Land, Debt, and Taxes: Origins of the U.S. State Default Crisis, 1839 to 1842.

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- The first draft of this paper was written for an All-UC Economic History conference held in 1992.
- It has been the most productive papers I have written, but never finished, as it led to whole line of research into the interaction of politics and economics in 19th century America, and in economic history more generally.

1840s State Default Crisis

- In 1841 and 1842, eight states and the territory of Florida defaulted on their debt service payments. Four states ultimately repudiated all or part of their bonded debt obligations.
- Most of the debt was issued to finance infrastructure investments in canals, banks, and railroads.
- In 1840, the total state debt of \$200 million was roughly 15% of GDP.

Questions

- Why?
- When?
- How?

The default question

- The answer to why states defaulted is almost completely explained by how much they borrowed.

Total Debt, Per Capita Debt, and Whether a State Defaulted

ST	Total Debt 1841	Debt PC 1841	Default?
FL	4,000,000	74.07	Y
LA	23,985,000	68.14	Y
MD	15,214,761	32.37	Y
IL	13,527,292	28.42	Y
AK	2,676,000	27.31	Y
MI	5,611,000	26.47	Y
AL	15,400,000	26.06	N
PA	33,301,013	19.32	Y
MS	7,000,000	18.62	Y
IN	12,751,000	18.59	Y
NY	21,797,267	8.97	N
MA	5,424,137	7.35	N
OH	10,924,123	7.19	N
WI	200,000	6.45	N
SC	3,691,234	6.21	N
TN	3,398,000	4.10	N
KY	3,085,500	3.96	N
ME	1,734,861	3.46	N
VA	4,037,200	3.23	N
MO	842,261	2.19	N
GA	1,309,750	1.90	N
NH	0	0.00	N
CT	0	0.00	N
VT	0	0.00	N
RI	0	0.00	N
NC	0	0.00	N
NJ	0	0.00	N
DE	0	0.00	N

Why Did States Borrow?

- States borrowed largely to invest in transportation projects (mainly canals) or to invest in banks.
- There was a marked regional variation. The northeast only borrowed for transportation, the south only for banks, and the northwest for both.

	State Totals	Percent Bank	Percent 1836-41
Illinois	13,527	22%	100%
Indiana	12,751	19%	83%
Michigan	5,611	0%	98%
Alabama	15,400	100%	64%
Florida	4,000	98%	3%
Mississippi	7,000	100%	71%
Arkansas	2,676	100%	100%
Louisiana	23,985	93%	7%
Ohio	10,924	0%	59%
Massachusetts	5,969	0%	100%
New York	21,797	0%	71%
Pennsylvania	36,336	0%	36%
Maryland	15,215	0%	68%
Maine	1,735	0%	100%
Virginia	8,744	5%	45%
South Carolina	3,691	4%	74%
Georgia	1,325	0%	100%
Kentucky	3,086	0%	94%
Tennnessee	3,416	43%	84%
Missouri	842	43%	100%
Total	198,030	34%	52%

When Did They Borrow?

- Although the traditional economic history of the 1830s suggests that the Panic of 1837 brought state borrowing to a halt, states actually borrowed a majority of the debt outstanding in 1841 after 1836.

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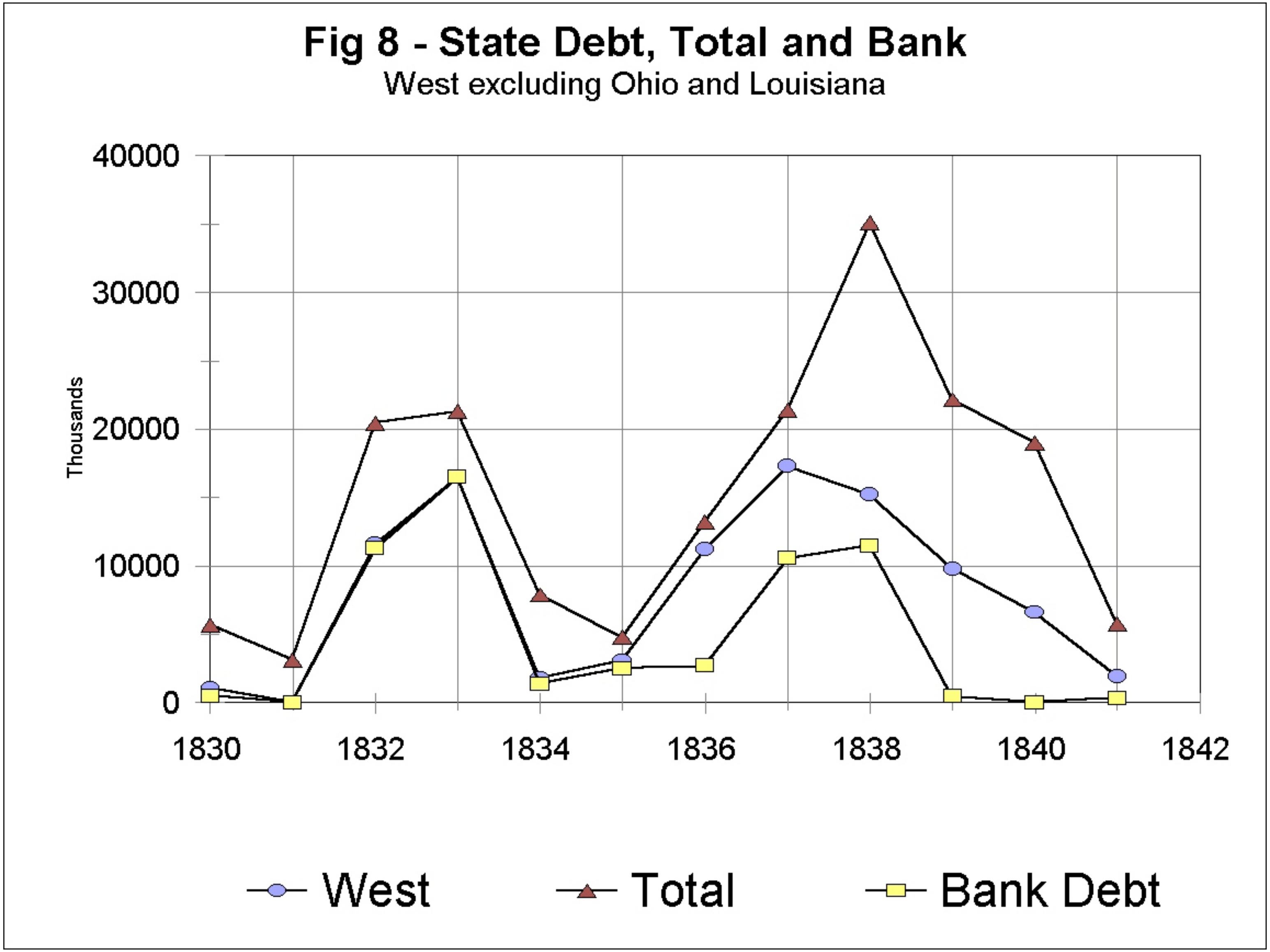
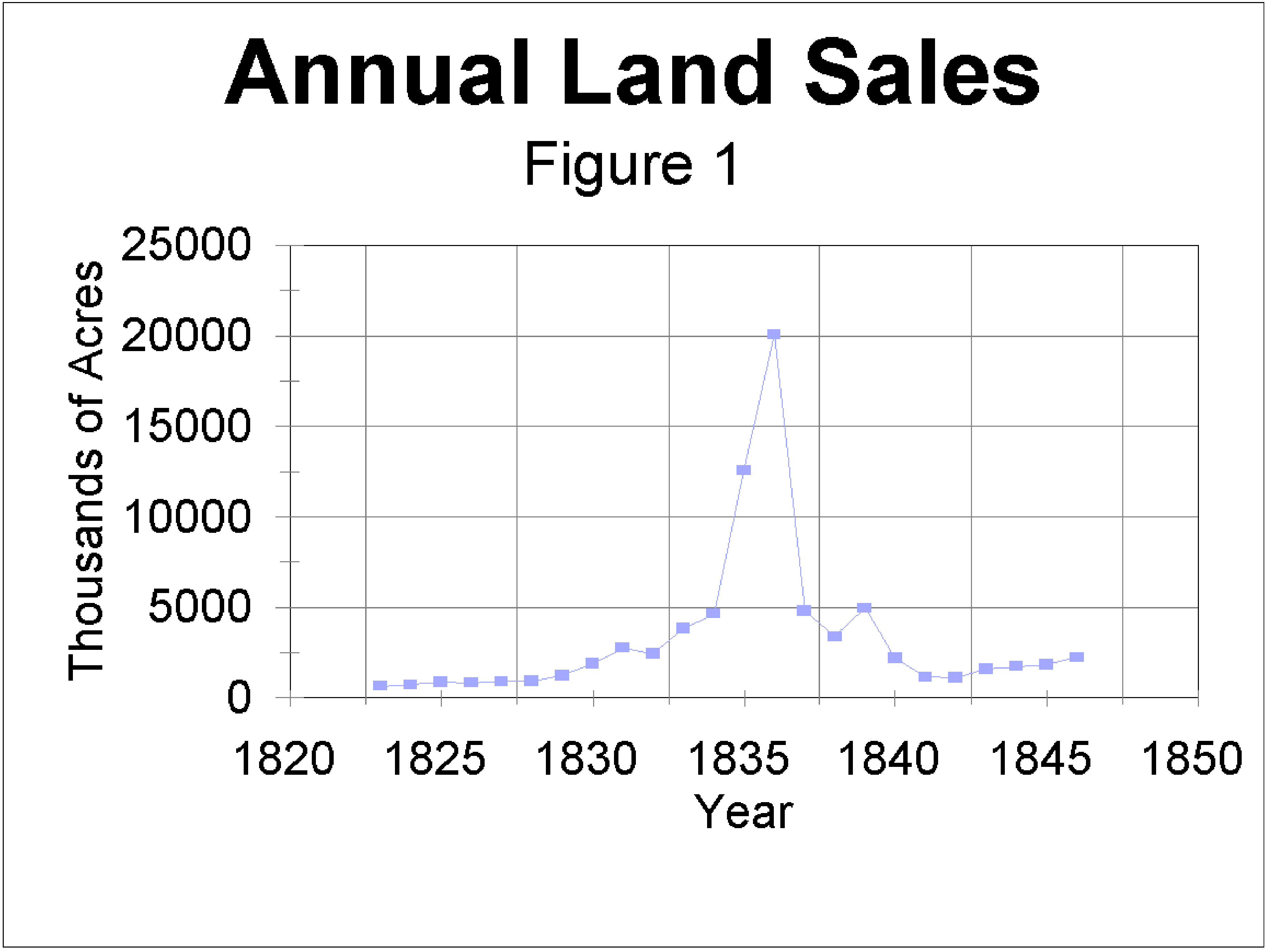


Fig 8 - State Debt, Total and Bank
West excluding Ohio and Louisiana
Thousands
40000
30000
20000
10000
0
1830
1832
1834
1836
1838
1840
1842
West
Total
Bank Debt

Why Did States Borrow II

- States were borrowing largely to lower the costs of transportation and finance necessary to get their goods to markets. This was true in every region.
- States in the west, with the exception of Louisiana, did not have rich fiscal resources to tax.
- That changed in the mid-1830s land boom, when millions of acres of land were sold in the west.


Annual Land Sales
Figure 1
Thousands of Acres
25000
20000
15000
10000
5000
0
1820
1825
1830
1835
1840
1845
1850
Year

Public Land Sales

- Public land sales in the west dramatically increased the amount of taxable land for state governments. States could not tax public land owned by the national government.
- In many western states, more land was sold in 1835 and 1836 than was taxed in 1836.
- But there was a catch. States could not tax land sold to private individuals for the first five years after the sale.
- So western states anticipated a tax boom in 1841 and 1842.

Land

- Land was important in all states, not just western states, because all states possessed land they could tax.
- If we assume that 75% of the land in a state is taxable, at a rate of 5 mills, (.005), and property taxes are used to service 5% bonds, the following table gives the sustainable debt that could be serviced if land was valued at $7.50 an acre.

	Land Area Square Miles	Potential Taxable Acres	Borrowing Capacity @ 5 mils, $7.50 an Acre	Actual Taxable Acres	Year
Indiana	35,885	17,224,800	$12,918,600	15,024,866	1843
Illinois	56,002	26,880,960	$20,160,720	15,000,000	1844
Ohio	40,740	19,555,200	$14,666,400	20,260,526	1843
Michigan	57,480	27,590,400	$20,692,800		
New York	47,654	22,873,920	$17,155,440	27,675,072	1844
Pennsylvania	44,832	21,519,360	$16,139,520		
Massachusetts	8,039	3,858,720	$2,894,040		
Maryland	9,941	4,771,680	$3,578,760		
Florida	54,861	26,333,280	$19,749,960		
Alabama	51,279	24,613,920	$18,460,440		
Mississippi	46,362	22,253,760	$16,690,320		
Louisiana	45,409	21,796,320	$16,347,240		
Arkansas	52,525	25,212,000	$18,909,000	3,048,168	1844

How did they Borrow?

- Three models:
- Pennsylvania:
  - Pennsylvania did not raise taxes when it borrowed, it financed interest payments in early years out of borrowed funds.
  - It expected canal tolls to appear to service the bonds.
- Mississippi:
  - Mississippi invested in banks, and the banks were supposed to service the bonds.
  - Taxpayers did not expect to repay the bonds.

- Indiana:
  - Indiana switched from a *per acre* land tax to and *ad valorem* property tax when they authorized bond issues in 1836. The *ad valorem* tax was intended to match the beneficiaries of canal projects with the those who paid taxes.
  - Indiana eventually raised its property tax rate from 1 mil to 4 mils in 1841, an attempt to avoid default.

1839 and after

- A second economic crisis hit in 1839, that was connected to state finances in the Northwest.
- States could see that they were in trouble, e.g. Indiana was were the crisis started, but continued to borrow if they could until 1841 when land from the land boom would become taxable.
- Unfortunately, by 1841 land values had fallen precipitously and states in the northwest could not meet their interest payments.

Land Values in Indiana

1835	$5.41
1836	
1837	$\boxed{\$9.87}$
1838	$8.50
1839	
1840	
1841	$6.20
1842	$\boxed{\$3.73}$
1843	$3.67
1844	$3.71

The Northwest: Indiana, Illinois, and Michigan

- States in this region defaulted because of unanticipated declines in land values, which eliminated a large part of their fiscal base.
- These states did not default because canal tolls failed to materialize, they weren't expecting canal tolls in 1841.

Northeast: Pennsylvania and Maryland

- These two states defaulted because of delays in implementing their property taxes. Neither state had a property tax in place in 1830.
- They both paid bond holders in full, with back interest, but only after a delay of three to five years while they got their property tax systems up and running.

The South: Florida, Mississippi, Louisiana, and Arkansas

- These states repudiated all or part of their debts.
- Taxpayers and voters in these states had never expected to pay interest or principle on the bonds the states issued to the banks. Unlike the north, taxpayers in general did not benefit from the banks, only large land-owning cotton growers did.

Lessons?

- The most important lessons from the American cases come in the 1840s after the defaults and repudiations, when the American states changed their constitutions and change the way decisions about borrowing are made.
- These changes required bond referenda to raise tax rates sufficiently to service debts before bonds could be issued,
- Prohibited state investments in private corporations
- And mandated general incorporation laws (Wallis, 2005).

The real lesson

- What states really learned in the 1830s and 1840s was that there were no natural or automatic tendencies in democratic politics to keep governments from making potentially bad decisions about borrowing.
- Rather than banning borrowing, they changed their institutions to make the political process work better when it came to making investment decisions, largely by forcing politicians and voters to raise taxes before they borrowed.