Comment on Thomas Sargent and George Hall, “U.S. Debt and Taxes, 1776-2023”

Path Towards Prosperity: Institutions & Development Conference
Hoover Institution, Spring 2024

William Summerhill, Hoover and UCLA

Eight papers, one slide

- “Accounting” (2012): official data do not report economically meaningful yields, returns, or debt valuations (!)
- “Federal or State?” (2012): the constitution is the Second American Revolution; creditors won, and government can borrow for war
- “Sustaining reputations” (2014): repudiate that from which you wish to dissociate
- “Unanticipated Consequences” (2019): the shift from external debtor to credit pries you off of isolationism
- “Debt limits” (2018): before 1939 congress controlled debt better, and in doing so conveyed more-useful info to creditors
- “8+2” (2021): Congress and Treasury experimented, innovated, and democratized debt, to borrow as early as possible in each war
- ”Gold Standard as a Nominal Anchor” (2024): Grant made post-war greenbacks as good as gold, US overtakes UK as global benchmark for quality government debt
- “Three World Wars” (2022): judging from primary deficit and inflation data, US Covid response looks just like a World War. Will bond holders again be disfavored?

What constitutes efficacious fiscal institutions? look to the framers and their second revolution

- The problem: breaking "the prevailing [1780s] stochastic process for the government surplus and replace it with another one that could service a bigger government debt" (Sargent, 2012)
- Out with the Articles of Confederation, in with the Constitution/Acts of Congress in 1790-1792
- Concentrate tax authority in the national government; monetary questions take backseat
- Create foundation for Barro-style (1979)tax smoothing; rule out Lucas-Stokey (1983) representative agent Ramsey models of state-contingent repayment
- NB: "the government surplus process is itself the outcome of a political decision process" (Sargent, 2012)
- Those decisions have fiscal, economic, and strategic implications

An alternative: no Hamilton in Argentina?

- Province of Buenos Aires (BA): “unstable” and “inefficient” tax base, external war, bond finance “less feasible,” banks of issue had to become “engines of inflation” (Bordo and Vegh, 2002)
- Lucas and Stokey-type model shows that inflation is optimal when conventional taxes are costly to collect, and when borrowing costs rise with demand—fits the BA story
- Elides critical elements of what actually transpired
- Tax base is not particularly inefficient—it was blockaded by Brazil’s navy
- The blockade resulted from Argentine decision to invade
- Bond finance became “less feasible” because BA then defaulted
- BA government broke the process for the government surplus…and made it worse, not better. Political decisions matter

Exceptional America, abnormal America

- 1790 Debt-to-GDP ratio ~40% (Sargent, 2012)
- This is painfully high (Reinhart, Reinhart, & Rogoff, 2012)
- Why not default? [almost] everyone else was doing it, even when it was less costly. Mexico defaulted at debt ratio of 11% (Salvucci, 1997, 2009)
- That none of the loan contracts included state-contingent provisions did not stop borrowers from defaulting in the bad state (Phillip II was an exception; Drelichman and Voth, 2014)
- 1790 is a time-zero moment in a representative agent Ramsey model. Use it or lose it.
- By instead paying, America was not just exceptional, it was also abnormal

American default, 1790: a counterfactual conjecture

- Fiscal costs of default
  - Exclusion from long-term credit markets during default spell
  - Maybe 600 basis-point increase in new borrowing costs upon work-out? (Mitchener & Weidenmier, 2008)
- Fiscal benefits of default
  - Defer debt service into the future, 40% of tax revenues (nearly 1% GDP)—default spell 6 to 19 years (Suter & Stamm, 2009; Esteves & Jalles, 2016)
  - Reduce debt by size of the haircut to the creditor, ~$37 million—median was 50 percent over last two centuries (Luckner et al, n.d.)
- Possible alternative paths: potential benefits
  - Restore some of tax breaks lost with ending the Confederation (don’t have to fight moonshiners in Pennsylvania)
  - Spend more on capacity: ships, cannons, horses, soldiers
  - Louisiana purchase—>Louisiana taking
  - Invade Mexico and absorb half their territory earlier (gold)
  - Accelerate already strong growth in GDP/capita, further reduce debt ratio

American default conjecture

- Alternative costs:
- Costs to private-sector from government default can be quite large (Esteves & Jalle, 2016)
- More importantly could the fiscal system survive the War of 1812 intact?
- Entire war was funded by borrowing ($110 million)(Hall & Sergeant 2014)
- Optimistic situation: assume US came to terms with creditors before war, imposed the haircut, and because of bad reputation was priced 600 bps higher than actual for new borrowing
- Raise taxes for debt service. Gallatin’s tax increase by annuity value of interest costs, around $12 million per year
- Pessimistic situation: assume no resolution, rationed out of credit market, has to finance with inflation,
- US becomes Buenos Aires. Would require massive clean up before Civil War. Risk of becoming Venezuela (recurrent defaults before 1870), or Peru (invaded and defeated by Chile)
- Expected B/C ratio from default seems terribly risky in a Lat Am mirror
- The appeal of US fiscal institutions is obvious. Yet most countries failed to get there.

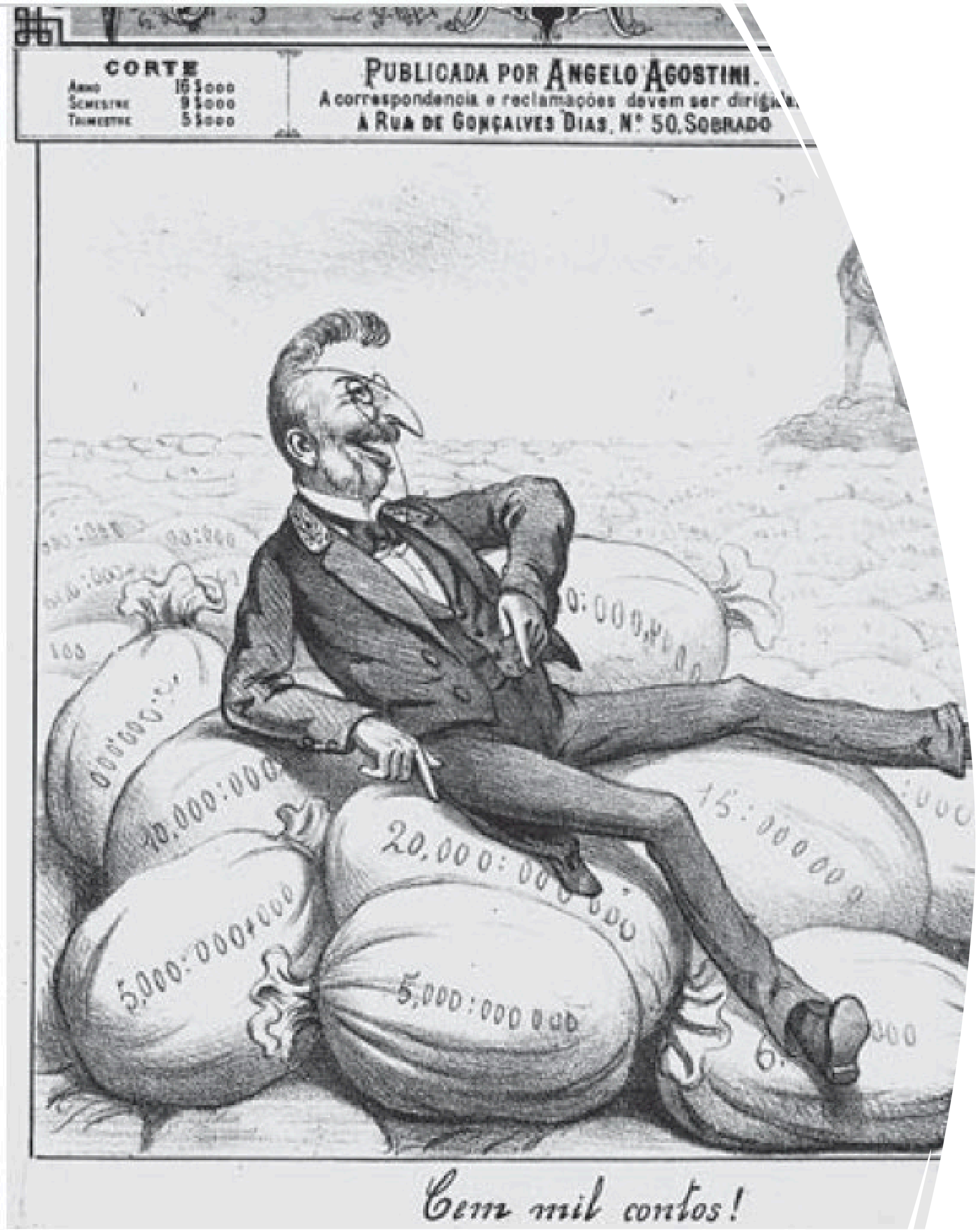

FIGURE 4.6 Caricature of Minister of Finance V
de Ouro Preto reclining on the proceeds of the
Loan of 1889: "Cem mil contos!" (One hun

A cautionary tale

- Effective fiscal system in the tropics: Brazil
- Like US it replaced the surplus process with one that allowed higher levels of borrowing
- Funded the unfunded debts after independence (1822)
- Centralized tax authority
- Faithfully paid interest to bond holders abroad and at home
- In 1889 took its largest and lowest cost loans to date
- After nearly 7 decades this was destroyed in a few short years, Brazil took the path of serial default for the next century
- Political choices matter for everything, not just the fiscal surplus process

Hall and Sargent data are too good to resist

- Greenbacks and gold: do Grant’s debt policy innovations show up as structural breaks in the spread, or risk premium, a la Willard, Guinnane, & Rosen (1995); Waldenstrom (various), Dincecco (various), Summerhill (2015)?
- Bonds’ bid-ask spreads/opening-closing difference, and liquidity premia—do these differ across loans? (Chavez & Flandreu, 2017)
- Do differences (perhaps seemingly small) in the terms of separate loans show up in the market as “big” at moments of stress? (Saiegh and Cox, 2018)

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