State and Development: The Need for a Critical Reappraisal of the Current Literature

By

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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.

This talk will focus on aspects of state-related development that are overlooked or under-emphasized in the now-dominant tradition. In particular we shall talk about
• some of the internal contradictions in the different ingredients of the recommended state imperatives in that tradition

• inadequacies of the whole approach in understanding and interpreting historical cases of effective states outside the West (for example, in East Asia)

• the manifold ingredients of state capacity that are being discussed in a recently growing literature

• the key debate on the role of political centralization vs. decentralization in the studies on state effectiveness to deliver public services

• complexities in the relationship between democracy and development

• a relative neglect in the literature of the differential role of the state in providing different types of public goods and services, and an insufficient appreciation of the complexity of tasks that state agencies face, compared to those by private firms and markets.
Much of the analysis in this talk will be comparative and historical-institutional.

Although we shall 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 (particularly in those with cross-country regressions).

I 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.

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

Besley and Persson (2011) take a closely related approach.
**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).

It is also possible that economies in their most successful phases have less social and political conflict (most groups are doing well without political exertion, and the few losing groups are placated with subventions) and that therefore their governments have an appearance of ‘strength’; their policies are not challenged or reversed by political action. This may give rise to a kind of selection bias.

A search of the literature suggests two (somewhat overlapping) components of a definition of strength, which may not be 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” their political and economic institutions are, and political centralization is one of their essential inclusive political institutions.

Some econometric evidence from different African polities on the positive impact of historical measures 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. 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 $\tau$ 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 $\tau$ 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 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 \(\tau\) and \(G\), subject to \(L = L^* (\tau, G)\).

From the first-order condition of maximization with respect to \(\tau\) 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 interventions (creating distortions in the process of generating rent for the lobbying groups), as the institutional economists usually emphasize.

But they do not usually note that by the same logic, the ‘soft’ state will have too little of the desirable interventions (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.

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 can degenerate into a geriatric protection lobby.
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.

A closely related 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—Dewatripont and Maskin (1995).
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 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 our earlier principal-agent ruler-ruled model. 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 $\tau$ —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.
As we have mentioned before, the institutional economics literature emphasizes that the state should have enough constraints on its powers so that private property rights are secure from its ‘grabbing hand’, 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

Apart from securing property rights from undue state encroachment, these checks and balances may also limit the state’s attempts at pushing for narrow-based or particular group-favoring programs, according to Besley and Persson (2011).
They 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), and weak states are described as having rather weak constraints on the ruling groups to supply these common-interest services.

In the burgeoning literature on state capacity different writers have emphasized different aspects.

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 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 millennia).
It shows that among developing countries this index is much lower for sub-Saharan 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).

It is useful to classify the different types of state capacity, as Conlick (2013) has done: technical, organizational and political.

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.
Political capacity is also linked with the ability to form ‘social pacts’ among important political stakeholders. The apparent weakness of state capacity in India is more a symptom of the underlying political difficulty of organizing any collective action for the long term, not because the country lacks administratively capable people. Consistent with the theory of collective action, India’s large heterogeneous population, fragmented polity, and high social and economic inequality make it hard to agree on common goals and, even when the latter is achieved, to get its act together in pursuit of those goals.

III  A critique of the dominant institutional view

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 inclusiveness in important respects.

Secondly, and a related point is that there is actually a potential contradiction between those two key political institutions stressed by Acemoglu and Robinson. Centralization and pluralism can be in contradiction with one another. Pluralism, encouraging diversity of goals and interests, can inhibit centralization and 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 participation, may not always secure the property rights of the few against encroachers and squatters or high taxes. Similarly, in the world of Besley and Persson (2011) all good things go together (like pluralism and security of property rights), and thus they ignore the possible tension between those factors.

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.
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.

One might say that the central government also cares about winning locally, but electoral sanctions are usually more effective at the local elections, than at national or even provincial elections, where multidimensionality of electoral issues dilutes responsibility.

As opposed to the inter-jurisdictional 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 over 1990-2004, 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 on decentralization and development has pointed out the political-economy and institutional issues involved in political centralization (like malfeasance, rent-seeking, shirking and absenteeism and other agency problems of governance).

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 other hand, 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.

(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 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 capture distorting local governance within a community, decentralization can also have more widespread adverse effects,

- if regional competition leads to a ‘race to the bottom’, provincial protectionism corroding the federal state, as has been the case in Russia immediately before Putin’s centralization of power --broadly similar accounts of rent extraction by provincial politicians in Argentina are available in Gervasoni (2010)
- or if it accentuates regional inequality on account of varying local endowments and institutions and richer areas having more clout with authorities above who allocate resource — Galiani et al (2008) show this in the case of Argentine secondary school quality. In Bolivia and South Africa, however, decentralization improved regional equality by improving the criteria of allocation of federal transfers to regions.
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**.

China, a recent dramatically successful state in achieving high growth, has been a somewhat unique 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.

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 accountability processes makes course correction 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). This brings us to the general question of the relationship between democratic governance and development.
I agree with Acemoglu and Robinson that economic performance crucially depends on political structures, but 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, no matter how clever the identification strategy applied is.

Democracy is slow but its deliberative and electoral processes

- manage social conflicts better
- lend some stabilizing legitimacy to policy decisions that grow out of the ‘conditional consent’ of citizens, that Levi (2006) emphasizes
- enrich individual autonomy, freedom (which Sen (1999) would regard as an important part of development itself), deliberation and participation
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.

On the other hand,

- There are many cases of electoral democracies functioning without regular institutionalized procedures of accountability, and there are some obvious cases of ‘illiberal democracy’.
- Even in liberal democracies accountability to the general public is often undermined by the corrosive influence of money in the political process.
- In analogy with market competition political competition is usually assumed to be a good thing. But there are cases, as we have noted before, when competition can lead to a race to the bottom.
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 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.
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).

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, a great deal of institutional conditions and contingencies are involved, and one can say that in general democracy (or the lack of it, for that matter) is neither necessary nor sufficient for economic development.
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 danger of instability. For all its 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 on 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.
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.

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, among other things, the state at that time providing 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, 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 self-selection bias. 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 recent 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. The issue of state coordination may also become important in future

--in inducing investment in ‘green’ technology that reduces negative externalities

--as some developing countries graduate to the middle-income stage, in fostering genuine innovations beyond the simple catch-up process (of learning and imitating off-the-shelf technology)

--in finding some alternative 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
The question about the appropriateness of large organizations (under state or private conglomerate leadership) in stimulating R & D and the innovation process has currently assumed importance in East Asian development (including in China).

The role of these large organizations 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 that some large organizations in Germany and East Asia have excelled in.

But there is always a danger that too-big-to-fail organizations (private or public) may turn into rental havens. It’ll, however, be hard to deny that in both kinds of innovations some form of background (if not always pro-active) support of the state has been significant.
Industrial policy is 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 necessary 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, or when the main challenge is 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.
State capacity and efficacy, of course, vary enormously across levels, regions, and functions of a government. As, for example, we have discussed in the section on Decentralization, there are some activities in which local governments can have comparative advantage over the central government; on the other hand, local collusive political practices can infect governance in remote villages and small towns much more than in national headquarters that are subject to more public scrutiny and media exposure, apart from the usual agglomeration factors draining talent away from local governments to central bureaucracies and professions.

In recent decades the Chinese case has been distinctive, with local governments playing an active role not just in delivery of social services, but in vigorously pursuing local business development, some of the most successful companies being run and funded by municipal governments.
The Chinese state, even beyond the local level, has been remarkable in presiding over a reinvigorated model of what used to be called State Capitalism. 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 markets often subjects them to international rules of corporate governance.

There are also some successful private companies (Lenovo, Huawei, Haier, Geely, etc.), heralded as national champions, which 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 and political connections (giving rise to the frequent charge of crony capitalism); they may thrive in the catch-up phase of development, but may wither when it comes to innovations and ‘creative destruction’.

This goes back to our discussion above on large conglomerates (private or public) and different types of innovations. Without more empirical studies, not just anecdotes, this debate is difficult to settle.
Finally, the performance of state enterprises 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, political agenda and soft budget constraints for public firms replaced by regulatory capture by private firms, etc. Still, much of the empirical literature shows superior efficiency of private firms, whereas the literature on privatization of public utilities gives mixed results.

Moreover, as Acemoglu and Robinson (2013) emphasize, well-intentioned efficiency-minded privatization programs sometimes upset old rental and political arrangements and may be counter-productive. 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-- are an obvious example.

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 Oliver 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 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.
In general, different types of governance mechanisms are appropriate for different tasks. Take the general task of 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 naïve, futile, 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. 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 individuals interacting 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 of institutional arrangements to cope with the strengths and weaknesses of different coordination mechanisms.
To recap, the purpose of this talk 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
- the diverse ingredients of state capacity
- 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.

Clearly, there is no unified theory here, 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”.