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AUGUST 2011

America’s First Debt Crisis

By Mark Roe

The West is ensnared in a debt crisis. The United States, as everyone knows, came perilously close to defaulting on August 2, and Standard & Poor’s downgraded US debt from AAA on August 5. In Europe, the outgoing head of the European Central Bank recommends more centralized fiscal authority in Europe in order to deal with likely defaults by one or more of Greece, Portugal, and Spain.

Both Europe and America can learn a lesson hidden in American history, for, lost in the haze of patriotic veneration of America’s founders is the fact that they created a new country during – and largely because of – a crippling debt crisis. Today’s crises, one hopes, could be turned into a similar moment of political creativity.

After independence from Britain in 1783, America’s states refused to repay their Revolutionary War debts. Some were unable; others were unwilling. The country as a whole operated as a loose confederation that, like the European Union today, lacked taxing and other authority. It could not solve its financial problems, and eventually those problems – largely recurring defaults – catalyzed the 1787 Philadelphia convention to create a new United States.

And then, in 1790-1791, Alexander Hamilton, America’s first treasury secretary, resolved the crisis in one of history’s nation-building successes. Hamilton turned America’s financial wreckage of the 1780’s into prosperity and political coherence in the 1790’s.

To understand Hamilton’s achievement – and thus to appreciate its significance for our own times – we need to understand the scale of the Revolutionary War debt crisis. Some states lacked the resources to pay. Others tried to pay but would not levy the taxes needed to do so. Others, like Massachusetts, tried to levy taxes, but its citizens refused to pay them.

Indeed, some tax collectors were met with violence. Indebted farmers physically disabled the repayment machinery in many states, most famously in Shay’s Rebellion in Massachusetts.

Even private debt-payment mechanisms via courts didn’t work. James Madison, who would become the Constitution’s principal author, couldn’t borrow to buy land in frontier Virginia, because lenders lacked confidence that Virginia courts could enforce repayment. George Washington bemoaned that America was not a “respectable country.” He found Shays Rebellion so worrisome that he came out of his first retirement to preside over the 1787 convention.

Today, the US Constitution’s most noted features are its allocation of power between Congress and the presidency, and its guarantee of individual rights via its first ten amendments. But, at the time, its key role was as a government-debt-repayment mechanism. The Constitution would create a new national government that could coin stable money, borrow, and repay debts, including the states’ defaulted Revolutionary War borrowings.

With the Constitution ratified by 1789, Washington became President and appointed Hamilton – still in his thirties – to head the Treasury. Hamilton had not been a finance person. He was Washington’s Chief of Staff during the Revolutionary War and a quick study: when it was time to learn battlefield tactics, he read military manuals; when it was time to become a national leader who understood finance, he read finance books.

Yet, it was no accident that two military men were key to making the US a “respectable nation” in financial terms. Both thought that only a fiscally strong US could have the military prowess needed to defend itself from the European powers, whose return to American soil both men expected.

But getting the dollars to repay the debt was not easy. There were no entitlements to cut or government funds to re-direct. Hamilton knew that the wrong kind of taxes would weaken the already-fragile economy. He focused taxation on imports and nonessential goods, like whiskey.

And Hamilton needed Congress to approve the federal government’s assumption of the states’ debts, which at first seemed unlikely. Some states, like Virginia, had already paid much of their debt, and others saw their debt as having become a financial game for New York speculators. As a result, many states feared federal assumption would mean that their taxes would go to pay northern speculators or to retire the debt of big borrowers, like Massachusetts.

Virginia and several other southern states that owed little or had repaid what they owed voted against Hamilton’s first assumption bill and defeated it. They were expected to be adamant – an outcome that could well have brought about the young country’s demise.

Jefferson and Madison, the southern leaders, opposed Hamilton’s assumption plan, and Madison was critical in blocking it in Congress. But then the three met for dinner and cut a deal. Jefferson and Madison did not want the country’s capital to be in the north, and Hamilton reluctantly agreed to support moving it to an area carved out of Virginia or Maryland. They, in turn, would secure the votes for the federal government to assume and repay the states’ defaulted debts.

A responsible fiscal state emerged from that grand compromise. Despite the enormous cost – more than half of the fledgling government’s expenditures in early years went to debt service – the economy shook off the 1780’s depression and entered a growth boom.

Hamilton’s task was both easier and harder than ours is today. It was easier, because there were few choices: no income-tax rates to adjust or entitlements to cut. And it was harder, because the US was an unknown entity, and there was little reason for confidence in the American non-nation.

Today’s trajectory is the reverse of that of the 1780’s and 1790’s. It is hard today for America (and, until recently, the world) to imagine a US default, because there has been no strong reason to fear one since the 1790’s.

Americans today know what must be done: some combination of entitlement cuts and tax increases. Europeans, too, know a new balance that needs to be struck. But, until Europe and the US find leaders with the authority and willingness to repeat a modern version of the deal-making example set by Hamilton, Jefferson, and Madison 200 years ago, their debt problems will continue to weaken their national foundations.

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