Explorations in Economic History 64 (2017) 1–20

Contents lists available at ScienceDirect

Explorations in Economic History

journal homepage: www.elsevier.com/locate/eeh

States and economic growth: Capacity and constraints☆

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ARTICLE INFO

JEL classification:
O10
O43
N40
H10

Keywords:
State capacity
Economic history
Fiscal capacity
Legal capacity
Rule of Law

ABSTRACT

State capacity has become one of the most discussed concepts in development economics and political economy. In this survey we argue that the study of economic history provides vital insights into the process through which modern states have acquired 'state capacity'. By evaluating the process of state building across a range of different countries in Europe and Asia, we are able to 'decompress' the relationship between state capacity and economic growth. Our analysis emphasizes the variegated nature of the state building process. We focus on recent research that helps to elucidate the mechanisms that relate state capacity to economic growth.

1. Introduction

Today's richest countries possess both sophisticated market economies and powerful, centralized, states. In contrast, the poorest people in the world tend to live in regions with dysfunctional markets and weak or failed states. This divergence between wealthy societies with strong states and poor economies with weak states is a comparatively recent phenomena. As late as 1800, the majority of the world's population lived in poverty and political authority across most of the world was dispersed and fragmented.

Since 1800, the developed world has experienced a twin revolution. Living standards in rich countries today are unimaginable to a person living in the premodern era. The average individual in the developed world is between 10 and 15 times richer than his ancestors. Alongside this unprecedented increase in wealth, the transformation in the scope and scale of the state has also been remarkable. OECD countries today tax between 20–40% of GDP. By contrast, preindustrial societies rarely succeeded in taxing more than 5% of GDP.

Recent scholarship in both political economy and development economics has emphasized the importance of state capacity in explaining why some countries have succeeded in achieving economic development whereas others have not. This literature points to the role of state capacity in explaining the durability of institutions that are both conducive to markets and to economic growth. It has been established that the richest countries in the world are characterized by long-lasting and centralized political institutions (Bockstette et al., 2002; Chanda and Putterman, 2007; Borcan et al., 2014; Besley and Persson, 2009, 2011, 2013; Dincecco and Kat, 2014); that poverty is particularly widespread and intractable in countries that lack a history of centralized government (Herbst, 2000; Gennaioli and Rainer, 2007; Michalopoulos and Papaioannou, 2013) and are internally fragmented (Michalopoulos and Papaioannou, 2014); and countries with weak state capacity are particularly vulnerable to civil war and internal conflict (Blattman and Miguel, 2010; Besley and Persson, 2011). This literature recognizes both that predatory behavior by states is frequently a cause

☆ We'd like to thank Hans Joachim-Voth, Tuan-Hwee Sng and John V.C. Nye for helpful comments and conversations. Some of the material in Section 4 appears in another paper authored by Johnson entitled 'Taxes, National Identity, and Nation Building: Evidence from France'.

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http://dx.doi.org/10.1016/j.eeh.2016.11.002
Received 1 December 2015; Received in revised form 12 July 2016; Accepted 29 November 2016
Available online 19 December 2016
0014-4983/

of economic stagnation and that well-functioning states can provide the institutional framework necessary for sustained economic growth.

State capacity describes the *ability* of a state to collect taxes, enforce law and order, and provide public goods. As a concept, it has its origins in the work of political scientists and fiscal sociologists (Tilly, 1975, 1990; Skocpol, 1985; Mann, 1986; Ertman, 1997) who in turn built on a tradition in German scholarship associated with Otto Hintze and Joseph Schumpeter.[1] More recently, it has also entered the lexicon of development economists, international agencies, and mainstream economics (for a recent survey, see Bardhan, 2015).[2] This essay seeks provides a historical analysis of the rise of high-capacity states in Europe and the rest of the world. It further aims to better understand the relationship between state capacity and the emergence of modern economic growth.[3]

Understanding economic history is critical for comprehending the importance of state capacity. In historical terms, the emergence of well functioning states is a relatively recent phenomenon. For many premodern polities, even the term state is an anachronism: there was no state in much of Europe prior to the late middle ages. Otto Heinze observed that feudal rulers 'lacked the attributes of sovereignty—that is, independence beyond its borders and exclusive rights within them' (Hintze, 1906, 1975, p. 192). In medieval Europe, characterized by fragmented political authority, overlapping and competing legal jurisdictions, and private armies—the modern concept of a state—has little empirical purchase (Strayer, 1970). The word 'state' only came to acquire its modern meaning in English at the end of the sixteenth century (Skinner, 2009). This was not merely a semantic change; when 'the word 'state', *l'etat, stato*' or *Der Staat* came into usage in the early modern period it was 'a word for a new political experience' (Oakeshott, 2006, p. 361).

State capacity can be thought of as comprising two components. First, a high capacity state must be able to enforce its rules across the entirety of the territory it claims to rule (legal capacity). Second, it has to be able to garner enough tax revenues from the economy to implement its policies (fiscal capacity). State capacity then should be distinguished from either the size or the scope of the state. A state with a bloated and inefficient public sector may be comparatively ineffective at implementing policies and raising tax revenues. Furthermore, historians agree that the eighteenth century British state had high state capacity even though it played a very limited role in the economy. Similarly, state capacity requires a degree of political and legal centralization, but it should not be identified with political centralization *per se*. The rulers of feudal society in which many legal and fiscal choices were devolved to local lords indeed had low state capacity. But the concentration of political authority in the center may cause inefficiencies and thereby undermine state capacity (Oates, 1999). As Weingast (1995), argues, federalized states have provided conducive environments for both effective governance and economic development.

We begin by surveying the history of state development first in early modern Europe and then in other parts of the world (Section 2). The path to high state capacity was different in different parts of Europe and we argue that these differences had important implications for subsequent economic and political developments. In East Asia, the failure of imperial China to invest in state capacity led in part to the economic and political disasters China experienced between 1850–1950, while the comparatively higher level of state capacity in Tokugawa Japan set the stage for that country's successful program of modernization and economic growth. Meanwhile many of the problems that beset sub-Saharan Africa can be traced to weak and fragmented states.

Having established a correlation between the rise of state capacity and modern growth in Section 2, in Section 3, we evaluate possible causal mechanisms linking state capacity with modern economic growth. We provide several historical case studies in which the rise of more effective states in early modern Europe lead to greater market integration, better enforcement of the rule of law, and to the establishment of a common national identity.

In Section 4, we explore what factors have enabled some societies to successfully build effective states. We connect the economic history literature on state capacity with the literature on the deep determinants of development. One insight from recent research on the deep determinants of sustained economic growth is that both geography and population level characteristics, such as the level of human capital or the degree of ethnolinguistic fractionalization, are important predictors of development and the effectiveness of political institutions. Finally, in Section 5, we conclude by pointing out areas for future research.

2. Different paths to the modern state

Recent work by Besley and Persson (2011) has drawn attention to an important correlation between per capita GDP and measures of state capacity, usually defined as per capita tax revenues. This positive correlation is robust and holds over a wide range of definitions of 'state strength'. This finding is part of a wider reappraisal of the concept of state capacity. For example: Acemoglu et al. (2014, p. 1) note that '[i]t is *now* widely recognized that the weakness or lack of 'capacity' of states in poor countries is a fundamental barrier to their development prospects. Most poor countries have states which are incapable or unwilling to provide basic public goods such as the enforcement of law, order, education and infrastructure'.

This new emphasis on state capacity developed out of the widespread acknowledgement that economic and political institutions

[1] See the essays collected in Hintze (1906, 1975) and Schumpeter's classic essay which distinguished between medieval domain states and the modern tax state (Schumpeter, 1954, 1918). The seminal survey of the history of the state by Finer (1999a,b,c) also deserves acknowledgement.

[2] The concept of state capacity first attracted attention from development scholars in the context of the debate concerning the role played by 'developmental states' in East Asian economic growth (see Wade, 1990; Haggard, 2004). Alongside there theoretical contributions of Besley and Persson (2009, 2010, 2011) there are some other theoretical contributions to this nascent field including McBride et al. (2011) and Herrera and Martinelli (2013).

[3] Relatedly, Dincecco (2015) surveys recent work on the rise of effective states in Europe. Philip Hoffman's Presidential Address to the Economic History Association also calls for economic historians to focus on questions of how politics shape economic outcomes, observing 'we still know too little about what determines the laws, regulation, and policies that states adopt or what goods and services they furnish' (Hoffman, 2015a, p. 305).