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STATES, NOT NATION: THE SOURCES OF POLITICAL AND ECONOMIC DEVELOPMENT IN THE EARLY UNITED STATES

Naomi R. Lamoreaux and John Joseph Wallis

Johns Hopkins Institute for Applied Economics,
Global Health, and Study of Business Enterprise

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Naomi R. Lamoreaux, Yale University and NBER

John Joseph Wallis, University of Maryland and NBER

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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. The purpose of this paper is to shift the focus of attention to the states without losing sight of the larger story of which they were a part. We accomplish this goal 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 show that these developments were part and parcel of a more fundamental institutional shift from a "limited access" to an "open access" social order, to borrow the terminology that Douglass North, John Wallis, and Barry Weingast developed for their book *Violence and Social Orders* (2009). 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 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 for economic development, 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 even then it played only a bit part.

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

Towards the end of his life Ernest Gellner declared, "America was born modern; it did not have to achieve modernity, nor did it have modernity thrust upon it."[1] Although few scholars would agree with Gellner's statement in this bald form, many social scientists would accept a milder version that, by the time of the American Revolution, social, cultural, political, and economic beliefs and norms were in place that would pave the way for a modern democratic political system and sustained economic growth. Generations of American historians have amassed evidence to the contrary, showing that it was by no means inevitable in 1800, or perhaps even later, that the United States would become this type of modern society. Yet, despite these labors, prominent scholars like Gellner still make claims to the contrary, Supreme Court justices still scour the writings of the "framers" for principles to use in resolving modern political and economic disputes, and policy makers still hold up early national American institutions as a model for developing countries around the world to emulate.

As the title of this paper suggests, we believe that an important reason historians' labors have had so little effect on the general perception of American history is because our synthetic histories have focused primarily on the national government and not the states, whereas most of the important developments that propelled political democratization and economic modernization in the nineteenth century occurred at the state level. Of course, in a basic sense the role of the states is common knowledge. On the political side, it is well known that all the changes that widened the suffrage before the Civil War were the work of the states. On the economic side, the

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[1] Ernest Gellner, *Anthropology and Politics: Revolutions in the Sacred Grove* (Oxford: Blackwell, 1995), 18.

development of a national market required investments in transportation and financial infrastructure, and it is well known that it was the states that supplied almost all the funding for public transportation projects. Similarly, it was the states that provided the country with its banking system. The national government chartered the two national banks (and a few small banks in the District of Columbia). Both the First and Second Bank of the United States generated political firestorms and did not live beyond the period of their initial charters. By contrast, the more than 600 state-chartered banks in existence in 1836 provided the country with the bulk of its money supply and much of the credit that fueled industrialization. More generally, the multi-owner firms that were the agents of economic development were creatures of state law. There were no national laws governing the formation of either partnerships or corporations. It was entirely up to the states whether the rules governing these forms inhibited or supported economic development.

Historians know all this. Indeed, there is a general consensus that the federal government was weak and unimportant during the nineteenth century.[2] Yet we do not have a general history that integrates the changes at the state level into a coherent narrative of how American democracy and the American economy developed together. Two recent and accomplished histories of early American development are Daniel Walker Howe's *What Hath God Wrought* and Sean Wilentz's *The Rise of American Democracy*.[3] These admirable books acknowledge that the United States developed through a co-evolution of political and economic change. But what do they actually

[2] This consensus can be seen especially clearly in the classic studies of the growth of federal power during the Progressive Era. See, for example, Robert H. Wiebe, *The Search for Order, 1877-1929* (New York: Hill and Wang, 1967); and Stephen Skowronek, *Building a New American State: The Expansion of National Administrative Capacities, 1877-1920* (New York: Cambridge University Press, 1982).

[3] Daniel Walker Howe, *What Hath God Wrought: The Transformation of America, 1815-1848* (New York: Oxford University Press, 2007); and Sean Wilentz, *The Rise of American Democracy: Jefferson to Lincoln* (New York: Norton, 2005).

have to say about such matters? Howe's view of the expansion of the franchise is neatly summarized by his introductory remark, "In most states, white male suffrage evolved naturally and with comparatively little controversy."[4] His chapter on "Overthrowing the Tyranny of Distance" treats questions central to the creation of a national market. He acknowledges that the national government could not overcome the internal political divisions that prevented it from promoting a system of roads, canals, and railroads, and so the states made the initial investments in transportation. How did the states overcome the same political problems? How did New York, for example, manage to fund the Erie Canal when the canal brought benefits to only a minority of voters and potentially imposed taxes on the entire state? We do not get an answer to such questions. Howe simply says that the states built the canals: "During the years after 1815, a society eager for transportation and open to innovation finally surmounted these difficulties... Many canals were built entirely by state governments, including the most famous ... the Erie Canal."[5]

As the title of his book suggests, the spread of the franchise plays an important role in of Wilenz's unfolding narrative, and he devotes a considerable amount of space throughout the book to political alignments and struggles over the vote at the state level. But this kind of detail disappears from his account of economic development. Wilentz's chapter on "Banks, Abolitionists, and the Equal Rights Democracy" describes the bank war between Andrew Jackson, Nicholas Biddle, and Henry Clay. It is a gripping story and a central one in the development of national politics and political parties, but it does not tell us much about how the banking system in the United States developed. Just as with transportation infrastructure, the political problems surrounding banking at the national level were equally present at the state level. Yet it was the

[4] Howe, *What Hath God Wrought*, 4.
[5] Howe, *What Hath God Wrought*, 216.

states that created the banking system in the early nineteenth century, even though the Constitution clearly gave the national government priority in the field of money creation and regulation. How did the states manage to overcome the political problems that blocked the development of banking at the national level?

As for corporations, both books scarcely touch on the subject. The lack of attention is not surprising; most general histories do not delve further than the U.S. Supreme Court's decision in the 1819 case of *Dartmouth College v. Woodward* that a corporate charter is a contract that the states must honor. In point of fact, however, the Court's decision did little to secure corporations against arbitrary actions by the states. After *Dartmouth*, states regularly inserted reservation clauses into charters that enabled them unilaterally to alter the charter terms or revoke them altogether, and by the 1840s a number of states had modified their constitutions to prevent their legislatures from creating any corporations whose charters could not subsequently be altered.[6] An open and competitive economy is a key prerequisite for sustained economic growth, one that most developing societies today do not have. Why do our histories miss the importance of the major waves of state legislation that gradually opened access to the corporate form in the first half of the nineteenth century, legislation that was subsequently made permanent and concrete through state constitutional provisions mandating that legislatures enact general incorporation acts allowing anyone to form a corporation who met minimal requirements? This phenomenon gets two pages in Howe (558-59) and no attention at all from Wilentz.

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[6] 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. The constitutional provisions often included some basic protection for shareholders' property rights. 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.

To the extent that there has been any effort to reconcile the focus on the national level that we see in these histories with the consensus view of the relative unimportance of the federal government, it has been to attack the latter with the aim of showing that the federal government played a more powerful role in economic and political life than the literature has recognized. Thus Paul Paskoff has documented extensive federal involvement in river and harbor improvements and in regulating steamboat safety in the decades before the Civil War.[7] Richard John has highlighted the contribution of the U.S. postal system to economic growth through its subsidization of transportation improvements and its contribution to political democratization by increasing the access of citizens everywhere to newspapers and other institutions of the "public sphere."[8] Zorina Khan and Kenneth Sokoloff have emphasized the role of the U.S. patent system in fostering innovation.[9] More recently, Brian Balogh has written a synthetic study arguing that the federal government did not govern less during the nineteenth century, it just governed less directly, "less visibly."[10]

We do not aim in this paper to contest any of the factual claims these scholars have made about the federal government's contribution to economic development. Nor do we intend to make a quantitative case for the greater magnitude of the states' development efforts. Rather our concern is with more fundamental matters of political economy. Contrary to Gellner, we contend that the United States was not born modern at the time of the American Revolution or even the

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[7] Paul F. Paskoff, *Troubled Waters: Steamboat Disasters, River Improvements, and American Public Policy, 1821-1860* (Baton Rouge: Louisiana State University Press, 2007).
[8] Richard R. John, *Spreading the News: The American Postal System from Franklin to Morse* (Cambridge, Mass.: Harvard University Press, 1995).
[9] Kenneth L. Sokoloff and B. Zorina Khan, "The Democratization of Invention During Early Industrialization: Evidence from the United States, 1790-1846," *Journal of Economic History* 50 (June 1990): 363-78; and Khan, *The Democratization of Invention: Patents and Copyrights in American Economic Development, 1790-1820* (New York: Cambridge University Press, 2005).
[10] Brian Balogh, *A Government out of Sight: The Mystery of National Authority in Nineteenth Century America* (New York: Cambridge University Press, 2009).

Constitution. Rather, the institutional prerequisites for political and economic modernization took form gradually 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. The key political innovations emerged first in a small handful of states in a highly contingent way. They were not deliberate attempts to create institutions that would promote economic development, but rather the unintended result of efforts to solve difficult contemporary problems with implementing democracy. Nonetheless, as subsequent events highlighted the benefits of the new institutional configuration for economic development, they not only persisted but began to spread rapidly, though never completely, across the various United States. The federal government played *no* role in this process until the Civil War, and even then it played only a bit part.

When we say the federal government played no role, we are not imagining a counterfactual world in which the states were independent countries. It is important to be clear on this point. 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. It also mattered that people and goods could move freely across state boundaries. As we work through our argument, we will point out the ways in which being part of a larger whole mattered, but it is worth emphasizing here the relative unimportance of what scholars call "competitive federalism."[11] The key transformations we describe were remarkably local in the sense that they were the outcome of internal state-level political conflicts, even when

[11] 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 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.

they were triggered by national-level events. States often copied each other's innovations, but in most cases it was more because their political leaders faced similar problems than because they were in direct competition with each other for capital or trade.

The starting point for our argument about political economy is to take seriously the connection that eighteenth-century republican thinkers made between economic privilege and political tyranny. As many scholars have argued, this republican understanding shaped the increasingly hysterical American response to British policies in the wake of the Seven Years War, and it continued to structure American political discourse through at least the first half of the nineteenth century.[12] The first part of this paper deploys the theoretical framework developed by Douglass North, John Wallis, and Barry Weingast (hereafter NWW) for their book *Violence and Social Orders* to show that the corruption colonial Americans were reacting against was a special case of a more general phenomenon that has characterized most societies in most places throughout human history.[13] One of the most common techniques that ruling elites everywhere have used to keep themselves in power has been to limit access to the returns that can be garnered by forming economically valuable organizations. The returns from economic privileges are then used to coordinate a political coalition. The monopoly privileges the elites grant to their political

[12] Bernard Bailyn, *The Ideological Origins of the American Revolution* (Cambridge, Mass.: Harvard Univeristy Press, 1967); Bailyn, *The Origins of American Politics* (New York: Knopf, 1968); Gordon S. Wood, *The Creation of the American Republic, 1776-1787* (Chapel Hill: University of North Carolina Press, 1969); 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). For the continuation of republican ideas into the 1790s and early 1800 see Lance **Error! Main Document Only.**Banning, *The Jeffersonian Persuasion.* (Ithaca: Cornell University Press, 1978) and *Sacred Fire of Liberty: James Madison and the Founding of the American Republic.* Ithaca: Cornell University Press, 1995; Drew R. McCoy, *Elusive Republic: Political Economy in Jeffersonian America*. Chapel Hill: University of North Carolina Press, 1980

[13] 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).

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 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. NWW argue that the rent-creating organizational arrangements that support ruling coalitions are equilibriums in the sense that, whenever such arrangements are destroyed, similar ones generally emerge to take their place. In the nineteenth century, however, first in the United States and then in a very small number of other countries, something very different occurred, and instead of restricting the formation of economically valuable organizations to the rich and powerful, ruling elites opened up access and allowed virtually anyone who wanted to form them, regardless of political affiliation, personal connections, or any similar traditional marker of alignment. NWW make the case that this opening up of access is the foundation of modern economic growth.[14]

The United States was in the vanguard of this transformation, but it was the states and not the national government that both conceived of how to open access and accomplished it. 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 this more fundamental shift away from a limited access social order. We

[14] This notion of open-access should be thought of as a Weberian ideal type. Access was never truly universal, and certainly, in the early nineteenth century, the ability to form organizations depended on one's sex, race, ethnicity, and class. See, for examples, 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).

do not focus in this paper on the expansion of the franchise. Although political competition is an important part of our story, the achievement of open access was by no means an inevitable result of widening the suffrage, as a quick glance around the world should be sufficient to underscore.[15] Rather, as we show, the achievement was highly dependent on state-specific circumstances that affected how elites responded to the new political pressures that came with an expanded franchise. Wherever access opened up, however, it had the effect of reinforcing democratic political processes and was reinforced by them in turn. 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 across the country.

A Conceptual Framework

In 1790 the United States was what today we would call a developing country. No one, in the United States or elsewhere, could have had any idea what a developed modern society looked like because none yet existed, but people had strong ideas about how to make their existing society work better. The republican thinkers who worried that the British government had been corrupted in the eighteenth-century had a historically specific and contingent set of fears, but concern that a political faction within the elite would manipulate economic privileges to get control of the polity is a much more general problem. NWW have built a general framework for thinking about societies where the kind of corruption that republications feared was a persistent feature. Rather

[15] For an excellent treatment of the expansion of the franchise that provides a model for how to synthesize state-level developments with a national narrative, see Alexander Keyssar, *The Right to Vote: The Contested History of Democracy in the United States* (New York: Basic Books, 2000.)

than viewing these fears as paranoid, the framework explains why they not only were reasonable, but represented a clear understanding of how politics and economics usually interact.

When republican publicists railed about corruption, they were not targeting what we commonly mean by the term corruption today—that is, the use of public office for private gain. For clarity, we call this modern sense of the word "venal" corruption. The corruption the republicans feared was "systematic" corruption, which occurred when a political faction gained control of the government and used it to confer economic privileges on select groups with the aim of perpetuating its dominance.[16] Systematic corruption was a product of the pursuit of power. The 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.

In eighteenth-century Britain, a group variously called the Old Whigs, True Whigs, Radical Whigs, Commonwealthmen, or the Country Party formed in opposition Whig leader Robert Whalpole's dominance of British politics. 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 Walpole had undermined this balance through the systematic use of economic privileges.[17] 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. Walpole was not venally corrupt, he was systematically corrupt.[18]

[16] Wallis, "Concept of Systematic Corruption."
[17] Bailyn, *Ideological Origins*; and Bailyn, *Origin of American Politics*.
[18] For a summary, see J. G. A. Pocock, *Virtue, Commerce, and History: Essays on Political*

NWW recast this republican view of the world in more general terms that enable them to escape its limitations. Starting from a Hobbesian conception of the world, they point out that the problem societies face is not anarchic atomistic violence, but organized violence by powerful groups of individuals who use coercion against one another. NWW ask what kind of social arrangements can limit violence and establish a modicum of social 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?

The answer that NWW provide essentially turns republican theory on its head by showing how the economic returns (what economists call rents) that the leaders exploit to keep themselves in power can themselves be a potent incentive to maintain the peace. Take the simple and unrealistic 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. Therefore, the leaders can reach a credible agreement in which they respect each other's rights to their territories because each can see that there is a range of circumstances in which the costs to the other leader of fighting exceed the benefits. Such a realization does not mean that leaders never fight. The range of circumstances where the incentives for peace hold may 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

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Thought and History, Chiefly in the Eighteenth Century (Cambridge, Eng.: Cambridge University Press, 1985).

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 (for example, that could challenge the leaders' territorial monopolies). To do otherwise, would be to allow the rents that make their agreement credible to dissipate.

In the terms of republican theory, this arrangement is systematic corruption. It is politics corrupting economics to keep a particular set and configuration of elites in power. Because all societies that appeared over the last 5,000 to 10,000 years seem to have had this internal structure (and most still do), NWW call them the "natural states" or, alternatively, because natural states restrict the ability to form organizations to elites in their governing coalitions, they also refer to them as "limited access" social orders. Republican theory accurately described life in a natural state. Powerful organizations and individuals created an interlocking set of privileged economic arrangements. Those arrangements limited violence and sustained political order, but they were inherently fragile. Any shock to the system that upset the balance of interests could potentially lead to a breakdown of intra-elite arrangements and civil war.[19]

British republicans, like Madison, 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. Republicans saw the social arrangements around them as natural, and what they feared were breakdowns in intra-elite arrangements. To this end, Madison and the other framers focused, in the first place, on erecting checks and balances that would reinforce the existing peace by making it more difficult for one set of elites, one faction, to take control of the government. They also sought, in the

[19] For a series of case studies describing natural-state institutions in 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).

second place, to forestall the creation of the kinds of valuable rent-generating organizations that could be exploited for the purposes of consolidating power. The goal of republican political theory, in effect, was to create the best and most stable natural state possible. It was not to create an open and thriving modern democratic and capitalist society. Neither Madison nor any of the other framers imagined that it would be possible both to have one's cake and eat it too by enabling anyone who wanted to form an economically valuable organization to do so, and the national government they designed made such an achievement difficult.[20]

NWW suggest, by contrast, that opening access to organizations provides the key to achieving both political stability and economic development. Under the right conditions, elites can find it in their interests to begin to order their relationships through rules that treat individuals impersonally—that is, treat everyone (or everyone in some class of people) the same. An impersonal rule that allows anyone to form an organization will weaken the economic benefits of doing so and thus weaken the dynamics that, in the natural state, hold elite relationships and violence in check through economic privileges. In an open access society, therefore, the stakes of controlling the government are greatly reduced. Open access is not the same thing as democracy. By itself, democracy cannot contain elite competition. But economic competition can help to secure political competition and vice versa. When the faction running the government can change hands 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.[21]

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[20] As we discuss below in the context of banks, not even a supporter of the corporate form like Alexander Hamilton believed that everyone should be able to form a corporation.

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

Contrary to Gellner, we follow NWW in arguing that the United States was not an open access order at its birth. We agree with Wilentz that the new forms of electoral and representative republican government that Americans implemented in their state constitutions, as well as in the national constitution, did not work right out of the box. The new institutions did not banish systematic corruption, and indeed, as we will show, their increasingly democratic structure may initially even have exacerbated it by creating new ways in which groups could compete to gain control of rents. The intensity with which partisan politics played out in the early years of the nineteenth century is consistent with these fears.

NWW provide a conceptual framework for understanding how economics and politics interacted that is missing from Wilentz and also from Howe. What Americans learned was that pursuing state-aided economic growth in democratic republics was bound to fail politically and economically if their political and economic institutions continued to be structured as theirs were circa 1800. As the states began met the challenges of "Overthrowing the Tyranny of Distance"—of economic development—by creating banks and building transportation systems, their political systems almost immediately began to display alarming evidence of systematic corruption. The ultimate solution to which they fumbled their way was not to make the system more democratic, although as we all know it became steadily more democratic over the period

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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. In 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. The NWW model is particularly appropriate for the United States, where intra-elite conflict at the state level propelled institutional change, and a relatively weak central government played primarily a background role.

1800 to 1840. What mattered were the changes they implemented in the way the political and economic systems interacted—changes that moved the country toward an open-access social order. Precursors of these changes had appeared as early as the 1780s, but it was not until the 1840s that states on a wide scale began adopting the new institutional arrangements.

States were the locus of these pivotal interactions. All of the changes that implemented open access in the decades before the Civil War occurred at the state level. The federal government was assuredly important, and its commitment to the open internal movement of people, goods, and ideas was an integral part of the process, but the key actors were the states, and it is on the states that we should focus our attention.

The Slow, Difficult 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 factions were in control of the national government, and also of the individual states, awarded banking privileges to their supporters and denied 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 and use them 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. Thus the Bank of the United States was a Federalist institution. When its charter expired in 1811, the Democratic-Republicans were in power, and they let the bank die. The Second Bank of the United States was dominated by leaders of what would become the Whig

Party. When Congress passed the bill to recharter the bank in 1832, President Andrew Jackson, a Democrat, vetoed it. His message stands to this very day as a classic (if somewhat disingenuous) denunciation of the systematic corruption of the 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…."[22] Following Jackson's destruction of the Second Bank, the national government abstained from chartering any more banks until the South left the Union during the Civil War. The United States did not have anything resembling a central bank again until the creation of the Federal Reserve System in the twentieth century.[23]

At the state level, however, whenever a new faction assumed power it more often than not took control of the banking system from the losing faction. As a result, most states were able to sustain at least the basics of a financial infrastructure during this period. More importantly, in a few key states the high stakes of electoral success, in combination with the increasing

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[22] 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. We say this rhetoric is disingenuous because Martin Van Buren, Jackson's vice presidential candidate and the mastermind of his campaign against the Second Bank of the United States, used control over bank charters in the state of New York to build a powerful political machine. See below.

[23] 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 modifications to the system enacted during the Great Depression.

competiveness of elections, pushed legislators to innovate institutionally and find a way to take the control of banks off the political table. That this shift to open access in banking would be, from the standpoint of economic development, the most effective solution to the problem of corruption seems obvious to us with the perspective of hindsight. But it was not to people at the time. To the contrary, those who benefited from limited access to banking were able to point with great persuasiveness to recent financial panics to argue that increasing the number of banks would lead inevitably to economic distress. Although the growing political competition that resulted from an expanded franchise played an important role in overcoming this objection, there was nothing inevitable about the outcome, and in some states politicians continued to exploit natural state practices or alternatively to imitate the national government and foreswear giving out bank charters entirely. Nonetheless, as the benefits of open access for economic development became increasingly apparent, the movement for "free banking" spread until finally even the national government followed suit and, spurred on by the need to finance the war effort, imposed it throughout the Union during Civil War.

Banking played an important role in coalition building in the early republican period because it was a valuable privilege. 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 the power that came from the ability who else would gain access. Most of banks' lendable funds at this time consisted of the capital their corporate status enabled them to raise. However, the privilege of issuing currency that the charters also conferred enabled banks to secure additional funds at almost zero cost which they could then lend to insiders and other favorites.[24]

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 worried, 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."[25]

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 largely be paid for with the U.S.

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[24] See Naomi R. Lamoreaux, *Insider Lending: Banks, Personal Connections, and Economic Development in Industrial New England* (New York: Cambridge University Press, 1994), Ch. 1; Brian Phillips Murphy, *Building the Empire State: Political Economy in the Early Republic* (Philadelphia: University of Pennsylvania Press, 2015), Ch. 1.

[25] Alexander Hamilton, "Public Credit," in John C. Hamilton, ed., *The Works of Alexander Hamilton Comprising his Correspondence and his Political and Official Writings ...* (New York: John F. Trow, 1850), Vol. 3, 1-46 (quotation from 14-15). 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. [Additional citations.]

government bonds.[26] To the extent that the bank was an attractive investment, therefore, demand for its shares would support the price of the government's debt. In order to make sure investors thought the Bank would be a good investment, Hamilton promised that it would have a monopoly: "No similar institution shall be established by any future act of the United States, during the continuance of the one hereby proposed to be established."[27] 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."[28] Although Congress could potentially override the limit, the interests of the national government and the bank would be aligned. The government would have an interest 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).[29] Finally, again following the model of the Bank of England, Hamilton built in incentives for controlling shareholders to keep the interests of the government in the front of their minds by limiting the duration of the bank's charter: "As the institution, if rightly constituted, must depend for its renovation, from time to time, on the pleasure of the government,

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[26] 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, "National Bank, in *Works of Alexander Hamilton*, Vol. 3, 106-46. See especially p. 137.

[27] Hamilton, "National Bank," 140. Hamilton had to work hard in his report to explain why Congress was justified in chartering the Bank of the United States when it had previously chartered the Bank of North America. He devoted about a fifth of his report to explaining how the restrictive Pennsylvania charter under which the Bank of North America was operating had compromised its ability to function as a national bank.

[28] Hamilton, "National Bank," 138.

[29] The government would not contribute real capital because it would immediately borrow back the amount of its investment. Hamilton, "National Bank," 141

it will not be likely to feel a disposition to render itself, by its conduct, unworthy of public patronage."[30] This provision probably helped garner support from the Jeffersonian opposition, which was horrified at the idea of recreating such a monopolistic institution but recognized the need to get the finances of the new government in order. When the charter expired in 1811, however, the Jeffersonians were in power, and they narrowly defeated an attempt to renew it.

Part of the reason they could let the charter lapse was that the Bank of the United States, unlike the Bank of England, never had a real monopoly on incorporated banking. The difference was a consequence of American federalism. Those in control of state governments were also engaged in coalition building and were chartering banks of their own for this purpose. Indeed, Hamilton himself had been involved in this kind of project in New York and had helped organize the Bank of New York in 1784. The bank was forced to operate without a corporate charter until 1791, however, because it faced stiff opposition from upstate elites whose own proposal for a bank had previously been quashed by Hamilton and his allies. The Bank of New York's tight interlinkages with Federalist political leaders enabled it to maintain its monopoly position for nearly a decade and a half, blocking all efforts to charter competing banks until Democratic-Republican Aaron Burr cleverly exploited a loophole in a charter for a water works in 1799 to start the Manhattan Bank. The Republicans (as the Democratic Republicans became known) gained control of the legislature in 1803 and founded a bank of their own in Albany. They refused, however, to grant a charter to a new Federalist bank in New York called the Merchants' Banks, and when the bank went into operation anyway without a charter, passed a restraining act that prohibited any association from operating a bank without a charter and giving

[30] Hamilton went on to lay out the reciprocal nature of the arrangement quite bluntly: "The Government, too, in the administration of its finances, has it in its power to reciprocate benefits to the bank, of not less importance than those which the bank affords to the Government." Hamilton, "National Bank," 135-36.

the Merchants' Bank a year to wind up its affairs. Although the bank was subsequently chartered by a narrow margin, the restraining act remained in place. Henceforth the legislature would strictly control entry into the banking sector.[31]

The situation was much the same in other states, which also passed restraining acts that prevented banks from operating without charters.[32] In Pennsylvania, the Bank of North America (which had originally been chartered by the Continental Congress but operated exclusively under a Pennsylvania charter after the ratification of the Constitution) fought to retain its monopoly. However, it was too small, and its operations necessarily too restricted, even to meet the needs of prominent Federalists in the state. Coalition-building required the legislature to cut others in, and over the next couple of decades the legislature chartered three additional banks in Philadelphia. These charters all went to prominent Federalists, and the four banks' leaders were able to join together to block additional charters until the Federalists lost political control in 1814.[33] In Boston, the Massachusetts Bank, chartered in 1784, had to share its initial monopoly with the Union Bank, chartered in 1792, but the two banks managed to hold off any further competition in the city until 1811. Although the legislature chartered a few other banks (also for Federalists) in

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[31] John Jay Knox, *A History of Banking in the United States* (New York: Bradford Rhodes & Co., 1908), 393-97; Bray Hammond, *Banks and Politics in America: From the Revolution to the Civil War* (Princeton, N.J.: Princeton University Press,1957), 149-61; Howard Bodenhorn, *State Banking in Early America: A New Economic History* (New York: Oxford University Press, 2003), 128-29; Eric Hilt, "Early American Corporations and the State," unpublished working paper (2014); Murphy, *Building the Empire State*, Chs. 1 and 3.

[32] For state by state accounts, see Knox, *History of Banking*. See also Bodenhorn, *State Banking in Early America*.

[33] Anna J. Schwartz, "The Beginning of Competitive Banking in Philadelphia, 1782-1809, in *Money in Historical Perspectiv*e, ed. Schwartz (Chicago: University of Chicago Press, 1987), 3-23; John Majewski, "Toward a Social History of the Corporation: Shareholding in Pennsylvania, 1800-1840," in *The Economy of Early America: Historical Perspectives & New Directions*, ed. Cathy Matson (University Park, Penn.: Pennsylvania State University Press, 2006), 294-316, esp. 297-99; Andrew M. Schocket, *Founding Corporate Power in Early National Philadelphia* (DeKalb, Ill. Northern Illinois University Press, 2007), Ch. 3.

other cities, such as Salem, these banks also were local monopolies or duopolies.[34]

As opposition to the Federalists grew over time, control of banking became an important political issue, and when a rival political faction came to power the first thing it did was charter new banks for its supporters. In Massachusetts, for example, when the Republicans took control of the state government from the Federalists 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 a massive new State Bank in Boston with a capital of $3,000,000, three times that of the largest bank previously chartered in the commonwealth. The State Bank was supposed to be a public institution. At least one third of the capital was supplied by the state, which would earn dividends from its operation, and the bank would pay an annual tax of 0.5 percent of its paid-in capital. But the fact that eleven of the State Bank's twelve directors were Republicans suggested that the bank would also operate in the interest of that party.[35]

The Republican dominated legislature went further and threatened to inflict real harm on the Federalists by blocking renewal of the charters of existing Federalist banks, most of which were set to expire in 1812. As in the case of Hamilton's plan for the Bank of the United States, finite terms for charters were a device that helped keep those who received them in line because bank insiders knew that renewal would depend on political loyalty and on the services their institution provided to the coalition. Such arrangements had worked well for the government in Britain, where the Bank of England, the East India Company, and other "monied" corporations had been required to grant the government loans and sometimes outright gifts to secure renewals of

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[34] Oscar Handlin and Mary Flug Handlin, *Commonwealth: A Study of the Role of Government in the American Economy* (Rev. edn.; Cambridge: Harvard University Press, 1969), 100-1, 112-16; Qian Lu and John Wallis, "Banks, Politics, and Political Parties: From Partisan Banking to Open Access in Early Massachusetts," NBER Working Paper w21572, September 2015.

[35] Lu and Wallis, "Banks, Politics, and Political Parties."

their charters.[36] But in a competitive political environment, like that of the early United States, they could easily backfire. The Republicans were in power when the charter of the Bank of the United States came up for renewal, for example, and had simply let the charter lapse. In Massachusetts the Republicans sought to destroy Federalist banks and replace them with banks of their own. To make matters worse, they took advantage of their control to take a variety of novel 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).[37]

Now it was Federalists' turn to denounce the Republicans' monopoly of banking. The Democratic-Republicans were not, as a matter of fact, able to maintain control, and in the next election the Federalists retook the lower house and the governor's mansion, though the Republicans' strategic redistricting enabled them to retain a majority in the Senate. The result of the shift back toward the Federalists was something of a compromise. The Federalists got their banks rechartered on condition that all would be subject to the same tax as the State Bank.[38] This tax on bank capital turned out to be a tremendous boon to the commonwealth's finances, so much so that opposition to expanding the number of banks largely evaporated. In any event, the two parties seem to have agreed at least implicitly to take banking off the political table. Although

[36] J. Lawrence Boz 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; Dan Bogart, "The East Indian Monopoly and the Transition from Limited Access in England, 1600-1813," NBER Working Paper 21536 (2015).

[37] Lu and Wallis, "Banks, Politics, and Political Parties." Gerry does not seem to have been the initiator of the redistricting effort, even though it bears his name. See Elmer Cummings Griffith, *The Rise and Development of the Gerrymander* (Chicago: Scott, Foresman and Co., 1907), 19-20.

[38] 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).

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 charters increased, the legislature responded by granting most of them, and the state's tax revenues soared. 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.[39]

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.[40]

In Massachusetts the formal shift to open access was almost a bureaucratic afterthought. As the number of charters increased, so did burden on the legislature, which moved to streamline the chartering process—first in 1829 by enacting a law establishing a template that would apply to all banks chartered subsequently, and then finally in 1851 by passing a general incorporation law

[39] Lu and Wallis, "Banks, Politics, and Political Parties"; Richard Sylla, John B. Legler, and John J. Wallis, "Banks and State Public Finance in the New Republic: The United States, 1790-1860," *Journal of Economic History* 47 (June 1987): 391-403; John Joseph 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, 121-44 (Chicago: University of Chicago Press, 1994).

[40] Massachusetts, Secretary of the Commonwealth, *Abstract of the Returns from the Banks* (1860), 75-76.

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.[41] 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), and the resulting abundance of credit and low cost of capital helped make Massachusetts the nation's industrial leader.[42]

In other states the road to open access was much rockier. In New York, for example, there was a similar shift in power from the Federalists to 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 the Democratic-Republicans used its power over bank charters and other sources of patronage to build a powerful (soon to be called Democratic) political machine, the Albany Regency, that dominated New York politics until the late 1830s.[43]

From time to time chinks appeared in the Regency's dominance. For example, in 1824 and 1825 the machine lost control of the legislature to a competing faction known as the "People's

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[41] 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.

[42] See Lamoreaux, *Insider Lending*, Ch. 3.

[43] See Howard Bodenhorn, "Bank Chartering and Political Corruption in Antebellum New York: Free Banking as Reform," in *Corruption and Reform: Lessons from America's Economic History*, ed. Edward L. Glaeser and Claudia Goldin, 231-57 (Chicago: University of Chicago Press, 2006); Eric Hilt, "Early American Corporations and the State," unpublished working paper (2014); 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).

Party," which proceeded to charter several new banks and a number of loan companies. The latter financed their operation through the issue of post notes, payable at a fixed future date rather than, like banknotes, being 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 the Albany Regency regained power, the legislature 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. The new charters that the Regency awarded to their supporters thus came with a "Good Housekeeping Seal of Approval."[44]

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 ultimately 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, insured 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.[45] 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 categories of government bonds. The result was a dramatic expansion in the number of banks and a decline in the number of bank

[44] 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.

[45] 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.

failures.[46]

Pennsylvania was even slower than New York to move to free banking. As the political balance in the legislature shifted in the wake of the War of 1812, anger about corporate privileges, coupled with the dire need for banking facilities beyond the four early Philadelphia banks, spurred the passage in 1814 of an omnibus banking bill that chartered about two score new banks. Then the political balance shifted back again, and the movement for additional charters stalled, in part because the expansion of banks was widely regarded to have exacerbated the Panic of 1819. The relatively few banks that the legislature incorporated over the next several decades had to pay hefty bonuses in exchange for their charters, leading to charges of a corrupt bargain between banks and the legislature and raising the specter of more nefarious exchanges of money behind the scenes. Even the panic of 1837 did not lead to significant change, though it erupted almost simultaneously with the opening of the state's constitutional convention. Some delegates to the convention attempted to nudge the state toward a system of general laws on anti-monopoly grounds, but they gained few adherents. Most delegates seem to have shared the view that allowing anyone who wanted to organize a bank would further undermine the soundness of the financial system. Pennsylvania would not pass a free banking statute until 1860, and in the meantime control of banking remained a powerful patronage tool to the detriment of the economy. As late as 1860 the amount of bank capital per person in Pennsylvania was only 30 percent of the amount in New York and only 16 percent of that in Massachusetts.[47]

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[46] Earlier version of the act did not have this provision. Michigan adopted one of them in 1837 with disastrous results. See Hilt, "Early American Corporations and the State."

[47] Majewski, "Toward a Social History of the Corporation"; Schocket, *Founding Corporate Power*, Ch. 3; Louis Hartz, *Economic Policy and Democratic Thought: Pennsylvania, 1776-1860* (Cambridge, Mass.: Harvard University Press, 1948); Naomi R. Lamoreaux, "Revisiting American Exceptionalism: Democracy and the Regulation of Corporate Governance in Nineteenth-Century Pennsylvania," in *Enterprising America: Businesses, Banks, and Credit*

It should be emphasized that the slow development of free banking in New York and Pennsylvania was not the result of any lack of experience with general incorporation laws. Both states' legislatures had passed such laws for churches, charities, schools, and other similar kinds of associations almost immediately after the Revolution. New York, for example, sought to reduce the "great difficulties" imposed on public worship by "the illiberal and partial distribution of charters of incorporation" by passing legislation in 1784 that enabled all religious denominations in the state to appoint trustees and constitute themselves "a body corporate."[48] It followed this act with a general incorporation law for colleges in 1787 and for medical societies in 1806.[49] Pennsylvania passed a statute in 1791 enabling groups formed for "any literary, charitable, or for any religious purpose" to incorporate by a simple registration process, aiming thereby to reduce "the great portion of the time of the legislature [that] has heretofore been employed in enacting laws to incorporate private associations."[50] Laws that expanded the statute's coverage to other types of organizations (for example, beneficial societies and voluntary fire companies) soon followed.[51] New York even enacted the first general incorporation law for manufacturing in 1811 as part of its larger effort to encourage domestic production during the embargo on trade with Britain and France, and the law seems to have been quite successful in encouraging the formation

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Markets in Historical Perspective, ed. William J. Collins and Robert A. Margo (Chicago: University of Chicago Press, 2015), forthcoming; Bodenhorn, "Bank Chartering and Political Corruption in Antebellum New York," 239.

[48] "AN ACT to enable all the religious denominations in this State to appoint trustees who shall be a body corporate …" 6 April 1784. Unless otherwise noted, all citations to acts are from the Session Laws of the respective state, available at www.heinonline.org.

[49] "AN ACT to institute an university …" 13 April 1787; and "AN ACT to incorporate medical societies …" 4 April 1806. See also Seavoy, *Origins of the American Business Corporation*, Ch. 1.

[50] Commonwealth of Pennsylvania, *Laws, Statutes, etc., 1700-1800* (Philadelphia: Bioren, 1810), Vol. 3, p. 20.

[51] For an overview of these developments, see Ruth H. Bloch and Naomi R. Lamoreaux, "Voluntary Associations, Corporate Rights, and the State: Legal Constraints on the Development of American Civil Society, 1750-1900," unpublished working paper (2015).

of small corporations in this sector.[52]

Rather than lack of experience, the problem behind the slow development of free banking was twofold: The coalition of political elites that dominated state politics did not want to risk the political power they derived from their control over bank chartering and their members did not want to forego the lucrative profits of limited access banking; and there was real fear (encouraged by incumbent bankers) that opening up the banking system to competition would produce financial disaster.[53] In the end, New York's highly successful experience with free banking pointed the way to change elsewhere, but it was not universally imitated in the years before the Civil War. Although the political earthquake that followed the Panic of 1837 encouraged a number of states to follow New York's lead, in others politicians took their cue from Jeffersonians and Jacksonians at the national level and simply shut down their banking systems. Texas, Iowa, and California, prohibited banking entirely, and Oregon would do the same after the Panic of 1857. Illinois and Wisconsin passed constitutional provisions requiring applications for bank charters to be approved by popular referenda.[54] All of these states, it should be noted, had universal (white) manhood suffrage. Open access did not follow inevitably from the expansion of the franchise.

Only the passage during the Civil War of the National Banking Acts spread general incorporation in banking throughout the nation. The driving force behind this legislation, of course, was the government's dire need for funds to finance the war effort. Following New York's example, the acts required banks taking out national charters to back their currency issues with

[52] "AN ACT relative to Incorporations for Manufacturing Purposes," March 22, 1811. See Eric Hilt, "When Did Ownership Separate from Control? Corporate Governance in the Early Nineteenth Century," *Journal of Economic History* 68 (Sept. 2008): 645-85.

[53] Limits on access in banking were critical to the building and sustaining of political coalitions in these states. While the coalitions used the rents from limited access banking to coordinate their supporters, the end goal of limiting access was not to maximize the profits the bankers made, but to create and sustain a political coalition. This was systematic corruption, not venal corruption.

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

bonds, in this case $100 in U.S. government bonds for every $90 in currency. The resulting captive market enabled the government was able to borrow at a lower rate than was otherwise possible because banks could earn interest on the bonds and also profit from lending out the currency. Many banks did not think the arrangement profitable enough, however, and when they balked at giving up their state charters, Congress imposed new taxes that forced them to make the shift.[55]

It is important to understand what the spread of free banking did and did not accomplish in the first half of the nineteenth century. It did not solve the problem of instability in the banking system. To the contrary, it was only when entry into banking was reasonably open that policy makers could begin to grapple with the structural characteristics that periodically produce 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 change was 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.

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[55] Lamoreaux, *Insider Lending*, 90.

Breaking politicians' control over bank charters helped to break it in other areas as well. As we will show, general incorporation laws for manufacturing enterprises spread throughout the country during the 1840s and 1850s.[56] These changes, however, were also part of a more general revolution in state government sparked by financial debacles in the realm of transportation. We turn to that story now.

The Attack on Monopolies in Transportation

The high cost of transportation in the new United States was a major impediment to settlement and to economic development more generally. On the one hand, there was a tremendous demand for roads, bridges, and other kinds of transportation improvements in the early years of the Republic; on the other, there was not much willingness on the part of the population to pay the taxes needed to build them. The most common solution that the states adopted was to charter corporations as a way of channeling private investment into transportation projects.[57] Wherever there was money to be made from these investments (for example, from steamboats and bridges in high-traffic areas), political elites deployed monopoly privileges in essentially the same way as they did in banking. Conflicts over these privileges led to important Supreme Court cases, most notably *Gibbons v. Ogden* (1819) and *Charles River Bridge v. Warren Bridge* (1837), that have often been interpreted as paying the way for a more competitive economy.[58] Like the

[56] See Eric Hilt, "General Incorporation and the Shift toward Open Access in the Nineteenth-Century United States," unpublished working paper (2014).
[57] See especially Handlin and Handlin, *Commonwealth*; Hartz, *Economic Policy and Democratic Thought*; John Majewski, *A House Dividing: Economic Development in Pennsylvania and Virginia before the Civil War* (New York: Cambridge University Press, 2000); and Guy S. Callender, "The Early Transportation and Banking Enterprises of the States in Relation to the Growth of Corporations," *Quarterly Journal of Economics* 17 (Nov. 1902): 111-62.
[58] *Dartmouth College v. Woodward*, 17 U.S. 518 (1819); and *Charles River Bridge v. Warren*

refusals to recharter the First and Second Banks of the United States, however, these decisions were little more than swipes at vested interests that contributed little to reimagining how a competitive economy could be underpinned institutionally. They did not create new federal supports for open access, and they left in place the state-level institutions that allowed political elites to manipulate the economy for their own purposes.

At the time of the American Revolution the only inexpensive way to transport goods or people over long distances was to float them downstream on navigable rivers. The steamboat had the potential to lower dramatically the cost of transportation and made it possible to ship goods upstream almost as cheaply as downstream. As a number of inventors and entrepreneurs raced to develop a workable steamboat at the turn of the nineteenth century, their ability to obtain financial backing for their ventures depended more than anything else on securing monopoly privileges, which in turn depended on political connections. State after state granted various types of monopolies to one or another of the contenders, usually in combination with one or more members of the ruling political faction.[59]

Inventor Robert Fulton's success owed to the business partnership he formed in 1802 with Robert R. Livingston, Chancellor of New York and a member of a wealthy and politically influential family. George Clinton, a Republican, was then the governor of New York, and the extended Livingston family formed an important part of his political coalition. Livingston exploited his political connections to secure the passage of legislation giving the partnership a monopoly of steamboat transportation in New York, and, once the venture was successful, he worked assiduously to protect it from competition by suing interlopers in New York courts, at the

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Bridge, 36 U.S. 420 (1837). [citations on the importance conventionally ascribed to these decisions.]

[59] The best account is Thomas H. Cox, *Gibbons v. Ogden, Law, and Society in the Early Republic* (Athens: Ohio University Press, 2009).

same time as he sought to extend the monopoly to other states. The company's downfall ironically owed to challengers with similar political connections in other states, most notably Aaron Ogden, a former governor of New Jersey. Ogden convinced the New Jersey legislature to pass a law that subjected New York steamboats to seizure in New Jersey waters unless New York rescinded the Livingston-Fulton monopoly. New York retaliated in kind, and the case headed toward the U.S. Supreme Court.[60]

The story is a convoluted one, but eventually the U.S. Supreme Court overturned the New York monopoly in the case of *Gibbons v. Ogden* in 1824.[61] Chief Justice John Marshall's opinion for the unanimous court rested in part on an interpretation of the federal Coasting Act of 1793, which set up a licensing process for ships engaged in commerce among the different states. Though the Act had instituted a simple registration system, the decision was not grounded in the principles of open access but rather in Congressional prerogatives under the Constitution's commerce clause. As a result, that great foe of monopoly, Thomas Jefferson, responded critically to the decision, grousing that "the federal branch of our government is advancing towards the usurpation of all the rights reserved to the States."[62] The decision, moreover, did not preclude states from granting monopoly rights to steamboats within their bounds, so there was still the possibility that the Fulton-Livingston monopoly would continue to dominate commerce on the Hudson River. But again circumstance, rather than principle, dictated the outcome. The political winds had shifted within the state of New York. Another Clinton (DeWitt) was now

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[60] See Cox, *Gibbons v. Ogden*. See also Murphy, *Building the Empire State*, Ch. 4

[61] *Gibbons v. Ogden*, 22 U.S. 1 (1824).

[62] Quoted in Cox, *Gibbons v. Ogden*.

governor, and he had fallen out with the Livingstons, who were now themselves internally divided. The monopoly did not survive its promoters' loss of political clout.[63]

The other type of early transportation project that offered significant potential for monopoly profits was bridges. The most famous example was the Charles River Bridge in Massachusetts.[64] The company was originally chartered in 1785 to build a badly needed bridge between Cambridge and Boston, and it had been granted the privilege of collecting tolls for a period of forty years. Once the bridge was built and proved profitable, the company's wealthy, politically well-connected shareholders formed a powerful lobbying group to perpetuate the company's privileges. Hence when the legislature sought to charter another bridge over a different part of the river, the company used the occasion to extend its right to collect tolls for an additional thirty years. Local residents chafed under the burden of the tolls and, after several failed attempts to do something about them, finally managed to induce the legislature to charter a competing bridge in 1828. The shareholders of the original company sued to overturn the new charter, claiming that the effort to build a new bridge next to the existing one was effectively "an act of confiscation" that threatened "all sense of security for the rights of persons and property."[65] Supporters of the new bridge depicted this effort to block construction as an example of a "spirit of monopoly" that enabled "the few" to pursue their "narrow and selfish" policies at the expense of the "interests of the many, and the prosperity of the state." The real threat to progress, they

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[63] Cox, *Gibbons v. Ogden*, Ch. 10.

[64] On this case, see especially Stanley I. Kutler, *Privilege and Creative Destruction: The Charles River Bridge Case* (Philadelphia, Penn.: Lippincott, 1971).

[65] *Charles River Bridge v. Warren Bridge*, 36 U.S. 420 (1837). The quotation is from pp. 73-74 of the 1837 U.S. LEXIS 180 edition of the case.

claimed, was the "monstrous" idea that special interests could, with the connivance of government, use the rhetoric of property rights to protect themselves against competition.[66]

The case ended up in the U.S. Supreme Court, where in 1827, in the judicial equivalent of Jackson's message vetoing the Second Bank of the United States, Chief Justice Roger Taney, a Jacksonian Democrat, issued an opinion that allowed construction to proceed. Acknowledging the Supreme Court's earlier decision in *Dartmouth College v. Woodward* (1819) that a corporate charter was a contract that the state could not unilaterally abrogate,[67] Taney declared that the Court must construe corporate charters 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." Nor could the grant of a monopoly have been implied. The rights of the community to "safe, convenient, and cheap ways for the transportation of produce ... shall not be construed to have been surrendered or diminished by the state; unless it shall appear by plain words, that it was intended to be done."[68] Like Jackson's veto message, the decision struck at a particular monopoly without grappling with the legislative discretion over corporate charters that had generated the problem in the first place. If the Massachusetts legislature had explicitly written monopoly privileges into the bridge's charter, the Supreme Court would have upheld the grant.

Although *Gibbons v. Ogden* and the Charles River Bridge case are sometimes taken as evidence that the national government was moving the country toward open competition, they did not alter the basic principle that states were free to limit access whenever it served their purposes.

[66] These quotations were from a pamphlet generated by a sister dispute in Boston. See A Citizen (David Henshaw), *An Appeal to the Good Sense of the Legislature and the Community in Favor of a New Bridge to South Boston* (Boston: True and Greene, 1825).
[67] *Dartmouth College v. Woodward*, 17 U.S. 518 (1819).
[68] *Charles River Bridge v. Warren Bridge*, 36 U.S. 420 (1837) at 549-50.

New Jersey offers a clear example of states' ongoing powers to grant monopoly privileges. In the late 1820s, promoters of canals and railroads pushed their favorite proposals and, after a period of conflict, the state exercised the wisdom of Solomon and chartered two companies, the Delaware and Raritan Canal and the Camden and Amboy Railroad, along parallel routes. A few months later, in the fall of 1830, the Camden and Amboy approached the state and asked for a monopoly on rail transport between Camden and Amboy, which effectively meant between New York and Philadelphia. In exchange, the state would acquire 1,000 shares of Camden and Amboy stock. Rather than opposing the monopoly, the Delaware and Raritan Canal agreed to combine with the Camden and Amboy Railroad. The two companies remained legally separate, but were jointly operated and became known as the "Joint Companies."[69]

In 1832, the state granted the Joint Companies an extension of the monopoly in return for another 1,000 shares of stock and a commitment to pay transit duties on the movement of cars over the Camden and Amboy tracks. The agreement guaranteed the state's return. If dividends and transit duties to the state did not total $30,000 a year, the deficit was to be made up by the railroad before any other stockholders were paid dividends. In exchange, the state promised not to charter any railroad lines paralleling the Camden and Amboy route for the next forty years.[70] Taxpayers and voters saw no reason to object. The higher freight and passenger rates fell primarily on residents outside of New Jersey, and the combination of dividends and transit duties made it possible for the state to suspend the state property tax in the early 1840s.[71] New Jersey was sometimes known as the state of Camden and Amboy, and the state retained its share of the

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[69] John William Cadman, Jr., *The Corporation in New Jersey* (Cambridge, Mass.: Harvard University Press, 1949).

[70] [citations]

[71] Christopher Grandy, "New Jersey Corporate Chartermongering, 1875-1929," *The Journal of Economic History* 49 (Sept. 1989): 677-692

railroad and its lucrative fiscal benefits until the 1870s. At that point out-of-state interests in the form of the Pennsylvania Railroad acquired a controlling share of stock in the railroad, and New Jersey promptly revoked the monopoly. But the important point for our purposes is that, despite the famous early Supreme Court decisions, it was quite legal throughout this period for states to create monopolies in transportation, just as they manipulated access to bank charters.

The Revolution Wrought by Canals

The most common overland transportation projects undertaken during the early republican period were turnpikes. Unlike banks, steamboats, and bridges, most turnpike corporations were not, and never would be, profitable. For that reason, restricting access to them was of little benefit to ruling political coalitions. To the contrary, there were votes to be gained almost everywhere from opening up access to this kind of charter. Even if the companies were not profitable, turnpikes helped farmers get their goods to market, and everyone around them stood to benefit from the resulting increase in trade and land values. Because the gains from turnpikes came mainly in the form of rising land values, however, citizens who were not members of these corporations could benefit from the increase in the value of their property and essentially free ride on others' investments. Solving the free-rider problem, rather than overcoming limited access, was the critical barrier to the construction of a road network.[72]

Turnpike promoters were usually local merchants who stood to gain most immediately from an increase in trade. They had more capital to put into these projects than other members of the community, but they would only be willing to invest if they could charge enough by way of

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[72] Daniel B. Klein and John Majewski, "Economy, Community, and Law: The Turnpike Movement in New York, 1797-1845," *Law & Society Review* 26 (issue 3, 1992): 469-512.

tolls to earn a reasonable rate of return and prevent local farmers and other members of the community from free riding on their investments. Farmers, however, protested the imposition of tolls that, from their perspective, reduced or even eliminated their gains from the transportation improvements. There were also heated battles over whose land would be taken for the roads and how landowners would be "justly" compensated, for example whether they would be reimbursed for the value of the land before the transportation improvement or after the road had raised land values. To the extent that these objections were accommodated—that is, tolls were reduced and farmers compensated more highly for land that was taken for the roads—the return to investment would fall even lower, worsening the free-rider problem.[73] Under these circumstances, wealthy merchants were not willing to shoulder the burden of investment, but they were willing to exert leadership to rally the local citizenry behind their efforts to build roads. And leadership was what was needed, first, to secure charters from the legislature, and second, to elicit investments from all members of the community who would benefit from rising land values. To generate the necessary spirit of boosterism, they wrote newspaper editorials, distributed circulars, organized meetings, and exploited their networks of personal associations. Engaging in what John Majewski has called "public arm twisting," they worked to make all members of their communities feel that it was a civic duty to buy stock and shamed those who shirked their responsibilities.[74]

Legislatures responded to communities' demands for turnpike charters, granting nearly a thousand between 1800 and 1830 in the New England and Middle Atlantic states alone.[75] Although many of the turnpikes that obtained charters never got off the ground, many did, and the

[73] Klein and Majewski, "Economy, Community, and Law."
[74] Majewski, *A House Dividing*, 28-58. See also Majewski, Christopher Baer, and Daniel B. Klein, "Responding to Relative Decline: The Plank Road Boom of Antebellum New York," *Journal of Economic History*, 53 (March 1993), pp. 106-22; and Sally F. Griffith, "Rituals of Incorporation in Ante-bellum Civic Life," *Mid-America*, 82 (Winter/Summer 2000): 51-70.
[75] Klein and Majewski, "Economy, Community, and Law," 470.

sums raised for road building were truly extraordinary relative to the size of the economy at the time. Again looking just at the New England and Middle Atlantic states, the cumulative investment in turnpike construction over the period 1800 to 1830 amounted to about 6 percent of 1830 GDP. By way of comparison, the cumulative investment in the interstate highway system in the entire United States between 1956 and 1996 was about 4 percent of 1996 GNP.[76]

Despite the enormous amount of investment, turnpikes did not reduce transportation costs sufficiently to enable bulky commodities like grain to be transported long distances. Given the limits on tolls typically imbedded in their charters, moreover, they were rarely well maintained.[77] All told, improvements in road construction and other technological advances in wagon transport reduced the cost of hauling freight overland from an average of about 40 cents per ton mile in the 1780s to about 15 cents per ton mile in the 1820s. That was a substantial drop, but it was canals that would bring about the big reductions, slashing the cost of transporting freight to below 1 cent per ton mile by the 1840s.[78]

Canals were much more expensive to build than roads, however, and over long distances required investments in amounts that were generally beyond the reach of private corporations at the time.[79] Although federal officials recognized the value of these projects, they could not solve

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76 Daniel B. Klein and John Majewski, "Turnpikes and Toll Roads in Nineteenth-Century America," EH.Net Encyclopedia, http://eh.net/encyclopedia/turnpikes-and-toll-roads-in-nineteenth-century-america/, accessed 4 April 2015.

77 Klein and Majewski, "Economy, Community, and Law."

78 Railroads would not hit the 1-cent target on average until the 1880s, though there were other advantages to shipping by railroad as opposed to canal, most notably speed. See Douglass C. North, *Growth and Welfare in the American Past: A New Economic History* (Englewood Cliffs, N.J.: Prentice-Hall, 1966), 111.

79 See George Rogers Taylor, *The Transportation Revolution, 1815-1860* (New York: Rinehart, 1951); Carter Goodrich, *Government Promotion of American Canals and Railroads, 1800-1890* (New York: Columbia University Press, 1960); Harry N. Scheiber, *Ohio Canal Era: A Case Study of Government and the Economy, 1820-1861* (Athens: Ohio University Press, 1969); and

the fundamental political problem of how to finance improvements, given Americans' general reluctance to pay taxes and their especial aversion to taxing themselves so that people in other parts of the country would gain. Citizens in Alabama were unwilling to pay taxes to build a canal that benefited New Yorkers, and vice versa. States faced similar problems in financing transportation projects, but unlike the federal government, were able to work out a variety of solutions. So again states were the main source of the investments that drove economic growth during this period. In many cases, however, the solutions were not financially sustainable. The economic depression that began in 1839 was closely tied to the collapse of state finances, and the causality ran from state finances to the general economy.[80] The political turmoil that ensued helped transform state governments in a fundamental way that would take them out of the business of enacting private legislation. It was this transformation that would move the country toward open access.

In order for the government to be able to finance construction, a basic political economy problem called the "majority constraint" had to be solved. That is, a majority of representatives in the relevant legislative body had to be convinced that their districts would benefit from the proposed project. A straightforward up or down vote on a measure to build a canal would inevitably fail, because voters in the majority of districts would end up paying higher taxes to

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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).

[80] The classic account of the economic crises of 1837 and 1839 is Peter Temin, *The Jacksonian Economy* (New York: Norton, 1969). The alternative interpretation of the Crisis of 1839 as originating in the state financial collapse is laid out in 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; Wallis, "The Property Tax as a Coordinating Device: Financing Indiana's Mammoth System of Internal Improvements, 1835-1842," *Explorations in Economic History* 40 (July 2003): 223-250; Wallis, "What Caused the Crisis of 1839?" NBER Working Paper H0133 (2001); and 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).

finance a project from which they received no benefits. Legislatures were also constrained by what is called the "exit constraint." Projects could not be perceived to be so costly that constituents in the districts that did not benefit from them would no longer find it worthwhile to stay in the polity.[81] At the national level, the exit constraint took the stark form of a threat to secede, and as is well known, the federal government was never able to overcome this problem in the decades before the Civil War. At the state level, exit meant a loss of population to other states. Policy makers in the East worried about the loss of population to the West; in the West they worried that the pace of in-migration would slow or that migrants would go to neighboring states with better economic and political conditions.[82]

In theory, there were several ways that a democratic polity could craft legislation that would satisfy both the majority and exit constraint. One was to bundle a big canal enterprise with other smaller projects (or with another type of "pork") to secure enough votes for passage. Canal costs were so large relative to state budgets in the 1810s, 1820s, and 1830s, however, that these kinds of logrolls were not feasible. Second, states could borrow money to build the canal, as well as to cover interest payments on the bonds, in anticipation that when canal tolls began flowing into the state coffers the bonds could be repaid without raising taxes. The problem was that this type of "taxless finance" included a contingent liability on taxpayers: if the canal failed, taxes would have to rise to service the state's debts, potentially violating the exit constraint. Finally, states could institute "benefit taxation" by tying the taxes that would be assessed to pay for construction to the extent of the benefits that different groups of citizens would receive from the canal. The

[81] 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. The model is on pp. 219-25.

[82] These population dynamics also shaped debates over the disposition of public lands. See Daniel Feller, *The Public Lands in Jacksonian Politics* (Madison: University of Wisconsin Press, 1984).

easiest way to do this was through user fees, like canal tolls, but another way was to impose an *ad valorem* property tax. If land values near the canal rose because falling transportation costs enabled farmers to realize higher prices for their crops, part of the gain to the farmers could be captured in the form of property taxes based on the value of their land.[83]

New York used benefit taxation to finance its pioneering Erie Canal. The project was shepherded through the legislature by DeWitt Clinton and members of his coalition, mainly Federalists who were fighting for their political lives against what would become the Albany Regency.[84] Clinton and his allies had worked tirelessly to drum up support in New York City and along the proposed route of the canal, using many of the same techniques that local elites used to rally their communities behind turnpikes. The memorial that Clinton presented to the legislature in 1816 bore thousands of signatures but was only the most dramatic of the thirty or so similar petitions the assembly received that year. The political economy problem could not be solved that easily, however. There was a lot more at stake than free riding. Many of the taxpayers who balked at the cost of the project lived in other parts of the state and thus stood to gain nothing from the increase in trade and land values that the canal would bring to those along its route. Many New York City merchants opposed the canal because they feared the project would fail, as the earlier canals had failed, and they would end up paying higher taxes as a result. It was not financially feasible to win the opponents over with pork; the canal was simply too expensive to be

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[83] Wallis shows how such a benefit taxation scheme was used to secure the passage of legislation inaugurating the Indiana canal system in 1836. See "The Property Tax as a Coordinating Device."

[84] On the politics behind the Erie Canal, see 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); Ronald E. Shaw, *Erie Water West: A History of the Erie Canal, 1792-1854* (Lexington: University of Kentucky Press, 1966); and Murphy , *Building the Empire State,* Ch. 5.

logrolled. To secure legislative approval, Clinton and his allies turned to benefit taxation.[85] To begin with, the state would finance construction of the canal by issuing bonds (that is, by borrowing money). But to insure that the bonds would be attractive to investors, it diverted two existing taxes to the canal fund (the auction tax and revenues from salt lands) and, in addition, enacted a new property tax surcharge that would be levied on property within 25 miles of the canal if the Canal Fund found itself in deficit. The state 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.[86]

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.[87] Some states (Ohio in 1825, Indiana in 1836, and Illinois in1837) 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 finance schemes. These states gambled that revenues from their projects would be sufficient to pay off the debts incurred for construction. When New York and Ohio, both states that had enjoyed considerable fiscal success with their first round of canal construction, began a second round of canal expansion in the late 1830s, they also

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85 See Wallis, "Constitutions, Corporations, and Corruption," 222.
86 Wallis, "Constitutions, Corporations, and Corruption," 227-28.
87 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).

turned to taxless finance.[88]

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; they were much more costly to build than the Erie because the terrain they went through was more mountainous. Nonetheless, canal construction continued to boom. The farther western states of Indiana, Illinois, and Michigan, did not begin canal construction until 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. Although most of the projects started in the late 1830s were not scheduled to generate revenues until later in the 1840s, that was not the case for Pennsylvania and Maryland, whose canal projects had, by the mid-1830s, clearly demonstrated that they were not about to produce the revenues anticipated when they were undertaken in the 1820s. Nonetheless, both Pennsylvania and Maryland borrowed money after 1837, significantly increasing their debt burdens.[89]

By the early 1840s it was clear that these debt levels were not sustainable, and the states found themselves in serious financial trouble. They were no longer able to raise funds on the bond market, and revenues from traffic were dropping with the level of economic activity. At the same time, hard-pressed citizens rebelled against the higher tax burden needed to keep construction going and pay interest on state debts. Construction everywhere ground to a halt. Pennsylvania, Maryland, Illinois, Indiana, and Michigan defaulted on their obligations, and Ohio

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[88] On the chronology of canal investments see Goodrich, *Government Promotion*; Larson, *Internal Improvements*; and Wallis, Sylla, and Grinath, "Sovereign Debt and Repudiation." On the taxless finance aspects see Wallis "Constitutions, Corporations, and Corruption."

[89] The details of the state investments and their anticipated revenue streams are described in detail in Wallis, Sylla, and Grinath, "Sovereign Debt and Repudiation." The finances of Indiana are closely examined in Wallis, "The Property Tax as a Coordinating Device" and of Pennsylvania in Kim and Wallis, "The Market for American State Government Bonds."

and even New York only narrowly avoided default.[90] The political turmoil that ensued would reshape state governments in ways that accelerated the shift toward open access.

The Revolution of the 1840s

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.[91] The Crisis of 1839 appears in this scholarship as little more than an aftershock and is usually associated with the second suspension of payments by the Bank of the United States of Pennsylvania (BUSP) as a result of cotton speculation. But the BUSP (the former Second Bank of the United States, now operating under a Pennsylvania charter) was deeply involved in marketing state bonds in Europe. Part of the reason it suspended specie convertibility was the shock to international bond markets in the fall of 1839 that resulted from the realization that Indiana, Illinois, and Michigan were in trouble as a result the way they had financed their canal and bank investments in 1836 and 1837. The 1839 crisis was made in America.[92]

When the crisis had 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. Eleven existing states wrote new

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[90] Three southern states, Louisiana, Mississippi, Arkansas, and the territory of Florida also defaulted on their obligations, which had been issued to finance banks. For an account of the defaults, see Wallis, "Constitutions, Corporations, and Corruption."

[91] Peter Temin, "The Economic Consequences of the Bank War," *Journal of Political Economy* 76 (March 1968): 257-74; Temin, *Jacksonian Economy*; Peter L. Rousseau, "Jacksonian Monetary Policy, Specie Flows, and the Panic of 1837," *Journal of Economic History,* 62 (June 2002): 457-88.

[92] Wallis, "What Caused the Crisis of 1839?" and Kim and Wallis, "Market for American State Government Bonds."

constitutions in the 1840s and early 1850s that aimed to preclude the kinds of financial schemes and political decisions that had gotten them into so much trouble. Although each state adopted somewhat different solutions, the constitutional revisions addressed a common set of problems with government borrowing, taxation, state involvement in private enterprises, and corporations. The decision to embody the reforms in constitutions and not just in legislation reflected the seriousness with which Americans regarded the problems that the 1820s and 1830s raised about the nature of American democracy.

Before delving into the details of the changes the states made in the aftermath of the crisis, it is useful to recall the framework that Bailyn and Wood laid in their work on early republican ideology. In very general terms, eighteenth-century British citizens, whether they lived in England or the colonies, were concerned that those in control of the government were manipulating the economic interests of voters and their representatives to maintain their political dominance. Fears of this kind of systematic corruption played a key role in motivating the colonists to revolt, and they did not much abate in decades that followed. Controversies over corporate privileges only exacerated them, as did the infrastructure investments in canals that states made in the 1820s and 1830s. States were spending enormous amounts of money on economic projects that would clearly benefit some groups more than others. Indiana, for example, authorized $10 million in state bonds paying 5 percent interest carrying an annual interest burden of $500,000 at a time when the state budget was roughly $50,000.[93] The easiest way to garner support for such projects was to promise that they would essentially be free.

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[93] There is a long history within Indiana regarding the state's naivete, beginning with Logan Esarey's *History of Indiana*. How Indiana hoped to service the bonds is explained in Wallis, "The Property Tax as a Coordinating Device," and Wallis, Sylla, and Grinath "Sovereign Default and Repudiation: The Emerging-Market Debt Crisis in the United States, 1839-1843." NBER Working Paper 10753, September, 2004

Americans came to realize that it was very difficult for citizens and their political representatives to resist proposed government policies that were really too good to be true. In a very general way, therefore, fear of systematic corruption came to manifest itself during the 1840s as opposition to what we have been calling taxless finance.

Table 1 lists the eleven existing states that wrote new constitutions in the 1840s and 1850s, and whether the new constitutions contained provisions with respect to debt, corporations, and taxation, as well as the four states that wrote their first constitutions in the period.[94] The most direct attempts to limit taxless finance were "procedural debt restrictions" adopted in ten of the eleven states. The restrictions did not prohibit state governments from borrowing in the future, but they prevented states from issuing bonds without immediately levying enough taxes to service them and required that voters approve the package in a referendum before the bonds could be issued. At the Indiana constitutional convention in 1851, Judge Kilgore, who had been a member of the Indiana legislature when it approved the $10 million internal improvement bond issue in 1836, spoke against an absolute prohibition on state borrowing then under consideration:

> I appear to be the last survivor of all the members of the Legislature of 1836 who voted for that bill. I know there are many still living, they seem to have been afflicted – perhaps in judgement for their political sins – with a loss of their memories. [Laughter]. ...If, with the light of the past to guide them, with the heavy burthens of the present to remind them of past errors, the people coolly and deliberately decide at the ballot-boxes to again borrow money, I shall aid to place no Constitutional barriers in their way to prohibit them from carrying out their will; *provided*, sir, that at the time they give the Legislature authority to contract a debt they provide by direct taxation for the payment of the interest, and the canceling of the principal, within twenty-five years. Right here, sir, and nowhere's else, was the great error committed by the people and their representatives in 1836. Gentlemen may confine themselves to the simple assertion that the people of that day were mad; I shall not deny it; they were mad, and very mad; but, 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,

[94] Details on the constitutional provisions are described in Wallis "Constitutions, Corporations, and Corruption."

> 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 whole system as projected.[95]

Indiana's new constitution limited state borrowing to a very narrow set of purposes, and Ohio's was similarly restrictive, but most states allowed legislatures wider leeway in issuing bonds so long as taxpayers voted to raise taxes on themselves before the state borrowed any money. In addition to the ten states that adopted procedural debt restrictions in the 1840s, eight states followed suit in the 1850s and six states each in the decades of the 1860s, 1870s, and 1880s. These types of restrictions remain in place in most state and local governments to the present day.[96]

Taxless finance could be used as a tool of systematic corruption in several other ways, and the states adopted provisions to limit those options as well. One avenue was to grant favored groups tax breaks or exemptions. General tax provisions, adopted in eight of the eleven states, eliminated this possibility by requiring that all taxes be assessed on the same basis and levied at the same rate. General tax provisions were important through the nineteenth century, but they began to disappear from state constitutions in the early twentieth century, as states began moving away from property taxes.[97] 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.

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[95] Kilgore Speech, Thursday, Nov. 21, *Debates,* [1850], vol. 1, p. 676.

[96] Rodriguez-Tejedo and John Joseph Wallis, "Fiscal Crises and Fiscal Institutions," in Peter Conti-Brown and David Skeel, *When States go Broke* (New York: Cambridge University Press, 2012), [pp.??]

[97] The history of the property tax is covered in 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.

As we have seen, the other way that states could promote infrastructural projects on the cheap was to charter private corporations and give them special privileges to encourage investment. These kinds of policies move us beyond taxless finance narrowly conceived into more general considerations of systematic corruption, and the constitutional provisions dealing with corporations were consequently more nuanced and complicated than those that limited states' ability to incur debts. Because corporations had been so closely tied to state finances, however, changes in the way states created, owned, and regulated corporations had fiscal implications. Thus eight states enacted constitutional provisions that prohibited them from investing in private corporations, and six barred the government from lending the state's credit to such entities.[98]

The most common and the most sweeping constitutional provisions regarding corporations mandated that state legislatures enact general incorporation acts. Such acts dramatically changed the corporate landscape by enabling anyone who met the impersonal criteria laid out in the act to obtain a corporate charter through an administrative procedure. Eight of the eleven new constitutions written in the aftermath of the crisis contained this type of mandate. Fourteen more states enacted them by 1859, another 9 in the 1860s, 5 in the 1870s, and 6 in the 1880s. By the end of the century, only four of the U.S. states lacked such provisions in their constitutions.[99] Even when not required by a constitutional provision, moreover, state legislatures passed general incorporation acts in profusion after the crisis. For example, only four states had general incorporation laws for manufacturing before 1840; only four states did not have such laws on the eve of the Civil War.[100]

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[98] Wallis, "Constitutions, Corporations, and Corruption."

[99] Evans, *Business Incorporations in the United States*, 11; Hennesey and Wallis, "Corporations and Organizations."

[100] Hilt, "General Incorporation" provides details on general incorporation acts for manufacturing, which are a subset of all general incorporation acts. His Table 1 shows the dramatic expansion of

Mandating general acts did not, in itself, prevent legislatures from continuing to create special corporations. Eight of the eleven states went further and banned incorporation by special acts. For example, Ohio's 1851 constitution included the blanket declaration, "The General Assembly shall pass no special act conferring special corporate powers."[101] However, eliminating special incorporation was problematic at a time when many general incorporation statutes included limits on capitalization and when transportation and communication corporations often needed specific rights of eminent domain. As a consequence, about half the states continued to allow it 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."[102] Such language created a loophole that allowed significant numbers of corporations to continue to be chartered under special acts.[103]

It is important to emphasize that the new constitutions by and large did not prevent states from borrowing, from raising taxes, from creating corporations, or even from 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

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acts after 1840.

[101] Ohio Constitution of 1851, Article 13, Section 1.

[102] Maryland Constitution of 1851, Article 3, Section 47, Maryland Constitution of 1851

[103] For counts, see 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.

stripped legislatures of their authority to award charters and substituted an impersonal administrative process in their stead. 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, and over the next few decades they would apply this principle to a progressively wider set of legislative actions. In some states this process began immediately. The Indiana constitution of 1851 required the legislature to pass general laws whenever possible for seventeen different purposes:

> 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 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.[104]

We have quoted the entire list for Indiana, not only because it shows that Indiana was mandating general laws for vital government functions like taxation, justice, infrastructure, and education, but because the list encompassed so many of the day-to-day actions of the legislature. The provision represented a serious attempt to limit legislative discretion and systematic corruption—to prevent legislators from building political support by doing favors for and manipulating the interests of constituents—and it gave inhabitants legal standing to challenge any

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[104] Indiana Constitution of 1851, Article 4, Section 22.

state law that treated individuals or groups differently. By 1900, 35 states had adopted constitutional provisions similar to Indiana's: 5 in the 1850s, 7 in the 1860s, 12 in the 1870s, and 7 in the 1880s.[105] States also began passing general incorporation laws for counties and municipal governments, removing the ability of state legislators to manipulate the structure of local governments for political advantage.[106]

We cannot emphasize too strongly that, though the constitutional changes of the 1840s and '50s enhanced economic entry and competition, they were not substantively "laissez faire." They did not prevent state governments from regulating business or commerce. Indeed, many of the general incorporation laws enacted in their wake were highly regulatory, limiting the size and duration of corporations, the kinds of activities in which they could engage, and their internal governance structures.[107] Many even imposed additional liabilities on investors beyond the value of their shares. States responded to the crisis of the 1840s by taking steps to save their democracies, not to free up their economies. Legislatures lost the ability to discriminate among citizens, groups, and businesses, but not to regulate their activities in general. Indeed, it is precisely in this period that legislatures began to create the first banking commissions and similar bodies to oversee important areas of economic activity.

[105] See Jessica L. Hennessey and John Joseph Wallis, "Corporations and Organizations in the United States after 1840," unpublished paper (2014), as well as Charles Chauncy Binney, *Restrictions upon Local and Special Legislation of State Constitutions* (Philadelphia: Kay & Brothers, 1894).

[106] Hennessey and Wallis, "Corporations and Organizations," document the geographic and temporal spread of constitutional provisions affecting business corporations, municipal corporations, and general law provisions over the nineteenth century.

[107] For examples, see Lamoreaux, "Revisiting American Exceptionalism."

Conclusion

There was no parallel movement to limit legislative discretion at the national level. It was the changes at the state level that wrought a revolution in the way democracy worked. 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. But the shift toward open access forestalled the more insidious political manipulation of the economy—systematic corruption—that factions had successfully achieved in states like Massachusetts and New York in the early years of the nineteenth century.

Nor did the changes eliminate inequality. Elites did not disappear, but they had to operate in a much different environment—one characterized by what 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. [108] 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

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[108] There is clear evidence that developed democracies tend to have more equal income distributions than developing countries, but it is by no means clear which direction the causation runs, or whether there is any inherent tendency for developed democracies to become less unequal. The evidence is neatly summarized in Roberto Patricio Korzeniewicz and Timothy Patrick Moran, *Unveiling Inequality: A World Historical Perspective.* New York: Russell Sage Foundation, 2009.

the very nature of political competition in the United States. The result was a vibrant competitive economy which in turn provided important support for stable democratic political competition.

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. 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 were sustainable, in the sense that they mutually reinforced one another. They also produced one of the world first societies with steady economic growth and secure political and civil rights.

Table 1
Constitutional
Changes

		Debt	Corporations Any Provisions	Corporations General Laws	Taxation
Replaced Existing Constitutions					
Rhode Island	1842	Y	Y		Y
New Jersey	1844	Y	Y	y	Y
Louisiana	1845	Y	Y	Y	Y
Louisiana	1851	Y	Y		Y
New York	1846	Y	Y	Y	
Illinois	1848	Y	Y	Y	Y
Kentucky	1850	Y	Y		
Michigan	1850	Y	Y	Y*	Y
Virginia	1850				Y
Indiana	1851	Y	Y	Y	Y
Maryland	1851	Y	Y	Y	Y
Ohio	1851	Y	Y	Y	Y
Wrote First Constitution					
Iowa	1847	Y	Y	Y	
Iowa	1857	Y	Y	Y	
California	1849	Y	Y	Y	Y
Wisconsin	1848	Y	Y	Y	Y
Florida	1838		Y		Y

Notes: *: Michigan amended its constitution in 1843 to mandate general incorporation.

Pennsylvania amended its constitution in 1838 to require the legislature to issue corporate charters that could be repealed or revoked at will; and in 1857 to limit state debts and prohibit the credit of the state from being lent to private corporations.