A THEORY OF LEADERSHIP AND STATE-BUILDING

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1. Toward an economic theory of state-building

When we live in a successful democratic society, we are surrounded by political, legal, economic, and social institutions, each of which may depend on many of the others. When some or all of these institutions are lacking, which ones must be established first to get from anarchy to prosperity? In state-building emergencies after the failure of a state, theoretical questions about the foundations of the state become practical concerns, both for strategic planners and critics of international stabilization missions. One may question the very possibility of a benevolent state-building intervention, but any hope for planning such interventions, or for holding their planners to account, requires us to have some understanding of what should come first in building a successful democratic society.

In this paper, I survey some basic models and ideas from economic theory that form the outline of a theory of foundations of the state which can address both theoretical questions of social philosophers from Socrates to Hurwicz (2008) and practical policy concerns of state-building and counterinsurgency missions today (as described in Galula, 1964, Dobbins et al., 2007, Ghani and Lockhart, 2008, and Myerson, 2009). The most relevant models here are coordination games and moral-hazard agency models. The central idea is that our fundamental political institutions are established by recognized leaders who are able to motivate a cadre of active supporters. To motivate his active cadre, the leader needs a reputation for reliably distributing patronage benefits to loyal supporters. In a democratic state, leaders also need a reputation for providing public services. To establish a state, political factions must develop networks of patronage and power that reach into every community. The political relationships between local leaders and national leaders are vital in this national consolidation of the state.

When I look for a basis for state-building doctrine in economic theory, I do not mean to suggest that state-building should be based on economic market-building. Failure of the state is a political emergency in which the highest priority must be rebuilding a stable political system, not reforming the markets. There are situations where our understanding of political behavior

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may be based on an analysis of the economic interests of different groups, of course. But such analysis of economic interests becomes less useful when the existence of the state itself is in question, because people's economic interests generally depend on their claims to property, and property rights cannot be considered secure when the state has failed. So our focus should be on building the state, and the interests that motivate people are likely to be more political than economic. But the state and its political factions are organizations that must solve problems of coordinating and motivating many individuals. We should apply economic analysis of incentives to understand the nature of these problems and their practical solutions.

This paper discusses several classes of economic models and ideas that can help us to understand the process of making an effective democratic state. We start with models of coordination games, which help us to see how a general recognition of leaders' authority can become a self-fulfilling prophecy. From the perspective of these models, arbitrary cultural and historical factors can determine who actually gets to be such an acknowledged leader.

But the realities of competition for leadership in any society imply that leaders need more than just recognition, they also need active support, and this consideration takes us to the second class of models: models of moral hazard in political organizations. The leaders of any political faction must solve some basic moral-hazard problems, to motivate the active supporters and agents who are needed to win power and to wield it. These factional moral-hazard problems can be solved by a reputational equilibrium between the leaders and their key supporters. More broadly, a state must also create a credible system for allocating moral-hazard rents to agents who provide loyal service to the state. The solution to this central moral-hazard problem of the state, we will argue, must begin with the reputations of individual political leaders and develop into constitutional norms of the state. From this perspective, political leaders' reputations may be seen as the primary social capital on which a state is built.

The vital agency relationship between national political leaders and the senior officials of government at local and provincial levels deserves particular attention here. The power of mayors and governors in their districts gives them large moral-hazard rents which national leaders may be tempted to centralize, but at a cost of weakening the effectiveness of the state outside the capital. We will argue that support from foreign state-builders can shift this trade-off toward a more centralized state unless national leaders are constrained by a federal constitution to share power with autonomous subnational governments.

Finally, we turn to democratic state-building. We understand leaders' reputations as the vital social capital for state-building, and a democratic state needs political leaders with good democratic reputations. Federal decentralization creates many more opportunities for politicians to begin developing democratic reputations for using public funds responsibly in the public interest, not merely to reward loyal supporters. Thus, we will argue, decentralized democracy can improve the chances for successful democratic state-building.

2. Coordination and focal leadership

In Myerson (2004; see also 2010), I suggested that a model of legitimate authority could be based simply on game-theoretic models of coordination and Schelling's (1960) focal-point effect. The basic idea goes back at least to Hume (1748) who argued that the foundations of political power generally depend, not on any prior consent of the population, but merely on a common recognition by the population. That is, the establishment of a sovereign government may be effected by a generally shared perception or belief of the population, which does not necessarily require any broad popular approval.

From a modern game-theoretic perspective, Schelling's (1960) focal-point effect explains how such shared perceptions can be socially decisive. Schelling argued that, in games that have multiple Nash equilibria, any cultural or environmental factor that focuses people's attention on one equilibrium can make it rational for everyone to act according to this equilibrium, as any single individual would suffer from deviating unilaterally. So by the focal-point effect, the effectiveness of one equilibrium instead of another is determined by a commonly shared understanding or belief. As Hardin (1989) has observed, severe costs of anarchy can make the process of constituting a state into a game with multiple equilibria.

The model in Myerson (2004) imagined a society where people are randomly matched each day to play simple coordination games (like "battle of the sexes" or "chicken") that have multiple equilibria, such as the following game among two potential claimants to a valuable asset which has value V, with conflict cost c, where the parameters V and c are strictly positive:

	Player 2 claims	Player 2 defers
Player 1 claims	-c, -c	V, 0
Player 1 defers	0, V	0, 0

Payoffs (u_1, u_2)

An individual in this society has focal arbitration power if, before any of these games, his suggestion that the players should act according to any specific equilibrium would make each player expect everyone else to act according to it, and so (by the definition of Nash equilibrium) each player would find it optimal to also act according to the suggested equilibrium. That is, a focal arbitrator is one who can select the focal equilibrium that others in the society will play. The focal arbitrator's power depends only on its being generally acknowledged by everyone in the society. No other means of enforcement is needed.

Consider also a longer dynamic game in which the same two players repeat the above game until some player defers. This dynamic game has a symmetric equilibrium in which each player independently randomizes between claiming with probability $V/(V+c)$ and deferring with probability $c/(V+c)$ in each round, so that the players' expected costs of conflict exhaust their potential value of an getting uncontested claim on the asset. A focal arbitrator can prevent such an exhaustive war of attrition by designating instead a nonsymmetric equilibrium in which one player should claim and the other should defer. But claiming here can be interpreted as an action which involves some potential use of violent force against a rival claimant. So when the focal arbitrator specifies that player 1 should claim and player 2 should defer, we may say that the focal arbitrator has assigned the legitimate use of force in this situation to player 1. That is, focal arbitration power can intrinsically involve an ability to assign rights of legitimate use of force to individuals in various social situations. This observation is significant because some theories of the state begin with a definition of the state as having a monopoly on the legitimate use of force. So our model shows how such power over the legitimate use of force can be derived simply from focal arbitration power, even for a leader who has no ability to apply force himself.

Now consider also an extension of such a social coordination model in which there are many societies occupying different areas of the world, but individuals are generally matched to play coordination games with others in their own society. If payoffs are in resources that increase people's reproductive fitness, and societies where people get more such resources can expand and crowd out other societies where people do worse in these coordination games, then Darwinian competition among societies should yield a world where all successful societies have concepts of justice and systems of focal arbitration that enable their members to identify efficient focal equilibria in most of the games that they commonly play. (See Myerson 2004 and 2010.)

Focal arbitrators are leaders in their respective societies. Thus, coordination-game models provide one view of what social leadership means, how leaders' influence is maintained, and why generally acknowledged leadership structures must exist in all societies. But these models also allow arbitrary cultural and historical factors to determine who can be legitimately acknowledged as a leader, because a leader's focal arbitration authority is self-enforcing when everyone expects everyone else to acknowledge it. Indeed, many societies have had generally acknowledged national leaders who seemed personally undistinguished by any factor except their birth into a family which was regarded as royal. So this theory gives us a weak general theory of leadership that says little about what kind of people can be leaders.

We can say more when we recognize the regular reality of competition for leadership. Even within the simple coordination-game model, we can see why a position of social leadership is a valuable asset, because many individuals would be willing to pay bribes to induce the leader to designate a better focal equilibrium for them. Furthermore, social criteria for recognizing legitimate leaders regularly admit more than one eligible candidate for leadership. Even in nations with strongly established traditions of hereditary monarchy, one can find frequent historical examples where a monarch was displaced by another member of the royal family. The nature of this competition has general implications about what kinds of individuals are fit or unfit for leadership in any society.

3. Models of moral-hazard and leadership in competition for power

The foundations of the state must be built anew in every generation by the leaders who win power in the state. In Myerson (2008), I suggested some general assumptions about the competition for leadership in any society. First, we may generally assume that, although a general recognition of leadership status may allow a leader to hold uncontested focal coordination power in a society over extended intervals of time, there will be some points in time when an acknowledged challenger can try to take the position of leadership, and then the incumbent will have to defend his status. The outcome of such a contest for power will be to install one of the rival candidates as the generally acknowledged social leader, and so the contest's outcome may be naturally influenced by the number of people who actively support each rival in the contest. In different societies, such contests for leadership might involve very different elements, from voting to street-fighting. But we may generally assume that, in any

society, a successful candidate for leadership must mobilize supporters to take costly actions that demonstrate their support for him.

These general assumptions imply that, to compete for power in any society, a leader needs the active voluntary support of many individuals, and these supporters must be motivated by some expectation of future reward in the event of their success. But when rivals have been defeated, a leader may be able to enjoy the fruits of power without such broad support, and so an established leader may be tempted to ignore the claims of past supporters. Thus, a successful leader must somehow credibly commit himself to reward those who supported him in the past. This is the central moral-hazard problem of political leadership.

In negotiation-proof equilibria of a simple model of sequential contests for political power, I showed (Myerson, 2008) that a contender for power would be unable to credibly recruit any supporters without organizing such a court where his supporters could depose him if he lost their trust. In this model, any would-be leader must recruit a band of captains to support him at the beginning of his career and then must challenge the current incumbent leader to a contest or battle. The probability of winning with n supporters against a rival with m supporters is computed in this simple model by the standard contest function

$$p(n|m) = n^s/(n^s+m^s)$$

for some given parameter $s \geq 1$. If successful, the leader will get revenue R at least until the next legitimate challenger arrives. Challenges are assumed to arrive as a Poisson process with rate λ, and the time rate of discount is δ. The act of supporting a candidate has cost c, which a supporter should be willing to pay only if he expects a reward worth $c/p(n|m)$ from the leader after they win. Before a contest for power, when it is expected that any rival will have m supporters, a leader with n supporters (each promised such a reward) would have expected payoff

$$w(n|m) = [p(n|m)R - nc(\delta+\lambda)] / [\delta+\lambda-\lambda p(n|m)].$$

A competitive environment in which every rival has m supporters is a negotiation-proof equilibrium if the expected payoff $w(n|m)$ is maximized by choosing n to equal m. After winning in such an equilibrium, however, a leader with n supporters would get ex post expected payoff $w(n|m)/p(n|m)$, but then he could instead get expect payoff $R/(\delta+\lambda)$ if he repudiated his promises to all his supporters and took all the revenue R for himself until the next external challenger arrives. Thus, if his disappointed supporters could not cause him to be overthrown then the leader could not credibly recruit n supporters unless

$$w(n|m)/p(n|m) \geq R/(\delta+\lambda).$$

The main result of Myerson (2008) is that this inequality cannot be satisfied by any positive n when m is a negotiation-proof equilibrium.

Thus, this model shows how competition for power can naturally create an environment in which a leader cannot recruit any active supporters unless he can credibly show that there is some mechanism by which he would risk losing power if he were to deny his promises to them after winning. Although the model begins with a conquest story about origins of the state, with power won by victory in battle, the analysis nonetheless identifies an essential role for a kind of collective agreement in the establishment of a viable state. Here, however, the fundamental social contract is not between a leader and the general population, but is between a leader and the active supporters who help him to defeat his rivals for power.

Analysis of this model (Myerson, 2008) can also show that egalitarian factions would regularly be smaller and weaker than factions that have one leader who is the residual claimant to the profits of power. In an oligarchic faction, the existing members' cost of admitting another member is increased by the norm of sharing profits equally, and so they would tend to recruit fewer participating members than a leader who can recruit supporters at their marginal cost. So a strong faction generally needs a leader, who in turn must be credibly committed to his promises to members of his faction.

Who can bind a leader who wields the sovereign power of the state? The active supporters and high officials who collectively sustain the state together have such power, if they share a sense of identity that would cause them all to lose trust in their leader if he cheated any one of them. As a minimal constitutional structure, a strong leader needs to organize a court or council where his active supporters can collectively judge his treatment of them. So in a leader's court, his reputation for reliably judging and rewarding his agents can be collectively guarded by his agents and courtiers, who must monitor the distribution of high offices and rewards while they serve him.

This reference to high officials indicates that we must extend our view of the central moral-hazard problem to include not only moral hazard in political activity to win power but also moral hazard in administrative activity to exercise power (see Myerson, 2015). Legal and constitutional rules of government are effective only when they are enforced by the actions of individuals who have positions of responsibility in the government. By definition, moral hazard

is the problem of creating incentives for agents to behave in some prescribed manner when their behavior cannot be directly observed by others. Thus, the problem of getting agents of the government to enforce the rules of the state is fundamentally a moral-hazard problem.

But powerful government agents have many opportunities to profit from abusing their power, and they must expect greater long-term rewards from serving the state appropriately. So in addition to basic compensation for the disutility of effort, responsible agents must expect greater rewards, called moral-hazard rents, as incentives for not abusing their power. Becker and Stigler (1974) have shown that, in an efficient solution to dynamic moral-hazard problems, the responsible agents should be motivated by promises of large late-career rewards that will be paid if they maintain a good performance record. (See also Myerson, 2015.) The prospect of large moral-hazard rents could make candidates willing to pay for appointment to such responsible offices. Becker and Stigler suggested that such payments for office could be interpreted economically as posting a bond for good performance.

The evaluation of agents' performance and their consequent rewards (or return of their performance bonds) must depend on judgments by their superiors in the administrative hierarchy, and so the system of incentives ultimately depends on top leadership. Promises of great rewards for past service become debts of the state, however, and ex post the leaders of the state would have a direct interest in repudiating such debts. Falsely finding evidence of corruption in an official's record would relieve the state of a large expense and would open the possibility of re-selling the office to a new candidate. Thus, we find a crucial moral-hazard problem at the very top of the state apparatus. Agents of the government must trust that their top leaders will judge their performance appropriately and will reward good service generously. Alchian and Demsetz (1972) called this the metering problem, but here we may also call it the central moral-hazard problem of administrative leadership.

Thus, we find similar central moral-hazard problems both in the political factions that compete for leadership of the state and in the state's administrative apparatus. Both to win power and to wield it, the political leaders need a mechanism for credibly guaranteeing the payment of promised rewards to their active political supporters and to powerful state officials. These central moral-hazard problems can be substantially combined when a new leader gives high state offices to individuals who actively supported his campaign to win power. That is, major supporters of the leader's campaign for power may be rewarded not by a direct payment but by

an appointment to a high government office, which in turn entails a long-term promise of large moral-hazard rents. Then the leader must be credibly committed to generously rewarding the long-run service of both his political supporters and responsible agents of the state. When a political leader achieves supreme power in a state, his circle of factional supporters must develop or merge into a high council of the state, where his major supporters and high officials meet regularly to monitor his decisions about distribution of offices and rewards.

This analysis suggests a basic model of political competition in which the competitors for power are leaders each of whom has organized a faction or circle of supporters around himself. That is, we should think of the basic political actor, not as a single individual alone, but as a leader who has intrinsically embedded himself in a faction or circle of active supporters. The leader can mobilize people's efforts only when they trust his promises of future rewards. Communication among faction members strengthens the leader because he can credibly commit to greater long-term rewards for each of his supporters when his failure to do as promised for any one of them would cause all of them to lose confidence in his future promises. Thus, the faction forms a court that regulates the leader's relationship with each member, and so enables them all to trust the leader more.

For this system of the faction collectively holding their leader accountable to be a rational equilibrium, the leader must understand that he would not be able to recruit an entirely new faction of supporters if he lost the confidence of his existing faction. But this is quite natural: if an established political leader tried to recruit new agents to serve as his main supporters without ever introducing them into an existing circle of long-term supporters, then the new recruits could rationally be dubious of the leaders' promises of future rewards. Grievances can be incentive-compatibly communicated among faction members because, in equilibrium, a supporter whom the leader has treated correctly should expect positive rewards from his relationship with the leader as long as he does not complain of mistreatment. When faction members are expected to meet regularly, the unexplained absence of one member could itself be taken by the others as an indication that he has lost confidence in their leader. To make this equilibrium focal, the faction members must feel enough sense of identity that their leader's cheating one of them would make the others lose confidence in the leader's promises to them all.

The members of a faction have two basic obligations in this system. They must actively support their leader in the contest for power, and they must actively monitor the leaders'

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relationship with other faction members, so that all faction members can be confident that the leader would risk losing all supporters if he failed to appropriately reward any one of them. This organization of mutual expectations among the leader and his faction makes the leader-in-faction the basic unit for mobilizing collective effort. These are the basic building blocks from which the political foundation of a state is constructed.

From this perspective, we see that the essential function of political leadership is to serve as the ultimate guarantors of incentive systems in the state. The development of bureaucratic offices and procedures can reduce the costs of moral hazard in the state, as systems of record-keeping in state offices make it harder to conceal abuses of power. But state bureaucracy requires more than just educated personnel who can manage sophisticated record systems; it also requires the basic support of political leadership. If political leaders do not support the standards for evaluating and rewarding the service of administrators in government bureaucracies then these standards cannot be maintained against temptations of corruption.

4. From leadership to constitutionalism

We have seen that, when a political leader achieves supreme power in a state, his circle of factional supporters must naturally develop or merge into a high council of the state, where his major supporters and high officials meet regularly to monitor his decisions about distributing high offices and rewarding high officials. Such councils, where courtiers judge their leader even as they serve him, are vital institutions in any state. In ancient Rome, the Senate was an institutional forum where rights of senior government officials could be protected. The central institution of the medieval English monarchy from 1170 was the Court of the Exchequer, where some of the most powerful officials in England closely monitored the king's transactions with his provincial governors (who were called sheriffs). The English Parliament in its early development from 1300 could be viewed as a forum where representatives of the local gentry, who served as the government's local agents, could express their grievances against higher government officials. As early as 1500 BCE, the Hittite king Telepinu saw the need to earn the confidence of other powerful members of the royal family by empowering a state council to judge his treatment of them. All such institutions can strengthen the state by guaranteeing its responsible agents that their loyal service will be appropriately rewarded, helping to solve the state's central moral-hazard problem.

These theoretical ideas have been expressed in many traditional political concepts. The faction members' two obligations may be summarized in the traditional formula of "aid and counsel" that a medieval vassal owed his lord. In this formula, aid meant supporting the lord in battle, and counsel mean regularly attending the lord's court where his relationship with other vassals would be judged. English political theory also had an old concept of sovereign power being vested in "the king in parliament," which expresses this idea that the basic political actor is, not an individual leader alone, but a leader with a group of supporters who regularly communicate about their relationships with the leader. In *Education of Cyrus*, an ancient classic of social philosophy about the foundations of successful states, Xenophon portrays Cyrus as establishing the Persian Empire on one essential quality of leadership: his reputation for generously rewarding good service.

The standards of behavior that a faction expects of its leader are a kind of fundamental law or personal constitution for him, which he must uphold or lose the confidence of his most important supporters. These expectations must include the essential requirement of leadership, that the leader will appropriately judge and reward the services of all members of the faction. But there may be other expectations or norms which, if violated by the leader, would stimulate the same loss of trust among his faction as if the leader had cheated a prominent supporter. That is, the leader's reputation among his supporters may also be used to enforce any other constraints on the leader's behavior that are recognized by his supporters. Such norms may be defined by codes of law or religious traditions or ethnic culture. It is only necessary that a leader's violation of these norms could be observed by his supporters, and that they would consider such a violation important enough to shift their expectations to a distrustful equilibrium in which nobody has the confidence to support the leader.

In particular, the constitutional and legal system of a state may be considered well established when any major political leader would fear shocking his supporters if he blatantly violated any legal or constitutional provision. Such a linkage may be particularly natural if the leader regularly proclaimed obedience to this constitutional system while developing his relationship with supporters, so that its violation would be a shocking change from the pattern of behavior that the supporters have come to trust. Thus, the effective power of written laws and constitutions to constrain political leaders may be based on leaders' fundamental need to maintain a fragile relationship of trust with a group of supporters.

Conversely, the effective terms of a new constitutional government can be constrained by the nature of pre-existing political relationships. The rules of a new regime are not written on a blank slate. The first high officials of the regime need support to win their offices, and so they cannot be expected to abandon their past supporters at the start of the new constitutional system. Provisions of the new constitution would be unenforceable if they asked these leaders to violate the terms of longstanding relationships with supporters. In this sense, the factional norms that bind political leaders to their supporters may be seen as the essential foundation for the formal constitution of any state.

In 2003, Paul Bremer refused to allow any elections in occupied Iraq without a written constitution, while Grand Ayatollah Ali Al-Sistani insisted that a constitution could only be written by elected leaders. In effect, they were debating a fundamental chicken-and-egg question about which should come first in a new constitutional republic: the election of national leaders or the writing of the constitutional rules under which national leaders are elected. In support of Sistani's position, we have argued here that any political system must be built from some pre-existing relationships between leaders and supporting factions. The first constitutional laws of any regime are the norms that define what political leaders must do to keep the trust of their supporters. Bremer's theory of the primacy of written constitutions would make it difficult to understand how they ever evolved in the first place. A complex system can be spontaneously self-organizing when it has many opportunities to start locally and then grow larger, which is true of leader-follower networks, but a constitutional system of government must be enforced nationally or not at all. In fact, the United States was founded by leaders who had already developed democratic reputations by serving in elected provincial assemblies under British colonial rule, and the subsequent adoption of the Constitution depended on its authors' personal reputations.

5. Broader perspectives on moral hazard in state-building

The previous two sections developed a view of political leaders with their faction as basic units of political mobilization and commitment that become fundamental building blocks of the state. But analysis of moral hazard has much broader significance in state-building. Indeed, the disaster that afflicts a nation when its state has failed can be viewed as a national crisis of moral hazard. A well-functioning state normally helps to reduce moral-hazard problems in all kinds of

social and economic transactions, when people can rely on the state's system of justice to help enforce contracts and laws that stipulate appropriate behavior in social and economic relationships. When the state has failed, systems of control are scarce and urgently needed throughout the nation, and the result may be described as a broad escalation of moral hazard problems in all kinds of relationships throughout the nation. Military intervention can have a value in such situations, when all other controls have failed, because military units are designed to obey orders in the most challenging circumstances. To get beyond military occupation, however, the state must be restored.

A state that can provide public services and protection of law to people throughout a nation must involve many thousands of government agents, far more than can be included in a small council around a leader. There are several basic ways of extending political leadership over a large modern state. The number of independent political leaders who provide leadership for the state can be increased by constitutional division of power among political offices that are held by different leaders. The key supporters of a high political leader may themselves be leaders of lower-level factions of their own, and these networks of active political supporters can form organized political parties that extend throughout the nation. Bureaucratic departments extend the administrative control of high officials. Constitutional division of power will be considered at length in later sections, but we should first say something about the organization of administrative departments and political parties.

Political parties are social networks that distribute power and privilege to their active members. Such networks are needed to mobilize agents who have stakes in sustaining the democratic political system. President Hamid Karzai refused to set up a political party (Rashid, 2008, page 258), and the national assembly was elected by the method of single non-transferable vote, which discourages party formation. Without parties, many areas of the nation lacked any local residents with a vested political interest in actively supporting the state.

The main point of bureaucratic organization is to reduce moral-hazard problems in government, by organizing agents of the state into departments which use standardized procedures and keep detailed records, so that agents' actions can be reviewed to find any abuse of state power. Such bureaucratic solutions require a staff of highly skilled literate agents, but the investment in their education reduces the need for paying them moral-hazard rents, at least for routine tasks of government. Dobbins et. al (2007) and Ghani and Lockhart (2008) particularly

emphasize the importance of the finance ministry as a bureaucratic department that helps to reduce moral-hazard temptations in all other departments of government by the monitoring and recording all payments to the state's agents and suppliers. Ghani and Lockhart observe that, in nations like Afghanistan where highly educated people are scarce, development assistance from foreign organizations can actually undermine state-building when foreign organizations outbid the government in hiring the skilled administrators.

The essential role of political leaders in guaranteeing the appropriate rewards of government agents applies even in bureaucratic departments. If political leaders do not support the standards for evaluating and rewarding the service of administrators in government bureaucracies then these standards cannot be maintained. Even in bureaucratic departments, the system of pay and promotion ultimately depends on political leadership. This dependence is particularly important for security forces. Police and military officers cannot be neutral to democratic contests between different parties unless it is understood that the various political parties agree on common standards for promotion and pay of security officers.

Moral hazard in policing is particularly problematic. Without appropriate controls, police could be tempted to ignore criminal activity or, worse, to threaten innocent citizens with protection rackets of their own. For appropriate controls, police work must be embedded in a larger justice system that involves legal and penal institutions that are separate from the police. Dobbins et al. (2007, chapters 3 and 4) emphasize this point by a detailed quantitative analysis of the personnel requirements to build effective policing and rule of law. (They estimate that state-building requires, per million residents, about 2250 police, who are paid on average about 3.2 times per-capita GDP, as well as 60 judges, 60 prosecutors, and 420 staff in detention facilities.)

The responsibility for guaranteeing police protection to any group of people must ultimately depend on political leadership. The police must be supervised by political leaders who directly or indirectly have some incentive to require that the police should extend appropriate protection to individuals in this group. In a democracy, elected leaders have a direct political incentive to guarantee that voters are not neglected or abused by the police. But any state must offer basic protection to its active political supporters, and other individuals can claim protection from an authoritarian state indirectly as clients of patrons who are counted by the regime among its active supporters. Indeed, one of the benefits of being part of the ruling elite in an authoritarian regime is the ability to offer protection to clients. Directly or indirectly,

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however, political assurances of basic protection from the state must be extended to people in all communities throughout the nation. If there are any communities where people cannot get basic protection from the state, then these people will be driven to seek protection from other organizations, which can then develop into serious rivals for state power. Thus, a failure to establish political networks that can monitor the problems of basic security for people in all parts of the nation can make the state seriously vulnerable to insurgency or breakdown.

Seth Jones (2009, chapter 10) has described the government's failure to provide effective police protection in most of rural Afghanistan after 2003 as the critical failure which ceded wide areas of the country to insurgent control. The police in Afghanistan were organized as a national force which, under the centralized constitutional state, could be held politically accountable only by the presidential government in Kabul. National police forces are effective in many successful countries, of course, but for police throughout the nation to be controlled from the capital requires extensive lines of administrative oversight, which are difficult to provide in rural areas of Afghanistan where illiteracy is prevalent. Furthermore, if these difficulties were overcome and an effective national police force with a centralized system of control was developed in Afghanistan, it would be impossible to guarantee that such a national police force could not become an instrument of centralized political repression under a new regime after the withdrawal of NATO forces. So the attempt to develop an effective national police force in Afghanistan should have been recognized both as unlikely to succeed and as potentially threatening to local liberties if it did. Both of these problems might have been avoided in a more decentralized system where locally elected leaders had authority to develop local police forces.

6. Political control of local government

The main point of the previous section was to argue that professional bureaucrats and security forces cannot establish a state without political supervision. In particular, from our political-agency perspective, we should recognize the vital importance of local officials who supervise the general operation of government at the municipal and provincial levels. These mayors and governors have the primary responsibility of ensuring that the nation has no neglected areas where a weakness of state authority could provide an opening for insurgencies to take root. Mayors and governors inevitably face great moral-hazard temptations to abuse their power over the people in their jurisdiction, however. So these powerful local offices must be

associated with substantial moral-hazard rents, and the reward system for these officials must be political. Indeed, the political control of powerful local officials may be the most important political agency problem of the state. The success or failure of the state may depend critically on how it solves this problem. We have already noted that two key institutions in the government of medieval England, the Court of the Exchequer and the Parliament, developed as forums for regulating the king's relationship with his provincial governors (sheriffs) and with his lesser local-government agents.

In a decentralized democracy, local officials are elected by local citizens, and I will argue that decentralized democracy can have important advantages for state-building. But we should consider first authoritarian regimes and centralized democracies (such as Afghanistan today) where local officials are appointed by national leaders.

For the purposes of national leadership, a local official should be well motivated both to collect the taxes in his district and to provide appropriate protection and public services for the population in his district. Standard agency theory suggests that an efficient way of motivating local officials to cultivate the long-term welfare of their district should be to promise them a substantial long-term ownership stake in the district. But from the national perspective, there is also a need to avoid a dissolution of national sovereignty to local officials who become too entrenched in their districts to be removed. The standard remedy against such dissolution risk is to rotate local officials among different districts during their careers, so that local networks of trust do not become focused on the individual official. But the prospect of such rotation reduces a local official's incentive to protect long-term investments in his district, which can seriously undermine economic growth in authoritarian states if local investors are not part of the ruling elite. A standard solution to these two problems in large authoritarian states is to distinguish two levels of local government, which we may call municipal and provincial, where the lower-level municipal officials can be long-term residents of their districts, but the higher-level provincial officials must rotate to different districts during their careers. To avoid dissolution risk, the municipal subdivisions should be too small to maintain political independence from the rest of the nation. Then municipal officials' long-term identification with local elites can make them advocates in the authoritarian state for protection of local investment.

The need to assure powerful local officials (at any level) that they can expect substantial moral-hazard rents for good service means that they must have status as members of the regime's

politically influential inner circle. As we have discussed above, the regime must commit itself to appropriately judging and rewarding the service of its powerful local officials. Support from mayors and governors can be decisive in a succession contest in an authoritarian state, and so there can be a tendency for national leaders to promise more generous standards for local officials. On the other hand, generously interpreted moral-hazard rents make local officials expensive for the regime. Thus, there is a natural incentive for narrowing the political elite and reducing the numbers and powers of politically responsible local officials, at least until the weakness of political supervision for local administration begins to create some risks of insurgency or breakdown of the state. Bates (2008) depicts a tendency of autocratic states in Africa to progressively concentrate the rewards of power within a political elite that was just large enough to hold power in the capital but too small to provide good public administration. He then describes how these regimes collapsed when foreign donors began to insist on economic and political liberalization, which reduced the economic rents that the government could use to reward supporters and increased political challenges to the regime.

This problem of political narrowness can be exacerbated when a foreign state-building intervention sends forces to support the new regime. Political negotiations with local leaders in remote districts of the country can seem tedious and costly for national leaders who have pressing need for resources to maintain the coalition that gives them primacy in the capital. As long as foreign forces will defend the regime from rural insurgents, an efficient plan for the national leaders is to use rotating governorships as rewards for national-level supporters and allies while conceding as little as possible to indigenous local leaders far from the capital. Such a plan concentrates the state's moral-hazard rents among people who have personal connections to major factions in the capital, at the cost of ignoring the political interests of people in other communities. Then foreign forces can bear the increased cost of fighting insurgency in weakly governed districts where local social leaders have little or no stake in the regime. (Miller, 2008, explores related incentive effects of intervention.)

Conversely, if the goal were to establish a stable political regime at the least possible cost to occupying forces, local leaders could be given the strongest possible incentive to do the work of state-building by promising them a long-term share in the profits of power in their district as long as they can maintain basic control there in collaboration with the national leadership. For such promises of local leaders' long-term privileges to be credible, however, the regime must

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essentially adopt a feudal or aristocratic political system. For example, when the British were first establishing their colonial rule in India, they regularly granted long-term local privileges of power and taxation to local agents, called zamindars, who took responsibility for keeping order in their districts. The zamindars' local authority was granted as a permanent property right that could be sold or bequeathed to heirs, and so they became a class of local leaders with a vested interest in maintaining the regime. The effectiveness of this feudal power proved remarkably durable, but it also had long-term economic costs. Decades after India's independence, the regions where the British distributed such feudal privileges were still found to be suffering significantly lower agricultural productivity and higher infant mortality than other regions of India (see Banerjee and Iyer, 2005). Similar scars of colonial state-building operations may be found in many poor countries. Such a feudal solution to the problem of motivating local political supporters requires a long-term imperial commitment, however, which fortunately is not available to American forces in stabilization missions today.

Instead, we should be considering state-building strategies that support the development of democratic governments. But the principle of sharing profits of power with local leaders can be applied in democratic regimes as well, with federal constitutionalism.

7. Democratic state-building

The focus of this paper has been on political leadership. A potential leader needs two reputational assets: he must be broadly acknowledged as a credible contender for positions of power in the state, and his promises of long-term rewards must be trusted by a faction of active supporters. The supply of such leaders is a vital part of a nation's social capital, and it can develop only gradually over time. From this perspective, we can see that the essential problem in building a democratic state is to develop the nation's supply of democratic leaders.

A democratic leader additionally needs a reputation among the voters for respecting the rules of democratic competition and for using public funds responsibly to serve public interests, not merely to reward his active supporters. If no politicians have such good democratic reputations, then it is hard for democracy to succeed. Voters would have no incentive to turn a corrupt incumbent out of office if the alternative candidates were expected to be just as bad or worse. The key to increasing the chances for successful democratization is to create more opportunities for more politicians to begin cultivating good democratic reputations. Such

opportunities are increased by a federal system in which power is shared with independently elected provincial and municipal governments.

In Myerson (2006), I developed a simple model to formalize this argument for federally decentralized democracy. In this model, success and frustration of democracy are interpreted as different equilibria of a dynamic political game in which voters have small costs of changing leadership and have incomplete information about politicians' virtue. Any untested politician has a small probability of being a virtuous type who (by nature) cannot behave corruptly, but normal politicians can chose to act virtuously or corruptly. Unitary democracy can be frustrated when voters do not replace corrupt leaders, because any new leader would be expected to also govern corruptly with high probability. Federal democracy cannot be consistently frustrated at both national and local levels, however, because local leaders who govern responsibly could build reputations to become contenders for higher national office. If voters expected corrupt frustration of democracy at both the national and local levels, then any local leader who governed well would be recognized as virtuous and so would become a strong candidate for national leadership; but then normal local leaders would also have an incentive to act virtuously. In another version of the model, I showed that democracy cannot be consistently frustrated in a democratization process that begins with decentralized provincial democracy and only later introduces nationally elected leadership.

This argument for decentralized democracy can also be justified in terms of the basic economic concept of barriers to entry. A successful system of democratic competition should reduce political leaders' ability to take corrupt profits from their positions as suppliers of government services. Economists understand, however, that the expected amount of profit-taking in a competitive market equilibrium may depend on barriers to entry against new competitors. By enabling more local politicians to establish their abilities to govern responsibly, federal decentralization and local democracy can effectively reduce barriers to entry in national political competition, and so can improve the performance of national democracy. So local democracy can make national politics more competitive and thus can improve the performance of national government, by sharpening the incentive for elected national leaders to provide better public services. (See Treisman, 2007, for a critical survey of other arguments for federalism.)

The effect on encouraging more entry into national politics could be increased by having more elected subnational governments in smaller districts, thus creating more opportunities for

more politicians to demonstrate their ability to serve the public. But there is one important constraint: The districts must be large enough, and the responsibilities of public administration in each district must be substantial enough, so that a politician's good performance in one locally elected office can be taken by the voters as evidence of his qualifications for service in higher levels of government. From this perspective, an ideal system of federal democracy should have several levels of subnational governments, with elected offices at different levels together forming a ladder of democratic political advancement that effective leaders can climb from local politics to provincial and national politics.

During the 2003-2004 occupation of Iraq, Paul Bremer (2006) did not permit any form of decentralized democracy. While Bremer prohibited local democracy and focused instead on writing a constitution with a group of selected national leaders, militant insurgents gained power in communities throughout Iraq. In Pakistan, local democracy has been cultivated in small districts only by military rulers who suspended democracy at the provincial and national levels. (See Cheema, Khan, and Myerson, 2010.) This countercyclical pattern of local democracy is less surprising when we understand that the thousands of elected officials in local governments become less of a competitive threat to leaders at higher levels when there are no intermediate levels of elected offices between their small localities and national leadership.

Devolving a share of power to independently elected local governments also broadens the distribution of rents in government, which can help to solve the narrowness problem that weakens the state against external threats. The narrowness problem arises when the national leader is mainly concerned about potential rivals in the capital or main population centers and thus prefers to use the moral-hazard rents of local government as rewards for supporters in the center. The result is to degrade public services and alienate local social leaders in remote districts until they become vulnerable to insurgency. The national president might be more motivated to share power with local leaders in remote districts if he could be relieved of opposition in the center by authoritarian repression. Alternatively, a federal constitution could require national leaders to devolve some power to local leaders. In this sense, a centralized democratic regime can be more vulnerable to insurgency than either an authoritarian regime or a federal democratic regime. In particular, the centralized democratic regime that was installed in Afghanistan in 2003 has proved to be particularly vulnerable to rural insurgency.

In theory, democracy should be an advantage in state-building because some politicians

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who do not hold any government office may still be motivated to actively support the democratic system by their hopes of gaining power in future elections. But if power is narrowly concentrated in a few national offices, then only a few out-of-power leaders can have any realistic hopes of competing successfully for these offices. Thus, a constitutional distribution of power among different levels of government can give more local leaders a positive expected stake in supporting the democratic regime.

Within a democratic political party, there are also local agency problems which can be mitigated by local democracy. For a party to win elections, it needs local party activists who work to win the confidence of voters in communities throughout the nation. Elections to local offices can provide a measure of which local party activists have done best at gaining the confidence of the voters. In a centralized democracy that lacks such local electoral measures, party activists may understand instead that their advancement within the party is likely to depend more on their personal relationships with party leaders than on their reputations with the voters.

Successful democracy depends on vital interactions between local and national politics. We have seen that local democracy can help to make national democracy more competitive, as a record of using public resources responsibly in local government can qualify a local leader to become a competitive candidate for power at higher levels of government. Conversely, the threat of small unrepresentative cliques dominating local governments can be countered by the participation of national political parties in local democracy. Local political bosses should know that, if they lose popular support, they could face serious challengers supported by a rival national party. Democratic political parties can develop naturally in an elected national assembly, where members owe their positions to competitive popular elections but also need to work as colleagues with political rivals.

Federal division of powers involves other agency problems that should be mentioned here. Different offices of government are always in some competition for public resources under any system, but this competition is exacerbated when different levels of government are controlled by rival parties in a federal democracy. Thus, political decentralization increases the need for a central finance ministry that can reliably and transparently distribute public funds to different levels of government. In this sense, the decentralized democratic distribution of moral-hazard rents in local government may depend on effective bureaucratic controls against moral hazard in the central government.

8. Conclusions

Government policies must be implemented by government agents, who will eschew regular temptations to abuse their power only if they expect greater long-term rewards from good service. So the effectiveness of the state depends on an incentive system that can promise long-term rewards for good political service. The responsibility for maintaining such a political incentive system ultimately belongs to the political leaders of the state.

Thus, we have presented a theory of the state based on political leadership. Acknowledged leadership brings powers of social coordination, but a political leader first needs a reputation for reliably rewarding loyal supporters. Such a reputation is necessary for a leader to mobilize a network of supporters who can win political power and wield it. Constitutional laws become enforceable on the leaders of the state when a leader who violated these laws would risk losing the trust of his supporters and agents. In this sense, the reputational expectations between political leaders and their supporters become the fundamental political laws on which the enforcement of all other constitutional laws may be based.

So the successful establishment of a new democratic state requires the development of political leaders with good democratic reputations. That is, the essential key to successful democratic development is to develop the nation's supply of leaders who have good reputations for using public funds responsibly to serve the public at large, and not just to give jobs to their active supporters. From this perspective, we have argued, decentralized democracy may be the best way to improve the chances for successful democracy. Elected local governments create more opportunities for politicians to begin developing good democratic reputations. Institutions of decentralized democracy can also strengthen the state by ensuring that the state's political networks reach into communities throughout the nation.

Our leadership-based theory of state-building also suggests a different perspective on development assistance. When the goal is political development, the essential measure of success for a development project may be, not in how many schools or roads it builds, but in how the project enhances the reputations of the political leaders who spend the project's funds. To increase the nation's supply of leaders with good democratic reputations, donors could distribute funding opportunities to leaders at different levels of government. Donors might even demand the right to fund some development projects for minority parties in the national assembly. For

this reputational goal, donors must also insist on transparent public accounting for all funds that are spent by political leaders at all levels. The essential accounting here must be to the local population, however, not to foreign donors who provided the funds. Local people must be able to learn what funds were spent by their leaders and must be able to monitor what public services were provided by these funds.

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