

# How Default Produced Constitutional Change

By Alasdair Roberts

IT HAS NOT BEEN A YEAR since President Obama promised in his 2013 State of the Union Address that American would never default on its debt. Default, the White House said, would be disastrous for the nation's economy. Still, the federal government came within hours of default in October 2013.

It's incredible that an American president should feel obliged to say anything about honoring the country's debts. There is no doubt that default would cause enormous damage to America's reputation abroad. We already have the evidence, provided by a humiliating moment in American history that produced critical changes in the nation's constitutional order.

The humiliation came in 1842. Although, the real cause of American embarrassment arose several years earlier. In the mid-1830s, the American economy was booming. Cotton exports to the United Kingdom were growing rapidly. British investors were pouring capital into the United States and lightly-regulated American banks were lending generously. Land speculation was rampant.

State governments wanted in on the action. Voters were pleading for new infrastructure -- canals, railroads and turnpikes -- as well as easier access to loans to speculate in real estate. Some states established government-owned banks that borrowed at 3 percent in London and lent at 6 percent to voters at home. Many states also borrowed heavily for new infrastructure, believing that they could repay loans from tolls and fees alone.

Between 1836 and 1838, states incurred obligations equal to the combined national debt of Russia, Prussia and the Netherlands. Then the bubble burst. A series of crises hit the US financial sector, which finally collapsed in the autumn of 1839. The country slid into a deep depression. Revenues from infrastructure projects evaporated and loans issued by state-owned banks went bad. Few states had other sources of revenue.

Michigan and Indiana were the first states to default in July 1841. They were followed in October 1841 by Arkansas, Illinois and Maryland. Then Florida and Mississippi defaulted in March 1842, Pennsylvania in August 1842 and Louisiana in January 1843. Nine governments, responsible for two-thirds of all American government debt in private hands, were delinquent on their loans.

The outrage in London was immediate and intense. British investors had been assured by statesmen such as Daniel Webster that state bonds were a safe bet. (No state, Webster said in London, in 1839, would risk "dishonor and disgrace" by defaulting.) Americans visiting London were barred from clubs, snubbed at dinner parties and mocked in the newspapers. "Great bitterness of feeling is very naturally felt," the American ambassador wrote home. "Many have by their investments lost all the earning of active life and the fund on which they relied for their support in old age."

The low point might have been the summer of 1842. The federal government, itself short of cash because of the depression, went to London to sell its bonds. This should have been easy: the federal government had completely paid off its debt six years earlier; but investors refused to touch any debt from the United States.

"You may tell your government," James de Rothschild told the U.S. agents, "that you have seen the man who is at the head of the finances of Europe, and that he has told you that you cannot borrow a dollar, not a dollar."

The default crisis even affected foreign policy. In the early 1840s, the United States and United Kingdom were jostling for territory and markets. As goodwill deteriorated, these conflicts became harder to manage. The two countries came close to war. However, the British knew that the cash-strapped American states would find it difficult to fight.

Americans "cannot draw the sword," one British writer taunted, "because they have not the money to buy it."

British investors' anger was stoked by the lack of any immediate remedies. The doctrine of sovereign immunity precluded any resort to American courts. The administration of President John Tyler refused to put pressure on defaulting states and the British government also refused to intervene on the side of creditors.

What is remarkable about this story is what happened next. The defaulting states were free to choose their own course. They could repudiate their debt if they wished. At first, it seemed that many states would follow this path. "The doctrine of repudiating state debts is spreading rapidly," a prominent Philadelphia merchant lamented in late 1841.

Indeed, many Americans were outraged at the idea that they should have to bear extra burdens, in the depths of a depression, to honor commitments to overseas financiers. Mississippi governor Alexander McNutt promised that the people of his state would never provide relief to "the Baron Rothschild . . . the blood of Judas and Shylock flows in his veins. It is for this people to say whether he shall have a mortgage upon our cotton fields and make serfs of our children."

Eventually, though, most states did not repudiate (Mississippi and Florida were the exceptions). Moreover, many states -- including those that had never defaulted at all -- began amending their constitutions to prevent a recurrence of the humiliation of 1842. This is how the now-familiar restrictions on state borrowing were born.

This was hardly an easy transformation in state policy. Honoring state debt meant establishing new taxes, as well as new capacities for collecting those taxes. This was resisted by many citizens, especially when times were so tough.

Constitutional restrictions were also resisted. The new rules didn't just prohibit borrowing. Often, they limited the capacity of state governments to engage in infrastructure or banking projects. In other words, they strictly curtailed activist government.

For many Americans this was a bitter pill to swallow. The Age of Jackson, which witnessed the extension of voting rights, had barely ended. The ideal of popular sovereignty was widely celebrated. "We have an abiding faith in the virtue, intelligence and full capacity for self-government, of the great mass of the people," one Democratic magazine said in 1838. "We are opposed to all restraints on the free action of popular opinion."

The wave of defaults compelled Americans to rethink this sunny view of democratic rule. The crisis seemed to show its darker side. Democratically elected legislatures could be swayed by popular passions or compromised by logrolling and corruption. Some kind of check seemed necessary.

"We have not that perfect confidence in ourselves," said one legislator in the late 1840s. "And we take our cool and calm moments to protect ourselves against the sudden and dangerous impulses of passion and prejudice."

British banks hired agents to press their case in state capitals and the first reports from those agents were grim. Complaints about the "corrupt morals" of state legislators were commonplace. However, profound changes did eventually come. Perhaps because it came mainly from within -- through the slow grinding of democratic processes, rather than by imposition from any external power -- those changes proved durable. We are still living with them today.

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