War, International Finance, and State Capacity in the Long-Run

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Abstract

This article revisits the relationship between war and state-making in the era of international finance. Drawing on crossnational interstate war data as early as 1815, I show that financing war with taxes exerts lasting effects on state capacity because new taxes require enhancements of the state apparatus and complementary fiscal innovations (e.g. central banks). By contrast, externally financed war may not contribute to long-term state capacity because countries might default once the war ends, preempting any persistent fiscal effect. To address concerns of endogeneity in access to war participation and war finance, I exploit unanticipated, historical crashes in international financial markets, which temporarily dried up capital flows around the globe and precluded warring states from borrowing irrespective of their (un)observed characteristics. Results show that states that waged war while being excluded from international markets developed tax capacity to finance the means of war, whereas countries that went to war while having access to international credit did not. Results imply that the advent of a genuinely global credit market in the nineteenth century facilitated external financing of the means of war but weakened incentives to conduct tax reform (taxes)- 5(exerts)c