State Capacity and Economic Development

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Structure of Talk

- Growth in Bihar

- State capacity and economic development – framework based on new book by Tim Besley and Torsten Persson “Pillars and Prosperity”

- Research questions for Bihar
Peace, Taxation and the Rule of Law

“Little 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)
Growth in Bihar

• Is recent growth in Bihar out of the ordinary?
  – What drives growth in Bihar?

• Methodology
  – State-level analysis, separated in two periods (1960-2000 and 2000-2010) due to data limitations and the bifurcation of Bihar
NSDP per capita growth rates: 5-year averages

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<th>India</th>
<th>Bihar’s neighbours</th>
<th>Bihar</th>
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<td>(weighted average)</td>
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<tr>
<td>1960-1965</td>
<td>-1.9</td>
<td>-2.4</td>
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<td>1965-1969</td>
<td>0.6</td>
<td>0.8</td>
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<td>1970-1974</td>
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<td>1975-1979</td>
<td>5.0</td>
<td>3.7</td>
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<td>1980-1984</td>
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<td>1985-1989</td>
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<td>1990-1994</td>
<td>2.5</td>
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<td>1995-1999</td>
<td>3.7</td>
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### NSDP per capita growth rates: 5-year averages

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<td>2000-2004</td>
<td>2.9</td>
<td>4.5</td>
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<tr>
<td>2005-2009</td>
<td>6.5</td>
<td>7.2</td>
<td>8.9</td>
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Log real Net State Domestic Product per capita
(in Rs., 1973/74 constant prices)

Source: Central Statistical Organisation, India
Log real NSDP per capita
(in Rs., 1999/00 constant prices)

Source: Central Statistical Organisation, India

Tim Besley and Robin Burgess
Growth in Bihar
Log real NSDP per capita by sectors
(in Rs., 1973/74 constant prices)

Source: Central Statistical Organisation, India

India

Bihar

Total output
Non-primary output
Primary output

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Growth in Bihar
Log real NSDP per capita by sectors
(in Rs., 1999/00 constant prices)

Source: Central Statistical Organisation, India

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Growth in Bihar
Log real tertiary and secondary NSDP per capita
(in Rs., 1973/74 constant prices)

India

Bihar

Source: Central Statistical Organisation, India

Tertiary sector
Secondary sector

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Growth in Bihar
Log real tertiary and secondary NSDP per capita
(in Rs., 1999/00 constant prices)

Source: Central Statistical Organisation, India

Tertiary sector
Secondary sector

Tim Besley and Robin Burgess
Growth in Bihar
Log real secondary NSDP per capita
(in Rs., 1973/74 constant prices)

Source: Central Statistical Organisation, India
Log real secondary NSDP per capita
(in Rs., 1999/00 constant prices)

Source: Central Statistical Organisation, India
Note: This includes only a selected number of sectors.

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Growth in Bihar
Log real tertiary NSDP per capita
(in Rs., 1973/74 constant prices)

Source: Central Statistical Organisation, India
Note: This includes only a selected number of sectors.
Log real tertiary NSDP per capita
(in Rs., 1999/00 constant prices)

Source: Central Statistical Organisation, India
Note: This includes only a selected number of sectors.

Trade, Hotels and Restaurants (left axis)
Public Administration (left axis)
Communication (right axis)
Banking and Insurance (right axis)
Real estate (right axis)
Motivation

- Increasing state effectiveness is an important feature of economic development.

- This has two main dimensions:
  - extractive dimension: the ability to tax
  - productive dimension: the power to support contracts and provide infrastructure

- Most economic analyses take the ability of the state to perform these functions as given rather than as something to be explained.
Motivation (continued)

- In the case of taxation, historians and historical sociologists who try to explain how the state acquired the power to tax.
  - 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.

- The term “state capacity” was coined in that field to describe this aspect of state effectiveness.
• In this lecture I will use the term to describe both the extractive and the productive roles.
Core Picture

State and Market Development Move Together

- The following picture plots the relationship between:
  - tax revenue to GDP
  - government anti-diversion policy

- State and market development are positively correlated.
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.
Figure A.1  State capacity and income
Figure 1.5 State Capacity and State Fragility
• 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.
Figure B.2  Tax mix and income
• 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 Larger 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.
  - 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.

- 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.
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

- 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
Figure A.4 Political institutions and state capacity
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 motives 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
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.
  
  – The role of institutions and factors which shape common interests are key.

• Studying state capacity requires looking at how economic and political institutions evolve
  
  – it naturally blends political economy and economic history.
Research Questions for Bihar

- Much of Bihar’s recent growth success seems to be correlated improvements in state capacity
  - resonates with view that peace, taxation and the rule of law are essential to kick-start economic growth
  - the strengthening of tax capacity and market development have moved hand in hand in Bihar
  - Bihar has moved from a weak state to redistributive state
  - and recent election results suggest that there is widespread support for development programs
– there is also some evidence that politics is becoming more consensual and more focussed on development goals as opposed to caste allegiances

– common verus sectional interests

– and as citizens see development programs being delivered they are likely to be more willing to pay taxes
- Enhancing revenue (to fund ambitious development program)
  - developing domestic tax base – both direct and indirect taxes
  - improving tax administration
  - implications of goods and services tax (GST)
  - increasing transfers from centre
  - making use of donor funds

- Improving the efficiency of expenditure
  - improving utilization of public funds
– strengthening local government and making it more accountable to citizens

– understanding how to incentivise civil servants and politicians to better deliver local services

– reducing leakages of public funds
• Improving the investment climate – sustained growth can only come from the growth of markets
  – investing in infrastructure – particularly power but also transportation infrastructure
  – making it easier for industrial and service companies to set up in Bihar
  – rethinking labor and entry regulations and improving the functioning of courts
  – improving the reputation of the state as an investment destination
  – improving the functioning of Bihar’s cities
  – improving access to finance for businesses in Bihar - both big and small
• Reducing conflict
  – confronting law and order problems
  – cracking down on crime
  – enhancing private sector development and economic diversification in the countryside
  – putting in place systems to resolve conflicts over land in the countryside
  – promoting migration to cities (which typically contain more opportunities)