

Sovereign Debt Threatens the Union: The Genesis of a Federation

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Eurozone sovereign debt crisis – Europe’s ‘Alexander Hamilton moment’ – American sovereign debt crisis of 1780s – Articles of Confederation – US Constitution – Assumption of states’ debt – Constitutional transformation key factor in enabling Alexander Hamilton’s debt restructuring

INTRODUCTION

James Carville, a political consultant who strategized Bill Clinton’s first election to the White House in 1992, once quipped that if he were to reincarnate, he would come back as the bond market.¹ His motivation was simple: ‘You can intimidate everyone’. And so it is: the bond market currently intimidates the governments of many Euro zone member states. In 2011, the Greek and Italian governments’ leaders were replaced by unelected prime ministers and early elections changed governments in Portugal and Spain, all under pressure of rising interest rates on sovereign debt.² ‘Europe,’ said Paul Volcker, the former Chairman of the Federal Reserve Bank, ‘has arrived at an Alexander Hamilton moment’. Referring to America’s first Secretary of the Treasury who successfully restructured America’s crippling sovereign debt in the 1790s by ‘federalizing’ the states’ debts, Volcker quickly added that he did not ‘see an Alexander Hamilton in sight’. The real significance of Volcker’s statements, however, is not for a lack of a European Alexander Hamilton. It is because in contemporary discussions in which Hamilton’s debt

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¹ Carville also coined the 1992 Clinton/Gore campaign slogan ‘It’s the economy, stupid!’

² In Belgium, the opposite occurred when rising yields on its government’s bonds ended 18 months of political stalemate over the formation of a governing coalition and put Elio Di Rupo into the prime minister’s office.

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assumption plan is presented as an example for the issuance of Eurobonds,³ one crucial aspect is often overlooked or underexposed: the constitutional transformation of the United States of America that occurred immediately prior to it. It was that transformation that provided Hamilton with the governmental tools to gain the bond market's trust and confidence in the American Union's survival and America's ability to honour its financial commitments.⁴ And 'trust,' according to a saying which Herman Van Rompuy, the European Council's President, has used to describe the Euro crisis, 'arrives on foot and leaves by horse'.⁵

This article rectifies this underexposure by focusing attention on the role of excessive sovereign debt and its societal consequences in the transformation of the young American Union from a loose confederation into a federal arrangement with a strong central authority able – at Hamilton's initiative – to effectively confront the bond market. It proceeds as follows. First, this article concisely describes the circumstances of the early American debt crisis. Second, it continues to analyse the perceived shortcomings of the Articles of Confederation and the drive for constitutional change. Third, it discusses, briefly, the measures that Alexander Hamilton presented to Congress to restore 'America's credit'. And lastly, this article will place Volcker's call for an 'Alexander Hamilton moment' in a broader perspective of historical constitutional development in which excessive debt and the bond market's pressures played a large role in changing a government's constitutional structure.

CRISIS

The reason for the American Union and the several states to get deep into debt is well known: a lengthy war of independence had to be financed. The debts were, in the words that Alexander Hamilton would use later, the price of liberty. During

³ It has repeatedly been suggested, in analogy to Hamilton's debt restructuring, that the Euro zone countries establish so-called 'Eurobonds', and 'mutualize' part of their sovereign debt (say 60% of GDP) by issuing new bonds supported by the creditworthiness of the Euro zone as a whole, thereby reducing interest rates on bonds issued by, for example, Spain and Italy. Undoubtedly to be continued.

⁴ Ultimately, the bond market's power is all about trust and confidence that you, as an (indirect) investor in a government's financing needs, will be repaid. And we all have an interest in getting repaid on European sovereign debt. A considerable share of bonds issued by European governments is held by European pension funds, banks, insurance companies, and, through a wide variety of other financial products, European retail investors. In other words, by *Europeans*.

⁵ The current 'crisis' in Europe began in the summer of 2007 and has evolved from a financial crisis with American 'sub-prime' origins to a banking crisis, which mutated into a sovereign debt crisis, and which is now developing into what can be appropriately characterized as a crisis of confidence.

the war of independence the states were reluctant to tax their citizens. It was, after all, a revolt against unjust British taxes, summarized best with the slogan 'No taxation without representation'. And the Continental Congress, serving as the American Union's central authority as established under the Articles of Confederation of 1777 (which were ratified by all thirteen states only in 1781), lacked the power to tax and depended on contributions from the states for its expenditures. Consequently, the states and the Continental Congress financed the war deficits by printing money (which led to skyrocketing inflation) and by raising funds in Europe, initially with loans from the French government under King Louis XVI.⁶ Additionally, the Continental Congress and the states issued promissory notes to suppliers and many of the soldiers who served in the Continental Army (among them a large contingent of French volunteers). Most of these bonds remained unpaid at the war's end, and many veterans resorted, either in need of cash or convinced they would never be paid, to selling those bonds to speculators at bottom prices – often as low as fifteen cents on the dollar,⁷ taking a 'haircut,' in modern terminology, of 85%.

At the end of hostilities in 1783, the American Union, the states and many individuals were left with a crippling amount of debt. John Adams, a future President of the United States but then Ambassador in The Hague, recognized the immediate danger of being predominantly indebted to one nation, France. Upon the United Provinces of the Netherlands' formal recognition of the young confederation, he negotiated various loans with the Amsterdam financial community to repay half of what was owed to France, thereby placing the 'credit' of the United States 'as much in Dutch hands as in those of its original benefactor'.⁸ Nevertheless, Adams was uncomfortable knowing that 'Dutch speculators already had other exploitative interests in the American economy, and that if they were able to buy up' America's 'domestic debt, they could control the direction of America's economic future'.⁹

All heavily burdened with debts owed to European nations and bankers who did not shy away from pitting one state against another, it was no surprise that the thirteen newly independent states suffered from disunion. And money issues seemed to permeate many of the other problems under the Articles of Confederation as the confederal government and the 'state governments found it impos-

⁶ Lawrence Kaplan, *Thomas Jefferson: Westward the Course of Empire* (Scholarly Resources 1999) p. 13-16. The French government began assisting the American revolutionaries in late 1775, secretly providing funds and military supplies. France formalized its alliance with the American revolutionaries when it entered into the Treaty of Alliance with the United States on 6 Feb. 1778.

⁷ Ron Chernow, *Alexander Hamilton* (Penguin Press 2004) p. 297-298.

⁸ Kaplan, *supra* n. 6, at p. 45.

⁹ Kaplan, *supra* n. 6, at p. 46.

sible to retire the gargantuan debt they inherited from the Revolution'.¹⁰ By the end of the 1780s, the Union's debt had grown to 54 million dollars and the states owed well over 25 million dollars. On the securities exchanges of Europe – where American bonds were traded – investors expressed their low confidence in the American Union's survival by trading its bonds at a fraction of face value.¹¹ Servicing the debt had become the largest government expense, as almost two-thirds of direct tax revenue in nearly every state was allocated to creditors.¹² Measures proposed by the Continental Congress to stop the Union's finances from further deteriorating – such as a 5% import tax – were defeated (most notably in Virginia and New York) with popular arguments about sovereignty and states' rights.¹³ The shifting of loans from French public hands into Dutch private hands, therefore, had not solved America's debt issues. It merely bought time. But time was running out. In 1786 and 1787, the Continental Congress could not raise the necessary funds to pay interest on outstanding loans from France.¹⁴

This situation further depressed a damaged post-war economy and resulted in various degrees of social and political instability. During the 1780s, a general sense of crisis pervaded America.¹⁵ In his Harvard College commencement address of June 1787, John Quincy Adams (son of John Adams and also a future President) termed the era 'this critical period,' when the United States of America were 'groaning under the intolerable burden of ... accumulated evils'.¹⁶ Indeed, for many Americans, 'the course of the Revolution had arrived at a crucial juncture', possibly leading toward 'a crisis of the most delicate nature'.¹⁷

Tolerance of this state of affairs seems to have reached its limits during the summer of 1786 with the farmers' rebellion in western Massachusetts. Shays' Rebellion, named after its leader Daniel Shays (a former Continental Army captain), brought to the fore the economic strains under which the American Union, the states and their citizens were labouring and the inability of the states' govern-

¹⁰ Chernow, *supra* n. 7, p. 224.

¹¹ Chernow, *supra* n. 7.

¹² Woody Holton, *Unruly Americans and the Origins of the Constitution* (Hill and Wang 2007) p. 32.

¹³ Calvin H. Johnson, 'Homage to Clio: The Historical Continuity from the Articles of Confederation into the Constitution', 20 *Const. Comment* (2003-2004) p. 463 at p. 466-470. Virginia considered any tax originating from the Continental Congress inconsistent with Virginia's sovereignty. In New York it was argued that the power to tax traffic in New York harbour was a privilege 'Providence hath endowed' New York with.

¹⁴ Kaplan, *supra* n. 6, p. 46.

¹⁵ Leading to land values in certain regions depreciating by two-thirds during the 1780s. See Holton, *supra* n. 12, p. 31.

¹⁶ Gordon S. Wood, *The Creation of the American Republic, 1776-1787* (W.W. Norton & Company 1969) p. 393.

¹⁷ Wood, *supra* n. 16, p. 393-394.

ments and the Continental Congress to do much about it. In particular, the ‘Massachusetts uprising shocked many who wondered just how far the rebels would go’.¹⁸ During the Rebellion, nearly 2,000 indebted farmers protested unendurable tax burdens passed by the Massachusetts legislature to pay for the state’s war debts and physically closed the courts to prevent – through violent means – the execution of mortgage foreclosures and other judgments for debt.¹⁹ While Shays’ and his compatriots’ violent activities were struck down by the state militia, their cause was victorious on Election Day in 1787, and the newly elected representatives in the Massachusetts legislature soon passed debtor relief legislation that further added to legal uncertainty and, consequently, economic unpredictability. Alexander Hamilton, writing at the end of 1787 as Publius in *Federalist No. 6*, echoed the turbulence of the times and argued that if ‘Shays had not been a *desperate debtor*, it is much to be doubted whether Massachusetts would have plunged into a civil war’.²⁰ While civil war surely was an exaggeration (after all, the *Federalist Papers* were pamphlets published in New York newspapers arguing in favour of ratification of the United States Constitution), it was felt that the American Union was losing control over its destiny,²¹ leading some to the conclusion that the ‘fate of America was suspended by a hair’.²² The United States under the Articles of Confederation were, ‘as an “institutional equilibrium”, ... decidedly unstable’,²³ and the financial predicament contributed heavily to that instability.

Remedies for this combustible combination of economic hardship, civil unrest and governmental incapacity seemed straightforward, but were, at least within the framework of the Articles of Confederation, impossible. Having experienced the difficulties of keeping the thirteen states and the Continental Army together during the war of independence (the last in particular because of a lack of funds and, consequently, a lack of supplies), George Washington already in 1783 wrote a

¹⁸ Chernow, *supra* n. 7, p. 225.

¹⁹ G. Edward White, ‘The Political Economy of the Original Constitution’, 35 *Harvard Journal of Law & Public Policy* (2012) p. 61 at p. 65.

²⁰ Alexander Hamilton, ‘Federalist No. 6’, in Clinton Rossiter (ed.), *The Federalist Papers* (Signet Classic 1999) p. 24 [emphasis added].

²¹ Judge Iredell, who spoke in Richmond in 1796, similarly reflected (but with hindsight): ‘The voice of the Union disregarded—public debts not only unpaid but unprovided for; private as well as public credit at a very low ebb; commerce languishing; agriculture discouraged; measures of disunion every day adopting; an illiberal malignant jealousy taking place of rational and manly confidence, and the most melancholy symptoms prevailing for a speedy dissolution of the Union, or a disgraceful and ungovernable anarchy. The magnitude of the danger alarmed all considerate men...’. Quoted in Frank I. Schechter, ‘The Early History of the Tradition of the Constitution’, 9 *American Political Science Review* (1915) p. 707 at p. 732.

²² Gouverneur Morris of Pennsylvania. Quoted in Chernow, *supra* n. 7, p. 224.

²³ C. Randall Henning and Martin Kessler, ‘Fiscal Federalism: US History for Architects of Europe’s Fiscal Union’, Peterson Institute for International Economics Working Paper 12-1, Jan. 2012, p. 8.

letter to the states in which he recommended the establishment of a 'supreme power to regulate and govern the general concerns of the confederated republic' and to 'give such a tone to our federal government as will enable it to answer the ends of its institution'.²⁴ Three years later, Washington expressed his fear that '[t]hirteen sovereignties pulling against each other, all tugging at the foederal head, will soon bring ruin to the whole'.²⁵ James Madison considered that all 'men of reflection,' were alarmed by 'the existing embarrassments and mortal diseases of the Confederacy',²⁶ and in 1786 Madison warned 'that the question whether it is possible and worthwhile to preserve the Union of the States must be speedily decided one way or other,' because 'those who are indifferent to the preservation would do well to look forward to the consequences of its extinction'.²⁷

DEFECTIVE CONSTITUTIONAL ARRANGEMENTS

So what, then, were the perceived defects in the Articles of Confederation? The Articles organized the thirteen revolutionary states into a loose union – by the document's own words, a 'firm league of friendship',²⁸ and a 'perpetual Union'.²⁹ The Articles established a Continental Congress, the confederation's central legislative authority, in which each of the states was represented,³⁰ but did not establish a separate central executive branch.³¹ Competences such as the conduct of international affairs and the borrowing of money were conferred upon the Continental Congress by the Articles, which simultaneously prohibited the states to conduct their own foreign diplomacy, to enter into international treaties and to declare war.³² Additionally, all travel restrictions between the states were eliminated, and the citizens of each state were entitled to the 'privileges and immunities' of the citizens of each other state.³³ The enumeration of powers of the Union was strictly limited, and the Articles emphasized that 'each State retains its sovereignty, freedom and independence, and every power, jurisdiction, and right, which

²⁴ George Washington, 'Circular to the States', dated 8 June 1783. Available at <press-pubs.uchicago.edu/founders/documents/v1ch7s5.html> (visited 25 Sept. 2012).

²⁵ Letter from George Washington to James Madison, dated 5 Nov. 1786. Available at <gw.papers.virginia.edu/documents/constitution/1784/madison2.html> (visited 25 Sept. 2012).

²⁶ Wood, *supra* n. 16, p. 471.

²⁷ Joseph J. Ellis, *American Creation* (Vintage 2007) p. 93.

²⁸ Articles of Confederation, Art. III.

²⁹ Articles of Confederation, Preamble and Art. XIII. Art. I proclaimed that the 'Stile of this Confederacy shall be "The United States of America"'.
³⁰ Articles of Confederation, Art. V.

³¹ Representative executive officers with limited authority, such as ambassadors, were appointed and instructed by the Continental Congress. The confederacy also lacked a central judicial branch.

³² Articles of Confederation, Art. IX.

³³ Articles of Confederation, Art. IV.

is not by this confederation expressly delegated to the United States, in Congress assembled'.³⁴ Moreover, amendment of the Articles of Confederation required unanimity among the states.³⁵ And in form and effect, the Continental Congress' legislative powers were limited to recommendations left to the states to implement and enforce. Finally, lacking the authority to tax, the Continental Congress relied for its budget upon apportioned payments by the states,³⁶ which, unsurprisingly, resulted in Congress having difficulty in collecting those funds, as some states took that provision to mean that they could pay only a fraction of their share and, sometimes, nothing at all.³⁷

The government established under the Articles of Confederation, therefore, was not really much of a government at all. In reality, it was a diplomatic legislative conference in which the thirteen sovereign states, each regarding itself as an individual and autonomous country, met to coordinate certain of their affairs, especially their foreign affairs.³⁸ The Union was, in effect, designed to be weak. And that, in the eyes of most Americans at the time, was just about right, as they had 'joined together in a common cause to defeat the British',³⁹ but only as a marriage of convenience and necessity. And from the moment that the war of independence 'was won, the states began to go their separate ways', with the vast majority of Americans seeing 'the Continental Congress as some distant irrelevant entity'.⁴⁰

³⁴ Articles of Confederation, Art. II.

³⁵ Articles of Confederation, Art. XIII.

³⁶ Articles of Confederation, Art. VIII.

³⁷ Chernow, *supra* n. 7, p. 226.

³⁸ Other (important) contemporaries, however, were of the opinion that the Articles of Confederation were not merely a treaty to be assessed under principles of international law. James Madison, for example, considered 'the federal union as anal[o]gous to the fundamental compact by which individuals compose one Society, and which must in its theoretic origin at least, have been the unanimous act of the component members'. In Max Farrand (ed.), 1 *The Records of the Federal Convention of 1787*, 565 (1937) (journal for 10 July 1787); quoted in Bruce Ackerman and Neal Katyal, 'Our Unconventional Founding', 62 *U. Chi. L. Rev.* (1995) p. 475 at p. 542-543. Thomas Jefferson, in a letter responding to John Adams' claim that the Confederation was not a legislative but a diplomatic assembly, argued that the Articles separated 'into parts the whole sovereignty of our states, some of these parts are yielded [sic] to Congress. Upon these I should think them both legislative and executive; and that they would have been judiciary also, had not the Confederation required them for certain purposes to appoint a judiciary. It has accordingly been the decision of our courts that the Confederation is a part of the law of the land, and superior in authority to the ordinary laws, because it cannot be altered by the legislature of any one state. I doubt whether they are at all a diplomatic assembly'. Letter from Thomas Jefferson to John Adams (23 Feb. 1787), in Lester J. Cappon (ed.), 1 *The Adams-Jefferson Letters: The Complete Correspondence between Thomas Jefferson and Abigail and John Adams* (North Carolina 1988) p. 174-175; quoted in Ackerman and Katyal, at p. 552.

³⁹ Ellis, *supra* n. 27, p. 89-93.

⁴⁰ Ellis, *supra* n. 27, p. 89-93. Even the location of the Continental Congress was unstable, as it moved from Philadelphia to Princeton, to Annapolis, to Trenton, and, ultimately, to New York City.

The Articles of Confederation's inherent weakness was precisely what many desired, as a stronger central government would only reproduce the distant power they had just fought against. Americans preferred their local and state governments as their only sources of political authority.⁴¹

And it was in the states that many of the troubles originated. During the war of independence and immediately afterwards, the states had established constitutions which centred most governmental power in state legislatures, as executive authority was associated with colonial government and monarchism.⁴² One unfortunate consequence of this particular practice of government by legislature was that law-making in the states became increasingly chaotic as state legislatures' compositions changed rapidly and shifting factional majorities accommodated their narrow local (self-)interests.⁴³ Under persistent electoral pressure to provide some respite against crushing debt and tax burdens, the state legislatures began to adopt various debtor relief laws, including stay laws, paper money bills, and similar measures affecting the validity and value of contracts, resulting in a high degree of legal unpredictability and consequently, economic paralysis. This instability of government would lead James Madison to warn in *Federalist No. 10* that 'a pure democracy can admit no cure for the mischiefs of faction'.⁴⁴ Having thrown out monarchical rule in the war of independence, the 'tyranny' of shifting majority factions was threatening the American republican experiment and brought 'into question the fundamental principle of republican Government, that the majority who rule in such governments are the safest Guardians both of public Good and private rights'.⁴⁵ And 'unstable government', Madison wrote in *Federalist No. 64*, results in 'great injury', as the lack of 'confidence in the public councils damps every useful undertaking, the success and profit of which may depend on a continuance of existing arrangements'.⁴⁶

⁴¹ Ellis, *supra* n. 27, p. 89-93.

⁴² White, *supra* n. 19, p. 64.

⁴³ White, *supra* n. 19, p. 64-65. Resulting in, among other things, Connecticut taxing goods from Massachusetts heavier than goods from Great Britain, and the states adopting conflicting navigation acts.

⁴⁴ James Madison, *Federalist No. 10*, *supra* n. 20, p. 49. 'Everywhere', Madison warned in *Federalist No. 48*, government by legislature was, 'drawing all power into its impetuous vortex'. And, Madison continued, such 'legislative usurpations, which, by assembling all power in the same hands must lead to the same tyranny as is threatened by executive usurpations'. Madison, *Federalist No. 48*, *supra* n. 20, p. 277.

⁴⁵ White, *supra* n. 19, p. 65, quoting Madison from letters he wrote to Edmund Randolph and George Washington in April 1787.

⁴⁶ James Madison, *Federalist No. 64*, *supra* n. 20, p. 349-350. Madison continued: 'What prudent merchant will hazard his fortunes in any new branch of commerce when he knows not but that his plans may be rendered unlawful before they can be executed? What farmer or manufacturer will lay himself out for the encouragement given to any particular cultivation or establishment, when he can have no assurance that his preparatory labors and advances will not render him a vic-

Excessive public and private debt, a dysfunctional and gridlocked confederate government and chaotic political and economic conditions persisting in the states simultaneously gathered as a perfect storm to bring urgency to the drive for change: it was seriously doubted whether the unstable confederation would survive the ‘accumulating strains between rich and poor, creditors and debtors’.⁴⁷ And the American Union’s survival required a stronger form of central government to stabilize the fragile Union’s politics and to gain trust and confidence in its economic prowess.

HAMILTON’S ‘MOMENT’

The story of how and why the delegates at the Philadelphia Constitutional Convention of 1787 created the United States Constitution is well described elsewhere. Suffice it to state here that the delegates to the convention (among them George Washington and James Madison for the Commonwealth of Virginia and Alexander Hamilton for the State of New York) only had mandates to propose amendments to the Articles of Confederation to improve the existing confederal structure.⁴⁸ Instead, they emerged with a proposal to replace the Articles with the United States Constitution and to transform the American Union’s confederative government into an innovative federal arrangement with a strong central authority⁴⁹ and the power to tax.⁵⁰

But after the successful battle for the Constitution’s ratification in 1787 and 1788⁵¹ and with the federal government in place⁵¹, there was still no immediate

tim to an inconstant government? In a word, no great improvement or laudable enterprise can go forward which requires the auspices of a steady system of national policy’.

⁴⁷ Chernow, *supra* n. 7, p. 226.

⁴⁸ Johnson, *supra* n. 13, p. 473 (James Wilson told the Constitutional Convention: ‘It has never been a complaint against Congress that they governed overmuch. The complaint has been that they have governed too little’).

⁴⁹ Divided among three branches of government (legislative, executive, and judicial). Arts. I, II, and III of the United States Constitution.

⁵⁰ Art. I, § 8, cl. 1 of the United States Constitution provides: ‘The United States Congress shall have Power to Lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the Common Defense and general Welfare of the United States’. The power to tax is understood to be broad. See the United States Supreme Court’s decision in *National Federation of Independent Business et al. v. Sebelius, Secretary of Health and Human Services, et al.* of 28 June 2012 (sanctioning the ‘individual mandate’ of President Obama’s signature healthcare legislation of 2010 – known as the Patient Protection and Affordable Care Act – as a *tax*, and not as a constitutional exercise of Congress’ power to regulate interstate commerce).

⁵¹ Leading, among other things, to the monumental struggle for public opinion in New York newspapers between federalists and anti-federalists memorialized in the Federalist Papers (*supra* n. 20) and the Anti-Federalist Papers (Ralph Ketchum (ed.), *The Anti-Federalist Papers* (Signet Classic 1986)).

solution on offer for America's debt troubles. Hamilton, though, was now in a position to try to seize his 'moment'. And seize it he did. As the Secretary of the Treasury in President Washington's first cabinet, he proposed a plan to Congress to resolve the sovereign debt problems. Hamilton devised a series of institutional innovations including the establishment of the Bank of the United States and, most strikingly, the assumption of the states' debts by the federal government. 'These were to be complementary, mutually reinforcing elements of the new American financial architecture',⁵² and proved to be as contentious as the United States Constitution's ratification itself had been two years before.

In his *Report on Credit*, delivered to the House of Representatives on 14 January 1790, Hamilton proposed a fourfold course of action.⁵³ In the first place, as provided for in the Constitution,⁵⁴ the federal government should honour all of the financial obligations that the Continental Congress had entered into during the war of independence, regardless of the current bondholders' identity, in order to establish the federal government as a good creditor. 'States, like individuals,' Hamilton wrote in his *Report*, 'who observe their engagements, are respected and trusted: while the reverse is the fate of those who pursue an opposite conduct'.⁵⁵ Hamilton proposed a variety of voluntary bond exchange options to restructure the outstanding debt. Among those ultimately enacted was the possibility to receive part of the payments at the original rate and part in the form of 'western land, enabling bondholders to participate in the appreciation of frontier property'.⁵⁶ Also, bondholders could choose to be paid at a lower interest rate, but over a longer period of time than was agreed to in the original bonds.⁵⁷

Second, Hamilton proposed that the federal government would assume the states' war debts. With this step, Hamilton envisaged securing the allegiance of the holders of those debts to the federal government as bondholders would feel a stake in preserving the government that owed them money. If not the states, but the federal government owed them money, creditors would shift their loyalty to the federal government.⁵⁸ Moreover, with the assumption of their debts, Hamilton

⁵² Henning and Kessler, *supra* n. 23, p. 8.

⁵³ Already in anticipation of the delivery of Hamilton's report to the House of Representatives, the value of government debt was increasing and interest rates were falling.

⁵⁴ Art. IV of the United States Constitution provides that 'All Debt contracted and Engagements entered into, before the adoption of this Constitution, shall be as valid against the United States under this Constitution, as under the Confederation'.

⁵⁵ Alexander Hamilton, *Report on Credit* (1790), in Harold C. Syrett (ed.), *The Papers of Alexander Hamilton* (Columbia University Press 1962), Volume 6, p. 68.

⁵⁶ Chernow, *supra* n. 7, p. 299.

⁵⁷ Chernow, *supra* n. 7, p. 299. As an incentive for this particular option, Hamilton proposed that the United States Treasury would pay interest each quarter instead of annually.

⁵⁸ Chernow, *supra* n. 7, p. 299. A further advantage of assumption was that the states would lose an incentive to challenge the federal government's new monopoly on collecting import duties, with the potential of recreating the chaotic financial situation under the Articles of Confederation.

intended to bind the states to the Union.⁵⁹ Third, to fund the regular payment of interest and the ultimate retirement of the (increased) federal debt, Hamilton proposed that the government establish a steady revenue stream by taxation of imported goods, in particular by pledging the revenues from a series of new 'sin taxes' on wine, spirits, teas and coffees, a measure that would shift the burden from citizens' income or property to their discretionary spending. And, finally, Hamilton proposed the establishment of a national bank to manage the financial transactions associated with the federal debt.

Hamilton's proposals to pay off the debt at full value without regard to the identity of its holders and to assume the states' war debts were received with a firestorm. To Hamilton's opponents, the plan to pay the debt indiscriminately felt like enriching the speculators who had bought the debt at bottom prices, at the cost of the farmers and soldiers who had been paid with depreciating IOUs for their products and service in the Continental Army, and which they had desperately sold off to fund life's basic necessities. In response, Hamilton shifted the terms of the debate and argued that those to whom the bonds were initially issued were not merely heroic victims as they had gotten payment when they wanted it and, by selling their securities, had not shown much faith in the Union's future. And the current bondholders, according to Hamilton, weren't simply unprincipled speculators since they had risked their money and should be rewarded for it.⁶⁰ Moreover, discrimination among bondholders was not only impractical (and, therefore, prohibitively expensive to administer), paying only certain 'deserving' bondholders at full value would not have the desired beneficial effect on America's creditworthiness because, according to Hamilton, '[i]n nothing are appearances of greater moment than in whatever regards credit'.⁶¹ Consequently, nothing less was required than the government's honouring of all of its commitments to establish trust and confidence in the American Union's financial affairs. Ultimately, Hamilton's arguments carried the day and on 22 February 1790, a majority in the House of Representatives defeated a resolution for an alternative plan that called for discrimination against subsequent – 'speculative' – holders of debt by thirty-six to thirteen votes.

The assumption plan, however, ran into stronger resistance as fundamental local loyalties resurfaced, now in the institutions of the new federal government. The frontline of the battle over Hamilton's assumption plan ran straight through

⁵⁹ On 1 January 1795, some of the largest holders of federal debt turned out to be the states with, for example, Connecticut holding over USD 750,000 worth of the bonds created in Hamilton's program. See Robert E. Wright, 'Cementing the Union', *Financial History* (Spring 2008) p. 14 at p. 15.

⁶⁰ Hamilton, *supra* n. 55, p. 73-78; and Chernow, *supra* n. 7, p. 298.

⁶¹ Hamilton, *supra* n. 55, p. 97 ('Opinion is the soul of [credit] and this is affected by appearances as well as realities').

Virginia, where, to his disappointment, Hamilton found James Madison to be his fiercest opponent.⁶² Madison, who came from Virginia and who, by then, was the leading member in the new House of Representatives, ferociously objected to Hamilton's proposal.⁶³ Madison thought the plan unfair, as it would relieve certain states of greater burdens as some had fulfilled their promises to pay off war debts, but others had not. And as Virginia, for example, had already paid its war debts, Virginia had no desire to finance other states' struggle with their heavy debt burdens, such as Massachusetts.⁶⁴ And if the debts of states that had failed to pay were shifted to the federal government, Madison argued, citizens in states that had already paid their debts would end up paying twice.⁶⁵ Hamilton countered arguing that all Americans had benefited from the revolution, and that, therefore, it would only be fair that all states should assume responsibility for the wartime debts.⁶⁶ The assumption of the states' debts was, in Hamilton's words, the logical and necessary 'price of liberty'.⁶⁷

But this time the House of Representatives was unconvinced and on 12 April 1790 rejected the assumption plan, albeit with only two votes.⁶⁸ Ultimately, this contentious distributional conflict among debtor and creditor states required a solution in the form of an old-fashioned grand political compromise. Hamilton found an opening for compromise in the equally divisive question of the new federal government's seat, which was to be determined by Congress under Article I of the Constitution. In short, Washington's administration was prepared to support moving the capital from New York to a location along the Potomac River on the border of Virginia and Maryland, and would agree to Philadelphia serving as the intermediate capital, in exchange for sufficient support for the debt assumption plan. The House of Representatives approved the Residence Act on 10 July 1790,

⁶² Hamilton and Madison had joined forces in authoring the *Federalist Papers* and had previously discussed the assumption of the states' debts during the Constitutional Convention of 1787. See also Chernow, *supra* n. 7, p. 305-306 and p. 320-321; and Ellis, *supra* n. 27, p. 174-179.

⁶³ Ellis, *supra* n. 27, p. 175. In Madison's view, Hamilton's plans represented the 'fullest projection of federal sovereignty over the states'.

⁶⁴ Chernow, *supra* n. 7, p. 322-324 (Hamilton also noted that certain states had paid their debts by less savoury means. For example, New York had chosen not to pay interest due on its bonds, driving down its debts' market value, and thereby making it cheaper for New York to buy its debt back).

⁶⁵ Chernow, *supra* n. 7, p. 321 ('Retreating from his old nationalist perspective, Madison complained that his home state and some other southern states had paid off most of their wartime debts and would be penalized if, "after having done their duty," they were forced "to contribute to those states who have not equally done their duty"').

⁶⁶ Chernow, *supra* n. 7, p. 323. Hamilton argued that if 'state debts were unequal, so were the sacrifices made' during the war of independence referring to heavily indebted Massachusetts where a great deal of the fighting had occurred.

⁶⁷ Hamilton, *supra* n. 55, p. 69.

⁶⁸ Chernow, *supra* n. 7, p. 324.

whereby it designated Philadelphia as the temporary capital and a ten mile square site along the Potomac River of what was to become Washington, DC, as the permanent seat of government. And, on 26 July 1790, the House of Representative adopted, albeit narrowly, the state debt assumption bill,⁶⁹ effectively approving Hamilton's fiscal program to manage the debt. Hamilton's debt exchange program turned out to be a great success as, by 1795 (when Hamilton left office), 98% of domestic debt had been exchanged for the new federal Treasury bonds. The final payments on Hamilton's program were made—and the debt left over from the war of independence was fully paid off—at the end of 1834.⁷⁰

SOVEREIGN DEBT AND THE AMERICAN UNION

The sovereign bond market can be very intimidating. Government debt and the bond market funding it can force governments out of office. Sometimes, however, the bond market's pressures and the economic consequences associated with a government's inability to manage excessive debt may not only change a government's personnel – it may even contribute to a government's constitutional transformation. The prime historical example of such a transformation is that of the United States of America. Originally conceived as a confederated union of sovereign states during the war of independence, the ratification of the United States Constitution in 1788 changed the United States of America into a federation with a strong central authority that filled the power vacuum of the Articles of Confederation, particularly in financial matters. The financial predicament of the United States of America, combined with the economic, social and political costs of governmental dysfunction in the 1780s, drove the movement for constitutional reform and innovation that assembled decisively in Philadelphia during the spring and summer of 1787. The critical period of the 1780s was full of opportunities for the American Union to dissolve, and what would have happened if the Constitution had not been ratified remains the subject of intense speculation. What we do know, however, is that with the federal government in place (although not yet firmly in place), Alexander Hamilton, the first Secretary of the Treasury, could seize his moment to turn weakness into strength by using the young republic's excessive debt to 'cement the Union'.⁷¹

Hamilton's accomplishments, therefore, cannot be viewed in isolation from the American government's constitutional transformation. And before we call for a European Alexander Hamilton to guide the Eurozone onto a path of mutualisation

⁶⁹ Chernow, *supra* n. 7, p. 329-330. While Madison voted against the assumption bill, he persuaded four congressmen from Virginia and Maryland to vote in favour of assumption.

⁷⁰ Wright, *supra* n. 59, p. 16.

⁷¹ Wright, *supra* n. 59.

of (part of) the member states' sovereign debt, it is important to realize that the debt restructuring plan Hamilton steered to Congressional approval, including the assumption of the states' debts by the federal government, was not the crucial element of the solution to the young American Union's debt problems. The crucial element that provided Alexander Hamilton with the governmental tools to win the bond market's trust and confidence in the American government's ability to honour its financial commitments was America's transformation from a loose confederated union into an innovative federal arrangement with a strong central authority (including the power to act decisively in financial matters).⁷² Without that transformation, trust and confidence might have continued to gallop away from the young American Union, and with it, the cement of the Union.



⁷²Hamilton acknowledged as much in the *Report on Credit*, *supra* n. 55, p. 69: '[T]he last seven years have exhibited an earnest and uniform effort, on the part of the government of the union, to retrieve the national credit, by doing justice to the creditors of the nation; and that the embarrassments of a defective constitution, which defeated this laudable effort have ceased. From this evidence of a favorable disposition, given by the former government, the institution of a new one, clothed with powers competent to calling forth the resources of the community, has excited correspondent expectations'.