POLITICAL TRANSFORMATIONS AND PUBLIC FINANCES

Europe, 1650–1913

MARK DINCECCO

CAMBRIDGE

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Political Transformations and Public Finances

How did today's rich states first establish modern fiscal systems? To answer this question, this book examines the evolution of political regimes and public finances in Europe over the long term. The book argues that the emergence of efficient fiscal institutions was the result of two fundamental political transformations that resolved long-standing problems of fiscal fragmentation and absolutism. States gained tax force through fiscal centralization and restricted the power of rulers through parliamentary limits, which enabled them to gather large tax revenues and channel funds toward public services with positive economic benefits. Using a novel combination of descriptive, case-study, and statistical methods, the book pursues this argument through a systematic investigation of a new panel database that spans eleven countries and four centuries. The book's findings are significant for our understanding of economic history and have important consequences for current policy debates.

Mark Dincecco is Assistant Professor in the Research Area of Economics and Institutional Change at IMT Institute for Advanced Studies in Lucca, Tuscany. His research focuses on economic history, political economy, and public economics. He holds a Ph.D. in economics from the University of California, Los Angeles, and has published in several academic journals.

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1

Weak and Strong States in Historical Perspective

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

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

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

1.1. Fiscal Fundamentals

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

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

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

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

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

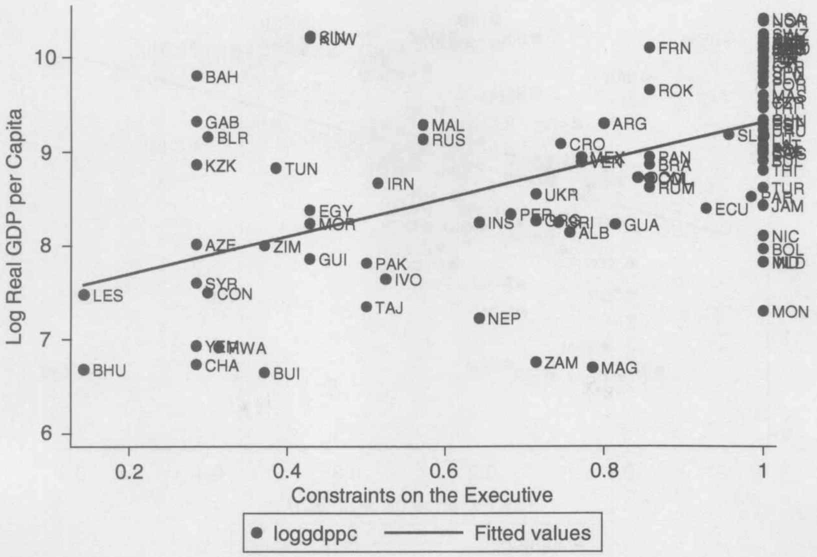

FIGURE 1.1. Constraints on the executive and income, 1995–2004. Constraints on the executive are the average constraints on the executive index normalized from 0 to 1 between 1995 and 2004 from the Polity IV Database. Log real GDP per capita is the average log GDP per capita over the same years in constant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

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

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

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

[3] Excluding the outlier countries Bahrain (BAH), Croatia (CRO), Kuwait (KUW), Lesotho (LES), and Madagascar (MAG) only strengthens this correlation.

[4] Acemoglu (2005) refers to this type of outcome as a "consensually strong state."

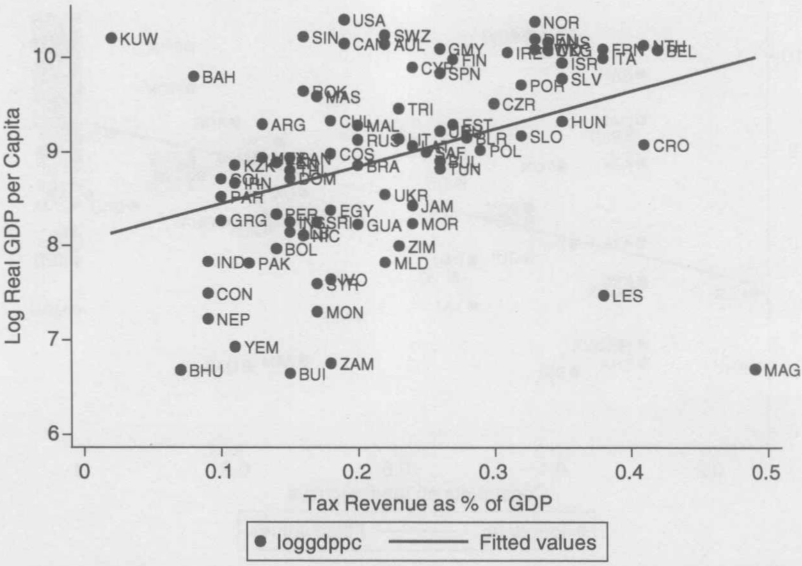

FIGURE 1.2. Tax revenue and income, 1995–2004. Tax revenue collected by central governments as a percentage of GDP is the average between 1995 and 2004 from the Government Financial Statistics Database. Log real GDP per capita is the average log GDP per capita over the same years in constant U.S.dollars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

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

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

1.2. The Approach

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

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

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

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

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

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

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

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

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

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