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Has the U.S. Government Ever “Defaulted”?

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Summary

During recent debt limit episodes, federal officials have contended that if the debt limit were to constrain the government’s ability to meet its obligations, that would be an unprecedented blemish on the nation’s credit. For example, the U.S. Treasury has asserted that “(f)ailing to increase the debt limit would have catastrophic economic consequences. It would cause the government to default on its legal obligations” or that it “would represent an irresponsible retreat from a core American value: we are a nation that honors all of its commitments. It would cause the government to default on its legal obligations.”

Failure to pay obligations on time is regarded as a central indicator of default, although default may be triggered by a wide range of contractual provisions. More generally, the concept of default stems from contract law, and thus may be ambiguous because contract terms may be private or contracts may be incomplete, in that the consequences of some contingencies are left unspecified. For instance, the terms under which Treasury securities are offered lack any mention of payment delays or nonpayment. The ambiguity of the term “default” leads many third parties to develop their own definitions to monitor compliance with promises to pay.

The U.S. Treasury in some historical instances was unable to pay all its obligations on time or made payments on terms that disappointed creditors. Those instances resulted from extraordinary stresses on public finances. Over time, the United States has managed its finances so that its credit history compares favorably to nearly all other advanced countries.

This report examines three episodes in the federal government’s fiscal history when some have questioned the public credit of the U.S. government. During the War of 1812, the federal government eventually became unable to meet its obligations. Shortly before that war, Congress had declined to renew the charter of the first Bank of the United States, leaving the government without a fiscal agent. In addition, President Jefferson and Treasury Secretary Gallatin had dismantled the administrative machinery needed to collect internal revenues, leaving Treasury revenues heavily dependent on customs income. In 1814, military expenses and lagging revenue left the U.S. Treasury unable to meet all of its obligations, including some interest payments on federal debt. The end of that war, the establishment of the second Bank of the United States, and the rebound of tariff revenues put federal finances on a sounder foundation.

In March 1933, newly inaugurated President Franklin Roosevelt soon took steps to suspend the gold standard, as one measure to address severe disinflation, a collapse of the banking system, and other consequences of the Great Depression. While the Supreme Court upheld actions that suspended the gold standard, others contended that the cancellation of gold clauses in federal bond contracts amounted to a restructuring of debt. Although the cancellation of gold clauses in 1933-1934 had no discernable effect on the U.S. Treasury’s ability to borrow, holders of Treasury securities lost money relative to what they had expected to receive.

More recently, when the U.S. Treasury failed to make timely payments to some small investors in the spring of 1979, some dubbed the incident a “mini-default.” While the payment delays inconvenienced many investors, the stability of the wider market in Treasury securities was never at risk. Shifts in monetary policy, as constraining inflation became a policy priority, provide a stronger explanation for changes in yields in federal securities. Moreover, payment delays were not uncommon at that time, when automatic data processing was at a relatively primitive stage.

Other countries that defaulted in the 1930s or in the 19th century apparently suffered no lasting damage to their ability to borrow. Nonetheless, the prominent role of U.S. Treasury securities in global and domestic financial arrangements implies that systematic delays in Treasury payments now could have serious consequences.

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Concerns arise during debt limit episodes that the lack of action to raise or suspend the debt limit could impede the U.S. Treasury’s ability to meet federal obligations. In October 2015, the U.S. Treasury argued that allowing the debt limit to constrain the government’s ability to meet its obligations “would represent an irresponsible retreat from a core American value: we are a nation that honors all of its commitments”;¹ and that “(f)ailing to increase the debt limit would have catastrophic economic consequences. It would cause the government to default on its legal obligations.”²

How the term “default” would apply to Treasury’s ability to pay federal bills, however, has been controversial. For instance, during a September 2015 House Ways and Means Committee markup of H.R. 692, some Members stated that a binding debt limit that would limit the Treasury Secretary’s ability to meet federal obligations on a timely basis would be tantamount to default, while other Members stated that default would only encompass a failure to make principal and interest payments linked to U.S. Treasury securities.³

This report discusses the concept of default in the context of the federal government’s financial obligations. The report then discusses past cases in which the federal government failed to make certain payments on time. During the War of 1812, the lack of a fiscal agent and the pressures of funding military operations at times left the U.S. Treasury without the means of meeting its obligations. The suspension of the gold standard in 1933-1934 has been considered by some to constitute default, even though the Supreme Court affirmed that taking that action was within the power of Congress to set monetary policy.

During the 2011 debt limit episode, some noted that the U.S. Treasury had failed to make timely payments to some small investors in the spring of 1979, which in the eyes of some, constituted a “technical default.”⁴ The 1979 incident, however, is more properly regarded as an inadvertent payment delay.

What Is a Default?

How the term “default” is applied depends on specific contexts. Default can be defined as failure to make a payment or more generally the failure to act or appear.⁵ Default, in the sense of failure to pay or perform, generally derives from contract law.⁶ Private contracts typically specify in some detail what actions or omissions would constitute default. For example, a firm that has borrowed funds by issuing a bond could in a contract be considered in default by failing to pay interest or principal, or by taking on additional debt, or by failing to deliver additional collateral in the event of a credit rating downgrade. Bond contracts can run to thousands of pages, in which

¹ Alastair M. Fitzpayne, Assistant Secretary for Legislative Affairs, letter to Chairman Jeb Hensarling, May 7, 2014.

² U.S. Treasury, *Debt Initiatives Webpage*, updated October 16, 2015, <http://www.treasury.gov/initiatives/Pages/debtlimit.aspx>.

³ U.S. Congress, House Committee on Ways and Means, *Default Prevention Act*, 114th Cong., 1st sess., September 18, 2015, H.Rept. 114-265 (Washington: GPO, 2015).

⁴ For example see Donald Marron, “The Day the United States Defaulted on Treasury Bills,” *Forbes*, May 26, 2011; or Jason Zweig, “Own Government Bonds? Here’s Why You Should Be Worried,” *Wall Street Journal*, May 21, 2011.

⁵ To wit, failure to appear before a court can lead to a default judgment. The word *default* derives from an old form of the word *failed*.

⁶ For example, the U.S. Department of Education on a website aimed at student borrowers explains that “default means you failed to make your payments on your student loan as scheduled according to the terms of your *promissory note*, the binding legal document you signed at the time you took out your loan.” See <https://studentaid.ed.gov/sa/repay-loans/default>.

various contingencies and default consequences are described. Private contractual terms can be specified in greater detail than public laws, and can be shaped to the interests of particular counterparties.

Default in some cases may be “cured” in some way that brings a party back into compliance with a contract. For example, a default caused by failure to pay may be cured by payment, perhaps along with specified penalties. A damaged party may also sue for breach of contract to compel a counterparty to perform as agreed or to void a contract or to seek other remedies.

Third Parties May Develop Their Own Definitions of Default

Third parties sometimes want to make their own evaluations of how well parties comply with a contract, and may therefore develop their own definitions of default or noncompliance. Those not party to a contract may be interested in how well those who have entered into a contract comply with its terms. A third party could become interested in compliance to contract terms as it assesses future dealings with contract parties. A potential breach of a contract could also directly affect third parties. For example, when one firm fails to pay another firm, that firm may in turn become unable to pay others.

Third parties might evaluate compliance in a different way than those party to a contract. For instance, one company may treat a delayed payment as a nonessential lapse, while a third party may view that delay as a more serious case of noncompliance. Moreover, third parties may have difficulty evaluating compliance because some contracts are private. While contract terms for publicly issued bonds in general must be disclosed, terms for other types of contracts and for securities issued to a small number of creditors might not be disclosed.

A substantial literature on international sovereign default has developed in recent years based on data stretching back centuries.⁷ In many cases, however, lists of defaults compiled by academic researchers have differed from lists developed from credit rating agencies.⁸

Third parties, therefore, may make or rely on compliance judgments that are not based directly on contract terms. Credit ratings agencies can make their own judgments on what constitutes a default. The credit default swap market sidesteps the issue of defining default by relying on committees organized by the International Swaps and Derivatives Association (ISDA) to determine when a “credit event” has occurred.⁹ In some cases, debts or other obligations might be restructured in ways that parties describe as voluntary, which outside parties might describe as default or, in ISDA’s terms, as a credit event. Thus, default or related terms like credit default can be linked to how parties comply with a contract, even if contracted parties have not contended that a default had occurred.

Default due to failure to meet obligations set out in a private contract may also act as a trigger for other legal consequences. For instance, Title II of the Dodd-Frank Act (P.L. 111-203) allows the Treasury Secretary to act upon a recommendation to put a financial institution into a receivership if the “financial company is in default or in danger of default” to limit damage to the wider

⁷ See Carmen M. Reinhart and Kenneth S. Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (Princeton, 2009).

⁸ See Sebastian Edwards, Francis A. Longstaff, and Alvaro Garcia Marin, “The U.S. Debt Restructuring of 1933: Consequences and Lessons,” NBER working paper 21694, November 2015; <http://www.nber.org/papers/w21694>.

⁹ For details, see, Treasury Securities and the U.S. Sovereign Credit Default Swap Market, by (name redacted) and (name redacted).

financial system.¹⁰ Those provisions of Dodd-Frank appear to reflect concerns that default by a major banking institution in some circumstances may lead to financial contagion affecting many other firms, even those without direct commercial ties to the defaulting institution.¹¹

Contracts Are Incomplete

No contract can anticipate or specify consequences for all possible future contingencies. All contracts are therefore incomplete to some extent. Contracts might not spell out contingencies because the benefits of doing so might seem remote, or because parties are confident that unanticipated situations could be worked out. For example, credit markets, according to one legal scholar, assess the riskiness of borrowers and impose substantial constraints only on those borrowers with the strongest incentives to take risks or to fail to repay debts.¹² In many cases, the usual principles of contract law are sufficient to resolve issues not made explicit in agreements.

Treasury Securities Carry No Contractually Specified Default Clauses

Conditions governing Treasury securities are specified in the U.S. Department of the Treasury’s Uniform Offering Circular (UOC), which describes how securities are sold, when payments are made, and what rules buyers must follow.¹³ In particular, the UOC details when bids must be submitted, when payments must be received, when interest will be paid, and when redemptions will be settled. The UOC states that the U.S. government “will pay principal on bills, notes, and bonds on the maturity” either by crediting a Federal Reserve account for those using the commercial book-entry system or by making a payment to an account at a depository institution specified by a security owner using the TreasuryDirect system.

The UOC, however, contemplates no contingency related to payment delays or default. Thus any discussion of potential default by the U.S. government on obligations related to Treasury securities cannot be based on contractual terms specified in the UOC. The absence of any provision in the UOC mentioning payment delays or defaults presumably stems from the widely held view that U.S. Treasury securities are risk-free assets. If Treasury payment delays or defaults were to become an issue, legal consequences would depend on how the corpus of contract law were applied.

¹⁰ For details, see Section 203 of the Dodd-Frank Act. Depending on the type of financial institution involved, different federal authorities are involved in the determination. Section 203(c) (4) provides the following definition of default or danger of default: “For purposes of this title, a financial company shall be considered to be in default or in danger of default if, as determined in accordance with subsection (b)—(A) a case has been, or likely will promptly be, commenced with respect to the financial company under the Bankruptcy Code; (B) the financial company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the company to avoid such depletion; (C) the assets of the financial company are, or are likely to be, less than its obligations to creditors and others; or (D) the financial company is, or is likely to be, unable to pay its obligations (other than those subject to a bona fide dispute) in the normal course of business.”

¹¹ See Bidisha Chakrabarty and Gaiyan Zhang, “Financial Contagion Channels: Market Microstructure Evidence from Lehman Brothers’ Bankruptcy,” *Financial Management*, vol. 41, no. 2, pp. 320–343, summer 2012.

¹² William W. Bratton, “Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process,” *European Business Organization Law Review*, vol. 7, 2006, pp. 39–87, <http://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=1575&context=facpub>.

¹³ Terms for Treasury securities are currently governed by the Uniform Offering Circular: <https://www.treasurydirect.gov/instit/statreg/auctreg/CFR-2014-title31-vol2-part356.pdf>. In earlier years, terms for Treasury securities were set by specific circulars.

Some federal laws do anticipate payment delays. The 1982 Prompt Payment Act (P.L. 97-177; 31 U.S.C. 3902) requires most federal agencies to take steps to ensure that bills are paid on time and provides for interest charges on late payments.¹⁴ The federal government is also mandated in general to pay clean claims from Medicare providers within 30 days or to pay interest as specified in the Prompt Payment Act.¹⁵ Federal payment delays may be inconvenient to those awaiting payment, but they are not considered defaults.

Payments of interest and principal on Treasury securities and other federal payments might be distinguished in two ways. First, the U.S. Treasury has sought to make its debt operations “regular and predictable” with the aim of reducing federal borrowing costs by issuing securities on a schedule designed to avoid surprising financial markets.¹⁶ Moreover, Treasury markets only issue a narrow set of security types, which aids in the standardization of the market in federal securities. By contrast, other federal agencies may deal with various types of payments that are far from “regular and predictable.” This in turn may lead to higher expectations that Treasury transactions will be completed on a more timely basis than those involving other parts of the federal government.

Consequences of Default Depend on Expectations

The consequences of a failure to pay or a late payment by the federal government or any other organization depend on the expectations of counterparties and others. The U.S. Treasury, as noted above, has sought to make its debt management processes as predictable as possible and to protect the reputation of Treasury securities as risk-free assets. A disruption to Treasury interest payments or redemptions would diverge sharply from market expectations of Treasury’s reliability. Holders of Treasury securities often undertake investment strategies that depend on Treasury’s payment schedule being fulfilled. In a simple case, firms use Treasury securities as collateral to obtain funding. A perceived change in the quality of that collateral could constrain the availability of credit, which could raise borrowing costs for the government and for others.¹⁷

The expectation that some other federal payments will be made on time may be weaker. For instance, few would be surprised if federal payments to some international organizations were not made on time. In other cases, complex administrative processes, such as review of a federal retirement application or review of a major federal contract, may hinder efforts to pay in full and on time. In addition, federal agencies are mandated to avoid improper payments, which could be hard to flag with compressed payment schedules. In those cases, well-informed federal payees may take steps to protect themselves from federal payment delays. For federal payments such as Social Security, beneficiaries generally expect that benefits will continue regularly, and thus might not have taken steps to protect themselves from payment delays.

¹⁴ For detailed information, see the U.S. Treasury, Bureau of Fiscal Service, Prompt Payment webpage, available at https://www.fiscal.treasury.gov/fs-services/gov/pmt/promptPayment/promptPayment_home.htm. Interest rates applied to late payments are periodically set by the U.S. Treasury.

¹⁵ Centers for Medicare & Medicaid Services, *Medicare Claims Processing Manual*, at Section 80.2.2; <https://www.cms.gov/Regulations-and-Guidance/Guidance/Manuals/downloads/clm104c01.pdf>.

¹⁶ Kenneth D. Garbade, “The Emergence of ‘Regular and Predictable’ as a Treasury Debt Management Strategy,” *Economic Policy Review*, Federal Reserve Bank of New York, vol. 13, no. 1, March 2007; <http://www.newyorkfed.org/research/epr/07v13n1/0703garb.html>.

¹⁷ Matthew Zames, Chairman of the Treasury Borrowing Advisory Committee of the Securities and Financial Markets Association (SIFMA), letter to Treasury Secretary Timothy Geithner, April 25, 2011; <http://www.sifma.org/workarea/downloadasset.aspx?id=25013>.

Do Intentions Matter?

While expectations of payees and others would shape reactions to payment delays, intentions of payors generally matter less. If a debtor fails to pay interest or principal set out in a contract, good intentions do not alter the character of that default. For example, if a sovereign government’s fiscal agent is barred from making payments to creditors, the willingness of that government to pay does not excuse the government from its obligations or relieve it from the consequences of nonpayment. In some cases, good intentions may be one factor that persuades a creditor from taking action against a debtor that has failed to pay, although such forbearance depends on the creditor’s judgement, rather than upon any legal basis.

Nonpayment due to events arguably beyond the control of the debtor might be considered “excused defaults” in certain cases.¹⁸ Some research suggests financial markets are less likely to react adversely to defaults due to natural disasters or commodity price falls than to defaults that are viewed as strategic—that is, defaults driven by an unwillingness to pay.¹⁹ In many cases, however, judging whether a default is an avoidable strategic default or one a debtor could not avoid may be difficult, which may lead to creditors being less willing to excuse defaults.²⁰

Has the Federal Government Defaulted?

During recent debt limit episodes, Treasury Secretary Lew and his predecessors have urged Congress to act to avoid an unprecedented failure to meet obligations. For instance, Secretary Lew on October 15, 2015, asked Congress to take action on the debt limit so that the Treasury would not be “unable to satisfy all of these obligations for the first time in the history of the United States.”²¹ An examination of American fiscal history, however, suggests that the federal government’s record of meeting its obligations is not unblemished.

This report focuses on three historical events in which the federal government’s reputation has been questioned: the War of 1812, the withdrawal from the gold standard during the Great Depression, and the so-called 1979 “mini-default.” Others might point to additional incidents, not considered in this report, such as the refusal to redeem Continental paper money issued during the Revolutionary War, or the issuance of “greenbacks” during the Civil War, or the abandonment of the gold standard in the early 1970s during the breakup of the post-World War II system of fixed exchange rates.²²

¹⁸ See Sebastian Edwards, Francis A. Longstaff, and Alvaro Garcia Marin, “The U.S. Debt Restructuring of 1933: Consequences and Lessons,” NBER working paper 21694, November 2015; <http://www.nber.org/papers/w21694>.

¹⁹ Herschel I. Grossman and John B. Van Huyck, “Sovereign Debt as a Contingent Claim: Excusable Default, Repudiation, and Reputation,” *American Economic Review*, vol. 78, no. 5, December 1988, pp. 1088-1097.

²⁰ Committee on International Economic Policy and Reform, *Revisiting Sovereign Bankruptcy* (Washington, DC: Brookings, 2013), p. 2; http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=5904&context=faculty_scholarship.

²¹ Treasury Secretary Jacob Lew, letter to Speaker John A. Boehner, October 1, 2015; <http://www.treasury.gov/Documents/Treasury%20Letter%20to%20Congress%20101515.pdf>.

²² For background on international monetary policy in the early 1970s, see U.S. Department of State, Office of the Historian, “Nixon and the End of the Bretton Woods System, 1971–1973,” available at <https://history.state.gov/milestones/1969-1976/nixon-shock>. Also see CRS Report R41887, *Brief History of the Gold Standard in the United States*, by (name redacted).

Federal Finances in Disarray During the War of 1812

In June 1812, war broke out between the United States and Great Britain, which lasted until February 1815.²³ The federal government, aside from military challenges including the burning of the Capitol and White House, suffered from severe institutional deficiencies that hindered its ability to meet its financial obligations. One pair of historians concluded that while the War of 1812 “was ill-managed militarily, [it] was even more bungled financially.”²⁴ Those financial difficulties included unambiguous examples of default.

Absence of Fiscal Agent and Internal Revenues Constrain Federal Finances

Aside from the central difficulty of mobilizing sufficient financial resources to conduct military operations, the federal government had to contend with two serious institutional shortcomings. First, Congress declined in 1811 to renew the charter of the first Bank of the United States, which acted as the government’s fiscal agent.²⁵ A fiscal agent carries out financial operations such as accepting tax payments, redeeming securities, or paying invoices. The absence of a national bank greatly complicated federal finances. Once the Bank of the United States closed, the federal government deposited its funds in local banks. By 1812, Treasury had accounts in 21 banks, which fragmented Treasury’s operational controls.²⁶

Second, Congress had followed President Jefferson’s call to repeal direct and excise taxes in 1802, leaving federal coffers dependent on tariff and customs revenue.²⁷ Even three years before the outbreak of war, restrictions on shipping from American ports cut customs revenues by more than half.²⁸ Treasury Secretary Gallatin, however, had trusted that war expenses could be financed by loans, rather than by taxes.²⁹ By December 1811, however, Gallatin called for imposing internal taxes to supplement falling customs revenues.³⁰ Soon after war was declared in June 1812, Congress doubled customs rates and authorized Treasury to issue notes, thereby avoiding reliance on internal revenues.³¹ Customs revenues rose temporarily, but fell even lower in the next year, while war costs rose. Thus by mid-1813, the government’s ability to borrow on reasonable terms had dwindled.

Madison Belatedly Calls for Raising Internal Revenues

Expanding federal purchases to support war efforts increased payment demands on the Treasury, while a dearth of effective tax instruments left it little alternative to additional borrowing. By the

²³ The Treaty of Ghent (8 Stat. 218) was signed on December 24, 1814, and ratified on February 17, 1815. The last major conflict, the Battle of New Orleans, occurred between January 8 and 17, 1814.

²⁴ Paul Studenski and Hermann Krooss, *Financial History of the United States* (New York: McGraw-Hill, 1963), p. 75.

²⁵ A measure to renew the charter was voted down in the Senate on February 20, 1811. Davis R. Dewey, *Financial History of the United States*, 10th ed. (New York: Longmans, Green, 1928), pp. 126-127.

²⁶ Dewey, pp. 127-128.

²⁷ Frederic C. Howe, *Taxation and Taxes in the United States under the Internal Revenue System 1791-1895* (New York: Thomas Y. Cromwell, 1896), p. 34.

²⁸ Dewey, p. 123.

²⁹ Dewey, pp. 128-129; Howe, p. 39.

³⁰ Howe, p. 40; *American State Papers*, Finance: vol. 2, p. 523+, House of Representatives, 12th Cong., 1st sess., available via <http://memory.loc.gov/ammem/amlaw/lwsp.html>.

³¹ Donald H. Kagin, “Monetary Aspects of the Treasury Notes of the War of 1812,” *Journal of Economic History*, vol. 44, no. 1, March 1984.

summer of 1813, President Madison was compelled to call Congress to a special session to consider new revenue sources. Congress agreed to reinstate internal revenue sources to raise an estimated \$5 million and authorized the Administration to borrow \$7.5 million.³² The government's ability to obtain credit, however, continued to deteriorate, and by early 1814 it could only borrow by offering unusually high yields, while efforts to borrow from American banks and European markets were rebuffed.³³ Internal revenue rates were raised at the end of 1814, although lags in the administration of those taxes meant that most of those revenues were collected after the war.³⁴

Specie Payment Suspended in August 1814

The U.S. Treasury's situation was further complicated by its lack of control over monetary policy. With the disappearance of the Bank of the United States, state banks proliferated and issued rising volumes of bank notes. Those notes, along with those issued by Treasury—some with denominations as low as \$3—effectively expanded the money supply. A growing imbalance between government purchases and receipts, along with the absence of monetary controls, helped spur inflation, leading the value of state bank notes to diverge from amounts defined in terms of specie, that is, in gold or silver coin.³⁵

In August 1814, payment in specie was suspended for most of the country outside of New England. Without specie payment, bank notes issued in one state were not accepted in other states. Thus, notes issued by a Philadelphia bank could not be used to pay bills in Boston or New York.³⁶ The breakdown of banks' willingness to accept notes issued by other banks obliged Treasury to expand the number of accounts it maintained. By 1814, Treasury had accounts in 94 banks. Moreover, Treasury had to keep separate bank accounts for in-state bank notes, out-of-state bank notes, interest-bearing federal securities, and non-interest-bearing securities.³⁷ While Treasury held some \$2.5 million in bank credits in the fall of 1814, they were of little use because they were so widely dispersed and could not easily be transferred from place to place.³⁸

In addition, because the federal government could no longer redeem obligations in specie it effectively could not demand specie or equivalent for tax payments. It thus began to accept heavily discounted bank notes as payment for taxes or for purchase of federal securities, further undermining the Treasury's ability to meet its obligations.

³² Dewey, pp. 129-130.

³³ John W. Kearny, *Sketch of American Finances: 1789-1835* (New York: G.P. Putnam, 1887), pp. 96-97. Also see U.S. Treasury Department, *Report and Estimates for 1814*, p. 14, September 23, 1814, which stated "an effort was made to obtain temporary loans from the banks by special contracts; but the attempt was not attended with success."

³⁴ Dewey, pp. 132-140; Howe, pp. 40-42. Following the initiatives of President Jefferson and Treasury Secretary Gallatin, the administrative machinery for administering Hamilton-era internal revenues had been dismantled in 1801-1806. See Kagin, p. 77.

³⁵ Encyclopedia Britannica, *Specie Payment: American Finance*, <http://www.britannica.com/topic/specie-payment>.

³⁶ Kearny, pp. 98-102. Some contended that Boston banks demanded specie payments from New York banks, which in turn called for payments from Philadelphia and Baltimore banks, thus creating a cascade of credit shortfalls. See Mathew Carey, *The Olive Branch: Or, Faults on Both Sides, Federal and Democratic*, 10th ed., (Philadelphia, 1818), pp. 300-302.

³⁷ Studenski and Krooss, pp. 79-80; Dewey, p. 145.

³⁸ Kearny, pp. 98-102. Also see George M. Dallas, *Life and Writings of Alexander James Dallas* (Philadelphia: Lippincott, 1871), p. 245.

Treasury Suffers “Every Kind of Embarrassment”

Alexander J. Dallas, who became Treasury Secretary in October 1814, soon complained that Treasury “was suffering from every kind of embarrassment” and that “the dividend on the funded debt has not been punctually paid; a large amount of treasury notes has already been dishonored.”³⁹ For instance, interest federal debt due to Boston investors on October 1, 1814, could not be paid and those investors refused to accept Treasury notes as payment rather than specie, thus providing a clear example of default.⁴⁰ At that time, the Treasury had not exhausted its authority to borrow or issue notes. Banks and investors, however, were unwilling to lend or to accept notes on terms that Treasury felt prudent to offer. Dallas lamented that, while “[p]ublic credit depends essentially upon public opinion, ... public opinion, manifested in every form, and in every direction, hardly permits us, at the present junction, to speak of the existence of public credit.”⁴¹

Government finances improved with the end of the war and the rebound in customs revenues stemming from the resumption of international commerce. President Monroe in December 1815 noted that “great satisfaction has been derived in contemplating the revival of the public credit.”⁴² The Second Bank of the United States, chartered in 1816 and opened the following year, for a time laid a more stable foundation for banking and currency.⁴³ Not until the 1820s were public finances restored to a sound basis, as land sales and rising customs revenues began to outrun federal expenditures consistently.⁴⁴

The Great Depression and the Gold Clause Cases

The decision by President Franklin Roosevelt and Congress to move the U.S. government off the gold standard in 1933 and 1934, in the eyes of some, amounted to a repudiation of the contract terms, and in particular, to the terms of the Second Liberty Bonds issued in 1917. The abandonment of the gold standard in 1933 was the culmination of a banking crisis that began with the onset of the Great Depression in October 1929.

An enormous literature discusses the Great Depression and the suspension of the U.S. gold standard. This section provides a thumbnail sketch of those events to focus on whether the U.S. government met its obligations.

³⁹ George M. Dallas, *Life and Writings of Alexander James Dallas* (Philadelphia: Lippincott, 1871), letter dated November 27, 1814, pp. 244-246.

⁴⁰ For a listing of such “embarrassments,” see Treasury Secretary Alexander J. Dallas, letter to House Committee on Ways and Means Chairman John W. Eppes, December 2, 1814, in Jonathan Elliott, *The Funding System of the United States and of Great Britain*, (Washington, D.C.: Blair & Rives, 1845), pp. 598-601.

⁴¹ Dallas (1871), pp. 244-246.

⁴² President James Madison, “President’s Message,” December 5, 1815, in *Annals of Congress*, v. 29 (13th Cong., 2nd sess.), pp. 11-18. Madison noted that “the improved condition of the public revenue will not afford the means of maintaining the faith of the Government with its creditors inviolate, and of prosecuting, successfully, the measures of the most liberal policy, but will also justify an immediate alleviation of the burdens imposed by the necessities of the war.”

⁴³ President Andrew Jackson effectively shut down the Second Bank in 1833 and its charter expired in 1836.

⁴⁴ Dewey, pp. 168-169.

Box 1. What Was the Gold Standard?

The monetary system of the United States for most of its history was linked to gold or silver. After the Constitution was ratified in 1789, Americans could redeem U.S. currency for specie, meaning gold or silver coin. Before the Civil War, a bimetallic standard based on a ratio between gold and silver was used.

Wars were probably the principal reason governments in the 19th century and before left the gold standard. Payment in specie was suspended during the last year of the War of 1812 and the Civil War. While the U.S. government returned to the gold standard relatively soon after the end of the War of 1812, after the Civil War it did not return to the gold standard until 1879.⁴⁵ The U.S. government reaffirmed its commitment to the gold standard in 1900.⁴⁶ In the 1920s and 1930s, however, financial and economic crisis caused many governments to abandon the gold standard.⁴⁷ In 1933, as described below, the U.S. government ceased redemptions of currency into gold, although gold maintained a role in international financial transactions.

In the early 1970s, the Bretton Woods framework of fixed exchange rates among currencies developed after World War II broke down. Despite efforts to maintain a dollar value pegged to gold, the international monetary system moved to a floating-rate exchange regime. In 1976, the U.S. government cut all ties between the dollar and gold.⁴⁸ U.S. currency is thus backed by the full faith and credit of the federal government, rather than a metallic standard.

Gold Clauses and Treasury Securities

During the first part of the 20th century, several Treasury securities carried gold clauses that specified that interest and principal would be paid in “U.S. gold coin of the present standard of value.” Some, during that period, argued that U.S. bonds without such protections would be “absolutely unsaleable.”⁴⁹ If Treasury had omitted gold clauses, higher yields would have been necessary to sell bonds, which would have increased debt service costs.

Investors were presumably wary that the U.S. government might leave the gold standard, as it had during the War of 1812 (as noted above) and during the Civil War.⁵⁰

The Great Depression and State Bank Holidays

The October 1929 Wall Street crash left many banks holding assets worth less than they had paid for them. As the financial crisis began to affect the real economy, the price level dropped sharply, and unemployment rose. Difficult economic conditions made debtors less able to pay, while constricted credit further reduced economic activity.

⁴⁵ CRS Report R41887, *Brief History of the Gold Standard in the United States*, by (name redacted).

⁴⁶ The Gold Standard Act (301 Stat. 45)—formally known as “An act to define and fix the standard of value, to maintain the parity of all forms of money issued or coined by the United States, to refund the public debt, and for other purposes”—was enacted on March 14, 1900.

⁴⁷ Some argue that the Great Depression and weak economic conditions in Europe during the 1920s were a direct consequence of World War I and postwar financial arrangements. See Peter Temin, *Lessons from the Great Depression* (Cambridge, Mass.: MIT Press, 1989).

⁴⁸ An act to provide for amendment of the “Bretton Woods Agreement Act,” 90 Stat. 2660, October 1976.

⁴⁹ See exchange between Rep. John Sterling and Treasury Secretary McAdoo in House Committee on Ways and Means, “Third Liberty Bond Bill,” hearings, 65th Cong., 2nd sess., March 27, 1918, p. 34.

⁵⁰ James D. Hamilton, “Role of the International Gold Standard in Propagating the Great Depression,” *Contemporary Economic Policy*, vol. 6, no. 2, 1988.

Between 1929 and 1933, over 9,700 of the 25,000 banks in operation before the Great Depression failed.⁵¹ A failure of one bank, in the era before deposit insurance, diminished the public's trust in ability of other nearby banks to redeem deposits. Governors began to impose state-wide bank holidays to tamp down contagion of bank runs, starting with Nevada in October 1932.⁵² By 1933, 34 of 48 state governors had declared banking holidays to allow financial institutions to reorganize, and at 2:30 on the morning of Franklin Roosevelt's inauguration, the governor of New York declared a banking holiday.⁵³ Other banks were closed under the authority of the Comptroller of the Currency.⁵⁴

Withdrawals Threaten to Exhaust Federal Reserve's Excess Gold

Concerns about the state of the American banking system and uncertainty about policies of the new President prompted international investors to withdraw funds from the United States. The United Kingdom and four Scandinavian countries suspended the gold standard in 1931, which fueled concerns that other countries would follow.⁵⁵ The Federal Reserve attempted to attract gold by raising discount rates in the fall of 1931 and in February 1933, which tightened the supply of credit and led to further falls in the price level.⁵⁶ Withdrawals of U.S. deposits strained the gold reserves of the Federal Reserve, which were required to be at least 40% of the value of currency issued. While the Federal Reserve normally had gold reserves well above the 40% minimum, heavy outflows in March 1933 drained those reserves. On Friday, March 3, 1933, the Federal Reserve Bank of Chicago (Chicago Fed) refused a loan to the Federal Reserve Bank of New York (NY Fed), which forced the Federal Reserve Board to suspend its gold reserve requirement.⁵⁷ The governor of New York, as noted above, declared a banking holiday early the next morning, which could have disrupted operations of the country's largest banks.

Newly Inaugurated President Roosevelt Takes Emergency Actions

President Franklin Roosevelt, upon assuming office, took a series of steps to resolve the banking crisis, including a suspension of the gold standard. Roosevelt, inaugurated on Saturday, March 4, 1933, declared a four-day federal bank holiday early the following Monday that suspended all banking activities and barred trade in gold bullion, thus ending the immediate banking crisis.⁵⁸ At the end of that holiday, Congress passed the Emergency Banking Act (P.L. 73-1), which empowered the President to control international and domestic gold shipments and gave the

⁵¹ Ben Bernanke, "The Federal Reserve and the Financial Crisis," lecture 1 (Origins and Mission of the Federal Reserve), slide 43, updated August 2, 2013; <http://www.federalreserve.gov/newsevents/lectures/origins-and-mission.htm>. The estimate of 25,000 banks dates from the end of 1928.

⁵² Kristie M. Engemann, "Banking Panics of 1931-33," Federal Reserve History website, November 22, 2013; <http://www.federalreservehistory.org/Events/DetailView/21>.

⁵³ Anthony J. Badger, *The New Deal* (New York: Hill & Wang, 1991), pp. 31, 67-68.

⁵⁴ U.S. Government Printing Office, *Documents and Statements Pertaining to the Banking Emergency, Part I: February 25-March 31, 1933*, p. 1.

⁵⁵ Barry Eichengreen and Jeffrey Sachs, "Exchange Rates and Economic Recovery in the 1930s," *Journal of Economic History*, vol. 45, no. 4, December 1985, Table 2 at p. 928.

⁵⁶ Engemann, op. cit.

⁵⁷ Engemann, op. cit.; Gary Richardson, Alejandro Komai, and Michael Gou, "Roosevelt's Gold Program: Spring 1933," Federal Reserve History website, November 22, 2013; <http://www.federalreservehistory.org/Events/DetailView/24>.

⁵⁸ Powers were invoked under the 1917 Trading with the Enemy Act (40 Stat. 411). See also, William L. Silber, "Why Did FDR's Bank Holiday Succeed?" *FRBNY Economic Policy Review*, July 2009, pp. 19-30.

Treasury Secretary the power to compel exchanges of gold for currency.⁵⁹ The President, in response to persistent gold outflows, suspended the gold standard on April 20, 1933.⁶⁰ On May 12, 1933, President Roosevelt signed legislation (P.L. 73-10) into law that reduced the gold content of a dollar by half and allowed the President to tie the dollar’s value to silver.⁶¹ On June 5, 1933, Congress passed a resolution that abrogated gold clauses in private and public contracts, which President Roosevelt signed the next day.⁶² Reducing the gold content assigned to the dollar had the effect of depreciating the dollar, making dollar-priced exports cheaper and imports more expensive, which improved the U.S. trade balance.

In October 1933, the Roosevelt Administration directed purchases of gold at set prices, which provided a link to the value of a dollar, even if gold were not exchanged for dollars.⁶³ In the following year, the Gold Reserve Act of 1934 (P.L. 73-87, 48 Stat. 337), signed into law by President Roosevelt on January 30, 1934, set a book value of gold at \$35, thus reestablishing a gold standard. The act, however, ratified earlier actions by barring private trade in monetary gold and brought all federal holdings of gold under the control of the U.S. Treasury.⁶⁴

Supreme Court Upholds Congressional Actions

The cancellation of gold clauses prompted some investors to sue the U.S. government. Holders of many Treasury bonds that promised payment in gold viewed the cancellation as a repudiation of federal obligations. In 1935, however, the Supreme Court upheld the power of Congress to regulate the value of money, but that “insofar as it attempted to override the obligation created by the bond in suit, went beyond the congressional power.”⁶⁵ The Court held that bondholders were not damaged, in part, because if they had been paid in gold, they would have been mandated to sell that gold to the federal government at the price set by the Gold Reserve Act or previous measures. The dissent, however, contended that in cancelling the gold clauses “Congress really has inaugurated a plan primarily designed to destroy private obligations, repudiate national debts, and drive into the Treasury all gold within the country in exchange for inconvertible promises to pay, of much less value.”⁶⁶

⁵⁹ Richardson, Komai, and Gou (2013), op. cit.

⁶⁰ President Franklin D. Roosevelt, *Executive Order Relating to Foreign Exchange and the Earmarking and Export of Gold Coin or Bullion or Currency*, April 20, 1933, https://fraser.stlouisfed.org/docs/historical/federal%20reserve%20history/bank_holiday/bank_emerg_pt2_19330405.pdf, pp. 2-3.

⁶¹ Those powers were provided in the amendment offered by Senator Elmer Thomas. See David D. Webb, “Thomas Amendment,” Oklahoma History Center website; <http://www.okhistory.org/publications/enc/entry.php?entry=TH007>.

⁶² 48 Stat. 112-113, ch. 48, (H.J. Res. 192, 73rd Congress). Available at https://fraser.stlouisfed.org/docs/historical/federal%20reserve%20history/bank_holiday/bank_emerg_pt2_19330405.pdf, p. 10.

⁶³ Purchases were made by the Reconstruction Finance Corporation (RFC). See Richardson, Komai, and Gou, op. cit.

⁶⁴ Exceptions for trade in gold were made for dentistry, jewelry, electronics, and other industrial purposes. Also see President Franklin D. Roosevelt, *White House Statement on Proclamation 2072*, January 31, 1934; <http://www.presidency.ucsb.edu/ws/?pid=14739>.

⁶⁵ *Perry v. United States*, 294 U.S. 330, 354 (1935). The Court’s reasoning for the invalidation of gold clauses in private contracts differed somewhat from its argument regarding federal Liberty Bond contracts. See Sebastian Edwards, Francis A. Longstaff, and Alvaro Garcia Marin, “The U.S. Debt Restructuring of 1933: Consequences and Lessons,” NBER working paper 21694, November 2015; <http://www.nber.org/papers/w21694>. Several gold cases were consolidated with *Perry v. United States*, including *Nortz v. United States* (294 U.S. 317), *Norman v. Baltimore & Ohio R.R. Co.* (294 U.S. 240). See Kenneth W. Dam, “From the Gold Clause Cases to the Gold Commission: A Half Century of American Monetary Law,” *University of Chicago Law Review*, vol. 50, 1983, pp. 504-532.

⁶⁶ *Perry v. United States*, 294 U.S. 330 (1935), at p. 369. A dissent has no precedential value in law.

Economic Consequences of the Cancellation of the Gold Clauses

The cancellation of the gold clauses appeared to have little effect on Treasury’s ability to borrow on financial markets.⁶⁷ While the suspension of the gold standard in the United States led some to shift investments to countries still on the gold standard, the U.S. Treasury had little difficulty in borrowing. Treasury auctions continued to be oversubscribed even after the 1933 actions to suspend the gold standard and after the 1935 Supreme Court decisions that upheld those measures. Over 80% of holders of Treasury securities with gold clauses rolled over their investments in new Treasury issues. Moreover, the improvement in the U.S. balance of trade, spurred by the devaluation of the dollar, served to bring gold back, and official government purchases of gold increased the Treasury’s holdings.⁶⁸

The suspension of the gold standard, while disappointing creditors, helped stimulate economic recovery and laid the foundations for modern monetary policy, according to economists who have studied the issue.⁶⁹ Researchers also concluded that the gold standard and how it was maintained by central banking authorities helped spread shocks from country to country, helping propagate the Great Depression.⁷⁰ Several economists found that countries that left the gold standard earlier in the 1930s recovered more quickly than those that remained longer on the gold standard.⁷¹ In the case of the United States, the economy grew at an annual average real rate of 9.4% a year from 1933 to 1937, while the economy in 1933 was 26% below its 1929 level.⁷² Although some have called for a return to the gold standard, no country currently operates on a gold standard. One survey of economists found no support for reinstituting the gold standard.⁷³

The So-Called 1979 “Mini-Default”

Delays in payments from the U.S. Treasury to some investors in the spring of 1979 were dubbed by some as a “mini-default.”⁷⁴ The timing of the first payment delay coincided with a sharp increase in Treasury yields. A security’s yield is its effective interest rate, which varies inversely with the security’s market price. The price investors are willing to pay for a security reflects judgements about credit risks and the expectations of the future inflation rate, among other factors.

If payment delays persuaded investors that Treasury securities were not risk-free investments, market demand for those securities would fall, leading to lower prices and higher yields. Higher

⁶⁷ Sebastian Edwards, Francis A. Longstaff, and Alvaro Garcia Marin, “The U.S. Debt Restructuring of 1933: Consequences and Lessons,” NBER working paper 21694, November 2015; <http://www.nber.org/papers/w21694>.

⁶⁸ Ibid.

⁶⁹ Barry Eichengreen and Jeffrey Sachs, “Exchange Rates and Economic Recovery in the 1930s,” *Journal of Economic History*, vol. 45, no. 4, December 1985, pp. 925-946; http://www.econ.columbia.edu/sitefiles/file/Sachs%20Writing/1985/EconHistory_1985_ExchangeRatesandEconomicRecovery_Dec1985.PDF.

⁷⁰ See Peter Temin, *Lessons from the Great Depression* (Cambridge, Mass.: MIT Press, 1989).

⁷¹ See Ben Bernanke and Harold James, “The Gold Standard, Deflation, and Financial Crisis in the Great Depression: An International Comparison,” in *Financial Markets and Financial Crises*, R. Glenn Hubbard, ed., (Chicago: Univ. of Chicago Press, 1991). See also Eichengreen and Sachs, op. cit.

⁷² Calculations based on Bureau of Economic Analysis data.

⁷³ Greg Ip, “Real Time Economics,” *Wall Street Journal*, November 12, 2015.

⁷⁴ Terry L. Zivney and Richard D. Marcus, “The Day the United States Defaulted on Treasury Bills,” *Financial Review*, vol. 24 (1989), issue 3, pages 475-89. As a point of reference, the U.S. Treasury redeemed \$6.3 billion in bills during the first week of May 1979. See “Treasury Bill Auction to Reduce U.S. Debt by About \$200 Million,” *Wall Street Journal*, April 25, 1979. Affected bills matured on April 26, May 3, and May 10, 1979.

yields, in turn, would imply an increase in Treasury's borrowing costs. A reexamination of available information, however, indicates that interest rate movements at that time were more likely driven by news that anticipated major changes in U.S. monetary policy aimed at reducing the inflation rate. Moreover, only a small fraction of holders of Treasury securities were affected. While the 1979 payment delays certainly inconvenienced many small investors, the stability of the wider market in Treasury securities was not put at risk.

Treasury Payment Delays in the Spring of 1979

In late April and early May 1979, about 4,000 Treasury checks for interest payments and for the redemption of maturing securities held by individual investors worth an estimated \$122 million were not sent on time.⁷⁵ Foregone interest due to the delays was estimated at \$125,000.⁷⁶ Wire transfers to financial institutions and large-scale investors, whose holdings were reflected in the Federal Reserve's book-entry system, were unaffected.⁷⁷ At the time, over 90% of marketable Treasury securities were held in book-entry form.⁷⁸ In addition, small investors who opted to roll over proceeds of maturing Treasury bills also would have been unaffected.⁷⁹ Check processing returned to normal by May 14, 1979, and payments for securities maturing on May 10, 1979, were mailed the following day.⁸⁰

Why Were Payments Delayed?

Payment delays were chiefly due to back-office technical and organizational problems. At the time, the Bureau of the Public Debt was in the process of automating its own book-entry system of accounts and its data processing office was being reorganized.⁸¹ The U.S. Treasury's check issuance operations were also in the midst of a relocation⁸² and word processing equipment failed unexpectedly.⁸³

Rising small investor demand for T-bills also contributed to pressures on Treasury operations. T-bills had become increasingly attractive as inflation was increasing yields. By the end of 1977, yields on Treasury securities rose above interest rate ceilings imposed by federal regulations on standard demand deposit accounts. By late April 1979, the 3-month Treasury bill carried a yield

⁷⁵ Ibid.

⁷⁶ Michael W. Sunner, *Borrowing Through the U.S. Treasury's 'Fast Money Tree'* (Author House, 2012), pp. 35-38.

⁷⁷ To provide a point of comparison, two days before the first payment delays the U.S. Treasury announced that it would sell \$6.1 billion in bills and would redeem maturing bills worth \$6.3 billion. "Treasury Bill Auction to Reduce U.S. Debt by about \$200 Million," *Wall Street Journal*, April 25, 1979. In a book entry system, ownership of a security is established by an entry in a register rather than by possession of a physical certificate.

⁷⁸ Kenneth D. Garbade, "Origins of the Federal Reserve Book-Entry System," *FRBNY Economic Policy Review*, December 2004, p. 44.

⁷⁹ See Treasury Form PD 4632 in Howard M. Berlin, *The Dow-Jones-Irwin Guide to Buying and Selling Treasury Securities* (Homewood, IL: Irwin), 1984, p. 19.

⁸⁰ "Treasury Paying Accounts on Time," *New York Times*, May 15, 1979, p.D12.

⁸¹ *Annual Report of the Secretary of the Treasury for 1979*, pp. 160-161; http://www.constitution.org/uslaw/treas-rpt/fra/AR_TREASURY_1979.pdf. The U.S. Treasury stopped issuing paper certificates for bills in 1979 and for bonds in 1986. See Michael Quint, "Credit Markets; Book-Entry Form for U.S. Debt," *New York Times*, February 23, 1985. Note for a rule governing the implementation of the U.S. Treasury's book-entry system was published on November 1, 1978 (41 FR 47959).

⁸² Edward P. Foldessy, "Treasury Hits Delays in Mailing Checks to the Holders of Its Maturing Securities," *Wall Street Journal*, May 6, 1979, p. 8.

⁸³ U.S. Treasury, Press release, May 8, 1979.

of over 9%, while federal regulations limited interest rates on standard demand deposit accounts to 5.25%.⁸⁴

The widening gap between Treasury yields and regulated rates on bank deposits spurred many small investors to invest directly in Treasury securities.⁸⁵ While the U.S. Treasury had sought to discourage small investor purchases by raising the minimum denomination of Treasury bills from \$1,000 to \$10,000 in February 1970, by the late 1970s inflation and rising real incomes had made that minimum a less formidable hurdle to many small investors.⁸⁶ One investment guide noted that until about 1978, very few average investors knew about investing in Treasury securities.

By 1979, small investor demand for Treasury securities was rising rapidly. From January 1978 to late April 1979, purchase requests (tenders) for Treasury bills rose 379% and the volume of Treasury’s daily bill transactions increased by 427%.⁸⁷ Small investors were also given the option of rolling over the principal for maturing Treasury bills into new bills. Many of those investors, according to Treasury officials, waited until the last minute to request rollovers, which added additional administrative burdens onto debt management operations.⁸⁸

The U.S. Treasury also attributed the delays, in part, to auctions that were postponed due to a contentious debt limit episode that culminated in a temporary increase in the debt limit on April 2, 1979 (P.L. 96-5).⁸⁹ The debt limit, however, was not a direct cause of payment delays, as federal debt was a comfortable \$32.5 billion below its limit when the first checks were delayed.⁹⁰ Thus, the U.S. Treasury had the financial means to make all payments that were due, even if its operational capacity to cut checks may have been impaired for some weeks.

Compensating Small Investors

The U.S. government has no legal mechanism in place to compensate investors for the consequences of payment delays.⁹¹ In particular, the U.S. Treasury has no authority to reimburse investors for the time-value of delayed payments. Moreover, Treasury bond offering documents then, as at present, did not contemplate delays in payments to bondholders.⁹²

One small investor, Claire Barton of Encino, CA, represented by her attorney husband, filed a class action suit against the U.S. government on May 11, 1979, in the U.S. District Court for the

⁸⁴ R. Alton Gilbert, “Requiem for Regulation Q: What it did and Why it Passed Away,” *Federal Reserve Bank of St. Louis Review*, February 1986; https://research.stlouisfed.org/publications/review/86/02/Requiem_Feb1986.pdf.

⁸⁵ R. Alton Gilbert and Jean M. Lovati, “Disintermediation: An Old Disorder with a New Remedy,” *St. Louis Federal Reserve Economic Review*, January 1979, pp. 10-15; https://research.stlouisfed.org/publications/review/79/01/Disintermediation_Jan1979.pdf.

⁸⁶ Federal Reserve Bank of New York, “Treasury Raises Minimum Bill Denomination to \$10,000,” Circular 6499, February 26, 1970.

⁸⁷ U.S. Treasury, Press release, May 8, 1979.

⁸⁸ Edward P. Foldessy, “Treasury Hits Delays in Mailing Checks to the Holders of Its Maturing Securities,” *Wall Street Journal*, May 6, 1979, p. 8.

⁸⁹ Ibid.

⁹⁰ *Treasury Bulletin*, May 1979, Table FD-9, p. 23.

⁹¹ “As a general rule, interest may not be recovered against the United States unless expressly provided by statute or contract.” See Government Accountability Office, *Principles of Federal Appropriations Law* (3rd edition), vol. III, GAO-08-978SP, September 1, 2008, p. 14-51.

⁹² Terms for Treasury securities are currently governed by the Uniform Offering Circular: <https://www.treasurydirect.gov/instit/statreg/auctreg/CFR-2014-title31-vol2-part356.pdf>. In earlier years, terms for Treasury securities were set by specific circulars.

Central District of California.⁹³ The suit alleged that payment delays, by allowing the government to use funds that were due to investors, “constituted unjust enrichment” at the “cost, loss, and expense” of Mrs. Barton and similar Treasury debt holders.⁹⁴ The government was granted a stay to allow time to put forth a settlement offer to affected investors, and reportedly more than 80% of them accepted.⁹⁵ Representative Richard Gephardt introduced a measure (H.R. 6054, 96th Congress) on December 6, 1979, to authorize the Treasury Secretary to compensate the remaining investors from the case. The bill was referred to the House Committee on Banking, Finance and Urban Affairs. No further action was taken. The class action suit was dismissed with prejudice on May 12, 1980.⁹⁶

Payment Delays Caused No Discernable Change in Treasury Yields

A decade after the so-called 1979 mini-default, a 1989 *Financial Review* article noted that the day the first delayed payments were due (April 26, 1979), Treasury yields spiked up by 60 basis points (100 basis points=1%). The resulting increase in annual borrowing costs of the federal government, according to estimates presented in the article, was about \$12 billion. The *Financial Review* article’s authors contended that the payment delays “apparently warned investors that Treasury issues were not completely riskless.”

This spike is evident in **Figure 1**, which shows secondary market daily yields for 3-month, 6-month, and 1-year Treasury bills from November 1978 through November 1979. This period is bookended by November 17, 1978 (first vertical line), when several banks announced increases in lending rates shortly after an influential Solomon Brothers economist, Henry Kaufman, delivered a speech predicting a sharp rise in interest rates,⁹⁷ and October 6, 1979 (last vertical line), when the Federal Reserve announced a new approach to monetary policy.⁹⁸

⁹³ Claire Barton et al. v. U.S., CV79-1718-LTL(Gx).

⁹⁴ Docket record for Claire Barton et al. v. U.S., CV79-1718-LTL(Gx).

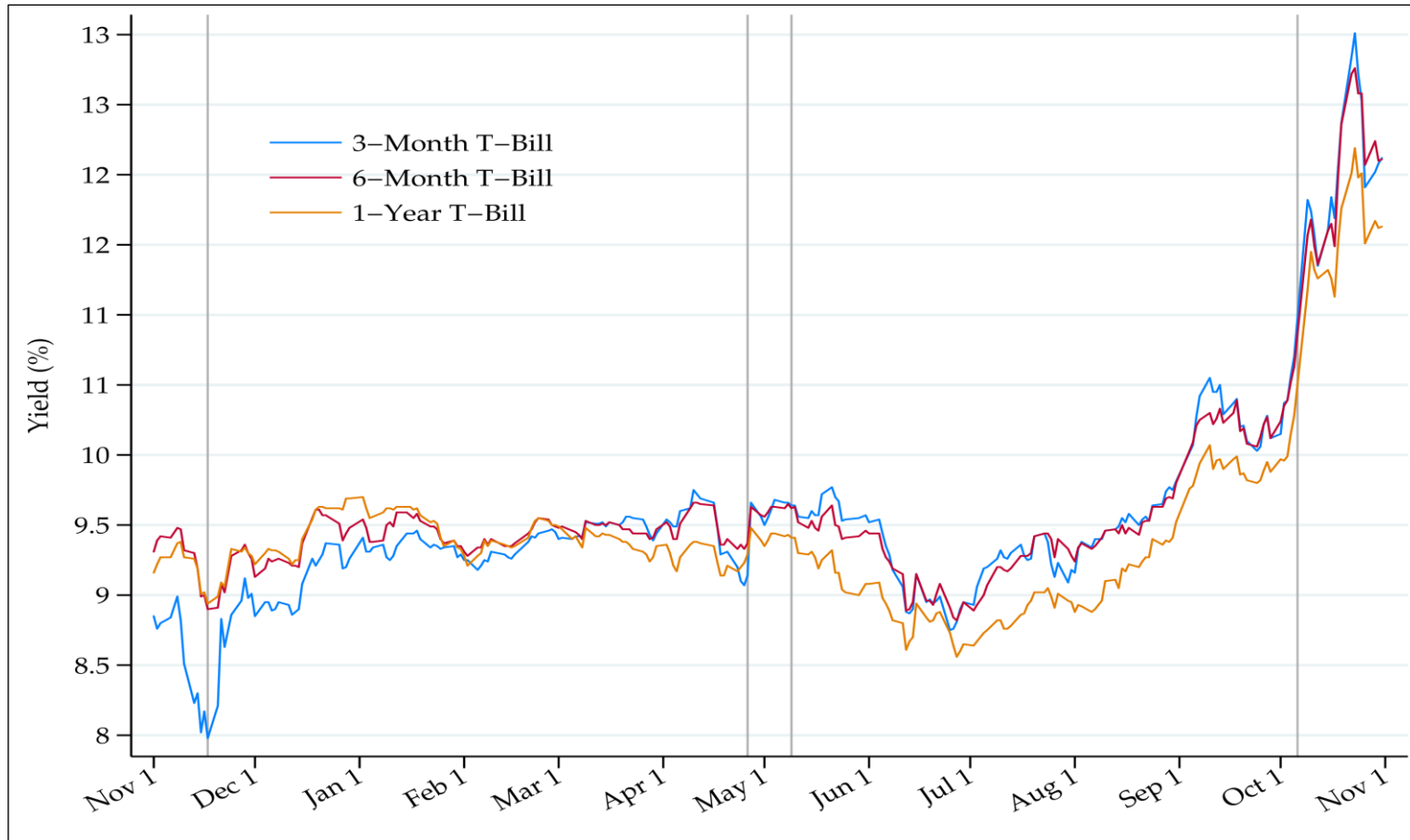
⁹⁵ “Damage Suit Filed Over Delay by U.S. in Paying Off Notes,” *Wall Street Journal*, May 29, 1979, p. 36.

⁹⁶ Docket record. Dismissal with prejudice bars refiling of a claim. Case records were destroyed on November 28, 2011, by the National Archives and Records Administration (NARA).

⁹⁷ *Globe and Mail*, “U.S. Rates Likely to Feel Pressure Rising This Year,” November 21, 1978, p. B5.

⁹⁸ David E. Lindsey, Athanasios Orphanides, and Robert H. Rasche, “The Reform of October 1979: How It Happened and Why,” Federal Reserve Board working paper 2005-2, December 2004.

Figure 1. Treasury Bill Yields in the Secondary Market: November 1978-October 1979



Source: Federal Reserve Bank of St. Louis, 3-month, 6-month, and 1-year bills, secondary market rate, daily, not seasonally adjusted. Series DTB3, DTB6, and DTB1YR.

Notes: The vertical lines, from left to right, indicate (i) November 17, 1978, when several banks announced lending rate increases following a Henry Kaufman speech; (ii) April 26, 1979, when the first delayed payments were due; (iii) May 9, 1979, when the *Wall Street Journal* first reported on those payment delays; and (iv) October 6, 1979, when the Federal Reserve announced a new approach to monetary policy. A security's yield varies inversely with its market price.

Whether the spike in Treasury yields noted in the *Financial Review* article stemmed from payment delays to small investors, which indicated that Treasury securities were not risk-free assets, or from larger shifts in monetary policy becomes a natural question. This time period spanned by **Figure 1** contains not only the so-called mini-default, but also one of the most dramatic shifts in U.S. monetary policy.⁹⁹ In particular, President Jimmy Carter's nomination of Paul Volcker to serve as chairman of the Board of Governors for the Federal Reserve System on July 25, 1979, reflected growing concerns about accelerating inflation rates and signaled a coming change in monetary policy.¹⁰⁰

Although the first delayed payments were due on April 26, 1979 (second vertical line), the *Wall Street Journal* (WSJ) first reported on those payment delays on May 9, 1979 (third vertical line). The previous day, the U.S. Treasury issued a press release noting the delay in mailing checks for Treasury bills.¹⁰¹ On both dates (May 8 and 9), no large movements in Treasury yields were observed.¹⁰²

Well-informed market traders conceivably could have known of the payment delays a few days before the WSJ report. Treasury yields for various bills, however, were falling in the days leading up to that date. Alternatively, traders may have taken a few days to absorb the implications of the WSJ report. Treasury yields fell, however, in the days after that news, as can be seen in **Figure 1**. In either case, market movements of Treasury yields around the time that payment delays became widely known are inconsistent with the contention that those delays reduced demand for Treasury securities by changing risk perceptions of investors.

One might argue, however, that large traders might have learned of the payment delays well before the first newspaper report, perhaps through banks that held accounts of affected small investors. Traders wishing to benefit from that information would have needed to short Treasury bills to profit. In a short sale, a trader borrows a security and promises to return it at a future date along with a borrowing cost adjustment. A short seller profits if the security's price falls. In general, short sellers aim to persuade others that an asset's underlying value has decreased. Short sellers often propagate that information aggressively once a short position is established. The lag of nearly two weeks between the first payment delay and the first report of it suggests that few or no such short sellers actively traded on information of those delays.

Federal Reserve Took Steps to Tighten Credit

The absence of discernable market reactions to news of Treasury payment delays suggests other factors might explain a spike in Treasury yields in late April 1979. The same day that delayed Treasury payments were first due, monetary policy developments signaled a turn toward credit tightening. As noted above, the Federal Reserve was in the midst of a major policy shift in its willingness to use monetary policy to restrain inflation.¹⁰³

⁹⁹ Paul Romer, "The Trouble With Macroeconomics," NYU/Stern School working paper, September 14, 2016, pp.1-3; https://www.law.yale.edu/system/files/area/workshop/leo/leo16_romer.pdf.

¹⁰⁰ President Jimmy Carter, "Federal Reserve System Nomination of Paul A. Volcker to be Chairman of the Board of Governors," July 25, 1979; <http://www.presidency.ucsb.edu/ws/?pid=32648> (American Presidency Project).

¹⁰¹ U.S. Treasury, press release, May 8, 1979.

¹⁰² Edward P. Foldessy, "Treasury Hits Delays in Mailing Checks to the Holders of its Maturing Securities," *Wall Street Journal*, May 9, 1979, p. 8.

¹⁰³ *Ibid.*

In the week before the first payment delays, market watchers thought the Federal Reserve was unlikely to tighten credit.¹⁰⁴ On April 26, 1979—the maturity date for the first Treasury bills affected by payment delays—a consumer price index estimate was released that indicated inflation was proceeding at a 13% annual rate. A few hours later, the Federal Reserve announced a large, unexpected increase in the U.S. money supply.¹⁰⁵ Financial markets reacted within minutes to that announcement, which signaled new expectations that the Federal Reserve would act to restrict credit.¹⁰⁶

In addition, that same day the WSJ noted a Federal Reserve research paper that argued that aggregate money measures should be redefined to include near-money substitutes, such as money market funds, which were expanding exponentially at the time, and repurchase (repo) agreements that large corporations had begun to use.¹⁰⁷ The expansion of near-money substitutes, the paper argued, was matched by slower than expected growth in traditionally defined monetary aggregates, which could lead to an underestimation of the expansion of the money supply. A broadening of those definitions might be expected to affect Federal Reserve policy statements, which were phrased in terms of those monetary aggregates.¹⁰⁸

On the following day (April 27, 1979), the Federal Reserve, according to market observers, took steps to tighten credit, which was generally taken as a signal that it would raise benchmark interest rates.¹⁰⁹

Market concerns about inflation, credit conditions, news of a rapid expansion of the money supply, and Federal Reserve actions provide a straightforward explanation for those Treasury yield movements in late April 1979. That payment delays experienced by small investors increased federal borrowing costs by changing perceptions of the riskiness of Treasury securities appears to be an implausible explanation of those movements.¹¹⁰

Federal Payment Delays Not Uncommon in Late 1970s

Paying federal obligations on time makes the U.S. government a more attractive business counterparty. The U.S. Treasury and other agencies have therefore sought over time to improve the timeliness of federal payments. Despite those improvements, some payment delays still occur, and were more common during the 1970s when the federal government was transitioning payment to electronic systems.

¹⁰⁴ “Money-Market Actions Bolster Belief Fed Isn’t Putting Further Squeeze on Credit,” *Wall Street Journal*, April 19, 1979. Lawrence Kudlow, who became an Office of Management and Budget official in the Reagan Administration, was quoted as stating that “there isn’t any evidence” that the Federal Reserve has decided to tighten credit.

¹⁰⁵ David Lascelles, “Testing Time for the Fed Brakes,” *Financial Times*, April 30, 1979; p. 34.

¹⁰⁶ “Big Boost in Money Supply May Put Fed Under Heavy Pressure to Tighten Credit,” *Wall Street Journal*, April 27, 1979, p. 32.

¹⁰⁷ Ibid. See John Wenninger and Charles Sivesind, “Defining Money for a Changing Financial System,” Federal Reserve Bank of New York, *Economic Policy Review*, Spring 1979; https://fraser.stlouisfed.org/scribd/?toc_id=352745&filepath=/docs/publications/frbnyreview/rev_frbny_1979_v04n01.pdf. Chart 2 of that paper indicates that money market fund shares totaled less than \$4 billion from 1975 to 1977 and rose to almost \$18 billion in early 1979.

¹⁰⁸ David E. Lindsey, Athanasios Orphanides, and Robert H. Rasche, “The Reform of October 1979: How It Happened and Why,” Federal Reserve Board working paper 2005-2, December 2004, p. 6.

¹⁰⁹ Edward Foldessy and Richard Levine, “Big Upward Push on Interest Rates is Expected as Fed Tightens Credit,” *Wall Street Journal*, April 30, 1979, p. 3.

¹¹⁰ Ibid.

The delays in Treasury interest and maturity payments in 1979 were unusual. Delays in federal payments for other types of obligations, however, were common during that time. In the late 1970s, federal benefits provided via direct deposit, such as Social Security payments, were often late, or early, misposted, or not issued.¹¹¹ A 1978 GAO¹¹² report that analyzed a sample of contractor bills found that only 61% of the number of bills and 81% of the dollar amounts owed were paid within 30 days. For bills not paid within 30 days, the time between invoice and payment averaged 74 days.¹¹³ Congress responded to those findings by passing the Prompt Payment Act of 1982 (P.L. 97-177), which generally requires agencies to pay bills on time or pay interest on delayed payments.¹¹⁴ A 1986 GAO follow-up study found that timeliness of agency payments was better, but could be improved.¹¹⁵

Causes of payment delays were diverse. The 1978 GAO report attributed most delays to lags in acknowledging delivery of goods, acquiring necessary paperwork, and failure of agencies to adopt procedures that would minimize paperwork.¹¹⁶ The 1979 Treasury bill redemption payment delays, as noted above, appeared to stem from the confluence of specific historical trends and unforeseen operational challenges, but were not the only payment delays in those years. For instance, the U.S. Treasury reportedly delayed some tax refunds in 1980 as part of a cash management strategy.¹¹⁷

Assessing the U.S. Government’s Payment Record

The historical record appears not to support the contention that the U.S. government has had an unblemished payment record since its origin. Under any reasonable definition of default, the federal government defaulted in 1814. The Treasury Secretary of the time, Alexander Dallas, referred to “every sort of embarrassment.” The current website of the U.S. Treasury notes that Secretary Dallas faced a “bankrupt” Treasury.¹¹⁸ The failure of the Treasury to pay interest on its securities due to Boston banks in 1814 represents an unambiguous default event.

Whether the suspension of the gold standard in 1933-1934 amounted to a default is controversial. Bondholders were repaid, albeit on terms other than those specified in their contracts. Breaking the linkage between gold and the dollar enabled the federal government to implement a more modern monetary policy that helped promote economic recovery. That linkage, however, could

¹¹¹ Mark Leymaster, “Electronic Banking and the Poor: Not Enough Concern—Part II: Direct-Deposit of Government Benefits,” *Clearinghouse Review*, vol. 15 (1981-1982), pp. 111-126.

¹¹² At the time, GAO was the General Accounting Office. It has since been renamed the Government Accountability Office.

¹¹³ GAO, *The Federal Government’s Bill Payment Performance is Good, But Should be Better*, FGMSD-78-16; B-160725, February 24, 1978; <http://www.gao.gov/assets/130/121549.pdf>.

¹¹⁴ For details, see U.S. Department of the Treasury, Bureau of the Fiscal Service, “Prompt Payment,” website, https://www.fiscal.treasury.gov/fservices/gov/pmt/promptPayment/promptPayment_home.htm. Other measures have been enacted to address more specific payment issues, such as for claims submitted by Medicare providers.

¹¹⁵ GAO, *Prompt Payment Act: Agencies Have Not Fully Achieved Available Benefits*, AFMD-86-69, August 28, 1986; <http://www.gao.gov/products/AFMD-86-69>.

¹¹⁶ GAO, *The Federal Government’s Bill Payment Performance is Good, But Should be Better*, FGMSD-78-16; B-160725, February 24, 1978, p. ii.

¹¹⁷ “U.S. Delays Tax Refunds So Checks Won’t Bounce,” *Los Angeles Times*, April 11, 1980, p. A1.

¹¹⁸ U.S. Treasury, “Alexander J. Dallas (1814 - 1816),” webpage, updated December 1, 2010; <http://www.treasury.gov/about/history/pages/adallas.aspx>.

also have been severed in a way that could have mitigated losses of owners of bonds that contained gold clauses.¹¹⁹

Claims that payment delays to small investors holding Treasury securities in the spring of 1979 constituted a default or a “technical default” appear weaker. Delays affected only a relatively small proportion of Treasury securities and the federal government responded to mitigate the inconvenience suffered by those investors. The legal document setting out terms for Treasury securities contained no default clause. Claims that such payment delays increased federal borrowing costs appear weak, if not implausible, in the face of stronger explanations reflecting shifts in monetary conditions and policy.

Delays to holders of Treasury securities might also be put in context of delays to other federal payees. Federal statutes provide no clear basis for prioritizing payment of one obligation over another.¹²⁰ In an organization as complex as the federal government, delays in meeting some financial obligations may be inevitable, and bondholders affected by the so-called 1979 mini-default represent a small fraction of those affected by federal payment delays.

Was the Government’s Ability to Borrow Affected?

Analysis of available evidence suggests that the federal government’s ability to borrow did not suffer lasting damage from any of the events discussed in this report. After the War of 1812 concluded, belated collections from internal revenue measures came into the Treasury and the resumption of international trade and higher tariff rates led to a rebound in customs revenues. Federal revenues in the following decades were strong enough to retire the federal debt in 1835.¹²¹ Recent research, discussed above, indicates that the U.S. Treasury faced little or no observable difficulty in borrowing after the 1933-1934 suspension of the gold standard.¹²² In 1979, as noted above, a major shift in monetary policy and conditions can explain changes in market yields on Treasury securities. Financial markets exhibited no discernable reaction to newspaper reports of the Treasury payments delays to some small investors. The U.S. experience accords with broader research on sovereign default. Countries that defaulted in the 19th century or 1930s, but not since, have suffered no credit market consequences.¹²³

That the U.S. Treasury’s ability to borrow on reasonable terms was not hindered by events in the 19th century or 1930s does not suggest that the consequences of a Treasury default in the present day would be minor. The market for U.S. Treasuries is broad, meaning that large numbers of

¹¹⁹ The United States did indemnify the Philippine government by paying \$23.9 million to offset the losses related to the suspension of the gold standard. See *Perry v. United States* (294 U.S. 378). The United States also reached a settlement with the government of Panama, which had been promised an annuity payable in gold related to construction of the Panama Canal. See Carmen M. Reinhart and Kenneth S. Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (Princeton, 2009), p. 113.

¹²⁰ See Office of Management and Budget, “Memorandum: Background Material on Prior Debt Ceiling Crises,” August 2, 1995; http://www.clintonlibrary.gov/_previous/KAGAN%20COUNSEL/Counsel%20-%20Box%20006%20-%20Folder%20011.pdf. For a discussion of these issues, see CRS Report R41633, *Reaching the Debt Limit: Background and Potential Effects on Government Operations*, by (name redacted) et al.

¹²¹ Studenski and Krooss, pp. 99-100. To be more precise, the entire interest-bearing federal debt was retired. The increases in tariffs, according to historians, were motivated as much by the desire to protect local industry as to raise revenues.

¹²² Sebastian Edwards, Francis A. Longstaff, and Alvaro Garcia Marin, “The U.S. Debt Restructuring of 1933: Consequences and Lessons,” NBER working paper 21694, November 2015; <http://www.nber.org/papers/w21694>.

¹²³ Eduardo Borensztein and Ugo Panizza, “The Costs of Sovereign Default,” IMF Staff Paper 08/238, October 2008; <http://www.imf.org/external/pubs/ft/wp/2008/wp08238.pdf>.

buyers and sellers trade in them, and liquid, meaning that traders believe they could engage in large transaction in Treasuries without significant price effects. Treasuries often serve as collateral, enabling financial firms to borrow or lend at low cost, which promotes the efficient supply of credit. Concerns about the quality of collateral assets can cause serious problems in credit markets.¹²⁴ Market participants have stated that systematic payment delays by the U.S. Treasury could have serious economic consequences.¹²⁵

What Lessons Can Be Learned?

In each historical episode examined here, the federal government was confronted with financial and operational challenges that it was poorly prepared to meet. The neglect of operational capacities appears to have played a key role. More recently, the federal government has paid more attention to contingencies that could affect its financial operations. For instance, the U.S. Treasury recently changed its cash management policies to keep a larger cash cushion to ensure continuity of operations in the face of catastrophic events.¹²⁶

On the other hand, expressions of fiscal constraint, such as promises to balance federal budgets, were not sufficient to prepare the federal government to address fiscal emergencies. In the years preceding each episode, policymakers had expressed a strong commitment to budgetary and fiscal discipline. Treasury Secretary Gallatin had reduced federal debts in the decade preceding the War of 1812, and President Herbert Hoover attempted to maintain a balanced budget in the early years of the Great Depression.¹²⁷ Less than four weeks before the first Treasury payment delay in April 1979, Congress stated it “shall balance the Federal budget” and directed the Budget Committees to submit budget plans for the next three fiscal years that would be in balance.¹²⁸

The failure to establish or maintain key operational capabilities, however, presented the government with obstacles that could not be overcome in short order. The lack of a fiscal agent or the administrative capacity to administer internal revenues undermined the U.S. Treasury’s ability to meet federal obligations during the War of 1812. On a smaller scale, the U.S. Treasury in 1979 found itself unable to cope with the strains of overhauling financial processing systems and procedures while relocating some of its fiscal operations, in the face of unprecedented increases in small investor demands for Treasury securities.

President Franklin Roosevelt, when he took office in March 1933, by way of contrast, was aided by proposals drafted by officials from the Hoover Administration. Furthermore, the Reconstruction Finance Corporation, which the Hoover Administration had created, provided the federal government with a powerful vehicle for economic policy.

¹²⁴ Gary Gorton and Andrew Metrick, “Securitized Banking and the Run on Repo,” *Journal of Financial Economics* vol. 104, 2012, pp. 425–451.

¹²⁵ Matthew Zames, Chairman, Treasury Borrowing Advisory Committee and managing director at JP Morgan, letter to Treasury Secretary Geithner, April 25, 2011; <http://www.sifma.org/workarea/downloadasset.aspx?id=25013>.

¹²⁶ U.S. Treasury, “Quarterly Refunding Statement of Acting Assistant Secretary for Financial Markets Seth B. Carpenter,” press release, May 6, 2015; <https://www.treasury.gov/press-center/press-releases/Pages/jl10045.aspx>. See also Jeffrey Lacker, “Payment System Disruptions and the Federal Reserve Following September 11, 2001,” Federal Reserve Bank of Richmond working paper 03-16, December 23, 2003; https://www.richmondfed.org/-/media/richmondfedorg/publications/research/working_papers/2003/pdf/wp03-16.pdf.

¹²⁷ See President Herbert Hoover, “Statement on Efforts to Balance the Budget,” March 8, 1932; <http://www.presidency.ucsb.edu/ws/?pid=23478>. See also Studenski and Krooss, pp. 70-72.

¹²⁸ Those provisions in the Temporary Increase in the Public Debt Limit (P.L. 96-5) were repealed in September 1982 (P.L. 97-258). See archived CRS Report, *A Balanced Federal Budget: Major Statutory Provisions*, by (name redacted) and Edward Davis, at p. 4.

The reluctance to set aside adequate fiscal resources to respond to emergency conditions may also have played a role. Congress, in the view of historians, was slow to make military or fiscal preparations ahead of declaring war in 1812. In more modern terms, macroeconomists have stressed the importance of “fiscal space,” that is, having a sound fiscal situation that enables a government to respond energetically to serious economic downturns.¹²⁹

Even if the payment history of the U.S. government is not completely unblemished, it does compare favorably to nearly all other advanced countries. Acknowledging past episodes when the U.S. Treasury’s ability to meet obligations was strained would underline the benefits of maintaining a strong fiscal and credit reputation.

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¹²⁹ David Romer, “What Have We Learned About Fiscal Policy from the Crisis,” in *In the Wake of the Crisis: Leading Economists Reassess Economic Policy* (Cambridge, Mass.: MIT Press, 2012), Olivier J. Blanchard et al. editors.

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