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Colonial Revenue Extraction and Modern Day Government Quality in the British Empire

RASMUS BROMS*
University of Gothenburg, Sweden

Summary. — The relationship between the extent of government revenue a government collects, primarily in the form of taxation, and its overall quality has increasingly been identified as a key factor for successful state building, good institutions, and—by extension—general development. Initially deriving from historical research on Western Europe, this process is expected to unfold slowly over time. This study tests the claim that more extensive revenue collection has long-lasting and positive consequences for government quality in a developmental setting. Using fiscal records from British colonies, results from cross-colony/country regression analyses reveal that higher colonial income-adjusted revenue levels during the early twentieth century can be linked to higher government quality today. This relationship is substantial and robust to several specifications of both colonial revenue and modern day government quality, and remains significant under control for a range of rivaling explanations. The results support the notion that the current institutional success of former colonies can be traced back to the extent of historical revenue extraction.

Key words — taxation, government quality, institutions, British colonies, history

1. INTRODUCTION

Over the last few decades, a growing number of studies have identified institutions as an essential component for spurring development (see, for example, Acemoglu, Johnson, & Robinson, 2001; North, 1990; North & Thomas, 1973; Nunn, 2009). Scholars, intermittently referring to the term as good governance, institutional quality, or quality of government, have extended this claim to apply for a wide range of public goods (see, for example, Holmberg, Rothstein, & Nasiritousi, 2009). Empirically, it is well established that the places in the world with the highest level of socioeconomic development tend to be those with the highest level of government quality, usually measured in terms of a relative absence of corruption, protection of property rights, or an effective government. The lion's share of these states is located in Western Europe and North America, countries that already a century ago tended to display a comparatively high level of wealth and government quality.

This suggests that institutional equilibria, while possible to change (as demonstrated by states such as South Korea and Georgia), generally tend to be path dependent, and stable over time. The fact that "good" institutions still remain the exception rather than the rule in today's world has led to a large body of research attempting to find their historical roots (Ertman, 1997; Mann, 1993; Rothstein, 2009). One factor uniting a majority of states with inferior government quality is that they were governed as colonies until relatively recently, and, to varying degrees, have inherited institutional features from their old metropolitan rulers (Charron, Dahlström, & Lapuente, 2012; La Porta, Lopez-de-Silanes, & Shleifer, 2008). Tracing institutional development back to colonialism is likely to offer useful insights into the birth and subsequent fate of the developmental state. As Conrad and Stange (2011) note, "the longevity of political structures and practices rooted in colonial times strongly suggests that there is a path dependency inherent in colonial governance. In order to understand present-day governance in formerly colonized countries it is therefore indispensable to take into account their colonial pasts" (p. 53).

This study will follow suit by attributing variation in current government quality to differences in the level of revenue that colonies under British rule collected during the early twentieth century. As demonstrated below, high revenue extraction during the early twentieth century, the decades preceding the critical juncture of independence, is significantly and positively linked with present day government effectiveness.

2. TAXES, EXTRACTION, AND INSTITUTIONS

In a highly influential study, Acemoglu, Johnson, and Robinson (2001, hereafter AJR; see also Acemoglu & Robinson, 2012) link the concept of extractive institutions to a predatory and destructive colonial system of rule, carrying few prospects of creating a governable and prosperous society. The authors show that, in colonies with low mortality rates among early modern European settlers, colonizers found environmental preconditions suitable for long-term settlement. Today, these tend to be well-functioning and prosperous states, while more dangerous settlements were used merely for the economic benefit of the metropolis. In this latter type of setting, colonizers developed institutions designed to facilitate revenue extraction, while little effort was devoted to the development of sound institutions or any deeper or wider measure of state building. While a number of studies have

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questioned the empirical underpinnings of the study (for example, Albouy, 2012; Fails & Kriekhaus, 2010), the basic argument has undeniably proven powerful in terms of understanding the importance of studying the root causes of institutional development.

There are, however, some outstanding issues regarding AJR's treatment of revenue and taxes *per se*, and the institutions devised for their collection. Although they do cite heavy tax levels as symptomatic of countries with a history of extractive institutions (AJR, p. 1375), Frankema (2010, p. 459) finds that settler mortality is *negatively* related to colonial tax levels in British colonies. This puts the underpinnings of AJR's theory into question, calling for a more nuanced view of extraction and institutions. Preceding AJR's study, Chaudhry (1997) presented a starkly different notion of "extractive institutions", using the term more specifically to indicate the state institutions tasked with extracting domestic taxation. According to this view, the creation of such institutions, through a centralization of the fiscal apparatus, establishment of territorial control, enhanced information gathering, and standardization of market activity, is in fact seen as a prerequisite for government quality. Chaudhry (1997) even notes that "the decline of a tax bureaucracy has unintended consequences that bode ill for the long-term development of all parts of the bureaucracy" (p. 33). As a contrasting case, Slater (2012) attributes the success of the successful, if authoritarian, state building of Singapore and Malaysia to strong extractive institutions set up during the twilight years of the colonial era.

These claims have garnered broad support elsewhere. Historical studies have demonstrated that the quest for extracting revenues can work as a potent agent of institutional development and state building. Several scholars (Bates & Lien, 1985; Levi, 1988; Mann, 1993; Olson, 1993; Schumpeter, 1991[1918]; Tilly, 1992) have laid out a convincing narrative of state-, nation-, and institution building, through the means of revenue extraction in general, and taxation in particular. This field is usually referred to as "fiscal sociology" (Campbell, 1993). The basis of this underlying argument is drawn from the study of the countries of early modern Europe, shortly before these states themselves embarked on their colonizing missions across the globe.

The advent of large-scale, regularized taxation was primarily driven by the increased demands of maintaining a standing army during the early modern era, followed by ambitions of providing a wider range of public services (Mann, 1993; Tilly, 1992). The argument can be summarized as such: to increase domestic revenue collection, mainly in the form of taxes, rulers needed to strike bargains with the prospective and existing revenue base over the extent and methods of revenue extraction. This process of bargaining is considered a significant impetus for spurring responsiveness, popular mobilization and accountability (Levi, 1988). Parallel to this, a strong and effective state bureaucracy developed out of the need to collect, administrate, and spend such revenue (Campbell, 1993, p. 177; Moore, 2007, p. 17). As illustrated by Chong and Calderon's (2000) definition of institutions, such factors are considered essential parts of government quality:

> Institutions, as the implicit and explicit rules by which the members of a society interact, shape the economic behavior of agents and help explain the performance of countries. When these rules change constantly or are not respected, when the discretion of the government is unlimited, when property rights are not well secured, or when corruption is high and rule enforcement is weak, there is likely to be a problem with the quality of the institutions (p. 761).

A number of recent studies have turned their eyes toward states currently undergoing—very broadly stated—development processes similar to those of early modern Europe, and have found positive links between revenue extraction and government quality. Key institutional features such as the legal system (Besley & Persson, 2011), overall government quality (Baskaran & Bigsten, 2013; Prichard & Leonard, 2010), democracy (Ross, 2004), as well as more specific features of the liberal state (Mahon, 2005) have all recently been shown to improve with revenue collection, primarily taxation.

Although the literature tends to overlook the difference between the bargain- and capacity building-centric mechanisms for government quality generation, recent works emphasize an inherent tension between the sequencing arguments inherent to these stances. Boucoyannis (2015), focusing on Medieval England, and D'Arcy and Nistotskaya (2016) employing a cross country-approach, use historical evidence to give credence to the notion that capacity building tends to precede bargaining in successful cases of institution building. This is supported in research showing that taxation spurs contemporary citizens of developing states to monitor and take a more active interest in politics (Broms, 2015; Paler, 2013), regardless of whether they have agreed to being taxed in the first place. While neither of these studies refutes the potentially beneficial effects from revenue bargains on government quality, they indicate that the initial impetus for the process to come about is more likely to start with the strengthening of capacity that tends to derive from efforts to raise revenue. Applying these notions to the colonial context, which involved foreign powers forcefully taking over territories in the quest for revenue, and thus by default did not involve much bargaining, can help shed further light on this emerging debate.

Still, little quantitative research has been carried out accounting for path dependency by linking past levels of taxation and today's institutional landscape. This leaves a rather crucial gap in the literature, as research on early modern Europe, especially England and later Britain (Daunton, 2008), describes the dual process of taxation and state building as having evolved over generations.

The positive consequences of the more limited notion of extractive institutions, or, put more succinctly, institutions for revenue extraction, will form the main hypothesis of the remainder of this study; if the conclusions from the fiscal sociology literature are correct in that revenue raising can be a positive factor for how nascent states evolve and prosper, and its effects are path dependent, we should expect to see a positive relationship between colonial revenue collection and modern day government quality.

3. CASE SELECTION

The sample for the analysis below consists of the states that were previously British colonies. Ideally, comparative data on colonial taxation for all former colonies would be readily accessible. In lieu of this, the British Empire provides a particularly illuminating testing ground for the argument at hand. Furthermore, as Katz, vom Hau, and Mahoney (2005) note, limiting the sample to a single group of colonies "help to control for unknown contextual variables that may substantially shape the effects of colonialism across different colonizers" (p. 544). Although this selection strategy does not guarantee full generalizability to all former colonies, no other colonizing power offers the scale of variation pertaining to geographical, political, or economic factors that surpass the British Empire. The resulting sample includes states from every continent, including both giants such as India and small island states like