



Fiscal capacity and the risk of sovereign debt after the Glorious Revolution: A reinterpretation of the North–Weingast hypothesis

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ABSTRACT

Several explanations have been given to account for the fact that, in contrast to the claim made by North and Weingast (1989), the decline in interest rates on British sovereign debt did not occur until several years after the Glorious Revolution in 1688. This paper puts forward the hypothesis that the decline in the risk premium on Britain's sovereign debt was due to the significant increase in excise duties in the early part of the eighteenth century. This increase was possible for two reasons. On the one hand, with the Glorious Revolution, parliament no longer had reason to fear that the King would strengthen his political power due to the availability of more fiscal revenue. On the other hand, the new excise taxes were borne mostly by the poor, that is a social class not represented in parliament. The delay in reducing the interest rate on British sovereign debt, following the Glorious Revolution, was, therefore, due to the length of time needed to increase and improve the fiscal bureaucracy responsible for the collection of excise duties.

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1. Introduction

In 1989 North and Weingast published a seminal article in the *Journal of Economic History* in which they argued that the Glorious Revolution of 1688 changed the structure of political power in England.¹ This change took two forms. On the one hand, on the constitutional level, the Revolution established the supreme authority of the Commons in fiscal matters. In this way, parliament took control of state revenues and their structure, as well as public spending. Tax-raising powers, previously the King's prerogative, passed to parliament. On the other hand, the redistribution of constitutional powers was accompanied by other institutional changes, such as the independence of the judiciary and, in 1694, the establishment of the Bank of England. North and Weingast saw these institutional constraints as constituting a necessary and sufficient condition for the enforcement of private property rights. By strengthening creditors' confidence that the state would keep its commitments, the reforms brought about by the Glorious Revolution led to a decreased risk premium on public debt.

However, the empirical evidence fails to offer clear support for this conclusion. Indeed, the interest rate on British government bonds did not begin to fall until several decades after the Glorious Revolution.

The weakness in the empirical support for North and Weingast's thesis has given rise to much debate. On the one hand, there are those who believe that the reduction in the risk premium on public debt was mainly due to the development of the tax administration (Brewer, 1990; O'Brien, 2003) and, therefore, had nothing to do with the Glorious Revolution, while, on the other, there are those who

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¹ For the history of this event see, among others, Pincus (2009).

maintain that the Glorious Revolution was a necessary, though not sufficient, condition for this reduction. This latter point of view is expressed in particular by Stasavage (2002, 2003, 2007), who argues that the constitutional reform brought about by the Glorious Revolution promoted the formation of political parties. The Whig party, led by Walpole, was able from 1715 onwards to unite interest groups with divergent economic interests under the banner of common religious values.

The purpose of the paper is to revisit the North and Weingast hypothesis and to propose a new explanation for the delayed fall in the interest rate on British government bonds. This explanation, which I call the *fiscal capacity hypothesis*, is based on three main points. Firstly there was the fact that prior to 1688 the Commons wanted to limit the king's fiscal resources. This was a way of making it impossible for him to consolidate his power in an absolutist sense. Secondly, after the Glorious Revolution, parliament, which by then had control over revenue and expenditure, promoted the establishment of an efficient bureaucracy for the collection of indirect taxes. These taxes affected basic necessities and consequently weighed most heavily on groups not represented in the House of Commons. Thirdly, over a few decades the excise department was properly strengthened, making for a significant increase in the yield from these taxes. This brought about a pronounced reduction in the risk premium on British government bonds.

My explanation builds on the ideas put forward by other scholars, like Brewer (1990) and Stasavage (2002, 2007), but it adds a new consideration regarding the nexus between the Glorious Revolution and the building of fiscal capacity. Along with Brewer (1990) and others² I share the view that attributes the reduction of the risk premium on Britain's public debt not so much to the creation of institutions protecting property rights, such as the Bank of England, but to the increased fiscal capacity of the state. However, in contrast to these scholars and their hypothesis – which I shall call the *public finance hypothesis* – the creation of this capacity, in other words, the construction of an efficient tax bureaucracy, was not an exogenous, deterministic factor but a policy choice made possible by the shift in fiscal power from king to parliament.

Therefore, this paper follows Stasavage (2002, 2007) in advancing the view that the Glorious Revolution was a necessary but not sufficient condition for the reduction of the risk premium on the public debt. However, differently from Stasavage's hypothesis – which I call the *political party hypothesis* – my view is that the political decision to create a proper tax bureaucracy was not the consequence of the emergence of parties, each with a different view of society, in the context of dialectic appropriate to a democratic system, but of a coalition between the interest groups represented in parliament, namely, the landowners and the monied interests. These groups introduced an oligarchic approach to power. In particular they decided on a significant increase in excise taxes, the burden of which fell mainly on groups not represented in parliament.

To support my hypothesis, I show first of all that the significant increase in tax revenue that occurred in the early part of the 18th century was principally due to the marked increase in excise taxes. This factor, together with the opportunity to use specific excise taxes to guarantee part of the debt, the so-called funded debt, helped reduce the interest rate on British public debt. The existence of this causal link is demonstrated by an econometric analysis. The fact that the growth of excise revenues was made possible by creating a dedicated bureaucracy and that this process took a certain amount of time, helps explain why there was a delay after the Glorious Revolution before interest rates on British public debt fell.

The rest of the paper is organized into four sections. Section 2 is devoted to a critical overview of the literature. Section 3 presents a model, based on Besley and Persson (2011), which shows how a shift in the balance of power between king and parliament, as occurred with the Glorious Revolution, lowers the cost for the latter of building up adequate fiscal capacity. Equally, the groups represented in parliament tend to use this capacity for collecting taxes that burden interest groups not represented in parliament. This seems to accord fully with what happened in Britain in the first half of the 18th century. Section 4 describes how a bureaucracy in a position to collect excise duties was built up in Britain and how long it took. This section also shows how the increased share of excise duties with respect to total fiscal yield made it possible to lower the risk premium on the public debt. In Section 5 an econometric test is carried out based on the Johansen procedure which compares the explanatory power of the various previously described hypothesis. The test shows that the *fiscal capacity hypothesis* has greater explanatory power than the alternative hypotheses. The final section concludes the paper.

2. A critical survey of the literature

The contradiction between North and Weingast's thesis and the historical facts is highlighted in Fig. 1: the interest rate on British government debt in the latter part of the 17th century actually rose. Then, in 1711 it started to decrease, only falling as far as the level of the interest rate on Dutch public debt in the 1720s.

Based on the evidence, three alternative hypotheses have emerged in the literature, either as alternatives to the original North and Weingast hypothesis or as a defence thereof. First, according to the *public finance hypothesis* the financial credibility of the British state is to be seen not in relation to protecting property rights as in North and Weingast's hypothesis, but in relation to the creation of an efficient state bureaucracy and increased tax revenues. This hypothesis belongs to the fiscal-military vision of the state. Indeed, according to Brewer (1990) and other scholars³ this process was a response to the need to cover the costs of war during a period in which these costs, due to technological innovations, were mounting considerably. It is no surprise, therefore, that in the perspective outlined above O'Brien (2002) dates the creation of an adequate state apparatus to around the middle of the 17th century, downplaying the role of the Glorious Revolution in underpinning Britain's achievements in the 18th century.⁴

² See, among others, O'Brien (2002).

³ See among others O'Brien (2002).

⁴ See Storrs (2009) and Hellmuth (2002).

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