

Early US Struggles with Fiscal Federalism: Lessons for Europe?

Richard Sylla

NYU Stern School of Business

Dubrovnik Economic Conference

June 2013

Robert Morris, 1734-1806, and Alexander Hamilton, 1757-1804



How to achieve a more perfect union?

- Robert Morris, as the US Congress's Superintendent of Finance from 1781 to 1784, tried and failed.
- Alexander Hamilton, as the first Secretary of the Treasury under the Constitution from 1789 to 1795, succeeded.
- Why was one a failure and the other a success?
- Are there lessons for Europe now?

Morris's plan

- Dire circumstances of US at the time of his appointment. His plan, in sequence, was to:
- 1) Found a [central] bank, the Bank of North America (BNA).
- 2) Supplement BNA loans to pay government bills and bank note issues with Morris notes backed by his personal credit as America's leading merchant.
- 3) Fund US debts by means of a national tax on imports, which he assumed Congress would enact...but which it failed to enact.

Morris's outcome

- The BNA opened in January 1782 and was of substantial aid to Morris; with peace it became an ordinary bank, the first in the US.
- Morris notes did aid government finance, but were an imperfect currency subject to discounts and in inconvenient denominations.
- The tax on imports was not enacted, so the US had to default on its debts.
- Morris resigned in disgust in 1784.

Morris's limited but important successes

- He founded the first US bank, the BNA.
- He established currencies, BNA notes and Morris notes, that were more stable than the fiat currencies of states and Congress.
- He established the principle that the debts of the union were obligations of Congress, not the states.
- He converted union debts to specie values and launched a settlement of state accounts that would apportion those debts to each state on the basis of population, with creditor and debtor states to receive or make payments of their credit and debit balances.

Hamilton's plan: what he could do directly as finance minister

- Use federal tax revenues to “fund” an enlarged **national debt that included the assumption of state debts**. Done in 1790.
- Founded a **CENTRAL BANK**, the Bank of the United States (BUS). Done in 1791.
- Defined the **US DOLLAR** in terms of gold and silver, and make this the unit of account and monetary base into which liabilities of banks would be convertible. Done in 1792.
- Result was a **US DOLLAR CURRENCY UNION**.

What Hamilton's execution of his plan co-opted others to do

- His debt plan created lots of securities, US bonds (6s, Deferred 6s, 3s) and his BUS plan created lots of equity shares; these led to active, liquid SECURITIES MARKETS
- His BUS was a very large corporation owned in part by the US government, which he said would profit from its investment in shares.
- The BUS example goaded states into chartering more BANKS (creating a BANKING SYSTEM), and into chartering lots of other corporations, financial (insurance companies) and non-financial.
- In short, Hamilton changed the US forever by his deft execution of a revolutionary financial plan. It achieved his goals of a strong central government and a financial system that would promote economic growth.

US Financial System, 1788 and 1795

	<u>1788</u>	<u>1795</u>
PUBLIC FINANCES, National	Bankrupt	Thriving
MONEY	Fiat state paper, foreign coins	Convertible US \$
BANKS	3, no system	20 state, 5 BUS branches, system
CENTRAL BANK	No	Yes, with 5 branches
SECURITIES MKTS	Trivial, sporadic	Several cities, organized
CORPORATIONS	Few	Many more

Public Finance and Debt Management

- Establishing Public Credit—Hamilton's January 1790 Report to Congress
 - Fund all debts at par value, but at reduced interest rate**
 - No discrimination between 'original' and 'present' owners
 - Assume state debts**
 - Commence interest on US debts in 1791, and assumed state debts in 1792

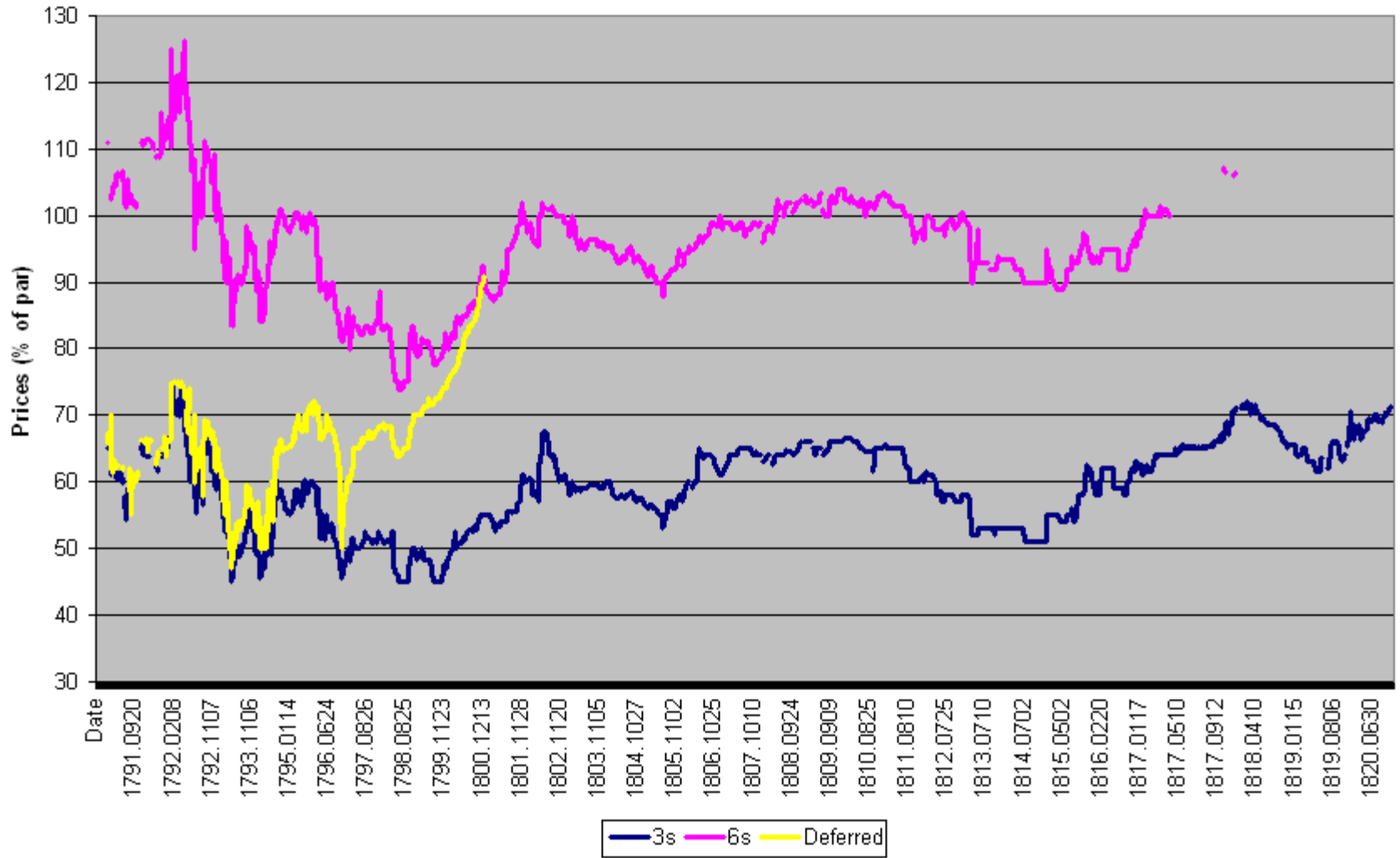
Problem: Government revenues far from adequate to deliver on the promises

Solution: Using deft financial management, borrow from domestic banks and foreign lenders to meet obligations until tax revenues become adequate

Foreign Loans of the US Government, 1777-1803

Source	Amount in \$	Issue Year(s)	Redemption Year(s)
France, Farmers General	181,500	1777	1778-79, mostly 1793
France	3,267,000	1778-1782	1791-1795
Spain	174,017	1781-1782	1792-1793
France	1,815,000	1781-1782	1792-1795
France	1,089,000	1783	1795
Holland, 1782	2,000,000	1782-1786	1793-1797
Holland, 1784	800,000	1784	1801-1807
Holland, 1787	400,000	1787-1788	1798-1802
Holland, 1788	400,000	1789	1799-1803
Holland, 1790	1,200,000	1790-1791	1800-1804
Holland, Mar. 1791	1,000,000	1791	1802-1805
Holland, Sept. 1791	2,400,000	1791	1802-1805
Antwerp, 1791	820,000	1791-1792	1803-1805
Holland, Dec. 1791	1,200,000	1791-1792	1803-1807
Holland, 1792	1,180,000	1792-1793	1803-1807
Holland, 1793	400,000	1793	1803
Holland, 1794	1,200,000	1794	1805-1809
Louisiana 6%	11,250,000	1804	1812-1824

U.S. Debt Prices, New York, 1790-1820



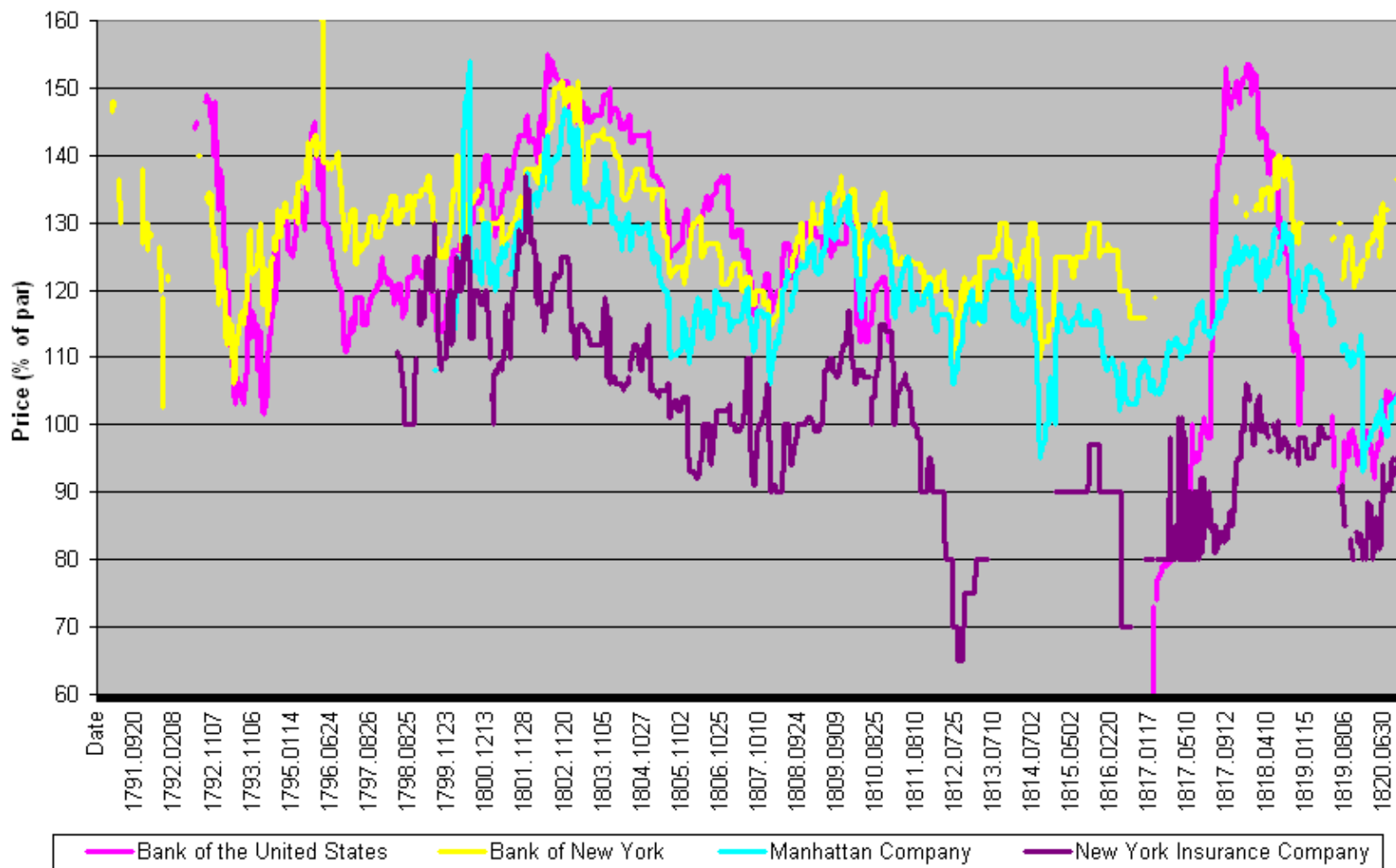
Report on the Bank, December 1790

- Hamilton's plan for the Bank of the United States (1)
 - Limited liability corporation, privately managed, with capital of \$10 million divided into 25,000 transferable shares with par value of \$400 each
 - US government to take 5,000 shares (20%), paying for them with a loan from the Bank, to be repaid in installments over ten years
 - Private investors offered 80% of shares, one-fourth payable in specie and three-fourths payable in the new US 6% bonds issued as part of the plan to restore public credit**

Report on the Bank

- Hamilton's plan for the Bank of the United States (2)
 - BUS to have 25 directors, one to be president
 - 'Prudent mean' voting rights—no shareholder to have more than 30 votes, regardless of no. of shares owned
 - BUS bills and notes receivable in all payments to US
 - Branch offices of 'discount and deposit' can be established throughout the US, i.e., union-wide banking**
 - BUS to report to Secretary of Treasury as often as weekly, and Secretary has right to inspect BUS books

Selected Equities Prices, New York, 1790-1820



Securities Markets: City Listings in 1811

<i>New York</i>	<i>Boston</i>	<i>Philadelphia</i>	<i>Baltimore</i>	<i>Charleston (1803)</i>
U.S. Six Percents	U.S. Six percents	U.S. Six percents	U.S. Six percents	U.S. Sixes
U.S. Three Percents	U.S. Three percents	U.S. Three percents	U.S. Three percents	U.S. Threes
Bank of United States	Bank of United States	Louisiana Six percents	Louisiana Six percents	U.S. Eights
Bank of New York	Massachusetts Bank	Bank of United States	Bank of United States	U.S. Navy Sixes
Manhattan Co. Bank	Union Bank	Bank of Pennsylvania	Maryland Bank	U.S. 5 1/2s
Merchants Bank	Boston Bank bond	Bank of North Amer.	Baltimore Bank	Bank of United States
Union Bank	Boston Marine Ins.	Bank of Philadelphia	Union Bk of Balt.	S.C. Bank
Mechanics Bank	Fire and Marine Ins.	Farmers & Mech'cs B.	Mechanics Bank	State Bank
New York Insurance	State Notes	Ins. Co. of Pennsyl'a	Farmers Bank	S.C. 6s
Columbian Insurance		Ins. Co. of N. Amer.	Columbia Bank	S.C. 3s
United Insurance		Union Insurance	Potowmac Bank	S.C. deferreds
Marine Insurance		Phoenix Insurance	Farmers & Mech'cs Bk	S.C. Ins. Co. (1804)
Commercial Insurance		Delaware Insurance	Comm'l & Farmers Bk	Union Ins. Co. (1809)
Phoenix Insurance		Marine Insurance	Franklin Bank	Union Bank (1810)
Eagle Insurance		U.S. Insurance	Marine Bank	Fire Ins. Co. (1810)
Mutual Insurance		Lancaster & Susq'a Ins	Baltimore Ins. Co.	
Ocean Insurance		American Fire Ins.	Maryland Ins. Co.	
NY Firemen Insurance		Schuylkill Bridge Co.	Chesapeake Ins. Co.	
		Delaware Bridge Co.	Union Ins. Co.	
		Lancaster Tpk. Co.	Fire Insurance Co.	
		Germantown Tpk. Co.	Reistertown Road Co.	
		Cheltenham & Willow	Fredericktown Co.	
		Springs Tpk. Co	York Co.	
		Chestnut Hill &	Falls Co.	
		Springhouse Tav'n Co.	Union Mfg Co.	
		Frankford Tpk. Col	Water Stock	
		Water Loan		
		City Loan		
		Masonic Loan		

Hamilton's Report on the Mint, January 1791

- **Hamilton defines a new US dollar as the monetary base:** 'the unit in the coins of the United States ought to correspond with 24 Grains and $\frac{3}{4}$ of a Grain of pure Gold and with 271. Grains and $\frac{1}{4}$ of a Grain of pure silver, each answering to a dollar in the money of account.'
- Recommends various coins be minted, including ten dollar gold coins, one dollar silver and gold coins, 'disme or tenth' dollar coins, and a copper 'Cent or Hundreth' of a dollar.
- Congress enacts the plan a year later, but US Mint develops slowly, so foreign coins with dollar ratings are used for decades.
- **A US dollar currency union among American states is established in the 1790s, two centuries before the euro. Monetary unification.**
- Banks money—notes and deposits—are convertible into dollar base. US banking system expands rapidly after 1790.

Foreign Investment and Capital Flows to the US Emerging Market

- One of Hamilton's main reasons for establishing a modern financial system in the US is that it would attract foreign investment and capital flows
- The new financial system did exactly that
- The US economy and financial system have continued to attract foreign investment and capital flows, with some fits and starts, for more than two centuries

**U. S. Debt and other Stocks, by Type and Origin Held by
Domestic and Foreign Investors, 1803/04, in Millions of Dollars**

Security Type	Domestic	Foreign	Total
Sixes	\$16.572	\$11.662	\$28.236
Threes	7.843	11.230	19.072
Deferreds	6.991	6.657	13.648
Eights	5.239	1.228	6.467
Five and One-Half	.577	1.271	1.847
Four and One-Half	.125	.050	.176
Navy 6's	.687	.022	.709
Louisiana 6's	-	11.250	11.250
Total U. S. Debt	38.035	43.369	81.405
Bank of U. S.	3.800	6.200	10.000
State Banks	7.120	9.000	16.120
Insurance Cos.	10.500	.500	11.000
Turnpike, Canal	3.220	.180	3.400
Grand Total	62.675	59.249	121.925

Foreign Holdings of U.S. Debt and other Stocks, by Type and Origin: 1803/04, in
Millions of Dollars

Security Type	English	Dutch	Other	Total
Sixes	\$3.448	\$7.286	\$.928	\$11.662
Threes	6.663	3.902	.664	11.230
Deferreds	4.207	1.904	.546	6.657
Eights	.787	.136	.304	1.228
Five and One-Half	.728	.446	.097	1.271
Four and One-Half	.042	.009	-	.050
Navy 6's	.008	.011	.002	.022
Louisiana 6's	9.250	1.500	.500	11.250
Total U.S. Debt	25.133	15.194	3.042	43.369
Bank of U.S.	4.000	2.000	.200	6.200
State Banks	5.000	3.000	1.000	9.000
Insurance Cos	.500	-	-	.500
Turnpike, Canal	.100	.080	-	.180
Grand Total	34.733	20.274	4.242	59.249

Hamilton in *Continentalist* No. 6

July 4, 1782

- There is something noble and magnificent in the perspective of a great Federal Republic, closely linked in the pursuit of a common interest, tranquil and prosperous at home, respectable abroad; but there is something ... diminutive and contemptible in the prospect of a number of petty states, with the appearance only of union, jarring, jealous and perverse, without any determined direction, fluctuating and unhappy at home, weak and insignificant by their dissensions, in the eyes of other nations. Happy America! if those, to whom thou hast intrusted the guardianship of thy infancy, know how to provide for thy future repose; but miserable and undone, if their negligence or ignorance permits the spirit of discord to erect her banners on the ruins of thy tranquility.