Duplication without Constraints: Alvarez Nogal and Chamley's Analysis of Debt Policy under Philip II

Mauricio Drelichman [1, 2]   Hans-Joachim Voth [3]

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Abstract

Carlos Alvarez-Nogal and Christophe Chamley (henceforth AC) recently published a paper in the Economic History Review on "Debt policy under constraints: Philip II, the Cortes, and Genoese bankers". In this note, we show that several claims in their article are very similar to earlier research results, published or circulated long before AC's original submission, by ourselves and other scholars (Section I). These results are repeated without attribution or even mention of the earlier work. In addition, we show that what AC present as new quantitative insights are actually replications of earlier results of ours (Section II). Finally, AC misrepresent our contributions, as well as those of several other scholars (Section III).

I.

The authors summarize their contribution as follows:

> "**We propose an interpretation of the financial crises under Philip II that is totally new**. These crises were not caused by a 'sudden stop' from foreign bankers, by a problem of liquidity, or by the inability of the Crown to raise sufficient revenues. […] We show that the cause of each of the crises lay elsewhere, in the protracted negotiations about higher taxes that took place in the Cortes between the Crown and the cities of Castile. When the service of that debt reached the implicit ceiling imposed by the domestic taxes, protracted negotiations had to take place between the Crown and the cities. These negotiations triggered a suspension of payments by the Crown on the loans with foreign bankers. […] the alleged defaults were part of a system that had efficient properties in the institutional context ." [emphasis added].

One of AC's "totally new" results is their argument that **"… the alleged defaults were part of a system that had efficient properties in the institutional context".** The

[1] The University of British Columbia, Vancouver School of Economics, 997-1873 East Mall, Vancouver, BC, V6T 2G2, Canada. Mauricio.Drelichman@ubc.ca
[2] The Canadian Institute for Advanced Research.
[3] University of Zurich, UBS Center for Economics in Society, Schönberggasse 1 ,CH-8001 Zürich, Switzerland. voth@econ.uzh.ch

authors recognize that they are not the first to think about this, but only cite contemporary economic theory making a similar claim. On p. 208, they write:

> "[r]ecent literature has emphasized the role of bankruptcy as the outcome of an efficient loan contract that saves the cost of information that must be acquired by the lender…" [the only reference is to Townsend (1979), a theoretical paper on optimal contracts].

The recent literature on lending to Philip II has already emphasized the role of bankruptcy as the outcome of efficient loan contracting. In Drelichman and Voth (henceforth DV) 2011a, we conclude that "the boom-and-bust cycles of the sixteenth-century Spanish monarchy reflect the efficiency and flexibility of private-order institutional arrangements". In our book we show that this built "a remarkably stable and effective system for financing government borrowing" (DV 2014). Also in our book, we write: "Our analysis shows that serials 'defaults' did not damage Spain's fiscal capacity; indeed, they had remarkably few negative effects. As far as the documentary record can tell, it is likely that defaults were anticipated, and constituted part of an efficient risk-sharing structure…"

To be sure, AC introduce some elements that are different from our argument. In particular, they link the negotiations between Crown and cities with the defaults on short-term debt. In this sense, some parts of their thesis could be considered complementary to our work. Nevertheless, the conclusion that the defaults were part of an efficient institutionalized system is found in almost identical formulations throughout our extensive work, entirely uncited by AC.

On page 200, AC write:

> The system of juros de resguardo enabled bankers to refinance asientos at a low interest rate. That system increased the banker's profitability (no source cited).

Nowhere in their article do AC discuss banker profitability. Indeed, one cannot do so without examining the detailed cash flows of short-term loans (asientos) and calculating their rate of return, something that AC do not do and for which they cite no sources. The only existing piece of scholarship that performs these calculations is DV 2011b.

On page 199, AC write:

> When the asientos included loans, the average maturity was about two years (though some contracts could last up to 10 years). (no source cited).

These figures can already be found in Table 1 of DV 2011a (p. 1212), where they are reported as 22 months and 134 months respectively. We are not aware of any database other than our own reporting the duration of all contracts that would allow a calculation of these summary statistics.

We are not the only ones affected by AC's lack of attribution. In page 202, they write:

> "A key feature of each settlement was the conversion of all the asientos, net of any debt reduction, into long-term juros. **That feature has been neglected in the literature** but reinforces our interpretation of the debt policy of the kingdom of Castile…" (p. 202 our emphasis).

Here, AC fail to do justice to the earlier, important contribution by Conklin (1998) – published in the *Journal of Political Economy*. He argued:

> "The debt ceiling predicted by theory accounts for the juro-for asiento swaps the Crown and the Genoese conducted at the conclusion of each bankruptcy. Because the Crown was at its debt ceiling, the Genoese could not roll over more asientos without undermining the mechanism that backed their claims. Nevertheless, to continue lending to the Crown, the Genoese needed to find a way to allow it to defer payment. Accepting newly issued juros as payment for asientos in arrears, the Genoese would then sell the newly issued juros to Castilians and liquidate their position. Consequently, the Genoese enabled the Crown to float more debt yet no longer be near its asiento ceiling. To secure funding for the newly issued juros, the Crown would convene the Cortes de Castilla to raise new taxes." (p.505)

While Conklin focuses on a supposed ceiling on short-term debt and AC on one on long-term debt, the essence of the argument is very similar, as are the mechanics of the debt swap. Claiming that the insight is "totally new" and that the conversion of asientos into juros is a "feature that has been neglected in the literature" is clearly wrong – and it diminishes Conklin's contribution by failing to cite him entirely.

It is important to point out that these are not mere oversights. AC had plentiful access to our contributions, most of which were published years before AC's original submission. The same is true of Conklin's article. In three cases, our pieces were published after their submission, but were widely circulated – through SSRN, CEPR, and personal websites – for 2-3 years prior. Manuscripts for one now-published paper (DV 2015a) and one book chapter (DV 2015b) were posted online since mid-2011; AC were made aware of them in an email dated July 28, 2011, and acknowledged November 8 of the same year (our email is available online at http://econ.sites.olt.ubc.ca/files/2015/06/pdf_email_drelichman_July_2011.pdf). AC actually cited DV 2011b in a 2013 Spanish language publication (Alvarez Nogal and Chamley, 2013), showing they were fully aware of its existence. Our book manuscript (DV 2014) was likewise widely circulated since early 2013.

II. Replication of Earlier Results Without Attribution

Several results and conclusions that AC present in their article are actually replications of earlier results of ours using only marginally different sources. There is nothing inherently wrong in these replications, and we are pleased that they confirm our earlier results. However, they clearly should not be considered novel contributions, and the original findings should be properly cited.

Table 1 (p. 198) gives an aggregate summary of revenue streams between 1556 and 1598. Such a reconstruction can be found, in much more detail, with careful sensitivity tests, and at a yearly frequency, in the Appendix A to the unabridged version of DV 2010.

Figure 1 (p. 199) presents a chart showing the evolution of the different revenue types between 1555 and 1596. The data in Appendix A to DV 2010 allows for the construction of a far more detailed chart, and indeed one is presented in page 818 of that article.

On page 199, AC write:

> Contrary to some descriptions in the literature, the greater share of asientos was not written into loans to pay the army in Flanders. For example, in 1575, less than 40 percent of the total disbursements of asientos were in Flanders, and about half were in Castile (with the rest in Italy and Besançon).

This statement (presumably backed by the list of asientos in table 2) is just a special case of our work showing the entire geographical distribution of asiento disbursement, reported in table 2 of Drelichman and DV 2011a (p. 1214). This information is not available anywhere else, as we were the first to examine the complete manuscript record of lending transactions to Philip II.

In page 209, AC write:

> "the existence of arrears is also confirmed by the terms of some asientos signed before 1575 that included clauses for the payments of arrears" (no source given).

Indeed, such clauses are important. The fact that these existed is a cornerstone of our argument that defaults were actually part of a system featuring frequent deviations from contractually-arranged payments. We describe this in detail inter alia in DV 2011b (p. 15), where we write:

> "We do not account for reschedulings that took place in the normal course of business. 78 asientos –almost 20% of the total– recognized and restructured earlier obligations that the Crown had failed to meet. This affected 24 different families. The average rescheduled amount was 108,946 ducats, almost half the loan value of an average asiento contract. Overall, 8.5 million ducats were rescheduled through different contracts, almost 10% of the total amount."

III. Misrepresentation and Misattribution of our Arguments

AC also consistently misrepresent the content and spirit of our work on Philip II. AC repeatedly attribute some of our findings to I. A. A. Thompson, even when our conclusions are the exact opposite of his. For example:

> More recently, Drelichman and Voth, following earlier work by Thompson and others, have shown that solvency was never the issue […] (p. 194)

In relation to this topic, Thompson (1994) writes:

> If, by "fiscal crisis", we simply mean an unbridgeable gap between unavoidable expenditure and disposable income, then the Spanish monarchy was in an almost continuous fiscal crisis. (p. 158).

One of the main conclusions from our research is that the Spanish Crown was NOT in a perennial state of fiscal crisis; indeed, we argue that it dealt better with adverse shocks than many modern financial systems (Drelichman and Voth 2014).

In another passage, AC write:

> Philip II's suspensions of payments were not caused by liquidity problems but were part of the overall efficiency of the system. Thompson, who is an exception to the literature, was the first to express that point of view (p. 211).

This is wrong on several counts. First, it is entirely possible for a monarch to suffer adverse liquidity shocks – and to still run an efficient system overall. Indeed, this is precisely what we argue. AC also wrongly attribute a structured and fleshed-out argument to Thompson. In footnote 75, they cite Thompson as writing that "this very periodicity [of the fiscal crises] suggests that rather than the manifestation of "crisis" these "bankruptcies" were an integral part of the financial system of the Monarchy". This, however, is a conjecture, and Thompson does not take it any further. Indeed, as the above quote shows, Thompson was more inclined to see the Spanish financial system as suffering from repeated, severe crises.

In our collective work, we show how such a system works. It begins with the fiscal position of the king being sustainable (DV 2010). A network of bankers is required to ensure that the king does not opportunistically default on his loans (DV 2011a). Lending must be profitable in the long run, after accounting for the losses suffered during bankruptcies (DV 2011b). In a volatile world, lending instruments must be flexible to allow for a multiplicity of contingent scenarios; defaults, when they happen, must be "excusable" (DV 2015a). The entire argument can be found in an organized and coherent way in our book (DV 2014). It does not strike us as good scholarly practice to attribute a conclusion to an earlier scholar's throwaway remark that is largely contradicted by the spirit of the rest of his article, instead of to the researchers who have written at length about a topic, and made it the central thesis of their research.

The misrepresentations continue:

> Previous works on the financial crises in sixteenth-century Castile fall into one of two categories. The first category, favoured especially by economists, views Castile as a modern state with central control over expenditures and revenues and a budget policy that could be evaluated by aggregates according to International Monetary Fund criteria (inter alia: Drelichman and Voth 2010).

This statement directly contradicts the general nature of our cited work, as well as specific passages. For example, we write:

> Philip II himself – like most early modern rulers– had very limited information about the state of his finances. The decentralized nature of early modern states, combined with rudimentary information collection, hinders attempts at reconstruction." (DV 2010, p. 814)

The statement also ignores our book (DV 2014). Building on the very literature cited in AC's footnote 15, we clearly discuss the constraints faced by the Spanish Monarchy, its failed attempts to centralize control over tax collection, as well as the absence of a budget policy (p. 261-270).

In a related argument, AC highlight the importance of Habsburg Spain's "composite monarchy", and claim that they are the first to point out its importance for debt policy. They write:

> "The second category of historical research on Spain follows Elliott in emphasizing the 'composite' nature of the state in which territories preserved most of their political-administrative structure and historic freedoms. We support this view and argue that relations between the Crown and the cities were directly related to the dealings between the Crown and the Genoese bankers who provided short-term loans. In order to understand the financial crises it is important to study both relationships at the same time." (p. 193 – several works on the composite nature of the state are cited, but not linking it to financial crises).

We agree that the composite nature of the state –and the constraints arising from this for tax policy– were of prime importance for financial crises. As a matter of fact, one of us delivered the EHS 2011 Tawney Lecture on precisely this theme, highlighting the importance of Spain's internal fragmentation for the structure of its finances and performance as a borrower (Voth 2011). Insights from the lecture are, again, part of our book manuscript, widely circulated since 2013. We argue:

> "The whole apparatus of sanctions a sovereign state typically applies to run its administrative machinery were almost never within the reach of the court in Madrid. Spain failed to develop an administrative infrastructure that could overcome such opposition, based on old custom and ancient legal agreements. Even in terms of collecting taxes, there was no centralization of administrative processes and no homogenization of rules…" (p. 259) "– an inability to force through change, to centralize, streamline, and to tax effectively and evenly (Grafe 2012; Epstein 2000). The failure to build a more capable state on the Iberian peninsula reflects two underlying weaknesses – initial heterogeneity, and the influx of silver. The first made it more costly for the ruler of a composite state to wrest control from local power holders, and to abolish ancient privileges and freedoms, remove internal customs barriers, and expand the tax net…" (p. 270).

In light of these statements, AC's framing of our work as portraying Castile as a centralized government with direct control over revenues and expenditures is without any foundation, and a simple distortion of the spirit and letter of our contribution.

AC's misrepresentations of our contributions are meant to support their claim that the finances of a composite monarchy, with serious constraints on its power to centrally collect taxes, cannot be evaluated using IMF criteria. Is this so? The IMF sustainability criterion we employ is simple –the present value of revenues must exceed the present value of debt service. This is not some arcane, new-fangled formula requiring complex assumptions about the institutional structure of the state or the expectations of economic agents –it is the simple intertemporal budget constraint from any standard course in macroeconomics. It can be applied to any infinitely-lived entity and, if the provision that the capital be repaid by the final period is added, for finitely-lived borrowers as well. It also applies regardless of whether the state in question is aware of it or not – if anyone permanently spends more than they take in, their fiscal position is not sustainable and a day of reckoning will eventually come. We fail to see why either the fact that a particular revenue stream is committed to the service of a particular debt issue, or that debt is administered by third-parties, or that a variety of constraints are imposed on a monarch would make such a simple and standard criterion inapplicable.

IV. Conclusions

In this comment, we demonstrate that several of the "totally new" findings claimed by AC are already found in earlier, published work, and that their claims about the efficiency of Philip II's restructuring of short-term debt merely repeat, without acknowledgement or attribution, what we have demonstrated as a result of a decade-long research project resulting in a 328 page book, four refereed articles, two book chapters, and two other articles. In addition, AC repeatedly misrepresent our conclusions, despite us pointing this out to them in private correspondence; they give no sources for several of their figures, which can already be found throughout our earlier work; and they mistakenly attribute our results to other scholars.

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