States, Not Nation: The Sources of Political and Economic Development in the Early United States

Naomi R. Lamoreaux, Yale University and NBER

John Joseph Wallis, University of Maryland and NBER

Draft of December 23, 2016

Acknowledgements: We are grateful for the helpful comments of Charles Calomiris, Brian Cheffins, Walter Friedman, Gary Gerstle, Timothy Guinnane, Eric Hilt, Geoffrey Jones, David Konig, John Majewski, Tom Nicholas, William Novak, Gautham Rao, Paul Rhode, Laura Sawyer, Stephen Skowronek, and participants in the Yale Economic History Lunch, in workshops at Assumption University of Thailand, the Harvard Business School, Harvard University (Economics Department), New York University Stern School of Business, the University of Michigan, the session on "The Local Roots of Economic and Political Development" at the 2014 annual meeting of the Organization of American Historians, and the conference "Taking Stock of the State in Nineteenth-Century America" at Yale.

Abstract

General histories of the United States focus almost exclusively on developments at the national level. Yet it is well known that most of the important changes that propelled political democratization and economic modernization in the nineteenth century occurred at the state level. This paper shifts the focus back the states by reexamining aspects of economic development that the states are conventionally acknowledged to have led—the creation of a banking system, the construction of transportation infrastructure, the promotion of corporations—and showing that they were part and parcel of a more fundamental institutional shift that gradually reshaped the way democracy worked. To borrow the terminology that Douglass North, John Wallis, and Barry Weingast developed for their book *Violence and Social Orders* (2009), this shift transformed the United States from a "limited access" to an "open access" social order. The United States was not born modern at the time of the American Revolution or even the Constitution. Rather, we contend, the institutional prerequisites for political and economic modernization took shape over the course of the first half of the nineteenth century through a series of mutually reinforcing political and economic changes that occurred at the state level. These prerequisites emerged first in a small handful of states where, for highly contingent reasons, seemingly intractable problems of implementing democracy were solved by changing the institutions governing the interaction of politics and economics. As subsequent events highlighted the benefits of the new institutional configuration, it not only persisted but began to spread rapidly, though never completely, across the various United States. The federal government played essentially no role in this process until the Civil War, and for a long time after that it played only a bit part.

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"Americans," Gordon Wood has declared, "were not born free and democratic in any modern sense; they became so—and largely as a consequence of the American Revolution."[1] Generations of historians have expressed similar views. True, they have often vehemently disagreed about the particulars. Nonetheless, the idea that the Revolution set the new United States on the path to modernity has long dominated historical writing, leading scholars to focus their attention on national-level developments and to place chronological emphasis first and foremost on the early period of nation building and next on the "Second American Revolution" of the Civil War. Our aim in this paper is to challenge this "grand narrative" of American history by shifting the focus of attention to developments that unfolded in the individual states over the first three quarters of the nineteenth century. This shift in focus, we argue, is necessary to understand the fundamental transformation that occurred during this period in the way American governments functioned. At the start of the nineteenth century, the United States was a limited-access society, to use the vocabulary of Douglass North, John Wallis, and Barry Weingast.[2] That is, it was a society in which elite factions controlled the allocation of privileges, especially the ability to form corporations and other similarly valuable organizations, in the interest of maintaining power. By the last quarter of the century, however, the U.S. had made

[1] Gordon S. Wood, *The Radicalism of the American Revolution* (New York: A. A. Knopf, 1991), ix.
[2] Douglass C. North, John Joseph Wallis, and Barry R. Weingast, *Violence and Social Orders: A Conceptual Framework for Interpreting Recorded Human History* (New York: Cambridge University Press, 2009).

the transition to what NWW call an open-access society—a society in which virtually anyone who wanted to could form organizations, regardless of political affiliation, personal connections, or any similar marker of alignment.[3] This opening up of access to organizations galvanized economic and political competition, supporting the more fluid relationship between economic interests and political coalitions that is the foundation for both modern economic growth and stable democratic politics.

The United States was one of the first countries in the world to undergo this transformation, but it was the states and not the national government that accomplished it. The earliest institutional innovations, we show, occurred in a small number of states in a highly contingent way. They were the unintended result of conflicts within the elite, not a deliberate effort to promote economic development or political democratization. However, as subsequent developments highlighted the benefits of the innovations, they not only persisted but began to spread throughout the country. The pace of change accelerated dramatically during the turbulent period that followed the financial crises of the late 1830s and early 1840s, climaxing in a wave of constitutional conventions that restructured many states' governments. A second wave of constitutional revisions in the post-Civil War era disseminated the reforms to most of remaining states. Although the federal government never went through a similar transformation, the increase in economic dynamism fueled by these changes spilled across state lines, spurring the

[3] This notion of limited- versus open-access should be thought of as a Weberian ideal type. When we use the term open access, we are not implying that all members of society benefited equally. Obviously that was not the case. Women still lacked the vote and many basic economic rights, and there was ongoing discrimination against blacks and other disfavored groups that impinged on their ability organize associations to further their interests. For evidence of ongoing discrimination, see Ruth H. Bloch and Naomi R. Lamoreaux, "Voluntary Associations, Corporate Rights, and the State: Legal Constraints on the Development of American Civil Society," NBER Working Paper 21153 (2015).

growth of a vibrant and integrated national economy. Moreover, by altering basic norms about what governments should do, the changes had consequences for national political institutions as well.

Our argument builds on but goes beyond the classic studies of Oscar and Mary Handlin, Louis Hartz and others that documented the active role played by the states in early-nineteenth-century economic development.[4] As these works showed, it was the states that chartered virtually all of the thousand plus banks in operation by the 1850s, providing the country with the bulk of its currency and much of the credit that fueled industrialization. It was the states that chartered the early turnpike and bridge corporations that extended the road network and connected trading communities separated by waterways. It was the states that supplied most of the public funding for the canals that dramatically reduced transportation costs to the interior of the country. And it was states that created and regulated the multi-owner firms that were the primary agents of economic development during this period.

The active role that the states played in the economy in the early nineteenth century contrasted starkly with the relative inactivity of the federal government and contributed to a view

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[4] Oscar Handlin and Mary Flug Handlin, *Commonwealth: A Study of the Role of Government in the American Economy* (New York: New York University Press, 1947); Louis Hartz, *Economic Policy and Democratic Thought: Pennsylvania, 1776-1860* (Cambridge, Mass.: Harvard University Press, 1948); John W. Cadman, *The Corporation in New Jersey: Business and Politics, 1791-1875* (Cambridge, Mass.: Harvard University Press, 1949); James Willard Hurst, *The Legitimacy of the Business Corporation in the Law of the United States, 17780-1970* (Charlottesville: University Press of Virginia, 1970); Ronald E. Seavoy, *The Origins of the American Business Corporation, 1784-1855: Broadening the Concept of Public Service during Industrialization* (Westport, Conn.: Greenwood Press, 1982); L. Ray Gunn, *The Decline of Authority: Public Economic Policy and Political Development in New York, 1800-1860* (Ithaca: Cornell University Press, 1988). An early forerunner of this tradition was Guy Stevens Callender, "The Early Transportation and Banking Enterprises of the States," *Quarterly Journal of Economics* 17 (Nov. 1902): 111-62.

of the latter as weak.[5] For the most part, however, this comparison did not lead historians to rethink the grand narrative. Indeed, in recent decades scholars have striven instead to show that the national government was more important than previously thought. Thus Richard John highlighted the contribution of the postal system both to economic growth, through its subsidization of transportation improvements, and to political democratization, by increasing the access of citizens everywhere to newspapers and other sources of information.[6] Paul Paskoff documented the extensive federal involvement in improving rivers and harbors and in regulating the safety of steamboats in the decades before the Civil War.[7] More generally, Brian Balogh has argued that the federal government did not govern less during the nineteenth century, it just governed less directly, "less visibly."[8]

A recent exception to this trend is Gary Gerstle's revisionist *Liberty and Coercion*.[9] Playing on the title of the famous book by Peter Evans, Dietrich Reuschemeyer, and Theda Skocpol, Gerstle calls upon historians to "bring the states back in" to narratives of American history.[10] American federalism, he argues, was shaped by two "contradictory principles of governance." A fear of tyranny led the founding generation strictly to limit the powers of the

[5] See, for example, James Sterling Young, *The Washington Community, 1800-1828* (New York: Columbia University Press, 1966); and Stephen Skowronek, *Building a New American State: The Expansion of National Administrative Capacities, 1877-1920* (New York: Cambridge University Press, 1982).
[6] Richard R. John, *Spreading the News: The American Postal System from Franklin to Morse* (Cambridge, Mass.: Harvard University Press, 1995).
[7] Paul F. Paskoff, *Troubled Waters: Steamboat Disasters, River Improvements, and American Public Policy, 1821-1860* (Baton Rouge: Louisiana State University Press, 2007).
[8] Brian Balogh, *A Government out of Sight: The Mystery of National Authority in Nineteenth Century America* (New York: Cambridge University Press, 2009).
[9] Gary Gerstle, *Liberty and Coercion: The Paradox of American Government from the Founding to the Present* (Princeton, N.J.: Princeton University Press, 2015).
[10] Peter B. Evans, Dietrich Rueschemeyer, and Theda Skocpol, eds., *Bringing the State Back In* (New York: Cambridge University Press, 1985).

national government. But the framers made no similar effort to restrain state governments. To the contrary, the states inherited all the broad "police powers" of Parliament to regulate public and private life. Because Gerstle's primary goal is to understand the growth of federal power over the course of the next two centuries, he does not truly bring what the states did back into his account. Our study complements his by doing just that. We show that there was a dramatic transformation in the middle of the nineteenth century in the way the states made decisions about such important matters as government borrowing and investing, chartering corporations, and levying taxes. These changes did not have a direct effect on the extent of state authority, but they profoundly affected the ways in which states used their police powers and consequently how political and economic processes interacted at all levels of government. Although this institutional transformation occurred exclusively at the state level, it shaped the national developments that are Gerstle's central concern.

The easiest way to grasp the critical importance of this transformation is to look at what state governments were doing in the early nineteenth century. If one examines Pennsylvania's legislative record, for example, what immediately stands out is the enormous part of the assembly's business taken up by the enactment of private bills.[11] Some of the bills were intensely personal. For instance, Act No. 44 of the 1831-32 legislative session legitimated John Rutherford's two sons, declaring that they "shall have and enjoy all the rights and privileges of children born in lawful wedlock, and that they shall be able and capable in law to take, hold,

[11] The Pennsylvania legislature enacted 250 bills at its 1831-32 legislative session. At most a score of them could be considered general laws that applied impersonally to all relevant persons or organizations in the state. More generally, see Robert M. Ireland, "The Problem of Local, Private, and Special Legislation in the Nineteenth-Century United States," *American Journal of Legal History* 46 (July 2004): 271-99. Ireland calculated that on average private bills accounted for 70 to 90 percent of the laws passed by the various state legislatures during the first half of the nineteenth century.

inherit, pass and transmit all and every estate, real and personal, of what kind or nature soever the same may be, which by law they might inherit, pass or transmit, had they been born in lawful wedlock."[12] Act No. 114 annulled the marriage contract of Henry Stille and his wife Mary Ann, declaring "the parties released, set free and discharged from the said marriage contract, and from all duties and obligations arising and derived thereby and therefrom …"[13] Other bills involved property or income. Act No. 201 allowed John G. Lowrey and Hamilton Humes, guardians of the minor children of John Miles, deceased, to sell some of the land in the children's inheritance.[14] Act No. 159 awarded a $40 a year pension to three revolutionary war veterans, William M'Crum, Jacob Parker, and Jacob Bickel.[15] More importantly, there were pages and pages and pages of acts granting specific individuals valuable charters of incorporation for transportation companies, banks, assorted businesses, fire companies, schools, charities, and other similar kinds of voluntary associations.

All these bills were acts of favoritism in that they required access to the legislature to secure. They were products of a fundamentally inegalitarian system in which who you were mattered for what you could accomplish and what privileges you could obtain. By the end of the century, however, such acts had not only disappeared from the legislatures' dockets, but

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[12] Pennsylvania, *Laws of the General Assembly … Passed at the Session 1831 '32* (Harrisburg: Henry Welsh, 1832), p. 62, available at http://www.heinonline.org/HOL/Page?handle=hein.ssl/sspa0120&id=1&size=2&collection=ssl&index=ssl/sspa. All subsequent referencess are to the session laws in the heinonline database. Other similar examples from the same session include Acts 45, 66, and 239.

[13] Pennsylvania, *Laws of the General Assembly … Passed at the Session 1831 '32*, p. 274. See also Acts 123, 148, 226.

[14] Pennsylvania, *Laws of the General Assembly … Passed at the Session 1831 '32*, p. 518. See also Acts 41, 53, 125, 144, 146, 158, 174, 201, 202, 210, 214, 216, 217, and 249.

[15] Pennsylvania, *Laws of the General Assembly … Passed at the Session 1831 '32*, p. 392. See also Acts 4, 10, 19, 25, 30, 31, 37, 43, 61, 62, 70, 92, 94, 95, 98, 147, 176, 186, 191, 205, 235, 236, 237, and 246.

virtually every state constitution proscribed them.[16] Thus, Pennsylvania's 1873 Constitution barred the General Assembly from passing "any local or special law …. [c]reating corporations, or amending, renewing or extending the charters thereof." It also forbade the legislature from "authorizing the adoption or legitimation of children," "granting divorces," "authorizing the creation, extension or impairing of liens," and a host of other acts whose prohibition conveys a sense of the extent to which the legislature had interfered in social, political, and economic life on behalf of privileged members of the polity: "fixing the rate of interest," "exempting property from taxation," "changing the venue in civil or criminal cases," "regulating the practice or jurisdiction of, or changing the rules of evidence in, any judicial proceeding or inquiry before courts," and so on. The last provision of this section aimed to close any remaining loopholes allowing for legislative favoritism: "Nor shall any law be passed granting powers or privileges in any case where the granting of such powers and privileges shall have been provided for by general law, nor where the courts have jurisdiction to grant the same or give the relief asked for."[17]

After the enactment of these constitutional proscriptions, legislatures performed essentially the same functions they had before, but in fundamentally different ways. The pages and pages of special laws disappeared from the statutory record, replaced by a smaller number of bills that applied to entire categories of individuals or organizations.[18] Contrary to the

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[16] The first constitutional provision prohibiting special laws for a wide variety of purposes was enacted by Indiana in 1851. See Indiana Constitution of 1851, Article 4, Section 22. For a chronology laying out when states adopted similar provisions in the second half of the century, see Jessica L. Hennessey and John Joseph Wallis, "Corporations and Organizations in the United States after 1840," in *Corporations and American Democracy*, eds. Naomi R. Lamoreaux and William J. Novak (Cambridge, Mass.: Harvard University Press, 2017), forthcoming.
[17] Pennsylvania Constitution of 1873, Article III, Section 7.
[18] As a result of these changes, many states reduced the length and frequency of the legislature's sessions. John Kincaid, "Early State History and Constitutions," in *The Oxford Handbook of*

conventional wisdom, however, the result was emphatically not a shift toward laissez faire.[19] Legislatures still enacted statutes regulating banking, for example. The difference was that any act that changed the terms of one bank charter, changed the terms of them all. The primary effect of the institutional transformation was not to curtail state intervention in the economy but rather legislative discretion—to limit legislators' ability to single out individuals or organizations for special treatment. Such special treatment did not, of course, completely disappear, but interventions on behalf of (or against) particular entities now required stratagems that made the statutes more difficult to draft and easier to block.

This paper is about this transformation—how it happened and what it meant for the workings of the economy and the polity. In the next section of this paper, we return to the subject of the American Revolution and use NWW's theoretical framework to set the revolt in a broader, world historical context. The corruption that the American colonists reacted against, we argue, was a special case of a more general phenomenon that has characterized most societies in most places throughout human history. One of the most common techniques that ruling elites everywhere have employed to keep themselves in power has been to limit access to the returns that can be garnered by forming economically valuable organizations and to use the resulting monopoly rents to coordinate a political coalition. Of course, the privileges that elites grant to their political supporters impose costs on everyone else, and if the costs are large enough, they can be an incentive to revolt. Although rebels often justify their uprisings as attacks on

State and Local Government, eds. Donald P. Haider-Markel, http://www.oxfordhandbooks.com/view/10.1093/oxfordhb/9780199579679.001.0001/oxfordhb-9780199579679-e-010, accessed Nov. 18, 2016.

[19] Here we part company with studies such as Handlin and Handlin, *Commonwealth*, Hartz, *Economic Policy and Democratic Thought*, and Gunn, *Decline of Authority*. For a similar view to ours, see William J. Novak, *The People's Welfare: Law and Regulation in Nineteenth-Century America* (Chapel Hill: University of North Carolina Press, 1996).

corruption and tyranny, they rarely behave any differently when they come to power. To the extent that rebels take their own rhetoric seriously and refuse to reestablish such structures of power, they tend not to survive very long and instead typically lose ground to contenders willing to restrict access to organizational rents for the benefit of their supporters.

The aftermath of the American Revolution was no exception, though the ability to deploy monopoly rents for the purposes of control was much greater at the state than at the federal level, in large measure for the reasons Gerstle suggests. However, it was also at the state level that elites gradually figured out that it could be in their interests to allow virtually anyone who wanted to form economically valuable organizations to do so. In the remaining sections of the paper we reexamine aspects of economic development that the states are conventionally acknowledged to have led—the creation of a banking system, the construction of transportation infrastructure, the promotion of corporations—and show that these developments were part and parcel of a more fundamental shift away from a limited-access social order. We cannot emphasize too strongly that this achievement of open-access was by no means an inevitable consequence of the American Revolution. Although the political competition that the Revolution set in motion is an important part of the story, its effect was highly dependent on state-specific circumstances that shaped whether elites responded to the increased risks of losing power by suppressing or instigating economic competition. The general tendency was toward suppression—toward the manipulation of economic privileges to support a political coalition that could maintain a majority in the electoral process. Wherever the outcome instead was a move toward open access, however, the change operated to reinforce democratic political processes and in turn was reinforced by them. The resulting payoff in terms of economic growth provided similar reinforcement. The visibility of the payoff, moreover, helped to stimulate the transformation to open access in other states, with snowballing consequences for economic development and political democratization across the country.

Before we plunge into the analysis, a couple of disclaimers are in order to avoid confusion. First, we do not aim in this paper to contest any of the claims that Balogh, John, Paskoff, and others have made about the importance of the federal government's investments in economic development. Although we believe the states' contributions were greater, our concern is with more basic matters of political economy—with the mutually reinforcing relationship between political and economic arrangements that characterizes all societies and with the fundamental transformation in these arrangements that occurred in the U.S. states over the course of the nineteenth century. Second, when we say that the federal government played little or no role in this transformation, we are not imagining a counterfactual world in which the states were independent countries. That the states were part of a larger union clearly mattered. It mattered that they shared a common institutional framework in which, as Stephen Skowronek has argued, courts and parties could play an integrative role.[20] It also mattered that people and goods could move freely across state boundaries. Here, however, it is worth emphasizing the relative unimportance of what scholars have called "competitive federalism."[21] The key transformations we describe were remarkably local in the sense that they were the outcome of internal state-level political conflicts, even when they were triggered by national-level events. States often copied

[20] Skowronek, *Building a New American State*.
[21] The idea that competition among the states spurred institutional innovation and regulatory races grows out of the literature on charter mongering at the turn of the twentieth century. It has often been asserted on the basis of little evidence that similar pressures operated earlier in the nineteenth century. For a recent example arguing that competitive federalism spurred the early development of banking, see Charles W. Calomiris and Stephen H. Haber, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit* (Princeton, N.J.: Princeton University Press, 2014), 164-71.

each other's innovations, but in most cases they did so because their political leaders faced similar problems, rather than because they were in direct competition with each other for capital or trade.

A Conceptual Framework

In 1790 the United States was what we would today call a developing country. No one at that time, in the United States or elsewhere, could have had any idea what a developed modern society looked like because none yet existed. Unlike leaders of developing countries today, therefore, no one could have a plan for how to transform society to achieve such a goal. Nonetheless, there was swelling support for policies that promised to promote economic opportunities, for example by opening up new lands for settlement, expanding the supply of credit, and increasing trade. At the same time, people had strong ideas about what could go wrong with their society—how corrupt policies that advantaged the few over the many could lead to political tyranny. The problem Americans faced circa 1790 was that the same government interventions that promoted opportunity seemed also to increase the risk of tyranny.[22]

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[22] On popular support for policies that promoted economic development, see Joyce Appleby, *Capitalism and a New Social Order: The Republican Vision of the 1790s* (New York: New York University Press, 1984); and Steve Pincus, T*he Heart of the Declaration: The Founders' Case for an Activist Government* (New Haven, Conn.: Yale University Press, 2016). On fears of corruption and tyranny, see Bernard Bailyn, *The Ideological Origins of the American Revolution* (Cambridge, Mass.: Harvard University Press, 1967); Gordon S. Wood, *The Creation of the American Republic, 1776-1787* (Chapel Hill: University of North Carolina Press, 1969); and Lance Banning, *The Jeffersonian Persuasion: Evolution of a Party Ideology* (Ithaca, N.Y.: Cornell University Press, 1978).

In the late eighteenth century, republican thinkers in both Britain and North America believed that an activist British government had been corrupted by the King's ministers. They had a historically specific understanding of how that had happened, but they also understood that the problem was a more general one—that political factions within the elite would always try to manipulate economic privileges to get control of the polity. Drawing on a larger set of ideas that traced back to Polybius and Machiavelli, these opposition thinkers were united by their belief that a mixed and balanced government was necessary for the protection of liberties and that British Prime Minister Robert Walpole had undermined that balance through the systematic use of economic privileges. By distributing shares in the Bank of England, the South Sea Company, and the British East India Company, as well as sinecures, pensions, and other forms of patronage, Walpole had suborned the independence of Parliament, particularly the House of Commons, to build a stable political coalition in support of the King's policies.[23]

Working from a similar understanding, NWW have built a general framework for thinking about societies where this kind of corruption was a persistent feature. Rather than viewing the republicans' fears as paranoid, the framework explains why their fears were not only reasonable, but represented a clear understanding of how politics and economics usually interact. Indeed, the fears the founders expressed remain relevant in most of the world today. When republican publicists railed about corruption, however, they were not targeting what we commonly mean by the term corruption—that is, the use of public office for private gain. For clarity, we call this sense of the word "venal" corruption. The corruption the republicans feared

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[23] For a summary, see J. G. A. Pocock, *Virtue, Commerce, and History: Essays on Political Thought and History, Chiefly in the Eighteenth Century* (Cambridge, Eng.: Cambridge University Press, 1985). On the appeal of these True Whig ideas in the American colonies, see Bailyn, *Ideological Origins*; and Wood, *Creation of the American Republic*.

was "systematic." It occurred when a political faction gained control of the government and used its power to confer economic privileges on select groups with the aim of perpetuating its dominance. Systematic corruption was bound up with the pursuit of power. Its perpetrators need not be corrupt in the venal sense. Rather, they could be motivated by the imperative to counter threats to the stability of their government or even to the social order more generally.[24]

NWW recast this republican understanding in more general terms that enable us to escape its limitations. Starting from a Hobbesian conception of the world, they point out that the core problem all societies face is not anarchic, atomistic violence, but organized violence by powerful groups of individuals who use coercion against one another. NWW then ask what kind of social arrangements can limit violence and establish a modicum of order in such a world, recognizing that violence can never be completely eliminated. They note that the biggest threats to leaders of powerful organized groups are the leaders of other groups. Agreements between leaders are inherently unstable; if one leader agrees to be peaceful and reduces his capacity for violence, the other leaders have an incentive to break the agreement. How can leaders credibly commit to a truce?

NWW's answer is that the economic returns (the "rents," in economists' terminology) that the leaders exploit to keep themselves in power can themselves be a potent incentive to maintain the peace. Take the simple hypothetical example of two leaders who each control territories and profit from the labor, land, and other resources they contain. If the leaders fight with each other, the productivity of the land, labor, and resources they control falls because their clients must stop working and hide or defend themselves. Because fighting is costly, the leaders

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[24] John Joseph Wallis, "The Concept of Systematic Corruption in American History," in *Corruption and Reform: Lessons from America's Economic History*, ed. Edward L. Glaeser and Claudia Goldin, 23-62 (Chicago: University of Chicago Press, 2006).

can reach a credible agreement in which they respect each other's rights to their territories. In other words, they can credibly commit to keep the keep the peace because they realize that under a range of circumstances the costs of fighting exceed the benefits. Such a realization does not mean that leaders never fight. The range of circumstances in which the incentives for peace hold may in practice be quite limited, and leaders may also misjudge the benefits and costs of fighting. Nonetheless, such agreements can create a minimum amount of social order and thus benefit everyone. For the arrangements to work, however, the leaders must essentially recognize and guarantee each other's right to exist—that is, deny to anyone outside of their coalition the right to form a competing organization that could challenge the leaders' territorial monopolies or reduce the returns from exploiting them. To do otherwise, would allow the rents that make their agreement credible to dissipate.

Because all the societies that have emerged in recorded human history seem to have had this internal structure (and most still do), NWW call this form of social order the "natural state." Alternatively, they also refer to it as a "limited access" social order, because natural states restrict the ability to form organizations to elites in their governing coalitions. In the terms of republican theory, this arrangement is systematic corruption. It is the political manipulation of economic privileges (rents) to keep a particular coalition of elites in some semblance of order. It is politics corrupting economics for the end of achieving at least a modicum of political stability.

Natural states, however, are inherently fragile. Republican theorists from Machievelli onward understood this fragility and were concerned with the problem of how elites could maintain their privileges (their "rights") in the face of the pervasive danger that coalition agreements would break down. Any shock to the system that upset the balance of interests could potentially lead to civil war. Moreover, groups within the coalition would inevitably and continuously jockey to increase their share of the rents at the expense of other groups. To the extent that they succeeded in this "tyranny," they might drive those who were disadvantaged by the maneuvering to revolt, perhaps in alliance with excluded parties—an outcome whose likelihood was greater if it seemed that the rents to be gained by wresting control of the government would exceed the costs of mounting a successful coup.[25]

American republican thinkers, like James Madison and Alexander Hamilton, lived in a natural state society. It was a wealthy and prosperous society, but not one that had banished the fear of violence and civil war. Having just emerged from a decade of conflict provoked by the belief that the coalition that ruled Britain had abused its power, they deliberately focused their institution-building efforts on creating a system of checks and balances that would reinforce the existing peace by making it more difficult for any particular faction to take control of the

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[25] Even states that seem strong in terms of the force they are routinely able to mobilize can be highly dependent for their persistence on elites' perceptions of the value of remaining in the dominant coalition. The government of Hosni Mobarak in Egypt provides a dramatic and recent example of how quickly apparent strength can evaporate if coalition members' interests shift. The Mubarak regime was autocratic and, by most measures, extremely powerful. And yet when the Army was unwilling, in the face of popular protests, to follow Mubarak's command to shoot people in Tahrir square, the government suddenly weakened. There was no change in the internal capacity of the Mubarak government, but there was a dramatic change in the configuration of the dominant coalition in Egypt. In that coalition the Army was only subordinate to the government if it agreed to be; when it declined to follow Mubarak's lead, the regime collapsed. Currently, the Army in Egypt still appears to be strong, but this strength in turn depends on the internal organization and cohesion of the groups that make up the Army. It is tempting to think of the current Egyptian Army as a "single actor" with a well-defined objective function, but the military council in Egypt is clearly itself a coalition. The Egyptian case is a very clear example of why it is the internal dynamics of the dominant coalition, rather than some notion of government capacity, matter so much to the ordering of society. ##citation on Egypt?? For a series of case studies describing natural-state institutions in other developing countries today, see Douglass C. North, John Joseph Wallis, Steven B. Webb, and Barry Weingast, eds., *In the Shadow of Violence: Politics, Economics, and the Problems of Development* (New York: Cambridge University Press, 2013).

national government. Where they differed was on whether the creation of valuable rent-generating organizations would reinforce the peace or destroy it. Madison, of course, took the negative view; Hamilton, the positive. In the next section we discuss how Hamilton's proposal for a Bank of the United States gave form to this difference. Here we simply underscore the point that the goal of republican political theory in both its Madisonian and Hamiltonian variants was to create the best and most stable natural state possible. The framers did not aim to create an open and thriving modern democratic and capitalist society, the likes of which they had never seen. More importantly, neither Hamilton nor Madison nor anyone else at the time imagined that it was possible to have one's cake and eat it too by opening access and enabling anyone who wanted to form an economically valuable organization to do so.

Writing from the vantage point of the twenty-first century, NWW posit exactly that: by opening access to organizations one could achieve both political stability and economic development. Under the right conditions, they show, elites can find it in their interests to begin to order their relationships through rules that treat individuals impersonally—that is, treat everyone the same (or at least treat everyone in a broad class of the population the same). Impersonal rules that allow anyone to form an organization will reduce monopoly rents and thus weaken the dynamics that, in a natural state, hold elite relationships and violence in check through economic privileges. Open access societies work because the stakes of controlling the government are greatly reduced and that in itself becomes a force for stability. When the faction running the government can change without severe negative consequences for the interests of any other group, then and only then it is finally possible to consolidate the means of violence in organizations inside the government.[26]

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[26] The transition process described by NWW differs from that offered by Max Weber, who was

Open access does not follow automatically from democracy. Democratic political arrangements cannot, by themselves, contain elite competition because elite factions are as likely to use privileged access to organizational rents to gain control of the government in a democracy as they are in an oligarchy. Democratic political competition can only be secured in an environment of economic competition and vice versa. The new equilibrium requires institutional changes that establish open access in both the economic and political systems. But how can such changes occur when no political or economic actor has any understanding of what is needed? As we will show in the next section, the initial steps toward change were highly contingent responses to charges that banks were being used for purposes of political control. Whereas at the federal level such charges led to the demise of banking, in a small number of states they led to open access, pointing the way to further change.

The Contingent Achievement of Open Access in Banking

The most striking evidence that the United States was not born modern—that even after the ratification of the Constitution it functioned like a natural state in the NWW sense—comes from the banking sector. During the late eighteenth and early nineteenth centuries, whichever

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concerned with the emergence of a leader capable of consolidating control of violence and, when combined with a competent bureaucracy, capable of dominating the elites. Weber's ideas are summarized in his essay "On Politics as a Vocation," in *From Max Weber: Essays in Sociology*, translated and edited by H. H. Gerth and C. Wright Mills (London: Routledge & Kegan Paul, Ltd., 1948). Charles Tilly's *Coercion, Capital, and European States: AD 990-1992* (Cambridge, Mass.: Blackwell Publishing, 1992), develops a Weberian explanation for the emergence of European nation states in the eighteenth and nineteenth centuries. In both Weber and Tilly the central actor is the government itself. By contrast, the NWW framework depends on intra-elite dynamics, rather than the appearance of a strong central king or government. It is the interest of elites in moving toward open access and impersonal rules that drives the transition to open access.

factions were in control of the national government, and also of the individual state governments, used their positions to award banking privileges to their supporters and deny them to opponents. Rival factions attacked banks as instruments of corruption, and if they managed to gain power, they either followed through on their rhetoric and shut the banks down or, alternatively, tried to take them over to bolster their own coalitions. At the federal level, the choice was always to shut them down, and the politics of banking never moved beyond this cycle of creation and destruction in the decades before the Civil War. Whenever a new faction assumed power at the state level, however, it more often than not expanded the banking system for the benefit of its supporters. As a result, most states were able to build up a significant financial infrastructure during this period. In a few key states, moreover, the high stakes of electoral success, in combination with the increasing competiveness of elections, pushed legislators to innovate institutionally and find ways to take banking off the political table.

Bank charters played an important role in coalition building during the early republican period because they were valuable privileges. There were no banks in the colonies before the Revolution, and credit was difficult to obtain, especially after the outbreak of war cut off access to British sources of finance. The charters that the new state and national governments began to issue after the Revolution were highly sought after for the simple reason that those in control of a bank had preferred access to credit and also the power to determine who else would gain access to credit. Most of banks' lendable funds at this time consisted of the capital their corporate status enabled them to raise. In addition, the privilege of issuing currency that the charters also conferred enabled banks to secure additional funds almost at no cost—funds which they could then lend to insiders and other favorites.[27]

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[27] See Naomi R. Lamoreaux, *Insider Lending: Banks, Personal Connections, and Economic*

Alexander Hamilton, perhaps more than anyone else, understood the value of a bank charter and how it could be used to solidify a political coalition in support of the government. As is well known, Hamilton used the refunding of the national debt and the assumption of states debts to align the interests of wealthy Americans with those of the new nation. He believed that holders of the national debt would have a financial interest in the success of the United States, and he did not want the loyalties of the wealthy divided between the national government and the states. "If all the public creditors receive their dues from one source, distributed with an equal hand, their interest will be the same. And having the same interests, they will unite in the support of the fiscal arrangements of the government." But, he warned, if there were "distinct provisions" for the debts of the states and the national government, there would be "distinct interests, drawing different ways." As a result, "[t]hat union and concert of views, among the creditors, which in every government is of great importance to their security, and to that of public credit, will not only not exist, but will be likely to give place to mutual jealousy and opposition."[28]

The Bank of the United States played an important role in Hamilton's plan to substitute a refunded national debt for the debts of the states because, following the model of the Bank of England, shares in the Bank of the United States could be paid for in large part with U.S.

Development in Industrial New England (New York: Cambridge University Press, 1994), Ch. 1.

[28] Alexander Hamilton, "Report Relative to a Provision for the Support of Public Credit" (1790), National Archives, Founders Online, http://founders.archives.gov/documents/Hamilton/01-06-02-0076-0002-0001, accessed Nov. 1, 2016. On Hamilton's refunding plan, see Edwin J. Perkins, *American Public Finance and Financial Services, 1700-1815* (Columbus: Ohio State University Press, 1994), Ch. 10. Max Edling downplays the political motive relative to Hamilton's desire to put the new nation on a firm economic foundation, but the two motives are by no means as mutually exclusive as he makes out. See Edling, "'So Immense a Power in the Affairs of War': Alexander Hamilton and the Restoration of Public Credit," *William and Mary Quarterly* 64 (April 2007): 287-326.

government bonds.[29] To the extent that the bank was an attractive investment, therefore, demand for its shares would support the price of the government's debt. Hamilton knew the value of a bank charter would attract subscribers, but the Bank of England offered additional lessons on how to align the interests of the wealthy with the success of the new nation. Formed in the aftermath of the Glorious Revolution, the Bank of England had its origins in the dire need of the government for funds. Parliament had secured a long-term loan of £1,000,000 in 1693 but within a year had burned through the whole amount. Lenders were understandably reluctant to commit more money to the government, but Parliament succeeded in attracting an additional £1,200,000 in loans by agreeing to incorporate the subscribers as a bank.[30] The government's debt, which was secured by additional taxes, served as the institution's capital, on the basis of which the bank could issue notes, make loans, and accept deposits, with the subscribers protected from large losses by limited liability. Crucially, Parliament restricted the duration of the bank's charter to a term of eleven years. To the extent that the bank proved valuable to the subscribers, this short lifespan gave Parliament additional opportunities to secure loans in exchange for privileges. As a matter of fact, Parliament needed funds before the eleven years were up, and it was able to obtain in excess of £1,000,000 in new loans in exchange for exempting the subscribers from taxes on their bank stock and promising not to set up any competing banks. In 1708, in exchange for still more loans, Parliament granted the Bank of England an effective

[29] Shares in the Bank of England could be entirely paid for with government debt. Hamilton insisted that one quarter of the value of shares in the Bank of the United States be paid for in gold and silver, but the rest could be paid for with U.S. bonds. See Hamilton, "Report on a National Bank" (1790), National Archives, Founders Online, http://founders.archives.gov/?q=Ancestor%3AARHN-01-07-02-0229&s=1511311111&r=3, accessed Nov. 1, 2016.

[30] Douglass C. North and Barry R. Weingast, "Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England," *Journal of Economic History* 49 (Dec. 1989): 803-32.

monopoly by prohibiting any joint stock company with more than six partners from doing business as a bank. Over the next century Parliament repeatedly renewed the bank's charter, confirming its privileges in exchange for loans.[31]

Hamilton built both the monopoly and the quid pro quo features of the charter into his proposal for a national bank. "No similar institution," he promised, "shall be established by any future act of the United States, during the continuance of the one hereby proposed to be established."[32] The Bank of North American, previously chartered by the Continental Congress, still existed, so Hamilton had to work hard in his report to make this promise credible. He devoted about a fifth of his report to explaining how the restrictive Pennsylvania charter under which the Bank of North America was then operating had compromised its ability to function as a national bank, suggesting that if these disabilities were eliminated the interests of the two institutions could be merged. He also reassured investors that there would be protections against expropriation of the bank's resources by the government. For example, there would be strict limits on the extent to which the government could borrow: "No loan shall be made by the bank for the use, or on account, of the Government of the United States, or of either of them to an amount exceeding fifty thousand dollars, or of any foreign prince or State, unless previously authorized by a law of the United States." Although Congress could potentially override the limit, the interests of the national government and the bank would be aligned. The government would have a stake in the bank's financial performance because it would be also be a shareholder (but not a controlling shareholder—it could only hold up to one-fifth of the capital). At the same time, Hamilton built in incentives for controlling shareholders to keep the interests of the

[31] J. Lawrence Broz and Richard S. Grossman, "Paying for Privilege: The Political Economy of Bank of England Charters, 1694-1844," *Explorations in Economic History* 41 (Jan. 2004), 48-72.
[32] All quotations in this paragraph are from Hamilton, "Report on a National Bank."

government in the front of their minds by limiting the duration of the bank's charter to twenty years: "As the institution, if rightly constituted, must depend for its renovation, from time to time, on the pleasure of the government, it will not be likely to feel a disposition to render itself, by its conduct, unworthy of public patronage."

The bank's limited duration probably helped dampen opposition to Hamilton's proposal, but it ultimately backfired as a scheme to align the interests of the wealthy with those of the nation. Many Jeffersonians were horrified at the idea of creating what they thought would be a potent tool of systematic corruption. Members of Congress warned that the bank "will raise in this country a moneyed interest at the devotion of Government; it may bribe both States and individuals." They charged that "the great object of the Bank Bill is to *consolidate* the monied Interest of America and strengthen, in an astonishing degree, the Executive Department of the General Government;" that the bank would establish "an Aristocratick influence subversive of the spirit of our free, equal government."[33] Madison himself led the opposition, reminding his colleagues that the Constitution had limited the powers of the federal government for just these reasons and that Congress had no authority to charter a bank unless the Constitution specifically allowed it.[34] This argument did not carry the day, but republican fears of systematic corruption continued to fester, and when the bank's charter expired in 1811, the Jeffersonians were in power. With the country's financial standing more secure and growing numbers of state-chartered banks meeting the need for credit at the state level, the bank's opponents narrowly

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[33] Quotations are from Stanley Elkins and Eric McKitrick, *The Age of Federalism: The Early American Republic, 1788-1800* (New York: Oxford University Press, 1993), 229; and Benjamin B. Klubes, "The First Federal Congress and the First National Bank: A Case Study in Constitutional Interpretation," *Journal of the Early Republic* 10 (Spring 1990): 19-41 at 24-25.

[34] For this argument and the Federalists' response, see Elkins and McKitrick, *Age of Federalism*, 229-34; and David Jack Cowen, *The Origins and Economic Impact of the First Bank of the United States, 1791-1797* (New York: Garland Publishing, 2000), Ch. 1.

defeated the bill to recharter.[35]

The financial debacle of the War of 1812 tipped the balance back again, and Congress chartered a second Bank of the United States in 1816, once more for a limited term of twenty years. From the beginning there was considerable political jockeying for control of the bank and its (ultimately) twenty-five branches. Despite the Jeffersonians' attacks on the first bank as a tool of systematic corruption, Madison sought to insure Republican control of the second. His initial picks for government directors were all Republicans, and, after shareholders chose a mix of Republicans and Federalists, he pushed successfully for William Jones, a Republican but unfortunately also an incompetent, to be president.[36] The extent to which the bank's operations were politicized under the administration of Nicholas Biddle, who became president of the bank in 1822, has been a subject of much discussion among historians. It seems, however, that Biddle was more interested in building a coalition in support of the bank than in promoting one of the two main national factions, but by the early 1830s he could not keep the institution from being swept up in the anti-Jackson coalition that was coalescing into the Whig Party.[37] Remarkably little has been written about the bank's branches and their role in state politics, but given the vehement opposition from banks in New York and a number of other states, especially

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[35] Madison was then president. He had come to see the utility of the bank and did not oppose rechartering it, but he did not use his clout to lobby on the bank's behalf. See Bray Hammond, *Banks and Politics in America: From the Revolution to the Civil War* (Princeton, N.J.: Princeton University Press, 1957), Ch. 8. For discussions of the continued Jeffersonian charges that the Bank of the United States was an agent of systematic corruption, see Saul Cornell, *The Other Founders: Anti-Federalism and the Dissenting Tradition in America, 1788-1828* (Chapel Hill: University of North Carolina Press, 1999), 176-79; and Banning, *Jeffersonian Persuasion,* 168, 192-200, 282-83.

[36] Ralph C. H. Catterall, *The Second Bank of the United States* (Chicago: University of Chicago Press, 1903), 22; Hammond, *Banks and Politics in America*; Robert V. Remini, *Andrew Jackson and the Bank War* (New York: W. W. Norton, 1967).

[37] Catterall, *Second Bank of the United States*; Hammond, *Banks and Politics in America*; Remini, *Andrew Jackson and the Bank War*.

in the South and West, the struggle for control of the Second Bank's various branches was probably more important for its subsequent history. A contemporary cartoon of "General Jackson Slaying the Many Headed Monster" depicted each of the branches as the head of an important politician from the locale.[38]

After Andrew Jackson, a Democrat from Tennessee and a foe of the bank, became President in 1829, Biddle began to maneuver to secure the institution's renewal. At Biddle's instigation, Congress passed the bill to recharter the bank in 1832 with significant but not veto-proof majorities in both houses, and Jackson promptly vetoed it in a message that stands as the classic denunciation of systematic corruption from this era. Laying out the suspicious features of the transaction—the sizeable bonus that the bank would pay to the government for the renewal of its charter, the huge profits that the bank's shareholders were earning, Congress's promise not to charter any rival banks—Jackson declared that the bill to recharter was a prime example of the abuse of government by the rich and powerful: "If we can not at once, in justice to interests vested under improvident legislation, make our Government what it ought to be, we can at least take a stand against all new grants of monopolies and exclusive privileges, against any prostitution of our Government to the advancement of the few at the expense of the many…."[39] Following Jackson's destruction of the Second Bank, the national government refrained from chartering any more banks until the Southern states left the Union during the Civil War and even then did not charter anything resembling a central bank until the creation of the Federal Reserve

[38] For the cartoon, see the Library of Congress's website, http://www.loc.gov/pictures/resource/cph.3a05364/, accessed November 19, 2016.

[39] President Andrew Jackson, "Veto Message Regarding the Second Bank of the United States" (10 July 1832), reprinted by the Avalon Project, http://avalon.law.yale.edu/19th_century/ajveto01.asp, accessed 18 March 2015.

System in the twentieth century.[40]

Part of the reason that the two national banks could be (and were) allowed to lapse, given the general pro-development spirit of the country, was that neither had a real monopoly on incorporated banking. Intent on solidifying their own political coalitions, the elites in control of state governments had been granting bank charters to political supporters since the 1780s. Although the earliest state banks were all dominated by Federalists, as that faction lost ground, control of banking shifted in many states toward the Republicans and then their Democratic successors.[41] Jackson's brilliantly articulated attack on the Second Bank thus obscured the extent to which his own supporters were implicated at the state level in precisely the same abuses he decried. Indeed, Martin Van Buren, who helped mastermind the attack on the Second Bank and who served as Jackson's vice presidential candidate in 1832, had used control over the award of bank charters with great success to bolster his New York Democratic political machine, the "Albany Regency." The destruction of the Second Bank promised only to further the control that such state-level machines exercised. Not only would it get rid the economy of an alternative source of credit that could aid the opposition, but the Jackson administration removed the federal government's deposits from the national bank and used them to increase the lending power of the state-chartered "pet" banks run by Democrats.[42]

[40] The Federal Reserve Act of 1913 created a set of regional reserve banks, not a central bank. The Board of Governors of the Federal Reserve System really only became a central bank as a result of additional legislation enacted during the Great Depression.

[41] For general overviews, see John Jay Knox, *A History of Banking in the United States* (New York: Bradford Rhodes & Co., 1908); Hammond, *Banks and Politics in America*; and Howard Bodenhorn, *State Banking in Early America: A New Economic History* (New York: Oxford University Press, 2003)

[42] On the Albany Regency and its control of banking, see Eric Hilt, "Early American Corporations and the State," in *Corporations and American Democracy*, eds. Naomi R. Lamoreaux and William J. Novak (Cambridge, Mass.: Harvard University Press, 2017), forthcoming; and Howard Bodenhorn, "Bank Chartering and Political Corruption in Antebellum

These political uses of banking provoked anti-monopoly reactions at the state level, just as they did at the federal, but with much more heterogeneous results. There was no doubt that states had the constitutional power to charter banks, so the argument to abolish them entirely had less rhetorical force than it did at the national level. Nonetheless, a few states enacted bans on banking on the grounds that republican checks and balances were insufficient to prevent abuses and so the only choice was to eliminate opportunities for systematic corruption. However, more states moved in the opposite direction and opened up access to bank charters.[43] That the move to free up banking would, from the standpoint of economic development, be the most effective solution to the problem of systematic corruption may seem obvious to us with the perspective of hindsight. But it was not to people at the time. Those who benefited from controlling bank charters were able to argue with great persuasiveness that open access would lead to financial instability, using recent financial panics as evidence. Change would only come when the elites who made these arguments decided that it was in their interest to open access. The very different histories of Massachusetts and New York show how historically contingent this shift in position was.

The Massachusetts Bank, chartered in Boston in 1784, was the first bank in that state. Although initially set up as a monopoly, it was too small to meet the credit needs of the Federalist elite that dominated state government. Over the next couple of decades, therefore, the legislature chartered a small number of additional banks, until there were one or two banks in most of the state's major cities, all controlled by local Federalists. Rival factions clamored for

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New York: Free Banking as Reform," in *Corruption and Reform: Lessons from America's Economic History*, ed. Edward L. Glaeser and Claudia Goldin (Chicago: University of Chicago Press, 2006), 231-57. On the removal of the deposits, See Hammond, *Banks and Politics in America*, Ch. 14; and Remini, *Andrew Jackson and the Bank War*, Ch. 5.

[43] Hilt, "Early American Corporations and the State."

banks of their own but to no avail.[44] When the Republicans finally won control of the state government in 1811, they immediately chartered two new banks: one in Salem, where Republican merchants had been trying for years to found a bank; and the other in Boston, a massive new institution with a capital of $3,000,000, three times that of the largest bank previously chartered in the commonwealth. The State Bank, as the latter was named, was supposed to be a public institution. At least one third of its capital was supplied by the state, and it was to return a portion of its profits to the taxpayers in the form of dividends on the state's ownership share and a tax amounting to 0.5 percent of its paid-in capital to be paid annually to the government. But the fact that eleven of the State Bank's twelve directors were Republicans suggested that the bank would also operate in the interests of that party. The Republican dominated legislature went further, moreover, and threatened to inflict real harm on the Federalists. All but one of the existing banks' charters were set to expire in 1812, and the Republicans threatened to block their renewal.[45]

Now it was Federalists' turn to denounce the Republicans' monopoly of banking. The Republicans were not, however, able to preserve their gains in the 1812 election, and the Federalists retook the lower house and the governor's mansion, though the Republicans' retained a majority in the Senate. The result of the shift back toward the Federalists was something of a compromise. The act chartering the State Bank had provided that its terms, particularly the tax

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[44] N. S. B. Gras, *The Massachusetts First National Bank of Boston* (Cambridge, Mass.: Harvard University Press, 1937); Handlin and Handlin, *Commonwealth*; Qian Lu and John Wallis, "Banks, Politics, and Political Parties: From Partisan Banking to Open Access in Early Massachusetts," NBER Working Paper 21572 (2015).

[45] Lu and Wallis, "Banks, Politics, and Political Parties." The Republicans took a variety of other steps to entrench themselves in power, including famously redrawing the state's senatorial districts (giving rise to the term "Gerrymandering" after the Republican governor who signed the bill into law). See Elmer Cummings Griffith, *The Rise and Development of the Gerrymander* (Chicago: Scott, Foresman and Co., 1907), 19-20.

on capital, would apply to all banks chartered in the future. With the Republicans still in control of the Senate, this condition held. The Federalists got their banks rechartered but only on condition that all would be subject to the same constraints as the State Bank.[46] This close call, in the context of the increasing competitiveness of state elections, seems to have led politicians of both parties to rethink their coalition-building strategies. Although there is no "smoking gun" in the historical record, legislators seem to have agreed at least implicitly to take banking off the political table. Although few new banks were chartered during the turbulent war and depression years that followed, as economic conditions improved during the early 1820s and the demand for bank charters increased, the legislature responded by granting most of them. All of the new banks paid the tax 0.5 percent tax on their capital, and surely the state's soaring tax revenues helped reinforced the new arrangement. In 1830, the first year for which data is available, the tax on banks accounted for fully 61 percent of the state's revenue. Indeed, thanks to the bank tax, Massachusetts did not have to impose *any* property or poll taxes on its citizens for half the years between 1826 and 1855.[47]

What mattered most for the long run, however, was honoring the promise that all bank charters would henceforth be the same. This agreement was made formal in 1829 when the legislature enacted a general regulatory act for banking. Entitled "An Act to Regulate Banks

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[46] In fact, the deal went even further and gave all the banks charters that (except in the details of their location and capital stock) were identical to that of the State Bank. See the *Laws of the Commonwealth of Massachusetts from February 28, 1807, to February 27, 1813* (Boston: Thomas and Andrews, 1813).

[47] Lu and Wallis, "Banks, Politics, and Political Parties"; Richard Sylla, John B. Legler, and Wallis, "Banks and State Public Finance in the New Republic: The United States, 1790-1860," *Journal of Economic History* 47 (June 1987): 391-403; Wallis, Richard E. Sylla, and John B. Legler, "The Interaction of Taxation and Regulation in Nineteenth-Century U.S. Banking," in *The Regulated Economy: A Historical Approach to Political Economy*, eds. Claudia Goldin and Gary D. Libecap (Chicago: University of Chicago Press, 1994), 121-44.

and Banking," the statute specified "[t]hat from and after the passing of this Act, every Bank which shall receive a Charter, from or by the authority of this Commonwealth, and every Bank whose Capital shall be increased, or whose Charter shall be extended, shall be governed by the following rules, and subjected to all the duties, limitations, restrictions, liabilities and provisions, contained in this Act."[48] The clincher was section 31: "*Be it further enacted,* That if, during the continuance of any Bank Charter, granted or renewed under the provisions of this Act, any new or greater privileges shall be granted to any other bank now in operation, or which may hereafter be created, each and every Bank in operation at the time shall be entitled to the same." From this point onward, whenever the Massachusetts legislature considered chartering a new bank or changing the charter of an existing bank, every bank in Massachusetts was affected. There would no longer be special deals for any individuals or groups forming banks.

This is not to say that bank charters were never again a hot-button political issue in Massachusetts, just that charters were no longer reserved for the support of the elite coalition. The idea that chartering too many banks would undermine the soundness of the banking system remained powerful. Incumbents still pushed this theory as a way of limiting the amount of competition, and it appealed as well to representatives of that part of the political spectrum that was hostile to the idea of banks more generally. In some years this view won out, and the legislature refused to grant any more requests for charters. But the logjam usually burst the next year with a surge of approvals. By the height of the 1830s boom, there were nearly 130 banks in the state; by the late 1850s there were more than 175.[49]

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[48] Massachusetts, 1831, Chapter XCVI, "An Act to regulate Banks and Banking," Section 1, pp. 145. [John, we should cite the 1829 statute rather than a later codification.]

[49] Lu and Wallis, "Banks, Politics, and Political Parties"; Massachusetts, Secretary of the Commonwealth, *Abstract of the Returns from the Banks* (1860), 75-76.

In Massachusetts the formal shift to open access was almost a bureaucratic afterthought, achieved finally in 1851 with the enactment of a general incorporation law for banking. Special charters were so routine by this time, however, that almost no banks found it worth their while to organize under the general law. Massachusetts' citizens were better served by banking institutions—that is, there was more bank capital and currency per capita—than anywhere else in the United States except Rhode Island (which had adopted a similarly liberal chartering policy).[50] On the eve of the Civil War, Massachusetts had nearly twice as much the bank capital per capita as New York and nearly six times as much as Pennsylvania. The resulting abundance of credit and the low cost of capital helped make Massachusetts and Rhode Island the nation's industrial leaders. Of course, there are other factors to consider, but value added per capita in manufacturing in these two states in 1860 was by far the highest in the nation—considerably more than twice as high as in either New York or Pennsylvania—and the ratios of capital invested per capita was similar greater.[51]

In New York, the basic story was similar but the shift to open access took longer and followed a somewhat different path. The tight interlinkages that the Bank of New York (organized in 1784 and chartered in 1791) had with Federalist political leaders enabled it to block all efforts to charter competing banks until Republican Aaron Burr cleverly exploited a loophole in a charter for a water works in 1799 to start the Manhattan Bank, which he then used to further the political interests of his faction. The Republicans gained control of the legislature

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[50] Lu and Wallis, "Banks, Politics, and Political Parties"; Lamoreaux, *Insider Lending*, 57-58; Kenneth Ng, "Free Banking Laws and Barriers to Entry in Banking, 1838-1860," J*ournal of Economic History* 48 (Dec. 1988): 877-99.

[51] Bodenhorn, "Bank Chartering and Political Corruption in Antebellum New York," 239; and Albert W. Niemi, Jr., *State and Regional Patterns in American Manufacturing, 1860-1900* (Westport, Conn.: Greenwood Press, 1974), 114-17, 148-52, 160-63, 183-88.

in 1803 and founded a bank of their own in Albany. At the same time, they refused to grant a charter to a new Federalist bank in New York called the Merchants' Banks, and when the bank went into operation anyway, passed a restraining act that prohibited any association from operating a bank without a charter and giving the Merchants' Bank a year to wind up its affairs. Although a Federalist resurgence enabled the bank subsequently to secure a charter, the restraining act remained in place and henceforth enabled the legislature strictly to control entry into banking.[52]

As in Massachusetts, power shifted toward the Republicans on the eve of the war of 1812, and the latter took advantage of the opportunity to charter additional banks for their supporters. Unlike Massachusetts, however, the Federalists never regained control of the state government. Instead, during the so-called Era of Good Feeling that followed the collapse of the first party system, Martin Van Buren's faction of Republicans used its power over bank charters and other sources of patronage to build a formidable political machine.[53] Although from time to time chinks appeared in the Regency's dominance, Van Buren was able to manipulate the banking system to regain control. For example, in 1824 and 1825 the machine lost control of the legislature to a competing faction known as the "People's Party," which proceeded to charter several new banks and a number of loan companies. The latter financed their operation through

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[52] Knox, *History of Banking*, 149-61; Bodenhorn, *State Banking in Early America*, 128-29; Eric Hilt, "Early American Corporations and the State"; Brian Phillips Murphy, *Building the Empire State: Political Economy in the Early Republic* (Philadelphia: University of Pennsylvania Press, 2015), Chs. 1 and 3.

[53] See Bodenhorn, "Bank Chartering and Political Corruption in Antebellum New York"; Eric Hilt, "Early American Corporations and the State"; and Ronald Seavoy, *The Origins of the American Business Corporation, 1784-1855* (Westport, Conn.: Greenwood Press, 1982), Ch. 4. More generally, on the rise of the Albany Regency, see Richard Hofstadter, *The Idea of a Party System: The Rise of Legitimate Opposition in the United States, 1780-1840* (Berkeley: University of California Press, 1969), Ch. 6; and Lee Benson, *The Concept of Jacksonian Democracy: New York as a Test Case* (Princeton: Princeton University Press, 1961).

the issue of post notes, payable at a fixed future date rather than, like banknotes, redeemable on demand. The result was a rapid expansion of credit followed by a crash in 1826. The financial turbulence reinforced incumbent bankers' claims that an uncontrolled expansion of banking would undermine the system's soundness. When Van Buren's Albany Regency regained power, the legislature temporarily put the brakes on new charters and also passed a co-insurance scheme call the Safety Fund. This law imposed a tax on bank capital to be paid into an insurance fund that protected holders of banknotes in the event of failures. Thus when the Regency began again to award charters to their supporters they came with a "Good Housekeeping Seal of Approval."[54]

During the economic boom of 1830s the New York legislature received on average about 70 petitions for banks a year, but under the machine's tight control only about ten percent of that number received charters. Not surprising, the large number of rejections helped fuel political opposition. When, despite the Safety Fund, the Panic of 1837 brought down the banking system, the Albany Regency collapsed as well. The opposition (now called the Whig Party) met the pent-up demand for charters and, at the same time took steps to insure that the Regency would never again be able to use bank charters for political purposes, by passing New York's famous free banking law in 1838.[55] To counter worries that open access to banking would undermine the soundness of the system, the legislature added an important regulatory provision to the act that required banks fully to back their currency issues by investing in specific

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[54] Hilt, "Early American Corporations and the State"; Bodenhorn, *State Banking in Early America*, 157-60; Bodenhorn, "Bank Chartering and Political Corruption in Antebellum New York," 236-40; Seavoy, *Origins of the American Business Corporation*, Ch. 5.

[55] Bodenhorn, "Bank Chartering and Political Corruption in Antebellum New York," 240-44; Hilt, "Early American Corporations and the State"; Seavoy, *Origins of the American Business Corporation*, Ch. 6.

categories of government bonds. The result was a dramatic expansion in the number of banks and a decline in the number of bank failures, though the slower shift to open access meant that New York would still for several decades lag Massachusetts in the amount of bank capital, credit, and currency per capita.[56]

In the end, New York's highly successful experience with free banking pointed the way for change elsewhere. In a few states, including for a time Texas, Iowa, California, and Oregon, politicians took their cues from Jackson's veto message and shut down their banking systems entirely to put an end to corruption. Gradually, however, the movement toward free banking gained ground until by 1860 almost all Northern states east of the Mississippi River had enacted laws modeled on New York's, as did four Southern states.[57] Unlike the changes in Massachusetts and New York, however, these subsequent adoptions typically were part of the broader wave of reforms set in motion by the financial debacles of the late 1830s and early 1840s. We discuss these more general developments in the next section.

Free banking was not, it must be emphasized, a solution to the problem of instability in banking. The history of bank regulation begins, not ends, with the achievement of open access. It was only when entry into the financial sector was reasonably free of political manipulation that policy makers could begin to grapple with the structural characteristics that periodically produce

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[56] In 1837 Michigan had adopted a free banking act without this backing provision to disastrous results. See Hilt, "Early American Corporations and the State."

[57] Hilt, "Early American Corporations and the State." The exceptions in the North, Rhode Island, New Hampshire, and Connecticut, already had de facto open access to banking. During the Civil War, the federal government would pass a free banking act of its own, the National Banking Act, modeled on Ohio's version of New York's act. The motive was to force banks to buy U.S. government bonds to back their currency issues. When the banks balked, Congress forced them to take out federal charters by taxing state banknote issues. This legislation effectively spread the federal variant of free banking throughout the country. ##citations about the National Banking Acts.

crises in fractional reserve banking systems. Nor did free banking eliminate the power that large financial interests exerted in the political area. As the response to the recent financial crisis has demonstrated, what nineteenth-century commentators decried as the "moneyed interest" continues to exercise a major influence over the formation of regulatory policy, including which banks should be deemed "too big to fail." What free banking did was change the ease with which access to banking could be used by elites to form a sustainable coalition to dominate the political process. This manipulation of the economy for political purposes—what we are calling systematic corruption—was not a problem that was unique to banks. It did not arise because bankers were rich, powerful, and able to use their influence to secure political favors. Rather, the problem arose because politicians had discretion over who could operate a bank and thus were able to manipulate the economic interests of individuals to perpetuate their own dominance. Control over access to other valuable economic activities could be (and was) used for similar ends, and the states would begin to confront this more general problem in the 1840s in the aftermath of a crisis in their *public* finances.

Taxless Finance

American governments faced insistent popular demands for initiatives that promoted economic development, particularly for improvements in transportation, but they faced equally insistent difficulties financing those initiatives. Americans were generally reluctant to tax themselves to pay for expensive infrastructure projects, but they were especially reluctant to tax themselves to build projects that would primarily benefit others, and it was too costly to bundle enough projects together to insure that everyone benefited.[58] The federal government was never really able to solve this problem until the Civil war, but the states exploited their larger set of powers to exploit various means of "taxless finance."[59] First and foremost, they granted charters of incorporation to private groups who would take on infrastructure projects, building lucrative privileges into the charters to insure the projects would attract private capital. From the standpoint of the elites in control of state governments, this mode of finance was doubly advantageous. Not only would important development projects be built, but the privileges imbedded in the charters could be used to secure the support of wealthy elites.[60]

There was also a disadvantage to this method of finance, in that the privileges often fueled political opposition. A common boon imbedded in charters for transportation projects, for example, permitted the corporations to recoup their investments by collecting tolls. Users of these services chafed at paying these exactions, and, given the increasingly competitive nature of

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[58] Technically, to be politically feasible projects had to satisfy a majority constraint and an exit constraint: That is, a majority of districts had to benefit from the projects, and the bundle could not be so costly that constituents in districts that did not benefit would no longer find it worthwhile to remain in the polity. For a formal model, see John Joseph Wallis, "Constitutions, Corporations, and Corruption: American States and Constitutional Change, 1842 to 1852," *Journal of Economic History* 65 (Mar. 2005): 211-56 at 219-25.

[59] John Lauritz Larson, *Internal Improvement: National Public Works and the Promise of Popular Government in the Early United States* (Chapel Hill: University of North Carolina Press, 2001); Wallis, "Constitutions, Corporations, and Corruption"; George Rogers Taylor, *The Transportation Revolution, 1815-1860* (New York: Rinehart, 1951). The federal government was able to make less costly improvements to rivers and harbors. See Paskoff, *Troubled Waters*; and John Joseph Wallis and Barry R. Weingast, "Equilibrium Impotence: Why the States and Not the American National Government Financed Economic Development in the Antebellum Era," NBER Working Paper No. 11397 (2005).

[60] James Willard Hurst, *The Legitimacy of the Business Corporation in the Law of the United States, 1780-1970* (Charlottesville: University of Virginia Press, 1970); Handlin and Handlin, *Commonwealth*; Hartz, *Economic Policy and Democratic Thought*; Seavoy, *Origins of the American Business Corporation*; Murphy, *Building the Empire State*; Andrew M. Schocket, *Founding Corporate Power in Early National Philadelphia* (DeKalb: Northern Illinois Press, 2007).

the political system, legislatures sometimes responded to their grievances by reneging on the grants. For example, after the Virginia assembly chartered the Richmond James River Company in 1804 to improve navigation on the river, a deluge of complaints led the legislature to amend the charter over the objections of the company and exempt small boats from having to pay tolls.[61] More famously, the Massachusetts legislature responded in 1828 to protests over tolls charged by the company it had chartered to build a bridge over the Charles River by chartering a second bridge right nearby.[62]

Both these ways of reneging on corporate grants were ultimately challenged in the U.S. Supreme Court. The decisions get a lot of attention in history books focusing on national events, but they were of little consequence for states' powers over corporations or their ability to engage in this type of taxless finance. The *Dartmouth College* case is perhaps the most famous. In response to New Hampshire's attempt to change the composition of the college's governing board, the Court ruled that a corporate charter was a contract that the states must honor.[63] However, the states could (and did) easily evade this restriction by inserting reservation clauses into charters that enabled them unilaterally to alter the terms or revoke them altogether.[64] The Charles River Bridge Company's lawsuit challenging the constitutionality of Massachusetts'

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[61] Bruce A. Campbell, "John Marshall, the Virginia Political Economy, and the *Dartmouth College* Decision," *American Journal of Legal History* 19 (Jan. 1975): 40-65 at 45-46.
[62] Stanley I. Kutler, *Privilege and Creative Destruction: The Charles River Bridge Case* (Philadelphia, Penn.: Lippincott, 1971).
[63] *Dartmouth College v. Woodward*, 17 U.S. 518 (1819).
[64] See, for example, William P. Wells, "The Dartmouth College Case and Private Corporations," *Report of the Ninth Annual Meeting of the American Bar Association* (1886): 229-56. By the 1840s a number of states had modified their constitutions to prevent legislatures from creating any corporations whose charters could not subsequently be altered. For example, Pennsylvania's 1838 constitution specified that bank charters "shall contain a clause reserving in the legislature the power to alter, revoke, or annul the same whenever in their opinion it may be injurious to the citizens of the Commonwealth, in such manner however, that no injustice shall be done to the incorporators." See Article I, Section XXV.

grant of a second bridge charter was similarly inconsequential. The Supreme Court acknowledged the *Dartmouth* precedent that a corporate charter was a contract that the state could not unilaterally abrogate, but it declared that corporate charters must be construed in the narrowest possible terms. The Charles River Bridge's charter did not include any explicit grant of monopoly or "words that even relate[d] to another bridge, or to the diminution of their tolls," so there were no grounds to overturn the legislature's second grant.[65] If it had included monopoly privileges, the outcome would have been different. States could and did write whatever provisions they wanted into corporate charters. For example, at the same time that the *Charles River Bridge* case was being litigated, New Jersey granted the Camden and Amboy railroad an effective monopoly on rail travel between New York and Philadelphia that lasted for decades. In exchange for dividend and tax payments to the state treasury guaranteed to amount at least to $30,000 a year, New Jersey promised not to charter any other railroad on a parallel route.[66]

States also had a second means of means of financing development projects without raising taxes. They could use their own credit to borrow the requisite funds on national or international markets, issuing bonds with the aim of using the revenues the projects would subsequently generate to pay down the debt. The problem with this type of taxless finance was that it imposed a contingent liability on the states' taxpayers: if the projects failed to generate enough revenue to meet the states' obligations, taxes would have to rise to service the debts. Nonetheless, state governments increasingly issued bonds for development purposes in the 1820s

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[65] *Charles River Bridge v. Warren Bridge*, 36 U.S. 420 (1837) at 549-50.
[66] Christopher Grandy, "Can Government Be Trusted to Keep Its Part of a Social Contract?: New Jersey and the Railroads, 1825-1888," *Journal of Law, Economics, & Organization* 5 (Autumn 1989): 249-69.

and 1830s.[67] Several Southern states borrowed to establish banks that would lend to planters on the security of mortgages on their land and slaves. Many other states, especially in the North, borrowed to finance transportation projects.

These projects did not initially awaken the same political opposition as the privileges included in corporate charters, but behind the scenes there was often much the same element of favoritism—both in the identity of the leading figures and in the choice of projects. The latter was particularly problematic as the logic of the natural state dictated that projects be shaped more by the exigencies of elite coalition building than by the amount of revenue likely to be generated. Not surprisingly, most of these ventures ran into trouble by the early 1840s, and the resulting crisis in state finance, in combination with growing discontent over corporate privileges, produced a political earthquake that would restructure state governments along open-access lines.[68]

Canals were the first infrastructure improvements to lower overland transportation costs to levels close to those achieved on navigable waterways, and there was consequently much interest in such projects.[69] They were considerably more expensive to build than roads,

[67] Hamilton's funding proposals aimed to raise the credit of the federal government relative to the states, but it was the states' credit that ultimately mattered for development purposes. The federal government borrowed to finance the War of 1812, but was paying down its debt at the very time the states were borrowing to finance infrastructure projects.

[68] See Wallis, "Constitutions, Corporations, and Corruption"; Hartz, *Economic Policy and Democratic Thought*; Taylor, *Transportation Revolution*; Bodenhorn, *State Banking*, Chs. 9 and 10; Larry Schweikart, *Banking in the American South from the Age of Jackson to Reconstruction* (Baton Rouge: Louisiana State University Press, 1987).

[69] Improvements in roads reduced overland transportation costs from about 30 cents per ton mile at the start of the nineteenth century to about 15 cents per ton mile in the 1820s. Canals further reduced transportation costs to under 1 cent per ton mile by the mid-1840s. Douglass C. North, *Growth and Welfare in the American Past: A New Economic History* (Englewood Cliffs, N.J.: Prentice-Hall, 1966), 111. See also Robert William Fogel, *Railroads and American Economic Growth: Essays in Econometric History* (Baltimore, Md.: Johns Hopkins Press, 1964).

however, and over long distances required investments in amounts that were generally beyond the reach of private corporations. As a result, they were undertaken for the most part as public works projects. New York led the way with its pioneering Erie Canal. The project was one for which there was an obvious need, and there had been previous (unsuccessful) efforts to get it off the ground. Finally, a canal bill was shepherded through the New York legislature by DeWitt Clinton and members of his coalition, mainly former Federalists fighting for their political lives against what would become the Albany Regency. The pro-canal forces included groups with interests that would benefit from its construction—large upstate landowners, agents of European land speculators, companies that invested in smaller canal projects along the route—but the poles around which New York state politics was organized shaped the larger pattern of support and opposition.[70]

Clinton and his allies worked tirelessly to drum up popular support in New York City and along the proposed route of the canal, and they were able to present a memorial to the legislature in 1816 that bore thousands of signatures—only the most dramatic of the thirty or so other petitions received by the assembly that year. They still had to solve the problem of how to finance construction, however. Many New York City merchants initially opposed the canal because they feared the project would fail, as earlier canal projects had done, and they would end up paying higher taxes as a result. Citizens in parts of the state that stood to gain nothing from the canal had similar objections. To secure legislative approval, therefore, Clinton and his allies had to guarantee that any necessary increase in taxes would be borne by the canal's primary

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[70] On the politics behind the Erie Canal, see Murphy, *Building the Empire State*, Ch. 5; Nathan Miller, *The Enterprise of a Free People: Aspects of Economic Development in New York State during the Canal Period, 1792-1838* (Ithaca, N.Y.: Cornell University Press, 1962); and Ronald E. Shaw, *Erie Water West: A History of the Erie Canal, 1792-1854* (Lexington: University of Kentucky Press, 1966).

beneficiaries. Rather than engage in taxless finance, therefore, they built into the enabling legislation provisions specifying that, if revenues from tolls on the canal were not sufficient to meet the state's debt obligations, a tax surcharge levied on property within 25 miles of the canal would kick in.[71] New York never had to impose the surcharge, however. When the middle section of the canal opened in 1819, it generated enough traffic and revenues to finance construction of the next stage. In the end, the canal was so profitable that New York was able to suspend property taxes on all of its citizens during the 1820s.[72]

The Erie's success galvanized elites in other states, especially in seaboard cities that now had to worry about losing trade to New York, and inspired a craze of canal building in the 1820s and 1830s that gave the nation a system of over 3000 miles of canal and dramatically reduced the costs of shipping goods from the rich farm lands of the prairies to coastal cities.[73] Some states (Ohio in 1825, Indiana in 1836, and Illinois in 1837) followed New York's lead and backed their bonds with taxes to be levied on the beneficiaries of the transportation improvements. However, the profitability of the Erie led other states (Maryland in 1828, Pennsylvania in 1828, and Massachusetts in 1837) to embark on taxless financial schemes. These states gambled that revenues from their projects would be sufficient to pay off the debts incurred for construction. The success of the Erie was so seductive that even New York succumbed and turned to taxless finance when it began a second round of canal expansion in the late 1830s.[74]

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[71] In addition, the measure diverted two existing taxes to the canal fund (the auction tax and revenues from salt lands). See Wallis, "Constitutions, Corporations, and Corruption," 222.

[72] Wallis, "Constitutions, Corporations, and Corruption," 227-28.

[73] This canal craze is the only important example from this period of competitive pressures among states driving policy. See Taylor, *Transportation Revolution*; and Ronald E. Shaw, *Canals for a Nation: The Canal Era in the United States, 1790-1860* (Lexington: University of Kentucky Press, 2014).

[74] On the chronology of canal investments see Taylor, *Transportation Revolution*; Carter Goodrich, *Government Promotion of American Canals and Railroads, 1800-1890* (New York:

None of the subsequent projects proved as profitable as the Erie, although the early Ohio canals were financially viable. Most of the trans-Appalachian canals were not even that, and they were much more costly to build than the Erie because they went through more mountainous terrain. Nonetheless, canal construction continued to boom. The farther western states of Indiana, Illinois, and Michigan, only began to construct their canals in 1836 or later. Even the Panic of 1837 and the ensuing economic disruptions did not slow state borrowing. State legislatures authorized more new borrowing in 1838 than in any other year in the 1830s—$35 million, as opposed to $21 million in 1837 and $13 million in 1836. Although most of the projects started in the late 1830s were not expected to generate revenues until the 1840s, that was not the case for Pennsylvania and Maryland, whose canal projects had demonstrated, by the mid-1830s, that they were not going to produce the revenues that had been anticipated when they were undertaken in the 1820s. Nonetheless, both Pennsylvania and Maryland borrowed additional money after 1837, significantly increasing their debt burdens.[75]

By the early 1840s it was clear that these debt levels were not sustainable, and the states found themselves in serious financial trouble. The literature has generally attributed the economic disruptions that prostrated state finances to the Panic of 1837, a crisis that had its roots in the international economy as well as in domestic policies.[76] The Crisis of 1839 appears in

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Columbia University Press, 1960); and Larson, *Internal Improvements*. See also Harry N. Scheiber, *Ohio Canal Era: A Case Study of Government and the Economy, 1820-1861* (Athens: Ohio University Press, 1969). On the use of taxless finance, see Wallis "Constitutions, Corporations, and Corruption" and John Joseph Wallis, Richard E. Sylla, and Arthur Grinath III, "Sovereign Debt and Repudiation: The Emerging-Market Debt Crisis in U.S. States, 1839-1843," NBER Working Paper W10753 (2004).

[75] Namsuk Kim and John Joseph Wallis, "The Market for American State Government Bonds in Britain and the United States, 1830-43," *Economic History Review* 58 (Nov. 2005): 736-64; and Wallis, Sylla, and Grinath, "Sovereign Debt and Repudiation."

[76] Peter Temin, "The Economic Consequences of the Bank War," *Journal of Political Economy* 76 (March 1968): 257-74; Temin, *Jacksonian Economy* (New York: Norton, 1969); Peter L.

this scholarship as little more than a financial aftershock and is usually associated with the second suspension of payments by the Bank of the United States of Pennsylvania (BUSP), the former Second Bank of the United States which was then operating under a Pennsylvania charter. The suspension has usually been blamed on BUSP's cotton speculations, but the bank was also deeply involved in marketing state bonds in Europe. The main reason it suspended specie convertibility was a shock to international bond markets in the fall of 1839. The shock resulted from troubles in Indiana, Illinois, and Michigan that brought canal construction in those states to a grinding halt and endangered their ability to service their debts. The 1839 crisis was made in America, but it awakened European investors to the dangers of holding American state bonds more generally and in that way spread from Europe back to the United States.[77]

No longer able to raise funds on the bond market and facing budgetary shortfalls as revenues dropped with the level of economic activity, the states found themselves in serious financial trouble. They could only service their debt obligations by raising taxes, but hard-pressed citizens rebelled against the higher burden. Pennsylvania, Maryland, Illinois, Indiana, and Michigan defaulted on their obligations, and Ohio and even New York only narrowly avoided default. The crisis also caused the three Southern states (Louisiana, Mississippi, and Arkansas) and the territory of Florida to default on bonds they had issued to finance plantation banks. All of the Northern states except Michigan eventually resumed payment on their debts, but all of the Southern states except Alabama repudiated at least a part of their debts.[78]

Rousseau, "Jacksonian Monetary Policy, Specie Flows, and the Panic of 1837," *Journal of Economic History* 62 (June 2002): 457-88.

[77] The story is a complicated one but turns on the failure of the Morris Canal and Banking Company of New Jersey, which served as the intermediary for these states in bond markets. See John Joseph Wallis, "What Caused the Crisis of 1839?" NBER Working Paper H0133 (2001); and Kim and Wallis, "Market for American State Government Bonds."

[78] Wallis, "Constitutions, Corporations, and Corruption"; and Wallis, Sylla, and Grinath,

The Revolution in State Government

When the crisis finally passed and Americans turned to the task of revising their economic and political institutions to prevent such a catastrophe from recurring, they did so with the understanding that responsibility for the defaults lay with the states themselves, not with international economic forces beyond their control. In assigning responsibility domestically, moreover, they interpreted the events in classic republican terms as an object lesson in how disastrously things could go wrong when elites in positions of political power manipulated the economy for their own ends. In some states, the groups that took power as a result of the crisis applied classic republic solutions and prohibited the legislature henceforth from creating banks or involving the state in transportation projects. For the most part, however, Americans sought ways to foster economic development without at the same time facilitating the systematic corruption that had brought the fiscal system down. Recognizing that taxless finance could be a seductive cover for policies that primarily benefited a favored few, they aimed to eliminate that device from the state's toolkit, first by changing the procedures for government borrowing, and second by preventing legislatures from handing out privileges to favored private companies. In many states, the second of these changes took longer to accomplish than the first, but the end result virtually everywhere was to move toward an open-access social order.

Because it was clear to everyone that the high levels of indebtedness that states had incurred during the late 1830s were the source of the crisis, the easiest and most obvious change to accomplish was to limit the states' borrowing powers. Eleven states revised their constitutions in the 1840s and early 1850s, and three new states wrote their first constitutions.

"Sovereign Debt and Repudiation."

All but one of these documents imposed new procedural restrictions on indebtedness. Most other states followed suit, either when they next revised their constitutions or by amendment. By the time of the Civil War, nineteen states had enacted these provisions. An additional six states adopted them in the 1870s, six in the 1880s, six in the 1890, and seven more between 1900 and 1919.[79]

These restrictions did not prohibit state governments from borrowing in the future. They merely prevented states from issuing bonds without immediately levying enough taxes to service them, and they required that voters approve the package in a referendum before the bonds could be issued. Delegates to the many state constitutions conventions held during the 1840s and 1850s understood that if voters were offered an opportunity to get a canal or other infrastructural improvement in their community at no cost to themselves, they would not turn down the chance. Even if the proposal was too good to be true, and many of the investments in the 1830s had turned out to be in that category, voters and legislators were likely to approve them. The best way to prevent such an outcome was make citizens commit in advance to tax themselves to pay for the project. As Judge David Kilgore explained to the Indiana Constitutional Convention in 1850, "Mr. President, had a provision been made before the public debt was created that a direct tax must be levied, high enough to pay the interest and to wipe out the whole debt in eighteen or twenty-five years, all would have been comparatively well. A provision of this kind, sir, would have brought the people to their right senses, and my word for it, before State Bonds to the amount of four millions of dollars had been sold, they would have risen and denounced the

[79] These types of restrictions remain in place in most state and local governments to the present day. Isabel Rodriguez-Tejedo and John Joseph Wallis, "Fiscal Institutions and Fiscal Crises," in Peter Conti-Brown and David A. Skeel, Jr., *When States go Broke: The Origins, Context, and Solutions for the American States in Fiscal Crisis* (New York: Cambridge University Press, 2012), 9-39.

whole system as projected."[80]

Another avenue of taxless finance that most states closed off fairly easily was to prevent legislatures from granting favors to particular groups in the form of tax breaks or tax exemptions. [Detail on the number of states initially adopting and time path of these "general tax provisions"][81] Closely related to these provisions were others barring states from investing directly in private corporations or from lending the state's credit to them. [details]

States also took aim at legislatures' practice of granting special charters of incorporation. Eliminating this type of political favoritism was a longer, more involved, more conflict-ridden process, but by the end of the century almost all states had prohibited their legislatures from enacting special charters and indeed had gone further and barred them from passing all kinds of private bills.[82] Indiana was the first state to enact the entire package. Its constitution of 1851 banned special charters of incorporation and went on to prohibit private bills for a long list of purposes indicative of the extent to which the legislature had been meddling in local governmental and judicial concerns, as well as in the economy:

> The General Assembly shall not pass local or special laws, in any of the following numerated cases, that is to say: Regulating the jurisdiction and duties of justices of the peace and of constables; For the punishment of crimes and misdemeanors; Regulating the

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[80] Indiana, *Report of the Debates and Proceedings of the Convention for the Revision of the Constitution* (Indianapolis: A. H. Brown), I, 676.

[81] General tax provisions were important through the nineteenth century, but they started to disappear from state constitutions in the early twentieth century, as states began moving away from property taxes. Today, tax breaks to encourage business activity play a significant role in state and local public finance. Tax breaks are the one area where the institutional changes implemented in the 1840s have not continued to be an important element of American political economy. John Josephn Wallis "A History of the Property Tax in America" in *Property Taxation and Local Government Finance,* Wallace E. Oates, ed. Cambridge: Lincoln Institute of Land Policy, pp. 123-147, 2001.

[82] Hennessey and Wallis, "Corporations and Organizations."

> practice in courts of justice; Providing for changing the venue in civil and criminal cases; Granting divorces; Changing the names of persons; For laying out, opening and working on, highways, and for the election or appointment of supervisors; Vacating roads, town plats, streets, alleys and public squares, Summoning and empanneling grand and petit juries, and providing for their compensation; Regulating county and township business; Regulating the election of county and township officers, and their compensation; For the assessment and collection of taxes for State, county, township or road purposes; Providing for supporting common schools, and for the preservation of school funds; In relation to fees or salaries; In relation to interest on money; Providing for opening and conducting elections of State, county or township officers, and designating the places of voting; providing for the sale of real estate belonging to minors, or other persons laboring under legal disabilities, by executors, administrators, guardians or trustees.[83]

That the various elements of the package of constitutional reforms—from tax restrictions to bans on private bills—were linked in the minds of the Indiana delegates is clear from published debates. From the beginning, the resolutions introduced to shape the convention's business gave prominent place to all of the package's elements. For example, the first such resolution consisted of ten provisions including "that corporations shall be created under a general law" (number 2), "that special legislation shall be prohibited" (3), "that the Legislature shall be prohibited from granting divorces" (4), and that "the Legislature shall be prohibited from borrowing money upon the faith of the State, without the consent of the people expressed

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[83] Indiana Constitution of 1851, Article 4, Section 22. Special charters of incorporation, except for banking, were banned in Article 11, Section 13. The banking provisions in Article 11 were slight more complicated because Indiana had a state bank, but aside from an institution like that, the new constitution banned special charters for banks. On Indiana's state bank, see ##

through the ballot-box" (5).[84] Other resolutions submitted at the start of the constitutional convention were similar, and among the standing committees set up to draft the new constitutions there were, in addition to those on the various branches of government, committees "On Special and Local Legislation, and Uniformity of Laws," "On Currency and Banking," "On Corporations other than Banking," "On State Debt and Public Works," and "On Finance and Taxation."[85] Speeches on the convention floor linked the state's fiscal debacle to excesses of special legislation, as well as to borrowing to finance transportation projects. Thus one delegate asserted that the proposed constitutional revisions would bring an end to "this special and local legislation that has … heaped upon us burdens of taxation for no good purpose."[86] Another argued that it was because of the influence that "corporations and combinations of wealthy men" exerted on the legislature "to secure special privileges and partial legislation" that it critical to "have it explicitly declared in our organic law" that the legislature had no unilateral power to contract a state debt.[87]

The article to ban private legislation was not in itself controversial. Almost no one spoke against it, and it seems to have passed overwhelmingly.[88] The only real debate was over whether the article should simply say that "the General Assembly shall not pass local or special laws" or whether the constitution should enumerate the kinds of special laws that would be prohibited.[89] There was more controversy over the article that banned special charters of

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[84] Indiana, *Report of the Debates and Proceedings of the Convention for the Revision of the Constitution* (Indianapolis: A. H. Brown), Vol. 1, 40.
[85] Indiana, *Report of the Debates*, Vol. 1, 43, 52, 58.
[86] Indiana, *Report of the Debates*, Vol. 2, 1032.
[87] Indiana, *Report of the Debates*, Vol. 1, 683.
[88] The vote on third reading was 91 in favor, 16 against. Indiana, *Report of the Debates*, Vol. 2, 1294.
[89] See Indiana, *Report of the Debates*, Vol. 2, 1768-69. There was also debate over whether the ban should be accompanied by a decline in the number of legislators and a shift from annual to

incorporation, but again the debate mainly concerned subsidiary issues such as whether the legislature should be given the power unilaterally to alter or repeal the laws conferring corporate powers and whether officers of corporations (or even shareholders) should be prohibited from serving in the legislature (a proposed remedy for systematic corruption).[90]

Most states did not adopt this full set of reforms right away, although by 1900 thirty-five states had constitutional provisions similar to Indiana's.[91] The more common path was for states first to enact constitutional provisions requiring the legislature to pass general incorporation laws without at the same time prohibiting the passage of special charters. Six states adopted such provisions in the 1840s, eight in the 1850s, nine in the 1860s, five in the 1870s, five in the 1880s, and three after 1900. Only four states never followed suit. [check numbers] Even when their constitutions did not require them to do so, moreover, most legislatures enacted general incorporation acts in the period between the public finance crisis and the Civil War. Take the case of manufacturing as an example. Although only four states had general incorporation laws for manufacturing before 1840, only six states (out of thirty-three) did *not* have such laws in 1860.[92]

Although general incorporation acts dramatically changed the economic landscape by enabling anyone who met the impersonal criteria laid out in the law to obtain a corporate charter through an administrative procedure, legislatures continued to charter large numbers of special corporations. Five years after the passage of Pennsylvania's 1849 general law for manufacturing,

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biennial or even triennial sessions.

[90] See the debates starting on pp. 1107, 1875, 1943 of Indiana, *Report of the Debates*, Vol. 2.

[91] See Hennessey and Wallis, "Corporations and Organizations," as well as Charles Chauncy Binney, *Restrictions upon Local and Special Legislation of State Constitutions* (Philadelphia: Kay & Brothers, 1894).

[92] Hilt, "General Incorporation."

for example, less than a dozen companies had incorporated under it. Yet in 1855 alone the legislature passed 196 private bills chartering or amending the charters of for-profit business corporations.[93] Moreover, even states that constitutionally prohibited special charters continued to allow them in circumstances where the corporate purpose could not be accommodated by the general acts. Maryland's 1851 constitution illustrates the resulting ambiguity: "Corporations may be formed under general laws, but shall not be created by special act, except for municipal purposes, and in cases where, in the judgment of the legislature, the object of the corporation cannot be attained under general laws."[94] Such language created a loophole that allowed significant numbers of corporations to continue to be chartered under special acts, but political norms had changed and most of the resulting charters had technical justifications. Corporations in transportation and communications often required powers of eminent domain to acquire rights of way, and those provisions could not be specified in a general law. Similarly, free banking laws often imposed minimum and maximum capital requirements on banks that could only be adjusted by special charter. In the most complete study of private charters granted in the approximately quarter center after 1875, Susan Pace Hamill counted a total of 8,075 incorporations, not including those for cities, towns, and other governmental entities. 3,550 were for transportation and communication companies and 2,336 for banks and insurance companies, leaving 2,189, or only about 75 a year across all of the states for all other purposes.[95]

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[93] Hartz, *Economic Policy and Democratic Thought*, 40. For the statutes, see Pennsylvania, *Laws of the General Assembly* (Harrisburg: A. Boyd Hamilton, 1855). See also George Heberton Evans, Jr., *Business Incorporations in the United States, 1800-1943* (New York: NBER, 1948); and Susan Pace Hamill, "From Special Privilege to General Utility: A Continuation of Willard Hurst's Study of Corporations," *American University Law Review* 49 (Oct. 1999): 81-180.

[94] Maryland Constitution of 1851, Article 3, Section 47.

[95] Hamill "From Special Privilege to General Utility," Appendix A, B, and C. Wallis has examined Hamill's counts and concluded that at most 34 were truly special in the sense of conveying extraordinary privileges. See "Constitutions, Corporation, and Corruption," 246-47.

Gradually, however, the remaining technical problems were solved and the loopholes closed. By the end of century about 70 percent of the states had imposed constitutional bans on special charters of incorporation, and most of the rest would soon follow suit. The number of special acts, even for transportation companies and banks, dwindled to a mere trickle in the twentieth century.[96]

The package of constitutional changes that the states enacted beginning in the 1840s did not prevent states from borrowing, raising taxes, creating corporations, or even chartering banks or building canals. What tied these constitutional reforms together was their common effort to eliminate the discretionary authority of state legislatures. In the case of borrowing, the reforms took discretion away from legislatures and placed it in the hands of the electorate. In the case of taxation, they eliminated the possibility of discretion entirely. In the case of corporations, they stripped legislatures of their authority to award charters and substituted an impersonal administrative process in their stead. In the case of other areas of private legislation, they substituted either administrative processes or the courts. Viewed from this lens, the reforms are an important signal that nineteenth-century Americans had come to understand that eliminating the ability of political leaders to make discretionary decisions by requiring state laws to "treat everyone the same" cut at the heart of systematic corruption.

Taken together, the reforms dramatically reconfigured the internal dynamics of legislative sessions. Rather than act on a long series of bills, each benefitting a small group or single individual, each part of the complicated matrix of back scratching and log rolling that

[96] Hamill, "From Special Privilege to General Utility," Appendix A, B, and C. States also enacted general incorporation laws for local governments during this period. Wisconsin led in 1848, followed by four other states in the 1850s, seven in the 1860s, seven in the 1879s, seven in the 1880s, four in the 1890s, and ten after 1900. Only six states failed to enact such provisions. Hennessey and Wallis, "Corporations and Organizations."

sustained political coalitions and party politics, legislatures were forced to focus on statutes that had much wider impacts and, necessarily, involved balancing the interests of everyone affected simultaneously, rather than piecemeal. Although the laws they passed had wider application, the decline in the sheer number of bills that the legislatures considered led them to shift from annual to bi- or even triennial sessions. At the same time, much of detailed work that had previously taken up legislators' time became the domain instead of administrative agencies and courts.[97]

Contrary to the literature, the reaction to the state bond defaults did not usher in a new age of laissez-faire. To the contrary, not only did states begin to set up railroad and banking commissions, but the general incorporation acts that replaced the thousands of special charters legislators had spent their time enacting were typically highly regulatory in their provisions.[98] Even if everyone who wanted to form a corporation could do so in theory, opponents of privilege worried, the wealthy were likely to be able disproportionately to benefit from the form's advantages. This fear had considerable political traction and led states to fill their general laws with restrictions on what corporations could do, how big they could grow, how long they could live, and even their internal governance structures.[99] Thus Pennsylvania's 1874 revision to its general incorporation law included clauses fixing the maximum amount of capital a firm could

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[97] Kincaid, "Early State History and Constitutions."

[98] For examples of the new state commissions and regulatory initiatives, see William R. Childs, *The Texas Railroad Commission: Understanding Regulation in America to the Mid-Twentieth Century* (College Station: Texas A&M University Press, 2005); Thomas K. McCraw, *Prophets of Regulation: Charles Frances Adams, Louis D. Brandeis, James M. Landis, and Alfred E. Kahn* (Cambridge: Harvard University Press, 1984), Ch. 1; Kris James Mitchener and Matthew Jaremski, "The Evolution of Bank Supervisory Institutions: Evidence from the American States," *Journal of Economic History* 75 (Sept. 2015): 819-59.

[99] For examples, see Naomi R. Lamoreaux, "Corporate Governance and the Expansion of the Democratic Franchise: Beyond Cross-Country Regressions," *Scandinavian Economic History Review* 64 (issue 2, 2016): 103-21.

raise, the magnitude of its debt relative to its paid-in capital, and the extent of the real estate it could own. Although the statute aimed to be comprehensive in its coverage and govern corporations "not for profit" as well as those formed for business purposes, it still listed the specific types of corporations that could organize under the law and included regulations that applied only to particular industries. As mandated by Pennsylvania's 1873 constitution, moreover, the statute required companies to allow shareholders to cumulate their votes in elections for directors, so that minority shareholders could cast all their votes for one person and thereby increase their changes of securing representation on the board.[100]

Regulated as it was, the opening up of access to the corporate form unleashed an enormous burst of entrepreneurial energy. It is difficult to disentangle the various causes of the extraordinarily high rates of economic growth that characterized the late nineteenth century, but one can see the effect in a more straightforward way in the numbers of new corporations by comparing the states of Ohio and New Jersey. In the decade after the Civil War it was possible to incorporate in New Jersey under general law but companies could still seek special charters and many did. Indeed, more corporations were chartered by special act than under the general laws, and the continued possibility of securing special charters seems to have held back the number of corporations. Ohio, which banned special charters in 1851, chartered about 2.2 times as many corporations in that decade as New Jersey. In 1875 New Jersey joined the group of states that banned special charters and began to close the gap. During the 1880s, the ratio of

[100] Later, some (but by no means all) of these regulations would give way in the chartermongering competition sparked by New Jersey in 1888-89. See Lamoreaux, "Corporate Governance"; and Lamoreaux, "Revisiting American Exceptionalism: Democracy and the Regulation of Corporate Governance: The Case of Nineteenth-Century Pennsylvania in Comparative Context," in *Enterprising America: Businesses, Banks, and Credit Markets in Historical Perspective*, ed. William J. Collins and Robert A. Margo (Chicago: University of Chicago Press, 2015), 25-71.

corporations chartered in Ohio to those in New Jersey fell to 1.5, at the same time as the numbers in both states soared. Although there are gaps in the series, the story for Pennsylvania seems to be much the same, with the number of corporations converging on those of Ohio only after the imposition of a ban on special charters in 1873.[101] More generally, Heberton Evans' counts of the number of new corporations in the United States show a tremendous surge following the spread of mandatory general incorporation in the last third of the nineteenth century.[102]

Conclusion

Limited government occupies a prominent position in how Americans view themselves and their history. Debates over the powers enumerated in the federal constitution and the mechanical structure of checks and balances, both horizontally within the national government and vertically between the national government and the states, have given a concrete reality to our notions of "limits." These limits are fine and good, but they are not the only ones that matter, and perhaps they are not even the most important limits. Neither the checks and balances imposed in the federal constitution nor those imbedded in the early state constitutions prevented elites in government from manipulating the economy for political purposes. To the contrary, the initial response to the resulting uncertainties of power had been to create and manipulate economic privileges to build political coalitions.

Only in the 1840s and only at the state level would Americans begin to limit the powers of government in ways that reduced the possibilities for systematic corruption. In an attempt to make their democracies work, they created a suite of political and economic institutions that

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[101] Evans, *Business Incorporations in the United States*, 12, and Appendix 3
[102] Evans, *Business Incorporations in the United States*, 32, and Appendix 3.

were sustainable, in the sense that they mutually reinforced one another. The package of constitutional changes adopted by the states in the middle years of the nineteenth century wrought a revolution in the way the political and economic system of the United States worked. The political institutions of democracy had not been enough in and of themselves to induce a transition from limited to open access. The achievement of open access required another set of institutional changes that required governments to treat people impersonally, to apply rules equally to all citizens, to treat everyone the same. The kind of vigorous political competition necessary to make democracy work was not possible without vigorous economic competition, facilitated by publicly provided organizational tools enabling any group that desired to organize and pursue entrepreneurial aspirations.

These changes did not, of course, eradicate corruption. Economic interests would always attempt to sway the course of policy in whatever directions they favored. That was venal corruption, and it would always be with us. Nor did the changes eliminate inequality. Elites did not disappear, but they now operated in a much different environment—one characterized by what Joseph Schumpeter called creative destruction. New firms were now free to enter into a wide range of economic activities, like banking, with the full legal and organizational support of the state. Open access dramatically affected the flexibility of the economy, the ability to shift resources from lower to higher valued uses, whether the shifts were between firms, between industries, or between geographic regions.

None of this could have been anticipated by nineteenth-century Americans, because no one had yet lived in the kind of open access society that enabled such economic flexibility. The changes were unintended, but they were extraordinarily important and reshaped the way politics and economics interacted. Making economic privileges available to everyone made it much more difficult to build a political coalition simply out of economic interests; limiting legislative discretion changed the very nature of political competition in the United States. The result was one of the world's first societies to enjoy steady economic growth and secure political and civil rights.