United States then, Europe now

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Abstract

Under the Articles of Confederation, the central government of the United States had limited power to tax. Therefore, the large debt incurred during our War of Independence traded at deep discounts. That situation framed a U.S. fiscal crisis in the 1780s. A political revolution – for that was what scuttling the Articles of Confederation in favor of the Constitution of the United States of America meant – solved the fiscal crisis by transferring authority to levy tariffs from the states to the federal government. The Constitution and Acts of the First Congress of the United States in August 1790 gave Congress authority to raise enough revenues to service a big government debt. In 1790, the Congress carried out a comprehensive bailout of state governments' debts, part of a grand bargain that made creditors of the states become advocates of ample federal taxes. That bailout created unwarranted expectations about future federal bailouts that a costly episode in the early 1840s corrected. Aspects of these early U.S. circumstances and choices remind me of the European Union today.

1   Introduction

I am here to accept a personal honor, but the truth is that my work builds heavily on that of many others. I work in a macroeconomic tradition developed by John Muth, Robert

E. Lucas, Jr., Edward C. Prescott, Finn Kydland, Nancy Stokey, and Neil Wallace. I use macroeconometric methods championed by Lars Peter Hansen and Christopher A. Sims. I interpret macroeconomic history in ways advanced by Irving Fisher, Milton Friedman, Anna Schwartz, and François Velde.[1,2] To indicate how these research traditions have shaped me, I tell how the predicament facing the EU today reminds me of constitutional decisions my own country faced not once, but twice.

I begin with a simple expected present value model for government debt and explain how Hansen and Sargent (1980) used rational expectations econometrics to render this equation operational by deducing cross-equation restrictions that characterize how the value of a government's debt depends on the statistical properties of the government's net-of-interest surplus. This econometric specification isolates essential determinants of the value of a country's debt or currency. The econometric theory leaves unanswered who chooses the all important statistical process for the government net-of-interest surplus. In democracies, voters choose. To understand more, we think about outcomes that emerge under alternative democratic political arrangements.

A case study illustrates ways democracies have balanced conflicting interests. I am an American provincial, so my case study is how the constitutions for my country have influenced the government net-of-interest surplus process and therefore the value of government debt. I say constitutions, plural, because we Americans have tried two of them, first the Articles of Confederation that were ratified in 1781 and then the U.S. Constitution that was ratified in 1788. Those constitutions embraced two very different visions of a good federal union. Our first constitution was designed to please people who preferred a central government that would find it difficult to tax, spend, borrow, and regulate our foreign trade. The second served opposite interests. Our founders abandoned our first constitution in favor of our second because they wanted to break the prevailing statistical process for the net-of-interest government surplus and replace it with one that could potentially support a bigger government debt. Exactly how and why they did that is enlightening: starting in

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[1]See Muth (1960, 1961), Lucas (1972, 1976), Lucas and Stokey (1983), Lucas and Prescott (1971, 1974), Kydland and Prescott (1977), Hansen and Sargent (1980), Hansen (1982), Sims (1972, 1980), Fisher (1926, chs. XI, XII), Friedman and Schwartz (1963), and Velde (2009). Fisher (1926, chs. XI, XII), entitled 'Statistical Verification', set out a road map for Friedman and Schwartz (1963). Velde and Weber (2000) beautifully formalize and extend an enlightening model of bimetallism created by Fisher (1926). The issues described in this paper have been with us for a very long time. See Conklin (1998) for a description and analysis of sovereign debt issues faced by Spain under Phillip II.

[2]For an exquisite example of how theory imitates life, see Velde (2009) for an account of an *actual* pure change-of-units monetary experiment that is a key ingredient of the mental experiment analyzed by Lucas (1972).

1789, they rearranged fiscal affairs first and only then approached monetary arrangements as an afterthought.

The fiscal institutions of the EU today remind me of those in my own country under the Articles of Confederation. The power to tax lies with the member states. Unanimous consent by member states is required for many important EU-wide fiscal actions.

Some lessons that I draw from my country's history are these:

1. *The ability to borrow today depends on expectations about future revenues.* Without institutions that provide adequate revenue sources, governments may have neither the current revenue nor the ability, by issuing debt, to pledge future revenues when occasions demanding especially large public expenditures arise. The inability to issue debt comes from the fact that prospective debt holders rationally anticipate that the government will be constrained in its ability to raise enough revenues to service the debt. To provide public goods, even rare ones like surges of defense spending during wars, governments require the flexibility to tap adequate sources of revenue.

2. *Free-rider problems exist for subordinate governments vis-a-vis a central government.* Because there is a classic free rider problem in paying for public goods, subordinate governments, like states in the U.S. or nations in the European Union, cannot be relied on voluntarily to provide revenue to the central government to pay for public goods. Each state has an incentive to refuse, hoping that other states will accept the burden.

3. *Good reputations can be costly to acquire.* In deciding whether or not to pay pre-existing debts, governments have strong incentives to default. Their anticipations of default make prospective creditors reluctant to purchase debts in the first place. Governments therefore have incentives to earn a reputation that they will pay off their debts in the future. Acquiring that reputation can be costly because it might well require making apparently unnecessary payments to debts incurred before the current government took office. Assisting such historical debt holders can seem unjust to current tax payers, but it may be necessary for the long run health of a republic.

4. *It can help to sustain distinct reputations with different parties.* It is challenging for a government simultaneously to sustain distinct reputations with disparate parties. This challenge manifested itself when the U.S. Federal Government struggled to confront British trade restrictions from 1790 to 1812 and in the early 1840's when it

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wanted its actions to send separate nuanced messages to foreign and domestic creditors as well as various state governments.

5. *Confused monetary-fiscal coordination creates costly uncertainties.* Fiscal and monetary policies are always coordinated and are always sustainable, even though they may be obscure. In the beginning, the United States coordinated them by adopting a commodity standard and restricting states and banks' ability to create fiduciary money. Other arrangements are possible. You can have a monetary union without having a fiscal union. You may want a fiscal union even though you don't want a monetary union. Obscure coordination arrangements increase uncertainty in markets and among ordinary citizens.

2　The math

A basic theory about how creditors value a government's debt starts with a sequence of one-period budget constraints $g_t + b_t = T_t + R^{-1}b_{t+1}$, or

$$b_t = s_t + R^{-1}b_{t+1}, t \geq 0,$$

where $R > 1$ is the gross return on one-period inflation-indexed government debt, b_t is the stock of one-period pure discount (zero coupon) inflation indexed bonds issued at $t-1$ and falling due in period t, and $g_t, T_t, s_t = T_t - g_t$ are government expenditures net of interest payments on the debt, total tax collections, and the government net-of-interest surplus, respectively. Iterate the government budget constraints for $t \geq 0$ *backwards* to get

$$b_t = -R[s_{t-1} + Rs_{t-2} + \cdots + R^{t-1}s_0] + R^t b_0, t \geq 1,$$

which states that large government *debts* come from accumulating big government *deficits* $-s_{t-j}, j = 1, \ldots, t$, as well as rolling over any initial debt b_0. But to sustain large government debts requires prospects of big government *surpluses* in the future. To appreciate this, iterate the budget constraints for $t \geq 0$ *forward* to get

$$b_t = \sum_{j=0}^{\infty} R^{-j}s_{t+j},$$

which states that the value of government debt equals the discounted present value of current and future government surpluses. Recognizing that future surpluses can be forecast only imperfectly induces us to replace s_{t+j} with $E_{t-1}s_{t+j}$, where $E_{t-1}(\cdot$

(1991), it is convenient to write the first equation of (2) as

$$s_t = \sum_{j=0}^{\infty} \sigma_j w_{t-j} = \sigma(L) w_t, \tag{3}$$

where L is the lag operator meaning $L^j w_t = w_{t-j}$ and $\sigma(L) = \sum_{j=0}^{\infty} \sigma_j L^j$. Assume that the spectral density matrix $S_y(\omega) = C(e^{-i\omega}) C(e^{i\omega})^T$ has full rank m for almost all $\omega \in (-\pi, \pi]$, a condition that is equivalent with y being stochastically nonsingular.[5]

It is revealing and convenient to compute the value of bonds under rational expectations in two steps by applying an argument that invokes the law of iterated expectations. First, temporarily give bond purchasers 'too much' information by replacing the subjective expectation $E_{t-1}(s_{t+j}) \equiv E(s_{t+j}|J_{t-1})$ in equation (1) with $E(s_{t+j}|J_t)$, the mathematical expectation of s_{t+j} conditional on the history of shocks $w_t, w_{t-1}, \ldots$ in equation (2). Under this expanded information assumption, Hansen and Sargent (1980) showed in another context that[6]

$$b_t = \sum_{j=0}^{\infty} \kappa_j w_{t-j}, \tag{4}$$

or

$$b_t = \kappa(L) w_t,$$

where

$$\kappa(z) = \frac{z\sigma(z) - R^{-1}\sigma(R^{-1})}{z - R^{-1}}, \tag{5}$$

where z is a scalar complex variable and $\kappa(z)$ is the z-transform of the $\{\kappa_j\}$ sequence.[7] Next, to condition down to the information set $w_{t-1}, w_{t-2}, \ldots$ actually available to prospective bond holders at time $t-1$ when they purchase the bonds, we follow Hansen et al. (1991) who establish that the requirement that b_t be measurable with respect to time $t-1$ information J_{t-1} information implies that $\kappa_j = \kappa(0) = 0$, which in light of equation (5) requires that[8]

$$\sigma(R^{-1}) = 0. \tag{6}$$

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[5]Stochastic nonsingularity means that no component of y can be expressed exactly as a linear combination of past, present, and future values of other components of y.

[6]Hansen et al. (1991) extend this formula to handle the interesting case in which the first difference of s_t is a linear combination of a stationary vector process y_t like (2). See Hansen (2011) and Hansen and Sargent (2013) for further generalizations.

[7]The numerator of $\kappa(z)$ is designed to contain a zero that cancels the pole at R^{-1}, i.e., the zero in the denominator at R^{-1}. This makes the Taylor series and Laurent series expansions of $\kappa(z)$ coincide.

[8]Related measurability requirements play a key role in Aiyagari et al. (2002).

Equation (6) has a natural economic interpretation: it states that the present value of the moving average coefficients for the net-of-interest surplus must equal zero. This condition renders the value of the debt maturing at t measurable with respect to J_{t-1}.

Equations (2), (3), (4), (5), and (6) encode cross-equation restrictions that are hallmarks of rational expectations econometrics: the coefficients κ_j that tells the response of debt b_t to past shocks w_{t-j} are nonlinear functions of the discount factor R^{-1} and the coefficients σ_j in the moving average representation for the net-of-interest surplus s_t.[9]

Equations (2), (3), (4), (5), and (6) illustrate much of the logical structure and empirical power of rational expectations econometrics:[10]

- Current and lagged values of every component of the shock vector w_t that impinges on future surpluses s_{t+j} appear in the debt valuation equation (4).

- The shock response coefficients κ_j in equation (4) for the value of the debt would change if government policy were permanently to alter the σ_j's in (3) that characterize the stochastic process for the government surplus. This technical finding is the core of the critique of pre-rational expectations econometric evaluation procedures forcefully stated by Lucas (1976). Section 3 below argues that George Washington and Alexander Hamilton somehow anticipated this finding. They knew that to increase the value of U.S. government debt they would have to break the stochastic process (3) for $\{s_t\}$ that had prevailed in the U.S. in the 1780s.

- The same basic theory applies when there are prospects for default. For example, each period, suppose that there is a probability $\pi \in (0,1)$ that the government will write off a fraction $\phi \in (0,1)$ of its debt.[11] Let $\tilde{R}^{-1}$ be the discount factor applying to default-free debt. Then a 'certainty equivalent' discount factor R^{-1} that compensates a risk-neutral creditor for holding default-prone debt is

$$R^{-1} = \tilde{R}^{-1}\big[(1 - \pi) + \pi(1 - \phi)\big]. \tag{7}$$

With this adjustment to the discount factor, the preceding theory applies. Bigger

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[9]See Sargent (1981) for more the role of those cross-equation restrictions in other contexts.

[10]This is the theme of the papers in the volume about rational expectations econometrics edited by Lucas and Sargent (1981), especially the introductory essay. Hansen (1982) and Hansen and Sargent (1991) extended and refined rational expectations econometrics.

[11]I assume that ϕ and π are constant and do not depend on the stochastic process for the net-of-interest surplus s_t.

haircuts ϕ and higher probabilities of default π lower the discount factor R^{-1} and thereby reduce the value of the debt.[12]

- Hansen et al. (2007) opened the way to extending the theory to incorporate variable discount factors that can absorb some of effects of the news shocks w_t.

- Important technicalities impede linking our theory to vector autoregressions. Shocks in vector autoregressions for y_t must be in the Hilbert space spanned by $y_t, y_{t-1}, \ldots$ (see Sims (1980)). These so-called 'fundamental' shocks emerge from constructing a Wold moving average representation for y_t as the limit of what amounts to a sequence of finite order vector autoregressions as the lag length is driven to $+\infty$. Hansen et al. (1991) show that the internal logic of the present value equation (1) and the associated restriction $\sigma(R^{-1}) = 0$ imply that the moving average (2) is *not* a Wold representation because the shocks $w_t, w_{t-1}, \ldots$ span a larger space than the linear space spanned by $y_t, y_{t-1}, \ldots$, and so the w_t shocks are *not* what would be recovered by running a vector autoregression. Hansen et al. (1991) discuss substantial implications of this fact for extracting econometrically testable implications from the theory.[13]

2.1   Need for more economic theory?

This piece of economics-plus-statistical forecasting theory forms the essence of the pricing model used by prospective buyers and sellers of government debt.[14] For the purposes of those market traders, it is enough to have a good fitting *statistical* model of the stochastic process (3) governing the government surplus.

But for other purposes, a statistical model alone is inadequate. The model formed by equations (2), (3), (4), (5), and (6) is superficial because the government surplus process $\{s_t\}$ is itself the *outcome* of a political decision process.[15] The model summarizes but does not purport to *explain* the statistical properties of the surplus process (2)-(3) in terms of the balance of conflicting interests that actually created it.

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[12]Arellano (2008) used related ideas to model sovereign risk.

[13]Thus, there is a subtle relationship between the present value theory described in this section and causality in the sense of Granger (1969) and Sims (1972).

[14]It is highly simplified relative to papers that embody standard practice today. In particular, the assumption that the interest rate is risk-free and constant is a big oversimplification. See Lucas (1978), Harrison and Kreps (1979), Hansen and Singleton (1983), Hansen and Richard (1987), Eaton and Gersovitz (1981), Arellano (2008), and Hansen and Jagannathan (1991) and references that they cite and that cite them for extensions of the basic model that relax that assumption about the interest rate.

[15]I intend the adjective 'superficial' to be descriptive, not critical.

Economic theory goes deeper by analyzing contending economic and political forces that actually produce a statistical regime. In economic theory, an economic agent is a constrained optimization problem. A model consists of a collection of constrained optimization problems. Theories of general equilibrium, games, and macroeconomics acquire power by deploying an equilibrium concept whose role is to organize disparate choice problems by casting them within a coherent environment.[16] In the presence of one or more large player – governments in our case – decisions of some agents typically impinge on the constraint sets of others, and therefore on their incentives to take subsequent decisions. In such cases, the statistical process that represents an equilibrium outcome emerges jointly with the agents' beliefs about what would happen in situations that they never face. Beliefs about those events have important influences on outcomes that do happen.[17] Chari and Kehoe (1990), Stokey (1991), and Bassetto (2005) have explored and applied notions of equilibrium appropriate to situations where a large government interacts with many atomistic private agents.

I won't *formally* use such a single model in the rest of this paper. But broad insights from this *class* of models shape virtually everything I see in the fiscal and monetary history of my country.

2.2   A humbling message?

Macro models use the standard equilibrium concept to produce statistical processes for things like the government surplus as *outcomes*. This is a powerful method for 'explaining' objects like $\{s_t\}$. But the equilibrium concept can disable someone who proposes to improve outcomes. Why? Because the equilibrium already contains the best responses of all decision makers, including any government agents who inhabit the model.[18] Assuming that an equilibrium that explained the historical data can also be expected to 'work' in the future puts a model builder in the position of not being able to recommend changes in policy precisely *because* he has understood the forces that have led policy makers to do what they

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[16]Kreps (1997) describes common features of the equilibrium concepts used in theories of games and general equilibrium. To understand the empirical observations in the U.S. case study presented later in this paper might require going beyond this equilibrium concept to incorporate improvisation and adaptation in new ways that Kreps indicates at the end of his paper.

[17]Fudenberg and Levine (1993) and Sargent (2008) and the references there describe and apply the notion of self-confirming equilibrium, a type of rational expectations equilibrium in which possibly erroneous beliefs about events that don't happen in equilibrium still have big effects on observed equilibrium outcomes.

[18]Goethe said it this way: 'So divinely is the world organized that every one of us, in our place and time, is in balance with everything else."

do. The model builder's way of understanding them is to say that they were optimizing. And giving advice would imply that he thinks that they weren't optimizing or weren't well informed.[19,20]

2.3 Modeling reforms

By an *environment*, economic theorists mean a list of agents, a specification of actions available to every agent, a timing protocol telling who acts when, and an information flow telling what is known, and when and by whom it is known. Some changes in an environment can amount to changes in institutions, e.g., reassigning particular decisions to an independent central bank or assigning particular taxes exclusively to states or exclusively to a central government within a federal system. Our concept of equilibrium ties our hands by telling us that if we want to change outcomes, like the government surplus process mentioned above, then we have to reform institutions, which can mean agreeing on a new constitution. This is subversive. Nevertheless, that is what economic theory teaches. Somehow, George Washington and Alexander Hamilton appreciated this lesson long before the economic theory was formalized. That is why they led our *second* political revolution, the one against the Articles of Confederation, not the original one against Britain. They redesigned American institutions partly because they did not like the (equilibrium) $\{s_t\}$ process and the implied value of government debt that the old regime had promised.

3 The United States

Acknowledging that I lack anything approaching a complete model, but highly prejudiced by a *class* of equilibrium models, I now pursue an informal pattern recognition exercise to organize historical events that occurred in my own country and that remind me of choices being faced now as Europe struggles to manage a common currency.[21] I see the authors

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[19]The issue of whether equilibrium models are normative or positive was raised at a general level by Sargent and Wallace (1976) and more specifically in the context of interpreting vector autoregressions by Sargent (1984).

[20]The only time I saw Milton Friedman speechless was at a dinner party at Stanford in the mid 1980s. His close friend George Stigler trapped Friedman by asking him two questions. First, Stigler asked whether Friedman consulted for private businesses. Friedman said no, that because businessmen had more information and had already optimized, there was nothing useful Friedman could tell them. Then Stigler said, "Well that makes sense to me Milton, but then why are you always telling governments what to do?"

[21]Maybe it is a pattern *imposition* exercise. I did not select facts out of the blue. You can't get anywhere accepting a complete 'democracy of facts', as Borges (1962) illustrated in his story about Funes

of our constitution in 1787 and the architects of our federal government's institutions and policies in 1790-1792 to be wrestling with the implications of the government budget constraint (1), an equation that preoccupies both the U.S. and some European states today.[22]

3.1 Victorious but in default

The United States emerged from our war for independence in 1783 with big debts and a constitution that disabled our central government. The Articles of Confederation established a Continental Congress and an executive weak beyond the sweetest dreams of a contemporary American advocate of small government. The Articles worked as intended to restrain the central government from taxing and spending. That outcome served the interests of some U.S. citizens, but not of others. It was not good for the Continental Congress's creditors. The Continental Congress lacked powers adequate to service its substantial foreign and domestic debts. To levy taxes, the central government required unanimous consent of the 13 sovereign states.[23] To finance the war, the Continental Congress had printed IOU's in the forms of non-interest bearing paper money ('bills of credit') as well as interest bearing debt.[24] So had each of the thirteen states. After the war, the states could levy taxes to service at least part of their interest bearing debts.[25] The central government could not. It regularly pleaded for contributions from the states, with at most limited success.[26] An outcome was that Continental IOUs traded at deep discounts and so did IOUs of many states. Paper currencies depreciated markedly.[27] Deprived of tax revenues,

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the Memorius, who refused to impose patterns because he wanted to account for everything. My exercise amounts to pattern recognition with strong preconceptions. Prejudices help when data are limited.

[22]The remainder of this paper relies on empirical evidence assembled for Hall and Sargent (under construction).

[23]Cournot (1897, ch. 9) constructed a model of a monopolist that buys complementary inputs from n monopolists. That model can be reinterpreted to explain how decision making by consensus can lead to very inferior outcomes.

[24]Bills of credit were small denomination circulating paper notes. They were not legal tender. Before the revolution, American colonies had issued paper notes declared to be legal tender, but the British government had prohibited them from being legal tender in an act of 1764.

[25]See Wood (2009) for an account of differing states' debt positions and how this fed into the politics. Also see Elkins and McKitrick (1993) for a comprehensive account of the political struggles associated with creating and running U.S. institutions during the Washington administration.

[26]Mailath and Postlewaite (1990) and Chari and Jones (2000) explain why decentralized systems with voluntary participation cannot be relied upon to provide public goods.

[27]The Continental currency eventually declined to 1/40 or 1/100 of its initial value, but that inflation in the paper currency is not revealed by aggregate price indexes. David and Solar (1977) report an authoritative price index for the U.S. during this period. An interesting thing about their series (David

the Continental Congress tried to roll over its maturing debt and to pay interest falling due by borrowing more.[28] This became increasingly difficult as the 1780s unfolded. Ultimately, the Continental Congress stopped paying its creditors and watched interest payments in arrears grow in the form of new IOU's called indents. Authority to levy tariffs, the most remunerative potential source of tax revenues, resided in the states. In 1781 and 1783, the Continental Congress asked the 13 states to ratify amendments to the Articles of Confederation that would have allowed it to impose a Continental import duty whose proceeds were to be devoted entirely to servicing the Continental debt. Each time, twelve states approved, but one state did not (Rhode Island the first time, New York the second), killing the amendments.[29]

3.2   Trade policies

In the 1780s under the Articles of Confederation, the U.S. had 13 tariff policies and 13 trade policies. The states' main trading partner, Great Britain, discriminated against American shipping and American goods. Britain had done less of that before the revolution, but a foreseeable consequence of our victory in the American revolution was that the 13 American states would be excluded from the British imperial trading system. Occasionally individual American states sought to retaliate against British discrimination, but their efforts were always undermined by neighboring states.[30] The British could play one U.S. state against another.

3.3   Crisis and a second revolution

Milton Friedman said that countries confront problems only after they have become crises. In the 1780s, the huge interest bearing debts and currencies that had been issued to finance the war set the stage for a prolonged fiscal crisis from the point of view of the government's creditors, if not its tax payers. Measured at par (but not at the deeply discounted values then prevailing in the market), the ratio of Continental plus state debt to GDP stood

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and Solar (1977, p. 17)) is that because the unit of account was in specie, the depreciation of the paper Continental currency does not show up. It is an interesting contrast that during the U.S. civil war, the paper greenback displaced specie as the unit of account in most states that remained in the Union. California and Oregon were exceptions. Their courts refused to enforce the federal legal tender law and they stayed on a specie standard.

[28]This ignites the dynamics that underlie the unpleasant arithmetic of Sargent and Wallace (1981).

[29]See McDonald (1985, pp.170-171).

[30]See Irwin (2009) for the history and Cournot (1897, ch. 9) for the theory.

at about 40%, a massive debt at a time when the government could raise at most only a small percentage of GDP in taxes. About 2/3 of this debt had been incurred by the Continental Congress, the rest by the 13 states.[31] Sometimes *fiscal* crises have provoked political revolutions that renegotiate past promises and resettle accounts among tax payers and government creditors as they did in France in 1789 and the United States in 1787-1788.[32]

4   Restructuring fiscal institutions

To rearrange powers and incentives, our founding fathers scrapped our original constitution, the Articles of Confederation, and wrote an entirely new one better designed to protect U.S. government creditors.[33] The U.S. constitution realigned incentives and authorities that (a) let the central government devote enough tax revenues to service the debts that both the Continental Congress and the states had issued to pay for the war, and (b) gave the central government exclusive authority to tax and regulate U.S. international trade. That gave the federal government the tools to implement a national trade policy that could provide incentives to deter British discrimination against U.S. citizens.

In the early days of our republic, the government budget constraint linked our debt service capacity very closely to our trade policy. That tariffs were the main source of federal revenues confronted the country with a choice that framed U.S. politics from 1789 to 1815. Britain was our main potential trading partner. Raising revenues to fund U.S. debt required sizeable and reliable trade volumes with Britain, even if that meant restraining U.S. reactions to British discrimination against our goods and our ships. But because they put a high priority on faithfully servicing our government's debt and thereby earning the U.S. a reputation for paying its bills, Washington and Hamilton and the Federalists made preserving a difficult peace with Britain a cornerstone of their policy. So they refrained from retaliating against British trade restrictions. Later, because they wanted to retaliate against British trade restrictions, Jefferson and Madison and the Republicans were willing to imperil trade volumes with Britain and to sacrifice federal tariff revenues. They were

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[31]Hamilton (1790) estimated that at the beginning of 1790, the total debt at par stood at 79 million dollars, of which 25 million was owed by the states, and 12 million was owed to foreigners.

[32]Sargent and Velde (1995) see the French Revolution through the lens of the government budget constraint.

[33]I accept that there is a grain of truth in a controversial interpretation of our founders' motives authored by Beard (1913).

increasing its liquidity. Confirming Hamilton's expectations, discounts on Continental and state bonds evaporated when news about the pro-administration outcome of the debate spread.[38]

4.3   Discrimination and liquidity

An especially fascinating part of Hamilton's report is his response to James Madison's proposal to discriminate among current owners of Continental bonds according to when they had purchased them.[39] Motivated by what he regarded as fairness, Madison wanted to take away inordinate capital gains from people who had purchased Continental bonds at discount; he also wanted to compensate former owners who had sold them at discount. Hamilton convinced Congress that such *ex post* discrimination would adversely affect the beliefs of *prospective* purchasers of government debt and would thereby damage liquidity and trust in the market for bearer government bonds.[40,41]

4.4   Federal bailout of states

The United States began with a comprehensive bail out of the individual states when on August 4, 1790 the U.S. Congress accepted Alexander Hamilton's proposal to nationalize (or 'assume') states' debts. That completed a negotiation begun at the Constitutional convention when authority to tax imports had been transferred from the states to the federal government. In exchange for acquiring that most important revenue source, the federal government agreed to bail out the states, a decision that realigned creditors' interests away

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[38]Hamilton had altered creditors' views about the government's 'type'. The situation of the new government in United States in 1789 reminds me of an example about sovereign default in Bassetto (2005, sect. 4). Assume that a government with a dubious fiscal record leaves office and is replaced by a new government that is perfectly credible and dedicated to repay the debt. Despite the best intentions, whether or not the new government defaults is still influenced decisively by the private sector's beliefs. If they persist in holding beliefs that the new government will default, they will demand prohibitive interest rates, so that even a well-meaning government will eventually be unable to meet its obligations at those rates. So to succeed the new government will have to implement good economic policies and also benefit from good (or lucky?) "expectations management", whatever that means. See Bassetto (2006).

[39]See Hamilton (1790).

[40]Although the Congress defeated Madison's proposal for discrimination, a related idea returned to affect the Madison administration two decades later during the War of 1812. Dewey (1912, p. 134) describes an act of March 24, 1814 that required the government retroactively to offer more favorable terms to previous creditors if subsequent issues garnered lower market prices.

[41]Proposals to discriminate among creditors often surface during negotiations to reschedule debts. For example, there are proposals for private holders of Greek government debt to take substantial voluntary haircuts while non-private creditors are to be paid in full.

from states and toward the federal government.[42] By converting creditors of the states into creditors of the central government, Hamilton transformed those bond holders into advocates of a federal fiscal policy that devoted a substantial share of the proceeds of a revenue-raising tariff to servicing those bonds. An important justification for nationalizing the states' debts was that most of them had been incurred to finance states' contributions to our national war for independence. The U.S. Treasury set up a system designed to account for each state's contributions to the Glorious Cause and to compensate them accordingly. It would have been wise for subsequent lenders to understand that the Congress had reasoned that it was states' contribution to that national enterprise that justified the 1790 bailout. Investors should not have interpreted it as a promise to bail out states in the future no matter what, but apparently some of them did, to their eventual regret (please see section 6.1 below).

4.5   Why pay?

The government institutions that they designed and the decisions that the Congress and President took in 1790 and 1791 confirm that the founding fathers intended fully to honor the debts that they had inherited from the Continental Congress. Making good on the promises originally made to Continental and state debt holders to finance our war of independence meant disappointing other expectations and breaking promises at least implicitly made about other dimensions of fiscal policy, for example, to keep taxes low. Those deep discounts at which Continental debts traded in the mid 1780s reflected traders' anticipations of those low-tax policies. Why, then, did our founding fathers choose to keep some promises (the ones to its creditors that had apparently already substantially written off) by breaking other promises (those to Continental tax payers) that had been protected by the Articles of Confederation?[43] If, as seems appropriate, we regard 1787 or 1789 as a new beginning – 'time 0' in models of Ramsey plans and recursive mechanism design – then Ramsey models in the representative agent tradition of Lucas and Stokey (1983), Chari et al. (1994), and Jones et al. (1997) won't help us to answer that question. Those models typically advise a government to *default* on all initial public debts[44] and thereby impose

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[42]McDonald (1985, pp. 166-167) describes how in the early 1780s Superintendent of Finance Robert Morris tried but failed to organize the Continental Congress's domestic creditors as a nationalizing force.

[43]The why pay question has been sharply posed by Bulow and Rogoff (1989) and Kletzer and Wright (2000).

[44]Sometimes they have also done whatever they could to acquire *net claims* on the private sector in order to finance future expenditures efficiently. See Paal (2000) for how the Hungarian communists deliberately

that least distorting of taxes, an unforeseen capital levy. Other revolutionary governments have done that,[45] but not our founding fathers. Their purpose in realigning authorities and interests was to affirm that a 'deal is a deal' at least so far as obligations to the government's creditors, if not to tax payers, were concerned.

To understand why Hamilton and Washington and other founders wanted to pay, we have to take into account heterogeneities of economic situations and consequent conflicting interests[46] as well as reputational considerations that are absent from these Ramsey models. The *purposes* for which those initial debt were incurred, the identities of the individual creditors, and the perceived adverse consequences of default all mattered in ways neglected at least by the three representative agent Ramsey models cited above.[47] Such Ramsey models help explain government policies after some political revolutions, but not those of our founding fathers.

In paying those Continental and state obligations, Secretary of Treasury Hamilton wanted the federal government to gain enduring access to domestic and international credit markets. That would expand options for financing temporary surges in government expenditures by borrowing, thereby allowing his successors to moderate the contemporary tax increases needed to finance those surges.[48] He also asserted that an outstanding stock

reset 'time 0' after World War II and used the monetary system to acquire claims.

[45]Lenin and Trotsky and their admirers in Eastern Europe did that. The French Revolution in 1789 did not, instead struggling valiantly for years to service the pre-revolution debt until circumstances eventually led to a substantial default in 1797.

[46]See Meltzer and Richard (1981).

[47]American politics and policies toward debt management in the aftermath of our war for independence differed strikingly, for example, from those in Germany after World War I. Domestic creditors owned most of a very large government debt that Germany had accumulated during World War I, but then the Versailles treaty imposed big further debts on the German government in the form of uncertain but huge reparations payments to some of the victors. The politics in the United States after the war for independence differed from those in Germany after World War I because our foreign debt had come from the benevolence and trust of friends in France and Holland who had sent us resources during our war, not the vengeance of foreign powers that had defeated us, as was true in Germany. A hyperinflation opened the door for Germany to escape most of those reparations payments, albeit at the cost of tremendous collateral damage in the form of a massive redistribution away from German nominal creditors to German nominal debtors as the value of German mark depreciated from its pre World War I value by a factor of 10^{12} by November 1923. Sargent (1982) describes how Germany abruptly ended its hyperinflation by using a version of our simple theory (1) for valuing government debt. Before November 1923, the most important component of Germany's government surplus process s_t was an inflation tax. The hyperinflation was arrested by adopting policies that adjusted government expenditures and taxes, along with fortifying a central bank that would refuse to continue to levy the inflation tax.

[48]That is, he wanted to have the option to issue debt in the fashion made explicit by Secretary of the Treasury Albert Gallatin in his 1807 report to Congress (see Dewey (1912, p. 128)), a strategy later formalized in the tax-smoothing models of Barro (1979) and Aiyagari et al. (2002).

of government debt earning a relatively risk-free return would foster the development of domestic credit markets, which he thought would be a boon to commerce and industry.[49,50]

4.6   Monetary arrangements

Only after fiscal policy had been set on course in the Acts of August 4 and August 5, 1790 did Hamilton and the Congress then turn to monetary policy. Hamilton presented his *Report* proposing a Bank of the United States on December 14, 1790 and his *Report* proposing that the U.S. mint our own silver and gold coins only on January 28, 1791. It was widely presumed that we would follow leading European countries in embracing a commodity money standard. So the remaining monetary policy decisions for our founders simply involved choices of coin sizes and of a seigniorage rate for the mint.[51]

4.7   A national bank?

After a tense debate during which James Madison argued that a federally chartered monopoly bank would be unconstitutional, the Congress awarded an exclusive 20 year federal Charter to a Bank of the United States.[52] The Bank was mostly privately owned and mostly operated in the interests of its private shareholders, though it did serve as fiscal agent of the federal government and as a depository for federal revenues. It also issued bank notes that circulated as currency and were convertible into specie on demand. It issued notes only in exchange for short term loans to the federal government or very short term commercial loans promising low risk. It avoided real estate and other long term and risky loans. In

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[49]See Krishnamurthy and Vissing-Jorgensen (2010) and references cited there for modern arguments about good effects promoted by a stock of safe government debt.

[50]See Brewer (1989) and North and Weingast (1989) for accounts of the flexibility that the government of Britain had achieved by successfully implementing fiscal institutions that Hamilton admired. An implication of Bassetto (2005, 2006) is that even with good institutions, sometimes there are multiple equilibria, and we need something to select among them (skill? luck?).

[51]They set the seigniorage rate to zero, a decision called "free coinage".

[52]Madison changed his mind, when serving as president twenty years later, the Bank's charter came up for renewal and opponents of the Bank brought up Congressman Madison's 1791 arguments to use against his administration's request to renew the bank's charter. Though he changed sides, Madison was on the losing side both times, as Congress refused to renew the Bank's charter, causing the United States to finance the War of 1812 with its longstanding fiscal agent having just been abolished and scrambling to improvise alternative arrangements for acquiring short-term credit. Whether to have a national bank serving as fiscal agent of the federal government is something that statesmen like James Madison and Henry Clay changed their minds about, and so did the country. The charter of the first Bank of the United States was not renewed in 1811, and neither was the charter of the second Bank in 1836.

these ways, it could be said to implement the 'real bills' regime of Adam Smith (1806), whose writings on the subject very probably influenced Hamilton.[53]

4.8   A mint

The founding fathers seem to have regarded monetary policy as a side show to be tidied up only after a sound fiscal policy had been secured. The Act of August 4, 1790 (1 Statutes, 138) had prescribed detailed procedures for funding U.S. and states' debts. New federal IOU's were to be denominated in 'dollars', which on August 4, 1790 meant *Spanish* dollars because at that time there were no U.S. dollars. In a report on coinage delivered in May 1791, Hamilton proposed that the U.S. manufacture a silver dollar defined to have the same silver content as a Spanish dollar.[54] The Mint Act of April 2, 1792 accepted Hamilton's recommendations virtually intact by creating a U.S. dollar. In terms of the fundamental determinant of its value, namely, its metal content, the U.S. dollar was a copy of the Spanish dollar, the only difference being that it had American and not Spanish 'advertisements' stamped on its sides. In terms of essential economic forces, whether or not the U.S. actually issued these dollars was incidental.[55]

4.9   Outcomes

Deep discounts on the Continental debt evaporated and the federal government successfully rescheduled its debt (again see equation (7) for the discount factor). Tariffs constituted virtually all of federal revenues. About 2% of GDP was collected in federal taxes annually during the 1790s. About 40% of those revenues were used to service the debt. Under Hamilton and his Federalist successors, the debt was serviced and the principal rolled over, but substantial economic growth allowed the debt/GDP ratio to decline more or less

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[53]Smith's real bills doctrine advocates benefits from permitting a government owned or private financial intermediary to issue circulating notes that are backed by safe evidences of private indebtedness. To Smith, 'real' meant relatively risk free. Smith pointed to efficiency gains that could be reaped for allowing paper notes backed by safe private evidences of indebtedness to circulate and displace precious metals that would otherwise be serving as media of exchange. See Sargent and Wallace (1982) for an analysis of pros and cons of the real bills doctrine.

[54]Section 9 of the act of April 2, 1792 states each dollar is 'to be of the value of a Spanish milled dollar as the same is now current'.

[55]The U.S. mint functioned as European mints typically did in those days. The mint stood ready to sell on demand at a fixed price, but did not purchase, gold or silver coins in exchange for gold or silver bullion, respectively. If you wanted to purchase coins from the mint, you took your bullion to the mint. The mint assayed the metal, then forged and stamped coins that they returned to you. If you wanted to melt the coins to retrieve the bullion, you could melt them yourself, or you could export or sell the coins for specie.

continuously until the War of 1812, except for a bump up used to finance much of the 15 million dollars paid to Napoleon Bonaparte for Louisiana.[56] In 1790, a bigger 'fiscal space' (see Ghosh et al. (2011)) for the U.S. was provided by our prospects for rapid population and economic growth, prospects that were realized in the 25 years after 1790. Appendix A displays some of these outcomes in graphs of data taken mostly from early reports of the United States Treasury.

5 Following through?

Timing protocols that prevail in a democratic society open serious issues about the roles of commitments, precedents, and reputations. Expectations about *future* governments' decisions influence prices and quantities *today*, but today's citizens and policy makers cannot bind future citizens to prescribed courses of action.[57] Decisions made in 1790 and 1791 were just the beginning of the great American fiscal and monetary adventure. Conjectures about how their successors would complete or modify the founding fathers' plans vitally concerned our founders.[58] They had sought to create institutions (timing protocols?) and precedents (reputations?) that they hoped would limit later choices in ways that would induce their successors to choose good public policies. Subsequent U.S. history witnessed tax revolts (an armed revolt against the federal government in 1794 western Pennsylvania when farmers protested a federal excise tax on whisky) and tariff and trade regulation revolts (in 1814 when New England states threatened to dissolve the Union, and in the early 1830s when President Jackson faced down John C. Calhoun and South Carolina during the nullification crisis). Struggles over how much the federal government should tax and spend and regulate continued until our Civil War and beyond.

It is useful at this point to mention examples of how an administration's decisions

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[56]To put the magnitudes in perspective, the total Continental and state debt that Hamilton rescheduled in 1790 was about 79 million dollars, which at that time was about 40% of GDP, an estimate subject to substantial uncertainty. The Louisiana purchase was a good bargain for the U.S.

[57]Kydland and Prescott (1977) delineated this tension elegantly. See Klein et al. (2011), Klein and Rios-Rull (2003), and Debortoli and Nunes (2011) for a small sample of an important literature in macroeconomics that computes Markov perfect equilibria and uses them to study quantitatively how outcomes under a sequential timing protocol differ from those under a timing protocol that awards a government the ability to choose once and for all. See Battaglini and Coate (2008) for a political-economic equilibrium under a sequential voting protocol.

[58]In 1811 Secretary of the Treasury Albert Gallatin told Congress "To meet these loans in the future we must depend on coming prosperity and the wisdom of successors; that is, favorable circumstances and rigid economy."

interacted with those of its predecessors and those of its successors.

5.1 Federal and state paper monies?

The authors of the Constitution and their supporters abhorred paper money and the sorry state to which American domestic, if not foreign, credit had been reduced. That attitude set the stage for a debate at the constitutional convention about which powers over monetary standards to assign to state and federal governments, and which to deny them. Delegates to the convention agreed to prohibit *state* governments from issuing bills of credit or otherwise make a paper currency a legal tender.[59] What about the *federal* government? Preliminary drafts of the constitution had given the federal Congress the right to issue bills of credit. Thus, even though the Convention had already agreed explicitly to forbid states from issuing paper money, on the morning of August 16, 1787, the eighth clause of the seventh article in the draft of the constitution said that "The legislature of the United States shall have the power to borrow money and emit bills on the credit of the United States." Madison's notes of the convention's proceedings on August 16, 1787 record a debate about a motion to strike out the clause authorizing congress to emit bills of credit. The motion carried 9 to 2.

Three contributions to the August 16 debate especially fascinate me. (1) James Wilson's clear statements stressing the *ex ante* advantages in terms of promoting credit to be reaped by denying future government decision makers the authority to take actions that would occasionally tempt them *ex post*; (2) George Mason's and Edmund Randolph's statements urging the convention to appreciate the advantages of reserving for future decision makers enough flexibility to deal with contingencies of a kind that could not be foreseen in 1787; and (3) Madison's remark that withholding the authority to make government bills of credit legal tender would be sufficient to restrain potential abuses.[60,61]

Partly affected by their reading of that August 16, 1787 debate, during the first three

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[59]Article I, section 10 includes the restrictions

> No State shall enter into any Treaty, Alliance, or Confederation; grant Letters of Marque and Reprisal; coin Money; emit Bills of Credit; make any Thing but gold and silver Coin a Tender in Payment of Debts; . . .

[60]See Bancroft (1886) for histories of legal tender acts in colonial America and of the founding fathers' aversion to making paper monies legal tender.

[61]Madison stood true on this matter. As President from 1809-1817, Madison presided over an administration that issued federal bills of credit to finance most expenditures for the war of 1812, but that did not make them legal tender.

quarters of the nineteenth century, many influential Americans believed that the founders had intended to shut the door on the federal government's issuing a paper legal tender, and that the fact that the majority of the delegates did not go further and explicitly *prohibit* the federal government from issuing bills of credit simply reflected the constitutional convention delegates' presumption that powers not explicitly awarded should be understood to be denied to Congress.[62,] An extensive review of the documentary record convinced Bancroft (1886) that the founding fathers' intent was clearly not to allow Congress to make a paper currency a legal tender.[63]

5.2 What kind of currency union?

Even before 1789, the 13 states effectively already had a currency union in the sense that all honored the Spanish dollar. Article 1 Section 8 of the U.S. constitution gives the federal Congress the exclusive power

> To coin Money, regulate the Value thereof, and of foreign Coin, and fix the Standard of Weights and Measures; . . .

As we saw in section 5.1, the constitution expressly prohibited states from issuing paper currency, and most believed that prohibition extended to the federal government. With the first Bank of the United States, the federal government only modestly and temporarily[64] circumvented that implicit limitation by allowing the Bank of the United States to issue circulating notes in exchange for short-term government IOUs. It took longer for the states to circumvent the restriction.[65] In January 1837, in *Briscoe v. Bank of Kentucky*, the majority of the U.S. Supreme Court, including newly appointed Chief Justice Taney, decided that state chartered and state owned banks have the right to issue paper money in the form of bank notes (see Howe (2007, ch. 11). Application of the real bills reasoning of Adam Smith (1806) and Sargent and Wallace (1982) or the Modigliani-Miller reasoning

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[62]Sustaining this tradition, the confederacy did not make its paper currency a legal tender.

[63]Bancroft's review of the evidence was prompted by what he regarded as the Supreme Court majority's flagrant disregard of the historical record in deciding the 1884 legal tender case Juilliard v Greenman. The court reasoned that because Congress had the power to pay debts, it could do so by any means not expressly prohibited by the constitution; and that little attention needed to be paid the debates and votes at the constitutional convention because it was difficult to glean a consensus from them; that Congress's power to borrow money included the power to issue obligations in any appropriate form, including hand-to-hand currency; and that the authority to issue legal tender notes accompanied the right of coinage. (see Dewey (1912, p. 366-67))

[64]Congress refused to renew the Bank's charter in 1811.

[65]Actually, some state chartered banks were issuing notes before the First Bank was chartered.

of Wallace (1981) indicates how this decision effectively disarmed the Article I, section 10 prohibition against states' issuing bills of credit. The decision allowed state banks to purchase state bonds with circulating bank notes issued by those banks. After that and until they were taxed out of existence by the Congress during the Civil War, a plethora of currencies circulated within and across states during what has sometimes been mislabeled a 'free banking era.'[66] Many such currencies circulated simultaneously with fluctuating rates of exchange that reflected probabilities that state chartered bank notes could be converted on demand into specie. So before our Civil War from 1861 to 1865, we had a currency union in one sense – the precious metals were the unit of account throughout the Union; but in another sense we did not – we had multiple currencies that presented citizens with choices about holding different currencies bearing different risks and returns. There was no lender of last resort, no deposit insurance, and no presumption of federal bailouts of banks' depositors. All that stood behind those notes was the prudence of bank managers promoted by what Bagehot (1920) called the "preservative apprehension" of owners of bank notes.[67]

So if our founders intended to establish a *currency* union, at least before the Civil War, they had at best mixed success. And if they had wanted a currency union, it would surely have been based on a commodity money, not a union based on a managed fiat currency like the one we have in the U.S. today.

We now turn to continuing controversies about the scope of the *fiscal* union that our founders had established in August 1790.

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[66]Free banking – in the sense of free entry – did not prevail. Most banks had to have state charters. Many of those state bank charters contained explicit provisions for the bank to have to make loans to the state or to buy bonds issued to fund canals, railroads, or turnpikes. Most of the assets that these banks purchased with notes were loans and discounts. However, banks that operated under so-called 'free banking laws' were required to purchase state bonds to back their notes.

[67]See Rolnick and Weber (1983, 1984). With multiple private media of exchange bearing different and fluctuating rates of return, issuers usually accepted (but did not redeem) the demand liabilities of others. An outcome was that issuers typically wanted to redeem and clear notes issued by other banks in order to augment their holdings of specie (or 'lawful money'). From the 1820s to the 1850s, the Suffolk Bank of Boston administered successful private note clearing operation for banks from all over New England. The Suffolk Bank managed a private "currency union" in the sense that notes of New England banks circulated at par throughout the region. See Weber (2009).

6 What kind of fiscal union?

From the start of the republic in 1789 until the Civil War, Americans continued to dispute the proper scope and magnitude of federal tax, spend, transfer, and regulation policies. Interests that coalesced around the great Whig statesman Henry Clay's American System in the 1830s advocated federal expenditures on infrastructure projects – roads, canals, railroads, universities – public goods that they argued merited national fiscal support. A coalition of interests with strong support in the southern states succeeded in blocking most such measures.[68] McPherson (1988, Sec. III, ch. 14) documents how the 37th Congress (1861-1862) seized the occasion of the secession of most slave states to reorder the federal union along lines that fulfilled many of Clay's goals. On July 1, 1862 the Congress passed the Internal Revenue Act, which among other things imposed the first federal income tax. On that same day, the Congress passed the Pacific Railroad Act awarding public lands and federal loans to companies that would construct intercontinental railroads. On July 2, 1862, Congress passed the Morrill Act awarding grants of federal land for establishing what came to be known as land grant colleges.[69] Earlier, similar legislation had bee22.8(a)-2.837(523w91(a)-

pose year-by-year balanced budgets. Adams (1887) tells how, in response to adverse fiscal occurrences in the late 1830s and early 1840s, many states rewrote their constitutions to require balanced budgets annually.[71] Here is the story.

During the first 30 years of our republic, citizens debated whether the federal government should or could finance public infrastructure projects. Before our Civil War, they decided that it couldn't. In response to a string of Presidential vetoes of public works appropriations, state governments assumed responsibility for public works projects. After 1829, many state governments ran large government deficits, substantial parts of which were justified at the time because they were said to be deficits on capital account, not on current account. The logic was that those state bonds had been issued to help finance public or private infrastructure projects. People advanced the theory that those bonds would be self-financing because ultimately they would promote growth and larger state government tax receipts in the forms of fees or taxes on increased land values. Belief in that theory allowed state bonds to be sold widely. Some were purchased by Europeans who were partly convinced by the self-finance theory and who also apparently mistakenly understood them to carry as much investor protection as federal bonds, which had earned a good reputation through a sustained record of having been honored after the wars of independence and 1812. And investors in state bonds knew that the federal government *had* comprehensively bailed out state debts at the beginning of the republic. Also, Article IV, Section 1 of the U.S. constitution mandates strong protection for owners of state debts:

> Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State. And the Congress may by general Laws prescribe the Manner in which such Acts, Records and Proceedings shall be proved, and the Effect thereof.

But foreign investors in state bonds may not have noticed an ambiguity in investor protection created by the eleventh amendment to the Constitution, passed in 1793 after a citizen of one state had taken a grievance against another state into a federal court. The eleventh amendment disarms the investor protection originally guaranteed by Article I, Section I by stating:

> The Judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United

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[71]Those new constitutions thereby mandated that states forego the efficiency gains of tax-smoothing delineated by Barro (1979) and Aiyagari et al. (2002).

States by Citizens of another State, or by Citizens or Subjects of any Foreign State.

For European and other bond holders, the story did not end happily. During a recession at the end of the 1830s, many states defaulted.[72] European bond holders then learned that the eleventh amendment deprived them and other creditors of American states of protection in federal courts. During the 1840s, Congress debated but ultimately rejected proposals for the federal government to nationalize and pay off those the state debts. During the debates, advocates of a bailout recited the precedent set by Hamilton's 1790 bailout of the states. But opponents successfully argued that Hamilton had bailed out state debts incurred for a Glorious national purpose, while the debts of the early 1840s had been incurred for disparate causes to finance local projects. That and other arguments led Congress to refuse to bail out the state debts.

This episode cost the U.S. a hard-earned high quality reputation for all U.S. government debt, federal as well as state, and cast long reputational shadows in two directions. It seems that the international bond markets' response to these state bond failures did not immediately include an inclination to adopt a nuanced view that discriminated finely between the credit worthiness of federal and state authorities. For years, the reputation of federal credit in Europe suffered along with that of the states.

But the Congress's decision not to bail out the states had other, arguably more beneficial consequences for our country. A legacy of the Congress's decision was that in the 1840s more than half of the U.S. states rewrote their state constitutions to require year-by-year balanced budgets. This is yet another example of fiscal crises that have produced the lasting institutional changes that we sometimes call revolutions.[73,74]

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[72]See Scott (1893) and Ratchford (1941).

[73]See Wallis and Weingast (2005). As noted, the eleventh amendment to the U.S. constitution stated that state debts can't be enforced in federal courts. However, debts of municipal corporations and counties are enforceable in state and federal courts. Adams (1887) claimed that this system of arrangements for protecting investors and the balanced budget restrictions placed state constitutions explains the dramatic shift in expenditures and debts from the state level to the local and municipality and county level during the course of the 19th century. Wallis (2000, 2001) has effectively taken up this theme.

[74]Although I cannot pursue it in the present paper, the story does not end here, as section 4 of the Fourteenth amendment to the U.S. Constitution says.

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.

Did the Congress do the right thing in refusing to assume those state debts? There is a strong case to be made that it did: at the cost of temporarily sacrificing the *federal* government's hard earned good reputation with international creditors who were unable or unwilling to distinguish between the actions of federal and state governments, that decision succeeded in establishing a strong reputation of the federal government vis a vis the states. The Congress told the states not to expect the Federal government to backstop their profligacy.[75] To put the point bluntly, if by bailing out those state debts the federal government had set up expectations that they would back up state loans in the future, that would have exposed the U.S. to adverse consequences like ones that Kareken and Wallace (1978) warned us about in another context, namely, the insurance of financial institutions. Kareken and Wallace taught us that under-priced government insurance of deposits of inadequately regulated financial intermediaries provides incentives for those intermediaries to become as big as possible and as risky as possible. That will almost surely put the government into the position of eventually having to bail them out. Therefore, Kareken and Wallace said that if you want to extend deposit insurance, you had better regulate financial intermediaries' portfolios. Extending and applying the Kareken and Wallace logic to federal bailout of states, in exchange for offering such insurance, a federal bailout of the states would have set us on the road to extended federal control of states' fiscal policies. And where would that have ended? With federal control of cities too?[76] Without Congress's 1840s refusal to bail out the states, it is probable that those state constitutions would never have been rewritten to mandate year-by-year balanced budgets.

7   Lessons for now?

For the type of government we had under the Articles of Confederation in the 1780s – a weak fiscal union unlikely to pay its creditors what they had been promised – those deeply discounted Continental bonds had been fairly priced in the 1780s. Hamilton and

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Washington had set out to change the government's 'type' by realigning interests in ways that would induce the Union to pay what it had promised then and later. And Hamilton wanted the market to price the bonds accordingly (via formula (7) for the discount factor again). Hamilton set out to manipulate current and prospective public creditors' expectations about whether the government would honor its bonds the only way he knew: by creating a fiscal union with institutions and interests aligned in ways that would increase the *actual* probability that the federal government would pay. Our founders' purpose in creating that fiscal union was not primarily to facilitate a monetary union, a distinct project about which they revealed substantial ambivalence in their subsequent indecision about whether to charter a national bank or whether instead to foster competition among private currencies issued by state chartered banks.

In terms of fiscal arrangements, the EU today reminds me of the U.S. under the Articles of Confederation. The power to tax lies with the member states. Unanimous consent by member states is required for many important EU-wide fiscal actions. Reformers in Europe today seek to redesign these aspects of European institutions, but so far the temporal order in which they have sought to rearrange institutions has evidently differed from our early U.S. experience in key respects. The U.S. nationalized fiscal policy first, and for the U.S. founders, monetary policy did not mean managing a common fiat currency, or maybe even having a common currency at all. The EU has first sought to centralize arrangements for managing a common fiat currency and until now has not wanted a fiscal union. And to begin its fiscal union, the U.S. carried out a comprehensive bailout of the government debts of the individual states. So far, at least, the EU does not have a fiscal union, and few statesmen now openly call for a comprehensive assumption of the debts of the governments of the member states by the EU.

Especially because of the contentious and obscure state of politics influencing monetary and fiscal policy in my country today, I am certainly not qualified to advise European citizens about what lessons, if any, to draw from the story about how the U.S. created a fiscal union. But I do know that to ferret out useful lessons, it would be important to identify circumstances in Europe now that match those of the U.S. then, and circumstances that differ. The U.S. created its fiscal union at a time when the vast majority of our people worked and lived on farms and when a substantial minority were slaves. People were much poorer then than now. Life expectancies were so very much shorter then than now that few working people lived long enough or ever earned enough to be able to stop working before they died. Doctors and medicine often did more harm than good, so it was probably

better that most people could not afford them. Deferred compensations, mostly for military service (pensions) but also some for land confiscated from Native Americans, were the only legal entitlements to government financed transfer payments. Most people could not vote. The federal government was small and it redistributed only a small fraction of GDP. In peacetime in the first two decades of our republic, federal expenditures averaged 1 or 2 percent of GDP and in the beginning in the 1790s the federal government allocated 40% of its tax revenues to servicing the federal debt. The government debt that the Congress and President nationalized in 1790 had been incurred for a widely endorsed national cause.[77] And fifty years later when Congress refused another massive federal bailout of state debts, its actions proved that the *purpose* for which those state debts had been incurred mattered.

Many of these circumstances differ in Europe today. Unlike the central government of the U.S. then, the EU itself does not have a large debt; instead, all of the troublesome debts that are large and discounted are obligations incurred by subordinate governments. People live longer and most do not work on farms. They retire for substantial periods of their lives and many do not start working until much later in their lives than those early Americans did. There are large public expenditures on education. Medicines and doctors make people healthier and older. Families are weaker. Government financed safety nets and retirement and medical systems are pervasive and absorb substantial fractions of national budgets. Government regulations of labor markets have changed – slavery is gone; there are minimum wages, unemployment and disability compensation arrangements, and employment protection laws. Some of these differ in their generosity and strength across EU states.[78] Are there greater differences in these institutions and peoples' skills and preferences across EU member states today than there were in the U.S. then? In some ways, U.S. member states were much *more* diverse, for example, in attitudes toward slavery. But in terms of the *fraction* of GDP that citizens in different states wanted the federal government to consume or redistribute, I suspect that there was much more agreement across member states than there is in the U.S. today. Then, beyond redistributing from tax payers to government creditors, the federal government's redistributional activities were minimal. Some advocates of a fiscal union in Europe may want more redistribution and some opponents may want less.

I end with a lesson for my own country now. The government budget constraint and

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[77] The Tories had either left or remained quiet.

[78] Ljungqvist and Sargent (2008) study how differences in these features of social safety nets across countries and continents can account for different outcomes for unemployment in the face of common changes in the microeconomic environment.

our pricing equation for government debt always prevail. The message of the unpleasant arithmetic of Sargent and Wallace (1981) is that with a responsible fiscal policy – namely, one that sustains present value government budget balance with zero revenues from the inflation tax – it is easy for a monetary authority to sustain low inflation; but that with a profligate fiscal policy, it is impossible for a monetary authority to sustain low inflation because the intertemporal government budget then implies that the monetary authority must sooner or later impose a sufficiently large inflation tax to finance the budget. In this sense, monetary and fiscal policies cannot be independent. They must be coordinated somehow. There are several clear cut and simple devices for coordinating fiscal and monetary policies.[79,80] Other more obscure ways are also possible, like one that seems to prevail in the United States today.

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[79]Milton Friedman may appear to have changed his mind drastically about how to coordinate monetary and fiscal policy, but if you look at it more deeply, he really didn't. Friedman recommended two apparently diametrically opposed ways to coordinate monetary and fiscal policy. In Friedman (1953), he recommended that the monetary authority use open market operations to purcha19.06(c)-1.6643.38668(w)-367.011(Y)8189017(5)-5.80017

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A   Outcomes in graphs

Figures 1, 2, 3, 4, 5, 6, 7, 8, 9 and 10 show some of the fiscal outcomes of the policies that Washington and Hamilton designed. Figures 1 and 2 show the total federal revenues and expenditures, and their sources and dispositions, respectively, measuring both relative to GDP. Figure 3 and 4 show these percapita, where we include in the denominator the 20% of the people who were slaves. Figure 5 shows the debt to GDP ratio, while figure 6 shows the debt to GDP ratio. Figure 7 shows the inflation rate and the growth rate, a figure whose data substantiates that the U.S. debt/gdp ratio did not fall over the period because of inflation. Figure 8 shows the composition of federal debt by type of bond outstanding. Figures 9 and 10 give per capita levels of real and nominal GDP, where real is measured in 2005 U.S. dollars.
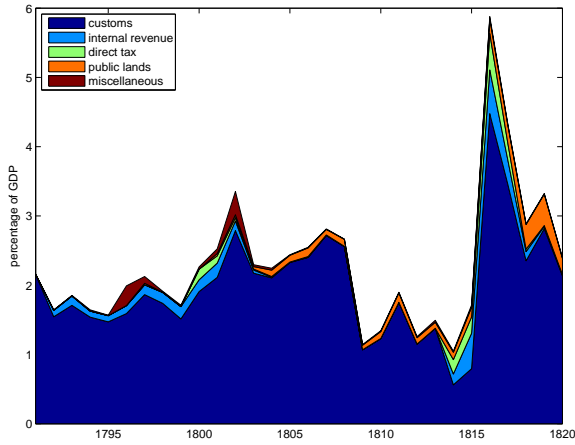
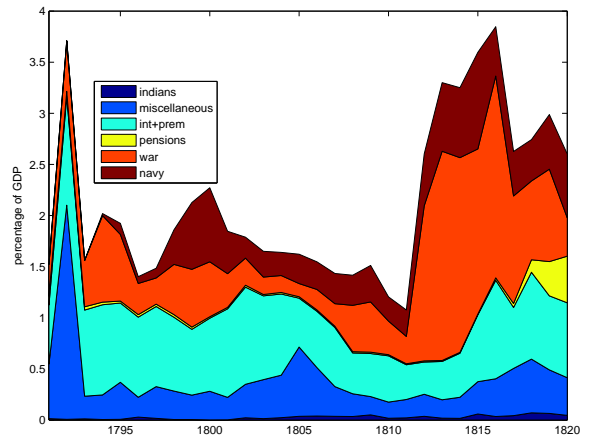Figure 1: Composition of Federal Revenues by Source

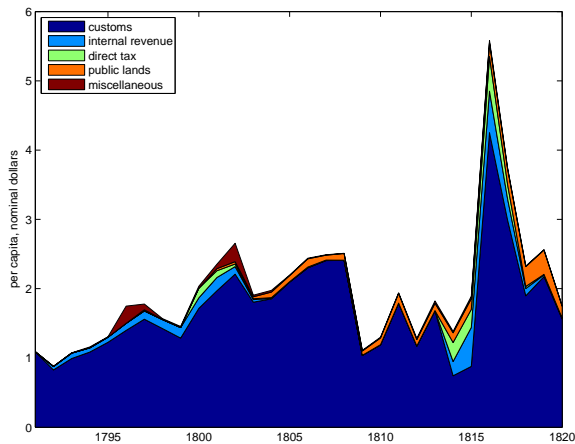Figure 2: Composition of Federal Expenditures by type

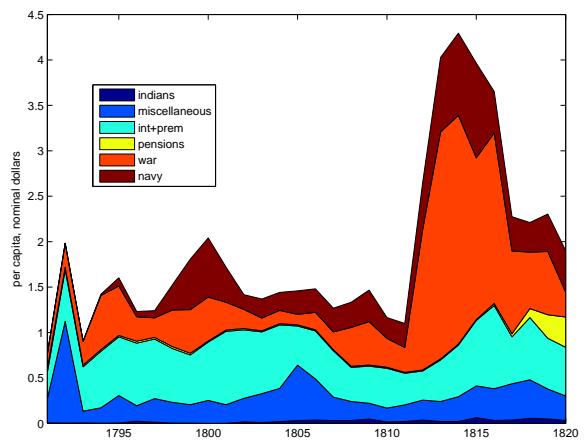Figure 3: Per Capita Composition of Federal Revenues by Source

Figure 4: Per Capita Composition of Federal Expenditures by type
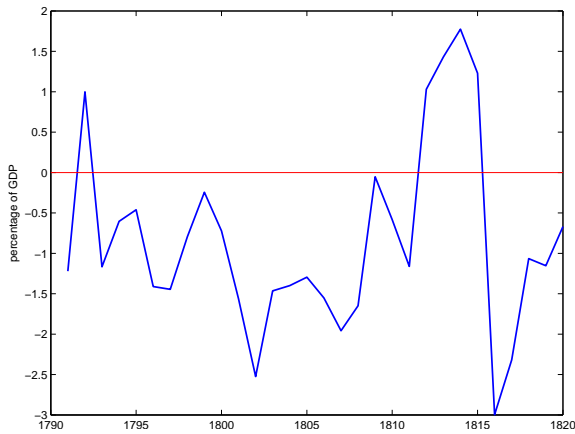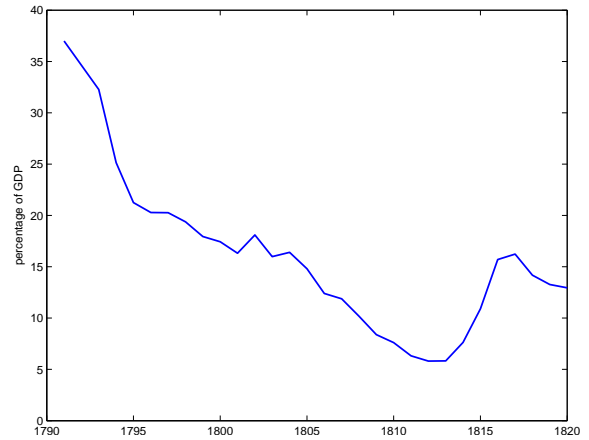
39

Figure 5: Primary Deficit to GDP Ratio

Figure 6: Debt-to-GDP Ratio

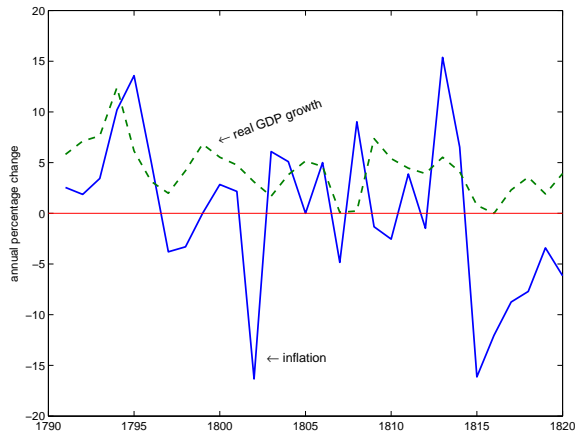Par Value of Debt. Source is the Annual Reports of the Secretary of the Treasury

Figure 7: Annual Inflation and Real GDP Growth

The solid blue line is the annual percentage change in the GDP deflator. The dashed green line is the annual percentage change in real GDP.
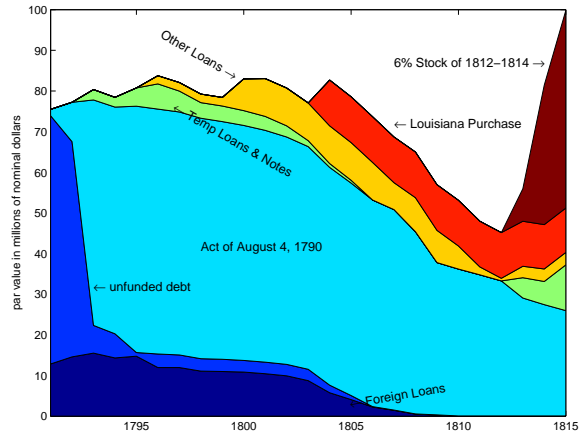

Figure 8: Composition of the Debt Outstanding by Type of Obligation
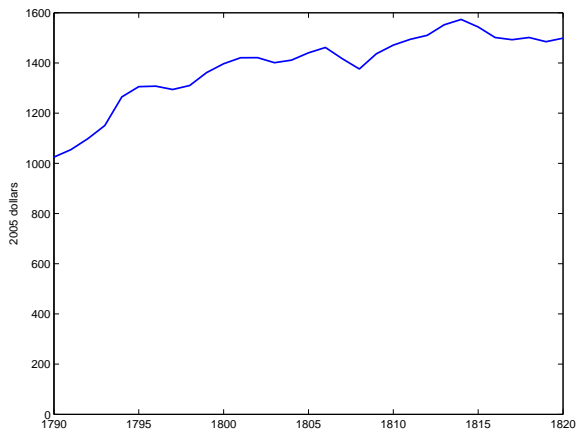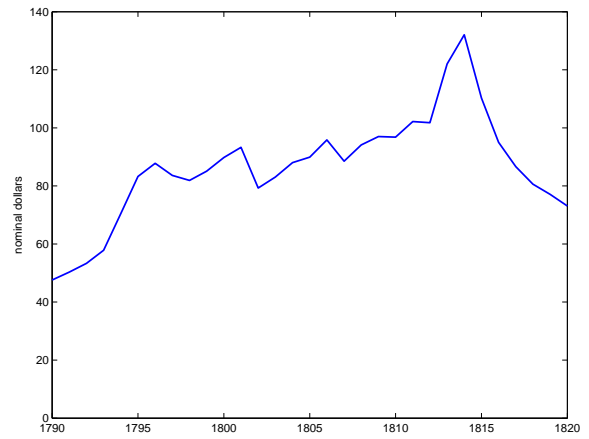
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Figure 9: Per Capita Real GDP (2005 dollars)

Figure 10: Per Capita Nominal GDP

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