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From internal taxes to national regulation: Evidence from a French wine tax reform at the turn of the twentieth century

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Abstract

The growth of the modern regulatory state is often explained in terms of an unambiguous increase in regulation driven by the actions of central governments. Contrary to this traditional narrative, we argue that as governments increased state capacity, they often strove to weaken the autarkic tendencies of regional laws, thereby promoting greater trade and a more integrated market. To show this, we exploit a quasi-natural experiment generated in the French wine industry by a law implemented on 1 January 1901 which lowered and harmonized various local tax rates.

We demonstrate that high internal taxes on wine, set by regional governments, discouraged trade and protected small producers of expensive and low quality wines. We then trace how the political response to this tax decrease led to increases in wine regulation.
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1. Introduction

A growing literature stresses the importance of state capacity for economic development.[3] These studies argue that the historical legacy of the ancestor states and noble holdings that were consolidated by modern centralized governments during the early-modern period left a legacy of inefficient institutions (Rosenthal, 1992; Grafe, 2012; Johnson and Koyama, 2012; Drechlichman and Voth, 2013). Furthermore, through the process of state-building, centralized governments gradually undermined these inefficient institutions (Epstein, 2000; Dincecco, 2009; Fukuyama, 2011; Johnson and Koyama, 2011; Gennaioli and Voth, 2011). Most of these studies, however, rely on theory or on cross-country evidence to support their claims. In this paper we study how this process unfolded in a single industry inside a single country, thereby providing a more nuanced version of how increases in state capacity undermined autarchic vestiges of the past. Our analysis shows the role played by centralized states in suppressing locally set taxes, of deep historical origins, that impeded market development.

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[3] A state with greater "capacity" is usually defined as being able to enforce consistent laws (legal capacity) and being able to collect taxes (fiscal capacity). For example, see Besley and Persson (2010), Besley and Persson (2009), Acemoglu (2005), Acemoglu and Robinson (2012).

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The existing literature on the growth of government portrays the rise of regulation as a straightforward conflict between a predatory state and a mostly unfettered private market.[4] But the rise of the modern state was as much about the conflict between different levels of government as control of the private sector. Reform was beneficial where growing state capacity allowed the central government to weaken the autarkic tendencies of local government and thereby promote trade and market integration. We present an important case study from French economic history that illustrates how central regulation could replace diverse, and often obstructive, local regulations. In the Third French Republic, local regional taxes on wine obstructed domestic trade and promoted inefficiencies in production. By unifying regulations and lowering regional taxes, the French state promoted the modernization of the French wine industry.

Our primary contribution is to show that internal taxes on wine in France (set by regional governments) during the late nineteenth century favored local producers and local consumption. To this end, we create a department level panel data set on wine tax rates, wine consumption, number of wine farmers (*récoltants*), the value of wine production, the proportion of tax exempt wine consumed on farms (*en franchise*) as opposed to purchased on formal markets, and total output between1896 and 1905.[5]

We identify the effect of internal taxes on market structure by taking advantage of a quasi-natural experiment created by the decrease in local tax rates due to a national law adopted on 29 December 1897 by the French parliament which came into effect on 1 January 1901. This law was the result of lobbying from "progressives" who wanted to improve citizens' health by encouraging the consumption of wine as opposed to hard liquor. Since there was significant variation in wine tax rates across regions before 1901, the exogenously timed decrease in rates generated by the binding tax rate ceiling varied across regions as well. Our main results show that the decrease in internal taxes in 1901 increased the amount of wine traded on formal markets and led to exit by small local producers of wine that was expensive and of low quality. These results are economically significant. A one standard deviation decrease in the tax rate resulted in an increase in formal market use and a decrease in the number of wine producers of over a quarter of a standard deviation of those variables. More generally, our finding that the number of wine producers decreased after taxes were lowered, when combined with the fact that wine production was increasing throughout this period, suggests an increase in the scale of production.

We complement our identification strategy which builds on the exogeneity of the 1901 tax change by undertaking falsification tests that assess the (lack of) significance of placebo tax reforms. The results from these tests reinforce our contention that the 1901 tax change was exogenous to the pre-1901 situation of wine production in each department. They therefore support our conclusion that internal taxes set by regional governments protected local producers and favored local consumption.

The locally set internal taxes that we study were unit taxes (collected on quantity consumed) and thus theoretically equivalent to transportation costs. They were also excise taxes as opposed to import taxes since they did not discriminate on point of origin. Our empirical findings are therefore also relevant to the modern literature on tax efficiency (Mankiw et al., 2009; Hines, 2008). Whereas the traditional cost of excises is taken as being the welfare losses to consumers and producers generated by the tax wedge, our analysis implies that excises on wine in nineteenth century France also discouraged the penetration of large-scale producers of cheap wine into certain markets.

We suggest that Alchian–Allen effects may explain this phenomenon (Hummels and Skiba, 2004; Alchian et al., 1972). The intuitive premise of the Alchian–Allen effect is that if there are two goods of different qualities, one with a high price and the other with a low price, then a fixed charge applied to both products will lower the relative price of the more expensive good. We provide evidence that regions producing cheap table wine using factory methods in the South of France were disproportionately benefited by the lowering of internal taxes in 1901. Thus, our paper also makes a contribution to the literature on local public finance by showing that excise taxes, even when they do not discriminate on point of origin, can still deter specialization and trade.[6]

We conclude by describing the political response by local interest groups to the increased market competition resulting from the elimination of local taxes. These popular movements ultimately resulted in the creation

[4] An obvious explanation for this over-sight is selection bias in our data sets. Easily accessible, centralized, records only became available as national governments increased their activities and, as a consequence, also started collecting more data. This creates an automatic, though potentially spurious, positive correlation between "size of government" and "size of national government". See Novak (1996) for an important exception to this observation.

[5] Departments are administrative divisions of the French territory which were created in 1790.

[6] See Baldwin et al. (2003) on changes in industry location under increased economic integration and changes in tax competition.

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