State and Development: The Need for a Reappraisal of the Current Literature[1]

Pranab Bardhan

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Abstract:

This essay tries to bring out some of the complexities that are overlooked in the usual treatment of the state in the institutional economics literature and supplement the latter with a discussion of some alternative approaches to looking at the possible developmental role of the state. It refers to a broader range of development goals (including the structural transformation of the economy) and focuses on problems like the resolution of coordination failures and collective action problems, the conflicting issues of commitment and accountability and the need for balancing the trade-offs they generate, some

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ingredients of state capacity and political coalition-building usually missed in the literature, the possible importance of rent-sharing in a political equilibrium, the advantages and problems of political centralization and decentralization, and the multi-dimensionality of state functions which may not be addressed by markets or private firms. **(JEL, H11, O10, O25, O43)**

I ***Introduction***

Since the flourishing of institutional economics in the 1990's, some ideas on the role of the state have come to dominate the development literature. Although different writers—say, North and Weingast (1989, 2000), Besley and Persson (2011), Acemoglu and Robinson (2012)-- have different points of emphasis, there is some commonality in this literature on the role of the state. The state has to be strong enough to provide a solid minimum framework of law and order, enforcement of contracts and other basic institutions underpinning the market, while at the same time the state executive has to be constrained not to interfere with security of property rights. There is no doubt that this points to some important features of the state that are conducive to the incentive framework of investment, enterprise and development. We shall try to capture some of

the nuances of this approach as discussed in the more recent literature, but we'll also consider cases where it may actually limit our perspective in understanding the diversity of development experience in different parts of the world and point to aspects of state-related development that are overlooked or under-emphasized in this now-dominant tradition. In particular we shall refer to a broader range of development goals (including the structural transformation of an economy) and multi-dimensionality of state functions compared to those that have been usually considered in the institutional economics literature.

A strong state may help economic growth, but what does one mean by a strong state? In the different strands of the literature one can decipher defining issues like a certain commitment ability of the state to transcend narrow sectarian interests and that of political centralization that allows the state to transcend diffuse local interests. But the *ability* to transcend narrow interests may not necessarily be accompanied by *willingness* to do so, and thus constraints on executive power are considered necessary to restrain pandering to narrow interests or self-aggrandizement on the part of the leadership (hence the frequent call for strong but 'limited' government).

But if the social goal is broad-based development, such essentially negative bars restraining government are not enough. In many cases it may be imperative for the state to play a more positive role. Pluralistic institutions, in the sense of being respectful of diversity of interests and goals, may facilitate such a positive role of the state. But institutional economists who see the need for pluralism, do not always pay attention to the possible tension between pluralism and the ability to carry out collective action toward development goals or even to secure property rights; similarly those who advocate political centralization do not give enough weight to its trade-off with local accountability, or the trade-off between commitment and flexibility. Democratic accountability mechanisms in this literature mainly take the form of constraints on the executive or checks and balances; but there are other aspects of the democratic process which form integral parts of the development process—for example, popular participation and democratic deliberation lend legitimacy and sustainability to development. On the other hand, the political competition of democracy can occasionally lead to a 'race to the bottom' and, instead of focusing the leadership's attention to broad-based interests, may in some cases encourage political clientelism to win elections. In contrast with the general

impression in the literature that 'all good things go together', we'll point to these kinds of antinomies and trade-offs that are largely missing in the discussion.

There is now a burgeoning literature on state capacity contributing to the aforementioned state 'strength', spelling out the various ingredients, particularly fiscal, legal and military aspects of capacity. For example, the role of wars in forging such capacity, and that of a Weberian bureaucracy, its autonomy from the political process, its career paths and incentive payments have been discussed in this context. Less often discussed is the nature of political coaltion among different interest or identity groups and 'social pacts' and inter-temporal bargains that make the key difference and the underlying problems of collective action that have to be overcome in building the all-important political capacity of the state.

The focus on security of property rights and market institutions has also diverted attention from the important issue of developing state capacity in resolving coordination failures. This issue used to be at the forefront of discussion in the early development literature, particularly when structural transformation used to be regarded as the core of development.

In the more recent literature there has been some parallel discussion of state promotion of industrial policy, and the lessons one can learn from its experience in several East Asian countries. In political sociology there has been active discussion on the so-called developmental state in this context. Much of this has been sidelined in the institutional economics discussion on property rights and state capacity, mainly drawing examples from pre-modern European and Atlantic economy, and more recently from institutional failures in Latin America and Africa, largely overlooking the analytical lessons from the experience of East and South Asia. It is time to join the stream of the literature on industrial policy with the mainstream on state capacity for market-supporting institutions, and discuss the problems and prospects of industrial policy in this larger context, particularly if it can be moved away from its old protectionist association and oriented to improving productivity rather than distorting prices. Of course, targeting of sectors and firms will generate rental opportunities, but in contrast with the strictures on rent-seeking in the earlier literature on the state, the new literature has emphasized how in second-best situations, particularly in early stages of development when entrepreneurship and capital are the binding constraints, some amount of rent

generation within broad limits of market discipline can provide dynamic incentives for new investments and learning processes. Rent-sharing may also be important in forging political coalitions behind structural change.

In general the purpose of this essay will be to open up the role of the state in the development context beyond the narrow confines to which much of the institutional economics literature has limited it, apart from pointing to the various trade-offs among the types of role already envisaged. Beyond being a 'nightwatchman' of property rights and markets, the state often needs to be a guide, coordinator, stimulator, and a catalytic agent for economic activities in situations where for various historical and structural reasons the development process has been atrophied and the path forward is darkened by all kinds of missing information and incomplete markets. The trade-offs between different aspects discussed here also suggest the need for some balance in working toward multi-faceted development goals, and a pre-fixed one-sided formulae may not be desirable. The multiple functions of the state and the multi-dimensionality of its agenda (compared to those of private firms or markets) also imply, as we'll discuss, that even when a state enterprise is inefficient in carrying out its functions privatization need not always be a better solution,

particularly when contracts are necessarily incomplete. Our focus on a broader role of the state, multi-dimensionality of its functions and that too at different levels of the political system, and the trade-offs and dissonances between objectives or mechanism designs does not make it easy for a unified theory or tidy unambiguous conclusions. But as Williamson (2000) said in a *JEL* survey of institutional economics, "there being many instructive lenses for studying complex institutions, pluralism is what holds promise for overcoming our ignorance".

The roadmap in this essay is as follows. In Section II we start with the idea of a 'strong but limited' government and its various ramifications. We concentrate in Section II A on two related aspects of state strength suggested in the literature, one on commitment ability and the other is political centralization. In the context of state strength we shall comment in Section II B on the different ingredients of state capacity discussed in a growing literature. In connection with limited government we discuss in Section II C the constraints on the executive and the role of other accountability mechanisms. In section III we shall start our critique of the view discussed in the previous Section, by pointing to tensions and trade-offs between different aspects of governance recommended in the literature. In

section IV we wade into a small part of the large literature on democracy and development, keeping our attention on how the democratic accountability mechanisms discussed earlier help in the development process and at the same time point to features of political competition in a democracy that may actually hinder development. In Section V we shall draw upon the growing literature on decentralization and accountability downward and show how the latter may provide a counterweight to the advantages of political centralization discussed in Section II, while at the same time draw attention to trade-offs in terms of special problems that afflict decentralized governance in pursuit of development goals. In this context we shall discuss the unique combination of political centralization and economic decentralization that the recently successful case of the Chinese state represents, and also the pitfalls of the Chinese state model. In Section VI we discuss the broader role of the state in coordinating investment activities and learning processes, and how the potential dynamic role of rental opportunities that sectoral targeting in industrial policy generates needs to be tamed by market discipline. In Section VII we discuss the special, often multi-dimensional, functions of public enterprises and the uncertainty of their role in fostering necessary innovations once the developmental catch-up

process in technology is over. In the final Section VIII we have some concluding comments and brief suggestions on under-researched areas.

Much of the analysis in this essay, as in the literature discussed, is comparative and historical-institutional. Although we shall often refer to the quantitative-empirical literature available, the latter is as yet relatively scanty, scattered, and not always satisfactory in terms of the identification strategies applied. For example, as the growth econometrics literature[2] makes it amply clear, the cross-country regressions of the literature on the state are riddled with problems in causal interpretation[3]. In addition, unlike in the case of some macro-economic policies, it matters a great deal more in this literature that the effectiveness of the state varies enormously across localities and administrative levels within the same country in their effect on the development process, not at all captured in data that take a whole country average as the point of observation, which is particularly problematic for countries with a medium to large-sized population. On top of all this there

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[2] See, for example, Durlauf *et al* (2005).

[3] In this essay, while we have not refrained from referring to some cross-country empirical exercises, the purpose is mainly to illustrate findings suggestive of interesting correlation, not causation.

are inherent difficulties of measuring quality of public goods and services. There are a few micro experimental studies now available, but as usual the relevance of the conclusions faces problems in scaling up or in 'external validity'. There have, however, been some hopeful beginnings of collaboration between the policy-making and research community in carrying out quasi-experimental evaluation of micro aspects of state policies covering large segments of the population.

Since this essay is not primarily on the process of state formation as such, we shall largely confine ourselves to states that have some minimum coherence in striving for development, and thus leave out many important cases where internecine violence and extreme social fragmentation have not yet allowed the minimum conditions for state building. While keeping in mind that the differences in the relevant state capacity are often a matter of degree rather than kind, we shall bypass the large and growing literature on 'failed states' and civil conflicts. For a relatively recent overview piece in *JEL* on civil conflicts[4], which are often associated with fragile states, see Blattman and Miguel (2010).

[4] For my own take on civil conflicts, see Bardhan (2005), chapter 9.

II *The Call for a Strong but Limited Government*

The idea of a strong but limited government in the institutional economics literature follows a long tradition of Anglo-American political philosophy dating back at least to Hobbes and Locke (the former emphasizing a strong state to prevent 'war of all against all', and the latter emphasizing limits to government at least for securing property rights)[5]. This is actually akin to much older ideas familiar from the classical texts of some ancient civilizations[6].

A major proposition in the recent institutional economics literature associated with North and Weingast (1989, 2000), and others is that for the purpose of economic development the

[5] Alexander Hamilton in *Federalist Papers* expressed it this way: "In framing a government….you must first enable the government to control the governed; and in the next place oblige it to control itself."

[6] For example, much more than a millennium before Hobbes, the theory of the state as enunciated in ancient Indian texts spelled out a variant of the social contract theory of the origin of the state, where the coercive authority (*dandaniti*) has to be combined with *rajadharma* (good governance). The relevant texts are the Buddhist text of Digha Nikaya (1st century BCE to 1st century CE), Arthashastra of Kautilya (4th century BCE) and Chapter 67 of Shanti-parva of the epic Mahabharata (1st century CE). For a discussion of these theories of the state, see Sharma (1996) and Thapar (1984).

state has to be strong enough to protect property rights and other institutions underpinning markets and contracts, but not too strong to be confiscatory, hence the need for democratic checks and balances[7]. They have cited the landmark historical case of the Glorious Revolution in England in 1688, which by strengthening political institutions that constrained the king enhanced his commitment to securing private property rights and thus fostered economic growth (a major mechanism has been through lowering the cost of capital). Acemoglu and Robinson (2012) in their recent remarkable book[8] also cite the case of the Glorious Revolution, resulting in a political pluralism, which along with centralization in England helped to secure private property rights against state predation and allowed private enterprise and capital markets to flourish.

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[7] A referee has rightly pointed out that there is a distinction between a 'limited' government and a 'constrained' one. North and Weingast do talk about a limited government, that has strict limits on interfering with private property rights and markets. Scholars in the Public Choice tradition also explicitly talk about limited government. Acemoglu and Robinson also emphasize security of property rights, but I presume they are more open to a more active role of the government.

[8] Even though the book is meant primarily for a non-specialist readership and their various technical articles at the background provide the theoretical and empirical underpinnings, we pay more attention to the book in this essay as it provides in one place a coherent framework for their understanding of institutions and development.

Besley and Persson (2011) take a closely related approach, citing Adam Smith that "peace, easy taxes[9], and a tolerable administration of justice" are the pillars of the wealth of nations.

II A *State Strength*

The 'strength' of a state in the development context has, of course, to be defined in a non-circular way (without reference to the development outcome). A search of the literature suggests two (somewhat overlapping) components of a definition of strength, without being just a reflection of the success of the economy: (a) political centralization, and (b) capacity to commit.

Acemoglu and Robinson (2012) are the most emphatic in stressing the importance of political centralization. In their view nations succeed or fail in development according to how "inclusive"[10] their political and economic institutions are, and

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[9] The idea of 'easy taxes' was explicit in the Indian epic Mahabharata, where it was suggested that taxes should be gathered in the manner of ' the bee taking honey from the flower'.

[10] Acemoglu and Robinson keep the definition of 'inclusive' somewhat vague. One presumes an inclusive political institution is one where large numbers (possibly a majority) of people are included in the

political centralization (a well-functioning state establishing a cohesive order across local jurisdictions) is one of their essential inclusive political institutions. It can internalize externalities generated by policy actions of different local authorities, enabling an encompassing organization to override various pressures of local clientelism. This also provides incentives for incumbent political leaders to invest in the creation of fiscal and legal capacity, as suggested by Besley and Persson (2011)[11]. Empirically, Osafo-Kwaako and Robinson (2013) cite evidence from a cross-cultural sample for a strong positive correlation between political centralization (in the sense of 'jurisdictional hierarchy beyond local community') and different measures of public goods and development outcomes. For different African polities Bandyopadhay and Green (2012) and Michalopoulos and Papaioannon (2013) provide direct econometric evidence of positive impact of historical measures

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process of governance. Similarly, an inclusive economic institution expands economic rights to large numbers of people.

[11] The theoretical model of Besley and Persson is that of a contest between an incumbent ruler and a challenger. Aoki (forthcoming) has a model of a more complex 3-person game, played by the ruler, the challenger and the opportunist (say, the local gentry) who chooses a strategic position between them, applied to interpret the transition out of the pre-modern states of Tokugawa Japan and Qing China.

of political centralization on contemporary economic development.

While political centralization refers to encompassing the divergent local interests and decisions, a more general characteristic of a strong and effective state is the capacity to make credible commitments in the face of pressures from diverse interest groups[12]. One can depict the relationship between the ruler and the ruled in such a strong state in terms of a simple principal-agent model.

Suppose the ruler provides a public input G (say, some infrastructural facility), which along with L, the labor put in by the ruled or the citizens, produces the national output. The ruler maximizes his net revenue [$\tau F(G,L) - G$] where τ is a linear tax rate and F is a production function with usual properties. But the principal/ruler cannot observe or control the labor effort put in by the agent/ruled. The latter decides on L, taking τ and G as given, to maximize [$(1 - \tau) F(G,L) + W(1 - L)$], where let us suppose the agent has the opportunity to use part of his or her labor effort (the total is fixed at unity) in the underground or informal economy (which the long arm of the

[12] For expositions of the strong state in these terms, see Rodrik (1992), Bardhan (1990), and Bardhan and Udry (1999), Chapter 17.

ruler does not reach) at a given compensation rate of W. If m is the marginal product of labor in the F function, the first-order maximizing condition for the agent is then given by

$$(1 - \tau)m(G,L) - W = 0,$$

which defines an implicit function, $L^*(\tau, G)$. This equation suggests the usual distortion on labor supply as a result of the tax imposition: the marginal product of labor is larger than its opportunity cost.

We can now write the principal/ruler's objective as maximizing $[\tau F(G,L) - G]$ with respect to τ and G,

subject to $L = L^*(\tau,G)$

From the first-order condition of maximization with respect to τ and with diminishing marginal productivity, it can be easily seen that $\delta L^*/\delta\tau$ is negative. One can also see that since the ruler takes into account the distortionary effect of the tax rate on labor supply his chosen tax rate is less than the maximum possible rate.

If the marginal product of labor increases in G, which is reasonable, then $\delta L^*/\delta G$ is positive. This means the ruler will in this case provide more of the public input G than if he were

to take L as a parameter and did not take into account the complementarity between G and L.

Thus in this simple model the ruler of a strong state maximizes his own objective function subject to the reaction function of the ruled and so in the process the ruler internalizes the economic costs and benefits of his actions in accordance with that reaction function. In other words the ruler is taken to be a Stackelberg leader. In contrast, one can say that the weak or the 'soft' state is a Stackelberg follower; it cannot commit to a particular policy and merely reacts to the independent actions of the private actors like special-interest groups. Thus we can now say that compared to the 'strong' state, the 'soft' state will have *too much of undesirable intervention* (creating distortions in the process of generating rent for the lobbying groups), as the institutional economists (as well as the earlier public choice theorists on rent-seeking) usually emphasize. But they do not usually note that by the same logic, the 'soft' state will have *too little of desirable intervention* (as in the case of provision of public inputs in the example above), since the state does not take into account or internalize the effects of its own policies. So the distinction between a 'strong' state (say, in much of East Asia) and a 'soft' state (say, in much of Africa or South Asia) is not necessarily in the *extent* of intervention, but in its *quality*

(i.e. it depends in this model on if it is through distortion of labor supply or enabling a positive complementarity effect of public input).

An important example of the strong state's ability to pre-commit like the Stackelberg leader arises in the case of the popular infant-industry argument for protection. In the last two hundred years this argument has been applied by the state in many countries in the early stages of industrialization, with a few successes and numerous failures, which has partly to do with the strength of the state or lack of it. At the time when such protection is initiated, by the very nature of this argument for temporary protection, it is granted for a short period until the industrial infant stands up on its feet. But in most countries infant industry protection inevitably faces the 'time inconsistency' problem: when the initial period of protection nears its completion the political pressures for its renewal from the vested interests become inexorable, and in this way the infant industry in a weak state can degenerate into a geriatric protection lobby (the history of import-substituting industrialization in developing countries is littered with examples of this).

In the recent history of the strong states of East Asia, however, there have been some remarkable instances of the government keeping its commitment, withdrawing protection from an industry if it does not shape up after the lapse of a preannounced duration, letting the industry sink or swim in international competition[13]. In terms of political pre-conditions for commitment Elster (1994) has argued that to be credible and effective, commitment requires democracy. The promises of a ruler are considered much more credible if well-established procedures exist for throwing the ruler out of office for failure to keep those promises; this is a central theme of much of the literature on constitutional political economy. But some of those strong regimes in East Asia were not at that time democratic, but over time they had established reputational alternatives to formal commitment devices. On the other hand, in democracies when the so-called infant-industry protection is prolonged violating earlier commitments, there is little popular pressure organized against it. No conniving leader faces dismissal on this ground, making constitutional provisions for throwing out the ruler largely irrelevant here.

[13] For some examples of this, see Wade (1990).

A closely related commitment issue is that of enforcing a hard budget constraint in public-sector run or funded projects. A strong state should be better at resisting the inevitable bail-out pressures from interests involved in failing projects. A weak state is unable to make a credible commitment to terminate a bad public project, since sunk costs in earlier periods of investment make it sequentially rational to refinance projects even when one realizes down the line that they had negative net present value initially[14].

Another important aspect of the quality of state intervention in East Asian recent history had to do with the use, by and large, of clear, well-defined, pre-announced rules of performance criteria. In South Korea, for example, the heavy involvement of the state in directing investment through subsidized credit allocation has been largely successful because of its strict adherence to the criterion of export performance. Through this pre-commitment device the strong Korean state has used the vital disciplining function of foreign competition in encouraging quick learning and cost and quality consciousness among domestic enterprises, something that has been conspicuously absent in many other interventionist regimes

[14] For the micro-foundations of such 'soft' financing problems, see Dewatripont and Maskin (1995).

(even though the Korean state at least until the 1980's shared with the latter regimes many of the restrictive policies on imports and foreign investment). We'll come back to this issue of combining sectoral commitment with competition in Section VI on industrial policy.

Somewhat paradoxically, the idea of the 'weak' state buffeted by pressures from interest groups, which is a staple of Public Choice theory and the literature on 'rent-seeking' by lobbying groups, has family resemblance to the older Marxist theory of the state on the other end of the political spectrum. But mainstream economists are often unaware that quite some decades back the latter theory went beyond this and adopted a theory that emphasized state strength. Orthodox Marxists used to consider the state as a tool of, or dancing to the tune of, the dominant interest group, i.e. the capitalist class[15]. Then in the 1960's and 70's a group of neo-Marxist political writers developed the idea of what they called the 'relative autonomy' of the state, whereby the state supersedes the narrow or particularistic interests of the capitalists and takes independent decisions and policies, even though it by and large safeguards their long-term systemic interests. (In non-Marxist

[15] There is clear evidence that Marx himself essentially abandoned this view after 1850. For an elaboration on this see Elster (1985).

literature during Depression or financial crises this sometimes appears in the form of a call for the state to 'save capitalism from capitalists')[16]. Later many political sociologists in and outside this group went even beyond this, and recognized several historical instances of the clearly vital role of the strong state. For example, Skocpol (1982) refers to 'the explanatory centrality of states as potent and autonomous organizational actors'. There are, of course, serious constraints posed by the imperatives of the dominant proprietary classes (after all they provide the main source of public revenue), but these writers recognized that to focus exclusively on those constraints is often to ignore the large range of choices in goal formulation, agenda setting and policy execution that the state leadership usually has. The strong state thus acts neither at the behest of, nor on behalf of, the dominant classes.

Of course in most actual situations the state is neither a Stackelberg leader nor a Stackelberg follower; neither the state actors nor the private interest groups usually have the power to define unilaterally the parameters of their action. Both may

[16] Marx in Capital vol I, when discussing the English Factory Acts, deduces the necessity of the state as a particular form 'alongside and outside bourgeois society', protecting capital from its own 'unrestrainable passion, its werewolf hunger for surplus labor'.

be strategic actors with some power to influence the terms, and the outcome of the bargaining game will depend on their varying bargaining strengths in different situations. This points to a major inadequacy of the principal-agent ruler-ruled model of earlier in this Section. In that model, for example, the power of the ruler to collect taxes or rents is invariant with respect to policies to promote productivity. But some of the latter policies may change the disagreement payoffs of the ruled if one thinks of it as a bargaining game: an increase in G may end up weakening the power of the ruler to impose τ—this is the standard story of the ruler introducing roads or railways enabling the peasants from the countryside to easily come to the city and aggregate their protest against the ruler's rent extractions.

II B *Ingredients of State Capacity*

Besley and Persson (2011) associate a weak state with a lack of state capacity, particularly fiscal, legal and military capacity, to be able to provide public goods and services (including law and order). In the burgeoning literature on state capacity different writers have emphasized different aspects. A well-known line of thinking associated with Tilly (1985) links the historical

making of the fiscal-military state in early modern Europe with inter-state wars. Levi (1988) associated state-making with inducing citizen compliance in providing revenue and conscripts for war. Others[17], however, have suggested that in more recent times and outside Europe, states have been formed without wars, and there have been cases where wars have unraveled pre-existing states.

In examining the ingredients of state capacity Evans and Rauch (1999) stressed the importance of certain Weberian characteristics of the state bureaucracy like meritocratic recruitment and long-term career rewards for officials. There is also a cumulative logic of bureaucratic functioning. A long history of continuous bureaucratic structure in place may foster a helpful bureaucratic culture[18] or *esprit de corps* that can contribute to state effectiveness. Bockstette, Chanda and Putterman (2002) have computed an index of state antiquity (continuous territory-wide state structure above the tribal domains over the last two millennia). It shows that among developing countries this index is much lower for sub-Saharan

[17] See, for example, Leander (2004), and Taylor and Botea (2008).
[18] Analogous to the term 'democratic capital' that Persson and Tabellini (2009) have used, one may call this historical experience of bureaucracy a kind of 'bureaucratic capital', though one should be careful in not stretching the definition of capital too far.

Africa and Latin America than for Asia, and even in Asia the index for Korea is several times that for the Philippines (a country that lacked an encompassing state before the 16th century colonization by Spain). A cross-country statistical exercise[19] shows a significant positive association between this state antiquity index and that for the rule of law currently in the country.

The effectiveness of a bureaucracy, of course, depends on the compensation structure and incentives. Dal Bo *et al* (2013) provide experimental evidence from Mexico that not merely higher wages attract higher-quality recruits to the government (even in difficult locations), but they also do not 'crowd out' the intrinsic non-pecuniary motivations[20] that are important in public service.

Cornick (2013) has classified the different types of state capacity into technical, organizational and political. Technical capacity is particularly relevant, for example, in the context of screening worthwhile public projects or monitoring the delivery to intended beneficiaries in social programs.

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[19] See Bardhan (2005), Chapter 1.

[20] Ashraf *et al* (forthcoming) find experimental evidence in Zambia that financial incentives augment, rather than crowd out, public service motivation.

Information technology has expanded the realm of possibilities here. Muralidharan *et al* (2014) evaluate the impact of a biometrically-authenticated payments infrastructure on public employment and pension programs in India, using a large-scale experiment that randomized the rollout of the new system over 158 sub-districts and 19 million people. They find that the new system delivered a faster, more predictable, and less corrupt payments process without adversely affecting program access. These results suggest that investing in secure authentication and payments infrastructure can significantly add to state capacity in effective implementation of social programs in developing countries. Similar issues arise in the context of building capacities in judicial, auditing and regulatory bodies.

Organizational capacity of a state is often crudely measured in the empirical literature in terms of tax-GDP ratio. But, as is usually recognized, this ratio may be relatively high in a natural resource abundant country on account of the resource rents, not necessarily organizational capacity, or low in a poor country where for independent reasons (say, the nature of factor market imperfections) the informal sector is large. Organizational capacity is also related to modes of governance. For example, Bandiera *et al* (2009) show (from a policy experiment associated with a national procurement agency in

Italy) that much of the sheer wastage in public procurement arises from some organizational modes ('top-down' governance modes in public bodies perform the worst). Organizational capacity, of course, varies between different types of state functions. The Indian state shows extraordinary capacity in some large episodic matters, like organizing the complex logistics of the world's largest elections or the world's second largest Census. But it displays poor capacity in, for example, some regular essential activities like cost-effective pricing and distribution of electricity. This is partly because local political considerations interfere in matters like under-recovery of costs from a large and politically sensitive customer base.

Political capacity is often largely an issue of commitment and resisting pressures for short-termism and soft budget constraints, as we have discussed above. In many parts of India and Africa the police and bureaucracy are highly politicized and deliberately incapacitated to serve short-term political goals of leaders. In such contexts measures to improve bureaucratic autonomy may enhance performance. In a study of 4700 public sector projects implemented by the Nigerian civil service, Rasul and Rogger (2013) find that one standard deviation increase in autonomy for bureaucrats corresponds to significantly higher project completion rates of 18 per cent. In

general, as Aghion and Tirole (1997) have pointed out in the context of allocation of authority in even private firms, in complex projects autonomy for an agent (the bureaucrat) who may be better informed than the principal (the politician) is called for.

II C *Limits to government*

As we have mentioned before, the institutional economics literature emphasizes that the state has to be strong but limited for helping development, i.e. not merely it should be insulated from the political pressures from special interest groups, but it should have enough constraints on its powers so that private property rights are secure from its 'grabbing hand'[21], and the state-provided institutions for supporting markets and contracts can operate unhindered. For this various kinds of checks and balances, including constitutional constraints on executive power, separation of powers, electoral rules, independent judiciary, free media, and other such accountability mechanisms for the state leadership have been regarded as necessary. Apart from securing property rights from undue state encroachment, these checks and balances may also limit the ruler's attempts at pushing for narrow-based

[21] This is the title of the book by Shleifer and Vishny (2002).

or particular group-favoring programs. In Besley and Persson (2011) states with weak constraints are described as having rather weak compulsions on the ruling groups to supply common-interest services. We shall come back to the accountability mechanisms when we discuss democracy and development in Section IV.

III *A critique of the dominant institutional view*

After our discussion of the different elements of strength and limits to government, both of which are clearly important in the process of development, we shall now provide a critique of some of the basic ideas in this literature. Let us start with political centralization. Acemoglu and Robinson (2012) regard this as a key 'inclusive' political institution along with a pluralistic distribution of political power. But the idea that political centralization is an element of political inclusiveness is rather puzzling. Most historical instances of political centralization, either in the empire states of the past or in the modern nation states (such as Meiji Japan, Ataturk's Turkey, and Mao's China), have been associated with less political inclusiveness in important respects. Secondly, and as a related point, there is actually a degree of potential conflict between

those two key political institutions stressed by Acemoglu and Robinson. To be sure, a certain degree of political unification is necessary to build a coherent institutional framework for long-term development policies. But centralization and pluralism may not be always compatible. Pluralism in the sense of a social idea that encourages diversity of goals and interests of a variety of social groups can inhibit centralization and society's collective action on long-run decisions and projects. India has been a major example of intensive pluralism and political competition resulting, as we have suggested above, in general in weak political centralization or collective action. This suggests the need for more attention to be paid in this literature to the theory of the determinants of collective action. Thirdly, economic inclusion in the world of Acemoglu and Robinson requires secure property rights. But political inclusion, with its pluralistic distribution of political power and broad popular participation, may not always secure the property rights of the few against the numerous encroachers and squatters or against high taxes. Similarly, in the world of Besley and Persson all good things go together (like pluralism and security of property rights), and thus they ignore the possible tension between those factors. Or, to take another example, the rule of law—part of political inclusion—is often an

instrument used to protect the propertied from the propertyless, thus enforcing economic exclusion[22]. English enclosure laws famously turned the poor users of the village commons into poachers. Of course, the rule of law may be, on balance, a very good thing, even if it is sometimes at odds with economic inclusion.[23]

There is also a definitional problem. Acemoglu and Robinson say they will "refer to political institutions that are *sufficiently* centralized and pluralistic as inclusive political institutions"

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[22] "Civil government, so far as it is instituted for the security of property, is in reality instituted for the defense of the rich against the poor, or of those who have some property against those who have none at all"—this is a quote not from Marx, but from Adam Smith in the *Wealth of Nations*.

[23] The nature of the tension involved in the rule of law is captured well in the nuanced conclusion of *Whigs and Hunters* (1975), by the Marxist historian E. P. Thompson:

"We reach, then, not a simple conclusion (law = class power) but a complex and contradictory one. On the one hand, it is true that the law did mediate existent class relations to the advantage of the rulers . . . . On the other hand, the law mediated these class relations through legal forms, which imposed, again and again, inhibitions upon the actions of the rulers. . . . In a context of gross class inequalities, the equity of the law must always be in some part sham. . . . We ought to expose the shams and inequities which may be concealed beneath this law. But the rule of law itself, the imposing of effective inhibitions upon power and the defense of the citizen from power's all-intrusive claims, seems to me to be an unqualified human good."

(italics added). This is unsatisfactory without an independent measure of sufficiency, since "sufficiently" leaves the door open for circularity. Clearly we do not want to call institutions 'politically inclusive' when they are inclusive enough to yield development, and still claim that inclusive institutions foster development.

Historically, however, England has indeed been a successful case where political centralization and pluralism have fitted together. But, contrary to North, Weingast, Acemoglu and Robinson, economic historians like Epstein (2000), Clark (2007) and Allen (2009) have expressed doubts if the economic success of England can be mostly attributed to the constitutional changes that came with the Glorious Revolution. Even some of the more recent defenders of North and Weingast, like Cox (2012) and Pincus and Robinson (2011), agree that neither cost of capital nor enforcement of property rights improved significantly after that Revolution, even though it represents an important constitutional watershed (Cox) or an institutional change shifting the balance of power from the king to the new manufacturing classes (Pincus and Robinson). Nor

did it lead to a particularly limited government: in fact taxes and public debt increased sharply after the Revolution[24].

On the state's ability to commit, it is important to keep in mind that in some cases of state effectiveness commitment has not been necessary; as we have indicated before, reputational substitutes for formal commitment devices established over a period have worked. More importantly, there are costs of commitment, say in terms of sacrifice of flexibility in dealing with changing technical and market conditions and in correcting wrong decisions. As part of the flexibility, some political sociologists, like Evans (1995), have emphasized the need for a Weberian bureaucratic structure with meritocratic recruitment *to be combined with* channels of deliberative processes involving the important political stakeholders in the development process—what he calls 'embedded autonomy' prominent in his account of South Korea. But we know that not all stakeholders were included--the autonomous Korean state

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[24] Outside England, across early modern Europe Stasavage (2011) cites evidence how the government's ability to raise long-term credit depended on assemblies where merchant representatives looking after lenders' interests had some political control over fiscal affairs. Dinsecco (2011) show how across countries in Europe in the period 1650-1913 political centralization combined with parliamentary oversight of the executive helped develop fiscal structures.

for some decades had also ensured political suppression of the labor movement so that the profits of the business stakeholders were not threatened too much. In a different political context, the Indian experience has shown how the political process can erode the commitment capacity of a meritocratically recruited bureaucracy, particularly as politicians can manipulate transfers and promotion of officers.[25]

In general our discussion of political capacity in the previous Section needs to be linked with the ability to form 'social pacts' among important political stakeholders and the nature of distribution of power and political coalitions. The Korean political coalition in the early decades of development involved a tight integration between a military bureaucracy and conglomerate business, which was clearly out of bounds for the elite to accomplish in democratic India. But within a democratic framework the relative weakness of state capacity in India has been more a symptom of the underlying political

[25] For evidence on manipulative transfers of Indian administrative officers, see Iyer and Mani (2012). A randomized experimental study in the police department in Rajasthan, India by Banerjee *et al* (2012) showed that a freeze on transfer of police staff increased police effectiveness.

difficulty of organizing collective action for the long term[26] (even among its divided elite), not because the country lacks administratively capable people. Consistent with the theory of collective action[27], India's large heterogeneous population, fragmented polity, and high social and economic inequality make it hard to agree on long-term common goals and, even when the latter is achieved, to get its act together in pursuit of those goals. Moreover, in recent years in many developing countries (including India) short-term considerations have sometimes predominated in the interest conflicts between rentier and entrepreneurial capitalism -- as the price of land (and other natural resources) shot up with economic growth, a growing nexus between politicians and rentier interests like real estate magnates, builders and contractors has often worked to undermine state capacity for good governance and long-term productive enterprise. In general, divided societies and polities will have weaker common interests, and as Besley and Persson (2011) have pointed out, in such cases the

[26] For an analysis of the difficulty of collective action in India in terms of the large numbers and heterogeneity of influential socio-economic groups, see Bardhan (1984).

[27] See, for example, Bardhan (2005) chapters 10 and 11 for a general theoretical and empirical analysis of collective action, in particular the impact on it of inequality.

incentive to invest in state capacity will be less[28]. In contrast, in the post-War decades in north-east Asia and north-west (particularly Nordic) Europe relative social homogeneity and less unequal distribution of wealth and human capital may have made it somewhat less difficult to enlist the support of most social groups in making short-run sacrifices and coordinating on growth-promoting policies. This also means that in terms of our earlier discussion the 'strength' of the state is ultimately sustainable by the breadth of support in the general population.

These matters are obviously helped if, as some cultural theorists point out[29], the predominant culture in society is 'collectivist' (when individuals internalize group interests), which is prominent in some description of East Asian societies, as opposed to 'individualist'. Going into the cultural issues is beyond the scope of this paper, except only to note that the issue of culture is a welcome reminder that some institutions of

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[28] For some cross-country evidence on the relation between ethno-linguistic fragmentation and governance, see Alesina *et al* (2003). The experimental evidence for Uganda in Habyarimana et al (2007) suggests that ethnic homogeneity facilitates coordination on public goods provision.

[29] On this see some references cited in Gorodnichenko and Roland (2013).

state capacity may not be easily transplanted in an alien cultural context.

An important but complicated question relating to the prevailing political coalition and hence the political capacity of the state, seldom discussed in this context, is its link with globalization, even apart from the usual constraints on state power in a global economy posed by volatile capital flows and international credit ratings. On the one hand, international competition and integration may strengthen domestic political accountability processes and make the political coalition somewhat more broad-based –- historically, Acemoglu, Johnson, and Robinson (2005) show that the rise of international trade in the Atlantic economies during the early modern period promoted a demand for institutional reforms; in more recent periods the European economic integration has been reported to have improved some governance institutions in Europe's southern and eastern periphery. On the other hand, much depends on the initial conditions, the type of goods internationally traded and the nature of political and economic competition. In many historical cases trade expansion in natural resource-intensive products (like oil, sugar, bananas, timber, diamonds), for example, has strengthened the political power of plantation elites and other large exporters who raised

domestic barriers to entry and promoted oligarchic dominance over the state.[30] More recently, globalization in the context of asymmetric international mobility of capital relative to labor has weakened labor organizations and practices in many countries and altered the political equilibrium in favor of capital[31]. The fall in customs revenue and capital taxes in a more open economy may also affect state fiscal capacity.

IV *Political Decentralization and Local Accountability*

There are trade-offs between commitment structures and accountability processes. Political centralization, for example, often leads to distant insulated bureaucracies that are insensitive to local needs and concerns and that fail to tap local information, initiative and ingenuity. The central government, of course, may also care about winning elections locally, but electoral sanctions are usually more effective at the local elections, than at national or even provincial elections, since at the latter forums multiplicity of electoral issues dilutes responsibility compared to the narrower agenda of local elections[32]. As opposed to the inter-jurisdictional

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[30] For a recent survey of these issues see Nunn and Trefler (2014), section 5.
[31] For a discussion of these issues see, for example, Rodrik (2011).
[32] See on this Seabright (1996).

encompassing advantage of centralization, there are many who argue for the local accountability and other advantages of decentralization—these include peer-monitoring, ease of citizen participation and relative transparency of decision-making and program benefits at the local level. Brazil now has a Participatory Budgetary (PB) process (with citizens' direct input in budgeting and investment priorities) in a substantial fraction of municipalities. From a panel dataset from all Brazilian municipalities over1990-2004, Gonçalvez (2014) show that municipalities adopting PB increased spending on health and sanitation significantly more than those that did not, and this already had sizeable effects on outcomes like infant mortality.

Contrary to the earlier fiscal federalism literature, the more recent literature[33] on decentralization and development has pointed out the political-economy and institutional issues (like

[33] We are somewhat cryptic in our discussion here of the growing literature, as we want to confine ourselves only to issues that are directly relevant in the contrast with the earlier discussion of political centralization that is supposed to be associated with better state capacity. The reader interested in more detail may refer to surveys of this literature in Bardhan (2002) and Mookherjee (2014), and to case studies from developing countries in different continents in Bardhan and Mookherjee (2006).

malfeasance, rent-seeking, shirking and absenteeism and other agency problems of governance) involved in political centralization. Decentralization also enables competition among regional governments for mobile private capital, which may keep them on their toes and off excessive rent extraction. In some developing countries—say, Brazil, South Africa and Indonesia-- decentralization has been an integral part of the democratic transition itself and has significantly affected the structure of subsequent development policy, particularly in the delivery of social services.

On the contrary, decentralized governance is often prone to local capture by a collusive elite (landed oligarchy in some agrarian contexts), proximity making collusion easier, as James Madison worried more than 200 years back in the *Federalist Papers*. The well-known safeguard in the fiscal federalism literature in the form of the Tiebout (1956) mechanism, by which fully informed and mobile citizens vote with their feet in response to differential public performance, is of limited applicability in the context of many poor societies (largely on account of various types of factor market imperfections). The

empirical literature[34] on capture suggests that the pre-conditions of local capture depend on

- **(a) initial social and economic inequality in the local area**
- **(b) degree of political competition in the area**
- **(c) how regular and well-functioning are the deliberative processes of local democracy (public hearings, town hall meetings, etc.)**
- **(d) how free is the flow of information about the functioning of governments , and about the entitlements and allocations at the local level---here the importance of information campaigns (and media exposure) about resources allocated to local governments and how they have been spent and audited (if there are provisions of periodic independent audits of accounts) are clear.**

Apart from trying to improve matters relating to (a)-(d), attempts at mitigation of the effects of capture have included political reservation of seats at local councils and their headships for disadvantaged social groups— like mandatory reservations for lower castes, tribes and women in India. There

[34] See, for example, Galasso and Ravallion (2005) for Bangladesh, Araujo *et al* (2008) for Ecuador, Ferraz and Finan (2009) for Brazil, Bardhan and Mookherjee (2010) for West Bengal, India, Bjorkman and Svensson (2010) for Uganda, and de Janvry *et al* (2012) for Brazil.

is now a growing empirical literature on its impact on targeting of benefits, starting with the papers by Chattopadhyay and Duflo (2004) which found significant positive effects of reservation of the position of village council head for women. The subsequent literature, including our own work—see Bardhan, Mookherjee, and Torrado (2010) and the literature cited there--has not confirmed this for the case of women, although there is evidence for political reservation for some ethnic minority groups in improving targeting of some benefits. Of course, even apart from immediate benefits targeting, the more important consideration may be that political reservation may have effects in empowering and confidence-building in potential leaders from disadvantaged groups over a longer period, as shown in the case of women by Beaman *et al* (2009). Bhavnani (2009) in an experimental study of the long-term impact of women's reservations in municipal councils in Mumbai finds that women's chances of winning ward elections were more than quintupled by reservations even in elections when the reservations were discontinued. The way to reconcile the contrasting empirical findings in this literature may be to recognize the initial handicaps the leaders from disadvantaged groups in reserved positions suffer from, particularly in terms of information, networks, contacts with higher-up authorities

and administrative experience, in all of which those leaders may gain over time and generate in themselves (and others) confidence in their leadership.

Apart from capture distorting local governance within a community, decentralization can also have more widespread adverse effects, if (a) regional competition leads to a 'race to the bottom'[35], provincial protectionism corroding the federal state, as has been the case in Russia immediately before Putin's centralization of power[36]--broadly similar accounts of rent extraction by provincial politicians in Argentina are available in Gervasoni (2010) ; or (b) if it accentuates regional inequality on account of varying local endowments and institutions and richer areas having more clout with authorities above who allocate resources[37]. In Bolivia and South Africa, however,

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[35] A different example of adverse effects of jurisdictional competition is given by Burgess *et al* (2012), who show evidence of how an increase in the number of political jurisdictions in Indonesian decentralization has been associated with increased deforestation.

[36] See, for example, Cai and Treisman (2004) and Slinko *et al* (2005).

[37] Galiani, Gertler, and Schargrodsky (2008) study the distributional effects of decentralization across municipalities on educational quality in Argentine secondary schools, and find that schools in poorer municipalities fell further behind, while those in better-off areas improved.

decentralization improved regional equality by improving the criteria of allocation of federal transfers to regions[38].

In many areas there is also a considerable gap between *de jure* and *de facto* decentralization. Higher level governments often devolve responsibilities for social services to the lower level, without corresponding devolution of funds or personnel—the notorious but frequent case of 'unfunded mandates'. In general the political and institutional context and the design and implementation of decentralization vary widely across areas, and it is not surprising that the limited number of empirical studies on the effects of decentralization in different developing countries show mixed results (even after accounting for the endogeneity of the decentralization decision). It is also the case that while in some matters local knowledge and information working in favor of decentralization are important (as in finding appropriate technology or in tapping indigenous natural and human resources), in other matters supra-local expertise is more important (for example, on issues like public health and sanitation, river systems or water quality or on curriculum development for schools or application of methods of

[38] See the chapters on Bolivia and South Africa in Bardhan and Mookherjee (2006).

monitoring like auditing). Agglomeration economies also work sometimes in draining away talent from local governments to central bureaucracies and professions, and so supra-local expertise may come to weigh more. Accordingly, comparative advantage of decentralization will vary from case to case and over time.

In the debates on centralization vs. decentralization it is important to note that China, a recent dramatically successful state in achieving high growth, has been in this respect a unique hybrid institutional case, with a high degree of political centralization, meritocratic recruitment and personnel control under an authoritarian Party, at the same time combined with a great deal of regional decentralization, competition and experimentation. Xu (2011) has described the system as 'regionally decentralized authoritarianism', in contrast with most authoritarian systems that are highly centralized. Particularly in the first two decades after economic reform started, decentralization has helped local business development in rural China through regional competition and a somewhat hard budget constraint enforced on failing local business enterprises. These were the essentials of the so-called market-preserving federalism—see, for example, Qian and Weingast (1997) and Qian and Roland (1998). But, as Rodden

and Rose-Ackerman (1997) have pointed out in a general critique of market-preserving federalism, the institutional milieu determines whether political leaders of a local government respond positively to highly mobile investors or instead pay more attention to the demands of strong distributive coalitions dominated by less mobile factors. It is possible that the highly egalitarian distribution of land cultivation rights following de-collectivization of agriculture in rural China meant that the local capture by oligarchic owners of immobile factors like land, familiar in many developing countries, was unimportant for China, at least in the initial years after reform.

But the Chinese authoritarian system without sufficiently independent sources of collecting information has from time to time made catastrophic mistakes (Great Leap Forward, Cultural Revolution, etc. in the past), and the lack of institutions of accountability makes course correction even in the case of lesser mistakes delayed and difficult. Similarly, the absence of checks and balances in China allows the tight political-business relations both at the central and the local levels to easily degenerate into massive corruption and abuse of power (resulting in recent years in high inequality, arbitrary land grabs, unsafe working conditions and food supply chains and

toxic pollution). There are also fewer checks on over-investment and excess capacity in state-controlled or politically connected firms. All this brings us to the general question of the relationship between democratic governance and development, an issue that has been prominent in the discussion on the comparative performance of the two largest developing countries, China and India[39]. In view of the clearly superior over-all economic performance of China compared to India over the last 3 decades or so, it has been the conviction of the elite in China as well as some outside China (often termed as 'the Beijing Consensus') that authoritarianism is good for development. As we discuss in the next Section, this is a false and pernicious generalization, but one should be careful in not jumping to the equally facile but opposite generalities about the unambiguously positive effects of democracy on development.

V *Democracy and Development*

The literature on democracy and development is by now large, and we want to wade into only a small part of it that is relevant

[39] For a detailed discussion of this relationship in the context of China and India, see Bardhan (2013), Chapter 10.

to our discussion of the trade-off between political centralization of power and accountability. I agree with Acemoglu and Robinson that economic performance crucially depends on political structures, but the political and the economic institutions may sometimes co-evolve and there may be strategic interactions between them which may not allow us to unambiguously privilege one over the other. In particular, the relationship between democracy or pluralism (politically 'inclusive' institutions in general) and development is actually rather complex, a complexity not captured in the usual cross-country regressions in the literature on the subject. As Durlauf (2005) and Brock and Durlauf (2001) indicate, the democracy-growth relation in these regressions is not robust, the identification strategies are not credible, and different papers in the literature have different results because of different choices of control variables and other forms of model uncertainty. For our present purpose what is important is that the regressions do not help us in understanding the mechanism in the complex process involved.

Democracy is, of course, slow but its deliberative and electoral processes manage social conflicts better and lend some stabilizing legitimacy to policy decisions that grow out of the

‘conditional consent’ of citizens[40]--- apart from enriching individual autonomy and freedom, participation and deliberation, which some would regard as an important part of development itself[41]. Democracy also tends to curb the excesses of capitalism and thus render development more sustainable, by, for example, encouraging social movements as watchdogs against environmental despoliation. To the autocrat power is too valuable to lose, and hence violence and the attendant potential shattering of economic stability and the social fabric are never very far off. It is also generally the case that the variance in economic performance is larger among autocratic regimes than among democratic ones, as the checks and balances in the latter weed out some of the worst leaders and outcomes[42].

On the other side, there are many cases of electoral democracies functioning without regular institutionalized procedures of accountability, and there are some obvious cases

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[40] This is emphasized by Levi (2006).
[41] See, for example, Sen (1999).
[42] This may not always be the case when weakly institutionalized democracies perform quite badly. On the other hand, even in the case of the best autocrats there is no inherent institutional guarantee that they will continue to be so.

of 'illiberal democracy'[43]. Even in liberal democracies accountability processes to the general public are seriously undermined by the influence of money protecting and promoting the interests of the wealthy and powerful. Besides, while in analogy with market competition political competition is usually assumed to be a good thing, there are cases, as we have noted before, when competition can lead to a race to the bottom[44]. Without political centralization political competition under democracy can encourage competitive populism or short-termism: come election time, Indian politicians, for example, often promise free electricity and water, which can wreck the prospects of long-term investments in them, or bank loan waivers for farmers, which can wreck the banking system. Many scarce resources are thus frittered away in short-run subsidies and handouts, which hurt the cause of long-run pro-poor investments (like in roads, irrigation, water and

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[43] For a popular-level discussion of these cases see Zakaria (2004). It also involves a definitional issue: in our judgment democracy should not be identified with just regular elections even where the incumbent has a chance of being defeated, but some accountability processes in day-to-day administration and respect for basic human rights should also be essential parts of the definition of democracy.

[44] This is related to the proposition in Persson *et al* (1997) that separation of powers can make citizens worse off by creating a common-pool problem in public decision-making.

electricity). Bates (2008) gives examples from Africa how competitive democracy could induce the ruling party to use its power to loot the public resources for short-term gain. Bardhan and Yang (2004) construct some models to show that while political competition can yield allocative benefits for the public, it can also generate aggregate welfare costs by constricting the set of politically feasible public investments. Of course, in social service delivery political competition can work better when executive action is easily verifiable (for example, verifiability in the lowering of school fees is easier than in the improvement of school quality). Consistent with this, Harding and Stasavage (2012) cite evidence that in Africa democracies have higher rates of school attendance than in non-democracies. Fujiwara (2014) finds that changes in voting technology in Brazil that enabled the political participation of the poor and the illiterate resulted in greater health spending and improved child health outcomes.

In some cases, instead of providing broad-based public goods, the political leaders can work out a clientelistic system for dispensing selective benefits (private or club goods) at least to a group of swing voters to win elections—anecdotes on this are easy to find, but for theoretical and empirical analyses of such systems, see Bardhan and Mookherjee (2012), and Robinson

and Verdier (2013). In a household survey in rural West Bengal Bardhan *et al* (2009) find evidence that voting behavior is significantly influenced more by recurring benefits arranged by local governments (like subsidized credit or agricultural inputs, employment on public works, help in personal emergencies, etc.) than by even large one-time benefits (like land reforms, or provision of houses and latrines), suggesting political clientelism. Also, in situations of social and ethnic heterogeneity where vote mobilization gets organized on sectarian lines, there may be more selective patronage distribution and less political interest in investing in general-purpose public goods. Wantchekon (2003) conducted a field experiment in Benin in which political candidates were persuaded to randomly vary their electoral platforms between a clientelistic program providing cash to specific ethnic groups and a developmental local public good oriented program—the former platform ended up generating higher votes. Such political clientelism, even while helping some poor people, can harm the cause of general pro-poor public investments. Fujiwara and Wantchekon (2013) cite some experimental evidence from Benin that shows how informed public deliberation in town hall meetings can reduce clientelism.

The incidence of clientelism may in general depend on the stage of development. As incomes rise and markets develop, the need for political connections for jobs or personalized help may decline (though rather slowly, as many cases in southern Italy suggest even now). With the spread of education and information, the importance of the local vote mobilizer who provides selective benefits (the proverbial ward captain in Chicago precincts) diminishes, herding of voters by ethnicity or regional affinity may also decline. With the development of transport and communication, the reduction of territorial insulation allows for supra-local affinities which may diminish the importance of the local patron.

Myerson (2013) has stressed how democratic decentralization can improve opportunities and incentives for local leaders to build reputation for using public funds responsibly, and may even reduce political entry barriers for them in national elections. Some of these reputation incentives linked with local development have been built into the career promotion schemes in China, even without democracy. In general, on the relation between political systems and development a great deal of institutional conditions and contingencies are involved, and under the circumstances it is easy to see that democracy (or the lack of it, for that matter) is neither necessary nor

sufficient for economic development. At the same time, going back to the China-India case, one cannot deny a basic comparative political feature related to the source of legitimacy. The pragmatic and professional Chinese leadership often show the ability to take quick and decisive actions more than the elected Indian leaders, but in the face of crisis or political shocks the former often over-react, suppress information and act heavy-handedly, which raise the chances of going off the rails or the danger of instability. For all their apparent messiness the Indian democratic governments are in a deeper sense less fragile, as they draw their strength from legitimacy derived from democratic pluralism.

VI *The Role of the State in Resolving Coordination Failures*

The institutional economics literature preoccupied with the capacity of the state to secure property rights leaves out a very important aspect of the necessary state capacity in early stages of industrialization, that of resolving coordination failures, which the early development literature used to emphasize. In this respect the East Asian state has been historically distinctive. East Asian growth was not simply a product of the state securing property rights and providing some market-

supporting institutions. Analogous to the 'varieties of capitalism' literature where Hall and Soskice(2001) pointed to the qualitative differences between Anglo-American 'liberal market economies' and the 'coordinated market economies' of Germany and Scandinavia, it may be important to bring out the varieties of developmental roles of the state in terms of liberal market support vis-a-vis coordination.

The large political sociology literature on the so-called developmental state of East Asia is suggestive and descriptive but—with exceptions like Evans (1995)-- not always analytically clear about the mechanisms involved. Aoki *et al* (1997) have more fruitfully described the deal between the state and large business conglomerates in South Korea and Japan as assuring some form of "cooperation-contingent rent" that will accrue to the latter in exchange of playing a role in the state coordination efforts. In this perspective[45], economic development in these countries was not founded just on institutions that secure property rights and enforce contracts—no doubt very important for long-term investment—but on a state that helped to foster coordination, particularly in financial markets in early stages of industrialization, facilitate

[45] This is consistent with the well-known 1993 World Bank Report on *The East Asian Miracle*.

interdependent investment decisions in orchestrated networks of producers and suppliers , establish public development banks and other institutions for long-term industrial finance, and nudge firms to upgrade their technology and move into sectors that fit with a national vision of development goals. Enabling and encouraging such coordination is fundamentally different from protecting property rights.

The recent literature on industrial policy has the virtue of recognizing this. But industrial policy has to be dissociated from the old-fashioned support for blanket protectionist policies, which are now particularly ill-suited to industries that can thrive only in the world of global supply-chain networks. Hausmann and Rodrik (2003) have emphasized that industrial policy should have less to do with the impossible task of 'picking winners'—the usual argument against industrial policy-- but more with a way of 'discovering' a country's range of potential comparative advantage in a coherent way in a world of uncertainties and missing information. There will be private underinvestment in any such discovery process, since the positive results are likely to be appropriated by others in the business. State involvement in helping and coordinating such exploration into new economic activities inevitably implies many trial-and-error experiments, some of which are

bound to fail. The main state capacity issue here is not that of picking winners but more of letting losers go, which is politically difficult, as we have discussed earlier on the question of soft budget constraints.

As with many other important development policy questions, the underlying issues involved here—capital constraints and credit market imperfections, learning spillovers, lumpy interdependent investments requiring coordination-- are easy to conceptualize but difficult to quantify[46]. On learning processes in new exportable activities there have been many case studies, even outside East Asia. Sutton (2012) shows how in the Indian (as in the Chinese) car industry within a few years after the arrival of international car makers, the domestic producers of car components in India attained 'world class' standards (as measured, say, by conventional defect rates in the parts supplied). The process involved the state at that time providing many kinds of support including local-content protectionism (which is, of course, now WTO-illegal). Sabel *et al* (2012) report many case studies of public-supported export pioneers from Latin America – for example, floriculture in Colombia, furniture-making and commercial aircrafts in Brazil,

[46] Rodrik (2008) discusses the difficulties involved in statistical inference on this topic, particularly when policy adoptions are endogenous.

avocados in Mexico, veterinary vaccines in Uruguay, etc.— where an ensemble of public support policies facilitated coordination, provided industry-specific public or club goods (say in the form of specialized services like technical assistance, help in meeting phyto-sanitary and other quality standards, etc.), and enabled export production activities to gain from substantial agglomeration economies in clusters of a large number of specialized firms. The studies also garner insights from 'counterfactuals' of failed efforts in broadly similar cases.

Of course, empirically, even careful case studies of export pioneers from developing countries suffer from replicability issues, apart from a frequent selection bias (successful cases surviving to get discussed). There is a sizeable empirical literature on 'learning by exporting', but much of it is marred by the possibility that more productive firms may select into exporting and by measurement issues in the absence of detailed firm-level performance data. A paper that is largely free of both problems is that of Atkin *et al* (2014), which, on the basis of a randomized control trial that generates exogenous variation in the access to foreign markets for rug-making firms in Egypt, finds substantial learning effects.

Harrison and Rodriguez-Clare (2010) have recommended a whole range of 'soft' industrial policies, not incompatible with WTO regulations (like encouraging R & D, extension services, vocational training, supporting collective action for self-help in business clusters, improving regulations and infrastructure, and so on), where the goal is to develop domestic policies of coordination that improve productivity more than interventions that distort prices. Aghion *et al* (forthcoming) cite panel data from medium and large Chinese enterprises over 1998 to 2007 to show that industrial policies targeted to competitive sectors or that foster competition (say, policies that are more dispersed across firms in a sector or measures that encourage younger and more productive enterprises in a sector) increase productivity growth. Further advances in the industrial policy literature have to explore the particular institutional combinations of domestic political coalitions and market structure and the design of particular policies which make the difference between success and failure, along with rigorous empirical and experimental studies to discern the link between policy and outcome.

In the near future the issue of state coordination may also become important in inducing investment in 'green' technology that reduces negative externalities, or, as some developing

countries graduate to the middle-income stage, in fostering frontier innovations[47] beyond the simple catch-up process (of learning and imitating off-the-shelf technology), or in finding some alternative[48] to the current intellectual property rights regime, which sometimes transfers too high a monopoly rent to the innovator, at the expense of poor consumers and future innovators trying to build on the current innovation.

Industrial policy is itself often suspected of generating rent-seeking opportunities. The emphasis on combining sectoral targeting with some form of market discipline is therefore necessary to curb excessive rent creation. But as Rodrik (2008) has pointed out, some amount of rent generation may be indispensable to preserve what he calls 'second-best' institutions, when first-best institutional rules or best practices are not feasible in the usual political-economy context of developing countries. If entrepreneurial activity is a binding constraint rents may provide dynamic incentives (as in some Schumpeterian growth models), or when the main challenge is

[47] In this context Aghion (2014) calls for a 'strategic state' that "acts as a catalyst using selective and properly governed support to the market-driven innovation process".

[48] Alternatives like the state buying the patent and putting it in the public domain have been suggested. This is, of course, subject to the arbitrariness and moral hazard in the pricing of the patent by the state.

to stimulate investment in a weak capital market rents sustained by moderate amounts of entry restrictions may provide the necessary finance. Acemoglu and Robinson (2013) show more generally how rents are often necessary for a balance of political power or preservation of a political equilibrium, and how insistence on first-best rules to eliminate rents may have unintended or counter-productive political consequences. In a somewhat different context North, Willis and Weingast (2009) consider the creation of rents as the key to controlling violence in what they call "limited access social order" often prevalent in developing countries. Particularly in weak or fragile states, where there is an 'oligopoly' of violence in contrast to the Weberian 'monopoly of violence' vested in the state, they consider rent-sharing as important in preserving order.

But rent-sharing as a way of political coalition-building can be and has been an important feature of the political equilibrium even in well-functioning states. The East Asian cases suggest that technological dynamism in large conglomerates has co-existed with rent-sharing, with political parties deeply implicated in rent-seeking (of which the Japanese LDP is an old

and durable example).[49] As we have mentioned before, it is possible that a long and continuous history of state institutions over many centuries that East Asian countries in general have, in contrast with those in Africa and Latin America, helps in building a bureaucratic culture, which along with a dense network of ties between public officials and private entrepreneurs, may moderate the excesses of rent-seeking. Possibly more importantly, the state-directed pressure of export success in an open economy in East Asia has disciplined these excesses and the need for cost and quality consciousness in global competition has kept collusion-prone firms and bureaucrats on their toes. In the absence of strict market discipline, there is plenty of evidence in developing countries of dysfunctional industrial policies with politically connected firms in kleptocratic states making money while the development process is atrophied.

[49] Even in early modern west European history, there are cases where patrimonial, rather than Weberian impersonal rule-bound, arrangements between ruling families, civil servants and merchant capitalists have been important in fostering the growth process—see Adams (2005) for an example from the 17th-century Netherlands.

VII *Public Enterprises and State Effectiveness*

As we have indicated in Section IV in recent decades the Chinese case has been distinctive in decentralized development, with local governments playing an active role not just in delivering social services, but in vigorously pursuing local business development, some of the most successful companies being run and funded by municipal governments. Even beyond the local level, the Chinese state has been remarkable in presiding over a reinvigorated model of what used to be called State Capitalism[50](where state-run or guided enterprises pursue profits or surplus). In recent years we have seen aspects of it in Brazil and Russia as well, but nowhere as prominently and in as large a scale as in China. Large state-owned companies (SOE's) dominate in transport, energy, basic metals, finance and telecom in China. Some of the Chinese SOE's are now important players in the global market competition. They are often highly commercialized: in recruiting professional managers, broadening their investor base, and shedding their earlier bloated labor force and traditional social and political obligations, many Chinese SOE's do not conform to the usual stereotypes about SOE's. Their listing in foreign stock

[50] This term originated in its negative use by anarchists and other socialists, but with more positive use by Lenin and his followers.

markets often subjects them to international rules of corporate governance. There are also some successful Chinese private companies (Lenovo, Huawei, Haier, Geely, Alibaba, etc.), heralded as national champions, but they often operate in the shadow of the state, with the state if not owning shares actively guiding and helping them. The state-owned or supported companies have the advantage of deep pockets to back them or easier access to bank loans and land, usually can take a longer-run perspective compared to most purely private companies (that are anxiously watching short-run share prices and quarterly earnings reports), and can ride the business cycle a bit better. On the other hand, their profitability is often based on monopolistic power[51] and political connections (giving rise to the frequent charge of crony capitalism); they may thrive in the catch-up phase of development, but some -–for example, Acemoglu and Robinson (2012)-- doubt if they will perform when it comes to innovations and 'creative destruction'.[52]

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[51] Li, Liu, and Wang (2012) suggest that the Chinese economy is largely dualistic in a vertical economic structure, with the state deriving profits and political rent from its monopolistic control in the upstream sectors that provide capital and inputs and services to the successful downstream largely private (including joint-venture) or hybrid sectors.
[52] A 'collectivist' culture encouraging conformity, rather than creativity, may also be not very conducive to innovations. For general evidence on

This raises a general question about the relation between large conglomerates (private or public) and different types of innovations. The role of these large organizations in stimulating R & D and the innovation process may vary depending on the type of innovation one has in mind, whether it is of the 'disruptive' kind that challenges incumbent firms (which the US private innovators in collaboration with venture capitalists are good at and a large entrenched organization usually isn't), or the steady 'incremental' kind which adds up to significant gains (the Japanese call it *kaizen*) which some large organizations in Germany and East Asia have excelled in. It is, of course, hard to deny that in both kinds of innovations in most countries some form of background (if not always pro-active) support of the state has been significant. But there is always a danger that too-big-to-fail organizations (private or public) may ultimately turn into rental havens.

Without more empirical studies, not just anecdotes, this debate about innovations under State Capitalism is difficult to settle. Ernst and Naughton (2012) cite examples of new directions of

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the positive link between 'individualist' culture and innovations, see Gorodnichenko and Roland (2013). This may also suggest that in collectivist societies the state may have a special role in stimulating individual creativity and innovation. But if the state is autocratic, it may dampen the creative and free spirit often important for innovation.

Chinese innovations from the integrated circuit design industry. Away from the government-sponsored attempts at 'indigenous innovations', China seems to be more successful in innovating in areas that involve global technology sourcing and quickly responding to changes in the increasingly fine divisions of the global value chain. At the same time there is evidence to believe that large SOE's and politically-connected private firms in China may have spawned a serious misallocation of capital (and managerial talent) and build-up of excess capacity. Such misallocation may have more bite in future as Chinese saving and investment rates (as well as the unpopular land grabbing by the state) come down. Meanwhile entrenched vested interests of the political elite with stake in incumbent firms may make resistance to change stronger.

Finally, it should be stressed that in general the performance of state enterprises in any country is often discussed in the literature in a kind of political and organizational vacuum and in terms of a single and simple metric of narrowly-defined efficiency. Questions like the relative efficiency of delivery of public services by state or private organizations abound in the public economics literature. Standard comparisons of efficiency of firms are often vitiated by frequent cases of private monopoly substituting for public monopoly after privatization,

or by political agenda and soft budget constraints for public firms replaced by regulatory capture by private firms. Still, much of the empirical literature[53] shows superior efficiency of private firms, whereas the literature on privatization of public utilities gives mixed results[54]. In building infrastructure public-private partnerships (PPP's) are increasingly in vogue. While these may usefully harness the services of profit-seeking private finance and expertise, in actual cases quite often the downside risks are on the public sector either through opportunistic renegotiation of terms or bad loans in public sector banks which the tax payers have to re-capitalize. Acemoglu and Robinson (2013) emphasize the political consequences of privatization: well-intentioned efficiency-minded privatization programs sometimes upset old rental and political arrangements and may be counter-productive. An

[53] There are quite a few survey articles; see, for example, Parker and Kirkpatrick (2005). *JEL* published an overview on the effects of privatization in transition economies by Estrin *et al* (2009).

[54] For example, in privatization of water supply, Galiani, Gertler and Schargrodsky (2005) show in a panel data framework that in Argentine municipalities where water services were privatized, there is indirect evidence that access and water quality improved. Using an almost similar method, Borraz *et al* (2013) find direct evidence that nationalization of water companies in Uruguay, after a period of privatization, delivered progress in terms of both access and water quality relative to companies that were consistently publicly owned.

obvious example is in the case of the political consequences of Russian privatization in the 1990's --redistributing assets extremely unequally in favor of a plundering oligarchy, the backlash to which paving the way for Putin's authoritarian crony-capitalist regime.

There are also organizational counterfactuals to which the public sector reform debates often do not pay enough attention. In assessing the inefficiency of a public utility, for example, we have to keep in mind the simultaneous and conflicting objectives it is required to serve (like cost recovery, cross-subsidization as in the case of commercial freights vis-à-vis passenger fares in railways, providing cheap service to the weaker sections of the population and remote areas, etc.). In such a usual context of multiple mandates, multi-dimensional goals, conflicting political principals facing agents, multiplicity of tasks and imprecisely measured and incompletely contractible outcomes that such an agency often faces, all of the inefficiency of the state agency may not be 'remediable' in the sense of Williamson (1996) in a simple way by alternative organizational devices like the market or the private firm. As Dixit (2012) has argued, while state agencies obviously have some crass inefficiencies (particularly when budget constraints are politically 'soft') remediable by organizational reforms and

incentive designs, they are often called upon to undertake functions that are too complex for the private sector to perform. Privatizing these functions may even make things worse, as private firms are not capable of coping with the transaction and governance costs of the complex and multi-dimensional issues that state agencies must handle. Hart, Shleifer and Vishny (1997) give an example from the issue of prison privatization to make the general point that when a government contracts out a service to a private provider the non-contractible aspects of the service quality are likely to suffer. The dilemma in public sector administrative reform is that in the context of multi-dimensionality of goals and tasks it is difficult to devise high-powered incentive contracts for civil servants; on the other hand, with low-powered incentives they are prone to corruption and capture by special interest groups.[55]

VIII *Concluding Comments*

In general, different types of governance mechanisms are appropriate for different tasks. Take the general task of

[55] For a discussion of incentive and organizational reforms to fight corruption, see Bardhan (2005), chapter 8.

coordination. Economies at early stages of development are beset with coordination failures of various kinds, and alternative coordination mechanisms—the state, the market, the community organizations-- all play different roles, sometimes conflicting and sometimes complementary, in overcoming these failures, and these roles change in various stages of development in highly context-specific and path-dependent ways. To proclaim the universal superiority of one coordination mechanism over another is simplistic and ahistorical. Markets are superb coordination mechanisms in harmonizing numerous non-cooperative interactions, in disciplining inefficiency, and in rewarding high-valued performance. But when residual claimancy and control rights are misaligned (say, on account of initial asset ownership differences that constrain contractual opportunities) and there are important strategic complementarities in long-term investment decisions, markets fail to coordinate efficiently. In particular, the implications of 'imperfections' and contract 'incompleteness' in credit and insurance markets are severe for the poor, sharply reducing a society's potential for productive investment, innovation, and human-resource development. The state can provide leadership (and offer selective incentives and disincentives) to stimulate individuals to interact cooperatively

in situations where non-cooperative interactions are inefficient. But the state officials may have neither the information nor the motivation to carry out this role. They may be inept or corrupt, and the political accountability mechanisms are often much too weak to discipline them. We thus need a whole variety and intermixture of institutional arrangements to cope with the strengths and weaknesses of different coordination mechanisms, and the nature of optimal intermixture changes in the development process.

The purpose of this essay has been to bring out some of the complexities that are overlooked in the usual institutional economics literature and supplement the latter with a discussion of some of the alternative approaches to looking at the possible developmental role of the state-- particularly involving resolution of coordination failures and collective action problems, the conflicting issues of commitment and accountability and the need for balancing the trade-offs they generate, some ingredients of state capacity and political coalition-building usually missed in the literature, the advantages and problems of political centralization and decentralization, the possible importance of rent-sharing in a political equilibrium, and the multi-dimensionality of state

functions which may not be addressed by markets or private firms.

The exploration of these problems suggests several under-researched areas in the literature, and we end with a brief enumeration of only a small subset of them.

(a) The literature is as yet in its infancy in understanding the forces and motivations behind formations of political coalitions and different kinds of elite bargains in different historical contexts. Not merely should the theory be linked up with the general literature on coalitions[56], but more empirical analysis and historical case studies on formation and breakdowns of political coalitions will be valuable. The declining role of organizations of unskilled labor in political coalitions, given the nature of technological progress and globalization in recent years, and its impact on state policy and (the already weak) welfare regimes in poor countries is a neglected area that needs to be discussed in this context.

(b) The theory of collective action and its various determinants need to be far richer than the free-rider issues emphasized originally by Olson (1965). For

[56] See, for example, Ray and Vohra (2014).

example, collective action may break down if there is a bargaining impasse on the perceived fairness of distribution of gains among different groups, and this and other distributive conflicts are likely to play a role in the political coalition formation issues mentioned in (a).

(c) As we have noted in the context of industrial policy in Section VI, more empirical and experimental studies are needed in understanding the precise link between policy and outcome, and a better insight into the particular institutional combinations of domestic political coalitions and market structure and the design of particular industrial policies.

(d) As indicated in Section VII, the relation between large public firms and the innovation process particularly in medium-income developing countries is a relatively unexplored research area. We do not have yet enough empirical studies in those countries on how entrenched incumbent firms hinder the innovation process or how the incremental innovations associated with those firms (particularly if there is workplace democracy encouraging exchange of ideas between workers and managers) can delay the set-in of diminishing returns in technological advance.

(e) Similarly, the experience in the many recent cases of public-private partnerships in large infrastructural projects needs to be critically examined, in the light of initial enthusiasm and recent onset of disillusion in some cases.

(f) In the discussion of political accountability the original hope from decentralization and devolution of power tried in many developing countries has faded somewhat on account of the various capture and dysfunctionality issues raised in Section IV. The empirical findings are mixed, primarily because the political and institutional context of decentralization and hence the design and implementation of devolution projects are widely divergent. It is time we dig a little deeper and try to decipher from micro empirical and experimental studies if there are any patterns in the jumble.

(g) An important, yet largely unresolved, issue is to find clear directions from empirical data about when democratic processes lead to long-term investments in public goods serving the poor and when they instead degenerate into short-term populism and clientelistic patronage distribution.

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