Revenue or Reciprocity?

Founding Feuds over Early U.S. Trade Policy

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"Our treasury still thinks that these new encroachments of Gt. Brit. on our carrying trade must be met with passive obedience and non-resistance, lest any misunderstanding with them should *affect our credit, or the prices of our public paper*." – Thomas Jefferson, 1791

"Every gust that arises in the political sky is the signal for measures tending to destroy [our] ability to pay or to obstruct the course of payment." – Alexander Hamilton, 1794

1. Introduction

An important motivation for the Constitutional convention of 1787 was to permit the national government to impose import tariffs and regulate foreign commerce, something that it was not empowered to do under the Articles of Confederation. Once Congress was granted this authority, the use of these powers became the subject of immediate controversy. Should import duties be imposed simply to collect revenue, or should they be used to strike back against countries that imposed barriers against U.S. commerce?

Debate over precisely this issue – using import tariffs for revenue purposes alone or to achieve reciprocity as well – divided President George Washington's administration in the early 1790s. The debate pitted Treasury Secretary Alexander Hamilton against Secretary of State Thomas Jefferson and his congressional ally James Madison. Seeing imports as the critical tax base on which he planned to finance government expenditures and fund the public debt, Hamilton advocated modest, non-discriminatory import duties to ensure a steady stream of revenue into the Treasury coffers. He also wanted a stable commercial relationship with Britain to avoid any conflict that might disrupt imports and diminish customs revenue. By contrast, Jefferson and Madison saw trade policy as an instrument for achieving reciprocity, a weapon to be wielded against what they perceived to be Britain's grossly unfair discrimination against U.S. commerce. They sought to impose countervailing restrictions in an effort to force Britain to improve its treatment of U.S. goods and shipping in its home and colonial markets.

To some degree, these objectives were conflicting and mutually exclusive. Revenue considerations meant that nothing should be done to interfere with or jeopardize the revenue coming from a large volume of imports, suggesting that Britain's discriminatory trade practices should be tolerated so that the public debt could be funded. Reciprocity considerations suggested that retaliatory barriers should be imposed against British goods even at the risk of jeopardizing the government's most important source of revenue because it held out the promise of freer trade in the longer term.

Thus, early U.S. policymakers faced a dilemma: were tariff more important as a means of raising revenue, or as a tool for achieving reciprocal market access? Put this way, the choices hardly seem fundamental. But in fact the stakes were considerable and had ramifications for the funding of the public debt and the role that overseas commerce would play in America's economy. This chapter examines how the nation's founding policymakers confronted this dilemma and evaluates the merits of different trade policy options. The main conclusion is that the Federalist policy of moderate tariffs, non-discrimination, and conflict avoidance provided much needed stability during the first decade of the new government. Some of the potential pitfalls that were avoided during this crucial period can be illustrated by examining, briefly, how policy changed when the Republicans took over in 1800 and initiated a more aggressive approach to trade relations with Britain.

2. From the Articles of Confederation to the Constitution

As a philosophical matter, America's political leaders were largely favorably to the idea of free trade after the nation achieved its independence. As students of the enlightenment and rebels against British mercantilism, the founding fathers wanted to have free and open commerce among nations. This did not mean the absence of import tariffs, because such duties were recognized as essential for revenue purposes. Instead, "free trade" mean something along the lines of unconditional most-favored nation (MFN) status in which discriminatory restraints and exclusive preferences that inhibited trade would be abolished.[1]

But the newly independent United States found itself in a decidedly mercantilist world. No longer part of the British Empire, Americans faced a host of restrictions on their goods in Britain and its West Indies colonies. Other European powers similarly protected their home market and sought to keep trade with their colonies for themselves.[2] This harsh reality tempered the initially high hopes that the United States could enjoy the fruits of unrestricted international commerce. In 1785, for example, Thomas Jefferson wrote the United States should embrace free

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[1] As McCoy (1980, 86-87) explains, "Many republicans eagerly embraced an eighteenth century ideology of free trade, whose leading spokesmen included Montesquieu, Hume, Adam Smith, and the French physiocrats. According to these writers, foreign as well as domestic commerce should be freed from all restraints to that it might flourish and, in the process, humanize men by refining their manners and morals. . . . Given their hostility to Britain and the mercantilist model, it is not surprising that many Americans in the early years of independence embraced this outlook and tied it directly to the spirit of their revolution."

[2] Shepherd and Walton (1976) examine the reorientation of U.S. trade and shipping as a result of achieving independence.

trade "by throwing open all the doors of commerce and knocking off all its shackles." Yet he immediately qualified this hope: "But as this cannot be done for others, unless they do it for us, and there is no probability that Europe will do this, I suppose we may be obliged to adopt a system which may shackle them in our ports, as they do us in theirs." James Madison expressed a similar view: "Much indeed is it to be wished, as I conceive, that no regulations of trade - that is to say, no restriction or imposts whatever - were necessary. A perfect freedom is the System which would be my choice." But, he added, "before such a system will be eligible perhaps for the U.S. they must be out of debt; before it will be attainable, all other nations must concur in it."[3]

Madison's observation, that before the United States could adopt free trade it had to be free of debt and have access to other markets, underscored two key weaknesses of the Articles of Confederation. Under the Articles, the national government lacked the ability to impose taxes or regulate foreign commerce. These two weaknesses created two enormous problems: the government could not fund its operations, finance its debt, or pay for national defense, and it could not credibly negotiate treaties of commerce with foreign powers. These closely intertwined problems had long been recognized. In 1782, Alexander Hamilton wrote that "the vesting of Congress with the power of regulating trade ought to have been a principal object of the Confederation for a variety of reasons. It is as necessary for the purposes of commerce as of revenue."[4] Yet the states, jealous of their sovereignty and fearful of creating a dominant national government, designed the Articles with such weakness in mind.

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[3] PTJ 8: 633; PJM 8:333-34.

[4] PAH 3: 75-76.

With respect to revenue, Congress's inability to impose any taxes left it entirely dependent on requesting funds from the states, without any ability to compel them to pay. And through the 1780s the states proved increasingly reluctant to respond to Congress's repeated requests for funds. In October 1781, just after the victory at Yorktown, Congress requisitioned $8 million from the states in 1782. Later requisitions fared no better. By January 1783, Congress had only received $420,000 of that amount (Baack 1991). By March 1787, states had paid two-thirds of the October 1781 and April 1784 requisitions, one-fifth of the September 1785 requisition, and two percent of the August 1786 requisition. "By the end of 1786," Brown (1993, 25) notes, "Congress literally was receiving no money from the states for current federal needs and expenses." An attempt by Congress to float a loan in October 1786 failed completely, without having attracted a single subscriber. This forced Madison to conclude: "Experience has sufficiently demonstrated that a punctual and unfailing compliance by 13 separate and independent Governments with periodical demands of money from Congress, can never be reckoned upon with the certainty requisite to satisfy our present creditors, or to tempt others to become our creditors in future."[5]

Attempts to remedy this shortcoming by modifying the Articles of Confederation failed repeatedly during the decade. The Articles could be amended only by the unanimous consent of the states. In February 1781, Congress requested that the states amend the Articles and empower the Congress to levy an import duty of 5 percent. To allay the fears of the states that this would create an overly powerful central government and threaten their sovereignty, the proceeds of this tariff would be devoted exclusively to paying the interest and principal on the national debt and

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[5] PJM 6:144-45.

the duties would be abolished when the debt had been retired. Enactment of the measure looked promising: the proposal was approved by eleven states within a year, but then it stalled in the Rhode Island legislature. In November 1782, the Rhode Island legislature unanimously rejected the proposal, choosing to finance its state government with import duties rather than direct taxes and desiring to keep all the revenue from any import taxes for itself.

Undeterred, in early 1783 James Madison proposed a similar revenue plan that called for limited 25 year authorization for Congress to impose specific duties on enumerated items and a 5 percent duty on all other imports; the duties would be administered in part by state authorities. Congress approved the measure in April 1783, but the unanimous approval of the states again proved to be out of reach. Although this time Rhode Island agreed to it, Connecticut rejected it twice until finally accepting it in early 1784. By July 1786, every state had approved the proposal except for New York. The state had rejected the revenue plan in 1785, after upstate agricultural interests realized that their taxes would go up if the state gave up its claim on the collection of import duties in the port of New York City. Then New York passed it in 1786 with the requirement that the state oversee the collection of the import duties, determine how much would be given to the national government, and make payments to Congress in New York currency. These conditions were unacceptable to Congress, which required gold and silver coin to repay foreign creditors, leaving the matter at an impasse.[6]

Writing in 1787, James Madison concluded:

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[6] "The failure of constitutional revision in 1786 reflected less a division of opinion – all the states had endorsed a federal impost in principle – than the inherent difficulty of securing unanimous agreement to any proposal," notes Ferguson (1961, 337). "It appeared that the Articles of Confederation could not by constitutional procedure be amended to give Congress the limited accretion of power which majority opinion already sanctioned."

> "the present System neither has nor deserves advocates; and if some very strong props are not applied will quickly tumble to the ground. No money is paid into the public Treasury; no respect is paid to the federal authority. Not a single State complies with the requisitions, several pass over them in silence, and some positively reject them. The payments ever since the peace have been decreasing, and of late fall short even of the pittance necessary for the Civil list of the Confederacy. It is not possible that a Government can last long under these circumstances" (Brown 1993, 27).

The situation was no better when it came to regulating foreign commerce in an attempt to negotiate better terms for U.S. goods in foreign markets. After it achieved independence, the critical foreign-trade problem facing the United States was the loss of preferential access to the markets of the British Empire. The nation's economy depended upon exports, which amounted to 12 percent of GDP around 1790, and the loss of access to British-controlled markets was keenly felt. Not only did American producers now face higher duties on their goods in Britain, but, in July 1783, the British government banned American ships from ports in the British West Indies and outlawed the importation of selected American goods as well. This action sharply curtailed demand for America's shipping services and severely harmed New England shipowners and fishermen, fish being one of the products excluded from the West Indies. Some American products, such as lumber, flour, and livestock, could be brought to the British West Indies, but only in British vessels. Prior to independence, more than a quarter of U.S. merchandise exports were destined for the West Indies and the trade employed a sizeable share of America's merchant marine. Britain's actions also created difficulties for the U.S. balance of payments because, in the pre-revolutionary period, the nation's trade surplus on the West Indies trade helped finance trade deficits with Britain itself.

Under the Articles of Confederation, the thirteen states could not formulate a unified national response to Britain discriminatory trade policies. Article IX of the Articles expressly stated that "no treaty of commerce shall be made whereby the legislative power of the respective States shall be restrained from imposing such imposts and duties on foreigners, as their own people are subjected to, or from prohibiting the exportation or importation of any species of goods or commodities whatsoever." As a result, there was no national trade policy at all, but rather thirteen state trade policies.[7]

The national government tried to negotiate commercial agreements with Britain and other European trading partners, but the negotiations failed because the American diplomats had nothing to offer. They could not commit the states to any particular policy. By making demands on others without the ability to give something in return, the U.S. diplomatic overtures were doomed from the start. "The commerce of America will have no relief at present, nor, in my opinion, ever, until the United States shall have generally passed navigation acts," Adams wrote to John Jay (10.21.85). "If this measure is not adopted we shall be derided; the more we suffer, the more will our calamities be laughed at."[8]

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[7] Eleven of the thirteen colonies passed their own tariff laws during the 1780s. New Jersey and Delaware, the only two states that did not pass tariff legislation, lacked the large seaports of Massachusetts, New York, and Pennsylvania, and wanted to provide every encouragement to trade they could. Most of the import duties in the state tariffs were relatively low, at about five percent, and the structure of duties was quite similar across the states (Shepherd 1993). This decentralized tariff system produced many problems, but trade wars between the states were not among them. By the end of the 1780s, the tariffs of the states were converging with one another.

[8] John Adams was impatient for action: "Patience, under all the unequal burthens they impose upon our commerce, will do us no good; it will contribute in no degree to preserve the peace with this country. On the contrary, nothing but retaliations, reciprocal prohibitions, and imposts, and putting ourselves in a posture of defense, will have any effect. . . . Confining our exports to our own ships, and laying on heavy duties upon all foreign luxuries, and encouraging our own manufactures, appear to me to be our only resource, although I am very sensible to the many difficulties on the way" (Davis 1977, 99).

Some states tried to retaliate against Britain's exclusionary policies, but the lack of coordination undermined those efforts. In response to the West Indies prohibition, for example, Massachusetts prohibited British ships from loading American goods in its ports. But when Connecticut refused to follow this example, British ships merely shifted their destination from Boston to New Haven, and Massachusetts was forced to suspend its action a year later (Marks 1973, 82). Indeed, the neighboring states of New York and New Jersey, Pennsylvania and Delaware, could not enact strict shipping legislation unilaterally without simply diverting trade to its bordering neighbor. Some states were persistent: in 1787, New York attempted to lay duties on goods coming from Connecticut, and New Jersey as well, to punish them for not levying additional duties on British goods or tonnage. Still, that effort failed and the duties were soon abolished because no other states cared to join New York: smaller states tended to free ride off of the retaliatory actions of larger states and thus undermine the effort. The British easily evaded the differing state-by-state policies on navigation and simply went to the most welcoming ports.[9]

As was the case with taxation, efforts to amend the Articles of Confederation to remedy this shortcoming came to naught. In December 1784, Congress appointed a committee to change Article IX of the Articles and give Congress "the powers to regulate the commercial intercourse of the States with other powers." The committee recommended that Article IX of the Articles be

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[9] The national government had no power to formulate a collective solution to this problem. A British magazine recognized this: "By the latest letters from the American States, the restraint laid upon their trade with the British West Indies has thrown them into the utmost perplexity; and by way of retaliation they are passing laws inimical to their own interest; and what is still worse, inconsistent with each other . . . . Hence the dissensions that universally prevail throughout what may be called the thirteen Dis-United States" (Marks 1973, 83).

altered so that Congress would have the "sole and exclusive" authority of "regulating the trade of the States, as well with foreign nations, as with each other, and of laying such imposts and duties upon imports and exports as might be necessary for the purpose." New England states, with their mercantile base, were desperate to give Congress the power to deal with the foreign trade situation, and the Mid-Atlantic states were supportive as well. But the proposal floundered due to the sectional jealousies. Southern states were much less adversely affected by British shipping regulations in the West Indies and elsewhere and objected out of fear that the power would be used to exclude British competition for the shipment of U.S. exports, putting the South at the mercy of New England merchants. In essence, the South feared that it would face a northern monopoly on the shipping of its staple exports, raising transport costs and diminishing its export sales.

New England merchants and politicians were incensed at the South's reluctance to act. In their view, the South was refusing to act out of its own interest without considering the economic distress felt in other parts of the country. "They may get their goods to market cheaper if our ships have nothing to do," one correspondent complained to John Adams (Davis 1977, 85). New England wanted some preferences for American shipping, such as a tax on goods arriving or departing on British vessels, to strengthen the American shipbuilding and shipping industry.

The commercial distress was so acute in New England that there was even talk of seceding from the union if the South continued to block commercial reform.[10] Madison worried

[10] In August 1785, Madison reported to Jefferson: "The machinations of G.B. with regard to Commerce have produced much distress and noise in the Northern States, particularly in Boston, from whence the alarm has spread to New York and Philada. . . . the sufferers are every where calling for such augmentation of the power of Congress as may effect relief. . . . If any thing should reconcile Virga. to the idea of giving Congress a power over her trade, it will be

that the problem might dissolve the fragile nation. Madison, who thought that the advantages of giving Congress the power to regulate trade "appears to me not to admit of a doubt," repeated these fears to others:

> "I conceive it to be of great importance that the defects of the federal system should be amended, not only because such amendments will make it better answer the purpose for which it was instituted, but because I apprehend danger to its very existence from a continuance of defects which expose a part if not the whole of the empire to severe distress. The suffering part, even when the minor part, can not long respect a Government which is too feeble to protect their interest; but when the suffering part come to be the majority part, and the despair of seeing a protecting energy given to the General Government, from what motives is their allegiance to be any longer expected. Should G. B. persist in the machinations which distress us; and sever or eight of the States be hindered by the others from obtaining relief by federal means, I own, I tremble at the anti-federal expedience into which the former may be tempted."[11]

By the mid-1780s, there was a growing consensus among national political leaders that the current system of government was unworkable and should be reformed to strengthen the national government. The nation's unsatisfactory experience with the Articles of Confederation in the 1780s gave a compelling economic and foreign policy rationale for creating a stronger national government. Although many other factors were involved, the belief that the federal

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that this power is likely to annoy G.B. against whom the animosities of our Citizens are still strong. They seem to have less sensibility to their commercial interests; which they very little understand, and which the mercantile class here have not the same motives if they had the same capacity to lay open to the public, as that class have in the States North of us. The [high] price of our Staple since the peace is another cause of inattention in the planters to the dark side of our commercial affairs. Should these or any other causes prevail in frustrating the scheme of the Eastern and Middle States of a general retaliation on G.B., I tremble for the event. A majority of the States deprived of a regular remedy for the distresses by the want of a federal spirit in the minority must feel the strongest motives to some irregular experiments. The danger of such a crisis makes me surmise that the policy of Great Britain results as much from the hope of effecting a breach in our confederacy as of monopolising our trade." PJM 8: 344.

[11] PJM 8: 334-35.

government should have an independent source of revenue and credible authority to negotiate with foreign powers over navigation rights and market access were both important motivations for the constitutional convention of 1787.[12]

At the convention, delegates had no difficulty in agreeing to give Congress the power to impose import duties. Article I, section 8, clause 1 of the new Constitution contained the key provision relating to trade policy, which stated:

> "The 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; but all duties, imposts and excises shall be uniform throughout the United States."

This uncontroversial provision was adopted without significant debate or apparent dissent. Few disagreed with John Rutledge's observation that "taxes on imports [were] the only sure source of revenue" for the government (Farrand 1911, 3: 126, 327).

The proposal to grant Congress the general power to regulate foreign commerce, such as shipping regulations, was more contentious. The shipping states of New England desperately wanted to give the federal government the authority to regulate commerce so that American navigation laws could be enacted. In their view, enacting preferential duties for American ships in U.S. ports through differential tonnage duties would not only promote the domestic shipping industry but would put the government in a better position to negotiate a elimination of foreign regulations that blocked U.S. access to foreign markets.[13]

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[12] Brown (1993) stresses the finance motive while Marks (1973) and Edling (2003) stress the foreign policy motives, although they were all intertwined.

[13] From the standpoint of his region, Nathaniel Gorham of Massachusetts argued that there was little other reason for drafting a new constitution because "the eastern states had no motive to union but a commercial one" (Farrand 1911, 2: 374).

As before, Southern states feared giving Congress the power to regulate commerce. With their prosperity dependent upon large exports of agricultural staples, they wanted maximal competition to ensure inexpensive shipping services. If competition from British ships was seriously handicapped by American navigation laws, the South believed that it would be exploited by New England shipping interests and charged exorbitant freight rates that would reduce the price and volume of its exports. The South wanted to deny Congress the power to regulate commerce, or at least require a two-thirds vote in Congress to enact such regulations, to prevent hostile legislation that would leave it completely dependent upon New England shipping interests.

How were the sharply opposing views of the North and South reconciled? The ability to regulate commerce became bound up with the slave trade and formed part of the "dirty compromise" that played out over a few days in late August.[14] The essence of the "dirty compromise" was that "the South Carolina delegation would support the commerce clause if New England would support protection for the slave trade and a prohibition on export taxes" (Finkelman 1987, 214). This inter-regional agreement allowed the convention to get around these contentious issues, but each part of the compromise was controversial.

Thus, the desire to vest Congress with the power to tax and regulate foreign commerce was one of the major forces behind the chain of events that led to the new constitution. As Madison later recalled,

> "It was well known that the incapacity [of the States to regulate foreign commerce separately] gave a primary and powerful impulse to the transfer of the power to a common authority capable of exercising it with effect. . . . . In expounding the

[14] See Finkelman (1987) and Goldstone (2005).

> Constitution and deducing the intention of its framers, it should never be forgotten, that the great object of the Convention was to provide, by a new Constitution, a remedy for the defects of the existing one; that among these defects was that of a power to regulate foreign commerce."[15]

Alexander Hamilton, who was briefly a member of the Continental Congress when it sought unsuccessfully to gain the power to impose import duties, was also impressed by the experience of the 1780s. In the Federalist papers, Hamilton made two arguments for granting Congress powers over trade. First, if there was to be a national government, it was imperative that it be able to raise revenue and not depend upon contributions from the states. "A nation cannot long exist without revenue," Hamilton argued in Federalist 12. "Destitute of this essential support, it must resign its independence and sink into the degraded condition of a province. . . . Revenue therefore must be had at all events." Hamilton observed that the United States would at first depend largely upon import duties as the means of raising revenue, but suggested that "unless all the sources of revenue are open to its demands, the finances of the community under such embarrassments, cannot be put into a situation consistent with its respectability, or its security."

Second, Hamilton made the case for a national trade policy to achieve reciprocity, so that "we may oblige foreign countries to bid against each other, for the privileges of our markets." In Federalist 11, Hamilton argued that imposing trade restrictions against Britain "would provide a relaxation in her present system" that hindered U.S. commerce, and such a relaxation would be beneficial "from which our trade would derive the most substantial benefits." Hamilton emphasized the bargaining advantages of federal powers over commerce:

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[15] Letters of James Madison 4:251.

> "By prohibitory regulations, extending, at the same time, throughout the States, we may oblige foreign countries to bid against each other, for the privileges of our markets. . . . . Suppose, for instance, we had a government in America, capable of excluding Great Britain (with whom we have at present no treaty of commerce) from all our ports; what would be the probable operation of this step upon her politics? Would it not enable us to negotiate, with the fairest prospect of success, for commercial privileges of the most valuable and extensive kind, in the dominions of that kingdom?"

Thus, Hamilton held out the hope that American navigation laws would "produce a relaxation in her system" and enable the United States to enjoy the commerce of the West Indies once again. Furthermore, such an agreement "would be likely to have a correspondent effect on the conduct of other nations."

As the first Treasury Secretary, Hamilton vigorously sought revenue, but - as we shall see - shied away from reciprocity.

3. Trade Policy in Practice: Revenue

The first order of business for the new Congress under the new constitution was raising revenue to fund the government's operations and service the public debt. On April 8, 1789, two days after the Congress first achieved a quorum, Madison introduced a bill in the House of Representatives to levy duties on imports. Citing the urgent revenue requirements of the new government, Madison argued that a tariff should be imposed without delay so that the spring importations from Europe could be taxed. As a temporary expedient, Madison proposed a tariff structure based on that approved by the Continental Congress in 1783. The 1783 proposal called for a general 5 percent ad valorem tax on all imports and higher specific duties on such commodities as wine and spirits, tea and coffee. Madison suggested that a more permanent tariff structure be crafted at a later date, but that Congress should act quickly to avoid missing the spring imports and to start the revenue flowing into the Treasury coffers.[16]

Madison's proposal sparked a debate as to whether revenue should be the sole objective of the tariffs on imports. Several members argued that import duties should be levied to promote domestic manufactures as well as raise revenue. As Thomas Hartley of Pennsylvania put it, "No argument . . . can operate to discourage the committee from taking such measures as will tend to protect and promote our domestic manufactures . . . I think it both politic and just that the fostering hand of the General Government should extend to all those manufactures which will tend to national utility."[17]

Knowing that this highly controversial issue would produce an extended and contentious debate, thereby delaying the imposition of import duties and exacerbating the government's financial problems, Madison sought, and succeeded, in postponing a debate over protective duties. Indeed, at this early stage, the United States did not seriously consider "protectionist" policies, in the sense of high tariffs designed exclusively to protect domestic producers from foreign competition without any revenue motive. The simple political economy explanation for the lack of interest in protectionist trade policies is that the nation, from the merchant shipping interests in New England and New York to the staple exporters in the South, was completely dominated by pro-trade interests. There were very few import-competing manufacturers, mainly around Philadelphia, and they lacked the political strength to press for a high tariff policy. Partly

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[16] Madison argued that "the deficiency in our Treasury has been too notorious to make it necessary for me to animadvert upon that subject." "Let us content ourselves with endeavoring to remedy the evil. To do this a national revenue must be obtained; but the system must be such a one that, while it secures the object of revenue, it shall not be oppressive to our constituents."

[17] Annals of Congress, Vol. 1, April 9, 1789, p. 114.

for this reason, Alexander Hamilton's controversial proposals for federal aid to fledgling industries in the Report on Manufactures (1791) were not seriously considered by Congress.[18] Hence, there was no great debate over protectionism as a trade policy in the first decade under 1787 Constitution; such policies did not emerge until after the War of 1812 when the country had begun to acquire a manufacturing industrial base that demanded protection from foreign competition. At least initially, the greater concern was that the nation so disliked taxes that Congress had to be careful about raising import tariffs to such an extent as to promote smuggling or provoke a popular backlash.

Madison's tariff proposal became the second piece of legislation passed by Congress and was signed by President Washington on July 4, 1789. The preamble of the law stated that import duties were necessary "for the support of government, for the discharge of the debts of the United States, and the encouragement and protection of manufactures." By the standards of later tariff legislation, the first tariff bill was not fiercely contested.[19] The first tariff schedule consisted of three parts: specific duties on select commodities, ad valorem duties on most other goods, and duty free treatment for a small number of items.[20] The specific duties were largely levied on alcoholic beverages, although some of these duties provided incidental protection to some producers. For example, although domestic spirits were subject to an excise tax, it was

[18] On Hamilton's report, see Cooke (1975), Nelson (1979), Peskin (2003), and Irwin (2004).

[19] Peskin (2003, 91) notes that the tariff rates were generally lower than those in Pennsylvania and Massachusetts.

[20] The list of goods subject to specific duties were initially imposed on 36 goods, including beer, wine, and spirits, molasses, salt, and sugar, tobacco, tea, and coffee. The specific duties were viewed as a tax on luxuries consumed mainly by the wealthy; their main purpose was to raise revenue.

much less than the import tariff. Other specific duties were imposed explicitly for the benefit of domestic producers, such as those on boots and shoes, nails and spikes, fish and hemp. Almost all other imports were subject to ad valorem duties. Four levels of ad valorem duties were established: 15 percent (on carriages and parts), 10 percent (on china, stone, and glassware, among others), 7.5 percent (on cotton and woollen clothing, hats, hammered or rolled iron and other metal manufactures, and leather manufactures, among others), and 5 percent on all other articles not specified.

In September 1789, Alexander Hamilton became Secretary of the Treasury and emerged as the chief architect of economic policy in the Washington administration. Hamilton almost singlehandedly reorganized the nation's finances, managing debts and establishing the public credit, as Richard Sylla's chapter discusses. He also performed the vital task of setting up the customs service that was charged with collecting import duties at the principal U.S. sea ports. By all accounts, he managed the customs service with efficiency and great attention to detail, ensuring that it operated smoothly and functioned free of corruption.[21]

The revenue collected from customs duties increased sharply after the federal government took over the customs service. The returns from the ports of New York,

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[21] Dalzell (1993, 142) writes that "putting customs collection on a sound footing represented a crucial first step in Hamilton's program, and the Secretary of the Treasury kept as close a watch on the customs houses as he could manage from the capitol. Through a steady stream of circulars, instructions and advice to the collectors, Hamilton vigorously exerted his authority over the customs collectors. He assumed control over major customhouse expenditures; asked to be apprised of all seizures and attempts to defraud the revenue; and most importantly dispense general interpretations of the revenue laws to govern their implementation in the ports. Energetic and determined to implement an efficient, uniform system of operation, Hamilton more than any other single figure left an enduring stamp on the experiment of federal customs collection, marking it with his distinctive ideas of federal style, financial policy, and political economy."

Philadelphia, Baltimore, and Charleston jumped from $1.975 million over the period 1785-88 to $11.845 million during the period 1792-95, an increase of 600 percent (Edling and Kaplanoff 2004). The revenue growth was partly due to a revival of foreign trade after the adoption of the constitution, but also an increase in the rates of duty (which were roughly double those of New York in the 1780s) and the efficiency of the customs service in collecting them.

This administrative achievement was critical because the federal government was almost completely dependent upon customs revenues for its revenue. In 1792, for example, customs duties (on imported merchandise and shipping tonnage) accounted for $3.4 million of the $3.7 million of total government receipts. In that year government expenditures amounted to about $5.1 million, resulting in a substantial revenue shortfall. Hamilton recognized the precarious fiscal situation of the federal government and sought to raise these early tariffs to generate additional revenue. Indeed, given that virtually all government revenue was derived from customs receipts, and that the revenue generated by the initial tariffs was uncertain, the specific duties were fine tuned almost immediately in order to provide additional revenue.

In January 1790, in his first report on public credit, Hamilton proposed that Congress increase the duty on Madeira wine, Hyson tea, coffee, and chinaware, as well as other adjustments to the tariff code. The highest revenue-raising duties were imposed on wine, spirits, tea, and coffee because they were goods for which demand was relatively inelastic: "Experience has shown, that luxuries of every kind lay the strongest hold on the attachments of mankind, which, especially when confirmed by habit, are not easily alienated from them." Hence, Hamilton concluded: "it will be sound policy to carry the duties, upon articles of this kind, as high as will be consistent with the practicability of a safe collection. This will lessen the necessity, both of having recourse to direct taxation, and of accumulating duties, where they would be more inconvenient to trade, and upon objects which are more to be regarded as necessaries of life." Congress enacted most of these recommendations in August 1790.

Still more increases followed. Acting again on Hamilton's advice, Congress increased the duties on spirits in March 1791. At this point, Hamilton believed that "the duties on the great mass of imported articles have reached a point, which it would not be expedient to exceed" for fear of offending the merchant class and diminishing the revenue.[22] Therefore, he advocated a excise tax on domestically-produced spirits to diversify the government's sources of revenue: "it is clear that less dependence can be placed on one species of funds [import duties], and that, too, liable to the vicissitude of the continuance, or interruption of foreign intercourse, than upon a variety of different funds, formed by the union of internal with external objects.. . . .the attempt to extract wholly, both deceptive and pernicious - incompatible with the interests not less of revenue than of commerce; that resources of a different kind must, of necessity be explored."

Yet the revenue requirements of the government continued to grow. In 1792, in order to finance expenditures related to the protection of the western frontier, Congress advanced the ad valorem tariff schedule by 2.5 percentage points, pushing the base rate from 5 percent to 7.5 percent. In 1794, the basic schedule was raised another 2.5 percentage points, bringing the base rate to 10 percent, and duties on sugar and wine were increased to start retiring the public debt. In 1797, Congress imposed higher specific duties on sugar, molasses, tea, cocoa, and other products, along with an increase in the base rate to 12.5 percent. In each of these cases, the primary purpose of the adjustment was to raise revenue to finance government operations and

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[22] Second Report on Credit, December 1790. PAH, 7: 232.

the payment of the debt.

Figure 1 shows the evolution of the average tariff during this period. Although import tariffs were relatively low in 1790 and 1791, at around 12 percent, on average, subsequent revisions to the initial duties quickly brought the average tariff up to about 20 percent by the mid-1790s. Each of the early tariff spikes – in 1794, 1797, and 1804 – is proximately related to legislation that raised import duties. These revisions were motivated almost exclusively by revenue considerations and were relatively free from political controversy.

These estimates indicate the relative height of import duties over time, but reveal nothing about the structure of those duties. As a rough approximation, the specific duties were levied on consumption items for revenue purposes while the ad valorem duties were levied for the protection of some domestic producers. The higher average tariff was largely due to increases in specific duties, which ranged between 40 percent and 60 percent, on average (Irwin 2003). The ad valorem duties on manufactured and other goods remained relatively low through the 1790s, rising from 5 percent to just over 13 percent by 1800, by which time the base rate was 12.5 percent.

Levying taxes on imports proved to be an economically and politically efficient method of raising revenue. Imports arrived at just a few large seaports on the coast and required relatively few officials to collect the taxes upon landing. The administrative cost of enforcing import duties was just 4 percent of the gross revenue collected, while the cost of collecting domestic excise taxes was 20 percent of the gross revenue (Balinsky 1958, 57).

An equally important consideration was the fact that import duties were a politically efficient way of raising revenue. Tariffs were automatically built into the price of imported goods and avoided the "political minefield" of domestic taxes (Brown 1993, 238-239). In the aftermath of the fight over the constitution and the fragile nature of support for the federal government, Hamilton and others were cautious about domestic taxes might trigger a domestic political backlash, as indeed they did with the Whiskey Rebellion in 1794. Hamilton's fiscal and revenue program brought about a large and welcome shift in the nation's tax system. Edling and Kaplanoff (2004) note that leading states had to rely on direct taxes (poll and land taxes) to a much greater extent than on customs duties. These intrusive and burdensome taxes sparked a political backlash. By reducing the burden of debt on the states – allowing states to reduce those direct taxes by a significant margin, as much as 75 percent in many states – and substituting trade taxes for direct taxes, the perceived tax burden fell sharply. The protests over state taxes that had been frequent in the 1780s disappeared in the 1790s.

Still, Hamilton sought to supplement and diversify revenue sources away from customs duties, which were subject to vicissitudes of trade, to more dependable forms of internal revenue, such as excise taxes. Confronting the argument that the government should rely solely on import duties without any internal taxes, Hamilton warned that it would "deprive the government of resources which are indispensible to a due provision for the public safety and welfare. . . . if the government cannot then resort to internal means for the additional supplies, which the exigencies of every nation call for, it will be unable to perform its duty or even to preserve its existence. The community must be unprotected, and the social compact be dissolved."[23] Yet domestic taxes

[23] PAH 11, 85-86.

were highly unpopular and Congress was reluctant to enact them.[24] As a result, as Figure 2 shows, Hamilton only managed to diversify the source of government revenue to a modest extent.

Despite the growth in customs revenues that came with expanding trade in the early 1790s, the fiscal position of the federal government remained precarious. In 1792, the interest alone on U.S. debt soaked up 87 percent of total tax revenue. The United States only covered the revenue shortfalls only through a large loan from the Netherlands, which helped pay off previous foreign loans and allowed for the redemption of significant amounts of domestic debt (Riley 1978). Still, this refinancing meant that the nominal value of the national debt did not fall during the 1790. (It was not until 1796 that the government's tax revenue would cover federal debt and non-debt expenditures.) This left Hamilton open to charges from the Jeffersonian Republicans that he was not serious about retiring the debt. But as we have noted, there were political and economic constraints on further increasing either import duties or excise taxes. As Edling (2007, 306) notes, "Faced with a choice between raising taxes to pay off the debt rapidly or accepting indebtedness for at least the foreseeable future, Hamilton opted for the latter alterative."

These revenue constraints made Hamilton extremely cautious about husbanding the government's meager financial resources and maintaining the country's creditworthiness. For this reason, he desperately wanted the United States to remain neutral in any European military conflict, fearing that U.S. involvement would destroy the nation's finances. Becoming entangled

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[24] The stability of excises as a source of revenue was at least partly balanced by the unrest they caused. The Whiskey Rebellion in western Pennsylvania was triggered when Congress, acting on Hamilton's advice, boosted the excise tax on spirits in 1791.

in a war for which it was unprepared would ruin the nation's finances: government expenditures would soar and its revenues would collapse. This fear deeply colored Hamilton's approach to the issue of trade reciprocity.

4. Trade Policy in Practice: Reciprocity

In Federalist 11, Hamilton argued that threats to close the U.S. market to British goods, or to impose discriminatory restrictions against British shipping, could force that country to improve its treatment of American goods in its home and colonial markets. Yet, as Secretary of Treasury, Hamilton aggressively fought every effort to implement such a policy. Instead, he put overwhelming emphasis on the economic goal of maintaining and increasing customs revenue. Given the fragility of the nation's finances, the overriding priority of the Washington administration, in Hamilton's view, should be to ensure that the government could finance the interest on the public debt: "Nothing can more interest the National Credit and prosperity, than a constant and systematic attention to husband all means previously possessed for extinguishing the present debt, and to avoid, as much as possible, the incurring of any new debt."[25] Given the revenue constraints facing the government, the United States, in his view, had to avoid any significant drop in imports or the customs revenues that they generated, and also had to avoid any sudden, unexpected rise in spending. Both events would occur should the country become embroiled in a war and nothing, in his view, could destroy the nation's finances and credit rating faster.

Thus, economic policy dictated foreign policy: the nation had to maintain political

[25] PAH 11, 141.

neutrality between Britain and France in order to avoid conflict. Neutrality in turn required that import duties be imposed on a non-discriminatory basis so as not to offend British officials. Yet the public continued to harbor bitter feelings against Britain, whose postwar policies with respect to American commerce did not improve matters. Many Americans resented the country's continuing commercial dependence on Great Britain; the overwhelming majority of U.S. imports came from Britain, many exports were sent to Britain or her colonies, and trade finance was still largely British. Britain did not treat the commerce of the United States as favorably as it had when it was a colony, and had begun to interfere with U.S. shipping with the outbreak of the war with France in 1793.

Despite the public sentiment, Hamilton wanted to stifle the temptation to strike back at Britain. Hamilton vigorously opposed commercial discrimination aimed at Britain because he feared it could start a trade war. (Indeed, a representative from Britain warned him that any discriminatory measure would bring about not a relaxation of British mercantile regulations, but retaliation instead.) A trade war would dry up the flow of customs revenues arising from British imports and jeopardize Hamilton's entire fiscal program. American was in a much weaker position than Britain, in Hamilton's judgement, and therefore had much more to lose as a result of a commercial or military conflict.

By contrast, James Madison (in the House) and Thomas Jefferson (as Secretary of State) desperately sought commercial discrimination against Britain. Although the United States had won its political independence, they believed that it had not achieved economic independence and was much too reliant on commercial and financial ties with Britain. At the same time, they attacked mercantilist regulations that kept American goods and ships out of Britain's home and colonial markets. They advocated adopting the retaliatory policies endorsed by Hamilton in Federalist 11.[26] In their view, discriminatory measures against Britain would force it to open up the West Indies market to American shipping and improve its treatment of U.S. goods in its market. (Ironically, if these measures succeeded in changing Britain's policies, American would only become further dependent on commerce with Britain and its colonies.)

The basis for Jefferson and Madison's confidence that trade measures could force Britain to change its policy came from the colonial period. After the passage of the Stamp Act in 1765 and the Townshend Duties in 1770, some American colonists organized a boycott of British goods. In the case of the Stamp Act, British merchants who saw their exports to the colonies fall flooded Parliament with petitions demanding accommodation to end the non-importation. The British government complied and repealed the act. In the case of the Townshend duties, British merchants did not protest the lost exports because there was a domestic economic boom, but a change in the British government resulted in a repeal of the duties. From this pattern of American resistance through non-importation followed by British retreat, the colonists drew the conclusion - correctly in the case of the Stamp Act but incorrectly in the case of the Townshend duties - that British policy could be manipulated with American trade embargos.

Between 1789 and 1794, Madison and Jefferson tried repeatedly to implement discriminatory trade measures against Britain.[27] Each time they failed as the politically adroit

[26] But Hamilton saw the Madison-Jefferson approach as threatening his conception of U.S. trade and revenue policy. Although Hamilton had been closely allied with James Madison in securing the creation and implementation of the Constitution, they diverged sharply in their view of trade policy, as well as many other matters of economic policy. Schwartz (2005).

[27] See Peterson (1965), McCoy (1974), and Ben-Atar (1993).

Hamilton maneuvered to defeat them.

The first attempt came in the summer of 1789 as the new Congress was debating the first tariff bill. Along with the tariff on imported merchandise, Congress imposed duties on the tonnage of ships entering U.S. ports. These duties favored U.S.-owned ships: the duty was six cents per ton on American vessels versus fifty cents per ton on foreign vessels. But Madison wanted further discrimination among foreign ships, distinguishing between those from countries that had a commercial agreement with the United States (such as France) and those which did not (such as Britain). Madison and Jefferson believed that the United States possessed enough economic leverage to harm Britain's trade and force the country to relax its restrictions on American commerce. In their view, Britain depended more on commerce with America than the other way around because the United States sent essential food and raw materials – necessities, in their view – to Britain in exchange for manufactures and luxuries, which could be safely done without. In a trade war, Britain's commercial interests would be "wounded almost mortally, while ours are invulnerable," Madison explained. "I have, therefore, no fears of entering into a commercial warfare with that nation; if fears are to be entertained, they lie on the other side."[28]

Although Madison's proposal easily passed the House, it failed in the Senate, due to what proponents attributed to the British influence coming from the city of New York. President Washington lamented the Senate's action, calling it "adverse to my ideas of justice & policy." But apparently he did not recognize that, behind the scenes, his soon-to-be Treasury Secretary,

[28] PJM, May 4, 1789, p. 248.

Alexander Hamilton, helped energize Senate opposition to the measure.[29]

In early 1790, Madison used a petition from merchants demanding higher tonnage duties on foreign vessels to reopen the debate over tonnage discrimination. A House committee recommended doubling the tonnage duties on foreign ships from 50 cents per ton to $1 per ton. Madison proposed that the doubling only applied to countries without a commercial treaty with the United States, so that it would apply to Britain but not France. The House passed the measure and Jefferson praised the "salutary effect" it would have on Britain's behavior. However, once again, the bill languished and died in the Senate, where Hamilton apparently worked hard to ensure its demise.

A third opportunity to introduce discrimination came in January 1791, when France argued that it was exempt from the tonnage laws under the 1778 Treaty of Commerce. Jefferson disagreed with the French construction of the treaty, but wanted to grant France an exemption as a gesture of good will.[30] Hamilton agreed with Jefferson's interpretation of the treaty, that the United States was not obligated to grant an exemption, but set forth a series of polite but firmly-stated objections to Jefferson's proposal. In Hamilton's view, one problem was the "want of reciprocity in the thing itself," i.e., French ships would be given the same treatment as American ships in U.S. ports, but American ships would only get most-favored nation treatment in French

[29] In Washington's view, "The opposition of the Senate to the discrimination in the Tonnage Bill, was so adverse to my ideas of justice & policy, that, I should have suffered it to have passed into Law without my signature, had I not been assured by some members of that body, that they were preparing another Bill which would answer the purpose more effectually without being liable to the objections, & to the consequences which they feared would have attended the discrimination which was proposed in the Tonnage Law." PGW 3: 323-24.

[30] PAH, 7: 408.

ports. Hamilton believed that such a policy would have little practical effect, but the concession would set a dangerous precedent: "The introduction of such a principle without immediate reciprocity, would be a high price for the advantage which it is intended to compensate."[31]

Hamilton also pointed out that the tonnage duties were earmarked for paying down the public debt. "I do not mention this as an insuperable objection but it would be essential that the same act which should destroy this source of revenue should provide an equivalent," he argued. "This I consider as a rule which ought to be sacred, as it affects public Credit." He summed up his position in this way:

> "My commercial system turns very much on giving a free course to Trade and cultivating good humour with all the world. And I feel a particular reluctance to hazard anything in the present state of our affairs which may lead to commercial warfare with any power; which as far as my knowledge of examples extends is commonly productive of the worse kind of warfare. Exemptions & preferences which are not the effect of Treaty are apt to be regarded by those who do not partake in them as proofs of an unfriendly temper towards them."[32]

Although President Washington forwarded Jefferson's brief on the issue to Congress, the Senate defeated any concessions for France for a third time. Jefferson was outraged: "Our treasury still thinks that these new encroachments of Gt. Brit. on our carrying trade must be met with passive obedience and non-resistance, lest any misunderstanding with them should *affect our credit, or the prices of our public paper*."[33] As Jefferson complained bitterly to Washington:

"My system was to give some satisfactory distinctions to the French, of little cost to us,

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[31] Hamilton suggested that a new treaty of commerce with France could formalize reciprocity as a permanent principle. This "would perhaps be less likely than apparently gratuitous and voluntary exemptions to beget discontents elsewhere" – referring to the dim view that Britain would take of such a grant.

[32] PAH, 7: 426.

[33] PTJ, 20: 236.

> in return for the solid advantages yielded us by them; and to have met the English with some restrictions, which might induce them to abate their severities against our commerce. I have always supposed this coincided with your sentiments; yet the Secretary of the Treasury, by his cabals with members of the legislature and by high-toned declamations on other occasions, has forced own his own system, which was exactly the reverse."[34]

Hamilton had his own complaints, writing that Jefferson was "an avowed enemy to a funded debt." In his view, Jefferson was consistently proposing policies that could undermine his financial plans: "Jefferson with very little reserve manifests his dislike of the funding system generally, calling in question the expediency of funding a debt at all. . . . I do not mean that he advocates directly the undoing of what has been done, but he censures the whole on principles which, if they should become general, could not but end in the subversion of the system." Foremost among these risks were Jefferson's overtures to France, which he thought could create a hostile wedge with Britain and adversely affect his plans to fund the national debt. Hamilton believed that the foreign-policy views of Madison and Jefferson were "unsound and dangerous." "Attempts were made by these Gentlemen in different ways to produce a Commercial Warfare with Great Britain. . . .Various circumstances prove to me that if these Gentlemen were left to pursue their own course there would be in less than six months <u>an open War between the U States & Great Britain</u>." Such a war would destroy Hamilton's fiscal policies. Therefore, "the Neutral & the Pacific Policy appear to me to mark the true path" that the country should follow.[35]

To Washington, Jefferson complained that the charge of his having a "desire of not paying the public debt" was completely untrue:

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[34] PTJ, 24, 353-354.

[35] PAH 11: 429-430.

> "every word, and act on the subject . . . prove that no man is more ardently intent to see the public debt soon and sacredly paid off than I am. This marks the difference between Colo. Hamilton's views and mine, that I would wish the debt paid tomorrow; he wishes it never to be paid, but always to be a thing wherewith to corrupt and manage the legislature."[36]

Jefferson accused Hamilton taking on so much debt such that the country was "obliged to strain the impost till it produces a clamour, and will produce evasion, and a war on our own citizens to collect it: and even to resort to an Excise law, of odious character with the people, partial in its operation, unproductive unless enforced by arbitrary and vexatious means, and committing the authority of the government, in parts where resistance is most probable, and coercion least practicable."[37]

This conflict over U.S. trade policy came to a head in early 1794, when the threat to Hamilton's fiscal system was perhaps the greatest. The outbreak of war between Britain and France in February 1793 triggered a debate about whether the United States should back France, its ally during the revolutionary war, and thereby risk war with Britain, or remain neutral. With the European powers attempting to destroy the trade of the other, they - but primarily Britain - began intercepting American shipping and confiscating the cargoes, actions that fueled anti-British sentiment. Washington took Hamilton's advice and issued the neutrality proclamation in April 1793, but Jefferson and Madison, who strongly supported a tilt toward France, made one last bid for economic non-neutrality.

In December 1793, the outgoing Secretary of State sent Congress a report on commercial discrimination. Jefferson's report documented the manifold foreign barriers placed on U.S.

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[36] PTJ, 24: 355.

[37] PTJ 23: 536.

goods and shipping in foreign markets, particularly those controlled by Britain. Jefferson's preferred course of action was "friendly arrangements" – trade agreements – with foreign countries to remove the impediments to trade. However, Jefferson argued at length that

> "should any nation, contrary to our wishes, suppose it may better find its advantage by continuing its system of prohibitions, duties, and regulations, it behooves us to protect our citizens, their commerce, and navigation, by counter prohibitions, duties, and regulations, also. Free commerce and navigation are not to be given in exchange for restrictions and vexations, nor are they likely to produce a relaxation of them."

He then outlined a policy of strict reciprocity, in which high duties would be met with high duties and prohibitions with prohibitions, all in an effort to free trade from such impediments.[38] The thinly veiled message was that the United States should strike back at British restrictions on U.S. commerce.

Jefferson's report prompted Madison to raise the issue of discrimination once again. Madison proposed to implement Jefferson's reciprocity policy by imposing higher duties on good and shipping from countries without a commercial treaty with the United States. Clearly aimed at Britain, without mentioning the country's name, Madison argued that "what we receive from other nations are but luxuries to us, which, if we choose to throw aside . . . . if we are force, in a contest of self-denial." Therefore, the United States could "make her enemies feel the extent of her power." Discrimination would also diversify trade away from Britain: "They would

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[38] Jefferson discounted the risk of foreign retaliation: "It is true, we must expect some inconvenience and practice from the establishment of discriminating duties. But in this, as in so many other cases, we are left to choose between two evils. These inconveniences are nothing, when weighed against the loss of wealth and loss of force, which will follow our perseverance in the plan of indiscrimination. When once it shall be perceived that we are either in the system or in the habit of giving equal advantages to those who extinguish our commerce and navigation by duties or prohibitions, as to those who treat both with liberality and justice, liberality and justice will be converted by all, into duties and prohibitions." American State Papers, Foreign Relations, 1: 300ff. See also Peterson (1965).

produce, respecting many articles imported, a competition which would enable countries who do not now supply us with those articles, to do it, and would increase the encouragements on such as we can produce within ourselves."[39]

Hamilton worked feverishly in Congress and within the Administration to defeat these proposals and avoid a potential conflict with Britain.[40] Hamilton argued that "The folly is too great to be seriously entertained by the discerning part of those who affect to believe the position - that Great Britain . . . will submit to our demands urged with the face of coercion and preceded by acts of reprisal . . . . it is morally certain that she will not do it." Hamilton mobilized his Congressional allies to speak out strongly against any reciprocity measure that involved discrimination against Britain. Indeed, Hamilton wrote the main speech against Madison's proposals, delivered by William Loughton Smith of South Carolina.[41]

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[39] PJM 15: 182ff.

[40] In 1792, Hamilton drafted a reply to Jefferson's impending report, which began by noting: "The commercial system of Great Britain makes no discriminations to the *prejudice* of the UStates as *compared* with other foreign powers" and "There is therefore no ground for a complaint on the part of the UStates that the system of G Britain is particularly *injurious* or *unfriendly* to them." PAH 13:412.

[41] The speech argued that setting up such trade barriers would hurt the United States more than Britain and that it was completely unrealistic to expect British policy to change as a result of such actions. Hamilton through Smith ridiculed "a Government attempting to aid commerce by throwing it into confusion; by obstructing the most precious channels in which it flows, under the pretense of making it flow more freely." He warned of "the impracticability and Quixotism of an attempt by violence, on the part of this young country, to break through the fetters which the universal policy of nations imposes on their intercourse with each other." "The main argument for the chance of success, is, that our supplies to Great Britain are more important to her than hers to us. But this is a position which our self-love gives more credit to than facts will altogether authorize. . . while a commercial warfare with Great Britain would disturb the course of about one-sixth of her trade, it would disturb the course of more than one-half ours." <u>Annals of Congress</u>, January 13, 1794, pp. 196, 203, 202. As Jefferson wrote to Madison, "I am at no loss to ascribe Smith's speech to its true father. Every tittle of it is Hamilton's except the introduction. There is scarcely any thing there which I have not heard

Sensing that he did not have sufficient political support for his proposals, Madison sought to delay any vote by the House. Still, anti-British sentiment was running high in Congress because of attacks on American neutral shipping. In March, Congress imposed a one-month embargo on trade with Britain. In April, Congress considered measures to sequester payments to British creditors and to prohibit trade indefinitely. Hamilton wrote to Washington that these actions - stopping debt repayment or enacting an embargo - "cannot but have a malignant influence upon our public and mercantile credit. . . . Every gust that arises in the political sky is the signal for measures tending to destroy [our] ability to pay or to obstruct the course of payment." In particular, an embargo would lead to the "derangement of our revenue and credit." Such a precipitous act would

> "give a sudden and violent blow to our revenue which cannot easily if at all be repaired from other sources. It will give so great an interruption to commerce as may very possibly interfere with the payment of the duties which have heretofore accrued and bring the Treasury to an absolute stoppage of payment – an event which would cut up credit by the roots."

Hamilton responded to Madison's claim that the United States possessed great commercial strength:

> "Tis as great an error for a nation to overrate as to underrate itself . . . . Tis our error to overrate ourselves and to underrate Great Britain. We forget how little we can annoy how much we may be annoyed. . . . To precipitate a great conflict of any sort is utterly unsuited to our condition to our strength or to our resources."

Which view was a more accurate appraisal of the situation? In terms of economic leverage, the figures on bilateral trade shown on Table 1 seem to confirm Hamilton's view. While Britain sent nearly a fifth of its exports to the United States, only six percent of its imports

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from him in our various private tho' official discussions. The very turn of arguments is the same, and others will see as well as myself that the style is Hamilton's. PTJ 28: 49.

came from the United States. On the other hand, the United States was much more dependent on Britain for its exports and imports. Of course, Madison argued that these percentages were misleading: the United States exported essential food and materials to Britain, whereas it imported trifles from that country. Therefore, he concluded, the United States had much more economic leverage than these shares indicated. Yet later attempts to coerce British policy through economic means demonstrated that other countries could, in fact, supply Britain with similar goods. When they had the opportunity to give their policies a trial, Jefferson and Madison were repeatedly surprised and frustrated by the ineffectiveness of trade sanctions to bring about the desired change in Britain's policy.

In terms of the dependence of U.S. commerce on British shipping, the European war rendered the debate over tonnage discrimination completely moot. The war diverted the British merchant marine into the navy, allowed American ships to take over the carrying trade left in the British wake. As Figure 3 shows, the British share of the tonnage entering U.S. ports fell sharply after 1792. American ships began to dominate the Atlantic carrying trade and U.S. commerce experienced a boom in re-export trade (Goldin and Lewis 1980).

Finally, Hamilton's fears about the financial market reaction to these events are borne out by the price of U.S. government debt in New York. Figure 4 illustrates Hamilton's remark that "Every gust that arises in the political sky is the signal for measures tending to destroy our ability to pay or to obstruct the course of payment" by showing that the price of U.S. government debt in New York appears to have been highly sensitive to political events during 1793-94. The market reacted negatively to Congressional attacks on Hamilton (Giles resolutions), the European war, Jefferson's report on commerce, and reacted positively to Washington's neutrality proclamation and the Jay peace mission.

Hamilton again won the debate in Congress and within the Washington administration. Hamilton convinced Washington to defuse the immediate crisis by sending John Jay to negotiate a treaty with Britain concerning neutral shipping rights.[42] With the Jay mission underway, Congress easily defeated the proposal to impose discriminatory tonnage duties on Britain (see Table 2). Madison's proposal for discrimination was a minority position even among representatives from the South.

The resulting Jay treaty was one of the most controversial foreign policy debates in American history. Under the terms of the treaty, the United States agreed not to discriminate against Britain in its commercial policy in exchange for a British opening of the West Indies market. After heated national debate, the Senate endorsed the treaty by the slimmest possible margin.

By putting the issue of discrimination to rest, the Jay treaty secured Hamilton's system. With commercial peace with Britain secure and the re-export trade booming, the government was finally able to begin paying down the debt. While the nominal value of the national debt was little changed over the 1790s, Hamilton did make an effort to begin paying down the debt

[42] PAH, 18: 451-452. In an analysis of the Jay Treaty written for Washington after Hamilton had left office, Hamilton noted that "the greatest interest of the Country in its external relations is that of peace." Any commercial advantages from particular treaties was much less important. Peace would allow the country to buy time to strengthen. "War at this time would give a serious wound to our growth and prosperity. Can we escape it for ten or twelve years more, we may then meet it without much inquieture and may advance and support with energy and effect any just pretensions to greater commercial advantages than we may enjoy."

after 1794, although this was partly masked by borrowing during the quasi-war with France.[43] However, Hamilton's policy of commercial peace did allow a sharp reduction in the debt to GDP ratio, even if the nominal value of the debt did not decline. In his Farewell Address (drafted by Hamilton), Washington stated that the public credit was "a very important sources of strength and security" which should be used "as sparingly as possible, avoiding occasions of expense by cultivating peace." The Adams administration continued the Federalist policies of neutrality, non-discrimination, and moderate tariffs until the end of the decade.

5. The Jefferson Administration

A detailed discussion of the Jefferson administration's economic policies is beyond the scope of this chapter, but the period gives us a glimpse at the possible consequences of the Republican alternative to Federalist policies.

Thomas Jefferson's election as president in 1800 portended significant changes to Federalist economic policy. Jefferson appointed Albert Gallatin as Treasury Secretary. Gallatin had written a strong attack on Hamilton's policies in 1796, the thrust of which was that Hamilton's complex financial management lacked transparency and that very little effort had been made to retire the debt. Yet once in office, Gallatin and the Republicans made relatively few changes to Hamilton's fiscal system: a functional revenue system was in place and the Jay Treaty prevented any major changes to trade policy. Over Gallatin's objections, internal taxes were abolished, which left the government completely dependent upon customs duties for fiscal

[43] On Hamilton's financial program, see Garber (1991), Swanson and Trout (1992a, 1992b) and Edling (2007).

revenues, as Figure 3 shows. They matched increases in spending with increases in import duties, levying higher rates in 1804 to pay for military action against the Barbary pirates and began paying down the national debt at an accelerated pace.

After the Jay treaty expired in 1805, however, the Jefferson administration took a much less accommodating stance with respect to Britain. The renegotiation of a successor agreement failed over the British impressment of U.S. sailors. Without a formal agreement establishing an understanding about neutral shipping rights, the risk of a conflict between the two countries became more pronounced. Such an event occurred in June 1807, when the British navy attacked the U.S.S. Chesapeake.

Rather than declare war, Jefferson proposed an embargo on all overseas shipping during 1808 to safeguard American merchants and punish Britain for its cavalier treatment of American ships and sailors. This experiment in "peaceable coercion" failed to change Britain's policy, but, in bringing the nation's foreign commerce to a halt, severely disrupted the U.S. economy. As the economic pain and political unrest caused by the embargo increased through 1808, pressures mounted for its abolition. Federalists vociferously opposed the embargo as harming the nation's prosperity and debilitating the government's finances, arguing that the measure was futile and would ultimately fail to coerce Britain into changing its policies. Even Jefferson's Treasury Secretary, Albert Gallatin, thought that it was "entirely groundless" to hope that the 1807 embargo would win concessions from Britain.[44] The embargo was lifted in early 1809 and was

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[44] Irwin (2005) calculates that the welfare loss from the year-long embargo was roughly 5 percent of GDP in one year. "Despite overwhelming evidence to the contrary," Ben-Atar (1993, 171) argues, Jefferson "continued until the end of his public life, to hold on to an inflated assessment of the strength of the United States and its commerce." In 1794, Hamilton predicted that any embargo would be short-lived because it would fail to affect Britain and the domestic

replaced with selective non-importation measures.

Although the embargo was a failure, it created surprisingly few fiscal problems for the United States. The fiscal impact came when customs revenues plunged to $7 million in 1809 from $16 million the previous year. This forced Gallatin to confront a significant budget deficit, but the Treasury could absorb the shortfall by using large existing balances built up from previous fiscal surpluses. Unlike the experience of 1794, the market price of U.S. government debt was virtually unaffected during this period. The federal government was able to continue paying down the debt and U.S. credit remained strong until the War of 1812.

6. Alternative Paths and Roads Not Taken

This chapter has broadly described the economic policy debate concerning trade and revenue policy in the 1790s. This debate was relatively narrow in the sense that there existed a broad consensus that import duties should be the principal source of revenue. There was no debate about whether there should be import duties or whether the public debt should be funded. Given this consensus, there were relatively few policy options that could have taken the country in a different direction. The disputes about the role of excise taxes, and the gains from discriminating against British shipping, were relatively minor in comparison to a decision to repudiate the public debt or rely on inflationary finance.[45]

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consequences “may occasion the most dangerous dissatisfaction & disorders in the community and may drive the government to a disgraceful retreat – independent of foreign causes” (PAH 16: 275).

[45] Of course, the country had already experienced the debilitating effects of inflation during the Revolutionary war and did not want to repeat the experience. Bordo and Végh (2002) contrast the early U.S. experience with that of Argentina.

The most obvious counterfactual to consider is: what if Washington had taken the advice of Jefferson and Madison instead of Hamilton with regard to commercial discrimination? In some sense, the issue was of greater symbolic importance than the underlying economic stakes might suggest. For example, the direct financial price of discriminatory tonnage duties would have been small. In 1791, the Treasury collected $3,171,474 in duties on imported merchandise and only $145,347 on tonnage.[46] Thus, the effect of discrimination on the government's fiscal balance would have been relatively small - in the absence of any British retaliation. Of course, the presumed absence of British retaliation is a key qualification. It is very difficult today to judge Britain's reaction if such a policy had been attempted.

Without much doubt, a Republican program of "aggressive reciprocity" would have been much more disruptive to trade than the Federalist approach. A fair trial was given in the Jefferson and Madison administrations. This would have proven a risky strategy earlier on, given the government's dependence on import duties for revenue. Although the fiscal impact of the Jeffersonian embargo was relatively mild because of accumulated Treasury surpluses, the government did not have had this financial cushion in the early 1790s.

Two other alternative paths also would have changed the course of history. If the Articles of Confederation had been amended to allow Congress to lay duties on imports, the Articles could have been perpetuated as a governing framework because the revenue issue would have been at least partly solved. While solving the government's financial problem, the United States still would have been saddled with a weak governmental framework that would probably have caused greater political problems down the road.

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[46] American State Papers, Commerce and Navigation, pp. 140-141.

Another path would have been trade protectionism through excessively high duties. The economic costs of such a policy would likely have been smaller than the political threat such a policy would have posed to the union. The United States was not the "united" states yet; the union was still fragile and many sections would have strongly opposed trade restrictions for infant industries. In later years, such extreme trade policies threatened the nation's unity. During the War of 1812, sentiment in New England ran in favor of breaking away from the Union because of the anti-shipping, anti-trade policies of the Jeffersonian Republican dominated the federal government's approach. If the United States could not err too much in terms of anti-shipping policy without alienating New England, it also risked erring on the side of too much anti-import, pro-protection for manufacturers policy that would have offended the South. One of the most serious antebellum threats to the union was the Nullification Crisis of 1832-33. After the passage of the Tariff of Abominations in 1828, South Carolina vowed not to enforce the federal tariff and even threatened to secede from the union.

Thus, approached without the spirit of compromise, the issue of trade policy had to potential to tear the country apart. That such extreme measures were avoided in the 1790s helped cement the union of states.

Conclusion

The Washington administration, blending George Washington's sound judgement and Alexander Hamilton fiscal acumen, successfully navigated the tricky economic transition from the difficult days under the Articles of Confederation in the 1780s to the new government under the Constitution of 1787. The financial foundation of the new federal government depended on its conduct of trade policy, which at the time was largely revenue policy. By avoiding many pitfalls, at a time when the political union and its finances were exceedingly fragile, the Washington administration helped put the nation on a sound economic basis.

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Table 1: Trade Dependence, circa 1792

	United States	Great Britain
Share of Exports to other	24%	19%
Share of Imports from other	88%	6%

Sources: American State Papers, Commerce and Navigation, Vol. 1, p. 194. Mitchell (1988), p. 494.

Table 2: House of Representatives Vote on Doubling Tonnage Duties on British Vessels, May 10, 1794

	Yea	Nay
New England	2	19
Mid-Atlantic	3	24
South	19	24
Total	24	55

Figure 1: Measures of Average Tariff, 1790-1820

Note: calculated as customs duties divided by value of imports for consumption

Source: Irwin (2003, Table 1).

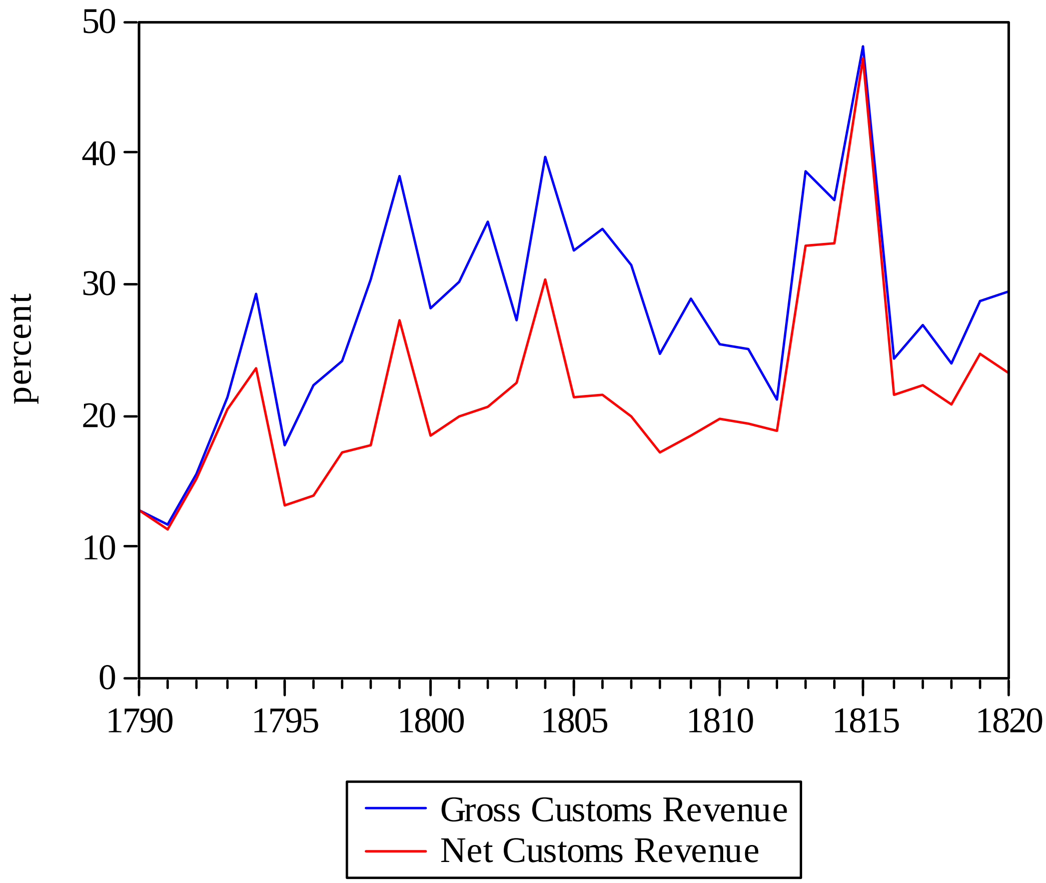


Figure 2: Sources of Federal Government Revenue

Source: U.S. Bureau of the Census (1975), series Y-352-353.

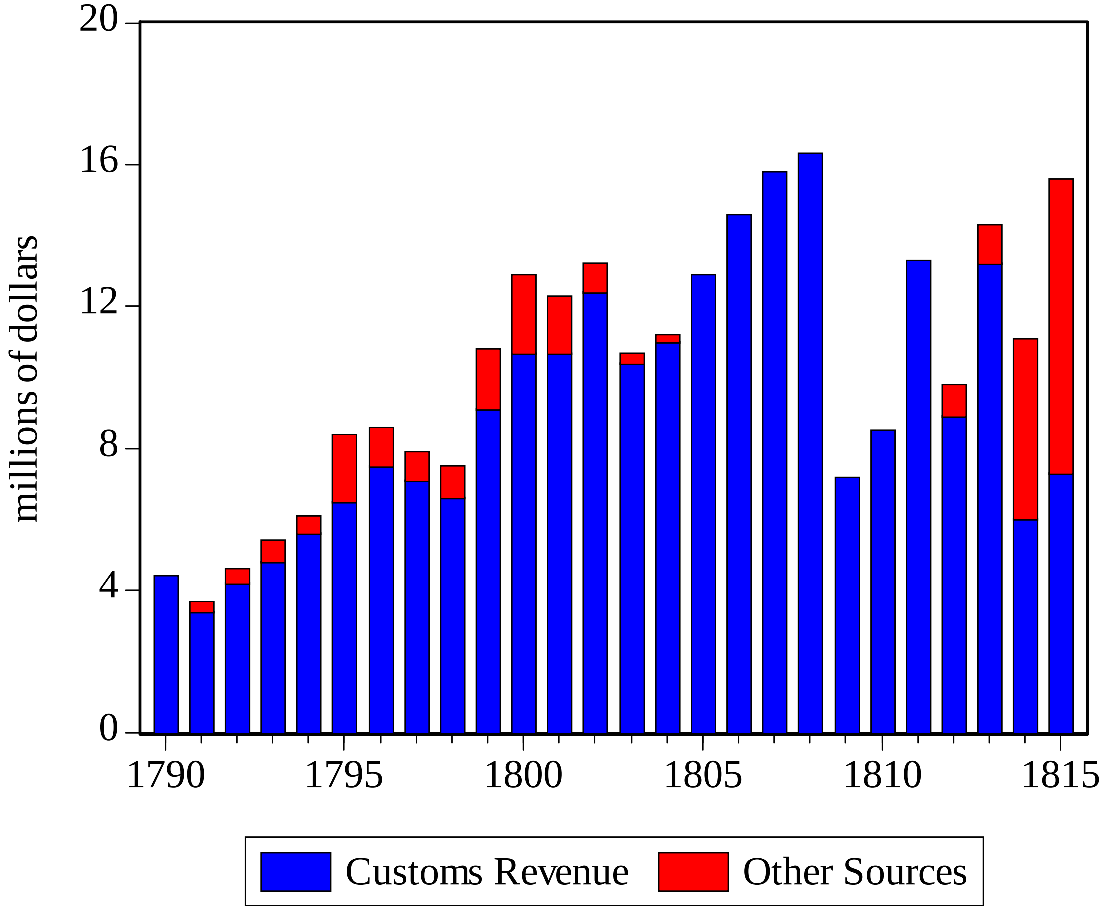


Figure 3: Tonnage of Shipping Entering U.S. Ports, by Ship Owner, 1789-1797

Source:

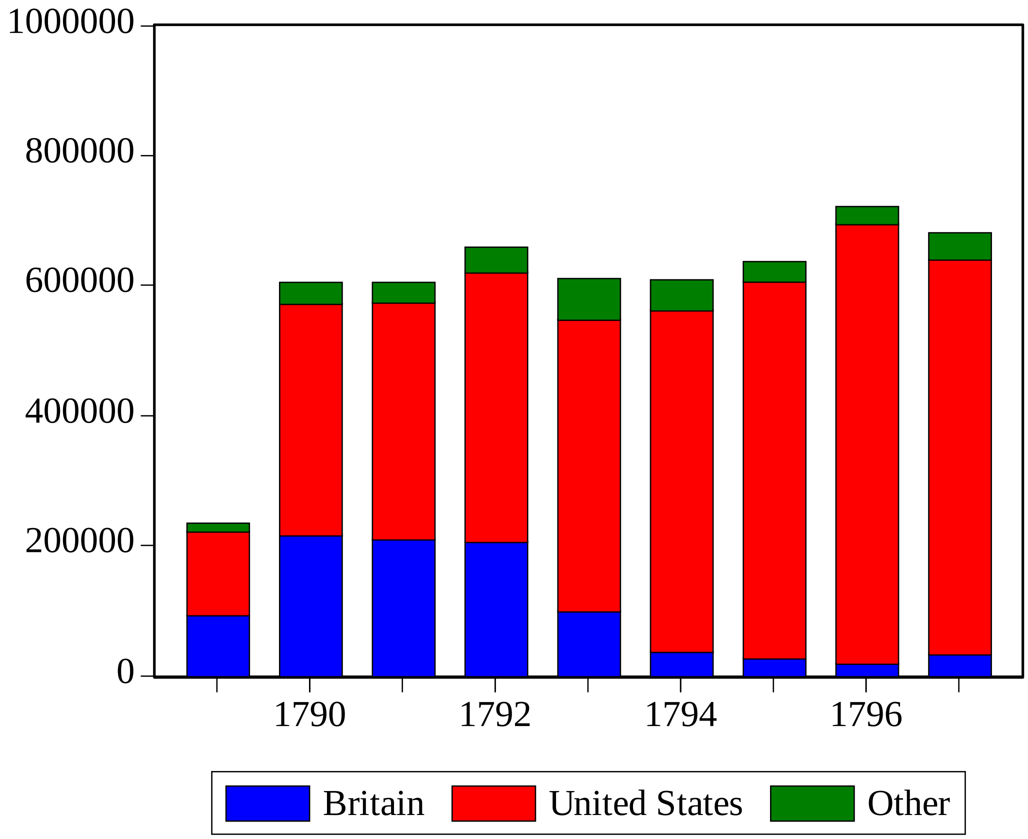
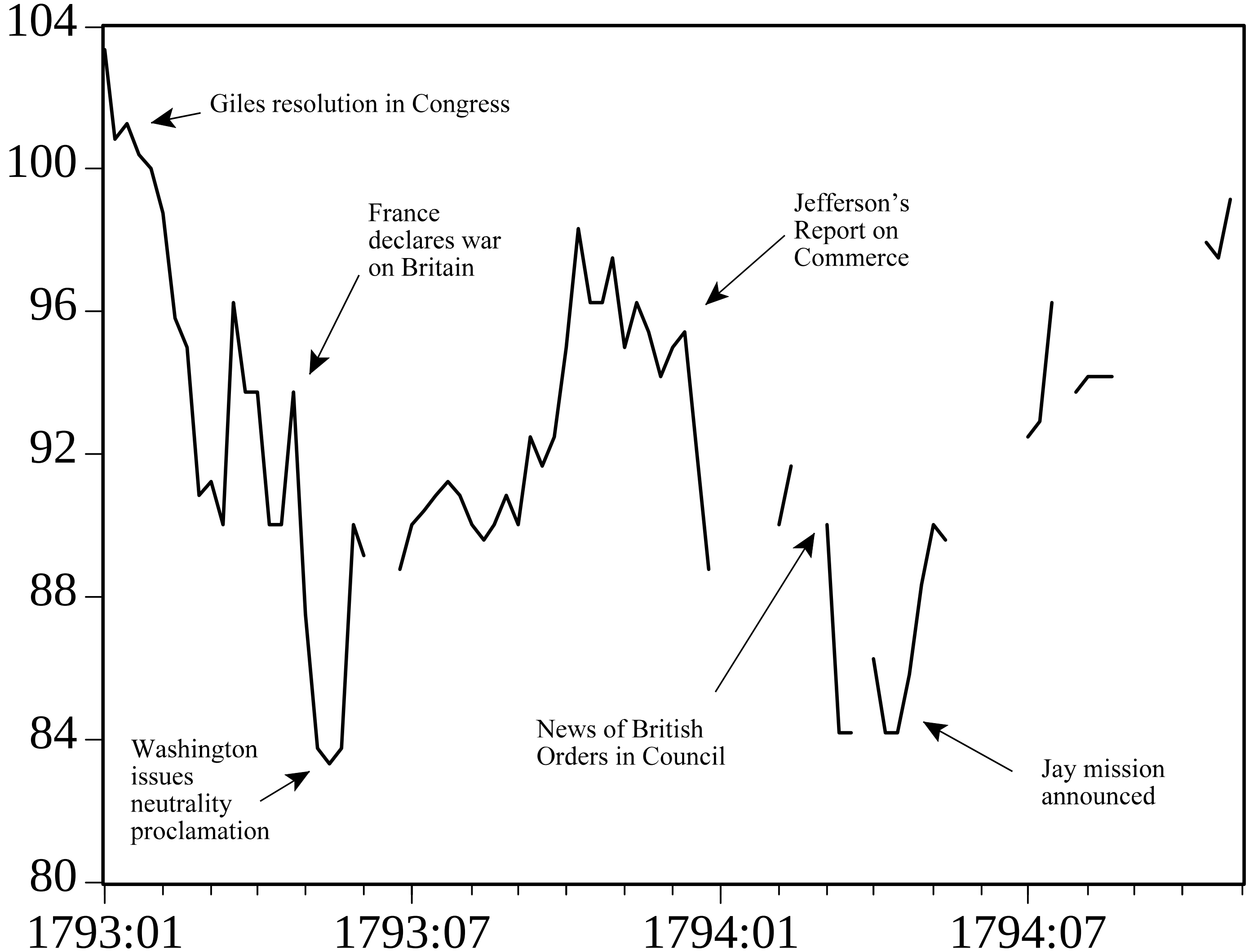


Figure 4: Price of U.S. Securities in New York, January 1793 - October 1794

Source: Sylla, Wilson and Wright. US 350, U.S. 6s. National Bond.



Available at http://eh.net/databases/early-us-securities-prices

Figure 5: U.S. Federal Government Public Debt to Nominal GDP Ratio, 1791-1815

Sources: Public Debt: U.S. Department of Commerce (1975), Series Y 493. Nominal GDP: Johnston and Williamson (2003).