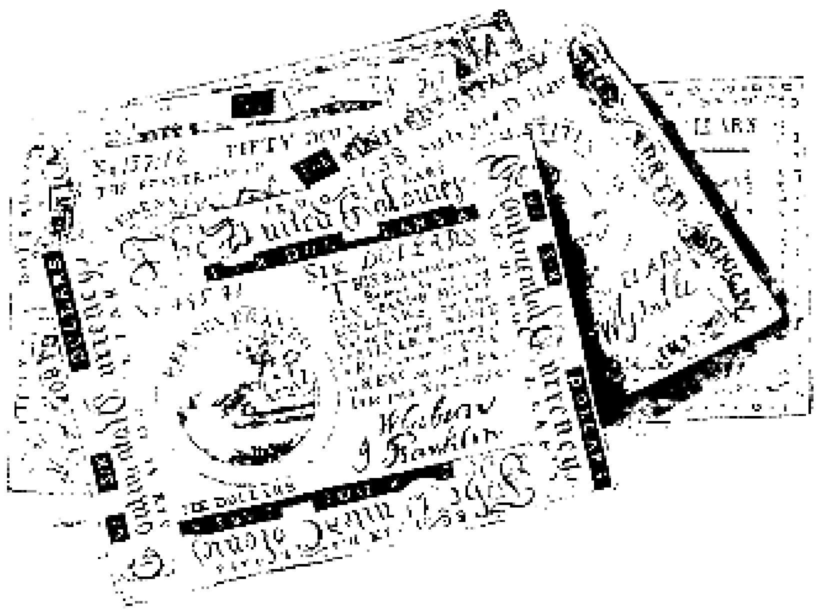
Chapter 3
Paying The National Debt



During the American Revolution, the Continental Congress often was unable to collect taxes from the states. Without money the National government could not fight the war effectively. It therefore used two necessary and practical means to raise funds. It printed paper money—about $400,000,000 worth. The money was used to pay soldiers and government officials and to buy supplies. Congress also borrowed money by selling bonds. Bonds usually sold for about $75; with interest payments, the government was obligated to pay back $100. Including these interest payments, the national debt mounted to $50,000,000; the states, which had also borrowed money to fight the British, owed another $20,000,000.

So much paper money had been printed that it lost almost all of its value. In 1780, then Congressman Alexander Hamilton suggested the government buy or mint gold coins and exchange them at the rate of $1 in gold for every $40 in paper. Hamilton's advice was followed, and this new gold currency replaced the old paper money. In the process, the money the United States needed to pay back in gold was reduced from $400,000,000 to $10,000,000.

When the Constitution was written in 1787, most $100 government bonds were selling for about $20 because people thought the government would never pay back the original face value (the amount printed on the face of the bond). The Constitution stated that the existing debts would be paid by the new government. Most Americans thought that the bonds, like the paper money, would be paid off at some fraction of the original (face) value.

With the first session of Congress coming to an end in November 1789, the issue of repaying the federal debt had not been raised. Congress had taken care of more immediate business. This business included organizing the executive branch of government, approving appointments to the cabinet and other positions, establishing the federal courts, levying taxes on imports to raise money for the government, and drawing up the Bill of Rights. As Congress was about to adjourn, it received a petition from bondholders. They wanted the government to make good on its promise to pay full face value for their bonds. Congress decided to ask Secretary of Treasury Alexander Hamilton to study the problem and suggest a solution.

Hamilton and others concluded there were three choices:

1. Pay the bonds at *face* value (the amount originally printed on the bonds).

2. Pay the bonds at *market* value (the price an owner of a 100 dollar bond could get for it) —in the neighborhood of $20.

3. Pay the original holders of the bonds at face value and those who bought the bonds from the original holders in order to make a quick profit at market value. Those who sold the bonds would be paid the difference between face and market value. This plan was called *discrimination* because it discriminated in favor of the original holders of government bonds.

This chapter invites the reader to decide which option should be used to pay the $50,000,000 national debt. It also examines whether the national government should pay the states' debts.

The Case for Face Value

Congress expected Hamilton to suggest paying market value for the bonds. In his report to Congress, however, Hamilton argued against reducing the government debt to save money. The National government would have to borrow money again, he reasoned. The best way for the government to establish credit would be to earn a reputation for paying its debts.

> *Public Credit can be achieved only by a punctual performance of contracts. States, like individuals, who observe their engagements, are respected and trusted; while the reverse is the fate of those who pursue an opposite conduct.13*

Hamilton also warned against making distinctions between the original holders of the bonds and those who bought them from the original holders. He pointed out that the bonds specifically promised to pay anyone who owned them.

In the debate over paying the debt, Congressman Fisher Ames supported Hamilton, saying:

> *We all agree that the main reason governments are formed is to protect the property of people. Shall it be said that one of the first acts of this Government shall be to deprive citizens of this country of millions of dollars to which they are justly entitled? We may choose to cheat bondholders today. But, then how can we expect people to trust the Government to protect their safety and their liberty in the future?* [14]

The Case for Market Value

While Congress debated how the debt should be repaid, many Congressmen and others with inside knowledge, including Hamilton's own assistant, began to buy government bonds. Since the market value

[13] Adapted from *Annals of Congress, First Congress 1789-91* (February 9,1790).
[14] Adapted from *Annals* of Congress (February 9, 1790).

of these bonds was about $20, many unsuspecting bondholders sold theirs for far less than the $100. Though Hamilton did not buy bonds for himself, many of his friends and political allies bought the bonds at market value and expected to collect face value.

> *One strong argument against paying the bonds as Hamilton proposed was that most of the money would go to the people who had purchased the bonds based upon inside information that the government planned to pay face value. Another argument was the amount it would cost the government—$50,000,000. A third argument was that the bonds had been bought at a time of inflation, when prices were high. Congressman Livermore made the last of these three arguments:*
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> *Much of our debt was lent in exchange for worthless paper money, or for goods and provisions sold at more than their real worth. It is very well known that those during the war who sold goods for these bonds raised their prices from six dollars (on the average) to ten dollars at the least.*
>
> *There are many good reasons we should consider these bonds worth far less than their face value. Indeed, every bondholder has considered them worthless from time to time. There was a time when they were considered of no greater value than 15 to 20 cents on the dollar. If that is what people thought they were worth, why should Congress pay them more?* [15]

The Case for Discrimination

Originally Hamilton thought that James Madison would support his plan to pay face value, but Madison realized that much of the money would be paid to speculators living north of his native Virginia—and that many would be Congressmen and others with inside information. Madison therefore came up with a plan that would pay the bonds back at face value only to the original holders of the bonds—those who bought them during the war when the money supported the country. Madison did not want to help the speculators to whom he proposed paying market value:

> *Only one course of action can be followed. Let the present holders of the bonds have the highest prices for which the bonds have sold, and let the rest go to the original holders. This will do more real justice and perform more of the public faith than any other plan. The present (holders) can not complain because they will get their investment back and more. The original holders who kept their bonds will get full face value. And the original holders who have sold their bonds will get the difference between the current (market) price and the value of their bonds. Thus they will get at least a token payment from the country for lending money in time of its need.16*

The Political Issue

Payment of the debt at face value, market value, or by discriminating between current and original holders was not merely a financial issue. It was a political issue as well. Hamilton never denied his intention was to win the support of wealthy businessmen. He thought their loyalty and willingness to invest their money in productive enterprises and to lend money to the Federal government was essential to its success as well as to the nation's prosperity. Madison advocated discrimination to secure "more perfect justice" for the original creditors, and give more help to his friends and political allies in the South. Livermore hoped to save the government money by paying at something far less than face value, and not rewarding those who could afford to lend money during war-induced inflation.

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[15]Adapted from *Annals of Congress* (February 11, 1790).
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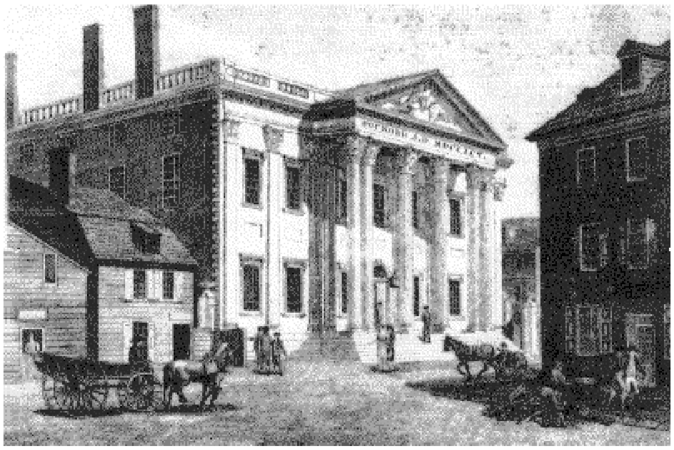
Assumption of State Debt



In addition to paying the debts of the national government at face value, Alexander Hamilton called for the federal government to assume (i.e. pay) the war debts still owed by the states. This would increase the national debt by approximately $20,000,000. Since some states had paid most of their war debts and others had not, assumption was as hot an issue as paying national government bonds at face value. Because Hamilton would not agree to separate paying the national debt from paying the state war debts, Congress had to vote for or against the entire package.

Hamilton's proposal for paying both the state and national debts would cost the government about $70,000,000, a staggering sum for those days. Just paying the interest on the debt would cost the U.S. government 40 percent of its entire operating budget. One wonders, therefore, why Hamilton insisted on paying the state debt. His reason, most historians would agree, was to get wealthy Americans to look toward the national government, rather than the states, for financial favors and rewards.

After all, Hamilton believed that the U.S. government could only succeed with the support of the rich and well-born and that the country would prosper only if those people would invest their money in developing it.

Student Exercises:

1. Explain the difference between paying the debt at face value, market value, and by discriminating between the original holders and speculators.

2. Prepare to state the case for one of the following options for handling the national debt:

- paying the entire debt at face value
- paying the national debt at market value and letting the states pay their own debt
- paying the entire debt by discriminating between current and original holders

3. Elaborate on the case you have made to pay the debt by showing what is wrong with at least one other proposal, as well as indicating what is right about your own.