

Cambridge University Press

978-0-521-59123-2 - The State, the Financial System and Economic Modernization

Edited by Richard Sylla, Richard Tilly and Gabriel Tortella

Excerpt

[More information](#)

1 Introduction: comparative historical perspectives

Richard Sylla, Richard Tilly and Gabriel Tortella

The more one studies the historical origins and development of modern financial systems, the more it becomes apparent that at most of the critical points when financial systems changed, sometimes for better and sometimes for worse, the role of the state was of paramount importance. That is hardly surprising. Long before private economic entities – trading, transportation and manufacturing enterprises may be cited – came to require financing on a scale beyond the capabilities of individual proprietors and partners, governments had needs for large-scale finance. The most durable reasons for these needs involved the political ambitions of governments: solidifying and extending their authority, unifying the disparate components of their states under a central administration, promoting state-led and state-financed economic development projects as a means of increasing state power, and, perhaps most important of all, waging wars against other competing states. But the state not only had a need for large-scale finance. It also had the coercive power of taxation that, among other things, gave it a stronger credit, that is, a greater ability to borrow and pay debts, than was possessed by any private parties. Moreover, the state had the power to create financial institutions and markets, and to shape their development through legislation and state regulation. States used all of these powers from the European middle ages up to and including the eighteenth century, when the modern industrial era commenced.

Curiously, the insights into financial development coming from the pre-industrial era, insights that point to the primacy of the state's role, have not carried over into the historiography of the industrial era itself. Here the fascination with industrialization reigns supreme, with commercial, agricultural and financial developments relegated to secondary, ancillary, facilitating roles, and with the role of the state itself pushed well into the background, where, many have argued, it not only was, but also ought to have been. The *laissez-faire*, anti-mercantilist traditions of classical and neoclassical economics were in major ways responsible for this shift of historical emphasis. So has been the division of labour among

Cambridge University Press

978-0-521-59123-2 - The State, the Financial System and Economic Modernization

Edited by Richard Sylla, Richard Tilly and Gabriel Tortella

Excerpt

[More information](#)2 *Richard Sylla, Richard Tilly and Gabriel Tortella*

modern economists, which has made public finance and private finance into separate sub-disciplines, each with its own practitioners, courses of study, students, textbooks and journals, and with few interactions between the two groups.

Those of us specializing in financial history have not been unaffected by these strong currents of thought. For one thing, they relegated us to the study of something that was inherently less important than the one big thing that was important, namely industrialization. For another, they fragmented finance itself into two fields, private and public, each with its own sub-fields, and each having seemingly little to do with each other. Most of us studied private finance – the economics of money and banking, other financial intermediaries, money and capital markets, the rate of interest and the returns of equity shareholders. Public finance divided itself into two sub-fields, the economics of taxation and of governmental expenditures, neither of which had much to do with any of the private-finance fields.

As financial historians buffeted by these currents, our strategy to be relevant was a simple one. Private banks were the one type of financial institution present throughout the era of industrialization in one form or another, and so we would gain attention for our work by studying what banks did, how their nature and functions changed over time, and how banks did or did not contribute to industrialization. This we did, in numerous dissertations, articles and books.

Since the 1960s, consequently, the literature on the role of banking in economic development has grown enormously. This represented at the time an overdue correction of the older view that ‘money and banking’ had much to do with short-run cyclical phenomena, but little to do with long-run economic change. In the meantime, however, the fields of finance, monetary economics and even financial history have moved on. It has become clearer that finance involves and involved much more than banking. Developments in economic theory (the theory of expectations, the economics of information and especially the economics of institutions) have helped here by making the interactions between financial markets, institutions such as banks and shifts in public policy more amenable to systematic generalization. We have begun to see new significance in the breadth and variety of institutions incorporated within financial systems – non-bank intermediaries, money, debt and equity markets, and stock exchanges.

In tracing these variegated institutions and markets back to their origins, we are no longer distracted by finding that the financial needs and intents of the state were of primary importance; that public or state banks to serve state financial interests arose almost simultaneously with private

banks; or that these public banks set patterns that private banks sometimes followed; and that they also evolved into central banks that regulated and controlled the activities of the private banks. New significance can be attached to the discovery that private banks themselves, though they may have begun in many instances as proprietorships and partnerships without governmental sanction or interference, evolved towards business corporations chartered and regulated by the state, in the state's financial interest. And it is no surprise that the money, debt and equity markets that eventually became mainstays of industrial and business finance, invariably began as issuing and trading markets for government debt obligations before there were many private obligations.

In our historical work we learned further that financial systems did not develop according to some uniform pattern dictated by the logic of industrial finance. Instead, there were divergences of systems. In Continental Europe, financial systems came to be dominated by large banks; open debt and equity markets were of relatively minor significance. In the 'Anglo-Saxon' countries, however, banks played a lesser role, and relatively more financing of enterprises, especially long-term financing, took place through the open bond and equity markets. What accounts for the differences that emerged among financial systems? Very often they resulted from the ways in which the state formulated financial legislation and regulated financial institutions and markets.

And yet these various insights, these rediscoveries being made for different sets of national historical experience, have not yet been brought together in a coherent, systematic manner. That is the purpose of this book. Its intent is to demonstrate, through comparative historical analysis, the richness of the history of modern financial systems, and to restore the state to its primary role in the shaping of those systems. The financial history of the era of industrialization, to repeat, is much more than the history of banks. And in this era the role of the state in determining its own notions of proper financial legislation and regulation, is far greater than one would gather from earlier accounts.

Economic historiography has of course long recognized that the state has exerted ongoing influence on the financial system through rules and regulations, e.g. through controls over the money supply, interest rates and so on. What has not always been appreciated, however, is that the non-intended consequences of state operations, especially the handling of public finances, could have had long-lasting effects upon the development of private financial arrangements. Take the emergence of the modern national state in the early modern period (since c. 1500). That development involved war-making and hence public borrowing from private sources on an unprecedentedly large scale. In some cases this generated

Cambridge University Press

978-0-521-59123-2 - The State, the Financial System and Economic Modernization

Edited by Richard Sylla, Richard Tilly and Gabriel Tortella

Excerpt

[More information](#)

financial distress among private wealthholders, and produced long-lasting results; in others, initially pernicious effects could be rapidly overcome. A brief survey of the historiography can illustrate the connection.

A key historical concept here is that of 'financial revolution'. Originally developed to describe the history of English public finance between the 'Glorious Revolution' of 1688 and around the middle of the eighteenth century (Dickson 1967), its basic idea can be generalized: the rising importance of bourgeois, capitalist wealthowners coupled to the above-mentioned increase in governmental financial needs led European states to adapt their financial practices to capitalist standards, e.g. by making their financial accounts more transparent, by improving their revenue bases or – in the extreme case – by making the power to spend and tax contingent upon the approval of a political body dominated by property-holders. The end result was emphasis on an appeal to the self-interest of capitalists in the form of an offer of assets that had an attractive combination of return, liquidity and risk of default. All of this represented a radical departure from such time-honoured practices as debasement of the coinage and confiscation of wealth through forced loans or default.

In one sense, the story of financial revolution should begin with the Netherlands. For in the seventeenth century, the Netherlands, or rather Holland, emerged as the first nation with public finances based on the honouring of capitalist principles, above all a power to spend and tax subject to the scrutiny and approval by legitimate representatives of the bourgeoisie – which dominated political affairs to an extent matched nowhere else in the world. The financial demands of the Dutch state consequently reached an entire class of investors, not just a privileged circle of wealthy capitalists, as was the case in all other countries at this time (De Vries 1976: 211–13, 218, 220). The combination of private wealth and the consent of the citizenry made for a strong state and provided the basis of the Netherlands' amazing great-power status (Kennedy 1988: 101–2). Since the emergence of an identifiable Dutch state was coterminous with capitalist-oriented institutions of public finance, there was no 'financial revolution', only evolution. For reasons which need not detain us here, the Netherlands were unable to exploit their head start in financial institutions as the basis for a head start in industrializing (Riley 1980). Instead, the country's main, lasting contribution to European economic modernization was in serving as an example for England and, indeed, in supplying the latter with a monarch, William of Orange, whose presence eased the implementation of the modern, Dutch principles of public finance.

At the heart of England's 'financial revolution' was the emergence, at the end of the seventeenth century, of a balance of power there between

Cambridge University Press

978-0-521-59123-2 - The State, the Financial System and Economic Modernization

Edited by Richard Sylla, Richard Tilly and Gabriel Tortella

Excerpt

[More information](#)

Introduction: comparative historical perspectives

5

the executive branch of government (the king and his ministers), on the one hand, and the legislative branch (parliament), on the other. The executive initiated policy, but its executing depended upon parliamentary approval. As North and Weingast (1989) have pointed out, this represented a division of labour which was favourable from a transaction costs point of view and one which – applied to the government finances – had enormous implications. The fact that the state's finances depended upon parliamentary approval did not merely enhance capitalist confidence in the former; it also encouraged the state to adopt financial measures likely to impress private capitalists: e.g. the chartering of the Bank of England, the creation of more liquid (and more tradable) forms of government debt, the publication of annual government budgets, and the development of a more efficient and centralized system of tax collection (Dickson 1967; Neal 1990; O'Brien 1988; Brewer 1989). These arrangements can be viewed as institutions which offered, in North's phrase, 'credible commitments' by the British state to a policy of monetary and fiscal soundness – which coincided with the interests of British capitalists.

There are good reasons to see this set of changes as an important basis for Britain's subsequent economic development. As a recent survey of Britain's 'industrial revolution' (Deane 1996: 23) commented:

The upshot of this transformation in the English (and after the 1707 Union with Scotland, the British) system of public finance was twofold. In the first place it strengthened the economic power of the central government by giving it virtual immunity from the financial crisis that plagued most of its European rivals. In the second place, and as a by-product of the massive increase in the National Debt, it contributed directly to the modernization of the nation's credit institutions, to the integration of its capital market and to the development of a prosperous and efficient financial sector.

And as Larry Neal has recently argued, the declining risk and increasing liquidity of government debt made its yield an increasingly convenient indicator of the opportunity cost of capital to private investors throughout the country, enhancing the integration of its capital markets (Neal 1994: esp. 153–5, 171–81; also Pressnell 1960). Indeed, it has been argued that falling yields through much of the eighteenth century may have induced ('crowded in') more investment in the private sector, while the increased demand of government war finance from the 1790s temporarily led to a 'crowding out' of that investment (Ashton 1948; Williamson 1984; Heims and Mirowski 1987; also Mokyr 1987).¹

Whatever one may think of the 'crowding out' argument, there can be no doubt of the relative superiority of Britain's financial position at the end of the eighteenth century. Its strength can be illuminated by comparison with another great-power contender of the times, France. Britain's

Cambridge University Press

978-0-521-59123-2 - The State, the Financial System and Economic Modernization

Edited by Richard Sylla, Richard Tilly and Gabriel Tortella

Excerpt

[More information](#)

financial revolution, according to Charles Kindleberger (1984), put it, financially speaking, one hundred years ahead of France. Kindleberger emphasized the collapse of John Law's bank project, the Mississippi Bubble and the ensuing state bankruptcy of 1720, for this left France with a legacy of popular mistrust of banks and government debt which could only be overcome in the nineteenth century, roughly one hundred years later (Cameron 1967). It should be added, however, that French financial backwardness followed not from the collapse of 1720 alone, but from the continuing unreformed character of eighteenth-century French political institutions and the resultant weakness of public finance. The crisis of state finances, we recall, led directly to the Revolution, and in the Revolutionary and Napoleonic eras which followed public finances remained precarious (Marion 1914–33; White 1989; Weir 1989; Velde and Weir 1992). The role of the *assignats* illustrates that precariousness. In François Crouzet's chapter in this book we see that role, as well as the emergence of Napoleon's cautious if ill-fated financial policies, as a reaction to this legacy. The reaction may have included ultimately constructive measures, e.g. the founding of the Bank of France, but in any case it was one with powerful and long-lasting consequences for the French monetary and banking system. The proverbial propensity of the nineteenth-century French financial system to accumulate gold and silver – which braked, even if it did not prevent, French industrialization – thus derived from a series of short-term responses to the state's immediate financial needs at the century's beginning.

Anglo-French comparison would seem to support strongly the notion of 'financial revolution' as a major historical force in the shaping of modern financial systems. A broader comparative perspective, however, leads to a less unitary view and offers, in particular, two important qualifications. First, in a number of successful industrializers modernization of the system of public finance came in bits and stages, and not in the form of a one-shot, unidirectional shift in fiscal mechanisms; and in such cases it hardly seems to deserve the name 'financial revolution'. Second, the state did not respond to its financial problems and influence private systems of finance through fiscal and borrowing mechanisms alone; it frequently relied on administrative measures and regulation (and deregulation) as well. These qualifications are documented throughout the book. The first point can be well illustrated by a brief survey of German experience.

We begin with Prussia, the most important German state. Its 'financial revolution' could be said to have entered an initial phase during the Napoleonic Wars. This phase followed a long period covering virtually the entire eighteenth century in which Hohenzollern Prussia, in contrast to Western countries, adhered to an older, paternalist view of finance

based on the parsimonious principle of 'living within one's means', i.e. holding expenditures to the minimum essential to the state's survival, mainly in order to keep the monarchy independent of the provincial estates and to avoid surrendering some power over the state in exchange for additional powers to tax.² The decisive defeat of Prussia at Jena in 1806 shattered the Hohenzollern state and the internal balance of power between monarchy, landed aristocracy (Junker) and the largely agrarian population of peasant producers (the small urban bourgeoisie was not yet a significant factor). The response was to free the economy from corporatist, quasi-feudal restraints, e.g. by abolishing serfdom, and to centralize government administration, i.e. to strengthen the central government bureaucracy at the expense of the Junker (and to some extent at the expense of the absolutist monarchy). However, the financial measures adopted – new taxes and borrowing from private merchants and bankers – did not have much effect until after the war had been won (in 1815), and they produced, in any case, only promises of parliamentary controls over government finances and no concrete concessions. Moreover, the major loans of 1810, 1818 and 1820 were actually mobilized along traditional lines, contracted through foreign bankers (the Rothschilds), and were not part of a new strategy to tap the financial resources of an indigenous class of capitalist investors.³ Indeed, secrecy remained a hallmark of Prussian finances in these years. For neither the king nor bureaucracy welcomed the guarantee of public credit which a parliament of property owners could have granted. Thus, in the subsequent period the Prussian government's policy stance was highly restrictive, marked by monetary and fiscal restraint, a return to the older Prussian 'Hausvater' tradition of parsimony, even down to considerable reliance on non-tax revenues which had a low political profile.⁴

This changed in the 1840s, when railway building attained high priority in government policy; but the unresolved question of the power to tax and borrow became a major issue. It was one of the problems which led to the Revolution of 1848–9; and one of the most significant results of the Revolution was the second phase of Prussia's financial revolution. For with the adoption of a constitution came the creation of a parliament of property owners with the right to review the government's budget and to control its power to tax and spend. And it is interesting to note the strong increase in government borrowing and related state spending on infrastructure which was registered at this time.⁵

Prussia was important, but Germany's financial modernization transcended Prussian history. Two developments are relevant here. First, the south German states of Bavaria, Baden and Württemberg modernized their systems of public finance earlier and more thoroughly than Prussia.

Cambridge University Press

978-0-521-59123-2 - The State, the Financial System and Economic Modernization

Edited by Richard Sylla, Richard Tilly and Gabriel Tortella

Excerpt

[More information](#)

By the late 1820s they had established accountable systems of government debt administration with taxing and spending powers limited – and legitimated – by parliamentary controls; and these seem to have had financial pay-off in the better borrowing terms which these states enjoyed *vis-à-vis* Prussia from around 1820 to the 1840s (Homer and Sylla 1996; Borchard 1968: 25–9; Ullmann 1986). These states, however, did not go as far as Prussia with respect to deregulation of their economies, e.g. the liberalization of trade, occupational entry or reform of land tenure, so their relative advantage in public finance was offset by Prussia's lead in other policy areas.

Second, for political reasons, Prussia pursued the goal of a German-wide customs union in these years, the realization of which had important financial implications. It turned out that the net revenues generated by the Zollverein were the latter's most attractive argument for many of the states, at least initially; and the distribution of those revenues led to an agreement on fixed exchange rates between the south German Gulden and north German Thaler areas, and eventually even to restraints on the issue of state paper money by the individual member governments (Dumke 1984; Holtfrerich 1989). Customs revenues outweighed seignorage potential, and thus unification of monetary standards and a built-in commitment to price stability and strict controls over the money supply developed out of the Zollverein as an instrument of public finance.⁶ These institutional changes, then, born of the need to respond to short-term problems of public finance, powerfully shaped the subsequent development of the German banking system.

British financial history, though it represents the classic case of 'financial revolution', nevertheless supplies a good illustration of our second point, which stresses the ongoing and general importance of the state as regulator of the private financial system. As noted above, one of the legacies of the English 'financial revolution' of the eighteenth century was the privileged position of the Bank of England and related limitations placed on the development of private, joint-stock banks (through the Bubble Act of 1720). The chapter by Cottrell and Newton in this volume demonstrates the importance of this legal arrangement by showing how rapidly joint-stock banks grew in the 1830s after the law was modified by Acts passed in 1826 and 1833. Their argument is reinforced, moreover, by reference to the slowdown in bank growth which followed another important piece of legislation – Peel's Act of 1844 – which regulated not just the Bank of England but entry into banking generally. Public concern for the status of the Bank of England, an early element of the country's 'financial revolution', thus continued to be an important determinant of its financial development.

Cambridge University Press

978-0-521-59123-2 - The State, the Financial System and Economic Modernization

Edited by Richard Sylla, Richard Tilly and Gabriel Tortella

Excerpt

[More information](#)

That chapter, however, also helps identify a more subtle point about British financial development. For Cottrell and Newton note that the loosening of the Bank of England's monopoly only led to an increase in the number of new joint-stock banks after restrictions on their participation in the London market for small and liquid bills of exchange had been lifted in 1833. This improved their competitive position *vis-à-vis* private bankers but it did so by permitting them to operate in the well-organized London money market. Legislation, that is, encouraged them to do, on a somewhat larger scale, what their predecessors, the country banks, had already been doing, and therefore strengthened the 'market-orientated' elements of the British financial system.

This is worth stressing since, by a species of dialectic, these strong market elements also shaped the further development of British financial institutions.⁷ In Forrest Capie's chapter on central banking, it becomes clear that when the Bank of England began to try to assume lender-of-last-resort responsibilities (e.g. in the 1870s) it defined these in terms of anonymous relationships (sometimes termed 'arms-length' relationships), and was concerned with 'keeping in touch with the market', infusing liquidity, but not with monitoring the individual institutions involved and keeping watch for bad risks. Thus Britain's central bank – whose behaviour pattern proved not to be a model for Continental Europe – had to respond to a market development which was, in turn, at least in part a response to the Bank of England's own history.

The case of the United States offers yet another relevant chapter of historical experience, for in that country decentralization of political power was even more pronounced than in the German case. The institutions which determined public finance reflected that decentralization. Yet it is worth remembering that centralization of power is, and always has been, a part of the American experience. Conflicts between decentralizing and centralizing forces were always present, but for the most part they were accommodated into a framework of stable politics by the country's ingenious federal system that, under the Constitution of 1787, divided up sovereignty between federal and state governments. Sylla's chapter explores, within the federal-system framework, how the fiscal needs of governments at several key times in US history gave lasting shape to the country's financial system. Thus, however 'exceptional' the United States may have been in some respects, in terms of the thesis of this volume it was not at all exceptional.

Sylla's first example antedates US independence. Fiat paper money appeared for the first time anywhere in the Western world in colonial Massachusetts as a solution to a pressing short-term problem of public finance. But it quickly became a solution to the problem of providing the

Cambridge University Press

978-0-521-59123-2 - The State, the Financial System and Economic Modernization

Edited by Richard Sylla, Richard Tilly and Gabriel Tortella

Excerpt

[More information](#)10 *Richard Sylla, Richard Tilly and Gabriel Tortella*

means of exchange to accommodate long-term economic expansion throughout the American colonies, and in time throughout the world.

The historical concept of 'financial revolution' has already been raised here in connection with England and the Netherlands. It applies as well, Sylla argues, to the United States, where the Federalists of the 1790s, led by an able finance minister, Treasury Secretary Alexander Hamilton, engineered a sharp break with America's previous financial history by introducing, in just a few years, a modern financial system with specie-based currency and public debt, corporate banks issuing convertible notes, a central bank and active securities markets. This financial system became a key underpinning of the country's early start on the road to economic modernization.

Public finance considerations also figured prominently in the proliferation of American banks under the auspices of state charters. The states saw that their bank charters had value and learned to appropriate some of that value for public purposes. The lessons learned early by the states were instrumental in the development of the federal government's national banking system, which came in during the Civil War of 1861–5 to aid in the government's wartime bond sales. The occasion was also used to introduce for the first time a uniform national paper currency backed by the credit of the federal government.

Mira Wilkins' chapter in a sense provides a sequel to Sylla's. The United States, in no small measure because it possessed a dynamic, modern financial system from its first years as a nation, grew over the course of the nineteenth century into the world's largest economy. Until the First World War, however, the country remained an importer of capital as well as the world's largest debtor nation. The war changed all that. When it ended the United States had become the largest creditor nation. By the 1920s, New York City had become the hub of international finance. This came about, Wilkins says, 'not because of any action or lack of actions of the US government, but because the United States was where the capital and the capital markets were'. The suddenness of the change in America's international position, coupled with the lack of governmental financial involvement and leadership in the 1920s, led to some of the abuses that became painfully evident at the decade's end. Wilkins notes that the ensuing crisis of the 1930s brought new governmental regulatory structures in finance that once again reshaped the US financial system. These changes, however, lie beyond the purview of this volume.⁸

The history of the other industrializing countries offers many variations on the same general theme. In the case of Belgium, as explained in the chapter by Herman Van der Wee, fiscal problems in the aftermath of