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What we can learn from the early history of sovereign debt☆

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Abstract

Many people believe that the early development of sovereign debt depended on institutions, but there are two very different ways of presenting this narrative and two very different conclusions one might draw for sovereign debt today. According to the first, this was an impartial story involving executive constraints, shared governance, increased monitoring, and increased transparency — in other words things that sound unambiguously good. According to the second narrative this was a story of distributive politics. States had the best access to credit when institutions gave government creditors privileged access to decision making while restricting the influence of those who paid the taxes to reimburse debts. This was a situation where institutions fostered commitment, but at a cost, and sometimes they may not even have been welfare enhancing. In this paper I present evidence from seven centuries of European history, and I suggest that available data support the distributive politics interpretation. I then draw implications for how we think about the politics of sovereign debt today.

Keywords: Public debt; Political economy; Europe

1. Introduction

Many people believe that the credibility of sovereign debt depends not only on the reputational consequences of defaulting but also on institutions that might prevent default from occurring. But there are two very different views of how institutions might achieve this objective. According to the first "impartial" view what matters is having good institutions, and not much reference is made to the people who control the institutions and what their interests are. Following this vein of thinking, some political scientists have investigated whether there is a "democratic advantage" when it comes to establishing sovereign creditworthiness.[1] In a similar spirit, recent work in economic history has found that the establishment of limited government was associated with lower costs of borrowing for eighteenth and nineteenth century European states.[2] International economists have found that the general quality of a country's institutions is

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[1] For a recent contribution see Beaulieu et al. (2012).
[2] See in particular the important work by Mark Dincecco (2009, 2010, 2011) on this subject.

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correlated with borrowing costs.[3] Finally, this impartial view of institutions has also informed recent policy debate.[4]

According to the second "distributive" view what matters is not just the presence of institutions but also the interests of the people who control them. Few scholars would dispute the idea that interests matter, but if they matter, then we need to think about how institutions may naturally advantage some social groups over others. European history is replete with such examples. Institutions sometimes privileged urban mercantile elites and in other cases large landowners. Institutions were often restricted to wealth holders, but in other instances allowed for more popular participation. In this paper I will suggest that the distributive view of institutions does a better job of explaining the early history of sovereign debt than does the impartial view. Therefore, if we want to understand the politics of sovereign debt in other places at other moments in time, then we need to think about the way in which institutions privilege the interests of creditors over those who repay debt.

Scholars studying the politics of public debt have emphasized that repayment creates both winners and losers, implying that the relative political weight of these two groups matters (Frieden, 1991). The idea that economic position maps into interests over debt has also been supported by recent survey evidence.[5] Scholars have also considered how political institutions have altered the balance between winners and losers when it comes to debt repayment. For the nineteenth century, some have suggested that a regime of restricted suffrage made it possible to sustain the classical gold standard together with full repayment of public debts.[6] In a similar manner, Mitchener and Weidenmier (2010) show that nineteenth century arrangements that allowed creditors to impose "supersanctions" on borrowers had a similar effect. For an earlier period of European history, others have suggested that institutions favoring a merchant oligarchy were the secret to gaining access to credit.[7]

Economists constructing formal models of sovereign debt have generally not paid much attention to the distinction between those who own debt and those who do not because they typically have in mind a setting where foreign agents hold the debt. Therefore, a representative agent model makes sense.[8] In the case of domestic debt, recent models have focused on the way in which the system of representation produces suboptimal distortions in debt policy (see Battaglini, 2011), but there has been less effort to think about distributive issues between debt owners and others. To see what such models might look like we can refer to closely related work in the area of capital taxation. Persson and Tabellini (1994) considered whether representative democratic institutions might prompt the election of a representative who owns more capital than the average member of society, precisely because of the commitment effect that might ensue. In more recent work Farhi et al. (2011) have considered a dynamic game where capital taxes are chosen by a democratic majority each period and individuals have differing wealth endowments. Distributive settings such as these should certainly also be applied to the case of sovereign debt as long as some citizens hold debt and others do not.

In this paper I demonstrate that the available evidence on the early history of European sovereign debt fits the distributive view of institutions. It also suggests that the effect of institutions was largest in early stages of financial market development where the reputational mechanisms for ensuring creditworthiness would have been expected to operate more imperfectly. I will first consider the beginnings of sovereign debt, focusing on the distinction between city-states and larger territorial states in Europe and the advantage that the former group had when it came to accessing credit. I will then suggest that the success of city-states in issuing long-term debt depended on the presence of political institutions that were biased in favor of state creditors. Following this, I will consider how, from the sixteenth century onwards, some larger states in Europe attempted to imitate their autonomous cities, though with varied degrees of success. Success depended on the extent to which political institutions insulated government creditors. While the Dutch Republic was the most successful state in this regard, it was ultimately Great Britain, with a system of parliamentary control, ministerial responsibility, and again institutions biased in favor of state creditors, that established a model that other large European states would eventually follow. As a final part of the inquiry, I will consider the diffusion of the British parliamentary model for government borrowing during the long nineteenth century (1789–1913). I will suggest that

[3] Gelos et al. (2011).

[4] As an example, Heinemann et al. (2014) suggest that appropriate fiscal rules can help make up for a country's lack of a "stability culture." On the effect of fiscal institutions see also Debrun (2011) and Iara and Wolff (2010). Irwin (2013) provides a fascinating discussion of the origins of fiscal transparency in Europe that shares a similar perspective.

[5] See in particular Tomz (2004) and Curtis et al. (2012).

[6] See Eichengreen (1996) and Obstfeld and Taylor (2003) on this point.

[7] See Stasavage (2011).

[8] See the review article by Aguiar and Amador (2014).