

Alexander Hamilton, Economist

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This public lecture was presented on April 26, 2006 at 7:30 PM in Cook Library 507 as the last of six lectures in the traveling exhibition **Alexander Hamilton: The Man Who Made Modern America**. This exhibition was at Towson University from March 9 to April 28, 2006.

10 “America’s first economist” was also “the foremost political figure in American history who never attained the presidency.” At least both of these are said of Alexander Hamilton, and I have no reason to dispute either. I’ll mostly leave his politics to my predecessors in this Program, since it isn’t my field anyway, and focus on his role as economist.

Alexander Hamilton was an economist as Alan Greenspan is an economist: a skilled practitioner, managing and shaping policy to make the United States healthier, stronger, more
15 prosperous, and — perhaps — more free. But they share more: each drew on the best economics of his day, but neither is noted for contributing to economic theory.

America actually had no prominent economic theorists for about a century after Hamilton. The great captains of industry we can name suggest that 18th and 19th century America was a much better place to apply the practical lessons of economics than to analyze them. Many
20 thoughtful early Americans wrote an occasional essay dealing with economic issues, but none of them contributed significantly to today's economic theory. So let's not hold it against Hamilton that he wasn't an economic theorist; no other American of his day was, either.

Hamilton was twenty-one when Adam Smith's *Wealth of Nations* was published in 1776 — that's what economists remember that year for — and he clearly learned a great deal from it. (I
25 came across an 1894 article that sets out nineteen illustrations of parallel wording and reasoning, using two columns to set Adam Smith's words adjacent to Hamilton's. Relax — I'm not going to go through them one at a time. A couple of illustrations will pop up naturally, in context, when

we get to Hamilton's economic policy.) He'd also read David Hume's 1752 essays on economics, and a few others. Hamilton's early life probably shaped his interest in economics and his ideas
30 about it, but you've heard about that... so we'll skip over his birth, his coming to the mainland, and his war record, and focus on the few years in the late 1780s and early 1790s, when he really was a practicing economist.

Hamilton helped to found the private Bank of New York in 1784, and participated in the Constitutional Convention. Concerned that “anti-federalist” opponents of the Constitution might
35 prevail, he wrote fifty-one of the eighty-five essays now known as *The Federalist Papers*; we'll look at a few that clearly involve economics. Only a few months after newly elected President Washington nominated him for Secretary of the Treasury in September of 1789, he presented to Congress a fifty-one page “Report on Public Credit.” Less than a year later, he proposed the creation of The Bank of the United States and defended its constitutionality, and in January 1791
40 gave Congress his Report on the Mint. Later that year Hamilton presented his famous Report on Manufactures.

The rest of the 1790s are filled with political and personal Hamiltonian intrigue, but there's not a lot immediately relevant to Hamilton as economist. In 1804, even though his son died in a duel a few years earlier, he allowed himself to be drawn into an “affair of honor” with Thomas
45 Jefferson's Vice President, Aaron Burr... and died at the age of 49.

On his economic policy, we'll look at specific issues rather than a chronological sequence that would require jumping back and forth. Following a few general comments, our first topic will be taxation, then Hamilton's industrial policy, and finally his work on money. There's some overlap among these categories — for example, a tax on imports might raise government revenue, protect
50 American manufacturers, and contribute to monetary stability — but we can address that as we

go along.

Every economic policy Hamilton proposed, in my judgment, had the goal of protecting the individual liberty of the American citizen. He shared this goal with Jefferson, but they differed on the kind of federal government it required. If a strong federal government is essential to
55 liberty, as Hamilton believed, then so were policies designed to strengthen that government.

This is a dangerous line of reasoning, obviously; some of my fellow libertarians would call it a contradiction. But Hamilton's overriding concern was with national defense, and those libertarians who accept any role for government at all, are usually inclined to accept that one. (Not all libertarians embrace Ayn Rand, but when she was asked “How much should the federal
60 government spend on national defense?,” her answer was: “whatever it takes.”)

Perhaps this view of Hamilton is too benign. It is surely wrong to believe that he sought power for its own sake. But like many young economists he may have been a bit overconfident, thinking — for example — he could take a dangerous instrument like the “necessary and proper” clause right up to the point that could be justified by national defense and then, with supreme dexterity,
65 keep it from intruding upon liberty. A lesson that every economist has to learn has been best expressed by Clint Eastwood's “Dirty Harry”: “A man's got to know his limitations.” Hamilton's papers are filled with delightful and correct economic insights, but they make enough serious mistakes that a good deal more modesty was warranted. He did not “know his limitations,” and — I hate to say this in the final lecture of this wonderful exhibit, but I'm afraid that's left his
70 economic legacy a bit open to question.

TAXATION

Under the Articles of Confederation, states often found reasons not to comply with the “requisitions” of the Continental Congress — some more often than others, creating dissension

among the states and producing little federal revenue, often a tenth of what had been
75 requisitioned. Hamilton and Madison's 1782 proposal for a 5% federal import tariff did not
achieve the required unanimous approval of the states. To solve the federal revenue problem,
Section Eight of Article One of the Constitution granted Congress the “Power To lay and collect
Taxes, Duties, Imposts and Excises...” But of course first the Constitution had to be ratified, and
that's where *The Federalist Papers* comes in. Ten of Hamilton's fifty-one essays deal with
80 taxation. (By the way, Clinton Rossiter put together a short list of *The Federalist Papers'* “cream
of the crop,” and none of these 10 is in it.)

In Number 12, Hamilton argues that tax revenue requires wealth, and wealth requires
commerce. He accurately forecasts that import duties will remain the primary source of federal
revenue. Anticipating the problem we see today in the form of states and cities using tax breaks
85 to compete to attract new businesses, Hamilton explains that uniform federal import duties would
prevent this kind of competition between states. “It is therefore evident that one national
government would be able at much less expense to extend the duties on imports beyond
comparison, further than would be practicable to the States separately, or to any partial
confederacies.”

90 The weakness of the Confederation was the theme of Number 21. Hamilton again suggested
his familiarity with Adam Smith. His argument was for direct federal taxation, and in another
nice understanding of the supply-side or laffer curve idea, based on the economic concept of
elasticity, Hamilton wrote:

95 It is a signal advantage of taxes on articles of consumption that
they contain in their own nature a security against excess.... If
duties are too high, they lessen the consumption; the collection is

eluded; and the product to the treasury is not so great as when they are confined within proper and moderate bounds. This forms a complete barrier against any material oppression of the citizens by taxes of this class, and is itself a natural limitation of the power of imposing them.

This elusive goal of finding exactly that rate that maximizes revenue reminds me of how the French finance minister of that time, Colbert, described taxation: It's "the art of plucking a chicken without making it squeal."

Seven consecutive papers beginning with number 30 return to Hamilton on taxation. The first of them emphasizes that national defense and the repayment of debts incurred in the War require a federal system of taxation. His thoughtful comparison of political economy to geometry at the start of Number 31, sounds a bit like Henry Hazlitt's explanation, in his famous little book *Economics in One Lesson*, of why so many well-intended people are bad economists. Hamilton then asserts that federal revenue must be limited only by the requirements of national defense, and tries to reassure those who worry that such a broad limit might usurp states' revenue. All I can make of his argument, which seems a bit weak, is that everything "must be left to the prudence and firmness of the people..." This sounds like an expression of confidence in democracy... something for which Hamilton wasn't always known.

Federalist 32 and 33 assure the states that the Constitution's proposals would restrict only their ability to tax imports and exports; the power to tax all other potential sources of revenue would be co-equal between the states' and federal government. But I'm not sure how much comfort the states would find in Number 34, where Hamilton again argues against limits on federal taxation because "the objects that will require a federal provision" — specifically, national defense — are "altogether unlimited" while "those which will require a State provision"

are “circumscribed within very moderate bounds.”

The economist in Hamilton appears most clearly in Number 35, beginning with the case against restricting the federal tax to “particular objects” because this would cause “oppression of particular branches of industry” and “an unequal distribution of the taxes...” In language again
125 echoing Adam Smith, he warned that restricting the federal power to tax to imports creates incentive for smuggling. It would also “give [the manufacturing classes] a premature monopoly of the markets” and “force industry out of its more natural channels into others with which it flows with less advantage,” and would bear unequally on the states according to the size of their imports. He knew a general tariff on imports would continue to be the main federal source of
130 revenue, but he didn't want it limited to that. And this worry about forcing “industry out of its more natural channels” was inconsistent with his views, earlier and later, on American manufacturing; on this subject, he seemed to forget what he learned from Smith.

He concludes his *Federalist Papers* on taxation with Number 36, ever mindful of the need to balance his case for federal taxation with his quest for the states' approval of the Constitution.
135 Today many states — including Maryland — base their taxes on the federal returns; Hamilton seemed to suggest the reverse: “The national legislature can make use of the system of each State within that State.”

The chief practical result of Hamilton's *Federalist* essays was ratification, but apart from the tax on distilled spirits, which was the largest revenue source other than customs, his case for
140 internal taxation bore little fruit until more than a hundred years later when we got a permanent income tax. (“Permanent” so far, I mean.) The percentage of “Federal Government Receipts” that came from “Internal revenue” hovered around 6% or 7% in the years between ratification and Hamilton's death in 1804, with 85% to 95% continuing to come from customs duties.

INDUSTRIAL POLICY

145 Hamilton's world was still very much under the grip of mercantilism, an economic policy by which a country tried to acquire money by promoting exports (causing money to flow in) and discouraging imports (which require money to flow out). England viewed its colonies as sources of raw materials for its own high-valued manufactured exports, and as a market for them, so she discouraged the spontaneous emergence of manufacturing in America.

150 Adam Smith's *The Wealth of Nations* was a vigorous refutation of mercantilist policy and theory. The wealth of a nation, Smith argued, consists not of its money but of the goods available to its citizens — food, clothing, shelter. that kind of wealth was best achieved by free trade. Smith argued, correctly, that free trade also promoted world peace, a conclusion with which Hamilton differed in *Federalist* Number 6. He and Smith agreed, though, that the United States
155 would one day surpass Britain in economic wealth. But that could happen, Hamilton thought, only if the new nation could industrialize.

He was not confident that this process would emerge naturally. In a 1782 essay he asserted that trade was not self-regulating and self-correcting, and in July 1783 he argued for deliberate government management of trade “so that 'injurious branches of commerce might be
160 discouraged, favourable branches encouraged, [and] useful products and manufactures promoted.’”

This conviction that economic experts, equipped with knowledge, good intentions, and enough political force, can shape a more prosperous future than could the natural incentives of a free market, is known as industrial policy. It's fallen on hard times in recent decades, and seldom
165 has a verdict been more deserved. (The best explanation of markets' superiority over deliberate central planning is Friedrich Hayek's famous 1945 essay, “The Use of Knowledge in Society.”) I

don't know if Hamilton feared we might never industrialize, or if he just didn't want to wait until it emerged naturally. But it's surprising to me that Hamilton did not appreciate that an energetic and entrepreneurial country, freed from colonial repression, would develop a healthy industrial sector just as soon as it made economic sense. (The country was rich in natural resources and agricultural products. At the time it surely made sense to specialize in them, and they were the country's principal exports until after Hamilton's death.) But despite some kind words, he did not trust free trade and free markets. In 1801, he wrote: "In matters of industry, human enterprise ought doubtless to be left free in the main, not fettered by too much regulation, but practical politicians know that it may be beneficially stimulated by prudent aids and encouragements on the part of the government." He was not as good a student of Adam Smith as he might have been.

In April 1791, he joined with Assistant Treasury Secretary Tenche Coxe in promoting an ambitious project called "The Society for Establishing Useful Manufactures." It developed into an entire town (Paterson, New Jersey), based on a textile mill, and was described as "the most ambitious industrial experiment in early American history." Within five years the project collapsed, the victim of several bad decisions. They did get some things right, though, for Paterson later developed into an important industrial city.

The groundwork of his December 1791 *Report on Manufactures* reads, in part, like the early pages of *The Wealth of Nations*, where Smith explains that the relative wealth of industrial versus agricultural societies arises from their greater ability to use the division of labor.

Hamilton's statement that "manufactures open a wider field to exertions of ingenuity than agriculture" could easily have been said by Adam Smith. Beyond this background, though, Hamilton again shows that he thought entrepreneurs lacked the imagination to perceive and act upon profit opportunities. In terms like those used by John Maynard Keynes in 1936, Hamilton

190 explained why: Entrepreneurs suffered from “the strong influence of habit and the spirit of imitation...” Like Keynes, he saw the solution in the wise use of political force.

His case for protecting from foreign competition a wide variety of specific American industries relied on the infant-industry argument. It goes like this: Even if a domestic industry will, within some years, have a cost advantage over its foreign competitors, when the industry is young its costs will invariably be higher. To cover those temporarily high costs, so the argument goes, it must be protected from lower-cost foreign competition.

But investment in the industry will be profitable if the present value of its expected long future period of profits is greater than that of the short period of losses. Greedy private capitalists have every incentive to realize that, if it is true. The initial losses are just part of their capital investment. (This is a little like the principle that someone opening a new restaurant doesn't charge his first customer \$50 for the food, plus a million dollars to cover the cost of building the restaurant.) Sometimes an industry's promoters can convince legislatures to force the public to make this initial investment instead — that's what “Infant Industry” does — and if the industry succeeds it seems like empirical support for the policy. (A recent example is Cambridge University economist Ha-Joon Chang's case, based on historical evidence that the world's strongest economies got their start by using it.) Infant industries that turn out to be losers, 205
bumbling along in obscurity or fading from the scene, are less apparent.

A far more enlightened position is that economies should develop in their own way and at their own pace. Congress included a great many import tariffs in its first session, but they really seem to be across the board and not focused on industries Hamilton wished to protect. I think the economic historians are correct who have argued that America was wealthier for rejecting 210
Hamilton's industrial policy and focusing on its natural comparative advantage. In fact the ante-

bellum decades are known for improvements in agriculture and infrastructure, with industry taking off after the Civil War. Hamilton was unwise to try to rush it. Madison and Jefferson were
215 appalled at the arrogation of federal power the *Report on Manufactures* proposed, and surely they were right.

MONEY AND BANKING

The contribution for which Alexander Hamilton is best known is pulling the new nation out of the financial morass in which the Revolutionary War and the Articles of Confederation left it.
220 The Continental Congress, unable to tax, financed the Revolution largely through the issue of paper currency. Its enthusiasm led to hyperinflation, and “not worth a Continental” became a common expression of worthlessness. (The Continental’s disrepute was shown in interesting ways: Barbershops were papered with it, and sailors had suits of clothes made from it.) The experience led to the clause in the Constitution's Article I, Section 8, granting the federal
225 government the power “To coin Money, [and] regulate the Value thereof...”

The “direct money cost of the Revolution,” economic historians Hession and Sardy estimate, was \$135 million. More than half of this was covered by paper currency and taxes, but the rest is accounted for by federal and state debt. In the mid-1780s, the federal government's receipts were less than a third of the interest on its debt, and it actually stopped paying interest in the late
230 1780s. As a result, its bonds traded at a huge discount; United States government bonds were the junk bonds of their day. By 1791 federal debt stood at \$54 million; the states' debts would add about \$25 million to that.

Tackling this problem as the new nation's first Secretary of the Treasury, Alexander Hamilton offered his brilliant Report on Public Credit in January 1790. He explained that a good credit
235 rating would make possible future borrowing — Hamilton always had national defense in mind.

Calling the nation's war debt "the price of liberty," he said the case for honoring it also "is enforced by ... the immutable principles of moral obligation; and in proportion as the mind is disposed to contemplate, in the order of Providence, an intimate connexion between public virtue and public happiness, will be its repugnancy to a violation of those principles."

240 The market, anticipating his successful refinancing, had doubled the market price of United States government securities. Renewed confidence in the government's credit, he argued, would benefit everyone because it would be accepted as money. This, he wrote (with a nice reference to the quantity theory of money), will reduce the rate of interest, "for this is always in a ratio to the quantity of money, and to the quickness of circulation." Hamilton is using what would be

245 consistent today either with the classical loanable funds theory of interest or Keynes's liquidity preference theory. He should have balanced this against the probability that the increased money supply will promote inflation, but Hamilton's emphasis (perhaps inspired by his reading of David Hume) on the trade-stimulating effects of money suggests a mercantilist influence, or a form of the real-bills doctrine, in which the new money produces enough new goods that there is no

250 inflation.

Hamilton brilliantly argued that refunding's benefits should go to current holders of government debt, not to original purchasers who subsequently sold it. Madison, among others, seems to have succumbed to the temptation to treat original purchasers as virtuous financiers of the Revolution and later buyers as greedy speculators, but Hamilton called discrimination

255 between them "inconsistent with justice... a breach of contract, in violation of the rights of a fair purchaser." In a truly insightful comment on the nature of market transactions, Hamilton wrote that when an original purchaser sells, the buyer "is not even chargeable with having taken an undue advantage. He paid what the commodity was worth in the market, and took the risks of

reimbursement upon himself. He of course gave a fair equivalent and ought to reap the benefit of
260 his hazard..." It was a powerful case, and fortunately Hamilton's arguments succeeded.

The 1790 Report then made the case for assumption: "The Secretary... entertains a full conviction that an assumption of the debts of the particular States by the Union ... will be a measure of sound policy and substantial justice." Not everyone agreed. The plan seemed unjust to those states who had already paid off most of their debts (Virginia, for one); others had made
265 little effort. It was Hamilton's famous compromise on this issue that placed the nation's capital in the swamps of Washington, D.C.

Much of the rest of this Report specified six different plans that investors in the new federal government debt could choose. We'll skip the complicated details; they involve annuities (and a couple of them include Western lands at 20c per acre) and really demonstrate some sharp
270 economic thinking.

Finally, Hamilton estimated that about \$2.8 million will be required to cover interest on the new debt, and proposed as a revenue source increases in import duties... particularly on "pernicious luxuries." (In December 1790 he added the excise tax on liquor.) He concluded his January report by noting that "the creation of debt should always be accompanied with the means
275 of extinguishment." In a brief note on what we'd call insider trading today, Hamilton urged that the Government purchase its own debt only after the refinancing plan had been made public; to buy it earlier, at depressed market values, would be "highly dishonorable."

Hamilton presented his Report on a National Bank in December 1790. Aware of a prejudice against banks (Jefferson, Madison, and Adams all disliked them, to put it mildly), Hamilton
280 explained that it would increase "the active or productive capital of [the] country" by providing a means by which gold and silver can conveniently be invested, rather than stuffed in a box

somewhere. Familiar with the “money multiplier” well known to modern students of Money and Banking, Hamilton wrote that “banks in good credit can circulate a far greater sum than the actual quantum of their capital in gold and silver.” Again with sharp economic reasoning, he
285 traces an increase in the velocity of circulation to the reduction in the time and cost of transportation involved in clearing payments. “And it is evident,” he wrote, “that whatever enhances the quantity of circulating money adds to the ease with which every industrious member of the community may acquire that portion of it of which he stands in need...” (He again missed the potential that the increase in money might ALSO increase “that portion of it of which
290 he stands in need,” through price inflation.)

Hamilton, echoing Smith, reminds us that “the intrinsic wealth of a nation is to be measured, not by the abundance of the precious metals contained in it, but by the quantity of the productions of its labor and industry,” but quickly again slips into a most un-Smithian mercantilist position that exports are better than imports because they increase the country's specie. Finally, he lays out
295 twenty-four provisions that constitute his plan for the Bank of the United States. After Madison, Jefferson, and others questioned its constitutionality, Hamilton responded with a spirited defense and Washington signed the bill in late February, 1791. There was a huge demand for its shares (its “IPO” was on July 4, 1791), and Hamilton's Greenspan-like management was affirmed by his deft handling of a crash in the government-securities market only about a month later. Central-
300 bank enthusiasts can point to other successes, but when the bank's charter expired in 1811, it was not renewed.

Hession and Sardy offer a standard evaluation: the “First Bank proved itself in the succeeding years to be a great asset to the nation; indeed, it was termed by one admirer 'the mainspring and regulator of the whole American business world.' It increased and stabilized the supply of the

305 circulating medium, made credit more available, and aided the federal government immensely in its fiscal operations.” Others are less complimentary. Murray Rothbard writes that the Bank “promptly fulfilled its inflationary potential by issuing millions of dollars in paper money and demand deposits...” resulting in wholesale prices rising 72% from 1791 to 1796.

Hamilton's massive Report on the Mint was delivered in late January, 1791; most of its
310 proposals have been well-received, such as its advocacy of plenty of small-denomination coins for the convenience of small purchases. Concerned about anything that might limit the quantity of money, though, Hamilton embraced bimetallism, using both gold and silver as a standard. (The problem is that if the mint promises to exchange 15 oz of silver for 1 oz of gold, that's fine as long as the market price of gold is 15 times that of silver. If it isn't, there's profit in exchanging
315 one type of coin for the other, and one of them disappears from circulation. This is the origin of Gresham's Law: “bad money drives out good.”)

Overall, most historians consider Alexander Hamilton's work on money, credit, and banking to be a stupendous achievement. He raised the credit standing of the new nation from its post-War junk-bond status to one the equal of advanced European nations and took what many
320 consider a necessary first step toward establishing a financial system suited to the rapid economic growth he hoped for. The economic theory in his reports of 1790 and 1791 is not without serious problems, but in many respects they reflect some of the best thinking of his day. And in terms of documents of policy significance in American economic history, Hamilton's amazing intellectual production during this one-year period is surely without equal.

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CONCLUSIONS

As I said a while ago, I think ALL of Hamilton's economic policies stemmed from his conviction that national defense required a strong federal government, a wealthy industrial economy, direct taxes, and a central bank. We have all of these things today, and — overall — things have turned out rather well for the United States, so there's a powerful temptation to
330 attribute our present-day wealth to Hamilton's policies.

This would be a mistake. I admire Alexander Hamilton's brilliance, energy, motivation, and dedication to his country... but the line of causation from his policies to our wealth isn't direct. Let's brush aside his protective tariffs — we still have them, but well-read people know them for what they are: socially impoverishing ways of paying political debts. We'll also sidestep his
335 industrial policy; never intellectually respectable, the past few decades have revealed its practical failures around the world.

Despite Hamilton's case for Federal direct taxes, those of his day never raised much revenue and were probably unnecessary to cope with the new nation's debt service. But our principal direct tax, the income tax, has made possible an exponential growth in government power. Those
340 who think Hamilton sought unchecked federal power will believe he'd applaud this tax and the way it's been used. But I think that's wrong, and see him as an advocate of liberty who valued a strong government for national defense. He might have welcomed the availability of an income tax for that purpose, but he would have been appalled at many of the uses to its revenue has been applied.

345 We're so familiar with the modern variant of Hamilton's Bank of the United States, the Federal Reserve System, that it seems necessary to a modern economy. But monetary theory and history suggest a bit of skepticism. It turns out, for example, that the problems of so-called

“wildcat banking” may have arisen from political regulation; one prominent monetary economist has concluded that “the historical record does not provide any clear evidence of the failure—
350 except politically—of free banking.” Questions of the Fed's benevolence also arise from studies of its role in the Great Depression, from money-induced distortions to the real economy, and from any chart of what's happened to the price level over the past couple of centuries. (We've become so numbed to inflation that we applaud Mr. Bernanke's policy that cuts the dollar's purchasing power in half in only 28 years... that's 2.5% per year inflation.) In short, it would be
355 imprudent to infer that because we have a central bank and prosperity that the latter depends on Hamilton's having set the stage for the former.

Whatever the validity of these irreverent concluding observations, there is no doubt that Alexander Hamilton tirelessly and brilliantly applied some of the best economic theory of his time to the problems facing our country at the time of its birth. His tenure as our first Secretary of
360 the Treasury was instrumental in creating a nation in which individual liberty could thrive. For that, we owe him our gratitude.

THE END