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Tax farming and the origins of state capacity in England and France

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Abstract

How did modern and centralized fiscal institutions emerge? We develop a model that explains (i) why pre-industrial states relied on private individuals to collect taxes; (ii) why after 1600 both England and France moved from competitive methods for collecting revenues to allocating the right to collect taxes to a small group of financiers—an intermediate institution that we call cabal tax farming—and (iii) why this centralization led to investments in fiscal capacity and increased fiscal standardization. We provide detailed historical evidence that supports our prediction that rulers abandoned the competitive allocation of tax rights in favor of cabal tax farming in order to gain access to inside credit, and that this transition was accompanied by investments in standardization. Finally (iv) we show why this intermediate institution proved to be self-undermining in England, where it was quickly replaced by direct collection, but lasted in France until the French Revolution.
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> 'It is common ground, therefore, that the Renaissance monarchies of England and France shared important characteristics. But by 1714 they were so different from one another that one might almost call them mirror-images. Herein lies a most profound paradox'.
> [Finer (1999, 1308)]

1. Introduction

A growing literature argues that state capacity—the ability of a state to raise tax revenues and to uphold the rule of law—is an important determinant of economic prosperity (Besley and Persson, 2011; Fukuyama, 2011; Acemoglu and Robinson, 2012). Much of this research looks at the rise of the fiscal institutions that constitute a modern tax state.[1] However, Charles Tilly observed that scholars of state formation face a selection issue. Economists and political scientists study the institutions that have survived. Tilly raises the possibility that institutions that did not survive to the modern era may have been more than 'the fading features of the old

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[1] See for example Tilly (1990), Bonney (1999), Ertman (1997), Bonney (1995), Kiser and Kane (2001), Dincecco (2011), O'Brien (2011), Karaman and Pamuk (2011), Johnson and Koyama (2011), and Gennaioli and Voth (2011).

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regime, but the *intermediate institutions* which were crucial to the emergence of the states we know'. Hence, studies that focus exclusively on the emergence of modern institutions 'will tend to misrepresent the developmental process' (Tilly, 1975, 48).

This paper argues that the intermediate institution of cabal tax farming, which was marked by the allocation of tax rights to monopsonistic cabals of financiers rather than using competitive markets, was crucial for the rise of the modern state as it encouraged investment in fiscal capacity. Our investigation focuses on the development of two prototypical modern states: England and France during the early modern period (1500–1800). Both of these polities adopted cabal tax farming and both saw dramatic increases in fiscal capacity in the period before the industrial revolution. In England the intermediate institution of cabal tax farming soon gave way to direct collection and the rise of a bureaucratic fiscal state, whereas in France it persisted until the French Revolution. By studying this institutional divergence we shed new light on the rise of modern fiscal and financial institutions.

We develop a model and analytical narrative that explains (i) why, before 1600, European states relied on markets to perform many functions, including tax collection; (ii) why early modern states moved from decentralized, market-based, methods for collecting revenues towards more centralized and eventually more bureaucratic fiscal institutions; (iii) why this centralization also encouraged investments in fiscal capacity and the standardization of laws and weights and measures; and (iv) why this intermediate institution proved to be self-undermining in the long run.

Our analysis is driven by the two main types of costs facing any early modern ruler. The first was the cost of collecting taxes in economies that were highly heterogeneous and fragmented. High costs to monitoring government agents meant that there was embezzlement and corruption. In response, states privatized tax collection. Tax collection was farmed out to private individuals who bid competitively for their positions, paying a fixed fee or rent to the king and were, in return, the residual claimants on whatever was collected.[2]

The second cost was that of borrowing. Since early modern monarchs could not credibly commit to repay debts that they incurred, their ability to borrow money was limited; this made them dependent on personal, or inside, finance. Whereas many city states had developed sophisticated forms of borrowing and public finance during the late middle ages, as late as 1650, the rulers of the major territorial states of Europe like England and France remained reliant on short-term loans from moneylenders, merchants, and tax collectors.[3]

A number of papers study the use of tax farming to overcome the costs of tax collection in the pre-industrial world.[4] However, this is the first paper to build a model that shows how borrowing, tax farming, and investments in state capacity were interconnected. Our model shows that when credit is less important to the ruler, states use competitive markets to allocate fiscal rights, especially when the costs of collection are high. In this equilibrium, the king has little incentive to invest in increases in state capacity that directly lower the cost of tax collection. However, if the ability of the king to borrow from outside sources of finance is limited, then, as access to credit becomes more important, there is a strong incentive to abandon competitive tax farming since the decentralized institutions which minimize the cost of collecting taxes are incapable of supporting large amounts of inside lending. Hence the model explains why states might move away from competitive allocation of fiscal rights towards monopsonistic allocation and cabal finance.

The move from competitive markets to monopsony grants means that rulers no longer benefit from the information revelation properties of market mechanisms. Under monopsony tax farming, therefore, governments have a greater incentive to lower the costs of directly monitoring the performance of tax collectors than they do under decentralized, competitive, tax farming. This requires investment in fiscal capacity, and in particular, in investments that reduce the cost of tax collection such as the standardization of laws, regulations, and weights and measures.

Nevertheless, the relationship between the king and the cabal of tax farmers is a fragile one. The model shows how it can break down, and why such a breakdown is more likely in an economy with less heterogeneity and more standardized laws, taxes, and regulations. In this case, the

[2] See Aylmer (1961), Prestwich (1966), Thomas (1983), Peck (1993), and Allen (2012).

[3] See Stasavage (2011) for an analysis of why city states were able to issue public debt while territorial states were not. See Voth and Drelichmann for analysis of the relationship between the Spanish monarch Philip II and his Genoese creditors (Drelichman and Voth, 2011b,a). See Epstein (2000) on the financial backwardness of early modern England.

[4] See Bonney (1979), Kiser and Schneider (1994), Kiser and Linton (2001), Maurer and Gomberg (2004), White (2004), Allen (2005, 2012), Johnson (2006a,b), Coşgel and Miceli (2009), and Balla and Johnson (2009), and there is an extensive literature on how monarchs in early modern Europe struggled to secure access to credit (see North and Weingast, 1989; Drelichman and Voth, 2011a; Stasavage, 2011).

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