Debt mutualisation lessons from the US

Some argue that debt mutualisation across the eurozone is the answer to the current crisis, pointing to the US experience for support. This represents a very selective reading of history, argues ***David Rowe***

Some proponents of mutualising debt through eurobonds, with joint and several liability of all members, point to a famous episode in US history for support. Shortly after the federal constitution replaced the much looser articles of confederation, Alexander Hamilton, first secretary of the Treasury, sought to have the federal government assume the remaining revolutionary war debts of the individual states. He was successful in gaining congressional approval, but only after much controversy.

The nascent country had many characteristics that led to the success of Hamilton's proposal. It had a common language, a broadly consistent culture (except for the deeply divisive issue of slavery) and a shared legal tradition rooted in English common law. Perhaps most importantly, it had a shared history of mutual support in fighting a war to gain independence from its colonial masters in the UK – and the debts to be assumed by the common central government were primarily incurred in that war for independence. The proposal was for a one-time assumption of debts previously incurred – it was not a proposal for an open-ended mutualisation of future debts.[1]

To glean meaningful lessons from US experience, it is necessary to consider the much longer history of the relationship between the federal government and the states. A paper by C Randall Henning and Martin Kessler, published in January, entitled *Fiscal federalism: US history for architects of Europe's fiscal union*[2] offers an excellent survey of this experience.

In fact, the practice of selective federal assumption of state debts continued from 1789 to 1840. The next round occurred after the war of 1812 (fought against those pesky Brits again) and then for the District of Columbia in 1836. Much of the sub-federal debt incurred during this period was effectively project finance for infrastructure, such as the Erie canal in New York. These projects were financed on the assumption they would be serviced and repaid out of project tolls and other revenue. During the financial panic of 1837 and the subsequent recession in 1839–43, much of this project debt became unserviceable.

The states petitioned the US Congress to assume these debts, as did UK and Dutch interests that held about 70% of the debt that eventually defaulted. Both were able to cite multiple precedents, and argued that a federal guarantee – although not explicit – was implied. In this case, Congress held firm and no bail-out was undertaken – a position that led to the federal government being cut off from European financing between 1842 and 1850. Eventually, most states repaid all or most of their debt as a condition for returning to the markets. As a result of this episode, the 'no bail-out' norm was established.

Today, the US has more than 170 years of history supporting the no bail-out practice.[3] Perhaps the most powerful structural obstacle to any such bail-out is the US Senate. In this chamber, each state has equal representation, but just seven states[4] account for half of all outstanding state debt. Over the past four years, only four states[5] have issued new bonds to finance current expenditures in significant amounts. As such, it is almost unthinkable that a bail-out proposal for one of these states could muster a 60% majority required to pass in the Senate.

As Henning and Kessler point out, the flip side of the no bail-out assumption is that states have control of their own financial affairs – they are not subject to debt brakes or similar restrictions imposed from above. Nevertheless, fear of being closed out from financial markets has led most states to adopt some form of balanced budget amendment in their constitutions. The stringency of these amendments differs, and credit spreads among states reflect this. Indeed, the differences in the credit spreads of US states are greater than those that prevailed for members of the European Union before the sovereign debt crisis began.

The basic lesson from the US experience is that a fully credible no bail-out provision is an effective source of fiscal discipline on constituent parts of a federated political structure. To be credible, however, it helps to have 170 years of precedent and a major structural obstacle to approval of any such bail-out proposal. ■

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[1] *Despite these supportive circumstances, Hamilton's proposal met with considerable resistance. Some states had already retired their war debts and they understandably felt is was unfair for the burden to be lifted from those who had not done so. Eventually, an equalisation arrangement was worked out and, in a classic case of legislative horse trading, it was agreed to move the capital from New York to a special district neighbouring northern Virginia to bring the southern states on board*

[2] *Henning CR and Kessler M, 2012,* Fiscal federalism: US history for architects of Europe's fiscal union, *Peterson Institute for International Economics, January, available at* www.piie.com/publications/interstitial.cfm?ResearchID=2018

[3] *This does not always stop states and municipalities from seeking such assistance. In 1975, during its debt crisis, New York City made such an appeal to the Ford administration. This gave rise to the famous* New York Daily News *headline,* Ford to New York: Drop Dead

[4] *These are California, Florida, Illinois, Massachusetts, New Jersey, New York and Pennsylvania*

[5] *Arizona, California, Connecticut and Illinois*