

# State Capacities for Delivering Higher Economic Growth

Zahid Hussain Memorial Lecture  
State Bank of Pakistan

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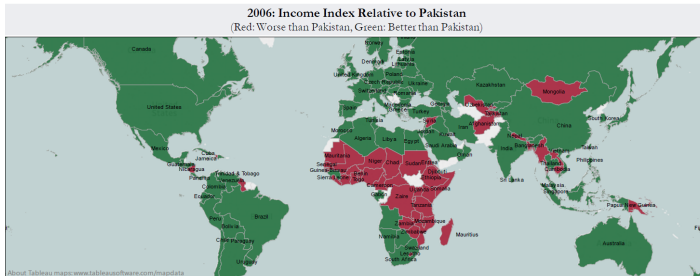
# Introduction

- ▶ What drives growth?
- ▶ Standard economic focus on accumulation:
  - ▶ skills (human capital)
  - ▶ plant, machinery, structures, infrastructure (physical capital)
  - ▶ technology
- ▶ These accumulation processes are intimately linked
  - ▶ e.g. skills and technology and infrastructure

# Introduction

- ▶ Recent work has emphasized government effectiveness lying at the core of the growth process.
  - ▶ But somewhat different view to the state-led development approach of the past.
- ▶ In this lecture, I will focus on types of capital accumulation that lie at the heart of government and makes government more capable.
- ▶ We call these “state capacities”
  - ▶ forms of capital which make the government work more effectively
- ▶ I will offer some insights into the factors that facilitate improvements in state capacity from recent research which takes a global and historical perspective
  - ▶ And, although I am not an expert, I will try to bring out some themes which are relevant for the future trajectory of Pakistan.
  - ▶ or at least frame the challenges in a particular way.

# The Challenge



The income index (by Besley & Persson 2006) has been measured by taking the logarithm of GDP per capita.

Red: 47 countries are worse than Pakistan.

Green: 103 countries are better than Pakistan.

# This Lecture

1. Background Thinking
2. Understanding State Capacities
3. The Role of Executive Constraints

# Genesis

- ▶ The ideas developed here draw on a range of academic papers
  - ▶ especially my work with Torsten Persson from IIES, Stockholm
  - ▶ ... our book *Pillars of Prosperity: The Political Economics of Development Clusters* was a progress report.
- ▶ That work began from building a theoretical framework that tried to understand how state capacities were built over human history
  - ▶ central to this is to develop an understanding of how polities deal with social and economic cleavages.
- ▶ As the research program progressed, we have been able to tie this to the factors which affect peace and security
- ▶ And we now argue that the main thing that lies behind both state capacities and peace/security is developing cohesive political institutions
  - ▶ requires a focus on specific institutional rules (constraints on executive authority)
  - ▶ but also social norms and societal values.

# A Brief Review of Relevant Development Thinking

- ▶ Approaches to Income Differences
- ▶ Approaches to State Capacity
- ▶ Approaches to Political Violence

# Approaches to Income Differences

- ▶ Core “Solow” model of growth
  - ▶ modified by second generation models with greater focus on innovation and market conditions
  - ▶ motivates a focus on transfers of capital and technology
- ▶ Catch-up approach justifies state-led development
  - ▶ with notable success in (e.g.) China, South Korea, Taiwan and Singapore
  - ▶ overall experience is mixed
- ▶ What is missing is a framework for understanding how government can intervene successfully.



# Approaches to State Capacities

- ▶ Much economics literature is “guilty” of assuming that the state has the capacity to intervene effectively in the economy.
- ▶ Outside of economics, there has been much discussion of state development in the area of taxation
  - ▶ Schumpeter and Tilly focused on the rise of the fiscal state
  - ▶ In political science, increasing focus on the costs of having weak states
- ▶ But until recently relatively little work on state capacities more broadly and what generates them

# Approaches to Political Violence

- ▶ Increasing appreciation in social science on the challenges posed by establishing peace and security
- ▶ There has been a particular focus on civil conflict
  - ▶ establishing the right to govern in a particular territory
- ▶ There has been a focus on the two way relationship between conflict and low income
  - ▶ conflict is most prevalent in low-income contexts
  - ▶ but does conflict cause low income or is it a symptom of low income?
- ▶ It is also important to think of alternatives to conflict
  - ▶ peace or repression?
- ▶ Thinking on these issues needs to be tied to thinking about growth and development

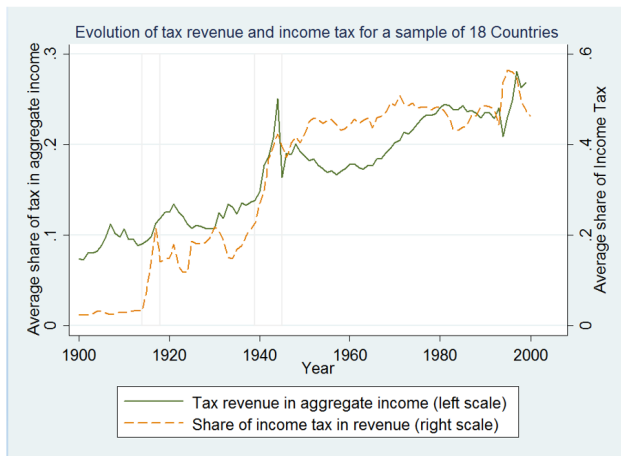
# State Capacities

- ▶ These are the “assets” which allow the state to function
  - ▶ “assets” could include values and norms
- ▶ Three main kinds of state capacity
  - ▶ Fiscal Capacity
  - ▶ Legal Capacity
  - ▶ Collective Capacity
- ▶ Such capacities are built up over time and the cornerstone of modern states.
  - ▶ can apply investment analysis to study how state capacities evolve as particular form of public capital
- ▶ They have often been neglected by those who study the public economics and political economy.
  - ▶ But have been of the essence in historical sociological accounts of the state (Hintze, Schumpeter, Tilly)

# Fiscal Capacity

- ▶ Building broad-based tax systems
  - ▶ personal income tax
  - ▶ VAT
- ▶ Require investments in monitoring and compliance
  - ▶ e.g. withholding at source
- ▶ Complementary with development of legal systems and collective capacity
  - ▶ e.g. formal registration of businesses
  - ▶ functioning social security systems for health and old-age support

# Illustration: Fiscal Capacity in 18 Countries



Countries are: Argentina, Australia, Brazil, Canada, Chile, Colombia, Denmark, Finland, Ireland, Japan, Mexico, Netherlands, New Zealand, Norway, Sweden, Switzerland, United Kingdom, and the United States.

# Legal Capacity

- ▶ The capacity to protect property rights
- ▶ Developing a credible legal code enforced by an independent judiciary
- ▶ Resourcing courts and training legal professionals
- ▶ Building effective regulatory institutions with monitoring and compliance systems.

# Collective Capacity

- ▶ Building the framework which allows states to deliver
  - ▶ Health insurance systems
  - ▶ Social security
  - ▶ Designing, maintaining and delivering infrastructure
  - ▶ Supporting innovation
- ▶ Need to build professional services for state action to deliver
  - ▶ fighting misappropriation and waste

# State Capacities and Economic Growth

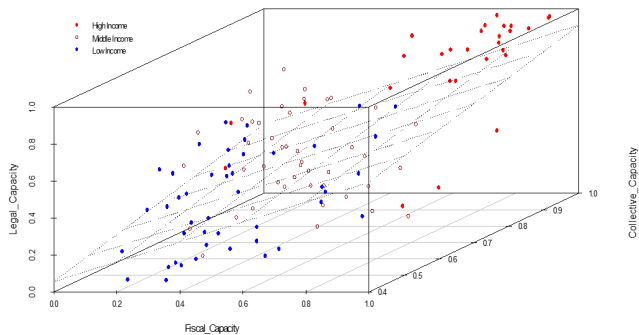
- ▶ All three state capacities are needed for growth
  - ▶ fiscal capacity to support the productive role of the state
    - ▶ infrastructure
    - ▶ education
  - ▶ legal capacity
    - ▶ supporting a competitive market sector
    - ▶ protection of property rights
  - ▶ collective capacity
    - ▶ sharing the proceeds of growth to increase political sustainability
    - ▶ supporting investments in human capacities (health and education)



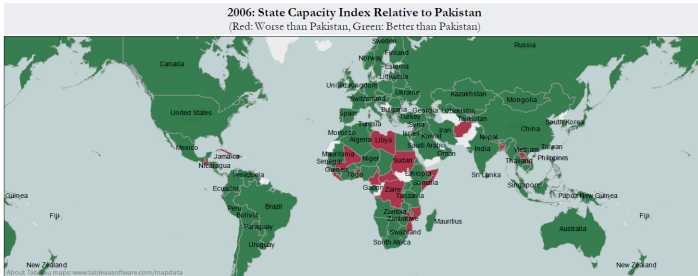
# Measuring State Capacities?

- ▶ This is not straightforward
- ▶ Crude illustration:
  - ▶ Collective capacity is an index based on school attainment and life expectancy as measured in 1999.
  - ▶ Fiscal capacity is the share of income taxes in total revenue in 1999.
  - ▶ Legal capacity is an index of contract enforcement as measured by the World Bank's Doing Business in 2006
- ▶ We now plot these against each other coloring the dots according to the income level of different countries.

# Complementarity of State Capacities



## The Challenge



The state capacity index (by Besley & Persson 2006) mainly modeled fiscal capacity as a constraint on the government's ability to levy an income tax

Red: 22 countries are worse than Pakistan.

Green: 128 countries are better than Pakistan.

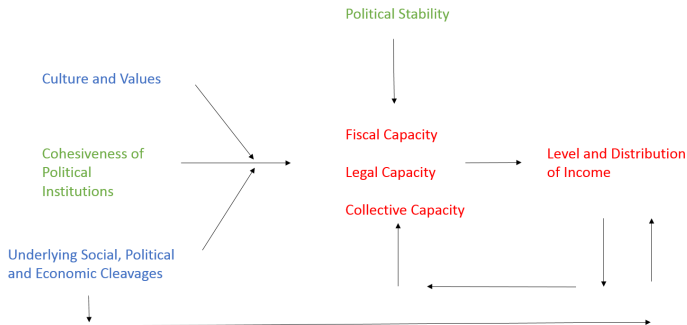
# Investment Logic

- ▶ An incumbent government is deciding how much to invest in building state capacities
  - ▶ Since this is an investment, it has returns which accrue over a range of future time periods
  - ▶ Government may however have a more limited time horizon (e.g. the next election)
  - ▶ So depends on how state capacities are used by successor governments
- ▶ Two key political parameters
  - ▶ turnover of political control
  - ▶ constraints on future incumbents and degree of polarization in society
- ▶ So cost weighed up against future expected benefits allowing for turnover of power.

# The Logic of Complementarities

- ▶ Fiscal capacity supports legal capacity
  - ▶ the larger the share of tax take, the larger the government stake in an efficient market economy
- ▶ Legal capacity supports fiscal capacity
  - ▶ a more extensive market economy with a formal sector widens the tax net
- ▶ Fiscal capacity supports collective capacity
  - ▶ the more tax revenue available, the greater the gains to enhancing collective provision
- ▶ Collective capacity enhances fiscal capacity
  - ▶ greater efficiency in the use of public resource, the greater the willingness of citizens to be taxed

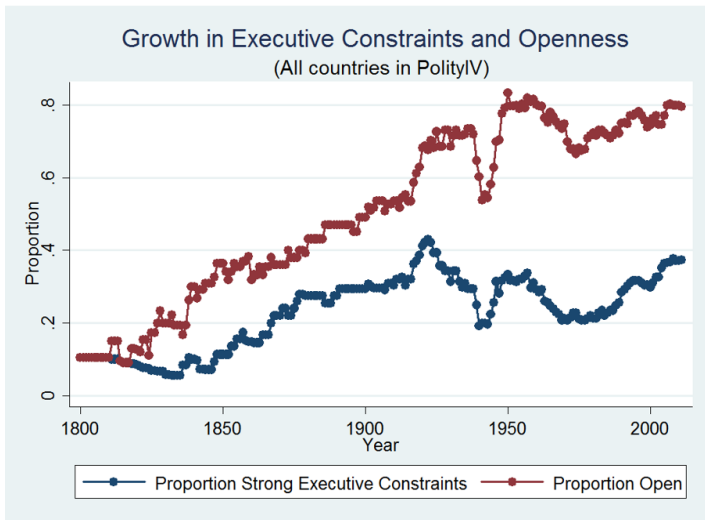
# Summary



# The Role of Political Institutions

- ▶ Affect the incentives of governments
- ▶ Two key dimensions:
  - ▶ Access to power
    - ▶ elections
    - ▶ lineages
    - ▶ military power
  - ▶ Regulating use of power
    - ▶ courts
    - ▶ parliaments
    - ▶ civil society/media
- ▶ Our approach to state capacity puts primary focus on regulating the use of power.

# Illustration: Global History in One Slide





# The Role of Executive Constraints

- ▶ By constraining discretion, executive constraints play a key role in determining how the coercive power of the state is used.

Mill (1859), for example, described a limit to the power of a ruler that can be achieved through "

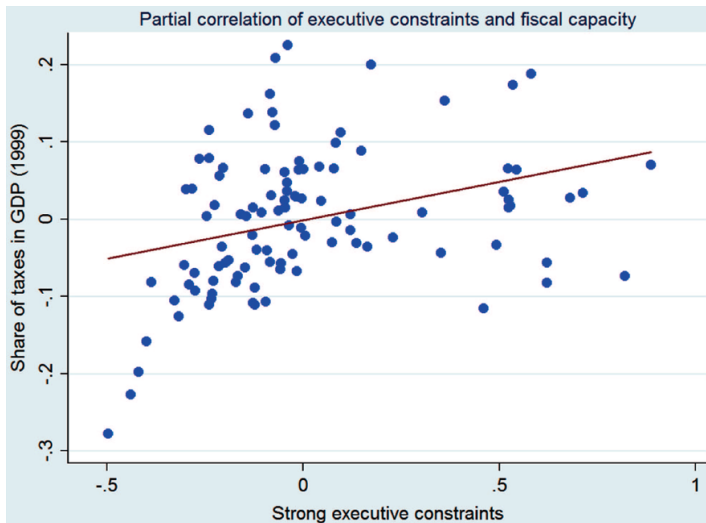
*[...] establishment of constitutional checks, by which the consent of the community, or of a body of some sort, supposed to represent its interests, was made a necessary condition to some of the more important acts of the governing power."*

- ▶ In the PolityIV data base , the high executive constraints also strongly correlated with independence of judiciary.
- ▶ By constraining power, limits the possibility of "winner takes all" politics
- ▶ Hope is to promote broad based redistribution and taxation.

# Executive Constraints and State Capacities

- ▶ Common interest use of the state reduces conflict over resources
  - ▶ Leads to more investment in collective capacity
  - ▶ Increases incentives to build fiscal capacity
  - ▶ Leads to complementary investments in legal capacity
- ▶ What matters is how groups are treated even if they do not have direct access to political power
  - ▶ the hallmark of a common interest state

# Illustration: Fiscal Capacity and Executive Constraints

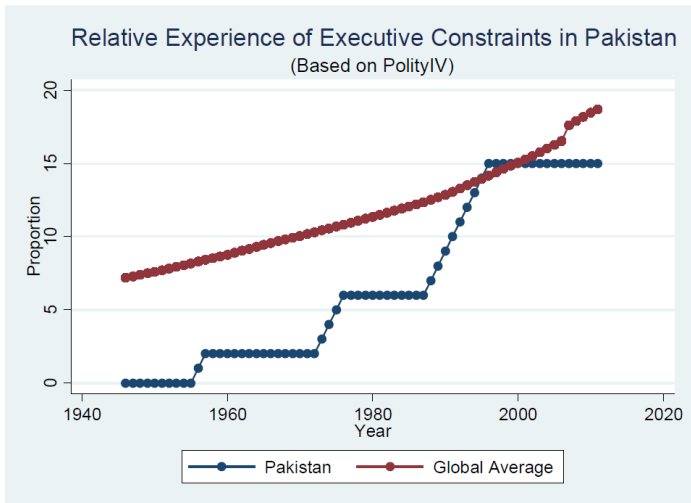


Note: Figure controls for differences in GDP per capita

# How to build strong executive constraints

- ▶ In many countries, this was part of a long historical struggle
  - ▶ e.g. in the UK required many centuries during which there were frequent civil wars
- ▶ Establishing rule-based governance is key
  - ▶ Strong Parliaments
  - ▶ Strong and independent judicial systems
  - ▶ Other independent institutions
- ▶ But supportive norms and values are also key
  - ▶ rules are highly incomplete and operate in a framework of supporting norms
  - ▶ e.g. monetary policy committee in the UK

# The Challenge



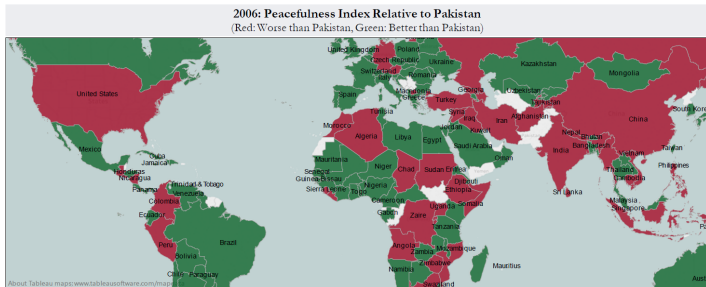
# Two other (related) roles for Strong Executive Constraints

- ▶ Based in both cases on research work with Hannes Mueller
  - ▶ Reducing political violence and inter-group inequality
  - ▶ Reducing political risk

# Reducing Political Violence

- ▶ Political violence plays a role in affecting political stability
  - ▶ high political instability can deter incentive to invest in state capacities
- ▶ Violence in the form of repression or civil disorder is much lower in societies with strong executive constraints
- ▶ We have shown that
  - ▶ countries with strong executive constraints have lower levels of between-ethnic inequality
  - ▶ higher incomes in regions where an ethnic group is not part of the ruling coalition
- ▶ Suggests that there is a stronger effort to provide more universal policies with strong constraints
  - ▶ This may help to explain why conflict is reduced

## The Challenge



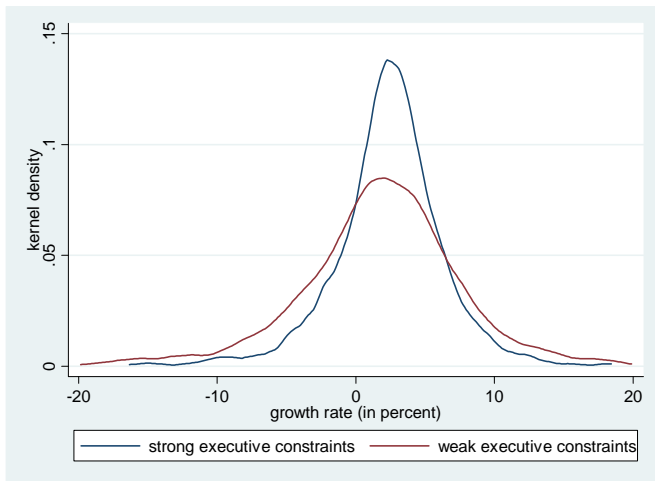
The peacefulness index (by Besley & Persson 2006) has been constructed keeping in view civil war and repression a country has faced. Civil war has been given twice the weight compared to repression.

Red: 45 countries are worse than Pakistan.

Green: 105 countries are better than Pakistan.



# Growth Volatility and Executive Constraints

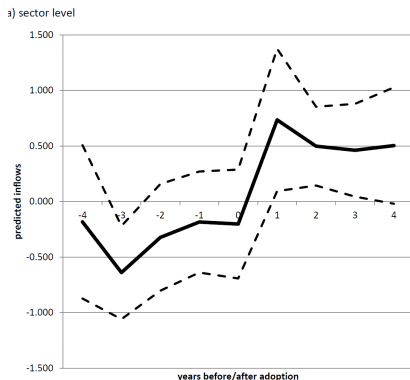


# Why Might Strong Executive Constraints Reduce Volatility?

- ▶ Strong executive constraints can provide insurance against
  - ▶ poor decisions by the executive
  - ▶ electing low quality executive policy makers
- ▶ This is important when policy makers have to be responsive to shocks hitting the economy
- ▶ Executive constraints can be particularly important in limiting downside risks
  - ▶ although it can come at the cost of losing some of the upside
    - ▶ but risk is reduced

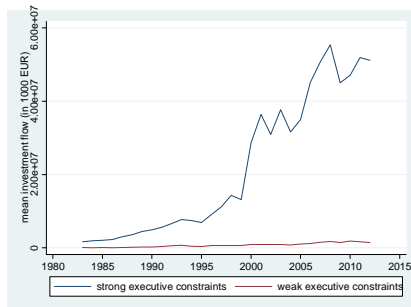
# Does this Matter?

- ▶ For forms of investment where political risk is a big consideration it may matter a lot
- ▶ We have focused on FDI and have shown that FDI flows respond decisively to adopting strong executive constraints
  - ▶ we estimate around an 80% increasing in FDI inflows from transitions to strong executive constraints:



# Does this Matter?

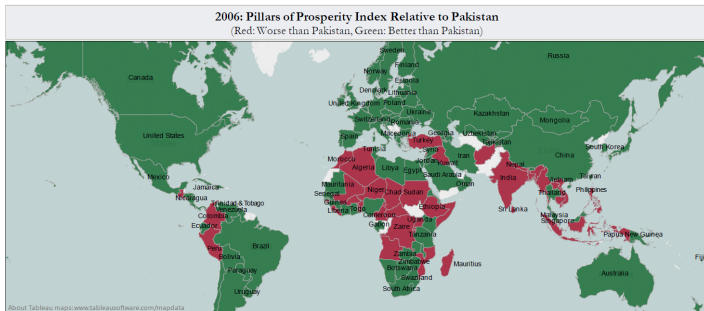
- ▶ For forms of investment where political risk is a big consideration it may matter a lot
- ▶ We have focused on FDI and have shown that FDI flows respond decisively to adopting strong executive constraints



# Framing Debates About Policy Reform

- ▶ Inputs, outputs and intermediate goods
- ▶ The key input I have focused on is building effective constraints on executive power
- ▶ The key outputs we care about are incomes (and human capabilities more broadly)
- ▶ The intermediate goods are security/peace and state capacities
  - ▶ Creating and enhancing state capacities should be a key part of the policy agenda
  - ▶ e.g. the national infrastructure commission in the UK

# The Challenge



The pillars of prosperity index (by Besley & Persson 2006) is constructed by combining state-capacity, income and peacefulness indicies.

Red: 42 countries are worse than Pakistan.

Green: 108 countries are better than Pakistan.

Thank You Very Much!