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The Upside of Government Default

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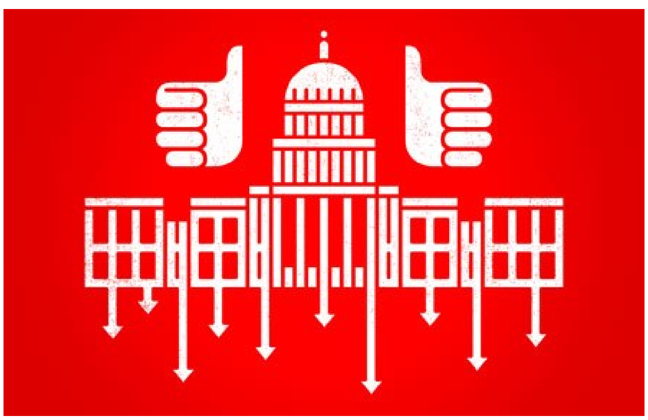
There is a good chance that the U.S. government will be forced to default on its explicit and implicit promises within the next few decades. Fortunately, the state government experience of the 1840s suggests that this may provide the best and most durable long-run solution.



Few now doubt that the U.S. government is rushing headlong toward a major fiscal crisis. An outright default by the U.S. government on Treasury securities looks increasingly likely. Most automatically conclude that such an outcome would be catastrophic. But one striking historical case, from the early history of the United States, dramatically contradicts this common presupposition. Indeed, it suggests that, in the long run, default can usher in such desirable results as decreasing government intervention and expanding prosperity. The case involves not the default of the national government but of several state governments in the 1840s.

After the War of 1812, New York state began construction of a canal connecting the Hudson River with the Great Lakes. The Erie Canal, completed in 1825, was one of those rare and curious instances where a socialist enterprise actually made a good profit, and it encouraged other states to emulate New York. An orgy of canal building resulted. Usually, state governments owned and operated these new canals. In those few instances where the canals were privately owned, the states contributed the largest share of the financing. By 1840, the canal boom had blessed the United States with 3,326 miles of mostly economically unjustified canals at an expense to the states of $125 million, a large sum in those days. Virtually all the new canals were a waste of resources and did not deliver the hoped-for monetary returns. Instead, the heavy state investments, when added to budget growth stimulated by the War of 1812, led to massive borrowing.[1]

Then, in May of 1837, a major financial panic engulfed the country's 800 banks, forcing all but six to cease redeeming their banknotes and deposits for gold or silver coins. The panic brought on a sharp depression that was quickly over.[2] Amazingly, after the recovery, the outstanding indebtedness of states nearly doubled, with a third of that invested in state-chartered banks in the Midwest and South.[3] By the end of 1839, a second bank suspension spread to half the country's banks. Over the next four years, nearly a quarter of state banks failed, the country's total money stock (M2) declined by one-third, and prices plummeted by 42 percent.[4] Needless to say, the state governments faced financial stringency, and during the deflation of 1839-1843, many became desperate. By 1844, $60 million worth of state improvement bonds were in default. Four states—Louisiana, Arkansas, Michigan, and Mississippi—as well as the territory of Florida eventually repudiated debts outright, while four others—Maryland, Illinois, Pennsylvania, and Indiana—defaulted temporarily. New York and Ohio escaped similar straits only by taking extraordinary measures.[5]

The Whig Party, under the leadership of Senator Henry Clay of Kentucky, saw the 1837 depression and the subsequent state defaults as a heaven-sent opportunity for a national bailout. They proposed in Congress that the national government assume the states' debts. Clay's party also advocated a national bankruptcy law that would allow individual debtors to voluntarily escape their obligations. But the Democrats, under the inspired leadership of Martin Van Buren, who had been elected president in 1836, not only blocked these initiatives but pushed government involvement in the opposite direction. Although total national expenditures suddenly spiked to $37.2 million in 1837, overall they declined through Van Buren's four years, from $30.9 million in 1836 to $24.3 million in 1840. That represents a 21 percent fall in nominal terms, no more than half as much if you adjust for price changes, but somewhere in between if you also adjust for population growth or the economy's size.[6]

Many of these federal spending cuts came in the realm of internal improvements, especially for rivers and harbors. As for revenue, tariff rates were already falling as a result of programmed reductions worked out during a previous compromise. The national government's only other source of revenue at the time was the sale of public land. So the president threw his weight behind two measures that would bring the allocation of public land into closer alignment with the homestead principle: preemption, giving settlers who cultivated the land first option to buy, and graduation, reducing the price on unsold land. Graduation failed to pass, but Congress renewed earlier preemption acts twice during Van Buren's term. At the end of his four years, with significant cuts in both national spending and revenue, the depression-generated national debt was holding near a modest $5 million, far less than one year's outlays.

Meanwhile, rather than having disastrous long-run effects, the combination of state defaults and repudiations generated a widening circle of benefits. To begin with, it prompted state governments to make major fiscal reforms. As the distinguished economic historian John Joseph Wallis reports: "Beginning with New York in 1846, almost two-thirds of the states wrote new constitutions in the next ten years. The constitutions restricted state investment in private corporations; limited or banned incorporation by special legislative act; created general incorporation laws for all types of business; altered the way state and local governments issued debt; put absolute limits on the amount of debt governments could issue; and fundamentally changed the structure of the property tax."[7] Economist Thomas J. Sargent asks in his 2011 Nobel Prize lecture: how likely would such reforms have been if the state governments had been bailed out by the national government?

States became wary of investing in internal improvements or in anything else. This ensured that as railroads came to dominate the next phase of the country's transportation revolution, the states left development and expansion of this network primarily to the market. State ownership of railways became negligible, as nearly all the previously state-owned lines were unloaded. Although state and especially local governments continued to subsidize railroads through some direct investment and in less conspicuous ways, private sources ended up providing three-quarters of the capital for American railways prior to 1860.[8] Indeed, the period after the fiscal crisis was when most of the states finally threw off their mercantilist heritage and, for the first time, moved toward a regime of *laissez faire*.

At the same time, foreign investors, particularly British, who had acquired about $100 million in state bonds, now became extremely cautious about loaning money to state governments. Wallis, along with co-authors Richard Sylla and Arthur Grinath have aptly invoked parallels "with [the less-developed country] debt crises of the 1980s, the Mexican, Asian, Russian-LTCM, and Brazilian crises of the 1990s, and the Argentine crisis of the early 2000s."[9] Foreign caution even extended to the national government. When American agents investigated the possibility of borrowing money in Europe in 1842, they were told that U.S. bonds could not be sold there because investors feared that the federal government would also default.[10] Moreover, the state constitutional restrictions on borrowing bequeathed a salutary fiscal legacy that, despite subsequent undermining, has lingered to the present day.[11]

Nor did the economic distress of the deflation of 1839–1843 extend far beyond the state governments and state-chartered banks. Many economists, including Milton Friedman, have been struck by the comparison between this episode and the Great Depression of 1929–1933. Qualifying as the two most massive monetary contractions in American history, they were of identical magnitude and duration. But there the similarities end. During the Great Depression, as unemployment peaked at nearly 25 percent of the labor force in 1933, U.S. production of goods and services collapsed by 30 percent. During the earlier 19th-century price decline, investment fell, but the economy's total output did not. Quite the opposite, it actually rose somewhere between 6 and 16 percent and real consumption rose even more. This episode was nearly a full-employment deflation. And once it was over, the country continued to enjoy the sustained economic growth that had begun in the 1830s, with rising real incomes and increasing prosperity.[12]

Today, there is a good chance that the U.S. government, like the state governments of the 1840s, will be forced to default on its explicit and implicit promises within the next few decades. Exactly how and when is less certain. But the fundamental and massive budgetary changes required to prevent a fiscal crisis are politically unimaginable. Perhaps only default can impose the necessary fiscal discipline. Fortunately, the state government experience of the 1840s suggests that this may provide the best and most durable long-run solution.

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***FURTHER READING*: Andrew Biggs and Matthew Jensen say "Yes, You Really Can Cut Your Way to**

Prosperity." Tino Sanandaji explains "Why Keynesianism Works Better in Theory Than in Practice." Arnold Kling contributes "The Soothsayers of Macroeconometrics." Peter J. Wallison discusses "Why the U.S. Doesn't Have the Debt Problems of the EU" and "How and Why a U.S. Sovereign Debt Crisis Could Occur." Alex J. Pollock writes "Make the Treasury Responsible for 'Unofficial Debt'."

Footnotes

1. Ransom 1964; Taylor 1951; Thies 2002

2. McGrane 1924; Rezneck 1935

3. Wallis, Sylla, and Grinath 2004

4. Hummel 1999; Temin 1969

5. Scott 1893; Ratchford 1941; Wallis 2002

6. U.S. Department of Congress 1975

7. Wallis 2001, 1

8. Fishlow 1965;1972, 496

9. Grinath 2004, 1

10. English 1996; McGrane1935

11. Kiewiet and Szakaly 1996; Wallis 2005

12. Temin 1969, 157; Friedman and Schwartz 1963, 299; Carter 2006, Table Ca219

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