Why Did Public Debt Originate in Europe?¹

David Stasavage
New York University
david.stasavage@nyu.edu
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Abstract

Medieval Europe was in many ways an economic backwater. Why then did such a region give birth to the distinctly modern innovation of public debt? In this short piece I consider what political, military, and institutional factors distinguished Europe from other world regions. I then suggest how these factors influenced the development of public credit.
Introduction

Today we take it as a given that to function effectively, a government needs to have the ability to borrow, and to borrow over long time horizons. Yet in the long history of fiscal states, public borrowing is a relatively recent innovation. This is a puzzle demanding explanation. Perhaps even more puzzling is the fact that a generalized form of long-term public borrowing first emerged in Medieval Europe, an economic backwater in many respects. In this short piece I will suggest why public debt first originated in Europe and what this tells us more generally about the political conditions necessary for a state to gain access to long-term credit. The initial development of public credit in Europe depended heavily on a particular political institution – a representative assembly that monitors and intervenes in the area of state finance. However, the emergence of representative political institutions itself depended on a deeper causal factor – the long-standing trend in Europe for certain cities to be able to govern themselves autonomously. In an era of high travel and transport costs it was initially only possible to sustain the institutions necessary for public credit in a small polity, such as an autonomous city. It was only over time that rulers in Europe’s larger territorial states would learn to establish access to credit, precisely by working through their cities.

In what follows I will develop my argument in the following sequence of steps. Beginning with an abstract consideration of the factors that condition the development of public credit, I will then chart the evolution of public borrowing in Europe over a period of five and a half centuries between 1250 and the French Revolution. This will then be followed by an exploration of why city-states were the pioneers with regard to credit, why they eventually died out, and finally how territorial rulers eventually learned to harness the power of their cities. The account here derives from material in my recent book (Stasavage, 2011) as well as two recent papers (Stasavage, 2010, 2014).
What Conditioned the Development of Public Credit?

If we are to ask why public credit first emerged in Europe, then it makes sense to first think in abstract terms about the factors necessary for a government to be able to borrow. There were four necessary pre-conditions for public credit to emerge.

A first and most obvious condition is that a government must have a monetary source of revenue that can be used to repay any debt that is contracted. Some of the states considered in this volume had fiscal systems, and sometimes even advanced ones, that were not monetary in form and therefore this condition was not satisfied.\footnote{For an example, see Terence d’Altroy’s contribution for this volume on the Inka fiscal regime.} In Europe, however, even in the early medieval era where state capacity was weak at best, polities had access to monetary forms of revenue.

A second condition for public credit to emerge, or more exactly to be desirable, is that a state must be faced with expenditure shocks. For modern states such expenditure shocks can come in a number of different forms involving the need to respond to economic crisis, sudden needs for infrastructure, or even those arising from natural disasters. For the polities considered in this volume, in which modern forms of social protection were absent, wartime needs constituted the almost exclusive form of expenditure shock. Once we take this into account, we can understand why a full fledged public debt did not develop in a place like Tokugawa Japan. With the problem of civil violence solved and external threats kept at a safe distance, there were no wartime expenditure shocks and therefore there was no need to establish a highly developed system of public credit.\footnote{For further elaboration see Phillip Brown’s paper for this volume on the Tokugawa fiscal regime.} The situation in Europe could not have been more different. Warfare was prevalent from a very early date and only increased in intensity as time progressed. It is a matter of debate whether war was the prime causal factor that drove European state development. What is certain though is that were it not for the demands of war, European polities would have faced far fewer needs to borrow.
Even if a polity is faced with a sudden expenditure shock, there remains an alternative to borrowing if it is possible to suddenly increase revenue in dramatic fashion. The problem is that doing this with monetary revenue involves very significant political and economic costs. However, it is also possible for polities to levy a "tax in kind" for war purposes. The most common tax of this sort has been military conscription. A number of the polities in this volume had effective systems of military conscription that avoided the need to offer soldiers monetary compensation for their services and which therefore reduced the need for developing a system of public credit. Once again, the situation in Europe could not have been more different. For European territorial states a system of conscription did initially exist in the form of feudal service. However, this system evolved towards one of monetary compensation of paid mercenaries. This development took place for the simple reason that those bound only by feudal obligation often failed to show up when summoned. In the autonomous cities of Europe a different set of circumstances prevailed, though the end outcome was the same. Initially cities defended themselves and waged war by drafting citizen militias. Over time, however, it became apparent that a much more efficient strategy was to hire mercenaries. In both the autonomous cities and territorial states then, the move away from waging war by obliging citizens or subjects to serve for free made it necessary to raise money, and often on short notice.

The above three conditions helped dictate why it was necessary and useful for European polities to have access to public credit. The presence of monetary revenues also explains why European rulers could repay debts. However, there is of course a fourth critical condition necessary for a system of public credit to emerge; there must be some expectation that rulers will want to repay their debts. Given the immediate financial advantages of defaulting, there has to be some constraint on a ruler’s incentive to exercise this option. One possibility is the fear for one’s reputation. Failure to prioritize debt servicing may make it difficult or impossible for a ruler to obtain credit from lenders in the future. While reputational constraints can be binding, it is also well known that in times of crisis, with
pressing and immediate needs, the risk of future sanctions may be insufficient to constrain a ruler.

Given the potential inadequacy of reputation as a constraint, a large body of work suggests that access to credit will depend above all on having a good set of institutions that offer creditors the assurance that debts will be repaid. In the context of medieval and early modern Europe it has been suggested that a representative assembly could play this role, constraining a ruler to repay debt when they might otherwise have preferred not to do so.\textsuperscript{3} There are two important questions about this however. First, why would a representative assembly itself prefer debt servicing to default?\textsuperscript{4} Second, if representative assemblies served this useful function, then why didn’t they emerge in all European polities?

The other attractive feature of the argument emphasizing representative assemblies is that both long-term credit and political representation were innovations that saw their most extensive early development in Europe. Along with the other factors listed above, the relative absence of strong representative institutions in other world regions may provide further reason why European polities were the first to develop an extensive system of public credit. With this said, even without representative assemblies as they existed in Europe, we should not ignore the possibility for rulers in other regions to establish alternative institutional forms that might have helped sustain a system of public credit.

\textbf{The Rise of European Public Credit in One Picture}

As part of the research for my recently published book, \textit{States of Credit}, I collected a new data set that charts the development of public credit in Europe from the thirteenth through the eighteenth centuries. This expands on the prior important work of Stephan Epstein for his book \textit{Freedom and Growth}. For a set of 31 European polities my data set pools together observations from many disparate sources that report the year in which a

\textsuperscript{3}This is an idea of course most closely associated with the seminal piece by North and Weingast (1989).
\textsuperscript{4}This is a point emphasized and considered in Stasavage (2003).
Figure 1: Nominal Interest Rates on Long Term Public Debt (sample of 31 European polities)
polity contracted a long-term debt and the nominal interest rate on this debt. In the vast majority of cases these were actually life or perpetual annuities, as opposed to true debts. While the Catholic Church in Europe deemed that charging interest on debt was usury, it did not make the same judgment with regard to annuities for which a regular payment was made but the “borrower” in effect never returned the principal.

Figure 1 presents the nominal interest on debt for each of the observations in the data set, distinguishing between two types of polities – autonomous cities and territorial states. This single picture is in fact very instructive about the evolution of public credit in Europe over this period of roughly five centuries. There is an obvious and immediate distinction here between the fortunes of city-states and territorial states. If city-states began issuing long term debt as early as the thirteenth century, at the height of the medieval commercial revolution, the first territorial states did not take this step until more than two centuries later. This requires an explanation. Likewise, during periods when city-states and territorial states both issued debt, we can see clearly from the figure that city-states were, on average, able to do so on more favorable terms. This too requires an explanation.

One possible explanation for the above pattern is that rulers of territorial states simply had no need or no desire to borrow prior to the beginning of the sixteenth century. This is implausible given that the demands of war placed financial strains on monarchs from a much earlier date. Another possibility is that European monarchs preferred to contract short-term loans, such as those taken out by Edward III with various Italian bankers, rather than incur long-term obligations. The problem with this argument is that these short-term loans almost invariably came at very high rates of interest that reflected the risk involved.

Given the weakness of these the above explanations, the most logical conclusion is that rulers of large territorial states would have benefitted from establishing long terms loans at an earlier date, but they found difficulty gaining access to credit. The key question then
is what were the underlying factors that differentiated territorial states from city-states in this regard?

**What Was the Secret of Europe’s City-States?**

At first glance we might think that autonomous cities had an advantage in terms of access to credit because of their economic structure. These were economic dynamos involving long distance commerce and proto industry (i.e. textiles), and it is only logical that there would have been an available pool of lenders in such places. The problem with this argument is that large territorial states also had numerous, vibrant commercial cities under their rule that could have supplied a pool of capital. This raises the possibility that there was something particular about governance in city-states, and this may explain why they were so successful in obtaining access to credit.

In *States of Credit* I report the results of an econometric analysis in which it was asked both what factors were associated with early access to credit, and what factors were associated with access to credit at lower cost. The results of this analysis present a puzzle. On the one hand we see clear evidence that the presence of a representative assembly with strong financial prerogatives, and that met frequently, was associated with better access to credit. However, once we introduce a dummy variable into the analysis to distinguish between city-states and territorial states we see, not surprisingly, that city-states had better access to credit, but also that the representative institutions variables lose any statistical significance. Does this mean that representative institutions simply did not matter? No, what it suggests instead is that an intensive form of political representation did favor access to credit, but this type of political representation existed almost exclusively in the autonomous cities of Europe. Why would this be the case? In what follows I will suggest that on one level it was the intensive form of political representation within city-states that was the key to their success in gaining access to credit. However, this form of
political representation was itself dependent on two underlying factors: compact geography and merchant dominance.

**Compact Geography and Political Representation**

Political representation is often presented as a necessary adaptation to a problem of scale. If the population of a polity is too numerous for direct democracy, then choose a set of representatives. If the population of a polity is spread too widely across the terrain, then adopt the same solution. However, if representation is an adaptation to problems of scale, ultimately it should be recognized that representative systems are themselves also constrained by scale. In medieval and early modern Europe geographic scale posed a major constraint for any and all who sought to maintain an intensive form of political representation within their polity. This fact has been cogently argued in a series of publications by Wim Blockmans (1978, 1998). In an era of high transport and communications costs in large polities it was costly to send representatives to an assembly. It was also costly for constituents to then monitor the actions of representatives once they were in place. Under these conditions autonomous cities had an obvious advantage when compared with their larger territorial state neighbors. In a recent article I provide econometric support for the argument first made by Wim Blockmans. Based on an original data set on functions and prerogatives of representative assemblies in a broad set of European states, I find very strong evidence of a negative correlation between geographic scale and the intensity of political representation. Moreover, this negative correlation continues to hold even when we exclude the set of city-states from the sample. This rules out the possibility of a spurious correlation between geography and representation that was driven by some other feature of city-states that led them to have an intensive form of political representation.
The "Virtues" of Merchant Oligarchy

I suggested above that a representative assembly might constrain a government or ruler to service debt, but it is certainly also plausible that a representative assembly might express exactly the opposite preference. For example, on several occasions when it met, the members of France’s Estates General expressed a desire to see the monarchy defer or default on debt payments so as to avoid what would otherwise be a significant increase in taxes. Why did the representative assemblies of city-states not follow this same course of action? The fundamental reason was that in most cases merchants dominated the membership of these assemblies and of the executive committees that most often ran them. These were the same individuals who had liquid capital and who purchased public debt. In sharp contrast, those inhabitants who paid the indirect taxes to service public debts most often had little lasting political influence. To see the importance of merchant oligarchy for credit, we can consider what happened when a mercantile oligarchy lost power, such as in Siena after 1355. When this took place public credit suffered.

The pattern of merchant dominance in autonomous cities was itself dependent on another underlying factor that was specific, if not unique, to Europe. As documented by Wickham (2007) from an early date a pattern was established for most regions of Europe in which merchants were located in cities and the members of the landed nobility resided in the countryside. This was a distinctive pattern that set the stage for merchants to become dominant in the governance of cities in a way that was not always or often replicated in other world regions.

How City-States Became Obsolete

If urban autonomy was crucial in leading to the development of public credit in Europe, there nonetheless seems to be a curious twist to the story. As a number of authors have observed and attempted to explain, over the long run it was the territorial states, and
not the city-states, of Europe that became predominant. For some, such as Tilly (1992) and Bean (1973), this had to do with changing military technology and economies of scale in war fighting. In other words city-states died out because they couldn’t raise the large armies nor afford new and expensive types of fortification or weaponry. However, in States of Credit I argue that city-states maintained a financial advantage over their territorial state neighbors for longer than is often realized, and this allowed a number of them to serve well after the year 1500AD, a date that is sometimes offered as the beginning of the era of the territorial state in Europe. So why then did city-states not retain their preeminence?

The secret of the financial success of city-states was that the same merchants who provided the funds for public credit also controlled all the levers of political power, ensuring adequate servicing of debt. Merchant oligarchy was therefore good for access to credit. The problem of merchant oligarchy in city-states was that if it had unambiguously good implications for credit, the implications of this political system for long run growth were considerably more mixed. One of the features of an oligarchy in which oligarchs are themselves engaged in economic activities is that it can provide very secure property rights for those on the inside of the political system. This can therefore be favorable to economic growth if those on the inside, so to speak, have access to the most advanced production technologies. However, a serious problem can then emerge if in order to sustain the process of economic growth it is necessary to have a continuous inflow of new entrepreneurs bringing new techniques. As long as an oligarchy establishes barriers to entry into markets, and this was certainly the case for urban oligarchies in medieval and early modern Europe, then this poses an obvious problem for sustaining economic performance over the long run.

In a recent paper (Stasavage, 2014) I provide evidence consistent with the above theoretical mechanism; an oligarchic form of rule was good for city-state economic performance in the short term but bad for the long term. Using population growth as a proxy for economic growth, I show econometrically that during the first century in which they were
politically independent, autonomous cities in Europe on average grew substantially more quickly than non-autonomous cities. However, after roughly a century of independence, autonomous cities stagnated relative to those cities subject to princely domination. This robust finding points to a new explanation for why Europe’s city-states eventually became marginalized despite their excellent access to credit. The same political institutions that gave them access to credit also condemned them over time to economic obsolescence.

How Territorial Rulers Used the Credit of Their Cities

The initial development of public credit in Europe was highly dependent on the existence of a particular form of polity, an autonomous city. This same pattern of urban autonomy would continue to influence the development of public credit when the territorial monarchies of Europe first established systems of long-term borrowing. Just as the autonomous cities of Europe issued annuities for which payment was backed by future municipal revenues, subject cities within territorial monarchies also often issued similar financial instruments. Initially territorial rulers used this as an ad hoc finance mechanism for their own purposes. Subsequently, territorial rulers began to do this more systematically resulting in the creation of the first true national debts. In France this practice was initiated with the creation of royal rentes sur l’hôtel de ville in 1522. Through this system annuities were issued in the king’s name but were managed by the municipality of Paris, and the rentes were paid using revenue streams monitored by that same body, or at least initially so. In Castile a different system emerged. The monarchy had a representative assembly that was dominated by eighteen towns. Each of these towns issued annuities that were then used for royal finance. The lesson of the French and Spanish experiences is clear. Lacking the state capacity to have a true unified system of national debt, complete with the institutions to sustain this, large monarchies found that the optimal solution was to piggyback off of the forms of governance that had been established by cities within
their territories. Though the case of England after 1688 is often, and rightly, hailed as a very successful system of public credit, England was actually something of an exception among European territorial states. Compared to other states in this category, it’s core territory was quite small. A feature that went hand in hand with this is that England’s fiscal system was centralized from a very early date, in fact from the Norman conquest.

**Conclusion**

In this contribution I have attempted to explore the reasons why a true system of public credit first emerged in Europe during an era where, paradoxically, the economic and administrative strength of European polities was considerably weaker than that in many other world regions. The combination of a monetary economy, sudden expenditure demands due to war, and the lack of a system for mobilizing manpower without payments made it very useful for rulers of European polities to have access to credit. However, access to credit also depended on a critical fourth condition, an expectation on the part of creditors that debts would actually be repaid. It is now well established that one method for establishing this expectation is to adopt a good set of institutions for managing debt. Yet this raises a paradox because medieval Europe was a place in which institutions of governance and state capacity were undoubtedly weak. Drawing on my work published elsewhere, I have argued that the answer to this puzzle can be providing by investigating the autonomous city phenomenon in Europe. Europe’s autonomous cities were islands of state capacity that had the institutions and political composition necessary for the development of a system of public credit. Ultimately, however, the same institutions that gave city-states a financial advantage put them at a long run disadvantage and ensured they would become obsolete.
References


