Journal of Institutional Economics (2023), **19**, 303–313
doi:10.1017/S1744137423000024

INTRODUCTION

The origins of fiscal states in developing economies: history, politics and institutions

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(Received 9 January 2023; accepted 13 January 2023)

Abstract
This is an introduction to the special issue that presents new research on the state and its links to economic and social development. The special issue focuses on the processes of institutional transformation of the state, looking at how fiscal states arise in the developing world. The resulting set of articles presents a variety of approaches, ranging from case studies (at state and regional level), to comparative historical analysis and to macro-quantitative (country and cross-country level) perspectives. The overarching message is that historical, political and institutional factors are key to understanding the process of fiscal states formation and change around the developing world.

Keywords: Domestic revenue mobilisation; fiscal capacity; fiscal states; institutions; SDG17; state capacity; tax revenues

JEL classification: O4; P5; H61; H83; P48; N46; N47

1. Introduction

There has been a revival of interest on the role of states in economic development. Recent research argues that the most developed economies are those where effective states can exercise an important productive role, such as providing an effective administration of justice and resolving coordination failures.[1] The process of transformation of public finance institutions, or the emergence of *fiscal states*, is a fundamental part of becoming an effective state.[2]

Historically, this process was pivotal to the transformation of the nowadays-advanced European economies, leading to the development of states capable of collecting revenues from a broad tax base, borrowing on domestic and internal markets, and capable of effectively spending public funds on a range of good and services benefitting households and firms. However, it is less clear why we

[1]See, for reviews of this literature, Bardhan (2016), Besley and Persson (2011) and Acemoglu and Robinson (2019).

[2]We borrow the term *fiscal states* from the economic history literature studying the evolution of public finance (e.g., Yun Casalilla and O'Brien 2011; He 2013). It refers to the nature and type of public finance institutions and to their transformation, leading from more 'primitive' forms of financing state activities to 'modern' ones. Taxation is a central part of such transformation. For example, the process of institutional transition from a domain state to a tax state, which can be seen as the 'polar cases' (as in Schumpeter, 1918), is part of becoming a fiscal state. This process includes acquiring fiscal capacity, i.e., the coercive aspects of taxation (e.g., efficiency of revenue administration), plus the contractual aspects of taxation. The term fiscal states should be empirically grounded. Most developing countries around the world are experiencing the transition from less developed forms of public finance to the most sophisticated forms of financing state activities. In the broader literature, however, the expression fiscal state has also been used as synonymous of fiscal capacity. The recent paper on Africa by Albers et al. (2020) is an example.

have not seen the same trajectory in less advanced economies, where states are much less effective and often taxation yields only a fraction of the revenues compared to rich countries.[3] Improving our understanding of how states finance their activities is also policy relevant. Countries' ability of generating resources for development spending is explicitly recognised in Sustainable Development Goal 17, where Target 17.1 requires *strengthening domestic resource mobilisation* (and its progress is measured using *Total government revenue as a proportion of GDP*). This research project aims to consolidate knowledge and to set an agenda for future research in this area.

Facilitating a new collaborative discussion among a group of political scientists, economic historians and economists studying the origins of effective states across world regions, this Special Issue presents new research on the process of institutional transformation of the state, looking at how fiscal states arise in the developing world. The Special Issue is the outcome of an UNU-WIDER project: The Origins and Developmental Implications of Fiscal States. Combining a variety of approaches, ranging from case studies (at state and regional level), to comparative historical analysis and to macro-quantitative (country and cross-country level) perspectives, the resulting set of articles, examines the effects of fiscal states in low- and middle-income countries and their economic, political and historical determinants. The overarching message is that historical, political and institutional factors are key to understanding the process of fiscal states formation and change around the developing world, while understanding their effects on economic and social development hinges on the heterogeneous characteristics of individual settings.

The rest of the article is in five sections- Section 2 makes the case for the importance of fiscal states in developing countries, and present stylised facts on taxation across the globe. Section 3 discusses the literature on the emergence of fiscal states. Section 4 introduces the papers in the Special Issue. Section 5 discusses some remaining puzzles in the literature and points out areas of future research. Section 6 concludes with some policy implications that come out of the papers in the Special Issue.

2. On the importance of fiscal states in developing economies

This section discusses the state of the literature. Thematically, we focus on two (inter-connected) questions: (i) what the developmental implications of fiscal states are; and (ii) how fiscal states arise. Let's start with some stylised facts.

Taxation is an important source of revenues, central to financing state activities. Using Total Non-Resource Taxes/GDP as an indicator of taxation capacity, Figures 1 and 2 illustrates the differences among different groups of countries by level of economic development (Low Income, Middle Income and High Income) and by region respectively.

High-income countries collect, on average, more than double the share of total revenues than low-income countries (Figure 1). By region, we see that East Asia and the Pacific, Middle East and North Africa, Latin America and the Caribbean, South Asia and Sub-Saharan Africa collect substantially lower taxes as a proportion of GDP than North America and Europe and Central Asia (Figure 2). In fact, the difference in the tax to GDP ratio for the developing regions and North America is fifteen percentage points, suggesting there is significant room for improvement in the domestic resource mobilisation of developing countries.

The gap in 'tax performance' between rich and poor countries is stable over time and the lack of improvement in taxation capacity in the developing world suggests that we should look at the 'deeper' determinants that may keep this gap in fiscal development unchanged over time, rather than focusing exclusively on technical fixes of revenue administrations performance. This special issue is on the deep historical, political and institutional determinants of fiscal capacity in the developing world.

There are three reasons why the emergence of fiscal states matters for economic and social development.

First, the rise of fiscal states may provide much-needed resources to provide public good and services. This is important to pursue the ambitious set of Sustainable Development Goals (SDGs) in low-income countries and in sub-Saharan Africa in particular. As Figure 3 shows, government

[3]See Besley and Persson (2013).

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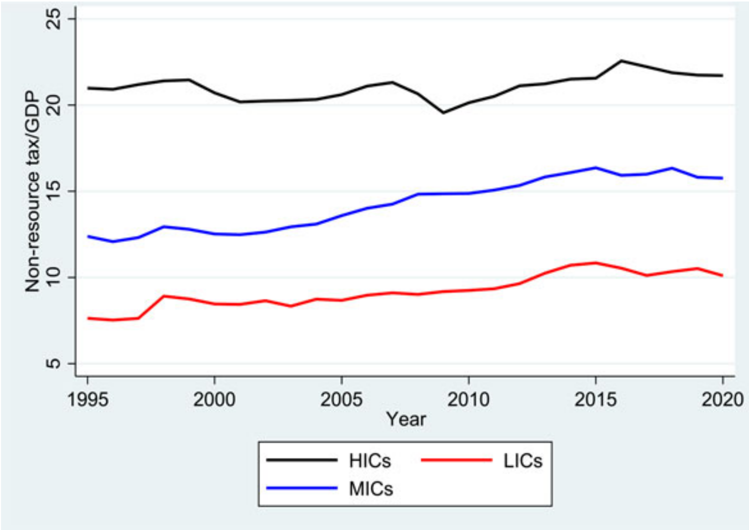

Figure 1. Total non-resource taxes/GDP, by level of economic development, 1995–2020.
Source: UNU-WIDER Government Revenue Dataset'. Version 2022. https://doi.org/10.35188/UNU-WIDER/GRD-2022.

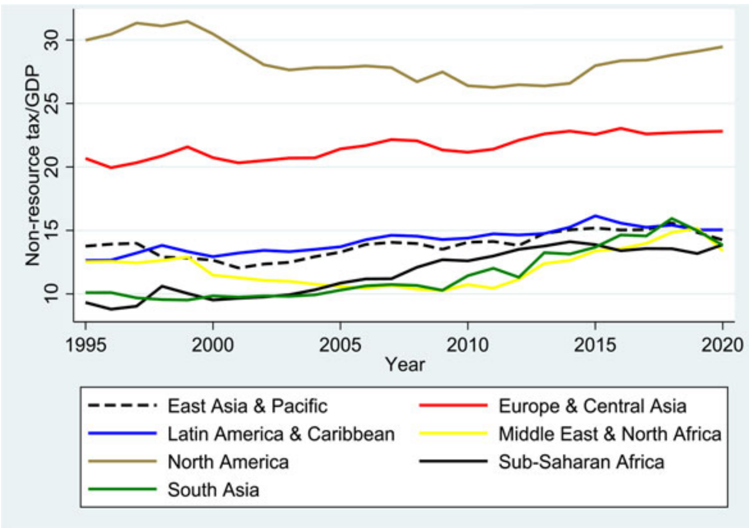

Figure 2. Total non-resource taxes/GDP, by region, 1995–2020.
Source: UNU-WIDER Government Revenue Dataset'. Version 2022. https://doi.org/10.35188/UNU-WIDER/GRD-2022.

spending on education and health mirrors the patterns in taxation capacity which we observed in Figure 2, with governments in regions such as North America and Europe and Central Asia that are able to obtain more tax revenue (as share of GDP) are more likely to spend more on both education and health.[4]

[4]Two exceptions are Latin America and the Caribbean and East Asia and Pacific. Latin America and the Caribbean also show how high government expenditures on education and health as a percentage of GDP, and East Asia and Pacific's share of government spending on education in GDP is converging to levels seen in high income countries.

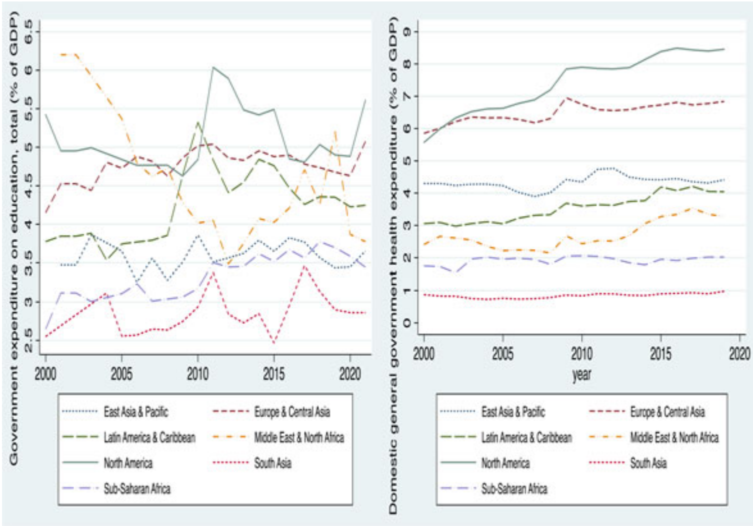

Figure 3. Government Expenditure on Health and Education as a percentage of GDP, 2000–2021.
Source: World Bank, World Governance Indicators 2022, https://info.worldbank.org/governance/wgi/.

Secondly, fiscal states may provide developing countries with access to tax and spending instruments, as a result of increased fiscal capacity, with significant distributional impacts (e.g., progressive tax systems). Income taxation, in particular, can act as a powerful redistributive tool and is a key feature of a modern fiscal state. As Figure 4 shows, low-income countries are increasingly mobilising domestic resources via income taxes, and the proportion of taxes raised through income taxes as a share of total revenues for low-income countries is not very different than that for high income countries in the late 2010s.

Third, the fiscal sociology literature suggests that the rise of fiscal states should come with a 'governance dividend': the quality of government should improve, as a result greater government accountability, because the taxpaying citizenry will subject the ruler to increased scrutiny (Brautigam *et al*., 2008). As Figure 5 shows, the *Voice and Accountability* measure derived from the World Bank's World Governance Indicators (see Kaufmann *et al*., 2010) for Low-Income countries remains at a low level relative to the High-Income countries over 1996–2021. This suggests the lack of a governance dividend for Low-Income countries due to the inability of the governments in these countries to raise tax revenues from their citizens.

3. How do fiscal states in developing countries arise?

Acquiring fiscal capacity is the product of investment in state structures, which includes a more efficient revenue administration that is able to enforce compliance with tax obligations. A large literature has examined the long-run determinants of fiscal capacity for Europe and North America. Three sets of factors have been identified in the literature as contributing to the emergence of fiscal states in in the developed country context. The first set of factors relate to war and external conflict. In the context of Europe, citizens of these countries accepted the need for increased tax revenues to finance wars (Brautigam *et al*., 2008). As Tilly (1985, p. 180) argues, 'war state apparatus, taxation and borrowing advanced in tight cadence' in Europe. However, more recent evidence does not suggest a strong correlation between the onset of wars and the need to mobilise resources through taxation. As Figure 6 makes clear, there is little difference in the incidence of external conflict across region over the 2000s. This suggests that external conflicts cannot be seen as a causal factor in the persistent gap in taxation capacity that we observed earlier between developed and developing regions. A second set of factors

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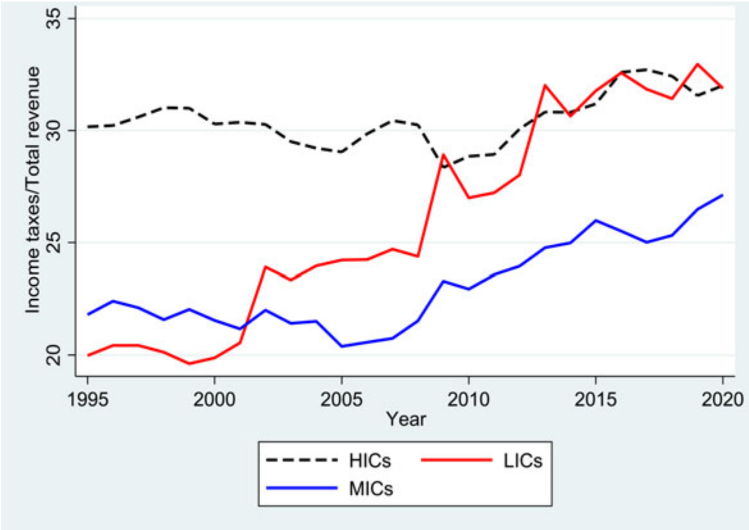

Figure 4. Income Taxes as a share of Total Revenues,1995–2020, by level of economic development.
Source: UNU-WIDER Government Revenue Dataset'. Version 2022. https://doi.org/10.35188/UNU-WIDER/GRD-2022.

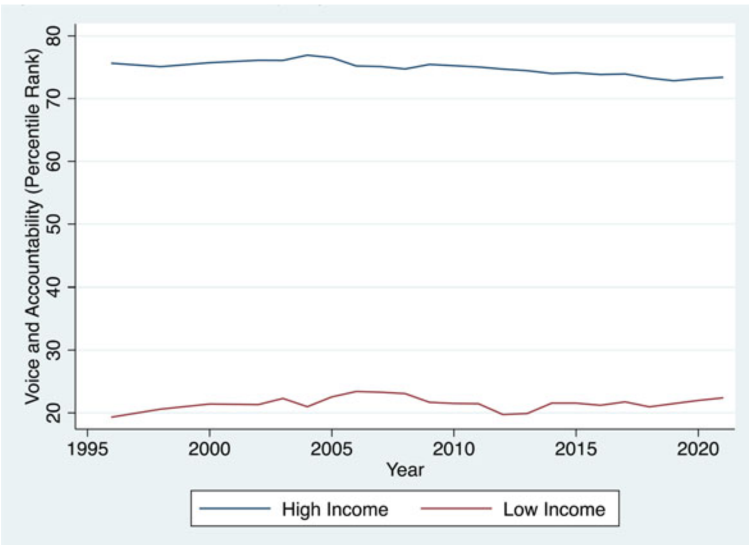

Figure 5. Voice and Accountability, High- versus Low-Income Countries, 1996–2021.
Source: World Bank, World Governance Indicators 2022, https://info.worldbank.org/governance/wgi/.

relates to the nature of the fiscal contract between the state and society. Acquiring fiscal capacity is the product of features of the taxation system that increases quasi-voluntary compliance of taxation by making taxation more consensual. Central to developing these features is the bargaining process between the state and the citizenry, where citizens enter a fiscal contract with the state involving an exchange of tax revenues for good and services as they have more control over its action (Levi, 1988). A third set of factors relates to the idea that democracies exchange taxation for representation. In democracies, taxation may be higher than in autocracies as elections allowed changing societal

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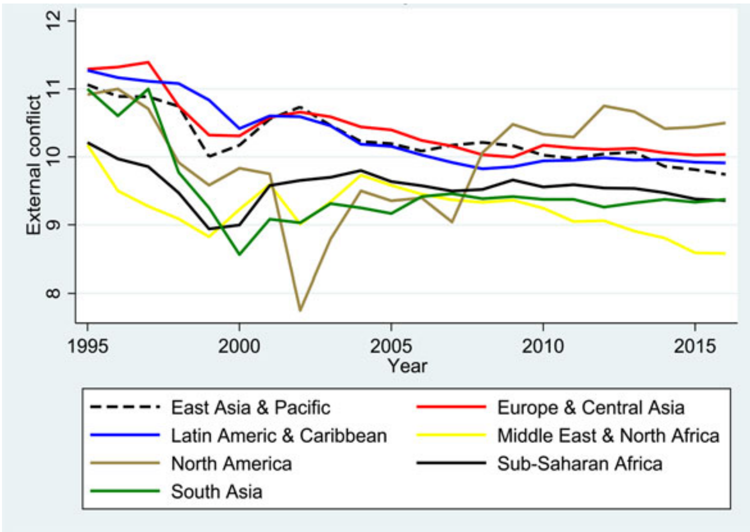

Figure 6. Incidence of External Conflict, by region, 1995–2016.
Source: ICRG – International Country Risk Guide (2018). International Country Risk Guide rating, https://www.prsgroup.com/explore-our-products/international-country-risk-guide/.

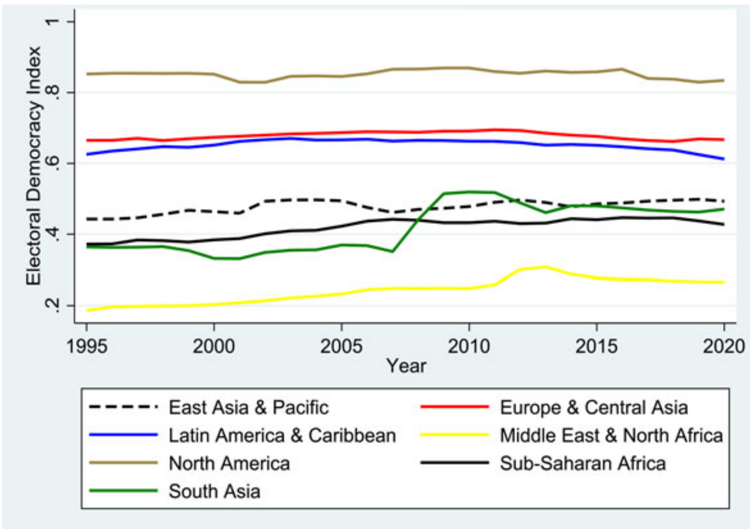

Figure 7. Electoral Democracy, by Region, 1995–2020.
Source: VDEM dataset, Coppedge *et al*. (2022).

interests to better express their preferences and redistribution becomes an important societal goal (Boix, 2001; Timmons, 2010). Consistent with this argument, Figure 7 shows very little evidence of increasing democratisation in the developing world over the 2000s, which may explain why we have not seen an increase in the share of tax revenues in GDP in the same period.

The above discussion highlights the need for further systematic econometric analysis and in-depth case studies on the factors that may explain why we have not seen the emergence of fiscal states in developing regions as we have done in the developed world. Unlike the case of Western Europe, where the role of wars, the fiscal contract and democratisation (among other factors) in explaining

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the emergence of fiscal states is well established, it is less clear which factors affect fiscal capacity in developing countries and their mechanisms remain relatively under-studied.

This special issue aims to fill the important gap in our understanding of the origins of fiscal states in developing countries, drawing from the cutting edge of research on the relationship between governance, institutions and long-term economic development (see Besley and Persson, 2011, 2013 and Ricciuti *et al.*, 2019). We describe the contents of the Special Issue in the next section.

4. Papers in the special issue

This special issue of the *Journal of Institutional Economics* includes eight papers that examines the factors that contribute to the emergence of fiscal states in developing countries. The first paper interrogates the concept of fiscal capacity in the context of Sun-Saharan Africa. Two papers look at the historical drivers of fiscal states. Two more papers examine the political factors that contribute to the emergence of fiscal states. The final three papers study the institutional determinants of fiscal capacity. We provide a summary of the key contributions of the eight papers below.

4.1 What is a fiscal state in a developing country context?

It is important to unpack this idea in order to understand its determinants and developmental consequences. Jeppesen *et al.* (2023) argue that the current literature is not able to provide a coherent definition of a fiscal state that is distinguishable from the effects and preconditions of fiscal states, as well as not conflating fiscal capacity with the notion of a fiscal state. The paper provides a new definition of the fiscal state – as a state whose public revenue base is dominated by taxation and borrowing and where the relationship between the two is balanced. Using a typology and country examples to illustrate the differences and dynamics between the fiscal state and three other state ideal types: the tax state, the rentier state, and the debt state, the paper argues that not all sub-Saharan African states can be categorised as fiscal states. This suggests that in the absence of fiscal states in Africa, fiscal policy reforms are unlikely to carry long-term positive effects.

4.2 Historical origins of fiscal states

Two papers look at the role of historical origins of fiscal states in sub-Saharan Africa. Heldring and Robinson (2023) look at the historical conditions that may have prevented the rise of fiscal states, using Rwanda as a case-study. Heldring and Robinson argue that local political institutions predating the establishment of African states were based on a social contract that did not allow the emergence of centralised tax systems, because they were never designed to support taxation. This argument moves beyond the emphasis on 'geography' mechanisms (such as Herbst, 2000) to explain the lack of state capacity in Africa, suggesting instead that it is the long-run effect of institutional choice and persistence that may play a key role and warning against simplistic transplantation of fiscal concepts and institutions from the Western European tradition.

Ali and Fjeldstad (2023) examine the long-run effects of pre-colonial institutions on tax compliance norms in Uganda. They exploit a natural experiment provided by the variation in the degrees of pre-colonial centralisation within Uganda and find that pre-colonial centralisation is correlated with stronger norm for tax compliance. They argue that the higher tax compliance norms in historically centralised parts of Uganda can be explained by the state's legacy of upholding authority and stronger social cohesion through interpersonal trust, but not by the quality of public institutions in these regions.

4.3 Political determinants of fiscal states

Two papers examine the political determinants of fiscal states. As noted earlier, a key feature of the modern fiscal state is the reliance on personal income taxes as a source of government revenue.

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Most personal income taxes were introduced by non-democratic states in peacetime, and were an investment in fiscal capacity, rather than a tool for redistribution. Andersson (2022) examines the political conditions under which non-democratic states introduced the personal income state and shows that institutional oversight through legislature is positively related to the adoption and expansion of income taxes in non-democratic regimes.

Savoia *et al.* (2022) look at the interplay between political institutions constraining the executive power and tax revenues, in the long- and short-term. They argue that tax revenues and executive constraints reinforce each other over time, bringing about a shift in the composition of revenues, from taxes levied on a narrow base to broadly levied taxes. Using historical cross-country data over the 1800–2012 period, they find that there is a long-run relationship between constraints on the executive and taxation, and this is most evident for direct taxes. The results suggest that executive constraints are a structural condition for fiscal development, as well as the emergence of broad-based taxation.

4.4 Institutional determinants of fiscal capacity

Three papers study the institutional determinants of fiscal capacity. Morrissey and Tagem (2023) estimate tax capacity for 39 Sub-Saharan African countries for 1985 to 2018, successfully separating fiscal capacity from tax performance, something that existing measurement exercises for fiscal capacity have not done very well previously. They show that tax capacity in Sub-Saharan Africa is high, and has improved for the low income countries. They find that the most institutional determinant of tax capacity is the equal distribution of resources, which they argue captures the perceptions of equity among citizens that supports the fiscal bargain between state and society.

Nitstotskya and D'Arcy (2023) look at the role of property rights in taxation. They argue that when property rights is assigned and upheld by the state, as opposed to other political authorities, this leads to an increased individual assent to taxation. They apply their argument to Sub-Saharan Africa, where the majority of the land is governed by traditional authorities. They find support for their argument that there is no taxation without state-assigned property rights.

vom Hau *et al.* (2023) advance our understanding of the relationship between different dimensions of state capacity: whether they arise together and whether they have the same determinants. Drawing on a case study of Latin American economies, they show that states' ability of gather salient information on the territory they administer (information capacity) may be complementary to the rise of fiscal states.

This set of articles draws on a variety of methodological approaches, ranging from case studies (at state and regional level), to comparative historical analysis and to macro-quantitative (country and cross-country level) perspectives. The overarching message from such a diverse set of studies is that historical conditions, political institutions and the presence of complementary institutions matter when it comes to developing tax systems and creating state-society relations conducive to compliance with taxation. This appears to be the case especially with reference to the sub-Saharan Africa context.

5. Remaining puzzles and future research directions

While the papers in the special issue make the case for the centrality of history, politics and institutions in our understanding of the emergence of fiscal states in developing countries, there are remaining puzzles that need to be addressed in future research. Further, the papers in the special issue point to future research directions for scholars working on taxation in developing countries.

First, do we see a fiscal state in Sub-Saharan Africa or not? While Jeppesen *et al.* (2023) in this issue suggest that the economic preconditions for the emergence of fiscal states in Sub-Saharan Africa do not seem to exist at present, Moore (2021) argues that an historical determinants of taxation capacity – powerful, centralised bureaucracies heavily focused on achieving revenue targets – is largely present in Sub-Saharan Africa and resemble more closely tax administrations in OECD countries. The failure of governments in Africa to collect more tax can be linked their inability to effectively tax multinational companies and the extractives sector, and to tax rich Africans with a light touch. Clearly,

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more research needs to be undertaken on the problem of low tax to GDP ratios in Sub-Saharan Africa is because of a lack of sufficient fiscal capacity, or the under-utilisation of that capacity, where it exists.

Second, is taxation the only route to build fiscal states in Sub-Saharan Africa? Ang (2022) argues that the experience of China in the twenty-first century suggests that the conventional narrative on the importance of taxation to build fiscal capacity may be flawed. In the case of China, the government heavily relied on taxless financing to finance an infrastructure boom that spurred rapid economic growth. While debt financing of public goods pose certain risks (as evident in the increasing debt distress of developing countries), it may well be an option that governments in Sub-Saharan African countries may need to consider, when there may be limited resources that can be collected from their citizens through taxation.

Third, while Savoia *et al.* (2022) in this issue point to the long-run relationship between political institutions and taxation capacity, the direction of causality between political institutions and the emergence of the fiscal state remains unclear. Do the emergence of the fiscal state lead to more accountable political institutions or is it the other way around? Similarly, does economic development naturally cause the rise in fiscal capacity, or is the increase in taxation capacity and therefore, the ability of the state to finance critical public goods, an essential pre-condition for economic development? More research is needed to understand the direction of causality between political institutions and economic development on one hand and fiscal capacity on the other.

Finally, if history plays a critical role in shaping the type of fiscal state that may emerge, as several papers in this issue argue, what is the role of contemporaneous factors and policy? Are there critical junctures in the nation's history that lay the foundation for a fiscal state, and if so, what are they? If political institutions that constrain the power of the executive are crucial in the building of a fiscal state, how do they emerge? Are they more likely to originate in democracies relative to autocracies, and if so, what does this mean for many developing countries where there has been democratic back-sliding in recent years (see Mechkova *et al.*, 2017)?

For economists, historians and political scientists that are interested in understanding how taxation capacity in developing countries may increase, the papers in the special issue point to an exciting area of research, that is genuinely multi-disciplinary and methodologically plural, combining macro time-series methods, micro econometrics, archival research and in-depth case-studies on a topic that is fundamental in achieving the SDGs.

6. Lessons for development policy

What lessons can we draw for developing economies from this set of articles on fiscal states? Below, we outline the following implications.

First, Rome wasn't built in a day. Based on the experience of the West, the construction of fiscal states takes time and is inextricably linked to historical processes of state-building. Therefore, donors have to stay the course in facilitating fiscal capacity in Africa and should not expect short-term quick fixes. Developing fiscal states is a long-term process. Countries do not go straight from domain state to tax state, there are intermediate steps to becoming a modern fiscal state. Developing broad-based taxation is clearly a sign of fiscal modernisation of the highest form. At the same time, states in the developing world finance their activities through non-tax revenues (e.g., aid and development assistance, natural resource revenues, fees), as well as by borrowing from private and international financial institutions. Hence, policy makers should be mindful that financing state activities requires developing modern taxation while managing other sources of public finance.

Second, history matters. If and how fast a developing economy can successfully develop taxation and tax systems depends on specific historical conditions, which cast a long shadow and they shape today's possibilities of developing taxation. For example, pre-colonial institutions can still affect tax compliance in sub-Saharan Africa, as the case study on Uganda shows. Understanding such mechanism may explain tax reforms work better in some context but not others.

Third, politics matters. Developing fiscal capacity is not a technocratic exercise. We often read of technical solutions to a more efficient tax administration, in various ways, including for example new IT solutions to tax collection and administration. This is important, but it is even more important to understand the politics behind the fiscal contract between state and citizens. The process of long-run development of fiscal states hinges on developing specific types of political institutions. Developing effective and accountable political institutions are key to the emergence of fiscal states. Donors need to support the augmentation of state capacity in Africa, as well as foster processes of horizontal and vertical accountability. This implies that there are significant interlinkages between SDGs 17 and 16: the goal of promoting inclusive and accountable institutions may work in synergy with that of generating internal resources to finance development goals.

Fourth, do not look at fiscal capacity in isolation: invest in other dimensions of state capacity that support tax system development, such as information capacity and property rights protection. Developing fiscal capacity hinges on simultaneous institutional reforms in other areas. Developing legal institutions protecting property rights may facilitate the emergence of tax systems in sub-Saharan Africa by expanding the taxable base. Similarly, the emergence of states' ability to collect information over their territory provides a base to improve tax revenues collection in Argentina and Chile. Complementarities are important.

Finally, Elites matter. Rwanda's state effectiveness, based on the dense network of social relations, provided public goods necessary for economic growth or broader economic development, allowing political elites to think long-term and engage in a project of systematic state building.

Acknowledgements. Antonio Savoia acknowledges generous financial support from UNU-WIDER's Fiscal States project, part of the Domestic Revenue Mobilization programme. We thank Abrams Tagem for his able research support. We are grateful to Professor Geoffrey Hodgson for his comments and for the enthusiasm and constant encouragement that he has shown for this Special Issue.

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Cite this article: Savoia A, Sen K (2023). The origins of fiscal states in developing economies: history, politics and institutions. *Journal of Institutional Economics* **19**, 303–313. https://doi.org/10.1017/S1744137423000024