a high cost to many of the provinces, particularly those that relied on gross business taxes rather than more difficult taxes on real estate or stamp taxes. The information debt of the provincial bureaucracies made their capacity too weak to implement higher quality taxes.<sup>39</sup>

The main exception to this low level of compliance was with the reform of the gross business tax on primary production. Every province except two, Santa Cruz and Santiago del Estero, complied with this reform. A few provinces complied with this reform more than others. These were the Peronist provinces of La Rioja, Misiones, San Luis and Tucuman<sup>40</sup> and Chaco, headed by a UCR governor. The level of compliance might be explained, in part, for the Peronist provinces by the party and the size of these provinces. They were most susceptible to presidential influence because they were small and heavily dependent of federal resources (De Luca 2004).<sup>41</sup> However, no province complied with the primary task of replacing the gross business tax with a tax on consumption.

The gross business tax reforms show the essential weakness of both the provinces' technical capabilities and the federal government's ability to impose compliance. The provinces recognized that the gross business taxes were unattractive—they were regressive and drove away economic activity by double-taxing productive

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obligations, implementing standard systems that give precedence to regimes of at-source withholding and collection or payment on account.”

<sup>39</sup> The push for compliance with this pact continues to this day. Peronist Governor Carlos Reutemann of Santa Fe announced in December 2009 that his province would put off compliance with the Fiscal Pact due to the global economic downturn. The province will continue to gross business taxes on industry and agriculture. <http://noticiaslachincheflaca.blogspot.com/2009/12/zabalza-reutemann-tambien-cobro.html>

<sup>40</sup> Tucuman had a Peronist Governor in 1992 and a provincial party governor in 1995. The Peronist Governor was Ramón “Palito” Ortega. The Provincial governor was Antonio Domingo Bussi of the Provincial Defense/White Flag party. Bussi was also an accused human rights violator for his service in the military under Isabel Peron and as governor under the generals following the 1976 coup.

activity (Saiegh and Tommasi 1999). Nonetheless, they did not have the capabilities to switch to a consumption tax while still maintaining a reasonable level of tax revenue. They were forced to rely on this tax because reforming it would have been too costly in the short term and they did not have the institutional incentives to invest in long term change. The federal government, for its part, was not powerful enough to impose compliance on the aspect of the tax reform that it cared about the most.

### **Discussion**

In all of my interactions with provincial bureaucrats in Argentina, I found them to be universally rational and realistic about the failings of their bureaucracies. Most had strong opinions about the reasons why their bureaucracy fails to implement policies effectively. They are distressed by their own position in a dysfunctional organization but feel powerless to change it. One official in Catamarca's tax bureaucracy described, "None of us is trained in our job beside what we learn after years of experience. We are frequently hit by budget cuts" (Personal Communication, March 2008 Catamarca).

One might argue that provinces did not change their taxes because there was a constituency in support of them. If businesses within the province or if voting citizens preferred these taxes, it would make political sense to retain them. However, there was no constituency for these taxes beside the politicians and bureaucrats themselves. These were taxes that hurt provincial productivity, drove away investment and pushed business into the black market. Provincial officials liked these taxes because they were easy to

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<sup>41</sup> Misiones governor Ramón Puerto ran into consecutive term limits in 1999.

collect, had an existing tax infrastructure, and were fairly lucrative, not because their constituents liked it.

A discussion with the owner of a winery in Mendoza exemplified the difficulties of Argentina's provincial taxes. This owner moved to Argentina from Canada to open her winery; she ran businesses in her native Canada before moving. She explained to me that half of her staff was "under the table" because of the taxes placed on employees for even the smallest businesses. She said that each legally registered person cost over 40% of her salary in taxes. Even a person who was accustomed to obeying tax laws prior to her work in Argentina evaded them because they were prohibitively expensive. The wine sector in Argentina is very visible and also highly subsidized, making this an easy sector for the government to tax. Argentina often "over-taxes" the industries that are easiest to tax.

The winery owner's willingness to admit evasion to me shows another difficulty that Argentina faces in collecting taxes—social collusion against tax compliance. Individuals freely admit they do not pay taxes and sometimes laugh at those who do. Citizens discuss and applaud tax evasion. There is little social pressure to pay income or property taxes; the opposite is more often true. Governments with high tax collection rates get a substantial portion of their revenue from voluntary compliance and social stigma against evasion (Bergman 2003). Argentina only gets tax revenue from the individuals and industries that know they are highly vulnerable to tax agents.

## Conclusion

In the previous chapter on the effects of the Convertibility reforms on provincial taxation, I demonstrated changes in provincial level tax collection that resulted from political will and technical capabilities. In this chapter, I show how these two factors informed politicians' decisions to comply with tax reforms of the Fiscal Pact of 1993. In both chapters, I was able to separate out these forces to better understand the logic of state capacity.

Political will explained many of the trends seen in compliance with the pact. The Peronist party designed the pact and should have had strong incentive to adhere to it. Many Peronist provinces took on the weight of the fiscal reforms in the interest of strengthening their bureaucracy and living up to the tenets of party cooperation. Parties lengthened the time horizons for many provinces, both Peronist and non-Peronists, interested in preserving their provinces' long-term position in the federal fiscal regime. The Peronist party, due to its decentralized structure and the importance of small provinces in the national legislature, also allows flexibility to keep the national party system alive. The result is complicated and ever-changing negotiation between co-partisans on how to handle national affairs. This negotiation is itself informed by the weak bureaucracies in Argentina since they can only have low expectations for policy implementation. Failure to achieve a policy goal, like the Fiscal Pact of 1993, is a common outcome. Party cooperation does not appear as discipline in Argentina.

Argentine parties (or at least the Peronists) allow leeway but at the same time they are more invested in national collective outcomes. Provinces with a governor of the same party as the president have shown more fiscal restraint, spending less and accumulating

less debt than opposition party provinces (Jones, Sanguinetti, and Tommasi 2001). Many Peronist provinces complied at a high level when they could have shirked the reforms almost entirely. They held up a level of compliance with the pact that would not only improve collective outcomes, but also allow the Peronists to convince the president that the provinces were trying to live up to their end of the deal.

Even though party responsibility is clearly not perfect, party is very important to explaining policy outcomes in Argentina. Parties allow for pacts and legislative agreement even if this does not look like party discipline. The Argentine party system also suggests something very important about party cooperation in states with diversity in technical capabilities. The party cannot hold their provinces with low-quality bureaucracies to the same standards as they do the provinces with high quality bureaucracies. The weak provinces are given much more leeway to “survive” rather than act the perfect partisan.

Federalism and, more specifically fiscal federalism, are crucial variables to explaining this weakness of the party to providing national public goods. Even though many institutional rules, particularly the election rules for national legislators and the party-controlled selection of presidential candidates, would suggest strong political parties, the decentralization of those parties and the sub-national “drag” of party power provide high barriers to the pursuit of national collective goods. They are given this flexibility in large part because of the institutional power they hold in their overrepresentation in the national legislature. In the case of the Fiscal Pact of 1993, provinces avoided many of the difficulties of tax reform yet still reaped the rewards of

federal transfers and reductions in national payroll taxes. The use of federal resources for patronage, rather than meritocratic hiring of civil servants, exacerbates these difficulties.

The federal government has held up its end of the bargain on the federal transfer floor, but provincial non-compliance has not been punished. The continued profligacy of the provinces has not been met with real change in the structure of fiscal federalism. In fact, the negotiation of the pact shows the provincial governors are not truly invested in improving the capacity of their states. They continue to delegate policy responsibility to the national government. In this case, the federal government looks like the “sucker” and those provinces that complied appeared to do so because it was in their best interest to do so anyway. Economic Minister bemoaned the problem of collective responsibility for national fiscal health. He said, in 1995: “The nation and the provinces as a whole must prevent themselves from falling into the trap of transferring the blame for mismanagement of provinces onto the nation and even onto the families and inhabitants of well-managed provinces” (Telam, 10/30/95).

Political instability also contributes to the weakness of party systems in Argentina, as well as the decentralization of political parties. Partly because of the weakness of political parties and partly due the short time horizons of any politician unsure of the longevity of her political career, politicians in Argentina simply do not invest in improving the quality of their provincial bureaucracies. Part of the trouble during this period, and most periods in Argentina, is remembrance of the not-too-distant experience with regime change. Particularly after the turmoil of the Alfonsín period, governors could not be sure that these negotiations would stick. The result of this



instability is systemic weakness in bureaucratic organization, management, staffing, training, and access to resources.

Compliance with the pact highlighted the importance of technical capabilities in state capacity. Provinces made choices to comply with the taxes that would not undermine their existing revenue structure. They made these choices on the difficulty of the tax. Those provinces with the information necessary to effectively collect real estate revenue were able to change these taxes and still make significant revenue. Provinces with low capabilities could not do this for the automobile tax because reduced valuation rates would have cut into the money from the one tax they collected well. The information available to the bureaucracies to implement these taxes was crucial to explaining provincial compliance.

The Fiscal Pact of 1993 showed the importance of the feedback mechanism of technical capabilities in political will. Politicians, including provincial governors, factor the quality of their bureaucracies into their decision-making. Governors did not have unrealistic expectations about the provinces' capabilities of implementing the reform efforts and the national government was rightly skeptical of the provinces' commitment to carry them out.

The obvious failures of the pact to fundamentally reform provincial tax systems reflect the poor political and administrative environment in Argentina to make such changes.

Bureaucrats also recognize the role of politicians' perceptions of their state capacity. They make pledges to reform without real expectations of doing so. Politicians also complain in public about the quality of their bureaucracy and blame this on the lack of resources from the national level. Politicians do not see the value of investing their

scarce resources in the provincial bureaucracies when they think this will pay off. Some bureaucrats, for their part, are frustrated by politicians' commitment to their agencies. A tax collector in Mendoza told me, "politicians always complain about us and to us but don't give us ways to become better" (Personal Communication, February 2008 Mendoza).

The national government surely must have understood that full compliance with this pact was unlikely. The fact that they delivered on their side of the pact to give a minimum to federal transfers and to reduce employer payroll taxes suggests that they were satisfied to some degree by the outcome. They understood that provinces did not have the means to transform their bureaucracies overnight. Menem related to this problem because, concurrent with the pact, he was trying to reform the national bureaucracy and facing similar challenges of information collection and management as well as organizational structure.

## **Chapter 6 Conclusion**

### **Introduction**

Capacity to implement policy is the basis for effective states. States are only as strong as their ability to influence the activity that goes on within their borders. Policy implementation is the bread and butter of modern states yet most states are unable to overcome high political and technical barriers to its improvement. This weakness in modern states inhibits the functioning of democracy and the political institutions that produce good collective outcomes.

From the beginning, states have made strong efforts to shape the behavior of their citizens. These labors were not simple exercises of conquest and control but systematic means to understand citizens so that they could use that information to govern. Scott (1998) traces these early efforts to transform the way that people spoke, lived, farmed and prayed, all in the effort to make these behaviors more visible and decipherable to the state. With more information, came more effective taxing and with that came more demands from citizens for government services in return.

In modern states, much like their predecessors, political and technical challenges plague efforts to improve policy implementation. Bureaucracies are long-term investments that require “stationary bandits” with the foresight and patience to wait for their visions to be realized (Olson 2000). Most political institutions and political regimes do not create incentives for rulers to think in these extended terms. Even if they do, they may not motivate politicians to invest in improving the capabilities of their own state.

Bureaucracies, for their part, reinforce politicians' reluctance to invest in them by showing themselves to be inept.

In the preceding chapters, I have argued that state capacity is a product of politician's incentives and technical capabilities of bureaucracies. Institutions such as political parties structure politicians' desires to invest in the long-term, collective project of capacity development. These institutions are, in turn, influenced by the weakness of bureaucracies. In the absence of effective policy implementation, these institutions do not have the tools to press politicians to pursue collective outcomes.

I have also shown that the primary input necessary for technical capabilities is information about citizens. This information is the basis for all policy implementation, and is built primarily from efforts to collect tax revenue. Argentina's provinces have weak state capacity because their politicians are not driven to invest in capacity building; they delegate out the task of taxation, and due to these factors, their bureaucracies are ineffective. Poor bureaucracies only worsen the policy-making environment. Taxation is not always appreciated for its crucial role in the development of states' capacity and reach. The importance of taxation in the development of technical capabilities informed my methodological contribution of tax type indicators to comparative literature.

In this chapter, I reflect upon the policy implications of my dissertation. I begin by summarizing my theoretical and substantive chapters. Next I offer policy conclusions for state capacity, federalism, taxation, and institutional design that emerge from my dissertation. The conclusion follows.

## Summary of Chapters

The goal of my dissertation is to explain why we see weak state capacity in modern states, evaluate its effects on political institutions, and to explore ways that we might disentangle the political causes from the administrative barriers to reform. I began, in my theory chapter, by arguing that the task of policy implementation requires both political support and technical proficiency of bureaucracies. Most political science literature also assumes that politicians cause bad bureaucracies and thus are responsible for poor policy outcomes. This chain of causality captures the general nature of politicians' interactions with bureaucracies. As their principals, politicians monitor their behavior and control their resources. However, these theories do not usually consider how weak bureaucracies also hurt the policymaking environment and politicians' incentives. The technical capabilities of bureaucracies, moreover, constrain the policy space as politicians can only legislate what is feasible for implementation and political parties lack many of the tools to impose discipline on their members.

In my chapter "Identifying and Measuring State Capacity," I discuss my methodological contributions to the study of state capacity. I show why taxation is a powerful indicator of capacity that is theoretically sound. I compare it to other measures of capacity, including other taxation-based measures to show that we can learn much more by analyzing the different types of taxes states collect. To provide a background for the application of my theories to Argentina, I next describe that country's political institutions and the situation in their bureaucracies. Argentina's politicians are rationally oriented toward short-term goals and provincial politicians do not have strong motivations to strengthen their bureaucracies due to the incentives of their system of

fiscal federalism. Party systems in some ways are able to lengthen politicians' time horizons but the short-term incentives of electoral and federal institutions usually triumph. Argentina's bureaucracies know surprisingly little useful information about citizens, which cripples their abilities to implement the policies that either extract from citizens or provide services to them.

My chapter, "When the Well Dries," on the Convertibility Reforms of 1991 shows how state capacity is affected by both political will and technical capabilities. These inputs to state capacity are usually muddled in theory and reality, but I am able to separate those provinces with weak technical capabilities from those that simply lacked the motivation to collect provincial taxes before Convertibility. Due to the reform, all provinces had the incentive to improve their capacity and I measure to what extent they did so through increases in tax collection. The provinces with latent technical capabilities prior to the reform were able to substantially improve collection on the most difficult taxes once they had incentive to do so. This chapter, in addition to providing support for the idea that political motivation is a strong driver of capacity, also shows the critical and independent role that technical capabilities play in policy implementation.

In "Governors' Calculations," I show how the Fiscal Reform of 1993 provides a laboratory for exploring, in depth, the political choices that go into capacity development and how technical capabilities influence these political decisions. The deal struck between provincial governors and the national government to reform their tax system should have motivated provincial officials to make their tax systems more efficient in return for guaranteed federal revenue. The compliance was mixed, however, because not all provincial officials could overcome the institutional incentives to privilege short-term

gains over long-term improvements. Others faced the glaring reality that their province did not have the existing technical capabilities to reform their taxes and remain solvent. The Peronist party was not able to force this compliance because they could not offer attractive collective goods or monitor compliance effectively. Moreover, they could not impose discipline because it would have undermined those Peronist provinces with weak capabilities. Those provinces that complied with the reforms responded to partisan incentives for longer term reforms, or had the existing technical capabilities to make these efficiency-oriented reforms. My field research in Argentina showed that politicians and bureaucratic debated in precisely these terms when making decisions about compliance with the Fiscal Pact.

### **Policy Implications**

My dissertation is relevant to both academic and policy audiences. “State capacity” is a policy goal, an explanatory variable for developmental success, and, increasingly a dependent variable for scholars seeking to understand how it can be obtained or maintained. International development organizations have rallied for the cause: “World Capacity Day,” spearheaded by the World Bank, was the culmination of an aggressive effort by international development organizations to improve state capacity for the improvement of economic conditions and social well-being. With this in mind, I digress from the academic task of testing my theories to draw out what I believe to be important policy implications of my project.

### Implications for State Capacity

My theory argues strongly that state capacity is both a political and technical matter and capacity interventions should approach it from both of these angles. However, many interventions to improve state capacity focus on only one of these two factors, usually centering exclusively around technical challenges. Capacity reform project carried out by international organizations typically identify problems in the organization of bureaucracies and training of bureaucrats and work to improve those conditions. These are valuable approaches to improving the conditions within bureaucracies, but they will not go far to improve policy implementation because state capacity is rooted in politics. Failures of state development are highly dependent on the institutions of government and the incentives that they provide to their politicians to make public-oriented policies. It is very important, therefore, that capacity development projects consider both the political and technical reasons for policy failure and attempt reform from both sources.

Most people innately understand that bureaucracies are important for policy implementation. A large subset of those people also believes that politics plays a defining role in how well those bureaucracies operate. Few people look the other way to see that the capabilities of those bureaucracies affect the policy choices that politicians make, and they even structure the political game itself by constraining choices. As Spiller and Tommasi (2007) argue: “The quality of the bureaucracy is an important component of the quality of the environment for political transactions” (156). We need to think seriously about how the existing conditions within bureaucracies are structuring politics



themselves and consider how reform of political institutions might need to be directed at not only at the political institutions themselves but also the bureaucracies that serve them.

### Federalism Implications

Argentina's federal system should give us pause when considering the virtues of devolution. Federalism can be a very important positive institution for state unification, in particular for placating ethnic and linguistic minorities (Roeder and Rothschild 2005). However, the way that the institutions of federalism have been constructed in many parts of the world, including Latin America, raises serious concerns about the connection between theory and reality. Weingast (1995) warned that the efficiency gains created by the federalism of the United States, Canada, and Australia did not obtain in Latin America because of their different initial conditions. I extend this critique to the design of federal fiscal institutions. In Argentina, the institutions of federalism do not motivate sub-national governments to become good at governance. They delegate the very task that improves their governance, taxation, to the national government and they expend most of their efforts toward fighting for common-pool national transfers. When the federal government devolves responsibilities to the provinces, the result is not closer to the preferences of local populations, but disorganized, badly implemented policy. This is not to say that the federal government would succeed at providing good services, but it is also clear that provincial devolution in Argentina leads to very inconsistent (and poor) quality of services in most cases.

The devolution problem in Argentina is exacerbated by the imposition by the national government of unfunded mandates. During Menem's presidency, he gave the

provinces responsibility for education, a job previously managed by the federal government. This devolution was not accompanied by increased revenue for the provinces to carry out the task. Education was “dumped” on the provinces without providing them any means to carry it out effectively. This was an enormous logistical task for the provinces coupled with burdensome expenses. This is a particularly short-sighted move by Menem because education is the foundation for future human capital.

The federal government can be the driver, rather than the destroyer of provincial capacity development. The efforts by national governments can trickle down to the provinces, if the provinces feel pressed to make changes. I argued in my cross-national chapter that this was the case for the Convertibility reforms. Schwartz and Liuskila (1997) agree with this assessment by saying: “federal government efforts to improve macroeconomic management and introduce various structural reforms have forced adjustment upon subnational levels of government, as, for example, evidenced in the fact that own revenues of the provinces grew by over 50 percent in real terms during 1989-1995” (271). The lesson learned from Convertibility could be that national governments can have strong, positive effects on sub-national capacity if they align the incentives of provincial politicians.

### Information Implications

My experience observing bureaucracies in Argentina and discussing them with citizens and agents reinforced my beliefs about the importance of state and society interaction for state capacity. I have not found a government yet where citizens look forward to interacting with their bureaucracies. However, the bureaucratic environment in

Argentina seems particularly toxic. Argentine bureaucracies do not appear concerned with customer service and never treat citizens as “clients” for their “business” of running the state. I understand that this is not always feasible, but governments should be wary of making the taxation process too unpleasant and cumbersome. Nobody enjoys the process of filing taxes and nobody loves to pay them, but to set up a system where you need an accountant to figure out the most basic returns and, once you figure them out, you must wait in a very long line to file them, is unacceptable. Citizens know that the government is unlikely to enforce this law, in any case, so the result is very unsatisfactory for the government.

Citizens are the foundation for information necessary for states to be effective. The relationship between states and citizens in a democracy should work something like a business where citizens pay for services and governments provide them to their satisfaction. The key input to make this transaction successful is for governments to understand citizens so that they may effectively (and equitably) tap their resources as well as provide the services that actually meet citizens’ needs. The best way to do this is by interacting with citizens. Bureaucracies cannot expect citizens always to approach them to share information about themselves. Even the best bureaucracies will not get this level of cooperation. States need to reach out to citizens in a careful and caring way and to do so in a variety of means with a variety of methods. Also, as bureaucratic services improve, so will citizens’ willingness to engage in their activities and help their productivity. To improve their collection and management of information, states need to consider the ways that their institutions are affecting state-society relations. As Evan’s (1995) argues, “States are not generic. They vary dramatically in their internal structures

and relations to society. Different kinds of state structure create different capacities for state action” (11).

The task of improving the bureaucracy does not have to involve the immediate overhaul of the bureaucracies but it can be incremental and affordable. The first way to improve bureaucratic output is to improve the state’s treatment of “street level” bureaucrats such as teachers and police officers. These are the most prominent faces of the government for all citizens and the bureaucrats that nearly every citizen interacts with on a regular basis. These are also the bureaucrats treated the worst by Argentina’s provinces. Missed paychecks and pay freezes in state bureaucracies go first to teachers, and that is why Argentine teachers strike so regularly. Good schools, good hospitals, and safer streets are the best start to improving Argentine’s view of the state. When they believe they are getting something good out of their state they will be more willing to interact with it and share the information necessary for effective policy implementation. Tax scholars, among others, have shown a strong connection between citizens’ approval of the state and their willingness to fund it (Levi 1989; Bergman 2003) and I think the best place to start with this is in the citizen-facing bureaucracies.

### Institutional Implications

State capacity has become a buzzword in international development organizations. They assume that many of the big problems of economic development cannot be solved if the state does not have the means to implement policies. There is a lot of truth to these claims, but they may not go far enough. We have not considered enough

how weak state capacity hurts the representative function of a democracy through its effects on political parties and the provision of broad public goods.

Scholars and policy experts alike are quick to blame political parties for behaving in short-sighted ways and preferring clientelist linkages over programmatic ones. The implicit assumption of these studies is that programmatic linkages are better for democratic representation because they are more equitable and they provide the broad public goods that are a primary purpose of governments. If this is true, then improving state capacity should have the effect of improving democratic representation because it opens the possibility for parties to operate on a programmatic basis. Parties with weak bureaucracies may not have the option of appealing to voters through programmatic appeals where they cannot deliver public goods.

Related to this, the feedback from a poor bureaucracy to the functioning of political parties may have profound effects on the linkages between party members and their constituents. Parties become programmatic when they deliver broad public goods to citizens regardless of party affiliation (Kitschelt 2000). When we see linkages between citizens and parties that are other than programmatic, such as the clientelist connections of the Peronist party, scholars often assume this is a “demand-side” phenomenon—that citizens prefer these kinds of connections with parties. For example Levitsky (2003) describes:

In Latin America, post-industrialism has been characterized by the growth of the urban informal poor, an electorate in which post-materialist appeals are less likely to succeed. Clientelist linkages may be more effective among these sectors, particularly in a context of economic crisis and state retrenchment (6).

This preference by voters may be true; in a clientelist system they can get more direct benefits from party affiliation. However, assuming clientelism comes about because of the preferences of voters, rather than the constraints of parties, ignores an important possible “supply-side” reason for this arrangement. With weak state capacity, parties have a difficult time being a programmatic party, even if they should want to become so, because they cannot distribute collective goods nor deliver on promises of broad public policy because their bureaucracy cannot implement it.

State capacity failures stand in the way of strong parties. Parties hold the possibility of controlling their members, of providing them with reasons to overcome the shortsighted or localized incentives of their electoral or legislative institutions. Party leadership gives their members motivation to ignore those incentives by promising them policies that will help their careers. Even a weak bureaucracy will have access to some of the tools to provide these goods, but they are likely to be limited in these cases. The only goods that such a party can provide will be individual to the party member or localized. They cannot claim the benefits of a party with strong tools to forward members’ policy goals or to improve policy-making.

Few political scientists will dispute the idea that institutions have strong effects on policy outcomes. When examining policy implementation, therefore, the failings of the institutions come into sharp focus. In particular, institutions structure politicians’ incentives to invest in long-term projects like capacity development. Politicians rationally opt to devote their energy to immediate gains when their fates are determined in the short-run. When we see short-sightedness on the part of politicians, we need to consider solutions to make politicians and citizens alike see their situations as more stable

and permanent. Only then are we likely to observe investments in future gains. The Argentine institutions that most need to be reassessed include mal-apportionment and the design of federal transfers because they have bad effects on implementation and quality of services (including economic growth, security, health, education). However, the political barriers to change in either of these institutions are so high as to be render reform nearly impossible.

The institutions of federalism, including mal-apportionment and federal transfers have been perpetuated in part to serve as progressive measures to support those areas with less natural endowment than the bounty of the pampas. The result, however, has not been to preserve the strength of all of the provinces, but to make the weaker of them entirely dependent on the will of the national government. They feel that the national government is always trying to withhold what is rightfully theirs. The national government, for its part, feels defensive of its efforts to collect revenue and preserve the macroeconomic health of the nation. They blame the provinces for the economic instability of the country. The equilibrium in Argentina is one where provinces only have a chance to thrive by breaking away from complete dependence on federal transfers and moving toward greater self-sufficiency.

Related to this, the revenue and expenditure process, largely disconnected in Argentina's provinces, should work together in important ways. The bureaucracies in the provinces are weak at the delivery of services for a number of reasons, including low resources, but primarily because of the same information difficulties that plague their taxation. Delivery of services such as healthcare, education, pensions, and infrastructure require detailed information about the needs of citizens. The primary ways this

information is known in other states is through the information collection process used to levy taxes. Since provinces largely delegate taxation to the national government, they are not effective services providers. The best way to do this is to improve provinces' own system of taxation so that they are rewarded for their efforts to improve the state with tax revenue.

### Methodological Implications

International organizations' interest in state capacity has not resulted in careful thought on the conceptualization and measurement of the concept. These groups usually rely on business surveys to measure state capacity without considering the validity of these measures. Those interested in improving capacity in the developing world need to devote more effort into defining and quantifying capacity in theoretically motivated ways.

### Tax Implications

If my beliefs about state capacity are correct, taxes are a critical to everything a state does. Taxation is not just a measure of one type of policy but an assessment of the policy from which all other policies and information flow. Taxes are not simply the means to pay bills or the hold that citizens have over policymakers, but they are also the key to states ability to do everything. With that in mind, politicians need to reevaluate the role of taxes in their government and reassess the costs versus benefits of pursuing better tax administration.



Argentina is one of five countries with a museum devoted to taxation. The tax museum is housed inside the large headquarters of AFIP, the Argentine IRS. I visited this museum while in Buenos Aires in July of 2007. I was asked by the woman staffing the front desk to sign my name before I entered; I was the first person in nearly one year to enter the museum. Before that lone visitor 10 months prior, no person had come in 6 months. This illustrated to me the low interest in taxation in Argentina. In the United States not many people would be beating down the doors to see exhibits of early customs agents, but some people with interest in changing the system would use the museum as a source of information and perhaps a staging ground for protest. People in Argentina avoid visiting the museum because, not only is it boring to most people, but most people who dislike the system of taxation simply do not pay them. The museum docent sits alone at her desk for a year at a time because taxes are not effectively integrated into their system of governance.

The best way to improve fiscal federalism in Argentina, including improving both provincial and national tax capacity, is to align incentives for provinces to collect taxes alongside the national government. Currently provinces have no incentive to work with the national government to improve taxation. They are not compelled to share information, standardize procedures, or join efforts with the national government. One proposition that might have improved the taxation system, called the shared VAT, was proposed by Menem in 1999 but never implemented. This tax would allow the provinces to collect a surcharge on the national VAT. This could have given incentive for the provinces to assist in federal collection, increasing money into the common pool resource for federal transfers, and could have improved provincial collection by improving their

access to information and their collection skills (Cuevas 2003). This is a good incremental way to bolster capacity that would lead them to improve the overall tax system. Moreover, it could be adjusted to fit the circumstances in the provinces by having a higher or lower percentage go to the provinces and allowing the provinces to have different rates based on their efforts to collect the VAT.

The Argentine tax collection bureaucracies at all levels need better technology to collect, manage, and share information. This requires more money for basics like computers and internet access and accounting software. In the tax bureaucracies that I toured, these basic tools were not always available. In all of the provinces, it seemed that agencies lag behind citizens and the private sector in technological and accounting sophistication. This allows businesses to evade taxes more easily and to find loopholes in the tax code.

Argentina is notorious for its liberal distribution of tax breaks and its complicated tax code. These tax breaks make for uneven collection and for low revenue. They also make taxes so complicated that average people cannot file without an accountant. The tax breaks privilege certain types of businesses in certain places, contributing to the perception of inequality in Argentina's tax code. The disastrous combination of factors where Argentina's taxes are unequal, overly complicated, and ineffectively enforced discourages citizens from paying taxes and results in very low tax revenue.

Like with inefficient fiscal federalism, I understand the coalitions that protect tax breaks. It is not just small provinces that protect fiscal federalism and tax breaks, but also the Peronist and provincial parties. The Peronist party's base of strength is in these small provinces even though the large majority of people live in the urban areas of Buenos

Aires and a couple other big cities. Only transformation of partisan forces, including perhaps the transition of Peronism to a more urban-based party, is likely to change these policies that hurt long-term productivity. Also, greater capacity would improve the functioning of the parties in Argentina, both Peronist and Radical. In the case of fiscal federalism, policies that force provinces to invest in themselves, such as Convertibility, will press provinces to establish themselves as more effective governors.

States need to find ways for their tax efforts to be taken seriously by citizens. They can do this by providing better government services but also increasing the perception of enforcement. Argentines will pay taxes if they are worried about being caught evading and if the punishment will be significant. For example, Cavallo's policies during the 1990s to freeze bank accounts and access bank information gave citizens a reason to pay taxes. A friend of mine in Buenos Aires said that Cavallo's policies made her pay income taxes for the first time in her life (she was in her 40s at the time) because she worried about going to jail. Tax officials in the province of Buenos Aires also seized televisions during the soccer championships in 2006 of those known tax evaders. These are extreme examples of tax collection, with questionable regard for citizens' rights, but they made tax enforcement more credible. Tax amnesties can also bring more citizens into the taxable sphere, but this can only be done on limited scale. It has been tried so often in Argentina that many people ignore the offers to file under amnesty because they believe more such offers will come in the future.

**Conclusion**

State capacity is a crucial component of the viability of states and in the quality of their democracy. It shapes party systems and affects the daily lives of citizens through service delivery. Future scholars of state capacity must consider the role of political will and technical capabilities in capacity, and how they should be measured. They should also consider how weak technical capabilities are impacting the environment for policymaking and political agreement.

## APPENDIX

**Table 5.1a: Fiscal Pact of 1993 Components**

<b>Fiscal Pact of 1993 Components</b>
<i>Provinces that are signatories receive:</i>
A minimum amount of coparticipated revenues is increased to Arg\$740 million a month, compared with a minimum of Arg\$725 million a month that was established under the previous federal pact that was in force during 1993
To the extent that they eliminate stamp duty and taxes on gross income for productive activities, provinces are not required to refund advances made by the Treasury since August 1992 to comply with the guaranteed coparticipation minimum (during September 1992 to June 1993; advances from the federal government amounted to Arg\$0.9 billion)
The option to transfer their pension funds to the national system, including the deficits they generate, that is, approximately Arg\$1.2 billion a year
Political guarantees to negotiate the offsetting of claims and debts between the provinces and the federal government
<i>Productive sectors receive:<sup>1</sup></i>
Exemptions from the provincial turnover tax—the process must be completed by June 30, 1995, the provinces having the option to apply it partially or gradually—or primary production; industry; mining; tourism; financial services; savings and investment companies for those generated in homes for domestic use
Exemptions from stamp duties for financial or insurance operations for the agricultural, industrial, mining, or construction sectors, with the commitment that this will fully apply to the remaining operations and sectors by June 30, 1995
Exemptions from specific provincial taxes levied on transfers of fuel, gas, electricity including taxes on self-generated energy, and domestic services
The elimination of rates or taxes that are levied directly or indirectly on the flow of goods among jurisdictions or the use of physical space, including airspace, for services
Waiver for the taxes on interest earned on fixed term and savings bank deposits, banking debts, and gradually all taxes levied on payroll, with completion of this waiver process by June 30, 1995
Relief from the assets tax, to the extent that they are affected by the repeals and exemptions arranged by each province in connection with stamp tax
Reductions of 30-80 percent in rates of employers' social security contributions, applying only to those sectors that are exempt from stamp duties and turnover taxes
<i>Provinces are also required to:</i>
As of January 1, 1994, revise taxes on real estate property, so that in no case they exceed for rural real estate, 1.2 percent; suburban real estate 1.35 percent; and urban real estate, 1.5 percent of the taxable base. The taxable base may not exceed 80 percent of the market value of the real estate
As far as possible, strengthen the tasks of auditing and supervising compliance with tax obligations, implementing standard systems that give precedence to regimes of at-source withholding and collection or payment on account
Within three years, replace provincial turnover taxes with general consumption tax, with a view to ensuring tax neutrality and an improved competitiveness of the economy
Move toward the full or partial privatization, or leasing/concessions to the private sector of provincial public enterprises
Undertake deregulation, removing the restrictions on the supply of goods and services and on interventions in the various markets
Adopt rules consistent with national legislation on occupational accidents

Source: *Ambito Financiero* of January 21, 1994

<sup>1</sup>Agricultural production, industry, construction, mining, tourism, and scientific and technological research.

**Table 5.2a: Tax Stipulations of the Pact of 1993—Obligations of the Provinces**

<b>Tax</b>	<b>Measures Adopted</b>	<b>Sector or Activity</b>
Stamp tax	Repeal	Any institutionalized financial or insurance operations for the agricultural, industrial, mining, or construction sectors
Specific provincial taxes and municipal taxes	Repeal	Transfers of fuel, gas, electricity, including taxes on self-generated energy, and similar services
Taxes on interest on fixed term and savings bank deposits	Repeal	
Provincial turnover taxes	Eliminate (completed by June 30, 1995)	Primary production, financial services provided by financial institutions Savings and investment companies, mortgage security issuing companies, private pension funds (AFJPs) Mutual fund management companies Insurance companies, with respect to income from their specific activity Currency transactions, with respect to income from such activity Production of goods, not including income from sales to consumers Provision of electricity, water, and gas services for commercial and/or industrial purposes Real estate construction
Real estate property taxes	Revise	As of January 1, 1994: Average tax rates should not exceed, for rural real estate, 1.2 percent; suburban real estate, 1.35 percent; and urban real estate, 1.5 percent The taxable base should not exceed 80 percent of the market value of urban and suburban real estate or the value of undeveloped land in case of rural real estate
Road taxes and road maintenance taxes	Revise	It is recommended to municipal governments that these or similar taxes not exceed 0.40 percent of the value of the provincial taxable base and be adjusted to reflect the cost generated by the actual provision of the service
Taxes on driver's licenses	Revise and coordinate	The obligation will be to ensure the uniformity of valuations or applicable tax rates among all jurisdictions as of 1994. Valuations published by the General Directorate of Taxation (DGI) are to serve as reference

Sources: Schwartz and Liuksila (1997), Instituto de Estudios Económicos sobre la Realidad Argentina y Latinoamericana (IEERAL)

**Table 5.3a: Automobile Valuation Non-Compliance, by Capabilities and Party**

<b>Automobile Valuation</b>	<b>Non-compliance</b>
Low Capabilities	Jujuy, Misiones, Santiago del Estero
Medium Capabilities	Buenos Aires, San Juan
High Capabilities	


**Table 5.4a: Real Estate Valuation Compliance, by Capabilities**

<b>Real Estate Valuation</b>	<b>Compliance</b>	<b>Non-compliance</b>
<i>Low Capabilities</i>	Corrientes, Formosa, Catamarca, Misiones, Santiago del Estero	Jujuy, Salta
<i>Medium Capabilities</i>	San Juan, San Luis	Buenos Aires, Chaco, Entre Rios, La Rioja, Rio Negro, Tucumán
<i>High Capabilities</i>	Capital City, Chubut, La Pampa, Mendoza, Neuquén, Santa Fe, Tierra del Fuego	Córdoba, Santa Cruz


Source: "Pacto Federal para el Empleo, la Producción y el Crecimiento." Decreto 1807/1993.

**Table 5.5a: Provincial Compliance with the 1993 Fiscal Pact**


Issues	C.F.	B.A.	Cat.	Cord.	Corr	Cha.	Chu.	E.R.	For.	Juj.	L.P.	L.R.	Men.	Mis.	Neu.	R.N.	Sal.	S.J.	S.L.	S.C.	S.F.	S.E.	Tuc.	T.F.
<b>1. Tax on contrates</b>																								
1.1. Short term reduction																								
1.2. Medium term reduction																								
<b>2. Specific taxes</b>																								
2.1. Tax on oil																								
2.2. Tax on gas																								
2.3. Tax on electrical energy																								
2.4. Tax on sanitary services																								
<b>3. Tax on bank accounts and payroll</b>																								
3.1. Bank accounts																								
3.2. Payroll taxes																								
<b>4. Turnover Tax</b>																								
4.1. Primary production																								
4.2. Financial services																								
4.3. Insurance services																								
4.4. Foreign currency transactions																								
4.5. Industry																								
4.6. Utilities																								
4.7. Construction																								
4.8. Tourism																								
4.9. Research and development																								
<b>5. Real estate taxes</b>																								
5.1. Valuation																								
5.2. Tax rates																								
<b>6. Tax agencies</b>																								
<b>7. Consumption tax</b>																								
<b>8. Tax on cars</b>																								
8.1. Valuation																								
8.2. Tax rate																								
<b>9. Privatization's and concessions</b>																								
9.1. Energy firms																								
9.2. Sanitary and water utilities																								
9.3. Provincial Banks																								
<b>Transfer of Provincial Pension System</b>																								




Total fulfillment




Partial



no fulfillment



municipal



no

Source: "Pact Federal para el Empleo, la Producción y el Crecimiento", UNLP, Lics. L.M.Monteverde, R. Ruiz del Castillo, S. G. Tarragona y H. Terán y Dres. T. Perez Balda y J.M. Prá información de la Dirección de Coordinación Fiscal con las Provincias

Note: The province of Buenos Aires has privatized the water company during 1999.

Source: Tommasi in Wallack and Srinivasan (2006)



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