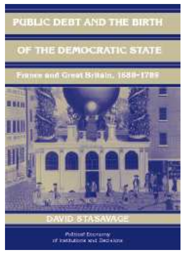
David Stasavage

Introduction

Book section (Published Version)

Original citation:
Originally published in Stasavage, D., *Public debt and the birth of the democratic state: France and Great Britain, 1688-1789.* Cambridge, UK : Cambridge University Press, 2003, pp. 1-25. ISBN 9780521809672



Public Debt and the Birth of the Democratic State

France and Great Britain 1688–1789

David Stasavage

Book DOI: http://dx.doi.org/10.1017/CBO9780511510557

Online ISBN: 9780511510557

Hardback ISBN: 9780521809672

Paperback ISBN: 9780521071277

Chapter

1 - Introduction pp. 1-25

Chapter DOI: http://dx.doi.org/10.1017/CBO9780511510557.001

Cambridge University Press

1

Introduction

1. Credibility and Public Debt

Like many areas of economic policy, public borrowing is subject to a credibility problem. Borrowing on capital markets is advantageous, because it gives governments a means of deferring part of the cost of financing public goods. A state that has access to credit can expand public investment without a sharp and immediate increase in taxation. The problem is that once a government has borrowed, it may face incentives to defer repayment or even to default on its obligations, in order to reduce the burden of taxation on those who contribute to repay debts. Default was a common occurrence that hindered the development of public borrowing in early modern Europe. Today, default may no longer be a worry for those who are considering investing in bonds issued by OECD governments, but it is a major issue for governments in developing and transition economies that seek to offer assurances about debt repayment. If prospective lenders anticipate that a government may default, they will invest only if they are given a high rate of return that compensates for this risk. In extreme cases, they will refrain from lending at all.

This book investigates the link between public debt and representative democracy. In it I develop three theoretical arguments about the effect of constitutional checks and balances, political parties, and bureaucratic delegation on government credibility, and I then confront these propositions with historical evidence from England and France during the eighteenth century. In a concluding chapter I consider broader implications of my findings, focusing on links between democracy and economic performance and on the study of institutions. The theoretical sections of the book use basic game-theoretic models to examine how different institutional features of representative government influence the possibility for states to commit to repaying their debts. While there are now a number of studies that investigate how representative institutions may allow governments to solve commitment problems, some authors have argued that this literature often fails to explicitly consider partisan motivations on the part of political actors.[1] Alternatively, those models of commitment problems in debt and taxation that do take partisan motivations into account often pay only limited attention to institutional features of decision making.[2] The theoretical and empirical analysis here attempts to fill this gap by drawing simultaneously on political economy theories that emphasize partisan pressures on economic policy, as well as analyses that show how the rules of democratic decision making may influence economic policy choices.

I pay particular attention to three features of representative political institutions that may improve a government's ability to make credible commitments. The first emphasizes constitutional checks and balances (multiple veto points in current terminology). According to one view, which extends back to theorists such as Madison and Montesquieu, representative institutions improve commitment when they involve features such as a division of power between legislature and executive or between multiple houses of a legislature. My first main argument suggests that while constitutional checks and balances can improve possibilities for credible commitment, they are neither a necessary nor a sufficient condition for this to occur. They are not a necessary condition, because interests opposed to default may gain influence even in the absence of checks and balances. They are not a sufficient condition, because those opposed to default may fail to gain influence even in a country where the constitution provides for checks and balances. The implications of this argument for credible commitment have not been previously examined.

A second potential credibility-enhancing feature of representative institutions involves party formation in a plural society. When governments borrow, a division is likely to emerge between those who own public debt and those who pay the taxes to service public debt. This raises the

[1] See Przeworksi and Limongi (1993) and Elster (2000). The most frequently cited piece in the literature on representative institutions and credible commitment is North and Weingast (1989). See also Bates (1996), De Long and Shleifer (1993), Firmin-Sellers (1994), Levy and Spiller (1996), North (1981, 1990), Olson (1993, 2000), Shepsle (1991), Tsebelis (2002), and Weingast (1995, 1997).

[2] A good example here is the model in Persson and Tabellini (1994) .

question of how society could commit to repaying debt if creditors are a minority of the population. My second main argument suggests that in societies where there are multiple dimensions of political conflict, even if government creditors are a small minority, other groups can face incentives to support timely repayment of debts in order to gain the support of government creditors on issues such as religion, foreign policy, or constitutional questions. As a result, careful attention should be paid to whether political conflict is in fact multidimensional and to whether government creditors are able to form durable coalitions with other social groups. This second argument implies that democratic compromise may provide commitment even in the absence of constitutional checks and balances.[3]

A third feature of representative government that may enhance credibility involves the possibility for rulers and politicians to delegate authority to individuals who are committed to pursuing a particular policy, whether it be repaying debt, maintaining low inflation, or regulating industries in a socially desirable manner. In the area of public borrowing it was common for rulers in early modern Europe to delegate authority with the express intent of improving their credibility. So, for example, a ruler might give a group of officials the right to manage public revenues so as to ensure full debt repayment. My third main argument suggests that bureaucratic delegation can reduce default risk, but it will be ineffectual in doing so unless creditor interests have power within a representative assembly, either as an outright majority or as part of a majority coalition. The reason is that when government creditors lack such political influence, rulers will find it easy to alter unilaterally agreements with individuals to whom they have delegated.

In exploring the politics of debt repayment, this book also asks when the institutions or practices that reduce the risk of default are consistent with basic democratic principles. The key question here is, When does commitment occur as a result of democratic politics pushing policies toward "moderate" outcomes? and alternatively, When is the problem solved only at the expense of democracy, by giving government creditors a privileged position in society? As a result, this study should be relevant not only to theoretical debates about credibility, but also to debates about the "structural power of capital" and economic policy making in an era of global finance.

[3] The effect of multi-issue conflict on economic policy choices has also been considered recently by Besley and Coate (2001) and Roemer (1998, 1999, 2001).

2. Historical Setting and Scope of the Study

My empirical focus on Britain and France is motivated by the fact that it has become popular to contrast the financial experiences of these two countries during the eighteenth century. Great Britain has been portrayed as the first state to establish a modern system of public finance, while France has been viewed more frequently as an example of failed reform.[4] For some authors, understanding the development of state finance in the two countries has been the end objective of study, while for others, state finance has proved of interest because of the possible link with other developments including economic growth and international rivalries.[5] In this book I pursue the former approach. As a result, I do not directly consider whether state finances must be sound before private financial markets can develop.[6] Nor do I seek to ask whether the Glorious Revolution in Great Britain coincided with increased protection of property rights in the economy more generally.[7] My objective is instead to consider Great Britain and France as fascinating cases that can be used to develop more general inferences about the link between representative government and credible commitment. In so doing I hope to add to other recent work that considers the link between political institutions and state finance in early modern Europe.[8] I also hope to show that it is possible to use game theoretic models of politics combined with historical analysis in the style of "comparative historical institutionalism."[9] Finally, while I draw extensively on research in the fields of economic history and political history, as well as primary sources in selected areas, it is worth emphasizing that this book is primarily a work of political science. My goal for the empirical

[4] Several classic contributions on the development of state finance in Britain include Clapham's study on the Bank of England (1958), Dickson (1967), Roseveare (1969, 1991), and, more recently, Brewer (1989) and Jones (1988). Knowledge about state finance in eighteenth-century France has been significantly expanded by Hoffman, Postel-Vinay, and Rosenthal (2000), Lüthy (1959–61), Marion (1919), Riley (1987), and Velde and Weir (1992). Comparative studies on state finance include Bonney (1999) and Mathias and O'Brien (1976).

[5] See Schultz and Weingast (1996).

[6] This is a claim made by North and Weingast (1989) but contested by Hoffman et al. (2000). See also Rousseau and Sylla (2001) for a more general discussion on the historical link between financial development and growth.

[7] Clark (1996) has argued that security of property rights was a feature of the British economy well before 1688.

[8] See Carruthers (1996), Ertman (1997), Hoffman and Norberg (1994), Potter (1997, 2000), Potter and Rosenthal (1997), and Root (1994).

[9] See Thelen (1999) on this point.

chapters is to draw on historical work on England and France in order to gain new perspectives on enduring questions posed by political scientists and economists. Likewise, I hope that historians may find this book of interest to the extent that it draws links between partisan politics, political institutions, and state finance in a way that existing work may not have emphasized.

The British historical background to this study involves the dramatic set of changes that took place in English government finance after the Glorious Revolution of 1688. When faced with the need to borrow, English monarchs before 1688 had resorted largely to ad hoc methods; default on these loans had always been a possibility; and as a result the Crown had often been unable to gain access to credit at anything less than exorbitant rates of interest. After the Glorious Revolution this picture changed dramatically. Methods for borrowing were regularized, Parliament gained substantial prerogatives in the area of public finance, the Bank of England was created, and the Crown found itself able to borrow larger amounts at lower rates of interest than ever before. Many of these changes were directly inspired by earlier institutional reforms in the Netherlands, a subject I explore in Chapter 3. It was the simultaneous nature of these developments in Great Britain that prompted North and Weingast (1989) in their seminal article to suggest there was a causal link between the establishment of a limited monarchy in the United Kingdom and improved access to credit.

Chapter 4 presents evidence to show that interest rates on British government debt did indeed take a downward trend after 1688. However, what North and Weingast's argument seems less able to explain is why it took over thirty years after 1688 before the British government could borrow as cheaply as could the government of Holland, which was universally recognized at the time for its creditworthiness. Moreover, despite the long-term trend toward lower costs of borrowing, there was very significant volatility in interest rates during the reigns of King William III (1689–1702) and of Queen Anne (1702–14), as well as periodic runs on Bank of England shares. At times during these years the British Crown actually found itself borrowing at rates as high as those that had prevailed before 1688, and as high as those paid by the French monarchy. These observations raise questions about how debt politics evolved over time in the United Kingdom. Was this post-1688 volatility related to political events, such as changes in the partisan control of government? What were the factors that allowed the British government after 1715 to borrow as cheaply as the Dutch government? While economic historians have extensively documented the development of British government borrowing after 1688, the possibility that post-1688 trends in interest rates were correlated with political trends has not been thoroughly investigated.

I argue that the improvement in the British Crown's access to finance cannot be understood unless one recognizes that apart from the establishment of a limited monarchy, the last decade of the seventeenth century also witnessed another major change: the development of cohesive political parties.[10] Politics in Great Britain between 1688 and 1742 was characterized by conflict between two parties, the Whigs and the Tories, that took differing stances on a range of issues including religion, the succession to the throne, foreign policy, and state finance. The Whigs in particular were a party founded on a compromise among several different groups with diverse interests, including government creditors, Protestant dissenters seeking religious freedom, and landed aristocrats who sought, among other objectives, to increase Parliament's constitutional prerogatives. Because those landowners who participated in the Whig coalition differed with government creditors over questions of taxation and finance, it was crucial for the success of the coalition that both groups nonetheless had similar preferences on a number of other issues in British politics. From the 1720s, as issues such as religion became less salient in British politics, the Whig coalition under Robert Walpole was increasingly held together by patronage, though patronage alone never sufficed for Walpole to maintain a majority.

In Chapters 4 and 5, I show that trends in interest rates on U.K. government debt after 1688 can be better understood when one considers that government creditors were active members of the Whig party, whereas the Tory party was much more closely aligned with those landed interests who chafed at the tax payments necessary to repay public debt on schedule. Chapter 4 presents several basic econometric tests to show that interest rates on U.K. government debt tended to be lower when the Whig party had firmer control of Parliament. Given that the shareholders of the Bank of England were the most prominent of the government's new creditors during this period, it is not surprising that the split between Whigs

[10] In emphasizing the importance of political parties, I draw on extensive work by historians of eighteenth-century Britain, as well as recent work by Carruthers (1990, 1996). Historical work on political parties in early eighteenth-century Britain is discussed extensively in Chapter 6 and includes studies by De Krey (1985), Hayton (1984, 2002), Holmes (1967, 1993), Holmes and Speck (1967), Jones (1991, 1997), Plumb (1967), Richards (1972), Sedgwick (1970), Speck (1970, 1977, 1981), and Walcott (1956).

and Tories over state finance was also reflected in Bank of England share prices. These suffered a precipitous crash after a Tory electoral victory in 1710.[11]

While the British government after 1688 gained access to larger quantities of credit at lower rates of interest, no such change took place in France, and the French Crown would continue for the duration of the eighteenth century to face greater difficulty than its British counterpart in borrowing. This has prompted a number of authors to suggest that the French Crown's difficulties were attributable to the failure to adopt British-style institutions. Painstaking work by economic historians has provided evidence consistent with this argument. Throughout the eighteenth century the French monarchy was forced to borrow at significantly higher interest rates than did the British government.[12]

While discussions of state finance in eighteenth-century France have often focused on "missed opportunities" for institutional reform, I argue that even if France had adopted British-style institutions, this would have been unlikely to improve the monarchy's credibility as a borrower. To support this claim I focus on three specific episodes of abortive reform. The first occurred following the death of Louis XIV in 1715. In the midst of a major financial crisis, several senior figures in the French court proposed reinvigorating France's national representative institution, the Estates General, which had not met since 1614. Two authors have recently argued that the failure of the Regent of France to follow England's example at this time represented a missed opportunity for the French monarch to establish credibility for its financial commitments. In doing so, however, Sargent and Velde (1995) do not consider which partisan forces would have been represented within the Estates. Chapter 6 presents evidence from contemporary eighteenth-century observers that the result of calling the Estates General would in fact have been to trigger a default on debt, rather than to avoid one. Evidence on the political divisions in French society during this period supports the conjecture that within the Estates

[11] This conclusion that default risk on government debt was lower under the Whigs represents a difference between my own interpretation of events and the argument about partisan politics presented by Carruthers (1990, 1996). Carruthers emphasizes the link between religion, party, and state finance, but he does not focus on credibility of debt repayment, nor does his work give as much emphasis to the role of political parties as heterogeneous coalitions.

[12] See in particular the study by Velde and Weir (1992), which is described in greater detail in Chapter 4. Hoffman et al. (2000) demonstrate that in spite of the French Crown's lack of credibility as a debtor, private financial markets developed quite rapidly in France during the latter half of the eighteenth century.

General, government creditors would have been poorly represented. As a result, the establishment of representative political institutions may well have been insufficient to solve the French Crown's borrowing problems.

A second episode of failed institutional reform in France involved the national bank created by the Scottish financier John Law in 1716. The Regent who governed France agreed to Law's plan for a public bank that would issue a paper currency and that would aid the monarchy in retiring its stock of debt. The plan was inspired in part by the success of the Bank of England, which had been founded in 1694. Law's bank failed soon after its creation, however, due in large part to an excess issue of bank notes. His project was one of a series of attempts by French rulers during the eighteenth century to borrow indirectly from the public via corporate groups or public banks in order to obtain better access to credit. The failure of these institutional innovations to establish credibility shows that as long as they retain the right to alter agreements unilaterally with officials to whom they have delegated authority, then absolute monarchs and other unconstrained rulers will find it impossible to reduce default risk through delegation.

After the period of financial crises following the death of Louis XIV and the failure of Law's bank, there was a gradual transformation of French public borrowing during the eighteenth century. The monarchy relied increasingly on the sale of bonds purchased by a broad cross-section of the French population. As a result, it would be inaccurate to say that there was no evolution of French financial institutions during this period.[13] No reduction in default risk accompanied these changes, however, as studies have shown that the French government continued to pay a premium on its loans, and in fact there were two further defaults in 1759 and in 1770.

With this background of repeated crises of public finance, the deputies of the new French Constituent Assembly in 1789 (now the chief law-making body in France) faced several options including proposals to default, to raise new taxes, and/or to create a national central bank. In the end, a majority opposed the proposal to create a national bank similar to the Bank of England, but the assembly did vote to create a new currency, the *assignat*, backed by funds generated from the confiscation of church lands. Subsequently, excess issues of *assignats* led to massive price inflation in France. Some authors have seen this episode as another missed opportunity for the French government to adopt the sort of financial institutions that would have improved its access to finance (Sargent and Velde 1995).

[13] See Hoffman et al. (2000).

Chapter 6 presents evidence that supports a different interpretation. The difficulties of the new revolutionary government were due not only to a failure to adopt certain institutional innovations. More fundamentally, they reflected an underlying distribution of political forces in France that was unfavorable to government creditors. Unlike the Glorious Revolution of 1688 in England, the transfer of significant prerogatives to a legislative assembly in France in 1789 was not accompanied by the development of a cohesive majority coalition within which government creditors played a significant role.

3. Theories of Representative Government and Credible Commitment

Theoretical arguments about representative government and commitment focus on the idea that there is less risk of a sudden reversal of policy when decisions are made by a legislature, rather than by an unconstrained executive such as an absolute monarch or a dictator. While this claim is an appealing one, existing work has not fully addressed the question of why those who control representative institutions should necessarily oppose actions such as defaulting on public debts. One possibility may be that devolving power to a legislative assembly will improve credibility if those who represent government creditors constitute a majority within the legislature. On the other hand, one could just as easily imagine a scenario where creditors would be in the minority, and thus a legislative majority would have an incentive to default on debt, because this would allow a reduction in future taxes. This would seem all the more likely given that in many historical contexts ownership of government debt has been concentrated within a narrow segment of the population.[14] Theoretical work in the field of political economy has not considered this issue in detail.[15]

To consider the link between representative government and public debt, then, one needs to allow for the possibility that legislators may represent government creditors, but they may also represent those who pay the taxes to service debt. When a legislature is given decision-making

[14] In their discussion of England after 1688, North and Weingast (1989) do not directly confront this issue, apart from suggesting that the "commercially minded Whig ruling coalition" would have found it anathema to default.

[15] One interesting exception here is an article by Dixit and Londregan (2000) that suggests that those who expect to hold power in the future will be more likely to purchase government debt. Their article, however, does not specifically consider decision making within a legislative assembly.

power over issues of debt and taxation, this should only reduce default risk if the legislative majority takes the interest of government creditors into account when making policy. In some legislatures, government creditors may actually form a majority, in which case the analysis is straightforward. This seems to be a fair description of the Estates of Holland during the sixteenth century, an early example of borrowing by a legislature that is considered in Chapter 3. More frequently, though, government creditors will be in the minority. Within the British Parliament during the eighteenth century, in fact, the overwhelming majority of legislators were landholders, as were their constituents. Given that landowners paid a significant share of the taxes that went to service government debt during this period, this raises the question of why granting more power to Parliament after 1688 should have necessarily reduced the risk of a default. More generally, how could a legislature commit to repaying debts if those who represent government creditors make up only a small percentage of its members?

Constitutional Checks and Balances

One way to refine the argument about political representation and public debt is to suggest that what actually matters for credibility is the number of constitutionally determined veto points in a political system.[16] The greater the number of veto points, the greater the likelihood that those favorable to repaying debt will be able to block attempts to default. This follows the classic defense given by James Madison in *The Federalist* No. 51 for checks and balances in government; oppression of a minority by the majority will be less likely to occur when the legislature is divided into different branches, and when there is a separate executive and legislature

[16] A "veto point" can be defined as a political institution, the holder of which has the power to block a proposed change in policy. Throughout this study when I refer to "veto points" or "veto players" I am referring to what Tsebelis (2002) calls "institutional" veto players, those specified by a country's constitution. Tsebelis distinguishes "institutional" veto players who have veto power because a country's constitution grants them this authority, and "partisan" veto players, who are individual member parties or factions in a ruling coalition. The latter may have veto power because they can threaten to exit a coalition if a bill they find unfavorable is passed. As a result, Tsebelis's "partisan" veto players are similar to the individual groups I consider that combine to form political parties. The key difference is that in Chapter 2, I provide an explicit model of the process of party formation rather than assuming that each group within a party is a veto player. For a comprehensive discussion of veto points and policy making, see Tsebelis (2002).

so that they can balance against each other. Madison himself followed earlier thinkers, and notably Montesquieu, who also saw the separation of powers as a means of protecting minority rights.[17] Following on this idea, we might suggest that establishing representative government will increase credibility to the extent that it involves an increase in the number of veto points in a political system. North and Weingast suggest something close to this in the conclusion to their 1989 article, highlighting the importance of the "balance between Parliament and the monarchy" in Great Britain after 1688 and of the presence of multiple veto points.[18] So, for example, if an absolute monarchy or a dictatorship (where there is only one constitutional veto point) is replaced with a unicameral legislature, then credibility may not be enhanced. If, on the other hand, an absolute monarchy is transformed into a limited monarchy where both king and Parliament have the right to veto policy proposals, then opportunities for commitment may be enhanced by the fact that the Parliament places a check on the authority of the monarch, while the monarch simultaneously places a check on the authority of Parliament.

A key question about constitutional checks and balances is whether the mere existence of institutions such as bicameralism, or a separation of power between legislature and executive, is sufficient to ensure that a given political group – such as government creditors – controls a veto point. Alternatively, one might argue that checks and balances will only ensure commitment if there is some mechanism that makes it virtually certain that a given group will control a specific institution, such as the upper chamber of a legislature. Modern critics of the separation of powers system have long suggested that in practice it is intended to stack the deck of the political game so that certain groups are ensured veto power. Charles Beard (1913) made a famous critique of the U.S. Constitution as an attempt by owners of property to reduce the risk that republican government might be controlled by debtors and small farmers. Subsequent work has pointed out weaknesses in Beard's account, but the underlying question remains. Among the founding fathers in the United States, Alexander Hamilton was the most explicit supporter of giving owners of property a privileged position in government, as illustrated by

[17] *De L'Esprit des Lois*, book XI.

[18] Referring to the constitutional changes introduced after 1688: "Increasing the number of veto players implied that a larger set of constituencies could protect themselves against political assault, thus markedly reducing the circumstances under which opportunistic behavior by the government could take place" (1989: 829).

the following statement made to the Federal Convention of 1787:

> All communities divide themselves into the few and the many. The first are the rich and well born, the other the mass of the people. The voice of the people has been said to be the voice of God: and however generally this maxim has been quoted and believed, it is not true in fact. The people are turbulent and changing; they seldom judge or determine right. Give therefore to the first class a distinct, permanent share in government. They will check the unsteadiness of the second, and as they cannot receive any advantage by a change, they therefore will ever maintain good government.[19]

There have been critiques of Montesquieu's support for the separation of powers that parallel Beard's critique of the U.S. Constitution. Althusser (1959) suggested that Montesquieu's advocacy of the separation of powers was motivated by a desire to ensure that the nobility would retain a privileged position in French society.[20] Montesquieu in *The Spirit of the Laws* does in fact make quite explicit his preference for a bicameral legislature with the upper chamber reserved for the nobility.[21] It is interesting to note in this regard that Montesquieu's idea of the separation of powers as a check on majority rule drew on earlier visions going back to Aristotle of a "mixed constitution" that would provide *guaranteed* representation for each segment of society.[22] In contemporary terms, one reason why federal systems may be particularly effective at protecting minority rights is precisely because they give guaranteed representation to certain groups (based on geographic location). One might make the same observation of the power-sharing arrangements that are sometimes created after civil wars; these too are characterized by guaranteed representation for each party.

Existing formal treatments of the effect of veto points have not asked whether multiple veto points alone are sufficient to ensure credible commitment, or alternatively whether credibility can be achieved only if, in addition to creating multiple veto points, there is some mechanism that

19 Max Farrand, ed., *The Records of the Federal Convention of 1787* (New Haven, 1911), vol. 1, p. 299. On this subject, see also the discussion in Manin (1997).

20 Althusser himself relies heavily on earlier work by Eisenmann (1933).

21 As an illustration of the importance of having different legislative chambers controlled by different social groups, Montesquieu cites the example of the Venetian Republic, which had constitutional checks and balances that meant little in practice, because all veto points were controlled by the same social group. *De L'Esprit des Lois*, book XI, chap. 6.

22 On this point, see the discussion in Raynaud (1993), and Manin's consideration of how modern forms of representative government have retained certain "aristocratic" elements (1997).

ensures that government creditors will control one of these veto points in the future.[23] In practical terms, if one assumes that control of one veto point by government creditors is sufficient to avoid a default, then those deciding whether to invest in government debt will need to develop some expectation about the likelihood that those who oppose default will have veto power. If it is thought that there is a very high probability that owners of public debt will control at least one veto point, then people will be more willing to lend to the government. In other cases, however, outcomes may be sufficiently uncertain that individuals would be dissuaded from purchasing government debt. The legislative bargaining model developed in Chapter 2 of this book considers the effect of multiple veto points under two different scenarios: when the future identity of veto players is known and when future control of veto points is random. In the case where government creditors are certain to have control of a veto point, not surprisingly, there is less risk of opportunistic actions such as default on debt. When future control of veto points is random, however, the effect is much less significant. In other words, constitutional checks and balances may have little effect on credibility unless there is some mechanism that ensures that government creditors are the ones to enjoy veto power.

Beyond uncertainty about future control, a further problem with multiple veto points as a commitment device is that even if government creditors have veto power over policy, this may be insufficient to ensure that public debt is repaid. The reason here is that default frequently occurs in situations where there is no agreement on the alternative (raising taxes and/or cutting spending). A government that aims to repay its debt needs to maintain a tax rate that generates sufficient revenue to meet its debt-servicing obligations. In an economy with a constant rate of growth and no shocks to economic activity, debt servicing could be assured with a stable tax rate. Under these conditions, as long as government creditors controlled one veto point, they could successfully oppose any attempts to change this rate. In practice, governments may need periodically to adjust tax rates and levels of spending to respond to revenue shortfalls.

[23] Tsebelis (2002) fully acknowledges that policies may not be stable even when there are multiple veto points, if veto points are controlled by players with similar preferences, but to my knowledge this implication has not been considered in discussions of multiple veto points and credible commitment. McCarty (2000) has developed general propositions about the effect of veto power on outcomes, but for a bargaining context where preferences are homogeneous. Londregan (2001) has considered the effect of veto points when the future bargaining context is uncertain, but not when future control of veto points is subject to uncertainty.

As a consequence, when revenues are unstable and unpredictable, holding veto power may be insufficient to guarantee full repayment of debt.

The above discussion leads to my first principal argument. *Constitutional measures establishing multiple veto points may reduce default risk, but they are neither a necessary nor a sufficient condition for this outcome*. They are not always necessary, because in some representative assemblies creditor interests may have an outright majority. At the same time checks and balances may be insufficient to ensure debt repayment if there is substantial uncertainty whether government creditors will hold veto power in the future, or if revenues are unstable and unpredictable.

Party Government in a Plural Society

Rather than establishing commitment through constitutional checks and balances, an alternative possibility I consider is that credible commitment in a democracy results from the compromises necessary to form a durable majority in a legislature that represents a diverse society. Even if owners of government debt are a small minority within the legislature, if they participate in a broader majority coalition, bargaining within this coalition may result in "moderate" policies with regard to debt and taxation. If wealth holders anticipate this outcome, they will be more likely to invest in government bonds.

In a frequently cited work, Schattschneider (1942) argued that in societies where there is conflict over multiple issues and where the dividing lines in each conflict do not coincide, then any legislative majority that votes cohesively on multiple issues will need to be held together by compromises and concessions that lead to moderate policies. For Schattschneider, political parties were the primary means in a representative democracy of cementing such compromises. He also suggests that the moderating effect of creating a legislative majority is a clear implication of James Madison's claim in Federalist No. 10 that the diversity of interests in a large republic makes it less likely that any one individual interest will dominate. In Schattschneider's opinion, Madison failed to foresee that if bargaining to construct a legislative majority necessarily leads to compromise, this might actually obviate the need for constitutional checks and balances in order to guard against tyranny of the majority.[24] Schattschneider's argument is also related to the well-known

[24] (1942: 9). See also Hofstadter (1969) on this point. Kernell (2001) and McLean (2001) provide recent discussions of the contradictions between Madison's writings in Federalist No. 10 and Federalist No. 51.

comparative politics literature on "cross-cutting cleavages" that suggests that when social divisions tend to cross-cut each other, policies are likely to be more moderate. As an example, this would be the case in a society divided between "rich" and "poor" as well as Catholic and Protestant, but where not all "rich" are Protestant and not all "poor" are Catholic.[25] It is also related to work in the field of American politics and in the field of international relations.[26]

This vision of political party formation is strikingly close to that presented in a number of recent game-theoretic models of parties. Voting in legislatures presents a collective dilemma in which there are strong incentives for a majority party to form in order to improve on the expected outcome of voting in the absence of parties. One can illustrate this possibility using the example of a three-member legislature facing three proposed bills, each of which would provide a positive payoff to two members while providing a negative payoff to a third member (with the third member differing in each case). If a bill is not approved, players receive zero utility. In this sort of a game, Aldrich (1995) and Schwartz (1989) have emphasized that two players can improve their payoff if they could commit to a party platform of only voting in favor of the one bill that provides them both with a positive payoff. One can extend this model of political party formation and legislative bargaining to a more general setting, using a legislative bargaining model first developed by Baron and Ferejohn (1989).[27] In Chapter 2, I present a game-theoretic model that demonstrates how the politics of public debt can be affected by cross-issue deals and by formation of political parties. In doing so I make sure to take account of the critique made by Krehbiel (1993), who argued that

[25] See Almond (1956), Lipset (1960), and Lipset and Rokkan (1967).

[26] See Aldrich (1995), Key (1964), and Stokes (1999) for accounts from the field of American politics on parties as collections of heterogeneous groups. Work in the field of international relations has also emphasized the implications for credibility of the multi-issue nature of political debate. See Frieden (1994), Martin (1994), and Stasavage and Guillaume (2002).

[27] In doing so I draw on work by Calvert and Fox (2000) and Jackson and Moselle (2002). Alternative models of parties as solutions to collective dilemmas faced by legislators have been developed by Cox and McCubbins (1993) and Snyder and Ting (2000). Roemer (1998, 1999, 2001) constructs a model where the presence of an ideological dimension influences choice of policies on a second, economic dimension. His model differs from that developed here in that, rather than focusing on a political party as a means for actors with different policy preferences in a legislature to commit to a common platform, he models a game where, in an electoral context, party members differ over the extent to which they prefer to win an election even if this implies a compromise on policy.

observed party cohesion may reflect similarities in preferences rather than an independent effect of parties on outcomes.

As with the argument about constitutional checks and balances, my argument about party formation and credibility is based on a number of assumptions that may not always hold. First, if government creditors are in the minority, then party formation can improve credibility only if there are multiple dimensions of social conflict. This is an observable implication of the argument that I consider at length in the following chapters. In societies where all conflicts can be distilled into a single dimension and where preferences across this dimension are highly polarized, a legislative majority is unlikely to be moderate.[28] A second requirement is that there must be means to ensure party cohesion; individual legislators must be able to commit to voting the party platform, even in cases where their short-term interest would be better served by voting otherwise. So, in the case relevant to this book, legislators whose constituents do not own debt must be prepared to support debt repayment in order to gain the support of creditors on other issues. Real-world political parties have evolved a number of mechanisms to ensure cohesion, such as the possibility of sanctioning members who deviate from the party line. I show that party members can benefit from the repeated character of legislative bargaining in order to enforce cooperation.[29] The empirical chapters of this book will investigate the actual mechanisms developed by political parties in eighteenth-century England and France to enforce internal cohesion.

The argument that party formation in a plural society can improve credibility is further complicated by the possibility of electoral volatility. Take the case where a legislature contains a majority party of which government creditors are a part. To the extent they think this party may not retain its majority in future elections, wealth holders will invest in government debt only if they are paid a higher rate of return that includes a default premium. As a result, we should expect trends in default premia on debt to be correlated with anticipations about the partisan composition

[28] This possibility was explicitly recognized by Schattschneider (1942). If there is only one dimension of conflict, but preferences are not highly polarized, then this may also clearly lead to a moderate outcome.

[29] See Calvert and Fox (2000). More generally, my arguments here follow the approach proposed by Calvert (1995a, b) to model a social institution (such as a political party) as an equilibrium outcome of an underlying repeated game. My model is also closely related to Bawn (1999), where players subscribe to an ideology that is defined as the equilibrium strategy profile of a repeated game.

of future legislatures. This is a key observable implication of the theory that I consider in subsequent chapters.

The above discussion leads to my second main argument: *In societies with multiple dimensions of conflict, the process of party formation will reduce default risk provided that government creditors are members of the majority coalition*. Default premia will also be lower to the extent that this coalition is expected to retain power. While this argument implies that party government may lead to credible commitment even in the absence of constitutional checks and balances, these two alternative arguments are not necessarily exclusive. In some cases, credibility may depend on both the process of party formation and the presence of multiple constitutional veto points. This would be the case if government creditors were a small faction of a larger party that controlled one veto point in a political system with multiple veto points.

This argument about party formation may seem surprising, given the implications from social choice theory that policy instability is likely to occur when there are multiple issue dimensions (in the absence of a structure-induced equilibrium of the sort identified by Shepsle 1979). While social choice theory in the context of legislative bargaining assumes that all alternatives are considered simultaneously, in Chapter 2, I adopt the assumption that legislative proposals are considered sequentially, and that if a proposal receives a requisite majority it is implemented for some amount of time. This plausible assumption yields equilibrium outcomes even for cases of multidimensional bargaining where social choice theory would predict that there would be no stable outcome.[30] While sequential choice theories of bargaining do not require institutions such as a committee structure to generate stability, when there are multiple dimensions of policy, creating institutions such as a political party may nonetheless allow legislators to realize significant gains. It is also worth noting here that even under social choice assumptions, it has been recognized that there are strong incentives for individuals to form coalitions, and these coalitions can imply trade-offs across issue dimensions, leading to moderate policies.[31]

One final implication of party government worth considering is that it is a fundamentally democratic means of achieving credibility. Commitment in this case is supported by a majority, rather than depending on according

[30] For a thoughtful discussion of the reasons for preferring either the sequential choice or the social choice assumptions, see Baron (1994).

[31] See Laver and Schofield (1990) and Schofield (1993).

some special status or privileges to owners of government bonds. To the extent that party formation is accompanied by creation of an ideology, then this ideology will also need to focus on ideas that resonate with a majority of the population, and thus it will need to emphasize some project that goes beyond the simple need to please government bond holders.[32]

Bureaucratic Delegation

A third feature of representative democracy that may influence commitment involves granting authority to unelected officials or intermediaries. There are reasons to believe that delegation of management of government debt to an independent agency, like a central bank, can increase credibility of debt repayment. This claim parallels more general arguments about the potential for bureaucratic delegation to change economic policy outcomes.[33] The literature on public finance in eighteenth-century Britain has suggested that the Bank of England (created in 1694) played a critical role in the modernization of British state finance.[34] While the Bank of England did not yet set monetary policy as does a modern central bank, it did arguably fulfill several functions that made it more costly for the British government to default on its debts. For one, because government revenues were increasingly channeled through the bank, some have argued that any decision to default would have quickly led to a halt in payments from the bank to the government.[35] In addition, as the largest lender to government during this period, in the event of a suspension of payments on debt, the bank might have organized a creditor cartel that would refuse to make any future loans to government.[36]

In strong contrast with Great Britain, France during the eighteenth century did not succeed in establishing a national bank. Some have argued that the French government's difficulties in obtaining access to cheap credit during this period were directly linked to this absence of institutional reform. Others have argued that despite its failure to create

[32] This argument would still be consistent with a rational choice approach if one referred to ideology as a rule for sharing benefits between different members of a coalition, as modeled by Bawn (1999).

[33] While bureaucratic delegation is relevant for a large number of areas of economic policy, the best-known example involves delegating monetary policy to an independent central bank. See Cukierman (1992) for an extensive survey.

[34] See, e.g., Broz (1998), North and Weingast (1989), and Root (1994).

[35] This is suggested by North and Weingast, following an earlier argument by Macaulay (1861).

[36] See Weingast (1997b).

a national bank, the French monarchy before 1789 was able to make at least a partial commitment to repaying its debts by borrowing indirectly through corporate bodies and local assemblies.[37] As discussed in Chapters 4 and 6, this indirect borrowing can also be seen as a form of bureaucratic delegation to the extent that it removed debt servicing from day-to-day management by the Crown.

My third principal argument suggests that *bureaucratic delegation will improve credibility only if government creditors already have influence within a representative assembly*. Much theoretical work on delegation and commitment makes the simplifying assumption that once a decision has been made to delegate, it can be reversed only at great cost. More recent work on the politics of delegation has demonstrated that this assumption is not always tenable in practice and that nominally independent government agencies often respond to pressures from partisan political principals. In some political systems, politicians who delegate to nominally independent bureaucrats actually retain substantial room to influence future decisions. One way in which this can occur is through the implicit or explicit threat of revising a bureaucratic agency's statute. Such threats will be more menacing in political systems where power is concentrated in the hands of a single individual, such as a monarch or dictator. In contrast, if government creditors have political influence within a representative assembly, then they may be able to block any attempts to revise an agency's statute.[38] Interestingly, this argument also corresponds closely with eighteenth-century views about the feasibility of establishing a national bank in an authoritarian system. Kaiser (1991) was the first to highlight the fact that contemporary observers in eighteenth-century France thought that a national bank could have little authority in an absolute monarchy. As far as credibility is concerned, then, bureaucratic delegation is at best a complement, but not a substitute, for having representative political institutions.

When Are Representative Institutions Stable?

One possible objection to my arguments about representative institutions and commitment is that they rest on the assumption that actors

[37] Sargent and Velde (1995) have focused on the absence of a national bank in France. Bien (1989), Potter (1997, 2000), Potter and Rosenthal (1997), and Root (1989, 1994) have considered the practice of borrowing through intermediaries.

[38] A point made by several authors, including Epstein and O'Halloran (1999) and McCubbins, Noll, and Weingast (1989); see also Keefer and Stasavage (2001, 2002).

who feel disadvantaged by policy decisions have no option but to respect them. This is not a plausible assumption for eighteenth-century France, nor for Great Britain, nor would it be justified in many countries today. Chapter 7 considers whether the theoretical propositions about representative government developed in Chapter 2 can hold even in a context where parliamentary groups have an "outside option" of resorting to political unrest.[39] Chapter 7's extension to the theoretical model developed in Chapter 2 relies on the basic idea that actors will be more likely to resort to rebellion the more they dislike the policies adopted by majority vote in the legislature. As a result, "moderate" policies are less likely to trigger extraconstitutional action by the minority. Some theorists such as Kelsen (1932) have suggested that the threat that the minority might exercise an outside option can be a force leading to more moderate policies.

Two main conclusions appear from Chapter 7. First, the process of party formation in a plural society can lead to credible commitment even when there is a threat of unrest. Second, the mere threat of the minority exercising an outside option will not necessarily be sufficient to prompt the majority to adopt a more moderate policy. I then argue that even if members of the majority do not have an incentive to compromise in order to reduce the risk of an outside option being used, when there are multiple political cleavages in society, the process of forming a legislative majority may nonetheless lead both to moderate policy choices and to a reduced likelihood of extraconstitutional action. Chapter 7 then considers this possibility using historical evidence from France and Great Britain.

The discussion about the stability of representative institutions also raises a further question: Would credible commitment through political bargaining be possible even outside the framework of democratic institutions? When there are multiple cleavages it might be possible for political bargaining to result in moderate politics even in an autocracy. While this is entirely plausible, it would need to be shown what institutional mechanisms in autocracies allow heterogeneous interests to make commitments over time in the same way that political parties allow diverse groups to commit to a common policy platform in representative democracies.

[39] In previous work, Ellman and Wantchekon (2000) have considered how the existence of this sort of outside option might influence electoral outcomes. Powell (1996, 1999) has considered the effect of outside options (the ability to resort to force) in interstate bargaining.

4. Alternative Routes to Credibility

While different features of representative government might reduce risk of default, there are also alternative forces that could have this same effect. These involve the risk of capital flight, the possibility for government creditors to serve as a lobby, and the effect of restrictions on political participation.[40] While each of these factors might allow commitment, the latter solution achieves this outcome through means that observers today would characterize as being fundamentally undemocratic.

Capital Mobility

When capital is mobile, governments may be more wary of taxing it heavily, so as to avoid a massive flight of funds from their countries. This might be true both with regard to taxes on capital, as well as for default, which can be seen as a one-off tax on holders of government bonds. Studies of globalization have made much of this idea recently, and it can be seen as a more general manifestation of Lindblom's (1982) conception of "the market as prison" or other arguments about the "structural power of capital."[41] The implication for public debt may be that rather than studying commitment problems, one might better study the question of how to reduce the preponderant influence of government creditors on policy choices. In the extreme case, if it were possible for owners of capital to shift their assets costlessly and instantaneously in anticipation of government actions, then credibility problems involving debt and capital taxation would disappear altogether.[42]

There are a number of reasons to believe that in the case of government borrowing, capital mobility is unlikely to serve as a full solution to commitment problems.[43] The most basic reason involves the fact that by lending to a sovereign government, individuals actually cede control over their capital. This means that in the case of default, in the absence

[40] Chapter 2 also considers the issue of reputation as a source of commitment.

[41] On this latter issue, see Przeworski and Wallerstein (1988). Arguing that capital mobility can actually help promote democracy, Bates and Lien (1985) have investigated the implications of capital mobility in the historical context of eighteenth-century France and Great Britain.

[42] This possibility has been formally modeled by Kehoe (1989).

[43] Arguments about the structural power of capital often also overlook the significant costs that capitalists face in reversing other types of investment decisions. In recent years economists have recognized that many investment choices, such as the choice to build a factory in a particular country, are essentially irreversible once made (see Dixit and Pindyck 1993).

of some third-party enforcement, the only way creditors can sanction a government is by refusing to lend in the future and investing their funds elsewhere. This is the key intuition behind a model developed by Bulow and Rogoff (1989), who show that fear of high future borrowing costs may be insufficient to dissuade many governments from defaulting.[44] It is true that a government may suffer from an immediate increase in borrowing costs if it is even feared that default is likely, but this does not alter the basic argument that capital mobility may be insufficient to guarantee commitment to repay debt. Finally, this argument is also supported empirically by the fact that today, in a context where capital is much more mobile than in the eighteenth century, many emerging market countries still pay very high risk premia on their debt issues. If capital mobility could guarantee commitment, one would expect emerging market countries to be able to borrow at interest rates similar to those paid by OECD governments.

Financial Sector Lobbying

Rather than trying to influence policy through representation in a legislature or participation in a political party, an alternative route for government creditors to gain influence on economic policy is to act as a lobby. The advantage of this strategy is that it may necessitate less compromise, and it may allow government creditors to retain their influence regardless of which political party has majority control. For lobbying to be successful, representatives must not be fully accountable to their electors. Otherwise, those who represent the non-debt-holding majority will be obliged to follow the majority's ex post facto preferences to default. Under these circumstances, even if government creditors are in the minority within a legislature, they may nonetheless be assured of repayment of government debt if their lobbying influence is sufficiently strong. Lobbying can involve campaign finance contributions (to legislators who value remaining in office regardless of the policies they choose), patronage, or bribes. In cases where ownership of financial capital is concentrated in a narrow group of wealthy individuals, while ownership of other factors of production is spread more widely, then lobbying will lead to outcomes that are less democratic to the extent that some individuals will have greater lobbying resources than others. While evidence that financial sector interests lobby governments is plentiful, as with the argument about capital mobility,

[44] I discuss this model in greater detail in Chapter 2.

one should not immediately assume that this provides an irresistible force in all countries obligating governments to repay their debt. Otherwise it would be difficult to explain why many governments continue to pay very high risk premia on their debt issues.

Restrictions on Political Participation

Rather than rely on the ability of government creditors to buy influence, in many countries historically, credibility of public debt has been reinforced by fundamentally undemocratic means: restricting the access of certain groups to the political system. This can involve formal restrictions on the suffrage as well as requirements for serving as a representative. While laws of this type controvert what most people today would see as a fundamental democratic principle, it is important to recognize that in the eighteenth century it was commonly seen as being legitimate to restrict political participation in this manner. There was broad support in eighteenth-century Britain for the idea that only those who owned property should be eligible to vote and to hold elected office, and despite controversy, this principle remained a feature of politics in both the early American republic and in France in the years after its revolution (Manin 1997). Restrictions on political participation undoubtedly provided the principal explanation for the weak representation of labor in the British Parliament after 1688 as well as in the French National Assembly after 1789. As a result, this book makes the simplifying assumption that labor was essentially absent from politics.

5. Observable Implications of My Arguments

My goal for the empirical sections of this book is to adopt a methodological approach that is eclectic yet rigorous. The phenomenon I seek to explain is government credibility, defined as the perceived likelihood that a government will honor debt contracts. Chapter 4 presents a number of different measures of credibility for the French and British governments over the course of the eighteenth century. I then examine relevant observable implications for my three arguments concerning constitutional checks and balances, party formation, and bureaucratic delegation. Some observable implications can be tested quantitatively using time-series evidence. More frequently, I rely on historical evidence.

My first argument suggests that constitutional checks and balances can improve credibility, but they are neither a necessary nor a sufficient condition for doing so. This is obviously quite a general statement, and so, based on available evidence from France and Great Britain, I restrict myself to one main implication of the theory: Credibility may not be assured even when there are multiple veto points. For Great Britain I consider to what extent there was substantial variation in the perceived likelihood of a default after 1688. As argued above, the existence of significant volatility in interest rates on government debt after the Glorious Revolution is a potential indication that the constitutional changes of 1688 were not sufficient to establish credibility for U.K. government borrowing. For France, the evidence is necessarily more speculative for the period before 1789. Existing work has assumed that the Estates General, if convened, would have taken actions in order to repay debts. I consider whether there is evidence to support an alternative interpretation; given the balance of political forces in France at the time, a default would have occurred even if the Estates had been called. I perform a similar exercise for the case of the French Constituent Assembly in 1789.

My second argument suggests that in countries where there are multiple dimensions of political conflict, the process of forming a majority will lead to commitment, provided that government creditors are members of the coalition. One observable implication here is that trends in partisan control should be correlated with trends in credibility, and this can be tested with time-series evidence on partisan control of government, interest rates on government debt, and prices for assets such as Bank of England stock. One should expect to observe that government creditors were members of the party that tended to be associated with low default premia when it was in power. I also examine to what extent contemporary observers saw changes in the partisan control of government as significant for financial markets. There are further observable implications of this second argument. If credibility was high we should expect to see that multiple dimensions of conflict existed, and that members of coalitions had the necessary mechanisms to enforce agreements over time. Both of these implications can be evaluated using historical evidence on the functioning of political parties in the British Parliament after 1688. I do the same for the French Constituent Assembly after 1789.

My third argument involves the claim that bureaucratic delegation will only improve credibility in cases where government creditors already have political veto power. This issue can be addressed by comparing British and French experiences in this area. Both the British and French governments made attempts during the course of the eighteenth century to improve their access to credit by creating national banks or by borrowing through intermediaries, yet only in the British case did government creditors actually enjoy significant power within a representative assembly. In Britain the principal innovation in this area involved the creation of the Bank of England in 1694 and subsequent decisions to increase the role that it played in government finance. In France monarchs also attempted to use bureaucratic institutions to improve their access to credit. These involved the creation of John Law's bank (1716–20) and a number of initiatives to borrow through bureaucratic intermediaries. If the evidence here is consistent with the argument, then one would expect to observe that the failure of bureaucratic institutions to improve credibility in France was directly attributable to the monarchy's penchant for unilaterally revising contracts with agents of the Crown. In Great Britain the argument would imply that the performance of the Bank of England was closely linked to the political fortunes of the Whig coalition in Parliament that continually supported the bank. In the absence of Whig support, my argument would imply that the bank would have been subject to the same sort of interference as occurred with bureaucratic arrangements in France.

6. Plan of the Book

Chapter 2 of this book presents the credibility problem in government borrowing in greater detail, and it builds a game-theoretic model that I use to support my three arguments about checks and balances, political parties, and bureaucratic delegation. Chapter 3 then presents historical background material by reviewing the development of public borrowing in early modern Europe. This includes a discussion of the emergence of modern institutions for public borrowing in the Netherlands during the sixteenth century, followed by England after 1688. Chapter 4 reviews the experience of public borrowing in Great Britain and in France between 1688 and 1789, relying on data covering rates of interest on government loans and episodes of default in order to measure trends in credibility. The goal here is to make comparisons both between the two countries and over time within each country. Chapters 5 and 6 continue the investigation by examining to what extent observed trends in credibility can be accounted for by partisan politics and by the structure of political institutions. Chapter 7 then considers the stability of representative institutions. Chapter 8 presents a summary and conclusion.