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978-0-521-77305-8 - Transferring Wealth and Power from the Old to the New World:

Monetary and Fiscal Institutions in the 17th Through the 19th Centuries

Edited by Michael D. Bordo and Roberto Cortés-Conde

Excerpt

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# 1

## Introduction

*Michael D. Bordo and Roberto Cortés-Conde*

The chapters in this collection examine the factors that allowed efficient fiscal and monetary institutions to develop in some countries at certain moments in time, while in others such development turned out to be unsuccessful. They also deal with the reasons why some governments were able to live within their means and provide public goods, while for others expenditure often exceeded revenue, financial difficulties were the norm, and, in the face of extraordinary shocks, fiscal crises arose.

On monetary issues, the collection considers the evolution of institutions designed to save on transaction costs, the extent and the manner in which sovereigns resorted to money finance (seigniorage), and the effects of this instrument on economic stability and development.

The collection compares the evolution of the fiscal and monetary regimes of the Old World countries from the seventeenth to the nineteenth centuries with the experiences of countries in the New World. The objective is to see how such fiscal and monetary institutions were transferred from the Old World to the New during the colonial era and how old institutions were modified or replaced by new ones. In addition, the chapters in this collection consider the experience of the colonies after they became independent countries.

The creation of efficient fiscal institutions involved the transition from regimes where sovereigns financed themselves with resources derived from their own lands (the *demesne*) or from their feudal rights (the *patrimonial state*) to a new regime where the rising expenditures of the new national states required resources to be exacted from their subjects (the *tax state*).

At the beginning of this transition, in the face of extraordinary circumstances such as wars, duties consisting of aid and requisitions were imposed. Later on they were demanded on a more regular basis, finally evolving into taxes. While the sovereign could dispose of his own

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property at will, this was not the case when the decision involved his subjects' property.

It should be remembered that in the feudal world, the sovereign's relations with his subjects, like those of the lords with their vassals, involved (mainly) an exchange of services. These obligations arose from the customs of the manor. It then became necessary to define a new set of property rights by which the sovereign could bind his subjects. Although property rights had been gradually defined over time, there was still an ambiguous area where the sovereign and his subjects continued to struggle for their respective rights. The sovereign claimed his right to receive aid in the case of needs of state (e.g., wars), while his subjects demanded the right to be consulted concerning the actual existence of such needs and the implementation of taxes.

This struggle gave rise to a process that led to a new set of property rights and to the creation of a competitive political environment where those affected were entitled to take part in the decision making that generated the expenditures and the distribution of the burden. This process, in turn, involved the creation of institutions of political representation that were quite rudimentary in some cases and more advanced in others (e.g., "no taxation without representation").

The degree of participation in decision making over taxation varied considerably across countries. In some cases, taxpayers' representation was wider, as in the Low Countries (de Vries, this volume) or the British Parliament after 1688 (Capie, this volume); in others, it was more nominal than effective, as in the Spanish courts (Tortella and Comín, this volume); and in still others (paradoxically), nontaxpayers were represented, as in the French parliaments of the eighteenth century (White, this volume).

However, it is evident that, regardless of the identity of those legally empowered to create taxes, the revenue collected was higher and the costs were lower if there existed consensus on the part of the taxpayers. Lack of consent resulted in tax evasion and the fiscal uprisings that were common in Europe.

The legitimacy of decisions had a bearing on their effectiveness. The negotiations between sovereign and subjects and the agreements reached on taxes depended on a series of circumstances. In the first place, they depended on the traditions of the country, the degree of evolution of its institutions and its economy. In the cities of northwestern Europe, where commercial activities had been widely established by the Late Middle Ages, the need to establish a set of property rights arose earlier than in predominantly agrarian societies, and in the urban environment the citizens' obligation to support their governments was already widely established.

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At the same time, commercial activities yielded a surplus that permitted the creation of capital markets. The early formation of debt markets for urban governments was a consequence not only of the existence of commercial surpluses but also of the fact that their citizens, among them rich financiers and merchants, unlike the sovereign, could be prosecuted for their debts (Ehrenberg, 1973).

The experience of the cities was the basis for the tradition continued by the seven provinces of the Low Countries in granting taxes and creating a debt market (de Vries, this volume). In England, the tradition of “dialogue” between ruler and subjects that led to parliamentary democracy can be traced back to the Magna Carta of 1215 (Capie, this volume), and it extends to the long conflict between the king and Parliament, with the latter’s success in the Glorious Revolution of 1688.

A second circumstance involved geography and related economic characteristics (Landes, 1998). England’s geography gave it the peculiar feature of a tightly interwoven territory that facilitated the early formation of homogeneous markets. Its insular nature facilitated the development of a variety of ports through which a more controlled trade took place. France, by contrast, was a continental country with a wide territory divided into several regions that were not always connected. This gave rise to segmented markets, quite autonomous regions, and lower trade flows. The Netherlands benefited from its small scale, from its location as entrepôt of the trade between the North Sea and the Baltic, and from its subsequent expansion overseas. It was the need imposed by the peculiar geography of The Netherlands that led to the creation of cooperative associations, such as those for drainage, which in turn established a precedent for collective action (de Vries, this volume).

At the same time, Spain consisted of a set of kingdoms with diverse features. Castile had a powerful central government, with the influence of the Cortes (parliament) continuously diminishing, while Aragon had an autonomous government with greater popular participation (Tortella and Comín, this volume).

The discovery of abundant mining resources in Spanish America, by alleviating the tax burden on the inhabitants of the Spanish metropolis, allowed the king of Spain to avoid entering into the agreements with his subjects necessary to establish sound fiscal institutions. On the one hand, the easy access to American treasure meant significant cost savings; on the other hand, it meant the postponement of fiscal reforms. Further reform finally became unavoidable when mining resources became insufficient. Thus the precious metals represented a source of significant royalties for the king of Castile. This windfall also permitted him to manage his debt quite carelessly.

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The fiscal experience of Portugal was determined by its geography and history. Portugal was a small country having, consequently, no significant regional differences, with a large waterfront on the Atlantic Ocean and a preeminence of the urban sector. The need to consolidate the national state in the face of the foreign menace facilitated the acceptance of reform leading to the modernization of the regime (de Macedo et al., this volume). These circumstances, according to the authors, allow a comparison to be made between the Portuguese and British cases.

Excises existed in Portugal from 1387, and the *dezima* applied to all sectors, including the nobility, from 1641. With the Cortes, there was a representation mechanism related to tax decisions. However, Portugal, like Spain, based its revenue on remittances from the colonies (on trade monopolies and the *quinto*), which accounted for 50 percent of the total revenue and helped alleviate pressure on the metropolis. When the court migrated to Rio de Janeiro during the Napoleonic Wars, colonial remittances dropped and expenditures (mainly war expenses) rose, and a fiscal crisis occurred that led to the liberal revolution of 1820. The attempt to finance expenditures through the issue of debt (tax smoothing) failed and the crown took to inflationary finance, which damaged its long-standing monetary stability. Nevertheless, this situation improved by the second half of the nineteenth century thanks to the implementation of the gold convertibility regime.

## 1.1 THE TAX REGIMES

Although during the seventeenth century a transition from a patrimonial tax regime to one based on the subjects' contributions occurred in most of the European countries surveyed, the path followed displayed idiosyncratic characteristics in each country, with many features of the old regimes often surviving. This transition required the modification of existing fiscal institutions or the creation of new ones. These institutions, in turn, were designed to deal with difficult aspects of the fiscal function: the creation of taxes, the generalization of the tax burden, the centralization or decentralization of taxes, the administration of revenue, and debt management.

### 1.1.1 Tax Creation

The decision on the taxes to be levied depended on each country's traditions and circumstances. In the cases analyzed in this book, direct taxes on income, production, or wealth and indirect taxes on consumption via both internal and external trade were imposed. In almost all countries both types were applied, although in different proportions, depending on

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the circumstances that made collection easier. Direct taxes demanded complex assessment mechanisms, while indirect taxes were easier to implement, provided that centralized markets existed. For this reason they became the most substantial source of revenue. Direct taxation was common in Spain (*tercios*), France (*taille*), and Portugal (*dezima*). Taxes on local consumption were levied in Spain (*alcabalas*), Great Britain and Portugal (excise), and France (*gabelle*, *traites*, and *aides*). The amount of the contribution depended on the general economic situation, but also on the simplicity and cost efficiency of the evaluation mechanism, the collection method, the degree of consensus, and generalization, that is, the fact that the tax burden affected all subjects.

To a considerable extent, the geography and the economy of the country conditioned the success of tax collection. In countries with a wide territory such as France, taxes were mostly levied on local production, while the insular nature of Great Britain made it easier to impose taxes on foreign trade. Custom duties and excise taxes constituted the most significant part of British revenue. During the Napoleonic Wars, following a decline in import duties, Great Britain was successful in imposing direct taxes on property and income from a wide sector of the community, including the nobility (Capie, this volume).

Spain based its resources on direct taxes such as the *tercios* and on indirect ones such as the *alcabalas*, but the revenue derived from the mining activities in the colonies (the *quinto* and later on the *decimo*) were of fundamental importance. Spain found a source of income in the colonial mines that were included in the patrimony of the king of Castile. In addition, taxes were imposed on colonial trade, which was also monopolized for the benefit of the Spanish crown (Tortella and Comín, this volume). Portugal was another example of a monarchy that exacted resources from its colonies. The Iberian example is in contrast to that of Great Britain, Holland, and France.

Economic growth in the sixteenth century and the growth of international trade raised the issue of who would levy taxes on the new activity. In the case of taxes on consumption, incidence depended on the elasticity of demand and supply; in the case of taxes on domestic sales, incidence fell on local producers or consumers; in the case of import duties, it was supposed that they were a burden solely on foreigners. For this reason, they were resisted less, and sovereigns understood that as long as they were not imposed on their subjects, there was no need to consult with them.

This was the source of a painstaking debate between the British monarchy and Parliament, in which the latter was successful and rules were set forth requiring consultation with taxpayers via their representatives (“no taxation without representation”). This outcome had

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favorable consequences, concerning not only revenue but financing as well, since it was then possible to place debt in the capital markets, as it was guaranteed by Parliament (Capie, this volume).

As regards the implementation of a long-term public debt market, the British adopted institutions successfully applied by the Dutch since the seventeenth century (de Vries, this volume). The Dutch monarchy, in placing bonds in the capital markets, in turn, had made use earlier of the experience of medieval cities (de Vries, this volume). When, as in the case of Great Britain, Parliament began to guarantee sovereign debt, the fear that the sovereign would repudiate it decreased (North and Weingast, 1989). Thus, it was possible to lower the sovereign risk. As credit standing rose, the risk premium and interest rates declined.

### **1.1.2 Generalization of the Tax Burden**

One of the characteristics of the modern tax state was the elimination of the numerous tax exemptions that had survived from feudal times. These had a social dimension, since certain estates (the nobility and the clergy) were not bound to pay taxes on their property. Since feudal times, the nobles were bound to arm themselves in defense of the king, which in turn exempted them from the burdens imposed on those not rendering military service. However, by the seventeenth century, the monarchies of the new nation-states found that to be successful in war, both a complex technology and the professionalization of the army were necessary. Thus, as the nobility ceased to render blood services, their traditional exemptions became anachronous. In France the nobility strongly opposed generalization of the tax burden and found support in the parliaments; during the seventeenth century they managed to dismiss any fiscal reform aimed at taxing them. This failure to widen the taxable base brought great financial difficulties to the monarchy during the course of that century (White, this volume).

But generalization of the tax burden was a question related mainly to those regimes mostly dependent on direct taxes. Indirect taxes on consumption, because of their very nature, were paid by all members of the community, as was the case in Great Britain and, to a lesser extent, in Spain (*alcabalas*) and Portugal (excise). Curiously enough, contrary to present practice, indirect taxes were (for this reason) more egalitarian than direct ones. During the Napoleonic Wars, because of the decline in custom revenues, Great Britain depended more on direct taxes and succeeded in making them universal to include the nobility (Capie). According to de Macedo et al. (this volume), Portugal also taxed its nobility.

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### **1.1.3 Centralization or Decentralization of Taxes**

Who would be entitled to collect taxes: the central government or the local authorities? In the European monarchies, where the transition to the tax state paralleled the consolidation of the nation-state, the tendency was to empower the monarch, that is, the central government, to collect taxes that in some cases previously had been local. Where there was no nation-state, as in the German principalities, the taxes continued to be local. The Dutch monarchy itself was a federative association of seven provinces empowered by the cities to collect taxes (de Vries, this volume).

Thus, in the Old World, the trend was toward centralization, although local regimes, different from those of Castile, continued in force in Spain in its relations with Aragon, Catalonia, and Valencia. The experience of the New World was different, as in the United States, Canada, Mexico, Brazil, and Argentina. There the newly independent governments tended to establish decentralized systems in which the right to collect taxes sometimes rested with the central government and sometimes with the local authorities. The demarcation between authorities, in turn, was closely linked to the political regimes of these countries.

### **1.1.4 Tax Administration**

Tax collection may be either centralized or decentralized. It may be performed by the administration itself or commissioned to third parties. In general, those systems with weaker collection capacity were more dependent on tax farming. The principle that the state's revenue should equal the future income of the farmer seldom was enacted in reality, although it came closer to it when farming was subject to bidding. In most cases, with scarcely transparent markets, this gave rise to mutual fraud between the sovereign and the farmers, ending in a great burden on the taxpayers and leading, in turn, to frequent tax revolts. Spain applied a farming regime in the seventeenth century (Tortella and Comín, this volume), but the most remarkable case was that of France (White, this volume).

### **1.1.5 Debt Management**

The answer to extraordinary circumstances such as the frequent wars of the period, demanding unusual resources, required complex institutional engineering. In the past, this problem had been solved by resorting to savings generated in earlier periods of peace (the war chest) or else borrowing directly from the suppliers of material or from bankers. Generally, these were short-term debts claimable in full. The idea was that at



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the end of the war the victorious party would acquire the defeated party's resources. However, it was not always possible to take everything from the loser, and as wars became more drawn out, the problem became how to schedule the debt so as to repay it over longer terms.

The needs of an increasingly complex and bureaucratic military structure increased the states' extraordinary demands and their need to search for new sources and forms of finance. Spain, during the seventeenth and eighteenth centuries, dependent on Genoese and German bankers, bound to repay short-term debts, and with no access to a capital market, went into repeated defaults. Something similar happened in France, with several defaults during the eighteenth century. The Low Countries and Great Britain were far more successful since they managed to place long-term debt in the markets.

De Vries (this volume) points to a special feature of the Low Countries that allowed them to organize a debt market. This occurrence reflected, first, the early rise of financial centers in Antwerp and later in Amsterdam and, second, the fact that the House of Orange took over the authority of the cities, which had earlier pioneered the issue of public debt. As Ehrenberg (1973) has pointed out, the cities had a patrimonial responsibility that made them more trustworthy in the eyes of investors. In England, according to Capie (this volume), the solution, in 1676, to Charles II's default ("stop of the Exchanges") was to create the annuity, a long-term investment instrument.

## 1.2 THE POLITICAL INSTITUTIONS

In the tax state, the government is sustained by the taxpayers instead of deriving resources from its own property. As tax levies impinge on taxpayers' property rights, the perception of the legitimacy of the tax regime becomes a key factor for the efficiency of the system. This is intimately connected to the political regime, that is, the regime that establishes who decides who must pay, the amounts owed, and the allocation of such funds. All this is essentially a political issue.

In both the Dutch and British experiences, a mechanism was achieved through parliamentary representation that involved taxpayers in the decision making concerning taxes and fiscal control. Such a principle, of decisive importance in the transition in the early modern period from an absolute monarchy to a limited constitutional monarchy, was made sacrosanct in Great Britain.

The importance of this political institutional structure in the development of an efficient tax system and in the formation of capital markets has been well established (North and Weingast, 1989). In this sense, the



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successful consolidation of a tax state coincided with the political transition from the ancient regime to limited government. Such political transitions, which occurred first in Great Britain and Holland, took longer to achieve in Spain and France. In Spain it took place only in the nineteenth century, thus contributing to a deeper crisis, both in the metropolis and in the former colonies. In France, failure to attain a consensus over tax reform brought about a series of crises during the eighteenth century and led to a summoning of the States-General and the French Revolution in 1789.

**1.3 MONETARY INSTITUTIONS**

All of the Old World countries under consideration were on a specie standard in the period covered by our study. With the exception of France in the brief John Law affair, none resorted to the issue of inconvertible notes (the inflation tax) as a form of revenue. The Spanish and Portuguese monarchies had, however, on different occasions engaged in debasement of the coinage. Philip III of Spain began the debasement of silver coins (*reales de plata*). These coins were displaced by an alloy of silver and copper (*reales de vellón*). Debt instruments such as *juros* and *vales reales* were also used as quasi-monies. Portugal after the restoration also resorted to debasement. Banks, other financial institutions, and financial markets also developed in The Netherlands, Britain, and France but not in the Iberian countries.

**1.4 THE COUNTRIES OF THE NEW WORLD**

The European colonies in America were recipients of the fiscal and monetary institutions of their respective metropolises. They adapted these institutions to their own resources and circumstances, population, customs, cultures, and distances. Did they modify them or did they create new ones instead? What was their experience as they became independent? Did they reject colonial institutions as an expression of their opposition to the ancient regime and adopt other institutions, which they considered more consistent with the ideology that had inspired those proclaiming their independence from the European monarchies?

In the cases studied, all outcomes prevailed in varying degrees. In the beginning, the colonial powers – it couldn't be otherwise – transmitted their institutions to the New World. These were the institutions familiar to them, but the distances were so large and the differences between the new territories and the metropolis so marked that they had to be adapted to the new circumstances. Later on, the colonial masters adapted to the

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new situation but also to the fiscal goals of the home country and to the special concerns of their colonies. This was not so much the case in the North American colonies, where little of the wealth discovered in Latin America was found.

### **1.4.1 The United States**

Along with this process of adaptation of institutions and the creation of new ones, perhaps the most remarkable case was that of the English colonies of North America. The representation principle in force in the metropolis after 1688 was upheld within the sphere of the governments of the 13 colonies (later of the states), but a typically American political innovation was added: that of local administration. The difference was relevant because the activity of government in the colonies was rather limited, while the local administration incurred most of the expenses to provide services, such as security and education. The British colonial governments collected taxes on foreign trade as well as some indirect excise taxes, but their expenses were very small. The local administrations instead collected direct taxes on property and wealth. Indeed, the English settlers in America did not directly support the central administration in London. Great Britain subsidized defense expenses because settlers were not represented in Parliament. When the Crown attempted to transfer these expenses to the colonists, the revolts that led to American independence broke out. Thus it was of great importance that the provision of basic public services occur at the local level and that, in their cities, the American settlers take part in making decisions concerning expenditure and taxation.

America not only took up the principle of no taxation without representation within its local governments, but also added to it the participation of taxpayers in local assemblies (Sylla, this volume). A correspondence between expenditure and taxes was established that not only legitimated taxes but also made their collection more effective and easy. These were largely taxes on property, and local officials were the ones who best knew the value of the taxable items and could make an accurate assessment, under the surveillance of the other settlers.

This regime was passed down to the independent Republic with a modification: the emergence of a federal government that undertook defense expenditures (and servicing of the national debt) and that, in turn, was empowered to collect taxes on foreign trade, a faculty formerly vested in the colonial administrations. The latter (the states) continued to collect indirect taxes and some direct taxes, while local governments concentrated mainly on property taxes.