INTERNATIONAL SHOCKS AND PUBLIC FINANCE STRATEGIES

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For my parents

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Abstract

International shocks such as wars and commodity price fluctuations produce financial shortfalls for regimes. In such circumstances, regimes may employ accommodational, domestic, and international strategies to obtain financial resources. Accommodational strategies frequently involve "money creation" and are relatively minor adjustments. Domestic strategies entail a higher domestic tax burden. International strategies represent attempts to obtain the required resources from foreign sources by external borrowing, foreign aid, and other means. The particular strategy chosen has consequences for state-building and development. Over a broad range of developing countries, a strong "political survival" assumption suggests that internationalist strategies will always be preferred. An alternative "political capacity" hypothesis predicts that domestic strategies will be chosen in stronger states. Regime type, "discount rates" of political leaders, central bank independence, and autonomous trends are important explanations of regime financial strategies generally. A major finding from the regression analysis of cross-national, multi-year data is that stronger states have better access to international financing and that all states usually avoid an increased tax burden. A case study examination of India and Pakistan confirms that policy-makers and observers see public finance strategies as intersubstitutable, and that policy-makers have historically preferred to delay or avoid politically costly choices altogether. The dominance of international strategies supports the political survival prediction over the political capacity one.

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CHAPTER 1: Background and Theory

Summary

International shocks such as wars produce financial shortfall for regimes. This means that regimes have to locate and mobilize financial resources to meet operating costs. The question is whether the regime will seek to extract from domestic or international sources. Barnett (1992) suggests that when faced with the needs of mobilization, three types of strategies may be employed: accommodational, restructural, and international. A strong "political survival" assumption suggests that internationalist strategies will always be preferred. An alternative hypothesis taken from the "political capacity" literature states that restructuring will be chosen in medium and high capacity states. Other statements in the literature suggest that regime type, "discount rates", political calculations of rulers, central bank independence, and autonomous trends are important explanations of regime financial strategies generally, and therefore need to be included in a model of regime financial strategy. In this chapter, I describe the theoretical background of a set of hypotheses. In Chapters 2, and 3 I test these hypotheses using pooled time-series models. In Chapters 4 and 5, I explore these hypotheses and their underlying assumptions with case studies of India and Pakistan. Chapter 6 concludes the dissertation with a description of the findings, a discussion of limits of this study, and presents topics for further research.

Plan of the chapter

I start by placing this work in the big picture of explanations of political phenomena. Why shocks are a particularly relevant object of attention is then discussed. I then offer definitions of some of the terms and make explicit some of the assumptions that will be used in this work. General perspectives on the state, rulership, and extraction are then discussed, followed by an examination of perspectives on what makes a state "strong" with respect to society. The warmaking-statemaking logic is then reviewed. After this, I survey a "text-book" approach to understanding government finance. I then describe the political survival model and the political capacity model and arrange two hypotheses in a summary table. Following this, the role of regime type in determining regime extraction policy is described. The general nature of fiscal crises is reviewed. I then discuss nonwar shocks and why they should be treated distinctly from wars. Finally, I summarize the hypothetical relationships in a diagram and a list of formally stated hypothetical propositions.

The big picture

In the broadest picture, this work looks at the nexus between international and domestic politics. Bienen and Gersovitz argue that "the complicated interactions of external and internal political and economic factors are not captured by overarching frameworks such as dependency theory or world-system theory" (Bienen and Gersovitz, 1986: 25). I suggest that the focus on one mechanism- the impact of external shocks on regime revenues- is one avenue to understanding the linkages between the IPE and domestic politics. In certain conditions, external shocks drive state attempts to increase extractive capacity, which in turn has implications for state power with respect to society. The sources from which states derive the revenues they need to operate have a significant influence on state-society relations. State-society relations are based on an implicit bargain or contract under which the taxes and compliance from the citizenry have been traded for security and order provided by the state. IPE shocks sometimes spur states to alter their sources of revenue, and in particular to seek increases in extractive capacity. IPE shocks also have the potential to directly affect society. This implies a remaking of state-society relations.

Figure 1.1 Summary diagram of theoretical relationships

In diagram form, this linkage may be outlined as follows.

International shock → (+) fiscal requirements → extraction strategy choice → state-society relations

Socioeconomic effects on society → Societal preferences   state power

consequences for political- economic development

While this is the big picture, the research in this dissertation will focus on the portion of the picture inside the oval. The focus on explaining regime extraction strategy is legitimate as it is both a cause and consequence of political development. The remaining set of theoretical relationships is important and deserves study. Domestic restructuring has consequences for political and economic development. For Chapters 2 and 3 of this dissertation, the remainder of the picture is placed inside a metaphorical black box. This black box will be reopened in the case study analyses of Chapter 4.

Why study shocks or crises?

Shocks have the potential to produce major changes in regime policy. Many scholars have pointed to war and international crises as promoters of domestic institutional change. These include Evans et. al (1985), Ikenberry (1988), North (1981), and Rasler and Thompson (1989). Barnett argues that wars and other international crises produce the potential for radical changes in policy by opening up the policy process and allowing the expression of different policy proposals by new groups. Both "state and domestic actors recognize that crisis politics demand a deviation from the routine to satisfactorily confront the exceptional challenge" (Barnett, 1992: 251). Furthermore, standard operating procedures and habitual ways of dealing with problems are not up to the task of dealing with a crisis. Therefore, decision-makers are more likely to find new alternatives as well as overcome social and bureaucratic opposition and inertia (Barnett, 1992: 251).

The definition of international shocks used here is those exogenous events that have the potential to result in radical increases in fiscal requirements. In certain cases these drive major changes in government policy of public finance. A war, in particular, is significant because it presents an immediate external threat. As Barnett puts it, "where war is ongoing, intense, and life-threatening, governments may be [...] more willing to extract from their societies" (Barnett, 1992: 288, note 60).[1] Other international shocks include changes in international credit and other markets. By dramatically reducing the flow of capital into a state, these shocks also have the potential to produce radical changes in fiscal requirements of states (Snider, 1996: 93).

A useful subclassification of shocks is to divide them into shocks to spending and shocks to revenues (Roubini, 1991). Shocks to spending occur when the spending needs of the state are suddenly increased. Shocks to revenues occur when some outside factor, frequently economic, cuts into the base from which government revenues are obtained. This produces a revenue shortfall. Wars can be classified as shocks to spending, and international economic shocks can be thought of as revenue shocks, but neither have to fit exclusively into these categories. In other words, it is conceivable that wars produce a national emergency in which the normal economic functioning of society is impaired so there is a shock to revenues. It is also conceivable that an international economic shock may produce a shock to spending, such as an oil shock that necessitates an expensive shift to a different energy source with a lot of government oversight.

Terms and assumptions

Max Weber defined the "ideal-type" of the state as "an organization, composed of numerous agencies led and coordinated by the state's leadership (executive authority) that has the ability or authority to make and implement the binding rules for all the people

[1] Rasler and Thompson question "the value of maintaining the internal-external distinction when pursuing questions related to the state-making consequences of war" (Rasler and Thompson, 1989: 12). Internal warfare may frequently have the involvement foreign allies of various warring parties. For this reason, it is reasonable to not focus exclusively on those events defined as "international" wars, but to include those events defined as "civil" wars as relevant shocks as well.

as well as the parameters of rule making for other social organizations in a given territory using force if necessary to have its way" (as worded in Migdal, 1988: 19). Real states fit this description to greater and lesser extents. Thus, the state is an organization with primary authority in a given territory. The regime of a state describes the style according to which national politics are organized. Examples of such styles are the traditional categories of democracy and autocracy.

A regime is administered by the government, or the managers of the affairs of the state. The administration of a regime is centered on the chief executive and named after him. One regime may see several administrations (for example, succeeding rulers in a monarchy). This regime-administration distinction was used by Barry Ames in his work on Latin American politics (Ames, 1987). Chief executives and state managers engage in mainly short-term estimations of costs, although there is reason to consider variation in discount rates for the future (Levi, 1988; Barnett, 1992). Chief executives and administrations react to threats to survival. Such threats can be domestic and/or international in origin.

Irrespective of ideology, regime leaders strive to obtain revenues. Levi (1981) argues that regardless of particular values they may hold, all leaders seek resources from society. Levi makes the assumption of the rational, revenue-seeking ruler robust for ideologically driven, ostensibly "altruistic" leadership. Such leadership stamps its own particular vision of the "social good" as the substantive goal toward which its activities are rationally directed. Despite this, the ruler still seeks the same maximization of revenue as a means justified in terms of the requirements of ideological goals (Levi, 1981).

Regime extraction strategy refers to the means by which regimes appropriate the financial resources needed to fund their policies. These means are broadly divided into taxation, borrowing, and money creation. The strategy that is actually followed is usually some combination of these three.

A strong assumption of the first two empirical chapters is that domestic society can treated as a "mass". Actors in domestic society are not differentiated from each other. Society is simply the pool into which governments reach to extract resources. This does not necessarily suggest the absence of societal constraints on state behavior. This strong assumption is relaxed in the case study of India and Pakistan. International society refers to all groups and organizations outside a country's borders that may possibly be a source of finance. This includes donor governments, international lending institutions, and other international agencies that may provide grants.

Perspectives on the state, rulership, and extraction

According to Organski, et. al., "any state must perform three principal functions: maintain national security (ie., external defense and the repression of internal rebellion or disorder), collect resources to meet collective needs, and mobilize the population for national purposes" (Organski, et. al., 1984: 45). Taxing constituents is a fundamental activity of the state. The rise in central political power is closely correlated to a rise in taxation. "Because whatever governments may wish to do will require resources, the amount of revenues they extract can be used as an indication of the level of political power attained by central authorities" (Organski, et. al., 1984: 45). Organski, et. al., suggest that people resist taxation whenever possible and "the growth of the state is punctuated by rebellions against taxation in all its various forms" (Organski, et. al., 1984: 50).[2]

Evans (1989) compares perspectives on the Third World state. The "predatory" or "rent-seeking" state is associated with neoutilitarian models (by which Evans refers to rational choice models). Another perspective describes a "developmental" state that engages in entrepreneurship and plays a needed role in economic transformation. Incumbents sometimes "extract and distribute unproductive rents", and "all states perform certain functions indispensable to economic transformation" (Evans, 1989: 562). Evans describes Zaire as an "exemplary predatory state" (Evans, 1989: 569). Taiwan, South Korea, and Japan are described as "developmental states" (Evans, 1989: 572). Most states contain elements of both models.

Douglass North's objective in developing his "neoclassical theory of the state" to explain the tendency of states to produce "inefficient property rights"; North's presumption is that "efficient property rights" are prerequisites for sustained economic growth (North, 1981: 23). The idea in using a "neoclassical" model is to produce a "disciplined and logically consistent approach to the study of the state" provided by the theory of choice methodology of neoclassical economics. North's theory is strongly grounded in the unified field of political economy. This is embodied in his statement that

[2] Attempts to increase extraction are therefore politically risky. Snider, however, suggests that "[a]n increase in a country's average penetration capacity (which emphasizes the share of direct taxes as a percentage of total revenue relative to trade taxes and indirect taxes), should have a dampening effect on political unrest arising from implementation of an austerity program" (Snider, 1990: 416-417). This appears to run counter to the logic that says that tax increases will always be resisted. Therefore, we have one hypothesis suggesting increased dissident activity following tax increases (Organski, et. al., 1984) and another hypothesis suggesting decreased dissident activity following tax increases (Snider, 1990).

"[o]ne cannot gain a useful understanding of the state divorced from property rights" (1981: 21).

North defines the state as an organization with a "comparative advantage in violence, whose boundaries are determined by its power to tax constituents" (1981: 21). Property rights are essentially the "right to exclude" (ibid.). Central to understanding North's model of the state is the notion of the "potential use of violence to gain control over resources" (ibid.).

North's model of the state assumes a single wealth- or utility-maximizing ruler (1981: 23). One characteristic of the model is the exchange process between the ruler and the constituents; the state trades a group of services in return for revenue (ibid.). The basic service provided by states to constituents is the "rules of the game". The objectives of these are firstly, to provide a structure of property rights for "maximizing rents accruing to the ruler", and secondly, to "reduce transaction costs in order to foster maximum output of the society and, therefore, increase tax revenues accruing to the state" (1981: 24).

The terms of this exchange are conditioned by two factors. Firstly, the state seeks to act as a "discriminating monopolist, separating each group of constituents and devising property rights for each so as to maximize state revenue" (ibid.). Secondly, the "opportunity cost" of his constituents is a constraint on the leader in that there are always potential rivals to provide the same set of services (these rivals may be external, such as other states, or internal, ie., competing individuals within the state aspiring to rulership) (1981: 23-4). An alternative way of conceptualizing these conditions is that the "degree of monopoly power of the ruler" is "a function of the closeness of substitutes ... [available to] the various groups of constituents" (ibid.). Throughout North's work, the nomenclature of microeconomics as seen in terms like "opportunity cost" and "monopoly power" is no accident; North's explicit aim is to create a theory of the state directly analogous to Ronald Coase's theory of the firm. To summarize, in North's model of the state, the latitude of action available to the ruler rests on the ability of his constituency to replace him.

Tilly (1985: 181) argued that states engage in four basic activities. These are defined as follows.

> 1. War making: Eliminating or neutralizing their own rivals outside the territories in which they have clear and continuous priority as wielders of force
> 2. State making: Eliminating or neutralizing their rivals inside those territories
> 3. Protection: Eliminating or neutralizing the enemies of their clients
> 4. Extraction: Acquiring the means of carrying out the first three activities-war making, state making, and protection. (taken from Table 1.1 in Rasler and Thompson, 1989: 7).

Extraction is therefore a central activity of the state, providing the resources necessary to carry out the other three activities.

All of these perspectives describe the appropriation of resources as a fundamental policy activity of the state. Although there is some divergence in their social science paradigms (Tilly, for example, tends to focus on groups and follows a "sociological" style of analysis, while North's work is grounded in a rational-actor tradition), it is revealing that all approaches converge on the centrality of regime extraction. The form of regime extraction can be both a reflection and a cause of state strength. Before this statement can gain a fuller meaning, some perspectives on state strength are needed.

Perspectives on state strength

Migdal describes Egypt, India, and Mexico as having a "middle level of capabilities" with respect to a relatively strong state (Israel) and a weak state (Sierra Leone) (Migdal, 1988: xix). [Others might classify India and Egypt as weak states (cite)]. Migdal suggests that the image of "weak states" encompasses the bureaucratic-authoritarian states of Latin America (Migdal, 1988: 7). Opposing images of strength and weakness in states may be due to scholars that "are looking for strength in different realms" (Migdal, 1988: 8). A focus on "capabilities involving state penetration of society and extraction of resources" has occupied "proponents of the strong state image" (Migdal, 1988: 8). These researchers have examined taxation and related issues. Advocates of "the weak state image, meanwhile, have examined capabilities involving regulation of social relationships and appropriation of resources in determined ways" (Migdal, 1988: 8). These scholars have looked at the state's efforts to transform society and implement policies.

Krasner classified state strength on the basis of three dimensions: their ability to resist private pressure, to change private behavior in intended ways, and to change social structure in intended ways. Weak states are not able to do any of these. Middle states are able to do the first two but cannot change the social structure in intended ways. Strong states can accomplish all three (Krasner, 1978: 57, as described in Migdal, 1988: 285). Katzenstein used the number and range of policy instruments as the distinguishing feature between strong and weak states (Katzenstein, 1977: 892, described in Migdal, 1988: 285).

Snider distinguishes between the "strong state" and the "predatory state" (Snider, 1996: 188).[3] A strong state fosters the wealth of the society as a whole whereas a predatory state is based on the extraction of rents and wealth-maximization for the group that captures the state. State power has a strategic and an infrastructural dimension. The strategic power dimension "includes the capacity (and the resources) to unilaterally project power into the international environment", and infrastructural power "reflects a political system's capacity to make internal structural adjustments to shocks and pressures emanating from the international environment" (Snider, 1987: 344). Snider asserts that "[a]part from the ability to extract human and material resources from society and some (as yet undetermined) degree of policymaking autonomy from private interest groups, a truly definitive conception of what makes for a "capable" state remains elusive" (Snider, 1996: 44).

While there is some overlap between these perspectives, there is not a complete convergence among scholars in their definition of state strength with respect to society. For this work, it is sufficient to note that all definitions involve some reference to the ability of the state to alter aspects of domestic society. There is also a reference to the ability to extract resources from society at will. Once a state engages in restructuring of society or increased extraction, the likely result is added state strength.

Financing government expenditures: a "text-book" approach to government finance

[3] Snider's "strong" and "predatory" state distinction closely parallels Evans' distinction between the "developmental" and the "predatory" state (see Evans, 1989).

Although the political economy of public finance policies of developed countries has received substantive empirical attention, scant empirical work has been done on the political determinants of fiscal policy in developing countries (Roubini, 1991). In a general textbook-style survey work, Richard Goode (1984) outlines issues of government budgeting, taxation, spending, money creation, and borrowing with special reference to developing countries. There are three major channels for financing government activities. These are taxation, borrowing, and money creation. The three are not mutually exclusive policy choices. Rather, they can be engaged in simultaneously.

Taxation/ domestic extraction

A "tax" is defined as a "compulsory contribution to government made without reference to a particular benefit received by the taxpayer" (Goode, 1984: 75). The ratio of tax revenue to GNP or GDP is a customary measure of the level of taxation (Goode, 1984: 84). Determinants of tax ratio are the demand for government expenditures, the availability of nontax sources of finance (such as borrowing and money creation) and the willingness to use these, and the taxable capacity of the country (Goode, 1984: 84). A useful distinction is that of "taxable capacity" and "tax effort". "Taxable capacity depends on the ability of the people to pay and the ability of the government to collect. Tax effort is the degree to which taxable capacity is used" (Goode, 1984: 84).

Money creation/ accommodational policies

Money creation occurs when a government finances its expenditures "by additional currency or bank deposits that are transferable and generally acceptable in domestic transactions" (Goode, 1984: 212). Seignorage in the form of printing money is a tangible act of money creation. Frequently, money creation takes the form of legal borrowing from the central bank. This results in net addition to the money stock (this may possibly also be the case in government borrowing from commercial banks, but this relationship is less clear) (Goode, 1984: 212-213).

In some ways, money creation is close to the "accommodationist" policy route suggested by Barnett (1992) as the first policy choice of all regimes. The accommodationist route is first chosen because it is easy to employ and uses existing monetary and fiscal instruments. Money creation fits this description. Furthermore, money creation has an element of disguise in it. It is possible that the public does not immediately catch on to this policy activity. Weak governments are especially attracted to this option. Goode (drawing on Keynes' *Tract on Monetary Reform* (1971)) describes policies of money creation in the following way.

> Although economic discussions usually imply that money creation is a deliberately chosen means of finance, probably it is more often the result of misjudgment, weakness, or fecklessness than of careful calculation. Financing by money creation appeals to a weak government. Unlike taxation, no administrative machinery is required and no administrative cost is incurred. The process is impersonal and at first usually unnoticed. Adverse incentive effects are not apparent. (Goode, 1984: 214).

Thus, the relatively unobtrusive nature of money creation and its ease of implementation make it appealing for weak governments in particular.

The main effect of "large and continuing" money creation is inflation (Goode, 1984: 213). (Balance of payments deficits are another effect, but these are constrained by the availability of foreign exchange reserves and international credit (Goode, 1984: 213).) (A substantial literature exists on the effects of inflation on deficits. Additionally, inflation has the potential to affect tax revenues. Inflation has multiple effects on various parts of the economy. The net political consequences of inflation are ambiguous (Goode, 1984: 229)).

Borrowing/financing abroad

Few opportunities for non-bank domestic borrowing exist in developing countries. Goode (1984: 198) provides some reasons for this. Borrowing from abroad is different from domestic borrowing "in that it gives the borrowing country command over more goods than it is currently producing" (Goode, 1984: 203). (Repayment and debt-servicing requires a transfer of resources out of the country, which is not the case with domestic borrowing). While domestic borrowing exists as a possibility, this research project will focus on borrowing or grants and aid from international sources.

Goode suggests that borrowing may be "advisable to meet an emergency that would otherwise require a sharp increase in taxation" (Goode, 1984: 197). This lends support to the idea that in times of heightened fiscal requirements, governments face a choice of strategies of finance. They can create money, increase taxes, and obtain resources from abroad, by borrowing or otherwise.

Warmaking and statemaking: how wars affect state power

The tendency for state-building results from the outside environment in which states are situated. In brief, "[a] prime motivation for state leaders to attempt to stretch the state's rule-making domain within its formal boundaries, even with all the risks that has entailed, has been to build sufficient clout to survive the dangers posed by those outside its boundaries, from the world of states" (Migdal, 1988: 21). War involvements are times when external dangers become especially prominent and have the potential to spark efforts to build state power.

Barnett (1992) summarizes the "warmaking-statemaking" argument as follows. "A security threat forces the state, owing to its pivotal role as defender of the country's borders, to mobilize the required material and human resources, and to take extraordinary measures, both politically and economically, to confront these foreign challenges. The end of hostilities does not, however, signal the state's withdrawal to its prewar stance, as these new-found procedures became a permanent part of its policy arsenal and thereby contribute to the expansion of the state apparatus and its control over society" (Barnett, 1992: 258). State power is thus "a beneficiary of war", a condition "best evaluated by examining [the state's] capacity to implement and extract from society" (Barnett, 1992: 258).

The part of Barnett's argument I focus on here is linked to his description of financial policy.

> "The government's financial policy is shaped by both the underlying distribution of societal power and the state's institutional capacities that enable it to penetrate, extract from, and monitor society. [....] [A]ll state managers are attentive to and constrained by the flow of resources upon which the deployment of the state's means depends, and the ability either to develop alternative sources of financial means or to loosen its dependence on the capitalist class substantially increases its autonomy. This independence may come from either the acquisition of foreign loans, which might give the state an additional instrument of control over society, or a fiscal crisis of the state, which might compel the government to devise new fiscal strategies" (Barnett, 1992: 27).

As was mentioned earlier, the "underlying distribution of societal power" is black-boxed in this analysis. (One exception is central bank independence, a factor that constrains the fiscal policy options available to the executive authority. This is discussed further below.) Barnett suggests that when faced with the need to raise resources, states will try "to mobilize the required resources at a minimal level of political cost" (Barnett, 1992: 31). Resources can be mobilized through accommodational, restructural, and international strategies.

The accommodational strategy relies on "already existing policy instruments" and modest changes in those instruments. This relatively routine action preserves the status quo and therefore carries few political costs. This strategy is "invariably" the state's initial approach (Barnett, 1992: 31). Money creation as described by Goode (1984) would be an accommodational strategy. Truly radical money creation (such as printing currency in the Weimar republic) is not in the spirit of the kind of relatively unobtrusive accommodational policy envisioned by Barnett (1992). Such drastic actions are too exceptional to warrant special treatment of money creation activities as non-accommodational or possibly even restructural policies. Instead, money creation will generally be treated as an "accommodational" policy.

In the restructural strategy, "state managers attempt to restructure the present state-society compact in order to increase the total amount of financial, productive, and manpower resources available to state officials" (Barnett, 1992: 32). Restructuring can follow a "centralization" scenario in which the state increases its direct control over societal resources, through such measures as introducing direct taxation (Barnett, 1992: 32). Alternatively, it can follow a ""liberalization" scenario, in which the state disengages from or withdraws control over society and economy to increase the societal contribution" (Barnett, 1992: 32). The objective of both tactics is to increase the proportion of social resources at the disposal of the state.

The international strategy involves "attempts to distribute the costs of war onto foreign actors" (Barnett, 1992: 33). The international strategy appears to be the most appealing from the standpoint of domestic political stability. The availability and sufficiency of external arrangements limit the implementation of this strategy (Barnett, 1992: 33).

Nonwar IPE shocks and consequences for state power

An IPE shock happens when flows of external capital are drastically reduced or cut off entirely (Snider, 1996: 10). In Snider' study, ""external shocks" refers to changes in international markets or financial flows that can drastically alter a country's terms of trade" (1996: 93). Here, external shocks will include drastic reductions in foreign aid, international credit, and terms of trade. External shocks can produce revenue crises of two kinds: liquidity crises and solvency crises. The revenue structure and level of political capacity determine whether an IPE shock becomes a liquidity crisis or a solvency crisis. Both liquidity and solvency crises are fiscal crises- government revenue falls far short of expenditures. Both are subcategories of Roubini's "revenue shocks", meaning a shortfall in revenues collected (Roubini, 1991). The crises differ qualitatively in the respective policy solutions demanded by each.

Regimes address a liquidity problem with a "short-term "quick-fix" package of measures designed to remedy a foreign exchange shortage [...] [t]he standard set of instruments includes fiscal austerity, credit ceilings and raising domestic interest rates"

(Snider, 1996: 11). Solutions to liquidity crises involve short-term macroeconomic policies. Solvency problems need these measures as well as longer-term structural adjustment, including such measures as trade liberalization, deregulation of commerce, and tax reform (Snider, 1996: 12). Solutions to a solvency crisis are "medium term" and require deep structural changes.

Despite the differing demands on regime economic policies, both liquidity and solvency crises increase fiscal requirements and therefore have the potential to drive efforts by the regime to generate revenues and cover financial shortfall. When faced with an IPE shock-based revenue crisis and its associated fiscal requirements, regimes have at least three options, which may be implemented exclusively or in conjunction with each other. The first is to seek resources from the IPE, whether through foreign aid, IMF aid, or more external debt through other forms of international borrowing. The second is to restructure domestically and extract more from the population. The third is to engage in minor domestic changes using existing instruments of fiscal and monetary policy. The theoretically possible options for financing regime expenditures are thus identical to the options available in the case of a war crisis. To the extent that domestic restructuring is chosen as a policy activity, and given that domestic restructuring typically produces an increase in the power of the state, IPE shocks have the potential to produce increases in state power.

The "political survival" model

Barnett (1992) suggests that state preferences are guided by two objectives. The first is war preparation. This involves mobilizing financial resources, the actual instruments of warfare, and personnel (Barnett, 1992: 21). The second objective is political stability, meaning protection from domestic challenges to rule (Barnett, 1992: 22). When these two objectives conflict, one may have to be privileged. Realists suggest that external security will take precedence. An alternative view, based on the observation that state survival has been "virtually guaranteed" by the sovereignty principle, suggests that state managers, concerned with their own survival, will privilege domestic stability over war preparation (Barnett, 1992: 24-25). The basis for the "political survival" model is the suggestion that in the modern era, except under those very rare circumstances in which state survival is threatened, concerns for domestic stability will always take precedence.

Thus, the "political survival" model assumes that the regime considers its political survival to be its first priority. This "survival" objective means that the "private" interests of the regime may diverge from the "public interest", the interests of the state, and the interests of future regimes. For example, if a regime feels that it is not negatively constrained domestically, or can avoid domestic repercussions, it will borrow hugely and mortgage its future in the knowledge that the costs of such borrowing will be borne by other, future regimes.

Under the political survival model, regimes will subvert all other objectives when they are threatened and in danger of being replaced. The assumptions driving the political survival model are best represented in Migdal's words: "[n]o agenda is worth anything if its sponsor has not lasted through the hazards of politics" (Migdal, 1988: 226). In other words, survival overwhelms policy preferences as a value for politicians. Leaders with agendas of social change may ascend to power, but then face the "structural dilemma in power- the danger of fostering the growth of powerful state agencies in the absence of adequate capabilities for political mobilization" causing a "critical shift in priorities" (Migdal, 1988: 226).

In cases of domestic politics, extracting additional resources is a highly politically sensitive act likely to encounter opposition. As a result, whenever possible, the regime will try to export the costs of adjustment. Anything else would be likely to threaten its domestic position. Under the "political survival" hypothesis, "international" strategies will always be preferred to domestic extraction. (This strict preference ordering may be alleviated to some degree in cases where the political ruler has a low discount rate, meaning that he is very insecure in his tenure. In such cases, it is possible that the ruler may resort to plunder in the belief that he will be unseated from power in any case. The notion of a discount rate is further discussed below.)

The "political capacity" approach

The sources from which states derive the revenues they need to operate have a significant influence on state-society relations. State-society relations are based on an implicit bargain or contract under which the taxes and compliance from the citizenry have been traded for security and order provided by the state. IPE shocks sometimes spur states to alter their sources of revenue, and in particular to seek increases in extractive capacity. This implies a renegotiation of the social bargain. The "political capacity" approach suggests that an attempt to increase domestic extraction (a type of "restructural" policy) is particularly likely to happen in stronger (higher capacity) states.

“Political capacity” is closely related to measures of state power. Kugler and Arbetman (1989) follow Kugler and Domke (1986) and Organski and Kugler (1980) in suggesting that “adequate evaluations of [state] power should include, along with objective components of capabilities, political factors that account for the ability of governments to extract and allocate available resources” (Kugler and Arbetman, 1989: 68). Kugler and Arbetman suggest the following equations:

Power = domestic capabilities + external capabilities

Domestic capabilities = GNP x relative political capacity

External capabilities = foreign aid x political capacity of the recipient (ibid.)

The authors argue that government revenues contain economic and political aspects that must be separated in order to measure political capacity. This can be achieved by relative political capacity, “the ratio of what a government actually extracts and what such a government should be able to extract given the wealth of the society” (Kugler and Arbetman, 1989: 69).

The “expected” extraction is an estimate based on “economic factors that ease or render more difficult the task of government to obtain revenues”; for developing countries, “where one assumes that governments extract all they can, controls are introduced for reliance on exports, productivity of populations, share of agricultural production, and reliance on mining” (Kugler and Arbetman, 1989: 69). In summary, “RPC provides a shadow measure of governmental performance that identifies the *relative* ability of a government to perform political tasks given the record of other governments in countries that have achieved the same socioeconomic level of development” (Kugler and Arbetman, 1989: 69).

The concept of political capacity gets at the degree of state reach into society. "Political capacity refers to a government's ability to extract resources from society in order to implement policies chosen by the political elite and to respond to pressures exerted by the international and domestic environments" (Snider, 1990: 405). ""Strong" political capacity refers to a government's ability to extract, allocate and *reallocate* public revenue from one sector to another" (Snider, 1996: 4). Snider further hypothesizes that "the stronger the aggregate political capacity of the state, the wider is the range of policy choices available to government leaders, the more able is the state apparatus to logistically implement political decisions, and the stronger is the performance of the economy" (Snider, 1996: 17). Thus, political capacity defines the extent of policy options and flexibility available to regimes. States with low political capacity are weak states. States with high political capacity are strong states.

Snider elaborates three elements of political capacity. The first, relative political extraction, is "the ability to mobilize and redirect the human and material resources in society in order to obtain policy objectives" (Snider, 1996: 6). The second is "the credibility or formality of political and economic institutions" (Snider, 1996: 7). The third element is the explicitness of government action, or "the degree to which government extractive efforts are overt and explicit "with consent" or covert and clandestine" (1996: 9). The reference to "covert and clandestine" describes policy changes that are unannounced and chosen because they are likely to go unnoticed (at least in the short term) by the public.

Kugler and Arbetman (1997) define the elements of political capacity differently. Relative political extraction remains one dimension of political capacity (it should be noted here that their calculation of the relative political extraction index differs slightly from Snider's (1996) calculation). The second dimension of political capacity in Kugler and Arbetman's formulation is "relative political reach" (RPR). This measure seeks to reflect the efficiency of government in "coopting" the citizenry and implementing goals (Kugler and Arbetman, 1997: 25). The measure for this concept involves estimating the size of the informal sector of the country's economy, based on the logic that this reflects the relative weakness of government in monitoring and sanctioning illegal activities. A larger informal sector reflects a lower ability to govern.

Scholars in the "political capacity" literature posit a "diminishing marginal growth of extractive capabilities" (Snider, 1996: 48; Organski, et. al., 1984). Over the course of development, a curvilinear pattern of growth in extractive capabilities is followed. At very low levels of development, the marginal cost of each additional unit extracted from society is high. At a medium level of state development, the marginal cost of extraction becomes lower. Once high levels of development are achieved, the political costs of achieving each additional increment of extraction become progressively greater. Thus, the political capacity approach suggests that a "restructural" response to an IPE shock is most likely to occur in a developing country. This theoretical position is summarized in the statement that: "[O]ur theory leads us to expect that these marginal costs are high at the underdeveloped and developed levels, but that they are low for developing countries, that is, at the intermediate stage in the process of development" (Organski, et. al., 1984: 59).

In comparing states across similar levels of development, the question is whether the political strength of that state allows it to extract higher levels in the context of an IPE shock. For the politically weak regime, resources from outside appear to "offer escape from the problems of balancing the simultaneous demands of political legitimation from domestic social groups and economic development, on the one hand, with a low capacity for extracting resources from society in order to finance these activities, on the other" (Snider, 1990: 404-405). The tax structures of weaker states are likely to be based on indirect taxes and trade taxes, making government revenue vulnerable to shocks originating in the IPE (1996: 10). This is correlated to low political capacity because such taxes tend to affect the fewest domestic constituencies and are also relatively easy to implement. Snider further illustrates this logic as follows. "The lower the share of revenues that come from direct taxes in relation to the revenue derived from taxes on trade, the narrower the tax base, and the less able is the government to effect structural adjustment, and the more vulnerable it is to external shocks from the global economy" (Snider, 1996: 10). Politically weak regimes therefore tend to also be the regimes with the weakest political capacity.

In the context of a revenue crisis the "restructural" option is a relatively feasible and attractive policy response for regimes with stronger political capacity. This is particularly likely in the case of developing countries as these are grouped on the low point of the marginal costs of extraction curve. The "international" option will be sought most frequently and aggressively by regimes with low political capacity. This is because international resources allow them to alleviate their fiscal problems without having to engage in the politically dangerous task of renegotiating their domestic social bargain. Higher capacity states are better equipped to deal with domestic adjustment in terms of policy instruments. Additionally, the nature of the crisis facing higher-capacity states is likely to be different- they are likely to face liquidity crises rather than the deeper solvency problems that are likely to face low-capacity states.

Another way to encapsulate the "political capacity" hypothesis is that low capacity regimes are already more IPE-dependent for their operating revenues. Snider argues that the "greater the proportion of tax revenues that comes from international trade and transactions, the greater the government's revenues are susceptible to shocks and unfavorable changes in the international system" (Snider, 1987: 326). In particular, LDCs that are mineral or petroleum exporters tend to have weaker governments that are less able to meet external threats because mineral production revenues "remove the need for these governments to penetrate their societies and extract more taxes from the population" (1996: 68).

A pessimistic conclusion of Snider's work is that "the countries that most urgently need to implement effective stabilization measures and structural adjustment programs are those that are in the worst position to do so" (Snider, 1996: 60). Weak governments are more vulnerable to IPE shocks and also less able to undertake the domestic reform necessary to reduce that vulnerability. When faced with an IPE shock, they are likely to reinforce this pattern. Higher capacity states are more likely to seek restructuring solutions as a way to reduce IPE reliance. (This of course begs the question of how states shift from IPE-dependent low capacity status to higher capacity status, if low-capacity is a self-reinforcing, self-perpetuating condition. This question will not be directly addressed but the results of this project may shed some clues on possible answers.)

Summary table, loose ends

The competing predictions of the political survival and political capacity perspectives may be summarized as follows.

Table 1.1 Summary of rival hypotheses

	Interna-tional shock	**Political Capacity**	**Increased domestic extraction**	**Increased International Financing**	**Increased Money Creation**
Political survival hypothesis	Yes	Low	No	Yes	Yes
Political survival hypothesis	Yes	High	No	Yes	Yes
Political capacity hypothesis	Yes	Low	No	Yes	Yes
Political capacity hypothesis	Yes	High	Yes	No	Yes, but less than the above.

The expectation from the political capacity hypothesis is that, assuming international funds are available, domestic extraction will be chosen as the response to shocks by regimes of higher capacity states (within the field of developing countries). According to the political capacity model, we expect low capacity states to avoid increasing domestic political extraction, and therefore most readily pursue international financing or covert money creation policies as solutions to increased fiscal requirements and liquidity/ solvency problems.

Under the political survival hypothesis, we expect a similar reaction from all regimes, regardless of level of political capacity. In the event of an IPE shock, we expect regimes to obtain funds abroad or engage in money creation rather than increasing their domestic tax efforts. We expect increases in political extraction only when alternative financing strategies are unavailable. While there is a degree of substitutability between international and domestic extraction policies, the two are not necessarily mutually exclusive. A "mixed" strategy in which both domestic and international strategies are simultaneously pursued is also a possible outcome.

Barnett's "accommodationist" strategy can be considered a mild, minor measure. We expect all regimes to try this because it is politically least costly in the short run. Money creation is the least obtrusive, most indirect policy, and furthermore relies on basic, existing policy instruments. Thus, money creation would generally be an accommodationist strategy. From a political capacity perspective, money creation should be particularly appealing to weak states. This is because existing policy instruments can be used in a covert fashion such that government policy is not explicit and clear to the public (a characteristic choice of weaker states). It is possible to engage in all three strategies simultaneously.

In the absence of an IPE-shock, our expectation is simply "no change" in the levels of domestic extraction, international financing, or money creation. It is also conceivable that in the context of an IPE shock, states will simply do nothing, possibly hoping to weather it with time. This discussion has so far left out the possibility of a "do nothing" response to external shocks. A do-nothing response would be reflected in a finding of no relationship between external shocks and levels of different sources of government finance.

Why IPE and war shocks should be treated distinctly

Both IPE and war shocks have the potential to change the fiscal requirements of states and thereby affect regime extraction strategies. However, there is an important qualitative distinction between the two. IPE shocks originate in a loss of international capital. They represent a contraction of resources available in the international realm. Therefore, it should be more difficult for a regime to increase it's international financing in the context of an IPE shock than a war. Metaphorically, it would be like trying to squeeze more water out of a towel that's already almost dry. This is close in spirit to Roubini's description of shocks to revenues. When the source of revenues is depleted and itself the shock under consideration, it is unlikely that state managers will be able to simply obtain more from that same source. Wars are more exclusively political events that are not closely associated with the drastic reductions in international capital that characterize IPE shocks. Instead, wars alter fiscal requirements by dramatically changing the security needs of the state. The occurrence of a war does not necessarily correlate to a reduction of the available pool of extractable resources from the international arena. Wars are thus primarily Roubini's (1991) spending shocks rather than revenue shocks.

Certain possibilities interfere with this logic. If a country has strategic value to capital-rich outsiders, the regime may be able to obtain international financing in the context of IPE shocks. Additionally, wars may pose stability problems for important status quo powers, who would then act to reduce the amount of international funds available to combatants. In other words, other nations could cut off regime financing to prevent wars from continuing. These are theoretical possibilities that need empirical investigation before their significance can be ascertained. For this work, it is sufficient to note that although the logic for regime preferences for financing is the same, wars and non-war IPE shocks have different implications for the set of strategic possibilities available to regimes. As a result, they should be investigated separately as distinct categories.

Regime type as a variable affecting fiscal policy

When thinking of the capacity of the ruler to raise resources from society, most people immediately think of the role of regime type. Various hypotheses about the regime type-fiscal policy link and the capacity of different regime types to adjust to changing environments and fiscal requirements are present in the literature.

Levi's distinction between autocracy and democracy is that these political conditions are "a reflection of the proportion of the population who are part of the contract every ruler must make with the supporters on whom his power depends" (Levi, 1981: 4). Regime types are a continuum and distinguished by the extent of this contract. A contract with a very narrow segment of society represents an autocracy while a contract with a broad segment of society is typical of democracies. A contract implies "buying off" a segment of the population instead of coercing it into acquiescence. Levi's approach is helpful in understanding Olson's perspective, detailed below.

Olson (1993) argues that taxation is generally likely to be higher in autocracies than in democracies. The ruler in an autocracy needs to buy off a small portion of the population, and is therefore able to further his private interest through tax policies, although that may be to the detriment of the majority. Under democracy, the ruler's survival depends on the support of the majority, and therefore his policies are closely tied to the majority interest. Revenues are governed by a condition under which "tax receipts will (if we start with low taxation) increase as tax rates increase, but after the revenue-maximizing rate is reached, higher tax rates distort incentives and reduce income so much that tax collections fall" (Olson, 1993: 569). A rational, self-interested autocratic ruler chooses the revenue-maximizing tax rate. Under democracy, the ruler needs to "buy" the majority vote by transferring income to it from the "population at large" (Olson, 1993: 570). The majority of the population in society "earns a significant share of the market income of the society, and this gives it a more encompassing interest in the productivity of the society" (1993: 570). Because of this, the majority redistributes less to itself through taxation than the amount the autocrat would choose to redistribute to himself. In other words, the majority actually increases its income by reducing the tax rate. As a result, democracies enjoy a lower tax rate.[4] It's possible to extend Olson's reasoning to say that in the event of new fiscal requirements caused by an external shock, an autocratic regime would have an easier time generating new revenues because it is less constrained by social preferences than a democratic regime.

Organski (1997) suggests that more limits on the power of government elites mean higher political costs of taxation but lower economic costs of borrowing. Closer to the autocratic end of the political spectrum, it is relatively easy in terms of political costs for elites to extract resources in the form of taxes. Because of low limits on their power, state elites face difficulties in offering security against the possibility that they will

[4] Snider (1996: 116) describes an interesting conceptualization of regime type by Przeworski and Limongi (1993): democracy: citizens decide both the size of government and have a right to the fiscal residuum; autocracy, state apparatus decides the size of government and can appropriate the fiscal residuum; and bureaucracy, where the state apparatus decides the size of government but citizens have a right to the fiscal residuum.

arbitrarily renege on debts. Thus the economic costs of borrowing are higher for elites in autocratic political systems. Towards the more democratic end, limits to elite power make it politically costly to raise more taxes from domestic society. Because of those same limits to power, those elites are able to offer more secure guarantees of repayment and therefore face fewer economic costs to borrowing. Other things being equal, Organski's reasoning suggests that autocracies are likely to tax more and borrow less than democracies.

A common notion is that in comparison to democratic regimes, authoritarian regimes are less politically vulnerable to economic shocks. Karen Remmer argues the opposite, namely that the political stability of authoritarian regimes tends to be particularly vulnerable to economic shocks (Remmer, 1996). The conventional wisdom is that democracies are fragile and require strong economic performance if they are to be sustained. Remmer argues that despite the conventional wisdom, a special vulnerability of democratic regimes is neither empirically nor theoretically clear. A dichotomous view of regimes holds that authoritarianism depends on coercion and democracy depends on consent. This view carries assumptions of authoritarian strength such that "[c]oercion is readily equated with capacity and autonomy, whereas consent is equated with weakness and vulnerability"(1996: 616). Yet "[t]he availability of economic resources directly influences the capacity of the state to induce compliance through coercion. What is more, opposition challenges to the repressive capabilities of the state apparatus presumably mount in response to economic setbacks."(1996: 616). This applies to authoritarian regimes and suggests that they are vulnerable to changes in economic resources, and potentially more so than more inclusionary or democratic regimes. Based on Remmer's reasoning, therefore, we would expect that authoritarian regimes, facing more domestic challenges in the face of economic shocks, would be more aggressive in seeking international financing as a way out of their domestic problems.[5]

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[5] Within the spectrum of regime types, sultanistic neopatrimonial styles of rule are particularly vulnerable to international and domestic threats to security.

Skocpol argues that maintaining "coercive effectiveness" is central to the survival of authoritarian rulers (1994: 311). Also relevant is the extent of the regime's ability and willingness to mobilize groups in society. The more it is able to absorb autonomous sectors and integrate them into state-sponsored configurations, the less likely it is to face revolutionary pressures. More inclusionary authoritarian regimes are more immune to revolutionary takeovers. Much further along the spectrum, liberal democracies enjoy high immunity. Inclusionary authoritarian regimes "impose controlled forms of political participation on key social groups, co-opting leaders and handing out certain benefits in the process; this tends to undercut possibilities for political action independent of the existing regime" (Goodwin and Skocpol, 1994: 265).

In contrast, "[s]ultanistic neopatrimonial regimes are centered in the personal manipulation of individual dictatorial rulers, who allow no stable prerogatives in the polity, not even collective prerogatives for military officers or upper social and economic classes" (Goodwin and Skocpol, 1994: 268). An example of "stable prerogatives in the polity" may be allowing independent parties to organize and persist. Another characteristic of sultanistic neopatrimonial regimes is that the armed forces tend to be "especially corrupt and incompetent, in part because the dictator is more concerned with preventing his own personal overthrow by military coup than with establishing an effective fighting force"(Goodwin and Skocpol, 1994: 269). The description of the sultanistic neopatrimonial regime is best treated as an abstraction along the lines of a Weberian ideal-type. Actual regimes can closely approximate the type or deviate from it on certain dimensions.

The degree to which political participation is institutionalized and channeled by the regime varies inversely with the degree of sultanistic neopatrimonialism. Regimes that actively mobilize society state-sponsored parties score a "low" on the sultanistic neopatrimonial scale. The sultanistic neopatrimonial ruler encourages economic stagnation and fears the social forces that economic development may unleash. Among authoritarian regimes, sultanistic neopatrimonial regimes tend to be particularly narrowly based and non-inclusive.

Sultanistic neopatrimonial regimes have a strong preference for exporting the costs of domestic policy. In other words, such regimes prefer to have foreigners pay for domestic policy particularly when that policy is unpopular and lacks social legitimacy. Costly policies are difficult to sustain if those outside sources of support are lost. Sultanistic neopatrimonial regimes are therefore likely to be highly sensitive to outside changes. Those changes are likely to be perceived as threatening to domestic security.
Among the steps a sultanistic neopatrimonial regime can take to reduce its vulnerability is to avoid being linked to a single patron. "The impact of extreme dependence on a single patron on the course of political development [...] is mediated by the configuration of domestic actors (that is, the presence or absence of viable moderate opposition groups, the degree of military autonomy) and by the willingness of domestic actors (especially the incumbent dictator) to participate in the schemes of foreign powers" (Snyder, 1992: 385). A dictator heavily dependent on a single patron is subject to the patron's policy preferences and also risks "managed transitions" (where the patron eases an acceptable opposition into power). By avoiding overdependence on one patron and diversifying sources of foreign support, neopatrimonial dictators can limit the leverage external actors have over them (Snyder, 1992: 385).

Another aspect of sultanistic neopatrimonialism is that it tends to be based on a rigid balance of forces in society, which, if upset, results in major threats to regime security. In other words, it is based on a delicate political coalition.

In summary, those regimes that more closely approximate the sultanistic neopatrimonial ideal-type are particularly likely to undergo political instability when a fiscal crisis forces domestic restructuring.

Cheibub (1998) examines whether regime type affects the extractive capacity of a government. Regime type is classified as democracy or dictatorship and extractive capacity is the level of taxes a government collects (1998: 350). Based on a set of large-n models of taxation, Cheibub concludes that democracies are as capable as autocracies of collecting taxes. This finding of "no difference", however, does not preclude different reactions to international crises based on regime type.

Because regime types represent different institutional filters through which the preferences of domestic actors are expressed, it is a valid hypothesis that regime type should influence the policy response to international shocks. Lake (1992) argued that in wartime, societies in autocratic polities would be willing to contribute proportionately less than democratic societies (Lake, 1992: 30). A lack of societal support constrains the extractive efforts of autocracies, and a resort to coercion produces higher "transactions costs" of revenue collection (Lake, 1992: 31). Thus, Lake's argument suggests that in the event of war autocracies would face more difficulties than democracies in the effort to extract resources domestically.

In a Latin America-based study, Remmer (1990) found no significant differences between authoritarian and democratic regimes in the management of economic crises (described in Snider, 1996: 119). Remmer (1986) found no difference in the ability of authoritarian and democratic regimes to undertake stabilization policies (described in Snider, 1996: 199).

Those regimes that have succeeded in locating reliable foreign patronage as a consistent means of overcoming resource problems are less likely to experience political instability.

In summary, a variety of possible linkages between regime type and regime extraction strategy have been articulated in the theoretical and empirical literature. While there is no final word on the issue, it is clear that a model of extraction strategy will need to include the influence of regime type.

Discount rates

The "discount rate" as used in this project refers to the perceived future stream of benefits accruing to the regime leader. Factors determining the discount rate have to do with the expected personal political survival of the leader rather than the time horizon of social value of specific projects (based on Levi (1988) and Cheibub (1998)). A high discount rate means that the regime leader anticipates few long-term benefits and therefore seeks to seize whatever he can in the short-term. A low discount rate means that a future stream of benefits counts heavily in a regime leader's calculations, and he is therefore unlike to engage in wanton activity in the short-term that may threaten his political support.

Discount rates as defined in this research project should not be confused with the discount rate sometimes used in text-book style descriptions of government finance (eg., Goode, 1984: 67). Such treatments are concerned with planning issues related to how the future benefits of proposed government projects are discounted.

Central bank independence

Monetary policy may be described as policies designed to manage currency and other forms of money and the money stock in the economy. Fiscal policy refers to the budgetary process of the state, including the way in which budgetary revenues and outlays are organized. There is a growing literature on the political economy of central bank independence and particularly on the relationship between central bank independence and monetary policy (Eijffinger and de Haan, 1995). The degree to which the central bank is independent of the executive authority will affect the extent to which public finance policy reflects the self-serving political considerations of the executive. Three areas in which the influence of the executive authority must be low or removed for a central bank to be considered independent are personnel matters, financial autonomy, and policy independence (Eijffinger and de Haan, 1995: 6). Appointments to the governorship of a central bank will usually include a political element because of the importance of this public post, so political considerations of the executive authority can't be entirely excluded. Financial autonomy refers to the extent to which the executive can use credits from the central bank to finance expenditures. Low financial autonomy means that the executive can easily obtain such credit from the central bank, and in effect add to the money stock (a form of seignorage). Thus monetary policy becomes subordinate to fiscal policy. Policy independence refers to the flexibility available to the central bank in forming and executing monetary policy (Eijffinger and de Haan, 1995: 6). Greater policy independence implies greater central bank independence.

A common assumption is the central banks try to keep low rates of inflation and to curb inflationary policies. The main effect of CBI should be on politically-motivated money creation policies, because central bank independence insulates the monetary policy instrument from the political interests of the executive authority. Indirectly, however, CBI also has the potential to affect domestic extraction and international financing because the executive can substitute these other strategies in place of money creation if the central bank is especially resistant.

Debt burden, economic growth, and income level

The public debt burden is widely considered to increase the fiscal requirements of states (eg., Snider, 1996). Economic growth and per capita income are also considered to be consequential for public finance policies and are regarded as important controls for inclusion in models of public finance (Roubini, 1996; Cheibub, 1998).

Summary of hypothetical relationships that will be investigated in upcoming chapters

The hypothesized relationships referred to in this chapter may be summarized in the following statements (the bracketed terms contain an author or a label and refer to the origin of the hypothesis; "capacity" and "survival" refer to the political capacity and political survival approaches respectively).

1. High capacity states will engage in a domestic extraction response to heightened fiscal requirements occasioned by an international shock. (Capacity)

2. Low capacity states will engage in an international financing response to heightened fiscal requirements occasioned by an international shock. (Capacity)

3. All states will engage in money creation in response to an international shock. (Barnett, capacity, survival)

4. Weak states are especially likely to engage in money creation in response to an international shock (Goode, capacity).

5. Lower availability of foreign patrons means it is less likely that an international financing strategy will be pursued.

6. Lower availability of international funds makes it less likely that international financing will be pursued.

7. Low discount rates of regime leaders mean higher levels of domestic extraction.

8. Autocracies will generally extract more than democracies (Olson)

9. Autocracies will more aggressively seek international financing than democracies (Remmer).

10. Regime type alone does not account for differences in level of domestic extraction (Cheibub).

11. All forms of government financing will increase over time (in levels and as proportions of national product) (Wagner).

12. Integration into the world political economy generally makes a state more vulnerable to IPE shocks.

13. War shocks will be associated with higher levels of international financing than IPE shocks.

14. IPE shocks will have different effects than war shocks.

15. Greater central bank independence will mean less inflationary money creation policies.

16. Greater central bank independence will increase the level of domestic extraction.

17. Greater central bank independence will increase the level of international financing.

18. Debt burden, economic growth and income level will affect all forms of public finance.

Conclusion

In summary, the theoretical discussion presented has framed a basic set of hypotheses that are concerned with the financing strategies of the state. The focus here is on evaluating the strength of the "political capacity" hypothesis in comparison to the "political survival" hypothesis. Other important variables bear on regime extraction strategies and have therefore been mentioned. Sometimes, the direction and nature of these relationships is ambiguous or is subject to disagreement among scholars. These other relationships will also be investigated in this project.

In Chapter 2, I estimate models of regime extraction strategy that focuses on the role of war shocks. In Chapter 3, I estimate models of regime extraction strategy that isolates the role of non-war IPE shocks, and also tests how these differ from war shocks. In Chapter 4, I review Barnett's findings with respect to the extraction strategies in Egypt and Israel (Barnett, 1992), describe the background of the Indian and Pakistani cases, and examine the Pakistani experience in some depth. In Chapter 5, I examine the Indian experience, offer observations on the three revenue-raising strategies and the nature of shocks using both the Indian and Pakistani cases, compare the Indian and Pakistani experience with reference to Egypt and Israel, and describe the implications of these case studies for the political survival and political capacity models. In Chapter 6, I conclude with an evaluation of the findings of the empirical chapters, a discussion of how these relate to some theoretical considerations, a discussion of lacunas in existing theory that need to be addressed, and some suggestions for further research.

CHAPTER 2: An Empirical Evaluation of the "Political Capacity", "Political Survival", and Other Hypotheses Using War-Shocks

This chapter tests the Political Survival and the Political Capacity models and some other hypotheses through regression analysis of pooled time series data. The theoretical bases for these models and hypotheses were developed in Chapter 1. First I outline the hypotheses that will be evaluated. I then discuss the variables and measures used in this analysis. I proceed to a discussion of method. I then report and summarize the results.

HYPOTHESES

The following hypotheses will be investigated in this chapter.

1. Higher capacity states will engage in increased levels of domestic extraction in response to heightened fiscal requirements occasioned by an international shock.

2. Low capacity states will engage in an international extraction response to heightened fiscal requirements occasioned by an international shock.

3. All states will engage in money creation in response to an international shock.

4. Weak states are especially likely to engage in money creation in response to an international shock.

5. Low discount rates of regime leaders mean higher levels of domestic extraction.

6. Autocracies will generally extract more than democracies.

7. Autocracies will more aggressively seek international financing than democracies.

8. Greater central bank independence will mean less inflationary money creation policies.

9. Greater central bank independence will increase the level of domestic extraction.

10. Greater central bank independence will increase the level of international financing.

11. Economic growth and income level will affect all forms of public finance.

12. Debt burden will affect all forms of public finance.

The dependent variable in each hypothesis consists of the level of money creation, domestic extraction, or international financing, all forms of public finance. The independent variables suggested by the above hypotheses are: international shocks, political capacity, discount rates, regime type, central bank independence, economic growth, and income level. The dependent and independent variables and measurement considerations are discussed below.

VARIABLES AND MEASURES

Dependent Variables

International financing. An international solution to fiscal requirements means that the regime funds its policy activities by obtaining resources from the international political economy. An international solution is likely to involve a wide variety of potential foreign sources of funds. These may include commercial and institutional loans (such as IMF loans) and direct aid from powerful donor states willing to sponsor the government financially. Since the focus here is on revenue extraction, the primary indicator of an internationalist solution is an increase in the flow of aid, whether in the form of grants or loans, as well as other financial flows.[6]

For the purposes of this project, the "Financing Abroad" series compiled by the World Bank is an appropriate indicator. The indicator includes "all government financing transactions with nonresident individuals, enterprises, governments, international organizations, and other entities" (IMF, 1986: 215). The indicator captures government financing obtained from all foreign sources at the broadest level.

Domestic extraction. This is defined as the level of domestic extraction as a proportion of the national product. A simple (Central Government Tax Revenue)/GDP

[6] Loans can sometime include a grant component through such features as "grace periods, concessional interest rates, and soft repayment terms" (Datta, 1992: 90).

measure is used, following Snider's logic that for the purpose of looking at one country's performance over time, such a measure is sufficient (Snider, 1996: 75, endnote 1).

Money creation. Money creation is Goode's (1984) suggested third route to government finance. It is also part of the "accommodational" strategy described by Barnett (1992). Money creation usually occurs with additions to the domestic money stock that result from regime borrowing from the central bank. Alcazar finds support for a "modified version of the inability hypothesis, where weak governments avoid facing a political struggle with the public by choosing seignorage over taxation policy" (Alcazar, 1997: 91). Thus, "covert taxation" in the form of seignorage by governments can provide funds.

Alcazar (1997) discusses empirical measures of the seignorage "tax". There is a no agreed-upon formula for measuring seignorage. Inflation is likely to be closely correlated to seignorage. A variety of other measures are possible. One possibility is the "rate of growth of the money supply multiplied by the real monetary balances" (Alcazar, 1997: 80). Alternatively, it may be measured as the inflation rate times real money balances, something closer to an "inflation tax" (1997: 95, endnote 3). Seignorage will only be equal to an inflation tax in the case of no output growth.[7] For the purposes here, the indicator will simply be an index of inflation based on Goode's logic that the main effect of "large and continuing" money creation is inflation (Goode, 1984: 213).

Independent Variables

Political Capacity. Relative political extraction, which describes the concept of political capacity as fiscal extraction, is an appropriate indicator. It is defined as follows.

Relative political extraction = Actual extraction/ Predicted extractive capacity

When actual and predicted extraction are very close to each other, the value approaches 1, indicating "that the government's political performance is average compared to the performance of other governments of countries with similar population characteristics, natural resources and reliance on the foreign trade sector" (Snider, 1996: 45). A detailed description of the construction of this indicator is given in Snider's Appendix 2.1 (Snider, 1996: 64).

Kugler and Arbetman argue that government revenues contain economic and political aspects that must be separated in order to obtain a measure of political capacity. This can be achieved by relative political capacity, "the ratio of what a government actually extracts and what such a government should be able to extract given the wealth of the society" (Kugler and Arbetman, 1989: 69).

The "expected" extraction is an estimate based on "economic factors that ease or render more difficult the task of government to obtain revenues"; for developing countries, "where one assumes that governments extract all they can, controls are introduced for reliance on exports, productivity of populations, share of agricultural production, and reliance on mining" (Kugler and Arbetman, 1989: 69). In summary, "RPC provides a shadow measure of governmental performance that identifies the

[7] For her own analysis, Alcazar operationalizes the "inflation tax" as the inflation rate multiplied by reserve money (Alcazar, 1997: 85). Seignorage is defined as the change in money reserves (the reasoning for this

relative ability of a government to perform political tasks given the record of other governments in countries that have achieved the same socioeconomic level of development" (Kugler and Arbetman, 1989: 69).

The concept of political capacity can be measured on a number of dimensions, of which relative political extraction is one. Policy explicitness, another dimension, refers to "the degree to which government actions are overt and explicitly "with consent" or covert and clandestine" (Snider, 1996: 9). Policy explicitness is measured by the ratio of direct to indirect taxes. A high tax ratio means high policy explicitness and therefore high political capacity.

RPE is that part of political capacity which determines the ability of the government to capture material resources (as suggested by Arbetman and Kugler, (1997: 7, endnote 1)). In the tests conducted here, political capacity is measured on the RPE dimension for all equations except for where the dependent variable is domestic extraction. For those cases the policy explicitness dimension is used. This is because RPE is calculated as the actual extraction over predicted extraction, and the domestic extraction dependent variable is essentially "actual extraction". In other words, actual extraction would end up on both sides of the equation (albeit as part of a ratio on the right hand side). To avoid this problem, policy explicitness is chosen as the measure of political capacity for the equations where domestic extraction is the dependent variable.

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choice is unclear) (Alcazar, 1997: 85).

Debt burden. Debt burden must be included because it indicates the extent to which regimes are faced with specific fiscal requirements resulting from fiscal deficits.[8] While the absolute size of outstanding foreign debt is important, the debt-servicing burden on a state is more likely to capture the actual effect on fiscal requirements of the state. The "debt-service" ratio used by Cheibub (1998) is an appropriate indicator. More specifically, it is the ratio of service on the outstanding public foreign debt to exports" (taken from Cheibub's "Codebook" (1998)).

Snider (1996: 55) does find that severe external indebtedness strongly limited the possibilities for further domestic extraction. Also, indebtedness suggests that further borrowing from international sources is likely to be difficult.

Discount rate. Levi (1988) suggests that the sense of security leaders have while in office affects their valuation of the future over the present. A greater sense of security means that leaders are less likely to plunder in the present because they anticipate ongoing benefits over their tenure. A yearly indicator for this variable was developed by Cheibub (1998). It measures the "the risk faced by chief executives of being removed from office, given their length of their tenure in office, the rate of past economic growth, and the rate of past executive turnover in each country" (Cheibub, 1998: 360-361).

Regime type. There are various categorizations of the political form of regimes. For the purposes here, regimes are coded as either democracy or autocracy, following Cheibub (1998) and Alvarez, et. al., (1996). The definition of democracy used here is a

[8] This was Snider's suggestion in personal conversation.

regime under which contested elections fill the highest political offices (Cheibub, 1998). The measure for regime type is a binary variable coded 1 for dictatorships and 0 for democracies.

Trend. Trends in the data series are captured by including the year of observation as a variable to control for the effects of autonomous changes over time. This is common strategy for dealing with autonomous time trends (see, for example, Snider (1996)).

Central Bank Independence. The degree to which the central bank is independent of the executive authority will affect the extent to which public finance policy reflects the self-serving political considerations of the executive. There is not a unanimously agreed upon, universal measure for central bank independence in the literature. Two suggested measures are the turnover rate of central bank governors and a legal measure that aggregates constitutional legal protections of central bank authority (Cukierman, et. al., 1992). Both measures are problematic. A high turnover rate could mean that central bank governors are dismissed often to suit the whims of the executive and that as a consequence, the central bank is less independent. On the other hand, a low turnover rate could mean that the central bank governor is excessively acquiescent to the wishes of the executive authority, and therefore manages to stay in the governorship. The legal measure presents a picture of the paper protections and insulation from politics offered to the central bank. However, there is frequently a gap between the formal legal code and actual practice in developing countries (and elsewhere). A questionnaire-based "actual practice" measure works better for developing countries as a predictor of inflation, while the legal measure works better for advanced industrial countries (Cukierman, et. al., 1992). However, the questionnaire-based data is available for a limited sample of developing countries only, and the most comprehensive data sets available are the aggregated legal one and the governor turnover one.

Because of these data and conceptual constraints, the tests here are conducted with both the aggregated legal measure and the turnover measure, and both sets of results are reported.

The main effect of CBI should be on politically-motivated money creation policies, because central bank independence insulates the monetary policy instrument from the political interests of the executive authority. Indirectly, however, CBI also has the potential to affect domestic extraction and international financing because the executive can substitute these other strategies in place of money creation if the central bank is especially resistant.

Per capita income level. The choice of this variable is based on Cheibub's (1998) suggestion that "Per capita income indicates the availability of resources to be taxed, as well as the existence of administrative capabilities for collecting taxes: at higher levels of per capita income, economies tend to be more monetized and less informal, making it easier for the government to collect taxes" (Cheibub, 1998: 357-358). Because of the assumption of intersubstitutability among alternative forms of public finance, per capita income level should also affect the level of international financing and seignorage. Furthermore, in his study of budget deficits in developing countries, Roubini (1991: S68) used level of per capita GNP to control for the potential effects of economic backwardness. Thus, there is evidence in the literature that per capita income needs to be included in a model of public finance.

Economic Growth. This variable is defined as the yearly change in national income. The choice of this variable is based on Roubini's usage in his study of determinants of budget deficits in developing countries (Roubini, 1991). Changes in economic growth can capture some effects of economic booms and busts Roubini, 1991: S68).

War shocks. IPE shocks are events and changes stemming from the world beyond a country's borders. These shocks result in the need to locate new resources by regimes. The theory tells us that historically wars have acted as the external driver of domestic state-building. Shocks can take the form of wars and other international crises. Wars do not have to be international- civil wars also count as shocks. A shock year is a year in which the war variable receives a code of 1, signifying a year in which the country is at war.

CASE SELECTION

The cases selected are developing countries. The competing predictions of the political capacity and political survival perspectives arise in the population of developing countries. The samples used here are chosen on the basis of data availability. "Developing" is defined in terms of per capita GNP as countries with less than $3900 per year in 1990 dollars. This is based on Snider's suggestion (Snider, 1996: 75-76, footnote 5). OECD countries are excluded with the exception of Greece and Portugal.[9]

The time frame used for this study is based primarily on those years for which data was available for all series. The widest range of years covered is the 1970-1990 period. The total number of observations is 308 for the analysis of money creation, 361 for the analysis of international financing, and 250 for the analysis of domestic extraction.

METHODOLOGY

Pooled time series data sets are analyzed with OLS regression estimation and robust standard errors. Beck and Katz (1995) suggested that robust errors are appropriate for the analysis of such data. The basic framework is that three models are tested for each type of public finance. These three are the Political Survival, Political Capacity, and Greene's Encompassing models. The Political Survival and Political Capacity models share all variables in common except that in the case of the Political Survival model, the impact of war is uniform for all countries, while in the Political Capacity model, the impact of war is mediated by the level of political capacity at the time of the war. Thus, these are non-nested models, meaning that although they have variables in common, the presence of unique variables in each means that one cannot be written as a smaller part of the other.

[9] This measure contains both "less developed economies" and "developing economies", a further categorization that Snider (1996) used.

One intuitively appealing strategy for comparing non-nested models (especially when they have the same number of variables) is to compare R-square values. This is because the R-square can be interpreted as the proportion of variation in the dependent variable that's explained by the model. Adding variables to a model generally increases the R-square. An "adjustment" to the R-square is needed as a correction for the number of variables in the model. The adjusted R-square statistic is designed to allow comparisons of R-square between models that have different numbers of variables.

Another suggested evaluative tool is the Encompassing model (Greene, 1997). An encompassing model is one that includes the variables that are common to both non-nested models, as well as the variables that are unique to each model. Thus, the encompassing model contains all variables that are present in the non-nested models. Hypotheses tests are then conducted on the variables unique to each non-nested model. If the variables unique to one non-nested model are retained in terms of statistical significance while those unique to the other model are statistically insignificant, then the former model is chosen over the latter.

This method is not unproblematic because the encompassing model is a statistical construct and tool rather than a model produced by theory. In the case of the tests presented here, the political capacity approach suggests that the impact of war on the levels of different kinds of public financing will vary based on the level of political capacity at the time of the war. This excludes the political survival prediction, which is that war will have a blanket, uniform impact on all countries in terms of the effect on public finance levels, an impact unmediated by other factors. Thus, the way in which war shocks operate in the two perspectives is mutually exclusive. As a result it doesn't make theoretical sense to include both a mediated and an unmediated shock term in the same model. Furthermore, it is problematic to conduct hypotheses tests in the context of a model that is not "true" in the sense of being theory-driven. In general, there is debate about how to compare the performance of non-nested models (Greene, 1997: 365). Greene's encompassing model strategy is used here because of its relative simplicity and straightforwardness.

Collinearity problems can occur when it is difficult to separate out the effects of different independent variables because there is covariance between them. There is always some collinearity, but if there is too much, both the coefficients and the statistical significance of estimated parameters can be misleading. The tables of results presented here also include reference to a "condition index" that has been suggested as a guide to identifying problems of collinearity (Greene, 1997: 422). A condition index rating of 20 or higher is the suggested threshold for identifying problematic collinearity (Belsley et. Al., 1980, cited in Greene, 1997: 422).

Collinearity problems are also the main reason that lagged effects are not explored (for example, looking at the impact of a shock in year 1 on policies in years 2 or 3, etc.). Because this is a pooled time series data set (rather than data on one country only), introducing a lag of only one year would mean cutting out as many observations out of my data set as there are countries. The data set used here is relatively small (constrained as it is by having to have observations on all variables) and there is a tendency for problematic collinearity (in several of the tests below, a measure of collinearity approaches and surpasses the threshold suggested for problematic collinearity). As a result, as many degrees of freedom as possible need to be retained. In future research, or with the production or distribtion of more data or alternative data, lagged effects would be an important area to explore.

All models were estimated using SAS Version 6.12.

Summary of Abbreviations and Data Sources

MAKEMONEY: the inflation indicator for money creation policies.[10]

TAX: the level of domestic extraction, measured as central government tax revenue divided by GDP.[11]

INTLFINANCE: the level of all international financing.[12]

POLCAP: a measure of relative political capacity as relative political extraction based on Kugler and Arbetman's (1997) method.[13]

DEBT: Ratio of service on the outstanding public foreign debt to exports.[14]

DISCOUNT: Probability that the chief executive will be removed from office, given the length of his/her tenure in office, the rate of economic growth, and the number of changes

[10] Source: World Bank CD-ROM data (1998).
[11] Source: World Bank CD-ROM data (1998).
[12] Source: World Bank CD-ROM data (1998).
[13] Data obtained through personal communication with Ismene Gizelis of the Claremont Graduate School.
[14] Collected by Cheibub (1998) from the World Bank 1994 CD.

of chief executive accumulated in each country since 1950. The estimation method is described by (Cheibub, 1998).[15]

REGIME: A binary variable coded as 1 for autocracies and 0 for democracies.[16]

TREND: A variable calculated from the year of the observation. 1970 is coded as "1", 1971 is "2", etc.

CBI: a measure of central bank independence based on a measure that aggregates different legal factors.[17]

CBI2: a measure of central bank independence based on the rate of turnover of the governor of the central bank.[18]

GROWTH: Economic growth, measured as annual rate of growth of INCOME.[19]

INCOME: level of per capita income, measured as real GDP per capita, 1985 prices.[20]

WAR: A binary variable coded as "1" for a year in which the country is at war (whether international or civil).[21]

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[15] Data Source: Cheibub, 1998.
[16] Data source: Cheibub, 1998.
[17] Data Source: Cukierman, et. al., 1992.
[18] Data Source: Cukierman, et. al., 1992.
[19] Data source: Cheibub, 1998.

POLCAP*WAR: An interaction term between WAR and POLCAP, calculated as WAR multiplied by POLCAP.

POLCAP2: A measure of the policy explicitness dimension of political capacity calculated as
[Taxes on income, profits and capital gains (% of current revenue)]/[[Taxes on goods and services (% of current revenue)]+[Taxes on international trade (% of current revenue)]+[Taxes on income, profits and capital gains (% of current revenue)].[22]

POLCAP2*WAR: An interaction term between WAR and POLCAP2, calculated as WAR multiplied by POLCAP2.

Collinearity Condition Index > 20?: If this statistic is greater than 20, then collinearity problems exist and may interfere with the interpretation of results.

*: statistically significant at the .1 level

**: statistically significant at the .05 level

***: statistically significant at the .01 level

RESULTS

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[20] Data source: Cheibub, 1998.

Table 2.1 Results for models of money creation

Dependent variable: money creation	Political Survival Model	Political Capacity Model	Greene's Hybrid Model
Independent variable			
CONSTANT	44.23	76.4	216.15
POLCAP	6.92	-45.34	-156.36
DEBT	-1.45	-1.03	-.92
DISCOUNT	883.54	923.59	829.14
REGIME	-172.73**	-165.1**	-169.5**
TREND	21.76*	21.09 (pval: .1202)	23.03*
CBI	-13.37	-15.85	27.56
GROWTH	-21.82 (p-val: .115)	-21.41 (pval: .1227)	-21.74 (pval:.1221)
INCOME	-.06 (p-val: .1039)	-.06 (pval: .1009)	-.07 (pval: .1144)
WAR	68.24		-293.68
POLCAP*WAR		95.72	311.94
R-square	.0906	.0923	.0946
Adj. R-square	.0632	.0650	.0642
F Prob>F	3.31 .0007	3.38 .0006	3.112 .0009
N	308	308	308
Collinearity Condition Index >20?	20.399	20.24	23.92

POLCAP, DEBT, DISCOUNT, and CBI have no statistically discernible impact on money creation. It should be noted, however, that the collinearity index is a little over 20 for both the Political Survival and Political Capacity models, and at almost 24 for the Encompassing model. This suggests that the interpretation of both the coefficients and the statistical significance is problematic. REGIME is negative and statistically significant throughout the models, suggesting that autocracies are systematically less likely to engage in money creation as indicated by inflation. TREND is positive and

[21] Data source: Correlates of War data obtained from Interuniversity Consortium for Political Science Research (Study # 9905).

statistically significant in both the Political Survival and Encompassing models, and its p-value approaches the .1 level of statistical significance in the Political Capacity model. There is weak evidence that both GROWTH and INCOME have a negative effect on money creation because their p-values approach the .1 level throughout the models.

The effects of WAR and POLCAP*WAR are not statistically discernible in any of the models. It appears that wartime is not associated with money creation policies, but this interpretation should be tempered by the indication of a possible collinearity problem.

Table 2.2 Results for models of money creation using CBI2

Dependent variable: money creation	Political Survival Model	Political Capacity Model	Greene's Hybrid Model
Independent variable			
CONSTANT	101.3	176.62	89.23
POLCAP	-71.59	-125.52	-60.79
DEBT	-8.32**	-8.21**	-8.36**
DISCOUNT	-210.98	-240.87	-209.85
REGIME	-69.62	-76.18	-69.39
TREND	25.2**	26.18**	25.1**
CBI2	723.5***	713.45***	723.19***
GROWTH	-21.52 (p-val: .1069)	-21.69 (p-val: .1062)	-21.53 (p-val: .1061)
INCOME	-.03	-.04	-.03
WAR	137.06*		160.1
POLCAP*WAR		97.33 (p-val: .102)	-19.63
R-square	.1513	.1502	.1514
Adj. R-square	.1240	.1228	.1208
F Prob>F	5.528 (.0001)	5.48 (.0001)	4.958 (.0001)
N	288	288	288

[22] Data Source: World Bank on CD-ROM (1998).

Collinearity Condition Index >20?	**17.745**	**17.253**	**23.313**

An important difference in the tests using the alternative measure of central bank independence is that it appears to cut down on collinearity. The index is comfortably below the 20 threshold for both the Political Survival and Political Capacity models, although it is high in the Encompassing model. This increases the measure of confidence that may be held for these results. POLCAP and DISCOUNT continue to be statistically insignificant. GROWTH continues to be almost statistically significant, and INCOME continues to not pass the threshold of statistical significance. REGIME becomes statistically insignificant in the tests using CBI2. TREND continues to be significant, with lower p-values, in the tests using CBI2.

Some interesting differences emerge from the earlier tests. CBI2 is highly statistically significant compared to CBI. CBI2 is also positive, suggesting that high turnover rates are associated with higher instances of money creation activity. Both WAR and POLCAP*WAR are not statistically significant in the tests using CBI. WAR becomes statistically significant in the Political Survival model in the tests using CBI2, and POLCAP*WAR is almost statistically significant (with a p-value of .102) in the tests using CBI2. This provides some evidence of a support for the Political Survival model over the Political Capacity model. Additionally, the R-square of the Political Survival model exceeds the Political Capacity model by a marginal amount (.11%). The encompassing model is not a useful evaluative tool here because of it's high multicollinearity and the fact that neither the WAR or the POLCAP*WAR coefficients are significant.

If a high governor turnover rate is an indicator of low central bank independence, then it does appear that countries with low central bank independence endure more money creation policies. If we treat the models with CBI2 as being better specified than those with CBI, then there is some evidence that war is generally associated with money creation activity, while it does not appear that the political capacity of the state mediates this relationship.

Table 2.3 Results for models of domestic extraction

Dependent variable: domestic extraction	Political Survival Model	Political Capacity Model	Greene's Hybrid Model
Independent variable			
CONSTANT	16.24***	15.98	16.17***
POLCAP2	-.07	.39	.09
DEBT	-.14***	-.14***	-.14***
DISCOUNT	-11.22*	-10.72*	-11.1*
REGIME	4.76***	4.83***	4.78***
TREND	.51***	.499***	.51***
CBI	-18.09***	-18.26***	-18.14***
GROWTH	-.06	-.05	-.06
INCOME	.002***	.002***	.002***
WAR	-.89		-.59
POLCAP2*WAR		-2.68	-1.08
R-square	.2983	.2982	.2984
Adj. R-square	.2721	.2720	.2692
F Prob >F	11.385 (.0001)	11.38 (.0001)	10.207 (.0001)
N	250	250	250
Collinearity index >20?			

In the estimated models of domestic extraction, there is evidence to show that the debt burden is negatively related to the level of taxation. In other words countries that are more externally indebted raise less taxes domestically, as seen in the negative, highly statistically significant coefficient of DEBT. DISCOUNT is also negative and statistically significant throughout the models, suggesting that leaders with a short shadow of the future tend to behave cautiously and keep levels of taxation low. REGIME is positive and highly statistically significant throughout the models, indicating that autocracies generally extract more than democracies. TREND is highly statistically significant and positive throughout the models, providing support for the notion of positive autonomous increases in the level of taxation over time. CBI is negative and highly statistically significant. Thus, more legally independent central banks are associated with lower levels of taxation. GROWTH does not have a statistically discernible effect. POLCAP2 also does not have a statistically discernible effect. INCOME has a small, highly statistically significant effect on the level of taxation (supporting Roubini's (1992) notion that it is an important control for the effects of backwardness, meaning that richer countries have better developed means of tax collection).

Neither WAR nor POLCAP*WAR have a statistically discernible impact on the level of taxation. Thus, the Political Survival predictions appear to be supported here, as countries generally don't raise the level of taxation in wartime. The non-significance of the

POLCAP*WAR term provides evidence against the Political Capacity prediction that stronger states would raise the level of taxation in wartime. Further support for this reading is that the R-square value is almost identical across the Political Capacity and the Political Survival models, and even declines slightly in the political capacity model.

Greene's Encompassing model shows that neither of the variables unique to the two non-nested models is statistically significant. Because of the nature of the prediction here (the prediction of the Political Survival Model was that there would be no relationship between war and level of taxation), the encompassing model result actually provides additional support for the political survival hypothesis. The adjusted R-square value declines in the encompassing model as compared to the two non-nested models, suggesting that the adding POLCAP*WAR term introduces no new information helpful in explaining the level of taxation.

Table 2.4 Results for domestic extraction using CBI2

Dependent variable: domestic extraction	Political Survival Model	Political Capacity Model	Greene's Hybrid Model
Independent variable			
CONSTANT	9.91***	9.57***	9.91***
POLCAP2	2.59	3.21	2.59
DEBT	-.14**	-.14**	-.14**
DISCOUNT	-20.96**	-21.31**	-20.96**
REGIME	4.74***	4.8***	4.74***
TREND	.58***	.58***	.58***
CBI2	2.25	3.21	2.59
GROWTH	-.05	-.04	-.05
INCOME	.002***	.002***	.002***
WAR	-.89		-.89
POLCAP2*WAR		-2.31	-.02
R-square	.2573	.257	.2573
Adj. R-square	.229	.2286	.2257
F Prob>F	9.084 (.0001)	9.069 (.0001)	8.141 (.0001)

N	245	245	245
Collinearity Condition Index >20?	15.95	15.801	16.42

The results for the models of domestic extraction using the governor turnover measure of central bank independence (CBI2) are almost identical to the results using the legal measure of central bank independence (CBI). An important difference is that CBI is highly statistically significant while CBI2 is statistically insignificant. WAR and POLCAP*WAR have no statistically discernible effect on domestic extraction in either set of tests. Thus, this indicates support for the Political Survival prediction that taxes would not be raised in any country in the event of a fiscal requirement crunch such as wartime. Countries with higher political capacity do not raise taxes either in wartime, contrary to the prediction of the Political Capacity model.

Table 2.5 Results for model of overall international financing

Dependent variable: international financing	Political Survival Model	Political Capacity Model	Greene's Hybrid Model
Independent variable			
CONSTANT	1.36*	1.84**	2.11***
POLCAP	.75*	.3	.1
DEBT	.02***	.03***	.03***
DISCOUNT	.15	-.56	-.95
REGIME	.47*	.43*	.39 (.1054)
TREND	-.05**	-.05**	-.04**
CBI	-1.72	-1.36	-1.22
GROWTH	.05**	.05**	.04* (.0528)
INCOME	-.0004***	-.0004***	-.0004***
WAR	1.18***		-.6

POLCAP*WAR		**1.07***	**1.54***
R-square	**.208**	**.2202**	**.2215**
Adj. R-square	**.179**	**.1919**	**.19**
F **Prob>F**	**7.237** **(.0001)**	**7.779** **(.0001)**	**7.029** **(.0001)**
N	**257**	**257**	**257**
Collinearity index >20?	**20.99**	**20.37**	**26.123**

The collinearity index hovers at about 20 for both the Political Capacity and Political Survival models, and then goes well above 20 in the encompassing model. This suggests that the interpretation of these results is problematic. CBI has no statistically discernible effect. When the CBI term is taken out of the models, the collinearity problems go away in the Political Survival and Political Capacity models, and the results become clearer.

The results below are reported for the model presented above, and then the results when CBI is dropped from the model are presented and discussed.

In all models of international financing, DEBT has a positive and highly statistically significant coefficient. In other words, countries with a greater external debt burden seek more international financing. DISCOUNT does not have a statistically discernible effect on international financing throughout all models. REGIME is statistically significant at the .1 level in both the political capacity and political survival models, and almost statistically significant in the encompassing model. This suggests that autocracies generally obtain more international financing than democracies. TREND is also statistically significant. GROWTH is positive and statistically significant, suggesting that faster-growing countries systematically obtain higher levels of international financing. INCOME is slightly negative and highly statistically significant throughout. This suggests that richer countries usually resort to less international financing.

The WAR term in the Political Survival model and the POLCAP*WAR term in the Political Capacity model are both positive and highly statistically significant. However, there is a discernible (1.29%) jump in R-square from the Political Survival to the Political Capacity model. Additionally, the Encompassing model test shows that the variable unique to the Political Survival model drops out to be a statistical zero while the variable unique to the Political Capacity model is retained because its statistically significant. This suggests that stronger states systematically obtain higher levels of international financing in wartime than weaker states.

When CBI is dropped and the model is re-estimated without CBI, the results appear as follows:

Table 2.5.2 Results for international financing without CBI

Dependent variable: international financing	**Political Survival Model**	**Political Capacity Model**	**Greene's Hybrid Model**
Independent variable			
CONSTANT	**.57**	**1.05****	**1.26*****
POLCAP	**.96*****	**.52****	**.38**
DEBT	**.02*****	**.02*****	**.02*****
DISCOUNT	**.1**	**-.42**	**-.63**
REGIME	**.49****	**.47****	**.45* (p-val: .054)**
TREND	**-.02**	**-.01**	**-.01**
GROWTH	**.04****	**.04****	**.04****
INCOME	**-.0005*****	**-.0005*****	**-.0005*****
WAR	**.896*****		**-.36**
POLCAP*WAR		**.94*****	**1.24****
R-square	**.1903**	**.2006**	**.2013**
Adj. R-square	**.1720**	**.1824**	**.1809**

F **Prob>F**	**10.372** **(.0001)**	**11.07** **(.0001)**	**9.86** **(.0001)**
N	**361**	**361**	**361**
Collinearity Condition Index >20?	**16.464**	**15.87**	**21.31**

In these estimations, the collinearity index dips well below the threshold of 20 in both the Political Capacity and Political Survival models, although it remains high at 21.31 in the Encompassing model. As can be seen, the major findings are similar throughout most of the variables, except that the weaker evidence for some of the findings in the former estimations are strengthened here. The influence of POLCAP, which was only seen at the .1 level in the Political Survival model, is now found in both the Political Capacity and Political Survival models. The finding about the influence of WAR as compared to POLCAP*WAR is strengthened here. DEBT remains statistically significant throughout, while DISCOUNT continues to be statistically insignificant. The statistical significance of the positive effect of REGIME is strengthened with lower p-values and a statistically significant estimated parameter in the Encompassing model. TREND loses its statistical significance in the tests conducted without CBI. This may be due to the collinearity problems in the earlier tests. GROWTH and INCOME both continue to be statistically significant with similar coefficient estimates.

In comparing the Political Survival and Political Capacity models, the findings are similar to the case under the tests conducted with the CBI term included. The WAR term in the Political Survival model and the POLCAP*WAR term in the Political Capacity model are both positive and highly statistically significant. However, there is again a discernible (1.22%) jump in R-square from the Political Survival to the Political Capacity model. Additionally, the Encompassing model test shows that the variable unique to the Political Survival model drops out to be a statistical zero while the variable unique to the Political Capacity model is retained because it is statistically significant (as was the case in the earlier tests). This reinforces the earlier finding that stronger states systematically obtain higher levels of international financing in wartime than weaker states.

Table 2.6 Results for models of international financing using CBI2

Dependent variable: international financing	**Political Survival Model**	**Political Capacity Model**	**Greene's Hybrid Model**
Independent variable			
CONSTANT	**.62**	**1.24****	**1.61*****
POLCAP	**.7 (p-val: .1105)**	**.21**	**-.03**
DEBT	**.02****	**.02****	**.02****
DISCOUNT	**-.21**	**-.76**	**-.96**
REGIME	**.61****	**.56****	**.52****
TREND	**-.04***	**-.04***	**-.04 (p-val: .1216)**
CBI2	**.94 (p-val: .1055)**	**.95 (p-val: .1015)**	**.89 (p-val: .1306)**
GROWTH	**.06****	**.05****	**.05****
INCOME	**-.0005*****	**-.0005*****	**-.0005*****
WAR	**1.28*****		**-.72**
POLCAP*WAR		**1.17*****	**1.72****
R-square	**.2046**	**.2203**	**.2224**
Adj. R-square	**.1754**	**.1917**	**.1905**
F **Prob>F**	**7.001** **(.0001)**	**7.693** **(.0001)**	**6.979** **(.0001)**
N	**254**	**254**	**254**
Collinearity Condition Index >20?	**18.886**	**18.59**	**25.093**

In the estimation of the models for international financing using the governor turnover measure of central bank independence (CBI2), the findings are very similar to the earlier sets of results. CBI2 approaches the .1 level of statistical significance but doesn't cross that threshold. The collinearity in the Political Capacity and Political Survival models is at acceptable levels based on the condition index threshold of 20. The major finding that the Political Capacity model outperforms the Political Survival model is retained. In the Encompassing model, the WAR term becomes statistically insignificant while the POLCAP*WAR term is statistically significant. Furthermore, the R-square of the Political Capacity model exceeds the R-square of the Political Survival model by almost 2 %. Thus, the Political Capacity model is a better predictor of different levels of international financing than the Political Survival model. Yet the direction in which political capacity mediates the effects of war on international financing is unanticipated and contrary to expectations of the political capacity approach. Stronger states are the ones that obtain the highest levels of international financing, based on the positive coefficient of POLCAP*WAR.

CONCLUSION

This section is organized in the form of a summary of findings with regard to starting hypotheses and lengthier answers to selected subtitled questions.

Table 2.7 Summary table of hypotheses and findings

HYPOTHESIS	FINDING	NOTES
1. Higher capacity states will engage in increased levels of domestic extraction in the context of an international shock.	Not supported	Wartime appears to have no effect on domestic extraction
2. Low capacity states will	Not supported.	All states increase international

engage in higher international extraction in the context of an international shock.		financing, but higher capacity states do so the most.
3. All states will engage in money creation in response to an international shock.	Supported.	All states engage in money creation, regardless of political capacity.
4. Weak states are especially likely to engage in money creation in response to an international shock.	Not supported.	Political capacity has no apparent effect on money creation levels in wartime.
5. Low discount rates of regime leaders mean higher levels of domestic extraction.	Supported.	Countries with leaders who are secure in their tenure extract more domestically.
6. Autocracies will generally extract more domestically than democracies.	Supported.	A binary measure of regime type has a clear statistical association with extraction.
7. Autocracies will more aggressively seek international financing than democracies.	Supported.	There is a discernible positive association between autocracy and international financing.
8. Greater central bank independence will mean less inflationary money creation policies.	Supported.	The "governor turnover" measure of CBI shows a strong positive relation with the inflation indicator of money creation (high turnover = low CBI).
9. Greater central bank independence will increase the level of domestic extraction.	Not supported.	The legal index measure shows a negative relation between CBI and domestic extraction; the turnover measure shows no relation.
10. Greater central bank independence will increase the level of international financing.	Weak support.	The turnover measure of CBI approaches statistical significance as a positive impact on international financing.
11. Economic growth will affect all forms of public finance.	Mixed support.	Positive effect on international financing, weak evidence of negative relation with money creation; no relation with domestic extraction.
12. Income level will affect all forms of public finance.	Support.	Positive effect on domestic extraction; negative effect on international financing; weak evidence of negative effect on money creation.

13. Debt burden will affect all forms of public finance.	Support.	Negative on money creation; negative on domestic extraction; positive on international financing

Do shocks affect the level of different kinds of financing?

Wartime has a clear impact on government finance. This impact is generally positive on the level of international financing and positive on money creation. There is no discernible impact on domestic extraction.

Does political capacity mediate the impact of shocks on each of these forms of financing?

In the case of money creation, there is no evidence that political capacity mediates the effect of wars on money creation. Wartime does have a statistically discernible impact on money creation. This provides support for the hypothesis that regardless of their level of political capacity, all governments will engage in money creation as their initial "accommodational" strategy. It does not support Goode's (1984) notion that weaker states will engage in more money creation.

In the case of overall international financing, however, there is strong evidence that political capacity affects the amount of international financing obtained by governments in wartime. Stronger states systematically obtain greater levels of international financing. I speculate that this may be due to their greater creditworthiness in the view of foreign creditors. Thus, stronger states may obtain higher levels of international financing than weak states in wartime simply because they can.

Wartime does not appear to affect domestic extraction in all states. Contrary to the prediction of the Political Capacity model, stronger states do not raise domestic extraction in wartime.

Does survival overwhelm capacity?

The prediction of the political capacity approach that stronger states will exhibit specific, different patterns of finance in the context of a war shock is not generally upheld. States in general do not raise domestic extraction in wartime, irrespective of political capacity. All states engage in money creation in wartime, irrespective of political capacity. Both findings run contrary to the political capacity predictions. Political capacity positively affects the level of international financing obtained in wartime. This is the opposite of the prediction of the political capacity perspective.

Survival generally overwhelms capacity. None of the predictions of the political capacity perspective are supported for the case of war shocks. A strong result of these tests, however, is that the level of political capacity in wartime is a significant positive predictor of the level of international financing obtained by states. This is an interesting empirical finding that calls for further theorizing as it contradicts the expectation of the political capacity hypothesis. I speculate that politically capable states are the best credit risks and therefore are best to obtain international loans in national emergency times. Domestically politically capable states may also be more likely to have the administrative apparatus required to locate and appeal to all sources outside their borders. If correct, this supports the spirit of the political survival perspective- namely, that all political leaders are very cautious about public finance policies that are likely to arouse domestic political opposition, and turn to seek international financing as an alternative. Those leaders who happen to be in higher capacity states have better access to international financing, and thus obtain more as a policy preference. The implication of this is that the observed behavior is more a function of opportunities rather than strategic differences between the behavior of leaders in low capacity states and those in higher capacity states. In other words, weaker states would also obtain higher levels of international financing if the opportunity was made available to them.

How does the political survival of leaders, as measured by the discount rate, affect government finance?

The discount rate has no identifiable impact on money creation or international financing. The discount rate has a negative impact on the level of domestic extraction. This finding contradicts the expectation that insecure leaders will plunder to get what they can before their fall from power. A possible explanation is that insecure leaders are more sensitive to the political implications of higher tax burdens and therefore avoid these. Caution thus overwhelms plunder.

Does regime type make a difference?

There is weak evidence that autocracies engage in less money creation than democracies. Collinearity in the model and the loss of statistical significance of the regime indicator when the model is re-estimated with a different measure of one variable makes this a weak finding. Autocracies do obtain greater levels of overall international financing. These results show that autocratic regimes also extract more domestically than democratic regimes. This contradicts Cheibub's (1998) finding that regime type alone does not account for differences in the level of domestic extraction. Autocratic repression may be the reason for the greater levels of domestic extraction enjoyed by autocracies. This ability to extract more domestically might make autocracies better creditors as external borrowers also. If this is the case, it may account for the finding that autocracies also obtain greater levels of international finance.

What are the consequences of central bank independence?

Neither measure of central bank independence employed here is unproblematic. The legal measure (CBI) does not account for actual practice. The rate of governor turnover (CBI2) is an empirical measure but encounters conceptual problems- high turnover may signify a dependent central bank, but low turnover may signify an acquiescent governor. For the purposes here, high turnover is treated as an indicator of low central bank independence. High CBI2 is associated with high inflation, the indicator of money creation. This supports the traditional assumption that central bank independence curtails inflationary policies.

Appendix 2.1: List of countries used for each set of tests.

COUNTRY LIST FOR TESTS OF INTERNATIONAL FINANCING (USING CBI)

ARGENTINA
BOLIVIA
BRAZIL
CHILE
CHINA
COLOMBIA
EGYPT
HONDURAS
HUNGARY
INDONESIA
INDIA
JORDAN
MOROCCO
MEXICO
NICARAGUA
PAKISTAN
PERU
PHILIPPINES
TURKEY
UGANDA
SOUTH AFRICA

COUNTRY LIST FOR TESTS OF DOMESTIC EXTRACTION (USING CBI).

ARGENTINA
BOLIVIA
BRAZIL
CHILE
CHINA
COLOMBIA
HONDURAS
HUNGARY
INDIA
INDONESIA
MEXICO
MOROCCO
NICARAGUA
PAKISTAN
PERU

PHILLIPINES
TURKEY
UGANDA

COUNTRIES USED IN THE TESTS FOR MONEY CREATION (USING CBI)
ARGENTINA
BOLIVIA
BRAZIL
CHILE
CHINA
COLOMBIA
GREECE
HONDURAS
HUNGARY
INDIA
INDONESIA
ISRAEL
MEXICO
MOROCCO
NICARAGUA
PAKISTAN
PERU
PHILIPPINES
PORTUGAL
TANZANIA
TURKEY
UGANDA

COUNTRY LIST FOR TESTS OF INTERNATIONAL FINANCING (USING CBI2)
ARGENTINA
BRAZIL
CHILE
CHINA
COLOMBIA
EGYPT
HONDURAS
HUNGARY
INDONESIA
INDIA
MOROCCO
MEXICO
NICARAGUA
PAKISTAN

PERU
PHILIPPINES
TURKEY
UGANDA
SOUTH AFRICA

COUNTRY LIST FOR TESTS OF DOMESTIC EXTRACTION (USING CBI2).

ARGENTINA
BRAZIL
CHILE
CHINA
COLOMBIA
HONDURAS
HUNGARY
INDIA
INDONESIA
MEXICO
MOROCCO
NICARAGUA
PAKISTAN
PERU
PHILLIPINES
TURKEY
UGANDA

COUNTRIES USED IN THE TESTS FOR MONEY CREATION (USING CBI2).
ARGENTINA
BRAZIL
CHILE
CHINA
COLOMBIA
GREECE
HONDURAS
HUNGARY
INDIA
INDONESIA
ISRAEL
MEXICO
MOROCCO
NICARAGUA
PAKISTAN
PERU
PHILIPPINES

TANZANIA
TURKEY
UGANDA

CHAPTER 3: An Empirical Evaluation of the "Political Capacity" and "Political Survival" Hypotheses Using International Economic Shocks

INTRODUCTION

The war-state-building link comes from the increased fiscal demands on the government that follow from the threat to regime survival. Wars place unusually high fiscal demands on governments. Other international crises such as those associated with international economic shocks also have the potential to cause increased fiscal requirements. Based on the causal mechanism underlying this connection, and based on the statement that wars *and other crises* spur state building (Barnett, 1992), I have hypothesized in Chapter 1 that non-war IPE crises can be associated with the changes in public finance policy associated with state-building.

Nevertheless, IPE shocks are qualitatively different from wars. A significant distinction is that international economic shocks are shocks to revenues rather than shocks to spending (Roubini, 1991). As shocks to revenues, different government responses may be expected. These include the possibility that because economic shocks are seen as uncontrollable outside events, the populace does not hold the government politically accountable. As a result, it might be easier to implement extraction measures than would be the case with wars. (Conversely, wars may be politically popular and therefore produce an easier time raising domestic extraction. In either case, IPE shocks would have qualitatively different impacts than wars.)

Roubini hypothesizes that seignorage might be a residual form of taxation when there are revenue shocks (Roubini, 1991: S66). In other words, the gap from unexpected shortfalls in revenues will be filled by money creation activities. In his examination of budget deficits in developing countries, Roubini finds that this hypothesis works in some countries and not in others, and that it is difficult to distinguish which countries it works in from which ones it does not work in.

The political capacity literature fits in here particularly well. Political capacity is described as the capacity of the government to raise and allocate new revenues. Policy explicitness is a characteristic and defining feature of high political capacity. Money creation is often a covert, non-explicit policy, not prominent in the press, while taxation is. We would expect higher capacity states to raise taxes in the event of a revenue shock because this is a more explicit action and because higher capacity states are the ones having the easiest time raising additional taxes (the original capacity hypothesis).

From a political survival perspective, economic shocks have a similar effect on the levels of forms of public finance of all states. This effect emerges from a combination of an impact on the economic revenue base of the state (constituting a "revenue shock") and an impact on the public finance policies. The impact on public finance policies is similar to that predicted in the case of war shocks: international financing and money creation will be the preferred methods of producing the needed revenues, while increased domestic extraction will be avoided.

Under the political capacity model, there are two distinct effects: a uniform (theoretically undifferentiated) effect of the shock itself on revenues, and a differential effect of the shock on public finance policies based on level of political capacity in interaction with the scale of the shock. The uniform effect will be on revenues and the economy generally, and therefore will have some influence on all forms of public finance. The mediated effect should vary as it did in the case of war-shocks. High capacity states are expected to increase domestic extraction, while low capacity states are expected to favor international financing and money creation. Thus, the political capacity model contains one more variable than the political survival model. The competing predictions of the two models are therefore that international shocks either have a uniform effect on states (political survival) or both a uniform effect and a mediated impact (political capacity).

HYPOTHESES

The following hypotheses will be investigated in this chapter (the bracketed terms refer to the perspective from which the hypothesis originated).

1. Higher capacity states will engage in increased levels of domestic extraction in response to heightened fiscal requirements occasioned by an international shock (capacity).

2. Low capacity states will engage in an international financing response to heightened fiscal requirements occasioned by an international shock (capacity).

3. All states will engage in increased international financing in the context of an international shock (survival).

4. All states will engage in money creation in response to an international shock (survival).

5. Weak states are especially likely to engage in money creation in response to an international shock (Goode, 1984).

6. War shocks will have a different impact from economic shocks.

The dependent variable in each hypothesis consists of the level of money creation, domestic extraction, or international financing, all forms of public finance. The independent variables are: international shocks, political capacity, discount rates, regime type, central bank independence, economic growth, and income level. These variables are taken from the hypotheses above, the theory developed in Chapter 1, and from the model of different forms of public finance described in Chapter 2. The variables unique to these tests and related measurement considerations are discussed below

VARIABLES AND MEASURES

Most of the variables and measures for these tests were used in Chapter 2. The variable that is unique to this chapter is non-war IPE shocks.

IPE shocks

Research on international economic changes tends to use the term "shock" without giving it an explicit a priori definition. A shock is broadly defined as a development in the international political economy that affects the economy generally in multiple ways and also the revenue base of regime financing. Shocks are changes in international markets that severely alter a country's terms of trade. Such shocks are conditioned by the extent to which a country's economy is tied to the international economy through the size of the import and export sector (Snider, 1996: 93-94, 184n). Shocks may spark or be associated with economic recessions. Shocks have the potential to put substantial pressure on the regime to raise new financial resources. An IPE shock may include drastic reductions in flows of external capital (Snider, 1996: 14). A suggested measure of IPE shocks is the index price of crude oil multiplied by fuel imports as a percentage of total imports (for countries that are net fuel importers) (Snider, 1996: 94).

CASE SELECTION

The cases selected are a sample of developing countries that are net oil importers. Net oil exporters are excluded because of the potential windfall effects of high oil prices for these countries. As a result, times of high fuel prices are unlikely to be associated with heavy fiscal burdens in these states. The competing predictions of the political capacity and political survival perspectives arise in the population of developing countries. The samples used here are chosen on the basis of data availability. "Developing" is defined in terms of per capita GNP as countries with less than $3900 per year in 1990 dollars. This is based on Snider's suggestion (Snider, 1996: 75-76, footnote 5). OECD countries are excluded with the exception of Greece and Portugal[1].

The time frame used for this study is based primarily on those years for which data were available for all series. The widest range of years covered is the 1970-1990 period. The total number of observations is 260 for the analysis of money creation, 172 for the analysis of international financing, and 186 for the analysis of domestic extraction.

METHODOLOGY

As described in the introduction, the Political Survival model contains one less variable than the Political Capacity model, and can be written as a subset of the Political Capacity model. Since the two models have different numbers of variables, the R-square alone is not a helpful comparison. This is because a model with more variables will generally show a better fit. The Adjusted R-square is somewhat more helpful because it allows for measures of improvement of fit while imposing a penalty for the addition of variables to a model. The adjusted R-square statistic has itself been criticized for insufficiently penalizing the loss of degrees of freedom incurred by the addition of variables to a model. An alternative statistic for comparing models is the Akaike Information Criterion (Greene, 1997: 400-401). The AIC tells us whether there is an improvement in explanation from the addition of a variable. It is useful in instances like this, where one model can be written as a subset of the other. The preferred model is the one that minimizes the AIC. As in Chapter 2, the tables of results presented here also include reference to a "collinearity condition index" that has been suggested as a guide to identifying problems of collinearity (Greene, 1997: 422). A condition index rating of 20 or higher is the suggested threshold for identifying problematic collinearity (Belsley et. Al., 1980, cited in Greene, 1997: 422).

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[1] This measure contains both "less developed economies" and "developing economies", a further categorization that Snider (1996) used.

As was the case in the last chapter, lagged effects are not explored. The size of the data set imposes a restriction because a lag of even one year in a pooled time series context means the loss of as many degrees of freedom as there are countries in the data set. As high collinearity is already a problem in several of the model variants tested, the further loss of degrees of freedom would likely make conclusions from the models impossible. Nevertheless, it is important to note that with a large enough data set, possible lagged effects deserve examination. In future research, where more data or alternative data are available, such possible lagged effects should be tested.

All models were estimated using SAS Version 6.12.

Comparing war-shock and economic shocks

One assumption underlying these tests has been that international economic shocks can serve in theory to drive state building in much the same way as wars by radically increasing the fiscal requirements of the state and forcing the state to obtain new revenues. As noted earlier, the war-making state-making literature typically notes that wars *and other international crises* can drive state-building (Barnett, 1992). Thus, there is some suggestion in the literature that international economic crises can be treated as the functional equivalent of wars. There are also arguments that the kind of shock produced by international price changes will be substantively different from war shocks. For example, war shocks carry greater traditional national security imperatives. The propositions about the effects of war and economic shocks are largely separate in the literature. Empirical investigations have often examined these separately (see, for example, Barnett, 1992, and Snider, 1996).

In organization, the tests conducted in this dissertation have largely followed the tendency to examine war shocks and international economic shocks separately, with a substantive focus on the war-making state-making proposition in Ch. 2 and a look at the economic shock- public finance nexus in the bulk of Ch. 3. Nevertheless, this chapter also examines a wide, inclusive model that looks at both sets of shocks simultaneously and uses a hypothesis testing methodology to evaluate the difference in impact between the two.

As before, the wider, inclusive tests are divided into a "political capacity" version and a "political survival" version. In this case, however, the political survival version is not nested within the political capacity version- because the political survival version contains a presence of war effect labeled WAR while the political capacity contains POLCAP*WAR, meaning the effects of WAR mediated by the level of POLCAP at the time of the war. In other words, the two big models contain unique variables and one cannot be written as a subset of the other. An "Encompassing model" strategy (Greene, 1997) is used for comparing the two (see the description of this in the Methodology section of Chapter 2).

Despite the probably collinear setting, hypothesis tests of equality are tried between economic shocks and wars. If these tests are not rejected, that indicates that wars are not statistically distinct from economic shocks in their impact on public finance levels. If these tests are rejected, then there is reason to entertain the idea that economic shocks and wars have different impacts on public finance, whether in type of impact or magnitude of impact.

Tests using different measures of central bank independence

The tests below are conducted twice, once for each of two measures of Central Bank Independence. (See the discussion in Chapter 2 for the merits and shortcomings of each measure.) The reason for doing this is twofold. First, CBI is important to include in the tests, but both measures are based on different understandings and there is not a unanimously agreed on measure. Other research on CBI has also followed the strategy of evaluating hypotheses using alternative measures (see Cukierman, et. al., 1992). Second, the collinearity problems in these results mean that the use of one measure of the other might reduce the collinearity in the model and provide a stronger interpretation of the results. It makes sense to try measures that are not collinear with other independent variables.

Summary of Abbreviations and Data Sources

Many of the abbreviations below have been described in Chapter 2. For convenience, they are reproduced here. Variable abbreviations unique to the tests in this chapter are also described below.

*: statistically significant at the .1 level

**: statistically significant at the .05 level

***: statistically significant at the .01 level

Collinearity Condition Index > 20?: If this statistic is greater than 20, then collinearity

problems exist and may interfere with the interpretation of results.

MAKEMONEY: the inflation indicator for money creation policies[2].

TAX: the level of domestic extraction, measured as central government tax revenue divided by GDP[3].

INTLFINANCE: the level of all international financing[4].

POLCAP: a measure of relative political capacity as relative political extraction based on Kugler and Arbetman's (1997) method[5].

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[2] Source: World Bank CD-ROM data (1998).
[3] Source: World Bank CD-ROM data (1998).
[4] Source: World Bank CD-ROM data (1998).
[5] Data obtained through personal communication with Ismene Gizelis of the Claremont Graduate School.

DEBT: Ratio of service on the outstanding public foreign debt to exports.[6]

DISCOUNT: Probability that the chief executive will be removed from office, given the length of his/her tenure in office, the rate of economic growth, and the number of changes of chief executive accumulated in each country since 1950. The origin of this measure and its estimation method is given by Cheibub (Cheibub, 1998).[7]

REGIME: A binary variable coded as 1 for autocracies and 0 for democracies.[8]

TREND: A variable calculated from the year of the observation. 1970 is coded as "1", 1971 is "2", etc.

CBI: a measure of central bank independence based on a measure that aggregates different legal factors[9].

CBI2: a measure of central bank independence based on the rate of turnover of the governor of the central bank[10].

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[6] Collected by Cheibub (1998) from the World Bank 1994 CD.
[7] Data Source: Cheibub, 1998.
[8] Data source: Cheibub, 1998.
[9] Data Source: Cukierman, et. al., 1992.

GROWTH: Economic growth, measured as annual rate of growth of INCOME[11].

INCOME: level of per capita income, measured as real GDP per capita, 1985 prices[12].

POLCAP2: A measure of the policy explicitness dimension of political capacity calculated as

[Taxes on income, profits and capital gains (% of current revenue)]/[[Taxes on goods and services (% of current revenue)]+[Taxes on international trade (% of current revenue)]+[Taxes on income, profits and capital gains (% of current revenue)].[13]

The following abbreviations are unique to this chapter.

SHOCK: IPE shocks measured as the index price of crude oil multiplied by fuel imports as a percentage of total imports (for countries that are net fuel importers) (Snider, 1996: 94)

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[10] Data Source: Cukierman, et. al., 1992.
[11] Data source: Cheibub, 1998.
[12] Data source: Cheibub, 1998.
[13] Data Source: World Bank on CD-ROM (1998).

POLCAP*SHOCK: An interaction term between SHOCK and POLCAP, calculated as SHOCK multiplied by POLCAP.

POLCAP2*SHOCK: An interaction term between SHOCK and POLCAP2, calculated as SHOCK multiplied by POLCAP2.

AIC: The Akaike Information Criterion, a statistic useful for comparing models nested models. A smaller value of this statistic means a better-fitting model.

RESULTS

Table 3.1 Results for models of money creation

Dependent variable: money creation	Political Survival Model	Political Capacity Model
Independent variable		
CONSTANT	-48.01	-38.17
POLCAP	284.62*	274.51
DEBT	-8.8*	-8.81* (p-val: .0574)
DISCOUNT	-15.86	-16.82
REGIME	-76.07	-75.76
TREND	32.41**	32.41**
CBI	36.58	38.41
GROWTH	-44.48*	-44.5*
INCOME	-.02	-.02
SHOCK	-31.25* (p-val: .0571)	-34.74
POLCAP*SHOCK		3.15
R-square	.1906	.1906
Adj. R-square	.1616	.1582
AIC	3408	3410
F	6.567	5.887

Prob>F	**(.0001)**	**(.0001)**
N	**260**	**260**
Collinearity Condition Index >20?	**18.9296**	**31.88**

The condition index for the Political Capacity model is well above the suggested threshold of 20. This reduces our confidence in both the estimated parameters and the statistical significances of those parameters in the Political Capacity model. The condition index for the Political Survival model is high but still below the suggested threshold of 20. Therefore, these results carry some more weight. The Political Survival model shows a surprising result: the effect of high international prices is actually negative on inflation, the indicator of money creation activities. Political capacity in general is positively associated with money creation, also contrary to expectations. The AIC statistic is marginally smaller in the Political Survival Model than the Political Capacity model. These findings show some support for Political Survival as a statistical model, although the sign of the shock coefficient is in the opposite direction from expectations.

A possible explanation for the surprising sign on the shock coefficient requires further investigation. "Cost-push" inflation resulting from high prices of basic supplies is a well-established notion. This finding not only runs against the predictions of the political survival model for the seignorage activities of states in the context of an international shock, but also against the cost-push inflation expected with high oil prices.

Table 3.2 Results for models of money creation using CBI2

Dependent variable: money creation	Political Survival Model	Political Capacity Model
Independent variable		
CONSTANT	-113.23	-146.08
POLCAP	239.7 (.1196)	270.43
DEBT	-10.61**	-10.54**
DISCOUNT	590.74	597.18
REGIME	-39.84	-41.76
TREND	33.69**	33.65**
CBI2	724**	729.06**
GROWTH	-42.47*	-42.42*
INCOME	-.1	-.1
SHOCK	-39.99* (.057)	-29.12
POLCAP*SHOCK		-9.69
R-square	.2179	.218
Adj. R-square	.1877	.1843
AIC	3183	3185
F Prob>F	7.211 (.0001)	6.467 (.0001)
N	242	242
Collinearity Condition Index >20?	18.548	32.65

Collinearity problems in the Political Capacity model (as indicated by the condition index of 32.65) may have distorted the estimates and taken away from the statistical significance of the findings. The condition index of the Political Survival model is below the threshold of 20. The results are similar to those using the legal measure of CBI, except that the empirical measure shows a statistically significant result: high turnover rates of the central bank governor are associated with higher money creation. The AIC statistic is marginally smaller in the Political Survival Model than the Political Capacity model. These findings show some support for Political Survival as a statistical model, although the surprising negative effect of economic shocks is retained in this set of tests.

Table 3.3 Results for models of domestic extraction

Dependent variable: domestic extraction	Political Survival Model	Political Capacity Model
Independent variable		
CONSTANT	12.94***	12.41***
POLCAP2	-9.63**	-8.55* (p-val: .0571)
DEBT	-.01	-.01
DISCOUNT	-11.1	-10.24
REGIME	3.165***	3.24***
TREND	.17**	.17**
CBI	-8.14**	-7.97**
GROWTH	-.07	-.07
INCOME	.003***	.003***
SHOCK	.37***	.44**
POLCAP2*SHOCK		-.22
R-square	.3009	.3012
Adj. R-square	.2653	.2615
AIC	655.804	658.927
F Prob>F	8.463 (.0001)	7.587 (.0001)
N	186	186
Collinearity Condition Index >20?	18.3576	24.301

Collinearity problems in the Political Capacity model (as indicated by the condition index of 24.301) may have distorted the estimates and the statistical significances of the findings. The condition index of the Political Survival model is below the threshold of 20. In consequence, a stronger interpretation from these results has more credibility. The shock term is positively associated with domestic extraction in both models. This contradicts the expectation based on the Roubini's "revenue shock" logic, and also the expectation in the Political Survival Model that states will not increase domestic extraction in the context of a shock. The AIC statistic is marginally smaller in the Political Survival Model than the Political Capacity model. Thus, these findings show some support for Political Survival as a statistical model, although the surprising positive effect of economic shocks contradicts Political Survival expectations. One possibility here is that states face less political opposition in their efforts to increase domestic extraction in the context of an international economic shock because they are not held to blame politically for an economic event. As a result, they may be able to implement a policy decision and sell it as a technically necessary move rather than a political decision.

Table 3.4 Results for models of domestic extraction using CBI2

Dependent variable: domestic extraction	**Political Survival Model**	**Political Capacity Model**
Independent variable		
CONSTANT	**9.446*** **	**8.52*** **
POLCAP2	**-2.24**	**-.09**
DEBT	**-.003**	**-.004**
DISCOUNT	**-19.39** **	**-17.69** **

REGIME	3.43***	3.58***
TREND	.22***	.21**
CBI2	10.37***	10.38***
GROWTH	-.07	-.06
INCOME	.002***	.002***
SHOCK	.27**	.41**
POLCAP2*SHOCK		-.43
R-square	.3365	.3381
Adj. R-square	.3028	.3005
AIC	646.011	647.578
F Prob>F	9.975 (.0001)	8.989 (.0001)
N	186	186
Collinearity Condition Index >20?	16.894	22.092

There is an increase in the R-squared values of these tests over the R-squareds of the tests using CBI. The coefficients generally retain their signs although not their statistical significances in this second set of tests. The discount rate is negatively associated with domestic extraction, supporting the "caution" hypothesis that insecure leaders try to avoid politically costly public finance policies. REGIME is highly statistically significant and positive, showing that autocracies generally extract at higher levels than democracies. CBI2 is positive and highly statistically significant while CBI was negative and statistically significant. Nevertheless, these are consistent, because CBI, the legal measure, is positively associated with central bank independence, while CBI2, the governor turnover measure, is negatively associated with central bank independence according to one interpretation. INCOME is positively associated with domestic extraction levels, supporting Roubini's (1991) suggestion.

Contrary to political survival expectations, the shock term has a positive effect on domestic extraction throughout the tests. In contrast, the POLCAP2*SHOCK term is negative although statistically insignificant. As was the case with the tests using CBI, the AIC statistic is marginally smaller in the Political Survival Model than the Political Capacity model. Thus, these findings show some support for Political Survival as a statistical model, although the surprising positive effect of economic shocks contradicts Political Survival expectations.

Table 3.5 Results for models of international financing

Dependent variable: international financing	**Political Survival Model**	**Political Capacity Model**
Independent variable		
CONSTANT	**2.62****	**4.61*****
POLCAP	**.6**	**-1.54****
DEBT	**.02***	**.002**
DISCOUNT	**1.72**	**1.53**
REGIME	**.49**	**.98*****
TREND	**.02**	**.05****
CBI	**-2.97***	**-2.93****
GROWTH	**.03**	**.03**
INCOME	**-.0009*****	**-.0008*****
SHOCK	**-.04**	**-.9*****
POLCAP*SHOCK		**.73*****
R-square	**.1709**	**.2653**
Adj. R-square	**.1251**	**.2199**

AIC	**258.86**	**239.95**
F **Prob>F**	**3.733** **(.0003)**	**5.85** **(.0001)**
N	**172**	**172**
Collinearity Condition Index >20?	**24.16**	**33.52**

Both models have condition indices higher than 20, suggesting that collinearity among the independent variables has potentially distorted both the parameter estimates and the statistical significances. A measure of caution is needed in interpreting the results

This set of international financing results is interesting despite its multicollinearity problems. The adjusted R-square is almost 9.5 % higher in the political capacity model. Furthermore, although SHOCK has a negative effect on international financing, the POLCAP*SHOCK term is positive and highly statistically significant. Therefore, political capacity in the context of a shock does appear to matter, in that stronger states obtain more international financing. The AIC statistic for the Political Capacity model is substantially lower than the statistic for the Political Survival model, providing additional support for the Political Capacity model as a better statistical explanation of international financing. It is important to note, however, that the direction of this relationship contradicts Political Capacity expectations. The expectation was that rather than stronger states, weaker states would be the ones to obtain more international financing. It is also interesting that POLCAP is negative and statistically significant in the Political Capacity model. This suggests that although stronger states generally have lower levels of international financing, they obtain higher levels of it in the context of a shock than weaker states.

Table 3.6 Results for models of international financing using CBI2

Dependent variable: international financing	Political Survival Model	Political Capacity Model
Independent variable		
CONSTANT	1.49**	3.53***
POLCAP	.82	-1.35**
DEBT	.02*	.005
DISCOUNT	2.21	2.01
REGIME	.52 (p-val: .1097)	1***
TREND	.02	.06**
CBI2	-1.11	-1.26
GROWTH	.04	.04
INCOME	-.001***	-.0008***
SHOCK	-.02	-.89***
POLCAP*SHOCK		.74***
R-square	.1559	.2528
Adj. R-square	.1093	.2067
AIC	261.953	242.872
F Prob>F	3.346 (.0009)	5.48 (.0001)
N	172	172
Collinearity Condition Index >20?	22.126	32.999

In the tests using CBI2, both models have condition indices higher than 20, suggesting that collinearity among the independent variables has potentially distorted both the parameter estimates and the statistical significances. Therefore, caution is needed in interpreting these results. The signs and statistical significances of these findings are essentially the same as for the results using CBI except that CBI2 is not statistically significant. The POLCAP*SHOCK coefficient is again highly statistically significant and positive (see discussion above), while POLCAP is negative and statistically significant in the Political Capacity model. As a statistical explanation of the level of international financing, the Political Capacity model outperforms the Political Survival model in terms of adjusted R-square and the AIC statistic. The positive sign of the POLCAP*SHOCK term, however, contradicts the expectation of the Political Capacity perspective.

RESULTS FOR THE "INCLUSIVE" MODELS

These models are similar to the ones reported above except that war shocks and IPE shocks are included in the models simultaneously. An Encompassing model is used to compare the Political Survival and Political Capacity models.

Table 3.7 Results for "inclusive" tests of money creation using CBI

Dependent variable: money creation	Political Survival Model	Political Capacity Model	Greene's Encompass -ing Model
Independent variable			
CONSTANT	-132.45	-103.83	-79.78
POLCAP	309.01*	281.85	262.38*
DEBT	-8.36*	-8.15* (p-val: .0541)	-8.1**

DISCOUNT	**77.8**	**61.87**	**48.29**
REGIME	**-81.13**	**-83.43**	**-83.83**
TREND	**29.07****	**28.76****	**28.86****
CBI	**37.19**	**35.2**	**35.53**
GROWTH	**-43.05***	**-43.39***	**-43.63***
INCOME	**-.01**	**-.01**	**-.01**
SHOCK	**-29.27***	**-21.95**	**-21.32**
POLCAP*SHOCK		**-6.88**	**-7.69**
WAR	**132.69***		**-64.06**
POLCAP*WAR		**133.7**	**189.01**
R-square	**.1962**	**.1974**	**.1975**
Adj. R-square	**.164**	**.1619**	**.1587**
F **Prob>F**	**6.101** **(.0001)**	**5.567** **(.0001)**	**5.086** **(.0001)**
N	**260**	**260**	**260**
Collinearity Condition Index >20?	**19.739**	**32.7698**	**34.1165**

The condition indices for all three models indicate the presence of some multicollinearity. The Political Survival model has the lowest condition index statistic, but at 19.739 it is very close to the threshold of 20 that indicates collinearity problems. This makes it difficult to treat these parameter estimates and associated statistical significances as strong findings. There are no major contradictions between these findings and the findings obtained when looking at economic shocks alone. A minor difference is that the sign on the DISCOUNT coefficient is positive in these tests while it was negative in the tests of economic shocks alone. However, this coefficient was not statistically significant in either case and is therefore statistically indiscernible from zero. The encompassing model is not very helpful in comparing the two models here because none of the variables unique to each model are statistically significant. The collinearity in the models further detracts from any strong conclusion about these two models in comparison.

The hypothesis test of equality between POLCAP*WAR and POLCAP*SHOCK is not rejected at the .1 level. The test of equality between WAR and SHOCK is not rejected at the .1 level. This does not mean that wars and IPE shocks have similar consequences. Collinearity problems make such a strong conclusion here difficult.

Table 3.8 Results for "inclusive" tests of money creation using CBI2

Dependent variable: money creation	Political Survival Model	Political Capacity Model	Greene's Encompass -ing Model
Independent variable			
CONSTANT	-245.86	-241.02	-244.07
POLCAP	261.66 (p-val: .1086)	261.09	263.4
DEBT	-10.72**	-10.34**	-10.35**
DISCOUNT	774.34	693.36	697.29
REGIME	-32.78	-45.46	-45.14
TREND	28.32**	28.24**	28.21**
CBI2	870.93**	887.91**	888.29**
GROWTH	-39.63*	-40.36*	-40.32*
INCOME	-.1	-.1	-.1
SHOCK	-37.77* (p-val: .0572)	-8.52	-8.71
POLCAP*SHOCK		-26.15	-25.96
WAR	218.3**		8.24
POLCAP*WAR		207.38*	200.38
R-square	.2311	.2328	.2328
Adj. R-square	.1979	.1963	.1928

F **Prob>F**	**6.972** **(.0001)**	**6.374** **(.0001)**	**5.818** **(.0001)**
N	**242**	**242**	**242**
Collinearity Condition Index >20?	**19.2721**	**33.5154**	**34.53**

As was the case with the estimations of the models for money creation, these models exhibit probable collinearity problems. In the Political Capacity and Encompassing models, the condition index statistics are substantially higher than the suggested threshold of 20. In the case of the Political Survival model, the condition index is very close to 20. As a result, these results may have problems in both the estimated coefficients and the associated statistical significances. The results are generally similar to those in the tests using CBI except that CBI2 is highly statistically significant while CBI was not significant. As was the case in the tests using CBI, the Encompassing model is not a useful strategy here because none of the coefficients of the variables unique to either model are statistically significant. The Political Survival performs marginally better than the Political Survival Model in terms of Adjusted R-squared, but the collinearity problems make this marginal difference a non-substantive finding.

The hypothesis test of equality between POLCAP*WAR and POLCAP*SHOCK is not rejected at the .1 level. The test of equality between WAR and SHOCK is not rejected at the .1 level. As with the case of the inclusive tests for money creation using the first measure of central bank independence, collinearity problems make a strong conclusion from this finding difficult.

Table 3.9 Results for "inclusive" tests of domestic extraction using CBI

Dependent variable: domestic extraction	Political Survival Model	Political Capacity Model	Greene's Encompass -ing Model
Independent variable			
CONSTANT	12.69***	12.48***	10.53***
POLCAP2	-9.56**	-8.38*	-2.15
DEBT	-.01	-.01	-.02
DISCOUNT	-10.73	-10.59	-14.53
REGIME	3.21***	3.23***	3.78***
TREND	.15**	.17**	.18**
CBI	-8.24**	-7.96**	-8.68**
GROWTH	-.07	-.07	-.05
INCOME	.003***	.003***	.004***
SHOCK	.38***	.44**	.54**
POLCAP2*SHOCK		-.22	-.5
WAR	.45		6.16**
POLCAP2*WAR		-.78	-22.56**
R-square	.3016	.3014	.3172
Adj. R-square	.262	.2575	.2701
F Prob>F	7.602 (.0001)	6.864 (.0001)	6.735 (.0001)
N	186	186	186
Collinearity Condition Index >20?	18.9036	24.7616	27.2949

These results are difficult to interpret with confidence because of collinearity problems. The encompassing model appears to show that the war part of the political capacity model is retained while the economic shock part is not. In the Political Capacity model, however, the POLCAP2*WAR term was not statistically significant. The confusing finding of the encompassing model does not carry much weight because of the high collinearity associated with that model, as indicated by the collinearity index of 27.2949. The political capacity model also has collinearity problems, as indicated by it's collinearity condition index value of 24.7616. Although the Political Survival model is a marginally better predictor of domestic extraction than the Political Capacity model in terms of Adjusted R-squared, WAR, the only variable unique to the Political Survival Model, is not statistically significant in the estimation of the Political Survival Model.

The hypothesis test of equality between POLCAP2*WAR and POLCAP2*SHOCK is rejected at the .05 level (p-val: .0674). The test of equality between WAR and SHOCK is rejected at the .1 level. These results suggest that wars and IPE shocks have different impacts. Both variables have positive coefficients, meaning that the difference in impact is a difference of magnitude rather than direction.

Table 3.10 Results for "inclusive" tests of domestic extraction using CBI2

Dependent variable: domestic extraction	**Political Survival Model**	**Political Capacity Model**	**Greene's Encompass-ing Model**
Independent variable			
CONSTANT	**7.72*** **	**7.81*** **	**5.27** **
POLCAP2	**.18**	**.001**	**7.38**
DEBT	**-.01**	**-.005***	**-.01**

		(p-val: .0586)	
DISCOUNT	-19.75**	-16.58* (p-val: .0586)	-21.23**
REGIME	3.76***	3.68***	4.3***
TREND	.16**	.17**	.18**
CBI2	13.29***	12.36***	13.04***
GROWTH	-.03	-.05	-.02
INCOME	.002***	.002** (p-val: .0105)	.002***
SHOCK	.28***	.39**	.51** (p-val: .0143)
POLCAP2*SHOCK		-.4	-.71 (p-val: .1102)
WAR	2.39**		6.79**
POLCAP2*WAR		6.13 (p-val: .1153)	-17.5*
R-square	.3546	.3466	.3657
Adj. R-square	.3179	.3055	.3220
F Prob>F	9.669 (.0001)	8.439 (.0001)	8.36 (.0001)
N	186	186	186
Collinearity Condition Index >20?	17.5042	22.6289	26.403

The collinearity in the tests of the models of domestic extraction using CBI2 is generally slightly lower than the collinearity in the tests using CBI. The results are otherwise similar in most respects. Although the sign on CBI2 is positive in this set of tests, it is substantively the same as the negative sign on the tests using CBI because CBI2 (central bank governor turnover rate) is a negative measure of central bank independence. Despite the collinearity in the Political Capacity model and the Encompassing model (as evidenced by their high condition indices), it is possible to note weak support for the Political Survival model. The variable unique to the Political Survival model (WAR) is statistically significant in the estimation of that model, while the variables unique to the Political Capacity model (POLCAP2*WAR and POLCAP2*SHOCK) are not statistically significant in the estimation of the Political Capacity Model. In the encompassing model, one of the variables unique to the Political Capacity model (POLCAP2*SHOCK) is statistically insignificant, and the other variable, POLCAP2*WAR, is significant but negative, the opposite of the hypothesized direction under the Political Capacity assumptions. Additionally, the Adjusted R-square of the Political Survival model improves on the Adjusted R-square of the Political Capacity model by 1.2%. Thus, there is some evidence that the Political Survival model is a better predictor statistically of levels of domestic extraction. Importantly, both the SHOCK and WAR coefficients are positive in the estimation of the Political Survival model, which runs contrary to the Political Survival prediction that all states will avoid domestic extraction increases in the context of a international shock.

The hypothesis test of equality between POLCAP2*WAR and POLCAP2*SHOCK is rejected at the .1 level (p-val: .0674). The test of equality between WAR and SHOCK is rejected at the .05 level. This supports the above finding that wars and IPE shocks have different impacts, with the positive coefficient in each suggesting that the difference is in magnitude rather than in direction.

Table 3.11 Results for "inclusive" tests of international financing using CBI

Dependent variable: international financing	Political Survival Model	Political Capacity Model	Greene's Encompassing Model
Independent variable			
CONSTANT	1.81*	4.63***	5.04***
POLCAP	.6	-2.28***	-2.61***
DEBT	.03***	.02**	.02**
DISCOUNT	2.93	1.33	.61
REGIME	.47	.8** (p-val: .0114)	.73**
TREND	-.04	-.01	-.01
CBI	-3.04	-2.68* (p-val: .0522)	-2.53*
GROWTH	.06* (p-val: .051)	.05 (p-val: .1014)	.04
INCOME	-.0008***	-.0007***	-.0006***
SHOCK	-.02	-.82***	-.79***
POLCAP*SHOCK		.69***	.67***
WAR	1.56***		-.82
POLCAP*WAR		1.46***	2.12** (p-val: .0146)
R-square	.2629	.3771	.3792
Adj. R-square	.2174	.3345	.3327
F Prob>F	5.777 (.0001)	8.859 (.0001)	8.145 (.0001)
N	172	172	172
Collinearity Condition Index >20?	24.9861	34.27	36.723

Despite collinearity problems in all three of these models (all have condition indices greater than 20), the major results of the earlier findings with respect to the influence of political capacity on international financing in wartime and in the context of an economic shock have been borne out. The positive signs of POLCAP*SHOCK and POLCAP*WAR provide evidence that stronger states obtain more international financing in the context of a war or economic shock. It is notable that the POLCAP coefficient is negative and statistically significant in both the Political Capacity model and the Encompassing model. This suggests that stronger states in general obtain less international financing than weaker states, but that they are particular adept at obtaining international resources in the context of a war or economic shock. The best performer in terms of adjusted R-squared is the political capacity model. Furthermore, in the Encompassing model, the WAR term (unique to the Political Survival model) is statistically insignificant, while the POLCAP*WAR and POLCAP*SHOCK terms (unique to the Political Capacity model) are statistically significant. According to the Encompassing model logic, we would retain the Political Capacity model over the Political Survival model. The Political Capacity model is thus a notably better performer statistically despite the collinearity problems in the results.

The hypothesis test of equality between WAR and SHOCK is not rejected. The hypothesis test of equality between POLCAP*WAR and POLCAP*SHOCK is rejected at the .1 level. The high collinearity of these three models, however, prevents a strong conclusion from the results of these hypotheses tests.

Table 3.12 Results for "inclusive" tests of international financing using CBI2

Dependent variable: international financing	Political Survival Model	Political Capacity Model	Greene's Encompass-ing Model
Independent variable			
CONSTANT	.47	3.52***	4.12***
POLCAP	.81	-2.16***	-2.57***
DEBT	.02**	.02*	.02**
DISCOUNT	3.46	1.68	.77
REGIME	.65**	.95***	.84***
TREND	-.04	-.01	-.009
CBI2	.95	.8	.61
GROWTH	.07**	.06**	.06*
INCOME	-.001***	-.001***	-.001***
SHOCK	-.02	-.82***	-.78***
POLCAP*SHOCK		.69***	.66***
WAR	1.71***		-1.01
POLCAP*WAR		1.59***	2.38***
R-square	.2441	.3624	.3656
Adj. R-square	.1974	.3189	.3181
F Prob>F	5.232 (.0001)	8.32 (.0001)	7.685 (.0001)
N	172	172	172
Collinearity Condition Index >20?	23.0547	33.6857	36.426

All the condition indices are greater than 20, and thus these results are characterized by similar multicollinearity to that found in the tests using CBI.

In terms of sign and statistical significance, these results are essential identical except that CBI2 is not statistically significant while CBI is. The Political Capacity model outperforms the Political Survival model in terms of adjusted R-squared. Additionally, the Encompassing model shows that the variables unique to the Political Capacity model are retained as being statistically significant (POLCAP*SHOCK and POLCAP*WAR) while the variable unique to the Political Survival model (WAR) loses its statistical significance. Thus, as was the case in the tests conducted using CBI, the finding here is that the Political Capacity model is the best predictor of international financing.

The hypothesis test of equality between POLCAP*WAR and POLCAP*SHOCK is rejected at the .05 level. The test of equality between WAR and SHOCK is not rejected (at the .1 level). This finding, similar to the finding under the tests using CBI, suggests that the interaction of international economic shocks with political capacity is distinct from the interaction of wars with political capacity in terms of their impact on international financing. While both have a positive effect on international financing, the size of this impact is not identical. As with the tests using CBI, however, the presence of high multicollinearity (as indicated by the collinearity condition index being above 20) means that a strong conclusion about the difference between the impact of wars and IPE shocks cannot be made.

CONCLUSION

This section is organized in the form of a summary of findings with regard to starting hypotheses and lengthier answers to selected subtitled questions.

Summary table of hypotheses and findings

(PC) denotes a hypothesis form the Political Capacity perspective. (PS) refers to a hypothesis originating from Political Survival assumptions.

Table 3.13 Summary of hypotheses and findings

HYPOTHESIS	FINDING	NOTES
1. Higher capacity states will increase domestic extraction in the context of an international shock. (PC)	Not supported	Shocks are associated with higher Tax/GDP but political capacity does not condition this relationship.
2. Low capacity states will increase international financing in an international shock. (PC)	Not supported.	The opposite happens: higher capacity states increase international financing in an international shock.
3. All states will increase international financing in an international shock. (PS)	Not supported.	Shocks are generally associated with a small decrease in international financing.
4. All states will create money in the context of an international shock. (PS)	Not supported.	The effect of shocks on money creation is slightly negative.
5. Weak states are especially likely to create money in an international shock. (PC)	Not supported.	Political capacity does not condition the relationship between shocks and money creation.
6. War shocks will have a different impact from economic shocks.	Partially supported.	War and economic shocks are indistinct in their effect on money creation, distinct in their effects on domestic extraction, and indistinct in

		their effects on international financing.
7. The impacts of war and economic shocks as conditioned by political capacity will be distinct from each other.	Partially supported.	The war-political capacity and economic shock-political capacity interactions are distinct from each other in their effects on domestic extraction and international financing, but indistinct in their effects on money creation.

Collinearity among independent variables is a problem in several of these tests. Specific collinearity problems have been described in the results section. While this table makes it appear that there is no support for either the political capacity or political survival hypotheses, I argue below that the spirit of the political survival hypothesis retains more weight after these tests.

Do shocks affect the level of different kinds of financing?

International economic shocks are associated with government finance. The impact is slightly negative on the level of international financing and slightly negative on money creation, and positive on the level of domestic extraction.

Does political capacity mediate the impact of shocks on each of these forms of financing?

In the case of money creation, there is no evidence that political capacity mediates the effect of shocks on money creation. Thus, Goode's

(1984) suggestion that weaker states will engage in more money creation is not supported. International economic shocks do have a statistically discernible negative impact on money creation. This is in the opposite direction of the political survival prediction.

In the case of overall international financing, however, there is strong evidence that political capacity affects the amount of international financing obtained by governments in the context of an international economic shock. Stronger states systematically obtain greater levels of international financing. This finding is analogous to the results for the tests of war-shocks described in Chapter 2. I again speculate that this may be due to their greater creditworthiness in the view of foreign creditors. Thus, stronger states may obtain higher levels of international financing than weak states in the context of an international economic shock simply because they can.

Contrary to the prediction of the Political Capacity model, the level of political capacity does not condition the effect of international economic shocks on domestic extraction. The shocks are in general associated with higher levels of extraction.

Do war-shocks differ from international economic shocks in their impact on public finance policies?

Collinearity problems make strong interpretation difficult in the tests of models that include both economic and war shocks. These are not distinct from each other statistically except in the case of the tests for domestic extraction. Here, the signs of the estimated parameters are both positive, but the two are statistically distinct. In examining the war and economic shocks as conditioned by political capacity, the finding is that these are distinct from each other in the case of domestic extraction and international financing, but not money creation. This difference is one of magnitude of effect rather than direction; the sign on both war and economic shocks as mediated by political capacity is negative in the case of domestic extraction and positive in the case of international financing. Wars as conditioned by political capacity generally have a bigger impact on international financing than international economic shocks, but these relationships are in the same direction and therefore qualitatively similar. This is the same for the tests of domestic extraction except that war-shocks and economic shocks in this case are not statistically discernible from zero. In sum, there are similarities in direction and differences in magnitude between war and economic shocks in their impact on public finance as conditioned by political capacity. Statistical problems make a stronger conclusion difficult.

Does survival overwhelm capacity?

The prediction of the political capacity approach that stronger states will exhibit specific, different patterns of finance in the context of an international economic shock is not generally upheld. Political capacity does not condition the relationship between international economic shocks and domestic extraction or shocks and money creation. Both findings run contrary to the political capacity predictions. As was the case with war-shocks, political capacity positively affects the level of international financing obtained in times of international economic shock. This is the opposite of the prediction of the political capacity perspective.

Nevertheless, it is difficult to argue that survival overwhelms capacity. The political survival predictions are not upheld, and the effects of international economic shocks are generally in the opposite of the predicted direction. None of the predictions of the political capacity perspective are supported. A strong result of these tests, however, is that the level of political capacity is an important variable for the explanation of international financing. This is an interesting empirical finding that calls for further theorizing. As was the case with the results of Chapter 2, I speculate that politically capable states are the best credit risks and therefore are best able to obtain international loans in national emergency times. If correct, the spirit of the political survival perspective is again supported, for the same speculative reasons that were suggested at the end of Chapter 2.

Appendix 3.1: List of countries used for each set of tests.

COUNTRY LIST FOR TESTS OF INTERNATIONAL FINANCING (USING CBI)

BRAZIL
CHILE
COLOMBIA
HONDURAS
HUNGARY
INDIA
MOROCCO
NICARAGUA
PAKISTAN
PERU
PHILIPPINES
TURKEY
SOUTH AFRICA

COUNTRY LIST FOR TESTS OF DOMESTIC EXTRACTION (USING CBI).

BRAZIL
CHILE
COLOMBIA
HONDURAS
INDIA
MOROCCO
NICARAGUA
PAKISTAN
PERU
PHILLIPINES
TURKEY

COUNTRIES USED IN THE TESTS FOR MONEY CREATION (USING CBI)

BRAZIL
CHILE
COLOMBIA
GREECE
HONDURAS
INDIA
MOROCCO

NICARAGUA
PAKISTAN
PERU
PHILIPPINES
PORTUGAL
TANZANIA
TURKEY

COUNTRY LIST FOR TESTS OF INTERNATIONAL FINANCING (USING CBI2)

BRAZIL
CHILE
COLOMBIA
HONDURAS
HUNGARY
INDIA
MOROCCO
NICARAGUA
PAKISTAN
PERU
PHILIPPINES
TURKEY
SOUTH AFRICA

COUNTRY LIST FOR TESTS OF DOMESTIC EXTRACTION (USING CBI2).

BRAZIL
CHILE
COLOMBIA
HONDURAS
INDIA
MOROCCO
NICARAGUA
PAKISTAN
PERU
PHILLIPINES
TURKEY

COUNTRIES USED IN THE TESTS FOR MONEY CREATION (USING CBI2).

BRAZIL
CHILE
COLOMBIA
GREECE
HONDURAS
INDIA
MOROCCO
NICARAGUA
PAKISTAN
PERU
PHILIPPINES
TANZANIA
TURKEY

CHAPTER 4: Case-Study: Historical Background and Pakistani Experiences

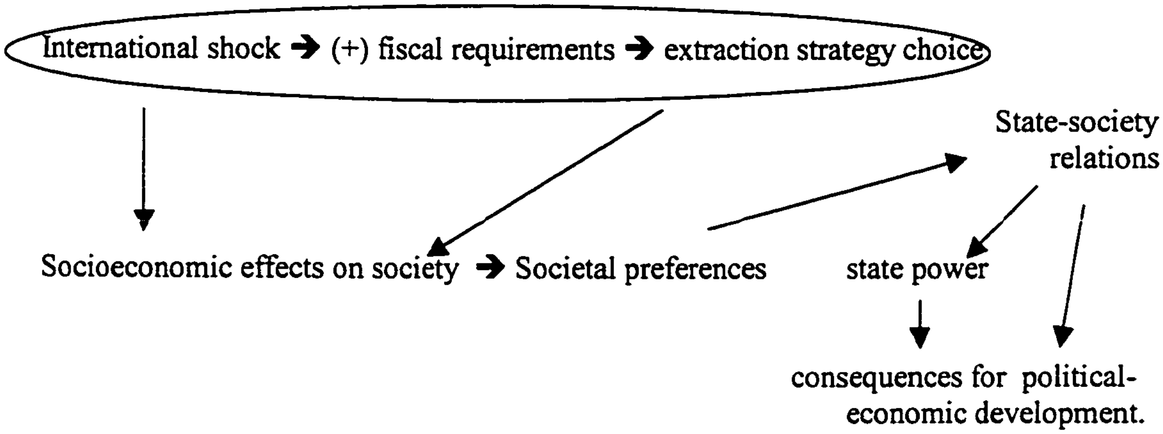
INTRODUCTION

Unlike the quantitative tests of the previous two chapters, the purpose of the case study examinations of this chapter and the next is not to evaluate a set of specific hypotheses through a systematic set of tests. Rather, the aim here is to gain some of the context and rich detail and nuance about revenue-raising efforts, outcomes, history, and context that is offered by focusing on fewer cases. Thus, it is primarily an exploratory effort, although a degree of evaluation is also offered.

One justification for this case examination is to get beyond the numbers presented in published data. Data from developing countries has been characterized as "poetry" or less kind labels. Data in Pakistan have been termed "notoriously poor, inadequate, of dubious quality, and often fabricated to suit the needs of the government in power" (Zaidi, 1999: xvii). Additionally, statistical sources often disagree. For example, in the Indian case a member of the Planning Commission notes that "there is a wide discrepancy between the trade accounts prepared by the Reserve Bank and the Directorate General of Commercial Intelligence and Statistics" (Sethi, 1992: 44). Moreover, changes like the Indian rupee devaluation in 1966 make certain comparisons based on numbers problematic (Singh, 1974: 296). It is partially for this reason that looking at a variety of historical and other qualitative accounts is useful.

The initial picture (from Chapter 1) of a suggested network of relations between international shocks, public finance, and development is reproduced below.

Figure 4.1 Summary diagram of suggested theoretical relationships



In Chapters Two and Three, the focus was exclusively on the region within the oval. In this chapter and in the next, there is room for reflection and empirical observation of some of the linkages outside the oval. The choice of public finance strategy affects state power. Accommodational and international strategies tend to reinforce the current condition of state power. (Barnett, 1992: 211). Restructural strategies, however, have the potential to alter state power. The linkages between public finance policy and state power are multiple and influence flows in both directions[1].

The focus of this investigation has been on the relationship between international shocks and public finance strategies. My interest here is also in trying to see whether the

[1] The literature on public finance policy in developing countries is generally concerned with government taxation, borrowing, and spending policies that are designed to promote economic development while maintaining monetary stability (see, for example, Sreekantaradhya, 1972: 14). The obvious function of taxes is to raise revenue, but they may also be imposed to redistribute wealth, correct market distortions, and guide consumer decisions (Joshi and Little, 1996: 63). Classics in the public finance literature have examined the role of taxation and other forms of government finance in mobilizing resources for economic development (for example, see Pigou, 1960). These consequences, often the traditional concern of analysts of fiscal policy, are ignored in this dissertation. The focus here is somewhat different: I'm interested in seeing how international changes affect existing revenue-raising strategies with the assumption that the

suggested causal paths that link variables in the statistical analyses of the last chapters are borne out by the empirical evidence in the finer-grained examination of specific cases. For example, the ease with which international financing may be obtained, or the specific opportunities for international financing available to different countries have not been addressed in the earlier tests.

Additionally, another point of interest here is the extent to which previous policy choices established reinforcing patterns for the future. For example, does a "ghetto-making" vicious cycle of dependency on international sources of revenues occur? This pessimistic possibility arose in the findings of Chapter 2, which showed that those states considered most likely to increase domestic extraction in wartime instead chose to increase international financing, thus circumventing the original war-making state-making logic.

This chapter reviews the experiences of Pakistan since independence in 1947. A similar review of the Indian experience is presented in the next chapter. India and Pakistan have been characterized as low capacity states. Michael Barnett's work on Egypt and Israel examined the resource mobilization choices in the war preparation behavior of those two states (Barnett, 1992). Since Israel is a stronger state, it is useful to include a brief review of Barnett's findings for comparative purposes.

This chapter is organized as follows. First existing work on Egypt and Israel by Michael Barnett (1992) is reviewed. An introduction to the Indian and Pakistani cases follows. Next, a chronology of shocks in the Indian and Pakistani cases is present. A summary introduction to the Pakistan case is then followed by graphs of four indicators

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choice of strategy has implications for the development of the state institutions as well as the economic development of the country.

of public finance in Pakistan, as well as brief discussions of notable features of the behavior of each indicator over time. A detailed account of Pakistan's history then follows, divided into time periods with a general overview and specific discussion of revenue-raising strategies. The next chapter (Chapter 5) presents a similarly-organized account of the Indian experience, discusses the two cases, with some comparisons to Barnett's work, offers general observations on the three revenue-raising strategies and the nature and impact of shocks, and then concludes with the implications for the theoretical models of public finance strategy proposed in this dissertation.

BRIEF REVIEW OF EXISTING WORK ON EGYPT AND ISRAEL

Barnett focuses on the effects of wars and war preparation rather than other international shocks on domestic policy in Egypt and Israel (although he acknowledges that other international crises have the potential to affect state-society relations significantly). Barnett finds three deviations from the traditional characterization of state power as a beneficiary of war. First, both Israel and Egypt chose to borrow rather than change their extraction capacities. Second, in both the major changes in state power came from the withdrawal of the state from society rather than increased intervention. Third, the decline of state power is found in the state's relative autonomy, rather than in the state's tax effort and extraction capacity. This decline in Israeli and Egyptian state power is defined in terms of being "increasingly circumscribed by domestic and foreign actors" (Barnett, 1992: 242).

Egypt

Barnett argues that Nasser's international financial policy was "a direct result of domestic circumstances and objectives" and "convinced him to limit his domestic extractive efforts" (Barnett, 1992: 89). Nasser sought the continued political support of the masses and therefore preferred to "mortgage Egypt's financial future" rather than burden the masses. At one time early in his period of rule, Nasser had "demonstrated a strong propensity to use such external shocks to move economically against the upper classes" (1992: 99). Increased societal opposition produced the fear of a revolutionary situation, and therefore the government looked to foreign assistance as a means of covering the balance of payments deficit. The USSR was located as a suitable patron.

Egypt's fiscal policy was characterized by a limited ability to extract domestically, and Barnett describes this at length (Barnett, 1992: 98). Because of weakness in administrative capabilities for direct extraction, the government relied on methods of indirect taxation. Excise taxes were one such indirect method. Some industrial nationalizations of the 1950s were an important activity and represented a "100 percent tax" (1992: 97), but did not eradicate future fiscal problems, such as those associated with the costs of the Yemen war. Barnett argues that heightened fiscal requirements could not be met by either "forced savings or direct taxation" because of "the country's low standard of living, political considerations, lack of state capacity to extract, or some combination thereof" (1992: 98).

The Egyptian government eventually turned to public sector borrowing/ foreign assistance. A 500 percent increase in annual debt took place between 1959 and 1963. "By

1963 over half the budget was financed through public sector borrowing" (1992: 98). In 1964, partially as a consequence of the rapidly increased debt burden, a liquidity and solvency crisis occurred. This was a "fiscal, foreign currency, and balance of payments crisis [...] produced by the three major drains on Egypt's hard currency reserves: the costs of the Yemen war and the Arab-Israeli conflict, the need to purchase greater quantities of wheat on the international market, and the failure of ISI" (1992: 110). This situation of severe stress on public finance was aggravated by the 1967 war. Major sources of revenue were lost in the 1967 conflict (the Suez Canal, Sinai oil fields, and tourism); revenues from the Suez Canal covered almost two thirds of the balance of payments deficit in 1966. Direct taxation could not be increased to produce the needed revenue. This was due to past practice and ideology. Earlier nationalizations meant that there was not a corporate sector to be taxed. Taxing the impoverished masses risked societal opposition, especially given the regime's ideological commitment to material betterment of the Egyptian masses. There was additionally the problem of an ineffectual bureaucracy.

The 1967 war was a major external shock that led the government to rethink its excessive reliance on an internationally-based war preparation strategy. Some attempts were then made to increase the level of domestic extraction (in addition to seeking resources from abroad). By 1971, the costs of war preparation were becoming "painfully clear" (Barnett, 1992: 108).

The 1973 war produced a boost for the legitimacy and popularity of Sadat's regime. The government made some attempt at raising taxes[2]. State collection of direct taxation as a percentage of GNP actually declined over this period; direct taxation was not pursued because of bureaucratic ineffectiveness and because of a bias in favor of the wealthy. Arab states were willing to pay some of the costs of the 1973 war. As Sadat negotiated peace with Israel, these Arab payments declined. Sadat's regime oversaw an explosion in public debt.

In summary, despite scattered attempts at increasing domestic extraction, it was rare for Egyptian officials to "attempt to fund their military activities with anything short of an international strategy" (Barnett, 1992: 146); "throughout the post-1952 period each Egyptian government constructed a fiscal policy that was a function of its objectives of war preparation, political mobilization, the dominant mode of capital accumulation, and socioeconomic constraints on its actions. This meant that an international strategy became the preferred method of closing the gap between commitments and resources" (Barnett, 1992: 148). Egypt's ability to sell its strategic value to outside powers was valuable in terms of obtaining international patronage. There was a clear element of historical habituation to choosing strategies other than difficult domestic extraction. Early external borrowing "gave both government and society a taste for exporting- that is, delaying- the costs of war" (Barnett, 1992: 147).

Barnett summarizes the fiscal dimension of Egyptian war preparation strategies as follows: 1952-57 was international/accommodational, 1957-1967 was international, 1967-1973 was international/accommodational/restructural, and 1973-1977 was international (Barnett, 1992: 146).

[2] Barnett provides details (1992: 135-136).

Israel

State power according to Barnett "is linked to the state's ability to penetrate and govern society and its autonomy from societal actors" (Barnett, 1992: 211). Thus Barnett has a two-dimensional version of state power. Israel is typically described as a "strong state". It was "both relatively autonomous from domestic economic actors and demonstrated an impressive ability to penetrate and extract from society when compared to the record of other postcolonial states" (Barnett, 1992: 246). In periods of "intense security pressures", we expect both "the government to be more forceful in its actions and societal actors to be more giving because of societal cohesion" (Barnett, 1992: 246). Despite Israel's strength as a state, it faced "real limits" to its mobilizing capabilities, even in demanding security conditions (Barnett, 1992: 246).

In its earliest years, Israel engaged in domestic extraction and also located multiple foreign patrons. Taxes were increased by 100 percent because of the emergency situation. As tax evasion increased, the government resorted to printing money. "In general, during these first years the government moved from a restructural policy to a series of accommodational gestures" (Barnett, 1992: 162). Indirect taxation has the advantage of "easier collection at decreased cost" (1992: 163). The decreased cost can be both political and administrative. In the early years in Israel, Histradut blocked some initiatives towards indirect taxation. International financing was therefore used. The sources were world Jewry and US aid.

In the 1957-1967 period, Israeli policies were primarily international and accommodational. Increased direct taxation was not a very viable strategy because of problems of evasion, potential societal conflict, and a weak administrative apparatus.

1973 was a particular powerful "shock" year because it combined an oil shock with war. Israel chose to rely more heavily on US aid and it's debt increased. This behavior is summarized in Barnett's statement that "although Israeli state managers might have been in a position to extract more from society because of the state's relative autonomy and capacity, the perceived political gains associated with such extraction attempts and the availability of U.S. offering was more than any prudent politician could resist" (Barnett, 1992: 207). Some domestic restructuring was therefore pursued, more so than was the case in Egypt, but international strategies continued to dominate.

Barnett summarizes the fiscal dimension of Israeli war preparation as follows: 1948-1949 was international/restructural, 1949-1956 was international, 1957-1967 was international, and 1967-1977 was international/restructural (from Table 5.3 in Barnett, 1992: 206).

INDIA AND PAKISTAN

India and Pakistan are not usually considered "strong" states comparable to Israel. Even Egypt would be considered a stronger state, especially when compared with Pakistan's early years, but also in comparison to India. State strength was the major variable of interest in the earlier chapters, and both India and Pakistan score relatively low on this measure. The purpose of this chapter is to explore the policy activities of two relatively weak states that have a lot in common as a way of seeing whether some of the assumptions made early on hold up to closer examination. Barnett's finding was that a strong state like Israel was able to engage in some domestic extraction increases in wartime and for war preparation. Nevertheless, there were important limits to what could be achieved. Part of what this chapter and the next will show is that similar and greater limits have existed in the Pakistani and Indian cases. The political survival perspective predicts that all states, irrespective of political capacity, will avoid seeking increased domestic extraction whenever possible. If the attempts to increase domestic extraction have been severely constrained in all states, then the political survival perspective receives support.

India and Pakistan are contiguous developing countries located in South Asia. They share a common heritage of British colonialism. Historical India had been under Muslim rule in the form of the Mughal Empire before the rise in influence of the British East India Company. By the mid-1700's Mughal rule had ceased to be effective. The lack of a strong central government in the subcontinent provided the British East India Company with an opportunity to expand (Razi, 1997: xiv). The 1857 "Indian Mutiny" was a Muslim attempt to curtail British power in India, and it failed (Siddiqui, 1972: 1).

The Partition in 1947 of the Indian subcontinent was bloody and associated with severe communal rioting and ethnic clashes unprecedented in magnitude. Estimates of the number of casualties range from hundreds of thousands to one million. Many more became refugees (one claim is that 8 million refugees entered Pakistan). A common perception is that the rushed British departure combined with a half-baked transfer and apportionment of political authority contributed to the violence that ensued (for example, see Ganguly, 1994: 39).

The modern borders of the two states and the seeds of the Kashmir conflict were closely tied to policy decisions by British statesmen. Kashmir was a princely state that had the option of joining either India or Pakistan. Although it was a majority Muslim state, its Maharajah (ruler) was a Hindu, and he delayed the decision before leaning towards India. Pakistan contested the legitimacy of this move. Although the exact sequence of events is unclear, war between India and Pakistan erupted in 1947. The UN brokered a peace in 1949. India agreed to a UN-resolved plebiscite in Kashmir that would allow Kashmiris to vote about whether to join India or Pakistan. This plebiscite was not implemented. Kashmir has continued to be a heavily contested region. The history of the two countries is peppered with border clashes over Kashmir, and occasionally those clashes have erupted into war or come to the brink of war.

Such shared history makes it a potentially fruitful exercise to examine the policy choices of the two countries. For example, a history of currency manipulation existed in British India (Rothermund, 1988: 76). This set a precedent for acts of seignorage by the governments of the post-partition states. Furthermore, the two countries often share an international shock. The most obvious such case is when war takes place between India and Pakistan, as has happened in three instances. A common perception and finding among laymen and scholars is that India and Pakistan have been and continue to be threatening to each other's security (Tellis, 1997; Thomas, 1986). India's security thinking has been dominated by concerns about Pakistan and to some extent China (Subrahamanyam, 1982: I). Furthermore, there is also the possibility of a shared economic shock.

Prior to independence and Partition, British India was a unitary state composed of princely areas. Old tax farmers and revenue collectors had been converted into landlords for the convenience of British revenue collection (Brown, 1963: 53). Central government resources in British India were obtained through a combination of taxation, borrowing, and manipulation of the money supply (Tomlinson, 1992: 277) [3]. The revenue-raising apparatus of the British colonists was largely left in place in the form of central government and financial institutions such as the Inland Revenue and Customs and Excise offices (Joshi and Little, 1994: 8). The Reserve Bank had been created in 1935 and was retained by India past independence. The British created the Indian Civil Service for higher-level civil bureaucrats, and produced the institution and model on which the subsequent Indian Administrative Service and Civil Service of Pakistan were based. Implementation of Partition agreements on government revenues divisions and other claims were not resolved immediately but continued to be negotiated and disputed as late as 1960 (Talbot, 1998: 101).

Both countries also inherited military resources from British India. The existing pre-Partition army was divided on a "roughly 2:1 basis, with the larger share going to the India Union" (Kavic, 1967: 82). Air power was similarly divided, with approximately two thirds going to India (Kavic, 1967: 102). This was also the case with a small navy (Kavic, 1967: 116). Thus, there were important commonalities between the two states at the time of partition. It is significant, however, that all functioning plants for the production of defence ordnance after Partition were located in India (Kavic, 1967: 126). Furthermore, Pakistan may have been short-changed in some of the military resources it received. In the division of the Indian army, Pakistan received only six armoured regiments (compared to forty received by India) and eight artillery and infantry regiments compared to India's forty and twenty-one respectively (Talbot, 1998: 99-100). This meant that "startup" costs of war preparation were likely to be higher in Pakistan.

[3] Other forms of appropriation were also used. In the course of World War II, a major portion of the industrial and commercial product of British India was directed towards military requirements (Tomlinson,

Important differences between the countries exist. Pakistan is a Muslim majority country while India has a Hindu majority. India is several times as large as Pakistan in terms of population. Although both countries have undergone significant changes and development since independence, "the base from which each started and significant differences in political, economic, and social circumstances make direct comparisons difficult" (Harrison, et. al., 1999: 1). In other words, the common historical origin of the states did not mean that they started on a level footing. India inherited more British colonial resources on the whole. Nevertheless, both India and Pakistan are usually characterized as low-income countries, and have health, literacy, and educational indicators that are typical for low-income countries. Agriculture has dominated the economies of both countries, although the industrial base in India is larger as a proportion of the economy. High population growth rates in both countries have been associated with a low rate of national savings, and consequently low domestic resources allocated for investment.

Problems of poverty and low living standards have occupied the thinking of planners in both countries. It is widely acknowledged that the scale of "development" expenditures needed to alleviate poverty exceeds the extractive capacity of either state. Small domestic revenues have meant that "[neither] nation can obtain from its own resources the amount needed to raise the living standards of its population, but must get assistance from outside" (Brown, 1963: 321). Reliance on foreign resources is thus an ongoing feature of expenditure planning in both states. The timing, extent, and type of foreign resources obtained, however, may vary.

1992:277).

India is frequently identified as a stable democracy while Pakistan has seen several instances of military rule. India is generally perceived as having more viable, solid, and continuing political institutions and constitutional framework than Pakistan, due in part to the lack of a military threat to civilian rule (Harrison, et. al., 1999: 3-5). Pakistan, in contrast, is not as far along in finding an effective and stable government, and has seen repeated military intervention and martial law (Harrison, et.al., 1999: 3-4). A variety of constitutions have been adopted. There have been shifts back and forth in executive authority from the President to the Prime Minister (Raza,1997: 26-27). Martial law regimes have appeared with regularity, including Ayub Khan's rule starting in 1958, Zia Ul Haq's regime beginning in 1977, and General Pervez Musharraf's coup in 1999.

Modern Pakistan consists of 4 provinces: Sind, Punjab, North West Frontier Province, and Balochistan. The current population of Pakistan is estimated at 135 million (CIA World Factbook 1998 figure). Modern India consists of 25 states which vary in size and population. The 1961 census placed India's population at 439 million (Chandrasekhar, 1965: 11). The 1981 census put the population of India at 702 million (Joshi and Little, 1984: 13); current estimates are that India has reached the 1 billion mark (Dawn, May 11, 2000: http://www.dawn.com/2000/05/11).

One factor to consider in public finance in both states is that subnational state governments also collect taxes. In both India and Pakistan, the central governments' collection exceeds that of the states and provinces. In India in 1980/81, for example, the central government's revenue collection amounted to 10.3 percent of GDP, while that of the states was 5.4 percent (Joshi and Little, 1994: 22). Furthermore, part of the revenues of the states in India reflects the extractive efforts of the central government because the states are constitutionally entitled to a portion of the income and excise taxes levied by the central government (Joshi and Little, 1994: 22). Thus, although the total revenues of the states may vary in relation to the central government (particularly because they receive entitlements, grants, and loans from the central government), the collection of taxes by the central government generally exceeds that of the states. In expenditures, defense spending is wholly central and borrowing is mainly central. Therefore, the central government bears the burden for meeting the demands of war preparation. It is also the central government that has the option of an international or seignorage strategy open to it. Hence, the focus here is on the central government in both India and Pakistan.

Chronology of Shocks in the Pakistani and Indian cases

1947-1948 Kashmir war

The exact starting date is unclear because there was never a formal declaration of war. On October 22, 1947, Pathan tribesmen from Pakistan crossed into Kashmir. Within three days the Kashmiri Maharaja agreed to join the new Indian state (over joining Pakistan). Indian troops were flown in to Srinagar, the Jammu-Kashmir capital, and the conflict became a war as Pakistan committed itself to the Kashmiri cause. The Indian army suffered setbacks in fighting the raiders, then made some advances after the spring of 1948. The official Pakistan army joined the conflict and started harassing the Indian forces. A UN brokered mediation brought an end to the war on January 1, 1949. It is estimated that there were a total of 1500 battle deaths. Limited firepower prevented more costly material and human destruction. India did lose an approximately 5000 square mile chunk of territory (Ganguly, 1994:13-14).

1962 India-China border war (October)

Disputes over the Sino-Indian border had raised tensions between the two states since 1959 (Sisson and Rose, 1990: 248). On 20 October, 1962, large numbers of Chinese infantry launched attacks on both ends of the Sino-Indian frontier (Kavic, 1967: 174). These included the Indian northwest (at Ladakh) and four other points south from Tibet (Brines, 1968: 192). Another Chinese offensive took place on November 17. On Nov. 21, 1962, the Chinese declared a unilateral ceasefire (Brines, 1968: 195). Brines, a war correspondent, describes the conflict as a classic limited war, with the attacker maintaining control and a "pre-timed cease-fire being an integral tactic (Brines, 1968; 199). Although Pakistan did not take advantage of the situation by invading Kashmir at this time, there were ongoing Sino-Pakistani border negotiations during and after the fighting. These concluded with an announced Sino-Pakistan border agreement on March 2, 1963, in which access to parts of Kashmir were given to Pakistan (Brines, 1968: 202-3).

1965 Kashmir war

Apprehension and clamor had built in India since the Sino-Pakistan border agreement of 1963. At the end of 1964, a change in the legal definitions of Indian officials in Kashmir incorporated Kashmir fully into the Indian state, removing its special or undetermined status (Brines, 1968: 238). Pakistan claimed this as the precipitating factor for military hostilities, as it removed the possibility of a legal resolution of the Kashmir issue and threatened to remove it from international attention (Brines, 1968:

239). The conflict began early in 1965 in the Rann of Kutch, a marshy wasteland bordering the southern part of West Pakistan (Brines, 1968: 9). Non-military fighters from Pakistan entered Kashmir in early August 1965. The first major engagement of the official Pakistani and Indian militaries took place on August 14, 1965. Attacks and counter-attacks escalated to the point that in early September, both sides started using air power to support ground forces. India reacted to Pakistani gains by moving to attack the Pakistani cities of Lahore and Sialkot (outside the Kashmir region). The Pakistanis counter-attacked into the Indian Punjab region. Destructive tank battles took place. A stalemate was reached and a UN Security Council cease-fire resolution was accepted by both sides by September 22. The material and human costs were higher than the 1947-48 war for both sides: Pakistan lost 20 planes, 200 tanks, and 3800 personnel, and India lost up to 70 planes, 190 tanks, and 3000 personnel (Ganguly, 1994: 47-48).

1971 Civil war / internationalized civil war

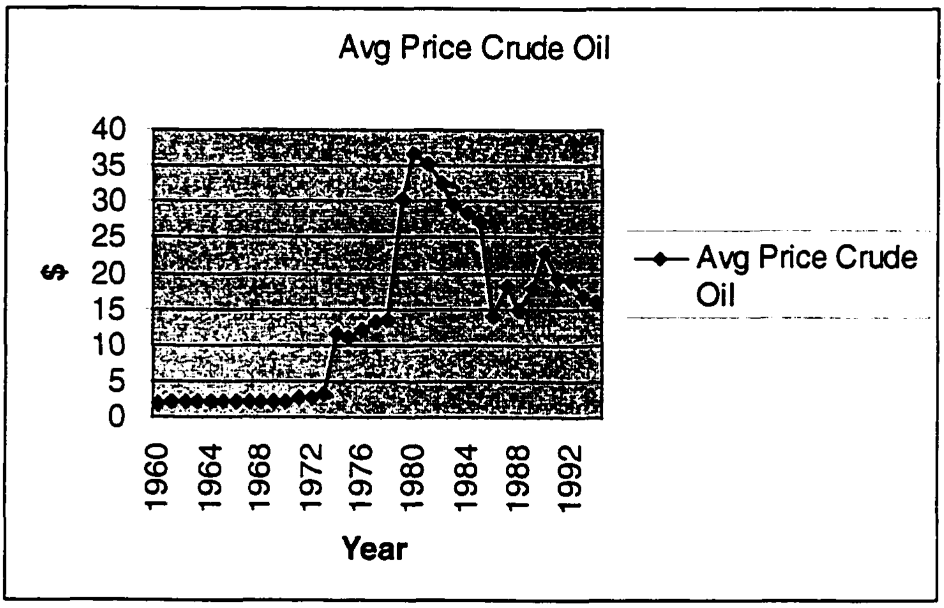
The fear of a national breakup had long been reflected in Pakistani policy (Brines, 1968: 234). This fear was realized in the 1971 war, which culminated in the secession of East Pakistan and the creation of Bangladesh. For Pakistan, this was actually two wars, a civil war in the face of East Pakistani dissent and a war with India (Sisson and Rose, 1990: 1). A central government bias against East Pakistan was discernible in the relatively little attention that region received. December 1970 elections had produced two regionally dominant political parties: the Awami League, led by Sheikh Mujibur Rahman in East Pakistan, and the Pakistan People's Party, led by Zulfiqar Ali Bhutto in West Pakistan. Each sought to wield power at the national level. Mutual suspicions about trustworthiness and West Pakistani concerns about the fidelity of the Awami League led to the civil war and brutal military crackdown in East Pakistan, which commenced in late March, 1971. Most Awami League leaders also fled to India and set up a "Government of Bangladesh" in Calcutta (Sisson and Rose, 1990: 2-4). A total of 7 million refugees fled to India (Talbot, 1998: 208).

Bangladeshi nationalist guerrillas continued raids into East Pakistan, and increasing direct Indian interventions took place (Talbot, 1998: 210). On December 3, 1971, a Pakistani air raid on Indian military bases took place. An Indian counterattack that included naval bombardment of the Karachi port followed. Pakistan also attacked into Kashmir and the Indian Punjab. The Indians counterattacked into multiple places and several major tank battles resulted. The war was not as intense on the eastern front, as marshes provided East Pakistan (what became Bangladesh) with natural defenses. India launched an air and ground attack into East Pakistan and imposed a naval blockade. The Indian forces reached the outskirts of Dacca (which became the Bangladeshi capital) on December 16. On December 17, the Indian Prime Minister Indira Gandhi and the Pakistani president General Yahya Khan made reciprocal cease-fire announcements. Losses included up to 9000 Pakistani men, 200 tanks, and 75 aircraft, and 2500 Indian men, 80 tanks, and 45 aircraft (not including Bangladeshi fighters). A Pakistani submarine and an Indian ship were also sunk (Ganguly, 1994: 81-84).

1973 Oil Shock

From September, 1973 to September, 1974, oil prices rose from $2.70 per barrel to $11.20 per barrel. For oil-importing countries unable to quickly adjust domestic demand for oil, this meant a sizeable increase in the import bill. See Figure 1 below for a graph of the average price of crude oil. The jump in 1973 is notable.

Figure 4.2 Average Price of Crude Oil



(Data Source: *International Financial Statistics Yearbook* (IMF, 1999))

1978/9 Oil Shock

A dramatic rise in oil prices occurred again, slightly less in magnitude than the 1973 shock. The graph in Figure 1 shows the noticeable jump in the average price of crude oil in this year.

THE PAKISTANI EXPERIENCE

This section is organized as follows. A summary overview of the Pakistani case is followed by a presentation and brief discussion of four indicators of Pakistani public finance. Pakistan's history is then arranged into segments of time organized around wars and their aftermaths. The impact of non-war shocks is also briefly examined. The final segment of time looks at developments from 1980 onwards. Each time period section begins with an overview in which selected elements of context and other observations are noted. Sub-sections on international financing and domestic extraction policies in each time period follow. Money creation and accommodational or covert strategies are not subdivided into the time periods but treated separately. The purpose here is not to provide a comprehensive representation of all extraction, international financing, and accommodational/money creation efforts in the Pakistan's history. Rather, a partial examination at certain prominent initiatives in international financing and domestic restructuring is made. Because the source of the information presented here is primarily the published work of informed observers from a variety of fields, linkages of specific actions and policies to other events is sometimes made. A brief description of the coverage of the three revenue-raising strategies follows.

International financing

In the international financing sections below, the focus is on whether aid or non-aid international resources in any form are made available or not. The idea is that even tied aid, ie., aid specific to projects, can still form part of an indirect "international solution" to a government's policy problems in at least two ways. First, tied aid can potentially free up resources elsewhere for the government. Second, a foreign funded project is likely to produce acquiescence to the status quo among social beneficiaries of the project (such as employees). This reduces the burden of welfare-provision on the state and thus also frees up resources. Material aid, such as shipments of machinery or arms, also have a relieving influence on the fiscal burdens of the state by freeing up resources that might otherwise have to be spent in arms purchases.

Domestic Extraction

The domestic extraction sections include historically prominent actions that affected the extractive capacity of the state or suggested that an effort to adjust state-society relations with regard to resource distributions was taking place. These include such efforts as increases in tax rates, changes in tax structure, and nationalizations, which represent a 100 percent tax (Barnett, 1992). Other elite-driven efforts to change formal political institutions of governance, such as constitutional changes, have been ignored here unless they have a direct impact on the extractive capacity of the state.

Covert policies

Money creation and accommodational efforts are frequently covert. As a result, while there is strong evidence to suggest that these have been repeatedly and consistently pursued, the actual coverage of such strategies here is disproportionately small. Often there is not clear information about money creation activity in the time period under consideration. Secondary accounts contain some general assertions and claims without specific reference to any but the most prominent policies. As a result, observations about money creation have been gathered separately at the end (rather than being included in the time intervals analyzed).

Accounts of the Pakistani experience

In general, there is a perception that security concerns have dominated and perhaps distorted Pakistani strategic planning. Thornton (1999) describes Pakistan's mixture of ambitions and threat assessments as being "out of balance" and resulting in wasted budget resources (Thornton, 1999: 184).

Plenty of anecdotal and popular accounts stress the corrupt, inefficient, and ineffective nature of the tax system in Pakistan. For example, Nawaz Sharif, the recently jailed former Prime Minister of Pakistan, belongs to a well-known, wealthy, industrialist family. That family paid a minute total tax bill, and was therefore lambasted in the press. There is a general sense from the man on the street that major reform in tax policy and collection is required. Academic analyses echo this: it is widely acknowledged that Pakistan continues to have problems in getting the well-off to pay their "fair share" of taxes (Weinbaum, 1999: 89). Others point to the lack of a "tax culture", low education, and mistrust of tax collectors, as well as a cumbersome filing process, as culprits (Interviewee B, 2000).

As the following recent blurb from Dawn, a national circulation Pakistani newspaper suggests, there also remains an official perception that Pakistani performance in domestic extraction is poor and must be improved.

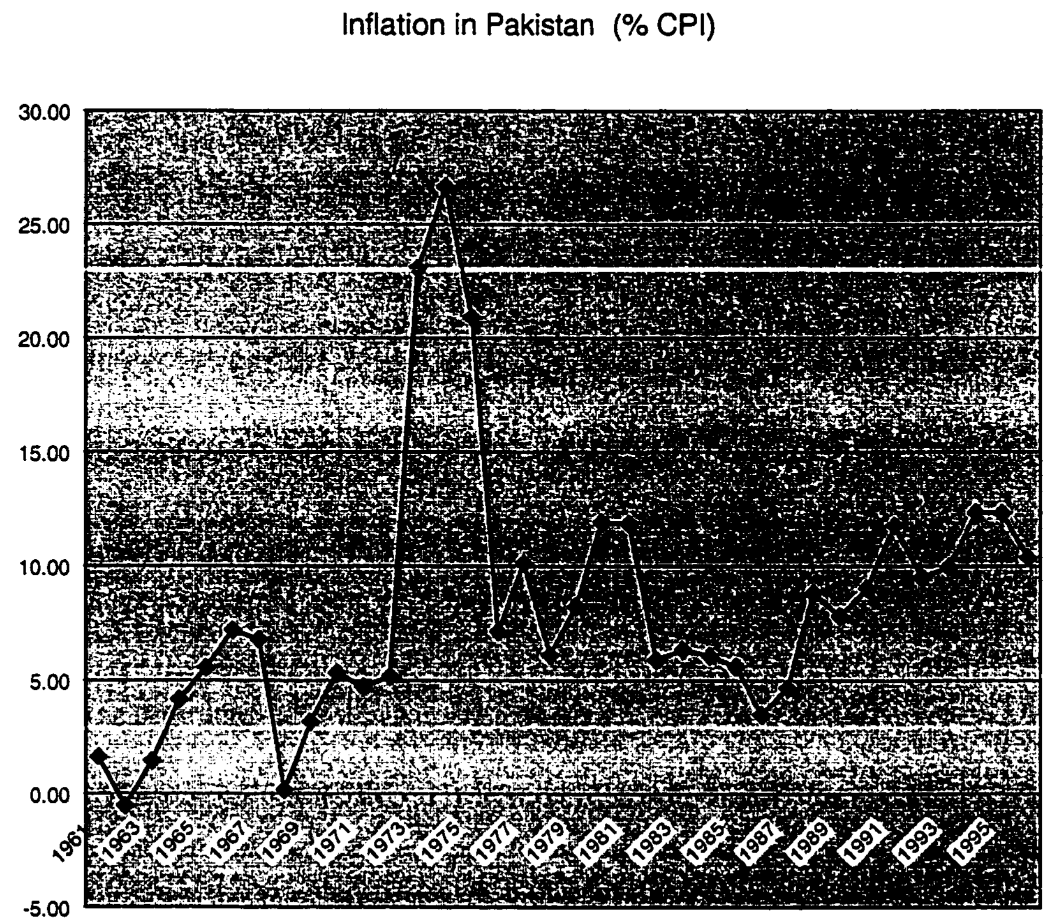
> Pakistan's military ruler General Pervez Musharraf today said the country's survival lies in everyone paying tax. "For the country to be sovereign, everyone has to pay the tax due from him," he said, announcing that a survey would be launched on Saturday in 13 big cities of the country to nab tax evaders and to document the economy. "I will not allow any hurdle in our way," he warned the traders' community which is resisting the survey. Musharraf said 3,000 corrupt and inefficient tax collectors are being dismissed. The figure represents 10 per cent of the total strength of the tax department. "It is shameful that only 1.2 million people in our population of 140 million people pay taxes," the general said. From Dawn newspaper, May 25, 2000 http://www.dawn.com/2000/05/25/.

A major portion of General Musharraf's effort is "nation building" through "national reconstruction". In practice, this means plans to broaden the tax base and increase tax revenue, in addition to cutting expenditures but reducing civil service jobs (see http://cnn.com/2000/ASIANOW/south/05/25/musharraf.pakistan.01/index.html).

Selected indicators of Pakistani public finance

This overview offers a visual glimpse of some of the indicators and indices relevant to Pakistan's public finance experience. The purpose here is not an exhaustive discussion of all trends and developments found in the charts, but rather to comment on a few notable features. The qualitative descriptions of this chapter elucidate and develop some of these ideas. Like those descriptions, the graphs here cover indicators reflecting different strategies for public finance. Two of the indicators (inflation and Tax Revenue/GDP) are identical to the indicators used in the quantitative analyses in the earlier chapters. The other indicators (Aid/Central Government spending and government debt) are elaborations on international financing. While government debt can be domestic as well as external, the market for domestic borrowing tends to be small and unorganized in both India and Pakistan, but particularly in Pakistan. Thus, the bulk of central government indebtedness in both countries is likely to be due to international borrowing. I include these four measures because they are significant in offering a visually and intuitively graspable sets of evidence and offer a step of greater detail than a more aggregated single measure.

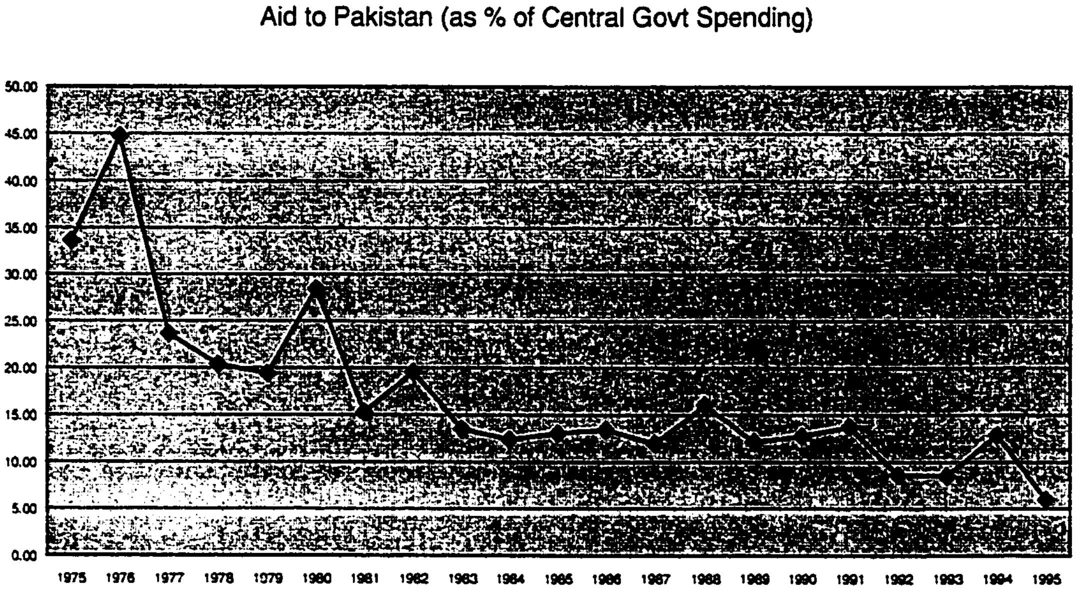
Figure 4.3



(Data source: World Bank's World Tables, 1997)

Inflation was the indicator for money creation in the quantitative tests of the preceding chapters. Yet inflation has many causes, and a deliberate policy of money creation is only one of them. Eyeballing the graph shows rising inflation right around 1965 (a war year). The big spike in 1973 is likely related to the oil shock in that year, and may have also been fed by Pakistan's efforts to locate resources needed to make payments to India for the many Pakistani prisoners of war (left over from the 1971 war). Rising inflation is again seen in 1979 and after, associated with the second oil shock.

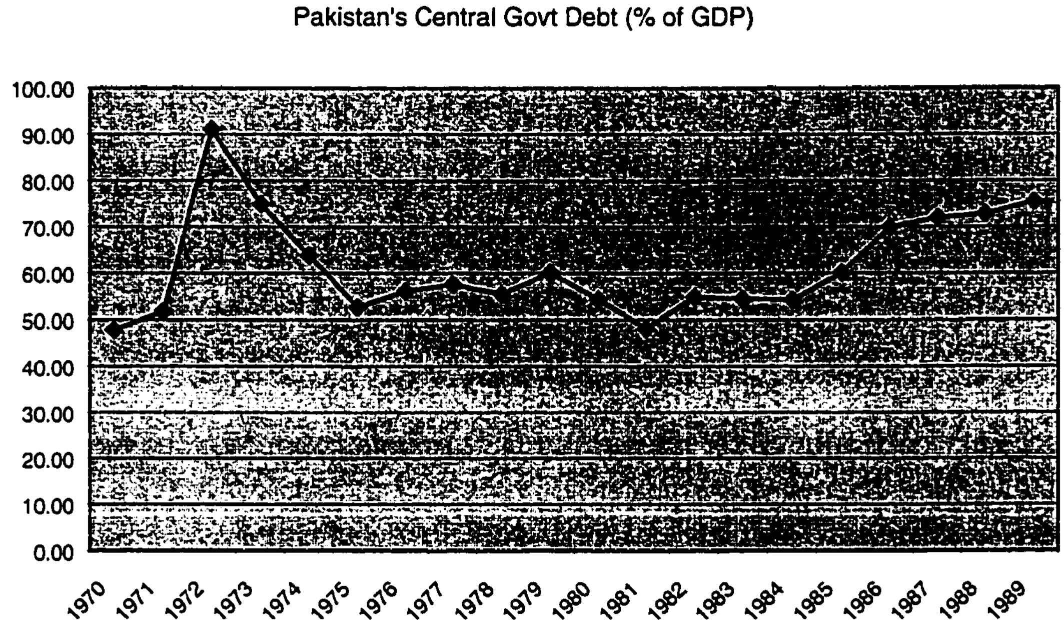
Figure 4.4



(Data source: World Bank's World Tables, 1997)

Aid to Pakistan as a percentage of its central government spending has followed a roughly downward trend since the mid-1970s. The leveling off through the eighties is probably due to the US support of the Afghan resistance to Soviet occupation at the time (Pakistan was used as a launching pad for US efforts at that time). With the end of the Cold War, aid as a percentage of Pakistani government spending has fallen to a new low.

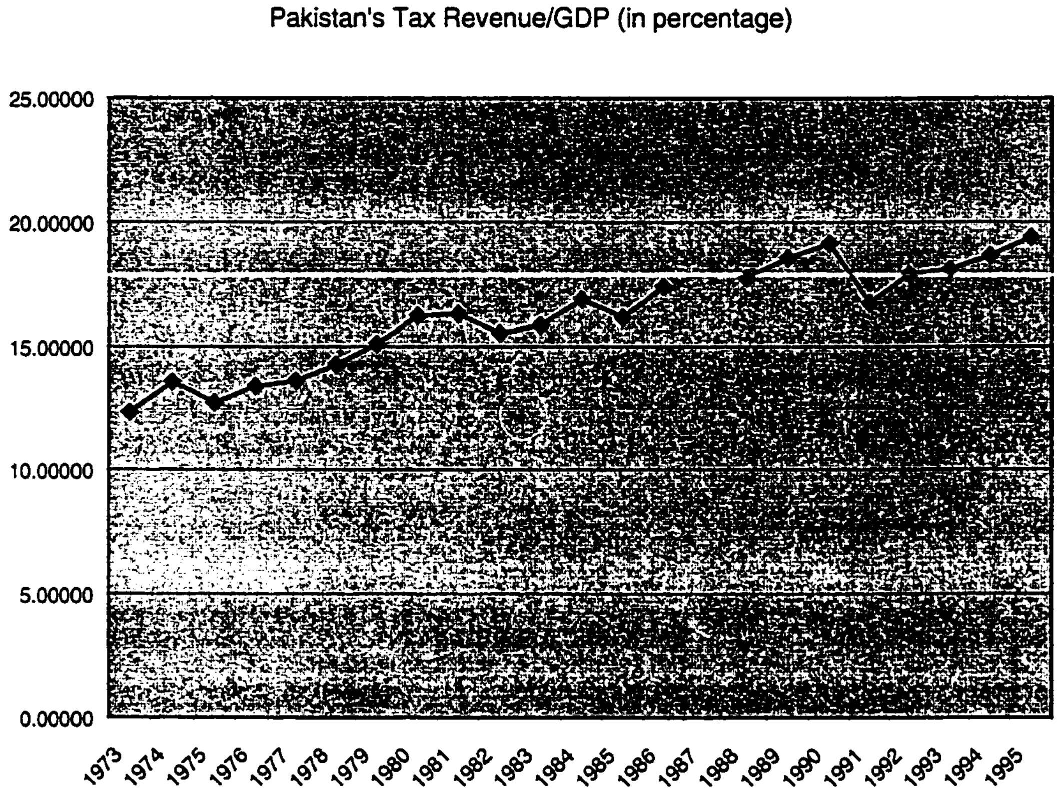
Figure 4.5



(Data source: World Bank's World Tables, 1997)

Pakistan's central government debt as a percentage of GDP has some clear association with war. The biggest increase- from about 50 to 90 percent comes immediately on the heels of the 1971 war (since that war happened right in the very end of 1971, it is likely that even the immediate effects would be captured in the statistic for 1972 (the year in which the big spike is seen). Through the late 1980s, a steady increase in central government debt takes place.

Figure 4.6



(Data source: World Bank's World Tables, 1997)

Pakistan's Tax revenue over GDP has followed a gradual, upward trend from the early 1970s onward. There is not a clear association with the oil shocks, supporting the finding of the previous chapters that domestic extraction is not substantially affected by international shocks.

Accounts of time periods in Pakistani history

1947-1961

Overview

The problem of raising revenues for government expenditures in a context of war dates to the very formation of the state of Pakistan. Pakistan sought a share of the cash balance of the former government of undivided India. The cash balances of undivided India had been left in the hands of the successor Indian state (Brown, 1963: 166). Although an agreement was reached in December, 1947, to transfer a cash sum to Pakistan, the Indian Deputy Prime Minister used the pressure of the Kashmir conflict as a justification for not releasing the funds to Pakistan in January, 1948 (Chaudhry, 1968: 63). Initial Pakistani customs taxes placed on jute and cotton were justified by the need to generate revenue, but viewed by the Indians as hostile economic acts (Brown, 1963: 169).

Pakistan's early years were preoccupied with bolstering the defence establishment, and this did act as a push towards the consolidation of state authority (Jalal, 1990: 49). In the first three years of independence, up to 70 percent of the national budget was allocated for defence (Talbot, 1998: 118). The conflict with India shortly after independence meant pressing demands on meager central government funds. A sense of insecurity about the survival of their state plagued Pakistani policy-makers. This was not the result of fears of military defeat alone. India's strategic location at the head of the Indus river meant that it could potentially "shock" and disrupt the Pakistani economy by interfering with the flow of irrigation waters (Choudhury, 1968: 155-59).(The World Bank was intimately involved in attempted negotiated settlements to this issue in the 1950s, and eventually an agreement was reached).

Other major spending needs faced the Pakistani government, including the resettlement of millions of refugees and installation of basic industries, as well as building the central government apparatus generally (Jalal, 1990: 54). It is estimated that 7 million refugees entered West Pakistan and 1.25 million entered East Pakistan (Ahmed and Amjad, 1984: 71). In general, Karachi was "quite unprepared to accommodate the administrative machinery of a nation then numbering somewhere around 70 million persons" (Brown, 1963: 205).

Substantial and creative efforts were required to build the state apparatus[4]. Domestic political dissent made this difficult. High defence-spending demands meant that the central government sought to control the provinces' finances as a way to appropriate needed resources (Talbot, 1998: 119). Within a year of independence, societal dissatisfaction manifested itself in labor and agrarian unrest, and the provinces resisted central government directives as encroachments on their authority (Jalal, 1990). Further incidents of agrarian unrest occurred in the early summer of 1950 in the Punjab, and severe communal disturbances took place in Bengal in February and March of the same year. In both cases, disillusionment with the Muslim League (the political party supporting the creation of Pakistan) and the financial policies of the central government were partially responsible (Jalal, 1990: 104-5).

In the aftermath of Partition, India appeared to enjoy "marked superiority in military resources, both in being capable of mobilization over an extended period, and in having greater material resources" (Kavic, 1967: 37). In comparison, "Pakistan had no domestic source of modern arms and military stores and her ability to wage war could be severely restricted by an Indian blockade of Karachi and diplomatic efforts aimed at preventing, or at least minimizing, the possibility of Pakistan's acquiring military aid from any other country" (Kavic, 1967: 37). Thus, international strategies for obtaining resources for war-making were an imperative for Pakistani policy-makers. Furthermore, India was aware of this and could act to restrict the possibilities that Pakistan had of obtaining such international resources. This dimension of strategic anticipation and action was not modeled in the earlier chapters but clearly could affect the extent to which an international solution was obtained.

Pakistan initially sought to buy military supplies using hard currency. Finance and commerce officials sought strategies to increase the dollars at their disposal and in the process began to "learn the ropes" of the international financial system (Jalal, 1990: 96). Thus, there was an early understanding that international sources of revenue needed to be tapped. Pakistan experienced what may be described as a minor international economic shock in the 1950-51 fiscal year. Import prices had risen sharply and export prices had dropped. The worsened terms of trade situation was combined with a low in foreign exchange reserves (Jalal, 1990: 141). The depletion of foreign exchange reserves was exacerbated by a liberal import policy, and it was hoped that foreign grants and loans would help make up the gap (Jalal, 1990: 141-2).

The governor of the state bank, Zahid Husain, was alarmed by Pakistan's revenue and spending situation featuring sharp budget deficits[5], indebtedness, and unsatisfactory tax collection (Jalal, 1990: 100). A controversial decision to not devalue the Pakistani rupee left higher prices for consumers and was potentially bad for the economy. However, the outbreak of the Korean war and rise in raw cotton prices opened new

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[4] Anecdotes describe ministers using wooden boxes in place of tables (Talbot, 1998: 100).

[5] The term "fiscal deficit" (interchangeable with the term "budget deficit") has been used by the IMF and in the US and other industrialized countries and refers to the difference between total government expenditure and current revenues (Chelliah, 1996: 50). Chelliah equates the fiscal deficit to net borrowing by the government, or the net addition to the public debt (Chelliah, 1996: 50-51).

markets for Pakistan's jute and cotton exporters, and the Pakistani government could increase revenue by imposing export taxes (Jalal, 1990: 100, 104). Such indirect taxation is typical of a low capacity state because customs duties on import and export all take place at ports and are relatively easy to collect.

Jalal (1990) suggests that the attempt of the central government to procure and allocate financial resources affected relations between the center and the provinces. The absence of a well-organized political party producing support from all constituent parts of the new country meant that economic grievances and social dissatisfaction produced a great deal of uncertainty in central and provincial politics (Jalal, 1990: 100-101)[6]. The primary spending concerns of the central government were in building industry and defense capabilities against the Indian threat. These priorities and the related efforts to expand the resource base and administrative capabilities of the newborn central government had an impact on the socioeconomic conditions of the provinces. Very early on in its national history, however, the Pakistani central government had encountered significant political instability and dissent and found itself the object of blame.

International Financing

The effort to obtain international resources for funding government activities began immediately with independence and continued thereafter (Sisson and Rose, 1990). Initially Pakistan sought this from the Islamic nations of Southwest Asia, but was stymied by differences within that bloc. In late 1947, a $2 billion loan request was made to the

[6] The Muslim League, associated with Jinnah and active in the foundation of Pakistan, was probably the natural choice for such a consensus-building party. Factional infighting, a lack of effective organization, insufficient funds, and "calculated neglect" worked to prevent this potential from being realized (Jalal, 1990: 101-2).

US but was turned down (Talbot, 1998: 119). Although the US imposed an arms embargo on both India and Pakistan after the Kashmir clashes of March 1948, Pakistan was able to obtain a credit of $10 million from the United States. This was ostensibly for refugee rehabilitation, but was in fact used to obtain military supplies (Jalal, 1990: 76-77). The USSR was seen as a threat and China appeared uninterested, so by the early 1950s Pakistan settled on the US as the only viable choice for reliable outside support (Sisson and Rose, 1990: 47). By the middle of 1952 Pakistan was seeking both wheat grants and long-term military credit from the United States (Jalal, 1990: 171). $10 million of economic aid was received from the US in 1952, and $15 million loan was also received in the same year (Brown, 1963: 381). The terms of such economic assistance were generous, allowing for 80 percent of the payments expenditures to be controlled by the central government of the recipient country (Brown, 1963: 382).

In addition to its revenue budget, the Pakistani central government had a "capital" budget which relied on borrowing through such means as treasury bills and other loan floatings (Brown, 1963: 294). The "war footing" at the time of Partition continued and military expenditures contributed to rising Pakistani indebtedness (Brown, 1963: 294). The problem of Pakistan being a poor bet for international creditors meant that it also had a difficult time obtaining international financing. This is noted in Jalal's (1990) analysis:

> As early as the first week of October 1947 the alarm had been sounded- Pakistan was quickly running out of cash. Archibals Rowlands, the financial adviser to the government of Pakistan, urged London to consider a long-term loan of #[pounds]100 million to help tide Pakistan over its financial difficulties. But no one in London was prepared to extend credit to a country that seemed such a poor economic bet. (Jalal, 1990: 45)

India had initially inherited the entire public debt and this meant that Pakistan had no basis for a credit history (Jalal, 1990: 35-36). Even lending agreements would be under unusual constraints. For example, international creditors "would sometimes demand advance deposits in foreign banks to guarantee payment when due" (Brown, 1963: 294). Nevertheless, the Pakistani government did engage in some international private borrowing by issuing securities.

In 1953, Pakistan decided to enter into an alliance with the United States (Sattar, 1997: 66). Pakistan remained a US ally throughout the Cold War period. Initially, US assistance to Pakistan was "half-hearted" in relation to Pakistani expectations (Sattar, 1997: 73). Military assistance during this period and earlier from the US was received but the amounts are not public (Brown, 1963: 382). In 1954, Pakistan and the US signed the Mutual Defence Assistance Agreement (Chaudhri, 1970: 26). Providing military assistance to Pakistan was part of US anti-Soviet strategy, but it raised concerns among Indians that the arms would be used against them (Brown, 1963: 371).

Pakistan joined the South East Asia Treaty Organization (SEATO) in 1954. Although there was no immediate increase in military aid, economic aid was increased from $15 million in 1954 to $114 million (Sattar, 1997: 74). Pakistan also joined the Baghdad Pact, a security alliance, which was established by Turkey and Iraq in 1955. This was renamed the Central Treaty Organization in 1959 (Iraq had a coup against the royal regime in 1958 and pulled out subsequently). Pakistan's dependence on American military and economic aid increased from 1954. One analyst describes the 1954-1965 period as being especially significant in terms of receipts of economic and military aid to Pakistan (Cohen, 1999: 191). In the 1954-1965 period, Pakistan received $4 billion in economic aid and $1.372 billion in military aid (Sattar, 1997: 77). Other estimates of military aid to Pakistan in this period have included figures of $1.5 billion and $750 million (Brines, 1968: 127). This aid included American aircraft and heavy armor, such as 200 Patton tanks and a squadron of supersonic F-104 fighters (Brines, 1968: 127). Despite this alliance, the Americans did not provide clear support for the Pakistani side on the Kashmir issue. Nor were the Americans unequivocal in their support for Pakistan over India. The US-Pakistan relationship deteriorated after the transfers of American military aid to India from 1962 onwards.

Pakistan's relationship with China has been friendly since 1959 (Sattar, 1997: 72), but it is not clear what direct aid, if any, Pakistan received from China prior to 1965. The Sino-Indian border conflict was associated with a warming in Sino-Pakistani relations according to the logic of "my enemy's enemy is my friend", or "my enemy's neighbor is my friend" (as once described by Kautilya)[7].

In general, corruption in the weak Pakistani state meant that international financing or resource and commodity transfers were often siphoned off by black-marketeers and smugglers (Jalal, 1990: 250).

A consortium of Western countries (the US, US, Canada, France, West Germany and Japan) pledged a $945 million credit to Pakistan for the first two years of its development plan, and of this amount $320 million was actually allocated in 1961. The bulk of this amount was provided by the US (Brown, 1963: 323).

Domestic extraction

In 1948-49, taxation measures attempting to cover rising budget deficits produced political dissent in the form of civil unrest. The potentially explosive consequences of attempting tax increases therefore became apparent at an early juncture in Pakistani history. For example, substantial rifts arose between the central and provincial governments over their respective shares of the export duties levied on jute (Jalal, 1990: 107).

Jalal (1990) clearly outlines the problems of revenue-raising through taxation in the 1950s. She also summarizes the intersubstitutable nature of strategies in light of official Pakistani plans to promote economic development.

> With defence and civil administration swallowing most of the foreign aid as well as nearly 80 per cent of its annual revenue, and increased debt servicing liabilities, the central government had to seriously consider reforming the tax structure. Yet the dramatic fall in world prices of its two main export crops, jute and cotton, foreclosed the possibility of raising indirect taxes which already provided approximately 73 per cent of its ordinary revenues as well as those of the provincial governments. Increasingly the role of direct taxes in public finance was out of the question; it would almost certainly erode the government's support among the propertied classes. ... So the only real alternative to easing financial hardship was to rely on a mixture of deficit financing and ever larger inflows of foreign aid. (Jalal 1990: 242-3).

This excerpt underlines the weakness of the Pakistani state. An extraction strategy was difficult to pursue. Even indirect taxation, normally relied upon by weaker states, could not be increased. Borrowing and foreign aid were the preferred (and only realistically available) strategies for obtaining needed funds.

There was an outside push to get the Pakistani state to increase its extractive capacity. American Secretary of State Dulles noted in 1954 that Pakistan had to expand its economic base and increase its ability to raise domestic resources for military spending (Jalal, 1990: 241). Pakistan sought the help of a group of experts in developing its five-year development plan. The panel became known as the Harvard Advisory Group.

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[7] See Modelski's discussion of Kautilya and the ancient Hindu international system (Modelski, 1964).

A Planning Board was instituted in July 1953 to oversee the government role in economic development in Pakistan. The Planning Board made recommendations about the scale and priorities in the assignment of financial resources for development in the public sector. The Board's operated through a sequence of 5-year plans that set objectives and targets for economic growth in specific sectors. There were also goals for managing the fiscal deficit. (Khan, 1997: 183-221). Focusing on the Plans in order to obtain a picture of actual government policy can be somewhat deceptive. For example, the first Five-year Plan (1955-1960) was not backed by the government until 1958 (Brown, 1963: 322).

The weakness of Pakistani extractive capacity is reflected in the fact that Pakistan's first Five-Year Plan left 36 per cent of the development expenditure to be financed by foreign capital (Jalal, 1990: 245). The difficulties of domestic extraction are notable in the following description of events surrounding the budget proposal in 1958.

> In an unusual move during an election year, the finance minister proposed a whole series of taxes... [the] taxes were not expected to raise more than Rs. 4.5 million in central revenues. But they were greeted by an almost universal outcry. ... Business interests for their part saw it as a wanton attempt to strangulate industry. A number of trade associations observed token strikes. The unkindest cut for the government was the decision by the board of directors of the Karachi stock exchange to close down business for three days. Interestingly enough, increased allocations for both defence and civil administration- and the main reason for the centre's taxation proposals-were only mildly criticized; an indication of the extent to which the so-called representatives of the people had resigned themselves to letting these two main institutions of the state get the better part of the national revenue (Jalal, 1990: 270-271).

The proposed taxation structure increased the income of public companies that was taxed (Jalal, 1990: 270, footnote 203), and business interests were therefore strongly opposed to it. Thus, both agrarian and urban business opposition stymied taxation proposals and efforts.

Starting in 1958, land reform efforts were made. The aim was to reduce the dominance of large landowners. The implemented reforms were not as radical as appeared, as the ceiling on landholdings was still high (Talbot, 1998: 165). More extensive land reform may have succeeded in creating a new class of capitalist farmers (and therefore an expanded tax base for extractive activities of the state). Scholars have found the results of these attempts to be "unimpressive" and argue that "landlordism remained virtually unchanged" (Talbot, 1998: 165).

1962-1970

Overview

The 1965 war with India and other circumstances raised the demands on central government revenues beyond expectations. The Third (Five-Year) Plan (1965-1970) witnessed a squeeze on government funds that was associated with increased defence expenditures since the 1965 war with India, "drastic cuts" in foreign aid and more difficult loan terms as well as an increased repayment load, as well as ecological disasters of droughts and floods in 1965-66 and 1966-67 (Khan, 1997: 190). Two Pakistani economists have described the 1965-67 as a period characterized by crises connected with poor harvests in 1966-7, large hikes in defence expenditures after the 1965 war, and reductions in foreign loans received (Ahmed and Amjad, 1999: 81).

International Financing

Ayub Khan's rule (1958-1969) was associated with further increases in received foreign aid. US economic aid to Pakistan tripled from its 1958-59 level, going from $61 million to $184 million (Siddiqui, 1972: 99). The 1960s decade and particularly its first half have been characterized as a "heyday" of foreign assistance to Pakistan (Zaidi, 1999: 113). The Sino-Indian border war of 1962 had an impact on Pakistan's foreign relations. American military assistance to India from 1962 onwards produced "deterioration" in the US-Pakistan relationship, although the material cost of this deterioration is not clear (Chaudhri, 1970: 26).

In the 1965 war with India, Pakistan received support from Indonesia, Iran, Turkey, and Saudi Arabia in the form of 6 naval vessels, jet fuel, guns and ammunition, and financial support, respectively. A slew of smaller outside patrons were therefore useful in wartime (Sattar, 1997). Nevertheless, one observer notes that the Pakistani President Ayub was unable to create an Islamic bloc for ongoing assistance that would support continued fighting (Brines, 1968: 353)[8]. During the course of the actual war, both the US and Britain embargoed military assistance to both sides (starting on September 7 for the US and September 8 for Britain) (Brines, 1968: 355). China also became a foreign patron for Pakistan. China gave Pakistan $60 million in development assistance in 1965, $40 million in 1969, and pledged an additional $200 million. In 1966, the Chinese also gave military aid, including Mig aircraft and army equipment (Sattar, 1997: 97).

In the aftermath of the 1965 war, the USSR became more active in managing the security affairs of the region, and departed from previous hostility to Pakistan with the start of an arms supply relationship (Baldev, 2000: 17). A Soviet mediation effort

[8] Brines also asserts that efforts by Ayub to invoke the CENTO and SEATO pacts in Pakistan's defense were futile (Brines, 1968: 353).

between India and Pakistan took place late in 1965 in Tashkent (Brines, 1968: 396). This was preceded by Soviet efforts to move closer to Pakistan, through economic barter agreements with East bloc countries as early as 1963, to hints of support for the Pakistani position on Kashmir (Brines, 1968: 261-262). The USSR also gave aid in the form of a steel plant in 1968 and also committed more than $1 billion in soft loans for development projects in Pakistan (Sattar, 1997: 98). A Soviet-Pakistani military aid agreement was made in July 1968 that provided Pakistan with $30 million of Soviet military equipment (Sesson and Rose, 1990: 238). Small Soviet sales of military equipment to Pakistan were discontinued, however, after Indian protests ((Sattar, 1997: 98).

Two Pakistani economists describe the war period as a time of overall cutbacks in foreign aid (Ahmed and Amjad, 1984: 81). The need for large food imports were paid for through a combination of Pakistani cash reserves and US and Canadian food assistance (Ahmed and Amjad, 1984: 81). The uncertain economic conditions associated with the war, in particular, resulted in a delay in the launching of the Third Five-Year Plan (Ahmed and Amjad, 1984: 87).

Late in 1965, Pakistan's President Ayub made a public statement to the Pakistani National Assembly reflecting the pitfalls of reliance on foreign military assistance. In the same statement, however, he affirmed Pakistan's internationalist strategy for locating resources. Asserting that he would search the world for weapons, Ayub stated that "[in] obtaining military assistance from foreign sources, we have to be on our guard against the danger of relying too heavily on any single source of supply. Already we have suffered on this account" (quoted in Brines, 1968: 395). Having "suffered on this account" referred to the effects of the embargo of American military assistance during the war.

Pakistan's decision to support an end to the war was closely related to the US arms ban of September 7, 1965, in the context of destructive tank battles and the run-down of non-replenishable equipment (Talbot, 1998: 178). There was a belief that the US betrayed Pakistan in the 1965 war (Sattar, 1997: 121). In other words, there was a sense that the US had not behaved well as a foreign patron in wartime.

Such strategic difficulties did not produce a call for substituting the international strategy with a domestic strategy for locating war-making resources. Instead, Ayub called for a refinement and strategic sophistication of the international strategy under which locating diverse patrons would ensure Pakistani security. A military mission sent to Moscow in July of 1966 reflected this spirit (Brines, 1968: 409). As if to symbolize the diverse sources of foreign support, Chinese aircraft and tanks were displayed alongside American-supplied arms in a Pakistani military parade in early 1966 (Brines, 1968: 413). The Anglo-American embargo during the war led to the emphasis on China and USSR as foreign patrons (Brines,1968: 414).

In both 1965 and 1968, Ayub's government made one year standby arrangements with the IMF, worth over SDR 125 million (Zaidi, 1999: 315)[9]. Substantial borrowing from the IMF thus took place. In 1970, US support for aid to Pakistan increased, and some B-57 and F-104 aircraft were sold to Pakistan (Sattar, 1997: 99). Kissinger and Nixon both used Pakistan in initiating contacts with China, signaling the closeness of the US-Pakistani relationship. The Aid-to-Pakistan Consortium (a group of Western

[9] SDR stands for Special Drawing Rights and is a form of loan from the IMF. Formally, IMF credits are "purchases of foreign currency with a repurchase obligation" (Datta, 1992: 164). Thus, IMF credits simply allow a country to increase the hard currency available to it when needed, and are a form of indebtedness to international sources.

countries and institutions) continued to be an important source of foreign assistance to Pakistan (Khan, 1997: 189).

Domestic extraction

Ayub Khan's regime showed some gains in domestic extraction as tax dodgers were forced to declare income and smugglers faced a crackdown (Siddiqui, 1972: 100)[10]. Nevertheless, Pakistan had difficulty bearing the costs of even the relatively short 1965 conflict. An austerity program had been set in place by late October of 1965. This began with a $217 million cut in the government's development expenditures (Brines, 1968: 402). It was followed by a reduction in private investment opportunities (meaning the reduction of selected state loans to private ventures, for example). There was also a 25 percent increase in excise, customs, and sales taxes (Brines, 1968: 402). A combination of spending cuts and tax increases were therefore used to reallocate resources and increase the funds available to the national government for the heightened spending needs associated with the war and war threat.

Interestingly, income and corporate taxes as a percentage of total tax receipts actually fell to less than 6 percent in 1970/71 (as compared to 15.7 percent in 1957/58). This happened in the context of some industrialization and widely acknowledged dynamism in the economy. The Pakistani economist Zaidi believes that this was due to tax fraud, and suggests that "it seems that the pattern of tax evasion and underreporting

[10] It appears that actions that consolidated the state as a tax-extractor happened at the same time as the increased receipts of foreign aid- echoing the finding of the earlier chapters that better extractors domestically also tend to receive more resources from the international realm. However, the substantive long-term consequences of Ayub's efforts at increasing domestic extraction are not clear. Furthermore, it is not apparent that the increase in foreign receipts was the result of perceptions of greater creditworthiness of the Pakistani state (as speculated in Chapter 2).

may have been established very early in Pakistan" (Zaidi, 1999: 203). It appears that the Pakistani state was not very successful in increasing the amount of direct taxes extracted, usually the major feature of increases in extractive capacity.

1971-1979

Overview

This period is frequently identified as a substantial departure from the past for Pakistan. Elections brought a populist leader with a socialist philosophy, Zulfiqar Ali Bhutto, to power. The 1971 war dismembered the country, and led to the loss of substantial revenues from the export produce of the East Pakistan. Additionally, an assured market for 40 percent of West Pakistani manufactures was lost (Talbot, 1998: 217). However, the loss of East Pakistan (which became Bangladesh) was not necessarily a pure negative. It has been described as a plus in terms of relieving certain pressures on the Pakistani economy and budget (Interviewee A, 2000). Furthermore, a rupee devaluation shortly after the war meant that Pakistani exports were competitive, and therefore the blow to earned foreign exchange was cushioned (Zaidi, 1999). Maintaining East Pakistan was an administrative nightmare. A bias had existed in government spending, favoring West Pakistan over East Pakistan (Jalal, 1990: 244). Yet it was difficult to govern territory located across from 1000 miles of hostile territory. The war itself, however, had been costly, as Pakistan lost "half its navy, a third of its army, and a quarter of its air force", and 93,000 troops had been surrounded and taken as Indian prisoners of war (Talbot, 1998: 212).

The oil shocks of 1973 and 1979 also placed stress on state funds for Pakistan. The worldwide recession associated with the first oil shock hurt Pakistan's exports, and as a result Pakistan's balance of payments deteriorated further (Zaidi, 1999: 6). At the same time, expanding social welfare provided by the state combined with high defense expenditures to squeeze the Pakistani budget. Cotton crop failures in 1974/75 and devastating flooding in 1976/77 had negative economic consequences for Pakistan in this period also (Zaidi, 1999: 101). Despite evidence of seignorage activity (see below), high inflation in the 1973-74 period was blamed by the government on the increase in oil prices (Ahmed and Amjad, 1984: 95).

International Financing

In the 1971 conflict, the US State Department also embargoed arms deliveries to Pakistan (Sattar, 1997: 105). In other words, Pakistan actually lost foreign patronage. In July 1971, the US suspended $75 million of economic aid to Pakistan for that fiscal year; except for food aid, practically all American military and economic aid to Pakistan was suspended by the late summer of 1971 (Sisson and Rose, 1990: 257-258). A small amount of prearranged US aid (worth about $5 million) was nevertheless provided (Sisson and Rose, 1990: 191-2).

China did not continue to provide the same levels of support as Pakistan got involved in the civil war that led to the secession of Bangladesh. The quote below explains:

> ...while China honored its previous arms aid commitments, it has been reported that Beijing was reluctant to approve new arms aid through the spring and summer of 1971. Pakistan made a specific appeal for some equipment, in

> particular aircraft, but China did not agree to the request until several months later. (Sisson and Rose, 1971: 251).

Thus, Chinese aid was reduced at the time that Pakistan needed it urgently. China's belated military and economic aid and limited diplomatic support was a disappointment to the Pakistan government (Talbot, 1998: 212).

Based on a Soviet-Indian understanding, Soviet arms sales to Pakistan had been suspended in the spring of 1970. Actual shipments on existing contracts continued until 1971 (Sisson and Rose, 1991: 198). The USSR's position as a patron of Pakistan after the 1965 war thus waned. Foreign patronage tended to desert Pakistan in high stress periods of wartime (as evidenced by the experience of the 1965 war).

By mid 1971, high defence expenditures and a collapse of foreign exchange earnings from jute placed stress on the resources of the central government. Pakistan had to negotiate short-term loans as the IMF and World Bank did not provide support for debt rescheduling (Talbot, 1998: 210). The aid consortium supporting Pakistan stopped discussions on new aid to Pakistan on June 21, 1971 (Siddiqui, 1972: 168). Siddiqui saw this move as a major shift in Pakistan's relations with international sources of financing.

> The Consortium's changed attitude meant that the Pakistani bureaucrats had at long last lost the support of their international backers. The era of the 'favorite child' treatment of Pakistan by the western aid-givers was at an end. To stop succour reaching Pakistan from the west had been a prime objective of Indian foreign policy for almost two decades. This had been achieved at a most propitious moment. (Siddiqui, 1972: 168)

However, Siddiqui was writing in the beginning of the 70's, and Pakistan was to eventually receive massive infusions of foreign aid in the 1980s.

In 1975, the US began the process of resuming supply of arms to Pakistan by removing the embargo that had been placed in the Bangladesh crisis (Baldev, 2000: 30).

In the 70's, Pakistan also received some rebates on purchases of oil from the Middle East. These lightened the impact of the oil shocks to a minor degree (Interviewee A, 2000). Annual disbursements from oil-rich Islamic countries helped also. In the late 1970s, Pakistan was receiving $50 million, $30 million, and $100 million from Kuwait, United Arab Emirates, and Saudi Arabia respectively (Talbot, 1998: 33-34). Additionally, Z.A. Bhutto's government concluded a total of four standby loans with the IMF worth a total of SDR 330 million (Zaidi, 1999: 315).

Domestic Extraction

Zulfikar Bhutto's government espoused a populist and socialist philosophy and engaged in some land reform and nationalizations in the early 1970s. In theory some portion of large landholdings could have been appropriated by the state without compensation. However, the proposed land reforms were not fully implemented (Khan, 1998: 15). Ingenious methods of evasion allowed large land possessions to persist (Khan, 1998: 284). Despite accompanying rhetoric against "feudal" landlords, the reforms " did not really break the hold of the large landowners and were more a showpiece political ploy" (Zaidi, 1999: 430).

One hope was that land reform would mean more tax revenue. However, it proved to not be the case, in part because small farmers did not enjoy the economies of scale found on larger farm units (Interviewee A, 2000). Even such things as getting farmers to pay "Canal tax" or "Aabiyaana" water tax (specifically designated for agricultural services) were not pursued because of fear of political opposition.

Nationalizations began in 1972 and included major industries (10 categories of industries were nationalized). A group of "scheduled" banks were also nationalized in 1974 (Stewart and Sturgis, 1995: 17). This growth of the public sector was associated with rising inefficiencies. The nationalization efforts also produced a backlash in the form of a prolonged "entrepreneurial strike" as well as some flight of entrepreneurial talent, undercutting the productive base of the economy from which revenue for state purposes could be extracted (Khan, 1998: 20). Capital also fled the country along with the industrialists (Zaidi, 1999: 430).

It is not clear, however, that these extractive actions were directly linked to the war or war threat as an effort to build state extractive capacity. The potential linkage is confounded by at least three factors. First, the socialist political philosophy espoused by Bhutto was one justification used for the nationalizations. Second, a wide perception exists that the rapid public-sector expansion became used for patronage purposes. More jobs could now be handed to politically favored citizens, especially supporters of Bhutto's political party. Finally, the war was over, Bangladesh had become an independent state, and the unique administrative and strategic demands of defending territory 1000 miles away were gone. This meant that in one aspect, the war had resulted in a lessened burden on the central government. This would imply that the nationalizations could not have been sought as a way to generate resources to control or administer distant East Pakistan.

1980- early 1990s

Overview

The Soviet-Afghan conflict colored much of this period for Pakistan. Other factors, however, were also prominent in affecting the revenue-raising requirements of the central government. In discussing Pakistan's 6^{th} Five-Year Plan (1983-1988), for example, Khan described Pakistan as being vulnerable to external shocks because of its narrow export base (Khan, 1997: 208). Fluctuations in international markets could therefore have severe consequences for the Pakistani economy, producing what Roubini would term a "revenue shock" (meaning a decrease in the tax base).

SAARC (South Asian Association for Regional Cooperation) was announced at a summit in Dhaka in 1985. It included Bangladesh, Bhutan, Maldives, Nepal, Sri Lanka, India, and Pakistan. The major aim was regional economic welfare, but there was cynicism from the outset about the possible outcomes of such an arrangement (Sattar, 1997: 134). Substantive changes to such things as import-export duties, for example, are not clearly linked to the creation of SAARC.

Hussain (1989b: 167) asserts that Pakistan's foreign exchange earnings in the 1980s have been based on agricultural exports and remittances of expatriate workers in the Middle East. Approximately 40 percent of Pakistan's foreign exchange earnings in the 1980s came from foreign workers' remittances (Talbot, 1998: 42). Hussain (1989b: 167-168) describes some aspects of the economic burden of foreign loans. The total level of annual loans has increased from $.15 billion in the 1950s to $2.2 billion today, a seventeen-fold increase. The steady increase in external indebtedness comes with additional international pressures, particularly in the form of conditionality. Although not a "shock" in the terms used in this dissertation, the pressures of indebtedness clearly have the potential to escalate to crisis proportions.

The expanded influence of the IMF and World Bank on domestic economic policies in this period has been noted by observers, sometimes indignantly. One Pakistani economist describes the period from 1988 onwards as the "era of structural adjustment" and writes that "an examination of World Bank and IMF documents since 1988 reveals that almost every decision of any consequence taken by the various governments that have been in power has been predetermined by the two Washington agencies, and that Pakistan has merely followed diktat" (Zaidi, 1999: 7). Structural adjustment programs in Pakistan have generally set targets for a lower fiscal deficit (Zaidi,1999: 7).

International Financing

The Soviet occupation of Afghanistan starting in 1979 and the associated "second Cold War" between the US and USSR revived US-Pakistan military ties and substantially increased US aid. In 1980, US President Carter offered $400 million for an 18-month period in military and economic aid. Pakistani President Zia Ul Haq rejected this as "peanuts" (Sattar, 1997: 120). Reagan offered a significantly larger package amounting to $3 billion in loans and grants over 5 years (Sattar, 1997: 121). Pakistan became the base for American support for the Afghan resistance but still sought a closer security relationship with the US, particularly a guarantee of US aid in the event of a Soviet or Soviet-supported Indian attack on Pakistan; the hope was to elevate the 1959 executive Agreement on Defence Cooperation into a binding treaty (Sattar, 1997: 120-121). Overall, "Pakistan received over $7 billion in military and economic assistance before the George Bush administration concluded (in 1990) that Pakistan's covert nuclear weapons program violated U.S. law" (Cohen, 1999: 191).

Expatriate labor remittances from the Middle East were an important source of increases in income in Pakistan (Khan, 1997, 208). However, these fell from the expectations of the Sixth Five-Year Plan, and thus constituted an external economic shock of the "shocks to revenue" category described by Roubini (1991). A boom period of such remittances in the early 1980s was then followed by a slowdown (Stewart and Sturgis, 1995: 55). Through official channels, expatriate Pakistanis remitted over $20 billion to Pakistan; it has been estimated that unofficial channels might account for an equivalent additional amount of remittances (Zaidi, 1999: 431).

Khan (1997: 212) describes the 1991 Gulf War as one of a set of international conditions that contributed to slowing growth in Pakistan. Persistent high budget deficits have meant that both domestic and external debt have increased substantially in the 1990's (Khan, 1997: 229) Today, the bulk of Pakistani national spending goes to debt servicing and military expenditures (Tellis, 1997: 45). This picture does not substantially differ from Pakistan's early days except that the debt burden was less. Outstanding foreign debt has increased dramatically so that by 1993 it was two and half times its 1977 level (Stewart and Sturgis, 1995: 55).

Domestic Extraction

The Pakistani economist Khan describes the Pakistani tax system as continuing to be characterized by "a narrow base, widespread tax evasion, and low elasticity with respect to overall economic growth largely attributable to numerous tax concessions and exemptions" (Khan, 1997: 230). "Low elasticity" with respect to growth means that higher growth levels won't be associated with substantially higher tax revenues. These are classic problems of developing countries with low political capacity. As a remedy for the problem of large fiscal deficits, Khan prescribes steps to control expenditures and improve the government's ability to administer and collect taxes (1997: 230)

In language consonant with the theoretical framework developed earlier in this work, Khan suggests that the Pakistani government faced problems because of lower-than-hoped-for international financing and the inability to tax domestically:

> A disconcerting feature of the performance of the Sixth Plan was the deterioration on the fiscal front. The plan had estimated net foreign resource inflows at $4.07 billion. Actual availability was around $2.8 billion. The shortfall in external resource inflows necessitated higher domestic borrowing. The government, however, failed to broaden the tax base and to improve its elasticity and equitable imposition, mainly on account of pressures from vested interests; it was very difficult to tax the prosperous elite adequately. (Khan, 1997: 208).

Thus, the government in Pakistan had a difficult time increasing domestic extraction, but also had difficulties in obtaining international financing.

This passage suggests that international and domestic routes to government financing were substitutable in the Pakistani case. (Substitutability between alternative government financing routes was one assumption used earlier). The 1983-1988 period saw increased pressures on government spending as a result of increased debt-servicing, defense spending, and poor revenue-raising efforts. This was accompanied by a sharp increase in domestic debt (Khan, 1997: 208). It appears that domestic spending was financed by domestic borrowing because political opposition prevented tax increases and international financing was not forthcoming.

As part of the Seventh Five-Year Plan, the Pakistani government began to privatize government-owned entities. A Privatization Commission was established in 1991 with several objectives, including the need to reduce the public debt and the demand on the government's resources (Khan, 1997: 214). In general, a slowdown in the growth of the public sector was notable from 1977 onwards, and a clear movement towards privatization, especially in the financial sector, has been observed since 1988 (Stewart and Sturgis, 1995: 49-50).

The agricultural sector has not traditionally been taxed by the central government in Pakistan. During Zia Ul Haq's rule in the 1980s, an attempt was made to introduce an "usher" tax of 10 percent on crops based on a claimed Islamic injunction. This was part of a more general effort aiming at "Islamization". Evasion of this tax was widespread (Interviewee B, 2000).

More recently, Pakistan has seen efforts to survey the economy and expand sales and income taxes (Interviewee B, 2000). The effort to broaden the tax base comes from a variety of factors, including a rising debt burden and conditional loans, as well as requirements by the World Trade Organization that Pakistan reduce tariffs. These efforts have become notable in the late 1980s and through the 1990s (Interviewee B, 2000). Specific efforts include an attempt to increase transparency and public accountability in the taxation process by standardizing tax rates and creating an office to deal with citizens' complaints (Interviewee B, 2000).

Money creation policies in Pakistan, 1947-1990's

In the initial period after independence, India retained control over the instruments of monetary policy. As a result, Pakistan did not have the money creation option for meeting the revenue needs of the central government (Jalal, 1990: 45). Initially, Pakistan did not even have the capacity to print and circulate its own currency.

Instead, a common monetary system under the supervision of the reserve bank of India was used until at least the end of March, 1948 (Jalal, 1990: 34). Indian banknotes and coins continued to be legal tender as late as March 1948 and September, 1949, respectively (Talbot, 1998: 128). Thus, the possible route of tweaking existing monetary policy instruments in minor ways to try to generate funds was out of the question in the absence of those instruments.

As the instruments of currency issue and central banking were developed, however, the possibilities for money creation policies grew accordingly. Money creation became a government strategy for providing needed funds in times of fiscal stress. The demand for food subsidies occasioned such policies.

> Crop failures in 1956-7 saw rice and wheat disappearing from the bazaars. … Anxious to stem the drift towards political unrest, the government not only bought food imports at much higher rupee costs but also introduced price subsidies, thus imposing an excruciating burden on an exchequer crippled by escalated rates of defence and administrative expenditure. The creation of paper money to meet the government's current account deficit, nearly 40 per cent of which was due to food subsidies alone, saw the inflationary spiral assuming monstrous proportions. (Jalal, 1990: 250).

Thus, money creation had clear inflationary effects (as suggested by Goode, 1984). Such activities were not without domestic critics. Jalal describes central bank warnings against increasing the money supply and the legislative approval required for further domestic borrowing during this period (Jalal, 1990: 251).

The propensity to create money as a fix for budgetary problems probably had its best known manifestation in the 1974-77 period. When seeking to bankroll spending in the aftermath of the first oil shock, Prime Minister ZA Bhutto was informed that the desired funds were simply not available. Bhutto's reputed response was: "well, print more money". This was associated with a severe inflationary period in the Pakistani economy (Interviewee A, 2000). Prior to this, in 1971, new currency notes were issued in Pakistan. These provided an additional seignorage opportunity for state managers (Interviewee B, 2000). In addition, borrowing from state-run banks as a way to deal with inadequate revenues was a persistent feature of government behavior throughout the 1970s. The addition to the money stock without underlying economic changes fueled inflation (Stewart and Sturgis, 1995: 56).

Government borrowing from state-run banks as a way to deal with inadequate revenues continued from the 1970s to the 1980s. Higher rates of inflation resulted from this credit expansion (Stewart and Sturgis, 1995: 56). This was especially true starting from 1990/91, when bank borrowing contributed a "very large share" of the financing of the budget deficit (Zaidi, 1999: 242). In the 1980s, foreign funds meant that money creation was not resorted to as often to finance the deficit, and inflation remained low as a consequence (Zaidi, 1999: 242). However, a strongly independent central bank (one that could constrain such money creation activity) has yet to come into existence in Pakistan; Pakistan's State Bank (central bank) remains a tool of the Ministry of Finance and is not an independent policy maker (Stewart and Sturgis, 1995: 91).

Summary appraisal of the Pakistani experience

The recent efforts of General Musharraf to simplify and improve the tax structure and combat tax fraud in Pakistan are part of a history of ostensible efforts by the Pakistani central government to increase domestic extraction. Historically, evasion and political opposition to such attempts have stymied the central government's ambitious plans. Already, commercial strikes and urban demonstrations indicate an active opposition to the recent initiatives. The Pakistani state was born with few resources at the disposal of the central government, and only an embryonic apparatus for governance. Very early on, efforts to increase revenues through direct taxation were blocked by violent political resistance. Indirect taxation was also difficult in the context of low prices for basic Pakistani commodity exports. In this context, international financing and indebtedness became the favored means of procuring government resources. Inflationary financing through short-term borrowings from the central bank and printing money have also been persistent features of government financing in Pakistan.

This picture fits the predictions of political survival model and the political capacity model for weak states. For low capacity states, both models predict that money creation and international financing will be favored over increased domestic extraction as revenue-raising strategies in the context of an international shock. In Pakistan, money creation policies continue to be pursued. International financing has been consistently sought. After the 1965 war, there was a national sense that reliance on international resources had endangered Pakistan's national security by constraining the materials needed to wage war. While minor initiatives in improving domestic extraction were pursued, the major consequence was that the international strategy was retained with an adjustment. The adjustment entailed efforts to diversify sources of international patronage. Experience with constraints on its international strategy produced a more sophisticated international strategy rather than a shift to a greater reliance on domestic extraction.

The Pakistani preference for international resources resembles the Egyptian and Israeli experiences. The 1967 war for Egypt led to a rethinking of Egyptian reliance on international resources, but only produced minor changes in domestic extraction. Since then, Egyptian reliance on international financing has grown. In this sense that Egyptian experience is analogous to the Pakistani experience in 1965. Israel, a strong state, did undertake some increased domestic extraction in wartime, particularly in its formative early years, but has consistently sought and obtained international financing for its central government revenue needs. Barnett (1992) characterized most of Israel's historical policy preferences as being geared towards international strategies. In this sense the Israeli experience also resembles that of Pakistan. One difference is the relative success Israel had in obtaining resources domestically in its very early years. It may be that the early, demonstrated ability to raise international resources influenced subsequent Israeli policy-makers' proclivities toward increasing reliance on international resources. Whatever the reason for the Israeli choices, the strong similarities in policy outcomes across Israel, Pakistan, and Egypt suggests that the basic predictions of the political survival model are borne out over those of the political capacity model.

CONCLUSION

This chapter has briefly reviewed findings on the Israeli and Egyptian experiences, presented the historical background of the Indian and Pakistani cases, described a chronology of shocks in the two cases, and followed them up with an examination of the Pakistani experience. Implications of the findings here will be discussed in the next chapter alongside other considerations. More specifically, the next chapter will review the Indian experience, discuss some aspects of the three revenue-raising strategies with reference to both countries, offer observations on the nature and impact of shocks in the two countries, compare India and Pakistan to the Israeli and

Egyptian experiences, and conclude with a discussion of the implications of the case examinations in these two chapters for the political capacity and political survival hypotheses.

CHAPTER 5: Case Study of the Indian Experience and Discussion of the Case Findings

This chapter is connected to the last chapter in that it reviews the Indian experience in a layout similar to that followed for the review of Pakistan. The effects of wars and their aftermaths on public finance are explored. The impact of non-war shocks is also briefly examined. The substance of this chapter begins with a summary introduction to the Indian case and graphs of four indicators of public finance in India (the counterparts to similar graphs presented for the Pakistani case in the previous chapter). Notable features of the behavior of these indicators are briefly discussed. Next, specific time periods of Indian history are examined. Each time period section begins with an overview in which selected elements of context and other observations are noted. Sections on international financing and domestic extraction policies in each time period follow this. Money creation and accommodational or covert strategies generally are not subdivided into the time periods but treated separately. As in the examination of Pakistan, the purpose here is not to provide a comprehensive representation of all extraction, international financing, and accommodational/money creation efforts in India's history. Rather, a partial look at certain prominent initiatives in international financing and domestic restructuring is pursued.

As in the previous chapter, the source of the information presented here is primarily the published work of informed observers from a variety of fields, and linkages of specific actions and policies to other events are sometimes made. These broader linkages are part of the value-added of the case examinations in that they offer an empirical record relevant to the wider connections suggested in Chapter 1. Furthermore, such linkages are part of the rich nuance and sense of context offered by more in-depth examinations of individual cases.

The account of the Indian experience is followed by a discussion of the findings for both the Pakistani experience presented in Chapter 4 and the Indian experience presented in this chapter. First, some observations related to the three revenue-raising strategies (domestic extraction, international financing, and accommodational/money creation policies, as described in Chapter 4) are noted. The nature and impact of shocks in the two countries and their implications for the study of shocks in general are then discussed. Next, the Indian and Pakistani cases are compared to each other, and reference is also made to the Israeli and Egyptian cases. Finally, the chapter concludes with the implications of the case study examinations in this chapter and the last chapter for the political survival and political capacity models.

THE INDIAN EXPERIENCE

The constraints imposed by economic resources in the quest to fund war preparation efforts are widely noted by observers of Indian history. In particular, the need for foreign exchange has been acknowledged (Thomas, 1986: 182). Thomas asserts that all peaks in Indian defense spending were reached during or immediately after wars with China and Pakistan (with the exception of 1980, when a major modernization effort for the military was in progress) (Thomas, 1986: 211). Wars have thus been historically associated with exceptional demands on defense spending.

In describing revenue-raising by the Indian government, Jalan (1996) echoes the assumptions made in this dissertation about politically weak states. "Most governments are unwilling to tax, but happy to borrow. An increase in taxes is politically unpopular. Borrowings, on the other hand, particularly overdrafts from central banks, do not impose any immediate economic or political costs" (Jalan, 1996: 56). Both accommodational and international strategies frequently rely on borrowing, and are preferred by weak states according to the theory suggested in Chapter 1.

As is the case with Pakistan, a pervasive sense of decay and corruption has been associated with all levels of governance in India (eg., see Manor, 1992). The very early days of independence were characterized with difficulties of economic management. For example, the Indian government sought to adjust price controls to deal with continuing problems in pricing imported goods, but simply lacked the level of sophisticated capacity required to implement such a policy (Tomlinson, 1992: 301).

In discussing proposals for tax reform, Burgess, et. Al., (1995) describe the accounting systems of both government and firms in a developing country like India as being limited. Tax reform is difficult to implement because of a dearth of those structures in both state and society that are needed to monitor income and administer the tax collection process. Weiner (1979) describes the growth in scope and role of government bureaucracies in India. In both India and Pakistan, there has been an increase in the civil bureaucracy. The focus of this work, however, is not in charting the development of such organizational structures. Instead, the focus here is on the special problems of central governments in coping with the revenue demands of high stress fiscal situations.

Joshi and Little (1994) suggest that India and developing countries generally face an acute fiscal problem. This comes from the "exceptional developmental role" assigned to government as well as the restricted tax base from which government can extract revenues (Joshi and Little, 1994: 346). In the Indian case, the particular structure of center-state relations serves as a constraint on tax collections. There is little incentive for the states to increase revenues and avoid subsidies. Furthermore, the center is constitutionally restricted from taxing agricultural income (Joshi and Little, 1994: 346). As in the Pakistani case, the Indian central government has difficulty extracting resources from the agricultural sector.

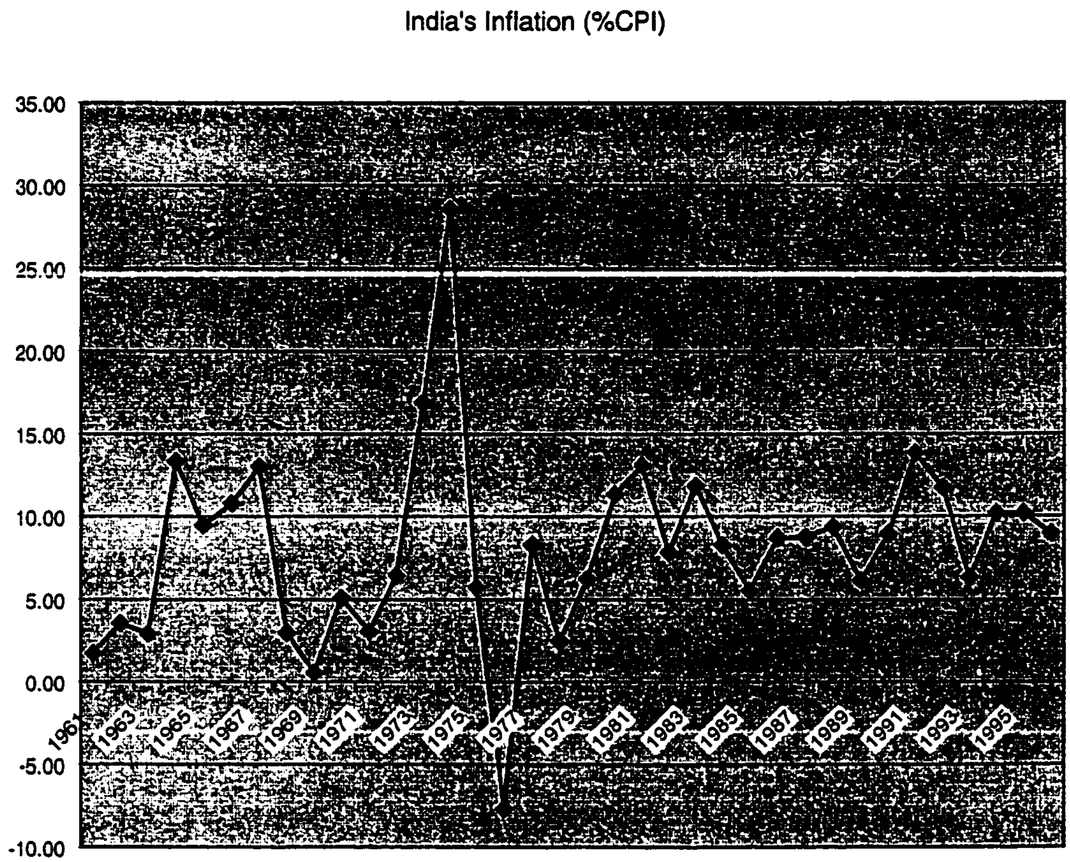
Bagchi describes trends in Indian revenues, and emphasizes the Indian tendency to opt for indirect taxes over direct taxes for political and administrative reasons (Bagchi, 1992: 202-210). A "furore" over a proposed reform and property tax "testifies to the opposition encountered by any attempt to tax the affluent directly" (Bagchi, 1992: 206). Political opposition to taxation attempts in India is can thus be rapid and visible. Furthermore, the preference for indirect taxes characterizes weak capacity states (Snider, 1996).

As is the case with Pakistan, the need to generate adequate foreign currency reserves has been a chronic problem in India. Jalan (1991) characterizes most of India's history as being associated with balance-of-payments problems. At certain points, the balance-of-payments situation reached crisis proportions.

Selected indicators of Indian public finance

This overview offers a glimpse of some of the indicators and indices relevant to India's public finance experience. The purpose here is not an exhaustive discussion of all trends and developments found in the charts, but rather to comment on a few notable features. The qualitative descriptions of this chapter elucidate and develop some of these ideas. Like those descriptions, these graphs cover indicators reflecting different strategies for public finance. Two of the indicators (inflation and Tax Revenue/GDP) are identical to the indicators used in the quantitative analyses in the earlier chapters. The other indicators (Aid/Central Government spending and government debt) are elaborations on international financing. I include these because they are significant in offering a visually and intuitively graspable sets of evidence and offer a step of greater detail than a more aggregated single measure. Furthermore, graphs of these indicators were also offered for the Pakistani case.

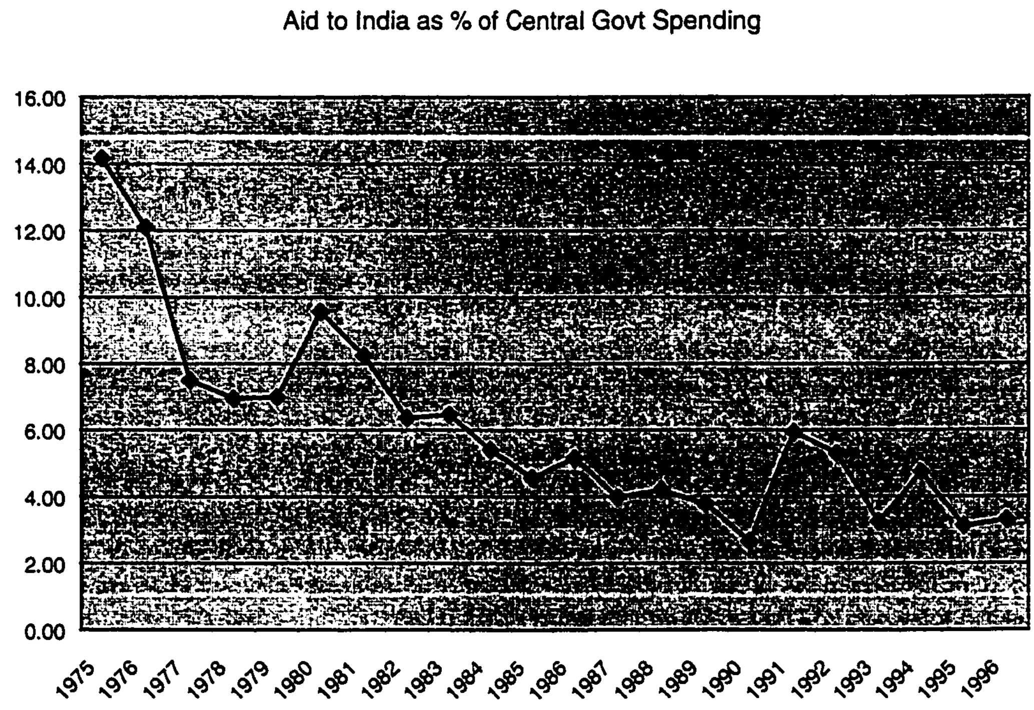
Figure 5.1



(Data source: World Bank's World Tables, 1997)

As noted earlier, inflation has many causes and deliberate money creation policies are one such cause. Nevertheless, there are certain important visual associations with international shocks in this picture. Inflation in India is high around the 1965 war. The first oil shock coincides with the biggest spike in inflation in the entire series. The period of low inflation and deflation in the later 1970s may be associated with Indira Gandhi's state of emergency rule, under which as effort was made to root out corruption and covert activities. Inflation in India rose again, however, at through the second oil shock.

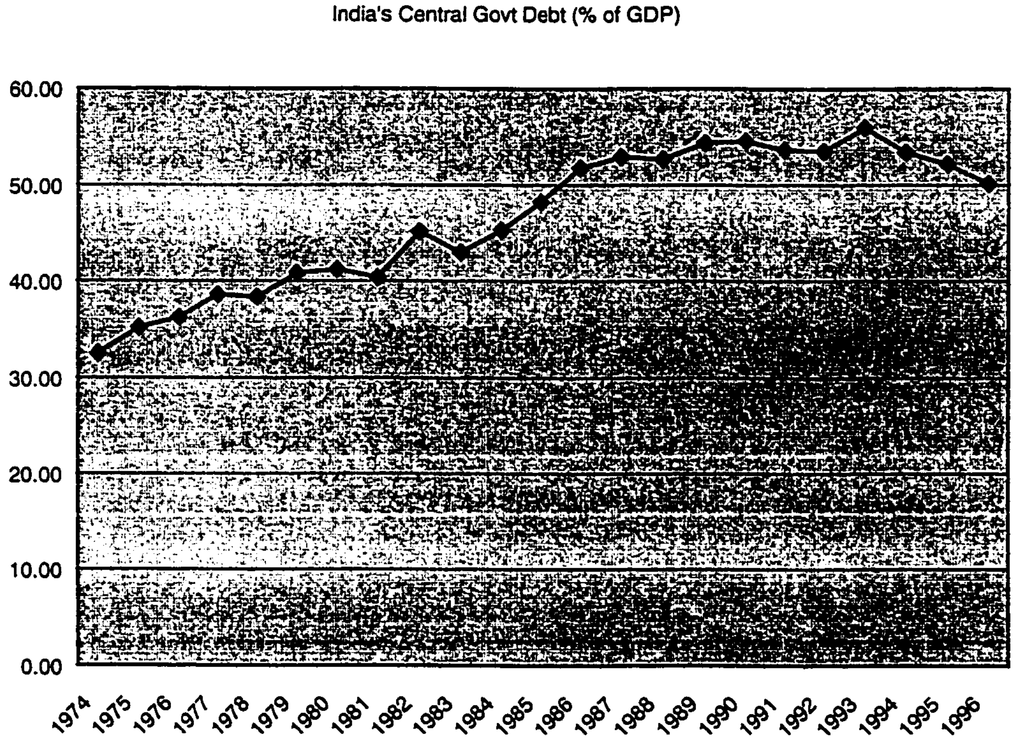
Figure 5.2



(Data source: World Bank's World Tables, 1997)

As was the case with Pakistan, aid as a percentage of Central government spending in India has followed a downward trend. An increase is notable in 1980, after the first oil shock. Aid as a percentage of Indian central government spending, however, has consistently been several percentage points below the indicator for Pakistan.

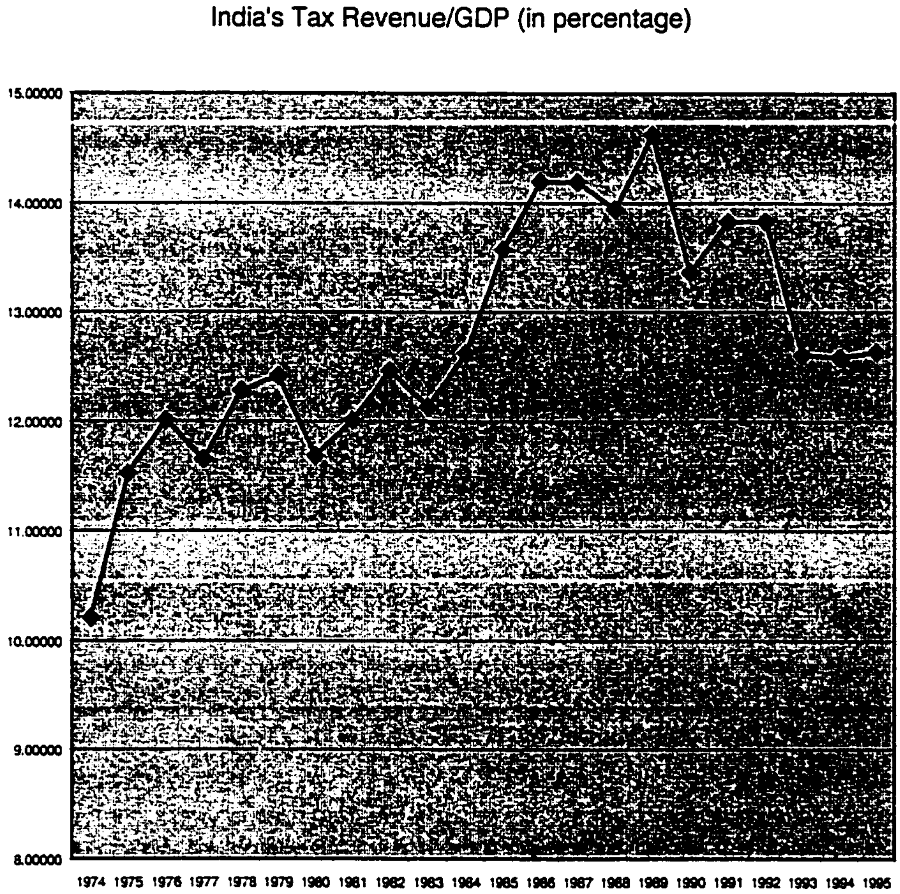
Figure 5.3



(Data source: World Bank's World Tables, 1997)

Unlike Pakistan, India's central government debt has followed a relatively gradual upward trend. While Pakistan saw a massive spike after 1971, India's central government debt increase has been relatively smooth, has leveled off in the 1980s, and enjoyed a modest downturn in the 1990s. As was the case with aid as a percentage of central government spending, central government debt in India has typically been several percentage points below Pakistan's, with the gap frequently being in the double digits.

Figure 5.4



(Data source: World Bank's World Tables, 1997)

India's tax revenue over GDP has followed a less clear upward trend than Pakistan. Furthermore, in contrast to the aid and debt indicators, India's tax over GDP ratio is in the same range as Pakistan's. While Pakistan's ratio has followed a relatively steady upward trend, India's ratio appears to have peaked in the late 1980s and has since fallen somewhat. As with Pakistan, however, there is not a clear association with the oil shocks, supporting the finding of the previous chapters that domestic extraction is not substantially affected by international shocks.

Accounts of time periods in Indian history

1947-1961

Overview

Kavic notes that when compared with Pakistan in the aftermath of Partition, India appeared to enjoy "marked superiority in military resources, both in being capable of mobilization over an extended period, and in having greater material resources" (Kavic, 1967: 37). Despite the first Indo-Pak war that broke out soon after Partition, it appears from at least one account that Indian policy-makers were not seriously considering the possibility of another war, at least in the early 1950's. "Pakistan... was more a serious nuisance than a mortal threat to Indian security and could be handled without external assistance; in any event, the contingency of conflict with Pakistan was regarded in high military circles as remote" (Kavic, 1967: 40-41). Even in the event of a war, the Army was considered to be "fairly well-prepared for conventional operations against a markedly smaller Pakistani adversary possessing similar organization, training, and equipment and deployed defensively" (Kavic, 1967: 98).[1] Thus, it appeared that a war with Pakistan was unexpected and furthermore, that India planned on handling such a circumstance with domestic resources only. A kind of complacency arose despite the fact that the Kashmir conflict took up more than half of central government revenue every

[1] Indian military planning was focused on West Pakistan. East Pakistan was not considered a significant security consideration and was therefore accorded only "watch and ward" duties (Kavic, 1967: 98).

year (Brown, 1963: 294). A war requiring substantial new material resources would therefore be a genuine shock to India.

"Shocks" might not have a substantial jarring effect on existing policy if war preparation has been an ongoing effort that has sought to anticipate national resource needs in the contingency of a military conflict. In other words, a war is likely to be less genuinely "shocking" if it is anticipated and planned for. In general, despite the early war with Pakistan, Indian defence planning was complacent and inadequate:

> Planning for defence production must always be related to existing and potential capabilities, to a careful evaluation of likely military requirements, and their projection over a period of time. The available evidence suggests that New Delhi generally ignored these truisms in the latter half of the 1947-62 period. Maximum self-sufficiency was desirable to enable the country to pursue its foreign policy objectives free of the limitations imposed by the virtual arms embargoes applied by external powers, as during the [1947-1949] Kashmir conflict. (Kavic, 1967, 138).

Ambitious notions of self-sufficiency, however, did not change the reality of dependence on external sources of either weapons systems or blueprints and vital parts (Kavic, 1967: 138).

Ecological factors placed severe demands on government resources. A food shortage crisis in 1949 drained Indian public funds. Droughts and floods followed this in 1950, leading to a further massive demand for food imports. Further famines occurred in 1951, 1952, and 1953 (Brown, 1963: 300).

A Planning Commission established in 1950 produced the five-year plans. They were guidelines and the advice of experts only and carried no formal legal weight (Rothermund, 1988: 133). Through a series of such five-year plans, Indian planners sought to establish heavy industries in the public sector. This was particularly notable under the Second Five Year Plan (1956-1961) (Baldev, 2000: 14). The Plans have increased in sophistication and comprensiveness in comparison to the First Five-Year Plan, which has been described as a "mere collection of projects" centered on a "modest program of industrialization" (Datta, 1992: 239). The initial planning period is notable for the influential, socialistic economic development proposals propounded by Professor P.C. Mahalanobis, a Nehru associate. The proposals called for substantially increased public investment in the production of capital goods (Frankel, 1978: 121-3).

International financing

Faced with drought and famine conditions, India appealed to the US for 4 million tons of wheat in 1950. The American Congress approved a long-term low interest loan of $190 million (Brown, 1963: 300). An ecological emergency thus drove the Indian government's initial efforts to obtain international resources. Other economic assistance designed to increase food production and promote rural development followed. In 1952, $54 million were provided by the US for an Indian-American Technical Cooperation Fund, and this was followed by an additional sum of $45.4 million (Brown, 1963: 381).

India signed a Mutual Defence Assistance Treaty with the United States in 1951, and subsequently renewed it in 1958 and 1962 (Chaudhri, 1970: 29). The Americans provided aid to India at the same time as they did to Pakistan. US aid went from $93 million in 1956 to $365 million in 1957 and $822 million in 1960 (Sattar, 1997: 78). India was one of the neutral countries that received special American attention, including "substantial" American economic aid for industrial development that was further increased after Eisenhower's visit to New Delhi in 1959 (Chaudhri, 1970: 20).

A foreign exchange crisis two years in to the Second Five-Year Plan (1956-1961) meant that India had to obtain foreign aid from the US and its allies (Baldev, 1990: 14). Foreign aid as a source of financing for five-year plan activities was negligible in the first Plan, but came to be firmly established by the Second Five Year Plan period (Mathur, 1989: 26). Outside resources came to be a regular part of the calculations of Indian national state managers. In his description of seven five-year plans, Mathur finds that there was apprehension about the role of foreign money, but only lip service was paid to the need for more self-reliance (Mathur, 1989: 25-31). Singh also notes that reliance on foreign resources in national planning came to be entrenched as a pattern traceable in origin to the mid-1950s (Singh, 1974: 299). The sum of US assistance in the form of loans and gifts amounted to over $4 billion by 1962 (Brown, 1963: 381).

The "Aid-to-India Club", a consortium of the US, UK, Canada, France, West Germany, and Japan, pledged a substantial amount ($2 billion) towards the first two years of the Third Five-Year Plan, the bulk of which was to be provided by the US (Brown, 1963: 322). While the pledges were not fully met in the second year, they nevertheless perpetuated Indian policy planners' reliance on foreign funds. An earlier IBRD (World Bank) loan had provided $225 million, in addition to earlier US loans totaling $45 million. Furthermore, Austria, Belgium, Italy and the Netherlands joined the consortium in 1962 and contributed a total of $79 million, which were then matched by the US. Another World Bank loan added $50 million (Brown, 1963, 322).

The beginnings of Soviet support were also visible. In 1955, Nikita Khrushchev visited India and emphasized the USSR's strong ties with the Indians by supporting them in their rejection of a plebiscite in Kashmir (Sattar, 1997: 75). International sources of financing were thus relatively forthcoming for India in this period. In general, non-aligned India in the 1950's and 60's received more economic aid than Pakistan (Cohen, 1999: 191). For example, the Kennedy administration's first budget provided $500 million in economic aid to India and $150 million to Pakistan (Sattar, 1997: 79).

Domestic Extraction

In 1949, the Reserve Bank of India was formally nationalized. The Imperial Bank of India became the State Bank of India at the beginning of 1955 (Datta, 1992: 112). A central bank under public jurisdiction of some form is a basic part of the state apparatus. It also has the potential to lend money and thereby provide a more sophisticated form of seignorage than printing currency. These nationalizations in the banking field were not "covert" in the sense used in describing money creation policies. Rather, they established important pieces of the state machinery, and these pieces had the potential to subsequently support policies of money creation. The actual act of nationalization, however, is best characterized as an instance of domestic restructuring because it is a major appropriation by the state.

Planners in the 1950s ambitiously sought substantially increased public investments, and these required dramatic increases in extraction. They proposed a series of measures, including nationalizations and revisions in taxation to increase income taxes and introduce new taxes on wealth, spending, and capital gains. At 1955/6 rates of taxation, however, a massive gap in between Plan resources and tax revenues existed. Important problems in additional taxation, such as the inability to reach subsistence farmers through the tax system, remained (Frankel, 1978: 123).

Tarlok Singh, a prominent Indian civil servant and member of the Planning Commission from its inception, describes tax policy as proceeding in an *"ad hoc"* fashion and in directions guided by what was politically feasible (Singh, 1974: 308). As part of the development of the machinery of taxation, a 1955 Taxation Enquiry Commission recommendation called for an All-India Taxation Council with a permanent Tax Research Bureau (Singh, 1974: 310). Tax increases and changes in the tax structure did occur in this period, but tended to happen "piecemeal" rather than in the form of a prominent and sharp effort to raise new resources. For example, a number of new taxes were introduced by the central government in 1957 in order to fill "gaps", such as the wealth tax and the gift tax (Singh, 1974: 308). Other changes in taxation, such as the customs and excise duties, were introduced to prevent profiteering or direct consumption to domestic goods.

In this period, therefore, there were changes in the tax structure, but these are not clearly and directly linked to an international shock. Rather, they are more associated with general pressures on public resources.

1962-1970

Overview

The Indian political historian Baldev describes the 1962 and 1965 wars as a "learning experience in realpolitik for the elite and the [Indian] nation, instructing them… to come to terms with functioning in the real world where force matters rather than remain in the relatively make-believe world of idealism" (Baldev, 2000: 15). The 1962 war, in particular, made the demands for war preparation especially strong in the perceptions of Indian policy makers, and resulted in a dramatically increased commitment to defence expenditure. Perceptions of the need for new and additional revenues became particularly acute. The 1962 war was immediately followed by a defence budget increase of 12 percent (Brines, 1968: 209). In 1963, about a year after India's war with China, Jawaharlal Nehru summarized the extraordinary strategic possibilities available to the Indian (and other governments) for mobilizing economic resources for a war effort as follows:

> When faced with extreme difficulty, like the Chinese invasion, you have to do it [undertake costly re-equipment] whatever happens. You can get it too from friendly countries. You can tax your people much more than normally you could. But, imagine in peacetime, how far can you create that atmosphere? How far will people bear such heavy burdens of taxation and how far will other countries be prepared to help you to that extent. It is only when danger comes and shakes you up that you can get more money by taxation, loans, credits and gifts from outside. (Quoted in Kavic, 1967: 89).

Thus, Nehru noted both taxation and international resources in the form of borrowing or grants as strategic possibilities for funding policy goals associated with war. War demands resources, and the associated atmosphere of national emergency improves the possibilities for obtaining those resources.

Some shocks were ecological in nature (as opposed to being "international"). One shock in the Indian case was a food crisis sparked by two successive droughts in the mid-sixties. In 1965, foodgrains production in India fell by one fifth, and remained at that low level in 1966; already a "food-deficit" country, India became even more dependent on food imports (Baldev, 2000: 18). This was triggered by two monsoon failures in 1965 and 1966.

Because the China war (1962) and the Pakistan war (1965) happened relatively close to each other in time, it is difficult to separate out their effects on policy. It appears, however, that the Pakistan war did not rival the Chinese one in terms of being a genuine shock. Kavic (1967: 214) suggests that the brief war with Pakistan in 1965 actually lessened Indian security concerns about Pakistan as a "real"military threat. Kavic (1967: 207) further argues that the major assumptions underlying India's post-1962 defence planning remained unchanged after the 1965 conflict with Pakistan. These assumptions included the following: "the People's Republic of China posed the major threat to Indian security; a Pakistani threat could materialize at any time; [and] Sino-Pakistan collusion against India was conceivable" (Kavic, 1967: 207). Nevertheless, heightened military spending associated with the 1965 war was substantial: the military budget in the war year was estimated at $2.1 billion, up from $1.8 billion in the previous year (Brines, 1968: 273). The end of the war did not mean a reduction in the military budget. Instead, the 1966/7 military budget was 15 percent higher than the war budget (Brines, 1968: 417) (this may be due to the way planning works, see discussion section below).

International financing

During the 1962 border dispute with China, India appealed for American help. The Americans and British both provided assistance, and even Israel provided heavy mortar (Sattar, 1997: 83). Two days after the Chinese offensive of Nov. 17, 1962, Nehru appealed for American air protection. The US responded by dispatching an aircraft carrier to the Bay of Bengal (Brines, 1968: 195). The Chinese declared a ceasefire on Nov. 21, pre-empting the possibility of direct American engagement. Emergency shipments from Britain and the US to India were valued at $120 million (Brines, 1968: 264). This $120 million commitment was agreed upon by the US and UK in December, 1962 (Talbot, 1998: 174). Thus, India used a clear international strategy in seeking the resources needed for the 1962 war. Defense expenditures prior to this war were less than 2 percent of GNP, and these more than doubled in the aftermath of the war (Baldev, 2000: 14).

India was ill-prepared for a war with China (Kavic, 1967: 99). Such a contingency had been "almost completely ignored in practice", and possibly also ignored in theory (Kavic, 1967: 114). Neither Indian ground nor air forces were likely to be able to effectively defend against a Chinese attack (Kavic, 1967: 114-115). Resource constraints had prevented some expansion of the Indian Army and Navy in particular, although the Air Force had been less constrained (Kavic, 1967: 109, 118). The war with China thus caught India underprepared, and "confirmed India's dependence upon external help against attack by a major power and the availability of Western military aid in a crisis involving Communist China" (Kavic, 1967: 187).

As a policy planning consequence of the war, Indian policy makers introduced a substantive agenda of increased military infrastructure, production, and manpower (Kavic, 1967: 192). A 3-year plan was put together shortly after the war with China, and in 1964 this was revised into a 5-year plan (Kavic, 1967: 192). The increased burden on national financial resources and particularly on scarce foreign exchange reserves meant that India undertook a "complete about-face" on the issue of receiving military aid; special aid-seeking missions were dispatched as India sought to rely on "'friendly' countries to make available the desired foreign exchange funds for the military in the form of outright grant aid or long-term credits on easy terms, while at the same time requesting increased general economic aid on better terms than hitherto and also concessions regarding repayment on precious aid" (Kavic, 1967: 193-4). Thus, a clear effort was undertaken to obtain international resources in the aftermath of the Chinese war.

Some international resources are not captured by the measures used in the early part of the dissertation. For example, efforts were made to have collaboration with outside countries in the domestic production of defence ordnances. Several such efforts followed the war with China and a "marked upsurge" in ordnance production followed (Kavic, 1967: 203). Such aid in the form of expertise and assistance is clearly valuable but intangible. It is also likely to reduce the material cost of war preparation to the government of the recipient country. An example is Soviet assistance. Shortly before the Sino-Indian war, the USSR had pledged $500 million of military assistance to India, and they reaffirmed this after the attack (Brines, 1968: 266). Most of this assistance was to be spent in building an Indian factory to produce MIG fighter planes. A significant weapon in India's defence arsenal could thus be produced without draining scarce foreign exchange reserves (Brines, 1968: 266-267).

Total foreign assistance to India increased from 2 percent of GDP in 1961/62 to 3.5 percent of GDP in 1965/67, despite the 1965 suspension of US aid in response to the war with Pakistan (Joshi and Little, 1994: 49). During the course of the actual war, both the US and Britain embargoed military assistance to both sides, starting on September 7 for the US and September 8 for Britain (Brines, 1968: 355). Food shipments from the US to India, however, were maintained throughout the conflict (Brines, 1968: 402)). In overall terms, deficits[2] and foreign aid rose substantially at the time of pressures

[2] The term "deficit" can refer to a variety of problems of revenue shortfall. For the Indian case, Chelliah suggests concentrating on three measures of deficit: overall fiscal deficit, revenue deficit, and monetized

occasioned by international war shocks. Kavic (1967: 207) describes the Indo-Pak war of 1965 as being "limited". The conflict was brief and "confirmed Pakistan's vulnerability to Indian military pressure and the relative security of Indian territory in any isolated and limited conflict with the Muslim state" (Kavic, 1967: 214). The impact of the Sino-Indian war on the perceptions of Indian policymakers was greater; there was a sense of desperation and severe emergency in Nehru's appeal for international assistance at that time. It was a severe adjustment to Nehru's previous emphasis on non-alignment.

The 1962 war also contributed to the warming of relations with the USSR. Inder Gujral, who later became the Indian ambassador to Russia, clearly describes the linkages between defense efforts and an internationalist strategy:

> Before the China War, India never did an arms shopping in the Sovier Union. We were all the time buying either from the Bristish or the Americans. It was only after 1962, when we wanted to modernize the Indian army, that we felt we had to do something. Chavan, who was Defence Minister under Jawaharlal Nehru, was asked to go first to London and then to Washington to request two second-hand submarines... both refused. And then, for the first time, he was sent to Moscow. (quoted in Tully and Masani, 1988: 42).

Active efforts to locate international resources for war-making were thus undertaken, and these were clearly associated with the shock of the loss to China.

Over the 1950's and 1960's, India received $13 billion in net resource transfers. An average of 18 percent of total central government expenditures originated in foreign assistance and in some years this share exceeded 25 percent (Weiner, 1979b: 57-63). The special post-1962 Indian emphasis on international strategies was not without its domestic detractors. The Indian academic B.R. Shenoy of Gujarat University strongly

deficit (Chelliah, 1996:59). Thus, there are possibilities for substantial further refinement of the empirical understanding of the revenue/spending burden on a national government. For the purposes here, such nuances are left aside in favor of examining a broad, overall picture of the central government's revenue-raising concerns.

advocated a drastic curtailing of foreign aid in 1966. Despite large quantities of aid, he asserted, socioeconomic conditions in India had worsened. Furthermore, easily available aid tended to perpetuate misguided and inefficient policies and corruption, and tended to prevent important adjustments to government spending (described in Behari, 1968: 47).

Domestic extraction

Anecdotal accounts point to the role of an atmosphere of national emergency in increasing the domestic resources devoted to state activities. An "unexpected sense of national unity" was expressed in the forms of "volunteer labor and militia training to the donation of gold ornaments for the national cause"; in "Indians of all strata responded to the emergency with a dedication of purpose that was unforeseen by New Delhi" (Brines, 1968: 195). While such broad description does not give a specific sense of exactly how much was gained in terms of domestic resources, or of how long the sense of unity was sustained, it nevertheless suggests that the external threat made it easier for the government to obtain domestic resources for national purposes.

Over the course of the Sino-Indian war of 1962 and the Indo-Pakistan war of 1965, defense expenditures in India doubled as a proportion of GDP. Fiscal deficits rose from 5.6 percent of GDP in 1960/61 to 6.7 per cent in 1965/66. There was a "substantial" revenue-raising effort in the 1963 and 1965 central government budgets, but it was "politically difficult to raise taxes year after year" (Joshi and Little, 1994: 48/9). The problems with generating tax revenues meant that borrowing increased. This was particularly the case after Nehru's death in 1964. There was a gradual shift away from fiscal conservatism and towards greater fiscal deficits, particularly after the mid-seventies (Joshi and Little, 1994: 68).

Planners drafting the proposed Fourth Plan in 1966 repeatedly emphasized the need for a "bold restructuring of the tax system and a greater resort to taxation at the source" (quoted in Frankel, 1978: 303). The planners made particular reference to the need for extracting additional resources from the agricultural sector, but did not suggest a strategy for doing this, and only repeated the problem in their draft proposal, stating that "the existing structure of agricultural taxation is not such as would enable any significant part of the increase [in agricultural incomes] to flow into financing of development expenditures" (quoted in Frankel, 1978: 303). The states traditionally had taxation power on agriculture, and proposed increases in agricultural tax revenues were based on new requirements imposed on the states. The drafted plan was severely criticized by the Indian chief ministers as they "questioned the ability of the states to mobilize new resources from taxation" (Frankel, 1998: 304). Thus, policy planners clearly sought increase in extractive activities, but were hampered by political impediments.

On July 19, 1969, Prime Minister Indira Gandhi announced an abrupt decision to nationalize all major commercial banks. Bank employees automatically became government employees. 85 percent of Indian bank deposits thus came under government control (Datta, 1992: 113). By end of 1969, all major banks and insurance institutions were under government control (Datta, 1992: 7). The banks' nationalization by the central government successfully overrode legal challenges (Frankel, 1978: 441). This move combined restructuring of state-society relations with new possibilities of money creation. Short- term credits for inflationary financing by the central government could now be obtained more easily. It is placed in the domestic extraction section, however, because it was a socially prominent policy and because it represented a "100 percent tax" on bank ownership.

1971-1979

Overview

Following increased US assistance to Pakistan in 1970, a Russian Treaty of Peace, Friendship, and Cooperation was signed with India. Nevertheless, US assistance to India continued. In the 1971 conflict, the US provided India with $350 million to ease the burden of refugees flooding in from East Pakistan (Sattar, 1997: 104). During the course of the actual war, however, the US suspended "uncommitted" economic aid to India, amounting to a total of $87.6 million (Sisson and Rose, 1990: 261).

As oil prices quadrupled starting in 1973, there was an associated massive jump in the current account deficit (Joshi and Little, 1994: 53). In the short run, the current account deficit was financed by increased aid from traditional donors, OPEC, and by IMF drawings (Joshi and Little, 1994: 55). India was also somewhat protected from the oil shocks as increased exports to oil-producing countries in the 1970s resulted in unanticipated increases in foreign reserves (Datta, 1992: 5). Nevertheless the oil shocks had significant effects. The oil-related category of imports, including "petroleum, oil, and lubricants" has become an object of special attention for import control policy; this group made up for 8.32 percent of value of total imports in 1970-71 (Datta, 1992: 214). (As a proportion of total value of imports, oil accounted for 15.51 percent in 1988-89 (Datta, 1992: 214)).

A brief period of authoritarian rule occurred in the form of a declared national Emergency between June 1975 and March 1977. This meant that unlimited formal powers were concentrated in the central government (Frankel, 1978: 550). In theory, more power in the hands of the center should have enhanced the implementation of growth and distribution policies. Deficiencies in the institutional infrastructure of governance, however, hampered these efforts (Frankel, 1978: 554). Furthermore, claimed economic gains in the period of Emergency are confounded by the record agricultural production of 1975/76, a result of extremely favorable weather conditions (Frankel, 1978: 556). This period is notorious for the forced sterilization campaign in rural India that was spearheaded by Sanjay Gandhi. A target of sterilizing 23 million persons over three years had been set, and in the first five months of the campaign, 3.7 million Indians had been sterilized (Frankel, 1978: 566). Despite these social engineering efforts, a gradual retreat from socialist planning ideals began in the 1970s (Datta, 1992: 7).

International Financing

As the war with Pakistan was fought, the US under the Nixon administration suspended licenses for military sales to India and also suspended $87.6 million in economic aid (Talbot, 1998: 212). On August 9, 1971, the Indo-Soviet Treaty of Peace, Friendship, and Cooperation was signed. Indian Prime Minister Indira Gandhi visited Moscow in September, 1971, and this was followed by a reported commitment by the USSR to provide $1 billion in military and economic aid. Additionally, some requested military equipment was provided in an emergency dispatch (Sisson and Rose, 1990: 243).

India was therefore able to locate an outside patron in the Soviet Union following a war situation.

The Indian economy coped surprisingly well with the four-fold oil price increase associated with the first oil shock (Jalan, 1991: 45). India had first obtained funds from the International Monetary Fund in the early 1950s (Jalan, 1991: 45). After the second oil shock, India made an extended arrangement with the International Monetary Fund (Jalan, 1991: 46). The predominant source of aid to India became the World Bank by the 1970s (Weiner, 1979b: 65). Weiner asserts that foreign funds allowed the pursuit of policy objectives without substantial increase in the level of taxation.

Domestic Extraction

The reality of difficulties in extracting additional resources through taxation contrasted with the aims of the Fifth Five-Year Plan (1974-79). These aims included substantially higher targets for resource mobilization to fund national development policy expenditures (Frankel, 1978: 561). "Resource mobilization" for the public sector usually involves a series of taxation measures (Singh, 1974: 290). Plans for "additional resource mobilization" usually involve new taxes (Singh, 1974: 292).

Seeking additional resources from the agricultural sector has long been an aim of policy-makers in India as well as Pakistan. Weiner summarizes the problem of increasing domestic extraction from the agricultural sector in the Indian case in the following excerpts:

> As it is well known, the least taxed sector in India, for reasons that are politically apparent, is the peasant proprietor class. In 1975-76, according to the annual report of India's Reserve Bank, collections from land revenue and agricultural income tax together constituted only 6.2 percent of tax receipts of the state

> governments. The political risks of seeking additional resources from a social class whose support is so essential for the government clearly would be substantial. (Weiner, 1979: 65).
>
> The peasant proprietor class ... became politically so well entrenched in the Congress party, in some of the opposition parties, and in the local administration that they successfully blocked the passage of legislation... to impose an agricultural income tax (Weiner, 1979: 25).

In connection with this, Weiner shows that the growth in revenues from indirect taxes was far greater than the growth in revenues from direct taxes from 1950 to the late 70's. Even a government campaign for better income distribution did not substantially alter this state of affairs (Weiner, 1979: 25, footnote 16). Significant improvements in extractive capacity of the Indian state from agriculture, therefore, were not visible in the 1970s.

In contrast to the story in agriculture, a success story in the mid-1970s was the campaign against tax evasion and smuggling as part of the Emergency declared at this time. Substantial new tax revenues accrued to the central government, particularly in an effort to allow "voluntary disclosures" of income. As a result, "collection of direct taxes increased by over 27 percent achieved in the corresponding period of the previous year" (Frankel, 1978: 555). State-level efforts against sales tax evasion also produced increased revenues. In certain cases, states also increased rates in certain categories of taxes. A campaign against smuggling led to 60, 000 raids, the imprisonment of 2100 alleged smugglers, and also substantial seizures of smuggled goods (Frankel, 1978: 555).

1980- early 1990s

Overview

The struggle to deal with acute balance-of-payments problems characterizes most of Indian public finance pressures in the post-1980 period. Foreign reserves were actually mounting at times in the 1970's, due in part to increasing India exports to oil-exporting countries. Starting in the 1980s, foreign reserves took a sharp downturn (Datta, 1992: 196). Joshi and Little (1994: 58) outline the multifaceted, combined nature of the economic shocks faced by India during 1979/80 and 1980/81. In this period, the Indian economy endured both internal and external shocks. The worst drought since 1947 occurred in 1979, such that agricultural production fell by over 15 percent. The rise in oil prices meant a 33 percent deterioration in terms of trade during 1979 and 1980. This combined with disruption of domestic oil supplies because of political agitation in Assam state, leading to power shortages and shortages in coal and transport. This set of factors set off an industrial recession in 1979/80 and 1980/81.

The ongoing problem of sources of public finance is captured in part by the following observation. Faced with a large deficit in the revenue account in 1990-91, the Indian Finance Minister had a choice between "new taxes and new money-creation", or some "acceptable mix" that combined tax revenues with monetized deficit (Datta, 1992: 217). This shows that adjusting the sources of government revenues across these broad strategies has been a continuing feature of policy debate and choice in India.

The Gulf crisis constituted an external shock for India (Ganguly, 1999; Jalan, 1991, Datta, 1992: 244).

> [T]he Gulf crisis of 1990-91 ... turned India's situation towards disaster. The increased costs of purchasing petrochemical products, the repatriation of some 130,000 expatriate workers from the Gulf region, and the loss of their remittances

> cost the Indian exchequer dearly. Worse still, a number of India's loan payments to multilateral banks were on the verge of coming due. (Ganguly, 1999: 1666).

Changes in the international political economy thus produced a "revenue-side" shock for the Indian government. Jalan (1991) characterizes the Gulf crisis of 1991 as being the context for acute balance of payments problems, comparable to the oil shocks of the 1970s.

International financing

Financing for the public deficit produced by the revenue loss in this time came from borrowing, primarily from the IMF, but also from commercial sources (Joshi and Little, 1994: 60). A large Indian drawing from the IMF of SDR 5000 million took place in 1981 under restrictive conditions (Datta,1992: 8). There was also a tendency for increased private sector borrowing from abroad (Datta, 1992: 18).

The Persian Gulf crisis beginning with Iraq's occupation of Kuwait in August 1990 can be classified as an international shock. There was a relatively short-lived oil shock component: the price of crude oil went from $15 per barrel in July of that year to $35 per barrel in October. In addition exports to and remittances from expatriates in the Persian Gulf were reduced (Joshi and Little, 1994: 65). Over this crisis, India began to face acute problems in new commercial borrowing, and in November, India's credit rating was sharply lowered by Moody's bond rating agency (Joshi and Little, 1994: 65-6). This external shock was important because it happened at a time of national economic weakness: the rise in oil prices following Iraq's invasion of Kuwait may have been "absorbed" but happened at a time when the economy was particularly vulnerable because of poor economic management by the state, and the drop in foreign lending was a consequence of poor policy. (Joshi and Little, 1995: 33). Joshi and Little trace the roots of this crisis to the previous oil shock of 1979-80. This sparked a persistent current accounts deficit. A 1982-84 IMF loan and commercial borrowing covered that deficit. Exports stagnated, the external debt burden continued to increase, and needed fiscal adjustments were not made. In a context of balance of payments problems and a crunch on foreign exchange, the IPE changes of 1990-91 had especially sharp repercussions for the Indian economy. IPE shocks thus bring to light the complex interrelatedness of public finance policies and general efforts of macroeconomic management.

Jalan, the Governor of the Indian Reserve Bank in 1996, describes features of the Indian tax structure that match closely with a description of a politically weak state from the political capacity literature.

> The tax structure is ... highly complicated and is riddled with elaborate laws and administrative rules, many of which are antiquated and unenforceable. An important result of structural anomalies, legal complexities, and procedural rigidities has been the increase in tax evasion and corruption at virtually all points of the elaborate tax chain and at different levels of tax administration. From all accounts, the amount of incomes not disclosed to tax authorities is large, and the amount of taxes (particularly income taxes) which are liable to be paid but are not paid are at least as large as the taxes that are actually paid (Jalan, 1996: 60).

A perverse consequence of this cumbersome, inefficient tax system is that evasion has become "socially respectable" (Jalan, 1996: 61). Thus the informal constraint of social embarrassment at being a tax evader does not exist, and evasion is encouraged even more.

A strikingly high ratio of indirect taxes to direct taxes is noted; for example, in 1994 and 1995, "indirect taxes (customs and excise) still account for more than 70 percent of tax revenue" (Jalan, 1996: 60). The low degree to which the Indian government reaches the domestic population for extractive purposes is reflected in the fact that personal income tax in India is only paid by two percent of the urban population (Jalan, 1996: 60). Other analysts of the poor extractive performance of India find it to be a "scandal that in a country in which the middle class is estimated to be between 100 and 200 million, the number of income tax payers is about eight million" (Joshi and Little, 1996: 40).

Joshi and Little find that the yield of direct taxes in India accounts for 15 percent of total tax revenue only, markedly less than the developing country average of about 30 percent (Joshi and Little, 1996: 80). Other analyses of taxation in India contain similar perceptions (Shand and Kalirajan, 1994). A political constraint works against substantial increases in direct taxation. In addition to difficulties in "assessment and collection" (part of the low political capacity/administrative weakness of the Indian state), the "personal income tax base has been kept narrow by pressure from organized sector employees for increases in the exemption level" (Shand and Kalirajan, 1994: 10). Furthermore, farmers have prevented any "serious taxation" of agricultural income ((Shand and Kalirajan, 1994: 10).

Warnings about severe conditionality on international loans seem to spark inquiries into the state of taxation. In late 1989, the World Bank warned India that it's external debt service burden was growing rapidly and that "the conditions under which foreign funds would be available are becoming increasingly harder" (Datta, 1992: 182). This shows that increases in debt burden make it harder to obtain more money abroad. In this connection, Datta also mentions the need for higher taxes, for closing loopholes, and for increasing the low ratio of direct to indirect taxes; in 1989 Datta estimates that direct taxes yielded less than 20 percent of total tax receipts (Datta, 1992: 182). The practice of privatization as a budget support measure was attempted in this period (Datta, 1992: 250).

Chelliah describes the reforms of the early 1990s as an attempt to curtail the power of the central government in favor of states and private actors (Chelliah, 1996: 23). These attempts followed the balance-of-payments crisis of 1990-91. As early as 1985, there was a discernible departure from basic planning principles that had been firmly espoused in the initial decades of independence. For example, the 1985-86 budget expressly postulated that private sector output would increase if both direct and indirect taxes were reduced. Such tax cuts were therefore desirable in the effort to increase productivity (Datta, 1992: 23). A sizable revenue loss was estimated to accompany such tax relief initiatives (Datta, 1992: 28).

Following 1991, several tax reforms were introduced to produce a simpler direct taxation system with lower rates and fewer exemptions, and a cut in indirect taxes. For example, the maximum rate of personal income tax went from 56 percent in June of 1991 to 40 percent within three years (Ahluwalia, 1995: 20).

Joshi and Little (1995: 33) argue that tax reforms of the early 1990s were part of an Indian stabilization program that sought to address the economic crisis of 1991. The crisis itself was associated with a sharp fall in foreign exchange reserves, a lowering of India's credit rating, and a "cut-off" of foreign private lending (Joshi and Little, 1995: 33).

Money creation in India, 1947-1990's

The Indian economist Raja Chelliah argues that both borrowing and seignorage have been considered "necessary and justifiable" for several purposes (Chelliah, 1996: 107-108). One such purpose is financing "war or other emergency expenditure". Other "justifiable" purposes for borrowing and seignorage include macroeconomic stabilization (for example, in countering business cycles), and smoothing tax rates (for dealing with "lumpy" capital expenditures in a consistent and stable manner.

Bagchi describes money creation activities as a frequent and repeatedly pursued option for public finance in India, particularly when facing difficulties associated with budget constraints in the context of rising debt:

> [W]here public expenditure is inflexible, it requires a rise in taxes together with the debt stock. ... If higher taxes are not feasible, the alternatives are either seignorage or inflation tax, or drawing down of foreign exchange reserves, or borrowing from the domestic capital market. Use of foreign exchange reserves or borrowing form abroad have well known limitations. Seignorage is often resorted to by Governments finding difficulty in bridging the budget gap. This is taking place in India continuously, even though deficit financing or borrowing for the Reserve Bank has its limits and attendant risks as well (Bagchi, 1992: 197).

Bagchi thus believes that seignorage is regularly exercised by political authorities in India as a means of appropriating needed resources. Bagchi also discusses the inflationary potential of unchecked money growth, and connects it to the lack of sufficient autonomy held by the Reserve Bank as an agency administering monetary policy (Bagchi, 1992: 201-2).

The practice of financing central government expenditures through borrowing from the Reserve Bank and thereby adding to the money stock is an act of inflationary seignorage. Such borrowing was notable in the 1985-1990 period but only continued existing practice (Datta, 1992: 8). The inflationary consequences of "monetizing" government budget deficits reached a measure of acceptance (Datta, 1992: 8). Short-term treasury bills and other securities are sold to the banking system and particularly the Reserve Bank under this arrangement. The Bank then credits "new" money to government accounts (Datta, 1992: 90-91). This is a relatively sophisticated form of seignorage. Government borrowing in India is made of such money creating policies as well as more long-term "market" borrowing which includes drawing on household and corporate savings (Datta, 1992: 90). A good portion of domestic borrowing thus consists of money creation-based "stealing" (Datta, 1992: 90).[3]

Six private banks were also nationalized in 1980. This added to Indira Gandhi's drastic nationalization of commercial banks in 1969. 95 percent of total Indian bank deposits were now held in banks owned and controlled by the Indian government (Datta, 1992: 112). In 1989, the Reserve Bank was issuing warnings about "incredibly large increases" in its credits to the government (Datta, 1992: 216).

Proposed IMF conditionality to India has included caps on the monetization of the fiscal deficit. A ceiling on bank credit to the government has been proposed (Datta, 1992: 197). Thus, it may be that conditionality is also linked to changes in the practices of money creation, although it is not clear if conditionality has led to the successful implementation of such restrictions.

One observer from the Indian Planning Commission describes a "vicious circle" relations between budget deficits, money supply and inflation.

[3] Arguments for the viability of such inflationary financing carried out in the interest of development exist in the literature, with some tracing their roots to Keynes' proposals for financing the war effort (Datta, 1992: 93).

> [The] gross fiscal deficit of the [Indian] Government rose from 3.5 percent of GDP in 1970-1 to nearly 9 percent in 1991. This had led to the acceleration of the creation of the money supply which induced higher inflation. Higher inflation, in turn, induced larger budgetary deficits as the Government expenditure was kept at an unreasonably high rate. Consequently, a higher rate of money supply was created leading to further inflation. (Sethi, 1992: 30).

Budget deficits, inflation, and money creation activities are thus interrelated and have historically tended to reinforce each other, with negative consequences for the Indian economy.

Summary appraisal of the Indian experience

Indian policy-makers have usually sought international resources when faced with the heightened resource demands accompanying an international shock. Indian policy-makers gave vocal recognition to domestic extraction as a substitutable alternative to international financing. Some efforts were made to increase domestic extraction and lip service was paid to the need to do this, particularly after the 1962 war with China. Indian policy-makers perceived the Chinese threat as being more pressing for national security consideration than the ongoing disputes with Pakistan. The 1962 war was thus an opportunity for a substantial departure from past revenue-raising behavior by the Indians. Yet the clearest consequence of the outbreak of the war was an urgent appeal and effort by the Indians to obtain international resources. An international strategy was established and affirmed. Domestic extraction efforts have been met with administrative problems, political opposition, and evasion throughout India's history. Money creation activities, as in Pakistan, have been a persistent feature of revenue-raising by the Indian central government. The Indian experience thus closely matches the Pakistani one, and fits the predictions of the political survival model for all states and the political capacity model for weak states.

DISCUSSION

Some considerations related to the three strategies

International financing and foreign patronage

International patronage for the two countries has the potential to rise and fall simultaneously. For example, a Western aid consortium pledged substantial aid packages for development expenditures to both India and Pakistan in the early1960s. Conditionality associated with international loans increased for both states in the 1980s. Major powers in general sought quick endings to the Indo-Pakistani wars (Sisson and Rose, 1990: 223). This meant that in the 1965 war, for example, both sides lost important outside sources of military assistance.

Differential shifts in patronage across India and Pakistan produce natural security concerns in each state. For example, Pakistan's military pact with the US in 1954 produced Indian fears about American weapons being used against India. The US had tried to balance arms aid to Pakistan in the 1950s with large-scale economic aid to India. India nevertheless considered this a pro-Pakistani position (Sisson and Rose, 1990: 254). Likewise, US arms shipments and the initiation of arms aid to India from the time of the 1962 Sino-Indian war raised Pakistani resentment and stated concerns that those weapons would be used against Pakistan (Brown, 1963: 371; Sisson and Rose, 1990: 254).

The behavior of patrons themselves is sometimes difficult to understand. For example, the US had hoped that the Chinese threat would produce cooperation between

India and Pakistan (Merrill, 1990: 152). Optimism about the prospects for such cooperation as two Cold War allies of the US underlay American commitment to providing development assistance to both countries. However, the depth of regional animosities in South Asia was underestimated (Merrill, 1990: 152). A more accurate and realistic assessment by American policymakers would have produced the conclusion that China was likely to move closer to Pakistan.

Foreign aid has met with some apprehension. The Indian academic Shenoy's (1966; quoted in Behari, 1968: 47) severe criticism of foreign aid as a means of delaying necessary changes in governance is one such example. Another apprehension is that military aid can be habit-forming as the receiving country starts to make security calculations on the basis of foreign-obtained strength and has difficulty ending military assistance once initiated (Krishnanath, 1971: 114). General suggestions that foreign aid takes away from the national value of self-reliance abound (eg. Mathur, 1989). Through the 1970s, Indians evaluating prospects for the long-term political development of their country were concerned that international resource transfers would reduce the need for tax reform. The fear was that "a democratic leadership faced with multiple pressures would ... view aid as a way of avoiding some politically unpleasant choices" (Weiner, 1979b: 67). Thus, the apprehension was that the reliance on international sources of financing would not foster the political development of the state and country. This perspective supports the suggestion of the earlier chapters that international financing has the potential to stunt the process of state-building.[4]

[4] Traditional versions of dependency theory focus on the distribution of income and productive assets and the structure of trade relations as driving close, asymmetric ties to outside states. This research has made a different set of assumptions about such foreign ties, namely that state managers seek international support

Concerns about the loss of decision-making autonomy to international lending institutions are also widespread. The IMF and World Bank were created to prevent "competitive devaluation, discrimination in foreign exchange dealings and tariffs, lack of convertibility and disorderly flows of capital, all of which characterized international conflicts in the 1930s following the severe depression in the world economy" (Mathur, 1989: 93). The US and UK had a special influence in the Bretton Woods system, and the US particularly because of the gold standard arrangement of backing the dollar with gold. The World Bank and IMF were influenced by the US and UK and came up with an approach to economic development that often conflicted with the policy preferences of developing countries (Mathur, 1989: 93). The IMF and World Bank "are meant to offer assistance when unavoidably required-as a last resort than a first- but they are not entitled to entrap a member country and act as overlord in determining its economic policy" (Datta, 1992: 2000). A general sense exists that international lending institutions tend to quickly overstep bounds and tread on areas that should be part of the sovereign decision-making authority of the state.

Domestic extraction

Ongoing national security demands have clearly imposed constraints and demands on national budgets in both countries, and tied up massive portions of national resources in defence-related expenditures. The major, well-known initiatives in the extractive activities of the state in both countries- nationalizations and land reform

to further their own political survival. This traditional dependency version as a possibility for the South Asian context has been described elsewhere (Hussain, 1989: 12).

efforts- appear to be primarily domestic in character, in that international shocks have not acted as a trigger or catalyst.

Nationalizations are a form of domestic extraction that are not necessarily captured in a focus on revenues. Barnett described nationalizations as a 100 percent tax (Barnett, 1992). While this is the case, nationalizations also reduce the size of the taxable corporate sector. Additionally, they create inefficiencies and capital and entrepreneurial flight, each of which Datta (1992) considered in his discussion of the possibilities of privatization as a strategy of raising government revenue (Datta suggested that it would not be as fruitful as in the case of privatizations in more developed countries, such as Margaret Thatcher's initiatives in Britain). (Privatization, also a form of domestic restructuring, is also not clearly linked to international shocks.)

Efforts at land reform or substantive new taxation of the rural sector were attempted under Ayub Khan, Zulfiqar Bhutto, and Zia ul Haq's periods of rule. This would have had the potential for substantial increase in extractive capacity through enlargement of the taxable base of the agricultural sector. Land reform in Pakistan has been unsuccessful by and large. India has also encountered significant political impediments in extracting resources from the agricultural sector (Weiner, 1979b).

The period best characterized as one of domestic restructuring (the 1970s under Zulfiqar Bhutto) saw state extraction of domestic resources in the form of nationalizations and is not clearly tied to an international shock stimulus. The Pakistani defeat in the 1971 war and the loss of East Pakistan preceded these events, but the causal links between the nationalizations and the effort to improve state security are unclear.

The linkage is indirect, insofar as part of what brought Zulfiqar Bhutto to power was the process and outcome of the 1971 conflict.

While extractive efforts and developments in the extractive capacity of the state have taken place, they have not been clearly associated with wartime resource demands except in minor ways. The major internationally-linked efforts associated with changes in state extraction have been connected with structural adjustment programs in the context of conditional loans. The major ostensible changes in tax policies and appearance of efforts at tax reform in Pakistan and India also fall in line with a regional trend. The 1980s were a period of attempted tax reforms throughout Asia; Chelliah notes that up to 25 such efforts took place in Asia between 1984 and 1990 (Chelliah, 1996: 81). Pakistan and Sri Lanka took "substantial" tax reform efforts as part of a structural adjustment program (Chelliah, 1996: 84). Tax reform generally aims for simplicity and transparency in tax policy and collection, and to be "sound and practicable" based on the three criteria of equity, economic efficiency, and administrative ease (Chelliah, 1996: 139). By the early 1990s, fiscal and budgetary reform as important policy goals were accepted by both countries (Harrison, et. al., 1999: 10).

In the Indian case, it appears that the deficit problem that began with the second oil shock combined with the balance of payments problems associated with the Gulf War of 1991 produced an effort to restructure domestically, under the requirements of structural adjustment programs. Thus, spending needs associated with international shocks can influence changes in state extractive behavior, but the causal route here appears to be conditionality in international loans.

Before ascribing causal influence in driving tax reform to these outside institutions, however, a measure of caution is needed. Overt efforts at adjusting extractive capacity may simply receive more press in the context of structural adjustment programs (the IMF riot, for example, has become a widely noted phenomenon). Also, political leaders may have an easier time endorsing unpopular measures if they can claim that their hands are tied by outside actors. Such a claim may absolve them from being held politically accountable for a measure they would have been obliged to take anyway.

Money creation

The historical roots of inflationary currency-issue based war financing in South Asia can be found in the British policy during World War II (Tomlinson, 1992: 276). Tomlinson asserts that the "cost of the war was supposed to be met by taxation in India and reimbursement from Britain. In practice, the war could only be financed by inflationary currency issue" (Tomlinson, 1992: 276). The exact route by which the Indian government was led to a severely inflationary seignorage policy is detailed in Tomlinson (1992: 276-277). Inflationary problems persisted well past the war. Currency manipulation was generally a well-established British tactic for other reasons such as affecting the terms of trade (Brown, 1963: 53). India and Pakistan became independent states with a living memory of seignorage. Seignorage as a revenue-raising tactic was already familiar to policy-makers.

The inflation measure of seignorage is problematic. While seignorage efforts are widely noted as being associated with high rates of inflation, inflation has many causes and as a result is a less than ideal measure. Food costs in Pakistan, for example, have been identified as a culprit in understanding the sources of consumer price inflation (Stewart and Sturgis, 1995). Another problem with the inflation measure of seignorage is that wars and their economic aftermath are considered by some to be inflationary (eg., Thomas, 1996: 230). Wartime inflation may be therefore be mistakenly assumed to be the result of money creation policies.

What is termed "market borrowing" in national budget figures may not be genuine market borrowing but instead may be a form of money creation involving borrowings from the central bank (Datta, 1992: 206). Borrowing from the central bank adds to the money stock and allows the central government to appropriate resources, the cost of which is eventually paid by the society in the form of an inflation tax. Such borrowing becomes easier in the context of bank nationalizations and low central bank independence, and has been repeatedly and frequently resorted to in the Indian and Pakistani cases. The lack of an ability to borrow domestically in more overt ways is also symptomatic of low state capacity. For example, part of Pakistan's underdevelopment is reflected in the fact that there is not an effective mechanism for moving private savings to the public sector except through government borrowing from the banking system; as late as 1980, the "market for government bonds and other papers is unorganized and small" (Ahmed and Amjad, 1984: 102). Borrowing from the banking system, especially when that system is under the direct control of the government, is thus best described as an accommodational policy in the spirit of avoiding politically difficult alternatives.

The nature and impact of shocks

One relatively obvious finding is that nonwar international shocks are different in form in terms of their effects on the domestic political economy. Roubini's spending shock versus revenue shock distinction is useful here. Nonwar international shocks are revenue shocks associated with general economic downturns, and are complicated in terms of their effects on central government policy. For example, the oil shocks of the 1970s had a variety of effects, including balance of payments problems for the central governments of India and Pakistan, but not the sense of heightened need for emergency resources associated with wars. Additionally, both Pakistan and India have been somewhat shielded from oil shocks because of close relations with the oil-producing countries. For example, Pakistan received oil rebates, and India found new export markets in oil-producing countries. Because revenue shocks act by reducing the base from which revenue is extracted through an economic downturn, the solution tends to be efforts to improve and macro-manage the economy rather than seek to raise new resources. In contrast, war shocks have a clear and direct impact on the spending requirements of the government (and thus constitute a spending shock).

IPE developments can be associated with favorable changes in commodity markets and thereby produce windfalls for states. For example, Pakistan didn't devalue its currency 1949, while other members of the "Sterling Area" did. India retaliated by closing off trade and therefore the common market between India and Pakistan. The potential balance of payments problems and economic consequences for Pakistan were warded off by a fortuitous development. This was the Korean war, which produced a commodity boom for Pakistani exports and allowed it to find new foreign exchange (Talbot, 1998: 137). (The rupee was eventually devalued in 1955)

Furthermore, there are ecological events that could count as "shocks" in that they impose unusual revenue requirements on the government. Droughts and crop failures, for example, have taken place several times in the Indian and Pakistani cases. While domestic in origin, ecological shocks radically increase the spending requirements of states. At the same time, they cut into the revenue base from which the state seeks to extract resources. Thus, they are a combined revenue and spending shock (in Roubini's (1992) terms). These have exacerbated the spending requirements of India and Pakistan, and also been rival explanations for the drive to obtain foreign resources. India's first major drive to obtain international resources, for example, came with a famine. The 1965 war was closely followed by years of crop failures. In such cases, it is difficult to separate the heightened security needs from the ecological event as driving forces for the effort to obtain new resources internationally.

All wars are not equal. Although the earlier chapters treated all war shocks as being implicitly similar, it is obvious from the case study work that this is not the case. Certain conflicts- such as India's border war with China- were vastly more influential in determining attitudes towards the demands of war preparation than others. In other words, the mere occurrence of war cannot be equated to similarly elevated demands of war preparation in all cases. Instead, a host of other factors enter into the equation. These include the nature of the conflict, the degree to which it was anticipated, and the sense of reinforcement or violation of existing assumptions about national security.

Different wars are likely to have qualitatively different impacts based on the level of security threats they pose and magnitude and the degree to which they are not anticipated. In the Indian case, for example, war preparation efforts were more significantly affected by the 1962 war with China than by the 1965 war with Pakistan. This was due in large part to the unanticipated nature of the conflict with China, and the consequent sense of genuine emergency. China was a major power and seemed to overrun Indian borders with impunity. In contrast, the Pakistani conflict had a longer history, was more anticipated, and seen as a more minor threat to Indian security. The 1965 war did not result in the same substantial adjustments to the thinking of Indian security planners. The conflict with Pakistan simply fit the assumptions of Indian state managers, and was therefore less of a genuine "shock".

It appears that wars are a time for questioning and reevaluating existing strategies for mobilizing resources. This was clearly the case in both India and Pakistan after the 1962 and 1965 conflicts respectively. The concrete results of this, however, are not entirely obvious. In both cases, it seems that a clear emphasis on international sources was retained and reinforced. A conflict that violates existing thinking, and particularly a disastrous conflict, appears to lead to a rethinking of security strategy. This was the case in 1962 in India, 1965 in Pakistan, and 1967 in Egypt.

Pinpointing the timing of a war "shock" is also difficult. The actual war may be relatively short-lived. The demands of war preparation that surround it, however, are much greater and more authoritative. These have to do with the perception of "war threat", something much more intangible than the actual clash of troops and tanks. Frequently in the South Asian conflicts, sources of additional war-making supplies have been cut off by international embargos. Additionally, the length of the war is not the only determinant of costliness: the first Kashmir war was the longest but also the least costly materially. The 1971 conflict was the shortest war but the most costly to Pakistan.

Furthermore, the beginning and end period of a conflict is frequently unclear. There was concern after the 1965 war, for example, that the conflict would progress to a second round (Brines, 1968). The use of "irregulars" or guerrillas allegedly working for one side tends to also make it difficult to pinpoint the start of genuine state-to-state clashes. India has alleged that Pakistan has made ongoing use of such irregulars to feed and orchestrate the insurgency in Kashmir from 1948 onwards. Pakistan also alleged Indian support for Bangladeshi guerrillas in the prelude to the 1971 war. If irregulars are treated as proxy armies (and if the mutual allegations are to be believed), then the conflicts appear to be much longer in duration.

A war threat can produce substantial spending pressures without being counted as an actual war. The "Brass Tacks" crisis of 1987 might be an example of such a crisis.[5] Starting with Indian military exercises, a massive mobilization occurred on both sides without an actual war breaking out. Clearly, such an event raised the sense of a security threat and affected the policy calculations of decision-makers.[6] What might have counted as a non-shock from the standpoint of observing wars might have had similar consequences in terms of raising the spending requirements of the two states.

Military budgets appear to only escalate in the aftermath of war. This was the case for both India and Pakistan despite abortive American diplomatic efforts to cap military spending in both countries (Brines, 1968: 417). This may be due to the nature of planning. Proposals and plans for the following year might be formed under war

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[5] Brasstacks was a codename for an Indian military exercise, the largest such exercise in South Asian history. The massive assembled forces were capable of striking into Pakistan. Pakistan responded with its own exercises. The crisis peaked in the fourth week of January when India demanded the withdrawal of Pakistani forces from the border. On Feb 4, 1987, and agreement was reached for the return of forces to normal locations (Sattar, 1997: 136-7).

conditions without foreseeing a cessation of hostilities. Thus, the planning period may be a natural source of lag in the effect of wars on military spending needs of the state. Institutional changes in national planning may have an effect on this also. For example, in 1977 the Indian Planning Commission and central government moved from a fixed 5-year planning horizon to a rolling 5-year plan (Dhesi and Bhullar, 1985: 120). Such a change is likely to reduce rigidity and increase pragmatic adjustments in national policy. Planning in general is an imperfect and problematic process. Glaring deficiencies in estimated budgetary resources resulted from questionable assumptions and untrustworthy estimates of balances from current revenues (Frankel, 1978: 333).

It is clear that in the minds of both policy-makers and observers, alternative strategies for public finance exist. It is commonly acknowledged that in the case of developing countries, a policy relying on explicit and transparent development of the tax structure and extractive capacity will have the healthiest consequences for the political and economic development of the state and society in question. Furthermore, it is also evident that the choice of public finance strategy is informed by political considerations. General opposition to taxation increases and entrenched interests make certain policies politically difficult. In this sense, some of the critical assumptions underlying this study have been validated by the examination of these cases.

Comparison of the Pakistani and Indian cases with reference to Israel and Egypt

Pakistan was faced with more demands for a basic state-building effort than India because of its lower starting point and extreme insecurity from a perceived Indian threat.

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[6] The argument that non-escalation of this crisis was due to successful nuclear deterrence has been made by a Pakistani statesman (Sattar, 1997).

This contrasts with the views of India policy makers, who did not perceive Pakistan as a genuine threat to the survival of the Indian state. Instead, Pakistan was more of a "nuisance" (Kavic, 1967). The Kashmir conflict and war with India in 1948-9 provided a "defining moment" which "established an apprehension of an Indian security threat to Pakistan", which led to Pakistani appeals for foreign assistance (Talbot, 1998: 124). This meant that "Pakistan was sent on the course of dependence on foreign aid and of the diversion of scarce resources to military expenditure in order to overcome its strategic weakness" (Talbot, 1998: 124). Suspicions of India "supported the need for a strong central authority" (Talbot, 1998: 124). India was also able to manipulate Indus waters and threaten thereby to strangle Pakistani agriculture (Talbot, 1998: 124). There is thus a differential effect of shocks and differential perception of security threats in different circumstances, each of which is likely to have different effects on national decision-making with regard to resource mobilization efforts. India and Pakistan were comparable in some ways to start with, but Pakistan was a weaker state and felt a greater security threat. As a result, it appealed more to international sources for material assistance. The history of policy choices has an impact on future policy decisions made by leaders, and in the Pakistani case this meant that a reliance on outside resources became entrenched.

The same shock can have different consequences. Thus, the effect of the 1965 Indo-Pakistani war was more 'shocking' to Pakistan than India: it "confirmed Pakistan's vulnerability to Indian military pressure and the relative security of Indian territory in any isolated and limited conflict with the Muslim state" (Kavic, 1967: 214). There are at least two aspects of war costs- one is the cost of actually waging it, and the other is the consequences in the aftermath. The winners and losers of wars would obviously face somewhat different consequences of the conflict. But the exploration here is more to do with the consequences of dealing with the heightened pressures associated with a shock. It may be the case that losing states are more susceptible to the sense of emergency associated with genuine efforts to raise new resources.

It does not appear that a clear and substantive effort to build extractive capacity followed any of the wars, except for some indications after the 1962 war for India. In its aftermath, Nehru described war as a time where special and unusual mobilization of resources from both domestic society and international sources was possible. While some increased domestic extraction did take place, it appears that the primary sources of funding were international financing and a move away from fiscal conservatism to greater reliance on deficits. This culminated in 1969 with Indira Gandhi's nationalization of major Indian banks (a restructuring effort that would allow for more monetized deficits for the Indian central government).

Some efforts to increase extraction are also visible in the 1965 war in Pakistan. Other efforts to increase extractive capacity, such as India's in the mid-1970s, are not clearly tied to the need for war preparation. Efforts in both India and Pakistan in the 1990s are tied to structural adjustment programs and loan conditionality.

There are broad similarities between the Pakistani and Indian cases and the Egyptian experience. Societal opposition and administrative difficulties made the pursuit of increased direct taxation in both cases more difficult. A partial success story in increasing domestic extraction exists in the Indian case during the 1970s. Part of the problem with nationalizations is that they take away from a corporate sector that can be taxed. This was Barnett's observation about Egypt and is likely to be also true for

Bhutto's nationalizations in the 1970s in Pakistan. Part of Pakistan's success at following an international strategy was its ability (like Egypt) to sell its strategic value to outside patrons.

The kind of massive domestic extraction efforts seen early on in Israel are absent in the Indian and Pakistani cases. In their earliest conflict, the Israelis imposed 100 percent taxes. Tax evasion quickly became a problem, and social opposition also arose (Barnett, 1992). While there is some evidence of increased domestic extraction in wartime in India and Pakistan, a domestic extraction effort for war preparation on an Israeli scale has not been seen. Furthermore, this remains unlikely because of the well-established history of well-entrenched and violent political opposition to increased taxation in both countries, the ongoing relative weakness of the Indian and Pakistani states, and the historical success of each in obtaining international financing.

Implications for the political survival and political capacity models and conclusion

In general, this chapter supports the logic of the political survival model over the political capacity model. There appears to be a regular preference for international strategies by policymakers regardless of the state in question. Through the history of India and Pakistan, and also Egypt, we see occasional and abortive attempts at tax reform and domestic restructuring associated with the demands of acquiring resources for war making. Nationalizations and privatization are obviously a kind of extractive effort by the state and have implications for revenue and the ability of the state to mobilize resources. The major initiatives in nationalizations, however, are not clearly and obviously associated with the demands of war preparation.

Accommodational/ money creation and international strategies appear to have been followed at all times in both cases. There have been changes in emphasis, however. In the Indian case, a substantial new emphasis on obtaining international resources took place in the 1962 war with China. In the Pakistani case, a sense of foreign betrayal in the 1965 war did not lead to an abandonment of internationalist strategies. Instead, a more sophisticated internationalist effort was pursued.

The Pakistani and Indian experiences resemble those of Israel and Egypt in the ongoing dominance of international strategies for obtaining resources necessitated by the demands of war preparation. The Pakistani and Indian states resemble Egypt in their low political capacity and administrative weakness. Israel is the strongest state of the four in terms of extractive capacity, but has still faced important limits to increasing state resources through domestic extraction. Increased domestic extraction on an Israeli scale in wartime has not taken place in India and Pakistan.

This work has focused on public finance decisions with the assumption that these have implications for state power and political and economic development. The assumption has been that changes in the extractive capacity of the state are correlated to changes in state power. Another dimension of state power is the relative autonomy of the state from domestic and international actors. That dimension has not been explored explicitly in this work. Nevertheless, the case material presented here offers relevant insights. For example, Ayub Khan's pursuit of an adjusted international strategy was justified by his assertion that over-reliance on few sources of international patronage had constrained Pakistani options in the 1965 war. Concerns about being overly tied to foreign interests in decision-making thus led to an adjusted revenue-raising strategy.

The classic warmaking-statemaking logic, based on the development of European states, has suggested that wars produce efforts to consolidate and strengthen the state domestically. Tax reform and efforts to locate new resources through taxation are an important piece of such state-building efforts. The finding here, however, is that this has not been the case in India and Pakistan in terms of the influence of wars on tax effort. The possibilities for seignorage, borrowing, and different forms of foreign material support make it easier for states to avoid this logic. Tax reforms and developments in extractive capacity have taken place in both states. However, an immediate and direct linkage to wars is murky.[7]

This study gives support to the idea that international resources have been sought and used when revenue problems associated with wartime have happened. It also shows that policy makers (for example, Nehru and Jalan) and academics and other informed observers confirm the notion that raising taxes is the preferable means for meeting the revenue demands in terms of the long-term good of the state. However, political opposition and administrative obstacles mean that such efforts have frequently run into difficulties. As a result, policymakers have usual preferred international and covert/ accommodational policies. Although Israel, a strong state, has engaged in some domestic restructuring in the context of war-shocks, international strategies have dominated there also.

[7] A general literature on defence spending and consequences for economic growth exists (see, for example, Benoit, 1973; Tibbett and Akram-Lodhi, 1996). The work here is concerned not with economic growth generally, but rather with public finance patterns in the context of international shocks. The focus on this particular causal path means that the defence spending-growth literature is not directly relevant.

CHAPTER 6: Conclusion

This conclusion is organized as follows. First, I describe the major findings of the dissertation, and summarize the material presented in each chapter. Next, I discuss some limits of this study, and speculate on what may improve on this research. Third, I offer suggestions for future research. Finally, I discuss some implications of this research with a return to the big picture.

SUMMARY AND DISCUSSION OF FINDINGS

My dissertation shows that the political capacity hypothesis is rejected in favor of the political survival model. An interesting result, the ability of politically capable states to receive more international financing in the context of an international shock, deserves further exploration. Case study examinations show that the presence or absence of war is only one of a set of considerations that produce genuine "shocks". Furthermore, history and regional context is important. The results of this research carry implications for the political development of states in the modern world.

In Chapter 1, the theoretical framework was outlined in the context of relevant literature. Linkages between the public finance activities of states and their political-economic development were elaborated. Domestic extraction was assumed to be a better strategy than money creation and international financing in terms of its long-term consequences for the development of the state and society. This is because increasing domestic extraction is normally associated with the development of the state apparatus. Two perspectives- political survival and political capacity- offered competing predictions for the public finance strategies of developing countries in the context of international shocks. The political survival prediction was that in the context of an international shock, all states would show increased levels of international financing and money creation, and that no state would show increased domestic extraction. The political capacity prediction was that in the context of an international shock, high capacity states would increase domestic extraction, maintain levels of international financing, and show minimal increases in money creation, while low capacity states would maintain domestic extraction and increase international financing and money creation. Secondary hypotheses included various predictions about the effects of regime type, central bank independence, and discount rates of regime leaders.

In Chapter 2, pooled time-series regression models were used to test hypotheses developed in Chapter 1 for the case of war shocks. Separate models were written for money creation, international financing, and domestic extraction. The findings support the logic of the political survival model. Wartime has no effect on domestic extraction. Evidence of money creation is found in all states in wartime. A surprising, interesting, and strong result is that more politically capable states obtain higher levels of international financing in wartime- the opposite of the political capacity prediction, which was that weaker states would obtain more international financing. The political capacity of the state matters in wartime, but in the opposite direction from that predicted by the political capacity hypothesis.

With respect to other hypotheses, the discount rate had no effect on international financing or money creation, but had a negative effect on domestic extraction. This implied that insecure leaders prefer to be cautious politically and generally extract less from their societies than more secure leaders. Autocracies obtain more international financing and more domestic extraction than democracies. High central bank independence was associated with low evidence of inflationary money creation.

In Chapter 3, a similar methodology to Chapter 2 was employed to test hypotheses developed in Chapter 1 for the case of international economic shocks. As before, separate models were written for money creation, international financing, and domestic extraction. As in the case for war shocks, more politically capable states obtain higher levels of international financing in the context of an international economic shock. Political capacity does not influence the level of domestic extraction or money creation in the context of an international shock. The rejection of political capacity predictions, however, does not mean that the political survival predictions are more accurate. Contrary to political survival predictions, international economic shocks are associated with slight decreases in money creation and international financing, as well as an increased level of domestic extraction. The substantive finding of higher political capacity leading to more international financing in wartime supports the spirit of the political survival hypothesis, in which political leaders seek to avoid politically costly domestic extraction. The impact of war and international economic shocks was also compared in Chapter 3. Statistical problems made strong conclusions here difficult, but some differences in magnitude of impact were found.

In Chapters 4 and 5, narratives of the Pakistani and Indian historical experiences were explored. The aim of these case explorations was to get away from the quantitative work of the earlier two chapters and obtain the sense of context, history, nuance, and detail that is offered by a more in-depth focus on fewer cases. Barnett's (1992) analysis of Israeli and Egyptian war preparation strategies was compared to the Pakistani and Indian cases. The case material also offered insights into pieces of the theoretical framework that were left out of the statistical tests. For example, violent protests influenced the ability of the newborn Pakistani state to obtain domestic resources through increased taxation. International support often relieved the pressure on governments to raise resources by providing valued services not found in national income accounts, such as expert aid in manufacturing defense ordnances.

The major result here was that a clear preference for international strategies was found across the cases. There was recognition among policy-makers and observers alike that alternative strategies for obtaining needed material resources existed, and that choices made reflected and entailed consequences for the political strength and development of the country in question. Popular dissent and frequent strikes and political violence confirmed assumptions about the political opposition aroused by attempted taxation increases.

History mattered. A pattern of reliance on outside material support for security policy was established very early on in Pakistan. Following Partition, the different starting points for India and Pakistan's respective state apparatuses meant that different strategic options were available to each. The influence of history could be in the form of historical continuity or in the form of a recognition that the policy used historically was not working. Pakistan's heavy emphasis on international strategies from its birth was simply refined and continued in the 1965 crisis. Barnett's reflection on the Egyptian experience, in which early external borrowing "gave both government and society a taste for exporting- that is, delaying- the costs of war" (Barnett, 1992: 147), is also true for the

Pakistani case. In contrast, India's defeat at the hands of China in 1962 awakened India from a historical complacency. The 1965 war with Pakistan did not violate historical security assumptions in India. Understanding historical behavior is important in both grasping policy continuity and departures from previous policy.

The regional context also mattered. Attempted tax reforms in both Pakistan and India in the late 1980s followed a regional trend. The rise of conditionality in international lending was closely associated with attempted tax reforms in both cases. The international financial community was therefore a potent force.

The nature and impact of different shocks varied greatly. Different wars had different consequences from each other and across the contestants. International economic shocks as modeled in the previous chapters increased the stress on public finance resources in both India and Pakistan, but this impact was dulled by such factors as rebates on oil purchases and the rise of new export markets.

State managers in each country consistently sought to use international sources of funding when new spending needs associated with international shocks arose. While some periods of domestic restructuring did occur, these were not clearly driven by international shocks. Despite alternative policy prescriptions from academics and observers, state managers usually opted for the easiest and politically least costly method of raising revenue. The case studies suggest that the political ease of implementing money creation policies means that they are frequently implemented, and the evidence from the quantitative chapters supports this conclusion. International financing and money creation are therefore generally favored over domestic extraction.

Why do higher capacity states receive more international financing in wartime?

The finding that higher capacity states have an easier time obtaining higher levels of international financing has some empirical support in the work done on the federal funding received by individual states in the United States. Ponder (1997) finds that states with higher political extraction receive more federal funding, and suggests that their in-state effectiveness also translates into the ability to better capture federal funds. Ponder suggests that it is because these states "incur lower transactions costs in both attracting and absorbing federal funds" (Ponder, 1997: 186-7). More capable states have an easier time making effective appeals for federal funding. If this logic is transferable to the international realm and different countries seeking international sources of funding, then it may be the case that those states with higher domestic extraction are also better at obtaining resources from the international realm simply because they are better obtainers of resources in general.

Another possible conclusion here is that although the political capacity expectations are not fulfilled in the no-lag tests done here, in the eyes of international financiers, they will eventually be fulfilled. In other words, international financiers have a substantial amount of faith in the creditworthiness of higher capacity states, presumably based on their long-term ability to come up with the needed revenues to repay loans. Thus, the findings here might be capturing only the most immediate effect of political capacity, which is reflected in the perceptions of international creditors. These creditors are willing to make more funds available to higher political capacity states because they feel more secure about being paid back.

Adji, et. al, (1997) provide support for my guess that politically stronger states are more attractive to outside financiers. "Because a country with high political capacity is expected to have more stable economic policies than a country with low political capacity, foreign investors are expected to invest more in the country with high political capacity" (Adji, et. al, 1997: 130). Thus, countries with high political capacity provide an attractive environment for international finance generally.

Linking shocks, creditworthiness, and international financing

In general, high political capacity is associated with a high credit rating for a country as a whole (Snider, 1996: 137). Snider (1996: 98) found that there was no relationship between a country's credit rating[1] and international economic shocks, even though external economic shocks increase lending risk (Snider, 1996: 137). Snider suggests that this is because governments are not held accountable for events beyond their control. Thus, a shock should not affect the ability of a country to obtain international financing. Based on the results of Chapter 3, this proposition should be modified. Shocks themselves may not affect the ability of a country to obtain international financing. However, politically capable countries that normally do not obtain high levels of international financing obtain extraordinarily high levels in the context of an international shock. Politically capable countries have better access to international financing in fiscally stressed times, including both war and international economic shocks. Although the country credit rating is not itself affected by international

[1] This country credit rating is taken from a survey of bankers conducted by *Institutional Investor* (Snider, 1996: 16-17).

economic shocks, the high credit rating associated with high political capacity does affect the international financing obtained in times of heightened fiscal requirements.

STRENGTHS AND LIMITS OF THIS STUDY

Doing research in both quantitative and qualitative methods shows the weaknesses and strengths of each. There is a breadth vs. depth tradeoff- the higher number of cases in the quantitative chapters precludes closer examination of each case, whereas the focus on 2 countries in Chapters 4 and 5 allows for more depth and consideration of other factors. Focusing on fewer cases also allows for a greater sense of the context of each case, and an appreciation for a host of significant factors. It is difficult to do both qualitative and quantitative research well at the same time. This is because different hats and skills are required for each.

The country focus chapters also allow for some more theory and hypothesis generation. A more nuanced version of the dependent variable can also be obtained. For example, Pakistan did adjust its revenue raising strategy in response to an international shock, but rather than switching to an entirely different strategy, the Pakistani leadership sought to diversify its sources of international patronage. Thus, different tactics are possible within the international financing category. Such a shift would not have been captured in the quantitative tests because the reliance on international financing is retained.

Issues related to the quantitative investigations

One concern is that the tax/GDP measure may be affected by changes in GDP. In other words, an international shock might change the domestic product of a country and thereby increase this fraction, making it appear that extraction has increased. While this possibility exists, the use of this measure is nevertheless valid. The reasoning for this is two-fold. First, the measure is well established in the literature on extraction. Frequent comparisons of a country's tax effort with respect to its own history or the behavior of other countries rely on this measure. Second, taxation is usually based on rates rather than fixed amounts. This means that a fixed proportion of the national product will be appropriated as taxes. This proportion remains the same regardless of the amount of income. A lower GDP would simply mean lower tax revenues, but the value of tax revenues / GDP will remain the same. Increases in this proportion are therefore likely to indicate genuine tax efforts by the government.

Inflation as a measure of seignorage is problematic. One reason for this is that inflation has a variety of causes, of which money creation is one. Seignorage is typically covert and is therefore difficult to detect by a simple measure. An alternative possible measure of seignorage is suggested by Cukierman, et. al. (1990). This measure compares the money stock to the rate of money growth. This measure is not universally endorsed in empirical research on seignorage (Alcazar, 1997). Sometimes seignorage activities are covert, and it is also difficult to distinguish genuine domestic borrowing from short-term, money-creating borrowings from central banks. The most observed consequence of all these activities, however, is inflation, and that makes it a plausible indicator of seignorage activities. Nevertheless, use of the Cukierman, et. al., measure would be a useful check on the results for money creation found in Chapters 2 and 3.

More dimensions of political capacity could have been captured in the effort to determine a country's strength at the time of the shock. This would have offered a fuller picture of the political capacity of a country, which can include reference to policy explicitness and institutional credibility (Snider, 1996) or Relative Political Reach (Kugler and Arbetman, 1997). Both the Snider and Kugler and Arbetman versions of political capacity use relative political extraction (RPE) as a fundamental dimension. RPE is common to both these versions of political capacity, as well as other versions (for example, Organski, et. al., 1984). Relative political extraction was therefore used in most of the tests conducted here, except for some tests using the policy explicitness dimension.

More specific indicators of the form of international financing might have given weight to the speculation that international creditors perceive stronger states as better credit risks, and therefore those states receive more international financing in stressed times. A mapping of the field of sources of international financing would have been a helpful starting point here.

More sophisticated indicators could have been used. For shocks for example, it would have been useful to try to have some sense of the magnitude of impact it was having. This was the case with oil price shocks, which were adjusted according the fuel-dependency of the country in question. Different possibilities for the shock indicators exist. One possibility would be to have a threshold, below which a change in international prices is considered too minor to be "shocking". Another possibility is to model shocks as the extent to which present prices deviate from the past. Distinguishing normal, everyday changes from abnormal disruptions is tricky because it involves more than simply magnitude- it requires some idea of the expectations of actors. Significant deviations from expectations are likely to be the genuine shocks. In the absence of a clear model of such expectations, the oil shock measure with a precedent in the literature was the most straightforward choice.

High collinearity in several of my statistical tests is a concern. Collinearity makes it difficult to identify which of a set of independent variables is responsible for explaining the behavior of the dependent variable. Perfect collinearity between two variables makes it impossible to distinguish their effects. For each model, the collinearity condition index statistic was noted and discussed. Values above a given threshold suggest problematic collinearity (see the discussion in Chapter 2). In general, the strongest results were not affected by collinearity problems. Furthermore, coefficients in the high collinearity models were generally consistent with those of the low collinearity models. The absence of major switches in sign (for example, in tests using alternative measures of central bank independence) adds credibility to the results overall.

Some strengths and limits of the case study

Predictably, the cases section has added nuance at the expense of generality. For example, not all wars are equal. The same war can be variably "shocking" depending on the actor involved. The simple notion of war-year vs. non-war year used in Chapter 2 does not cover the variety of possible impacts different wars can have.

One clear lesson from the case material is that one-direction causal explanations are incomplete. Cases show the interrelationship and endogeneity of choices made by all actors, and expose the problem of fitting a somewhat artificial theoretical framework of one-way causality on observed social behaviors. For example, the availability of aid structures domestic policy choices. Those policy choices in turn affect the likelihood that aid will be sought. A causal circle is therefore a more accurate representation of the relationship between domestic policy choices and received international aid. Even the shocks are not purely exogenous. For example, early expenditures on war preparation might produce domestic coalitions with interests in perpetuating warlike behaviors, thus increasing the likelihood of further "shocks".

The case study was limited by the reliance on secondary sources alone. This reliance has meant that some specifics are not further investigated where they could have been. For example, is the retreat of the state due to the onerous demands of war preparation, or in line with the prevailing trends in the neighboring political economy? Separating such factors out might be more fruitful in the context of extensive interview work with policymakers. The political survival and political capacity perspectives both contain assumptions about the nature of strategic thinking on the part of policy-makers. While the case study material offers some support for assumptions about such strategic thinking, interviews with policy makers would have been helpful as the most direct corroboration for these assumptions.

State strength can be coded on a variety of dimensions (see theory section, for elaboration on different perspectives on state strength). While the work here focused on the extractive activity of the state, other dimensions of state strength could have also been explored. One example is relative political reach, or the extent to which social and economic life is effectively regulated through legal channels imposed by the state. A black economy suggests a realm of activity in society that is outside the purview of the state, and not subject to the formal institutions associated with the state. Therefore, a large black economy means that the state is not very effective in regulating the economic life of the society. The size of the black economy in India and Pakistan, for example, is huge. Another state might have comparable extractive capacity but be far stronger that India and Pakistan in the sense of having a smaller black economy. Kugler and Arbetman's (1997) Relative Political Reach measure tries to capture the size of the black economy as a dimension of the political capacity of the state. Extensions of the research presented here could use that dimension in the quantitative tests of Chapters 2 and 3.

Another dimension is the extent to which the state is autonomous from domestic political actors in its policy choices. In Pakistan, the state has often been thought of as being captured by "feudals". Popular and academic accounts persistently point to the disproportionate political power wielded by large landholding families. This suggests that the Pakistani state was not very autonomous from domestic political actors. Israel, in contrast, is often described as having high autonomy from domestic political actors.

Several of the variables included in the quantitative models were ignored or not explicitly addressed in the case study chapter. For example, the role of central bank independence was not analyzed either in the Indian and Pakistani cases. The information available suggests low central bank independence in each for most of their history. Additionally, there was little explicit reference to the role of regime type. Nevertheless, an observation is possible. Indira Gandhi's dictatorial rule in a brief state of emergency is associated with higher tax revenues and some increase in the extractive capacity of the Indian state. Musharraf and Ayub (both military rulers in Pakistan) have appeared to choose moves to restructure domestic extraction. However, important developments in domestic restructuring- such as the Pakistani nationalizations of the 1970s and the Indian tax reforms in the early 1990s- took place under democratic regimes. A clear and absolute rule connecting regime type to specific public finance policies, therefore, is not supported by the case studies.

Case selection in the quantitative and case study chapters

The set of cases in the sample for the quantitative chapters did not contain extremely weak states. The possibility of selection bias and the extent of variation across the states in terms of their political capacity is therefore a credible concern. One problem is that data on very weak cases is difficult to find. Data availability was a governing factor in case selection for the quantitative tests.

Also, the terribly weak states also usually happen to be extremely underdeveloped and therefore should be left out of the sample anyway. This is based on Organski, et. al.'s. (1984), premise that at extremely low and high levels of development the marginal costs of domestic extraction are very high. In extremely underdeveloped states, the political capacity and political survival hypotheses offer identical predictions. The universe of cases to which this research is relevant is that of states that are not in the extremely underdeveloped or highly developed categories, but rather in the broad middle. It is over this set that the political capacity perspective predicts different policy behaviors in the context of an international shock.

With regard to case selection in the case studies, it might have been helpful to focus on two countries that differed substantially in their level of political capacity. This would have helped in evaluating the political capacity hypothesis. Some reference was made to existing work on Israel, a strong state, and this provided some idea of the behavior of a high capacity state. Focusing on two low-capacity states meant that both political survival and political capacity perspectives had similar predictions of behavior. The two perspectives shared some assumptions. These include the intersubstitutability of public finance strategies, and the appeal of international financing and money creation to weak states. These assumptions needed some substantiation given the quantitative methods of Chapters 2 and 3. The shared colonial experience and geographical proximity made India and Pakistan a set of cases with important similarities. Important differences in terms of early policy choices and starting endowments nevertheless existed. This meant that there was interesting room for comparison between the cases in terms of their reactions to shocks. Across the cases, a preference for international strategies was noted, and this suggests support for the political survival prediction.

In general, more data on more cases would have been helpful. This would have allowed for the study of lags in particular. One finding from the case study chapter is that the associated state-building that comes as a consequence of war is more likely to happen after the war. During the war, immediate resources are garnered wherever possible, and stronger states are better able to do this internationally. In the aftermath of the war, security preparation of states is reconsidered and this is when substantive changes in state capacity may happen. The 1962 Sino-Indian war led to appreciable changes in Indian defence planning. However, these happened in the several years that followed the conflict. A substantial lag is therefore possible. A systematic investigation of such lags would have been more practicable with more years of data in the quantitative chapters.

The paucity of cases is also a threat to the external validity of the findings. The fact that the set of cases examined in the quantitative chapters is primarily in the cold war period means that an important environmental determinant of international financing might have conditioned the propensity and ability of states to obtain international financing generally. Ideally, the rival predictions should be tested on a number of years outside of a Cold War context also. Data availability on all the variables in the models governed the selection of years in the tests presented in this dissertation.

SUGGESTIONS FOR FUTURE RELATED RESEARCH

Other strategies for public finance: Domestic borrowing

The routes of public finance examined here- international financing, domestic taxation, and money creation- are not an exhaustive listing of all possible ways a government can obtain funds. Domestic borrowing through the issue of government bonds is one possibility that has not been examined explicitly. A more complete picture of public finance behavior would include a separate category for domestic borrowing. Nevertheless, the lack of an explicit focus on domestic borrowing is not fatal to the present study for several reasons.

First, the money creation route includes not only seignorage through printing currency but also additions to the money stock that come about from central government borrowing from the central bank. Obtaining short-term credits from the central bank is a specific, widely-used type of domestic borrowing that fits closely with the description of money creation, with similar inflationary consequences (Easterly and Schmidt-Hebbel, 1993: 213 (cited in Zaidi, 1999: 239)). In national income accounts it can sometimes be difficult to distinguish genuine market borrowing from money creation activities. Thus, a portion of domestic borrowing is captured by the broad money creation category.

Second, there are problems associated with domestic borrowing. Khan asserts that in Pakistan, "high interest payments on domestic debt resulted in partly 'crowding out' private investment" (Khan, 1997: 208), because the returns on private investment could not compete with high rates of return offered on government bonds. The potential damage to domestic investment would be a consideration weighing policy-makers' decisions with regard to domestic borrowing.

Additional links between shocks and development

Questions of how well countries are able to adjust to shocks are prominent in the literature on international political economy. Adjustment usually means more than the immediate public finance concerns associated with shocks. There are other important qualitative dimensions also. Snider (1996: 172) suggests that shocks may be associated with switches between export-oriented and import-substituting development strategies. Moreover, the domestic economic impact of international economic shocks is conditioned by the political capacity of the country in question (Snider, 1996: 174, 179). This may be because the impact of shocks varies according to the way the economy is managed (Snider, 1996: 220).

Shocks, domestic dissent, and regime-dissident relations

External shocks have the potential to affect regime-dissident relations in a number of ways. In her discussion of the dramatic Iranian social revolution, Skocpol argues that it, "like others, occurred through a conjuncture of state weakness and popular revolts rooted in relatively autonomous communities"(Skocpol, 1994: 17). Significantly, shifts in international oil markets in the 70's contributed to the political crisis of the Shah's regime. An external factor distant from domestic politics (the international oil market) was part of the story. The Sandinista takeover in Nicaragua was fueled in part by popular discontent following an earthquake. Thus, shocks can alter the resource balance and create mobilization possibilities for dissidents.

By the following logic, shocks have the potential to change regime treatment of dissidents. Assume that regimes engage in ongoing policy choice about relations with dissidents. Policy choice is a function of resources and strategies. Policy is predicated on resources, and policy options are contained in a choice set bounded by resource availability. Regimes need reliable supplies of resources of coercion. Resource changes are likely to mean policy changes. Let us assume that regimes normally have enough resources so that there is substantial variation in policy decisions within a given normal amount of resources. At certain times, resources become the critical determining factor in policy choice. In brief, accommodation-repression decisions have specific costs. It is frequently asserted that repression costs more than accommodation. At least severe domestic repressions depend on the availability of certain types of resources. Resources are a *necessary* but not *sufficient* condition for repression. A major change in the availability of resources is likely to affect the ability to pay for specific policies. This is likely to result in policy change or substantial renewed support for existing policy.

If the regime is able to match a significant gain in dissident resources by coming up with new resources of its own, it is unlikely to be forced into concessions, for example. Systemic threats can force regimes to make concessions- likewise, the regime can hunt for support elsewhere in the system in the context of those systemic threats. By systemic threats I mean sharp reductions in the available resources originating in the international political economy. There are examples of regimes collapsing when their major source of revenue disappeared. A related example could be IMF austerity programs and the associated political liberalizations and crackdowns. We cannot understand regime responses to Eastern European dissident mobilizations in 1989 without reference to the international context of retreating Soviet hegemony.

Of relevance here is dilemma of the fiscal crisis of the state, or the related dilemma of "rising demands, insufficient resources" developed by Robert Gilpin from the work of Sprout and Sprout. Gilpin suggested that the international hegemonic actor had to retrench its costly overseas commitments to avoid bankruptcy. I make an analogy from this to the domestic arena. A regime facing a resource crisis is going to retrench domestically by reducing the costs of domestic control, whether this takes place through the elimination of dissidents in an effort to be rid of the opposition once and for all, or through liberalization in an effort to absorb demands cheaply.

In the big picture, the theory here predicts that IPE changes, when they have a major impact on the resources of coercion available to regimes, or affect the demands on regime resources, will result in major changes in the way the regime relates to dissidents. Certain regimes are likely to be more vulnerable to forces originating in the international environment. Such regimes' policy towards dissidents is likely to change in response to IPE changes. The causal paths underlying this relationship are several.

First, the clearest case is when an external shock results in a drastic fall in the resources available to regimes. An example is the case where the regime is heavily dependent on a foreign patron, and that patron cuts resource supplies. By the sheer physical constraint of a loss of capability, the regime is unable to continue to engage in costly repression. Thus, it is forced to discontinue repression, or liberalize and accommodate dissidents to avoid the danger of revolutionary overthrow.

Second, the loss of resources originating in the international political economy means that in order to continue policy commitments, regimes are forced to increase their extraction of resources domestically. But increasing demands on constituents typically means a renegotiation of the institutional bargain on which regime rule is predicated. The principle underlying this is the idea of "no taxation without representation". In one possible path, the regime trades some institutional autonomy for increased domestic resources. This is also a feature of the warmaking-statemaking arguments in which a bargaining process is linked to a major change in the state's extraction capabilities.

Third, dissidents may gain resources and support from a new and powerful external patron. This raises the cost of repressing these dissidents substantially, and makes the regime more likely to liberalize.

The converse of these cases also applies. A secure rise in the resources available to regimes is likely to make the regime more willing to engage in repressive policies. A loss of patronage for dissidents is likely to make the regime more willing to repress those dissidents.

Differential impact of international price changes across domestic socio-economic groups

Ronald Rogowski's now famous argument connected the Hecksher-Olin proposition to relative support for trade liberalism or protectionism by different socioeconomic groups (Rogowski, 1989). In brief, the argument was that the relatively scarce factor of production domestically stood to lose from foreign competition and therefore would support protectionism. The relatively abundant factor stood to gain from foreign demand, and therefore supported trade openness. Changes in international prices would affect the advantages and disadvantages of specific policy positions accruing to different groups, and therefore may change political alliances favoring protectionism or trade openness. This is another possible modeling direction in which to describe the reaction of domestic political actors to international price changes.

When combined with the research on international shocks here, the behavior of domestic political coalitions could introduce a more sophisticated picture of the set of constraints and opportunities facing policy-makers as they seek to obtain resources. The rise of a strong protectionist coalition, for example, might reduce opportunities for international borrowing from outside states seeking an export market. Thus, a certain type of international economic shock could make an international financing strategy more difficult to pursue.

Income distribution as a neglected variable

The linkages between economic growth, income inequality, and political variables have been discussed in the literature. One example is the "Kuznets hypothesis", which states that over the course of economic development, income inequality is first low, then rises, and lowers again as the country becomes highly developed. Income inequality has been suggested as an important cause of both political instability and fiscal deficits (Roubini, 1991). Popular accounts also stress the role of concentration of wealth- the widespread blame heaped on the small Pakistani group of landholders for the country's development woes is one example. This is another reason to investigate the role of income distribution and it's contribution as both a cause and effect on a variety of political and economic variables related to development. I suggest that this is a variable that needs to be brought in to the study of paths of state-making in general.

IMPLICATIONS

Understanding the growth of state power in the modern world requires further theorizing. A route to state-building followed by some European countries does not seem to be followed by modern states. Although Tilly's work is based in the European experience, there is nothing intrinsically European either culturally or historically about the *logic* of the warmaking-statemaking argument. It seems natural to transport that to developing countries today. Yet it appears that this logic does not hold, which begs the question of what has changed in circumstances that interferes with this logic.[2] I suggest that it is something to do with the fact that international credit is now very well established and easy to access.

[2] Organski, et. al., (1984) assert that "the process of socioeconomic change today is *far* more independent of concurrent socioeconomic change than was true in the European experience at the same point in the trajectory of development" (1984: 58). Vietnam, China, and North Korea have managed to build political capacity independent of concurrent socioeconomic change (1984: 57). Thus, the ability to build capacity without social development might be uniquely modern and influence the relative willingness of state managers to extract additional resources domestically. A possibility is that lack of concurrent social

The finding that higher capacity states are better at obtaining international financing implies that a new understanding of state development is required. Wars and international economic crises are not making stronger states. Instead, states are becoming more dependent on international financing generally, and those states in the best position to become stronger are becoming the most dependent. One possibility here is that creditworthiness in international capital markets might lead to a perpetuation of borrower status for certain countries, rather than increased state-building. This gives rise to strong probability of a permanent ghetto of borrower states that becomes solidified over the course of revenue and spending shocks. An alternative possibility is that developing countries will fall into two camps. High political capacity states would receive more international loans, and be more affected by the conditionality terms designed to ensure repayment. Low political capacity states would receive generally less international loans, and may find proportionately more loan forgiveness because of their recognized inability to raise the needed resources for repayment domestically.

Highly capable states are better at obtaining international financing presumably because they can make a better case for repayment. This means that those states are likely to continue to slide deeper into debt and eventually face solvency problems. However, increased reliance on international loans and resultant solvency problems can mean increased conditionality in international lending, which might in turn drive domestic restructuring. Conditionality has some potential as a route to inducing some tax reform. In other words, the original linkage between war-making and state-making was based on the increased domestic extraction activities of the state. In modern circumstances, a more

development means that there is not a substantive change in the income distribution, and this increases the political opposition to new taxes.

indirect route might still link war-making to statemaking, as follows. States borrow money to cope with the heightened fiscal requirements associated with an international shock. Conditional lending, however, leads states to enact important domestic changes in extraction, and eventually become stronger states. However, this is a whole other area of study.

Snider states that in contrast to the 1930's when "external shocks generated heterodox policy experiments, persistent pressures from the international financial community in the 1980s pushed in the direction of a return to orthodox economic policy" (Snider, 1996: 13). In the Indian and Pakistani experiences, structural adjustment programs and responses to loan conditionality appeared to follow a regional trend, and came relatively close to each other in time. Tax reform efforts and other national macroeconomic policy adjustments in the two countries appear to be linked to a contextual factor in the regional or global environment. I speculate that this environmental factor may be the increase in conditionality stipulations in international lending.

The end of the Cold War, in particular, has coincided with the rise in conditionality in international lending. It is a reasonable suggestion that as the security stakes of maintaining aid relationships have become less clear for major powers, so has the willingness of the major Cold War powers to dispense aid. In this breach, the IMF and World Bank have gained ascendancy as overseers and mediators for international lending, frequently on conditional terms. An earlier force driving the increased role of these international institutions was the massive wealth redistribution associated with the oil shocks in the 1970s and the associated petrodollars that fed easy loans to capitalhungry developing countries. Over time, difficulties in repayment raised the specter of a challenge to the entire international financial system based on a chain of defaults. International institutions and conditional lending gained prominence in light of such impending crises. Since the quantitative tests in this dissertation use data from 1970 onwards, there is a strong likelihood that perceptions about the likelihood of repayment are important in the distribution of international funds. This adds further credibility to the suggestion that the creditworthiness of high political capacity states is driving the finding that high capacity states systematically obtain greater levels of international financing in the context of shocks than weak states.

CONCLUSION

At the outset of the dissertation, two competing hypotheses were described for where governments would raise the needed financial resources in the context of an international shock. The political capacity hypothesis predicted that stronger states would privilege domestic extraction over other strategies of public finance. The political survival hypothesis claimed that all states would prefer international financing and money creation as public finance strategies. Based on the findings of this research and the described developments in the international environment, a hybrid model incorporating aspects of both political capacity and political survival perspectives fits the findings best. The hybrid model includes both the political survival notion that international financing is the preferred strategy for politicians of all states (because it allows them to delay the risky business of increasing domestic extraction) and the political capacity notion that high political capacity states are better able to raise additional resources domestically (because this translates into more creditworthiness in the eyes of foreign lenders and hence makes international loans more forthcoming). However, conditionality in international lending has the potential to lead to improved domestic extraction by borrowers as they seek to maintain their international lines of credit. While the immediate consequence of international shocks is that higher capacity states obtain more international financing, the eventual consequence may be that higher capacity states improve domestic extraction.

The international financial community thus can have a potentially significant impact on the domestic policy choices of regimes. Conditionality in international lending and the need to maintain good international credit could spur increases in domestic extraction. This would be especially likely to be true in those stronger states that obtained more international loans based on their ability to extract more resources from domestic sources. This added domestic extraction might then be the base for increased extractive capacity, and through this roundabout way, development of state power may happen. This reasoning addresses the wider issue of the long-term ramifications of international resources for development. In general, the international political economy of development and wider linkages between international and domestic politics offer vast grounds for further research.

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Education

Ph. D. (2000):	Political Science, Indiana University, Bloomington. Dissertation Title: "International Shocks and Public Finance Strategies" Advisor: William R. Thompson Major Fields: International Relations, Public Policy, Development
M.A. (1999):	Economics, Indiana University, Bloomington Specialization: Applied Econometrics
B.A. Highest Honors (1993):	International Political Economy. Marlboro College, Marlboro, Vermont Senior Thesis: "Theories of Hegemonic Decline" Minor: Economics

Research Skills, Training, and Experience

Graduate coursework in Statistics:	Statistics (two-course sequence in Political Science) Time Series Advanced Statistics Workshop Business Econometrics (two-course sequence in Business Economics)
Software:	Extensive experience with programming in SAS Experience with Excel, SQL queries Familiarity with GAUSS, RATS, and SPSS
Languages:	Advanced Proficiency in Arabic Proficiency in Urdu Basic skills in French
Fieldwork:	Jordan, Sept. 1995- Aug. 1996. Experience conducting interviews, guided discussions, archival research (funded by Social Science Research Council).
Formal Experience 1996-1998:	Research Assistant Dr. Karen A. Rasler, Political Science, Indiana University. Project on dynamics of the *intifada* as a protest movement. Involved translation of Arabic news sources and coding/ organizing/ entering data.

Teaching Experience

Fall 2000	Assistant Professor, Political Science, DePauw University The US in the Post Cold War Era Introduction to Quantitative Reasoning
Spring 2000	Visiting Instructor, Political Science, Indiana State University Middle East in World Affairs (graduate/undergraduate class)
Fall 1999	Visiting Instructor, Political Science, Hanover College Research Methods Introduction to Politics
Fall 1998	Instructor, Student Academic Center, Indiana University Learning Strategies for Mathematics (linked to Finite Mathematics)

Summer 1995, 1999	Instructor, Political Science, Indiana University War and International Conflict
1993-1995	Associate Instructor, Political Science, Indiana University Assisted with Introduction to American Politics, American Constitutional Interpretation, Introduction to World Politics (three times)

Publications

"Understanding the Political Behavior of Islamists: the implications of socialization, modernization, and rationalist approaches" (*Studies in Contemporary Islam*, Spring 1999).

Conference Papers

"Political Capacity vs. Political Survival: Explaining Regime Extraction Strategies". Midwest Political Science Association Annual Convention, Chicago, April 1999.

"International Shocks, Political Capacity, and Regime Extraction". International Studies Association Annual Conference, Washington, D.C., February 1999.

"IPE Shocks and Regime Extraction Strategies: Does Political Capacity Matter?". International Studies Association-West, Annual Conference, Claremont, California, Oct. 1998.

"Understanding the Political Behavior of Islamists: the implications of socialization, modernization, and rationalist approaches". Indiana Academy of Social Sciences Annual Meeting, Indianapolis, Indiana, Oct. 1998.

"Rational Choice and Political Participation". Social Science Research Council Predissertation Fellows Conference, Park City, Utah, Oct. 1996.

"A Statistical Test of Gilpin's Model of Hegemonic Decline". North East International Studies Association, Providence, Rhode Island, Nov. 1992.

Other Papers

"Unpacking the Second Image". Workshop in Political Theory and Policy Analysis Mini-conference, Bloomington, Indiana, May 1995.

"Reconceptualizing the Realist Picture". Workshop in Political Theory and Policy Analysis Mini-conference, Bloomington, Indiana, Dec. 1994.

Awards and Honors

Advanced Foreign Graduate Student Travel Grant. American Political Science Association. (September, 1998).

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International Predissertation Fellowship. Co-sponsored by Social Science Research Council and American Council of Learned Societies (1995-96 academic year)