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What Would Thomas Jefferson Do?

by *Robert Sloan*

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How can A.I.G. lose billions of dollars and justifiably distribute taxpayer aid to the people whose actions put the company in the government's hands in the first place? This type of riddle has rankled the nation before. In fact, Thomas Jefferson and Alexander Hamilton engaged in a similar debate more than two centuries ago.



In the early days of our republic, the economic foundation of the country was in disarray. The debt of the federal government was vast, as was that of the states, each of which had its own currency, not to mention debt and tariff laws. Some states were credit-worthy, some were not, and most paid the soldiers who had helped win the Revolutionary War merely in I.O.U.'s.

In order to steady the economy, Treasury Secretary Hamilton consolidated these I.O.U.'s, and other state debt, under the federal government. The move was called "assumption," and Hamilton planned to pay for it by introducing a debt scheme funded by new taxes and the use of western land as collateral. Even before Hamilton's plan was enacted, skillful investors and speculators began purchasing these depressed instruments from soldiers and other debt holders, creating the widespread appearance of an arbitrage. The states' debt and I.O.U.'s were trading at very large discounts to par, some as low as 15 cents on the dollar.

A vast fortune could be made if you could locate state creditors and purchase their claims at a discount. As historian Thomas Fleming noted in a recent issue of *American Heritage*, Senator Robert Morris, considered by some to be the wealthiest man in America, sent agents scurrying to western Pennsylvania to buy up cheap paper from unsuspecting citizens. Congressman James Wadsworth sent two ships to South Carolina for the same purpose. Many of Hamilton's influential New York friends ended up owning more than \$2.5 million of the state debt through similar maneuvers.

This profiteering of the insiders caused a public uproar. Did the shrewd speculators deserve the money more than the soldiers who had risked life and limb for it? Did they attain it fairly? In the Senate, Thomas Jefferson—supported by John Adams—decried that many New York fortunes had been made at the expense of unsophisticated citizens. Even if no laws had been broken, Jefferson argued, the money was ill-gotten and the profits should be redistributed to the original bond and I.O.U. holders. That was the only fair response, wasn't it?

It wasn't, Hamilton argued. The country's financial well-being relied upon the sanctity of contracts. The speculators should be rewarded because they had shown faith in the success of the new government. But, perhaps more important, in order to develop viable markets, a deal had to be a deal. Hamilton knew the speculators may not have had a patriotic motivation for buying the soldiers' debt, but this matter paled in comparison to preserving the underpinning—and the future—of the young country's financial system. Were the monies to be redistributed, he feared, the economy would be dealt a massive—potentially irreparable—blow.

It may have been controversial, but Hamilton's clear vision of the government's role in a financial imbroglio created the modern American capital markets. By contrast, in today's crisis, Washington's plans have been murky and rapidly changing—based partly on the government's reaction to the public's Jeffersonian distaste for speculation and its own unease about adopting a (albeit unpopular) Hamiltonian stance. But the ramifications of this ambiguity are making

matters worse. We now face new rules for stock borrowing, changes in market-to-market accounting, and new taxes on carried interests and T.A.R.P.-related bonuses. Even a ban on proprietary trading by T.A.R.P. recipients is receiving consideration. Unsure of the principles that govern the behavior of our financial institutions, the markets have lost confidence. And since investors don't know the rules for participation, cash balances in hedge funds and money-market funds have never been higher.

Though he lost the assumption battle, Jefferson eventually got what he wanted: a government that would be far away from the influence of money. (Figuratively, of course, but also literally: the nation's capital began a decade-long southern migration—first to Philadelphia, then to the banks of the Potomac.) Unable to halt the (heavily taxed) A.I.G. bonuses, now is the time for Congress and President Obama to figure out what they want in return from Wall Street. As we did centuries ago, we must move beyond the public's ex post facto cry to redistribute soiled income and concentrate instead on creating lending capacity. Washington must figure out how to replace the asset-backed, structured investment vehicles and other parts of the non-traditional, or “virtual,” banking system that have all but disappeared. Until an overall deal or structure is clear, the critical risk capital that drives our economy will stay on the sidelines interminably to the detriment of us all, and the dismay of our founding fathers.

Robert Sloan is the managing partner of S3 Partners, LLC, a New York– and London-based prime brokerage risk manager. He is the author of the forthcoming Don't Blame the Shorts: Why Short Sellers Are Always Blamed for Market Crashes and How History Is Repeating Itself, to be published by McGraw-Hill this fall.

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