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Feature Essay

State Capacity and Inequality

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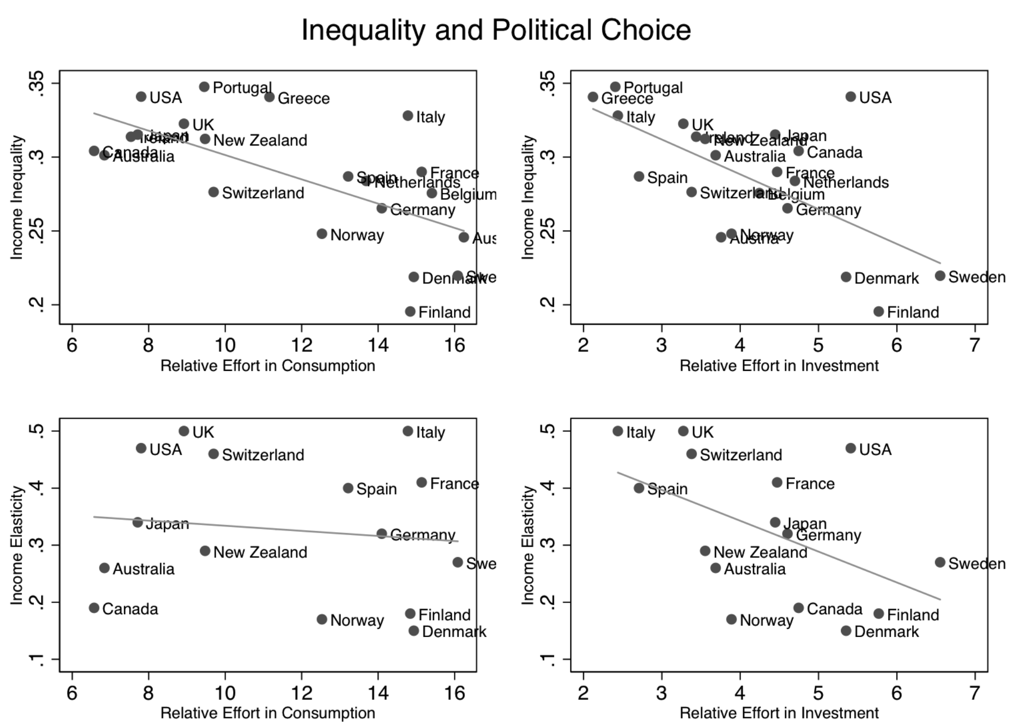
Along with much suffering throughout the world, the Great Recession has brought back an old acquaintance for political economists, namely the idea that prosperity and distribution merely reflect the long-run impact of structural transformations. Seen with sufficient hindsight, the progressive welfare state, to give just a prominent example, would be an exceptional creation of the postwar era now under effective dismantling by the return of capitalism to its steady state. In the most extreme version of this interpretation, politics provides at best the *icing on the cake*. There is certainly a sense of déjà-vu in this old tune. Built on an implicit contrast between social and economic processes on the one hand and political and institutional factors on the other, it shapes scholarly debates as if these two sets of factors were independent from one another, and it shapes empirical work as a race of variables with little, if any, analytical push.

For all the talk about the Great Recession marking the return of capitalism to its bare, and increasingly unconstrained, principles, there remains considerable cross-national variation in the distribution of economic outcomes and opportunities. Figure 1 below (*Inequality and Political Choice*) presents data on income inequality (Gini coefficient for post-tax and transfers income for the working age population around 2010), the income elasticity of children's income on that of their parents[1] (Corak 2013), and the relative effort governments make on current consumption and long-term investment. Investment refers to policies that contribute to increase the overall productivity of the economy, and includes effort in education, research and development, childcare, activation, and public infrastructure. Consumption refers to policies devoted to boost citizens' ability to purchase goods and services in the short run. The balance between these two sets of policy instruments provides an indicator of the willingness by governments to sacrifice current consumption for future prosperity (Beramendi et al. forthcoming).

Among the most prosperous democracies on earth, there is quite a bit of variation in terms of the trade-off between current consumption and future prosperity. This variation is highly consequential to understand economic and distributive outcomes in the postindustrial world. Societies that are able to achieve at once high levels of equality and social mobility (as represented by a lower elasticity of children to parent's in-

1 A higher elasticity implies a higher impact of parents' income on that of their children. A lower elasticity implies that childrens' income is less dependent on that of their parents, presumably reflecting an equalization of economic opportunities.

Figure 1



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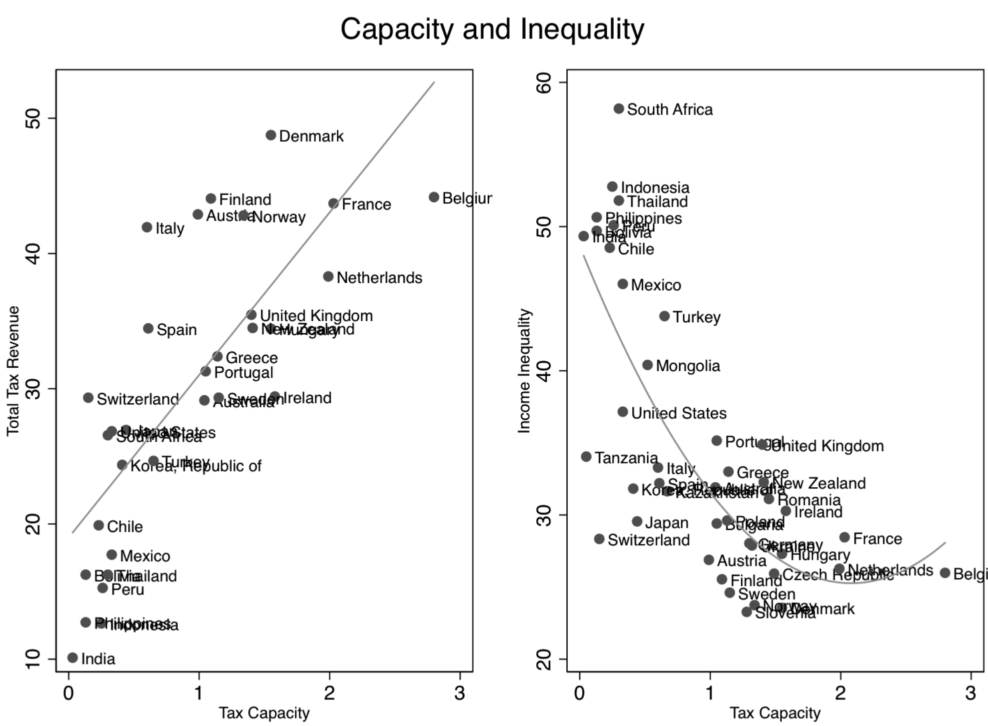
come) are those who spend large amounts of resources in both universalistic transfer programs and progressive investments via public services. The former protect against economic downturns. The latter equalize future economic opportunity. By contrast, the dominant political coalitions outside the Scandinavian paradise generate a different set of outcomes. At low levels of public consumption and when access to investment policies is regressive, as in the USA case, equality of both outcomes and opportunity suffer. Governments fail to ameliorate the social consequences of economic hardship and future opportunities are skewed towards the top. And the concentration of income and wealth at the very top (Piketty 2014) becomes a self-sustained process increasingly difficult to curb.

In between these two extremes, countries such as Italy and, to a lesser extent, Germany, feature large budgets tilted towards weakly (if at all) progressive insurance systems and effectively regressive investment policies. Accordingly, inequality is only moderately contained and economic opportunities are more and more segmented socially, as reflected by the size of the income elasticity of parents' income on that of their children. These are well known patterns to students of the political economy of inequality, patterns that have been around for quite some time amidst common trends such as aging populations, the rise of the service economy, or the rebalance between capital and labor income. Against the background of these common trends, the persistence of these variations reinforces the idea that inequality is, and always has been, genuinely political.

Inequality is genuinely political first because its contours depend largely on what governments choose to do when they have the capacity to opt (as in different combinations of consumption and investment policies). But, critically beyond the subset of advanced industrial democracies, it is political also because it is fundamentally shaped by the scope of the state as an institution and its impact on the incumbents' choice set. The very development of markets, that is the size of the pie to be allocated via future political struggles, requires effective legal and fiscal institutions (Besley and Persson 2011). Unsurprisingly, the fiscal development of the state becomes in itself a major political battleground, because inequality and prosperity around the world are as much about what governments can do as they are about what governments cannot do.

This important point becomes apparent even within the small subset of rich democracies captured in Figure 1. Countries such as Greece or Portugal, and to a lesser extent Spain, are trapped in a low capacity, high consumption political equilibrium that fundamentally limits their ability to undertake public investments and limit dramatically the governments' ability to pursue the equalization of either outcomes or opportunities. The centrality of state capacity, however, becomes starker when the comparison group includes both developed and developing democracies. Figure 2 below (*Capacity and Inequality*) plots an indica-

Figure 2



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new data that the US Treasury could collect at low cost. A modest data collection effort would make it possible to obtain a better picture of the joint distributions of wealth, income, and saving. In turn, this information would be of great relevance to evaluate proposals for consumption or wealth taxation.

Kopczuk, Wojciech and Emmanuel Saez "Top Wealth Shares in the United States, 1916-2000: Evidence from Estate Tax Returns", *National Tax Journal*, 57(2), Part 2, June 2004, 445-487.

Piketty, Thomas and Emmanuel Saez "Income Inequality in the United States, 1913-1998", *Quarterly Journal of Economics*, 118(1): 2003, 1-39, series updated to 2012 online.

Saez, Emmanuel and Gabriel Zucman "Wealth Inequality in the United States since 1913: Evidence from Capitalized Income Tax Data", NBER Working Paper, October 2014, online at http://elsa.berkeley.edu/~saez/.

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What do these rising elites want? They want taxation with representation. Redistributivist approaches assume away a predatory state that expropriates income from rising elites and the masses. However, the threat to life, liberty and property is central to the nature of autocratic regimes. Our argument extends North and Weingast (1989) and other neo-institutionalist theories of the state to the study of regime change. The key political threat in these accounts is not that the poor will expropriate the rich but that the incumbent elite - through their control of the state - will expropriate everyone else. This echoes Lockean themes from Enlightenment liberalism about the symbiotic relationship between democracy and property, and suggests that liberalization of an autocratic regime occurs when outsider groups demand political power commensurate with their growing economic influence.

Once we understand that in a developing autocracy high Gini coefficients indicate the presence of sizable rising middle classes, we can better understand the relationship between economic growth, income inequality, and regime change. The empirical analyses in our book confirm that income inequality strongly predicts democratization, even as land inequality retards it; that redistribution in fact *falls* in new democracies with high inequality, and that high-income citizens in autocracies who dislike redistribution are often democracy's strongest advocates. In short, our argument - which focuses on fear of the expropriative threat of those who control the state - offers a better approach to the comparative study of regime change and its contemporary effort to understand the complicated interplay between growth, inequality, and the politics of democratization across time and space.

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tor of tax capacity[2] against the overall tax revenue yield as a share of the economy (left panel) and a measure of post-tax and transfers income inequality (right panel).[3] Unequivocally, the institutional capacity of the state drives both the level of revenue collection and the ability to combat inequality. Interestingly, Southern Europe provides a clear transition, a *missing linkage* as it were, towards a world in which the government's choice set becomes narrower and narrower.

And yet, despite its importance, our collective understanding of the processes governing the rise of effective state institutions around the world is fairly sparse. A number of recent contributions highlight the importance of domestic political conflicts (Acemoglu 2005, Acemoglu et al. 2011, Mares and Queralt 2013, Beramendi and Queralt 2014), of wars as shocks to the nature of political bargains (Stasavage and Scheve 2010, Dincecco 2011), as well as that of economic geography as the driver of elite preferences for different types of states (Beramendi 2012), but there is much work ahead in unpacking the connection across space and time between state capacity and different forms of inequality. Herein lies a major research frontier in comparative political economy.

2 Source: USAID Project on Fiscal Reform. The indicator captures the number of tax agency personnel for every 1,000 inhabitants living in the country (circa 2009).

3 Gini Coefficient for post tax and transfer income (Solt 2009)

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