

The Political Economy of State Capacity

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Motivation

- The power to tax is the most important coercive function of the state.
 - this is often referred to as state capacity
- Most economists and political scientists who study taxation analyze how the power to tax is used rather than how it is created.

Motivation (continued)

- This contrasts with historians and historical sociologists who try to explain how the state acquired that power.
 - Charles Tilly has popularized the thesis that wars are the source of Western European exceptionalism that lead to the development of the state.
- Wars and recessions have historically played an important role in creating common interests in policy making.

Motivation (continued)

- These ideas are of contemporary relevance.
 - One of the largest problems in the modern world, particularly in developing countries is that the state is too weak to
 - State capacity is important in many countries in the current economic crisis – particularly in countries that have bailed out their banks.

Today's talk

- I am going to discuss the forces that shape the creation of state capacity giving a progress report on a research project with Torsten Persson.
- We define state capacity more broadly than most of the literature
 - to include the ability of the state to enforce contracts and regulate.

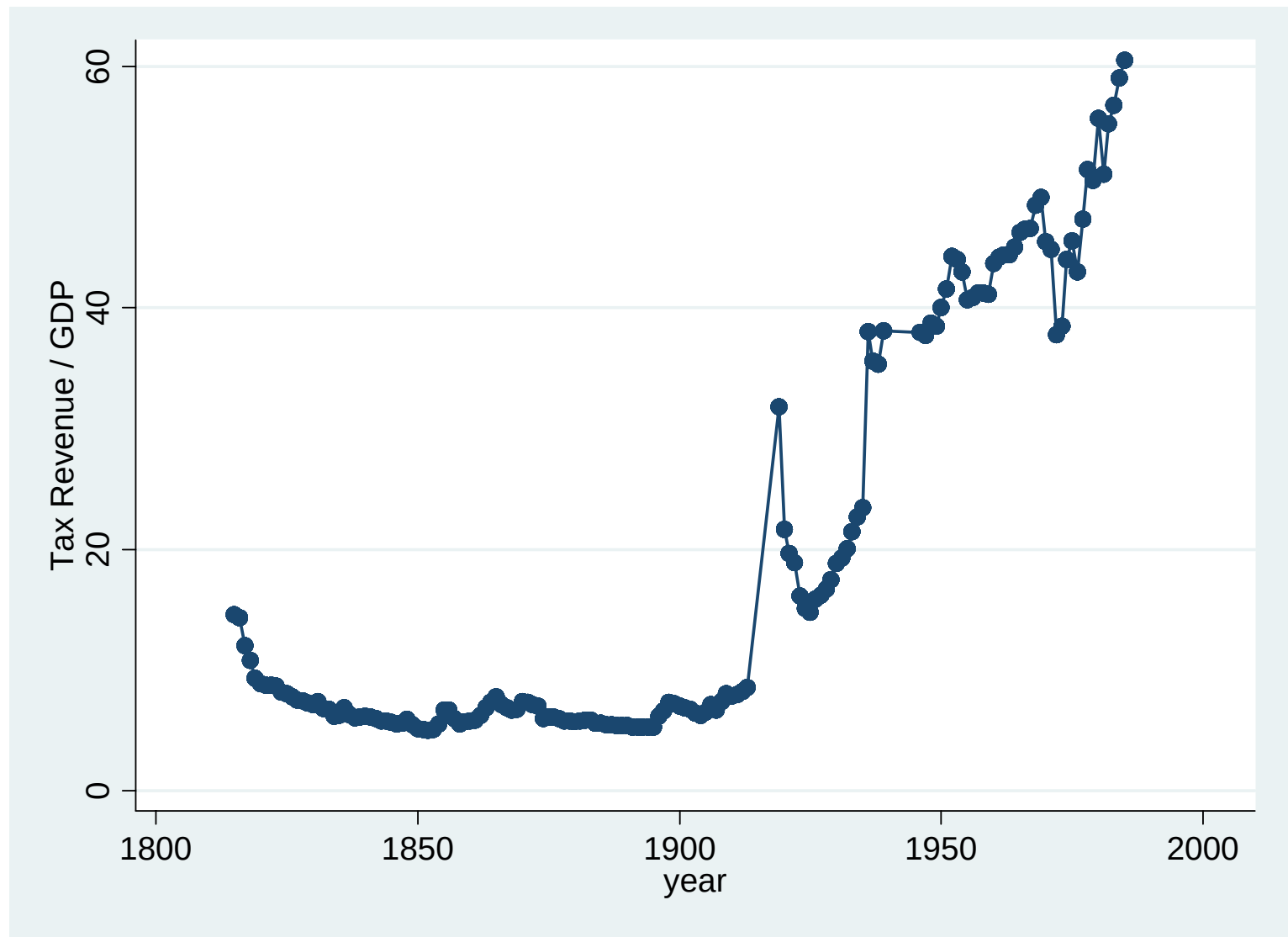
Today's talk (continued)

- I will sketch for you a simple framework for thinking about the dynamic evolution of state capacity and the forces that shape it.
 - our papers contain a modeling approach but I will discuss this only informally today
- This mainly draws on two papers:
 - The Origins of State Capacity: Property Rights Taxation and Politics, forthcoming in AER
 - State Capacity, Conflict and Development, paper behind Torsten Persson's Econometric Society Presidential Address.

Growth of Taxation

- The growth in the size of government was one of the most remarkable historical facts of the 20th century.
- It is remarkable how "sticky" this number has become in recent years and in the political debate.
- It has been institutionalized in the way that we collect taxes
- Also, there are entrenched public programs which require large amounts of revenue.

- For UK: Government expenditure as a % of gdp was (according to Angus Maddison):
 - 1913: 13.3
 - 1938: 28.8
 - 1950: 34.2
 - 1973: 41.5
 - 1999: 39.7
- This includes both transfers and spending on goods and services.



Evidence

- The literature has failed to find much of a relationship between size of government and growth.
- But this exercise is fraught with difficulty
 - it is hard to get any kind of convincing causal evidence.
- Calibration exercises can suggest larger effects.
- But micro-evidence does not tend to get big effects of taxation on savings or labour supply margin.

- Bottom line:
 - one could be skeptical in either direction on whether growth is affected by the size of government on the margin
 - and it surely depends on the form of the tax system (not just the level of overall taxation).

The Development of Tax Systems

- 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.

The Origins of Large Government

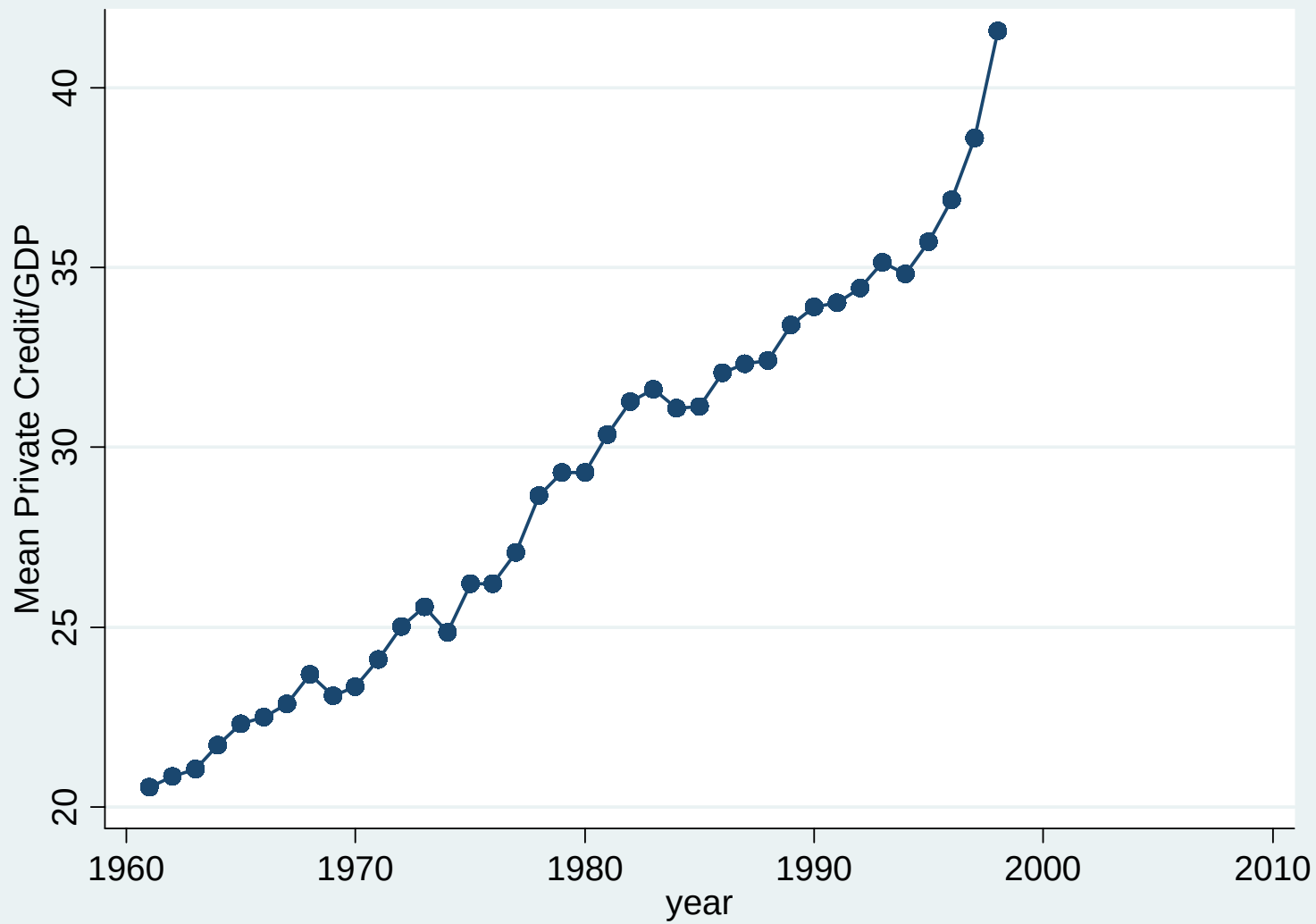
- Two different traditions:
 - benevolent government – growth of government reflects the fact that government does things well
 - private interest view – growth of government reflects abuse of power, rent-seeking etc.
- Some forms of political institution appear to be correlated with large government
 - proportional representation
 - parliamentary democracy.

Market Development

- This 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.
 - Financial 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.
- Political institutions are also important in shaping regulation decisions.

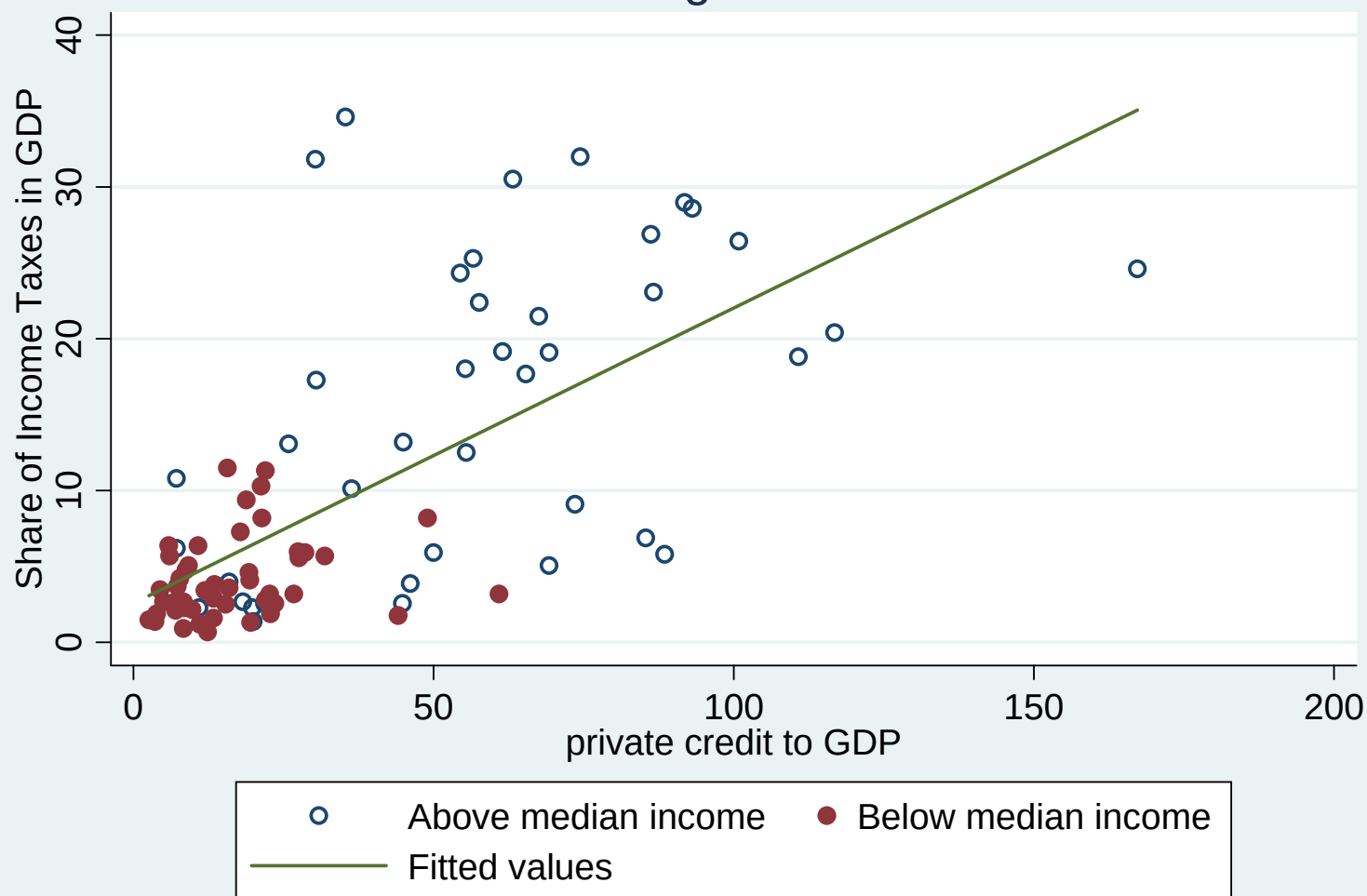
Summary

- 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 focus on policies rather than the capacity of the state to deliver 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.

State and Market Development Move Together

- The following picture plots the relationship between:
 - tax revenue to GDP
 - private credit to GDP
- State and market development are positively correlated.

Figure 1



Towards a Model of State Capacity

- 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

- 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 is the state used?
- 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
 - 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

The Approach in Besley/Persson

- Governments choose investments in improving the operation of states and markets – state capacity.
 - fiscal capacity
 - legal capacity

- The government's ability to implement policy is constrained by such investments
 - additional constraint to the government budget constraint.
- These investments are somewhat sticky
 - although it would be interesting to understand more about state decline as well as state building.
- These investments could have long-lived historical determinants (e.g. legal origins)

Two Main Components

- A market economy – with trade in a capital market
- A government that taxes and spends.
 - institutions affect the way that government behaves

The Financial Market

- Individuals have projects that require capital
- Those with high returns wish to borrow and those with low return projects want to lend.
- Trade requires security that loans will be repaid
- We model legal investments as making this possible.

Government

- Government can raise taxes
- Investments in fiscal capacity make it possible to raise more revenue.
- Government can spend on two things:
 - general interest public goods
 - redistribution
- The demand for general interest public good is stochastic in future.
 - there are high and low redistribution regimes.

Politics

- Government controlled by one group
- There is uncertainty about future political control.
- Also institutions may limit the ability of a group to redistribute.

Outcome

- A set of policy decisions and investments in state capacity which evolve over time.
- We are interested in the dynamic path and not just the steady state.

Complementarity of Fiscal and Legal Capacity

- more market intermediation raises the value of a given level of taxes (assuming sufficient common interests in the use of the tax proceeds)
- more taxation makes the development of markets more attractive (Diamond and Mirrlees).

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.

Some Suggestive Empirical Evidence

- Common determinants of fiscal and legal capacity
- Common interest public goods proxied by a history of warfare affect both financial development and fiscal development
- Role of legal origins?
- Parliamentary democracy matters?

Table 1: Economic and Political Determinants of Legal Capacity

	(1) Private Credit to GDP	(2) Ease of Access to Credit (country rank)	(3) Investor Protection (country rank)	(4) Index of Government Anti-diversion Policies
Incidence of External Conflict up to 1975	0.510*** (0.143)	0.647** (0.191)	0.029 (0.209)	0.576*** (0.170)
Incidence of Democracy up to 1975	0.953 (0.059)	0.110 (0.267)	- 0.044 (0.078)	0.126** (0.050)
Incidence of Parliamentary Democracy up to 1975	0.001 (0.063)	0.145 (0.114)	0.339** (0.137)	0.112* (0.061)
English Legal Origin	- 0.009 (0.033)	0.068 (0.057)	0.125** (0.063)	- 0.007 (0.040)
Socialist Legal Origin	-	0.098 (0.111)	0.097 (0.115)	0.010*** (0.035)
German Legal Origin	0.406*** (0.120)	0.295*** (0.064)	- 0.008 (0.149)	0.248*** (0.053)
Scandinavian Legal Origin	0.112*** (0.041)	0.204*** (0.067)	0.087 (0.098)	0.254*** (0.055)
Observations	93	122	120	115
R-squared	0.524	0.334	0.256	0.596

Notes to Table: Robust standard errors in parentheses: * significant at 10%; ** significant at 5%; *** significant at 1%.

Socialist legal origin is dropped in column 1 due to Private Credit to GDP being missing for all countries in this category.

Table 2: Economic and Political Determinants of Fiscal Capacity

	(1) One Minus Share of Trade Taxes in Total Taxes	(2) One Minus Share of Trade and Indirect Taxes in Total Taxes	(3) Share of Income Taxes in GDP	(4) Share of Taxes in GDP
Incidence of External Conflict up to 1975	0.762*** (0.250)	0.598*** (0.241)	0.579*** (0.220)	0.555*** (0.162)
Incidence of Democracy up to 1975	0.143 (0.077)	- 0.078 (0.100)	0.091 (0.059)	0.088 (0.059)
Incidence of Parliamentary Democracy up to 1975	0.031 (0.083)	0.122 (0.103)	0.212*** (0.078)	0.160** (0.068)
English Legal Origin	- 0.038 (0.058)	- 0.012 (0.061)	- 0.034 (0.043)	- 0.015 (0.042)
Socialist Legal Origin	0.136** (0.058)	- 0.222*** (0.037)	- 0.109*** (0.065)	- 0.119 (0.031)
German Legal Origin	0.175*** (0.052)	0.196*** (0.090)	0.171* (0.010)	0.010*** (0.083)
Scandinavian Legal Origin	0.189** (0.077)	0.068** (0.084)	0.258** (0.134)	0.292*** (0.087)
Observations	103	103	103	103
R-squared	0.356	0.305	0.600	0.576

Notes to Table: Robust standard errors in parentheses: * significant at 10%; ** significant at 5%; *** significant at 1%

The genius of taxation

- The big difference between redistribution between countries with poorly developed states and those with well-developed states is that the former tend to use highly inefficient government policies which redistribute in a way that tends to impoverish citizens much more than tax -based redistribution.
- Thus governments sacrifice production efficiency for the sake of redistributive ends.
- This is likely to happen more when the tax system is poorly developed
 - i.e. it is a symptom of weak state capacity.

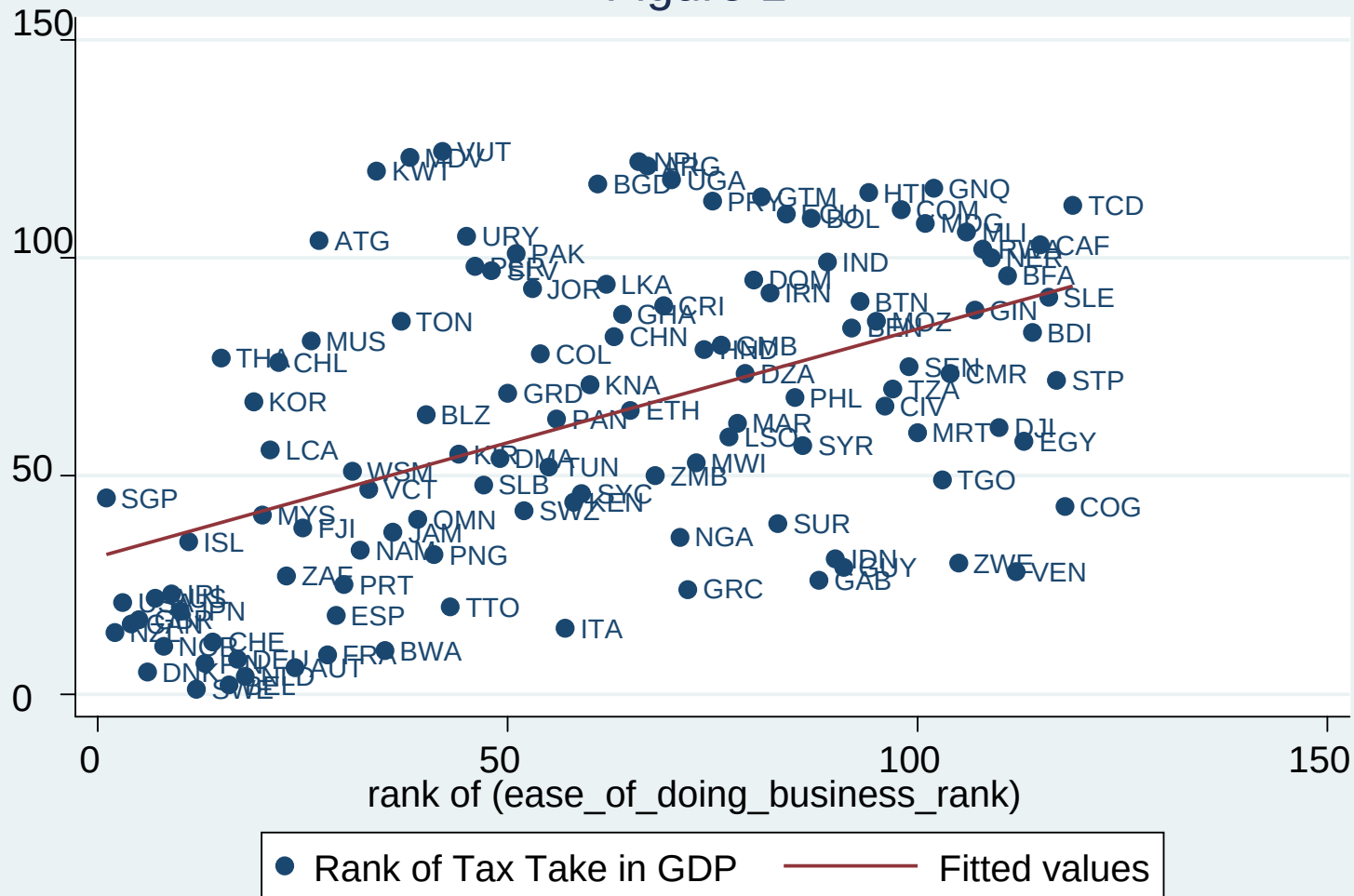
The genius of taxation (continued)

- The inability to redistribute the proceeds of market development will limit dramatically the constituency for market development.
- Through the complementarity that we have emphasized strong states that redistribute and strong market economies will go together.
- Taxation can increase productivity efficiency and enhance market development.

The genius of taxation (continued)

- The following graph shows that size of government and measures of market regulation (ease of doing business) are positively correlated.

Figure 1



The genius of taxation (continued)

- There is an implicit critique of this view of both left and right wing views of state development.
 - the case for taxation does not hinge on the government being benevolent as often is taken as a premise of left wing analyses
 - constitutional limits on taxation may actually be more damaging to the development of a market economy than allowing for a richer tax system.

Take away message

- There may be a margin on which taxes affect investment decisions and reduce efficiency as in the standard view.
- But looking at the bigger picture, the narrowness of the margin on which we now conduct debates about government size seems broadly justified.
- The neo-liberal critique on the size of modern states is politically naive.
- If the state is built on common interests (institutionalized in broad based public programs) then striving for an efficient and broad-based tax system can encourage development of effective markets and economic efficiency.

- Thus it is no coincidence that the twentieth century saw a huge development of both markets and states together.
- It allows us to understand why even left wing parties/governments have become pragmatic when it comes to market development.

Concluding Comments

- Limited power to tax and enforce contracts (low state capacity) has to be understood not assumed.
 - But this intimately linked to how state capacity is used.
- Studying state capacity requires looking at how economic and political institutions evolve
 - it naturally blends political economy and economic history.