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# Paying for the Liberal State: The Rise of Public Finance in Nineteenth Century Europe

*José Luís Cardoso and Pedro Lains*

### **Abstract**

Public finance is a major feature of the development of modern European societies, and it is at the heart of the definition of the nature of political regimes. Public finance is also a most relevant issue in the understanding of the constraints and possibilities of economic development. This paper is about the rise and development of taxation systems, expenditure programs, and debt regimes in Europe from the early nineteenth century to the beginning of World War I. Its main purpose is to describe and explain the process by which financial resources were raised and managed. We analyse nine countries or empires that are considered highly representative of the widest European experience on the matter and discuss whether there are any common patterns in the way the different European states responded to the need for raising additional resources to pay for the new tasks they were performing.

**Keywords:** Nineteenth Century Europe, governments, public finances, taxation.

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# **PAYING FOR THE LIBERAL STATE: THE RISE OF PUBLIC FINANCE IN NINETEENTH CENTURY EUROPE<sup>1</sup>**

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In recent decades, economists and economic historians alike have turned their attention to the study of the relations that institutional development may have with the comparative economic performance of nations. One major conclusion of that discussion is that the success of national institutions depends to a large extent on the existence of consolidated national political systems. The vitality of institutions that provide services for

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<sup>1</sup> This text is the ‘Introduction’ to the book Cardoso and Lains (Eds.), which will be published by Cambridge University Press. The book has contributions from Martin Daunton (on Great Britain); Jan Luiten Van Zanden and Arthur Van Riel (the Netherlands); Richard Bonney (France); Mark Spoerer (Germany); Michael Pammer (Austria-Hungary); Giovanni Federico (Italy); Lennart Schön (Sweden); Francisco Comin (Spain); Cardoso and Lains (Portugal); and Larry Neal (Concluding chapter). We would like to thank comments from the authors and participants in the preparatory conferences held for the volume at the University of the Azores (2006) and the European University Institute (2008), as well as from Patrick O’Brien and Larry Neal. Financial support from *Fundação para a Ciência Tecnologia* and *Instituto de Ciências Sociais, University of Lisbon*, is gratefully acknowledged. The text was concluded while one of the authors (Lains) was Fernand Braudel Visiting Fellow at the EUI.

the management of particular fields of economic activity, such as transport networks, banks, or schools, are crucially dependent on the overall national institutional background provided by states. Yet the new institutional economics is at present bereft of a foundational theory for state formation. One way to overcome that deficit is to study the ways that liberal states were financed in nineteenth century Europe. The reform of fiscal and financial systems at the end of the *ancien régime* and in the aftermath of nearly a quarter of a century of revolutionary warfare (1792-1815) was crucial for both the establishment of liberal regimes and the development of European economies in the century to 1914. In this essay, we will firstly outline the history of the reconstruction of fiscal and financial regimes and, secondly, will look for patterns in the processes by which funds were obtained by the European states, as they responded to the new and evolving tasks of government throughout the long nineteenth century.

Nineteenth century Europe was marked by sustained institutional and economic progress at national levels, as well as increasing exchanges of people, goods, capital and ideas at international levels. It was globally a century of peace. Between 1815 and 1914, the only wars that occurred were short and confined regionally. It was also the century in which nation states were consolidated or, in some cases, were formed. Because it was a century of peace and prosperity, the strengthening of states was compatible with increasing levels of institutional and economic integration across borders. Stronger liberal governments and the consolidation of national states open the way to a stronger international economy which on the other hand promoted the transmission of ideas related to the political economy of states<sup>2</sup>. The institutional developments that we observe had both a national and an international

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<sup>2</sup> Not unlike what happened during the process of European integration after the Second World War. See Milward (1992). See also Daunton and Trentmann (Eds.) (2004).

character. Nevertheless the success of the modern European state was crucially dependent on how it financed itself.

By 1815, most European states were not new and the states that were thereafter formed were solidly grounded on past experiences of political integration (such as Italy and Germany)<sup>3</sup>. The nineteenth century was clearly a period when states increased their role in everyday social, political and economic life, as populations were converted from subjects to citizens. This transition had important roots in the past but gained momentum in the nineteenth century and the problems facing European liberal states then were different in many ways from the problems that the states had faced in previous centuries<sup>4</sup>. After 1815, central states became more liberal and closely connected with their populations. Governments imposed taxes and regulations, such as standard weights and measures or compulsory education, and provided security at domestic and international levels<sup>5</sup>. Taxation and regulations had to be accepted by the public. Acceptance became a crucial factor determining the success of the states and the speed with which they managed to implement policies. Levels of acceptance varied across time and space and depended on the capacities of states to supply services for its citizens. The level of political and occasionally military confrontation occurred more frequently in the poor countries of Europe, where states had more difficulties in providing their citizens with services because lower levels of institutional and economic development implied fewer resources for managing and funding government. Because of the reduction in war expenditures and despite the increase of state activity, tax burdens declined in several of the more developed economies, after 1815, whereas in the poorer economies

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<sup>3</sup> Crouzet (2003).

<sup>4</sup> For previous centuries, see Bonney (Ed.) (1995 and 1999), Neal (2004), Winch and O'Brien (Eds.) (2002) and O'Brien (2008). For the more recent periods, see Webber and Wildavsky (1986), Dincecco (2009a and 2009b) and, for the United States, Wallis (2000).

<sup>5</sup> Teichova and Matis (Eds.) (2000). See also Scales and Zimmer (Eds.) (2005).

they became proportionally heavier. The relative weight of taxation was linked both to levels of economic development and to the debt that had been accumulated before Waterloo. In many instances, such as was the case of the UK, that heritage weighed heavily on state finances and the management of public debt became a major institutional challenge. That was so particularly for states where considerable shares of their debts were raised on international capital markets, where the ability to borrow, as well as the price paid for loans, were dependent on the credibility of the state, both domestically and internationally.

National case studies are the best basis upon which to construct a European framework for the analysis of these problems, because historical problems tend to appear as national in character and the sources are also fundamentally national. We have attempted to arrive at a taxonomy based on a number of case studies, each of which was taken as significant and illustrative of a wider European pattern. Historical processes can be best understood by systematically comparing experiences across time, regions and countries and it is necessary to generate a wider and deeper perspective on institutional developments that emerged everywhere in nineteenth century Europe.

Such meta questions derive directly from Gerschenkron's seminal work on European banking and have also been addressed for other institutional developments such as international finance, the building of railways networks and education<sup>6</sup>. We propose to address the rise of public finance systems in nineteenth century Europe and to emphasise on the following questions: how were tax regimes established; in what ways were they extended and deepened over time; what other forms of revenue continued or became available; how did governments secure compliance for their fiscal and financial policies; how was public debt raised and how did it evolve; with what degrees of efficiency did governments manage their

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<sup>6</sup> Gerschenkron (1962). See O'Brien (Ed.) (1983) and Milward (2005) on transports, Cameron (1972) and Kindleberger (1993), on banking and financial markets, and Tortella (Ed.) (1990), on education.

needs for credit and loans; how were public revenues spent; how was government activity evaluated by national citizens; how did the reputation of national governments evolve in the international markets; and, finally, what were the main theoretical and political debates around taxation and public finance?

We investigate whether a comparative analysis will generate general insights and expose a European pattern for the evolution of taxation and public finance in the nineteenth century. Questions posed at a European level follow closely those that have been raised in the country studies, but go beyond national levels of enquiry. Hopefully we may provide some further hypothesis about taxation and public finance that will contribute to a better understanding of the problems involved and offer generalizations that transcend nineteenth century Europe. The fiscal and financial institutions of states are connected to policy making processes. They contribute to the shaping and design of economic policies and to assessment of their outcomes, at political, social and economic levels. A general overview of institutional settings for the implementation of public policies helps to explain cross-country variations in economic performance. We need to look “from one country to another for general explanations”<sup>7</sup> and focus on countries or empires, which are representative of the European experience. The sample needs to include: a) early developers where sets of rules governing taxation and public finance had already reached some stability by the beginning of the century, namely Great Britain, the Netherlands and Sweden; b) countries for which the creation of such systems were crucial for the construction of the new nation-states, namely Germany, Italy and the Austria-Hungarian Empire; and c) countries which entered the modern age for taxation and public finance after major political revolutions, namely France, Spain and Portugal. This sample includes national economies of various levels of economic

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<sup>7</sup> See Kindleberger (1993, 3-4). See also Hatton, O'Rourke and Taylor (2007).

development, different levels of foreign and imperial connections, and of disparate size in terms of population and area, and geographical location.

### *The ancien régime legacy*

According to Schumpeter (1954), fiscal systems evolved from ‘domain states’ in antiquity to the ‘tax state’ in the Early Modern period, which arose from the need of governments to raise money to pay for war<sup>8</sup>. Bonney (1995) and Bonney and Ormrod (1999) expanded the model to four stages, which included a ‘tribute state’, a ‘domain state’, a ‘tax state’ and, finally the ‘fiscal state’. Their approach updates Schumpeter’s taxonomy and offers a concept of gradual transition which accommodates fiscal reforms when new phases are reached. This is not a teleological process implying the completing of each stage of evolution in one sequence. Indeed, this is an open model that considers that it is possible for a given country to skip one of the stages of evolution and admits the co-existence of diverse national states at different fiscal stages in the same historical period. According to Bonney and Ormrod (1999), by 1815, fiscal states ruled in most of Europe, which means that taxation was overwhelmingly controlled by central governments and geared to finance their goals. The centralization of public finances was to a large extent the outcome of the need to finance the almost permanent state of warfare in which the European states were engaged throughout the eighteenth century and in particular extensive warfare that followed the French Revolution (1789-1815). Warfare accounted for more than half of total expenditure in a number of European states throughout the century (Körner 1995a, 416). Wars were also financed by

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<sup>8</sup> This work was first published in 1918 in German.

raising public debt which accounted for an increasing share of total financial resources within the reach of the central state<sup>9</sup>.

The rise of fiscal states was associated with an increase in the ability of central states to manage the administrative apparatus to raise taxes, as well as the sophisticated financial institutions to manage public debt. The latter led to important financial innovations, such as the creation of central banks and the development of financial markets where bonds and other assets were traded (Körner 1995b, 532-35). These developments meant that states increasingly depended on its ability to service debt and concomitantly on their financial reputation. By increasing taxation to credits and loans, states became more dependent on the good functioning of financial and commodity markets. Disruptions to the economy meant lower revenues from taxation, and disruption in the financial markets meant that less public debt could be raised or that more taxes had to be allocated to pay for past debts. This higher level of dependency on the markets emerged by the end of the Napoleonic wars as a major problem for most European states. The creation of public debt as a means to cover public expenditure was linked to the capacities to increase the collection of tax revenues on a regular base. The main issue faced by the *ancien régime* was the management of the trade-off between the need to borrow, on the one hand, and the capacity to tax, on the other hand.

Yet national tax systems were loosely integrated and suffered from many inconsistencies. The finances of *ancien régime* in European states reveal very different degrees of fiscal centralization. The structure and rates of taxation within the same political national unit varied considerably, either between urban or rural areas, or between different provinces. Taxes were imposed on domestic trade across regions and between rural and urban areas. Taxes were also mainly indirect, that is, based on the taxation of economic and in some

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<sup>9</sup> See for further discussion on this model, Petersen (1975), Krüger (1987), O'Brien (2008) and Spoerer (2008).

cases financial transactions. In England, for example, indirect taxes accounted for 70 percent of total taxes in the second half of the eighteenth century (Bonney 1995, 502). These ratios were however very disparate across Europe and moved in different directions. Tariffs on international trade weighted heavily on indirect taxation too. Direct taxes were also overwhelmingly fixed and thus not related to changes in the values of outputs, which implies that levels of direct taxation did not follow closely the economic cycle. Historically, the states fiscal institutions were geared to collecting taxes to pay for the administration of the state, the judiciary, the consumption of the aristocracy and mostly to pay for war, the military and the navy.

The coercive functions of the state were not abandoned in the liberal age but their relevance declined substantially, as new functions related to universal law enforcement, the management of economic and monetary issues, investment in social overhead capital, health services and education emerged. The structure of state revenues also underwent transformation and adapted to the new sets of state functions. When dealing with the development of public finance in nineteenth century Europe, we need to understand how modern tax regimes were constructed at national levels and how they were made acceptable to the public. The notion of modernity in the organization of public finance is used here in the sense of enhancement and consolidation of the functions generally ascribed to fiscal states. These functions are usually associated to the management of new types of state revenues, based on both direct and indirect taxation, as well as to the administration of an expansionary state committed to increasing control over its territory, and to fostering public education, welfare, justice, investment in economic infrastructures and defense. This agenda called for a continuous increase in public spending, and above of all, to an efficient process of public debt creation, management and servicing. A new ability to extract taxation, a coherent program of public expenditure and a sound system of public debt management: these were the main

points featuring the substantial changes that contributed to the development of modern fiscal state in nineteenth century Europe. It should be noted that this is not the only available model to analyse the evolution of fiscal systems. An alternative framework is offered by Hinrichs (1966), who explains the transition from traditional society to modernity through changes in taxation systems. Traditional economies were characterized by restrict use of direct taxation, while in modern economies a regular system of taxation is an indispensable condition to finance increasing public expenditure.

The state's power to tax implies the existence of coercive means of government, as well as the tacit acknowledgement of the fiscal rules which direct the process of tax collecting (Bonney 1999, 6). The alternative to the predatory role of states associated mainly with period of crisis or warfare was the creation of economic opportunities in the marketplace, through cooperation between the state and the private sphere. The rent seeking processes associated to the negotiation of privileges and to the concession of special monopoly conditions exemplify the mastering of peaceful means of fiscal enforcement that are at the origins of the consolidation of modern fiscal states. The study of the evolution of public finance regimes in different European countries is a first step of inquiry that points to promising directions of research. National differences were undoubtedly important and explain certain dimensions and specific features of fiscal doctrines and taxation regimes in each of the countries considered<sup>10</sup>. However, our major concern is not only to explain how national regimes of taxation, expenditure and debt management were implemented during the nineteenth century, but also to elucidate the underlying economic and political interests that such regimes were serving or challenging, and how they were made acceptable to their societies.

The conventional wisdom about the allegedly autonomous roles of states is built upon the claim that the State performs a variety of functions that are not subject to dispute, namely

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<sup>10</sup> See Kayaalp (2004).

those related to the pursuit of general objectives of well-being that serve society as a whole. The engagement with common good is certainly a strong caveat for the justification of the provision of public goods and services. However, it does not prevent us from recognizing the existence of vigorous interactions between governmental institutions and organized groups of interests in civil society. It is precisely such interactions that provide an explanation for the prevalence of redistributive tax policies in a certain historical context, while also serving to explain why in different settings preferences may emerge in support of policies for investment and economic growth.

Public finance is about taxing, spending and balancing budgets. These activities are assigned to governments and it is therefore their mission to make the appropriate choices and to take the right decisions, bearing in mind the effects of such activities upon the welfare of their citizens. One may concede that governments have goals and an agenda which imply costs. The objectives of governments are made possible through a set of fiscal policy decisions designed to extract sufficient resources from the population under the state's control. Limits to the growth of fiscal states depend on the ability to develop the tax bases without endangering social and political support, but also on the ability of governments to service and redeem the debt. In order to raise the amount of funds required to finance its activities, supposedly devoted to the common good, politicians and bureaucrats may be impelled by personal interests and are therefore subject to the rules of utility maximizing behavior. The agenda for public expenditure can also be appointed in ways that reveal the tendency of governments to excess spending to maximize future political results. These issues inform the public choice approach to the discussion of the functioning of different fiscal and financial regimes<sup>11</sup>.

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<sup>11</sup> See Buchanan (1979). On the continuity between certain types of public finance theory and the public choice approach, see Backhaus and Wagner (2005). The methodological and

When invited to explain the running of the political process, public choice theorists consider that governments are not organic or institutional entities that make decisions with an abstract public interest in their mind. By extending the methods of economics to the analysis of political decision making processes, public choice theorists emphasize the role of self-interest and incentives acting as a main motivation for political action. For this reason, the study of the political decision structure and conditions within which taxing and spending choices are made is of a paramount relevance. The peculiarities of the political process elucidate the outcomes arising from changes in fiscal institutions (Wagner 2007). One may dispute whether or not a certain fiscal reform is an attempt to limit the role of the government or to control its impulsive tendency to increase spending, taking for granted the validity of Wagner's law. Nevertheless, taxing and spending decisions should not be left to the arbitrariness of central and local governments acting in contexts of political constraint. According to the arguments put forward by public choice analysis, constitutional rules (common law, general legislation passed in Parliament and institutionalized values and traditions) form indispensable conditions for the creation of a reliable system of public finance. Furthermore, governments in modern societies are obliged to deal with increasingly complex sets of issues claiming for the formation and use of proper economic knowledge, which supports the process of legitimization or rejection of policy decisions<sup>12</sup>. Governments need to justify their actions on the basis of sound constitutional rules and credible economic reasoning.

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conceptual differences concerning the interpretation of the economic functions of the government should not be dismissed, as is clearly shown in the debate between Buchanan and Musgrave (1999). The appeal to the public choice approach in the analysis of the functioning of state finance regimes has also been summarized in Bonney (1995) and Daunton (2001, 8-9).

<sup>12</sup> On the contribution of economic knowledge to government decision-making, see Furner and Supple (Eds.) (1990).

When applying this type of approach to the nineteenth century realities, we may certainly find worthy attempts to create a kind of ‘fiscal constitution’ procedures designed to restrain expenditure and to make feasible the abolition of certain unpopular taxes and duties. Such was the case, in Britain, of Gladstone’s 1853 proposal to phase out the income tax, as a strategy to create ‘constitutional’ limitations to public spending<sup>13</sup>. However, nineteenth century classic contributors to the theory of public finance were more concerned with the ability to pay approach, viewing the problem of taxation as more or less independent of the process of determination of both the amount and the allocation of public expenditures. Though this approach did not reduce public finance to taxation, it has nevertheless imposed a separate account to both sides of the balance<sup>14</sup>. The success of the implementation and development of tax regimes across Europe had much to do with different levels of legitimacy, the credibility of governments and their budgetary policies, as well as with the outcome of those policies. In order to take those issues into account, we need to look at the evolution of political stability at the national level, as well as to the credibility of governments. Moreover, it is also necessary to take into account the efficiency of public expenditure in terms of the provision of public goods, including infrastructures, schooling, police and defense. One further aspect that can be better understood through a public choice approach is the issue of the economic interests represented by politicians, in their quality of ministers and members of the parliament<sup>15</sup>.

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<sup>13</sup> Baysinger and Tollison (1980) argue in favor of the coherence of that constitutional strategy, while Leathers (1986) claims that the project was condemned to failure.

<sup>14</sup> On the theoretical principles explaining this tradition, see the authors’ introduction to Musgrave and Peacock (1958). See also Dome (2004) for a survey of the fiscal problems by Enlightenment and Victorian British political economists.

<sup>15</sup> See Nehring and Schui (2007) and Schonardt-Bailey (2006).

### *Nineteenth century transformations*<sup>16</sup>

We will analyse the fiscal history of nine countries that represent about 90% of the total population and GDP of Europe to the East of Germany and Austria-Hungary, in 1900, and a wide variety of experiences in the field of public finances<sup>17</sup>. As we shall see, financial distress was common to both the poor South as well as to the wealthier cases of Britain and the Netherlands. The speed at which governments solved the problems inherited by debt representing the costs of wars varied significantly but again the divide was not between more or less developed countries, and depended on other factors, of a political or social nature. France for example did not have as a heavy debt inheritance as Britain, but the French governments throughout the century faced more difficulties in balancing the budget. The same was the case of Portugal and Spain.

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

The case of Great Britain is highly revealing of the role of political coordination in governing public finances. Britain was in a difficult position in terms of state finances by the end of the Napoleonic wars. In 1815 government expenditure was a staggering 23% of

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<sup>16</sup> This section relies heavily on the country chapters in Cardoso and Lains (forthcoming).

<sup>17</sup> Maddison (2001).

national income. In that year, debt charges accounted for 26.6% of gross public expenditure, and climbed to 54.4% in 1825. In the eighteenth century, public expenditure and the national debt were taken by the public as the 'bulwarks of liberty and Protestantism against the French', as they were raised to a large extent to pay for past wars. Yet, having reached such large sums, the state could easily become the major threat for those liberties. Trust in the eighteenth century was higher in the UK than in France because the British state was more responsible in dealing with its financial affairs. But if trust were to be regained, the tax system had to change and it did so in the following decades.

One factor that contributed to the recovery of trust was the fact that the fiscal pressure on the economy was considerably reduced throughout the following decades. That was made possible up to a certain point because Britain was no longer fighting the expensive wars of the previous century. Yet the reversal was only gradually achieved. By 1840, public expenditure was still high in contemporary terms (at 12.4% of GDP). Further reforms implied political initiatives and agreements across parties in Parliament which were achieved firstly with the reintroduction of the income tax by Robert Peel, in 1842, and carried further by Gladstone in the early 1850s. They and their successors also recognized that the fact that taxes, which were interlinked with votes, could introduce risks into the financial system. Thus they took care to implement sets of rules that would limit the capacity of governments and parliaments to overspend. By 1905, the cost of debt service was 16.6% of gross expenditure and total debt in relation to British GNP had fallen by 90%. There were other major changes, including the increase in the share of direct taxes to total revenues and changes of the structure of indirect taxes, which meant that the level of taxation became more intimately connected to the growth of the economy. The fact that the economy was growing although not as fast as in other places on the Continent provided a basis upon which trust could be recovered. Yet the major factor in that recovery was not the ability to tax in itself, but the ability to tax on an acceptable way,

linking the state with those who had to finance it. Such levels of trust were reached in some parts of Europe, whereas in other parts they were not and the reason why that was so becomes a major question in understanding the evolution of the modern European fiscal state.

In the Netherlands 'public finance reflects the balance of power between the social classes controlling the state and the basic institutions underlying its society and economy'. Thus the wider political setting necessarily has a large impact on how state finances evolved. There were three different phases, starting with a strong monarchy with limited parliament interference, from 1815 to about 1840, followed by two decades of 'liberal offensive', to the 1860s, and a third period to the end of the century, which was above all marked by mass movements and the democratization of the society with the gradual extension of the franchise and the move to welfare. This last period coincided with the adoption of the gold standard by the Netherlands which partially determined the way the state was financed. As in Britain the status quo prior to 1815 had to be changed and was changed. Yet the set of problems that emerged in the following century was considerably different, mainly because levels of political pressure were higher, as the franchise expanded and the welfare state came into existence. The differences between the types of pressure imposed on both countries derive from specific national characteristics and we need to understand how the state managed the demands imposed on it by those who paid taxes and lend the money.

The departing point was rather bleak, as the debt had amounted to an astonishing level of 147% of GDP, by 1814. However, the fiscal system inherited from the eighteenth century was already efficient, in the sense that it was centralized and well connected to a sophisticated 'commercial economy'. The annexation of southern Netherlands was another positive factor, as it enlarged the tax basis for the central state. Moreover, another source of revenue developed quickly, namely, revenues from the colonies. State finances remained highly problematic at the beginning of the century because Parliament was weak and state finances

were made a major political battlefield by the king, Willem I. In the following liberal period the needed reforms were effectively implemented because of two factors that were paradoxically linked. The first is that the liberal governments ceased to act as though the Netherlands was a great power and military expenditure was substantially reduced. The second is that the colonies supplied revenues. It was also a great help that the economy continued to expand at a reasonable rate. But in the end the Netherlands lived throughout the century with a heavy debt and heavy interest payments, as in 1900, the debt amounted to about 80% of GDP and interests amounted to 35% of total government expenditure. One may speculate that trust had to be high as those high levels of indebtedness did not lead to public default. That is even more relevant if we take into account that the Netherlands was in the gold standard, and did not experience major macroeconomic problems, after 1875. Large state debts could thus coexist with political stability.

In France, the health of public finances was intimately linked to levels of political stability. But the main determinants of how the state expanded its capacity and was financed, was the slow population growth and the 'longevity of an *oligarchic* social order' which was overrepresented in Parliament. Slow population growth meant that the fiscal basis of the state expanded only gradually. The existence of powerful oligarchies meant that they were able to slow down the rise of the state expenditure by opposing the development of direct taxation which affected their interests. By 1913, the size of the French state was half that of the German as a share of GDP. However, the financial problems of the state were particularly acute for most of the time, up to the war with Prussia. Ultimately, the growth of public expenditure was halted from the beginning of the 1880s onwards and that was a crucial element for the stabilization of the system. The central government was unable to tax the whole territory of France and did not resort to local sources of taxation, in contrast to Germany.

Because tax revenues were harder to collect in France, a large part of state expenditure was paid for by the rise of public debt. Financial problems were rendered less serious because the economy grew rather fast, throughout the century, both in terms of total GDP and foreign trade. Also the banking system expanded and made an important contribution to funding the state by mobilizing domestic savings, and guaranteeing monetary stability and low interest rates. Monetary stability was a crucial and was strongly supported by the political elites, namely members of parliament who held *rentes*. The main basis of the rise of the state, however small that rise was, was not the increase in taxation but the rise of public debt. Excessive debt creation was avoided because total government expenditure remained low in comparison to other large countries, such as Britain and Germany. France looks like a case where reforming the fiscal constitution was not a priority of governments in the nineteenth century. The rise of state expenditures was particularly restrained and paid for by an expanding economy (although population did not increase significantly) or by debt creation which was well managed due to favourable monetary conditions. France is thus the case of a wealthy country which elites opted to have a small state.

Countries integrating with new political units in the nineteenth century had a different set of problems. The growth and consolidation of central states was intimately linked to the process of political unification – and in some occasions was the single most important element of that process. A wide range of financial practices appear in the territories that ultimately would form the German Empire in 1871. In some of the smaller German territories the tax system was based on indirect taxes. In other territories taxes were predominantly ‘impersonal’ and fell on property, like in Prussia. Changes occurred during the Napoleonic period and its aftermath, through the introduction of constitutions in some states, in the years from 1818 to 1849, which included norms about the administration of public finances.

Meanwhile, the creation of the *Zollverein*, in 1833, also led to a higher degree of integration and the unification of tariffs on foreign trade.

When the German Empire was created, in 1871, some degree of institutional convergence had already been achieved but the tax regimes and economic and financial conditions remained very different. The Empire did not, however, manage to unify them. The central government became responsible for defence and international relations and needed a smaller tax base than elsewhere in Europe, where central governments exercised a wider range of functions. The central government collected customs revenues and managed state monopolies such as the post office. Member states could be called upon to help finance the central government in case of need and that effort was distributed on a per capita basis. The share of military expenditure declined throughout the nineteenth century but increased again in the decade preceding World War I, while expenditures on education, administration, utilities, transport and welfare expanded considerably and these were mostly covered by the budgets of member states or the municipalities.

In the Austria-Hungarian Empire, the devolution of power under the 1867 Compromise impacted on the administration and evolution of public finances in the two halves of the empire. This compromise led to the creation of two states with independent political and fiscal institutions. Like Germany, the Austria-Hungarian central government after 1867 managed defence and international relations. However, unlike Germany, revenues were collected by the two governments of Austria and Hungary which would then be reallocated to a central military and diplomatic budget according to quotas that were negotiated every 10 years. The contribution of the Austrian government was never below 73% which implied a small albeit politically relevant redistribution effect.

The transition from the pre- to the post-compromise fiscal arrangements implied important institutional developments particularly in the case of Hungary which had to

converge institutionally to the more developed Austrian fiscal system. Thus, for example, the share of direct taxes in the Hungarian public revenues increased steeply even before 1867. Clearly there was an objective of political harmonization which was absent elsewhere in the other two large European countries, namely Germany and, as we shall see below, Italy. The partition of expenditures was linked to the relative size of the population. The Empire's common budget was dominated by military expenditures. In addition to the common budget, both states had to pay for the debt incurred before 1867. Overall, public finance contributed to the integration of the two halves of the Empire. The initial steps of integration were taken during the 'neo-absolutist' period from 1848 to the 1867 Compromise, but fiscal integration proceeded despite the fact that there was an increase of political autonomy of the separate kingdoms. Fiscal policy, by way of investments on education and infrastructure also contributed to integration within a dual Monarchy. Whether this was an express purpose or just a means of gaining political support for the central government remains an open question.

Of all the states that would form Italy after 1861, only Piedmont had significant levels of taxation and expenditure. Its ambitions materialized in the form of growth of public administration and investments in public infrastructures, namely railways, paid for by taxes and also by the issue of sovereign debt. Increased taxation in Piedmont was made possible by institutional reforms, including the introduction of yearly budgets controlled by the Parliament, and the increase in the levels of taxation on consumption, land, on interest from capital and wages. Yet the increase in taxation did not match the increase in public expenditure and the debt surged. Piedmont was responsible for more than half of the total debt of Italian states in the 1850s, and that share increased even further after the wars against Austria from 1859-1861.

After unification Piedmont introduced to the rest of Italy its ambitious development policies, which led an increase in public debt and then to difficulties in servicing it. A decade

of reducing expenditures then unfolded, and from mid-1870s onwards Italy's state budget was kept relatively balanced. The Italian government was, however, able to increase taxation throughout the rest of the period down to the World War I. Firstly that implied an increase of revenues to GDP but after 1890 Italy entered a period of economic boom and the ratio of taxation to GDP actually declined. Despite such achievements, Italian financial history is marked by promises by successive governments to reduce the deficit and the debt, and attacks from the opposition parties accusing governments of not being able to achieve that goal. Yet, the deficit to GDP ratio averaged just 0.64% in the whole period, peaking at higher levels of about 3% only after the 1861 war, and re-emerging in the 1880s. Although the state budget was never on a 'firm ground', it also never 'fell into abyss', as fiscal policy was successively adapted and revised so that revenues could rise to meet expenditures. There was a major reason behind such a consistent position of Italian governments which was the fact that sound financial policies were the basis for financing of the military and the achievement of great power status. Public expenditures were, however, not a unifying factor. On the contrary, unification meant the tax load of the poorer South increased. During the early 1910s, some changes were introduced, namely through the centralization of education expenditures, which had some small redistributive effects.

The northern European periphery was in many instances different from the southern peripheries, as it had high levels of political stability and also a more developed economy and institutional setting. In Sweden, public finances went through a thorough institutional transformation during the nineteenth century, which was relatively smooth and negotiated with different political forces. Sweden started the century with a fiscal regime with many *ancien régime* characteristics, which included some taxes of medieval origin, based above all on indirect taxation, and with a large share of expenditure devoted to the army. But then it evolved into a modern fiscal regime based on the taxation of income and monetary

transactions. Such transformations meant that the structure of the fiscal regime adapted to the wider transformations in the structure of the economy. The starting point was bleak if taken out of context, given that Sweden emerged from the Napoleonic wars with a large public debt and relatively high shares of expenditures and revenue in national income, although still much smaller than elsewhere in Europe. Yet in the years to about 1850 that would change considerably. The share of revenues and expenditures were reduced from about 10% to about 5% of GDP, between the early and mid nineteenth century, and public debt was reduced even further. The reduction of military expenditures was the key factor in the overall reduction of public expenditures.

From the 1850s on the size of government started to increase again but this time geared to other kind of modernizing expenditures. Increase in wealth and a political consensus led Sweden through a velvet revolution to become a 'development state'. The rise of expenditures was however not immediately followed by substantial institutional reforms, which gained momentum only from the 1870s onwards. By 1900 90% of the state revenue was still based on indirect taxation, including a large share of revenues from customs duties. The speed of reforms was not conditioned by political conflict which was relatively low and the increasing role of Parliament in the design of fiscal policies contributed largely to that outcome. As the economy expanded and went through considerable structural transformations, the gap between the fiscal structure and the economy became more evident without however causing institutional problems. True change in the fiscal structure came only in the early twentieth century and in that decade the share of the income tax in total revenues was raised to 25%. Again the change was led by parties in Parliament with high levels of political representation. The tax reforms took however decades of public investigations engaging economists and political scientists since taxes and political voting rights were intricately interwoven.

Spain was a case where the transition from *ancien régime* fiscal structure to one in tune with the needs of an expanding economy was far from smooth and was achieved with high degrees of political tension. The period of political instability lasted down to the 1870s and that made fiscal reforms particularly hard to implement. Liberal tax reforms were linked to successive plans for constitutional reform and were attempted in 1813, 1821 and 1845. The 1845 reform introduced a rather complex tax system, based on quotas, set by Parliament, for the central government, the provinces and the municipalities, which reflected the complex administrative system of the Spanish Kingdom. The reform was mildly successful as budgets became approved annually in Parliament, the fiscal system as envisaged became more centralized, the privileges of the nobility were abolished, and some proportionality was introduced. But the new system was composed of a large array of indirect taxes which certainly made it difficult to estimate revenues and deficits. It was followed by a slight increase of the fiscal pressure from 7.8 to 8.5% of GDP, between 1850 and 1865. The structure of public spending also changed, as military expenditures were somehow reduced whereas expenditures on education and public infrastructure increased.

The success of the reform was soon to be checked by the aggravation of political instability which affected the collection of revenues, led to the increase in expenditures, and reduced the role of Parliament in controlling the budget. Instability became common for most of the second half of the nineteenth century, on somehow reduced scale after the end of the short republican experience, in 1874. A period of other reforms followed. The Bank of Spain, founded in that year, was granted the monopoly of note issue in return for lending to the government. Printing money became a source of revenue for the public budget which ultimately led to the abandonment of the gold standard by Spain in 1883. In the following years, state revenues increased as did expenditures, deficit and the debt. The debt was financed domestically, which may have had a negative impact on the private capital markets,

and about 25% was financed abroad. A new tax reform was implemented in 1900, this time slightly more successful, leading to a substantial modification of the tax structure and ultimately to government surpluses from 1903 to 1908 in the eve of the war in Morocco, which was followed by another period of political instability. The debt service accounted for 8.1% of total expenditure in 1849, peaked at 52.6% in 1870 and then declined to 31% in 1913.

The fiscal history of nineteenth century Portugal was also largely marked by severe political instability. Military confrontations ended in 1834 but some level of political stability was achieved only after 1851 and only then serious attempts to reform the fiscal state inherited by the *ancien régime* could be made. By mid-century the government in Lisbon did not have full control over its territory, in terms of military security, ability to tax income or trade, or to enforce legislation. The task of state building was harder, because in many instances the presence of the central government had to be built anew and not by reforming existing local institutions. To engage in the tremendous efforts of state building, the governments in Lisbon had to raise financial resources which meant that it was of paramount importance to build an efficient fiscal system. This was a task that was never fully accomplished and the history of nineteenth century Portugal is also partially the history of that process. Many would argue that an efficient and just fiscal system was not fully accomplished because people in government were too busy with their own private interests and less concerned with the public good. Yet, to understand this problem we also need to take into account the vast dimension of the tasks involved.

Figures 1 to 3 quantify the extent of converging and diverging features of the European states we have just reviewed. They show a general rise in the shares of revenues to total GDP, a convergence of the shares of expenditure in GDP to levels between 7 and 15 percent. The most important divergence in terms of how state finances were managed lie in

that share of debt as percent of GDP. Such differences appear not only as we compare countries but also across time. Austria-Hungary had a higher debt than France before the Compromise (1867), but then the two countries evolved in a similar way. Two countries appear as quite different from the rest, namely Spain which registered two spurts of public debt, whereas Sweden managed to have very low debt ratios throughout the period.

[Figures 1 to 3]

### ***Patterns of European convergence and differentiation***

Nineteenth century European history was clearly marked by the rise of the state as a political and economic actor. We need to understand how that rise was financed and provide a European answer to the question which will necessarily come in the form of a complex set of different responses. There is of course no European model and also no ideal model. National models were however gradually defined, as the functions of states were largely centralized, even when there was some sort of regional distribution of the administrative functions. No national model dominated or was even exported from one nation to the other. Moreover, there was also no national model that proved to be ideal or dominant in terms of efficiency or geopolitical outcomes. Thus the European answer to the question of how the liberal state came to be financed is the sum of different national outcomes.

But there was a European pattern defined by the prosecution of forms of financing government activity by taxing the economy efficiently and by servicing political and social consensus. The concern with efficiency is reflected in the search for policies that relate levels of taxation to the rhythm of economic activity. Concomitantly, tariffs were perceived to be a poor source of revenue compared to taxes on domestic activity. The concern for consensus is reflected in the option for systems based on the backing of parliaments and which were not regressive and possibly generated some social and regional redistribution effects. There is also

a pattern where most governments and political forces considered that the public deficit and the public debt should be held at the minimum levels, as large debts could undermine political systems. And there were other less generalized sources of convergence in fiscal matters, namely, the idea that the state could raise money to fund certain types of investment in social overhead capital and education. There was also convergence in the reduction of levels of expenditures on defense, although that occurred more rapidly in some countries than in others.

But differences were more important, particularly concerning the institutional forms the conduct of tax policies could have<sup>18</sup>. Domestic political institutions developed according to different political and institutional experiences, as institutions were intimately connected with the past practices in the realm of public finances. The nineteenth century is markedly different from previous centuries in the field of public finances. Yet the past inheritance had a relevant role in the shaping of the nineteenth century tax policy and tax institutions. Different financial systems had been developed in Holland, England and France between Westphalia and Waterloo (Neal 2004). England may have been a good model for an eighteenth century state but it certainly was not for the nineteenth century, simply because the increasing role of the state meant that it had to be more in tune with national institutional and other characteristics<sup>19</sup>. Moreover, the institutional format of taxation also responded to differences in how states were formed. If we look at the widest range of cases, from Britain to Austria-Hungary and from Sweden to Portugal, we may conclude that each state had concerns and purposes of its own. Thus taxation reflected the strong divergence in terms of institutional

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<sup>18</sup> See Steinmo (1993, 12-13).

<sup>19</sup> Grossman (2001, 461-2) tellingly asks: “Why have the British institutions of Commons, Lords and constitutional monarchy, or the American variant of Congress, Supreme Court, and president, not been readily transferable to other nations? The answer, I think, is that the British legacy of a state that protects property rights and that is accountable to its citizens is not attributable to institutional design. Rather, the key to the British legacy, starting with the success of the Glorious Revolution of 1689, is its foundation on a consensus of the citizenry.”

responses to the same type of problems at the European level. Different regimes were the outcome of different stages of state building and also different levels of economic development. The case studies in this volume show that no modern liberal state, including the British, which was widely appraised by contemporaries, could be replicated elsewhere, because historical legacies narrow the range of political options, as shown in the last chapter for this book.

Public finances were an instrument to construct public policies. The degree of ‘failure’ or ‘success’ of governments in dealing with deficits and debts were not an outcome of levels of institutional development but rather an outcome of policy options. Britain balanced its budget because that represented the equilibrium of power between parties and between the Parliament and the government. France was not too concerned to reduce rising deficits and debt because changing that would imply a change in the relative strength of political forces. A sound monetary system, facilitated by the growing economy and the development of the banking sector, helped the fulfilment of that path and implied that the burden of the debt remained manageable. Germany developed a three-tier system which central, state and municipal levels of government, the later being remarkably autonomous. The central government was more preoccupied with defence and the state and municipal governments with economic and social issues. The system provided the needed funds for the three levels. When comparing Spain and Portugal with Sweden we have to conclude that the main problem was not the ability to reform in itself but the ability of the state to tax the economy even with the old institutional framework. In Sweden the low levels of political dispute and high levels of political stability enabled the state to increase the levels of taxation of the economy until the very end of the century within the institutions inherited from the *ancien regime*. This is an important conclusion because it helps clarify the counterfactual with which many contemporaries and historians have worked. The absence of reforms was just another aspect

of the incapacity of the state to tax. The analysis of the sources of that incapacity to tax is what we should concentrate our attention upon. It is important to notice that the reformation of the old tax regime in Sweden was not a paramount issue in the political debate as we will find in other parts of the European periphery or, for that matter, in France.

The history of nineteenth century public finance was interrupted by the First World War which caused many distresses in the domestic and the international order, at all levels. During the interwar period, economic, institutional and political divergence ensued, notwithstanding the development of some points of ideological convergence. Thus the development of the efficient state was interrupted. Such developments were resumed after the Second World War but then Europe became clearly divided by the “Iron Curtain”. But in the West developments proceeded again with generally common purposes in terms of the role of the states and generally different institutional solutions. It may be the case that the level of institutional integration is higher now than it was in the nineteenth century. However fiscal and financial institutions are still far from integrated. That is probably the reason why, after having achieved the single market, the European Union has still not made any serious attempts to introduce a common fiscal policy.

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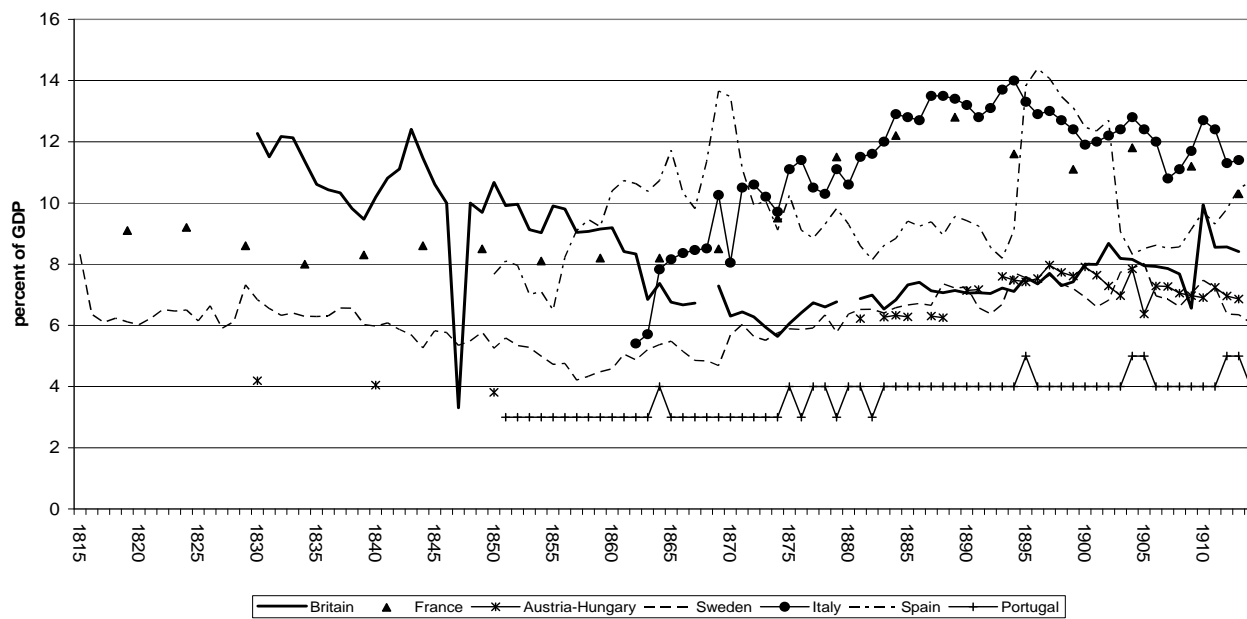
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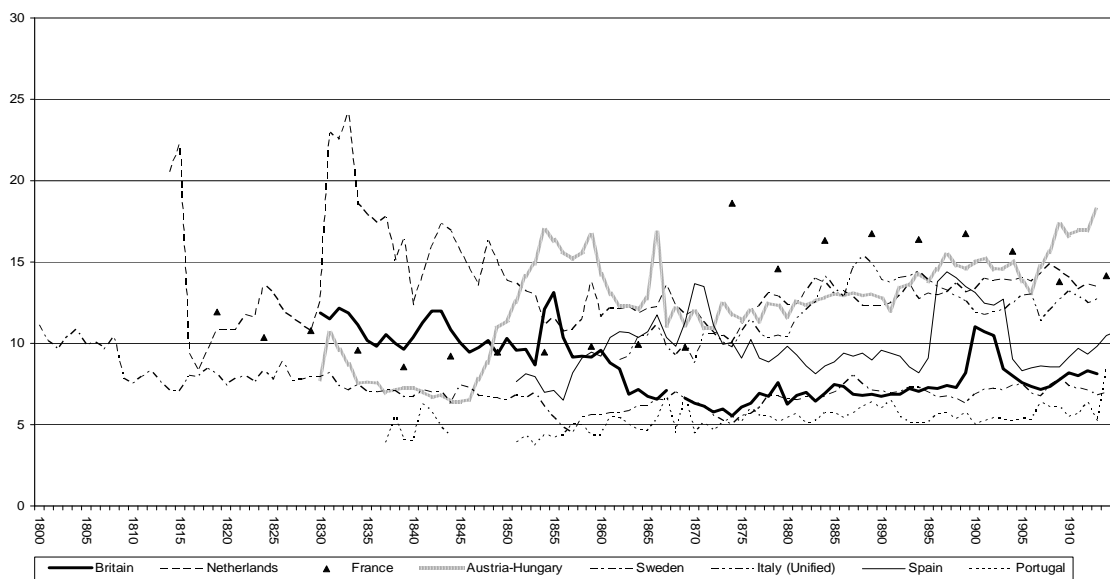
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Figure 1 – Government revenue as percent of GDP



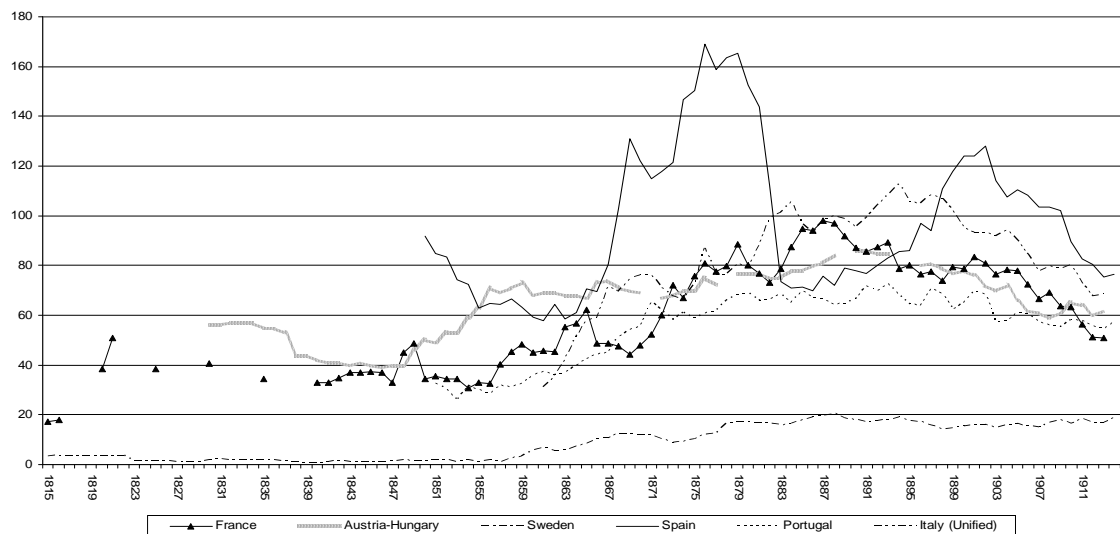
Source: Cardoso and Lains (forthcoming)

Figure 2 – Government expenditure as percent of GDP



Source: Cardoso and Lains (forthcoming)

Figure 3 – Public debt as percent of GDP



Source: Cardoso and Lains (forthcoming)