INTRODUCTION

Paying for the Liberal State

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Introduction

In recent decades, economists and economic historians alike have turned their attention to the study of the relations between institutional development and the comparative economic performance of nations. One major conclusion of that discussion is that the success of national institutions depends to a large extent on the existence of consolidated national political systems. The vitality of institutions that provide services for the management of particular fields of economic activity, such as transport networks, banks, or schools, is crucially dependent on a nation's overall national institutional background. Yet at present, the new institutional economics is bereft of a foundational theory for state formation. One way to overcome that deficit is to study the financing of liberal states in nineteenth-century Europe. As economic historians, the contributors to this volume recognize that the reform of fiscal and financial systems at the end of the ancien régime and in the aftermath of nearly a quarter century of revolutionary warfare (1792–1815) was crucial for both the establishment of liberal regimes and the development of European economies in the century to 1914. The aims of this book are, first, to outline the history of the reconstruction of fiscal and financial regimes and, second, to look for patterns in the processes by which the European states obtained funds as they responded to the new and evolving tasks of government throughout the period under analysis.

Nineteenth-century Europe was marked by sustained institutional and economic progress at national levels, as well as increasing exchanges of people, goods, capital, and ideas at international levels. It was globally a century of peace. Between 1815 and 1914, the only wars that occurred in Europe were short and confined regionally. It was also a century in which nation-states were consolidated or, in some cases, formed. Because it was a century of peace and prosperity, the strengthening of states was compatible with increasing levels of institutional and economic integration across borders. Stronger liberal governments and the consolidation of nation-states opened the way to a stronger international economy, which, however, promoted the transmission of ideas related to the political economy of states.[1] The institutional developments observed in this book had both a national and an international character. Nevertheless, the success of the modern European state was dependent on how it financed itself. This book studies that process, by looking at the institutional arrangements for the financing of the modern nineteenth-century state.

By 1815, most European states were not new, and the states that formed thereafter were solidly grounded in experiences of political integration (e.g., Italy, Germany) (Crouzet 2003). The nineteenth century was clearly a period in which states increased their role in everyday social, political, and economic life, as populations were converted from subjects to citizens. This transition had important roots in the past but gained momentum in the century of peace and economic progress, and the problems facing nineteenth-century liberal states in Europe were different in many ways from the problems that those states had faced in previous centuries.[2] After 1815, central states became more liberal and connected with their populations. Governments imposed taxes and regulations, such as standard weights and measures or compulsory education, and provided domestic and international security (see Teichova and Matis 2000: intro.). The public had to accept taxation and regulations. That acceptance became a crucial factor that determined the success of the states and the speed with which they managed to implement policies. Levels of acceptance varied across time and across states and depended on the capacities of states to supply services to their citizens. Political, and occasionally military, confrontation occurred more frequently in the poor countries of Europe, where states had more difficulties providing their citizens with services because lower levels of

[1] This is not unlike what happened during the process of European integration after the Second World War. See Milward (1992). See also Daunton and Trentmann (2004).

[2] For previous centuries, see, among others, Bonney (1995a, 1995b), Neal (2004), and O'Brien (2008). See also Dincecco (2009a, 2009b).

institutional and economic development resulted in fewer resources for managing and funding government. Because of the reduction in war expenditures, and despite the increase of state activity, tax burdens declined in several of the more developed economies after 1815, whereas in the poorer economies, they became proportionally greater. The relative weight of taxation was linked both to levels of economic development and to the history of debt accumulated before Waterloo. In many instances, such as in the United Kingdom, that history weighed heavily, and the management of public debt became a major institutional challenge – particularly in states that raised considerable shares of their debts on international capital markets, where the ability to borrow, as well as the price paid for loans, depended on the states' credibility.

The use of national case studies is the best way to construct a framework to analyze these problems in Europe, because historical problems tend to be national in character and their sources are fundamentally national. In this book, we have attempted to arrive at a taxonomy based on a number of case studies, each of which illustrates a broader European pattern. Historical processes can be best understood by systematically comparing experiences across time, regions, and countries, and it is necessary to generate a broader and deeper perspective on institutional developments that emerged everywhere in nineteenth-century Europe.

Such meta-questions derive directly from Gerschenkron's seminal work on European banking and have also been addressed with respect to other institutional developments, such as international finance, the building of railway networks, and education.[3] We address the rise of public finance systems in nineteenth-century Europe and emphasize the following questions: How were tax regimes established? In what ways were they extended and deepened over time? What other forms of revenue continued or became available? How did governments secure compliance for their fiscal and financial policies? How was public debt raised, and how did it evolve? With what degree of efficiency did governments manage their needs for credit and loans? How were public revenues spent? How did citizens evaluate government activity? How did the reputation of national governments evolve in the international markets? and, finally, What were the main theoretical and political debates around taxation and public finance?

[3] See Gerschenkron (1962). See O'Brien (1983) and Milward (2005) on transport. See Cameron (1972) and Kindleberger (1993) on banking and financial markets. See Tortella (1990) on education.

We engage in comparative analysis to generate insights and to expose a pattern for the evolution of taxation and public finance in nineteenth-century Europe. Questions posed about Europe closely follow those raised in the individual country studies but go beyond national levels of inquiry. We provide hypotheses about taxation and public finance that we hope will contribute to a better understanding of the problems involved, and we offer generalizations that transcend nineteenth-century Europe. The fiscal and financial institutions of states are connected to policy-making processes. They contribute to the shaping and design of economic policies and to the assessment of their outcomes, at political, social, and economic levels. A general overview of institutional settings with respect to the implementation of public policies helps to explain cross-country variations in economic performance. This book 'looks from one country to another for general explanations' (see Kindleberger 1993: 3–4; see also Hatton, O'Rourke and Taylor 2007). It presents studies on nine nation-states that are representative of the European experience, including early developers in which sets of rules governing taxation and public finance had already reached some stability by the beginning of the century (i.e., Great Britain, the Netherlands, and Sweden), countries for which the creation of such systems was crucial for the construction of the new nation-states (i.e., Germany, Italy, and the Austro-Hungarian Empire), and countries that entered the modern age for taxation and public finance after major political revolutions (i.e., France, Spain, and Portugal). The sample includes national economies of various levels of economic development; of different levels of foreign and imperial connections; and of disparate size in terms of population, area, and geography.

The Legacy of the Ancien Régime

According to Schumpeter (1954), fiscal systems evolved from domain states in antiquity to the tax state in the early modern period, which arose from the need of governments to raise money to pay for war.[4] Bonney (1995) and Bonney and Ormrod (1999) expanded the model to four stages and considered a tribute state, a domain state, a tax state, and a fiscal state. Their approach updates Schumpeter's taxonomy and offers a concept of gradual transition that accommodates fiscal reforms in successive phases. This is not a teleological process, which would imply the

[4] Schumpeter first formulated these ideas in 1918 in Germany.

completion of each stage of evolution in sequence. Rather, it is an open-ended model that allows for the possibility that a given country skip one of the stages of evolution and admits the coexistence of diverse national states at different fiscal stages in the same historical period. According to Bonney and Ormrod (1999), by 1815, fiscal states ruled in most of Europe, which means that taxation was overwhelmingly controlled by central governments and geared toward financing their goals. The centralization of public finances was largely the outcome of the need to finance the almost-permanent state of warfare in which the European states engaged throughout the eighteenth century, and particularly the extensive warfare that followed the French Revolution (1789–1815). Warfare accounted for more than half of total expenditures in a number of European states throughout the century (Körner 1995a: 416). Wars were also financed by raising public debt, which accounted for an increasing share of total financial resources within the reach of the central state.[5]

The rise of fiscal states was associated with an increase in the ability of centralized states to manage the administrative apparatus for raising taxes, as well as with the ability of the sophisticated financial institutions to manage public debt. The latter led to important financial innovations, such as the creation of central banks and the development of financial markets where bonds and other assets were traded (Körner 1995b: 532–5). Such developments meant that states depended increasingly on their ability to service debt and concomitantly on their financial reputation. By increasing taxation on credits and loans, states became more dependent on well-functioning financial and commodity markets. Disruptions to the economy meant lower revenues from taxation, and disruption in the financial markets meant that less public debt could be raised or that more taxes had to be allocated to pay for existing debts. This greater dependency on the markets emerged by the end of the Napoleonic Wars as a major problem for most European states. The creation of public debt as a means to cover public expenditures was linked to the ability to increase the collection of tax revenues on a regular basis. The main issue faced by the ancien régime was the management of the trade-off between the need to borrow and the capacity to tax.

Yet national tax systems were loosely integrated and suffered from many inconsistencies. The finances of the ancien régime in European states reveal different degrees of fiscal centralization. The structure and rates of taxation in the same political national unit varied considerably,

[5] For further discussion of the model, see O'Brien (2008) and Spoerer (2008).

either between urban and rural areas or between different provinces. Taxes were imposed on domestic trade across regions and between rural and urban areas. Taxes were also mainly indirect, that is, based on the taxation of economic and in some cases financial activity. In England, for example, indirect taxes accounted for 70 percent of total taxes in the second half of the eighteenth century (Bonney 1995b: 502). Such ratios were, however, disparate across Europe and they did not necessarily converge. Tariffs on international trade were also an important aspect of indirect taxation. In many circumstances, tariffs were imposed to raise revenue, not to protect manufacturers or agriculture (see Dormois and Lains 2006). Direct taxes were overwhelmingly fixed and thus not related to changes in the values of outputs, which implies that levels of direct taxation did not closely follow the economic cycle. Historically, the states' fiscal institutions were geared toward collecting taxes to pay for the administration of the state; the judiciary; the consumption of the aristocracy; and most of all, war, the military, and the navy.

The coercive functions of the state were not abandoned in the liberal age, but their relevance declined substantially as new functions related to universal law enforcement; the management of economic and monetary issues; and investment in social overhead capital, health services, and education emerged. The structure of state revenues also transformed and adapted to the new state functions.

When dealing with the development of public finance in nineteenth-century Europe, we need to understand how modern tax regimes were constructed at national levels and how they were made acceptable to the public. Modernity in the organization of public finance is used here to refer to the enhancement and consolidation of the functions that are generally ascribed to fiscal states. These functions are usually associated with the management of new types of state revenues, based on both direct and indirect taxes, as well as with the administration of an expansionary state committed to increasing control over its territory and to fostering public education, welfare, justice, investment in economic infraestructures, and defense. This agenda called for a continuous increase in public spending and, above all, an efficient process of public debt creation, management, and servicing. The ability to extract taxes, a coherent program of public expenditure, and a sound system of public debt management – these were the main changes that contributed to the development of modern fiscal state in nineteenth-century Europe. It should be noted that this is not the only available model for analyzing the evolution of fiscal systems. As Larry Neal discusses in the conclusion to this book, a different framework is offered by Hinrichs (1966), who explains the transition from traditional society to modernity through changes in taxation systems. Traditional economies were characterized by restricted use of direct taxation, whereas in modern economies, a regular system of taxation is an indispensable condition for the financing of increased public expenditures.

The state's power to tax implies the coercive means of government, as well as the tacit acknowledgement of the fiscal rules that direct the process of tax collecting (Bonney 1999: 6). The alternative to the predatory role of states, associated mainly with periods of crisis or warfare, was the creation of economic opportunities in the marketplace, through cooperation between the state and the private sphere. The rent-seeking processes associated with negotiating privileges and the concession of special monopoly conditions exemplify the mastering of peaceful means of fiscal enforcement that are the origins of the strengthening of modern fiscal states. The study of the evolution of public finance regimes in different European countries is a first step of inquiry that points to promising research directions. National differences were undoubtedly important and explain specific features of fiscal doctrines and taxation regimes in each of the countries considered herein (see Kayaalp 2004). However, we are concerned not only with explaining how national regimes of taxation, expenditure, and debt management were implemented during the nineteenth century but also with elucidating the underlying economic and political interests that such regimes were serving or challenging, and how they were made acceptable to society.

The conventional wisdom about the allegedly autonomous roles of states derives from the claim that the state performs a variety of functions that are not subject to dispute, namely those related to the pursuit of general objectives of well-being that serve society as a whole. The engagement with the common good is certainly a strong caveat for justifying the provision of public goods and services. However, it does not prevent us from recognizing the existence of vigorous interactions between governmental institutions and organized interest groups in civil society. It is precisely such interactions that explain both the prevalence of redistributive tax policies in a certain historical context and why in different settings preferences may emerge in support of policies for investment and economic growth.

Public finance is about taxing, spending, and balancing budgets. These activities are assigned to governments, and it is therefore their mission to make the appropriate choices while bearing in mind the effects of such activities on the welfare of their citizens. One may concede that governments have goals and an agenda, which implies costs. The objectives of governments are made possible through a set of fiscal policy decisions designed to extract sufficient resources from the population under the state's control. Limits to the growth of fiscal states depend not only on the ability to develop the tax bases without endangering social and political support but also on the ability of governments to service and redeem the debt. To raise the amount of funds required to finance the government's activities, supposedly devoted to the common good, politicians and bureaucrats may be impelled by personal interests and are therefore subject to the rules of utility-maximizing behavior. The agenda for public expenditure can also be appointed in ways that reveal the tendency of governments toward excess spending in order to maximize future political results. These issues inform the public choice approach to the discussion of the functioning of different fiscal and financial regimes.[6]

As to the functioning of political process, public choice theorists consider that governments are not organic or institutional entities that make decisions with an abstract public interest in mind. By extending the methods of economics to the analysis of political decision-making processes, public choice theorists emphasize the role of self-interest and incentives as a main motivation for political action. For this reason, the study of the political decision structure and the conditions within which taxing and spending choices are made is of paramount relevance. The peculiarities of the political process elucidate the outcomes that arise from changes in fiscal institutions (Wagner 2007). One may dispute whether a certain fiscal reform is an attempt to limit the role of the government or to control its tendency to increase spending when revenues raise. Nevertheless, taxing and spending decisions should not be left to the arbitrariness of central and local governments acting in contexts of political constraint. According to the arguments put forward by public choice theorists, constitutional rules (i.e., common law, general legislation passed in parliament, and institutionalized values and traditions) form indispensable conditions for the creation of a reliable system of public finance. Furthermore, governments in modern societies are obliged to deal with increasingly complex sets of issues with respect to the formation and use

[6] See Buchanan (1979). On the continuity between certain types of continental European public finance theory and the public choice approach, see Backhaus and Wagner (2005). The methodological and conceptual differences concerning the interpretation of the economic functions of the government should not be dismissed, as is clearly shown in the debate between Buchanan and Musgrave (1999). The appeal to the public choice approach in the analysis of the functioning of state finance regimes has also been summarized in Bonney (1995a) and Daunton (2001: 8–9).

of proper economic knowledge, which supports the process of legitimization or the rejection of policy decisions.[7] Governments need to justify their actions on the basis of sound constitutional rules and credible economic reasoning.

When applying this type of approach to the nineteenth-century realities, we may find worthy attempts to create fiscal constitution procedures designed to restrain expenditures and to make feasible the abolition of certain unpopular taxes and duties. Such was the case in Britain of Gladstone's 1853 proposal to phase out the income tax as a strategy to create constitutional limitations to public spending.[8] However, the classic nineteenth-century contributors to the theory of public finance were more concerned with the ability-to-pay approach, viewing the problem of taxation as more or less independent of the process of determining both the amount and the allocation of public expenditures. Although this approach did not reduce public finance to taxation, it has nevertheless imposed a separate account on both sides of the balance.[9] The success of the implementation and development of tax regimes across Europe had much to do with different levels of legitimacy, the credibility of governments and their budgetary policies, and the outcome of those policies. To take those issues into account, this book looks at the evolution of political stability at the national level and at the credibility of governments. Moreover, several chapters take into account the efficiency of public expenditure in terms of the provision of public goods, including infrastructures, schools, police, and defense. A further aspect that can be better understood through a public choice approach, which is implicitly addressed in the chapters, is the relationship between economic interests and their support by politicians in the government or parliament (see Nehring and Schui 2007; Schonardt-Bailey 2006).

Nineteenth-Century Transformations

This book deals with nine countries that represent about 90 percent of the total population and gross domestic product of Europe to the east

[7] On the role and contribution of economic knowledge to strengthen government decisions, see Furner and Supple (1990), introduction.

[8] See Baysinger and Tollison (1980), who argue in favor of the coherence of that constitutional strategy, and Leathers (1986), who claims that the project was condemned to fail.

[9] On the theoretical principles explaining this tradition, see the authors' introduction to Musgrave and Peacock (1958). See also Dome (2004) for a survey of the fiscal problems by Enlightenment and Victorian British political economists.

of Germany and Austria-Hungary in 1900, as well as a wide variety of experiences in the field of public finances (Maddison 1992). As we shall see, financial distress was common in both the poor southern countries and in the wealthier cases of Britain and the Netherlands. The speed with which governments solved the problems of debt inherited from wars varied significantly, but again the divide was not between more or less developed countries; it depended on other factors of a political or social nature. France, for example, did not have as great a debt inheritance as Britain, but the French governments throughout the century faced more difficulties in balancing the budget. The same was the case for Portugal and Spain.

The major source of differentiation came from the degree of institutional development, which depended on the ability of governments to reach some kind of consensus involving both the taxpayer and the purchaser of public bonds and other debts. The main task was to reach that consensus before creating the necessary institutions. In fact, as the century evolved, the economies integrated, and the public became more educated, the creation of the institutions became within reach of every country in western and southern Europe. When that consensus was reached, it was possible to find balanced solutions that satisfied the concerns of taxpayers and borrowers as well as those of the state at the central or local levels.

The case of Great Britain is highly revealing of the role of political coordination in the governing of public finances. Britain was in a difficult position in terms of state finances by the end of the Napoleonic Wars. In 1815, government expenditures were a staggering 23 percent of national income. In that same year, debt charges accounted for 26.6 percent of gross public expenditures and climbed to 54.4 percent in 1825. In the eighteenth century, public expenditures and the national debt were considered by the public as the 'bulwarks of liberty and Protestantism against the French,' as, to a large extent, they were raised to pay for past wars. Yet having reached such large sums, the state could easily become the major threat to those liberties. Trust in the eighteenth century was higher in the United Kingdom than in France because the British state was more responsible in dealing with its financial affairs. But if trust were to be regained, the tax system had to change, and it did so in the following decades.

The recovery of trust was dependent on the reduction of the fiscal pressure on the economy. That was made possible because Britain was no longer fighting the expensive wars of the previous century. Yet