

14.773 Political Economy of Institutions and  
Development.  
Lectures 6 and 7: Weak States and State Building

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February-March 2025

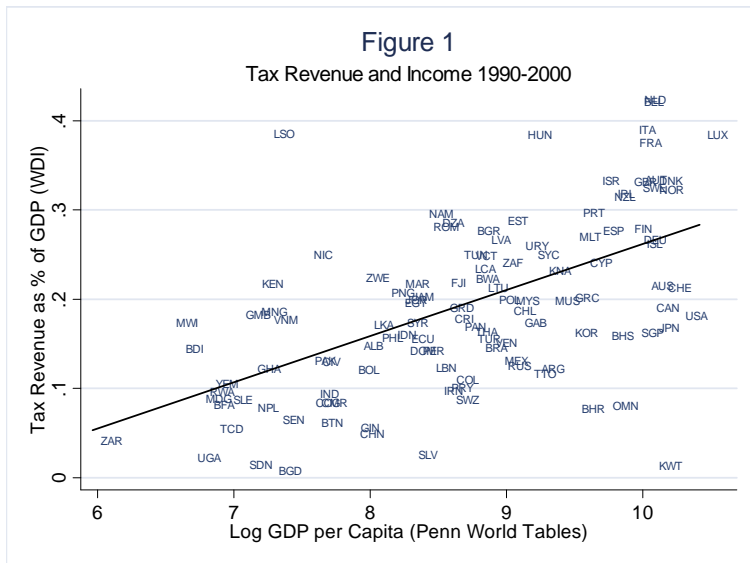
# Introduction

- A simple reading of the model/ideas so far would suggest that when states have less power to tax or interfere in economic activities, then there will be fewer political economy distortions and better economic outcomes.
- However, as we will next see, “weak states” are generally associated with worse economic outcomes.
- In fact, many of the ideas we have seen so far might have little relevance to the problem of economic development in some parts of the world where the state is notable in its absence.
- In Joel Migdal's words in *Strong Societies and Weak States*:

*“In parts of the Third World, the inability of state leaders to achieve predominance in large areas of their countries has been striking...”*

- In traditional political science, much emphasis on “state capacity” and “weak states”.

## Income and Taxes



## Other Evidence

- Bockstette, Chanda, and Putterman (2002): countries with early state formation grow faster (but this work should be read with some caution, since they are not richer today according to their empirical work....).
- Gennaioli and Rainer (2007): within Africa, countries with a history of centralized tribal institutions is associated with higher program of public goods.
- Michalopoulos and Papaioannou (2013): within Africa, ethnic groups with the history of centralized tribal institutions are richer.

# State Centralization within Uganda



**Map 1** Distribution of centralized and fragmented ethnic groups across Uganda regions

# Public Goods and State Centralization within Uganda

**Table 1** Precolonial centralization and public goods in Uganda

Region Precolonial institutions of ethnic groups	Central Centr	Western Centr	Eastern Mixed	Northern Fragm
% of roads paved in 2002	13.37	10.32	10.89	1.33
Infant mortality in 2001	71.9	97.8	89.3	105.9
% of children under five years with diarrhoea in 2001	14.5	16	23.3	26.7
Availability of sewerage system in 2000 (% of households)	15	14	9	6
Piped water inside house in 2000 (% of households)	10	10	8	5
Availability of latrine or human waste disposal service in 2000 (% of households)	96	86	77	67
Adult literacy rate in 1997	72	61	54	54
Adequacy of facility & equipment at primary schools in 2000 (% of households satisfied)	62	72	55	51

# Public Goods and State Centralization across Sub-Saharan Africa

**Table 2** Precolonial centralization and public goods provision

	% of roads paved in 1990–2000		% of infants immunized for DPT in 2001		Infant mortality in 1960–2001		Adult illiteracy rate in 1970–2002		School attainment in 1960–1990	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Centralization	21.02*** (7.21)	21.53*** (7.04)	36.79*** (6.53)	36.08*** (7.13)	−35.24** (14.79)	−42.5*** (15.12)	−18.74** (9.04)	−23.77*** (8.29)	1.24** (0.47)	1.24** (0.49)
Log of initial GDP/cap		4.95 (3.38)		0.9 (2.5)		−23.8** (9.26)		−11.17** (4.56)		0.36 (0.61)
Constant	7.12** (2.65)	−26.72 (22.73)	38.11*** (4.85)	33.22* (17.37)	146.6*** (10.01)	306.72*** (63.48)	66.94*** (5.95)	145.63*** (32.36)	1.2*** (0.33)	−1.12 (3.91)
Obs.	40	40	42	41	42	40	37	36	26	26
Rsq.	0.24	0.27	0.33	0.31	0.13	0.23	0.1	0.26	0.12	0.14

# Prosperity and State Centralization within Countries

PRE-COLONIAL ETHNIC INSTITUTIONS AND REGIONAL DEVELOPMENT WITHIN AFRICAN COUNTRIES<sup>a</sup>

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
Panel A: Pre-Colonial Ethnic Institutions and Regional Development Within African Countries												
All Observations												
Jurisdictional Hierarchy	0.3260*** (0.0851)	0.2794*** (0.0852)	0.2105*** (0.0553)	0.1766*** (0.0501)								
Binary Political Centralization					0.5264*** (0.1489)	0.5049*** (0.1573)	0.3413*** (0.0896)	0.3086*** (0.0972)				
Petty Chiefdoms									0.1538 (0.2105)	0.1442 (0.1736)	0.1815 (0.1540)	0.1361 (0.1216)
Paramount Chiefdoms									0.4258* (0.2428)	0.4914* (0.2537)	0.3700** (0.1625)	0.3384** (0.1610)
Pre-Colonial States									1.1443*** (0.2757)	0.8637*** (0.2441)	0.6809*** (0.1638)	0.5410*** (0.1484)
Adjusted R-squared	0.409	0.540	0.400	0.537	0.597	0.661	0.593	0.659	0.413	0.541	0.597	0.661
Observations	682	682	682	682	682	682	682	682	682	682	682	682
Country Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Location Controls	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes
Geographic Controls	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes
Population Density	No	No	Yes	Yes	No	No	Yes	Yes	No	No	Yes	Yes



# State Capacity

- By weak states, we mean states that lack “state capacity”.
- But then, what is state capacity?
- Four different aspects (mostly interwoven).
  - ① Max Weber’s monopoly of legitimate violence so as to enforce law and order and eliminate competitors.
  - ② Ability to tax and regulate economic activity (related, but of course not identical, to the share of tax revenue shown above).
  - ③ Infrastructural power/capacity of the state—related to the presence of the state and its functionaries.
  - ④ Max Weber’s rational/autonomous bureaucracy—related the ability of state institutions to be somewhat autonomous from politically powerful groups in society.

# Key Political Economy Question

- **Key political economy question** that is rarely asked: why are states weak?
- In other words, why do states remain weak, especially if:
  - state weakness is economically costly;
  - most political powerful groups and individuals would prefer to control a strong state.

# Plan

- We will start with a simple model of weak vs. strong states based on ability to tax and regulate economic activity.
- We will then turn to models and empirical evidence on different aspects of the state.
- Throughout the emphasis will be on:
  - why state weakness affects economic (and sometimes political) outcomes;
  - why state weakness emerges as equilibrium;
  - how state building takes place.

# Ideas about State Building

- Otto Hinze and later Charles Tilly emphasized the role of inter-state wars in the formation of the state.
- Tilly:

*“War made the state, and state made war.”*

- Based on this, Jeffrey Herbst in *States and Power in Africa* suggested that the weakness of the sub-Saharan African states is due to its difficult terrain and low population density that discouraged inter-state warfare.

# A Simple Model of State Building

- Besley and Persson (2009) provided a simple formalization of Tilly.
- “State power” is a state variable (i.e., is persistent “stock”). It enables more efficient taxation.
- In an economy with two competing groups, the group in power may not want to invest in state power if it expects to lose power because then this power will be in the hands of its rival group.
- However, if there is a threat of war, then building state power becomes a necessity.

## Evidence

Table 2: Economic and Political Determinants of Fiscal Capacity

	(1) One Minus Share of Trade Taxes in Total Taxes	(2) One Minus Share of Trade and Indirect Taxes in Total Taxes	(3) Share of Income Taxes in GDP	(4) Share of Taxes in GDP
Incidence of External Conflict up to 1975	0.921*** (0.229)	0.683*** (0.201)	0.747*** (0.246)	0.678*** (0.211)
Incidence of Democracy up to 1975	0.005 (0.085)	- 0.037 (0.096)	0.057 (0.062)	0.097 (0.064)
Incidence of Parliamentary Democracy up to 1975	0.123 (0.086)	0.208** (0.094)	0.231*** (0.074)	0.166** (0.069)
English Legal Origin	- 0.013 (0.069)	- 0.012 (0.061)	- 0.015 (0.056)	0.013 (0.051)
Socialist Legal Origin	0.051 (0.095)	- 0.332*** (0.084)	- 0.155** (0.065)	- 0.110 (0.082)
German Legal Origin	0.283*** (0.064)	0.290*** (0.093)	0.295*** (0.084)	0.206*** (0.065)
Scandinavian Legal Origin	0.333*** (0.068)	0.195** (0.078)	0.364** (0.141)	0.363*** (0.092)
Observations	104	104	104	104
R-squared	0.412	0.435	0.628	0.639

Robust standard errors in parentheses: \* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1%  
All specifications include regional fixed effects (for eight regions).

## But

- Osafo-Kwaako and Robinson (2013), using the Standard Cross-Cultural Sample, show that these ideas have limited explanatory power for Africa.

Table 3

Correlates of state formation (full SCCS sample).

	Dependent variable: jurisdictional hierarchy beyond local community (SCCS variable §237)							
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Population density	0.386*** (0.0407)	0.363*** (0.0403)					0.361*** (0.0609)	0.295*** (0.0590)
Africa * Population density	-0.317*** (0.115)	-0.325*** (0.112)					-0.217 (0.180)	-0.173 (0.171)
Being attacked			0.293* (0.168)	0.364** (0.146)			0.263 (0.170)	0.253 (0.175)
Africa * Being attacked			-0.315 (0.382)	-0.472 (0.379)			-0.102 (0.366)	-0.220 (0.382)
Trade					0.191* (0.112)	0.172 (0.115)	0.0113 (0.107)	-0.0375 (0.117)
Africa * Trade					-0.000762 (0.258)	0.104 (0.263)	0.294 (0.227)	0.408* (0.227)
Africa dummy	1.631*** (0.442)	1.644*** (0.413)	0.975 (0.780)	1.064 (0.793)	0.863 (0.823)	0.253 (0.862)	0.595 (1.271)	0.263 (1.326)
F-stat	0.41	0.13	0.00	0.10	0.67	1.37	1.06	1.46
p-Value	0.52	0.72	0.95	0.76	0.41	0.24	0.37	0.23
Geographic controls	No	Yes	No	Yes	No	Yes	No	Yes
Disease environment control	No	Yes	No	Yes	No	Yes	No	Yes
Observations	182	182	152	152	98	98	94	94
R-squared	0.342	0.369	0.040	0.206	0.099	0.272	0.381	0.440

## But (continued)

**Table 4**  
Correlates of state formation.

	Dependent variable: levels of sovereignty (SCCS variable §83)							
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Population density	0.388*** (0.0353)	0.379*** (0.0379)					0.397*** (0.0542)	0.325*** (0.0516)
Africa * Population density	-0.288** (0.131)	-0.314** (0.129)					-0.293 (0.220)	-0.272 (0.199)
Being attacked			0.199 (0.156)	0.263* (0.140)			0.106 (0.147)	0.0423 (0.137)
Africa * Being attacked			-0.645* (0.347)	-0.789** (0.327)			-0.263 (0.323)	-0.397 (0.331)
Trade					0.248** (0.103)	0.260** (0.104)	0.0255 (0.0898)	0.0102 (0.0918)
Africa * Trade					-0.254 (0.340)	-0.165 (0.362)	0.0511 (0.375)	0.160 (0.393)
Africa dummy	1.415** (0.560)	1.445*** (0.535)	1.428** (0.709)	1.456** (0.694)	1.695 (1.126)	0.980 (1.231)	1.995 (1.569)	1.620 (1.664)
F-stat	0.62	0.27	2.07	3.10	0.00	0.08	0.24	0.58
p-Value	0.43	0.60	0.15	0.08	0.99	0.78	0.87	0.63
Geographic controls	No	Yes	No	Yes	No	Yes	No	Yes
Disease environment control	No	Yes	No	Yes	No	Yes	No	Yes
Observations	182	182	152	152	99	99	95	95
R-squared	0.355	0.373	0.028	0.187	0.108	0.321	0.401	0.505



# Stationary Bandits

- Mancur Olson, also based on some of Tilly's ideas, argued that the origins of the state lie in organized banditry (e.g., Olson, 1993, and McGuire and Olson, 1996).
- A roving bandit will apply maximal extraction (as in the model above in the MPE with  $\delta$  high). Roving bandits arise when the bandits themselves don't have any security and for this or other reasons have a short horizon.
- A stationary bandit, with a longer horizon, will act like a state, encouraging production and taking more moderate taxes (as in the SPE of the models we have seen before).
- A stationary bandit ultimately becomes a state.

# Evidence

- Sanchez de la Sierra (2014) provides evidence for this perspective by exploiting the differential increases in incentives of armed groups in the civil war of Eastern Congo to become “stationary bandits” because of the Colton price hike.
- Colton is easier to tax because it’s much harder to conceal than gold, so he uses gold as a control.
- He therefore hypothesizes that “attempted conquests” should increase due to the higher interaction of Colton deposits and Colton price, but not the same for gold.
- But does this have anything to do with State building?

## Evidence (continued)

Table 3: Effects of price shocks, conquests

VARIABLES	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Coltan X Coltan Price	0.25*	0.61***	0.26*	0.30**	0.60**	0.59**	0.60**	0.30**	0.66***
	(0.14)	(0.14)	(0.14)	(0.14)	(0.24)	(0.24)	(0.25)	(0.14)	(0.20)
Coltan X Coltan Price X Far		-0.58***			-0.57*	-0.56*	-0.57*		-0.66**
		(0.19)			(0.29)	(0.29)	(0.29)		(0.27)
Gold X Gold Price	-0.01***	0.00	-0.01***	-0.02	-0.02	-0.02	-0.03		
	(0.00)	(0.01)	(0.00)	(0.02)	(0.03)	(0.03)	(0.04)		
Gold X Gold Price X Far		-0.01			0.01	0.02	0.02		
		(0.01)			(0.05)	(0.04)	(0.04)		
Congolese Army, Village			-0.06**						
			(0.03)						
Constant	0.12***	-70.08	0.12***	0.15*	-0.02	-0.04	-0.05	0.09***	0.09***
	(0.03)	(74.18)	(0.03)	(0.09)	(0.09)	(0.08)	(0.09)	(0.02)	(0.02)
Observations	1,342	1,342	1,342	732	732	678	732	244	244
R-squared	0.21	0.33	0.22	0.34	0.35	0.29	0.37	0.68	0.69
Year FE	YES	YES	YES	YES	YES	YES	YES	YES	YES
Village FE	YES	YES	YES	YES	YES	YES	YES	YES	YES
Region*Year FE	NO	NO	NO	NO	NO	NO	YES	NO	NO
Distance to road	NO	NO	NO	NO	NO	YES	NO	NO	NO
Sample	1998-2009	1998-2009	1998-2009	1998-2003	1998-2003	1998-2003	1998-2003	1999-2000	1999-2000

# But

- Empirically, long-lived dictators (Mobutu, Mugabe, the Duvaliers in Haiti) are not more developmental, and if anything seem to be among the most kleptocratic.
- Conceptually, this equates the state with organized banditry. But is that right?
- Theoretically, Olson's vision is too narrow also.
  - Acemoglu and Robinson (APSR 2006): the relationship between entrenchment and likelihood to take actions against economic development is inverse U-shaped. This is because a very non-entrenched dictator has no reason to sabotage development in order to save his future rents.
  - Acemoglu, Golosov and Tsyvinski (JET 2010): from a repeated games perspective, a less entrenched dictator may be easier to discipline. This is because if he deviates, society can more easily punish him by removing him from power. We next explain this result.

# Environment

- Time is discrete and indexed by  $t$ .
- There is a set of citizens, with mass normalized to 1, and a ruler.
- All agents discount the future with the discount factor  $\beta$ , and have the utility function

$$u_t = \sum_{j=0}^{\infty} \beta^j [c_{t+j} - e_{t+j}],$$

where  $c_{t+j}$  is consumption and  $e_{t+j}$  is investment (effort), and we assume that the ruler incurs no effort cost.

- Each citizen  $i$  has access to the following Cobb-Douglas production technology to produce the unique final good in this economy:

$$y_t^i = \frac{1}{1-\alpha} A_t^\alpha (e_t^i)^{1-\alpha},$$

where  $A_t$  denotes the level of public goods (e.g., the state of the infrastructure, or the degree of law and contract enforcement between private citizens), at time  $t$ .

## Environment (continued)

- The level of  $A_t$  will be determined by the investment of the ruler
  - a certain degree of state investment in public goods, the infrastructure or law-enforcement is necessary for production;
  - in fact, investment by the state is complementary to the investments of the citizens.
- The ruler sets a tax rate  $\tau_t$  on income at time  $t$ .
- Each citizen can decide to hide a fraction  $z_t^i$  of his output, which is not taxable, but hiding output is costly, so a fraction  $\delta$  of it is lost in the process.
- This formulation with an economic exit option for the citizens is a convenient, though reduced-form, starting point.
- Given a tax rate  $\tau_t$ , the consumption of agent  $i$  is:

$$c_t^i \leq [(1 - \tau_t) (1 - z_t^i) + (1 - \delta) z_t^i] y_t^i,$$

where tax revenues are

$$\mathcal{T}_t = \tau_t \int (1 - z_t^i) y_t^i di. \quad (1)$$

## Environment (continued)

- The ruler at time  $t$  decides how much to spend on  $A_{t+1}$ , with production function

$$A_{t+1} = \left[ \frac{(1 - \alpha) \phi}{\alpha} G_t \right]^{1/\phi} \quad (2)$$

where  $G_t$  denotes government spending on public goods, and  $\phi > 1$ , so that there are decreasing returns in the investment technology of the ruler (a greater  $\phi$  corresponds to greater decreasing returns).

- The term  $[(1 - \alpha) \phi / \alpha]^{1/\phi}$  is included as a convenient normalization.
- In addition, (2) implies full depreciation of  $A_t$ , which simplifies the analysis below.
- The consumption of the ruler is whatever is left over from tax revenues after his expenditure and transfers,

$$c_t^R = T_t - G_t.$$

# Timing of Events

- The economy inherits  $A_t$  from government spending at time  $t - 1$ .
- Citizens choose their investments,  $\{e_t^i\}$ .
- The ruler decides how much to spend on next period's public goods,  $G_t$ , and sets the tax rate  $\tau_t$ .
- Citizens decide how much of their output to hide,  $\{z_t^i\}$ .



# First-Best Allocation

- The first best allocation maximizes net output:
- Given by public goods investment

$$A_t = \beta^{1/(\phi-1)}$$

and

$$e_t^{fb} = \beta^{1/(\phi-1)} \text{ and } y_t^{fb} = \frac{1}{1-\alpha} \beta^{1/(\phi-1)}.$$

# Markov Perfect Equilibrium

- Exit options:

$$z_t^i \begin{cases} = 1 & \text{if } \tau_t > \delta \\ \in [0, 1] & \text{if } \tau_t = \delta \\ = 0 & \text{if } \tau_t < \delta \end{cases} .$$

Then, the optimal tax rate for the ruler is

$$\tau_t = \delta. \quad (3)$$

- Next, investment decisions:

$$e_t^i = (1 - \delta)^{1/\alpha} A_t. \quad (4)$$

- Substituting (3) and (4) into (1), the equilibrium tax revenue as a function of the level of infrastructure is

$$T(A_t) = \delta y_t = \frac{(1 - \delta)^{(1-\alpha)/\alpha} \delta A_t}{1 - \alpha}. \quad (5)$$

## Markov Perfect Equilibrium (continued)

- The ruler will choose public investment,  $G_t$  to maximize his net present value, written recursively as:

$$V(A_t) = \max_{A_{t+1}} \left\{ T(A_t) - \frac{\alpha}{(1-\alpha)\phi} A_{t+1}^\phi + \beta V(A_{t+1}) \right\}$$

- First-order condition for the ruler:

$$\frac{\alpha}{1-\alpha} A_{t+1}^{\phi-1} = \beta V'(A_{t+1}).$$

- The marginal cost of greater investment in infrastructure for next period must be equal to to the greater value that will follow from this.
- The envelope condition:

$$V'(A_t) = T'(A_t) = \frac{(1-\delta)^{(1-\alpha)/\alpha} \delta}{1-\alpha}. \quad (6)$$

- The value of better infrastructure for the ruler is the additional tax revenue that this will generate, which is given by the expression in (6).

# Markov Perfect Equilibrium (continued)

- Equilibrium actions of the ruler are:

$$A_{t+1} = A[\delta] \equiv \left( \frac{\beta (1 - \delta)^{\frac{1-\alpha}{\alpha}} \delta}{\alpha} \right)^{\frac{1}{\phi-1}} \quad \text{and} \quad G_t = \frac{\alpha}{(1-\alpha)\phi} (A[\delta])^\phi, \quad (7)$$

- And therefore:

$$V^*(A_t) = \frac{(1-\delta)^{(1-\alpha)/\alpha} \delta A_t}{1-\alpha} + \frac{\beta(\phi-1)(1-\delta)^{(1-\alpha)/\alpha} \delta}{(1-\beta)(1-\alpha)\phi} A[\delta].$$

# Markov Perfect Equilibrium (continued)

- Summarizing:

**Proposition:** There exists a unique MPE where, for all  $t$ ,  $\tau_t(A_t) = \delta$ ,  $G(A_t)$  is given by (7), and, for all  $i$  and  $t$ ,  $z^i(A_t) = 0$  and  $e^i(A_t)$  is given by (4). The equilibrium level of aggregate output is:

$$Y_t = \frac{1}{1-\alpha} (1-\delta)^{(1-\alpha)/\alpha} A[\delta]$$

for all  $t > 0$  and

$$Y_0(A_0) = \frac{1}{1-\alpha} (1-\delta)^{(1-\alpha)/\alpha} A_0.$$

## Second Best

- What is the level of  $\delta$ —economic strength of the state—that maximizes output.
- Considered a problem

$$\max_{\delta} Y_t(\delta) = \frac{1}{1-\alpha} (1-\delta)^{(1-\alpha)/\alpha} A[\delta],$$

where  $A[\delta]$  is given by (7).

- The output maximizing level of the economic power of the state, denoted  $\delta^*$ , is

$$\delta^* = \frac{\alpha}{\phi(1-\alpha) + \alpha}. \quad (8)$$

## Second Best (continued)

- If the economic power of the state is greater than  $\delta^*$ , then the state is too powerful, and taxes are too high relative to the output-maximizing benchmark.
  - This corresponds to the standard case that the political economy literature has focused on.
- In contrast, if the economic power of the state is less than  $\delta^*$ , then the state is not powerful enough for there to be sufficient rents in the future to entice the ruler to invest in public goods (or in the infrastructure, law-enforcement etc.).
- This corresponds to the case of “weak states”.
  - With only limited power of the state to raise taxes in the future, the ruler has no interest in increasing the future productive capacity of the economy.

# Political Power of the State

- Do the same insights applied to the political power of the state?
- Generally yes,



## Extended Environment

- Citizens decide replacement:  $R_t \in \{0, 1\}$ .
- After replacement, the existing ruler receives 0 utility, and citizens reclaim a fraction  $\eta$  of the tax revenue and redistribute it to themselves as a lump sum transfer,  $S_t$ .
- Replacement is costly: the cost of replacing the current ruler with a new ruler equal to  $\theta_t A_t$ , where  $\theta_t$  is a nonnegative random variable with a continuous distribution function  $\tilde{F}_\lambda$ , with (finite) density  $\tilde{f}_\lambda$ .
- Assume that

$$\frac{\tilde{f}_\lambda(x)}{1 - \tilde{F}_\lambda(x)} \text{ is nondecreasing in } x \text{ and } \tilde{F}_\lambda(0) < 1, \quad (\text{A1})$$

which is the standard monotone hazard (or log concavity) assumption.

# Timing of Events

- The economy inherits  $A_t$  from government spending at time  $t - 1$ .
- Citizens choose their investments,  $\{e_t^i\}$ .
- The ruler decides how much to spend on next period's public goods,  $G_t$ , and sets the tax rate  $\tau_t$ .
- Citizens decide how much of their output to hide,  $\{z_t^i\}$ .
- $\theta_t$  is realized.

Citizens choose  $R_t$ . If  $R_t = 1$ , the current ruler is replaced and the tax revenue is redistributed to the citizens as a lump-sum subsidy  $S_t = \eta T_t$ .

# Markov Perfect Equilibrium

- Suppose

$$\delta \in (\delta^*, \alpha), \quad (\text{A2})$$

where  $\delta^*$  is given by (8).

- This assumption ensures that taxes are always less than the value  $\alpha$  that maximizes ruler utility, and also allows the potential for excessively high taxes (i.e.,  $\tau > \delta^*$ ).
- Citizens will replace the ruler, i.e.,  $R_t = 1$ , whenever

$$\theta_t < \frac{\eta T_t}{A_t}. \quad (9)$$

- Therefore, the probability that the ruler will be replaced is  $\tilde{F}_\lambda(\eta T_t / A_t)$ .

## Markov Perfect Equilibrium (continued)

- To simplify the notation, define

$$\mathcal{T}(\tau_t) = \frac{(1 - \tau_t)^{(1-\alpha)/\alpha} \tau_t}{1 - \alpha}.$$

- Also parameterize  $\tilde{F}_\lambda(x/\eta) = \lambda F(x)$  for some continuous distribution function  $F$  with (finite) density  $f$ . Then

$$V(A_t) = \max_{\tau_t \in [0, \delta], A_{t+1}} \left\{ (1 - \lambda F(\mathcal{T}(\tau_t))) \left( \mathcal{T}(\tau_t) A_t - \frac{\alpha}{\phi(1 - \alpha)} A_{t+1}^\phi \right) + \beta (1 - \lambda F(\mathcal{T}(\tau_t))) V(A_{t+1}) \right\}.$$

- Now the ruler's maximization problem involves two choices,  $\tau_t$  and  $A_{t+1}$ , since taxes are no longer automatically equal to the maximum,  $\delta$ .

## Markov Perfect Equilibrium (continued)

- In this choice, the ruler takes into account that a higher tax rate will increase the probability of replacement.
- The first-order condition with respect to  $\tau_t$  yields:

$$\frac{\partial \mathcal{I}(\tau_t)}{\partial \tau_t} \times [(1 - \lambda F(\mathcal{I}(\tau_t))) - \lambda f(\mathcal{I}(\tau_t)) \left( \mathcal{I}(\tau_t) - \frac{G_t}{A_t} + \beta \frac{V(A_{t+1})}{A_t} \right)] \geq 0,$$

and  $\tau_t \leq \delta$  with complementary slackness

- The envelope condition is now

$$V'(A_{t+1}) = (1 - \lambda F(\mathcal{I}(\tau_{t+1}))) \mathcal{I}(\tau_{t+1}). \quad (10)$$

- It only differs from the corresponding condition above, (6), because with probability  $\lambda F(\mathcal{I}(\tau_{t+1}))$ , the ruler will be replaced and will not enjoy the increase in future tax revenues.

## Markov Perfect Equilibrium (continued)

- Using this, the first-order condition with respect to  $A_{t+1}$  implies that in an interior equilibrium:

$$A_{t+1} = A[\tau_{t+1}] \equiv \left( \alpha^{-1} \beta (1 - \lambda F(\mathcal{T}(\tau_{t+1}))) (1 - \tau_{t+1})^{\frac{1-\alpha}{\alpha}} \tau_{t+1} \right)^{\frac{1}{\phi-1}}$$

- The optimal value of  $A_{t+1}$  for the ruler depends on  $\tau_{t+1}$  since, from the envelope condition, (10), the benefits from a higher level of public good are related to future taxes.
- Also suppose:

$$\left( 1 - \frac{\beta}{\phi} (1 - \lambda F(0)) \right)^2 - (\phi - 1) \frac{\beta}{\phi} (1 - \lambda F(0)) > 0. \quad (\text{A3})$$

- This assumption requires  $\beta (1 - \lambda F(0))$  not to be too large, and can be satisfied either if  $\beta$  is not too close to 1 or if  $\lambda F(0)$  is not equal to zero.

# Markov Perfect Equilibrium (continued)

- Then we have:

**Proposition:** Suppose (A1), (A2) and (A3) hold. Then, in the endogenous replacement game of this section, there exists a unique steady-state MPE. In this equilibrium, there exists  $\lambda^* \in (0, \infty)$  such that output is maximized when  $\lambda = \lambda^*$ .

## Markov Perfect Equilibrium (continued)

- Similar to the case of the economic power of the state, there is an optimal level of the political power of the state.
- Intuitively, when  $\lambda < \lambda^*$ , the state is too powerful and taxes are too high and citizens' investments are too low.
- When  $\lambda > \lambda^*$ , the state is too weak and taxes and public investments are too low.
- The intuition is also related to the earlier result.
- When the state is excessively powerful, i.e.,  $\lambda < \lambda^*$ , citizens expect high taxes and choose very low levels of investment (effort).
- In contrast, when  $\lambda > \lambda^*$ , the state is excessively weak and there is the reverse holdup problem; high taxes will encourage citizens to replace the ruler, and anticipating this, the ruler has little incentive to invest in public goods, because he will not be able to recoup the costs of current investment in public goods with future revenues.



# Consensually Strong States

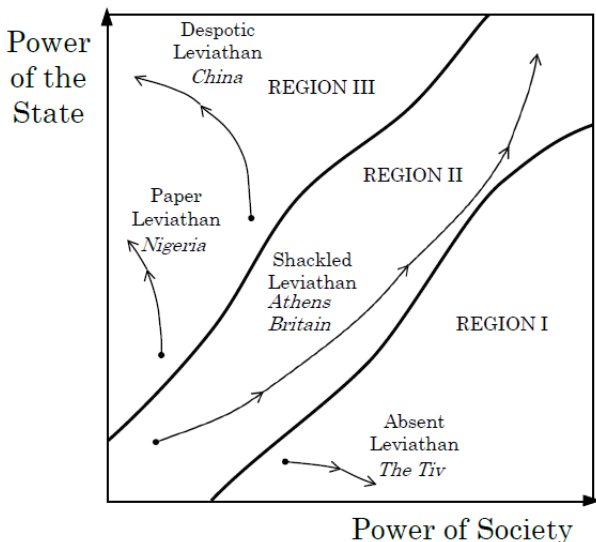
- Neither the analysis of the economic or the political power of the state generate a pattern in which better institutional controls lead to greater government spending.
- But comparison of OECD to Africa might suggest such a pattern.
- Why would this be the case?
- One possibility: go beyond MPE
- *Consensually Strong States*: citizens have low costs of replacing governments, a new look at SPE, where if the government does not follow citizens' wishes, it is replaced.
- Consensually Strong States can generate the pattern of greater public good provision in situations of better controls on government.

## Alternative Thesis: From “The Narrow Corridor”

- Different types of stable states, which we call *Absent Leviathan* (weak state), *Despotic Leviathan* (despotic state), and *Shackled Leviathan* (inclusive state).
- Very different implications from different types of states:
  - For *conflict resolution*—in the Absent Leviathan, there is “dominance” of the strong against weak, Hobbesia “Warre”; in the Despotic and Paper Leviathans, there is dominance of the state against the rest.
  - For *public services*—in the Absent Leviathan, there is none; in the Paper Leviathan, very little; in the Despotic Leviathan, the public services that the state deems appropriate are provided).
  - For *economic growth*—very little of it in the Absent Leviathan; distorted, non-sustained growth in the Paper and Despotic Leviathans).

## Alternative Thesis (continued)

- Perspectives on their evolution:



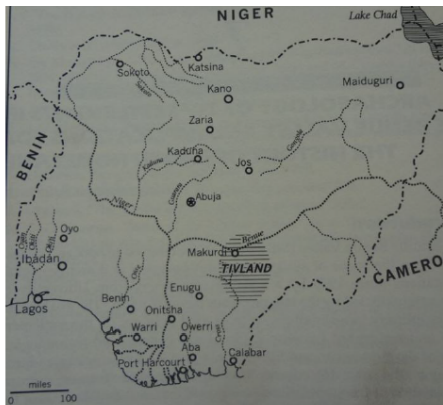
## Alternative Thesis (continued)

- Contrary to structural views (e.g., Hintze, 1975, Tilly, 1990), great diversity within similar geographies and cultures. Contrary to (post-)Hegelian views similar to “End of History”, no tendency for these states to converge into a unitary form.
- Most importantly, contrary to common views (e.g., Huntington), a state capable of providing effective conflict resolution, services and appropriate economic policy (our Shackled Leviathan) needs a strong society, not a strong leader or uncontested monopoly of violence—the opposite of the “state first” theses.
  - In other words, it needs to mobilize the *Red Queen Effect*, whereby state and society need to race to become stronger against the other, in the process of becoming more capable.

# The Rest of This Lecture

- A model of the race (or the lack thereof) between state and society, and how this leads to a simplified form of the phase diagram above.
- Main mechanism: a contest between state and society.
  - If the state is too weak relative to society, it is dominated by society, and state building doesn't get off the ground—weak state or Absent Leviathan.
  - If the state is too strong relative to society, society gives up its attempts to control it—and how strong the state becomes, i.e., the balance between Despotic and Paper Leviathan, depends on the costs and benefits of state strength.
  - If the two are equally matched, they are both encouraged to invest in their “capabilities”—inclusive state or Shackled Leviathan.
- Note that this is just one aspect over a broader theory (another aspect is the “consensually strong state” we discussed already).

## An Example of Region III: The Tiv in Nigeria



- *Social norms of societal control*—over political inequality and economic inequality.

## The Tiv in Nigeria (continued)

- During the summer of 1939, social and economic activity came to a standstill in Tivland because of a cult called *Nyambua*. At the heart of the cult was a shrine and a man called Kokwa who sold charms to provide protection from *mbatsav* or “witches”.
- *Tsav* means “power”, particularly power over others. A person with *tsav* (it is a substance that grows on the heart of a person) can make others do what they want and kill them by using the power of fetishes and *tsav* can be increased by cannibalism.

*“A diet of human flesh makes the tsav, and of course the power, grow large. Therefore the most powerful men, no matter how much they are respected or liked, are never fully trusted. They are men of tsav - and who knows?” (Bohannon, 1958)*

- The people with *tsav* belong to an organization — the *mbatsav*, which means a group of *witches*.
- *Mbatsav* also means: *Powerful people*.

## The Tiv in Nigeria (continued)

- In 1939, the Nyambua cult had turned against the 'chiefs' created by British indirect rule (the Tiv had no chiefs before).
- In fact, turning against the powerful was a common occurrence:

*"... the Tiv have taken strong measures to overcome the mbatsav. These big movements have taken place over a period extending from the days of the ancestors into modern times" (Akiga, 1939).*

*"Men who had acquired too much power ... were whittled down by means of witchcraft accusations.. Nyambua was one of a regular series of movements to which Tiv political action, with its distrust of power, gives rise so that the greater political institutions - the one based on the lineage system and a principle of egalitarianism - can be preserved" (Bohannon, 1958)*

- But to have a state someone has to become powerful, start giving orders to others who accept their authority...



## Why Stay in Region III?

- Why not start from a position of societal strength as with the Tiv, and then engineer the building of a Shackled Leviathan?
- Fear of *slippery slopes*: the Tiv did not have the institutions to check power once it started being accumulated.
  - Their social norms were predicated on the notion that they had to nip any accumulation of power in the bud. So once the social norms were broken and a group or individual allowed to become economically or politically powerful enough, there was nothing they could do to stop its domination.
- A lot of parallels to the norms and attitudes towards power in other stateless societies.

## An Example of Region II: Ancient Greece

- Classical Greece: huge diversity of states— Athenian democracy, despotism in Syracuse and Sparta, absence of effective state in Thrace, Paper Leviathan in Crete, etc.
- Recent scholarship (Ian Morris, Josh Ober) ties the roots of the economic boom from 700 BC onwards to the emergence of inclusive economic and political institutions starting with the reforms of Solon in 594 BC:
  - economic: made enslaving an Athenian citizen illegal, established freedom of movement within Attica, implemented an egalitarian land reform.
  - political: assembly which all Athenian citizens could attend; created a Council of 400 equally representing the 4 traditional tribes of Athens. Although the chief executive offices were reserved for elites, their decisions could be challenged by anyone in front of juries which were composed of all classes.

# Shackled Leviathan in Greece

- Solon's reforms came out in the context of deep and sustained conflict between elites and masses.
- Consolidated by Cleisthenes in 508/7 BC, once again in the context of ongoing conflict.
  - New Council of 500 chosen at lot from all of Attica. You had to be older than 30 but could only serve for a year and at most twice in your life (almost every citizen ended up serving once in their life).
- The most interesting aspect of Solon and Cleisthenes reforms were the institutionalization of social norms for controlling elites.
  - It was these institutional prerequisites that were important for the building of a Shackled Leviathan in Greece that were absent in the Tiv.
- Solon's *Hubris Law* which made behavior aimed at humiliation and intimidation against any resident of Athens illegal.

## Shackled Leviathan in Greece (continued)

- Cleisthenes *Ostracism Law*:

- Every year the Assembly voted on whether there should be an ostracism. If at least 6,000 voted and 50% said yes then each citizen wrote a name on a fragment of broken pottery (an *ostrakon*, hence ostracism). Whoever got the most votes was banished from Athens for 10 years.
- Fantastic device for disciplining elites who threatened to become too powerful and overthrow inclusive institutions (next slide).
- A threat “off the equilibrium path” in the 180 years where the institutions functioned only 15 people were actually ostracized, but the threat was ever present.

# The Model

- Consider a game with two types of players: civil society and an elite synonymous with the state.
- Let us assume that the game is played between non-overlapping generations of representatives of civil society and the state, and thus without forward-looking behavior.
- At time  $t$ , the state variables inherited from the previous period are  $(x_{t-\Delta}, s_{t-\Delta}) \in [0, 1]^2$ , where the first element corresponds to the strength (or conflict capacity) of civil society and the second to the strength of the state controlled by the elite
- We will take  $\Delta$  to be small so as to work with differential, rather than difference equations.

# Investment Decisions

- The players simultaneously make their investment decisions,  $i_t^x \geq 0$  and  $i_t^s \geq 0$  such that

$$x_t = x_{t-\Delta} + i_t^x \Delta - \delta \Delta$$

and

$$s_t = s_{t-\Delta} + i_t^s \Delta - \delta \Delta.$$

# Production

- A state and society with strengths  $s_t$  and  $x_t$  produces output/surplus given by

$$f(s_t, x_t),$$

where  $f$  is assumed to be nondecreasing and differentiable. Let us first simplify the discussion by imposing:

**Assumption 0**  $f(s, x) = 1$  for all  $(x, s) \in [0, 1]^2$ .

- This assumption simplifies the treatment by making the state and civil society symmetric as players.
- Generalizations discussed below.

# Contests for Power

- There is conflict over the division of production.
- At date  $t$ , if the state and citizens decide to fight, then one side will win and capture all of the output of the economy, and the other side receives zero. Winning probabilities are functions of relative strengths. In particular, the state will win if

$$s_t \geq x_t + \sigma,$$

where  $\sigma$  is drawn from the distribution  $H$ , and denote its density by  $h$ .

- The existence of the shock captures the stochastic nature of winning the conflict.



# Costs

- The costs of investment of society and state are

$$\Delta \cdot C_x(i_t^x, x_{t-\Delta}) = \begin{cases} c_x(i_t^x) & \text{if } x_{t-\Delta} > \gamma_x, \\ c_x(i_t^x) + (\gamma_x - x_{t-\Delta}) i_t^x & \text{if } x_{t-\Delta} \leq \gamma_x. \end{cases}$$

$$\Delta \cdot C_s(i_t^s, s_{t-\Delta}) = \begin{cases} c_s(i_t^s) & \text{if } s_{t-\Delta} > \gamma_s, \\ c_s(i_t^s) + (\gamma_s - s_{t-\Delta}) i_t^s & \text{if } s_{t-\Delta} \leq \gamma_s. \end{cases}$$

- Because this cost is defined as per unit of time, it is multiplied by  $\Delta$ .
- The term  $\gamma_x > 0$  captures the “increasing returns” nature of conflict: once one of the players stops making investments in its conflict capacity, it faces greater costs to get started.

# Assumptions

Assumption 1 ①  $c_x$  and  $c_s$  are continuously differentiable, strictly increasing and weakly convex over  $\mathbb{R}_+$ , and satisfy  $\lim_{x \rightarrow \infty} c_x(x) = \infty$  and  $\lim_{s \rightarrow \infty} c_s(s) = \infty$ .

②

$$\frac{|c_s''(\delta) - c_x''(\delta)|}{\min\{c_s''(\delta), c_x''(\delta)\}} < \frac{1}{\sup_z |h'(z)|}$$

③

$$c'_s(\delta) + \gamma_s \geq c'_x(\delta) \text{ and } c'_x(\delta) + \gamma_x \geq c'_s(\delta).$$

## Assumptions (continued)

**Assumption 2**  $h$  is differentiable, single-peaked and symmetric around zero and satisfies for each  $z \in \{x, s\}$ :

$$c'_z(\delta) > h(1)$$

and

$$\min\{h(0) - \gamma_z; h(\gamma_z)\} > c'_z(\delta).$$

# Objective Functions

- Under these assumptions at time  $t$  civil society maximizes

$$H(x_t - s_t) - \Delta \cdot C_x(x_t, x_{t-\Delta})$$

while the state maximizes

$$H(s_t - x_t) - \Delta \cdot C_s(s_t, s_{t-\Delta})$$

where we have used the investment equation to substitute in for the state variables.

# Investment Decisions

- Given Assumptions 1 and 2, the investment decisions of both state and civil society are given by their respective first-order conditions.
- Take the limit  $\Delta \rightarrow 0$ , the optimality conditions for the state and society as

$$\begin{aligned}
 h(s_t - x_t) &\leq c'_s(\dot{s}_t + \delta) + \max\{0; \gamma_s - s_t\} && \text{if } \dot{s}_t = -\delta \text{ or } s_t = 0, \\
 h(s_t - x_t) &\geq c'_s(\dot{s}_t + \delta) + \max\{0; \gamma_s - s_t\} && \text{if } s_t = 1, \\
 h(s_t - x_t) &= c'_s(\dot{s}_t + \delta) + \max\{0; \gamma_s - s_t\} && \text{otherwise,}
 \end{aligned}
 \tag{11}$$

$$\begin{aligned}
 h(x_t - s_t) &\leq c'_x(\dot{x}_t + \delta) + \max\{0; \gamma_x - x_t\} && \text{if } \dot{x}_t = -\delta \text{ or } x_t = 0, \\
 h(x_t - s_t) &\geq c'_x(\dot{x}_t + \delta) + \max\{0; \gamma_x - x_t\} && \text{if } x_t = 1, \\
 h(x_t - s_t) &= c'_x(\dot{x}_t + \delta) + \max\{0; \gamma_x - x_t\} && \text{otherwise.}
 \end{aligned}
 \tag{12}$$

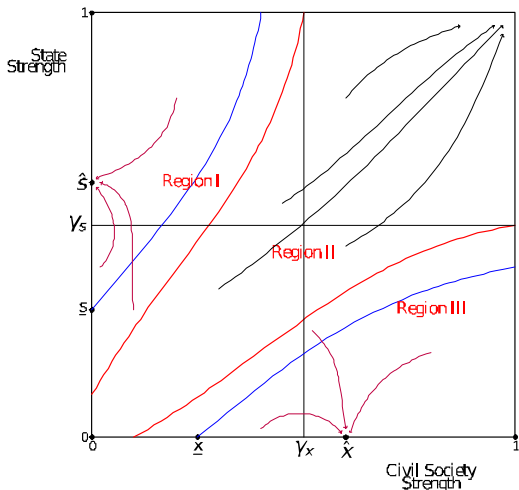
# The Main Result

## Proposition

*There are three locally asymptotically stable steady states*

- 1  $x^* = s^* = 1$ .
- 2  $x^* = 0$  and  $s^* \in (\gamma_s, 1)$ .
- 3  $x^* \in (\gamma_x, 1)$  and  $s^* = 0$ .

## Global Dynamics

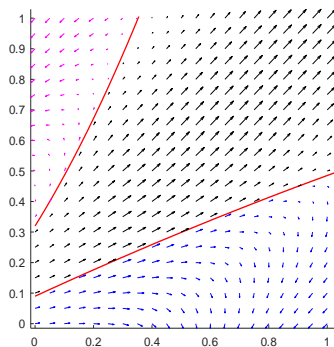


# Numerical Results

- Take the following cost functions for state and society:

$$0.006 \times (i + \delta) + 0.001 \times \left(\frac{i}{\delta}\right)^2,$$

- $\gamma_x = 0.3$ ,  $\gamma_s = 0.6$ , and  $\delta = 0.05$ .





# Interpretation

- These three asymptotically stable steady states correspond to very different types of states/governments
  - $x^* = s^* = 1$ : here both state and society are strong and this results from a dynamic where each pushes the other in accumulating strength — this is the highest capacity.
  - $x^* = 0$  and  $s^* \in (\gamma_s, 1)$ : society is ‘prostrate’ (to use the terminology of James Scott) but as a consequence the state gives up and is weaker than the previous case — there is lower capacity even if the state is dominant in society.
  - $x^* \in (\gamma_x, 1)$  and  $s^* = 0$ : society dominates the state which gives up the fight.

# Red Queen Effect

- We can see this from the dynamics of Region II.
- Also, note that investment incentives are highest when

$$h(x - s) = h(s - x) \approx h(0).$$

- Both parties are discouraged from investment when there is a big difference between their strengths.

## Sketch of the Proof

- Let us outline the proof for the first part.
- At  $x^* = s^* = 1$ , the marginal cost of investment for player  $z \in \{x, s\}$  is  $c'_z(\delta)$ , while the marginal benefit starting from this point is  $h(0)$ .
- Assumption 2  $\Rightarrow$  marginal benefit  $>$  marginal cost, and thus  $x^* = s^* = 1$  is a steady state.
- For asymptotic stability, first note that the laws of motion of  $x$  and  $s$  in the neighborhood of  $x^* = s^* = 1$  are given by

$$\begin{aligned} c'_x(\dot{x} + \delta) &= h(x - s) \\ c'_s(\dot{s} + \delta) &= h(s - x). \end{aligned}$$

- Why? We are away from the steady state and there cannot be an immediate jump and thus the first-order conditions have to hold in view of Assumption 1, and because we are in the neighborhood of the steady state  $(1, 1)$ , we must have  $x > \gamma_x$  and  $s > \gamma_s$ .

## Sketch of the Proof (continued)

- This dynamical system can then be written as

$$\begin{aligned}\dot{x} &= (c'_x)^{-1}(h(x-s)) - \delta \\ \dot{s} &= (c'_s)^{-1}(h(s-x)) - \delta.\end{aligned}\tag{13}$$

- Now to establish asymptotic stability, we will show that

$$L(x, s) = \frac{1}{2}(1-x)^2 + \frac{1}{2}(1-s)^2$$

is a Lyapunov function in the neighborhood of the steady state  $(1, 1)$ .

- Indeed,  $L(x, s)$  is continuous and differentiable, and has a unique minimum at  $(1, 1)$ .
- We will next verify that in a sufficiently small neighborhood of  $(1, 1)$ ,  $L(x, s)$  is decreasing along solution trajectories of the dynamical system given by (13).

## Sketch of the Proof (continued)

- Since  $L$  is differentiable, for  $x \in (\gamma_x, 1)$  and  $s \in (\gamma_s, 1)$ , we can write

$$\frac{dL(x, s)}{dt} = -(1-x)\dot{x} - (1-s)\dot{s}.$$

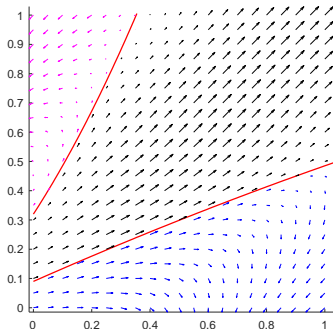
- First note that since  $h(x-s) > c'_x(\delta)$  and  $h(s-x) > c'_s(\delta)$  for  $x$  and  $s$  in a sufficiently small neighborhood of  $(1, 1)$ , we have both  $\dot{x} > 0$  and  $\dot{s} > 0$ .
- This implies that, in this range, both terms in  $\frac{dL(x,s)}{dt}$  are negative, and thus  $\frac{dL(x,s)}{dt} < 0$ .
- Moreover, the same conclusion applies when  $x = 1$  (respectively when  $s = 1$ ), with the only modification that  $\frac{dL(x,s)}{dt}$  will not only have the  $\dot{s}$  (respectively the  $\dot{x}$ ) term, which continues to be strictly negative.
- Then the asymptotic stability of  $(1, 1)$  follows from LaSalle's Theorem (which takes care of the fact that our steady state is on the boundary of the domain of the dynamical system in question).

## Sketch of the Proof (continued)

- The argument for the existence and local stability of the other steady states is analogous.
- To show that there are no other locally stable steady states, we consider all different types of steady states, and either show that they do not exist or that they cannot be locally stable even if they existed.

## Forward-Looking Model

- These results can be (exten) generalized to forward-looking players.
- For example, take same parameters as above, but now also  $\rho = 500$ .  
The resulting vector field is identical to the static model:



- But different when players are very patient.

# Main Idea

- Key new idea: comparative statics are *conditional*: opposite effects depending on where society is.
- Mathematically, we relax Assumption 0.

**Assumption 0'**  $f(x, s) = \phi_0 + \phi_x x + \phi_s s$ , where  $\phi_0 > 0$ ,  $\phi_x > 0$  and  $\phi_s > 0$ .

- In addition, we modify Assumptions 1 and 2 in minor ways, in particular, ensuring that at  $x = s = 1$  the marginal benefit of investment exceeds the cost for both parties.
- Then, all of the results so far generalize.



# Comparative Statics

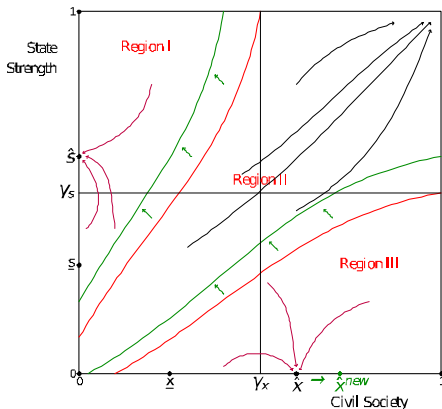
- For comparative statics, let us also adopt:

**Assumption 3**  $h(y)(\phi_0 + \phi_z y) + H(y)\phi_z$  is a decreasing function of  $y$  for  $z \in \{s, x\}$  and for  $y \geq 0$ .

- A sufficient condition for this is that the elasticity of the  $h$  function is greater than  $1/2$ .
- Then, we can show that:
  - 1 A small increase in  $\phi_s$  has no impact on the steady states with  $s = 1$  and  $s = 0$ , and increases the level of state strength in the steady state with  $s = \hat{s}$ .  
This implies that we can think of Paper Leviathan is a situation in which  $\phi_s$  is very low, while the Despotic Leviathan is one in which it is high.
  - 2 A small increase in  $\phi_x$  has analogous effects.
  - 3 Changes in cost functions also have similar effects.
- Furthermore, all of these parameter changes shift the boundaries of the basins of attraction.

# Changes in the Basins of Attraction

- With an increase in  $\phi_x$ ,  $\hat{x}$  increases, and its basin of attraction, Region III, expands. Region I tends to contract.



## Comparative Statics in Action: Greece

- The transition from the use of bronze to iron in itself redistributed political power in society. As Gordon Childe put it

*“cheap iron democratized agriculture and industry and warfare too”.*

- Other technological revolutions.
  - The emergence of writing. Bronze Age Greece had Linear A and Linear B, restricted to the elite and use primarily for record keeping by the state. Around 800 BC a new type of writing emerged which spread much more broadly in society.
  - The perfection of hoplite warfare, perhaps connected to the spread of iron weaponry. Polities who could amass more hoplites in battle had a military advantage and it is possible that this helped to undermine a further empowerment of the mass of citizens.
  - Political leaders could not claim to rule by divine right and there was no fusion between the political elite and religion. Religious power, such as that of the oracle at Delphi, was not controlled by political elites.

## Comparative Statics in Action: England

- Economic diversification intensified after the discovery of the Americas, broad participation in trade and mercantile activities
- Absence of natural resources creating very high rents from holding political power (as in Early Modern Spain with its' colonial extractions)
- Relatively weak Monarchy faced with constitutional constraints in principle since the Magna Carta of 1215
- Absence of labor coercion after the final collapse of feudalism in the wake of the Black Death in the 1340s allowed emergence of vibrant civil society