Debt and Democracy

Forging a More Perfect Union

By Edward J. Larson

The drive to establish a new Constitution for the United States during the late 1780s and replace 13 sovereign states with one energetic national union had many sources. But perhaps none was more important than debt. Congress and the states had run up massive foreign and domestic debts during the Revolutionary War that, with peace, were falling due. Although some states had less debt or more resources than others, all of them at least had the power to tax citizens and impose tariffs to finance past debts and fund current services. Congress did not. It lacked the means to pay even interest on its debt, much less repay principal.

During a period of nationalist ascendency from 1781 to 1783, Congress made two attempts to get the general government's fiscal house in order by passing measures to impose a 5% duty on imported goods. The first would have been collected by national agents; the second, in a concession to the states, would have been collected by state agents and transferred to Congress. Under the Articles of Confederation, however, all 13 states needed to approve any national tax, and neither plan gained universal assent.

Congress was forced to rely on requisitions from the states, which often went unpaid. In a 1786 letter to the Confederation's brilliant but beleaguered Foreign Secretary John Jay, the then retired but still concerned wartime Commander-in-Chief George Washington lamented, "Requisitions are a perfect nihility where 13 sovereign, independent, disunited

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George Washington full-length portrait by Charles Willson Peale, circa 1918.

States are in the habit of discussing and refusing compliance with them at their option."[1] Most of the nation's war-related debts were owed to Americans, however, and represented the collective obligations of all the states. If Congress failed to repay them, then the states could step in to take care of their own citizens and, by doing so, supplant Congress in the hearts, minds and wallets of their people. At the time, this represented an ultimate threat to federal union.

The scheme was simple and the results potentially debilitating for the central government. In every state, Congress owed money to public creditors: persons holding bonds or other securities issued during the war for money, goods or services. Many of these securities — which originally went to a large number to lenders, suppliers and veterans — had passed into the hands of a small number of speculators, who purchased them at a discount.

In turn, the states owed annual requisitions to Congress, and public creditors owed taxes to their states. As long as Congress was unable to pay public creditors, the states could accept national securities from their citizens as payment for state taxes and apply them at face value toward their requisitions. Congress was obligated to use most of its revenue for debt financing anyway. By inserting itself as a middleman between Congress and public creditors, a state could assure that its requisitions went to repay its own citizens rather than foreign and domestic public creditors generally.

Of course, if states accepted securities at face value for tax payments, speculators who purchased them at discount would stand to gain. Those speculators and their allies in government became the principal supporters of the scheme in many states. For them, it was profitable; for the states, it was efficient; for Congress, it was disastrous.

Congress might object to states meeting their requisitions by offsetting debt obligations rather than remitting hard money, but it could do little about it since many states did not pay their full requisitions and specie was scarce. Every nationalist knew the power to tax was the power to rule. Without it, Congress had to take what it could get from the states, and it was rarely hard money. One reckoning put the total amount of cash turned over to Congress by the states during the period from October 1786 to March 1787 at $663, or a mere 2% of the August 1786 requisition.[2]

Ever since the war began, hard money in the form of internationally accepted gold and silver coins had been in short supply throughout the states. At the time, Americans relied on other countries for specie, with Spain's gold dollar being especially popular. As these coins passed overseas to pay for imported goods and repay foreign loans, Congress tried to make up the deficit by printing paper dollars, called "Continentals," but stopped in 1779 after their value collapsed.

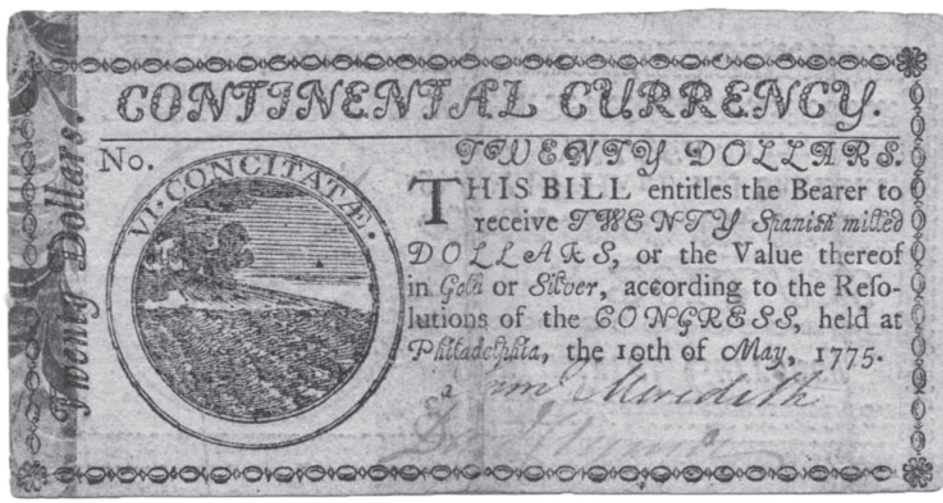
By 1781, a Continental was worth half a cent and even Congress refused to take them.[3] During the war, state-issued paper money did not fare much better. Most suffered hyperinflation. People wanted hard money or paper backed by something of more certain value that a shaky government's doubtful promises. The states moved in to fill this monetary vacuum.

The attack on Congress's control over the national debt and money supply began in Pennsylvania, which had the country's most democratic state constitution. Adopted in the revolutionary fervor of 1776, less than three months after the Declaration of Independence, Pennsylvania's constitution abolished property qualifications for voting, established a one-house legislature with all seats elected annually and gutted traditional checks and balances by having the President, Supreme Executive Council and judges appointed by the legislature for short terms and removable at will. More than in any other state, the people ruled in Pennsylvania — but they did so as a majority faction that was sensitive to manipulable shifts in popular opinion.

In 1782, when an all-but-bankrupt Congress stopped paying interest on its domestic debt, Pennsylvania began issuing state certificates of interest on that debt to public creditors in its state in place of the unpaid interest. It then accepted them back in partial payment for a newly-imposed tax and credited the certificates toward its requisition instead of paying hard money to Congress. Once issued, Congress no longer owned the interest covered by the certificate but never obtained the hard cash that it needed to pay its other creditors or fund on-going operations.

Further, until redeemed in payment of taxes, the certificates circulated as a form of paper money within Pennsylvania. This stimulated the cash-strapped local economy, which was depressed due to the lack of hard money and the collapse of other forms of paper money. The certificates retained value because the state accepted them in payment of taxes and, as Pennsylvania's Benjamin Franklin famously observed during the 1780s, "in this world nothing can be said to be certain, except death and taxes."[4]

Emboldened by Pennsylvania's example, other states quickly adopted, adapted and expanded on the scheme. New Hampshire and New Jersey began offering certificates, or "revenue money," for unpaid interest within the year. By 1785, more than half of the states had implemented a



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$20 continental currency, dated May 10, 1775 and signed by Samuel Meredith and Daniel Clymer. The polychromed left edge is attributed to Benjamin Franklin.

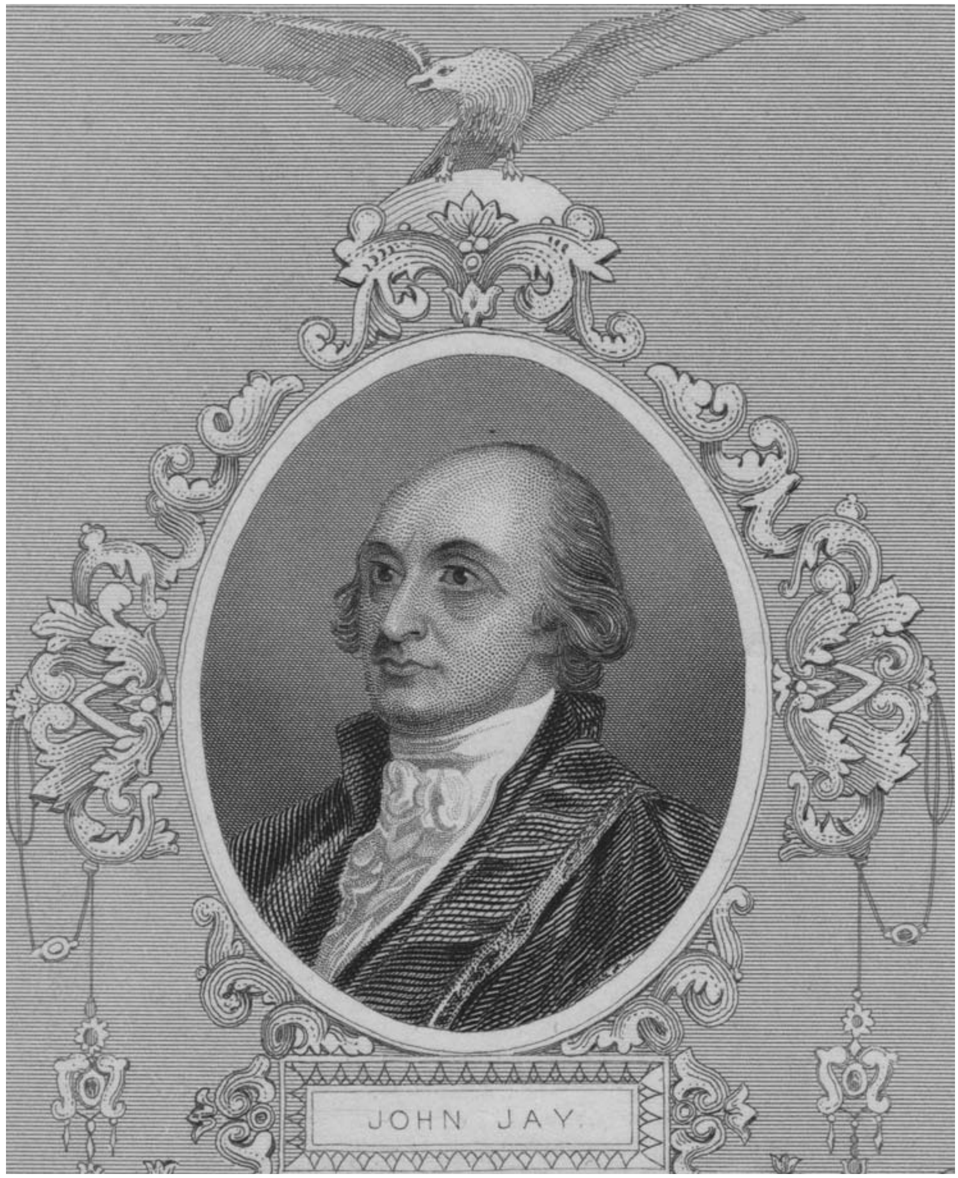
system of paying interest on their citizens' national securities. Once this ball started rolling, it was hard to stop, especially since it aggrandized the states.

Congress tried twice to regain control of its own debt. In 1784, it offered its own paper certificates, or "indents," in lieu of interest to public creditors, who then could redeem them through the states in payment of state taxes. Seeing nothing in this program for them, most states either refused to implement it or implemented it so poorly that it had little impact.

A year later, Congress attempted to bar states from paying their requisitions with state interest certificates, but this backfired badly. Some states ignored the mandate; others, again led by Pennsylvania, got around it by calling in all or part of the national securities held by its citizens and exchanging them for state bonds that typically paid interest in some form redeemable as tax payments. The states then fulfilled their current requisitions to Congress by offsetting the interest or principal owed on these securities and held the remainder either to pay later requisitions or for any future reconciliation among the state and national governments over war-related debts.

By 1786, the states had assumed much of the total national debt, with Pennsylvania, New York and Maryland alone holding nearly one-third of it. Congress was rapidly becoming irrelevant. By replacing state bonds for national securities, the loyalties of public creditors shifted from the nation to the states. And the flood of new state bonds, many of which were issued in small denominations and circulated almost like cash, addressed the urgent economic need for currency without involving Congress.

Severe deflation in the value of hard money had caused a nationwide recession that a well-regulated emission of paper credit could ameliorate. Many cautious Americans doubted, however, that elected state legislatures could regulate it well. In a June 1786 letter to Washington, Jay described these paper-money skeptics as "the better kind of people – by which I mean the people who are orderly and industrious, who are content with their situations, and not uneasy in their circumstances." This sort, he warned, "will be led by the insecurity of property" to question republican rule and "prepare their minds for almost any change that may promise them quiet and security."[5]



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Engraved portrait of statesman John Jay.

Washington agreed and found it "much to be feared … that the better kind of people" might resort to a monarchy or worse. "We are apt to run from one extreme into another," he wrote back to Jay. "To anticipate and prevent disastrous contingencies would be the part of wisdom and patriotism."[6]

Jay's fears notwithstanding, the benefits from expanding the money supply through state-issued bonds and interest certificates revived popular demands for states to issue paper money. The wartime experience with hyperinflation, which hit creditors like Washington especially hard, had soured many wealthy Americans on paper money. Having lent out money in pounds sterling prior to the Revolutionary War, for example, Washington was repaid during the war in depreciated paper money worth less than one fourth its face value — and he never forgot it.

In 1786, as demands for paper money grew, Washington depicted the practice of repaying hard cash with inflated paper money as "ungenerous, not to say dishonest." He would not do it to his creditors and did not want his debtors to do it to him. "Paper bills of credit," he complained, give "the shadow for the substance of a debt."[7]

Even less restrained in their words, Jay, Virginia Congressman James Madison and many other leading nationalists denounced state-issued paper money in the strongest terms. Arguing against its issuance by his state in 1786, for example, Madison lectured Virginia's legislature that paper money would "destroy confidence between individuals" and "disgrace republican gov[ernmen]ts in the eyes of mankind."[8] Yet under the Articles of Confederation, Congress was as powerless to prevent states from issuing paper money as it was to stop an incoming tide. Creditors like Washington, who feared that cheap paper money would erode the value of fixed investments, were swimming against that tide in trying to prevent state legislatures from authorizing it. At most, opponents could try to limit its use to paying taxes or have it secured by something of value, such as state-owned land.

The dam broke in 1786, when seven states emitted paper money. "Pennsylvania and North Carolina took the lead in this folly," Madison wrote in August to Thomas Jefferson, who was then serving as America's ambassador in Paris. Most of the initial emissions incorporated limits that helped them to hold value at least initially, but in debtor-controlled Rhode Island, which made its paper money legal tender for virtually all public and private debts, the bottom dropped out of the currency's value almost immediately and hard money was driven underground.

"Supplies were withheld from the market, the shops were shut, popular meetings ensued and the state remains in a sort of convulsion," Madison told Jefferson. "Depreciation is inevitable" in every state with paper money, Madison predicted, yet driven by popular factions, he feared that more states would join others in printing "this fictitious money."[9]

Madison perceived a pattern in the rush to paper. State governments with the fewest checks and balances tended to act first and in the most extreme manner. Pennsylvania and Rhode Island, for example, placed all power in the legislature, with the executive and the judiciary serving at its pleasure. In contrast, he observed in his letter to Jefferson, Maryland held back because the state Senate — presumably because of the long terms, indirect selection process and property qualifications of its members — stood as "a bar to paper in that state."

But as "the clamor for [paper money] is now universal, and as the periodical election of the Senate happens at this crisis," Madison added with his customary pessimism, Maryland's next Senate will likely surrender.[10] This experience confirmed his view that America needed a balanced national government that could check the power of state excesses and majority factions. From Paris, Jefferson had sent Madison a shipment of treatises on government by European political philosophers that arrived early in 1786. Now he began trolling through them in earnest for arguments in support of his view.

Expressing similar sentiments at the same time, Washington wrote to former Congressman Theordorick Bland in August 1786, complaining about "the *present alarming troubles* in Rhode Island."[11] Writing to Jay on the same day, Washington added, "What a triumph for the advocates of despotism to find that we are incapable of governing ourselves, and that systems founded on the basis of equal liberty are merely ideal and fallacious! Would to God that wise measures may be taken in time to avert the consequences we have but too much reason to apprehend."[12]

For nationalists, Rhode Island became an object lesson in the dangers of excess democracy and a clarion call for constitutional reform. Proponents of paper money pointed to the success of other states in preserving its value, but critics saw it from Madison's perspective and, all but giving up on the states, turned toward the nation for salvation. Referring to related developments in New Jersey, Madison asked James Monroe earlier in 1786, "Is it possible with such an example before our eyes of impotency in the federal system, to remain skeptical with regard to the necessity of infusing more energy into it?"[13]

Echoing these sentiments in his August letter to Jay, Washington wrote, "I do not conceive we can exist long as a nation, without having lodged somewhere a power which will pervade the whole Union in an energetic a manner." Significantly, he then added, "Retired as I am from the world, I frankly acknowledge I cannot feel myself an unconcerned spectator."[14]

The specter of unpaid debt, and the states replacing Congress as the functional center of governing authority drew Washington, Madison, Jay and the other nationalists to the fore — driving them, and their country, to a new Constitution and a more perfect union that would forever change the nature of government. $

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Notes

1. George Washington to John Jay, Aug. 15, 1786, PGW CS 4: 213.
2. Ray Raphael, *Constitutional Myths: What We Get Wrong and How to Get it Right* (New York: New Press, 2913), 21.
3. For an analysis of the value of Continentals, see E. James Ferguson, *The Power of the Purse* (Chapel Hill: University of North Carolina Press, 1961), 51–52
4. Benjamin Franklin to M. Le Roy, Nov. 13, 1789, ed. Jared Sparks, *Works of Benjamin Franklin* (Boston: Hilliard, 1840), 10: 410.
5. Jay to Washington, June 27, 1786, PGW CS 4: 131–32.
6. Washington to Jay, Aug. 15, 1786, PGW CS 4: 213.
7. George Washington to George William Fairfax, June 30, 1786, PGW CS 4: 137.
8. James Madison, "Notes for Speech Opposing Paper Money," Nov. 1, 1786, PJM 9: 159.
9. James Madison to Thomas Jefferson, Aug. 12, 1786, PJM 9: 94–95.
10. Ibid at 95.
11. George Washington to Theodorick Bland, Aug. 15, 1786, PGW CS 4: 211.
12. Washington to Jay, Aug. 15, 1786, PGW CS 4: 213.
13. James Madison to James Monroe, Apr. 9, 1786, PJM 9: 25.
14. Washington to Jay, Aug. 15, 1786, PGW CS 4: 212–13.