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Weak and Strong States in Historical Perspective

Powerful fiscal states underlie today's advanced economies in the West and beyond. Wealthy governments typically gather large tax revenues as shares of GDP and spend great sums on the military, infrastructure, and social programs. How rich European countries first established modern systems of public finance is a fundamental question in economic history. It is the key question that this book tackles.

The answer, which involves centuries of political reforms, wars, revolutions, defaults, technological change, and economic growth, has profound implications for current political debates. The financial meltdowns of the late 1990s in East and Southeast Asia and Latin America illustrate the vital links between fiscal policy and development. Beyond financial crisis, emerging economies also face fiscal problems resulting from the lack of tax resources available to provide basic public goods like transportation infrastructure. Yet fiscal troubles do not affect developing countries alone. One of the most pressing issues that advanced nations must confront over the coming decades is how to keep entitlement programs solvent. No country is immune to fiscal imperatives.

To meet fiscal challenges, political regimes will have to evolve. The process of institutional transformation finds crucial antecedents in history. Links between politics, taxation, and public spending and debt are long-standing. Today's world certainly differs from that of the past. However, it is clear that a solid understanding of the establishment of modern systems of public finance will enrich current debates about how to best design and implement efficient fiscal institutions, for both emerging and developed nations.

1.1. Fiscal Fundamentals

A large literature in economics emphasizes the negative effect of executive predation on economic growth.[1] This view suggests that institutional constraints such as parliamentary control over government finances protect property rights and encourage investment by limiting the ability of rulers to expropriate. Figure 1.1 plots the average score of constraints on the executive from 1995 to 2004 from the Polity IV Database of Marshall and Jaggers (2008) against average log real GDP per capita over the same years from the Penn World Tables of Heston, Summers, and Aten (2006) for nearly 100 countries. Consistent with arguments that link predatory states with poor economic performance, there is a clear increasing relationship between ruler limits and income.

Though illustrative, Figure 1.1 masks the role of history. Many of today's rich states were not established with parliamentary institutions intact. Rather, executive constraints are the culmination of a long and arduous historical process. The political transformation from absolutist to parliamentary regimes and its fiscal effects are among the main themes of this book.

The literature's focus on executive predation, moreover, discounts the positive economic roles that robust governments may play. Political scientists argue that traditional local elites such as bosses, chiefs, clan leaders, landlords, and rich peasants in parts of sub-Saharan Africa oppose fiscal control by national governments, leading weak states to underinvest in public services that increase productivity. The successful development experiences of Asian Tiger nations, by contrast, took place under powerful fiscal states.[2] Figure 1.2 plots the average share of total taxes collected by central governments as a percentage of GDP from 1995 to 2004 from the Government Financial Statistics Database of the IMF against average log real per capita GDP for the same set of countries as before. There is a strong positive correlation between

[1] For theory, see North and Thomas (1973), Brennan and Buchanan (1980), North (1981), Levi (1988), McGuire and Olson (1996), and North, Wallis, and Weingast (2009). For empirics, see De Long and Shleifer (1993), Knack and Keefer (1995), and Acemoglu, Johnson, and Robinson (2001, 2002, 2005).

[2] For Africa, see Migdal (1988), Herbst (2000), and Bates (2001). For East Asia, see Wade (1990) and Kang (2002). There is also a recent related literature in economics. See Acemoglu, Robinson, and Verdier (2004), Glaeser et al. (2004), Acemoglu (2005), Besley and Persson (2008, 2009, 2010), Acemoglu, Ticchi, and Vindigni (2011), and Dincecco and Prado (2011). Finally, Lindert (2004, 2009) argues that social spending on public services like mass formal education is a major determinant of long-run economic growth.

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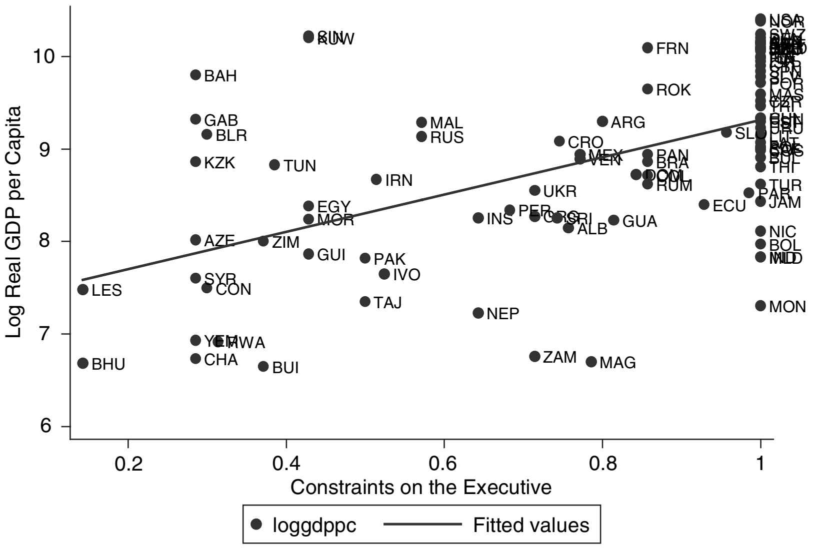

FIGURE 1.1. Constraints on the executive and income, 1995–2004. Constraints on the executive are the average constraints on the executive index normalized from 0 to 1 between 1995 and 2004 from the Polity IV Database. Log real GDP per capita is the average log GDP per capita over the same years in constant U.S. dollars expressed in international prices, base year 2000, from the Penn World Tables, Version 6.2. The set of 96 sample countries is from Dincecco and Prado (2011).
Sources: Penn World Tables, Version 6.2, of Heston et al. (2006), Polity IV Database of Marshall and Jaggers (2008).

tax revenues and income, which is consistent with claims relating fiscal strength to better economic outcomes.[3]

However instructive, Figure 1.2 also neglects history. Fiscal prowess did not always characterize wealthy states. Instead, fiscal strength is the result of a deep process of political transformation. The establishment of robust tax systems and their effects on public finances is another of this book's core themes.

Overall, today's advanced economies strike a balance between weak and strong fiscal elements. Rich states typically possess a set of political institutions that link powerful centralized tax structures with parliaments that limit executive control over public finances. They are thus able to gather large tax revenues and can channel funds toward public services with positive economic benefits.[4]

[3] Excluding the outlier countries Bahrain (BAH), Croatia (CRO), Kuwait (KUW), Lesotho (LES), and Madagascar (MAG) only strengthens this correlation.
[4] Acemoglu (2005) refers to this type of outcome as a "consensually strong state."

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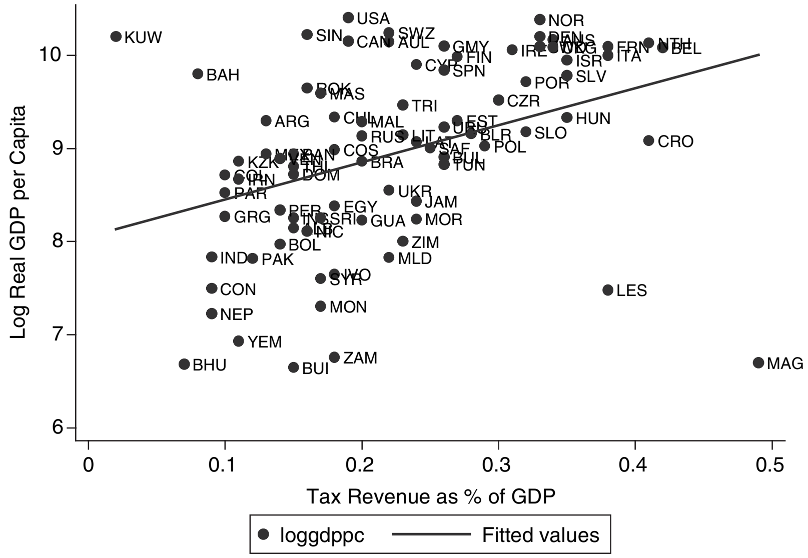

FIGURE 1.2. Tax revenue and income, 1995–2004. Tax revenue collected by central governments as a percentage of GDP is the average between 1995 and 2004 from the Government Financial Statistics Database. Log real GDP per capita is the average log GDP per capita over the same years in constant U.S.dollars expressed in international prices, base year 2000, from the Penn World Tables, Version 6.2. The set of 96 sample countries is from Dincecco and Prado (2011).
Sources: Government Financial Statistics Database of the IMF (2010), Penn World Tables, Version 6.2, of Heston et al. (2006).

But how did wealthy countries achieve regimes that are both fiscally centralized and politically limited? Many of today's advanced economies were not "born" with efficient fiscal and political institutions. To answer, this book examines the evolution of political regimes and public finances in Europe over the long term, from the height of the Old Regime in 1650 to the eve of World War I in 1913. Sovereign governments in Old Regime Europe generally faced two key political problems: fiscal fragmentation and absolutism. Though rulers exercised weak authority over taxation, they wielded strong control over spending. Under this equilibrium, executives were typically starved for revenues and often spent available funds on foreign military adventures rather than public services like roads that would most benefit society. To improve fiscal outcomes, states had to gain force by implementing uniform tax systems at the national level. They also had to restrict power by establishing parliaments that could monitor government expenditures at regular intervals. This book argues that the emergence of modern systems of public finance is the result of the resolution of these two fundamental political problems.[5]

By adopting a long-run perspective, this book enhances both historical and current debates over weak and strong states. The study of the development of public finance systems over the long term is valuable in its own right. Knowledge of the long-run process of fiscal change also has major implications beyond economic history. A proper understanding of the European experience translates into useful lessons for today's emerging and advanced countries, not the least because governments around the world have implemented European forms of fiscal governance.[6] Fiscal challenges from development policy to entitlement reform are with us to stay. To guide the course of future debates in useful ways, we must understand the past.

1.2. The Approach

Two seminal works form the core of this investigation. The first is North and Weingast (1989).[7] They claim that institutional reforms in England with the Glorious Revolution of 1688 enabled the king to make a credible commitment to responsible fiscal policies. Since the new constitution granted the national parliament the regular right to audit government finances, the ruler could keep promises to execute fiscal plans in time-consistent ways. By tying its hands, the executive was able to borrow much larger sums. The second seminal work is Epstein (2000).[8] He argues that institutional fragmentation within European polities, and not fiscal abuse by rulers, was the key source of fiscal troubles prior to the nineteenth century. Since provincial elites had strong incentives to oppose fiscal reforms that threatened

[5] The term "state," which is used interchangeably with "polity" throughout the text, has no normative connation.

[6] See La Porta et al. (1997, 1998, 1999), La Porta, Lopez-de-Silanes, and Shleifer (2008), and Nunn (2009).

[7] Also see Dickson (1967), Jones (1972), Stone (1979), Hill (1980), Brewer (1989), and Schultz and Weingast (1998). Scholars disagree over the fiscal impact of the Glorious Revolution. Clark (1996) argues that there were secure property rights in England from 1600 onward. O'Brien (2001) claims that England made key constitutional and administrative reforms in the 1640s. Stasavage (2003) highlights the development of cohesive English political parties in the 1690s. Sussman and Yafeh (2006) argue that the parliamentary innovations of 1688 did not lower British capital costs over the next century. Finally, Drelichman and Voth (2008) claim that fiscal repression rather than political change enabled England to sustain large debts.

[8] Also see Henshall (1992), Hoffman and Norberg (1994b), Hoffman and Rosenthal (1997, 2000), Rosenthal (1998), and O'Brien (2001).

traditional tax rights, there was a classic public goods problem whereby each locale wished to free-ride on the tax contributions of others. By establishing national tax systems with (high) equalized rates across provinces, states could gather much greater revenues. England – whose fiscal revolution epitomizes North and Weingast's argument – had centralized fiscal and political institutions from medieval times, making it exceptional.

The book claims that the political transformations that North and Weingast and Epstein identify are complementary components, and not competing or contradictory ones, of sound public finances. The book's long periodization makes it possible to fuse the arguments for fiscal centralization and parliamentary reforms into an integrated analysis of institutional change. Many studies of European fiscal history (including that of Epstein) finish with the fall of the Old Regime at the end of the 1700s.[9] These works often focus on weak-state problems of jurisdiction fragmentation. Other studies concentrate exclusively on the institutional shifts that took place during French revolutionary and Napoleonic times from 1789 to 1815.[10] Finally, studies of the nineteenth century after 1815 tend to emphasize the growing role of parliament.[11] The total result is to downplay or miss the key links between these diverse eras.

By contrast, the period under analysis in this book (1650–1913) spans fundamental transformations in political systems, as European states moved from fiscally fragmented and absolutist regimes to fiscally centralized and politically limited ones. The book thus examines the fiscal effects of both institutional changes, and not just one or the other. The findings support the argument that fiscal centralization and limited government alike led to major improvements in public finances. The results also indicate that the establishment of modern fiscal systems provided a solid institutional basis on which national governments could play positive economic roles, both during the Industrial Revolution over the late nineteenth century and during the rise of the welfare state over the twentieth century.

The book uses systematic methods of analysis to test for the impacts of political transformations both within and across European countries over time. Since North and Weingast focus on seventeenth-century England, and Epstein draws heavily from medieval Italy, one may worry that characteristics particular to those polities and eras drive their findings. The investigation in this book, by contrast, is general and applies the same set

9 Also see Hoffman and Norberg (1994a) and Bonney (1995, 1999).
10 See Godechot, Hyslop, and Dowd (1971), Woolf (1991), and Grab (2003).
11 See Carstairs (1980), Flora (1983), and Cardoso and Lains (2010a).

of analytic tools to nearly a dozen sample countries. There is an intrinsic trade-off between historical breadth and depth. The broad scope of this book's inquiry compensates for any (necessary) loss of specific details. In this regard, the investigation complements works that rely upon chapter-by-chapter case studies.[12]

Most long-run comparative analyses of European fiscal history are qualitatively oriented.[13] This book constructs a new yearly database for three key fiscal indicators: free-market yields on long-term sovereign bonds, per capita revenues collected by national governments, and ratios of budget deficits to revenues. It also assembles new datasets for external and internal conflicts, economic growth, fiscal and monetary policies, and other elements. These data are used in a variety of ways. The book first characterizes fiscal time trends with respect to political transformations and other economic and political factors by country. It then subjects the data to a standard battery of rigorous tests. The book employs two distinct statistical procedures: structural breaks tests and regressions that exploit the panel nature of the data. The breaks tests assume no a priori knowledge of major turning points in the different fiscal series but let the data speak for themselves. The panel regressions incorporate a wide-ranging set of control variables to evaluate the fiscal effects of political transformations. In total, the empirical inquiry indicates that the resolution of weak- and strong-state problems – that is, the establishment of political regimes that were both fiscally centralized and politically limited – had significant positive fiscal effects.

Finally, the book moves beyond the analysis of sovereign credit risk alone. The fiscal history literature typically focuses on the links between

[12] See Hoffman and Norberg (1994a), Bonney (1999), Bordo and Cortés-Conde (2001), and Cardoso and Lains (2010a). This book also analyzes case histories.

[13] See Tilly (1990), Bonney (1995), O'Brien (2001), and Karaman and Pamuk (2010). Two econometric exceptions for the period before 1800 are Stasavage (2005, 2011). There is also an econometric literature on sovereign debt for the classic gold standard era from 1870 to 1913. See Bordo and Rockoff (1996), Obstfeld and Taylor (2003), Flandreau and Zumer (2004), Ferguson (2006), Ferguson and Shularick (2006), and Accominotti et al. (2010). Similarly, Lindert (1994) performs an econometric investigation of the rise of social spending in industrial nations from 1880 to 1913, while Aidt, Dutta, and Loukoianova (2006) and Aidt and Jensen (2009) examine the fiscal consequences of democratization from the 1800s to 1938. Other works that employ historical data series to test for the fiscal impacts of economic and political variables include Neal (1990), Willard, Guinnane, and Rosen (1996), Brown and Burdekin (2000), Frey and Kucher (2000), Sussman and Yafeh (2000), Mauro, Sussman, and Yafeh (2002), Reinhart, Rogoff, and Savastano (2003), Mitchener and Weidenmier (2005), Brown, Burdekin, and Weidenmier (2006), Tomz (2007), and Reinhart and Rogoff (2009).

parliamentary reforms and public debts.[14] In turn, it tends to overlook the direct impacts of institutional reforms on state budgets. This book analyzes two key channels through which political changes reduced credit risk: increases in government revenues per head and improvements in fiscal prudence. The investigation thus accounts for the precise ways in which fiscal centralization and limited government transformed public finances.

1.3. Overview of Contents

Chapter 2 examines the shift from fiscally fragmented to fiscally centralized regimes, the first fundamental transformation that European states underwent. Tax centralization granted new fiscal authority to national governments. However, the problem of executive discretion remained, since rulers could still use public funds as they pleased (e.g., on foreign military adventures). Chapter 3 examines the second fundamental transformation, the shift from absolutism to limited government.

Taken in combination, these two chapters demonstrate how institutional transformations resolved the Old Regime political problems of fiscal fragmentation and absolutism. European states gained tax force through fiscal centralization, and restricted executive power through limited government. The end result was a set of balanced fiscal and political institutions that had major implications for public finances. The rest of the book pursues this argument using a combination of qualitative and statistical methods.

The set of sample countries is inspired by, and overlaps with, those used in previous studies of European fiscal history.[15] For clarity, sample states are divided into two distinct groups. Group 1 countries were typically core powers. They are also characterized by long data series over a variety of political regimes. The Group 1 countries are Austria, England, France, the Netherlands, Prussia, and Spain. Group 2 countries, by contrast, were generally peripheral players, with relatively short data series. They are Belgium, Denmark, Italy, Portugal, and Sweden. In total, this set of sample states well captures the diversity of the European historical experience.

[14] See Epstein (2000, ch. 2), Sussman and Yafeh (2000, 2006), Quinn (2001), Stasavage (2003, 2005, 2011), and Summerhill (2011), as well as the citations listed in the preceding note.

[15] These works typically focus on Western Europe. See Hoffman and Norberg (1994a), Bonney (1995, 1999), Bordo and Cortés-Conde (2001), and Cardoso and Lains (2010a).

Chapter 4 examines sovereign credit, a vital statistic of the fiscal health of nations. The descriptive and case study evidence suggests that political transformations typically led to notable improvements in yield levels on government bonds. But by what means? Chapter 5 identifies two precise mechanisms by which fiscal centralization and limited government generated credit gains. It examines the evolution of public revenues and budget deficit-to-revenue ratios, where the latter measure fiscal prudence. Here the descriptive and case study evidence suggests that improvements in revenue collection and fiscal prudence were important channels through which political transformations reduced sovereign credit risk. Both fiscal centralization and limited government generally led to notable increases in government revenues and reductions in deficit ratios.

The findings in these two chapters are then subjected to a battery of rigorous statistical tests. Chapter 6 describes the results of structural breaks tests, which assume no a priori knowledge of key turning points in the different fiscal series. When the data speak for themselves through the breaks methodology, they typically identify political transformations as major turning points. These breaks generally led to significant increases in government revenues and improvements in fiscal prudence, coupled with significant reductions in sovereign credit risk.

Historical factors beyond political transformations, however, also affected public finances. To account for the impacts of conflict, growth, fiscal and monetary policies, country- and time-specific effects, and other elements, a regression analysis is undertaken in Chapter 7. The key strength of this approach is the ability to systematically disentangle the role of political regimes from other potentially relevant factors through the use of control variables. The econometric evidence confirms that political transformations led to significant improvements in public finances even after accounting for other important historical factors.

Overall, the qualitative and quantitative findings provide robust support for the argument that political transformations enhanced public finances. The final chapter examines the implications of fiscally centralized and politically limited regimes for the changing economic role of the state. It also draws historical lessons for today's emerging and advanced economies.

2

Gaining Force

From Fragmentation to Centralization

Fiscal fragmentation and absolutism plagued Old Regime states. This chapter examines fiscal centralization, the first fundamental political transformation that European states underwent. It begins by characterizing the problem of fiscal fragmentation in both qualitative and quantitative terms. It then describes the coding process for institutional reform and identifies the dates for fiscal centralization for each sample country.

2.1. The Fragmented Old Regime

Most polities in Europe were fiscally fragmented before the nineteenth century. Contrary to the conventional wisdom, early modern monarchs confronted a host of incumbent local institutions that reduced their fiscal powers.[1] To illustrate, this section examines France, Spain, the Netherlands, and England, four of the most celebrated cases in the literature on state formation in Europe.

Modern France inherited the territorial borders set under Louis XI during the late 1400s. As the state expanded, it was forced to superimpose control on top of entrenched regional institutions. The fiscal implications of this political arrangement, which Brewer (1989, p. 6) describes as "particularistic," were harsh. Since the French Crown had to negotiate independently over tax amounts with local authorities, tax rates were

[1] In the words of Epstein (2000, p. 13): "[D]ecades of research on pre-modern political practices … has shown how 'absolutism' was a largely propagandistic device devoid of much practical substance." Also see Henshall (1992), Hoffman and Norberg (1994b), Hoffman and Rosenthal (1997), Rosenthal (1998), O'Brien (2001, pp. 14–24), and Magnusson (2009, ch. 2).