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0521809673 - Public Debt and the Birth of the Democratic State: France and Great Britain, 1688-1789

David Stasavage

Excerpt

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I

Introduction

I. Credibility and Public Debt

Like many areas of economic policy, public borrowing is subject to a credibility problem. Borrowing on capital markets is advantageous, because it gives governments a means of deferring part of the cost of financing public goods. A state that has access to credit can expand public investment without a sharp and immediate increase in taxation. The problem is that once a government has borrowed, it may face incentives to defer repayment or even to default on its obligations, in order to reduce the burden of taxation on those who contribute to repay debts. Default was a common occurrence that hindered the development of public borrowing in early modern Europe. Today, default may no longer be a worry for those who are considering investing in bonds issued by OECD governments, but it is a major issue for governments in developing and transition economies that seek to offer assurances about debt repayment. If prospective lenders anticipate that a government may default, they will invest only if they are given a high rate of return that compensates for this risk. In extreme cases, they will refrain from lending at all.

This book investigates the link between public debt and representative democracy. In it I develop three theoretical arguments about the effect of constitutional checks and balances, political parties, and bureaucratic delegation on government credibility, and I then confront these propositions with historical evidence from England and France during the eighteenth century. In a concluding chapter I consider broader implications of my findings, focusing on links between democracy and economic performance and on the study of institutions. The theoretical sections of the book use basic game-theoretic models to examine how different

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institutional features of representative government influence the possibility for states to commit to repaying their debts. While there are now a number of studies that investigate how representative institutions may allow governments to solve commitment problems, some authors have argued that this literature often fails to explicitly consider partisan motivations on the part of political actors.¹ Alternatively, those models of commitment problems in debt and taxation that do take partisan motivations into account often pay only limited attention to institutional features of decision making.² The theoretical and empirical analysis here attempts to fill this gap by drawing simultaneously on political economy theories that emphasize partisan pressures on economic policy, as well as analyses that show how the rules of democratic decision making may influence economic policy choices.

I pay particular attention to three features of representative political institutions that may improve a government's ability to make credible commitments. The first emphasizes constitutional checks and balances (multiple veto points in current terminology). According to one view, which extends back to theorists such as Madison and Montesquieu, representative institutions improve commitment when they involve features such as a division of power between legislature and executive or between multiple houses of a legislature. My first main argument suggests that while constitutional checks and balances can improve possibilities for credible commitment, they are neither a necessary nor a sufficient condition for this to occur. They are not a necessary condition, because interests opposed to default may gain influence even in the absence of checks and balances. They are not a sufficient condition, because those opposed to default may fail to gain influence even in a country where the constitution provides for checks and balances. The implications of this argument for credible commitment have not been previously examined.

A second potential credibility-enhancing feature of representative institutions involves party formation in a plural society. When governments borrow, a division is likely to emerge between those who own public debt and those who pay the taxes to service public debt. This raises the

¹ See Przeworski and Limongi (1993) and Elster (2000). The most frequently cited piece in the literature on representative institutions and credible commitment is North and Weingast (1989). See also Bates (1996), De Long and Shleifer (1993), Firmin-Sellers (1994), Levy and Spiller (1996), North (1981, 1990), Olson (1993, 2000), Shepsle (1991), Tsebelis (2002), and Weingast (1995, 1997).

² A good example here is the model in Persson and Tabellini (1994).

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question of how society could commit to repaying debt if creditors are a minority of the population. My second main argument suggests that in societies where there are multiple dimensions of political conflict, even if government creditors are a small minority, other groups can face incentives to support timely repayment of debts in order to gain the support of government creditors on issues such as religion, foreign policy, or constitutional questions. As a result, careful attention should be paid to whether political conflict is in fact multidimensional and to whether government creditors are able to form durable coalitions with other social groups. This second argument implies that democratic compromise may provide commitment even in the absence of constitutional checks and balances.³

A third feature of representative government that may enhance credibility involves the possibility for rulers and politicians to delegate authority to individuals who are committed to pursuing a particular policy, whether it be repaying debt, maintaining low inflation, or regulating industries in a socially desirable manner. In the area of public borrowing it was common for rulers in early modern Europe to delegate authority with the express intent of improving their credibility. So, for example, a ruler might give a group of officials the right to manage public revenues so as to ensure full debt repayment. My third main argument suggests that bureaucratic delegation can reduce default risk, but it will be ineffectual in doing so unless creditor interests have power within a representative assembly, either as an outright majority or as part of a majority coalition. The reason is that when government creditors lack such political influence, rulers will find it easy to alter unilaterally agreements with individuals to whom they have delegated.

In exploring the politics of debt repayment, this book also asks when the institutions or practices that reduce the risk of default are consistent with basic democratic principles. The key question here is, When does commitment occur as a result of democratic politics pushing policies toward “moderate” outcomes? and alternatively, When is the problem solved only at the expense of democracy, by giving government creditors a privileged position in society? As a result, this study should be relevant not only to theoretical debates about credibility, but also to debates about the “structural power of capital” and economic policy making in an era of global finance.

³ The effect of multi-issue conflict on economic policy choices has also been considered recently by Besley and Coate (2001) and Roemer (1998, 1999, 2001).

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My empirical focus on Britain and France is motivated by the fact that it has become popular to contrast the financial experiences of these two countries during the eighteenth century. Great Britain has been portrayed as the first state to establish a modern system of public finance, while France has been viewed more frequently as an example of failed reform.⁴ For some authors, understanding the development of state finance in the two countries has been the end objective of study, while for others, state finance has proved of interest because of the possible link with other developments including economic growth and international rivalries.⁵ In this book I pursue the former approach. As a result, I do not directly consider whether state finances must be sound before private financial markets can develop.⁶ Nor do I seek to ask whether the Glorious Revolution in Great Britain coincided with increased protection of property rights in the economy more generally.⁷ My objective is instead to consider Great Britain and France as fascinating cases that can be used to develop more general inferences about the link between representative government and credible commitment. In so doing I hope to add to other recent work that considers the link between political institutions and state finance in early modern Europe.⁸ I also hope to show that it is possible to use game theoretic models of politics combined with historical analysis in the style of “comparative historical institutionalism.”⁹ Finally, while I draw extensively on research in the fields of economic history and political history, as well as primary sources in selected areas, it is worth emphasizing that this book is primarily a work of political science. My goal for the empirical

⁴ Several classic contributions on the development of state finance in Britain include Clapham's study on the Bank of England (1958), Dickson (1967), Roseveare (1969, 1991), and, more recently, Brewer (1989) and Jones (1988). Knowledge about state finance in eighteenth-century France has been significantly expanded by Hoffman, Postel-Vinay, and Rosenthal (2000), Lüthy (1959–61), Marion (1919), Riley (1987), and Velde and Weir (1992). Comparative studies on state finance include Bonney (1999) and Mathias and O'Brien (1976).

⁵ See Schultz and Weingast (1996).

⁶ This is a claim made by North and Weingast (1989) but contested by Hoffman et al. (2000). See also Rousseau and Sylla (2001) for a more general discussion on the historical link between financial development and growth.

⁷ Clark (1996) has argued that security of property rights was a feature of the British economy well before 1688.

⁸ See Carruthers (1996), Ertman (1997), Hoffman and Norberg (1994), Potter (1997, 2000), Potter and Rosenthal (1997), and Root (1994).

⁹ See Thelen (1999) on this point.

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chapters is to draw on historical work on England and France in order to gain new perspectives on enduring questions posed by political scientists and economists. Likewise, I hope that historians may find this book of interest to the extent that it draws links between partisan politics, political institutions, and state finance in a way that existing work may not have emphasized.

The British historical background to this study involves the dramatic set of changes that took place in English government finance after the Glorious Revolution of 1688. When faced with the need to borrow, English monarchs before 1688 had resorted largely to ad hoc methods; default on these loans had always been a possibility; and as a result the Crown had often been unable to gain access to credit at anything less than exorbitant rates of interest. After the Glorious Revolution this picture changed dramatically. Methods for borrowing were regularized, Parliament gained substantial prerogatives in the area of public finance, the Bank of England was created, and the Crown found itself able to borrow larger amounts at lower rates of interest than ever before. Many of these changes were directly inspired by earlier institutional reforms in the Netherlands, a subject I explore in Chapter 3. It was the simultaneous nature of these developments in Great Britain that prompted North and Weingast (1989) in their seminal article to suggest there was a causal link between the establishment of a limited monarchy in the United Kingdom and improved access to credit.

Chapter 4 presents evidence to show that interest rates on British government debt did indeed take a downward trend after 1688. However, what North and Weingast's argument seems less able to explain is why it took over thirty years after 1688 before the British government could borrow as cheaply as could the government of Holland, which was universally recognized at the time for its creditworthiness. Moreover, despite the long-term trend toward lower costs of borrowing, there was very significant volatility in interest rates during the reigns of King William III (1689–1702) and of Queen Anne (1702–14), as well as periodic runs on Bank of England shares. At times during these years the British Crown actually found itself borrowing at rates as high as those that had prevailed before 1688, and as high as those paid by the French monarchy. These observations raise questions about how debt politics evolved over time in the United Kingdom. Was this post-1688 volatility related to political events, such as changes in the partisan control of government? What were the factors that allowed the British government after 1715 to borrow as cheaply as the Dutch government? While economic historians have

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extensively documented the development of British government borrowing after 1688, the possibility that post-1688 trends in interest rates were correlated with political trends has not been thoroughly investigated.

I argue that the improvement in the British Crown's access to finance cannot be understood unless one recognizes that apart from the establishment of a limited monarchy, the last decade of the seventeenth century also witnessed another major change: the development of cohesive political parties.¹⁰ Politics in Great Britain between 1688 and 1742 was characterized by conflict between two parties, the Whigs and the Tories, that took differing stances on a range of issues including religion, the succession to the throne, foreign policy, and state finance. The Whigs in particular were a party founded on a compromise among several different groups with diverse interests, including government creditors, Protestant dissenters seeking religious freedom, and landed aristocrats who sought, among other objectives, to increase Parliament's constitutional prerogatives. Because those landowners who participated in the Whig coalition differed with government creditors over questions of taxation and finance, it was crucial for the success of the coalition that both groups nonetheless had similar preferences on a number of other issues in British politics. From the 1720s, as issues such as religion became less salient in British politics, the Whig coalition under Robert Walpole was increasingly held together by patronage, though patronage alone never sufficed for Walpole to maintain a majority.

In Chapters 4 and 5, I show that trends in interest rates on U.K. government debt after 1688 can be better understood when one considers that government creditors were active members of the Whig party, whereas the Tory party was much more closely aligned with those landed interests who chafed at the tax payments necessary to repay public debt on schedule. Chapter 4 presents several basic econometric tests to show that interest rates on U.K. government debt tended to be lower when the Whig party had firmer control of Parliament. Given that the shareholders of the Bank of England were the most prominent of the government's new creditors during this period, it is not surprising that the split between Whigs

¹⁰ In emphasizing the importance of political parties, I draw on extensive work by historians of eighteenth-century Britain, as well as recent work by Carruthers (1990, 1996). Historical work on political parties in early eighteenth-century Britain is discussed extensively in Chapter 6 and includes studies by De Krey (1985), Hayton (1984, 2002), Holmes (1967, 1993), Holmes and Speck (1967), Jones (1991, 1997), Plumb (1967), Richards (1972), Sedgwick (1970), Speck (1970, 1977, 1981), and Walcott (1956).

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and Tories over state finance was also reflected in Bank of England share prices. These suffered a precipitous crash after a Tory electoral victory in 1710.¹¹

While the British government after 1688 gained access to larger quantities of credit at lower rates of interest, no such change took place in France, and the French Crown would continue for the duration of the eighteenth century to face greater difficulty than its British counterpart in borrowing. This has prompted a number of authors to suggest that the French Crown's difficulties were attributable to the failure to adopt British-style institutions. Painstaking work by economic historians has provided evidence consistent with this argument. Throughout the eighteenth century the French monarchy was forced to borrow at significantly higher interest rates than did the British government.¹²

While discussions of state finance in eighteenth-century France have often focused on "missed opportunities" for institutional reform, I argue that even if France had adopted British-style institutions, this would have been unlikely to improve the monarchy's credibility as a borrower. To support this claim I focus on three specific episodes of abortive reform. The first occurred following the death of Louis XIV in 1715. In the midst of a major financial crisis, several senior figures in the French court proposed reinvigorating France's national representative institution, the Estates General, which had not met since 1614. Two authors have recently argued that the failure of the Regent of France to follow England's example at this time represented a missed opportunity for the French monarch to establish credibility for its financial commitments. In doing so, however, Sargent and Velde (1995) do not consider which partisan forces would have been represented within the Estates. Chapter 6 presents evidence from contemporary eighteenth-century observers that the result of calling the Estates General would in fact have been to trigger a default on debt, rather than to avoid one. Evidence on the political divisions in French society during this period supports the conjecture that within the Estates

¹¹ This conclusion that default risk on government debt was lower under the Whigs represents a difference between my own interpretation of events and the argument about partisan politics presented by Carruthers (1990, 1996). Carruthers emphasizes the link between religion, party, and state finance, but he does not focus on credibility of debt repayment, nor does his work give as much emphasis to the role of political parties as heterogeneous coalitions.

¹² See in particular the study by Velde and Weir (1992), which is described in greater detail in Chapter 4. Hoffman et al. (2000) demonstrate that in spite of the French Crown's lack of credibility as a debtor, private financial markets developed quite rapidly in France during the latter half of the eighteenth century.

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General, government creditors would have been poorly represented. As a result, the establishment of representative political institutions may well have been insufficient to solve the French Crown's borrowing problems.

A second episode of failed institutional reform in France involved the national bank created by the Scottish financier John Law in 1716. The Regent who governed France agreed to Law's plan for a public bank that would issue a paper currency and that would aid the monarchy in retiring its stock of debt. The plan was inspired in part by the success of the Bank of England, which had been founded in 1694. Law's bank failed soon after its creation, however, due in large part to an excess issue of bank notes. His project was one of a series of attempts by French rulers during the eighteenth century to borrow indirectly from the public via corporate groups or public banks in order to obtain better access to credit. The failure of these institutional innovations to establish credibility shows that as long as they retain the right to alter agreements unilaterally with officials to whom they have delegated authority, then absolute monarchs and other unconstrained rulers will find it impossible to reduce default risk through delegation.

After the period of financial crises following the death of Louis XIV and the failure of Law's bank, there was a gradual transformation of French public borrowing during the eighteenth century. The monarchy relied increasingly on the sale of bonds purchased by a broad cross-section of the French population. As a result, it would be inaccurate to say that there was no evolution of French financial institutions during this period.¹³ No reduction in default risk accompanied these changes, however, as studies have shown that the French government continued to pay a premium on its loans, and in fact there were two further defaults in 1759 and in 1770.

With this background of repeated crises of public finance, the deputies of the new French Constituent Assembly in 1789 (now the chief law-making body in France) faced several options including proposals to default, to raise new taxes, and/or to create a national central bank. In the end, a majority opposed the proposal to create a national bank similar to the Bank of England, but the assembly did vote to create a new currency, the *assignat*, backed by funds generated from the confiscation of church lands. Subsequently, excess issues of *assignats* led to massive price inflation in France. Some authors have seen this episode as another missed opportunity for the French government to adopt the sort of financial institutions that would have improved its access to finance (Sargent and Velde 1995).

¹³ See Hoffman et al. (2000).

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Chapter 6 presents evidence that supports a different interpretation. The difficulties of the new revolutionary government were due not only to a failure to adopt certain institutional innovations. More fundamentally, they reflected an underlying distribution of political forces in France that was unfavorable to government creditors. Unlike the Glorious Revolution of 1688 in England, the transfer of significant prerogatives to a legislative assembly in France in 1789 was not accompanied by the development of a cohesive majority coalition within which government creditors played a significant role.

3. Theories of Representative Government and Credible Commitment

Theoretical arguments about representative government and commitment focus on the idea that there is less risk of a sudden reversal of policy when decisions are made by a legislature, rather than by an unconstrained executive such as an absolute monarch or a dictator. While this claim is an appealing one, existing work has not fully addressed the question of why those who control representative institutions should necessarily oppose actions such as defaulting on public debts. One possibility may be that devolving power to a legislative assembly will improve credibility if those who represent government creditors constitute a majority within the legislature. On the other hand, one could just as easily imagine a scenario where creditors would be in the minority, and thus a legislative majority would have an incentive to default on debt, because this would allow a reduction in future taxes. This would seem all the more likely given that in many historical contexts ownership of government debt has been concentrated within a narrow segment of the population.¹⁴ Theoretical work in the field of political economy has not considered this issue in detail.¹⁵

To consider the link between representative government and public debt, then, one needs to allow for the possibility that legislators may represent government creditors, but they may also represent those who pay the taxes to service debt. When a legislature is given decision-making

¹⁴ In their discussion of England after 1688, North and Weingast (1989) do not directly confront this issue, apart from suggesting that the “commercially minded Whig ruling coalition” would have found it anathema to default.

¹⁵ One interesting exception here is an article by Dixit and Londregan (2000) that suggests that those who expect to hold power in the future will be more likely to purchase government debt. Their article, however, does not specifically consider decision making within a legislative assembly.

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power over issues of debt and taxation, this should only reduce default risk if the legislative majority takes the interest of government creditors into account when making policy. In some legislatures, government creditors may actually form a majority, in which case the analysis is straightforward. This seems to be a fair description of the Estates of Holland during the sixteenth century, an early example of borrowing by a legislature that is considered in Chapter 3. More frequently, though, government creditors will be in the minority. Within the British Parliament during the eighteenth century, in fact, the overwhelming majority of legislators were landholders, as were their constituents. Given that landowners paid a significant share of the taxes that went to service government debt during this period, this raises the question of why granting more power to Parliament after 1688 should have necessarily reduced the risk of a default. More generally, how could a legislature commit to repaying debts if those who represent government creditors make up only a small percentage of its members?

Constitutional Checks and Balances

One way to refine the argument about political representation and public debt is to suggest that what actually matters for credibility is the number of constitutionally determined veto points in a political system.¹⁶ The greater the number of veto points, the greater the likelihood that those favorable to repaying debt will be able to block attempts to default. This follows the classic defense given by James Madison in *The Federalist* No. 51 for checks and balances in government; oppression of a minority by the majority will be less likely to occur when the legislature is divided into different branches, and when there is a separate executive and legislature

¹⁶ A “veto point” can be defined as a political institution, the holder of which has the power to block a proposed change in policy. Throughout this study when I refer to “veto points” or “veto players” I am referring to what Tsebelis (2002) calls “institutional” veto players, those specified by a country’s constitution. Tsebelis distinguishes “institutional” veto players who have veto power because a country’s constitution grants them this authority, and “partisan” veto players, who are individual member parties or factions in a ruling coalition. The latter may have veto power because they can threaten to exit a coalition if a bill they find unfavorable is passed. As a result, Tsebelis’s “partisan” veto players are similar to the individual groups I consider that combine to form political parties. The key difference is that in Chapter 2, I provide an explicit model of the process of party formation rather than assuming that each group within a party is a veto player. For a comprehensive discussion of veto points and policy making, see Tsebelis (2002).