The impact of the global financial crisis: What does this tell us about state capacity and political incentives to respond to shocks and manage risks?

Literature review

Part 2: State capacity and response to external economic shocks

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Much of the literature on external shocks, and government responses to these shocks, focuses on the specific drivers of the shock and on the role of economic institutions and of economic policy measures taken as a result. As a consequence, issues of political economy and political context – such as the role played by political settlements – have at times been overlooked. This prompted Haggard, in relation to the East Asian crisis, to note that "the striking feature of the debates among economists… is the absence of systematic political analysis" (2000: 7). Yet at the same time there is growing recognition that economic policymaking rarely takes place in a vacuum, as it occurs within a political context in which some hold greater power than others (Bates 1995: 42).

In light of some these gaps, this literature review seeks to draw on a wide range of material, including some relevant political economy thinking, as well as literature on structural adjustment and state capacity. Where relevant, it also brings in analysis of specific external shocks, such as the East Asian financial crisis. Overall, it finds that there appears to be increasing recognition of the extent to which political factors can contribute to both increasing or decreasing vulnerability to external shocks, as well as to shaping the nature of the response to shocks. Further research is needed to pin down the key dimensions of these political factors. Four themes are identified from this preliminary literature review, namely flexibility and adaptability of decision making, the autonomy of the state particularly in terms of the bureaucracy, state capacity, and the nature of the political settlement and political interests.

Economic flexibility and adaptability

There has been some analysis of the extent to which flexibility and adaptability can decrease vulnerability and strengthen responsiveness to external shocks. In general, the overriding focus has been on economic flexibility, but there is some recognition of the extent to which this can be shaped and affected by the wider political context. The work of Killick and others, for example, has sought to explore what contributes to **economic flexibility** and adaptability. For Killick, economies with flexible structures, which can more quickly adjust, can achieve faster development than those which are rigid: "We can view economic competition among nations as a kind of survival of the fittest, where fitness is determined by the speed with which economies can respond to shocks, can move to take advantage of new technologies and markets, and adjust to the actions of others" (Killick 1995a: 2).

For Killick, the key dimensions of economic flexibility include responsiveness (in other words, the ability of governments to respond to external shocks) and the ability to innovate, linked to entrepreneurship (at individual, firm and state levels) (Ibid: 10). Killick recognises the importance of politics in shaping flexibility and responsiveness – for example, noting that a government which is insecure, corrupt or repressive is unlikely to respond quickly to changes in economic performance. Similarly, he notes that in the face of widespread public rejection, government may respond in ways not previously thought politically feasible (Ibid: 12). But no further analysis is provided of the differing types of political settlement and political context and how they might impact on responsiveness and flexibility.

In seeking to understand the political factors which may contribute to flexibility, issues of incentives and of the use of information, however, seem significant. In specific reference to Africa, Killick focuses on why the economies of many African countries collectively seem to show 'symptoms of inflexibility' while African people appear to be generally resourceful, responsiveness and enterprising (Killick 1995b: 157). He argues that, in these contexts, the flexibility of an economy reflects, firstly, the informational and incentive systems in place, and secondly, how actors respond to that information and those incentives (Ibid: 169). He notes that "The flexible economy needs good intelligence: about changing conditions in world trade and finance; about developments within the domestic economy; about scientific matters, for example, as they bear upon technological progress or climatic changes; and about how these and other variables interact with each other" (Killick 1993: 49-50).

Yet in many developing countries, these forms of information are rarely readily available, as shown in the lack of early warning for disasters like famines or in the lack of available data on levels of debt (Ibid.). In turn, formal and informal institutions and norms shape how actors respond to incentives and available information – for example shaping the extent to which entrepreneurial classes will take risks or how the executive will decide to act on available information regarding external shocks (Killick 1995b: 171-176).

Linked to discussions of flexibility are issues of adaptability. For Seddon and Belton-Jones, economic flexibility depends on **policy adaptability**, defined as the need for effective insulation from short-term pressures (such as from special interest groups), combined with responsiveness to the longer term needs of the economy and of civil society (1995: 326). While these factors clearly have political underpinnings, there has been little analysis of the specific features of this. As Seddon and Belton-Jones note, there is increasing recognition of the role of the state in adaptability and flexibility, but "Simple recognition of the importance of the state leaves unresolved the relationship between the state and the social groups or interests that it represents" (Ibid: 334). For Seddon and Belton-Jones, in trying to explain some of the development successes of East Asian countries, it is the degree of autonomy of the state (government and bureaucracy) which is seen as key in building adaptability and responsiveness, including to external shocks (Ibid: 347).

Summary of key concepts:

Concept	Definition	Key variables
Flexibility	Responsiveness to external shocks and ability to innovate (entrepreneurship)	Availability and accessibility of relevant information; role of incentives; formal and informal norms and institutions which shape how actors will respond to information and incentives.

Policy adaptability	The need for effective insulation from short-term pressures as well as longer term responsiveness to economy and civil society	The nature of the political settlement; the degree of autonomy of the state including from special interests.

Autonomy and notions of bureaucracy

There is a wide ranging literature which builds on Weberian notions of bureaucracy, and looks at example of autonomy such as those offered by development state models. Specifically in relation to responses to economic crises, Evans has warned against a simplistic approach to **autonomy**, highlighting that in the case of a country like the Democratic Republic of Congo, the state could be seen as lacking autonomy – because it was effectively 'up for sale' to private elites – but that at the same time, it was highly autonomous as it did not need to respond to societal interests in the event of a crisis (Evans 1992: 151).

He stresses the importance of state capacity in influencing policy choices and outcomes, and challenges what he terms "the tendency to equate capacity with insulation" (Ibid: 176). Instead, what is key for more effective (or 'transformative') state capacity is "a combination of internal coherence and external connectedness that can be called embedded autonomy" (Ibid.). In other words, Evans recognises that states cannot be completely insulated from society but rather are embedded in a dense network of social ties which structure political elite interactions, including with business actors. In part, this points to the need for effective bureaucracies and suggests that it is the lack of a predictable, coherent and functioning bureaucracy which might explain the gap between the capacity required and the capacity available in many developing countries in responding to crisis (Ibid: 177). But it also points to the importance of analysing the surrounding political context and the motivations and networks of political elites. Others have similarly stressed the extent to which macroeconomic stability can be "profoundly affected by the political security of governmental elites and the extent of their independence from the pull of short-term distributive political pressures" (Haggard and Kaufman 1992: 271).

Callaghy also addresses the extent to which autonomy – of technocrats and governments – determines the ability of African states to adjust and respond to economic crises. Thus the predatory nature of many African states has weakened administrative capacity, and as a result, "African governments developed even more dualistic decision-making structures" with a dominant political half and weakened technocratic half (Callaghy 1990: 261). During periods of economic crisis, however, technocratic elements in post-colonial African states may be temporarily strengthened: "At crisis points, the new rulers felt they had to take corrective measures, a view often reinforced by external pressure. The result was partial, but usually temporary, reliance on the small technocratic stratum" (Ibid). Moreover, Callaghy goes on to argue that the extent to which this technocratic half can be strengthened – and insulated from political pressures – will have a major impact on the extent to which states are able to respond effectively to economic crisis and to adjust their economic policies.

For Callaghy, this '**ability to insulate**' the state is affected by five key factors. Firstly, how the economic crisis is viewed by rulers and how this then affects the commitment to reform;

secondly, the extent to which decision-making can be influenced by "the technocratic half of the *dualistic decision-making structures*" (author's own italics); thirdly, the level of government autonomy from socio-political interests; fourthly, the capacity of the state and overall levels of reform before the crisis; and finally, external influence (for example, by donors) will also have an impact (Ibid: 263). Taken together, it is these factors which, for Callaghy, are likely to impact more on the ability of the state to respond to economic crisis.

Summary of key concepts:

Concept	**Definition**	**Key variables**
Embedded autonomy	Refers to both internal coherence and to external connectedness with wider political context and networks	Predictable, coherent and functioning bureaucracy; network of social and political ties, including with business actors
Ability to insulate	The extent to which technocratic aspects of decision making can be isolated from political pressures	Perception of crisis and commitment to reform; nature of dualistic decision making structures between technocratic and political elements and level of government autonomy from political interests; capacity of the state; role of external actors

State capacity

Issues of state capacity are intimately linked to those of state autonomy and flexibility. Multiple dimensions of state capacity to respond to external shocks can be identified, ranging from technical and administrative to more institutional and political dimensions. Understanding the ways in which a range of political factors influence these different aspects of capacity is therefore crucial.

Nelson defines state capacity as the "**[c]apacity to generate informed and objective analysis** of economic problems and options", with an emphasis on the number of experienced and trained analytical staff in economic agencies (and the extent to which they agree on a common analysis), the authority of central economic agencies (for example, in terms of the constitutional and legal framework), and the levels of managerial capacity (Nelson 1990: 21-22). Although not fully developed, there is recognition of the extent to which these largely technocratic issues cannot be separated from their wider political context: "These dimensions of state capacity are partly matters of technical training and experience, administrative organisation, and legal authority, but they are also intertwined with regime type and political structure, interest groups and political support bases" (Ibid: 22).

Another aspect of state capacity to respond to crisis is that of **policy choices and implementation** capacity. For example, for Stallings, policy choices will be determined by the political interests or coalitions which have the most influence over the government in question, and these choices will in turn depend on the analysis and judgement made about the crisis (Stallings 1990: 113). Implementation is more complex, as it can be affected by the particular dynamics in a state (for example, the level of centralised control or authority) and by the nature of the political settlement and rules of the game (including power dynamics between political interests). Implementation can also be influenced by the role of external actors' such as donors and by other external factor factors including the prices of exports and imports and so on (Ibid: 113-114).

Grindle has also examined the key dimensions of state capacity, and how economic crisis can affect these dimensions (Grindle 1996: 8). She unpacks state capacity into four key dimensions – **institutional, technical, administrative and political capacity**, and compares what states ought to have in terms of capacity and how this is likely to be affected by sustained economic and political crises. Technical capacity is similar to Nelson's definition of capacity (in terms of the ability to generate analysis and options), but it goes wider to include the ability to set and manage macroeconomic policy. Again, this requires experienced, trained analysts and this form of capacity is primarily concerned with technical inputs into decision making. For Grindle, economic crisis may fact strengthen this form of capacity, by increasing the visibility and influence of technocrats and technical capacity, with Ministries of Finance, central banks, national planning institutes and so on becoming much more powerful (Ibid.). This is also linked to administrative capacity, which refers to the effective administrative of basic public services and infrastructure, although for Grindle, this form of capacity is likely to be weakened by economic crisis, undermining government's ability to deliver basic public services and their ability to mediate different social and economic demands (Ibid.).

Grindle also introduces definitions of institutional and political capacity into her analysis of the impact and likely effects of political and economic crisis. Institutional capacity can be linked to the 'rules of the game' in terms of the legal and constitutional frameworks which regulate economic and political interactions. Grindle argues that prolonged crisis is likely to contribute to increased conflict over these rules, weakening states' ability to set and uphold standards for individual and group behaviour (Ibid.)

She distinguishes this from political capacity, which refers to channels for representation and conflict resolution and is linked to the responsiveness of political leaders and the ability of citizens to participate in decision making. Following prolonged crisis, Grindle suggests that political leaders may be less responsive and have less capacity to mediate conflict: crisis may undermine the capacity of state leaders "to command adherence to traditional norms of civic behaviour or to purchase allegiance through beneficial policies or clientelistic distribution of public resources" (Ibid: 10). There may also be tensions between technocratic decision making and pressures for more responsiveness and participation (Ibid.). Overall, Grindle usefully highlights the extent to which different dimensions of state capacity may be affected in differing ways by economic and political crises, suggesting the need to further unpack notions of state capacity.

Moreover, Grindle usefully examines variance in states' ability to respond effectively to crisis, highlighting the importance of a range of political and social factors: "it will depend on economic exigencies and constraints, the strength of pressures for economic and political change from domestic groups and international actors, legacies of a variety of historical and policy experiences, the legitimacy, coherence, and strength of state institutions, and the goals and skills of state leaders" (Ibid: 11). These factors will determine the response from the different dimensions of capacity – for example, following a crisis the extent to which institutional capacity can be strengthened by the development of new rules and institutional structures; or whether weakened administrative capacity will be compensated by experimentations with alternative service delivery mechanism and so on (Ibid: 12). This suggests that it is firstly important to map the different dimensions of capacity and how they have been affected by the crisis, and then to analyse likely options for strengthening capacity where it may have been weakened

Summary of key concepts:[1]

Concept	Definition	Key variables
Technical capacity	Includes capacity to generate analysis of economic problems and options as well as the ability to set and manage macroeconomic policies	Level of experience and training of analytical staff in economic agencies; authority of central economic agencies (Ministry of finance, central bank etc); levels of managerial capacity. (Also Nelson 1990)
Implementation capacity	The extent to which policies can be delivered	Particular dynamics of the state (e.g. level of centralised control); nature of political settlement and rules of the game; access to resources; role of external actors (Stallings 1990)
Administrative capacity	The effective administration of basic pubic services and infrastructure	Ability to deliver basic services; ability to mediate social and economic demands within administrative processes.
Institutional capacity	The 'rule of the game'; the legal and constitutional frameworks which regulate economic and political interactions	Authority and legitimacy of the government; levels of societal agreement on rules.
Political capacity	The channels of representation and mediation between citizens and the state	Levels of responsiveness of political leaders, levels of civil society activism, role of special interests

Political settlements and political interests

Concepts of flexibility, autonomy and capacity allude to varying degrees to notions of political settlements, power dynamics and political interests. Some of the factors explored in this context include political leadership and will, political interests and power dynamics and issues of potential regime change or changes to the political settlement.

Nelson has addressed issues of **political leadership and economic shocks**, highlighting two common views – firstly, that leadership is a major factor in implementing adjustment strategies: "Political will is the major determinant of capacity to adopt and implement adjustment measures; where the political leadership has the required will, the program will carry; where will is lacking the program will fail" and secondly the opposing view that political leadership or will is largely unimportant: "what counts is the constellation of key pressure

[1] Drawn from Grindle (1996) unless otherwise stated.

groups and political circumstances" (Ibid: 24). For Nelson, in practice it may be a combination of political leadership and levels of central authority or control which impact the most (Ibid: 25).

Moreover, Nelson questions the view that authoritarian regimes are more likely to respond effectively to economic crisis or to enforce unpopular adjustment strategies, as she instead highlights growing evidence that authoritarian regimes may be most likely to continue with the status quo while newly elected democratic governments might be more likely to break with the past (Ibid.). Rather than focusing on regime type, it might therefore be more helpful to focus on some specific political variables such as electoral cycles, which may have a bigger impact. For example, if a country is facing an approaching election it may be less likely to significantly adjust economic policies, or alternatively following an election, there may be greater opportunities to take more radical measures (Ibid: 23).

Stallings goes on to analyse how different **political settlements and interests** influenced the responses to economic crises in Chile, Peru and Columbia. She argues that economic crises in the 1980s led both Chile and Peru to initially adopt 'orthodox responses' to the crises but political protests in both subsequently pushed their governments to move away from these preferred policies. In Chile, the authoritarian regime under Pinochet was able to wait for these protests to pass and then continue with its planned approach whereas in Peru, political protests led to a change of government, with the new government (elected in 1985) adopting different adjustment policies (Ibid: 135-6). In contrast, in Columbia, the political alliance forged in 1958 meant that a "closed elite of Liberals and Conservatives… ran the country with substantial consensus" which served to limit the policy options for responding to crisis: "Economically, this quasi-democratic alliance placed boundaries on the types of policies that could be followed, preventing the violent economic swings that typified Chile and Peru" (Ibid: 160).

Alongside this analysis of the ways in which political interests shape both the vulnerability and responses to external shocks, there is a body of literature which looks at how shocks themselves can remake or alter the political balance. Haggard and Kaufman, for example, have examined the potential **relationship between external shocks and regime change**. They critique the commonly held view that external shocks increase the likelihood of regime change and instead focus in on the conditions under which external shocks might lead to such political change (Haggard and Kaufman 1992: 324).

According to their analysis, regime survival depends on whether there are effective mechanisms of representation that can channel group conflict, and on the extent to which an external shock leads to the loss of key supporters (political, military or business) (Ibid.). They point to examples of Nigeria and Ghana, in the late 1970s and early 1980s, where democratic rule collapsed following external shocks, and highlight that both countries had institutional weaknesses and histories of movement between military and democratic rule (Ibid: 328). Thus, external shocks might exacerbate internal divisions or conflicts, and further weaken fragile political settlements. Moreover, economic crisis and external shocks may indirectly contribute to political instability for example where sudden (or gradual but sustained) economic deterioration increases the likelihood of strikes, riots or civil violence (or contributes to the rise of extreme political movements) (Ibid: 35).

East Asian financial crisis

Some of these issues of state capacity, adaptability, political interests and political settlements, have been examined in the context of the **East Asian financial crisis**. Despite the differing country contexts, this crisis had some common features including similar forms of collapse of currencies and stock markets and a high degree of synchronisation of capital market collapse (Chandrasekhar and Ghosh 1998: 66). The 'globalisation of capital' resulted in growing East Asian exposure to international finance, following financial liberalisation, which meant that any setbacks, even those which appeared to be relatively small, could trigger outflows of capital, leading to losses in investor confidence, currency volatility and so on (Ibid: 68). There have been some useful attempts to analyse aspects of the political-economy of this crisis, with a particular focus on the nature of government and business relations.

Haggard, for example, argues that strong **business-government relations** were a key strength during periods of growth in East Asia, but that they also contributed to 'moral hazard' and increased the region's vulnerability to economic shocks (Haggard 2000: 7). Greater political and institutional checks on business influence, as well as increased transparency, could have reduced this vulnerability, as overly close relationships between politicians and some firms became detrimental to responding effectively to the crisis. This close relationship was fostered in part by elements of corruption or cronyism but also by the more prevalent influence of business interests over legislation and regulation (Ibid: 38).

Haggard echoes others arguments that in practice **authoritarian government have few advantages over democratic ones** in responding to the East Asian financial crisis, and he points to democracies such as South Korea which were able to quickly build support from interest groups and the legislature for economic reforms (Ibid: 7). But he also highlights that some political factors can impact on levels of vulnerability to crisis, namely whether there are electoral (or non-electoral) challenges to the current government; the level of inefficiency of decision making processes; and inefficiencies or weaknesses in business-government relations, which all may weaken a government's ability to take action (Ibid: 47). For example, he argues that in Thailand, a weak coalition government struggled to respond quickly to early warning signs and to develop a coherent response, and in South Korea, forthcoming Presidential elections spilt the ruling party and made the government more susceptible to lobbying (Ibid: 50).

Authoritarian Indonesia and semi-authoritarian Malaysia, in contrast, initially seemed to face fewer political constraints but this also contributed to other vulnerabilities, for example by allowing for erratic behaviour by chief executives (Ibid: 51). Moreover, Suharto's centralised control also made it vulnerable to any signs of his weakness, and vulnerable to his discretion: "It is no accident that the authoritarian regime facing the most wide-ranging political change, was also the country that experienced the deepest policy uncertainty and the most profound weakness" (Ibid.). For Haggard, it was significant that the East Asian financial crisis did not lead to any reversals in democratic rule and he argued that the (democratic) transition to new governments in South Korea and Thailand – and to a lesser extent in Indonesia – allowed opportunities for new policy initiatives and responses (Ibid: 221-2).

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