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1

Introduction

Societies thrive when people can depend upon a functional or "capable" state, one that monopolizes the use of force, protects property rights, and delivers extensive public goods and services from roads to public education to health care; but functional states cannot be taken for granted. State capacity, "the institutional capability of the state to carry out various policies that deliver benefits and services to households and firms,"[1] varies widely from state to state as well as within and across regions. Why do such differences exist, and why are they so persistent?

In this book, I trace differences in state capacity back to the nineteenth century. I will show that countries that then relied on domestic resource mobilization as opposed to foreign debt to fund government hold higher levels of state capacity today. Whereas tax collection compelled incumbents to invest in state strengthening institutions (from a tax agency to a universal census), external finance distorted incentives to initiate state apparatus modernization, pushing highly indebted nations into state weakening trajectories.

In the nineteenth century, recently created and traditionally isolated states floated sovereign loans in Europe to pay for war, balance the budget, and fund infrastructure projects. Rapid indebtedness of these weakly institutionalized economies often ended in external default—the suspension of debt service. In return for fresh capital, borrowers agreed to increasingly

1. Besley and Persson (2011, p. 6).

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onerous conditions, including infrastructure concessions, the exchange of old debt for public monopolies, and leasing control over branches of the tax administration. After handing over key sources of government income to foreign bondholders, more loans were soon required to balance the budget. In anticipation of a likely default, foreign investors requested newer hypothecation of public assets, further slicing the effective tax base of the local government. By 1914, when the lending euphoria came to an end, many nations had already fallen into a debt trap, causing persistent fiscal imbalance.

Unlike one-sided theories of financial imperialism,[2] my argument also emphasizes the domestic angle to the surge of external indebtedness at early stages of state building. Foreign loans secure government funds to revenue-thirsty rulers while helping them dodge administrative reform and constraints on their power. That is, building an efficient tax bureaucracy consumes funds that incumbents cannot use for self-indulgence or nurturing patronage networks. Moreover, rulers may be obliged to share fiscal power with taxpayers to overcome hesitancy to increased taxation.[3] By relying on external debt, rulers in the global periphery can avoid the administrative and political costs of fiscal innovation, precluding advances in state capacity.

I quantify the consequences of foreign loans for state building by focusing on war finance in the nineteenth century. This decision is based on two grounds: First, war is the largest shock to any treasury[4] and the thriving force of state building throughout history.[5] Second, the euphoria in sovereign lending and the high frequency of interstate conflict concentrated between the end of the Napoleonic Wars (1815) and the onset of World War I (1914), declining dramatically thereafter. By studying the means of war finance in the so-called Bond Era, I can examine the commitment of rulers to mobilizing internal resources and whether early fiscal policy decisions pushed countries into different state building trajectories.

Addressing the usual suspects in causal inference analysis, I demonstrate that countries that relied disproportionally on foreign capital to finance war before 1914 show a lower capacity to raise taxes all the way to the present day. By contrast, countries that mobilized domestic resources to finance

2. Hobson (1902).
3. Levi (1988).
4. Barro (1979).
5. Boix (2015); Dal Bó, Hernández-Lagos, and Mazzuca (2015).

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war show higher tax ratios and stronger tax bureaucracies today, and in some particular cases, stronger democratic institutions. The econometric evidence is accompanied by a collection of case studies that speak to different geographic areas and institutional contexts: Argentina, Chile, late-Qing China, Ethiopia, Japan, the Ottoman Empire, Peru, Siam, and South Africa. These cases illustrate the political game between foreign financiers, local incumbents, and taxpayers, and how early fiscal decisions shaped state building in the long run. In combination, the econometric analysis and qualitative accounts offer complementary evidence of the key assumptions, implications, and mechanisms of the theoretical argument.

On paper, foreign capital in the Bond Era offered an unmatched opportunity to overcome barriers to economic growth and invest in infrastructure with high social returns; however, it also weakened incentives to build capable states, pushing poor and weakly institutionalized nations into debt traps. Counterintuitively, developing nations might have benefited from tighter access to external capital at early stages of state building, which would have strengthened rulers' incentives to expand state capacity on a permanent basis. My conclusions have implications for the study of international finance, state building, and political reform, as I outline below.

The Globalization of Finance

The argument of the book builds on the assumption that countries in the Global South or periphery had access to relatively cheap external credit during the Bond Era;[6] however, sovereign borrowers outside Europe had weak fundamentals and little or poor reputation in capital markets, and they experienced regular episodes of default.[7] I shed light on this apparent contradiction by introducing the concept of *extreme conditionality*: the hypothecation of local assets (e.g., state monopolies, railroads, and customs houses) for fresh foreign loans.

The ability of foreign bondholders to gain new concessions and take control over collateralized assets in the case of default heightened as the interests of financiers and creditor governments grew closer, a phenomenon accelerating in the last decades of the nineteenth century. In Britain—the leader of capital exports—the gradual alignment between financial and government interests resulted from three interrelated factors: elite replacement, bondholders' coordination, and imperial competition. The

6. I use the terms *Global South* and *periphery* interchangeably to refer to countries in Asia, Africa, Central and South America, and Southern and Eastern Europe.

7. Reinhart and Rogoff (2009).

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new "gentlemanly class"[8]—the marriage of banking families and landed elites—assumed leading positions in the Foreign Office, the Bank of England, and consular service. Meanwhile, foreign bondholders inaugurated the Corporation of Foreign Bondholders (CFB), an encompassing organization representing big and small investors that perfected the art of requesting diplomatic assistance in sovereign debt crises. Initially hesitant, the British government grew receptive to such demands, incorporating finance into the set of imperialist policies, a practice that France and Germany had been open about since the 1870s.

Mitchener and Weidenmier have shown that "supersanctions" involving foreign financial control and gunboat diplomacy were regularly imposed on *embarrassed governments*—as countries that suspended debt service were referred to. Forty-eight percent of the countries that had defaulted between 1870 and 1914 were supersanctioned. Borrowers that defaulted more than once were supersanctioned 70 percent of the time.[9] Mitchener and Weidenmier argue that supersanctions were imposed on a case-by-case basis and upon manifest bad behavior, namely, *ex post*. I argue instead that severe sanctions gradually became part of the lending business model, a generally recognized practice of debt collection. The possibility of imposing supersanctions following debt service interruption was increasingly agreed upon at time of issue, or *ex ante*, thus my preference for the term *extreme conditionality*. Seizure prioritized pledged assets—state monopolies and tax sources that had been hypothecated in the original loan contracts.[10] Coding the presence of pledges out of 700+ sovereign bond prospectuses in 1858–1914, I show that the expectation of taking control of local public assets decreased the premium paid by countries with poor or no reputation in international markets. For one, extreme conditionality offers an original explanation of the secular decrease of the spread (the interest rate difference between wealthy and poor nations) in the Bond Era despite the high frequency of sovereign default.

My treatment of international lending resonates with the *Hobson-Lenin hypothesis*, according to which European powers used international finance as an instrument of imperial domination.[11] Extreme conditionality can be

8. Cain and Hopkins (2016).

9. Mitchener and Weidenmier (2010, p. 27). As I discuss in chapter 4, this is only a lower-bound estimate of the frequency of supersanctions.

10. Until the mid-twentieth century, the terms *loan* and *bond* were used interchangeably. I follow that convention throughout the book.

11. Hobson (1902) and Lenin (1934), and Frieden (1994) for a concise review.

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interpreted as a microfoundation of financial imperialism, a nonviolent policy to gain control over foreign assets. However, unlike the Hobson-Lenin hypothesis, I emphasize the domestic angle to the surge of external finance in the Bond Era: foreign loans secured government funds while helping rulers postpone administrative reform and constraints on their power.

War and State Making

The argument in this book revisits the connection between war and state making in the era of international finance. Contrary to the unconditional characterization of the so-called bellicist hypothesis, that is, *more war, more state*, I argue—very much alongside Tilly's original work—that the effect of war on state building ultimately depends on how warfare is paid for: financing war with taxes (or domestic credit) is conducive to state making, whereas financing wars with external loans may not be similarly conducive because rulers may dodge the long-term equivalence between loans and taxes if war debt is repaid in specie.[12] When this equivalence holds—when rulers repay war debt with tax money—positive institutional transformations associated with the bellicist hypothesis can be expected. That is, war makes states because rulers are compelled to expand tax capacity to repay war debt. If rulers find ways to minimize the war bill or manage to service war debt in specie rather than tax money, war will not make stronger states, unraveling the equivalence of debt and tax for the purpose of state building.

The importance of external finance of war for state making has been emphasized by the institutional sociologist Miguel Angel Centeno.[13] I advance our understanding of external finance on state building in two ways: First, I put forward a political explanation for the preference of external finance over taxation. I argue that the possibility of bypassing administrative costs and tax bargaining with domestic constituency can preempt investment in tax modernization and political reform, impeding the growth of state capacity over time. The new theoretical predictions shed light on which countries are likely to be negatively affected by external finance and why those effects are long-lasting. Second, by introducing the

12. In the economic literature, this equivalence is referred to as *Ricardian equivalence*. My argument suggests that the Ricardian equivalence was largely met for lenders because they recovered their investment one way or another, hence their willingness to lend; but the equivalence does not necessarily apply for the purpose of state building if rulers repay foreign debt with equity instead of tax money, avoiding gains in tax capacity.

13. Centeno (1997, 2002).

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concept of extreme conditionality into sovereign borrowing, I elucidate the reasons that weakly institutionalized countries were allowed to float loans even after recent default and despite showing an eroding tax base.

Public Finance and Limited Government

The argument and evidence advanced in this book speak to the relationship between state finance and political reform. Public credit in Europe gave rise to a key political institution: limited government, the constitutional right of a parliament to control the national budget on an annual basis.[14] To prevent monarchs from reneging on war debt, the Crown's lenders demanded veto power over spending decisions.[15] This compromise secured war funds for the Crown and enabled taxpayers and creditors—often the same individuals—to hold the monarch accountable. Mutual gain transformed taxation into a nonzero-sum game—the ruler secured funds for war and the taxpayers protection from foreign aggression—enabling sustained investment in state capacity.[16] State building in Europe, in sum, brought together public credit and political development.

In this book, I reexamine contractual theories of public finance and representation in light of the first globalization of credit markets. Cheap external capital may strengthen incentives to finance externally while preempting tax bargaining with domestic constituents and the development of *domestic* credit markets, thus the formation of a mass of domestic lenders with whom to strike bargains conducive to limited government. In other words, the internationalization of credit may work against the spread of democracy, a key driver of strong, capable states.[17]

1.1 External Public Finance and State Building

Before I delve into historical evidence, let me anticipate the main logic of the argument in chapter 2, where I advance a political economy of public finance and delineate fiscal consequences of early policy decisions. Although I focus on war financing—a paramount fiscal shock often related to state building—I envision the argument to apply to other policy realms that require substantial revenue mobilization in a relatively short period of

14. Dincecco (2009, p. 95).
15. Bates and Lien (1985); North and Weingast (1989).
16. Levi (1988); Besley and Persson (2009).
17. Acemoglu and Robinson (2019); Stasavage (2020).

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time: for example, combating a pandemic, building critical infrastructure, and recovering from a natural disaster.

Suppose there is an incumbent or ruler who must finance a given exogenous war. To simplify the analysis, I assume two funding options, taxes or loans, ruling out intermediate combinations. Likewise, I consider only *external* loans because domestic credit markets outside Europe were largely tight or nonexistent before the twentieth century.[18] The ruler, motivated only by individual gain, seeks to maximize private income by keeping a cut of total government funds (i.e., rents). Taxpayers, by contrast, prefer all their tax money to be spent on public goods, whereas government lenders—private individuals based overseas—want to recover their investment (the principal and interest) within a stipulated time (or maturity).

To discipline the ruler, taxpayers demand some institutionalized say in how public moneys are spent, that is, power-sharing institutions. If these are granted, the ruler secures war funds at the cost of limiting his discretion over fiscal policy, hence rents from office. Once power-sharing institutions are in place, they are likely to stay for two reasons: First, taxation can become a win-win for the ruler and taxpayers: the former secures a stable stream of funds, and the latter hold the ruler accountable while benefiting from public goods. Second, power-sharing institutions help taxpayers overcome collective action problems in disciplining the ruler, hence their bargaining power.[19] Foreign private investors have market-based means to discipline the ruler: they compensate the risk of default ex ante by charging a higher interest rate (or premium) and ex post by imposing a default sanction: for instance, denying new loans if debt service is interrupted (also known as *capital exclusion*).

The ruler decides which principal to serve: taxpayers or foreign financiers. On the one hand, taxes strengthen power-sharing institutions, thus reducing the share of public funds the ruler can retain for self-consumption. But the capacity of the state to tax improves by exercising it, expanding future tax revenue and the size of the pie the ruler can partially appropriate. On the other hand, external finance secures funds for war today while saving the costs of administering taxes and postponing constraints on the ruler's power. In the future—once the war is over—the ruler will decide whether to assume the cost of taxation to repay war debt with tax money (i.e., funneling resources to enhance tax capacity and sharing

18. Japan is an outlier and because of that it is one of the few successful cases of state building.

19. Stasavage (2011).

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fiscal power with taxpayers)—or to suspend debt service and deal with the consequences of default.

The incentives of a ruler to finance war with external loans instead of taxes depend on three domestic factors—the initial strength of power-sharing institutions, the initial strength of the tax administration (or fiscal capacity), and the ruler's time horizons—plus two external factors—the liquidity of international capital markets and the size of the default sanction.

If the war bill is to be paid tomorrow, rulers with short time horizons—for instance, in polities with political instability—might find external war finance preferable even at the cost of future default sanctions. Arguably, those costs are the problem of some future leader. Initial fiscal capacity and political conditions matter, too: If the state has high tax capacity and strong limited government to begin with, preference for financing the war with taxation will strengthen, all else constant. By contrast, rulers in countries with weak executive constraints and low fiscal capacity will find taxation disproportionally burdensome because they need to relinquish political power for relatively small increases in tax capacity.

International factors interact with domestic institutions—a leitmotif in the book. As the liquidity of international finance grows, interest rates decrease for both unseasoned and seasoned borrowers, diminishing the future tax cost of war. This effect is particularly relevant to the Bond Era, when capital surplus from the Industrial Revolution was poured into global financial markets, fueling a culture of cheap credit.

The ruler honors debt in the future only if the cost of interrupting service, namely, the external default sanction, is higher than the cost of building up tax administration and sharing power with domestic taxpayers. The ability of external default sanctions to discipline borrowers depends on its severity and credibility.[20] Foreign bondholders devised in the Bond Era a mechanism that met both properties: extreme conditionality. This involved the hypothecation of public assets (e.g., state monopolies, customs houses, land) as a precondition of new loan issues. In case of default, pledges would be seized or managed by foreign bondholders until debt was liquidated.

Confiscation of national assets, or *debt-equity swaps*, and foreign control of local tax administration, known as *receiverships*, were perceived unpopular enough to preempt the temptation to default. The key for extreme conditionality to work was the enforcement mechanism. Seizure of national

20. Bulow and Rogoff (1989); Schultz and Weingast (1998).

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assets, which was impossible if borrowers did not agree to it, occurred only under the veil of coercion. Although bondholders lacked military capacity, they sought diplomatic help from their government.

Officially, the British government resisted involvement in private disputes between bondholders and embarrassed governments. Unofficially, British ambassadors would exert good offices on behalf of home creditors if only to counterbalance the growing and open interventionism of the French and German governments in private credit markets. At other times, the Foreign Office would be as blatantly interventionist as its continental counterparts. Elite replacement within the British government greased the alignment between financial and national interest. In nineteenth-century Britain, landed elites and big merchant families merged into a gentlemanly class that assumed key positions in government and the Bank of England, the pillar of British public credit. Public and private interest became intertwined. International lenders took advantage of this and geostrategic competition between the Great Powers to request of emerging economies the hypothecation of national assets and sources of revenue as a precondition of fresh loans. This had two substantive effects—one of interest for public finance historians and the other for students of state building.

First, extreme conditionality sheds light on the causes of the secular reduction of the spread in the Bond Era. By raising the credibility of default sanctions—the confiscation of national assets—the risk and premium levied on developing nations declined over time despite repeated episodes of default. Second, extreme conditionality was a double-edged sword for state building. By pawning national assets, rulers secured cheap cash without having to assume administrative costs of taxation or sharing power with taxpayers—the hook—but they opened the door to financial control by foreign private investors—the catch. By "agreeing" to debt-equity swaps and installment of receiverships, emerging economies regained access to international markets after default without having strengthened their capacity to tax. If anything, default sanctions shrank the tax base in the hands of the government, leaving the local treasury in a precarious position.

1.2 The Rise of External Public Credit

A key assumption in the argument of this book is that the Global South had access to cheap credit overseas. International capital markets were not invented in the nineteenth century; however, they acquired an entirely

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new dimension at that time.[21] Following the Napoleonic Wars, first Britain and later France and Germany pushed surplus capital emanating from the Industrial Revolution into the developing world in the form of sovereign loans. Recipients were a combination of previously closed economies (e.g., China, Japan, Siam), newly independent states (mostly in Latin America, Southern and Eastern Europe, and Northern Africa), and colonial dominions. Borrowers used foreign capital to wage war, balance the budget, and invest in large infrastructure.

The nineteenth century was exceptional for many reasons: First, the magnitude of international lending was unprecedented, and unseen until the turn of the twentieth century. Relative to world GDP, international capital flows in 1980 were still three times smaller than a hundred years earlier.[22] Second, sovereign loans were private contracts between European financiers and foreign governments. Official lending (bilateral or multilateral) played a residual role, the opposite of the modern day.[23] Third, and perhaps most surprisingly, capital was cheap.

Figure 1.1 plots interest rates of an original dataset of 900+ sovereign loans floated in the London Stock Exchange (LSE) between 1816 and 1913. The vertical distance between the two superimposed curves shows the time-varying average spread between emerging economies and European countries, that is, the premium levied on developing nations. The spread remained around 100 basis points until 1860 and gradually vanished thereafter.

I elaborate on the conditions of external public credit in chapters 3 and 4. Here it suffices to say that the modest spread between advanced and developing economies remained for effective interest rates, and that risk was not compensated with shorter maturities. I argue that extreme conditionality—the hypothecation of public assets—helps explain the secular reduction of the spread in the Bond Era. I examine this hypothesis by analyzing the effect of bond securities (also known as pledges, collateral, and hypothecation) on effective interest rates of 700+ newly digitized sovereign loans floated in London. The evidence indicates that the credibility of pledges, hence their capacity to reduce risk, increased as private financial interests and British national interests grew closer in the later decades of

21. Eichengreen, El-Ganainy, Esteves, and Mitchener (2019).

22. Eichengreen (1991, p. 150).

23. Stallings (1972, pp. 13–26) for evidence of this switch following World War II, and Bunte (2019) for continuation of that pattern until the present day.

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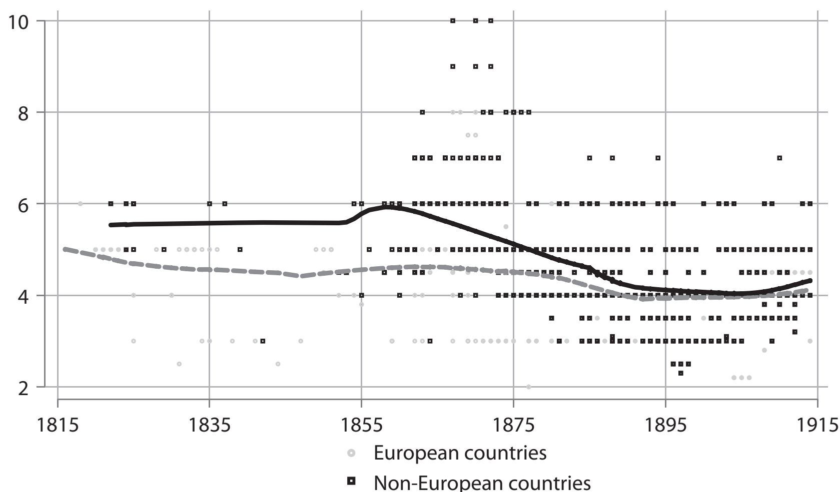

FIGURE 1.1. Nominal Interest Rates in the Bond Era: European vs. non-European Countries. A dashed lowess line is superimposed for the European sample and a solid line for the non-European sample. Compiled by author from multiple sources (see chapter 3).

the nineteenth century. This result contributes to the theories of the spread while revisiting the principle of absolute sovereign immunity in the era of high imperialism.[24]

1.3 State Building and Fiscal Capacity

To quantify the consequences of cheap capital on state building, I focus on the capacity of the state to tax, also known as *fiscal capacity*. This involves the state's ability to assess wealth, monitor compliance, and secure a stable stream of government funds. Taxes are one of the three pillars of the modern state, the others being the monopoly of coercion and the enforcement of property rights or *legal capacity*.[25] Because neither of the other two key functions of the state can be implemented without funds, "the history of the state revenue production is the history of the evolution of the state."[26] For the sake of illustration, figure 1.2 shows the modern-day relationship between tax capacity, measured by income tax ratios, and a general proxy of state capacity produced by the Fund for Peace, the *Fragile States Index*.

24. Verdier and Voeten (2015) for the standard interpretation.
25. Besley and Persson (2011).
26. Levi (1988, p. 1).

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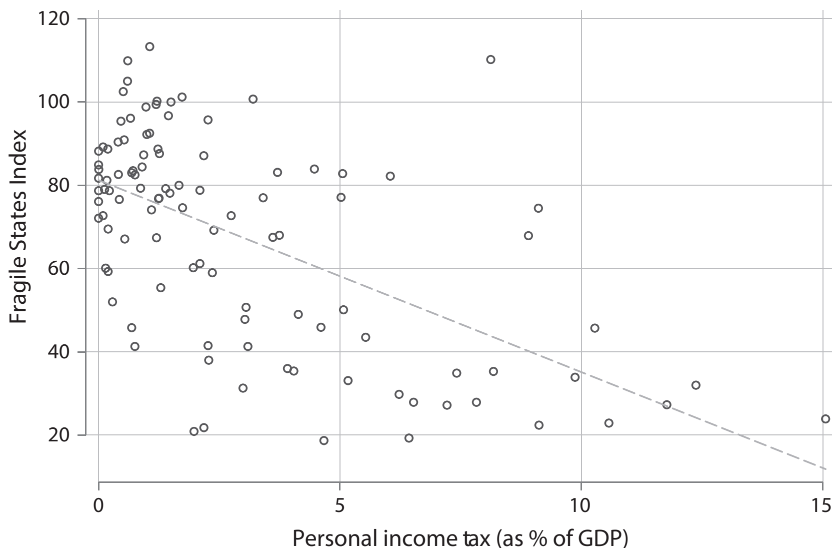

FIGURE 1.2. State Fragility and Fiscal Capacity. This figure plots the Fragile States Index for 2010 on average income tax ratios from 1995 to 2005, drawn from the IMF's government financial statistics and augmented by the author with information from national treasuries (N = 102). The Fragile States Index (Fund for Peace, 2020) triangulates news content analysis with economic, political, and institutional indicators plus qualitative review.

One thing remains clear: a state that underperforms in tax capacity is not a strong state.

Building fiscal capacity requires tax harmonization across the territory and the establishment of a professionalized tax apparatus endowed with extensive powers to assess wealth, collect taxes, and sanction noncompliers. In recent decades, a burgeoning group of scholars has addressed different aspects of fiscal capacity building. A consensus exists about the key role of war in growing the state capacity to tax. Raising an army; buying firearms, cannons, and equipment; transporting troops; feeding soldiers at the front; treating the wounded—all consume vast resources. The fiscal effort required by war is expected to strengthen the capacity of the state to penetrate all layers of society and extract resources in the form of taxes.[27] To implement this in an expedited, orderly, and systematized fashion, rulers may apply a series of "self-strengthening reforms,"[28] including fiscal centralization and the introduction of budgets,[29] the pro-

27. Mann (1984).

28. Hui (2004).

29. Dincecco (2011) and Cox and Dincecco (2021), respectively.

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fessionalization of the tax administration,[30] and the adoption of modern forms of taxation—from excises[31] to progressive income taxes.[32] Far from disappearing, the financial innovations that fund the means of war are expected to exert lasting effects on the extractive capacity of the state;[33] or, as Charles Tilly famously put it, "war made the state, and the state made war."[34]

The foregoing argument, known as the *bellicist theory of state formation*, draws heavily from the history of state building in Western Europe.[35] Evidence of the bellicist hypothesis outside Western Europe is mixed. Some point to dissimilar initial conditions: non-European societies were too fragmented and ethnically heterogeneous to capitalize war efforts.[36] Others to the type of war waged in the Global South: short and small.[37] I deviate from this interpretation by showing in chapter 6 that war in the nineteenth century in the global periphery was bigger, longer, and more frequent than usually understood. A key reason it did not translate into stronger states is because it was disproportionally financed with external capital. Rulers in the Global South waged war without having to put forward the institutional transformation and agree to political innovations that European monarchs were compelled to before 1815, simply because the international credit market was too small and expensive at that time.

The reexamination of the bellicist hypothesis in the era of international finance reveals ways in which the joint consideration of debt and taxes can expand the study of fiscal capacity. To date, major contributions focus on one of these two instruments, keeping the other constant.[38] The results in this book indicate that our understanding of the political dilemmas of public finance can benefit from examining the opportunities and trade-offs between taxation and credit, internal and external revenue mobilization.

30. Ardant (1975).

31. Brewer (1988).

32. Scheve and Stasavage (2010, 2016).

33. Besley and Persson (2011); Brewer (1988); Dincecco and Prado (2012).

34. Tilly (1990, p. 42).

35. Seminal contributions can be found in Downing (1993), Ertman (1997), Hintze (1975), Mann (1984), and Tilly (1990).

36. See, for instance, Centeno (2002) and López-Alves (2000) for Latin America and Taylor and Botea (2008) for Asia and Africa.

37. See Centeno (2002, ch. 2) and Soifer (2015, ch. 6) for war and state building in Latin America.

38. See Besley and Persson (2011), Dincecco (2011), and Stasavage (2011).

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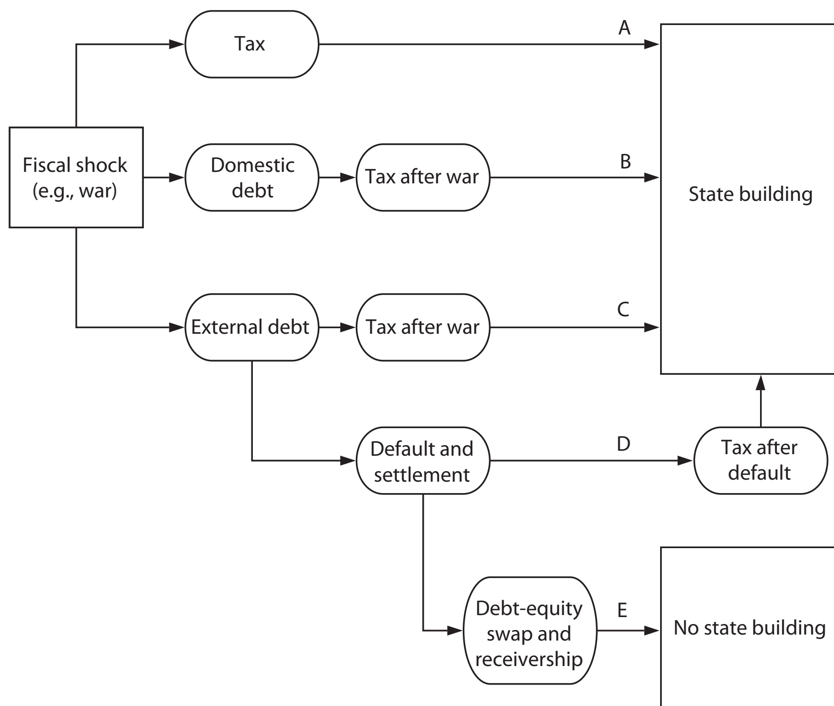

FIGURE 1.3. Fiscal Shocks and State Building Trajectories.

1.3.1 STATE BUILDING TRAJECTORIES

The means to fund government in the Bond Era had lasting consequences because they compromised future policy options. To explain why, I need to expand the time frame to early-modern times as well as the set of revenue-generating policies by considering domestic credit. In this stylized setup, a ruler decides how to secure funds to address a major fiscal shock—and I stick with war. I consider five possible responses, A through E, in figure 1.3.

Paths A and B imply domestic resource mobilization in the form of taxes and domestic debt. Following paths A and B, monarchs in early-modern Europe secured funds for war by relinquishing fiscal power over national elites in return for taxation, domestic credit, or both. Power-sharing institutions materialized into constitutional monarchies (e.g., Britain) or oligarchic regimes in which tax farmers and regional parliaments kept the Crown in check (e.g., France).[39] Because monarchs depended on domestic resources, they were compelled to build large tax bureaucracies to honor

39. For France, see Johnson and Koyama (2014) and Mousnier (1974).

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debt after war. Repudiation was political suicide because it implied the loss of political and financial support of big taxpayers and Crown lenders.[40] By making debt repayment self-enforcing, military expenses grew fiscal capacity over time.

European monarchs were compelled to mobilize domestic resources because international markets were tight before the Bond Era.[41] The few who managed to finance war externally (e.g., Spanish monarchs relied on Genoese bankers) were not compelled to invest in state institutions, leading their countries into decay.[42]

After 1815, external loans emerged as a widespread option to fund public spending. Emerging economies could follow path A (taxation) or C–E (external finance in its different trajectories). B was off the table because of the low levels of capital accumulation outside Western Europe, a requirement for domestic credit markets.

Resorting to taxation to finance the means of war (path A) could be a matter of luck—for instance, having skilled politicians in office capable of seeing down the path as Ethiopia and Siam once had—or imposition by circumstances—for example, having to wage war while being excluded from international markets as had once occurred in Spain and Chile.

Statistically, most countries in the periphery during the Bond Era took paths C–E, consistent with the theoretical argument: when the initial stock of fiscal capacity was low and power-sharing institutions were weak—conditions common in the Global South—the administrative and political costs of taxation trumped those of external finance even if it opened the door to foreign control in the (distant) future.

Japan exemplifies path C to state building. This country raised numerous external loans yet never defaulted.[43] Compared to Siam (a relatively similar case[44]), Japan built a stronger bureaucratic state because it assumed the political cost of taxation—power-sharing institutions—as part of the Meiji Restoration. Compared to Argentina, the poster child of international economic integration in the Bond Era, Meiji Japan borrowed less overseas because it inherited a stronger domestic credit market, a rarity (and a blessing) in the Global South. Joint external and domestic resource mobilization

40. Saylor and Wheeler (2017).

41. Homer and Sylla (2005).

42. Drelichman and Voth (2014).

43. Suzuki (1994).

44. See Paik and Vechbanyongratana (2019) for a comparison of state building in Japan and Siam.

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pushed Japan down the same path of state building that Western European powers jumped into before 1800.

Japan was unique. The vast majority of countries lacked a domestic credit market to work with and financed externally, taking paths D and E freely or by force. Path D is not necessarily bad for state building, but it can retard it. Arguably, it describes the cycle followed today by countries in financial hardship; for example, Greece after 2010. In the modern day, external default is a relatively ordered process led by multilateral organizations that condition financial support on austerity programs that combine spending cuts and tax reform intended to improve local capacity. For instance, the "first memorandum" between Greece and the troika (the EC, IMF, and ECB) conditioned bailout on an increase in the value added tax (VAT); taxes on corporate profits, real estate, luxury goods, and imported cars; and excises on alcohol, cigarettes, and fuel.

The absence of multilateral organizations in the Bond Era, combined with geostrategic competition of the Great Powers, allowed bondholders to push emerging economies onto path E. Hypothecation of national assets gradually became required to access external capital—extreme conditionality. When default happened—and it often did—foreign control followed. Debt-equity swaps were not intended to produce improvements in tax capacity, nor were receiverships. These parastate organizations took control of entire branches of the local tax administration and were installed for one purpose only: the repatriation of private capital. Receiverships were managed by foreign bondholders or their representatives and operated under European (and American) standards. They might have brought in new tax technologies and created positive externalities in the local administration, but evidence in chapter 5 suggests otherwise. In the Bond Era, receiverships were installed to make profit, not to build capacity.

In sum, unlike paths A–D, E does not satisfy the long-term equivalence between debt and taxes. Quite the opposite, debt-equity swaps and receiverships erode the local tax base and require fresh securitized loans to balance the budget, creating endemic fiscal deficits.

1.3.2 CHANGE AND CONTINUITY

The political dilemmas of public finance shed light on the reasons that fiscal policy in the nineteenth century could affect long-term state capacity. External finance, which allowed rulers to dodge political compromise with taxpayers and investment in tax capacity, was not always available. Countries could be excluded from fresh loans but nevertheless need funds,

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for instance, to wage international warfare. Warring states could also be in good standing with foreign creditors but happen to wage a war in the midst of an international financial crisis, when credit was tight.

As speculative as it was, the Bond Era was characterized by ups and downs, lending euphoria followed by "sudden stops"[45] of credit, freezing capital flows around the world on a temporary basis—usually four years. I take advantage of these exogenous episodes to examine whether incentives to enhance taxation strengthened when rulers needed funds for war but could not count on foreign credit. Pursuing this path, rulers would be putting in motion two mechanisms that connected fiscal efforts in the past to state capacity in the future. First, to foster compliance with higher taxes, rulers would be compelled to articulate power-sharing institutions over fiscal policy to overcome taxpayers' hesitancy to further taxation. Once in place, taxation would become a self-sustaining compromise: the rulers would secure funds while taxpayers would hold them accountable for their fiscal decisions, expanding the capacity to tax in the long run. I refer to this as the *political mechanism* of transmission.

Students of democracy agree that power-sharing institutions are actionable when taxpayers face low coordination costs and easy ways to escape taxation—conditions harder to meet in large-scale and poor economies.[46] Negotiating power-sharing institutions in return for tax increases was also off the table for most countries under colonial rule. In response, I consider a second mechanism of transmission that is independent of political status, geographic scale, and capital mobility. I call it the *bureaucratic mechanism*, which refers to the efforts against fiscal capacity disinvestment that tax bureaucracies exert to safeguard organizational survival.[47]

In chapters 8 and 9, I evaluate the effect of external finance on fiscal capacity and the plausibility of the two mechanisms of transmission. A battery of statistical analyses involving advanced and developing nations suggests that access to external finance distorted incentives to invest in fiscal capacity, preventing state building. By contrast, waging war excluded from capital markets expanded the capacity of the state to tax in the short and long run. Resorting to taxation contributed to the expansion of power-sharing institutions, particularly in smaller and wealthier countries, and the growth of the state bureaucracy in sovereign states and colonial dependencies.

45. Catão (2006).

46. Bates and Lien (1985); Boix (2003); Stasavage (2011).

47. Schumpeter (1991).

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1.4 Why Europe and Not the Global South?

Ultimately, the theoretical argument and empirical evidence in this book seek to shed light on the broader question that gives this section its name. It is common knowledge among economic historians that states in Europe were made by war *and public credit*. Then why did war make states in Europe but not elsewhere? In short, European monarchs borrowed from domestic sources, guaranteeing efforts in fiscal capacity building to repay debt after war.

Before 1800, international capital markets were limited at best.[48] Lacking access to cheap foreign capital, European monarchs were compelled to mobilize domestic resources to pay for war. Following the military revolution in the mid-sixteenth century, military outlays grew at a faster pace than tax revenue, requiring new forms of government funding. Monarchs then borrowed heavily from merchants and landed elites, but loans came at a price. To convince elites that debt would be repaid, monarchs shared power over fiscal policy with the Crown lenders. Organized into parliaments or lending cartels, the Crown lenders would deny the monarch new funds if debt service was interrupted and withdraw political support if necessary. To avoid the consequences of domestic default, monarchs invested in modernizing the tax administration and secured proceeds to meet domestic debt obligations. By 1815, most European powers had already achieved relatively high levels of fiscal capacity.[49] Securing high tax yields, they could benefit from international liquidity in the Bond Era without having to compromise national sovereignty.

The globalization of public credit in the nineteenth century changed all that. Recently independent states and semiautonomous countries that came to exist outside Europe only in the nineteenth century faced starkly different initial conditions to build states. While European monarchs lacked external options but counted on domestic creditors, rulers in the global periphery lacked home lenders but had access to foreign capital. Emperors, presidents, and sultans outside Europe contracted loans to finance war, budget deficits, and infrastructural investment while postponing key administrative and political reform. External debt soon piled up, consuming vast foreign reserves. When debt service was interrupted, severe conditions were imposed for fresh funds, including receiverships and debt-equity swaps, further eroding the tax base. Many emerging

48. Homer and Sylla (2005).
49. Dincecco (2011).

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economies fell into debt traps, causing detrimental long-term consequences for state building and political reform.

Why Europe and not the Global South? One thing is clear: European monarchs before 1800 were hardly more public spirited than leaders of emerging states after 1800—they simply faced a different international context, and state building benefited from it.

1.5 Competing Arguments

States are weak when government cannot accomplish the tasks it intends to do: economic, social, or political. Next, I discuss three widely accepted causes of state weakness: access to natural resources, ethnic division, and colonialism. The argument I advance in this book is not meant to substitute or falsify any of these three hypotheses. I interpret external finance as an additional cause of state weakness, which nevertheless has connections to existing accounts; for instance, natural resources were used as collateral in international loans, and colonial rule was partially articulated via financial control. After briefly addressing these debates, I comment on productive uses of foreign capital, also known as *developmental finance*,[50] and ways to fund government other than tax and debt.

1.5.1 FACTOR ENDOWMENT AND RESOURCE CURSE

Engerman and Sokoloff emphasize the role of factor endowment in explaining the divergence in economic growth, inequality, and political institutions within the American continent. Climate and soil conditions supporting slave-plantation economies and an abundance of natural resources highly valued on world markets led to political institutions that exacerbated long-term inequality and state weakness in Latin America.[51]

In the modern day, institutional quality is eroded by rents from oil and gas. The availability of nontax revenue weakens incentives to initiate tax bargaining with taxpayers[52] and to invest in the bureaucratic apparatus of the state.[53] In rentier states, patronage becomes the means to rule.[54] Corruption trickles down from the political to the bureaucratic

50. Fishlow (1985).
51. Engerman and Sokoloff (2002). See Coatsworth (2005) for a competing argument.
52. Brautigam, Fjeldstad, and Moore (2008); Morrison (2009); Prichard (2015); Ross (2004).
53. Besley and Persson (2011).
54. Beblawi (1987).

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arena, reducing professionalism, neutrality, and independence of public administration.[55] The voracity to seize rents from natural resources can destabilize resource-rich states and make civil war endemic.[56] Building capable states under such conditions is extraordinarily difficult.

Foreign aid also allows autocrats to cultivate patronage,[57] dilute accountability mechanisms, and abandon the search for legitimacy,[58] leading to perverse effects not different from those of oil.[59] Instead of a competing hypothesis, external finance can be understood as an alternative form of "easy money," carrying dilemmas similar to foreign aid. Once aid or loans are disbursed, donors and lenders experience similar difficulty disciplining recipient governments.[60] In addition, in the case of loans, rulers may decide to interrupt debt service in anticipation of debt relief or some form of foreign financial intervention or both, relaxing present-day efforts to expand tax capacity and pushing the cost of default onto future generations.

1.5.2 SOCIAL DIVISIONS

Ethnic heterogeneity is a common deterrent to the provision of public goods,[61] chief among them state bureaucracies.[62] Countries outside Europe are said to be highly diverse or ethnically fractionalized, hence their weaker state capacity, a point often made to explain state fragility in Latin America[63] and Asia.[64] This argument might raise issues of reverse causality: states become strong by substituting preexisting social divisions—ethnic, religious, linguistic—for one national identity. Social homogenization is achieved in multiple ways, from indoctrination to mass expulsion to ethnic cleansing.[65] Take France, for instance: exploiting within-country variation, Johnson shows that at the turn of the eighteenth century those parts of France with higher state capacity (measured via

55. Ross (2001); Vandewalle (1998).

56. Collier and Sambanis (2005); Tornell and Lane (1999).

57. Ahmed (2012); Bueno de Mesquita and Smith (2009); Smith (2008).

58. de la Cuesta et al. (2021); Moss, Pettersson Gelander, and van de Walle (2006).

59. Easterly (2006).

60. Collier (2006).

61. Alesina, Baqir, and Easterly (1999); Baldwin and Huber (2010); Easterly and Levine (1997); Habyarimana, Humphreys, Posner, and Weinstein (2007).

62. Besley and Persson (2011); Lieberman (2003).

63. Centeno (2002); López-Alves (2000).

64. Taylor and Botea (2008).

65. Alesina, Reich, and Riboni (2017); Sambanis, Skaperdas, and Wohlforth (2015); Wimmer (2013).

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tax receipts) showed higher identification with the French nation.[66] The French state manufactured the French nation, not the other way around. This process continued after the Revolution with state-led cultural assimilation.[67] Contemporary examples outside Western Europe can be found in China, where the state uses the public education system to build national identity,[68] and Africa, where state capacity leads to lower levels of ethnic-based contestation.[69]

Social divisions may also be exacerbated by having access to international capital. To fund the central government, rulers in the capital may be compelled to negotiate institutional design and grant policy concessions to territorially concentrated minorities, building robust federal states.[70] Access to external capital can discourage the central government from reaching out to regional elites, abandoning nation building projects and intensifying territorial divisions.[71]

1.5.3 COLONIALISM

Colonialism is a key cause of state weakness. "Extractive institutions" imposed by Western powers in nonsettler colonies deprived the periphery of its main sources of wealth.[72] The lack of self-determination, the continuation of slavery in the form of forced labor,[73] and arbitrary border design[74] raised tremendous obstacles to state building.[75] This is a compelling explanation with little to add.

I interpret external finance as a complementary hypothesis that amplifies the negative effects of colonial subjugation. In chapter 3, I show that colonies were allowed to borrow from international markets—a widely known result in economic history—and in chapter 6, I show that colonies participated in war, regional and colonial, and were expected to be financially self-sufficient, hence to build fiscal capacity. If colonies met all

66. Johnson (2015).
67. Weber (1978); Zhang and Lee (2020).
68. Cantoni, Chen, Yang, Yuchtman, and Zhang (2017).
69. Müller-Crepon, Hunziker, and Cederman (2021).
70. Alesina and Spolaore (1997); Sambanis and Milanovic (2014).
71. Bormann et al. (2019); Hierro and Queralt (2021).
72. Acemoglu and Robinson (2012).
73. Mamdani (1996).
74. Herbst (2000).
75. See Michalopoulos and Papaioannou (2018) for a detailed and fascinating review of mechanisms linking colonial rule and long-term state weakness.

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criteria for war to make states, why did they not build stronger states? Although colonies financed virtually all domestic expenses, including policing and public administration,[76] the lion's share of interstate war was assumed—reluctantly—by the metropole, in the form of either grants-in-aid or heavily discounted loans; hence, the weak connection between colonial war and state making.

1.5.4 DEVELOPMENTAL FINANCE

Developmental finance refers to investment in projects with high social returns. Railroads, accounting for a third of all international capital flows in the Bond Era, were the paramount example of developmental finance at the time.[77] Railroad investment, for instance, grew the US economy[78] and helped irradiate state power in Sweden.[79] The success stories of developmental finance, however, tend to concentrate on a handful of relatively wealthy economies with robust institutions. In large parts of the Global South, railroads reduced dramatically the cost of internal transportation, hence the price of export staples, but did little to stimulate local industry. Or, as Coatsworth put it, railroads brought growth *and* underdevelopment.[80]

The mixed record of developmental finance reflects the international and domestic politics at the time, and it transpires the theoretical argument. The search for yield and strong bargaining power of foreign investors combined with corrupt and opportunist politicians often led to irrational network planning, external dependence for capital and inputs, and budget deficits caused by profit guarantees. The book offers various examples of aggressive foreign lending (e.g., the imperial railroad guaranteed bonds in China) and the conditions under which investors competed for new concessions and seized existing lines. But embezzlement,[81] delusional greatness,[82]

76. Frankema (2011).

77. Suter (1992).

78. But see Fogel (1963) for a restrained assessment.

79. Cermeño, Enflo, and Lindvall (2018).

80. Coatsworth (1981).

81. Claudio Bruzual Serra, the Venezuelan delegate who negotiated the largest and most ruinous foreign loan in the nineteenth century, pocketed Bs.114,000. Venezuela's president, Joaquin Crespo, kept a larger cut, Bs.2 million (4% of loan total). Back to Venezuela, Bruzual Serra was appointed Minister of Finance. The person who brought the scandal to light, Federico Bauder, was put in jail (Harwich Vallenilla, 1976, p. 225). Not surprisingly, the economic record of railroad investment in Venezuela is poor.

82. In 1910, the Cuban president, José Miguel Gómez, negotiated a new foreign loan in Britain to build a new presidential palace and other buildings. President Gómez was willing to

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and short-sighted policy[83] on the side of local governments also played a part. My reading of international lending is that more often than not, both developmental and nondevelopmental finance in the Global South during the Bond Era exacerbated external dependence and eroded the effective tax base, causing persistent fiscal disequilibria—the opposite of state building.

My focus on war finance—a form of nondevelopmental investment—is based on two factors: First, increased demand of foreign capital caused by war is easier to date thanks to existing war datasets. Second, the analysis of the effect of war allows me to pin down the scope conditions under which the bellicist hypothesis holds, clarifying the important relationship between military competition and state building from the military revolution in the late sixteenth century to the present.

1.5.5 OTHER FORMS OF PUBLIC FINANCE

Debt and taxes constituted two prominent ways to fund governments in the Bond Era, but there were others, including monetary expansion. This policy often led to price instability, a decline in real tax receipts, and currency depreciation, contravening the mandate of the gold standard. While money printing addressed the liquidity shortage, it created problems larger than those it was intended to solve. In general, this policy was to be avoided to finance fiscal shocks.[84]

Rulers could also exert financial repression,[85] expropriate the Church,[86] sell offices,[87] trade slaves,[88] or rely on intraempire transfers[89] to secure public funds. Choosing taxation instead of any of these measures is, again, a matter of capacity and political calculus. Notably, in terms of state building, any alternative path to taxation would be expected to exert effects

---

surrender to British investors a public railroad with its connection to the waterfront of the port of Havana, granting de facto control over Cuban exports. President Gómez accepted the conditions despite the outcry from the opposition and local press. The loan did not move forward only because the US Department of State stepped in to protect American interests in the island (Zanetti and García, 1998, pp. 245–251).

83. The search for short-term popularity gains derived from inaugurating major infrastructure played a key role in the poor performance of road investment in the second half of the nineteenth century in Spain (Curto-Grau, Herranz-Loncán, and Solé-Ollé, 2012).

84. Cappella Zielinski (2016); Fujihira (2000); Sprague (1917).

85. Calomiris and Haber (2014); Menaldo (2016).

86. Comín (2012).

87. Hoffman (1994).

88. Herbst (2000).

89. Grafe and Irigoin (2012); Davis and Huttenback (1986).

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similar to those of external finance because it would not require building a tax apparatus capable of assessing wealth and securing a steady stream of revenue—namely, enhancing fiscal capacity—nor would it activate key mechanisms of transmission of the ratchet effect of war—that is, strengthening power-sharing institutions and bureaucratic capacity. The scope conditions for state building are somewhat narrow. Easy access to foreign credit following the globalization of capital in the nineteenth century narrowed them further.

1.6 Plan of the Book

In the next chapter, I advance the theory of the book by articulating a political economy of public finance. Although the discussion can be generalized to other major fiscal shocks, I focus attention on military expenses because war was a major and clearly identifiable reason to tax and issue debt before 1914. I pin down a series of domestic and external factors shaping the ruler's preferences for loans vs. taxes, including initial levels of tax capacity and power-sharing institutions, default sanctions, and liquidity in international markets. The discussion leads to the notion of extreme conditionality because it helps us understand why countries with weak fundamentals accessed capital at favorable terms. The case of Peru is examined in brief to illustrate the logic of conditionality. I conclude chapter 2 by formulating the reasons that war finance exerted long-term effects on state building, or mechanisms of transmission.

The remainder of the book is organized into two parts: "The Rise of Global Finance" (chapters 3–5) and "The Consequences of Global Finance for State Building" (chapters 6–9). Chapters 3–5 may be of particular interest to economic historians and international relations scholars inasmuch as I focus on the rise of global finance, test for extreme conditionality, and elaborate on the causes of the low spread between advanced economies and the periphery. Chapters 6–9 may be of interest to students of state capacity building from the Industrial Revolution onward as well as to students interested in historical origins of democratic politics.

In chapter 3, I articulate the main characteristics of the Bond Era—who lent, who borrowed, and how capital was invested—and elaborate on my skepticism about the difference between "developmental" and "revenue" finance for the purpose of state building at that particular time.[90] I then

90. Fishlow (1985).

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review standard *push* or supply explanations for the lending euphoria in the long nineteenth century. To this end, I document the rise of public finance by introducing an original dataset of interest rates for 92 countries from 1816 to 1913. The data show clear evidence of the favorable terms of access to capital offered to emerging economies compared to those offered in early-modern Europe and to those offered today.

Chapter 4 sheds light on the *pull* or demand determinants of the lending euphoria, namely, which country-specific characteristics predict low interest rates. Along with standard theories—the gold standard, reputation, and empire membership—I test the notion of extreme conditionality, that is, the hypothecation of public assets for the purpose of external finance. Law scholars have found that asset seizure was grounded in previously pledged assets. To assess the effect of hypothecation, I coded pledges among 700+ original loan prospectuses issued in London between 1858 and 1913 and examined whether pledging decreased effective interest rates. The statistical analysis, which exploits within-country longitudinal variation, shows that pledging reduced the spread when both bondholder coordination and geostrategic competition intensified—in other words, when the capacity to confiscate foreign assets gained credibility.

Default sanctions derived from extreme conditionality included asset seizure and receiverships. The latter were debt collection agencies that took over the local tax administration for the purpose of debt liquidation. In principle, receiverships could be advantageous for local tax capacity if they incorporated know-how and new tax technologies. I review secondary evidence of the performance of receiverships in chapter 5 and complement it with an in-depth analysis of the Ottoman Public Debt Administration (1881–1914), the most ambitious receivership ever run based on the outstanding debt it was meant to liquidate. Results are pessimistic throughout, in line with modern experiences of foreign-led state building.[91] Receiverships were profitable for bondholders because debt was liquidated; however, local tax ratios and administrative performance did not improve relative to preintervention years. The last part of chapter 5 brings us to late-Qing China, where foreign financial control was installed in 1911 after two decades of trying. This case illustrates, first, that the Qing's reluctance to share power with provincial leaders paved the road to foreign intervention; and second, that bondholders took control of an institution, the Maritime Customs Service, which was *already* proficient in tax collection.

91. Lake (2016).

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The findings in chapter 5 illuminate the reasons that external finance rarely translated into state building in the Bond Era. Cheap capital often led to high indebtedness and default. Debt restructuring included a mix of new concessions and receiverships, softened with some debt relief. By agreeing to those conditions, countries were readmitted to capital markets without having improved their capacity to tax. If anything, their fiscal position was weakened because foreign control shrank the tax base left for local authorities. New loans and debt suspension loomed on the horizon. In the second part of the book, "The Consequences of Global Finance for State Building," I show that states that relied heavily on external finance to secure government funds did not build state capacity. Because military expenses were a key reason to float loans, I examine the consequences of war finance for short- and long-run state building, with a focus on taxation.

In chapter 6, I elaborate on the nature of war outside Europe and how it was financed in the nineteenth century. First, I revisit historical statistics of war. Based on duration, intensity, and frequency, war in the periphery in the nineteenth century was not different from the average war in the formative period of state building in Europe in the fifteenth to seventeenth centuries. Along with statistical evidence, I rely on war historiographies to shed light on the characteristics of interstate warfare outside Western Europe. Second, I show statistical evidence to document the use of external finance for war purposes, a result that allows me to revisit Polanyi's haute finance hypothesis.[92] Last, I reflect on colonial war finance by studying the effect of war, access to foreign funds, and fiscal performance with a paired comparison between the Cape of Good Hope and the Transvaal in South Africa.

Having shown that war was pervasive around the globe and that it was commonly funded with external capital, I examine the consequences for state building in chapter 7. Some tests focus on short-term effects of war on taxation, others on its long-term repercussions. The study of war finance on state capacity raises questions of reverse causality and selection. I gain leverage on endogeneity issues by exploiting exogenous shocks in international credit markets and focusing on ongoing wars, namely, those initiated while capital flowed but that were eventually hit by a global credit crunch. The chapter also addresses issues of what historians refer to as *history compression*[93] in the study of legacy effects. Overall, the evidence in chapter 7

92. Polanyi (2001).
93. Austin (2008).

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suggests that war funded primarily with external debt did not make states in the short or long run; by contrast, war funded by taxation did.

Whereas chapter 7 shows that war finance is consequential for state building, chapter 8 examines why. To that end, I elaborate on the political and bureaucratic mechanisms of transmission introduced in chapter 2. The discussion identifies key differences in war finance before and after 1815, shedding light on the reasons that Europe built strong states and constitutional monarchies while most emerging economies did not. The historical comparison motivates an empirical test of the political channel of transmission from 1815 to date. I show evidence that war finance in the Bond Era shaped the strength of power-sharing institutions by 1914, particularly in small and densely populated polities, and that those effects, although attenuated, persist until the present day. The bureaucratic mechanism of transmission, namely, the idea that tax bureaucracies made by and for war seek organizational survival, also receives support once tested against historical data. Results in chapter 8 emphasize the importance of the study of history to understand political, economic, and bureaucratic characteristics of modern-day states.

In chapter 9, I illustrate the book's argument by studying state building trajectories in five sovereign countries of varied geographic and institutional extraction: Argentina, Chile, Ethiopia, Japan, and Thailand. To assess the different paths in figure 1.3, I divide the exercise into two paired comparisons, Japan–Argentina and Siam–Ethiopia, and a longitudinal analysis for Chile. The comparison between Japan and Argentina sheds light on the importance of domestic credit markets (strong in Japan, weak in Argentina) to keep foreign dependence under control and prevent falling into a debt trap. The Siam-Ethiopia comparison exemplifies the perils and limits of bureaucratic strengthening in the absence of political reform and how access to external funds can undo state strengthening efforts, causing stagnation (Siam) and decline (Ethiopia). Finally, Chile illustrates opposite incentives to mobilize domestic resources depending on access to foreign capital. The War of the Pacific (1879–1883), waged under capital exclusion, activated both the bureaucratic and political mechanisms of transmission. Advances in fiscal capacity were followed by stronger parliamentary power to hold the executive accountable for the growing funds it was to manage.

I conclude in chapter 10 by reflecting on the effects of external public finance on state building, and why interstate competition helped build strong states in Europe but seldom elsewhere. Then I look at the similarities and differences between external finance in the Bond Era and today.

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Much has changed: The weight of private loans has declined dramatically in favor of official lending, switching the priority of conditionality from debt collection to capacity building. Relatedly, extreme conditionality is no longer practiced, perhaps with the exception of China. And yet, some problems persist. First, external finance allows rulers to escape politically costly reform and to postpone state capacity building, feeding all sorts of perverse incentives and attracting vulture investors. And second, when default comes, the foreign enforcers today (e.g., IMF inspectors) face legitimacy barriers similar to those that receiverships did a hundred years ago despite their different mandates. Directed state building, now and then, might just be an impossible enterprise.

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