Pillars of Prosperity

The Political Economics of Development Clusters

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Outline

1. Motivation
2. Origins of State Capacity
3. Political Violence
4. Putting Pieces Together
5. Policy Implications
6. Conclusion

Background

"Little else is required to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and a tolerable administration of justice; all the rest being brought about by the natural course of things."
(Adam Smith, 1755)

- In this quote Smith is focusing on the role of government in economic development.
  - And increasing state effectiveness is central to economic development

State effectiveness

- State effectiveness has (at least) four important dimensions:
  - an extractive dimension: the power to tax
  - a productive dimension: the power to support contracts and to provide vital infrastructure
  - establishing peace and order
  - spending on collectively valuable goods and services
- Most economic analyses take the ability of the state to perform these functions as given rather than as something to be explained.

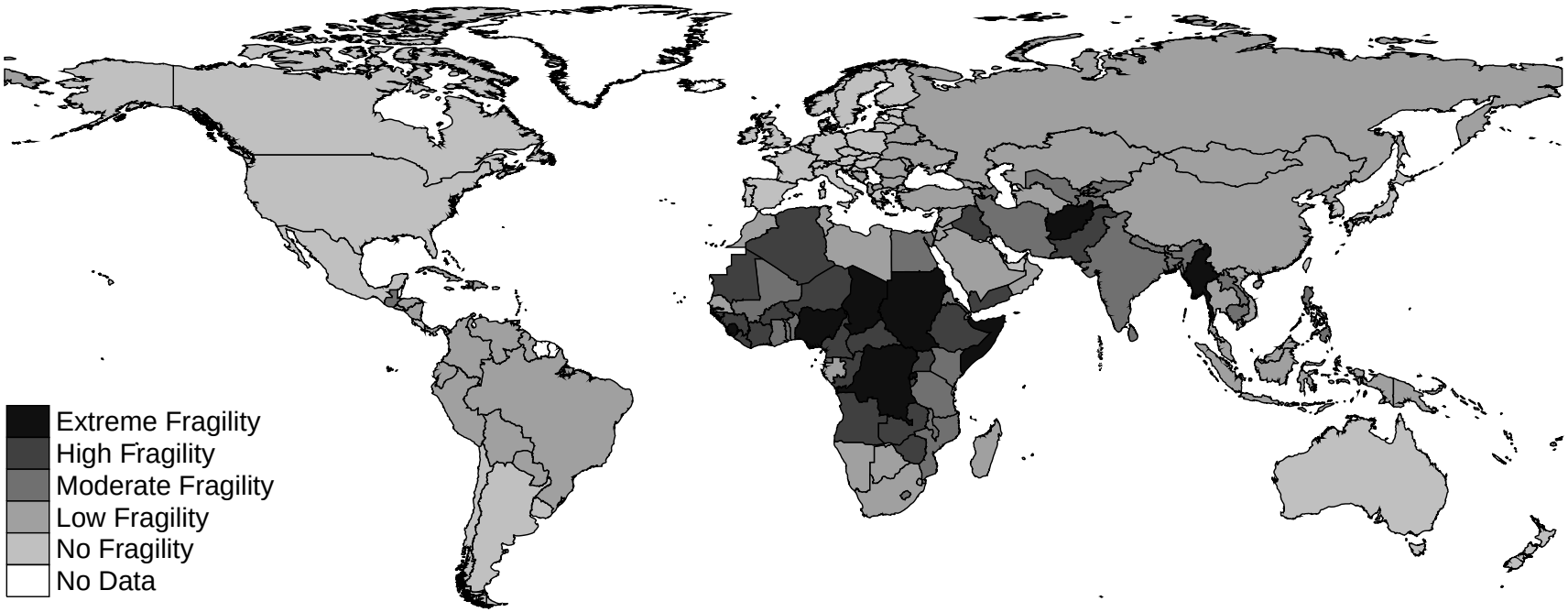
Huge Income Disparities

- Massive gap between rich and poor countries
  - ratio of income per capita on the order of 200
- Why are some countries rich and others poor?
  - classical question in economics, and in other social sciences
  - also of paramount importance for donors in various forms of development assistance
- But development not only about income
  - very clear in policy discussion about weak (fragile) states

Weak or fragile states

- Central concept in development policy community
- Weak states:
  - fail to provide public services and raise taxes
  - fail provide infrastructure to support contracts and markets
  - are prone to political violence (repression and civil conflict)
- Quite frequent phenomenon
  - perhaps 20-30 states failed or seriously weak
    equally many weak, others in risk zone
  - concentrated in sub-Saharan Africa, south/central Asia

Polity IV State Fragility Index (2008)



Development Clusters

- *State institutions* link with *income*, but also with *violence*
  - weak states in countries with massive poverty and societies plagued by internal conflicts
  - developed countries: high income, institutions work, policies in good order, conflicts resolved peacefully, ...
  - strong clustering of state capacity in different dimensions few strong economies with weak states
- Multidimensional problem — *the* development problem?
  - clustering of low income, violence, and a number of dysfunctional institutions

Examples of Clustering - Figures 1.3 - 1.5

- Two forms of *state capacity*
  - extractive capacity: e.g., infrastructure to raise taxes from broad bases, like income or value added
  - productive capacity: e.g., infrastructure to enforce contracts or protect property rights
- Illustrate with two specific measures
  - alternative measures produce similar results
  - *fiscal* capacity: total taxes as share of GDP in 1999 (IMF data)
  - *legal* capacity: index of protection of property rights in 1997 (ICRG data)
  - strongly positively correlated with each other, income per capita (Fig 1.3), prevalence of civil war (Fig 1.4), and fragile state indexes (Fig 1.5)

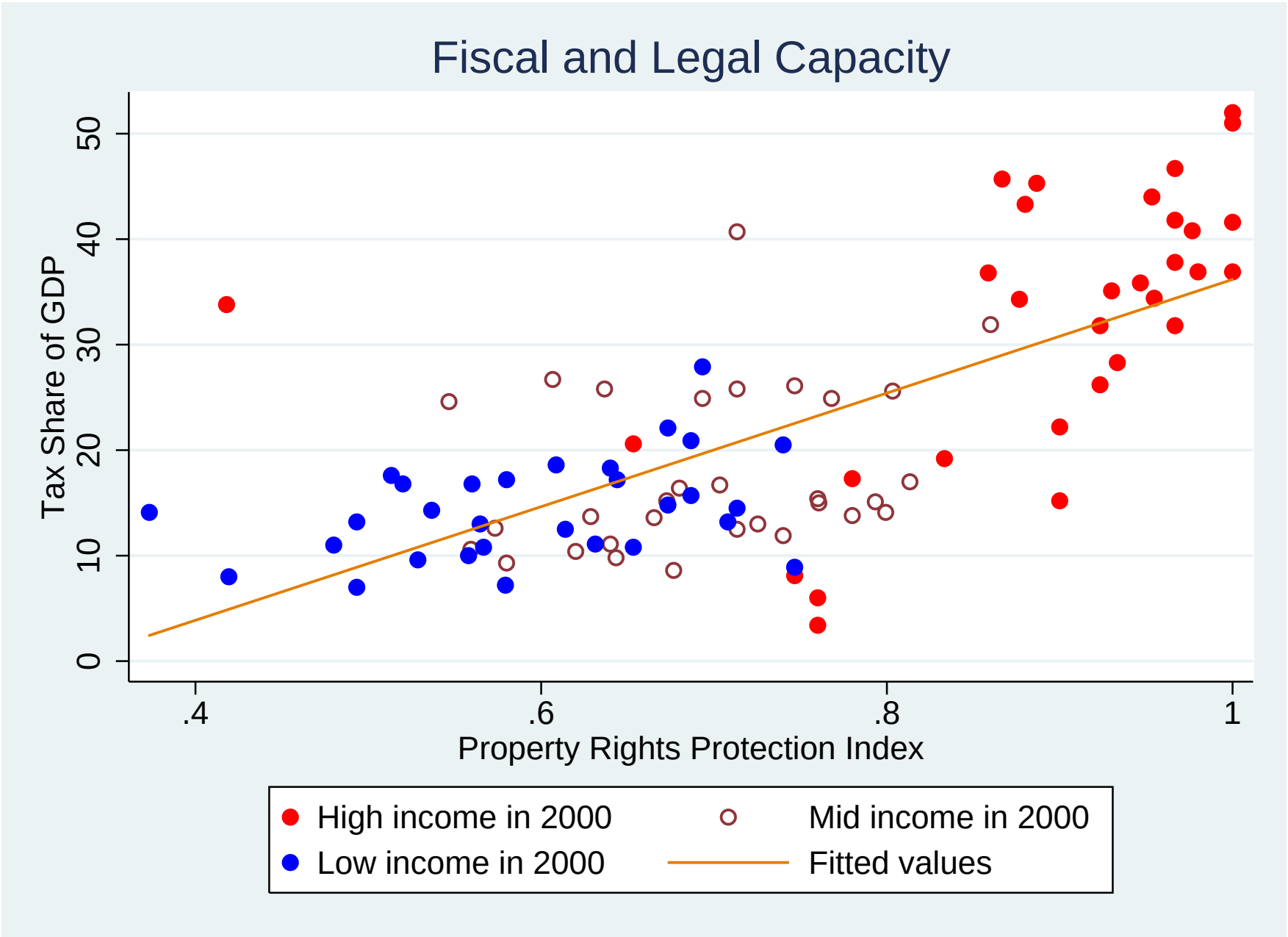


Figure 1.3 Legal and fiscal capacity conditional on income

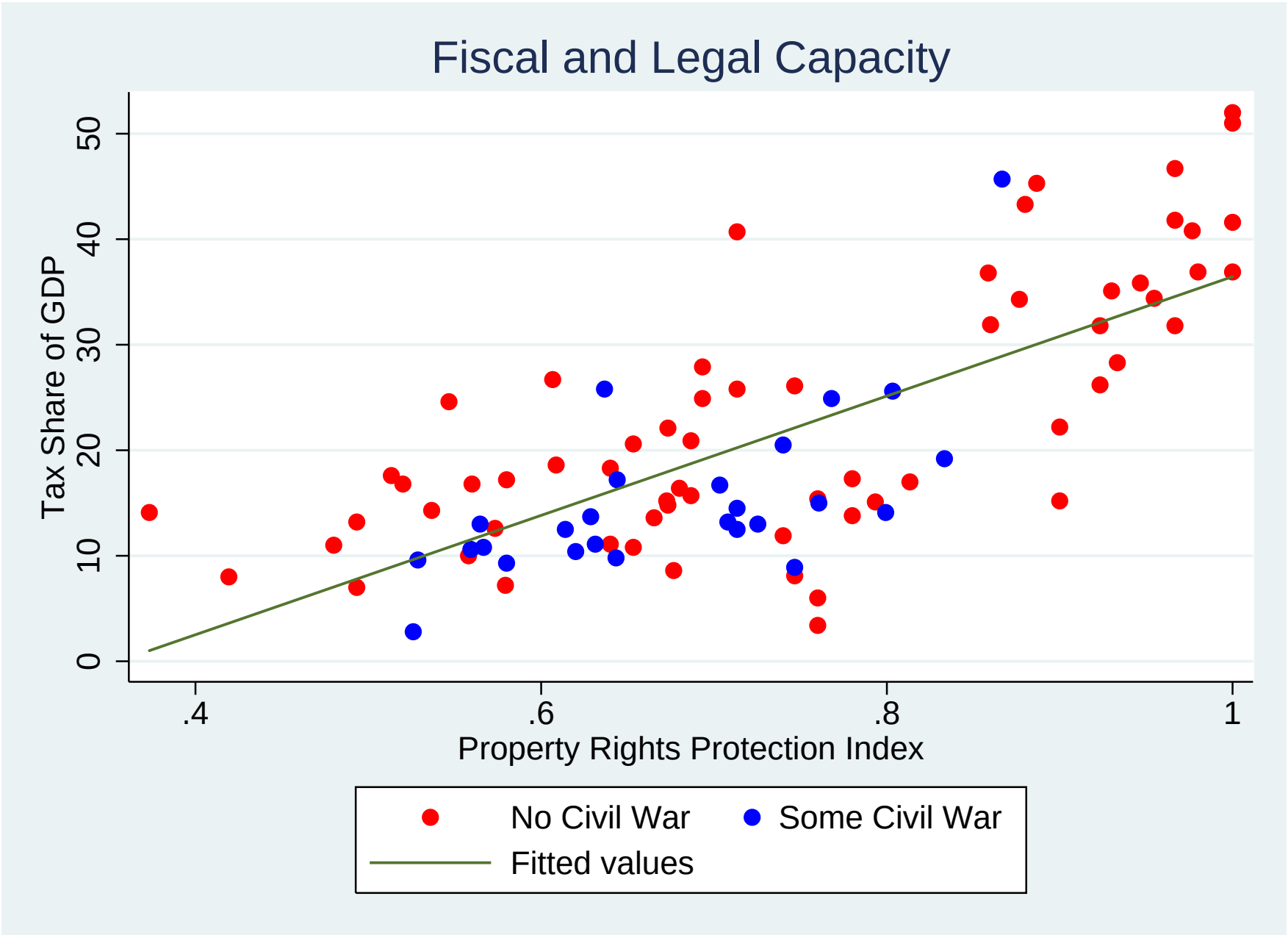


Figure 1.4 Legal and fiscal capacity conditional on civil war

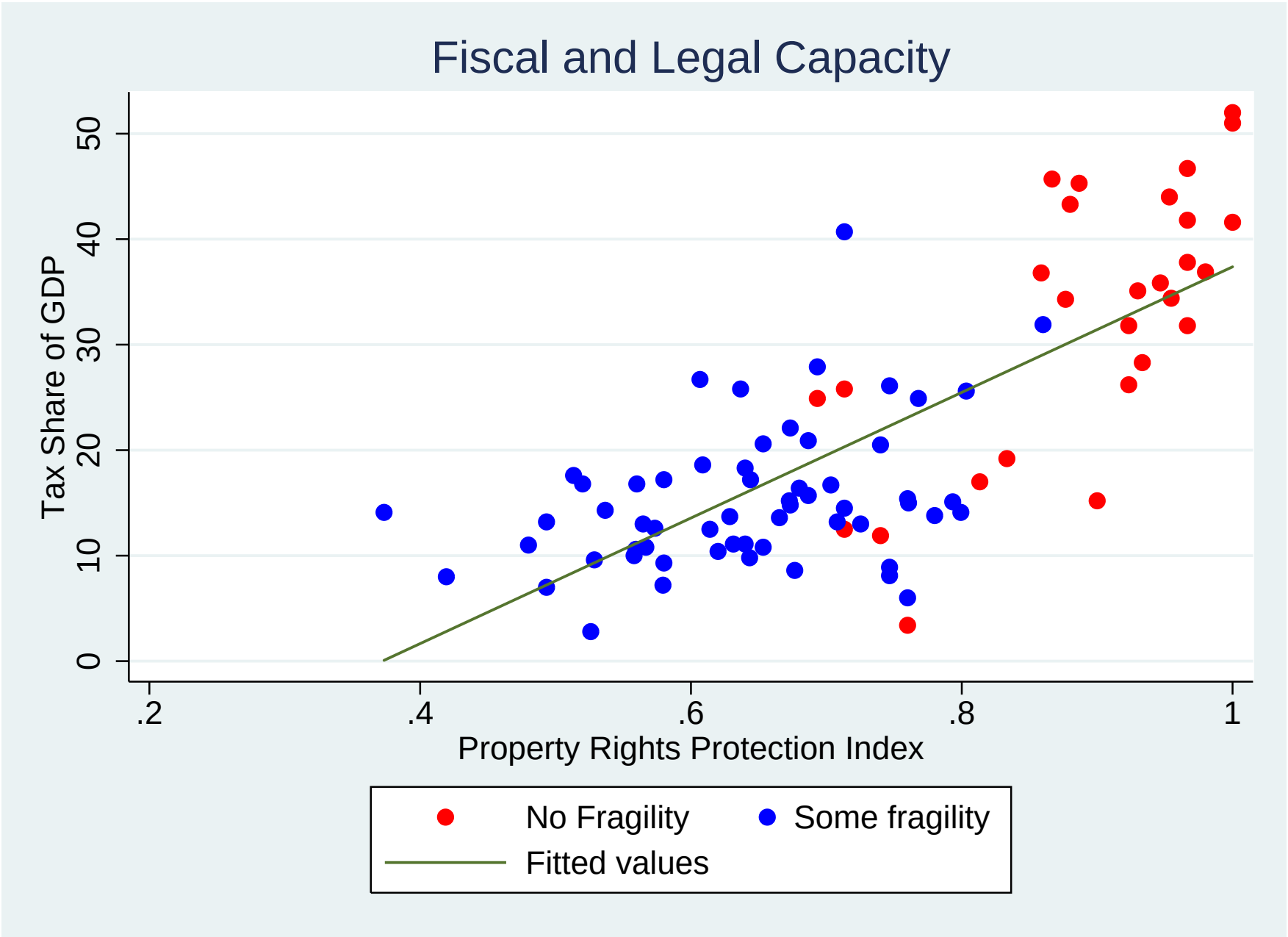


Figure 1.5 Legal and fiscal capacity conditional on fragility

How understand such patterns in the data?

- Basically need to pose — and answer — three general questions

Question 1

What forces shape the building of different state capacities and why do these capacities vary together?

Question 2

What factors drive political violence in different forms?

Question 3

What explains the clustering of state institutions, violence, and income?

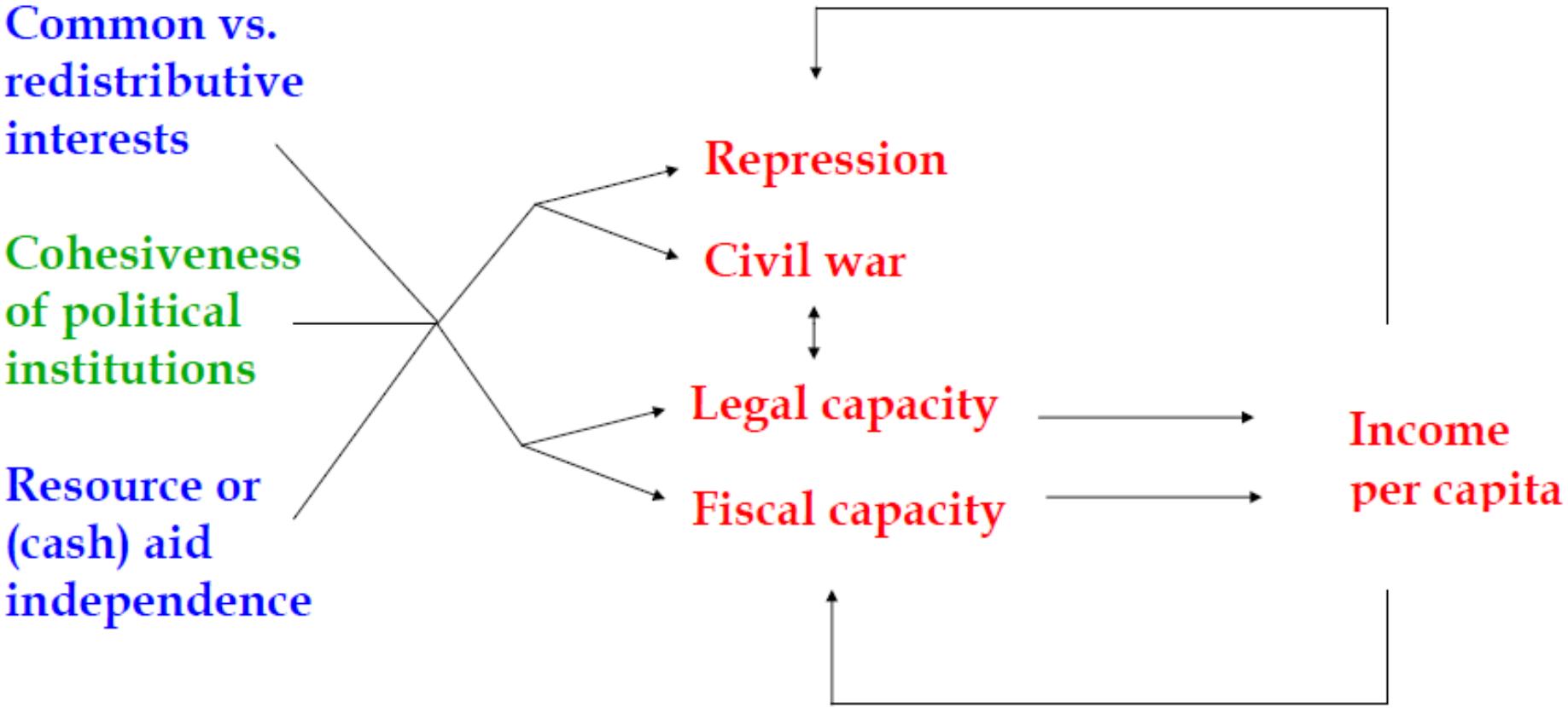
Scope of the Book

- Some over-arching objectives
  - analyze the politics and economics of state building and political violence in the process of development
  - try to understand the observed development clusters of institutions, income, and violence
  - aim at constructing new theory and uncovering new evidence
  - hope to bring state capacity into mainstream of economics
- Pool together four broad research agendas
  - determinants of long-run development
  - determinants of different forms of political violence
  - importance of history in explaining today's patterns of development
  - interaction of economics and politics in shaping of societies

Overview of the approach

- Governments in power represent the interests of specific group
- Governments raise taxes, spend the revenues and enforce contracts/property rights
  - A key role of political institutions is to constrain executive authority while a group is in office
- Political turnover is determined by political institutions but may also be influenced by investments in violence
- A group which is out of power can also make investments in violence in order to win power in future.
- Public spending divided between:
  - public goods
  - transfers
  - investments in state capacity
  - violence (army/police)

Overview of the Approach



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Histroical perspective

- Historians and historical sociologists who try to explain how the state acquired the power to tax.

  "The fiscal history of a people is above all an essential part of its general history. An enormous influence on the fate of nations emanates from the economic bleeding which the needs of the state necessitates, and from the use to which the results are put." (Joseph Schumpeter, The Crisis of the Tax State, 1918)

- Historical sociologist Charles Tilly has popularized the thesis that wars are the source of Western European exceptionalism that lead to the development of the state.

State Capacity

- Wars and recessions have historically played an important role in creating common interests in policy making.
- The term "state capacity" was originally coined to describe state effectiveness in raising taxes.
- However, I will use the term more broadly today to refer to multiple dimensions of state effectiveness.

The Nature of Fiscal Capacity

- States in low income countries rely disproportionately more on trade and indirect taxation (particularly excises).
  - They also make a greater use of the inflation tax.
  - For example countries below median income raised approximately 46% of revenue from trade taxes in 1995 compared to 19% for above median income countries.
- In advanced economies, there is greater use income taxes and VAT's
  - requires more investment in enforcement.
  - For example countries below median income raised approximately 31% of revenue from income taxes in 1995 compared to 51% for above median income countries.
  - In 1995 29% of below median income countries had a VAT and 71% of above median income countries.

Fiscal capacity tends to grow as states develop

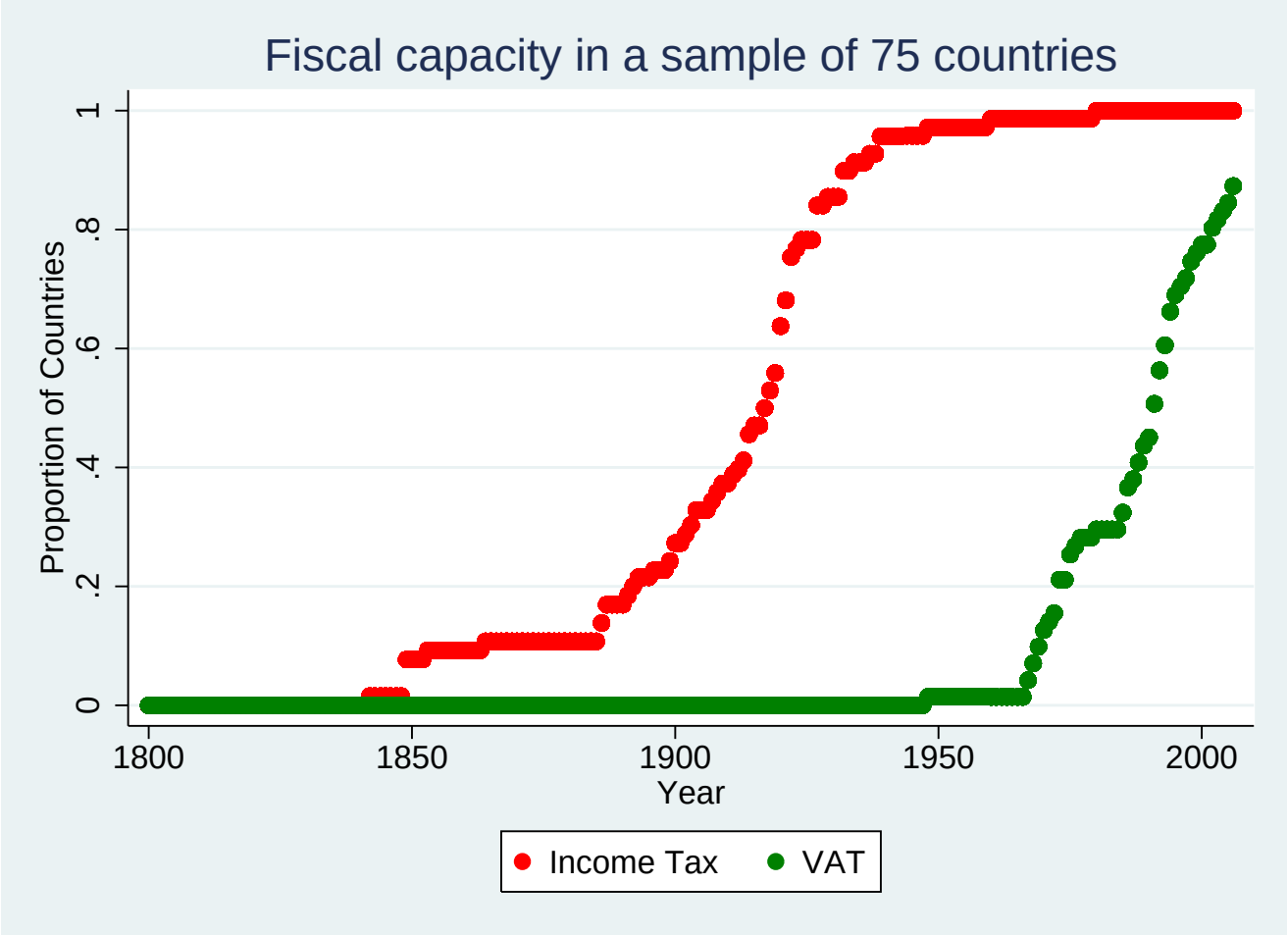


Figure 2.1 The historical evolution of fiscal capacity

Market Development and Legal Capacity

- Market development is also a feature of economic development
  - less intermediation in families and networks
  - smaller role for the informal sector
    - ★ arms length trade increases relative to personalized trade
- This is supported by development of a formal legal system where contracts are enforced by anonymous enforcement.
  - Capital markets are a particular barometer of this.
- State capacity is important in supporting markets.

Evidence

- Increasing the depth and importance of markets is a clear correlate of economic development
- Beginning with Schumpeter, many have argued that financial market development is particularly important in the development process.
- The correlation with GDP per capita is particularly strong
- But again causality is difficult to establish.

Origins of Market Development

- Legal origins view
  - common law associated with financial development and free contracting more generally
    - ★ common law is efficient?
- Forms of market regulation are a key factor.
  - particularly enforcment of property rights

Current Approaches

- Although the factors quoted are similar, there has been a tendency to focus on either state or market development as separate narratives.
- There has mostly been a focus on policies rather than the capacity of the state to deliver those policies.
- However, recently economists have taken a more historical perspective and looked for institutional features that matter
  - this has lead to a resurgence of interest in political economy.

A Unified Approach

- The aim is to understand how governments have been able to appropriate tax resources and to support markets.
- Inevitably in a big picture approach like this, we will only be able to make progress at a stylized and superficial level.
- The approach will give a role for economics, historical factors and political institutions in shaping the dynamics of states.

Ingredients I

- Distinguish institutions and policy
  - incumbent government's choice of taxation and regulation limited by fiscal and legal capacity, and political institutions
- State capacity as a capital investment
  - courts
  - tax collection authorities
- An interesting issue is how far such investments are reversible

Ingredients II

- Sectional versus common interests
  - how consensual are political institutions?
- Political institutions should serve to mediate across these interests.
- The power to tax surfaces historically at key points in the development of Parliamentary democracy.
- The role of war (common interests)
  - war when the existence of a polity is threatened is a key example of common interest
- States have often introduced new tax structures in wars.
- Role of recessions
  - creation of the welfare state/pensions/unemployment insurance.
- War and welfare states were also shaped by (and fostered) political development.

Ingredients III

- Markets and taxation are complements
  - market transactions are easier to tax on the whole
  - so governments who care about taxation will tend to want to invest in markets
- Diamond/Mirrlees efficiency theorem
  - governments with a rich array of tax instruments will tend to encourage production efficiency

Implications

- Investments in fiscal capacity grow during the development process
  - market intermediation and government both grow.
- More stable politics is conducive to greater investment in state capacity
- More consensual institutions are conducive to development of state capacity
- More demand for common interest public goods increases investment in state capacity.

Three kind of states

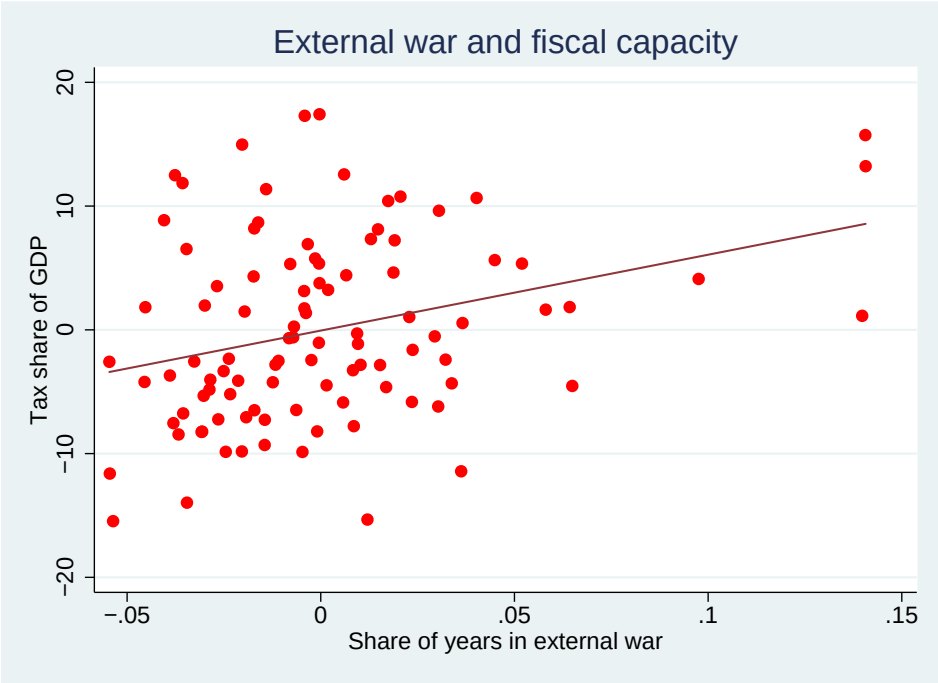
- Common-interest states
  - government revenue mainly used for public goods
  - any incumbent group invests in fiscal capacity
- Redistributive states
  - government revenue mainly used to redistribute, with incumbent more or less constrained by political institutions
  - incumbents invest in fiscal capacity if there is sufficient political stability
- Weak states
  - government revenue used for redistribution, but non-cohesive political institutions and high levels of political instability
  - no incumbent invests in fiscal capacity of the state

Complementarities

- Investment in one type of state capacity reinforces the other
  - if future fiscal capacity higher, additional fiscal benefits of legal capacity, which expands market incomes
  - if future legal capacity higher, market incomes and tax bases higher, which raises motive to invest in fiscal capacity
- Implications of complementarity
  - natural way to think about forces behind observed clustering
  - determinants of legal and fiscal capacity should be *common*
- Which major determinants does this approach suggest?

A look at the data – External conflict

- Partial correlations: common-interest spending and state capacity?
- Gauge past demand for public goods by prevalence of war
  - time in external war 1816/independence – now (COW data)
- Illustrate results for tax share and property rights index
  - hold constant other determinants, such as cohesive political institutions, plus legal origins, and continental location
  - data consistent with prediction – Figure 1.8



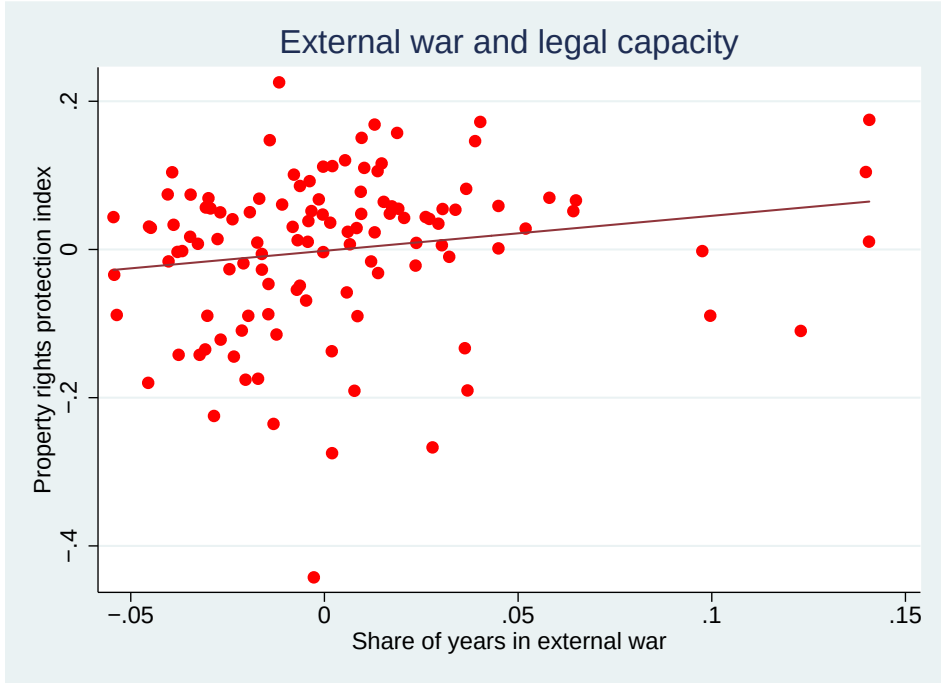
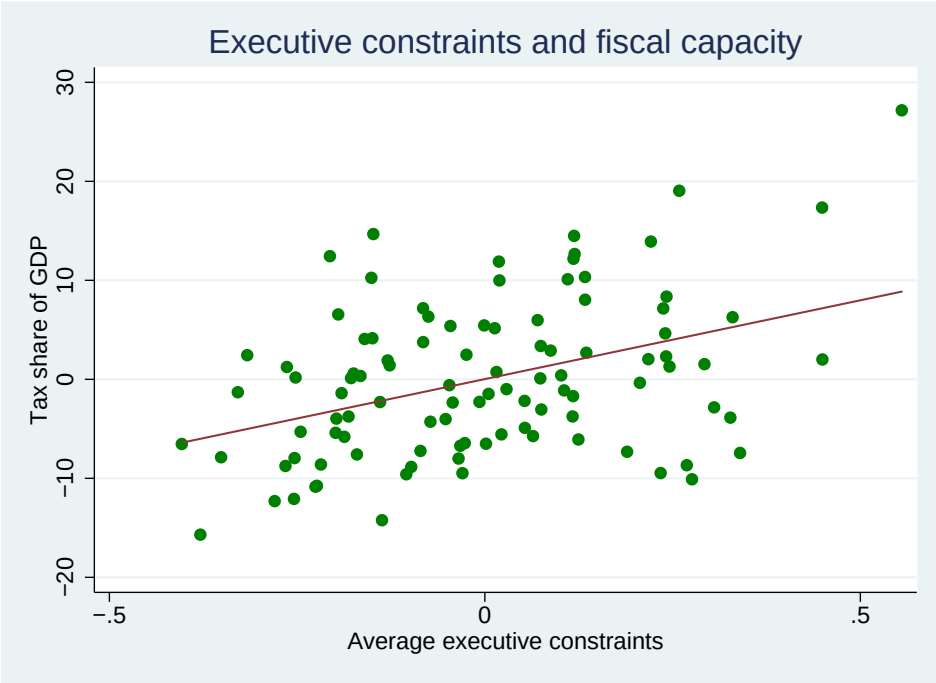


Figure 1.8 State capacity and external war

A look at the data – Political institutions

- Partial correlations: cohesive institutions and state capacity?
- Measure cohesive political institutions by constraints on executive
  - time with high(est) score 1800/independence – 2000 (Polity IV data) similar results for prevalence of parliamentary democracy
  - control for same variables as earlier
  - again, data conform with prediction – Figure 1.9



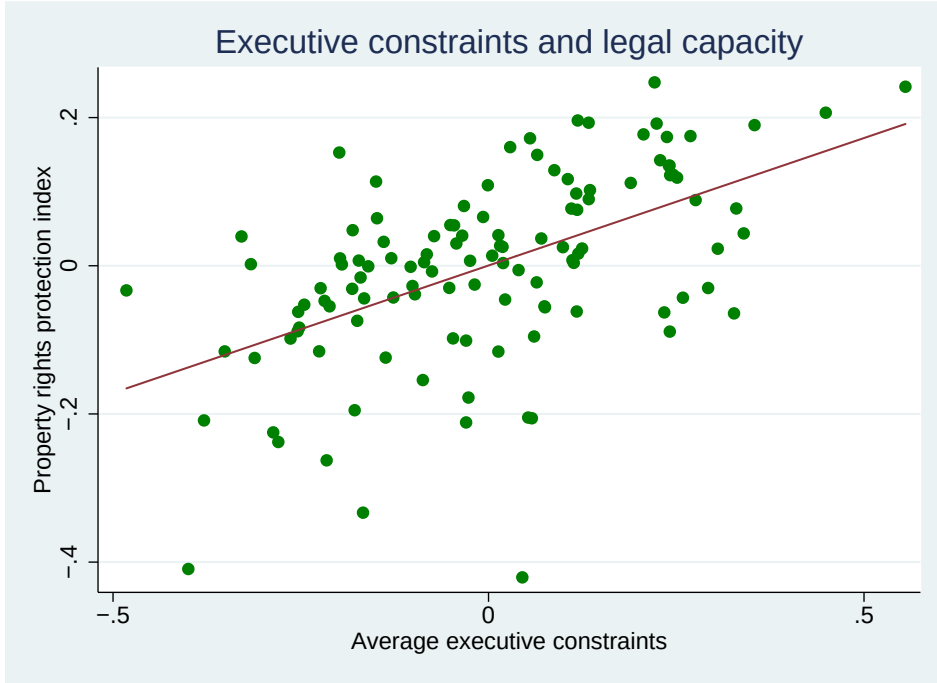
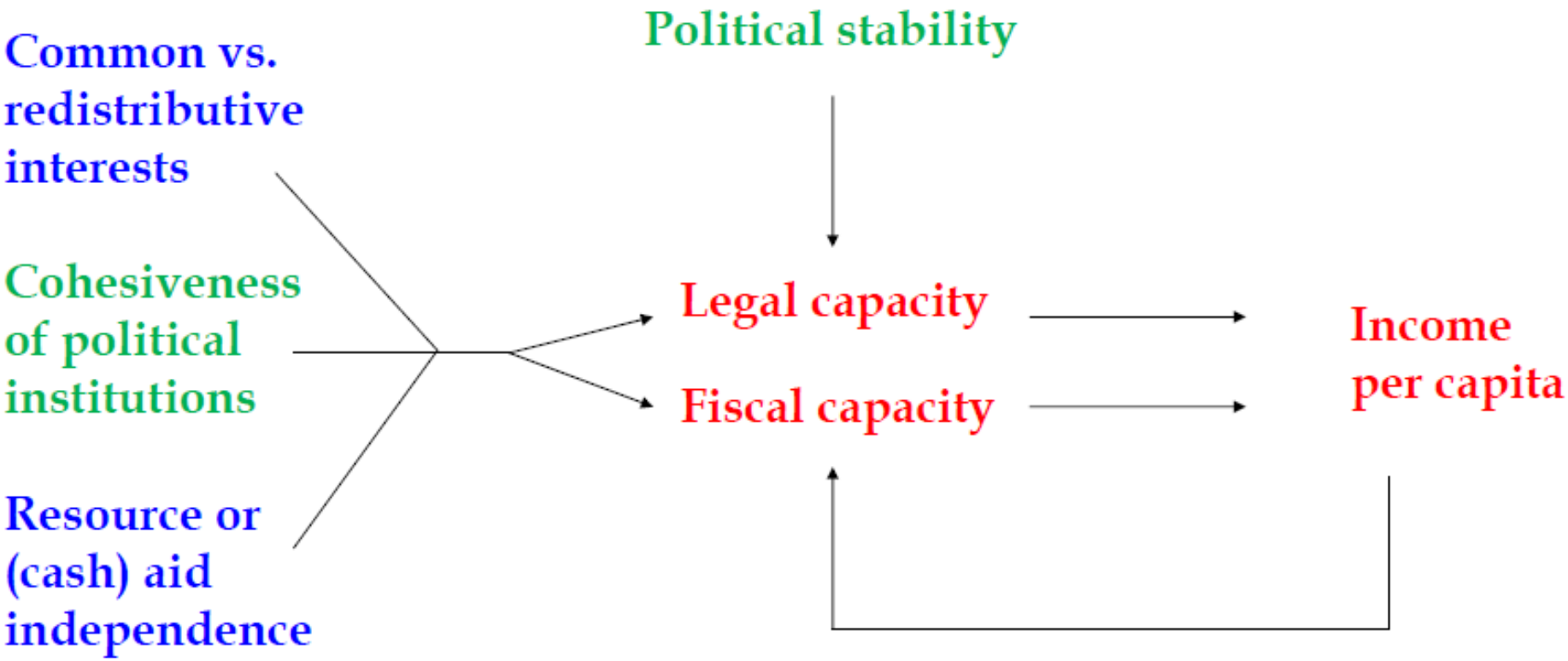


Figure 1.9 State capacity and executive constraints

Summary of the argument so far



Back to clustering of income and state capacity

- Low income can cause weak states
  - low prospective market incomes and tax bases reduce motives to invest in legal and fiscal capacity
- Weak states can cause low income
  - low legal capacity makes incumbents unable to support markets
  - low fiscal capacity leads to inefficient forms of redistribution
- Virtuous or vicious circles
  - can produce clusters of strong state capacities in strong economies or weak state capacities in weak economies

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Political Violence

- We have seen that political stability is a key determinant of investments in state capacity.
- The use of violence is an important determinant of stability
  - repression can lower instability
  - civil war may increase it.
- We will also show that the forces that diminish the use of violence are strongly related to those that engender investments in state capacity.

The Logic of Political Violence

- Suppose thet government and opposition can consider the strategic use of violence to acquire or maintain political power.
- Violence becomes a purposive investment.
- The incentive to use violence depends on the value of political control.
- This simple rational choice approach gives a central role to the benefit cost ratio:

$$\frac{E[\text{Benefit of political control}]}{\text{Cost of violence}}$$

Benefit of Control

- Depends on common interest use of the state and cohesiveness of political institutions
  - worst case: low cohesiveness and lots of natural resources
- Thus we expect lots of political violence in places where cohesiveness is low.
- High fiscal capacity without cohesive institutions means that violence is attractive.
  - the fragility of redistributive states

Cost of Violence

- Depends on ability to organize violence.
- High wages make violence more costly.
  - so high legal capacity should help to diminish political violence all else equal.

Three Cases

1. Peace – no group invests in violence:
   - $\frac{E[\text{Benefit}]}{\text{Cost}}$ is too low to warrant investment in violence
2. Repression – incumbent, but not opposition, takes to violence:
   - $\frac{E[\text{Benefit}]}{\text{Cost}}$ is higher, but incumbent's violence threshold lower than opposition's (due to cost or other advantage)
3. Civil war – both groups take to violence:
   - $\frac{E[\text{Benefit}]}{\text{Cost}}$ is high enough that both parties choose to fight

Evidence

- Civil War: Use the ACD civil-war incidence measure, starting in 1950.
  - Value of 1 if a given country in a given year is involved in a violent conflict which claims a (cumulated) death toll of more than 1000 people.
  - Over 10% of all country-years in the 1950-2005 period are classified as civil war in our sample.
- Repression: from Banks (2005) which counts up purges: systematic murders and eliminations of political opponents by incumbent regimes.
  - Create an indicator which is equal to one in any year when purges exceed zero.
  - In the 1950-2005 period, on average 7% of country-years are classified as being in a state of repression, but not in civil war.

Income per capita

- Evidence of ordering?
  - Peaceful countries have an average GDP per capita of $4,365
  - Repressing countries $2,503 per capita
  - Civil war are the poorest with average incomes of $1,789.

Cohesive Institutions

- Constraints on the executive from Polity IV
- Evidence of ordering?
  - 19.6% of the country-years with peace occur in countries with good institutions
  - 8.9% for repression
  - 6.3% for civil wars.

Determinants of political violence?

- Which roots of repression and civil war?
  - largely *common* factors – confirmed in empirical work
- How related to determinants of legal and fiscal capacity?
  - factors that diminish motives to invest in state raise motives to invest in violence

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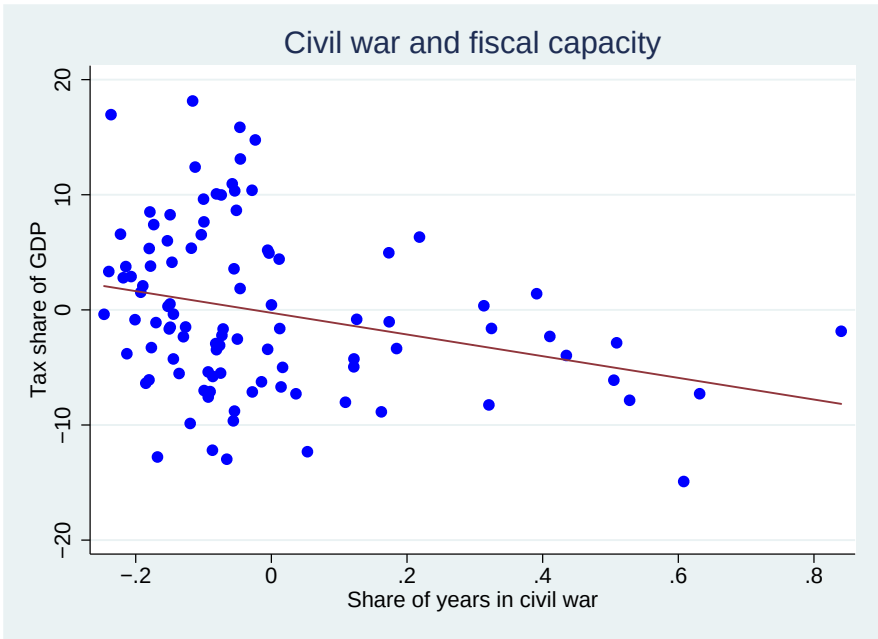
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Revisit investments in state capacity

- Should see negative correlation between state capacities and political violence
  - these outcomes have similar roots
  - magnification effect: higher risk of internal conflict raises political instability for incumbent, further diminish motives to build strong institutions, in redistributive or weak states
  - patterns in data consistent with these ideas – see Figure 1.13



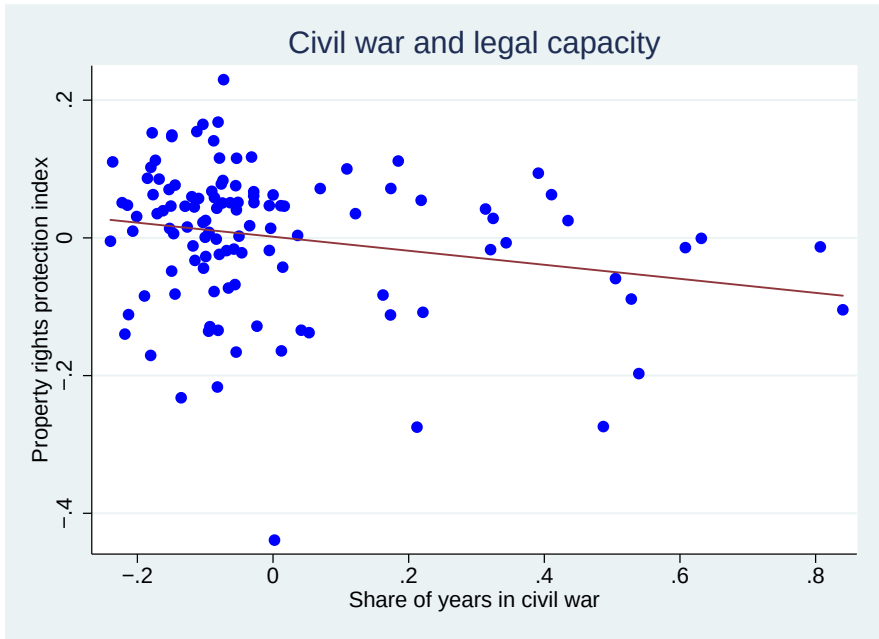


Figure 1.13 State capacity and civil war

The State Space

- Summarize insights from our core model, so far:

	Weak	**Redistributive**	**Common interest**
Peace	weak common interests non-cohesive institutions high military effectiveness poorly-organized opposition	strong common interests non-cohesive institutions low natural turnover	strong common interests cohesive institutions
Repression	weak common interests non-cohesive institutions low military effectiveness poorly-organized opposition	weak common interests non-cohesive institutions high military effectiveness poorly-organized opposition	n/a
Civil war	weak common interests non-cohesive institutions low military effectiveness well-organized opposition	weak common interests non-cohesive institutions high military effectiveness well-organized opposition	n/a

Summary of main ideas

- Recall three basic questions – hint at answers
  - (i) what drives building of different state capacities?
    - ★ have suggested some "proximate" and "ultimate" determinants of investments in the state
  - (ii) when and why do these capacities move together?
    - ★ when state-capacity investments are complements
  - (iii) what drives correlation between institutions, income, violence?
    - ★ state capacity and violence share some political and economic determinants, including income
    - ★ two-way feedbacks between income and state capacity, and between income and political violence

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Application 1 – Why weak states in sub-Saharan Africa?

- Several factors contribute directly to weak states
  - dependence on resource rents and aid, low threat of external conflict, and non-cohesive political institutions
- Same factors raise risk of internal conflict
  - societies become plagued by political violence; instability further weakens motives to build state capacities
  - invest in violence rather than in strong state
- Weak states hamper development
  - cannot support markets due to low legal (productive) capacity
  - pursue inefficient policies due to low fiscal (extractive) capacity
- Feedbacks from low income
  - foster conflict and weak incentives to build the state

Application 2 – Lessons for foreign intervention?

- Effects depend crucially on type of intervention, and type of state
  - six examples
- (i) Development support – cash aid to government
  - may help raise state building, if common-interest state
  - no effect on state building and higher risk of repression or civil war, if state is redistributive or weak
- (ii) Infrastructure or project assistance
  - can work like legal capacity: raise private incomes
  - strengthen motive to build the state, and lessen risk of violence

Lessons for foreign intervention (continued)?

- (iii) Military assistance to government
  - further advantage to incumbent in financing army or higher return to incumbent's investment in violence
  - raises risk of violence and expands range of outcomes with government repression, except in common-interest states

- (iv) Post-conflict settlement
  - like cohesive political institutions (minority protection): cuts gain to winner of conflict, in redistributive or weak state
  - may cut conflict risk, and (indirectly) strengthen motives for state building, but only if credible (expected by everybody) *ex ante*

Lessons for foreign intervention (continued)?

- (v) Direct assistance in capacity building
  - may be helpful in common-interest states that already do invest
  - but investments likely not sustainable in weak states, where it is the most needed
- (vi) Conditionality of assistance on free, multi-party elections
  - may raise political instability (from viewpoint of incumbent)
  - can raise the risk of repression and weaken state building, unless combined with reform to stronger executive constraints

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Institutional Change

- The discussion highlights the key role of institutional change towards cohesive institutions.
- So next phase of the research is to understand how some countries have managed to achieve this while others have not:
  - institutions
  - culture/norms

Strategic View of Institutional Change

- Security on power main determinant:
  - weak leaders will tend to increase cohesiveness
- Evidence that random leader deaths increase turnover and precipitate institutional reform

Concluding Comments

"Little else is required to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and a tolerable administration of justice; all the rest being brought about by the natural course of things" (Adam Smith, 1755).

- Three Pillars of Prosperity
  - Peace: giving up a violence as a means of acquiring/maintain power
  - Taxation: high fiscal capacity
  - Justice: high legal capacity –
- All three are a product of common interests and cohesive institutions.

Research ahead?

- Integrate other aspects of state capacity
  - e.g., capability to provide basic health care, or education
  - further insights into clustering of institutions
- Study motives for political reform
  - so far, political institutions taken as given
  - when is better (worse) accountability, representation introduced?
    quid pro quo for significant expansion of taxation?
    interaction with risk of political takeover by opposition?
  - complementarity fiscal capacity – political institutions?
- Just first steps
  - simple framework, but helps think about data in new ways