

State Capacity and Economic Development

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IGC Bihar Growth Conference

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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

	India	Bihar's neighbours (weighted average)	Bihar
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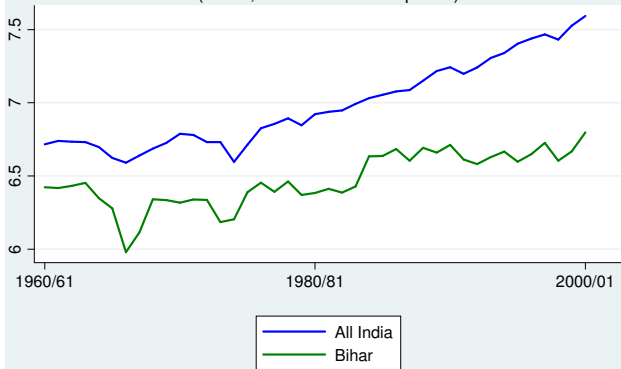
1960-1965	-1.9	-2.4	-2.9
1965-1969	0.6	0.8	-0.3
1970-1974	-2.6	-3.4	-2.6
1975-1979	5.0	3.7	3.3
1980-1984	3.7	4.9	5.3
1985-1989	3.7	2.3	0.5
1990-1994	2.5	0.5	0.1
1995-1999	3.7	4.2	0.1

NSDP per capita growth rates: 5-year averages

	India	Bihar's neighbours (weighted average)	Bihar
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2000-2004	2.9	4.5	3.1
2005-2009	6.5	7.2	8.9

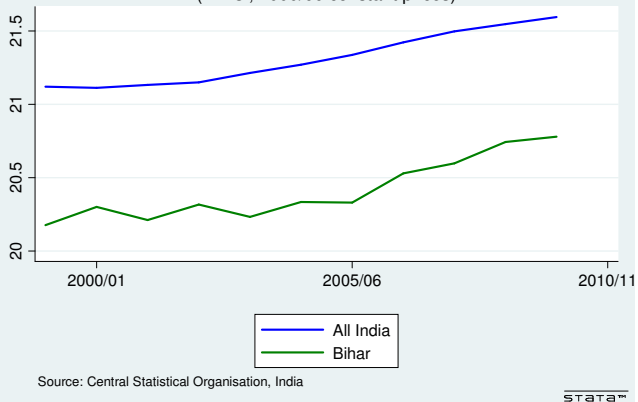
Log real Net State Domestic Product per capita
(in Rs., 1973/74 constant prices)



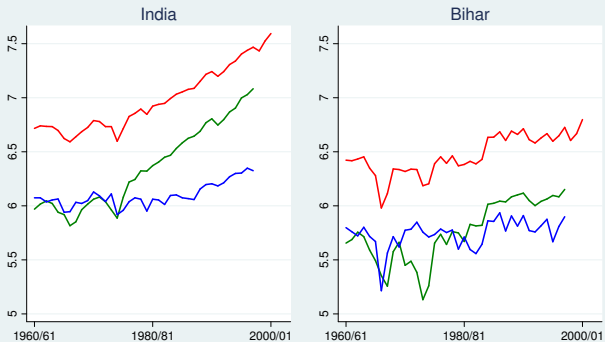
Source: Central Statistical Organisation, India

STATA™

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

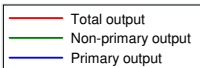


Log real NSDP per capita by sectors (in Rs., 1973/74 constant prices)

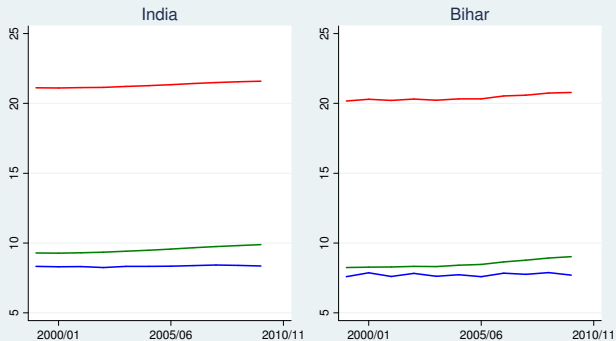


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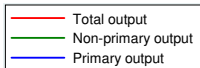


Log real NSDP per capita by sectors (in Rs., 1999/00 constant prices)

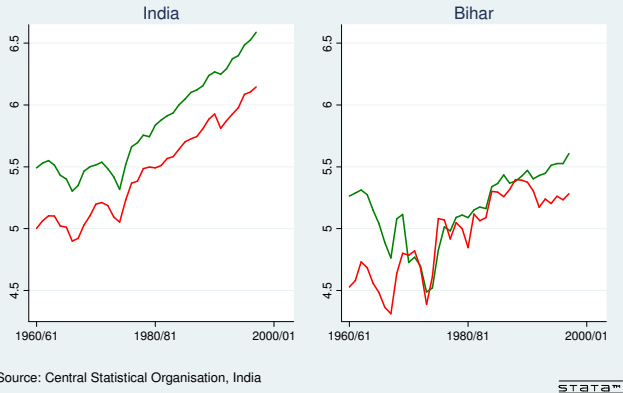


Source: Central Statistical Organisation, India

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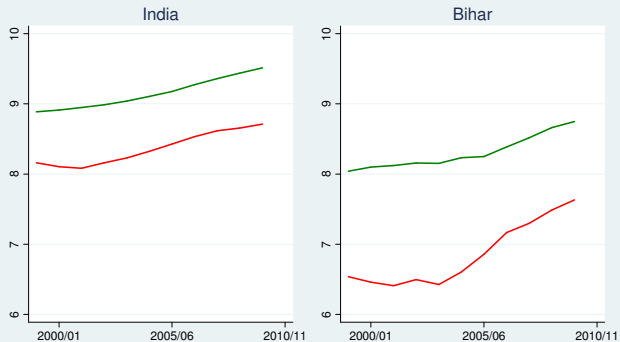


Log real tertiary and secondary NSDP per capita (in Rs., 1973/74 constant prices)



— Tertiary sector
— Secondary sector

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

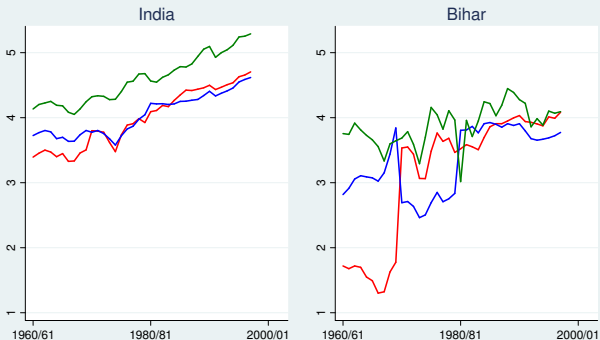


Source: Central Statistical Organisation, India

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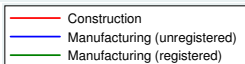
— Tertiary sector
— Secondary sector

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

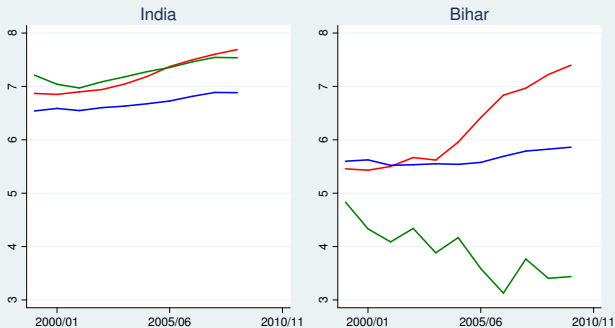


Source: Central Statistical Organisation, India

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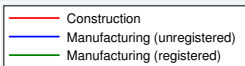


Log real secondary NSDP per capita (in Rs., 1999/00 constant prices)

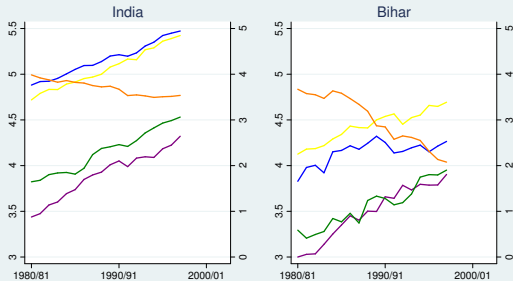


Source: Central Statistical Organisation, India
Note: This includes only a selected number of sectors.

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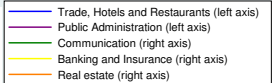


Log real tertiary NSDP per capita (in Rs., 1973/74 constant prices)

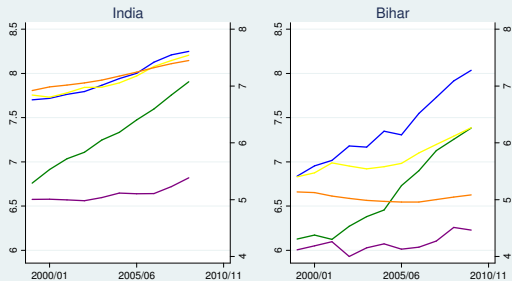


Source: Central Statistical Organisation, India
 Note: This includes only a selected number of sectors.

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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.

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- 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.

Fiscal and Legal Capacity

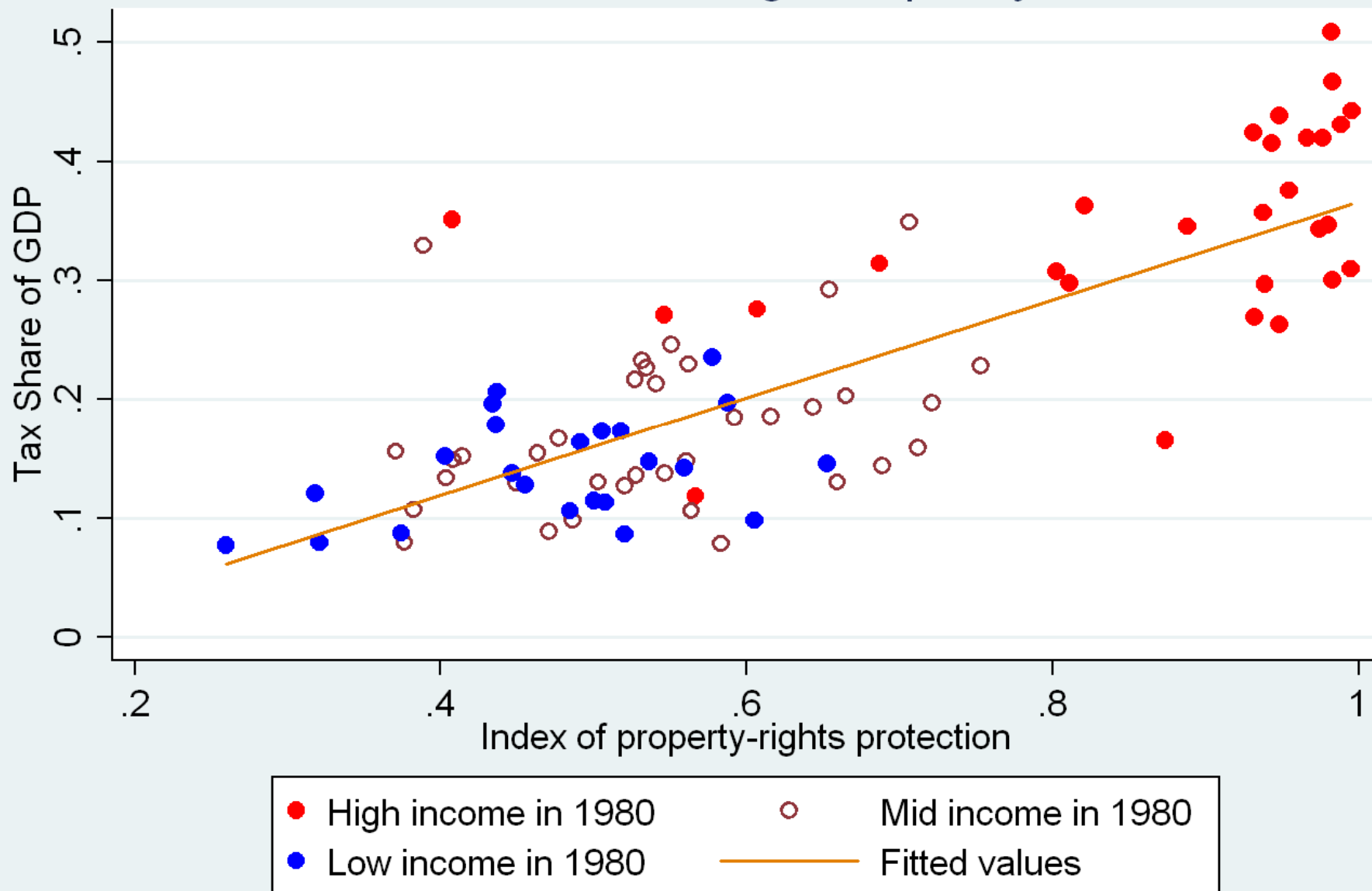


Figure A.1 State capacity and income

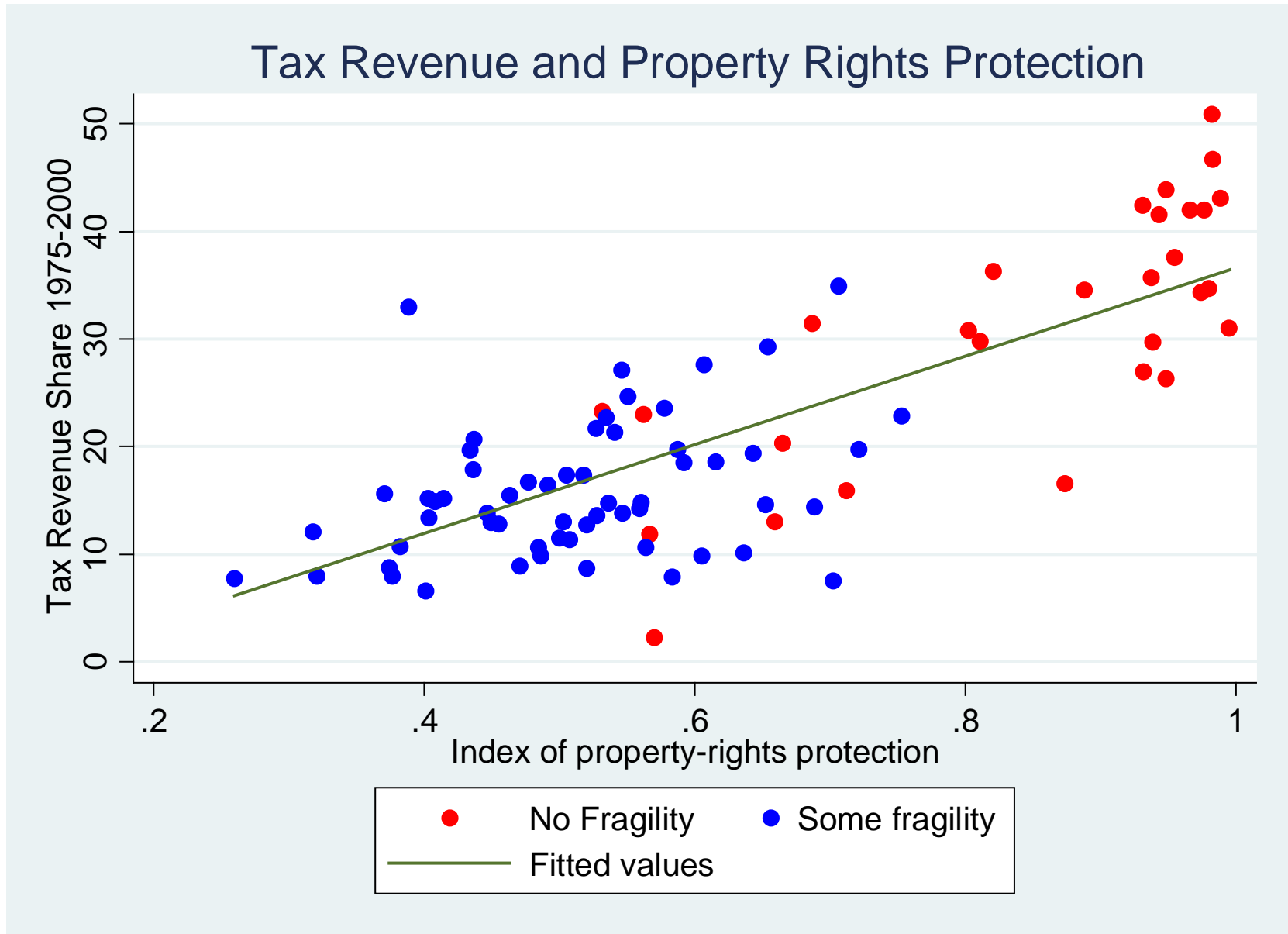


Figure 1.5 State Capacity and State Fragility

- 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.

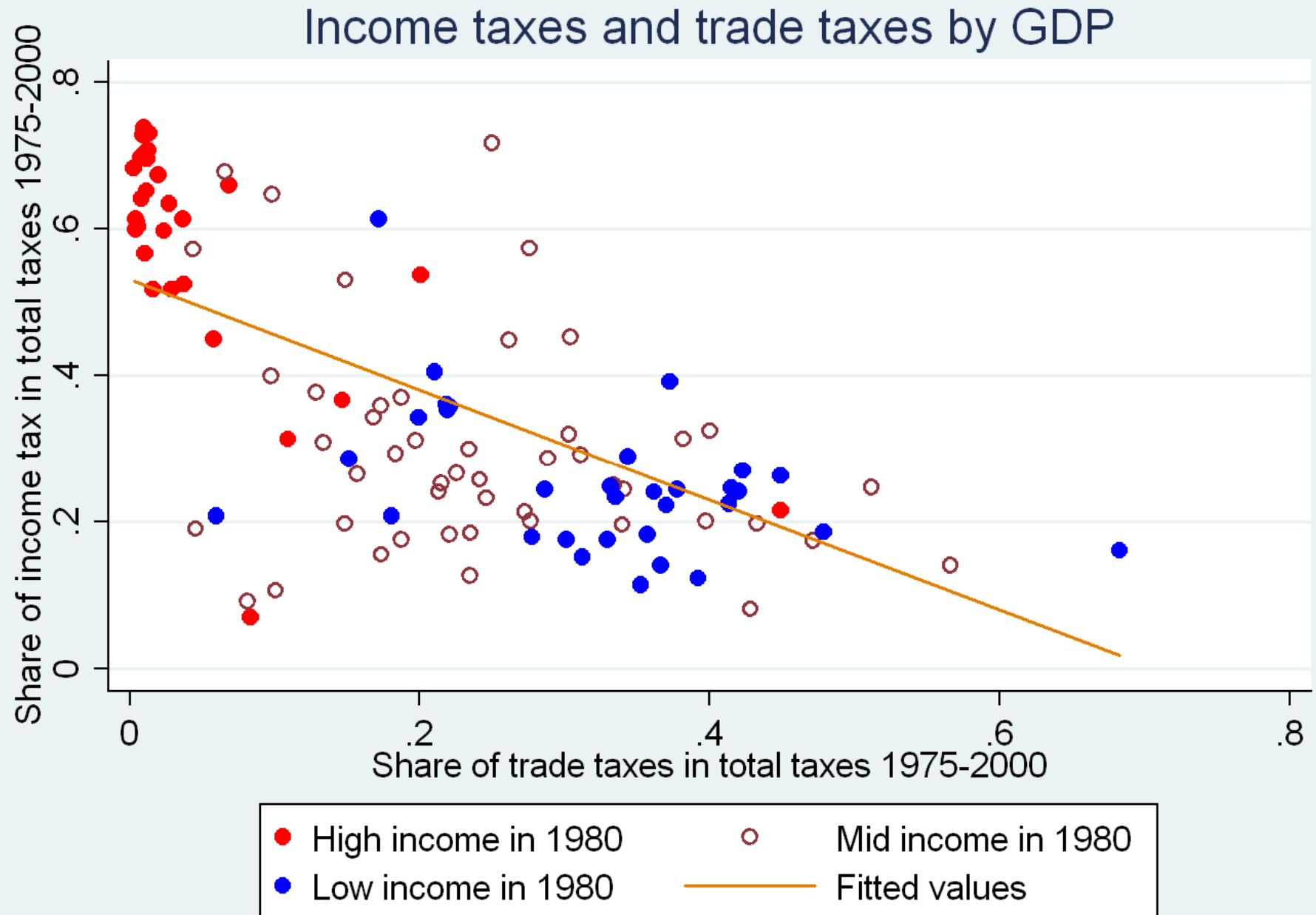


Figure B.2 Tax mix and income

- 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

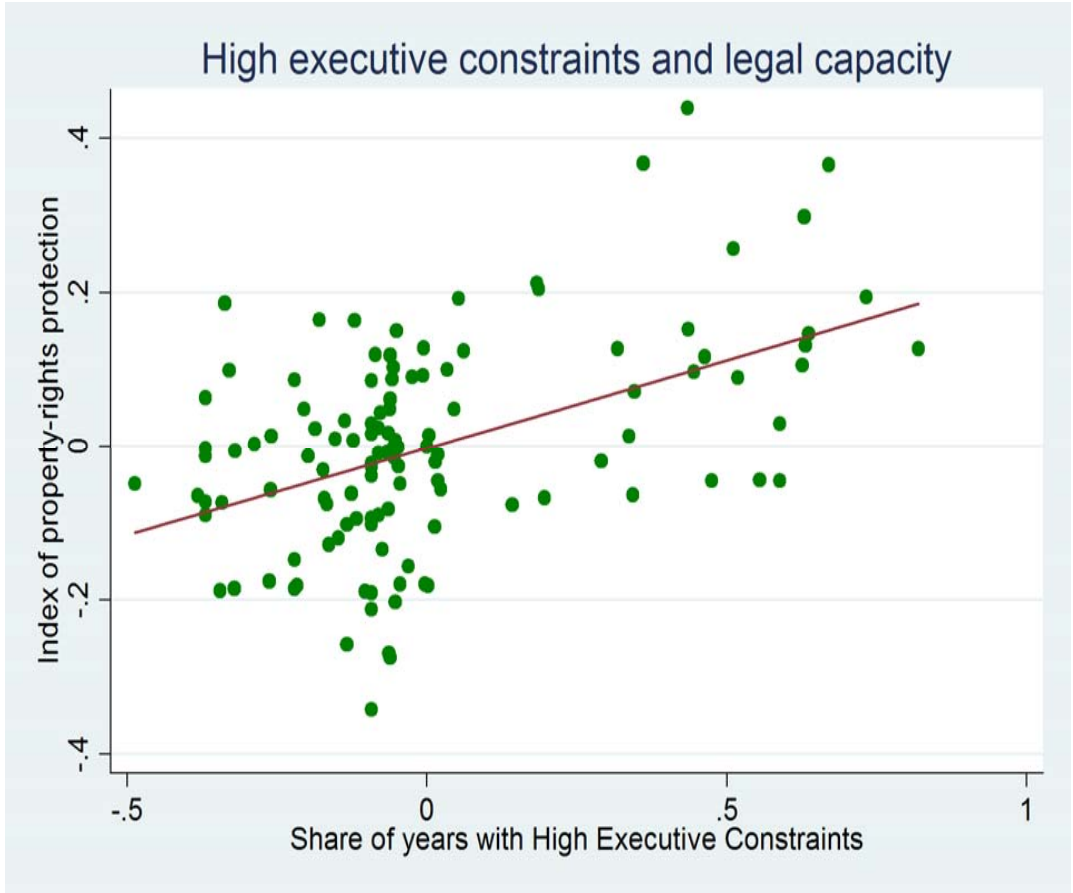
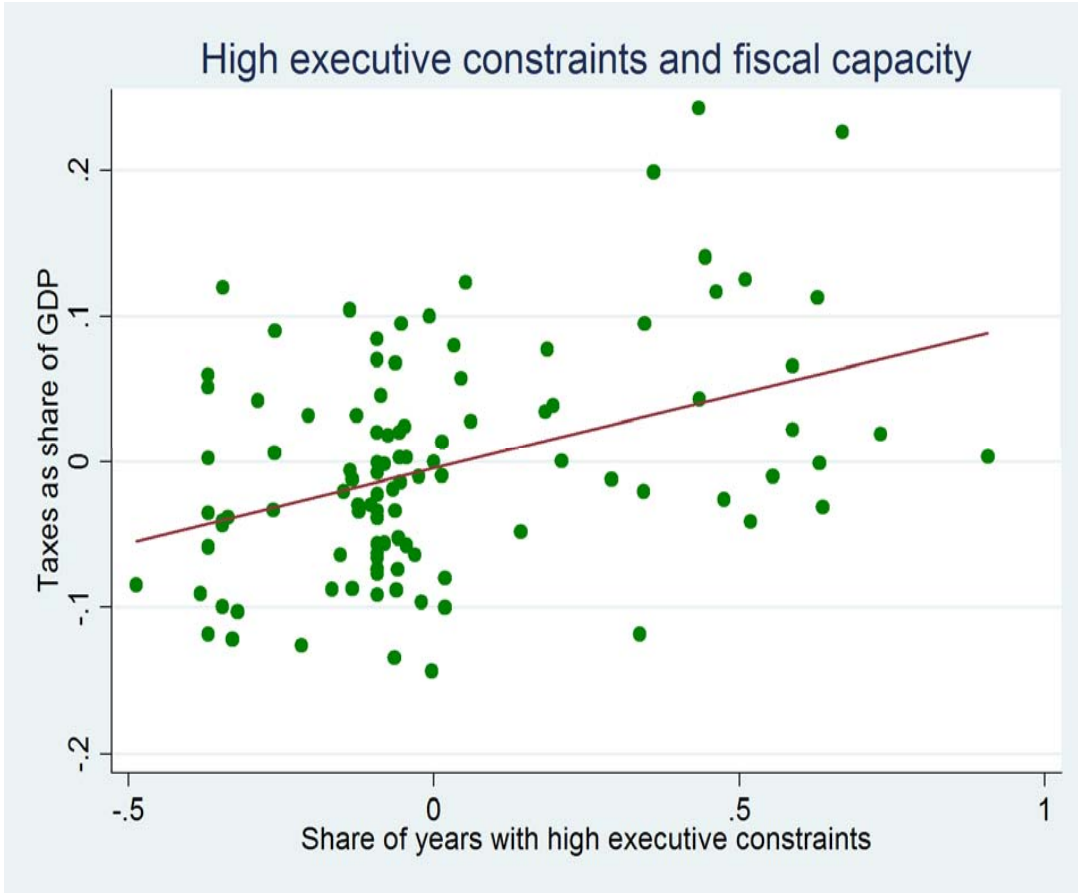


Figure A.4 Political institutions and state capacity

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 versus 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 a 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)