

An Analytical Narrative of Capitalist Transformation in Germany and in the Habsburg Empire in the 19th Century

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I. Introduction

Recent research in New Institutional Economics shifts the theoretical interest to the interdependence between economic and political institutions as the causal factor for economic development. Expanding on the well-known claim that “institutions matter” for economic performance, the dependency of economic institutions on the political system starts to attract systematical investigation. Succinctly, New Institutional Economics emphasizes that a competitive order in the economy is only possible and sustainable if political power is attained by political competition. Currently this is to the most extent realized in Western democracies which bestow a “monopoly of legitimate coercive power” (Weber) temporarily. By contrast, if an autocrat or a small group depending on him can wield political power without elections, the autocrat will make use of his power in order to create rents for him or his supporting group. Rent-creation, in turn, is at variance with free-market capitalism because market entry is controlled by politics and competition cannot unfold. By implication, capitalism without political participation is not feasible. Otherwise power holders have to refrain from using their political power for rent creation, which is an unreliable and irrational self-restriction. A key distinction is made between a competitive and a non-competitive order that is based on privileges, which revises former distinctions between a market economy and a planned order; also a non-competitive order which rests on rents and privileges can coordinate its activities by means of prices.

Acemoglu/Robinson (2012) and North/Wallis/Weingast (2009) advocate different versions of the idea that economic institutions depend on political institutions. Their prime examples of a concomitant liberalization of both politics are Britain, France and the US in the 18th and 19th century. It is argued that these countries have established universal rights, both in politics and in the economy in an early stage. To a large extent, capitalism and democracy are claimed to have emerged more or less simultaneously; steps towards more economic freedom have been

accompanied by more political freedom and vice versa, occasional discontinuities notwithstanding (North/Weingast, 1989; North/Wallis/Weingast, 2009, 2).

At a closer look (Acemoglu/Robinson 2012) and North/Wallis/Weingast (2009) delineate an idealized version of British, French and American history respectively (which the authors partly concede). It rules out many obvious elements which do not fit into the story of universal human rights, among them slavery in the US until the late 1860s, the presence of autocracy in France during the restoration period after 1815 or after the Second Republic, but also political repression of workers in Britain which were largely prevented from voting due to a census voting system. Nevertheless, good reasons are given for the theoretical idea of a “double balance” between the political and economic system (see the following subsection). In order to broaden our understanding for the conditions necessary to develop a market society we analyze two cases which are mostly neglected in Newest Institutional Economics or undergoes inaccurate interpretation.

In the following the successful capitalist transformation in Germany and the retarded transformation in Austria will be under consideration. Within a few decades after 1800 Germany was developing from an economic laggard into a high performer. The Habsburg Empire, by contrast, is largely seen as an economic laggard throughout the 19th century and failed to catch up with the high performing centers of European capitalism. According to Maddison’s estimation British GDP was approximately 40 percent higher than the German GDP in 1820, while the German economy outperformed the British economy after 1908 as far the total GDP is concerned.¹ In the end of the 19th century the economy of the German Empire (existing after 1871) underwent a period of high industrialization, high economic growth, highest growth of population in the world and technological progress which jointly contributed to this performance. By comparison, the economic development of the Habsburg Empire was more sluggish and “never experienced a great spurt in industrialization” (Gerschenkron, 1977, 52). According to Maddison (1995) per capita GDP in Germany grew by 1.1 percent on average between 1820 and 1870 as compared to 0.7 percent in Austria. From 1870 to 1913 per capita GDP growth rates were 1.63 percent in Germany and 1.15 percent in the Habsburg Empire (1.02 percent in modern Austria; Schulze, 2000, 324).

Strikingly, the political orders in both countries did not differ very much. Political participation and even a constitution which constrained the power of the monarch was absent in Prussia (the South German states had constitutions in the first half of the nineteenth century) until 1848 but

¹ See www.ggdnc.net/maddison/historical_statistics/horizontal-file_03-2007.xls

also in the Habsburg Empire. In either countries the nobility remained in power and enjoyed political and economic privileges. While the political orders were rather similar at least in the first half of the nineteenth century, economic institutions and therefore economic development took a different route. This fact challenges the view of Newest Institutional Economics according to which economic and political institutions are closely linked to each other. In the following we try to solve this puzzle by presenting an alternative explanatory framework; we reject Acemoglu/Robinson's conception of a hierarchy of political and economic institutions and expand on NWW's explanatory scheme. Before we present our argument in a nutshell, let us briefly reconsider the theoretical conception under review. Then we describe the institutional status quo ante around 1800 before the capitalist transformation took place. In reaction to the military defeat of Prussia and Austria against Napoleon institutional reforms took very different routes, notwithstanding that the nobility remained the ruling class in either political orders. While an entrepreneurship independent from the nobility could develop in Germany, Austrian capitalism remained an annex of the estate-based society and did not form a new type of societal order. Then we analyze the reasons which we consider more appropriate to broaden our understanding of capitalist transformation processes.

I. 1. Recent Literature on the dependence of economic and political institutions

Acemoglu/Robinson (2012) as well as North/Wallis/Weingast (2009; NWW in the following) argue that competition set up by all members of society is the defining element of capitalism. Innovation competition gives way to upward social mobility and is suitable to transgress a pre-capitalist social stratification. By contrast, to the extent that the prevailing economic institutions exclude groups or even the majority from market entry in key economic sectors, innovation competition is constrained and likewise the constituent feature of capitalism.

Accordingly, Acemoglu/Robinson (2012; A/R in the following) speak of inclusive as opposed to exclusive institutions, which resembles NWW's distinction between "open access orders" as opposed to "limited access orders". The idealized version of this conception reads as follows: "Inclusive economic institutions create inclusive markets, which not only give people freedom to pursue the vocations in life that best suit their talents but also provide a level playing field that gives them the opportunity to do so. Those who have good ideas will be able to start businesses, works will tend to go to activities where their productivity is greater, and less efficient firms can be replaced by more efficient ones" (A/R, 2012, 76 – 77). As an unintended consequence, however, economic agents could challenge prevailing market positions, e.g. in

terms of a creative destruction. If economic institutions are inclusive and open markets for outsiders, incumbent's incomes become challenged. This gives rise to a conflict if the incumbents have access to political power. But privileges are alien to a competitive order. By contrast, exclusive (or extractive) institutions "enrich the same elites, and their economic wealth and power help consolidate their political dominance" (ibid., 81). These elites oppose capitalist institutions because "the spread of industries, factories, and towns took resources away from the land, reduced land rents, and increased the wages that land-owners had to pay their workers. These elites also saw the emergence of new businessmen and merchants eroding their trading privileges. All in all, they were the clear economic losers from industrialization" (ibid., 85).

As a consequence, elite groups in pre-capitalist societies are viewed to have a genuine interest in opposing capitalist transformation. Accordingly, they would also defy pluralist political institutions, as A/R point out with respect to elites in absolutist regimes: "Would they be interested in changing political institutions to make them more pluralistic? In general not, since this would only dilute their political power, making it more difficult, maybe impossible, for them to structure economic institutions to further their own interests" (ibid. 86). This argument echoes what NWW term a "double balance" between limited access in politics and economics. But unlike NWW, A/R consider political institutions as key for the economy, which implies that capitalist transformation must take its starting point from politics: "The only way to change these political institutions is to force the elite to create more pluralistic institutions" ((ibid., 87). Acemoglu et. al. (2011) apply this one-way causality from political power to economic institutions. They interpret the sweeping change of economic institutions in Germany after the French occupation by Napoleon's troop as a top-down institutional change and argue that Napoleon has imported the French Revolution to the German territories. By contrast, the defensive modernization of Prussia would have yielded lower economic benefits, even though a difference is measurable only 80 years after the end of the French occupation of the Rhine-territories. This re-interpretation of economic history is at variance with consent among historians who have made clear that Napoleon did not import the French Revolution to Germany. Rather, when he made reforms at all – among them the introduction of the civil code and the commercial code – it took place in regions where the political influence of the nobility was low before. Elsewhere, whenever a conflict with the nobility arose, Napoleon confirmed the economic and political privileges of the nobility and linked to the former distribution of power.² A/R downgrade the institutional reforms instigated in Prussia and claim that a top-

²) For a detailed critique see Wegner (2014). It is a consensus among historians that Napoleon only "translated" the inherited economic privileges of the nobility into the French Code Civil which made

down institutional change, e.g. administered by a military occupation or a revolution, would be more effective than a transformation “from within”. (Acemoglu et. al., 2009). Some external force or a revolution would be necessary because otherwise otherwise extant elite groups would have a genuine interest in defying capitalist transformation (see above).

The problem we see with this top-down approach is that any external imposition of institutional change or a revolution in society cannot instantaneously create a middle class which stabilizes a market economy. Such bourgeoisie or civil society is only the long-term outcome of capitalist development but cannot be the maker of sweeping institutional change. As a result, even a revolution or an imposition from above has to face a restoration period because the former elite group still commands over economic resources or possesses its social status. A successful institutional transformation is hardly possible without the support of at least parts of the former elite group. Research in economic history has got distant from “big bang” and “big push” stories; instead, it suggests that capitalist transformation in both economic and political terms was always a gradual process and took it lead from the prevailing political order (Allen, 2009; Deane, 1977; Borchardt, 1977; Kopsidis, , Reckendrees, 2010). The motivation of the following is to articulate a reservation against the big bang bias in A/R’s (2009) analysis, namely the idea that capitalist institutions can be designed or imposed from above.

NWW do not claim a hierarchy between political and economic institutions. But they mention the German capitalist transformation only in passing and apparently interpret the 19th century development from the viewpoint of the Nazi-period in the 1930s, which gives the impression that capitalist institutions have been imposed after WWII. In fact, a gradual but profound capitalist transformation started 140 years earlier.³ This period requires an explanation of its own; a retrospective view on German economic history in the 19th century from the angle of Hitler’s self-sufficient war economy is likely to produce a multitude of misguided interpretations and obscures our understanding of institutional change in the 19th century. The Habsburg Empire is rightly described as a markedly delayed economic development by A/R (2012); but a comparison of Austria with absolutist Russia and even Ethiopia is an obvious and occasionally absurd misperception of retarded capitalist transformation which – despite

its later removal far more difficult; see Dipper (1980, 62), Fehrenbach (1993, 81 and 87); see also the Articles 25 to 28 of the Act of Confederation.

³ The introduction of a market economy in West-Germany after 1947 was effectively a re-establishment of all major economic institutions that constitute a market economy (the civil code, the commercial code, free prices); the radical change which attracted so much interest mainly concerned the rapid dissolution of the Nazi’s war-economy.

political interference – did also occur at least in the Western parts of the Habsburg Empire in the late 19th century.

I. 2. The explanatory framework for different routes of institutional change in Germany and in the Habsburg Empire

In order to explain the different routes and pace of institutional change in the German states and in the Habsburg Empire we outline the analytical narrative in a nutshell before we go into more details in the remainder of this paper:

During and after Napoleon's occupation the German states found themselves in a competitive environment which made economic development essential for their independence and survival. This did not change after 1815 (the end of the Congress of Vienna) when the German Federation set up a competition among the states; it displays many features of Weingast's conception of "market preserving federalism" (Weingast, 1995). An important effect was that the requirement to develop the economy of the state drove a wedge between the interests of the dominant coalition (landed gentry) and the monarchs; the latter tended to adopt a public interest perspective concerning the economy. A by-product was the emergence of a public administration whose mission was the promotion of the economy. It became more independent from vested interests of the traditional elite group and strengthened the legislative power of the state. The public administration pursued liberal ideas and the "vision" of a liberal society, which meant the equality before the law and the abolition of the estate-based society. Because the interests of the traditional elite groups could not be compromised as a result of the political order, progressive reformers organized a bargain: the endowment of the elite groups was protected (and sometimes even enlarged) in exchange for capitalist institutions. This was, for the moment, a good deal for the traditional elite group but was to challenge its status in the periods to come – a plan which the progressive reformers had in mind. Even though the institutional reforms were far from being perfect, capitalist transformation took on a life of its own. The creation of a common market which was set up by the tariff union (*Zollunion*) in 1834 made the capitalist transformation irreversible. A competitive industrial sector could emerge because its entrepreneurs (nearly) exclusively came outside from the aristocracy which still held key political influence. The aristocracy could come to terms with capitalist institutions because it was not an economic loser of the transformation as far as its early stage is concerned. In the end, politics and the economy became sufficiently separated from each other. A few decades

later, the economy fulfilled the criteria of an open access order in terms of NWW (but in contrast to NWW's own categorization).

By comparison with Germany, capitalism in the Habsburg Empire emerged as an annex of the estate-based society and lacked the independency from the state, particularly the independency from the traditional aristocratic elite groups. In view of its imperial political power resources the monarch largely ignored the development of the economy which ranked low in the political agenda. An independent bureaucracy which pursued a liberal agenda comparable to the German states did not exist or lacked political support from the monarch. The less-developed capitalist bourgeoisie overlapped with the traditional aristocratic group and controlled the economic institutions. Therefore market entry became politically controlled as well; the economy was protected by excessive tariffs unknown in the *Zollunion*; also within the Habsburg Empire an integrated economy did not emerge. The multiethnic feature of the empire did not stimulate competition but corroborated rent-creation of the traditional elite groups in the non-German (Hungarian) crownlands. In order to commit these elite groups to the central government, their rents became tolerated, for which reason a common market with low tariffs did not evolve. By its very nature the Austrian economy – even the more developed Western parts of present-day Austria – remained closed and did not integrate into European capitalism. A vigorous liberal agenda which could have overcome Austrian backwardness lacked support by the monarch and the traditional elite groups as well. In view of the multiethnic nature of the Habsburg Empire, an alternative for this policy was hardly feasible. Even though it was line with the interests of the elite groups, the policy defies the characterization of compromising the will of the majority. In the end a cartelized capitalism with low economic growth rather than an open access order emerged.

In the remainder we amplify and modify this straightforward line of reasoning.

II. The point of departure for capitalist transformation

By capitalism A/R and NWW understand a competitive economic order which has established economic freedom for all members of society (e.g. general freedom) in order to unleash competition. We share this view of capitalism which considers competition rather than profit making or unconstrained prices as the distinguishing feature. Pre-capitalist economies exhibited market coordination in many economic sectors but restricted competition due to constraints on economic freedom of larger parts, if not the majority, of society. In many – but not in all – cases

these restrictions served the interests of the power holders, for which reason economic institutions correspond to political institutions. Therefore, A/R give priority to the change of political institutions and consequently the shift of political power.

If we concentrate on the economic institutions which make up a capitalist economy the following institutions matter:

- the security of property rights
- the freedom of contract
- the freedom of occupation and profession
- the freedom of movement (right of abode)
- the freedom of trade and industry and the right of establishment
- the freedom of association.

Commonly considered to be of particular importance is the security of property rights, as A/R and NWW (but also many other scholars of NIE) repeatedly emphasize. Interestingly, this was the only institutional element of a market economy which was already established before capitalism emerged in the German states and in the Austrian Empire. The Prussian General Common Law (*Allgemeines Landrecht*) guaranteed the property of all subjects also formally. Even though formal economic rights of the subjects within an absolutist monarchy can only mean a self-commitment of the state, confiscation of private property by the monarch or the elite group was absent; for that reason alone a comparison with pre-capitalist societies, e.g. in 18th century Africa or Asia (namely in A/R's book) is misleading. Rather, it were the remaining elements of capitalist institutions which fell short of manifestation and institutional guarantees in late absolutism. But also here economic historians stress that prior to the formal introduction of capitalist institutions (namely the formal introduction of the freedom of business in 1810 in Prussia) a strong tendency towards economic freedom was present in the German states and the Austrian empire in the end of the 18th century (Kaufhold, 1982). Economic freedom was always a matter of degree rather than of kind. Specifically, capitalism took its point of departure within the estate-based society (*Ständegesellschaft*) of late-absolutism (Reckendrees, 2010). The degree of openness for economic institutions varied from region to region considerably. As a rule of thumb, the economic institutions in the Western parts of the German states as well as in the Austrian Empire can be considered as more inclusive than those in the respective Eastern parts.

Roughly speaking, late-absolutist economic order in the 18th century constrained economic freedom in three areas corresponding to the distribution of political power:

- (1) In the rural areas peasants were subjects of the lord of the manor and could lack the freedom of movement. The manor (*Gutsherrschaft*) was the most restrictive economic system while the seigneurial system (*Grundherrschaft*) was far less restrictive and came closer to an agro-capitalist system. In the manor dependent peasants were paid in kind instead of money wages and thus bore further constraints of economic freedom. Peasants (including their children) had to fulfill service obligations for the lord of the manor – e.g. unpaid horse and cart work – who could decide on the kind, the time and the duration of working time. The personal subordination of the peasants was aggravated by patrimonial courts carried out by the lord of the manor. However, the personal property of peasants was protected. Land ownership was the privilege of the nobility, namely the right to bequeath land. Hence, for peasants the use of land was largely separated from property. Land property of the gentry could be prevented from entering a real estate market (*Fideikommiss*). The personal dependence of peasants on the lord of the manor was less severe than serfdom performed in the Eastern parts of the Habsburg Empire, namely the Ukraine under the Polish nobility (not to speak of Russia), which at times caused riots until the mid 19th century. As a rule, the personal dependence under the rule of the manor was common in the Eastern parts of Prussia as well as the Central part of the Habsburg Empire. In the central and Western parts of both the German states and the Habsburg Empire (that is present-day Austria) the strict rule of the gentry was replaced by a more impersonal dependency of the peasants, that is the seigneurial system (*Grundherrschaft*). Here the nobility was not economically active but received rents for the use of land; peasants were exempted from (nearly) all service duties. Depending on the strength of rights, aristocratic land owners could appropriate land in the event of defaults on payments (a practice called “Bauernlegen”); but in the course of the 18th century rights for land use became much stronger and were also enforced in other parts of Germany such as Saxony (Kopsidis/Pfister, 2013, 10).

A further restriction of economic freedom in the rural area concerned the freedom of occupation and profession. According to the mercantilist doctrine as regards the regional division of labor, the craft sector was reserved for the cities. Only few exemptions were made, namely for the homework sector. This restriction reduced the exploitation of comparative advantages in the rural area, even though workers – often successfully – attempted to circumvent this restriction (Kaufhold, 1982, 82).

- (2) In the cities craftsmen and tradesmen were organized in guilds. Guilds were both a kind of political self-organization and a constraint to the access to labor markets. In contrast to modern interest groups, medieval (and late-absolutist) guilds held the right to sanction violations of their rules. For instance, wealthy merchants in big cities such as Hamburg or Cologne controlled groceries to keep them within their limited markets in order to prevent potential entrants. Furthermore, cities controlled the influx of workers in order to stabilize the municipal economic order. Social obligations to assist needy people also played a role for the exclusiveness of cities. For instance, the independent city of Hamburg kept the right of closing the boundaries for outsiders until the 1880s. When the period of capitalist transformation took its point of departure after the “October Edict” in 1807, the privilege of the cities turned out to be the major conflict with the Prussian state (Nolte, 1990; Wehler, 2008; Koselleck, 1989; Fehrenbach, 1989).
- (3) Running manufactories required licenses of the Dukes or monarchs. The freedom of business and trade outside the guilds did not exist in absolutism which stuck to the economic policy of mercantilism. Instead, the Dukes bestowed privileges to business men which then held a monopoly, e.g. for producing porcelain or textile goods. However, at least in the German states Dukes tended to give these rights more generously in the second half of the 18th century which gradually undermined monopolies; after 1786 monopolies for manufactories expired (Kaufhold, 1982, 84). Likewise, German political economists of mercantilism took a more positive view on competition (Volckart, 2012). The willingness of the authorities to grant licenses of running manufactories was crucial for the establishing of capitalism. In Austria the practice of licensing manufactories remained more restrictive and preserved monopolies for a longer time than in the German states, foremost in the first decades of the 19th century (Matis, 1972, 62).

In accordance with A/R and NWW economic constraints were corresponding to constraints to politics; with emphasis to exceptions and the instability of any order as regards external changes, NWW speak of limited access in politics and the economy. Generally absolutist rule consisted of monarchs (the Emperor in Austria, Kings, Dukes, Grand Dukes, Reichsritter, Archbishops in the German territories still integrated into the Holy Roman Empire and formally lead by the Austrian Emperor). While the 340 independent German territories, some of which were as tiny as counties, were independent, the Austrian crown countries were under the rule of the Emperor. Nevertheless, a monopoly of coercive power of the state did not exist. In Habsburg the power of the state was split and carried out by the regional aristocracy and the

nobility on which the Emperor depended. Similarly, the Prussian state was ruled by a dominant coalition (in terms of NWW) which performed state functions such as lower jurisdiction by patrimonial courts. However, the extent of which the power of the state was centralized varied between the states. In Prussia the political strength of the nobility remained significant throughout the 18th century; namely Frederick the Great re-strengthened its power. In the Habsburg Empire the aristocracy (namely in Poland, in the Ukraine and in Hungary) demonstrated its political power when it obstructed and delayed social reforms instigated by the open-minded emperor Joseph II. (Fehrenbach, 1993, 55; Good, 1986, 38).⁴ These reforms softened the control and mastery of the landed gentry over its peasants; namely the use of land now had to be re-paid in terms of rents whereas labor duties were constrained, which made the mastery of the gentry more impersonal (Good, 1986, 37). However, in the Eastern part of the Habsburg Empire the Polish and the Magyar nobility reversed some of these reforms after the death of Joseph II. (up to the mid 19th century this institutional reversion provoked riots by Ukrainian peasants against the Polish nobility). This attests to the fact that the absolutist rule rested on the dominant coalition on the nobility rather than representing a single-actor state. In the South German states Bavaria, Wuerttemberg and Baden, but also in the Western parts of Prussia including the Rhenish duchies Mark and Berg the nobility exerted far less political influence. The same holds true for cities such as Cologne, Aachen, Düsseldorf, Hamburg or Frankfurt where merchants began to transform into a capitalist bourgeoisie. In the Rhenish region the political influence of this class turned out to be strong enough to maintain institutional reforms imposed by Napoleon's rule (namely the Code Civil and the Code de Commerce) when the French occupation ended in 1814.

A main obstacle towards capitalist development was the lack of a common market, which had both political and economic reasons. The German territories levied custom duties, often even within greater territories such as Prussia. The Rhine River was intercepted by numerous duties and staple rights by cities such as Cologne for which reason the interregional division of labor was restricted. The Austrian Empire was likewise split into regional markets as a result of custom duties even though the unity of the Empire would have facilitated the establishment of an internal market compared to the German political patchwork. Yet, ideas for the abolishment of custom duties had been rejected in 1762. Even later the Austrian Empire lifted its internal

⁴ These reforms concerned the freedom of marriage, the prohibition of child work, constraints for service duties (*robot*), the freedom of movement for peasants and the freedom of practicing a craft (Good, 1986, 38).

tariff barriers only gradually (Sandgruber, 1995, 230). This turned out to be major difference between the German and the Austrian route to capitalism throughout the 19th century.

Regarding the economic backwardness of the German states and the Habsburg Empire it is tempting to compare these regions around 1800 with present-day developing countries as it is done by NWW and A/R.⁵ For the following reasons such comparison is inaccurate and misleading: (1) The restriction of economic freedom was selective rather than comprehensive. Property rights besides land were secure; the *distribution* of land was far more an issue than the security of property rights as such. The use of land became better protected from confiscation of noble land owners in the case of defaults on payment. The main restrictions concerned the freedom of contract regarding land, the freedom of occupation and the freedom of running a business as a result of restrictive mercantilist economic policy. (2) Notwithstanding these restrictions, the late-absolutist economic order gradually eroded and gave way to more economic freedom. Namely in the German states licenses for businesses were granted more generously, which eroded monopolies for manufactories (Kaufhold, 1982). Guilds were challenged by the influx of unorganized craftsmen; hence, the population growth set the restrictive guild system increasingly under pressure. (3) The level of elite culture was extraordinary and set the standards of that time, encompassing sciences as well as fine arts. Already in the 18th century universities became aligned with the ideas of enlightenment and re-oriented universities (Halle, Göttingen, Jena) in German states put emphasis on sciences as well as on the humanities. Leading intellectual figures (Kant, Schiller, Lessing, Schlözer, Wilhelm v. Humboldt) forcefully advocated the ideas of enlightenment with no regard of the absolutist political order. (4) Illiteracy was low and declining; in the German states and in the Western parts of Austria compulsory schooling existed which was increasingly supervised by skilled authorities (Block, 1996; Bruckmüller, 2001, 187 - 189). (5) The state was sufficiently separated from the church. This applies first and foremost to the protestant German states rather than for the catholic South German states and the Habsburg Empire. But even here the state made efforts to restrict the influence of the church in some realms, e.g. by reducing religious holidays and pilgrimage which were considered an impediment for the economy (Sandgruber, 1995, 145). In spite of the powerful rule of the Catholic Church in the Austrian political order it would be an exaggeration to identify its role as a crucial impediment towards capitalist transformation. (6) Important steps towards the rule of law had been undertaken in the 18th

⁵) See A/R (2012, 236); for a rejection of the analogy of Germany in 1800 with developing countries see Wehler (2008, Vol. II, 25-26)

century; the equality before the law represented a key value benchmark which was accepted – and often outwardly advocated – by monarchs in order to legitimize their rule (Frederick II. in Prussia, Joseph II. in Austria). Public administration became more effective since the rule of Frederick II. in Prussia and Empress Maria Theresia in Austria.

Taken together, as far as Central Europe around 1800 is concerned, it is a myth to proclaim a great divide between inclusive capitalist institutions (France, Britain) on the one hand and exclusive pre-capitalist institutions on the other. Such alternative obstructs our understanding for the ambiguity of capitalist transformation which defies a straightforward political assignment. Rather, in spite of the prevalent absolutist political order the economic order in Germany and Austria was prepared for capitalist transformation and must be understood as an order under change towards capitalism which was sometimes tolerated as an ongoing process, sometimes actively promoted and sometimes hampered by its monarchs, public administrations or local aristocratic power holders.

For reasons to be discussed below, the Austrian authorities kept markedly stronger reservations against the new economic order than the authorities in the German states which is why Austrian economic development came under delay. The key conditions for a capitalist transformation nevertheless existed in either political orders and did not depend on a political revolution or a “big bang” as Acemoglu et. al. (2009) suggest. Rather, the relaxation of binding institutional constraints – sometimes silently carried out by an attentive public administration – became more important than comprehensive “blue print” reforms or legal announcements which appeared to be revolutionary but waited for some further decades to become effective.⁶ The economic rise of Saxony, which was to become a center of German capitalism, represented an example of effective capitalist transformation by accommodating public administration without high-sounding singular turning points of institutional change (for a detailed description see Kiesewetter, 2007).

The pace of economic transformation and the extent of growth depended on many factors, some of which were economic data for the economies (availability of natural resources such as coal deposits, the topography of land or the ethnic homogeneity) whereas others were up to political decision. The remainder focuses on institutional factors which (at least to some extent) depended on political decisions.

⁶ See Rodrik (2007) for the advocacy of accommodating instead of radical reforms in developing countries.

Methodologically, it is a particular task for institutional economics to disentangle the “objective” or allegedly given economic interests of agents who pursue institutional change from their own interpretation of their interests. Moreover, long term conceptions or visions for future society are not necessarily congruent with economic interests; namely the German capitalist transformation cannot be understood without the role of political ideas (“beliefs” or “ideology” in terms of Douglas North) of (mostly aristocratic) agents in public administration. Furthermore, competition among the states – specifically among the German middle states – has changed the interests of the monarchs who tended to adopt a “public interest”-perspective; this reorientation, in turn, opened up opportunities for liberal reformers to instigate institutional changes towards capitalism. As a result, as will be shown below, institutional changes can be interpreted in light of Weingast’s conception of “market preserving federalism”, which likewise emphasizes the modification of the interests of policy makers (Weingast 1995).⁷

Even though we apply an economic explanatory framework, it is inappropriate to ascribe super-rationality to the behavior of power-holders in the absolutist regime by deducing their political interests in retrospect from the long term development (see the methodology of A/R 2012). Resistance to capitalism and industrialization cannot be simply inferred from the end of capitalist progress which always results in social newcomers, namely the capitalist bourgeoisie, and the undermining of former elite groups (here: Aristocratic power holders). Such knowledge is not available when capitalist institutions are in the making. The question is whether and to what extent the aristocracy could have foreseen the decline of its economic role for such a long time horizon. And even if it had foreseen the long-term consequences of capitalist dynamics, it remains open whether monarchs or influential ministers would have considered their personal interests as being affected by this development. Hardenberg in Prussia and Kaunitz in Austria are counterexamples of liberal aristocratic reformers which do not fit into a super-rational explanatory framework of A/R (2012).⁸ Generally, German monarchs and the increasingly independent public authorities, namely in Prussia but also in Wuerttemberg or Saxony, held a positive stance on capitalist development. They instigated a process which was to remove the estate-based society in favor of capitalism. This was an intended but in many respects an unintended result of political decisions (see below). In contrast, and foremost after the French Revolution, Austrian rulers were reserved and for a longer time hostile to capitalism which they identified as a long-term subversion of the extant social order. But this does not mean that

⁷ See below

⁸ Wehler points to a remarkably high proportion of enlightened aristocratic reformers in Prussia; see Wehler (2008, Vol. I., 535)

capitalism, if only in a less developed form, was (or could be) successfully obstructed. Even reactionary power holders such as the Austrian Emperor Franz I. lacked control of economic developments directed towards capitalism. Under the specific conditions of the Austrian Empire the social forces were strong enough to transform the former economic order; however, the distribution of power delayed the institutional change in Austria and formed a specific type of capitalism that sustained in the early 20th century.

III. Different political reactions after the French Revolution and the Coalition Wars

In the period prior to the French Revolution the so-called “enlightened absolutism” saw *endogenous* tendencies of overcoming the economic order and softening the dependencies of the peasants (Reckendrees, 2010). The Prussian Common Law (installed in 1794) codified principles of the rule of law and constrained the arbitrariness of the monarch. As mentioned above, the freedom of trade and business was not formally codified, but informally and silently put into practice through generous award of licenses for start-up enterprises (“reforms before the reform”). Hence, mercantilist economic policy took up a more positive view towards competition, for which reason Kaufhold considers the introduction of the freedom of trade and industry in 1811 a purely formal act. Property rights gained formal protection, but effectively they had been rather secure before. (Kaufhold, 1982; Volkart, 2012).

Similar developments occurred in Austria under the rule of Maria Theresia and her successor Joseph II. The equality before the law was formally introduced and both emperors softened the dependency of the peasants from aristocratic land owners (constraints of the “robot”, that is service duties). Whereas Joseph II. stuck to mercantilist economic policy, he embraced the ideas of enlightenment and made attempts to institute the monopoly of coercive power of the state by establishing authorities which he kept free from the nobility (Butschek, 2012, 90).

The French Revolution caused different reactions in Prussia and in Austria: At least the first “civilized” period of the French Revolution until 1792 found a quite positive resonance among open minded administrators in Prussia who committed themselves to the ideas of enlightenment (see the opening remarks of Hardenberg’s Riga memorandum in Hardenberg 1807); in contrast, the Austrian authorities strongly rejected even the intentions of the French revolution. Franz II. revoked reforms of the liberal predecessor Joseph II. and eliminated public administration from

liberal reformers such as its leading figure v. Kaunitz (Butschek, 2012, 96; Good, 1986, 42; Bruckmüller, 2001, 205,). Censorship was re-introduced and a secret police established. The Emperor based his rule again solely on his aristocratic peers and the Catholic Church. Surprisingly, the Emperor also intended to ban the establishment of new factories in Vienna which attests to the hostile stance towards capitalism. Ultimately reasonable administrators (Herberstein-Moltke) managed to dissuade the monarch from this plan (Butschek, 2012, 96). Even in the period before the military defeat of Austria (Battle of Austerlitz in 1805) and Prussia (Battle of Jena/Auerstedt in 1806) in the Wars of the Third and Fourth Coalition both political regimes demonstrated divergent political and economic reactions, which paved the way for alternative institutional changes and patterns of growth.

III.I. Reforms in Prussia and in the German states

The military defeat affected the German states and the Habsburg Empire in different ways, which can explain alternative reactions of the elite groups (dominant coalition) in either regime. Prussia escaped its dissolution only narrowly in the Treaty of Tilsit in 1807 and had to cede half of its territory in the West to France. Heavy contributions were imposed which overtaxed the prevalent economic system. The country suffered from the Continental System and had to open its economy for French imports while the French export market – as well as the British market – remained closed until Napoleon's defeat. The Western territories, which were to come back to Prussia after the Congress of Vienna, suffered similar burdens in addition to the requirement to contribute troops for Napoleon. There was consensus among Prussian elite groups that the state required profound reforms in order to survive (see Hardenberg's Riga Memorandum in Hardenberg 1807). These ideas embraced the ideas of the French Revolution and were inspired by Kant's political philosophy, particularly the equality before the law. Now a group of (namely aristocratic) reformers took initiative and instigated reforms which strengthened the monopoly of coercive power of the state and established key institutions which were to constitute capitalism. After the military defeat, senior officials and ministers could push a liberal agenda more forcefully than two decades before when the Prussian Common Law was outlined by liberal reformers who had to compromise on the extant social order. As Deecke (2015) points out, renowned professors at the universities of Königsberg and Göttingen were familiar with Adam Smith's economic theories which they intended to put into practice. These scholars taught a new generation of civil servants and thus exerted practical influence on public administration. They got distant to the paternalism of mercantilist economic doctrine and

became aware that the dependency of peasants as well as the constraints of economic freedom in the cities fettered economic progress. As a consequence, administrative intervention into economic life was seen more critically. The organization of the manor as well as servant duties of the peasants were identified as disincentives for productivity growth in the agricultural sector. Advocates of Smithian liberalism (among them Kraus and Sartorius) were convinced that the system of natural liberty will unleash economic progress. Only few exceptions (e.g. concerning sustainable forest management) were accepted (Fehrenbach, 1993, 56 – 57). Free trade was seen as a remedy for an underdeveloped economy. An infant industry argument, as favored by List some decades later, did not find academic support at that time. Prussian reformers, such as Scharnweber, envisaged a middle-class society and criticized mercantilist economic policy, namely its efforts to modernize the economy through state owned enterprises rather than private entrepreneurship (Vogel, 1983, 142). Educational trips to England encouraged these reformers to instigate a capitalist society in which the proper task of the state was to rise the educational and cultural level of the lower classes (ibid.; Maiwald 2005).

After the military defeat and the ongoing threat by Napoleon's troops former reforms were resumed and gained considerable momentum. Now the strengthening of the economy and the increase of legitimation through the rule of law was also seen as a "weapon" against Napoleon. As Koselleck argued: "Public administration in Prussia deliberately opted for Adam Smith against Napoleon in order to dispel the latter by means of the former. It took up the challenge of instigating an industrial revolution in order to avoid a French revolution but nonetheless realize its ambitions." (Koselleck, 1989, 14, my own translation). The key problem, however, was that the reformers could not afford to compromise the economic interests of the landed gentry, at least for two reasons: First, the Prussian state had to take out loans from the landed gentry in order to pay contributions to Napoleon (according to Napoleon's strategy that "the war nourishes the war"). Second, the fabric of society still lacked a middle class which could support and stabilize the bourgeois society. As long as capitalism was in the making, the new capitalist institutions required political support by the extant elite group, which largely consisted of the aristocracy and the landed gentry. But even an emerging capitalist class will not necessarily support a competitive economic order since proto-capitalists have an interest to protect their pioneer advantages. This problem of a lack of political support due to economic underdevelopment is apparently a common feature of any capitalist transformation process.

Under the given distribution of political power, open minded ministers, such as Hardenberg, organized a political bargain: They introduced capitalist institutions while respecting the interests of the dominant coalition, the landed gentry, as far as necessary. The ambition of the compromise was the comprehensive establishment of capitalist institutions and the monopoly of coercive power of the state, which was to be constrained by a constitution. The constitution was designed to abolish the estate-based society (as compared to the 17 articles of the French National Assembly), which implied that the aristocracy had to give up state functions such as patrimonial jurisdiction on behalf of the state. For this reduction of political power the aristocracy should be compensated by favorable redemption rules. They concerned the manor (*Gutswirtschaft*) as well as the seigneurial system (*Grundherrschaft*). In the latter case land use rights were transformed into property rights. In the former case, peasants became formally free and now enjoyed the freedom of movement. The relief from work obligations and the transfer of land use rights into property rights required repayments (if possible) in terms of rents and also in terms of land. Commons became transformed into property rights.

Even though the reforms were not as radical as Hardenberg had intended – a constitution was not introduced in Prussia before 1848 and reactionary aristocrats made efforts to undermine his reforms after his death in 1822 – recent historical research confirms that the key elements of the institutional change were kept in place during the early decades of the 19th century, which is why the term “restoration period” does not fit very well (Harnisch, 1996). Now land property was integrated into the market economy: Land property owned by the nobility could no longer be excluded from markets and commoners had the right to own and to bequeath land. Changes in possession of land became a common practice as a result of the newly established real estate market (Wehler, 2008, Vol. I, 427; Harnisch, 1996, 172)⁹. Generous compensation rules notwithstanding, the landed gentry, as part of the dominant coalition, became under pressure by capitalist institutions but also by an emerging bourgeoisie (Harnisch, 170 – 171). While the monarchist government made some concession to the landed gentry until 1848 and preserved vestiges of political rights (exerted in the local *Provincialstände*), it was mindful that the monopoly of coercive power of the states was not challenged. Complaints of the conservative nobility about the new “impersonal political order” abounded (Berding, 1996, 24; Quelle: Wehler).

⁹ Harnisch estimates that around 1800 approximately 7 Percent of the land property was owned by citizens outside the nobility as compared to more than one third in 1842 (ibid.)

The new political influence of the public administration and progressive reformers rested on the competition among the states (Berding, 1996, 17 – 24). After the Congress of Vienna and the establishment of the German federation (of which Austria remained a so-called guarantee power) monarchs in Prussia but also in the consolidated smaller South German states were aware that states were economically competing with each other (ibid.). A prospering economy and fiscal revenues were now considered a pillar of the state in order to retain its independence. Therefore the nobility could no longer rival with the state for the exercise of political power. Political privileges and tax privileges notwithstanding, the nobility had to accept that it was integrated into the state.

The key effect of the Prussian reforms was the fact that former dominant coalitions gradually lost control over the power to set rules for the economy. Inspired by Adam Smith's political economy (his "Wealth of Nations" was translated and received in Germany before 1800; Weecke, 2015; Priddat, 1998), the Prussian reformers abolished internal tariffs and introduced the freedom of occupation and profession as well as the freedom of trade and industry (Wehler, 2008, Vol. I, 429). The guilds in the cities became abolished and a craft sector was permitted in the rural area (before it was a privilege of the cities). Manufactories required licenses which were given under formal rules without discretion. That was the first step for general economic freedom regarding the industry. Political opposition of guilds and merchants in the cities which stuck to their guild privileges was ignored. Here the state took no consideration of local political power and imposed capitalist institutions. However, the new economic order became more acceptable for local power holders as far as they could benefit from their wealth accumulated in the former economic order.

In line with Adam Smith's political economy Prussian reformers rejected tariffs and abolished the Continental System imposed by Napoleon. The areas west of the Rhine, formerly annexed by France and protected by tariffs, were suddenly integrated into the Prussian market and lost their protection. Complaints of the politically powerless entrepreneurs received no consideration in the whole Prussian territory. The liberal reformer Hardenberg stuck to the free trade regime and emphasized that the free trade doctrine "requires explanation but cannot be called into question" (Koselleck, 1989, 320 – 321). Nascent capitalism in Germany was not protected by tariffs, which turned out to be a major difference to capitalism in Austria and the Habsburg Empire.

In the other German states the monarchist public administration made a similar, at least implicit, decision towards capitalism. In the South German states (and in the Rhenish territories which became part of Prussia after the Congress of Vienna) the political influence of the nobility was far less marked. Public administration was not in need to show consideration of the nobility. Instead it could concentrate on the interest of the state which encompassed two areas: (1) The monopolization of coercive power and modern state building as the consequence of the consolidation of the states (so-called mediatization after 1805). (2) The promotion of the economy in order to compete with other German states for public revenues (Berding, 1996). Delayed reforms regarding the dissolution of guilds, e.g. in Bavaria or in Saxony, defy a straightforward interpretation as rent-seeking. Rather, the states attempted to moderate social conflicts in view of the creative destruction of the craft sector.¹⁰

Of key importance was the joint decision to establish a custom union among several German states (including Luxemburg) without introducing prohibitive tariffs.¹¹ In fact, the tariffs of the *Zollverein* (“Customs Union”) were the lowest in Europe.¹² The early period of industrialization before the *Zollverein* lacked any protection. Hence, the *Zollverein* set the course for market integration and removed trade barriers for the industry as well as agriculture (Dipper, 1996). The prevailing political order facilitated such a radical decision towards capitalist institutions for two reasons: (1) Neither the monarchs nor the landed gentry (namely in Prussia) were engaged in the industrial sector, which distinguishes German from Austrian transformation. Besides some exceptions (distillery, coal mining and banking in Silesia) the nobility (if it was economically active at all) confined its economic activities to the agricultural sector. Apart from the fact that industrial engagement of the nobility was socially not acceptable in the first decades of the 19th century, and at that time even formally prohibited, the incentive for such engagement was low considering the economic home territory of the East-Elbian nobility in the agricultural sector; here, the nobility was politically most powerful. Therefore, the nobility had no interest in setting the rules for the industrial sector on its own behalf in order to create rents or to prevent bourgeois outsiders from market entry. As a consequence the landed gentry transformed into agro-capitalists and could take profit from its improved endowment resulting from the

¹⁰ Saxony gives an example of how the authorities mastered a balancing act between economic freedom for the industry and preliminary concessions for the craft sector (Karlsch/ Schäfer, 2006, 63 – 64).

¹¹ In 1835 the *Zollverein* encompassed the following states: Prussia, Hesse-Darmstadt, Hesse-Kassel, Wurtemberg, Bavaria, Baden, the States of Thuringa, Saxony, Nassau.

¹² The average nominal rate of protection of the *Zollverein* amounted to 8.4 percent between 1834 – 1913 which was lower than tariffs in France and Italy “and barely superior to that of free-trading nations such as Denmark and Britain” (Dedinger, 2005, 231). The US had the highest tariff rates, escalating to more than 30 percent (ibid.).

redemption clauses concerning the liberation of the peasants. The industrial sector developed outside the domain of the politically influential class. (2) Industrial capitalists lacked political influence in order to protect the industry. Even petitions to the king for retaliation tariffs against Britain were declined.¹³ As a consequence, industrial capitalists as well as the landed gentry became subject to capitalist institutions and cross-border competition within the *Zollverein*. Most importantly, the landed gentry could not make use of its still extant political privileges (still preserved in the *Provincialstände*) in order to set the rules for the economy or to protect its markets. As the agricultural sector was subject to price competition, the landed-gentry was not able to create rents through local monopolies although tax privileges were still in force. Indeed, regional price differentials declined in the course of the early 19th century which suggests that the nobility could no longer escape the pressure of competition (O'Rourke, K.H./Williamson, J.G., 1999, 44 – 45). The separation of aristocratic power from the authority of market rules turned out to be the major reason for the gradual disentanglement of politics from the economy which prepared the ground for capitalist transformation in Germany.

Furthermore, the profound change of society, transforming into a capitalist class society, was neither a predictable nor a worrying outcome for the aristocracy. Despite some warnings about a looming scarcity of labor force as a result of industrialization and a long term change of society, the agricultural sector still benefited from the increasing population growth and gradually rising wages leading to a higher demand for agricultural products (Pfister, U., Riedel, J., Uebele, M., 2012). Succinctly, the aristocracy was economically a winner of its own “creative destruction” up to the late 19th century and adapted to rising wages through the promotion of productivity growth.¹⁴ That way the aristocracy became subject to capitalist institutions and could not arrest capitalist transformation in order to create rents. A new class of successful entrepreneurs, outside of the former dominant coalition, formed the economy. It had no ambition to become part of the aristocracy and integrate into the former order. In this respect the German capitalist transformation differed remarkably from Habsburg where the aristocracy held political power and was a stakeholder in the economy (see below). Even the introduction of tariffs for wheat in the late 1870s reminds of rent-seeking in a modern

¹³ See Kosellek, 1989, 321 – 322.

¹⁴ The decline of the agricultural sector defies the Schumpeterian interpretation of a creative destruction (Borchardt, 1977; Allen, 2009). Rather, the agricultural sector took profit from rising average purchasing power and growing population in the course of industrialization. Due to productivity growth the agricultural sector remained profitable for a longer time; the long-term decline of agricultural labor force indicated a successful adaptation to changing relative prices rather than an economic decline of the agricultural sector.

democracy rather than pre-capitalist rent creation.¹⁵ Despite numerous opponents and dissenters within the landed gentry, capitalism became irreversibly established. Further changes of German capitalism in the late 19th century, namely in terms of the introduction of social insurance, reflected the advancement of capitalist transformation and defy the interpretation of a regression of the economic order or the “end of the liberal period”, as it is often assumed (e.g. Borchardt, 1977)¹⁶. These extensions of capitalism had nothing in common with rent creation based on political privileges nor did they reverse free markets. The advanced (however not perfect) separation of politics from the economy remained intact. It gave way to the high industrialization period characterized by the highest per capita income growth rates achieved at that time in combination with the highest population growth rate (Grimmer-Solem, 2014). In the second wave of industrial revolution the economy of Imperial Germany became leading (for instance, Siemens and Carl Zeiss became the first firms in the world to undertake industrial research). Notably even then key elements of economic policy were decentralized: regulation and income taxes remained within the domain of the member states while the economic competences of the federal states were limited.

Weingast (1995) has viewed federalism as a key condition for preserving markets. Its features are (1) the authority of lower level governments as to economic institutions, (2) a common market for goods, services, capital and labor, no (or limited) fiscal transfers between the jurisdictions, (3) limited borrowing of the lower jurisdictions (hard budget constraints including no bail out for lower jurisdiction). Since the states were independent during the German Confederation (which ended in 1866 and was replaced by the North-German Federation), all these conditions had been present except for the existence of a central state. Two currencies coexisted in Prussia (including Hanover) and South-Germany. Hence, the *Zollverein* was an economic integration and does not represent a precursor of the united Reich in 1871. The member states remained economically and politically autonomous. In order to strengthen their economic position, the states made strong efforts to create budget surpluses (or, as in case with Prussia, at least strongly diminish public debts) and painfully studied the fiscal policy of their rivals (Ullmann, 1996, 99 – 109)¹⁷. Public expenditures were concentrated on infrastructure and

¹⁵ Indeed, Bismarck needed a winning coalition in parliament for his introduction of tariffs on wheat.

¹⁶ The introduction of the Health Insurance (1883), the Accident Insurance (1884) and the (small scaled) introduction of pensions (1889) against the opposition of the liberal parties in the Reichstag can be interpreted as the participation of the workers in rising productivity rather than a change of the economic order. Only the permission of cartels in 1897 after a decision of the Supreme Court changed the economic order to the detriment of free competition.

¹⁷ For instance, an official report of the State of Baden praised the industry-friendly economic policy of Prussia but recommended not to take over its intransparent tax system (Schremmer, 1996, 124)

education and thus were largely an investment in economic growth.¹⁸ Competition among the states encompassed the economic development and the financial strength of the state (Berding, 1996, 17 – 24). In addition, the educational system including culture – namely after 1871 – became a field of rivalry among the German states by which the monarchs made strong efforts to increase the attractiveness of their territories (Kroll, 2013, 119 - 136).

The *Kaiserreich* founded in 1871 fulfills Weingast's conception of market preserving federalism nearly perfectly. The legal authority of the newly created central state concerning economic institutions was limited. Income taxes, including corporate taxes, were entirely decentralized whereas custom tariffs and indirect taxes remained the critical source of revenue for the federal state. Even within the Kingdoms, Grand Duchies and Duchies income taxes were not altogether harmonized (for instance, the Kingdom of Hanover, whose dynasty ruled England since the 17th century, stuck to an English tax system after its annexation by Prussia). The *Bundesrat*, the representation of the states, ensured that the central government did not transgress the autonomy of the states as laid down in the constitution. Social policy, however, became the responsibility of the federal state in the 1880s.

Taken together, the economic as well as the political institutions set capitalist dynamics in motion, which set incentives for entrepreneurship, innovation and a civil society. The bourgeoisie grew up to a significant class which laid claim to political influence. Its earlier denial had been one of the driving forces behind the Revolution in 1848. This revolution had failed to establish a universal suffrage but brought about a Prussian constitution encompassing major civil rights: the freedom of assembly, the inviolability of the house, the freedom of press and speech, formal guarantees for the independence of the judiciary and the opening of court proceedings to the public. Dispute settlements between firms or between firms and employees became the matter of newly established local civil courts rather than the matter of public authorities. The liberal model of the state, regarding the economy, was largely pushed through in the period from 1840 to 1860 and was finalized by the enactment of new commercial codes in the 1860s (Wichermann/Nieberding, 2004, 152). Furthermore, administrative acts became subject to appeal by citizens, which further strengthened the rule of law.

¹⁸ *ibid.*; see Karlsch/Schäfer (2006) for Saxony's efforts to concentrate state activities on the establishment of polytechnical institutes which started in the late 1820s and the improvement of traffic routes (*ibid.*, 55)

The existence of the aristocracy which still held political power in the East-Elbian territories of Prussia did not interfere with the emergence of capitalism. Rather, the former dominant coalition was compensated by economic benefits resulting from its transformation into agro-capitalists but had to come to terms with the monopoly of coercive power of the state by which it lost its role as a power holder. Besides, it still enjoyed tax privileges. To conclude so far, the lack of democracy was not an impediment for the development of capitalism in the early decades of the 19th century. At the onset of reforms it was sufficient to instigate capitalist development no matter whether the reforms met some ideal of capitalism. In the later period the “paternalist model” of economic policy turned out to be a binding constraint until it was removed by the constitution in 1848. Referring to Rodrik’s (2007) criticism of the blue print conception of present day emerging economies, the defensive modernization abandoned institutional constraints for economic development without imposing capitalist institutions from above. That way it became feasible from the perspective of political economy.

III.II. Withheld capitalism in the Habsburg Empire

Capitalist transformation took a completely different route in the Habsburg Empire including its Western part (modern Austria). Whereas liberal members of the elite group in Prussia only got distant from the eruption of violence in the second stage of the French Revolution, the Austrian dominant coalition (above all the Emperor Franz II./I.) rebuffed even its political ideals.¹⁹ Emperor Franz II./I. revised liberal reforms of his predecessor Joseph II., who had committed himself to the ideas of enlightenment.²⁰ These reforms concerned constraints of labor duties of the peasants (*robot*) and redistributions of the risks of bad crop to the benefit of the dependent peasants (Good, 1986, 38; Sandgruber, 2001, 205). Namely the Polish and the Hungarian landed gentry opposed those reforms and succeeded to annul them under Joseph’s successor Franz II./I. Only the freedom to choose an occupation and the freedom of marriage survived these revisions. The multiethnic Habsburg Empire strengthened the political power of the aristocracy and the landed-gentry. Efforts to monopolize the power of the state to the detriment of the local dominant coalition were likely to instigate national conflicts in the Hungarian crownlands (namely in the later decades of the nineteenth century) for which reason the distribution of power was much more balanced between the ruler and the aristocratic

¹⁹ After the termination of the Holy Roman Empire in 1804 (*Reichsdeputationshauptschluss*) Franz II. became the new Austrian Emperor Franz I.

²⁰ In line with his liberal stance, Joseph II. permitted the opera librettist Da Ponte a subtle parody on traditional privileges of the lords of the manor; Mozart wrote the music for the “Marriage of Figaro”.

dominant coalition. Therefore the monopolization of the power of the state was far more advanced in the West-Austrian part of the Empire (modern Austria, Bohemia, Moravia, Krain) than in the Hungarian territories.

Unlike the German states, where an independent bureaucracy started to take up public administration and set the course of political strategies, the monarch and the aristocracy determined daily politics in Austria. Chancellor Metternich was intent on fending off any public disagreement with the estate-based society and advocated what he called the “*legitimacy principle*”, under which he meant the unconstrained power of the monarch. Censorship and suppression of any critical association or clubs became the notorious feature of that period until 1848, notwithstanding its relaxed implementation by Austrian bureaucracy (“everything was forbidden and allowed at the same time”; Quelle Matis). Besides the aristocracy the Catholic Church re-established its role as a pillar of the state (which Joseph II. had challenged two decades before) and resumed its former state functions. The religious homogeneity and the insufficient separation of the Church from the state proved to be an obstacle for the formation of an open access order. Primary schools and Latin Schools were run by the Church or by catholic orders and thus exposed to the anti-liberal stance of the Church which sought to preserve the aristocratic order. The wide-spread inclination for reading books was disapproved as an “addiction of the people”; reading societies were forbidden and mistrusted until the mid-nineteenth century (Sandgruber, 1995, 153). According to an official edict of Emperor Franz – and in sharp contrast to his open-minded predecessor Joseph II. – the content of teaching had to be in accordance with the social status of the students; “wasteful knowledge” and “unnecessary speculation” had to be avoided. That edict was in force until 1869 (Bruckmüller, 2001, 242). Education was not seen as an instrument to open up opportunities for the lower classes but to maintain the prevalent order. Accordingly the state made efforts to reduce higher schooling (effectively by re-introducing fees; Sandgruber, 1995, 152). In contrast to the German states, where reformed universities became oriented to the requirements of scientific research, the scientific level of the Austrian universities were reported to remain inferior until the mid-nineteenth century (Bruckmüller, 2001, 239). Establishments of poly-technical schools were an exception from this rule. The lack of economic resources (which were likewise or even more limited in the German states after the Napoleonic wars) cannot explain the underinvestment in human capital in the Habsburg Empire. It rather followed from the political order and the intention of the dominant coalition to prevent upward social mobility, which would have challenged the estate-based society. Remarkably, the state confirmed the role of the Catholic

Church in education without governmental controls rather lately in the 19th century (Concordat in 1855). Nevertheless, this repressive educational policy could not prevent an outstanding level of Austrian elite culture – regionally concentrated in Vienna – in the second half of the century and beyond. However, the average level of schooling, which is more relevant for human capital in the economy, remained insufficient given the capabilities of the economy and the standards set by the elite culture.

Strikingly, the Austrian monarch was hardly aware that the economy could become crucial for the competition among the states and foremost for the rivalry among the Great Powers in Europe. Nor had he (and Metternich as the leading figure) foreseen that economic development in the German states could change the balance of power in favor of Prussia. By contrast, in the German states (including the smaller ones) such awareness of the increasing role of the economy created an independent public administration which pursued a liberal agenda (Berding, 1996). Senior officials rather than the monarchs and dukes became more and more the genuine representatives of their state and considered themselves to be “above the classes”, which provoked aristocratic complaints about the “new impersonal order” (Wehler,). By contrast, the Austrian monarch himself held the reigns which is why the political strategies were far more submitted to his personal preferences and ideosyncrasies. As a result, the development of the economy became neglected; a liberal agenda did not exist. For instance, Franz I. intended to prohibit the siting of businesses in Vienna and other large cities. Although senior officials managed to convince him of the importance of manufactories for the economy, they were unable to revise disincentives for the emerging capitalism. As a result, higher taxes in the cities still discouraged businesses enterprises and urged them to settle in the countryside (Butschek, 2012, 97; Sandgruber, 1995, 225). An obvious reason for the disregard of the economy as a vital part of a powerful state was the fact that the Habsburg Empire, after the Congress of Vienna, prevailed as the most powerful state in the European continent, and thus could avail itself of non-economic power resources. It consolidated its strength in the German Federation as a so-called guarantee power and exerted key political influence until its dissolution in 1866. Remarkably, not before the Austrian defeat in the battle of Solferino in 1859 and the loss of its Italian territories did reflections about the importance of the economy for the strength of the state gain ground (Bruck, 1860, see below).

Despite this Austrian double balance of limited access in politics and the economy, a constrained version of capitalism nevertheless developed in the Metternich period. In the

beginning it was designed as an annex of the estate-based society without changing its political institutions and the agricultural economic constitutions. Its distinguishing feature as compared to Germany was the dependency on the crown and the selective practice of giving concessions for firms. Nor was capitalism the exclusive domain of a bourgeois civil society. The aristocracy was in many ways engaged in capitalist activities besides the agricultural sector and made use of its political power in order to shape the rules (see below). One result was the fact that the Austrian economy became protected by prohibitive tariffs and import bans. That is why it did not integrate into the gradually prospering German economy or the other parts of Europe. Import bans for 200 goods (reduced to 91 goods in 1835) were introduced and later on supplanted by high tariffs (Sangruber, 1995, 241). Thus, protectionism became a pervasive feature of Austrian economic policy. According to Bairosch the Austrian economy made up only 5.8 percent of total European exports in 1850 (14.6 percent in Germany) and fell to 5.6 percent in 1910 (20.4 percent in Germany; Good, 1986, 100). Tariffs for important semi-products such as pig iron reached 40 percent (Butschek, 2012, 161). When the German states formed a common market and abolished internal tariffs, Metternich, who anticipated the political consequences of a united Germany without Austria, made half-hearted efforts to join the *Zollverein*; but these efforts were revived in the 1850s. However, the Austrian dominant coalition did not back Metternich in order to avoid competition with German enterprises as long as it was not accompanied by higher tariff rates of the *Zollverein*. Prussia rejected these demands and stuck to free trade, which resulted in the disintegration of the Austrian economy from German industrialization. The greater weakness of the central state in the Habsburg Empire, as compared to the German states, was the obvious reason for this uncommonly excessive protectionism. Throughout the nineteenth century the Austrian state depended on the aristocratic dominant coalition which itself sought to protect its regional markets. Until 1848 the state took consideration of the Magyar elite groups in Hungary and did not create a common market between the Austrian and the Hungarian half of the Habsburg Empire; the tariff border was maintained. The tardiness of railway construction, of which the first horse-drawn (!) railway between the industrial towns of Budweis and Linz in the late 1820s became a charming symbol, can also be attributed to local economic interests. Austrian political rule could not override regional economic interests, namely if the aristocracy itself was economically engaged or had a non-German ethnic origin. Under such circumstances an ethnical conflict added to the already conflictual claim of the state to monopolize coercive power but also to economic conflicts between groups. Steps towards an integrated economy remained unfinished. The fixed-termed removal of internal trade barriers after 1848 was not sufficient to create a common

market in the Habsburg Empire. Even in the final quarter of the 19th century local elite groups have found ways to protect their agricultural markets from competition by other ethnic territories within the Habsburg Empire, as price differentials for agricultural products confirm (Schulze/Wolf, 2009). Public administration was wise enough to leave these internal obstacles to free trade intact because this would have challenged the rents of ethnical elite groups in the non-German parts of the Empire. Establishing the monopoly of coercive power of the state in order to set up capitalist institutions and interregional competition was not an option for the Habsburg Empire.

The institutional changes after the revolution in 1848 concerned the removal of the serfdom of the peasants. In some aspects the redemption rules for dependent peasants were more generous than in Prussia because the Austrian state subsidized redemption payments of the peasants (Good, 1986, 75). Now capitalist institutions in the rural area became predominant in the Western half of the Habsburg Empire, while dependency of the peasants still existed in some Hungarian Crownlands. Unlike Prussia, a constitution was not established and instead a neo-absolutist period under Emperor Franz-Joseph began. Not before 1867 a constitution (*December Constitution*) came into force which secured basic rights for citizens comparable to the Prussian constitution in 1848. Because of relaxations of institutional constraints for capitalists (concerning concessions) and reductions of tariffs, the period after 1848 is frequently termed as “liberalization period”, notwithstanding its mixed record. On the one hand, the guild system was removed and the freedom of running a business at least formally guaranteed in 1860 (Matis, 1972, 49). On the other hand the dismissed minister of finance v. Bruck pointed to the still existing institutional deficiencies of Austria which he held in charge for its economic but also for its political backwardness (Bruck, 1860). The diagnosis of his memorandum (*“Austria’s Agenda”*) fits well into the NWW-framework concerning economic institutions required for capitalist advancement (ibid. 43). According to Bruck the Austrian state still suffered from general rules concerning concessions for businesses, which furthered corruption in public administration (ibid. 43). Furthermore, the lack of local civil courts was seen as an impediment for capitalism because entrepreneurs were unable to enforce outstanding debts (ibid. 45). Bruck viewed the disentanglement of the Catholic Church from the state a necessary condition for economic progress, e.g. to attract protestant and Jewish entrepreneurs from Germany. Above all, Bruck emphasized that the Austrian state must rest on a middle class civil society instead of a privileged aristocracy in order to regain its political power (ibid. 49). As Bruck was in charge of financing wars (e.g. against Venetia) he was confronted with the

economic backwardness of the Austrian Empire for which he sought a long term solution. Remarkably, he drew his attention to institutional changes necessary to strengthen the economy (ibid. 64 – 65). However, Bruck became the victim of intrigue and committed suicide in 1860.

The Habsburg Empire lacked central features of an emerging open access order as far as the 19th century is concerned. Politically, the first constitution which became effective was the December constitution of 1867. It established a census suffrage which preserved the political power of the aristocracy and the Catholic Church (“iron ring”; Good, 1986, 201) and fell behind the monarchist democracy of the German Kaiserreich. Unlike the German Kaiser, the Austrian Emperor had a veto right against the parliament until 1914 which became more important as the suffrage was gradually opened to broader parts of society until WWI. In economic terms the Austrian type of capitalism exhibited many features of an estate-based-capitalism which transformed the aristocracy into capitalists while sticking to its inherited social status. The banking sector but also industrial joint stock companies became new fields of economic activity for the aristocracy. Members of high aristocracy (e.g. Chlumecky, Hardegg, Andrásy, Palvacini, Thurn und Taxis, Auersperg) were CEOs of important banks in Vienna. In the Hungarian half of the Empire, as reported by Good, 88 Earls and 64 Barons were CEOs or members of the directorial board of joint stock companies in the industrial, railway and banking sector (Good, 1986, 203; Butschek, 2012, 131). Due to their privileged access to the Imperial Court the aristocracy could shape the rules of capitalism in accordance with their own interests. The reported anti-competitive stance of aristocratic entrepreneurs apparently resulted from the chosen rules of capitalism which closed the economy against domestic and foreign competition. The growing influence of the banking sector in the industry combined with a growing number of cartels kept domestic competition at bay. (Good, 1986, 189 – 196; Matis, 1972, 80 - 81). Because the economy was smaller than the German one (which also saw an increasing tendency towards cartelization around the turn of the century) and enjoyed far more protection from tariffs, the negative impact on economic growth and prosperity was significant. Market power added up to the social status inherited in the pre-capitalist society. Never did the Austrian economy become strictly independent from the estate-based society and form a counterweight which overturned the vestiges of late-absolutism.

This institutional description of the Austrian political and economic system leaves aside Weberian arguments of an anti-competitive catholic spirit. It solely concentrates on institutional reasons for its backwardness. Given the successful attempts of Maria Theresia and Joseph II. to

push back the influence of the Catholic Church in the second half of the 18th century, it seems questionable to identify Catholicism itself as a cause for anti-competitive institutions. If at all, the *combination* of Catholicism and the aristocratic political order caused the delay of institutional development. In this combination the critical stance of the Catholic Church towards a liberal society could have become powerful. Nevertheless, immigrating Protestants and Jewish businessmen formed a large proportion of the emerging capitalist class also in Austria (Bruckmüller, 2001, 286). In contrast to Germany, however, this class could not become key political supporters of institutional change towards capitalism in Austria: As Germans they were in opposition to the ethnical elite groups in the non-German half of the Empire; as Protestants and Jews they were in opposition to the traditional aristocratic and catholic elite group in the Austrian half.

To summarize, some characteristics which gave German capitalism a boost were absent in Austria: Economic policy was settled in Vienna instead of a variety of capital cities which was the case in Germany before and after the unification; due to its imperial position the Austrian state largely ignored its dependency on the economy as a necessary condition of its power; related to this fact an independent bureaucracy which forcefully stuck to an liberal agenda lacked influence comparable to Hardenberg in Prussia, some farsighted ministers notwithstanding. Due to the growing national conflicts, arising from the multiethnic Habsburg Empire, the power of the central state was constrained; unlike the German states, the Austrian monarch had to respect the economic interests of regional power holders and could not push through the rules of capitalism. The protection of regional markets from international and interregional competition was the key consequence of this political order. Eventually, due to these constraints the self-reinforcing tendencies of capitalism, albeit existent also in Austria, were too weak to supplant the former economic order.

Specifically, the Habsburg Empire lacked key elements of a market preserving (not to speak of fostering) federalism comparable to Imperial Germany. Even though it comprised a multitude of ethnical groups, it could not make use of this variety in terms of economic progress. First of all, the Empire lacked a central bureaucracy which could implement unrestricted competition between the Austrian and Hungarian Crownlands. Namely in the Hungarian Crownlands (“Transleithanien”) regional elite groups found ways to protect their local markets against competition even after the abolishment of intra-tariffs in the 1850s (Schulze/Wolf, 2009). The freedom of movement was restricted for commons until 1857 (Sandgruber, 1995, 230). Even

cross-country travelling by train across was restricted and required licenses (Bruckmüller, 2001, 280). The freedom of business became established rather lately in 1859. Later on, restrictions had been imposed which aimed at social protection for craftsmen and small enterprises. Even though such restrictions worked against more efficient large scales enterprises, the sociopolitical intention to protect craftsmen should not be overlooked (Butschek, 2011, 150). However, the Prussian government, which faced similar social disruption to the detriment of craftsmen some decades earlier, stuck to the freedom of business and established capitalist institutions forcefully; namely the interests of local elite groups in the cities who sought to protect their markets were ignored. (Koselleck, 1989, 591; Reininghaus, 2002, 71). In Austria, a common market for goods, services, capital and labour, which is key for a market preserving federalism, was late in coming and never fully developed. The complementary policy for internal market restrictions is protection against foreign competition. A potential compromise would have been the partial integration of the Austrian half of the Habsburg Empire where industry was more developed as in the Hungarian Crownlands. However, such partial integration was politically not feasible because it would have contributed to the erosion of the Empire. As a result, the economically advanced regions lacked competition from outside as well.

Economic historians repeatedly point to waging wars as an impediment for economic development in Austria (Sandgruber, 1995, 243). In fact, the Austrian Empire was involved in numerous military conflicts, for which reason public debt increased rapidly. From 1847 to 1858 interest payments for loans on average absorbed 20 percent of total savings of the economy and payments for the military made up 63 percent of totals state expenditures. From 1848 to 1867 between 16 to 30 percent of the total state expenditures needed to be financed by loans as a result of high military expenses (ibid. 242). According to estimations of a leading Austrian economist of that time, v. Peez, the public sector absorbed 50 percent of credit supply in the financial sector and thus crowded out private investment (Matis, 1972, 58). However, it is questionable whether waging wars is the crucial external factor which inhibited economic development in Austria. Though the German economy developed (with few short wars in the 1860s and 1870) in peacetime after 1814 throughout the 19th century, Britain represents a counterexample. In the second half of the 19th century Britain was heavily involved in wars; the British War Office drew up a list of 15 “principal British wars between 1857 – 1899” and waged more imperialist wars than any other nation. (Darwin, 2012, 117). This rarely affected Britain’s technological and economic leading role. But unlike Britain, the Habsburg Empire lacked the

economic institutions which created sufficient tax revenues. Strikingly, this deficiency was not taken as an opportunity to install growth promoting institutions. Rather, the Austrian government invented a variety of new types of taxes which impeded economic development (Matis, 1972, 60). Obviously the prevailing political order in the Empire constrained the discretion of any reform oriented administration in the Empire.

IV. Conclusion

After 1814 reformers in Prussia were able to install economic institutions constitutive for capitalism to a considerable extent. In the other German states public administrations further developed the inherited institutions in order to create more economic freedom for businesses. Such a push towards liberal reforms was absent in Austria where reactionary administrators obstructed and revised reforms which already began some decades earlier within absolutism. The comparison between the German states and the Habsburg Empire makes clear that reforms were not forced by the military defeat but were the result of intentional efforts of an elite group. Of course, it did not only follow idealistic motives but also took profit from its new role as an arbitrator and mediator of group interests. A difference between German and Austrian transformation was the fact that in many parts of the German Confederation the aristocracy was less influential (Rhine territory, Wuerttemberg, Baden, Bavaria). The same holds true for the dominant coalition in the cities. After the central bureaucracy gained ground in Prussia and in the South German states it was easier to pursue a liberal agenda. The emerging capitalist class was yet politically powerless so that ministers such as Hardenberg could ignore their interests in tariffs to protect their domestic markets. Where the aristocratic elite group exerted more political power (namely in the Eastern parts of Prussia), it became compensated by land in exchange for the redemption of peasants. This was not a perfect establishment of capitalist rules but it worked sufficiently to instigate capitalist dynamics which took up a life of its own. Hence, a nascent capitalist sector in the industry developed along with a transformed market oriented agricultural sector which was still dominated by the landed gentry. Not before the 1848 revolution was the Prussian state forced to concede a formal constitution and guarantee further rights which separated the individual sphere from the state explicitly. In the following decade the establishment of a liberal order was finalized. Of key importance was the creation of free trade within the German federation one decade earlier because capitalist dynamics was set in

motion in the whole territory. In contrast to a popular view referring to List's infant industry argument the union was protected only by moderate tariffs which were the lowest at that time (Dedinger, 2006, 231, Fig. 11.4). Besides a few observers, among them Marx and Engels, a sweeping social change as a result of capitalist dynamics was not generally foreseen at that time. The capitalist class society, which caused conflicts between industrial workers and capitalist entrepreneurs in the end of the century, was an unintended outcome of intended reforms.

A distinguishing feature of Austria's way towards capitalism was the far more powerful role of the high aristocracy and local aristocratic groups in the multi-ethnic Habsburg Empire. Liberal and reform-oriented ministers lacked political influence and could not take up an independent role as in Prussia, Baden, Württemberg or Bavaria. Central bureaucracy was weaker and lacked influence in order to implement capitalist institutions against local power holders and the high aristocracy. Capitalist dynamics was fettered, and even when it came into being it did not result in a capitalist class independent from the aristocracy. This is also reflected in the cultural dominance of the high aristocracy ("first society") over successful capitalists ("second society"), while German capitalists became far more independent from the old elite group (and sometimes self-confidently rejected its formal ennoblement offered by monarchs). Nevertheless, due to slow economic growth and lack of opportunities in the capitalist sector, the delayed institutional change found support in a broader part of society, as the wide-spread support for maintaining guilds and some updated version confirms. After the end of the short period of economic liberalization the government took efforts to increase tariff rates and to reduce the freedom of business in favor of the guilds (Butschek, 2012, 151). Ongoing constraints of domestic competition became the characteristic for Austrian economic policy for the next hundred years. The cartelization in the economy, however, found wide acceptance in society including critics of capitalism such as Austrian Marxists. Constrained capitalism rather than free market capitalism was widely considered as the better alternative, economic stagnation and slow growth rates notwithstanding. The rationale of this critical stance is that capitalist transformation will affect all social classes, whether or not they had direct stakes in cartels or high tariffs. Therefore, the relationship between capitalism and democracy which NWW and Acemoglu et. al. (2009) deem to form a double balance is apparently more complex as the breakthrough of democracy after World War I in both countries confirms: When the aristocratic groups lost all their political and economic privileges and full political participation supplanted the old political order, free-market capitalism was in neither country on the political agenda.

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