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### Between shared and conflicting interests

*The political economy of the markets for public debt in the Dutch Republic, 1600-1795*

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## English Summary

### **Between shared and conflicting interests. The political economy of markets for public debt in the Dutch Republic, 1600-1795**

Our knowledge of provincial capital markets is remarkably limited considering the much-praised Dutch financial prowess during its Golden Age. Insofar as this has been studied, it concentrated on the province of Holland and its public finance. The limited number of observations of market prices for other provincial bonds displayed notable differences, as late as the mid- and late eighteenth century. Therefore, this thesis analyses the causes of and explanations for these eighteenth-century price differences for provincial public debt within the Dutch Republic, by comparatively studying the developments in Zeeland, Friesland and Groningen, with Holland serving as point of reference.

There are three proximate factors that explain interest rate variations; (1) supply and demand, (2) risk and (3) transaction costs. The first factor reflects a base rate that a risk-free asset would yield. The second factor of additional risk increases interest rates through the risk premium. The third factor relates to additional costs to execute borrowing transactions being reflected in the transaction costs. In this study, these are predominantly interpreted as hindrances to market integration.

These expressions of interest variations reflect underlying causes for differences in the risk premium and market integration. State formation forms a central element in many of the most prominent explanations for the manifestations of the interest rate variation between polities. This concerns the interest rate differentials for both public and private debt. Chapter 1, the introduction, lists and discusses nine of these ultimate causes that figure prominently in the current historiography: four institutional, two technical and three geographical explanations.

The first and most important concept in this regard is that of the financial revolution. It forms the point of reference for the discussion of the ultimate causes. The concept of the financial revolution is based on the enormous increase in English public debt since the late seventeenth century. It focussed on the switch from risky unfunded short-term debt to more secure and funded long-term debt. This was the result of parliamentary involvement in public finance, and good relations between the Treasury and the City of London. Consequently, the British state borrowed more cheaply, which was reflected in low interest rates. Tracy recoinced Dickson's thesis for the Dutch province of Holland in the sixteenth century. He emphasizes the more political innovations of collective liability and funding that lowered risk, to explain similar

manifestations of lower interest rates and a growing public debt in the Dutch Financial Revolution.

Building on this concept, the New Institutional Economics school of thought popularized the concept of 'credible commitment'. This singles-out the representatives' assembly's control over public finance as the necessary condition to protect property rights in general prevent sovereign default in particular. This consequently results in economic growth and a sound functioning of capital markets. The credible commitment thesis has become one of the most debated topics in economic history, having been criticized and elaborated upon from many perspectives.

One such sharpened reinterpretation of the credible commitment thesis is the third institutional explanation, by Stasavage. He suggests an alternative "distributive" interpretation to the "impartial" interpretation of the credible commitment thesis – in that a representative assembly is both a necessary and sufficient condition for credible commitment to debt. The "distributive" interpretation holds that control over politics by the state's creditors assures the upholding of the debt compared to the power of the tax payers. This, he suggests, better explains a lower default risk.

The fourth institutional explanation concerns the concept of citizenship. The suggestion is that urban citizenship fostered trust between the state and its inhabitants. In this view, the high degree of trust caused high taxes and low interest rates; the Dutch Republic benefitted from this mechanism because it retained this city-state advantage through its federal multi-stage form of representation.

The high taxes form an individual fifth (technical) explanation. It challenges the idea that borrowing was the essence of the financial revolution, by focussing on tax increases. The rise in public monitoring of the state's increasing income created trust among investors, who could thus be assured of a sufficient revenue stream to pay for the debt service. The 'classical' Financial Revolution in borrowing was therefore, at best, conditional on the 'tax revolution'.

In turn, in a sixth (technical) explanation, Gelderblom and Jonker indicate that the availability of a sufficient pool of capital formed a necessary condition for borrowing and a growing economy to simultaneously expand the tax base. This intertwined development was crucial to increase the surplus money that investors could lend to the state. They do not contest the necessity of a state's credible commitment, nor that of efficient fiscal institutions, but argue that this is not sufficient to lower interest rates.

In the seventh (geographical) explanation, the aforesaid Stasavage added a geographical factor to the credible commitment thesis; he argues that geographically confined city-states ruled by merchant elites borrowed most effectively at low costs. Intensive monitoring of the state's behaviour was possible at low monitoring costs – a

form of transaction costs – because of the short physical distance, with subsequent low traveling costs for creditors to the state.

This interpretation builds on an earlier study by Epstein, here introduced as an eighth (geographical) explanation, suggesting that a polity's internal fragmentation increased transaction costs and consequently interest rates. The subsequent economic friction reduced market integration, whereas centralised states levied taxes more efficiently and faced less coordination problems. Decentralized states consequently suffered from lower tax yields and market frictions that increased interest rates. Regarding fiscal fragmentation, the idea has taken root that the Dutch republic suffered from inadequate and uneven taxation because the other provinces free-rode on Holland's disproportionate share in the common expenses. This idea has been labelled as the concept of "institutional impotence".

Finally, in a recent study, Chiosi highlighted another aspect of Epstein's institutional fragmentation, namely legal fragmentation, which forms a ninth (geographical) explanation. He argues that legal fragmentation increases transaction costs because it hampered market integration. Institutional borders form barriers to capital flows that prevent supply and demand across jurisdictions. This is a relevant explanation with which to confront De Vries' and Van der Woude's argument that the Republic's economy formed a single entity despite its internal provincial borders.

In the application of the theoretical explanations above, the thesis concentrates on three categories of the Dutch Republic's institutional framework: (1) the Republic's fiscal fragmentation as manifestation of its federal state formation process, (2) the functioning of the capital markets and (3) the legal system.

The first category examines the fixed apportionment system that distributed the fiscal burden throughout the provinces, in relation to the debt at the Republic's dissolution, and tax pressure. The second one explores the state of the art for Dutch markets for public and private debts; the limited evidence shows contradictory results in association with the integration of the capital markets. The third pays attention to the Dutch legal system and what this means for the options of contract enforcement. It notices that hardly any research exists concerning itself with the period after the late sixteenth century, into which strangely neglected topic this thesis offers first insights.

The final part of Chapter 1 explains the research method and sources used to encounter the debates about the relationship between state formation, economic development and public finance. The method is a long-term comparison of numerous factors that determined the political economy of the Dutch Republic, between three case studies and using Holland as a shadow reference case. The subsequent building up of each of the three case studies follows a similar structure. Each chapter starts by providing an overview of the institutional characteristics of each of the provinces,

Zeeland, Friesland and Groningen. Secondly, the chapters analyse the economic developments as they ultimately formed the tax base for each province. Thirdly, it assesses the private capital market, to assess to what extent there was a local provincial capital supply available. Fourthly, after charting the potential sources of public revenue and borrowing, it analyses the state's public finance. For each case, it compares income and expenditure and, within a more in-depth analysis of each, assesses the tax pressure with corrections for welfare differences. Finally, each case scrutinises the public debt management, considering the specific local contexts of each of the cases, often referencing the situation in Holland and in the other cases.

Consequently, this study places state formation at the centre of a political economy story by uncovering the consequences of the institutional fragmentation by distinguishing between fiscal and legal fragmentation, and outlines the limits of the economic integrations within the Dutch Republic; it nuances the widely-held belief about the flawlessness of Dutch public credit during the early-modern period; and it adds to debates about the relationship between public finance and economic growth.

The essence of Chapter 2, the case of the province of Zeeland, is that the capital surplus enabled the Provincial States to cover the fiscal deficits in the provincial budgets. Both the fiscal problems and the solution must be understood in the context of the complexity of the Dutch Republic's political economy. The economic growth slowed in the second half of the seventeenth century, causing the public revenue from the excises to fall short to cover the expenses that largely originated from a high share in the Republic's apportionment system. To make ends meet, the States of Zeeland attempted to both reduce expenditure and increase its income. To begin with the former, it strove for a reduction in the share to the Union and decrease the interest payments by obtaining loans with low coupons, to which end it constantly issued new loans and reimbursed existing ones. To increase income, the States of Zeeland increasingly tapped into the resource of private wealth, by increasing direct taxes and increased borrowing. From the turn of the eighteenth century, taxation in Zeeland exceeded that in Holland largely due to higher direct taxes, most of which were wealth taxes. The latter option of investing in the public debt became more attractive for investors, because the economic slowdown eroded the number of lucrative private investments. On the other hand, the States of Zeeland benefitted in the form of relatively cheap borrowing conditions. So long as the economy slackened, and the province maintained its reputation by neatly paying the interest, this posed no problem, because the creditors were only too happy to accept a prolongation so long as investment opportunities were meagre. This debt management policy worked well until the War of the Austrian Succession: it decreased the debt service considerably, while the high per capita tax revenues produced a fiscal surplus by the outbreak of the war.

The War of the Austrian Succession formed a watershed in Zeeland's fiscal history. Zeeland's war efforts plunged the province into an abyss of insurmountable deficits. Until the 1770s, it managed to live up to its financial obligations. Meanwhile, Zeeland's constant interest payments added to the pool of money available within the province, which might have contributed to a lower coupon as well. From the late 1770s, the province encountered difficulties in paying its creditors neatly.

The urgency of reducing the expenditure consequently increased. The province remained nevertheless committed to its debt service, which left a reduction in the Generality's expenses as the one other effective means to balance the budget. The recommendation by the Generality-committee in 1769 to reduce Zeeland's share was only accepted by the other provinces in 1792. The Dutch Republic's other constituent member provinces felt little urge to rescue a troubled province. Claims of financial distress were thus regarded with suspicion, because a discount for one province implied an increasing fiscal burden for the others. It was only long and intensive lobbying, including examination of the total tax schemes of the other provinces, which led to a revision of the fixed scheme of 1616.

In terms of financial development Zeeland was expected to be the most advanced province, since of all the provinces it more closely resembled Holland in other respects. It had a high degree of urbanisation, it had shared in the sixteenth-century economic boom, it had a high degree of urbanisation, commercial agriculture, international commodity trade, an Exchange Bank and offices of the Chartered Companies VOC and WIC. Institutionally, it had a history of state formation at the provincial level, including provincial public debts, whereas the cities dominated the provincial assembly, the States of Zeeland. Therefore, Zeeland appears to have met the preconditions associated with the Financial Revolution thesis; the massive increase in its public debt was accompanied by relatively low interest rates that resulted in a long-term debt to which it was credibly committed. Notwithstanding its early resemblance to Holland, including an ostensible financial revolution in its public finance, this did not place Zeeland on a trajectory of sustained economic growth, and thus this case provides ample reasons to reconsider the value of the financial revolution thesis for economic growth.

Concerning the underlying factors in interest rate variation, the case of Zeeland shows that an increase in borrowing, as associated with a Financial Revolution, was slower there than in Holland. Zeeland's fiscal policy was characterised by a high per capita tax burden, from the start of the Revolt, indicating that it experienced a tax revolution. Only when the high taxes fell short to cover the expenses, did borrowing become important. Due to the high degree of local issuance, Zeeland remained committed to its debt; not because of citizenship, but out of enlightened self-interest. With the option of restructuring consequently thwarted, it depended on the federal level

for a cost reduction. The fiscal fragmentation hampered an immediate remedy to the deterioration of Zeeland's public finance. Consequently, the case of Zeeland supports Stasavage's distributive interpretation of the credible commitment thesis as well as underlining Gelderblom and Jonker's emphasis of the effects of a large local capital surplus.

The case of Friesland, in Chapter 3, highlights the development of the Dutch Republic's fragmentation and subsequent effects on its political economy. Friesland proved obstinate in implementing the adequate taxation to support the Union's expenses to sustain the Republic's warfare. This resulted in repeated conflicts between the States-General and the States of Friesland, throughout the Eighty Years' War. The root of the Frisian reluctance was threefold. Firstly, decisions about fiscal matters required unanimity amongst the States' constituent members. Second, the urban representative feared to be overburdened by the excises compared to the countryside and thwarted the implementation. Third, the annual election of the representatives made them reluctant to make unpopular decisions, such as tax increases. If the Diet nevertheless agreed upon fiscal reforms, the next year's newly elects reversed their predecessors' decisions or at least halted the execution thereof. Only when the Generality enforced fiscal reforms at gunpoint in 1637, did the Frisian public revenues increase and its debt was reduced. Insofar as it experienced a tax revolution, this was superimposed and short-lived. As soon as peace was concluded in 1648, the Frisian Diet reduced the tax rates and kept tax pressure relatively low. When the Generality's means of coercion were curbed after 1650, Friesland fell back on the old behaviour of inadequate payments, often accompanied with the argument that its contribution was too excessive. Therefore, the erosion of the federal powers added to the effects of the Republic's fiscal fragmentation.

As well as the Generality, the debtholders in Holland also suffered from Friesland's inadequate payments in the 1630s and after 1711. The distinction between internal Friesland debt and external non-Friesland debt demonstrates that the political borders caused economic frictions, especially regarding contract enforcement options. This friction was further evident from persistence of interest rate differentials from the private capital market. Incidental references to the invocation of the Law of Reprisal further add to the impression of a fragmented economy along the Republic's provincial borders, due to its legal fragmentation. What is more, after 1711, Friesland's dual-tier debt allowed the prohibition of repatriation of its bonds sold in Holland, where Frisian bonds circulated as legal tender and could be used to pay taxes.

Consequently, the case of Friesland provides empirical support to Stasavage's distributive interpretation of the credible commitment thesis. On the one hand, it shows the effect of the landed elite's control over taxation: the income from the land taxes did not increase when the agricultural sector of the economy expanded. In other words,

these tax payers managed to shift the burden of taxation to the urban economy. On the other hand, the case of Friesland highlights the importance of creditors' control over the public finances to assure regular interest payments. In this case, about half of the debtholders lived outside the province and consequently exercised no control over its public finance.

The political pressure from the States of Holland yielded a partial success for the creditors. From 1720, the States of Friesland paid the interest with a 4- or 5-year time lag, which the internal Friesland debtholders did not suffer from. The protests by the States of Holland produced the desired result: the interest on all bonds was lowered from 4% to 2%. Yet Friesland never actually restructured the debts or compensated for its default. The regularity of these belated payments, together with the capital abundance in Amsterdam, quickly restored the market yields. New debt issues in Holland remained problematic, however, until the 1770s. Investors' efforts to discipline a bad debtor were further undermined by political conflicts of interest. During the War of the Austrian Succession, the States of Friesland convinced the Holland Grand-Pensionary to secretly issue a loan for the province, consequently undercutting the position of the creditors in Holland for the sake of shared interest to support the Union's budget. In the following years, the loans that the States-General further issued for the province added to the weakening of the creditors' power to force Friesland to better behaviour. This implied that the potential punishment for a default was minor, which casts doubt on the assumption that creditors' interests within the Dutch Republic always prevailed, as for example Stasavage recently suggested. Hence, both the political and legal fragmentation of the Dutch Republic hampered the effectiveness of contract enforcement mechanisms, and consequently the capital market integration within the Dutch Republic. So, Friesland's beggar-thy-neighbour behaviour was successful in avoiding both the high taxes and crushing debts shouldered by Holland and Zeeland, as well as escaping the Generality-imposed austerity experienced by Groningen.

Chapter 4 analyses the case of the province of Groningen, which had a unique institutional relationship with the States-General that enabled the possibility of interventions circumscribing the provincial autonomy. Therefore, the case of Groningen forms a counterfactual for the jealously regarded provincial autonomy and consequently offers contemplation of what could have happened if the Republic's central authorities had been strengthened. This is relevant to the claims about the Republic's institutional impotence as cause for its decline.

From the earlier period, the Generality's impact upon Groningen's political economy is undeniably important. The fiscal reforms from two forceful Generality interventions in the 1600s and 1620s increased the tax levels in Groningen to Holland's level, when corrected for welfare differences. In this process of increasing taxation, the



Generality shared an interest with the city. Because of the city's strategic importance to the Republic's northern defences, the Generality did not want to alienate its magistrate. Therefore, it restored the city of Groningen to its acclaimed rights. By confirming the urban rights over the countryside, the Generality brought the commodity streams under urban control and won the support of the city, which enabled the city to tax them and thus improved the provincial public finances. For the city, control over the countryside was vital, because it was economically dependent on the rural areas. Consequently, Groningen underwent a superimposed tax revolution that diminished the need for borrowing until the mid-1660s.

The two Münster invasions in 1665 and 1672 form a watershed in the history of Groningen's provincial public finance and debt management. Firstly, in the years after 1665, borrowing, and the subsequent debt, soared. About half of this debt was issued in Holland. During the 1670s and 1680s, Groningen had trouble adequately paying the interest in Amsterdam. For the duration of the war, its creditors treated Groningen with leniency. Towards the end of the war, however, the States of Holland increased its pressure on Groningen to pay the overdue interest to the creditors in Holland. Despite some temporary makeshifts, the arrears increased in the 1680s. Curiously, the States of Groningen did not officially repudiate its debt liabilities; it did not announce a moratorium or suspension of payment but stopped paying an increasing number of its creditors, albeit unevenly distributed. This complicated the coordination for the creditors to oppose the States of Groningen. Moreover, Groningen managed to restructure part of the debt in 1686, when it reached an agreement with the redeemable annuity holders in Holland, but not the life annuity holders. When Groningen was forced to borrow anew, in 1688, it learned that it could avoid coming to terms with the capital market, for it could use the credit of the Generality. The States of Groningen played out their military strategic importance to acquire the loans from the Generality, whose prime concern was the external security of the Dutch Republic. Financing the upkeep of the northern defences fit this purpose. Consequently, the Generality and the States of Groningen discovered a shared interest, which left the Holland creditors out in the cold.

This situation reinforced Groningen's dependence on the Generality during the next war, the War of the Spanish Succession. The quadrupling of the debt during this war consisted almost exclusively of Generality-guaranteed loans. The province however failed to live up to its financial obligations towards the Union; it defaulted for the second time. In 1726, the Generality again intervened in Groningen's fiscal policies by increasing the taxes and reserving a large part of the revenue stream for interest payments and redemption of the Generality loans. This policy halved Groningen's debt at the start of the War of the Austrian Succession. The Generality's imposition caused liquidity shortages that forced the States of Groningen to borrow locally despite its fiscal surplus.

Consequently, the case of Groningen supports Stasavage's impression that it matters for the debt service who controlled the public finances; in this case the central authority of the States-General reserved the funds for itself.

In exchange for conceding part of its say over its fiscal policy, the province received access to the capital market at reasonable terms and was sheltered from excessively harsh actions by its disadvantaged creditors. Moreover, the Generality protected its interests by forcing the province to designate part of the revenues exclusively for debt service and redemptions of its loans. This externally imposed austerity made Groningen's provincial debt manageable and comparatively modest, aided by the economic upswing after 1750. The economic and population growth, together with the fixed distribution of the Union's budget, caused a considerable decline in tax pressure for the population, while the province could simultaneously redeem its debt. When it issued loans without the help of the Generality in 1783, it did so at 3%, which was a lower rate than the going rate on the private market. This level also barely exceeded that of Zeeland's provincial debt, notwithstanding that that province had always honoured its debt. So, in the very long run Groningen ended up with a modest per capita debt and good credit. The price Groningen paid for this was to possess much less autonomy over its finances than the other provinces enjoyed.

From the three proximate causes addressed, risk proved the main variable to explain the price differences for the provincial bonds. Regarding the transaction costs, the analysis of the private interest rates showed persistent differences between the various polities within the Dutch Republic; despite similar long-term delinking trends, the Law of One Price did not apply, indicating a persistent fragmentation along the provincial borders. With reference to supply and demand, the secondary market prices for Friesland indicate that a large capital supply in Holland pushed the risk premium, and consequently the yields, down soon after the 1711 default. This produced the counterintuitive effect that price convergence between Amsterdam and Friesland could occur because the capital market remained compartmentalised.

Consequently, the thesis demonstrates that the Dutch Republic's federal state formation process is key to understanding the functioning of the markets for public debt. It provides empirical support to Stasavage's concept of a distributive interpretation of credible commitment. However, the study reveals disadvantages of his positive interpretation. The results also indicate that a vested interest in a polity's public debt hampered the option of restructuring the debt, as shown when this grew out of hand in the second part of the eighteenth century. This is more in line with Adams' interpretation of the Dutch Republic. It further refines the distributive interpretation of the credible commitment thesis by including the effects of externally-held debt. This then leads to the conclusion that it was coercion and control, and much less voluntary commitment,

that determined the outcomes for the management of public finance. This concerns the levels of taxation, the financial support of the Union, the honouring of the public debt and the subsequently low interest rates. A stronger central state may overcome coordination problems among nominally equal members. This forms the crucial factor to ensure commitment and engagement if solidarity fails to produce this effect.

When trying to establish links between finance and growth following regime change, the political factor appears to be decisive. A political revolution gives way to fundamental reform that counters vested interests; it removes barriers for previously disadvantaged groups which can then benefit from new opportunities that had previously been thwarted because they harmed the vested interests of the ruling elites. The economically innovating groups in society bring dynamism and the latest economical insights and techniques to the politics that, once no longer blocked by the vested interests of the sitting elite, allow for the state to benefit, resulting in a financial revolution and economic growth.