

Honoring public debts

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The want of parsimony in time of peace imposes the necessity of contracting debts in time of war. Adam Smith, *An inquiry into the Nature and Causes of the Wealth of Nations*, 1776.

The validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellion, shall not be questioned. But neither the United States nor any State shall assume or pay any debt or obligation incurred in aid of insurrection or rebellion against the United States, or any claim for the loss or emancipation of any slave; but all such debts, obligations and claims shall be held illegal and void. *Section 4, 14th amendment to the US Constitution.*

1 Introduction

The renowned University of Chicago economist George Stigler said: “A war can ravage half a continent and raise no new issues in economic theory.” It is not a coincidence that George Stigler was an avid student of economic history and the history of economic thought. Economic histories entail not just time series of prices and quantities but also newspaper articles and legislative and executive reports describing theories, opinions, and interests that motivated measures that governments used to manage situations that resemble ones that we confront today or can expect to encounter in the future. Most good economic theories were constructed to organize evidence about these recurring situations. Stigler and his good friend Milton Friedman were both devoted students of economic history because they were vitally interested in recognizing patterns and extracting generalizations about successful and failed economic policies.

In the spirit of Stigler and Friedman, I offer some examples of past situations and choices that resemble ones that we confront today. My examples involve mechanical relationships between government debts and taxes and the political interests that they create. Owners of government bonds want to be paid, and that makes them want tax collectors to succeed. These interests cross international borders, another theme that I’ll stress. Drawing on work supported by the Becker-Friedman Institute that my colleague George Hall and I have been doing, I describe a set of political and economic interests and forces affecting fiscal policy that influenced events, alliances, and revolutions.¹ An account of forces at

¹For example, see Hall and Sargent (2011, 2014, 2015).

play in the United States during the transition from the Articles of Confederation to the US constitution in the 1780s naturally brings to mind difficulties Europe confronts as it experiments with the Euro as a step toward creating a United States of Europe.² Another lesson relevant for today comes from the 1840s, when the US Congress weighed the consequences of bailing out creditors of state governments. Large deficiencies in provisions for funding state and municipal pension obligations today might soon confront Congress with similar choices. And a reader of my account of the situation shaping attitudes of American holders of UK and French bonds in late 1916 could be forgiven for thinking about Mr. Trump’s summer 2016 musings about renegotiating payments promised to holders of US government bonds.

Economic theory sharpens the mind by narrowing it. I’ll view historical events entirely through the lens of government bond prices. I start at the beginning, with “bond pricing 101”.³ The same time and risk factors at which creditors discount prospective payouts affect market prices of both privately issued and government bonds. But important differences come from the sources of the payouts. Payouts from private securities depend on differences between future revenues from sales of goods and services and costs of production while payouts from government securities depend on differences between future collections of taxes plus sales of public property, on the one hand, and government purchases and transfers, on the other. Prices of government bonds depend on bond holders’ estimates of future taxes, government purchases, and transfers.

Every new U.S. Congress reassesses what public goods to purchase, how to redistribute income, and how to pay for what the government spends. Constrained by national resources, the US Constitution, and their respect for precedents; pressured by their constituents; and prejudiced by their theories of how an economy works and about how the public responds to their decisions,⁴ members of Congress confront enduring questions about what the federal government should spend and who should be forced to pay. Because the authors of the US Constitution understood that, they framed the government so that republican processes would produce good outcomes across a variety of circumstances, some that they anticipated, others that they knew they could not. The framers wanted markets

²This is the theme of Sargent (2012).

³We confront significant measurement issues in interpreting government accounts. See Hall and Sargent (2011) and Dias et al. (2014) for descriptions of how accounts typically record face values while markets care about market values.

⁴Ancient Chinese proverb: “The government has a strategy; the people have a counterstrategy.”

to value US public debts highly.⁵

Ferguson (1961) described how the following questions preoccupied framers of the Constitution:

1. Should a government pay its debts?
2. Should a central government pay debts incurred by subordinate governments?
3. Should subordinate governments pay debts incurred by a central government?

The framers took for granted that a buyer of a government IOU today must be convinced that a government has the authority and the public's consent to honor its promise to pay him either by taxing someone or by selling something valuable (e.g., public lands). They viewed government bonds as revenue anticipation certificates and interpreted the three questions as being about how to assign responsibilities to incur and pay public debts. Let's take the questions one by one.

1. Should a government pay its debts?

Because government debt is typically owned by only some of a nation's citizens, there is usually no unique good answer that all citizens will endorse. There are countervailing good reasons to pay and not to pay. A good reason not to pay is that taxes are costly and distorting. Taxpayers who don't own government debt benefit directly from not paying. Owners of government debt benefit from paying. Avoiding the stigma attached to not paying is a good reason to pay if contingencies can be anticipated in which a government might want to borrow again. Having "good credit" – meaning having a reputation for paying completely and on time - lowers future interest costs by lowering future default premia.

2. Should a central government pay debts (previously or subsequently) incurred by subordinate governments?

Here timing and incentives matter. The ability to pay debts coincides with the power to tax. If a central government is to pay debts owed to creditors of a subordinate government, it must have the authority to tax and prospects of future legislative majorities willing to vote sufficient taxes. But even if it has the authority to accomplish a bailout, should a central government do it? Here timing is relevant. If, at the founding of a Republic (1789-1790 for

⁵Probably for reasons less selfish than Beard (1913) discerned.

the US), an *initial* bailout of subordinate governments' debts is part of an understanding (e.g., at a Constitutional convention) that awarded tax authority to the central government, then a bailout is just part of that deal. But what about subsequent bailouts? If a bailout now creates expectations of subsequent bailouts of subordinate governments, that creates adverse incentives that encourage subordinate governments' profligacy. And taming those incentives can motivate a central government to regulate a subordinate government's decisions, imperiling federalism and fostering unintended centralization.

3. Should subordinate governments pay debts incurred by a central government?

This is the other side of question 2. Control and incentives are again in play. If bailing out a central government's creditors is part of an original constitutional bargain that awards to subordinate governments the lion's share of tax authority, then advocates of strong subordinate governments might endorse that arrangement.

A single strong political force affects all three questions: a government – central or subordinate – that has acquired *both* the power to tax and the obligation to service debts will attract the political support of government creditors to levy the taxes that service their government bonds.

Ferguson (1961) tells how between 1776 and 1790 North Americans struggled with these three questions. Before 1789, creditors of the 13 states and creditors of the Continental Congress answered yes to question 1, while many tax payers answered no. The Articles of Confederation (more a Treaty than a constitution) assigned to the Continental Congress no authority to tax, with the consequence that continental debt was not being serviced and sold at 10 or 20 cents on the dollar in the mid 1780s. (That prices for the Continental Congress's debts were that high indicated that buyers were betting on a political reorganization (i.e., a revolution) that would benefit creditors of the Continental Congress). The 13 states were authorized to levy taxes sufficient to service their debts, and some had done so.⁶ Beyond that, some states – for example, Pennsylvania and Rhode Island – had answered yes to question 3 by arranging to exchange Continental debt owned by their residents for state bonds that they then serviced. In doing so, these states sought to bind their monied interests to a status quo that under the Articles of Confederation kept powers to tax in the hands of the thirteen states. Contending against such proponents of strong separate states, “nationalists” led by Robert Morris early in the decade of the 1780s and Alexander

⁶See Taylor (2016, ch. 10, p. 364) who reports that in the 1780s, two-thirds of state governments' revenues were devoted to paying owners of state bonds.

Hamilton later in the decade answered question 2 in the affirmative because they wanted to transfer much of the authority to tax and regulate international trade from the 13 states to the central government.

The “nationalist” Morris-Hamilton proposal that the central government assume state debts, most of which had been incurred to fight the War of Independence, prevailed in 1790.⁷ Did it set a precedent for subsequent Federal bailouts of state debts? British purchasers of huge amounts of state issued securities in the 1830s may have believed that it did, but in the 1840s, though it was a close decision, the Congress voted not to bail out the states and to stand by as many of them defaulted. It is fascinating to read the 1840s debates about proposals for Federal assumption of those state debts.⁸ In the 1780s, the original 13 states had ceded vast public lands to the central government. Then why shouldn’t the states have a claim on revenues from sales of Federal land? Further, the states had issued most of the troubled 1840s bonds to fund infrastructure projects and to set up banks, activities that the Federal government had declined to pursue because of constitutional doubts about the authority to undertake them. And British financiers had clearly warned Americans that defaults by US states on debts owed UK bond holders would impair the US federal government’s access to credit. But many federal tax payers welcomed a poorer international credit rating for US states and the federal government because it would help to rein in future government expenditures. They fought bailouts. More US voters would probably have supported proposals to tax US residents to pay state bond holders if more of those bonds had been owned by US citizens and fewer by UK citizens.⁹

The facts that government debt is a tax anticipation certificate and that future taxes will be set by future legislative majorities – either at home or abroad – make bond holders want to influence prospective tax collections.¹⁰ Even when US federal debt had been held mostly by US citizens, some Americans owned US bonds and others didn’t. Bond owners advocated policies that increased the likelihood that the government’s promises to them would be honored. Abraham Lincoln’s administration during the US Civil War and Woodrow Wilson’s during World War I sold war bonds to a wide cross section of US

⁷Relative to initial promised principal and coupon payments, Hamilton and the Congress gave state bonds substantial haircuts, bigger haircuts than owners of Federal securities suffered. See Hall and Sargent (2014).

⁸See Adams (1887) for a summary.

⁹In the early 1840s, approximately 70% of these state bonds were owned by foreigners, many by residents of the UK. This contrasts with the situation in 1790 when most US debt was owned by US citizens.

¹⁰Article 4 of the 14th amendment to the US Constitution acknowledged that holders of Confederate bonds would want to urge their state legislatures to levy the taxes required to service those bonds.

citizens. By doing that, those administrations sought political support for honoring the debt.¹¹

If payouts on government securities are denominated in a domestic currency, their real returns depend on the path of the domestic price level. Government creditors care about real returns on their securities. Large government debts to domestic creditors therefore politicize issues about units of accounts, monetary policies, and international exchange rate policies. An important issue in the 1868 campaign, the first presidential election after the victory of Union Armies in 1865, was about the units of account in which to pay interest and principal on vast quantities of US government bonds issued to finance the US Civil War. The Democratic party platform promised to pay with a paper legal tender currency called the greenback dollar, which in 1868 purchased .6 of a gold dollar. The Republican party platform promised to pay gold dollars. The voters elected the Republican nominee Ulysses Grant, who with Congress's consent took steps to redeem the Republicans' 1868 promise.¹² After World War I, British holders of UK government securities advocated that the UK adopt policies that would support an increase in the value of the UK pound sufficient to restore its exchange rate relative to gold to its pre World War I value, a feat accomplished (albeit only temporarily until September 1931) during the administration of Chancellor of the Exchequer Winston Churchill in April 1925. The widely criticized downward pressure that those policies put on the UK price levels served the interests of holders of pound-denominated UK government securities.

The notion that government bond holders want a fiscal policy providing them high real returns has practical ramifications about how the US should account for Federal debt today. Large amounts of Federal debt today are implicit, taking the form of retirement, disability, and medical "entitlements" that have been promised to citizens but that are not recorded as debt on the government's books and are not recorded as assets in private citizens' accounts, obscuring what should be the interest of entitlement holders to support the taxes that will be required to deliver them. A "tell-it-like-it is" proposal for "privatizing" these entitlements would award Federal debt certificates to US citizens as a way to make those promises explicit and tangible.

Returning to question 1, it matters who owns public debt and of which countries they are citizens. The political forces that make sovereign creditors want governments to collect

¹¹In the early 1920s, tax payer Harry Truman was very concerned about the value of his World War I liberty loan bonds. Twenty five years later, President Harry Truman was also concerned about the value of bonds issued to finance World War II.

¹²For more details, see Hall and Sargent (2014).

enough revenues to repay them cross national political borders. Writing in 1887, the economist Henry Carter Adams warned Americans that

The granting of foreign credit is a first step toward the establishment of an aggressive foreign policy, and, under certain conditions, leads inevitably to conquest and occupation. Adams (1887, p. 25)

Adams's remark came from his having observed many 19th century incidents in which loans from private citizens of European countries to citizens or governments in North Africa and Central and South American induced European governments to use force to collect payments and to impose fiscal policies on nominally sovereign foreign countries.¹³ Though the United States had mostly kept out of European and Asian affairs until then, in 1887 Adams prophesysed:

It lies altogether within the range of possibilities that the city of New York, like the cities of London and Paris, should become a storehouse of capital to which the sovereigns of petty states may resort to fill their depleted treasuries. This tendency is fraught with danger to the policy of isolation thus far maintained by the United States, and it becomes an important question, what attitude this country should assume with regard to the interests of those who place their funds beyond the control of American law. One of two policies must be declared, nor ought the nation to be permitted to drift in this matter. Either citizens of this Republic should know that money placed in foreign bonds is at their own risk, or they should prepare themselves to see questions of foreign policy become much more important than they now are. It seems, then, from whichever point of view we consider the question, that the United States can not reasonably expect to avoid political complications sure to come with an extension of international credits; and it is on this account desirable that the Federal Government should present a clearly formulated policy, upon which the public may rely. Adams (1887, pp. 37-38)

Adams's words portended tragic events thirty years later, grippingly described by Tooze (2014). In late 1916, politically influential private American citizens would have been very

¹³Rogan (2009) documents a number of such 19th century episodes. Rogan (2009) writes that in the mid 19th century "The single greatest threat to the independence of the Middle East was not the armies of Europe but its banks."

adversely affected by an Entente defeat because they lent large sums of US dollars to the governments of Britain and France between 1914 to 1916. That made German authorities predict that private American financial interests would soon impel the US to enter the war against Germany, leaving Germany little reason not to start unrestricted submarine war on February 1, 1917. Entry into the war in April 1917 led the US federal government to lend billions more to Britain and France, putting Britain and France after the War into a situation that impelled them to impose large reparations payments on Germany in order to service the private and public credits that Britain and France owed Americans. Ultimately that meant that American owned British and French sovereign bonds would be anticipation certificates for taxes to be paid by citizens of a defeated Germany. Schuker (1988) and Tooze (2014) describe the shadows that those American credits cast on inter European politics and economics and the disorderly process by which those debts were written down or forgiven. An interlocking chain gave American creditors an interest in Germany's fiscal policy. For as Adams had noted long before

... there is no such thing as repudiation of a foreign debt except through the acquiescence of the government of which the creditor is a citizen. Adams (1887, p. 27)

But the US government acquiesced. Schuker (1988, pp. 77-78) describes how and perhaps why Franklin Roosevelt's ambassador to Germany, Professor William Dodd, former chairman of the History Department at the University of Chicago, did not exert himself to protect the interests of American creditors:¹⁴

The United States as the main creditor power, failed to defend its equity vigorously after 1933 because it favored exporter over bondholder interests. For a variety of reasons, Great Britain, the other major world creditor, did not suffer anywhere near the default rate that afflicted American-issued securities during the great depression. Schuker (1988, p. 13)

Today, residents of China and Japan hold substantial fractions of outstanding US marketable government debt. About 35% of marketable US government debt is held by foreigners. They have large claims on taxes to be collected by the US government. They are interested in US fiscal policy. Though they don't vote in US elections, they have other ways of expressing their preferences.

¹⁴Also see Larson (2011).

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