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Fiscal discriminations in three wars ☆

George J. Hall [a,*], Thomas J. Sargent [b,1]

[a] Department of Economics, Brandeis University, 415 South Street, Waltham, MA 02454-9110, United States
[b] Department of Economics, New York University, 19 W. Fourth Street, New York, NY 10012-1119, United States

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ABSTRACT

In 1790, a U.S. paper dollar was widely held in disrepute (something shoddy was not 'worth a Continental'). By 1879, a U.S. paper dollar had become 'as good as gold'. These outcomes emerged from how the U.S. federal government financed three wars: the American Revolution, the War of 1812, and the Civil War. In the beginning, the U.S. government discriminated greatly in the returns it paid to different classes of creditors; but that pattern of discrimination diminished over time in ways that eventually rehabilitated the reputation of federal paper money as a store of value.

Inflation is repudiation. Deflation is assumption. Calvin Coolidge, 1922.

1. Introduction

In 1790, the framers of the U.S. federal government debated whether and how to discriminate the rates of return given to U.S. creditors. James Madison urged the government to allocate payoffs among current and former bond holders in ways that would withhold capital gains from more recent purchasers and compensate former holders who had experienced capital losses from selling their bonds. Alexander Hamilton (1790) opposed Madison's discrimination scheme because of its adverse effects on the expectations of prospective government creditors. Hamilton criticized Madison's proposal, first, because it would defeat Hamilton's goal of fostering a liquid market in U.S. government bonds, and, second, because it would inappropriately reward former holders of government bonds who, by selling, had bet against the credit of the U.S.; it would also unfairly punish current holders who, by buying, had expressed their confidence in U.S. credit.

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* Corresponding author. Tel.: +1 781 736 2242; fax: +1 781 736 2269.
E-mail addresses: ghall@brandeis.edu (G.J. Hall), Thomas.Sargent@nyu.edu (T.J. Sargent).
[1] Tel.: +1 212 998 3548.

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Hamilton won that argument and Congress did not implement Madison's particular version of a discrimination scheme.[2] But it did discriminate. In particular, in following Hamilton's advice about restructuring U.S. and state debts in 1790, Congress discriminated among creditor classes in ways that poisoned the U.S. government's reputation for servicing some types of debt (the despised paper money known as 'bills of credit') and that enhanced its reputation for servicing other types of debt (interest bearing medium and long term obligations, especially to foreign creditors).

This paper is about how from 1790 to 1880 the U.S. discriminated among its creditors. U.S. fiscal authorities' propensity to discriminate diminished over time, as revealed in how the United States financed its expenditures during the Revolutionary War, the War of 1812, and the Civil War. During all three wars, the federal government and the states issued debts that differed in their maturities, denominations, and units of account.

A theoretical contribution of Bryant and Wallace (1984) shapes our understandings about why federal and state governments might want to award different rates of return to different classes of government creditors. Bryant and Wallace showed how such price discrimination can improve fiscal efficiency. The analysis of Fudenberg and Kreps (1987), who studied the mechanics of sustaining different reputations with different parties, also influences our story. The U.S. occasionally tried, with mixed success, to sustain different reputations vis a vis different classes of creditors.

The units of account in which government debts can be expressed and enforced are central to a price-discrimination analysis of monetary and fiscal policy. Bryant and Wallace in effect assumed that a government can issue some securities that are expressed in a foreign government's unit of account or otherwise indexed against domestic inflation, and that it can issue other securities that are not. Whether units of account should be arranged in this way is an issue that underlies a fascinating part of our story, namely the evolution of U.S. government officials' opinions about whether they should, or even legally could, issue small denomination zero-interest notes (paper money) and whether they should declare those notes legal tender for public and private debts. James Madison thought that making paper money a leading tender was reprehensible, while Ulysses S. Grant thought that it was useful. But making U.S. paper money a legal tender meant something different to James Madison in 1787 or 1813 than it did to Ulysses S. Grant in 1869. In 1787 and 1790, issuing paper money portended depreciation and repudiation. In 1869 and 1870, when the Congress and the President took actions to make U.S. issued paper money as good as gold, paper money meant appreciation and resumption.

The U.S. Constitution prohibits states from issuing bills of credit; during the 1790s federal issues of bills of credit, though not explicitly prohibited, were widely regarded as bad. There was also a broad sentiment against making anything other than specie a legal tender.[3] Madison thought that denying legal tender status to a government issued paper money was a good way to limit its capacity to damage credit markets.[4,5] Alexander Hamilton's restructuring of federal and state government's debt harshly discriminated against continental bills of credit. That saved federal tax revenues, but by impairing their reputation, it also had the salutary effect of discouraging future issues of federal bills of credit.

Despite that history, on February 25, 1862 the Union made greenbacks a legal tender for all private debts and some public obligations, an act hotly disputed at the time. In 1869 the Supreme Court declared unconstitutional the act that made greenbacks a legal tender. Soon thereafter President Grant appointed two new justices who concurred in the Court's quick reversal of that earlier decision, thereby affirming that the federal government was empowered to make a paper fiduciary currency a legal tender. Instead of unleashing an era of high inflation fueled by government printing of paper money, President Grant and the Congress presided over a deflation of the greenback price level. That had the effect of awarding people who held greenbacks *higher* returns than those who, when Union Armies had suffered setbacks, had speculated against the greenback. In 1790, people deplored federal paper money as 'not worth a continental'; after 1879, people trusted greenbacks to be small denomination warehouse certificates for gold.[6,7] Reputational considerations were very much on the minds of public officials in both periods.

1.1. Imputing theories to decision makers

Any history of fiscal policies must also be a history of the thoughts of the fiscal authorities. So it is that any historical account of debt management and tax policies has to confront a challenge posed by a group of irrelevance theorems from modern macroeconomics. These theorems assert that for real economic outcomes, choices among different tax, debt

[2] 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. Bayley (1882, pp. 52–53) describes the sale in 1814 of a $25 million loan that was partitioned into three installments. Under the Treasury's invitation for subscriptions, buyers of the first installment were promised retroactively more favorable terms if subsequent installments garnered lower prices. This was indeed the case, and the Treasury was forced to issue additional shares to buyers of the first installment.

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

[4] The Madison administration (1809–1817) issued substantial amounts of short term debt during the War of 1812 but did not make it legal tender.

[5] Newcomb (1865) severely criticized the Union's act of making the greenback a legal tender for private debts because of how it redistributed resources among private lenders and debtors. Also see Adams (1891b).

[6] At least they were until 1933. The Madison-to-Grant transformation of attitudes and policies toward legal tender bills of credit helped set the stage for the U.S. eventually to become a challenger to the UK's status as managing an international monetary standard. See Silber (2008) for an account of how U.S. Treasury policy at the start of World War I pursued this aim.

[7] This transformation did not occur in a vacuum. The Bank of England suspended convertibility in 1797 but resumed convertibility at par in May 1821. That example of how to run a responsible monetary and fiscal policy was in the air in the mid nineteenth century U.S. Bank of England notes were not a legal tender during the suspension, a fact cited in the debate over the 1862 legal tender act in the U.S. See Fetter (1950) and Adams et al. (1891a,b).