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.
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 of 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

The graph shows the relationship between private credit to GDP and the share of income taxes in GDP. The data points are color-coded: blue circles represent above-median income groups, while red circles represent below-median income groups. The green line represents the fitted values. The x-axis represents private credit as a percentage of GDP, ranging from 0 to 200, and the y-axis represents the share of income taxes in GDP, ranging from 0 to 40.
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 1

- 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

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

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

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

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.
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.