

# War and Society

## The Fundamental Problems of Resource Extraction

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The choice of revenue policy must depend on some purely technical variables that reflect the administrative costs of acquiring information, making reliable assessments, collecting the revenue, and enforcing the rules. We already discussed many of these when we enumerated the various types of taxation rulers can choose among. However, whereas deficiencies in these areas might have been sufficient for preventing monarchs from extracting large portions of the wealth of their subjects, they were certainly not necessary. Even if the Crown had access to a reasonably competent machinery for wealth assessment and collection, it would still be unable to tap into societal wealth effectively until it overcame the **political obstacles** to taxation. It is to these that we now turn. To simplify matters, for the time being we shall ignore the **redistributing role** of the government (this would become increasingly important by the end of the 19th century, and will come to be the dominant one from the mid-20th century on), and will focus instead just on its **extractive capacity**.

## 1 From High Taxes to Despotism?

Raising revenue essentially boils down to extracting wealth from individuals for some public purpose (public sometimes defined in terms of the Crown rather than the commonwealth). This inevitably creates political problems that need to be resolved, and so one must pay some attention to who has the power to raise revenue, collect it, and spend it. For most of the early modern period, governments distinguished between two types of income: ordinary and extraordinary. Although this categorization would not be of much use to us analytically, it serves as a convenient short-hand to distinguish between taxes that the ruler could levy on his own recognized authority and those that required explicit consent of some sort of representative assembly.

**Ordinary** revenue is raised by the ruler according to custom for the normal day-to-day peacetime functioning of the government. Traditionally, a considerable portion of ordinary revenue was supplied by the personal income of the monarch — from the royal domain, from feudal rights (e.g., pay the king for the right to inherit land, wardship of underage heirs of tenants-in-chief, right to marry off heiresses should no sons survive), and from royal prerogative (ship money, sale of monopolies, purveyance). Collecting this revenue did not require the explicit consent of a representative assembly. The right to these taxes and fees usually accrues over time from monetizing feudal obligations, using a precedent-setting consent granted in the past, or by symbolic consent whereby the relevant representative body automatically grants the right, sometimes annually but sometimes once at the beginning of the ruler's reign, in which case it would last for the duration of that reign.

**Extraordinary** revenue was supposed to be collected only under exceptional circumstances, and for our period this meant foreign policy and, essentially, war-making. Although some prerogative taxation was sometimes justified as extraordinary income, the difference we care about is that with most types of extraordinary revenue, the explicit consent of some sort of representative body was required. These grants could be in direct taxes (initially lump sums but later based on wealth assessments), as low-interest loans, or as loan forgiveness. The grants could be fairly substantial, provided the representative assembly could be persuaded to give them, and they often were not, at least not for the amounts the rulers were requesting. These taxes were not supposed to be permanent; they were meant only to tide the ruler over the fiscal emergency. However, in their quest for revenue, rulers were forever

trying to convert extraordinary revenue based on consent into ordinary revenue they could raise on their own authority.

It is often assumed that because of their resistance to the tax demands of the rulers, representative bodies served as a check on taxation and thus protected the property rights and liberties of the subjects. Their absence (or their effective relegation to irrelevance) are said to have led to the emergence of states with absolutist rulers whose powers over their citizens were virtually unchecked. As we shall see, this interpretation of history leaves a lot to be desired when confronted with facts — it is often precisely in the countries with *effective* representative institutions that citizens found themselves carrying the heaviest tax burdens, willingly surrendering to the government a portion of their wealth that would have made their “oppressed” counterparts in countries without such institutions rebel. Before going into these details, however, we should take a look at the interaction between rulers and representative assemblies (which we shall call **parliaments** for brevity).<sup>1</sup>

Let us begin by parsing the common argument that parliaments provided checks on taxation. It is quite true that parliaments were often reluctant to grant rulers the money they were asking for. However, the argument confuses the reasons for this opposition — it seems to assume that resistance to government taxation came out of desire to preserve one’s income and, by extension, one’s liberties. In this view, low taxation is equated with preservation of personal liberties, and since parliaments were instrumental in keeping taxes low, they were the guardians of liberty. This Whig history inevitably credits English parliament with the lightly-burdened free Englishman in contrast to the oppressed and heavily-taxed continental European in France or Prussia. As we shall see, however, equating parliaments with low taxation has little basis in history. In fact, it was generally the countries with most representative assemblies that were able to tax their citizens most heavily. In other words, heavy taxation was not only compatible with representation and personal liberties (at least for the elites), but it may have critically depended on them.

To concern with taxation really came from the fear that granting income to the ruler could shift the balance of power in his favor and the resulting centralization could lead to despotism of some sort or another. This concern was (and in some countries even today is) very real. To put it crudely, allowing the ruler to amass wealth and authority to extract it without consent would enable him to create a coercive apparatus — army or police — that could be used to enforce policies by fiat, and could therefore lead to complete disenfranchisement of the citizens. A ruler strong enough to enforce the law could also be strong enough to make it. And as Juvenal famously asked,

Quis custodiet ipsos custodes?<sup>2</sup>

This problem was recognized very early on, probably from bitter experience, and societies

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<sup>1</sup>Representative bodies can take many forms. For instance, they could be national, regional, or even municipal. They could be territorial (members of various classes all meet within the same chamber) or class-based (members of different classes meet separately; these are usually called *estates*). They can also differ in who they represent, and could be fairly exclusive (e.g., only members of the nobility), elitist (only members of landed, clerical, or merchant elites), or fairly broad (everyone, meaning, until recently, every male, with or without some minimal property qualifications). We shall discuss some pertinent differences as the occasion demands it.

<sup>2</sup>“Who will guard the guardians?” He was talking about using guards to ensure the fidelity of his wife, but of course recognized that his wife might corrupt them.

did evolve some institutions to protect against it.<sup>3</sup>

The central problem is one of control of the coercive apparatus. When the scale was sufficiently small, the ruler's independent military capability would be roughly similar to that of the greatest members of the elite. In this setting, the ruler is really the "first among many", and since any augmentation of his power would involve these elites bringing in their own retinues (that were loyal to them), there would be no significant shift in the balance among them. The feudal system was characterized by such direct checks on royal power, and self-aggrandizing kings would often face formidable coalitions of their nominal vassals arrayed to check their attempt at centralization.

The system was not static, however, and changes in military technology along with monetization of the economy increased the scale of warfare, which necessitated larger armed forces and their better coordination. This gave the ruler advantages in economies of scale as one to enforce property rights and provide for defense, and it also made it impractical for elites to compete with their own military forces. The checks provided by decentralization of the military apparatus weakened, and so other means had to be found to prevent the complete usurpation of authority by the ruler. The most common solution was to restrict his ability to maintain these forces without periodic re-authorization — this is what consent to extraordinary taxation was supposed to accomplish. Parliaments were thus the guardians who were supposed to protect the realm from the voracious appetites of the rulers.

But now we have a problem. In some places parliaments did not exist, in many they were suppressed and largely irrelevant for fiscal purposes, and in all they were highly unrepresentative — they often excluded the people who bore the heaviest brunt of taxation (the peasantry). Not only did absolute rule fail to develop in most of these countries, but (as I keep pointing out), the heaviest taxation was often found in countries in which parliaments did exist and were effective. One might well wonder what prevented effective parliaments from becoming the tyrants themselves.

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<sup>3</sup>This is not to say that they solved it completely. Even philosophers did not know what to do about it. Take, for instance, Plato who advocated "philosopher kings" ruling over the rest of society, and whose rule would be protected by "guardians". Since the guardians would, by design, have coercive powers that the rest of society does not, who is to guarantee that they would not degenerate into a caste of despots? Plato's answer is that these guardians would be indoctrinated with a "noble lie" to care only about the state and society, so they would not abuse their position of power. He even asserts that "it would be absurd... for a Guardian to need someone to look after him." (Plato, *The Republic*, Book III, 403e. The translation is from the 2003 Penguin edition, p. 101.) This piece of wishful thinking has proven about as effective as fairy dust, as the exploits of the Roman Praetorian Guard — which repeatedly made or broke Emperors — famously showed. Even when indoctrination could be successful, as for example in the totalitarian regime of the Stalinist Soviet Union, there was nothing to ensure that a commitment to the "state" could not also imply commitment against "subversives" as conveniently defined by the ruler. When these "subversives" number in the millions, one might start questioning the wholesomeness of the rule. More people have died at the hands of their own governments than in wars, and among those governments, the ones with extensive coercive powers have been the worst murderers. See R.J. Rummel. 1994. *Death by Government*. New Brunswick: Transaction Publishers. Some figures and data can be found at <http://www.hawaii.edu/powerkills/NOTE1.HTM>, accessed January 25, 2013.

## 1.1 Coercive Resource Extraction?

The basic idea is that fiscal pressures — initially produced by increasing costs of warfare but later arising out of the expanding scope of government responsibilities — drove demand for resources, and that the ruler's (and the ruling elite's) ability to raise these resources was fundamentally constrained by the extent to which the ruler could commit to policies that were congruent with the interests of those whose assistance he needed in order to extract these resources from the population. Although it was, in principle, possible to resort to coercive resource extraction, there were several problems with that approach.

First, in order to coerce the contributions of some segment of society, the ruler would need the cooperation of another segment. In practice, this mostly meant relying on a noble warrior elite to extract taxes from peasants, but with time the composition of the ruling elite changed with the wealth distribution in society and with the tax collection technology (what types of taxes were most effective in the balance among predictability, yield, and ease of collection). Having to rely on some elites meant that the ruler had to secure their cooperation, which meant not merely showering them with privileges, exemptions, and opportunities for increasing their wealth, but also being able to credibly promise not to expropriate all these perks at first opportunity.

This leads us to the second problem: since the ruler often did enjoy a coercive advantage with respect to any particular member of the supporting elite, he could expropriate recalcitrant, dangerous, inconvenient, or merely temptingly wealthy members of that elite. He could, that is, unless other members of the elite came together to defend their corporate interest against any such encroachment on the privileges of any one of their member. This could restrain the ruler and provide him with the ability to commit to the selective benefits as long as elites could not coordinate their resistance effectively. Since their dominant position in society did require the suppression of all other classes, this meant that intra-elite struggles could be dangerous since they were opportunities for destabilization of the entire ruling structure. Competing elite factions could recruit supporters from other classes. This permitted those excluded from rule to train, coordinate, and get a taste of participation and influence in affairs they normally would have no say in. This made them more difficult to suppress afterwards, both because of ideas that challenged the “natural order of things” and because of the more practical side of both acquiring some competence in military affairs, and of acquiring some experience in coordinating and managing collective affairs while elites were busy squabbling with each other. In addition, the military losses among elites would also be dangerous because they depleted their ranks, which were never too numerous to begin with. This further weakened their hold on others and permitted villages and cities to slip away from their control.

But if intra-elite conflict could be so detrimental to them as a group, elites had a strong interest in minimizing it. This then meant that fighting of one elite coalition against another would be undesirable and avoided as much as possible. Elites would tend to settle their problems through mediation, adjudication by the ruler, and compromise. Only under extreme circumstances would they resort to arms to enforce collective interests. Since this destroys the elite's collective threat to protect any individual member, the ruler could expect to get away with expropriation most of the time.

Thus, there appears to have been no effective check on the ruler's rapaciousness, which

seems to put him in what looks like a very advantageous position. However, as we have now seen on several occasions, when it comes to bargaining strength, “unconstrained” very often means “weaker”. In this instance, unconstrained means having no ability to commit to deliver on the promised benefits consistently, which undermines the elite’s willingness to cooperate in general, and to assist in raising revenue in particular.

Even if the ruler could somehow organize an effective coercive apparatus that would allow him to extort financing from elites, the fact that he remains unconstrained when it comes to policy means that he would fail to properly internalize the risks and costs of these policies. In other words, when someone else is paying for his wars, the ruler’s incentive to pick his wars carefully will be weakened. This means that on average such a ruler would do worse in these wars, which would impose heavy losses on the financing elites. As the wealth of these elites gets depleted in wanton warfare, the ruler’s revenue will fall, which would weaken his long-term prospects. Being able to commit to policies in the interest of these elites alleviates this problem because by having to take into account these interests, the ruler becomes less likely to wage wars detrimental to their wealth:

A king who could finance his wars via coercive transactions... would enter too many wars, with too little chance of victory, in the process bankrupting his financiers, or driving them to increasingly elaborate schemes of hiding their wealth. [...] Thus, the king’s own grasping might eventually result in his being constrained to make all his financial transactions voluntarily.<sup>4</sup>

Finally, as a method of revenue extraction, coercion is highly inefficient. It is costly because the ruler has to deploy and maintain an expensive coercive apparatus in addition to supporting the institutions for the more mundane administration of the tax collection. It is risky because it provides ample opportunities for abuse by the agents who could extort much higher payments from the population and pocket the difference. This does not merely mean revenue lost to the ruler, it means increasing resistance to taxation, riots, which could boil over into revolts or even widespread rebellions. These are yet another drain on the ruler who now has to suppress armed subjects, which involves not only paying the costs of the repressive apparatus but also foregoing the tax revenue from these subjects while the disturbances last. The more the ruler has to lean on the elites for help in this, the more likely is he to have to make more concessions to them.

Thus, consistent coercive resource extraction is not merely difficult to implement because of the credibility problems of the ruler with respect to the power elites; it is also unattractive even when it can be implemented because it is inefficient and because it risks killing the golden goose. Although rulers in desperate financial straits might occasionally resort to purely coercive tactics, the long-term strategy must involve the voluntary cooperation of the power elites, who could then help secure the quasi-voluntary cooperation of the taxpayers.

## **2 Absolute Rule: Low Taxes and Revolts**

We now develop an argument that shows why unconstrained (“absolute”) rulers must, in fact, be quite incapable of tapping into societal wealth effectively. Although the converse

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<sup>4</sup>Cox, “War, Moral Hazard,” p. 129.

— that a very constrained ruler would command large resources — is also untrue, there is a significant degree to which the monarch could generate immense revenues by imposing constraints on himself. To understand how this works, we must first examine why unconstrained rulers will only manage to command taxes that fail to generate nearly as much revenue as the overall wealth of the economy would suggest is available, why attempts to increase that revenue would provoke frequent revolts by the poorer segments of society, and why even elites will occasionally join in this open resistance to royal authority.

## 2.1 Unwillingness to Pay Taxes: The Problem of Commitment

Fundamentally, the issue is whether the ruler can **credibly commit** to following some policy. When it comes to the coercive apparatus, if he controls it, can he credibly commit not to use it against the wishes of his subjects? When it comes to taxes, can he credibly commit to use them in accordance with the wishes of the tax-payers? When it comes to war, can he credibly commit only to wage wars that his tax-payers want him to?

To understand why this is the fundamental issue, consider the consequences if a ruler is “above the law”, absolute and relatively unconstrained in his choices; that is, suppose that he can only credibly commit to pursue policies that are in his own interest to implement — promising anything else would not be credible since there is no way to enforce that promise. Assume further that the wealthy elites do have an interest in having the ruler provide centralized enforcement of property rights or public goods like domestic order and defense. This preference might arise for variety of reasons. For example, centralizing command of the military means standardization, superior organization, and effective coordination, all of which would contribute to the military efficiency of the armed forces. Enforcing unified laws common for all increases predictability of contracts, reduces transaction costs, and fosters economic development. Providing professional permanent police forces to maintain internal order allows private individuals to disinvest from the maintenance of private forces for their own protection, which permits them to shift spending on consumption or profitable economic activities. Finally, pooling societal resources can achieve economies of scale and can open up the road to projects that could be very attractive to individuals but completely out of reach. In other words, the elites would like the ruler to have extensive coercive and financial powers as long as these powers are used “appropriately.”

I put the word “appropriately” in quotation marks to indicate that the judgment of whether a particular use of coercive and financial resources is desirable rests entirely with those who are providing the ruler with the means to execute policies. These policies could be (and have been) normatively deficient because they invariably impose costs on the disenfranchised: large segments of society might shoulder the burden of taxation imposed upon them by wealthy elites colluding with the ruler. For most of history, taxation without representation was the reality for peasants, religious minorities, and even urban and commercial elites. This was true even in places where taxes required parliamentary approval because members of these social strata were seldom given access to the representative bodies. What mattered most was not the consent of the actual tax-payer but rather on those who could extract that tax and transfer it to the ruler. This means that the classes who would obtain representation would be limited to those who could provide means of coercion (e.g., landed aristocracy), means of collection (e.g., the gentry if they ran the tax apparatus), those who could not

be coerced easily (e.g., commercial urban elites under some circumstances), or those who helped the ruler maintain legitimacy (e.g., the clergy in some cases). The rest — peasants for most of history but after the Industrial Revolution also the workers — would have to make their voice heard in less deliberative fashion, by revolting when demands exceeded their ability to pay.

To return to our argument, we assume that if the ruler were to exercise his coercive and fiscal powers in accordance with the wishes of the elites, then they would prefer to grant him these powers. If the ruler and elites have congruent policy preferences, centralization presents no problems even if the ruler cannot credibly commit to follow particular policies. Trivially, the policies he wishes to follow — and so can credibly commit to — are precisely the policies that elites want as well. Even though centralization might be desirable in this case, it does not mean that the ruler and elites will be able to agree on it. The problem is that implementing policies is costly and requires both the ruler and elites to commit resources. Since the benefits will accrue, by our assumption, to both, they have a conflict over how to distribute the costs — each might prefer to shift the burden on the other. This incentive to **free-ride** on each other's efforts can greatly reduce the degree of cooperation even when the goals are mutually desirable.

In principle, however, one might envision some ways that the ruler and elites can negotiate their way out of the free-rider problem when their preferences are similar and it is important to achieve the policy goals. The deeper problem, of course, is that rulers and elites might have **divergent preferences**.<sup>5</sup> Sometimes their interests may coincide — in which case the elites might become more cooperative — but often they would not. For instance, the ruler might wish to pursue some policies for personal glory, dynastic gain, or to increase his authority domestically. He might wish to build palaces instead of fortresses at the frontiers. He might wish to reward favorites and punish opponents. He might simply disagree with the effectiveness or desirability of particular policies even if he agrees with the goals they are supposed to achieve. Disagreement over policy can greatly reduce the degree of cooperation. In situations like these, cooperation between ruler and elites can easily break down and rulers will find themselves seriously underfunded.

The consequences of divergent preferences are not limited to the situations in which the divergence occurs; they also have negative implications even for situations in which it does not. Elites always have to worry that cooperating over an issue where they agree with the ruler's desired policy might have consequences for issues where they do not. For example, providing the funds that enable the ruler to fight a defensive war that the elites want as well will increase the probability that he will prevail, and thus they will be more likely to achieve the outcome they wish. However, this cooperation can also leave the victorious ruler in command of a military force that he can then use for other purposes that elites disagree with. He can choose to fight another war or, even worse, he can use it to coerce the elites into granting further concessions domestically. Even if the army is disbanded after the war, the ruler might obtain disproportionate benefits from the spoils of victory (e.g., territory that passes into the domain and so outside parliamentary control when it comes to

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<sup>5</sup>For a formal statement of a version of this argument, see Jean-Laurent Rosenthal. 1998. "The Political Economy of Absolutism Reconsidered," in Robert H. Bates, et al., eds. *Analytic Narratives*. Princeton: Princeton University Press, pp. 64–108.



raising revenue), and this might enable him to gain far more relative to the elites, with the ultimate consequence that he can use that new wealth to fund a larger coercive force on his own. Even if such a power shift would not occur, if there is asymmetry in the distribution of benefits from the policy that favors the ruler but the costs are borne jointly implies that there will be circumstances when the ruler wishes to pursue such a policy (e.g., war) but elites do not. This creates a **moral hazard** problem because the ruler does not internalize the costs properly: he can use the funds provided to pursue policies that are riskier than what elites want him to. The upshot (again) is that this decreases the elite's incentives to cooperate.

We conclude that *the ruler's inability to credibly commit to use the resources for the purposes they were granted can undermine cooperation even in situations where the ruler and elites have shared preferences over policy.*

## 2.2 Low Taxes or Peasant Revolts: The Problem of Asymmetric Information

We have focused on the primary effects of divergent preferences (lack of cooperation when there is disagreement over policy) and on the secondary effects (lack of cooperation even when there is agreement over policy because the ruler cannot credibly commit not to abuse the resources granted). We now turn to tertiary effects in which the first two combine to further undermine the prospects for cooperation. As we have already noted, taxation is a coercive activity, and in the extreme the ruler will tax as much as the subjects can bear to pay. There are many ways one can conceptualize this **willingness to pay**. At the extreme level of coercion, the ruler can tax the subject down their subsistence level; extracting anything above that would threaten their physical survival, and is therefore undesirable in the long run even if the subjects could be induced not to run away.<sup>6</sup>

At the other extreme where physical coercion is not used extensively, the ruler can tax the subject until the distortionary effect outweighs the benefit. The higher the tax, the lower the marginal benefit from labor effort, and thus the lower the optimal level of effort that an individual is willing to put into the economic activities being taxed. The inverse U-shaped **Laffer curve** represents the hypothetical relationship between the tax rate and the revenue that the tax will generate.<sup>7</sup> At very low levels of taxation, the yield from the tax will be small although economic activity will be very high. As the tax rates increase, revenue will go up (the "arithmetic effect") but incentives to engage in the taxable activity begin to weaken (the "economic effect"). At some point the negative distortions of the economic effect will come to dominate the positive arithmetic effect, which means that increasing taxation further would lead to a *decrease* in revenue. At very high levels of taxation, the yield from the tax will be very small because economic activity will be very low. Thus, the tax with the highest yield will be intermediate, which means that it is limited by the individual incentives to participate in the taxable activities.

The reality of taxation is, of course, somewhere between extreme coercion and pure voluntarism. Subjects, and especially elites, often have enough means at their disposal to

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<sup>6</sup>Dan Usher. 1992. *The Welfare Economics of Markets, Voting, and Predation*. Ann Arbor: The University of Michigan Press, pp. 89–96, 110-30.

<sup>7</sup>For a history of the concept, see Arthur B. Laffer. 2004. "The Laffer Curve: Past, Present, and Future." The Heritage Foundation No. 1765. [www.heritage.org/research/taxes/bg1765.cfm](http://www.heritage.org/research/taxes/bg1765.cfm), accessed January 26, 2013.

ensure they have “exit options” other than mere survival. Conversely, the ruler can always use some coercion to ensure participation in some taxable economic activities even though the individual incentives might be lacking.

A simple alternative to the above two approaches is to think of an individual’s willingness to pay as the maximum amount the individual is willing to contribute without rebelling.<sup>8</sup> Since rebellion is both risky and costly, the refusal to pay the tax would leave the individual with a worse expected payoff than if such refusal were to go unpunished (in which case the only loss would accrue from the ruler’s inability to provide the desirable public goods). This means that the level of taxation that causes an individual to rebel must be strictly higher than the level of taxation he would pay voluntarily without the threat of coercion. In other words, in this model the ruler will be able to extract more than in the purely voluntaristic world.

When taxed at the subsistence level, the individual is barely scraping by, and so the payoff is fairly low. Let us assume that the worst that can happen to an individual in a rebellion is to lose his life. On the other hand, rebellion does offer the prospect of success, and thus in expectation rebellion can easily be strictly preferable to subsistence. Because the probability of success must be increasing in one’s wealth — with more resources one can organize better, raise more troops, and fight more effectively — it follows that the wealthier the individual, the higher the expected payoff from rebellion must be. Thus, elites will generally have rebellion expectations that far exceed their subsistence levels. The upshot is that when faced with a tax that reduces them to mere survival, elites will generally prefer to rebel. This implies that the maximum tax that the ruler can expect them to pay without rebelling is strictly lower than the subsistence tax. In other words, in this model the ruler will be able to extract less than in the purely coercive world.

To fix these ideas, consider Figure 1. On the horizontal axis are the various taxes the ruler can demand, from nothing all the way to everything the elite has. We shall consider two hypothetical elites, one of which is of modest means with wealth  $w$ , and another that is richer with wealth  $\hat{w} > w$ . Let  $R(w)$  and  $R(\hat{w})$  denote their payoffs from rebellion.<sup>9</sup> Since we have assumed that rebellion increases in one’s wealth, it follows that  $R(\hat{w}) > R(w)$ . Assuming that the payoff from rebellion does not depend on the tax the ruler is demanding, the two horizontal dashed lines in Figure 1 depict these payoffs.<sup>10</sup>

Consider now the elite’s payoff from agreeing to pay some tax that the ruler demands. Let  $U(t, w)$  be the payoff from paying tax  $t$  for elite with wealth  $w$ , and let  $U(t, \hat{w})$  be the payoff from paying tax  $t$  for elite with wealth  $\hat{w}$ . These are the two concave curves

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<sup>8</sup>For a formal statement of the argument in this section, see Branislav L. Slantchev and Troy Kravitz. 2013. “Rich Elites, Poor Kings: Rebellion Relief and the Ratchet Effect in Taxation.” Manuscript, Departments of Political Science and of Economics, University of California, San Diego.

<sup>9</sup>You can think of these payoffs as analogous to the simple war-as-a-costly-lottery model we used before. For this, let  $p(w)$  be the probability that elite with wealth  $w$  prevails in a revolt and let  $c > 0$  be the costs of rebelling. If the ruler suppresses the revolt, he expropriates the elite, leaving them with nothing. If the elite is victorious, it retains its wealth untaxed. With these assumptions, the expected payoff from rebellion will simply be  $R(w) = p(w)w - c$ .

<sup>10</sup>The assumption that the payoff from rebellion does not depend on the tax rate is reasonable but not the only one possible. For instance, if the ruler’s demand for high taxes angers people, more of them might become supportive of the rebellion, which will increase its chances of success. This logic would require the payoff from rebellion to be increasing in the tax demanded.

in Figure 1. We shall assume that the wealthier the elite is, the more it can benefit from the public goods provision of the ruler:  $U(t, \hat{w}) > U(t, w)$  for any tax. This is reasonable because it is usually the rich that profit from secure property rights and that stand to lose a lot from defeat in war. This assumption biases the model toward higher taxation, and so avoids the pitfall of assuming that individuals are opposed to taxation in principle. In the model, the elites do want to pay some taxes in order to avail themselves of the more efficient public goods provision of the ruler. However, as we shall see, they want to pay less than what the ruler can extract from them.

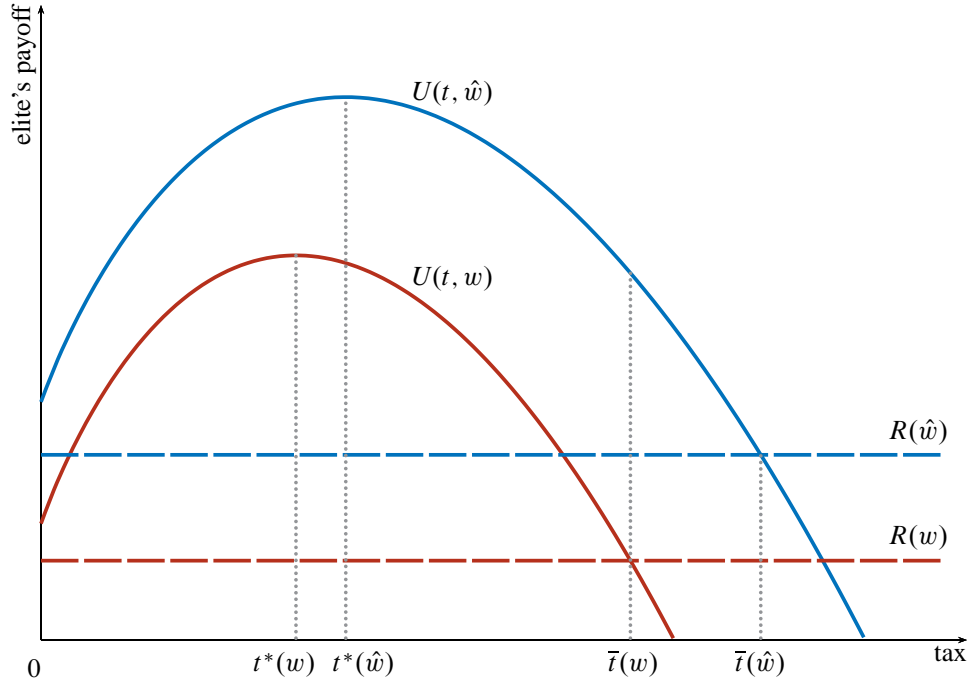


Figure 1: Violence-constrained Taxation.

To understand the shape of the payoff from paying the tax peacefully, consider the following logic. When elites pay no taxes, they consume their wealth privately (which gives them a positive payoff) but they enjoy none of the advantages of central provision of public goods by the ruler.<sup>11</sup> As taxes go up, the ruler provides more of these services, which at moderate levels of taxation is worth the cost, so the payoff to the elites increases. However, as taxes continue to go up, the marginal benefit from additional services is decreasing until at some point it is precisely equal to the marginal sacrifice in private consumption the elite has to make by paying the tax. This is the optimal tax from the elite's perspective: if it were lower, the elite would want to pay more in order to obtain more services, but if it were higher, the elite would prefer to pay less to enjoy private consumption. The elite-preferred tax rates are  $t^*(w)$  for the poorer elite and  $t^*(\hat{w})$  for the richer elite. Since the richer elite

<sup>11</sup>Why is  $U(0, w) > R(w)$ ? The best a rebellion can achieve is permit the elites to consume privately all their wealth. This is equivalent to paying no taxes but whereas  $U(0, w)$  means enjoying full private consumption in peace, rebellion can only deliver that outcome with some probability and the costs of rebelling still have to be paid.

is assumed to benefit from public services more,  $t^*(\hat{w}) > t^*(w) > 0$ , as expected.

Increasing the taxes beyond the elite-preferred levels leads to unambiguous decreases in their payoffs from paying these taxes. At some point, elites will be indifferent between paying these high taxes and rebelling. Let  $\bar{t}(w)$  denote this tax for elite with wealth  $w$ , and let  $\bar{t}(\hat{w})$  denote this tax for elite with wealth  $\hat{w}$ . In Figure 1, these are the points where the tax-payment payoff curve intersects the rebellion payoff line. Assuming that the benefit from peaceful tax-payment is increasing faster in wealth than the payoff from rebellion, we conclude that  $\bar{t}(w) < \bar{t}(\hat{w})$ ; that is, the maximum tax that the poor elite is willing to pay without rebelling is strictly lower than the maximum tax the rich elite is willing to pay without rebelling.

Putting these two things together tells us that the ruler can always extract more than the elites prefer to grant him as long as he knows their rebellion constraint; i.e., as long as he knows their wealth. Since rebellion is costly and risky for both the ruler and the elite, with complete information about the wealth of the elites the bargaining range must exist, and so the ruler will be able to tax them all the way up to their rebellion constraint without provoking an actual rebellion. For instance, if the ruler knows that the elite's wealth is  $w$ , he would demand  $\bar{t}(w)$ , which this elite would pay peacefully even though this tax exceeds its preferred tax  $t^*(w)$ . Alternatively, if the elite's wealth is  $\hat{w}$  and the ruler knows that, he would demand  $\bar{t}(\hat{w})$ , which the elite will pay even though its preferred tax,  $t^*(\hat{w})$ , is much lower. Thus, when we apply our bargaining model of war to the problem of taxation in the shadow of rebellion, we conclude that if the ruler had complete information about the wealth of the subjects, he would be able to extract quite a bit of resources without causing a rebellion, and he would do so at regressive rates.

The problem, of course, is that for most of history it is precisely this information that was unavailable to rulers and that elites jealously guarded. Without knowing the actual wealth of his subjects, the ruler does not know their expected payoffs from rebellion. This creates a bargaining obstacle that we are already familiar with: the problem of optimism, which we know to cause bargaining breakdown.

To see how the same problem crops up here, consider the ruler's demand when he is uncertain about the wealth of the elite. If he demands  $\bar{t}(w)$ , then taxation will be peaceful — if the elite happens to have  $w$ , it would be indifferent between paying and rebelling, and if it happens to have  $\hat{w}$ , then it strictly prefers to pay (you can see that  $U(\bar{t}(w), \hat{w}) > R(\hat{w})$  in Figure 1). On the other hand, the ruler can demand the higher tax,  $\bar{t}(\hat{w})$ . Since this tax makes the rich elite (with wealth  $\hat{w}$ ) indifferent between paying and rebelling, that elite would pay peacefully. However, the poor elite (with wealth  $w$ ) strictly prefers to rebel. Demanding the high tax, therefore, comes with a risk that the elite will rebel.<sup>12</sup> When the ruler makes such a demand, he estimates that the risk of rebellion is just the probability that elite only has  $w$  at its disposal; moreover, he estimates that the likelihood of peaceful taxation is just the probability that the elite is sufficiently rich to pay the tax demanded. This means that the more optimistic the ruler is — the higher the probability that he attaches to the elite being wealthy — the less the estimated risk of making the high tax demand. When the ruler is too optimistic, he will demand the high tax, and the elite will rebel if it is not rich

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<sup>12</sup>The ruler will never make a demand that is so high that the elite always rebels. The reasoning is the same as in the bargaining model of war we discussed.

enough to pay it. This is the **risk-return trade-off**: the ruler trades some risk of rebellion for a higher gain by increasing his demand.

We conclude that, parallel with the reasons for the breakdown of peace in our bargaining model of war, asymmetric information on its own can create problems for peaceful taxation: *If the ruler is sufficiently optimistic that the elite can afford the high tax, he will demand high taxes and run the risk of rebellion. Moreover, if rebellion occurs, it is the poorer elites that participate, not the wealthy ones.*

### 2.3 Low Taxes and Revolts with Elites Joining Peasants

The moral hazard problem explains why elites might be unwilling to contribute funds to the Crown, and the asymmetric information problem explains why the Crown will have difficulty compelling them to do. Combining the two problems — the situation in which every early modern monarch found himself or herself in with respect to the rest of society — dramatically aggravates matters. For reasons we shall now explore, the interaction of these two problems produces an even worse outcome for the monarch: taxes are either very low (but the polity is peaceful) or they are intermediate at best, but then there are endemic peasant revolts, and these are occasionally joined by wealthier elites.

Let us consider a dynamic setting, in which the ruler and the elites interact twice. The ruler demands a tax, which the elite can choose to pay or rebel. If the elite pays, the first interaction ends and the ruler provides public goods using the taxes raised. If the elite rebels, it can either win, in which case it pays no taxes, or it can lose, in which case the ruler expropriates its wealth permanently. When the ruler wins, there is no further interaction with respect to taxation because the elite is dispossessed. When the elite wins, however, tax remission is temporary. Thus, if taxation is peaceful or if the elite rebels and wins, there is a second opportunity for the ruler to demand taxes.<sup>13</sup> In the second interaction, the ruler makes the tax demand, and the elite either pays or rebels.

Clearly, the tax the ruler will demand in the second interaction must depend on the beliefs he has about the wealth of the elite *following the outcome of the first interaction*. As we have seen, if the ruler is sufficiently optimistic, he will demand a high tax, otherwise he will demand a low tax. Elite, of course, knows this, and will therefore take it into account when deciding whether to accept the first demand or to rebel.

Let us suppose that the first demand induces responses like the static second demand would; that is, if it is too high, only the wealthy elites pay, and the rest rebel. If the ruler expects this, then he can infer certain things from the behavior of the elites after he makes that demand. In particular, if his demand is accepted, the elite's willingness to pay would reveal to the ruler that his initial optimism was warranted — the elite is, in fact, rich (recall that before that acceptance the ruler only believed there is a relatively high probability that this was the case). How will the ruler act on this belief in the second interaction? He can, of course, make the same demand again — there is no risk in doing so anymore. However, the initial acceptance has made the ruler even more optimistic than before, and as a result

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<sup>13</sup>Rulers were only very rarely deposed in rebellions. Some of this has to do with the fact that tax revolts tended to involve the poorer segments of society, and were thus more likely to fail. But even when rulers decided to give in, it would be by rescinding the offending tax, nothing more. These types of tax revolts had no chance of replacing a ruler with a member of the rebelling group.

he will prefer to engage in the risk-return trade-off yet again: he can *increase* his demand slightly and accept the risk that the elite is not wealthy to pay it. Thus, upon learning from the acceptance of the original demand that the tax-payer is wealthier than expected, the ruler has incentives to increase the level of taxation to take advantage of that information.

A very clear instance of this dynamic can be seen in France, when in 1772 the *vingtièmes* (an income tax) was increased by 100,000 *livres* in the district of Tours. The local administrator wrote that “It is the facility with which the 250,000 *livres* were obtained by the last increase which has doubtless suggested that cruel step.”<sup>14</sup>

This process could continue until the taxes stabilize at very high rates (so the ruler no longer wishes to run any risks of upsetting the income) or until rebellion occurs. The ruler’s inability to commit not to use this revealed information against the tax-payer means that when deciding whether to agree to any given tax demand, the tax-payer must consider the higher taxes he might be faced with in the future. Naturally, this decreases the incentive to agree to any particular tax in the first interaction.

The incentive to agree to a tax in the first interaction is further diminished when we consider the consequences of rebellion. Suppose then that the first demand is rejected, a tax revolt occurs, and the elite is victorious. Consider now the ruler’s demand in the subsequent second interaction. Since the tax-payer is supposed to revolt only when he is not sufficiently rich to pay the initial demand, a rebellion signals that the initial demand was too high. Consequently, the ruler knows that were he to make the same demand again, he is guaranteed to provoke another revolt. Since this is costly and risky, the ruler is always better off by engaging in the risk-return trade-off: he can *lower* his demand and thus ensure that it is accepted with positive probability while still running some risk of rebellion if the tax-payer turns out to be even poorer than that. In other words, after a successful tax revolt, taxation is expected to *decrease* because the ruler will use the information obtained to adjust his policies.

These two arguments now imply that the rich have even weaker incentives to agree to pay any given tax in the first interaction: if they agree, they will be faced with a tax hike, but if they revolt, they are both more likely to succeed and they will get tax relief if they do succeed. This makes rebellion more attractive to the rich generally: *since the ruler cannot credibly promise not to use the information revealed by peaceful taxation and revolt, the rich elites have incentives to conceal their wealth by joining a tax revolt.*

This leaves the ruler with a very unpleasant choice of taxation policy in the first interaction: higher tax demands are a lot riskier because of the commitment problem than they would have been merely because of asymmetric information. In the static setting, the risk comes from the poor revolting; with the addition of the commitment problem, the risk comes from a combination of the poor and the rich revolting. This makes tax rebellion significantly more dangerous to the ruler, which means that the original risk-return trade-off can no longer be optimal. The ruler must significantly *decrease* the tax demand in order to weaken the incentives of the wealthy to join with the poorer elites. Since the rich do benefit more from the public goods he provides, if the tax demand decreases enough, the incentive to conceal wealth strategically will be outweighed by the incentive to contribute so that the ruler can provide these public goods. Thus, taxation will stabilize at positive but fairly low

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<sup>14</sup>Alexis de Tocqueville, *The Old Regime and the French Revolution*, note 70, p. 287.

levels: the ruler will be generally underfunded (relative to the wealth actually available to society) and the public goods he provides will be correspondingly limited.

To summarize, *the ruler's inability to credibly commit not to use information about elite's willingness to pay in his own interest can seriously impede cooperation on taxation. In particular, his inability to commit not to provide relief after tax rebellion forces him to reward wealthy elites with tax breaks in order to offset their increased incentives to join rebellions to obtain that relief.*

### **3 Overcoming the Political Obstacles to Taxation**

We have now arrived at a simple conclusion: when the ruler and elites have divergent preferences, the ruler's inability to credibly commit to policies preferred by the elites can seriously undermine fiscal cooperation. Rulers would be perpetually underfunded both because the elites do not want to waste resources on policies they might not agree with and because they fear that revealing their wealth to the ruler would have adverse consequences on subsequent tax demands. Analogous to the situation with tax collection where the ruler was the principal who was trying to implement effective control of the agents (the tax-collectors), here the principal is the elite who is trying to control the behavior of the ruler (the agent).

Opposition to taxation in this world arises because the elites have no say in how the money is actually spent — they have no way of monitoring the (potentially misbehaving) ruler and no way of enforcing sanctions if misbehavior is detected — and because they know that the unconstrained ruler can use their actions to infer information he does not possess, which he can then use to his own advantage. Consequently, if the monarch wishes to increase the Crown's revenue, he would have to overcome these political obstacles to taxation.

An immediate implication of the argument here, then, is that *if the Crown can alleviate the moral hazard and asymmetric information problems, then its ability to tax will increase and the incidence of tax resistance will decrease: taxes will become higher while anti-tax revolts will become fewer.*

But how can the Crown “fix” these problems?

#### **3.1 Selective Benefits**

One source for the Crown's moral hazard problem is the attractiveness of pursuing its own policies after its gets access to revenue. This suggests that one way to reduce the gap between what those who pay want and what those that spend do is to reduce the attractiveness of acting against the interest of tax-approving elites, and this can be done by increasing the costs and risks of these policies. The two basic ways this can be accomplished is by either making the ruler's future benefits dependent on the cooperation of these elites or by transferring some degree of control of the coercive apparatus to them.

In the first instance, elites can acquire a stake in the political system by becoming beneficiaries of its functions as state officials in judicial, enforcement, and bureaucratic roles. When the provision of justice, law & order, and the collection of taxes becomes dependent on these elites, the ruler's ability to disturb the system would be seriously circumscribed:

any attempt to deny the promised benefits to this new class in society could bring the government machinery to a standstill even if it does not provoke violent resistance. In other words, the costs that these elites can impose on the ruler by refusing to cooperate would be larger the more dependent the state is on them for its functions, and this would decrease the incentives to renege on the policies that benefit them. Even if the ruler can behave more or less arbitrarily to one of these officials or even to a small subset, revising the “agreement” for the entire class quickly becomes infeasible even if the ruler has a reliable coercive instrument.

One interesting example of the political constraint that the ruler provided by these state-endowed power elites comes from the monarch of the Sun King Louis XIV. In 1695, Sébastien Le Prestre de Vauban (1633–1707), the famous French military engineer and Marshal with experience in managing large-scale mobilization projects had successfully lobbied King Louis XIV for a temporary wartime capitation tax (which was abolished at war’s end, and reintroduced in 1701 without gradations by ability to pay. Right before his death, Vauban published a study of a reform of the tax structure that proposed, among other things, to abolish all existing property and income taxes and internal tolls and replace them with a unified single income tax without exemptions. This would also allow the king to dispense with tax-farmers and venal office-holders. He was quite aware of the resistance these reforms would encounter from elites and spent an entire chapter identifying all groups who might oppose them. He then baldly estimated that the king could quell their opposition with about 200,000 soldiers, and judged the reforms feasible. The proposal did not fare well: the book was officially condemned and Louis had all copies that could be found destroyed.<sup>15</sup>

The second basic method is for the ruler to endow these elites with command positions in the coercive apparatus itself. This can also come with its own privileges tied to the place these positions occupy in the state-related social hierarchy, but more importantly it restricts the ruler’s ability to deploy this apparatus against the interests of its top brass. If the ruler were to attempt renegeing on the promised policies that benefit these elites, he might quickly find himself in a very vulnerable spot as the army commanders become non-cooperative. This does not mean that they have to mutiny or revolt; sometimes worse damage could be inflicted by simple inaction or foot-dragging. With the army’s loyalty in doubt, the ruler will have a tougher time dealing with domestic disturbances, and his foreign policies might be placed in serious jeopardy. It is for this reason that rulers were always especially careful to cultivate the armed forces. The most, and perhaps the only, serious threat to a ruler has always been to lose the loyalty of the army. Then, and only then, could revolution from the poorer classes have a chance of becoming a threat to the regime.<sup>16</sup>

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<sup>15</sup>James B. Collins. 2009. *The State in Early Modern France*, 2n Ed. Cambridge: Cambridge University Press, p. 217.

<sup>16</sup>In this respect, the quiescence of the Red Army during the Stalinist purges is a stupefying puzzle. One of the most formidable coercive machineries in the world stood still while its top ranks were decimated not once but twice. In the Great Purge between 1937 and 1939, 3 of the 5 marshals, 13 of 15 army commanders, 8 of the 9 admirals, 50 of the 57 corps commanders, 154 out of 186 division commanders, all 16 army commissars, and 25 of the 28 army corps commissars were removed. Between 3.7% and 7.7% of the officers were purged although about a third were later reinstated. See Stéphane Courtois, et al. 1999. *The Black Book of Communism: Crimes, Terror, Repression*. Cambridge: Harvard University Press, p. 198. In the second wave between 1940 and 1942, about 350 Red Army officers all the way to generals were also executed, some as scapegoats for the abysmal performance of the army in the first months of the war. Perhaps the main reason Stalin could purge military



It is worth noting that not all armed forces fall into this category. For example, a navy is useful for defense, but it is far less useful for domestic enforcement. Expanding the navy should thus be seen as an instance of selective provision of benefits to elites rather than to allowing them partial control of the coercive apparatus. Since building and maintaining a naval force does not raise commitment problem issues for domestic policies that a standing army might, the elites would be far more supportive of the navy even without taking into account its beneficial role for commerce and trade. In a society that can use a navy and that does not have to maintain a sizeable army to deal with land-based opponents the ruler can enjoy significant cooperation from elites for naval programs. Because they are so complicated to coordinate, these programs can also encourage the process of professionalisation and bureaucratisation, which can lead to the emergence of complex organizations in service of the state.

As long as warfare did not require enormous standing armies, a mix of these two basic types of deals would prove sufficient to maintain the ruler in power without him having to grant significant concessions to the elites. During war the armies would temporarily swell in size (often by hiring foreigners) and they could often pay a significant share of the ongoing costs by maintaining themselves in the field during campaigns and off seasons. The power elites would cooperate with the ruler in extracting sufficient resources from their societies, part of which would go toward funding the army and part of which the elites themselves would appropriate. However, without exclusive authority to tax and an effective power of the purse, the elites always had to worry about the moral hazard problem, which decreased their incentives to contribute. This limited how much revenue the ruler could expect to raise without ceding taxation authority.

### **3.2 The Role of Parliaments**

As changes in military technology make it preferable to increase army sizes and to convert contract-based forces to permanent standing ones controlled by the state, the financial pressures escalate. The crisis can also be hastened by the strain of resisting a much larger aggressor. Since the number of offices the state can provide and the number of commissions it can give out are finite, even the larger societies will reach a limit to these types of selective benefit provision. Smaller polities will naturally reach that saturation point much faster. If the ruler wishes to increase revenue, the next step would be to attenuate the moral hazard problem that is preventing the power elites from cooperating more fully. This can be done by relying on a representative assembly to raise the funds.

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commanders in ways that the Sun King could not even dream of (or perhaps even conceive of) and that Hitler could only envy had to do with the fact that in the Soviet system the military leaders did not have any support base in society: no private wealth, no networks of patrons, nothing to fall back upon if it became necessary to resist. They were not members of the same elites that staffed the judiciary and who would be concerned about arbitrary repression of so many of their own. There was a powerful internal repression instrument (NKVD) to enforce the arrests and executions. There was a serious problem coordinating among officers because of the possibility of betrayal. The officers were often rotated away from their loyal troops before being arrested. The lower-level officers also had a career interest in seeing their superiors purged. See Brian D. Taylor. 2003. *Politics and the Russian Army: Civil-Military Relations, 1689–2000*. Cambridge: Cambridge University Press, pp. 154–74. Even then, I do not know of a satisfactory answer to the simple question: Why did the Red Army allow itself to be purged without even an attempt to resist?

It is important to realize that this argument implies that the mere existence of a parliament did not in itself make much of a difference. Even when there was no such organized representative body the ruler had to bargain, either implicitly or explicitly, with members of the elite in order to levy taxes successfully. In fact, and contrary to the oft-repeated assertion that rulers always sought to disband parliaments, having access to a collective body could make bargaining easier on the ruler. It provided a ready forum in which the ruler invariably had the seat of honor and enjoyed numerous agenda-setting privileges. It also gave him the opportunity to play off various coalitions of representatives against each other. Rulers skillful at politics could expect great rewards from bargaining within parliaments as opposed to negotiating a series of separate deals with members of the elite. It is little wonder that rulers sometimes actively encouraged these assemblies to gather, at least as long as they did not try to interfere with actual policy-making.

There were, of course, drawbacks to permitting parliaments to meet — the representatives could very well use the opportunity to coordinate and press demands on the ruler or, in extreme circumstances, rebel. When this happened, rulers retaliated, especially after a revolt. Victorious rulers would sometimes disband the offending parliament and then levy taxes backed by their newly-found coercive power. But this was not sustainable in the long run because coercion was so expensive. The next fiscal crisis would send rulers back to the bargaining table with the very elites whose representation in parliament they had suppressed. They would then either have to negotiate bilateral deals or agree to let parliament reconstitute itself.

From the perspective of the ruler, parliaments were not a problem as long as they did not try to exercise control over policy or extort privileges. But of course, precisely because they could not exercise such control, parliaments were often loath to agree to the fiscal demands of the ruler. A recalcitrant ruler who wished to have full independence in policy-making (thereby creating the commitment problem) would run headlong into obstructionist elites — whether sitting in parliament or not — who resisted his fiscal demands precisely because he insisted on this independence. This would lead to an impasse that could be broken only by some fiscal emergency, usually war.

The history of parliaments in early modern Europe does not exhibit a uniform tendency toward any particular form; some persisted, others were suppressed; some assumed ever widening authority over policy-making, others merged into the centralized state apparatus.<sup>17</sup> The parliaments ability to assert any control over the ruler depended to a large extent on the ruler's ability to mobilize resources from other sources. Rulers that did not command enough resources on their own were at the mercy of their parliaments, and if those were fractious enough, the ruler might find himself with no support whatsoever. The polity would lose the advantages of scale and centralization, and would weaken in the competition with its neighbors. The enormous country of Poland-Lithuania with its weak elective kingship and a raucous parliament reserved exclusively for the nobility ended up disappearing from the map.

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<sup>17</sup>For a general overview, see A.R. Myers. 1975. *Parliaments and Estates in Europe to 1789*. London: Harcourt, Brace, Jovanovich. For more detail on the institutional variation and the effects of the Renaissance and Reformation, see Michael A.R. Graves. 2001. *The Parliaments of Early Modern Europe*. Harlow: Longman. For the medieval origins of representative assemblies and the thinking that motivated them, see Antonio Marongiu. 1968. *Medieval Parliaments: A Comparative Study*. London: Eyre & Spottswode.

At the other extreme, a ruler who could muster significant resources without having to resort to extraordinary taxation could dispense with parliaments altogether. For all their inefficiencies, the fiscal system of France and the influx of silver from the New World to Spain did permit their rulers to mobilize considerable resources for the pursuit of their policies. When the rulers' ambitions outran their finances, the systems were flexible enough to allow them to borrow, often on a vast scale. The regime worked reasonably well but within built-in constraints: as long as the rulers refused to share authority in policy-making, they could not gain access to the wealth of their elites. It was in this way that the mighty Spanish Empire was brought low by its renegade province that became the Dutch Republic, and the giant France was out-competed globally by the upstart British constitutional monarchy.

So what role could parliaments play? Since the fundamental issue is the ruler's inability to commit, the solution would have to involve some type of control. This control cannot be exercised by disorganized members of the elite — to be effective, they would have to coordinate their effort and resources. Parliaments, then, would be necessary, but not sufficient, institutions for such controls to develop. Let us now take a look at three basic forms in which these controls could find implementation.

The most effective form would be in **shared policy-making**, which would ensure that the ruler was not pursuing policies wildly out of sync with the desires of elites. Executive authority in general but in foreign policy especially was something rulers would not give up easily, if at all. In fact, despite the nominally consultative role that many parliaments had, rulers almost never conceded to formal power-sharing in policy-making. The rare cases in which parliaments managed to assert such authority either involved weak rulers (e.g., a regency while the ruler was a minor or an elected ruler who had no power base in the country itself) or rulers that parliament had recently defeated in civil war.

Without direct access to policy-making, elites would have to make do with indirect forms of control. They could **monitor expenditure** to ensure that the resources were being spent for the purposes they were granted. Rulers universally detested this type of inquiry into their dealings, and although it was slightly less obnoxious than demands for power-sharing. Even if rulers were to agree to submit their expenditures to scrutiny, the absence of adequate accounting methods, the budgeting chaos when attempts to create budgets were made (often no such thing existed), and the multiple opportunities to conceal both income and expenditure ensured that this monitoring, even when agreed to, would not be very effective. The modern equivalent of parliamentary oversight would have to await the development of state bureaucracies (prodigious producers of written records) and standardized systems of accounting. Another problem, of course, was that without the ability to sanction malfeasance parliaments had little use for oversight — it did not avail them much to find out that the ruler had misbehaved if they could do nothing about it.

This brings us to the third form of control — the **control of appropriations**. By taking over revenue raising (thus removing it from the independent authority of the ruler), parliaments could exercise influence over policy. They could refuse to finance policies they disagreed with, and they could punish the ruler by withholding funding if he engaged in policies they did not want him to. Although this influence could be more effective when coupled with parliamentary oversight of expenditure, the latter was not necessary, at least not when it came to the large issues like war or paying back state debts. This constrained the ruler's ability to renege on promises, and so allowed him to make credible commit-

ments even while retaining nominal freedom of action in policy-making. Even though the ruler could no longer make policy at will (for fear of the consequences of running afoul of parliament), his access to resources for policies for which he had parliamentary support was enormous. Elites could now increase their contributions without fear of adverse consequences for their own well-being and without serious concern about misuse.

Collectively, these forms of control are known as the **power of the purse**. Let us examine its various components a bit more closely.

### 3.2.1 The Authority to Tax

Assuming that rulers would prefer to retain autonomy in policy and avoid scrutiny of their finances for as long as they can, their next step after exhausting selective benefits must involve political bargains that shift the authority to tax toward these elites. Recall that the moral hazard problem arises from the power elite's inability to control how the resources were actually spent. Since the ruler is more efficient at providing the public goods that the power elites are interested in and because violence-constrained taxation allows him to overtax relative to their preferred levels but without triggering resistance, the ruler will end up with a surplus of revenue. That is, he will be able to pay the power elites enough to keep them supporting the system and he will have some funds left over: the surplus. Having satisfied the minimal demands of the power elites, the ruler can now freely choose how to spend that surplus. The problem is that the elites might not like some of the policies he can choose to pursue. For example, he can engage in wars that the elites have no interest in because they do not expect significant gains for themselves, or because they fear that the ruler might gain access to new sources of revenue, and eventually become able to overturn his commitment to them, or because they worry that defeat in this war might undermine the system on which they depend for income and social privileges. This will limit how much these elites want to contribute, which is why the ruler would have to reduce the moral hazard problem if he is to generate more revenue. If the ruler can be counted on not to pursue policies contrary to their interests, the elites' expected payoff from cooperating on raising revenue increases because they profit not simply from the selected benefits the ruler provides but also from the policies he is expected to execute with the surplus.

Rulers always guard their executive prerogatives quite jealously, and could only be induced to relinquish it under duress. Although they might not be happy about sharing tax authority with power elites, doing so could be a more palatable measure than allowing the power elites direct voice in policy. This makes conceding tax authority a more acceptable compromise than either allowing auditing of the ruler's fiscal practices or extending the franchise irrespective of how the ruler came about to the need for such concessions — as a result of a war-generated fiscal need or of not being able to win a civil war. This concession would usually take the form of an agreement that the ruler cannot impose certain taxes without the explicit consent of the power elites. These could be new taxes that the ruler wishes to collect or taxes that he previously collected on his own authority.

To obtain such consent, the ruler would have to call parliament, and if one did not exist, create one. Most parliaments would come into being from the top-down, as a result of rulers needing to obtain the consent of the power elites to higher taxes, and not from the bottom-up, as a result of power elites coming together to resist the ruler. Calling parliament would

be necessary for the simple reason that there would be no way to negotiate with members of the power elites separately — even setting aside the significant transaction costs of doing so, it would be quite unclear what each member would be agreeing to without knowing what the others are doing. Moreover, it would be impossible for the ruler to claim that any such privately-reached deal is legitimate because nobody would know what individuals have agreed to in private. The ruler could just claim that a “large majority” of the power elite have agreed to a new 10% tax, but who would know whether any of this is true?<sup>18</sup> The main purposes of parliament are to enable power elites to coordinate their own expectations about each other’s behavior and, perhaps more importantly, to make it possible for any deal to become common knowledge among the power elites. This confers legitimacy on the bargain, which coordinates the expectations of the ruler and the power elites about possible interactions in the future regarding that issue. In other words, this makes the bargain more likely to stick.

With parliament in place, the ruler can concede some of his taxation authority (or agree that the new tax is solely subject to parliamentary approval). The effect of this is that the share of income independent of power elite consent will decline, which will reduce the ruler’s freedom of action. It is important to emphasize here that there is a difference between having the authority to tax and actually exercising this authority in a meaningful way. For example, parliament could have the sole right to authorize the collection of certain taxes, but it might choose to authorize that collection once at the beginning of the ruler’s reign for the reign’s duration. Even if parliament meets every year, it could vote to extend the tax on a customary ritualistic basis without really ever considering the option not to. In situations like these, the authority to tax will have no effect on policy even though the ritualistic votes at least preserve the principle of parliamentary consent (which can be useful if and when parliament does decide to exercise that authority).

This ritualistic function was actually quite common but since it cannot affect the moral hazard problem, it would be of no practical consequence in terms of policy. We shall only focus on authority-sharing when parliament decides to use the need for its consent to exercise some influence on policy. Without the ability to monitor expenditures, any grant parliament agrees to cannot be earmarked for particular purposes — the ruler can choose how to spend it. This is part of the reason the traditional parliamentarian cry has always been “redress before relief” meaning that the ruler had to address deficiencies in policies before parliament agreed to supply funds. Rulers simply could not promise credibly to address these grievances after the money was given.

Of course, with parliament in control of some taxes, the ruler could be disciplined by the threat to deny future funds if he strayed too far in his policies. The larger the share of revenue controlled by parliament, the more consequential that threat would be, and the more attenuated the moral hazard problem will become. The authority to tax is a blunt instrument when it comes to policy influence, but as long as parliament could coordinate, the power elites would be able to exercise some measure of control and redirect policy to favor their interests.

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<sup>18</sup>One could envision some sort of verification: for example, publishing the private agreements so that everyone can verify what others have agreed to, but this is not merely impractical, it could be highly prejudicial to individual members.

### 3.2.2 The Power of the Purse

If fiscal pressure continues, the next step must enable parliament to exercise more effective control of policy; i.e., it must acquire the **power of the purse**. In addition to the authority to levy taxes, parliament must have the authority to **appropriate funds** (designate them for specific purposes), and it must have the ability to **monitor expenditure** to ensure that the funds are spent per authorization. The idea here is that parliament does not merely agree to supply funds, it supplies them to support a particular policy, and it can then audit the executive's accounts to make sure that the funds were not misappropriated.

This power of the purse reduces the moral hazard problem in two ways. First, it decreases the scope for fraud because it makes it harder to conceal expenditures. Thus, all else equal, it will be easier for parliament to find out when the ruler has misbehaved. Since the audit is available for all in parliament to see, it will be easier to agree that misbehavior has, in fact, occurred. With a common agreement that a "punishable offense" has been perpetrated, it will be easier to coordinate on a proper response.

Second, it makes it easier to execute a de-funding threat. With the authority to tax, the threat is an all-or-nothing proposition: the denial of funds may force the ruler to reallocate his budget to deal with the shortfall and as a result other policies would have to go underfunded. If the power elites are benefiting from the policies that would suffer, they are much less likely to implement the threatened cut. This, of course, reduces the credibility of the threat and leaves room for the moral hazard problem to assert itself. Appropriations and monitoring, on the other hand, allow power elites to deny funds for specific policies while still supplying others. The targeted threat is more credible than the general one, and as a result it will have a far more consequential effect on the moral hazard problem.

Thus, the power of the purse puts the ruler and the power elites represented in parliament in a situation where the moral hazard problem is as small as parliament wants to make it. Does this mean that parliament will eliminate it completely? No, it does not, and here's why. In order to eliminate the moral hazard problem entirely, parliament will have to ensure not merely that all funds appropriated for specific policies are spent appropriately, but that the policies themselves are most likely to achieve the goals parliament has in mind. For example, let's say parliament appropriates funds for fighting a particular war, audits the ruler and finds that the ruler has, in fact, spent all the funds on the war as required. Consider now two possibilities. In one case the ruler has appointed his relatives as generals and distributed the funds to them. The generals paid the soldiers after keeping a hefty chunk for themselves as compensation commensurate with their high ranks and then donated money to building a palace for the ruler. In another case, the ruler promoted generals from the officer corps on merit, had them organize the fighting, and all money went to purchasing materiel, supplying the troops, and paying their salaries. It does seem that in the first case executive discretion has enabled the ruler to circumvent the appropriations-monitoring process and implement other policies without really violating the letter of the agreement. Parliament would (rightly) take a dim view of such a scheme even if it were to come to light, which very often it might not.

More generally, **agency slippage** can occur whenever a principal (parliament) cannot control the actions of the agent (ruler) and there is preference divergence over the policies the agent is supposed to execute. This slippage might occur when the agent has better

information about what the appropriate action is, when the principal can only imperfectly monitor the actions actually taken, and when the results of the action do not reveal the action (there is some noise in implementation such that you can never be sure exactly what the agent did even after observing the outcome of the policy).

Agency slippage resurrects the moral hazard problem, and so to eliminate that problem, one has to minimize slippage. The obvious way of doing this is by reducing the agent's freedom of action; i.e., by deciding on the policy itself and then micromanaging the agent's execution. This, however, obviates all the advantages of having an agent in the first place: after all, the agent is supposed to have expertise, superior organizational capability, and perhaps better information than the principal. For instance, consider what micromanagement would require during a war. Parliament would have to approve specific military actions even while fighting is going on. This means it will have to act on information that is possibly severely outdated by the time parliament obtains it, the natural pace of a deliberative body will delay decisions so the directive will be also likely outdated by the time it travels back to the theater of operations, and the composition of parliament being what it is, every decision might involve politics (efforts to build coalitions, trade votes, and so on) that are unrelated to the war, likely to delay decisions, and even likely to distort decisions because they would involve considerations peripheral or unrelated to the war effort. All of this makes the process very cumbersome, inefficient, and prone to erratic decisions.

In contrast, delegating the execution of the policy to the ruler enables the ruler to exercise the advantages of centralized control of the military, fast decision-making based on new information, and perhaps better access to information if the ruler travels to the theater of operations. In order to enable the ruler to fight effectively, parliament must give up some control over his actions. Delegation has to be a balancing act between reducing the moral hazard problem (which requires closer supervision) and increasing efficiency (which requires giving the agent more freedom of action).

An analogy might be helpful. Let's say that the goal of the policy is to transform a block of marble into the statue of David. The authority to tax is like a sledge hammer: you can shape the block very roughly but you will not be able to get much detail. The micromanaged power of the purse is like a scalpel: it is very exact but it is quite inefficient at chipping marble: you will not be able to get much detail, at least not in any reasonable amount of time. The power of the purse with delegation is like a chisel: it is tough enough to crack stone but also sufficiently precise to carve details.

The conclusion, then, is that an effective power of the purse must involve appropriations and monitoring but with significant degree of delegation: the moral hazard problem will only be reduced to the degree that considerations of efficiency allow; that is, only until the benefit of any further reduction in moral hazard is smaller than the losses from reduced efficiency.

This suggests that polities where parliament's power of the purse is too strong (it delegates very little to the ruler) might actually be worse off compared to polities in which there is no power of the purse — the first might be able to raise a lot of resources provided they agree on policy, but much of this would be dissipated, whereas the latter might be able to raise less resources but they would be able to use them more effectively.

One very important consequence was that rulers thusly constrained suddenly found themselves able to borrow vast amounts at previously unimaginably low rates. The security of

taxation controlled by parliament meant that debt would be serviced as long as parliament did not renege. With many of these members being either lenders themselves or investors in businesses dependent on debt service, it was highly unlikely for that to happen. As debt service ceased to be subject to the whim of a single person, the risks abruptly declined, and the interest rates plunged. Moreover, with policy more or less synchronized with the wishes of the elite, investing in the government could become truly profitable. Wars would now be fought for the enrichment of the investing elite, not for dynastic reasons or the personal glory of the ruler. Since these wars would be well funded with higher taxes and easy credit, these constrained rulers would tend to emerge victorious more often, further rewarding their supporters and enriching the state. Even though this fiscal system could stagger when parliament could not coordinate on desirable policy, and even though it could find itself badly strained by a well-coordinated fully-centralized one based on coercion, in the long run its inherent superiority would reassert itself.

*Thus, parliaments could play a crucial role in revenue generation but only to the extent that they had effective control of taxation — that is, not only did taxation require their consent but the ruler's ability to raise revenue on his own authority was limited.*

One can understand the satisfaction of the pacifist Thomas Jefferson when he wrote to James Madison in 1789 that

we have already given. . . one effectual check to the Dog of War by transferring the power of letting him loose from the Executive to the Legislative body, from those who are to spend to those who are to pay.<sup>19</sup>

In this case, the President could not spend public revenue without appropriation by Congress (effective control of the purse) but could not even wage war without declaration by Congress (shared policy-making). Moreover, control of the purse also meant that Congress could influence how long the U.S. would fight (by refusing to appropriate money to continue the war). Even though, direct participation in policy-making on security issues proved highly ineffective and Congress allowed the initiative to slip to the President, the control of the purse still constrained the executive from straying too far from the preferences of the elite.

Parliaments, however, might not be unambiguously preferable when one considers policy effectiveness. When a collective body has to agree on a particular policy, the various preferences of the members of that body might come into conflict about the details. It is much easier to achieve agreements on general (and sometimes vague) principles or goals than on details of implementation. When parliaments have a direct say in the execution of policy — either because they participate in its formation or because the members have veto powers — policy paralysis can easily result because of these disagreements. Parliaments that are strong both in that the ruler has access to very little or no revenue without their consent and in that they can decide on policy might make it impossible either to raise revenue or execute policy. In some sense, these parliaments might be worse than tyrannical — they can be completely ineffective in providing for the proper defense of the realm or enforcement of property rights that would aid in its economic development. It is perhaps for these reasons that the most successful polities have had parliaments that have limited (or no) say in policy

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<sup>19</sup>Quoted in William C. Banks and Peter Raven-Hansen. 1994. *National Security Law and the Power of the Purse*. New York: Oxford University Press, p. 3.



execution — where disagreements over particulars are most likely to emerge — but that retain extensive control of the purse, crucial for exercising some control over the ruler but generic enough that agreement should be easier to achieve.

Thus, *when it comes to the ability to raise revenue effectively and utilize these resources efficiently for policy-making, parliaments that have extensive control over revenue but limited control over execution of the policy would have the advantage.*

### 3.2.3 Variations in Powers of the Purse

The power of the purse is itself fundamentally constrained by the ruler's ability to raise revenue from sources whose exploitation does not require the consent of the power elites (i.e., his ordinary revenue). Although it might appear that rulers with large independent sources of income (*demesne*, customary dues, precious metals, foreign subsidies, alliances) will be better positioned to pursue their policies, they might not have the advantage when it comes to bargaining with their elites. On one hand, this reduces their dependence on their consent, and so decreases the need to make unpleasant concessions in situations where the elites have little incentive to support the war (e.g., an offensive war or a defensive war that does not threaten them directly). On the other hand, in situations where they have shared interests (e.g., a defensive war that threatens them all), the ruler's strength turns into a weakness because it encourages free-riding. The better able the ruler is to finance the war with his own income, the less likely are elites to contribute to their joint defense. Since the ruler is the focal point of the defense effort, this will shift the burden disproportionately on him. In that respect, rulers without much revenue of their own can expect their elites to be far more cooperative in providing the funds for the common defense.

The **authority to levy taxes** thus has much to do with how much independent revenue-raising capacity the ruler has vis-à-vis the power elites. At one extreme, the ruler's *demesne* income (I will use this a shorthand to include both territory, customary dues, and even access to precious metals) is very large and he needs little assistance from power elites except perhaps the occasional extraordinary levy for specific defense purposes. At the other extreme are rulers whose power elites have complete control over taxation (e.g., elective monarchies, constitutional monarchies, and republics). In the intermediate cases, which encompass most of history, we can think of a variable distribution of taxation authority between the ruler and power elites.

These elites might be coordinated in a “national” parliament (**unitary state**) or might be decentralized into “regional” parliaments (**mosaic state**), depending on how the “region” was incorporated into the country (amalgamated or conquered), whether it required special provisions for autonomy (marches), and whether it had lost a civil war or a revolt against the ruler.<sup>20</sup> The elites' ability to coordinate matters because it determines the extent to which they can take advantage of a favorable shift in taxation authority. As the ruler's tax authority shrinks relative to that of the power elites, the preconditions are created for elites to exercise the **power of the purse**. The smaller the ruler's independent authority, the larger the potential to assert that power. However, effective power of the purse requires significant coordination among elites who need to agree on appropriations, on monitoring, and, if

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<sup>20</sup>In some more extreme forms of fragmentation, regional elites might enjoy considerable autonomy without parliaments (prominent magnates are *de facto* rulers).

necessary, on denying funding to the ruler. In a mosaic state, elites will have difficulty coordinating a response to the ruler, which will allow him to play off one regional elite against another, grant selective privileges in exchange for support, and thus raise revenue without making significant policy concessions. Although the ruler can still play politics with groups within the power elites in a unified state, their ability to coordinate makes this less likely. When the tax authority shifts significantly in their favor, these elites can assert effective control of the purse as well.

This leads us to a significant difference between rulers who had to deal with unified parliaments representing power elites across their territories or regional parliaments representing separate territories within a mosaic state. The logic so far assumes that the ruler is dealing with power elites coordinated in a unified parliament (e.g., the king in England). Consider now a situation in which the ruler has to deal with multiple regional parliaments (e.g., the king in France). In the latter case, the fact that the regional parliament controls some share of taxation for that region does not mean that it controls a large share of the overall income of the ruler, who is raising revenue from multiple localities. Any threat to withhold regional revenue would be far less consequential because it would not be as damaging to the ruler. Using the resources raised from the other regions, the ruler might choose to suppress a recalcitrant regional parliament, disband it and call a new one, or simply ignore its remonstrances. This means that these parliaments cannot expect to have much influence on policy, and as a result they would be far more accommodating to the ruler's demands. Without an ability to coordinate on a "national" level, the regional power elites would not be able to use their authority to tax very effectively, and as a result these types of parliaments can decay and disappear altogether. They could persist if they prove useful to the ruler who might offer some concessions on the regional level in exchange for their cooperation in raising taxes, but in general they would not be able to affect "national" policies like the decision to go to war.

This suggests that rulers of mosaic states cannot really take advantage of sharing the authority to tax: since the regional power elites cannot influence policy much having that authority will not help diminish the moral hazard problem. This implies that all else equal, rulers in mosaic states will not be able to extract as much resources as rulers in states with unified parliaments.

This discrepancy will become even more pronounced when unified parliaments acquire an effective power of the purse. As we noted already, even when vigorously exercised by a coordinated unified body, the authority to tax still leaves a lot of leeway to the ruler in how he spends the funds. Even if parliament authorizes a levy for fighting a particular war, there is no way of knowing whether the ruler spent all of the money on that war or redirected some to other uses. There is also no way of knowing whether the funds he asked for was what he believed was necessary or whether he "padded" the request because he wanted to spend on other things. When a ruler is victorious in war, it would be extremely difficult to censure him even if parliament finds out somehow that he has misappropriated some of the money. Also, if the state finds itself in another war-related fiscal emergency that threatens the power elites, they will have a hard time denying the funds solely to punish the ruler for prior misbehavior. This gives the ruler further incentives to gamble with the funds. In other words, even if the authority to tax attenuates the moral hazard problem, it will not eliminate it. The upshot is that there is still a ceiling on how much the power elites would agree to

although that ceiling is higher compared to the situation in which they had no authority to tax.

We conclude that regional parliaments in a mosaic state will be unable to get much use of the authority to tax. The same reasoning implies that they are highly unlikely to develop any power of the purse as well, especially when it comes to questions of war. Thus, rulers in mosaic states will not be able to overcome the moral hazard problem, and will tend to be significantly underfunded, all else equal, to their counterparts with authority to act from unified parliaments. This means that we should ask why these polities were so fragmented and why they could not be effectively centralized for so long.

Whether the ruler had to deal with parliaments depended on how the new territory was integrated with the ruler's existing domain.<sup>21</sup> Most territorial aggrandizement was gradual and non-violent, a product of strategic marriages, complicated rules of inheritance, and assertion of dynastic claims. Since this amalgamation was, in essence, voluntary, it was the product of bargaining, and rulers often had to accept whatever regional and local traditions these territories came with. One reason the Habsburg empire was so badly fragmented is undoubtedly the family's extensive reliance on dynastic ties to accumulate new territories. Although Austria was not quite the pacific state that Prussian sympathizers and detractors have made it out to be, there was a grain of truth to the sarcastic epigram about the Habsburgs (often erroneously claimed to be the family's motto) that said:

Bella gerant alii tu felix Austria nube!  
Nam quæ Mars aliis, dat tibi Regna Venus.<sup>22</sup>

In addition, border regions (so-called **marches** or **marks**) were generally awarded a host of privileges and exemptions because they were supposed to assume the burden of defense of the state. In those regions the elites also tended to exercise more independent control because they were supposed to be able to act decisively and quickly if the circumstances demanded. As a result, some rulers came to preside over a chaotic melange of institutions, privileges, and local practices, the entities we have called **mosaic states**.<sup>23</sup> This meant that one locality would legally escape taxes that another had to pay; in one area taxes would require consent of parliament while in another they would not (and there might not even be a parliament); in one region elites would raise their own taxes while in others the ruler had a monopoly; and so on. It was very difficult to unify and centralize the fiscal system without violating long-standing agreements in countries cobbled up in this manner. It is for this reason that a bewildering variety persisted in the largest European powers of France, Spain, and Austria. It was in these countries that rulers had to constantly negotiate and renegotiate with provinces, estates, cities, powerful families, venal office-holders, and so on.

The alternative to voluntary amalgamation is, of course, annexation by right of conquest. With the local elites defeated and their institutions destroyed, the victorious ruler could im-

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<sup>21</sup>Mark Greengrass, Ed. 1991. *Conquest and Coalescence: The Shaping of the State in Early Modern Europe*. London: Edward Arnold.

<sup>22</sup>"Let others wage wars, but you, happy Austria, marry! For what Mars awards to others, Venus transfers to you.", Quoted in William Coxe. 1882. *History of the House of Austria*. London: George Bell and Sons, Vol. I, p. 401-2. <http://books.google.com/books?id=uoxHAAAAIAAJ&pg=PA402>, accessed February 10, 2013.

<sup>23</sup>Joseph R. Strayer. 1971. *Medieval Statecraft and the Perspectives of History*, Princeton: Princeton University Press, p. 346

pose a unified system that would allow him to retain control over both policy and revenue. This would usually mean foreign territory, but it could also be a territory that was defeated in civil war or rebellion — the ruler could use that opportunity to do away with the old institutions now that the prior agreement was effectively rendered null and void by the act of rebellion. Countries created by the force of arms because they were conquered or because they won their independence would tend to exhibit less institutional variation and would have more rational administrative systems: they would be **unitary states**. Analogously, countries enlarged by conquest would also have a similar tendency, at least in the areas involuntarily annexed. It was for this reason that countries like England and Sweden had more coherent institutions. In these countries rulers could negotiate with a unified representative body if one existed, and it was in these countries that efficient centralized state-controlled bureaucracies were most likely to emerge.

*Thus, the relative bargaining power between ruler and parliaments partially depends on how the territory was incorporated into the state: voluntary amalgamation and strategic border considerations would leave regions with significant fiscal privileges whereas forceful annexation or defeat in civil war would permit the ruler to impose fiscal institutions more favorable to him and undermine the role of parliament.*

The distinction between mosaic and unitary states is an ideal-type categorization. Since a mosaic state is one where the constituent territorial units were amalgamated voluntarily (through dynastic unions, inheritance, or sometimes petition), its institutional arrangements specific to each new territorial unit are likely to be preserved. Rulers of mosaic states come to preside over territories with sometimes vastly different political and financial institutions. Moreover, if these territories are geographically distant, they are more likely to face different geo-strategic challenges and opportunities. For example, the people in a frontier territory bordering a hostile neighbor are going to be far more concerned about their defense than the citizens of a distant region even though they are all nominally in the same state. As another example, people living in a coastal territory and heavily involved in maritime commerce will have different policy preferences than those living in a landlocked region with an economy based mostly on agriculture. To the extent that the mosaic state does not possess an interest-aggregation institution that spans these disparate territories (a national parliament), the ruler will have a hard time securing support from one territory for policies that benefit another.

It should be noted that our model implicitly argues against any predictable deterministic pattern of development of fiscal and representative institutions. With integration mostly context-dependent and subject to chance and happenstance, it is impossible to predict how particular institutions would evolve in a particular state. Whether a territory can be integrated on a voluntary basis could depend on what the line of succession looked like at that precise moment, on the ready availability of a marriageable relative, on the existing configuration of alliances, on the current commitments of the ruler, and so on. All of these factors would jointly influence the probability that an opportunity for a voluntary integration arises, and they will combine with others to determine the relative bargaining power of the ruler and the elite that is being integrated into the realm. Thus, if the context happens to favor the ruler, he would be able to drive a harder bargain and implement significant reforms in the institutional fabric of the new territory. If the context does not favor the ruler, however, the new territory might come in with its institutional structure largely intact. This means that

even if we can understand why the institutions took one shape rather than another at any given historical juncture, we cannot posit a generic path of development. In other words, we might be able to explain existing institutional structure but not predict how institutions will change.

Consider, for example, Imperial Spain, which is a classic example of a mosaic state. It was a dynastic union of Castile and Aragon, the latter itself a union of Aragon with the County of Barcelona, and the kingdoms of Majorca, Valencia, and Sardinia. The empire then gradually expanded to include the kingdoms of Navarre and Naples, the Duchy of Milan, the Netherlands (among other things), and of course the overseas possessions. The European expansion almost always preserved the local institutions even when it was by conquest, and as a result the Spanish monarchs ended up with a vast composite empire of badly-integrated territorial units.

If the a region rebelled and the Crown was successful in suppressing the rebellion, Madrid could impose its institutions on the defeated territory. Having recognized the Habsburg Leopold as king in 1702, the Catalans and Valencians took up arms against the new Bourbon king of Spain Philip V in 1705. It took Philip nine years and French assistance to put down the rebellion, but in the end he prevailed. He then used this opportunity to promulgate and enforce the Nueva Planta decrees, which suppressed all former privileges and institutions in the Crown of Aragon, and imposed his centralized administration. From 1716 on, there was no legal distinction between those who lived in Castille and those who lived in Aragon.

Of course, if the region rebelled and the Crown failed to win — as it happened with the Dutch provinces by 1618 *de facto* (and in 1648 *de jure*) and with Portugal in 1668, then not only will there be no centralization, but the Crown will be seriously weakened by the permanent losses.

France is also an archetypal example of a mosaic state. Even after the victory in the Hundred Years' War that expelled the English from the continent, France remained fragmented. Even at the height of the so-called "absolutist rule" during the *Ancien Régime*, the constituent provinces were divided into three groups. The *pays d'élection* were the longest-held possessions of the Crown, where the monarch was able to impose relatively unified institutions and even suppress the regional estates although in exchange for their cooperation the noble elites often enjoyed extensive fiscal privileges. The *pays d'état* were more recently acquired and as a result they retained their political institutions — the estates — which limited the monarch's taxation authority. The *pays d'élection* were essentially *pays d'état* whose representative bodies got suppressed, usually as a result of rebellion that the king won. Finally, the *pays d'imposition* were the most recently conquered lands, where many institutions could be retained but where taxation was controlled by the Crown. This cursory categorization hides astounding variation provincial, regional, and even local variation, but even it is sufficient to suggest the complexity of the French state, and the highly fragmented nature of its fiscal institutions. Even though a national representative body, the Estates-General, did exist, it met intermittently at the pleasure of the king, and did not meet at all between 1614 and 1789.

On the other end of the political spectrum, the Dutch Republic provides another example of a mosaic state. The Republic comprised eight provinces, each with its own representative body and fiscal institutions. Seven of these provinces were also represented in the federal government, the States-General, a central representative body, which met at least once a

year and decided on policy.<sup>24</sup> In addition, the Republic had Generality Lands that did not have regional representation and were governed directly by the States-General. The federal government did have independent tax authority over customs dues, but most of its income came from provincial contributions that were raised according to provincial laws (mostly excise taxes). The provincial share in the federal budget depended on the wealth of the individual province, with Holland paying the lion's share (hovering around 60%).<sup>25</sup> This fragmentation, however, did not prevent the Republic from tapping into the vast financial wealth of its citizens. As we shall see, it resisted Spain for 80 years, and even managed to survive the determined onslaught of France under the Sun King.

Depending on the fortunes of war, the geo-political situation, dynastic vagaries, economic structure, and administrative capacity (which, as we shall see, had a lot to do with urbanization), some mosaic states developed into fairly efficient states with representative institutions (Dutch Republic), others into less efficient but very impressive world powers (France), while others fragmented and lost their status altogether (Spain).

### 3.2.4 Franchise Extension

Having acquired the power of the purse and tempered it by delegating executive authority to the ruler, the power elites have maximum effective control over policies: the remaining moral hazard is balanced by the efficiency gains from having a somewhat independent executive. The policies the ruler pursues will be highly congruent with the interests of the power elites, who in turn are willing to fund them. This polity is at the limit of the revenue that these power elites can assist the ruler in collecting. But what happens if the resources they can jointly mobilize prove to be insufficient to meet the next war-produced fiscal crisis?

Recall that power elites sitting in parliament are a subset of all elites that are particularly useful in raising revenue (collecting taxes, enforcing policies, coercing if necessary). Even though their interests are represented in policy-making, all other taxpayers are excluded because they do not have representation in parliament. Consider a relatively well-off but politically disenfranchised segment of society (e.g., perhaps merchants or financiers). The situation between the ruling condominium (ruler and parliament) on one side and these elites is very similar to the original situation between the ruler and power elites. The disenfranchised elites would contribute more to policy-making if the ruling condominium could commit to policies that are also in the interest of these elites. The problem is that now it is the ruling class that cannot credibly promise to implement such policies. The inability of the disenfranchised elites to control policy-making and execution creates a serious moral hazard, and depresses their incentives to contribute.

The first step of the ruling condominium would be to provide selective benefits: just like the ruler preferred to minimize concessions to the power elites, so now the ruling elites and the ruler have an interest in minimizing concessions to the disenfranchised elites. These

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<sup>24</sup>The eighth province, Drenthe, was so poor that it was exempt from federal taxes, but as a consequence did not have representation in the federal government, the usual "no representation without taxation" logic that governed these things.

<sup>25</sup>As we shall see, the American confederate states looked very similar to the United Provinces, down to the decentralized revenue collection mechanism. It was, in fact, this perceived weakness of the Dutch Republic that gave strength to Hamilton's argument in favor of a federal authority to tax that the new United States acquired.

selective benefits must be self-enforcing, which means giving members of the new elites access to activities that determine the benefits of power to the ruling class. As before, this means expanding their participation in the state apparatus or in the military. As we noted, this type of credible commitment, however, has a limit, and this limit is likely to bind now before many such benefits are dispensed because the old power elites have already taken most such positions.

With the potential for selective benefits quickly exhausted, the next step is to give the new elites access to parliament; that is, to **extend the franchise**. In other words, *the extension of the franchise is caused by the relentless fiscal pressure that is pushing ruling elites to search for revenue, and it occurs when these elites have exhausted all other ways of minimizing the moral hazard problem with respect to the unrepresented segments of the population.*<sup>26</sup>

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<sup>26</sup>There are other theories that try to explain the extension of franchise. One contends that it was driven by an ideological shift resulting from the Enlightenment: denying representation to others became increasingly unacceptable. Another asserts that in their competition for votes, elites extended the franchise to groups they believed would support them. A variant of that claims that economic interests drove the middle class to prevent decline of its influence by extending the franchise to the poor. A very prominent theory holds that elites extended the franchise to avoid revolution: without a credible commitment to redistribute in favor of the poorer strata, giving them the vote was the only way to forestall a revolutionary takeover of the state by the poor. Daron Acemoglu and James A. Robinson. 2000. "Why Did the West Extend the Franchise? Democracy, Inequality, and Growth in Historical Perspective." *Quarterly Journal of Economics*, 115(4): 1167–1199. This version has several serious problems. First, the poor have no chance of winning such a revolution, as repeatedly shown by history. When they rebel, it is merely to obtain tax relief. It is the elites that are dangerous in that respect. As long as power elites retain control of the army, they could easily suppress even revolutions that involved the middle classes, as 1848 amply shows. In contrast, the model assumes the exact opposite: that revolution succeeds when attempted. This is a problem because if one considers revolution a risky and costly conflict for both sides, then it might be possible to stave off revolution by promising future redistribution and conditioning on whether previous promises were honored. In other words, elites redistribute now and promise to redistribute for some number of periods, possibly infinite. The poor do not revolt but if elites renege on that promise, then the poor expect them to renege always, and so they rebel at the next available favorable opportunity. This strategy would sustain redistribution indefinitely without any extension of the franchise. Second, the theory has trouble explaining why the franchise extension did not occur until the 19th century (and then was basically limited to Britain), why it was gradual, why it was top-down, why it snowballed toward full suffrage, and why women were the last to gain it (the theory supposes that women would have revolted and taken over the state without it, a dubious proposition; it is more likely that as women's involvement in the economy growth, they become more "taxable" and thus in need of co-opting to maximize revenue). Rulers always faced risks of rebellions but were quite content to deal with elites, and even power elites did not see the need to extend the franchise for centuries. It is also unclear why extension of the franchise is the only way to commit to policy: selective benefits can also do this. To extend the franchise, power elites who stand to benefit from the new policies after extension must prevail upon power elites that expect to lose out. Some might be afraid of violence, but in the end support for extending the franchise must be driven by the expectation of larger benefits from public spending which would be made possible by the higher taxes the government can collect because of the reduction of the moral hazard with respect to the newcomers to the power elite. Perhaps the most damning piece of evidence, however, is that the case the model purports to explain goes contrary to what the model says should have happened. In that model, the elite's inability to commit to future benefits — which is what causes the poor to credibly threaten revolution today (and so forces elites to extend the franchise) — is caused by the expected decline in relative power the poor tomorrow. As long as the poor expect to have a credible threat of revolution tomorrow, there is no need to extend the franchise — elites can credibly promise to keep delivering the benefits to avoid that revolution. During the 19th century, the poor (or, rather, urban working) classes did, in fact, represent such a persistent, and some would say, growing, threat. Discontent in the cities was rising, the workers were organizing, and their ability to revolt was increasing. According to the model, this is precisely the situation where extension of the franchise would not occur. But of course it did. Our model explains why: these classes were being asked to contribute too much without getting enough in return, and the only possible

Since parliament already has achieved an effective power of the purse with respect to the ruler, the newcomers can influence policy through their voice in parliament. The new elites will also have incentives to gain representation because doing so enables them to obtain policies closer to their interests, which is stronger than the incentive to join merely to limit taxation.<sup>27</sup>

This extension will be limited: the ruling class will only admit those that are both important for increasing revenue and whose policy preferences are not too far from those of existing parliament members. The second requirement must be satisfied because admitting influential groups of people with wildly divergent preferences would imply policy swings detrimental to the interests of the existing elites, and so reduce the overall benefit from the power of the purse. If the enlarged parliament is going to increase the revenue (to deal with the fiscal crisis), it has to be that the expected net benefits from enlargement outweigh the expected net benefits from keeping the status quo and remaining underfunded. This suggests that when ruling class extends the franchise, it will be to those most similar to them in wealth and political preferences. In other words, the extension will be top-down and gradual.

Extending the franchise, however, will change the composition of parliament, and therefore alter the policy-preferences parliament seeks to satisfy. With effective power of the purse, the policies the ruler pursues in cooperation with an expanded parliament will reflect better the interests of this new class, and so increase its incentives to agree to funds. Taxes and government expenditures will therefore increase after extension of the franchise.

This is not all, however: there is a powerful secondary effect of extending the franchise, and it has to do with the definition of what constitutes an **actionable crisis**; that is, a crisis to which the government is expected to respond as part of its responsibilities. Initially, it was more or less purely military security threats that qualified as actionable crises. This was what the ruler ostensibly ruled for, and since the power elites were all relatively rich, they could deal with (or absorb the losses from) other crises quite well. Consequently, there would be little pressure on the ruler to do anything about other types of crises (e.g., fiscal, economic, or social). Now that the franchise was extended to people with somewhat different preferences, the scope for policies must increase. For example, whereas a parliament based on the land-owning elites might be blasé about decline in trade as a result of government policy, a parliament in which commercial interests are also represented would be far less so. A situation that would have been ignored previously has now become actionable. In other words, *the definition of actionable crisis has expanded*.

But this now means that there are more opportunities for crises overall — it is not merely

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way of getting them off the streets and back into production was to expand the franchise (to split the movement, and eventually, to minimize the moral hazard problem).

<sup>27</sup>The actual policy content will, of course, vary with the representativeness of political institutions. Even under universal suffrage, the electoral system and government formation rules will affect how influential groups of voters are. Majoritarian systems are less representative than systems with proportional representation (PR), and the latter vary with the thresholds that parties need to meet before they qualify for seats in parliament. Government formation rules affect how seats in parliament get translated into ministerial positions, although the so-called Gamson's Law states that coalition governments will distribute ministerial seats in proportion to each member party's contribution to the coalition. At any rate, if majoritarian systems are less representative than PR systems, then the model suggests that the latter would have larger public sectors and more intrusive governments.



military threats that matter now but also commercial ones (these can, of course, be related). This implies that fiscal emergencies arising from the government's need to deal with a crisis will proliferate, which increases the fiscal pressure, and thus the need to raise revenue. As a result of franchise extension, taxes will go up, but so will the demand for government policies. To gain access to larger revenues, the ruling class must reduce the moral hazard with respect to the still-disenfranchised taxpayers. With the possibility for credible selective benefits already strained or exhausted, this requires another extension of the franchise, to the next segment of society that is sufficiently important and politically similar to the existing ruling class. This increases taxation but also expands the scope for government policy, and so the process repeats itself.

Thus, once the franchise is extended, the new power elites become more heterogeneous in their preferences, which expands the definition of actionable crises. This generates pressure on spending because it increases the frequency of events to which the government is expected to respond. Moreover, since the process is top-down, the newly enfranchised people will be poorer than those who had already been enfranchised. But since the poor also tend to be more vulnerable to economic downturns, their inclusion is going to escalate the demands on policy; that is, it is going to expand, possibly quite dramatically, the range of events to which the government will be supposed to respond to. This implies that *extending the franchise is self-sustaining: once it begins, it will proceed at an accelerating pace until full suffrage is achieved. Moreover, the evolution of political institutions in response to crises has gone from being driven purely by war to being driven by commercial, economic, and social crises as well.*

#### **4 Conclusion: The Representative Tax State**

Let's go back to the oft-repeated assertion that low taxes mean liberty that we discussed before. The arguments we have developed here show that if we equate political liberty with representation (as is usually the case), then we must conclude that effective representation obtains when there is a pressing fiscal need that cannot be met in the context of existing institutions with their moral hazard and asymmetric information problems. In other words, representative institutions flourish because the government needs to get into the pockets of its citizens. As such, one must expect that citizens in polities with such institutions will bear disproportionately high taxes. Of course, since these representative institutions ensure that these taxes will be spent in ways more consistent with the interests of these citizens, one can hardly argue that the state is more oppressive because its taxes are heavier. In the end, the taxes are high because the citizens are more willing to pay them, and the institutions are the reason for this willingness.