# War and Society
# Revenue Collection

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**Contents:**

We now turn to a discussion of the most common methods of organizing revenue collection. In this we need to consider the administrative ability of the ruler to determine:

(a) the tax base — who is going to pay the tax; what is the tax going to be imposed upon (real estate, movable wealth, activities); how to assess the value of the wealth or activities being taxed?

(b) the effort and honesty of the tax collector — does he extract the tax desired by the ruler or does he collude with the taxpayer to evade the tax; does he extort the taxpayer into paying more than the ruler demands; does he pocket more than his agreed-upon allowance?

(c) the amount of revenue collected — is it possible to measure this without knowing either the actual tax base or the collection effort? how stable and predictable is the yield going to be? will it decline when it is needed most?

While considering the administrative side, we shall also examine the political implications of choosing one revenue collection system over another. One thing of particular concern to us is the evolution of the tax administration from a small-scale, decentralized, privatized, and inefficient system toward the large-scale, centralized, state-owned, and relatively efficient system we know today. The ability to impose taxes gives governments wide-ranging ways to intrude into the political and social life of the polities they govern, and they enable them to fight wars on a scale that would have been unimaginable to their predecessors. We shall see a very important development: the need to finance expensive wars forced cash-strapped governments to borrow from their own citizens, mostly the wealthy elites.

In order to attract debt, governments would attempt to guarantee its service (payment of interest and repayment of principal) by backing it up with tax revenue. While governments tended to be "above the law" when it came to their fiscal responsibilities, lenders would be wary of providing the requested loans because they were afraid that the government would renege on its promises to repay. Correspondingly, the rulers found various ways to enhance the credibility of these promises — they would give the lenders the right to collect the taxes themselves (tax-farming), they would provide them with salaried positions and titles (venal office-holding), and they would share control of policy or relinquish control of the purse (parliamentarism).

Some of these arrangements perpetuated the decentralized corrupt system that prevented rulers from tapping into the full potential wealth of their subjects, but others enabled a transition to a modern efficient bureaucracy with substantial extractive capabilities. The enormous revenues the old system could raise undermined the incentives for the rulers to change until these funds began to fall short in the military competition with those that had made the transition. The entrenched interests the system had created also made change very difficult, so most transitions occurred only in the wake of serious social upheavals like military defeat, a civil war, or a revolution. As deputy Marc-Antoine Lavie declared to the French National Assembly in 1792,

> We only made the Revolution to become the masters of taxation.[1]

[1] Quoted in Gail Bossenga. 1989. "Taxes." In François Furet, and Mona Ozouf, Eds. *A Critical Dictionary of the French Revolution.* Cambridge: Harvard University Press, p. 589.

Thus, war served as the major cause in the creation of the fiscal systems, and it was also often the cause for their disintegration and constitution of alternatives.

## 1 Tax Farming

For most of history, rulers did not have the administrative or coercive means of properly assessing the wealth of the taxpayers. The occasional censuses conducted for that purpose were expensive, took many years to complete, and were obsolescent by the time the information was collected. The major obstacle was that rulers lacked information about regional and local economies; precisely the type of information that locals had but would not be easily induced to divulge. Generally, when someone with property rights over a resource (e.g., a king with right to collect certain taxes within a region) does not have the information or expertise that another does (e.g., a regional magnate who who maintains a client-patron relationship within a regional network), there are gains from cooperating in the exploitation of that resources (tax collection). The holder of the property rights (the principal) can temporarily assign these rights to the agent in exchange for a pre-determined sum of money. This sum would cover the agent's operating expenses and allow him to skim off some profit if his exploitation of the property rights yield income in excess of the payment. The agent sells his expertise to the principal who profits by not having to develop and maintain such expertise himself. This form of fiscal administration is called **revenue-farming** and was a very common way of managing one's estates throughout history. It was practiced by kings, by princes, by the nobility, by Estates, and by the Church (for the collection of tithes).

Until the modern era, the distinction between the ruler's *demesne* (personal holdings) and his sovereign right to public taxation was often blurry, and the same principles applied to managing personal estates were often applied to managing the collection of taxes. In effect, rulers would contract out, for a fixed fee, their rights to collect taxes to private collectors for a specified period of time. This system of **fixed rent contracts** is called **tax-farming**. The important taxes farmed in France were the *gabelles* (salt monopolies), the *traites* (internal and external customs duties; the largest was the huge tariff boundary around the center of France), the *aides* (excise tax on everything the Crown could define, like wine and tobacco), and the *domains* (traditional seigniorial dues). In Britain, the important taxes farmed were customs, excise, and the hearth tax.[2]

Since this method of collecting taxes might be quite alien to our experience, it is perhaps worth spending a little bit of time on it. As the economy monetized, landowners generally found it profitable to commute their various rights (to share of the crop, to free labor, and so forth) to money payments. As a medium of exchange, money was far more useful than trading in kind. It was also far easier to manage one's property with a common unit of account. Finally, barring devaluations, money was a relatively safe and non-perishable way to store wealth. In short, as specie flowed into the economy, owners of property rights began to convert their claims into monetary equivalents. With this, they also intensified the farming out the revenue collection to specialized agents. The ruler, who was often among

[2] For a discussion of this method of fiscal administration as it was used in France, see George T. Matthews. 1958. *The Royal General Farms in Eighteenth-Century France.* New York: Columbia University Press. The following discussion is largely based on Chapter 1 in that book.

the greatest of these property-rights owners (in practice this meant land ownership), was no different in that respect. As rulers gradually acquired rights to collect taxes, they applied the same principles to their collection. Since, as we shall see, many taxes were granted in times of emergency, rulers initially did not have the time to develop the administrative capacity to collect them — they looked for agents who already possessed some of that capacity.

From the perspective of the ruler, tax-farming offered several advantages. First, the ruler did not have to maintain an expensive administrative apparatus to manage the tax collection. Second, he did not have to acquire the information necessary to ensure the smooth operation of that process, and so did not have to engage in the politically explosive inquiry into the wealth of his subjects. Third, since the fee was fixed, he could count on a stable regular income — sometimes he would fail to collect as much as the taxes would yield (the profit would go to the tax farmer) but sometimes he would collect more than the yield (the losses would also accrue to the tax farmer). Fourth, by requiring partial prepayment of the fees in advance of the collection, the ruler would obtain immediate access to cash — obviously very useful in the emergency that gave rise to the new tax in the first place. Fifth, any local resentment and outright hostility would often be directed to the entity performing the collection, deflecting it from the ruler who could distance himself from his agent whenever this was politically expedient. Tax-farming could be very attractive to rulers, especially if they found ways to minimize the profits of the tax-farmers; that is, if they could lay their hands on most of the revenue the tax-farmer, with his better expertise, managed to raise.[3]

But how would rulers do this without having access to the information the tax-farmers possessed? In every aspect the tax-farmers had the advantage. They knew the tax base better through their local connections — this means they had a far better idea how much revenue was, in principle, possible to obtain. They knew their own operating costs — this means that they could profit from the "deductions" they assessed ostensibly to cope with variable costs of collection and uncertainties like weather and war (this is money that would be deducted from the amount owed the ruler). Finally, they also knew their own capacity — this means that they were also better informed about their ability to collect the revenue (overcome resistance and enforce their demands). And, of course, only the tax-farmers truly knew exactly how much money they got. In short, tax-farmers had asymmetric information about everything of importance, and thus about the crucial difference between their costs of running the tax-farm and the yield of that business. Since profits would be determined by them equating their marginal cost of collection to the marginal benefit, only the tax-farmers themselves would really know what these profits were. So how would the ruler lay his hands on these profits without investing in the very type of surveillance and enforcement that the farm was supposed to make unnecessary?

[3]Rulers did not have to be primarily interested in maximizing their revenue. They might, for example, be more interested in maintaining the political support of powerful regional elites. This they could do by dispensing privileges and assigning the tax farm to the desired beneficiary without a strict competitive bidding process. Such privileges could be economically and socially important. For example, they could include being subject to a special magistrate for adjudication of disputes arising from farm operation; exemption of various tolls, local taxes, or billeting of troops; the conferral of title and the right to appoint assistants (many with similar privileges) — which enabled the farmer dispense patronage himself. On the importance of these political motives that are not necessarily related to revenue maximization, see Matthew Vester. 2004. "The Political Autonomy of a Tax Farm: The Nice-Piedmont Gabelle of the Dukes of Savoy, 1535–1580." *Journal of Modern History,* 76(4): 745–92.

One very common method of extracting profits was to **auction off** the tax-collection rights to the highest bidder; that is, use the information the agents had "against" them. In an auction, each tax-farmer will bid based on the best estimates he has about the expected profits and, barring collusion among the tax-farmers, the highest bidder would be the one with the greatest expectations. The competitive bidding would force the potential tax-farmers to reveal their estimates of profits. Assuming that the assessments were, on average, correct, this would enable the ruler to extract quite a bit of revenue without having to invest into any fact-finding. Not surprisingly, then, auctioning off the tax-collection rights to the highest bidder was perhaps the most common method of allocating those rights. Rulers encouraged numerous small-scale operators and actively discouraged (and even banned) both wealthy elites and syndicates from participation since the latter would undermine the effectiveness of the auction mechanism, and channel larger profits into private hands, which could have political consequences especially when it came to elite participation.

Initially, then, new taxes would be auctioned off to some agent. Rulers with extensive regional holdings and large regional variation soon found themselves dealing with a great many of these tax-farmers, each of whom had to develop the administration necessary to manage the tax he was responsible for collecting. Depending on the type of tax the farmer was charged with collecting, the capital investment required for building the appropriate administrative capacity could be quite substantial. For example, in order to collect customs, the farmer had to construct toll gates and purchase or rent buildings to house products until the duties are paid; in order to manage a monopoly, the farmer would have to buy the requisite quantities of the product, purchase or rent storage facilities and distribution centers, and organize the transportation between these; in order to manage excise taxes, the farmer would have to purchase weights and measures, train personnel in documenting and assessing production, and maintain these officers at own expense. More generally, all activities required a considerable investment in human capital in the form of trained accountants, guards, officials, and managers.

When tax-farmers had to make such prodigious investments, these costs would have to be accounted for in their bids, depressing the revenue remitted to the ruler. It thus made sense to preserve that capacity after the expiration of one lease and then make it available to the tax-farmer who won the bidding for the next one. If the lease included the apparatus for collecting the tax in addition to the rights, then the tax-farmer would simply rent that apparatus for the duration of the lease at a much lower price than it would have cost to build one from scratch. Since this would permit the tax-farmer to bid more, the resulting revenue from the farm would also increase. This is why it did not take long for rulers to acquire the administrative machinery developed by the early tax-farmers (by reimbursing the tax-farmer for it at the end of the farm, for instance). Rulers in effect became owners of these proto-bureaucracies, with continuity and expertise now residing largely in the administrative apparatus itself rather than in the personal clientelistic networks of the tax-farmers. Over time, these bureaucracies became less dependent on local grandees to run it.

Moreover, when rulers ended up owning many of these disparate apparatuses designed to collect specific taxes, it became possible to take advantage of economies of scale by reorganizing them into a large institution. Profit dissipation could be avoided by eliminating unnecessary duplication of effort and expertise. Thus, tax-farming also witnessed a process of consolidation in many countries as the various small proto-bureaucracies were amalgamated and integrated into large organizations responsible for the collection of numerous taxes, like the General Farms in France, which employed over 35,000 people by the end of the seventeenth century. The economies of scale could be quite profitable: French tax revenue tripled after the Crown switched from competitive auctions with numerous tax-farmers to a single large farm.

There was, of course, one major disadvantage to centralization: as the farms grew in size, there were fewer and fewer tax-farmers who could afford them or that could manage a business of that magnitude. The solution was to organize tax-farming syndicates where investors would pool their money to lease the farm. As the principal wealthy investors were drawn into these syndicates, however, the pool of potential bidders shrank dramatically, and it became quite impractical to auction off the farm. Instead, the ruler now had to engage in **direct bargaining** with a monopsony farming syndicate. In other words, centralization undermined one of the great advantages of tax-farming that decentralized auctioning offered — the ability to extract a large share of the profit without direct and expensive inquiry into the tax base. Although the years of dealing with private farmers must have enabled that proto-bureaucracy to acquire considerable know-how, the political difficulties of negotiating the farm leases with very wealthy and influential men were often dramatic.[4]

Thus, the multitude of relatively small tax-farming apparatuses evolved into a large integrated general proto-bureaucracy owned by the ruler but leased to powerful financial syndicates after direct bargaining. Since these proto-bureaucracies were already staffed by salaried officials directly appointed by the government and because negotiating the farm lease involved both the sacrifice of the benefits of the auction mechanism and the granting of extensive privileges and exceptions to the tax-farmers to induce them to take that lease, the logical next step would have been for the proto-bureaucracy to become a full-fledged government bureaucracy. Instead of leasing the tax-collection apparatus, the government would manage it itself. In effect, the ruler would become his own tax-farmer, and so avoid the agency problems. With the apparatus already in place there was no need to worry about the costs of creating one. Since the professionals were already salaried, the ruler was paying for that apparatus, either directly (when the lease could not be negotiated) or through the deductions to the tax-farmers (when they were running it). By fully "nationalizing" the tax-collection agency the ruler would not have to worry that the profit maximization motive of the tax-farmer would run contrary to the revenue-maximization interest of the ruler. The incentives appear fully aligned to ensure the emergence of a modern government-run salaried bureaucracy. And yet, in most countries this did not happen for a very long time, and when it did, it was often the result of a serious social upheaval like a civil war or an outright revolution.

So the question is: why did tax-farming continue on such a large scale despite the obvious inefficiencies and drawbacks that it presented the ruler with? Farming had outlived its usefulness in almost every aspect that had initially made it an attractive mode of fiscal administration. The ruler had come to possess the apparatus and the expertise; that apparatus had more than enough information to ensure the collection of taxes; and since the

[4] For example, the French Crown was sometimes unable to persuade the farming syndicate, *The Company of General Farms*, to accept the lease of the tax-collecting agency, *The General Farms*. The result was that the bureaucracy continued to operate under direct royal supervision until the lease was negotiated. The next section explains why the Crown did not want to run the farm itself.

proto-bureaucracy was staffed by the ruler's officials, any hostility generated by the tax collection would no longer be effectively deflected away from the ruler. Of course, some of the original advantages were still there. The farm would provide the ruler with immediate cash in advance upon inception of the lease, and with a regular stable income in the form of the fixed payments the tax-farmer was making. The ruler could also share the risks with the tax-farmers who would have to absorb at least some of the losses in any given year. The agency itself could do neither because it had no access to resources outside the taxes it collected, and so could only make remittances after collection and depending on the actual yield. However, many of these potential advantages were dissipated in agency problems because without the auction mechanism, the ruler was forced to negotiate deals with a unified consortium that, as a monopsonist, was able to drive hard bargains. The tax-farmers would thus secure higher profits, reduce their payments, and decrease their share of the risk to which the collection was exposed. This only worked to make farming less and less attractive to the ruler, giving him strong incentives to replace it with a salaried bureaucracy. It was, in essence, how farming of customs duties was effectively ended in England in 1671.[5]

So why did tax-farming fail to evolve into a salaried government-run bureaucracy more generally (e.g., in France, Spain, and Austria — the three principal Great Powers of that period)? The answer is that whether the transition occurred depended on the ruler's ability to borrow. In most places, by the time the tax-farms were "ripe" for takeover by the ruler, they had evolved into the most important sources of **public credit** for him. Their primary function had ceased to be tax collection — even though of course they did that and even though their own credit-worthiness was tied to that revenue — they had become financiers and were functioning like embryonic banks, providing both direct loans to the ruler and floating their own bonds to the public.

[5] In 1670, King Charles II was negotiating the terms of the customs lease with a powerful syndicate, which demanded guaranteed reimbursements in case of another war with the Dutch. They were not only refusing to share some of the risks (the war would interfere with trade and so drastically cut receipts from customs) but were interfering in foreign policy — after all, it was the King who was supposed to decide on that very war, and thus, by implication, bear the responsibility for these losses. In other words, since they would commit to advancing funds to the King, his involvement in the war would be a reckless endangerment of their investment. Since this constitutes a form of misappropriation of funds — **defalcation** — the Crown would have to be held legally responsible. The King could not tolerate this interference. In 1671 he ordered the contract cancelled, the farmers reimbursed, and the management of the royal customs transferred to the government. From this point on, customs revenue was no longer farmed out in England. See C.C. Crews. 1935. *The Last Period of the Great Farm of the English Customs, 1660–1671.* University of London, Unpublished M.A. Thesis. Cited by Patrick O'Brien. 2001. "Fiscal Exceptionalism: Great Britain and Its European Rivals. From Civil War to Triumph at Trafalgar and Waterloo." Working Paper No. 65/01, Department of Economic History, London School of Economics. `http://eprints.lse.ac.uk/22369/1/WP65.pdf`, accessed January 20, 2013. O'Brien also notes the transition of excise to royal control by 1683, placing two key events in the emergence of the modern-style "tax state" in England *prior* to the Glorious Revolution. Since the Crown could not raise taxes without generating serious discontent that could threaten the recently restored monarchy — it even had to abolish taxes imposed during the Civil War and the Interregnum — the cash-strapped King focused his energies on improving collection, hoping to raise enough money despite the lower rates of taxation. This, in part, explains the push toward bringing tax collection agencies under direct government control. With the abolishment of the hearth tax farm in 1684, tax-farming in Britain became history. Of course, it could have been that this centralization of tax collection revenue made the Crown suspect again and was itself part of the reason for the Glorious Revolution, whose reforms eventually gave more financial voice to Parliament along with oversight of royal expenditure, thereby reducing the risks of centralization for the balance between Crown and Parliament.

Although the practices of borrowing varied, the principles were common: the ruler would obtain credit from the tax-farmers backing it with the security represented by the expected revenue that they controlled. For example, the ruler would engage in **deficit spending** by paying for goods and services with promissory notes (e.g., the *assignations* in France). These notes were evidence that the government owed money to the bearer, and the discharge of that debt was the responsibility of the tax-farmers. These fiscal instruments would generally be short-term, due to mature in six months to a year, and would carry a relatively low interest rate. The bearer could present the note to tax farmer upon maturation and receive the principal and the interest; he could sell the note to the tax farmer, at a discount, prior to its maturity; or he could extend the term for another short period. The tax-farmer would then recoup the price of the note plus any additional fees for his services by charging it against the tax revenue he collected. That is, he would reduce the amount of money transferred to the ruler by the cost of these notes.

The ruler could also "ask" the tax-farmer to handle certain expenses directly. Tax-farmers were often in charge of local expenses incurred in the name of the ruler — this was convenient since having them handle local spending would reduce the amount of money that would need to travel to the central treasury and then back to pay for these expenditures, a process that was both costly and risky. The ruler would then increase the charges they were responsible for, and when the payments were in excess of the income from the tax-farm, the tax-farmer would be financing the deficit from his own pocket. In effect, he would be advancing a large loan to the ruler. As in the case of promissory notes, this debt would be discharged from future tax revenue.

In both situations, the tax-farmer would be called upon to fund immediate expenses without having access to the necessary tax revenue to cover them for some time. This had two effects. First, rulers became more interested in getting wealthy members of the elite to run the farms. The smaller operators and speculators were quite sufficient to handle the smaller farms of the past, and the rulers often actively discouraged the formation of syndicates or larger farms in order to prevent collusion and exploit the advantages of the auctions. When it came to borrowing on a large scale, however, the limited resources offered by the small-time operators fell short of the rulers' needs, and so they began encouraging the involvement of the truly rich. This, of course, accelerated the process of amalgamation of the tax-farms into proto-bureaucracies.

Sometimes, however, even the large syndicates and the wealthy tax-farmers could not fund the demands of the rulers because they did not have enough cash on hand. The need could be especially acute when they had to purchase the stocks of product in a monopoly, when they had to finance operations during war, or when they had to handle a large amount of promissory notes. The second effect of using the tax-farms for credit, then, was to enable the tax-farmers to borrow, in their own names, from the public at large. The tax-farmers would sell short-term bonds (e.g., the *billets des fermes* in France) on the money market, and then buy them back or refinance them when being presented with a request for payment. Since these bonds were backed by the tax revenue over which the tax-farmer had control, they would be relatively safe investments, and correspondingly carry low interest rates. This was manifestly not true for many rulers, whose personal credit was far worse because they could (and did) sometimes renege on their debt obligations with impunity. Thus, rulers could rely on the better credit of the tax-farmers to borrow at rates that they themselves might not have been able to obtain on the credit market. Ultimately, of course, these bonds were dependent on the tax revenue, and so their face value plus interest would be charged against that revenue (reducing the amount due to the ruler).

This fiscal system allowed rulers to spend a year's (or sometimes even several years') worth of expected tax revenue in advance of tax collection. Since the terms of that debt would often be far more attractive than what the sovereign ruler could hope to obtain personally, the ruler's voracious appetite for income made the system very attractive. By the time tax-farms were no longer the most advantageous way of collecting taxes, they had evolved the lending function that made them very valuable to the cash-starved ruler, especially when he had no ready access to cheap credit elsewhere. This is why tax-farming tended to persist even after rulers acquired the proto-bureaucracies with the expertise to manage the actual collection of taxes: the tax-farmers had become **financiers**. This is why rulers were always anxious to lease the tax-collection apparatus even when they could have operated it themselves. The tax-collection bureaucracy could not provide the credit that they so desperately needed. This is also why tax-farmers were able to drive hard bargains and obtain numerous privileges and exemptions in addition to making enormous profits by leveraging the difference between their credit and that of the ruler.

With such gigantic financial interests at stake, any disruption to the system would be costly and very risky. The large tax-farms became permanent (in the sense that they were no longer auctioned off to different operators every year), and with this stability their ability to lend money to the ruler went up. The profits of the tax-farmers increased substantially, and this created very serious entrenched interests in protecting that system. In other words, if the ruler tried to shift to an efficient government-run bureaucracy, he would have to find other ways to borrow and he would have to overcome a powerful array of interests that would resist such a change. In most countries, this combination made the system nearly impregnable to reform, and many rulers and ministers miserably failed in their efforts to rationalize it. This is why such a highly decentralized system — inefficient, corrupt, and largely out of government control — could persist for so long in so many places (ironically, precisely in those places usually characterized as "absolutist", where the ruler supposedly had unlimited power). This is also why the emergence of a modern-style government-managed bureaucracy would tend to follow a serious social upheaval; a revolution or a civil war that would destroy some of these entrenched interests, and reconfigure the others, creating an environment in which a restructuring of the fiscal system would, at least in principle, become possible.

## 2 Venal Offices

Tax-farming involves, at its core, contracts with fixed rents that, together with the auctioning mechanism, can nearly eliminate the need to assess the actual amount collected. When this amount was easier to ascertain, it was possible to design **share contracts** that specify the proportion in which the ruler and the collector would share the actual revenue. For example, capitation taxes would require little more than a decent idea of how many individuals resided in the tax area, and a fairly rough account of their ability to pay the tax. Because rulers did not have the administrative capacity to assess the property and income of their subjects, direct taxes also tended to become customary in the sense that the government would demand a fixed amount from a locale, and let the residents of that locale sort it out amongst themselves how to best come up with the required amount. The amount to be collected was thus pre-set and the ruler would contract with a tax-collector who would perform the actual collection and who would in exchange retain some portion of that amount. The "income" tax known as the *taille* was collected under share contracts in France, as was excise in Prussia from the 1680s.[6]

These types of arrangements evolved an important difference from tax-farming: the share contract tax-collectors tended to become government officials (e.g., royal commissioners). That is, they were no longer private individuals who had the (temporary) right to collect the tax on behalf of the ruler but specifically commissioned state employees to whom the ruler delegated the administrative tasks of managing the tax. One reason for this divergence comes from the type of tax that share contracts where useful for. As we noted above, some types of *direct* taxes did not require an assessment of the revenue collected, much unlike all indirect taxes which did require an extensive monitoring system to administer. Recall that direct taxes are assessed on the individual who had no legal means of evading payment (indirect taxes can be legally evaded if the individual does not engage in the taxable activities). These types of taxes are the most obvious expression of the government's power to coerce, and thus represent a clear assertion of the ruler's power — it was a direct link between the ruler demanding the payment and the individual subject paying the tax. In essence, these taxes were the concrete form of the abstract ideas of authority and legitimacy of the ruler. Farming these out to private individuals would insert an intermediary in that link and dilute the symbolic value of the tax. Consequently, rulers often preferred to develop their own apparatus for collecting direct taxes. Without a modern-style state-owned salaried bureaucracy (which we shall examine next), rulers had to contract with private individuals to whom they would grant the authority to act in the ruler's name — they would commission them — thereby making them official representatives of the ruler and employees of the state. Those direct taxes that could be collected with share contracts would thus end up being administered by government officials who would assess, collect, and often administer them, while keeping a fixed percentage of the proceeds as their salary.

With revenue roughly known in advance, there was no need to farm out these taxes for fixed fees. Moreover, because the tax-collector would retain a percent of the amount collected, his effort would be high, and so there was less need for monitoring performance relative to that of a salaried bureaucrat's whose income was fixed regardless of the effort he put in. However, one might still wonder why rulers used share contracts instead of a state-owned bureaucracy — after all, it seems like the only difference between the two is that the tax collectors would be paid a portion of the amount they handled in the former

[6]The *taille* in France was assessed against peasants in the so-called *pays d'élection*, or areas in which the Crown had the right to impose such taxes without consulting any representative bodies (the *pays d'état* were regions in which the Crown had negotiated agreements that allowed the respective representative assemblies to impose such taxes and collect them, with almost the entire amount being spent locally). The Crown determined an amount that had to be paid by each of the *pays d'élection*, and then divided that among the each of the 24 generalities in these areas. This was further subdivided into the *election* comprising each generality, and then the amount due from each *election* was further apportioned among the parishes in it. Within each parish, a local tax collector would determine how much individual parishioners had to contribute in order to raise the amount that was due from that parish. At each managerial level in this system, officials would retain a fixed portion of the money they handled.

and a fixed salary in the latter. This does not appear to be of crucial importance, especially since salaries could be adjusted to reflect the responsibilities of the office-holder (and thus, indirectly, the amount of money he administered). Even if it did take rulers some time to build the infrastructure that would allow them to switch from tax-farming to share contracts, the transition from share contracts to a salaried bureaucracy should have not taken long. In many cases, however, that transition did not take place until the entire fiscal system was swept away in a dramatic social upheaval. To understand why it happened that way, we need to take a closer look at the development of these commissioned offices, especially in the country where they were most extensively developed and used: France, where the institutions were called the *Financial Receipts* and *General Receipts*.[7]

The chronic lack of funds impelled rulers to search for sources of credit, and as we have seen, farming out tax collection eventually evolved into a financial institution. The fiscal system of collecting taxes on share contracts would follow the same path — since the office-holders would have access to revenue they collected, the ruler could use various methods to borrow from them in advance of the actual collection on the security of these future taxes. There was one big difference between a commissioned post and a farm lease, however. The latter enjoyed some legal protection in the sense that it would be fairly difficult for the ruler to revoke the lease before it expired: even "absolute" rulers only rarely dared break legal contracts. A commissioned office-holder, on the other hand, served at the pleasure of the ruler, and could be dismissed at will. Since tenure in office was not nearly as secure as owning a farm lease, office-holding was not as attractive and, more importantly, could not be exploited for credit-generation — after all, who would advance a loan backed by taxes that one might never get to collect because he got fired by the ruler?

The solution was to sell the office, at first for several years, but then for longer periods, up to the lifetime of the owner. Tax-collection under share contracts in this system developed into **venal office-holding**. Although the ruler could still dismiss these officials, doing so now would involve breaking a legal contract over property rights, which made office-holding as secure as tax farming. The sale of the office also generated an immediate profit in proportion to the office's value, and so constituted a loan to the ruler. The office-holder would then use the revenue processed by his office as interest payments on this loan. By selling the offices to wealthy men with strong personal credit standing, the ruler could also expect to be able to obtain additional credit. When the ruler demanded a loan, these men could borrow on their own credit, advance the funds to the ruler, and then use their office to service the loan by withholding the appropriate amount to cover principal and interest. With the backing of the revenue they collected, the interest rates they commanded would be relatively low; and without the credibility problems of the ruler, these rates would often be far better than anything the ruler could obtain himself.

The rulers could still coerce recalcitrant office-holders by manipulating their stipends (e.g., by paying only interest but no principal or by delaying and refusing payment for a period of time altogether), by diluting the value of the office (e.g., by duplicating its responsibilities and having officers serve in rotation), or by threatening to terminate it (e.g.,

[7] George T. Matthews. 1958. *The Royal General Farms in Eighteenth-Century France.* New York: Columbia University Press, pp.22–33. For an extensive analysis of venality in France, see William Doyle. 1997. *Venality: The Sale of Offices in Eighteenth-Century France.* Oxford: Clarendon Press.

demanding a fee to renew the contract or promulgating rules so that the office would revert back to the ruler in case of the untimely death of the office-holder). As the prices of offices went up and with sizes of loans the rulers needed mushrooming, these uncertainties about the property rights over venal offices made them less attractive yet again. To solve them, the ruler made the offices fully heritable — if the original office-holder passed away, the investment would remain in his family. In return for a modest fee (e.g., 1/60th of the value of the office), the right to inherit would be renewed annually, making the property rights more secure and generating some extra income for the ruler. To further sweeten the deal, the ruler would also endow some offices with social status so that either the holder or his descendants (if the office remained in possession of the family for several generations) would become ennobled. The wealthy bourgeoisie gobbled up these offices because they were lucrative, provided a relatively safe way to invest, and offered a path into the upper strata of society.

This system ended up creating a dense network of entrenched interests that made it exceedingly difficult to reform. Since it also provided rulers with access to credit, the incentive to reform was weakened as well. As a result, in the countries where venal offices evolved primitive financial roles as lending institutions, the fiscal system proved especially invulnerable to rationalization despite its many known inefficiencies, its corruption, and its decentralization. Rulers lost control over their own officers but could do little as long as these officers were providing them with loans.

## 3 Salaried Bureaucracy

As rulers developed the administrative capacity to collect revenue it became possible to move to a modern-style salaried bureaucracy, a type of **fixed wage contract**. Under this arrangement, the ruler hires an agent who performs the assigned tasks (assessing, collecting, and administering the tax) for a fixed salary. The wage is, at least in principle, tied to the responsibilities of the office and thus, indirectly, to the magnitude of the labor effort of the office-holder. Unlike venal office-holders, the civil servants have no property rights over the office and can be dismissed at will. Unlike tax-farmers, they do not have rights over any portion of the revenue collected.

The advantages of this arrangement for the ruler are obvious and many. First, the government could now obtain the entire profit from the tax — the difference between the amount collected and the costs of tax collection and apparatus maintenance. To get some idea about the wastefulness of tax-farming and venality, examine the calculations that Colbert, the famous reforming finance minister to the French King Louis XIV, performed upon taking office. The estimated receipts from the *taille* (the income tax administered by venal state officials) stood at 57 millions livres tournois, but actual receipts were only 20 million (40%). If you think this is bad, the farmed excise and other taxes were estimated to bring in 45 million of which the Crown received only 13.5 (30%). And if this were not enough, the *gabelle*, which was easiest to abuse, was supposed to generate 20 million, of which the government saw only 4 (20%). Thus, on average the French Crown was losing 70% of its income to the organizational deficiencies of its tax system.[8] In comparison, from 1980 to

[8]Carolyn Webber and Aaron Wildavsky. 1986. *A History of Taxation and Expenditure in the Western World.* New York: Simon and Schuster, p. 278. These numbers should be treated with caution because of the

2011, the Internal Revenue Service in the US spent on average 49 cents to collect $100 in taxes, an administrative cost of less than half percent.[9]

Second, the government retained control over the apparatus and could ensure its loyalty and the quality of its performance. With competent agents whose jobs depended on satisfactory performance of their tasks, efficiency and reliability increased as well. Third, the skills and knowledge of individual civil servants could be turned into routines, operating procedures, and standards that the bureaucracies stabilized, disseminated, and perpetuated. This promoted uniform practices, predictability, and efficiency. The centralized administration of taxation performed by professionals avoided the substantial fraud and abuses that characterized both the private tax farming and the semi-private venal offices. Developed (or, rather, re-discovered for the first time after the fall of the Roman Empire) during the Middle Ages in the precocious urban centers in Italy, the system spread north of the Alps to Bavaria and Prussia, as well as farther north to the Dutch Republic and Britain, where it really took off after the Glorious Revolution.

Despite these obvious advantages, the system did have several shortcomings that conspired to prevent its ready universal adoption. With wages supposedly tied to labor effort but not necessarily related to the work actually done and the revenue realized, rulers had to worry about their bureaucrats shirking on their responsibilities. This is not so much of a problem with the fixed fee or share contracts. With a fixed fee, anything the agent generates above that fee he gets to keep. Analogously, with a share contract, the larger the amount generated, the larger the income for the agent. In both cases, the arrangements are non-distortionary for the labor effort, and so agents do not have to be motivated by other means. This is not the case with salaried civil-servants whose wage is fixed regardless of the revenue they generate. In other words, left to his own devices, such an agent should only be expected to put just enough effort to keep himself from getting fired. Because the direct link between effort and remuneration is severed, the incentive to work hard is misaligned.

Without motivation to perform the requisite tasks to the best of his ability, the agent has to motivated by providing disincentives to shirking; i.e., his performance must be monitored, evaluated, and punished if found lacking. In other words, the ruler would have to create another layer of bureaucracy in order to ensure that the civil-servants in the tax-collection agency are performing their duties. These supervisors also have to be organized and paid their own salaries, and in some cases, they would require an additional layer of supervision to ensure that *they* are taking their jobs seriously. The bureaucracy would expand, and with it, the costs to the government. This is one of the reasons this change took time to effect even after it became, in principle, possible — it had to await the development of monitoring techniques (e.g., principles of book-keeping and auditing) before the agents could be adequately supervised.

The other, and far more important reason for many rulers, however, was that the modern-style bureaucracy with salaried civil-servants could not provide credit to the government. Rulers, whose government depended on the patrimonial fiscal system of tax farming and venal office-holding, and who were interested in moving to a centralized efficient salaried

complicated system of assigning local expenses and debt service to the tax-collectors.

[9] Internal Revenue Service. 2012. *Data Book, 2011 (Publication 55B)*. Washington, DC: IRS, Table 29. Available online at `http://www.irs.gov/pub/irs-soi/11databk.pdf`, accessed January 28, 2013.

bureaucracy faced two obstacles that in combination often proved impossible to overcome. They had to find other sources of credit, which proved incompatible with them being "above the law" when it came to reneging on sovereign debt. As long as the ruler could force restructuring of loans in his favor or repudiate the debt with impunity, lenders would be wary of the risks and would demand high interest rates or refuse the lend in the desired amounts. In order to obtain access to better credit, rulers had to find a way to commit credibly to debt servicing. Paradoxically, this required them to relinquish the very power in whose name they were trying to incur these debts. The second problem was that a reform of such magnitude had to contend with the entrenched interests the highly profitable (for the administrators, not the ruler) semi-private fiscal system had created and solidified. Any attempt to deprive these semi-official individuals of their property rights, lucrative incomes, and privileges risked upsetting the delicate balance of bargains that sustained the government.