

# The Importance of Effective States: State Capacity and Economic Development

Author: Sam van Noort

## Summary:

In my thesis I challenge the currently most dominant theory in development economics and revise the ongoing debate on which institutions are most important for enhancing economic growth.

The existing development literature is limited to examining the effect of political institutions that constrain political executives to decide upon policy without institutionalized checks-and-balances (i.e. despotic state power).<sup>1</sup> In contrast I study the effect of institutions that *empower* state executives to implement policy effectively *after* policy has been decided upon in the political process (i.e. state capacity).

My key finding is that institutions that generate state capacity are substantially more important for economic development than those institutions that constrain the despotic power of state executives.

## Research and policy implication:

The thesis makes both scientific and policy contributions. It is a first attempt to examine the independent effect of state capacity relative to institutions constraining the despotic power of state executives. It is among the first three papers to study the effect of state capacity on economic development in a large sample of countries, the first to explicitly model the causal mechanisms through which state capacity might affect economic development, and the first to do this with the new and more precise measure of state capacity generated by the World Justice Project.

The thesis also opens a new debate about the causes and effects of private property rights security. In the literature, private property rights security is seen as central to explaining cross-country differences in economic development, and private property rights insecurity itself is claimed to be caused by (the risk of) state expropriations by despotic state executives. In sharp contrast, I find that state capacity explains most of the variation in the security of private property rights and that the net effect of private property rights security on GDP per capita PPP is weak after controlling for state capacity.

For policy makers, the results of this study highlight the importance of investing in the capacity to implement policy effectively rather than (only) focusing on accountability initiatives that help constrain the power of political executives but do little to increase the effectivity of law enforcement and public good provision.

## Empirical approach and results:

The conclusions described above are derived from several multivariate regression models (across countries) that I employ in order to compare the effect of state capacity with the effect of institutions

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<sup>1</sup> Existing studies focus, for example, on: to what extent courts function independent of the government, the extent to which there exist regular free and fair elections, and the extent to which most (important) legislation is produced by an independent parliament rather than by the executive branch itself.

that constrain the despotic power of state executives.

In order to do this I combine various datasets for the operationalization of key concepts. I measure despotic state power by the “constraints on the executive” and “competitive elections” variables of the Polity IV Regime Authority Characteristics and Transitions Database; which are the preferred measures in the existing literature (Acemoglu and Johnson, 2005).

I operationalize state capacity in two ways. First, I use the “effective enforcement” variable of the World Justice Project. This variable is generated through citizen surveys, triangulated by expert assessments, which ask respondents what typically happens in several real-life scenarios of law violations (such as tax evasion, demand for illegal payments in exchange for goods and services, disregard for safety regulations by an employer, and business activity without the required documentation). This variable measures directly to what extent a state enforces its law effectively, or rather if individuals/ companies generally remain unpunished after breaking the law. Second, I follow Lieberman (2002) by operationalizing state capacity through income, profit, capital and property tax as a percentage of GDP. Contrary to other types of taxes these require extensive monitoring and enforcement throughout the states’ territory and provide societal actors with significant opportunities to free ride, as such this type of tax extraction is the most demanding test for state bureaucracies to enforce its rules upon society.

Using ordinary least square regression models I find that the effect of state capacity on GDP per capita PPP, the Human Development Index and child mortality rates is several times larger than the effect of institutions that constrain the despotic power of state executives. I also find the effect of state capacity to be larger than other commonly expressed explanations for economic development. The effect is, for example, 1.5 times as large as latitude, 5 times as large as generalized trust and almost 2 times as large as ethnic factionalism. Both operationalizations of state capacity yield the same conclusion, which adds to the validity of the results given that both measures are unlikely to share biases in common.

Moreover, I establish empirically that the effect of state capacity is mediated through four causal channels: the security of private property rights (which is far more strongly associated with state capacity than with constraints on the executive), human capital accumulation, technological innovation and public infrastructure quality. The findings are robust to over 130 control variables, different model specifications and several sample restrictions. Evidence from instrumental variable regressions suggests that the association is not driven by reversed causality or omitted variable bias.

## **References:**

- Acemoglu, D. and Johnson, S. (2005) “Unbundling Institutions” *Journal of Political Economy*. Vol. 113(5): 949-995.
- Lieberman, E.S. (2002) “Taxation Data as Indicators of State-Society Relations: Possibilities and Pitfalls in Cross-National Research.” *Studies in Comparative International Development*. Vol. 36(4): 89-115.