

Banks and Democracy

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This is a very preliminary draft.

Dick Sylla changed my life. When we met at the Economic History Association meetings in 1983 I was a new assistant professor working on the political economy of the New Deal. We soon began working together with John Legler on a project gathering state and local government financial data, and by 1987 were presenting papers at the EHA meetings on early 19<sup>th</sup> century government public finance. While I have an abiding interest in government finance, I had no notion of moving backward in time from the 1930s, in fact I anticipated moving forward through WWII to the 1950s and the Great Society programs. Allied with Dick, I found myself learning more about early 19<sup>th</sup> century banking. My life changed.

In the early 1990s, a graduate student at Maryland, Art Grinath, wrote a dissertation comparing infrastructure, property taxation, and state government borrowing in Maryland and Virginia in the 1830. Dick and I joined forces with Art, and gave a paper titled “Debt, Default, and Revenue Structure” at an ALL-UC economic history conference in Berkeley in 1992. Although still unpublished, that paper opened up the research questions that I have pursued ever since. The paper asks why eight states and the Territory of Florida defaulted on their debts in 1841 and 1842, including a significant amount of debt issued by states in favor of banks. The paper and the research that followed led me to see a more central role for the states in the process of economic and political development in the early 19<sup>th</sup> century, and eventually to come to a different view about the larger process of American development. The United States did not spring forth from the Declaration of Independence, the revolution, the Constitution, the minds of the founders, or even the political and economic arrangements in place in 1800. Lots of things, ideas, institutions, markets, behavior, and firms would change over the next 50 years. The

changes in the relationship between politics and economics occurred primarily at the state level, so the national level history that we usually tell misses important developments. The focus of this paper is banks and democracy, and the larger purpose to lay out a way to think about the interaction of political and economic forces in American development and document it at the state level.

As my research agenda matured it grew away from Dick's. I became increasingly concerned with the discontinuities in American government between 1790 and 1850, while Dick became increasingly concerned with the continuities in economic and political development after 1789, as he clearly laid out, with Doug Irwin, in their introduction to *Founding Choices* (2010). This was not a surprise, Dick's fascination with Alexander Hamilton and his vision for the American Republic is legendary. I moved down a different path, as Dick broadened and deepened his. We honor our favorite teachers and friends by showing what we have learned after we go out on our own. This is my offering.

Americans of the revolutionary and founding eras held ideas about the relationship between politics and economics that developed initially in Britain and then in the colonies. The ideas evolved as a criticism of the Whig government that came to dominate British politics after the Revolution of 1688. While their ideas had older roots, they took on a distinct and unique tone in the 18<sup>th</sup> century. They accused the Whig regime of corruption, the systematic manipulation of economic privilege to build a political coalition in the royal interest and to subvert the independence of the House of Commons. To both the surprise and disenchantment of the American founding generation, the new system of government and politics they designed turned out to be just as vulnerable and corrupt as the British government they excoriated. On the

intellectual side, my argument starts with republican theory, the ideological origins of the American Revolution (Bailyn, 1967) and the Constitution (Wood, 1969), and Hamilton's republican ideas (Stourzh's, 1970, Rossiter 19).<sup>1</sup> On the historical side, the evidence of banking in the 1790s and early 19<sup>th</sup> century shows the predilection for corruption that early American politics clearly demonstrated. This was not a problem that the national government was capable of dealing with, even though there were no constitutional constraints on doing so. In fact, the inability of the national government to wrestle with the perception that it was corrupted by the political manipulation of economic interests ultimately resulted in a civil war.

Traditional republican ideas did not carry all the way through the 1840s. I draw a very simple before and after picture. A sophisticated version of republican ideas, taken from Hume, which Hamilton cites, provides a representation of 18<sup>th</sup> century republican principles of government, specifically of balance and equality. Yet, as the banking examples show, neither balance nor equality between groups could be maintained under the original republican forms of governments that the states created. Competition between factions, ala Madison and Federalist paper #10, could not be balanced even by the extended republic. It seemed that economic interests were inevitably manipulated by political interests for political purposes. A different way of thinking about how a government could be constituted that preserved balance and

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<sup>1</sup>Republican theory has been the most studied subject in political and intellectual history, political theory, and political philosophy over the last 60 years. Its origins lay in the rediscovery of what the Whigs really meant in 17<sup>th</sup> and 18<sup>th</sup> century Britain, Robbins 1959, Weston 19. Bailyn's 1967 applications of these ideas to the origins of the American revolution and Wood's 1969 to the formation of the second American constitution brought the issues to a prominence in American history that they have yet to yield. Pocock (1975, 1985), Skinner (19), and the Cambridge school widened the inquiry to include political thought from the Middle Ages forward. The debate and investigation goes on, see Skinner and van Gelderen, 2002.

equality gradually emerged in the 1830s and 1840s. While the new ideas had clear antecedents in republican theory, they did not produce a similarly integrated body of thought. Historians, like Wilentz and Foner, call this the “rise of American democracy.” But I will try to show it was not the democratic elements that made the new political arrangements work, it was the changed relationships between political and economic institutions. Americans created, in the terms of North, Wallis and Weingast, an open access social order.

## **II. Republican Ideas**

I want to draw out aspects of republican theory dealing notions of balance and equality, and since these ideas do not play central roles in the existing literature my interpretations are less substantiated than I would like. Bailyn painted the classic picture of liberal theory in the American case and his description still holds. British critics of the Whig government saw the revolution of 1688 as a triumph of mixed government in which the independence of the three parts of government – the King, the Lords, and the Commons – provided a defense of liberty and a bulwark against tyranny and slavery. A clean description of their logic had been annunciated long before by Charles I in 1642 in “His Majesties Answers to the XIX Propositions of both Houses of Parliament” (Weston, 1965, pp. 263-5). During the 18<sup>th</sup> century wars with France, the necessity for the Crown to raise large sums for military expenditures necessitated close association with the House of Commons, which gained power over taxation in the settlement in the Glorious Revolution. This close association between Crown and Parliament reflected the creation and management of a royal interest or party in the Commons. Of particular significance for economic historians was the clear identification of economic interests as the tool that the

Whig regime used to manipulate members of Parliament (Bailyn, 1969, ch. 1). This was “systematic corruption,” the manipulation of economic privileges by a political group, in order to build or consolidate a political coalition (Wallis, 2006). Systematic corruption emerged immediately in America after the revolution, too. Hamilton argued in the Report on the Public Credit that “If all the public creditors receive their dues from one source... their interests will be the same. And having the same interests, they will unite in support of the fiscal arrangements of the government.” His political opponents interpreted his actions as systematic corruption.<sup>2</sup>

Not everyone agreed about exactly how corruption was manifest in the late 18<sup>th</sup> century. Hume’s essay on the *Independence of Parliament*, which follows the famous passage that everyman must be considered a knave, argues

If, on the contrary, separate interests be not checked, and be not directed to the public, we ought to look for nothing other than faction, disorder and tyranny from such a government. In this opinion I am justified by experience, as well as by the authority of all philosophers and politicians, ancient as well as modern...

But, in this opinion, experience shews they would have been mistaken. For this is actually the case with the BRITISH constitution. The share of power, allotted by our constitution to the house of commons, is so great it absolutely commands all other parts of the government. The king’s legislative power is plainly no proper check to it. For though the king has a negative in framing laws; yet this, in fact, is esteemed of so little moment, that whatever is voted by the two houses, is always sure to pass into a law, and the royal assent is little better than a form. The principle weight of the crown lies in the executive power. But besides that the executive power in every government is altogether

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<sup>2</sup>Separating systematic from “venal” corruption is important. Hamilton’s critics did not claim that his policies were intended to promote his personal economic interests, he was not abusing his public office for private gain. The criticisms were directed at Hamilton’s stated purpose of building a sustainable political coalition. Likewise when Bolingbroke laid charges of corruption against Robert Walpole he was not accusing Walpole of venal corruption. This does not mean that the word “corruption” was not used to suggest at times that political actors were venal, or that it was often used to denote a decline or decay in public morals (on this see Montesquieu in particular). The same word was used in several ways simultaneously in the 18<sup>th</sup> and 19<sup>th</sup> century.

subordinate to the legislative; besides this, I say, the exercise of this power requires an immense expence; and the commons have assumed to themselves the sole right of granting money. How easy, therefore, would it be for that house to wrest from the crown all those powers, one after the other, by making every grant conditional, and choosing their time so well, that their refusal of subsidies should only distress the government, without giving foreign powers any advantage over us?"

Hume argues that the Commons, not the King, has powers to suborn the independence of the other. Hume then rescues balance in the mixed British government by appealing to the King's ability to manipulate the economic interests of members of Parliament:

How, therefore shall we solve this paradox? [how is the Commons to be checked?] I answer, that the interest of the body is here restrained by that of the individuals, and that the house of commons stretches not its power, because such a usurpation would be contrary to the interests of the majority of its members. The crown has so many offices at its disposal, that, when assisted by the honest and disinterested part of the house, it will always command the resolutions of the whole; so far, at least, as to preserve the ancient constitution from danger. We may, therefore, give to this influence what name we please; we may call it by the invidious appellations of *corruption* and *dependence*; but some degree and some kind of it are inseparable from the very nature of the constitution, and necessary to the preservation of our mixed government. (Hume, 1994, pp. 25-26)

With apologies for the long quotation, Hume turns the prevalent argument about the corrupt subordination of the Commons by the King on its head, arguing instead that it is only by the manipulation of the economic interests of individual members of Parliament that balance is maintained in the system of mixed government. Hamilton appeals to Hume in the passage in *The Farmer Refuted* where he repeats that in politics men "ought to be supposed a knave."<sup>3</sup> Stourzh, p. 78, suggests that "these reflections of Hume's illuminate in a flash the whole edifice of Hamilton's political science."

I am not interested in illuminating all of Hamilton's political science in a flash or in detail, but to emphasize the shared commitment to the idea of balance in a system of mixed

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<sup>3</sup>Hamilton, 1904, volume 1, p. 73.

government that was widely held by both sides of what became the Hamilton/Jefferson divide in American politics. Theoretically, if mixed government defended liberties by balancing the power of the elements of government (the one, the few, and the many or the Kings, Lords, and Commons), then a threat to balance could come from the over weaning power of any of the elements. In a sense, all the theorists were concerned with the equality of the elements within the system, even as they understood that the elements themselves were fundamentally different and unequal. The king as an individual had to be more powerful than an aristocrat as an individual, but for balance to hold the aristocracy as a whole had to equally balance the crown. Mercantile and urban actors would be less powerful as individuals than the aristocrats, but as a whole equal to the power of the king or the aristocracy in order to maintain balance.

The phrase “equality between unequals” was never used in the 18<sup>th</sup> century. Yet, the notion of balance between organically constituted parts of society required a kind of balance of social, economic, and political power. This balance went far deeper than formally institutionalized procedural checks. Charles’s answers to the 19 question wrestled with equality between unequals in 1642. If the Commons were to acquire the power of preference “since so new a power will undoubtedly intoxicate persons who were not born to it, and beget not only Divisions among them as equals, but in their contempt of Us as become and equal to them, and Insolence and Injustice towards Our people, as now so much their inferiors, which will be the more grievous unto them, as suffering from those who were so lately of a neerer degree to themselves, and being to have redresse onely from those that placed them, and fearing they may be inclined to preserve what they have made, both out of kindnesse and policie; since all great changes are extremely inconvenient, and almost infallibly beget yet greater changes, which beget

yet greater Inconveniences.” (In Weston, 1965, p. 264) The balance between the parts of a mixed government, however perceived or constituted, was of necessity an equal balance, but not a balance between equals.

Madison was explicit in Federalist #10: “The diversity in the faculties of men, from which the rights of property originate, is not less an insuperable obstacle to a uniformity of interests. The protection of these faculties is the first object of government. From the protection of different and unequal faculties of acquiring property, the possession of different degrees and kinds of property immediately results; and from the influence of these on the sentiments and views of the respective proprietors, ensues a division of the society into different interests and parties.” Inequality produces the different interests and parties that need to be in balance.

The importance of ‘equality’ in our modern sense came to play such an important role in the political reality and theory of democracy that developed between 1790 and 1850, that it is important to be clear about its nature and definition over time. Madison clearly did not think of equality among men as a requirement for a republic. Again from Federalist #10: “Theoretic politicians, who have patronized this species of government, have erroneously supposed that by reducing mankind to a perfect equality in their political rights, they would, at the same time, be perfectly equalized and assimilated in their possessions, their opinions, and their passions.” The species of government he refers to is democracy and the theoretic politician is Montesqueiu. This is part of Madison’s argument for the extended republic against Montesqueiu’s conclusions that democratic republics must be small. Madison’s notion of balance required equality among unequals.

Equality was a central concept for Montesqueiu. The opening sentence of the 1757

edition of *The Spirit of the Laws* began: “In order to understand the first four books of this work, one must note that what I call *virtue* is love of the homeland, that is, love of equality. It is not a moral virtue or a Christian virtue; it is a *political* virtue, and this is the spring that makes republican government move, as *honor* is the spring that makes monarchy move.” (Montesqueiu, 1989, p. xli, italics in original) Montesqueiu gives us another entry to understand the logic of men like Madison and Hamilton, as well as the myriad meanings of equality and some of the words used to represent them in the 18<sup>th</sup> century.

Montesqueiu distinguished four kinds of governments: despotisms, monarchies, aristocratic republics, and democratic republics.<sup>4</sup> Despotism was the rule of one many without law, monarchy the rule of one under laws. Republics contained an element of representation. Aristocratic republics were ruled by representatives of elites, and democratic republics ruled by representatives of the people. Each type of government had a characteristic animating principle. As Montesqueiu says, the principle “is the spring that makes” society move.<sup>5</sup> Perhaps it is unwise to fit Montesqueiu’s argument into contemporary terms, something is surely lost by doing so. Nonetheless, Montesqueiu’s notion of political principle suggests that in each of the four types of government the dynamics of how society is governed create in individuals a

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<sup>4</sup>This is technically inaccurate, since Montesqueiu begins book 2 (1989, p. 10) with the statement that “There are three kinds of government: REPUBLICAN, MONARCHICAL, AND DESPOTIC.” Yet the differences between the two types of republics, aristocratic and democratic are so large and meaningful that Montesqueiu effectively has four types.

<sup>5</sup>Stourzh’s chapter III is titled “The Springs of Republican Government: Private Passions, Public Interest, and the Love of Fame,” and concludes that “the love of glory emerges as a passion of prime significance in Hamilton’s outlook.” (p. 99)

preference for certain types of behavior.<sup>6</sup> In a democratic republic the principle political virtue is love of the homeland and equality (which are the same).<sup>7</sup> In an aristocratic republic “*moderation* is the soul of these governments.” Or “a certain moderation that renders the nobles at least equal among themselves, which brings about their preservation.” In a monarchy, governed by laws, the political principle is honor, and in despotism, the principle is fear.

Montesqueiu is famously complicated. I want to draw out the distinction between the two republics and their characteristic principles, equality in a democratic republic and moderation in an aristocratic republic, because it is the logic of the aristocratic republic that motivates the founding generation, not the logic of the democratic republic. Equality for Montesqueiu, as it had been for Machiavelli, was a political virtue because it produced frugality. If everyone cared more for the republic than themselves, and loved equality above all, then the resources of the citizens would be available to the state. In *Discourses on Livy*, Machiavelli clearly equated the virtue of equality in the citizens with keeping “the state rich, and the people poor.” (Stourzh, p. 64) In the *Discourses* Machiavelli lays the blame for the end of the republic on the agitation by the plebs for an agrarian law that would make a more equal distribution of

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<sup>6</sup>Create is too strong a word. Montesqueiu wanted to understand the dynamics of societies. He understood that in order for a specific political system to work, it would have to be consistent with the values that people held. A democratic republic required people to love equality, as a political system it would not work without such a virtue. But whether a society, or the political system, could create such values was an open question.

<sup>7</sup>“Virtue, in a republic, is a very simple thing: I is love of the republic; it is a feeling not a result of knowledge; the lowest man in the state, like the first, can have this feeling.” Montesqueiu, book 5, ch. 2, p. 42. “Love of the republic in a democracy is love of democracy; love of democracy is love of equality. Love of democracy is also love of frugality As each one should have the same happiness and the same advantages, each should taste the same pleasures and form the same expectations; this is something that can be anticipated only from the common frugality.” Book 5, ch. 3, p. 43.

lands that Rome conquered. Once the plebs had secured the creation of plebian tribunes: “for having attained that, it [the plebs] began at once to engage in combat through ambition, and to wish to share honors and belongings with the nobility as the thing esteemed most by men. From this arose the disease that gave birth to contention over the Agrarian laws, which in the end was the cause of the destruction of the republic. Because well-ordered republics have to keep the public rich and their citizens poor, it must be that in the city of Rome there was a defect in this law.” (Machiavelli, 1996, pp. 78-9) The defect in the agrarian law was to give the masses hope for economic improvement through the actions of the government, in this case claims on land in conquered territories. Frugality in the general population was necessary to political balance, because if the people became interested in improving their material lot beyond some measure of subsistence, it would provide the raw material for factional disputes and upset the political order. Machiavelli draws this connection directly between economics and politics.

Montesquieu repeats the logic. Equality is an equality of frugality and limited means and a desire by the citizens not to improve their material standard of living, but instead devote their resources to the service of the republic. Montesquieu has democracies walking a very fine line when it comes to equality: “The principle of democracy is corrupted not only when the spirit of equality is lost but also when the spirit of extreme equality is taken up and each one wants to be the equal of those chosen to command” “Therefore, democracy has to avoid two excesses: the spirit of inequality, which leads it to aristocracy or the government of one alone, and the spirit of extreme equality, which leads it to the despotism of one alone, as the despotism of one alone ends by conquest.”

Montesquieu’s claim is not that democracies are inherently virtuous in this way, but that

in a democratic republic the citizens must exhibit this virtue or their democracy will become corrupted. One may wonder, then, whether a system that requires such a shared magnanimous virtue among the population will appear or survive. In fact, as Jacob Levy points out, “Montesqueiu’s insistence that republics were constituted by virtue was an *indictment* of them, since the obsession with monk-like virtue and self-abnegation was anachronistic in an age of commerce. And republics were far from being intrinsically free governments.” (2014, p. 150) Montesqueiu’s democratic republic was not a blueprint for the new American republic. As Madison said in Federalist #10, the point of the constitution was to protect the differences in faculties among people, not to equalize them. Both Machiavelli and Montesqueiu saw the dangers of a democracy flowing from the ability of political actors to take advantage of the economic interests of the wider body of citizens. Unless the citizens are virtuous, and shun the opportunity to use the government to improve their economic condition, democracy will easily be corrupted.

Equality has other meanings in Montesqueiu. The political principle in an aristocratic republic is moderation, because the major danger in an aristocratic republic is factions within the aristocracy. Aristocracies are inherently unequal: “There are two principal sources of disorder in aristocratic states: extreme inequality between those who govern and those who are governed, and a similar inequality between the different members of the governing body.” (Montesqueiu, part 1, chapter 8, p. 52) Widening those differences weakens an aristocratic republic: “The means invented to perpetuate the greatness of families in monarchical states cannot be used in aristocracy. When laws have equalized families, it remains for them to maintain the union between the families.” (Part 1, chapter 8, p. 54)

You might think, given the complicated notions of equality in Montesqueiu that he would argue for laws that treat everyone the same, that are impersonal. But he does not. The spirit of the laws must be consistent with the nature of the society, and only in a democratic republic would laws that treated everyone the same be consistent with society. In a democracy, therefore, Montesqueiu says the laws would call for equal divisions of property. Montesqueiu spent much more time discussing laws that are uniform, laws that are everywhere the same. And he is, in general, against those laws.

The reasons for opposing uniform laws relate, in part, to monarchy. Montesqueiu believes that in a monarchy, as in an aristocratic republic, that it is the presence of the *corp intermediare*, the privileged organizations of the nobility, the church, the towns, the guilds, and the courts that provide the defense against the power of the monarch and keep government moderate. If the laws are everywhere the same, if they are uniform, then the privileges that sustain the *corp intermediare* vanish, and along with them the ability to check the monarch. It is necessary that the laws not treat everyone the same in order to maintain the balance of interests in a society that enables moderate government to be sustained. A similar notion of balance must remain in place in an aristocratic republic. It is the inequalities in the faculties of people that provide the differences in interest that enable a society to maintain a balance of interests.

Balance in a republic, therefore, is connected intimately with equality. But it is an equality of unequals. It is not an equality where everyone is treated the same. It is an equality where the unique privileges that powerful individuals and organizations possess enable the society to construct a balance of interests, capable of checking attempts by anyone of the elements to tyrannize the remainder.

Perhaps I have gone on too long about the notions of equality in Montesqueiu. However, the raw normative power of the concept of equality plays such a central role in American history, and particularly in American economic history, that it can seem hard to doubt that a modern egalitarian concept of equality was not already an inherent part of American character and culture from long before the revolution. The meaning of equality that came to dominate American political thinking and American political rhetoric in the 1830s and afterwards, the notion that every free white male is equal and that the laws should apply equally to the governed and the governors, skates close to Montesqueiu's notion of extreme equality. To assume that a profound belief in equality is a virtue that the American society either possessed or engendered, and that such a belief not only created an American democratic republic but enabled it to succeed, is to make the mistake that Montesqueiu cautions us against. A virtuous belief in equality on the part of the population is too slender a reed for a society to base its freedom and liberty on. The equality inherent in balance, while an equality of unequals, is far more durable and potentially important. As I will argue, the initial American republic(s) did not manage to attain the desired balance. Ultimately, encouraging and constructing a balance of unequals involved a much wider set of changes in the institutional structure of the economy and society than the founding generation perceived or conceived.

The ideas of equality that came to dominate American democracy in the mid-century and later, more radical egalitarian ideas about equality, if you will, were clearly present in the founding era as Wood, 1991 and Holton, 2007 among others have shown. One way to tell the

history of American democracy is to attribute its rise to the triumph of egalitarian ideals.<sup>8</sup> On the surface, it appears that happened.

But ideas about balance did not go away. Egalitarian ideas remained in concert with the notion of checks and balances, of limited government, a debate that continues as vigorously in the United States today as in the early 19<sup>th</sup> century. The remainder of this section lays out a conceptual view of balance in the republican ideas of the founders and why it didn't work out like they planned. Then a conceptual view of how Americans came to see government working, and the kind of changes in the interaction of political and economic institutions were necessary to implement the new view.

Figure 1 depicts the an aristocratic republic (or even a monarchy) as described by Montesqueiu. Factions are made up of groups of elites. The factions are represented by vertical ellipses. The factions hold together because of rent sharing agreements between and among their organizations as described by North, Wallis, and Weingast, 2009, and Wallis, 2011. In Montesqueiu's scheme, these elite factions could be thought of as the *corp intermediare*, the privileged organizations that serve as the counter-balance to the king in a monarchy, or the factions of elite organizations that must reach agreements in an aristocratic republic. In a larger sense, the vertical ellipses contain everyone in society, since everyone is embedded in a network of organizations and associations that structure human relationships. The figure depicts the connection of those organizations, groups, and networks.

The horizontal circle connecting the vertical ellipses contains the organization(s) through

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<sup>8</sup>For example, Sean Wilentz's *Rise of American Democracy*, 2005, in the end argues that it is the triumph of the free labor north over the slave south that accounts for the rise of democracy.

which the elites coordinate. There may be public or private arrangements through which elites and elite organizations coordinate. Although it may seem odd, there is no overarching government organization, although there may be governments. North, Wallis, and Weingast develop a logic of how such a society could be organized. The ability to form an organization that the larger society, that is the other elites, will recognize is limited. Limits on the ability to form organizations create rents for the organizations that do exist. Those rents enable the elite organizations to credibly reach agreements between themselves, because breakdowns in the agreements reduce the rents that all elite organization realize because of their agreement(s).

With that social logic in the background, Figure 1 represents the classic republican idea of mixed and balanced government. One of the vertical ellipses is the monarch, several are the aristocracy, and several more are commercial and urban networks. As stressed earlier, in order for balance, these groups must have equal power in the system of balance, even if their individual members are unequal from one another, both within and between groups. The idea of an organic balance between interests in society, as Madison conveys in Federalist #10, suggests that there are more than three groups, indeed there are many groups. The internal arrangements between elite organizations can be both fluid and stable. To the extent that elites are able to agree on credible rules for interacting, their relationships can be more stable. To the extent that elites are able to adopt what the legal theorist H.L.A. Hart calls “secondary rules,” that is rules for making new rules or altering existing ones, then something like a constitutional arrangement exists between the groups. The stability of the arrangements is not maintained by the rules, but by the balance of interests between the factions.

It may seem strange that Figure 1 has no vertical dimension, there is no king or

government “set over” the society. That feature reflects the nature of balance in both republican theory and in societies that existed up to the beginning of the 19<sup>th</sup> century. The balance that matters for social, political, and economic order was horizontal balance, not vertical balance. Montesqueiu’s *corp intermediare* must be able in aggregate to balance the king, it is not a vertical arrangement but a horizontal one. Hobbes argued that balance produced civil war, and only with a Leviathan sovereign capable of coercing everyone could social order be guaranteed. Madison and Hamilton shared some Hobbesian leanings, but they were not willing to abandon the idea of a republican balance in 1787.<sup>9</sup> It didn’t work. The balance necessary to produce an equality of unequals was continuously threatened by attempts from a coalition of groups, or factions, to dispossess, expropriate, or govern other groups within the society. As the political theories Philip Pettit has forcefully argued, the essential feature of freedom in republican theory is freedom from “domination.” Horizontal balance in Figure 1 is required to insure that none of the constituent groups can be dominated by another, and in the extension of the theory, no individual can be dominated either.<sup>10</sup>

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<sup>9</sup>The Hobbesian world is a Figure 2 world, but without vertical balance. The Leviathan must be able to overawe all. As James Madison famously asked in the Federalist papers: “But what is government itself, but the greatest of all reflections on human nature? If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself.” James Madison, writing as Publius in *The Independent Journal*, Wednesday February 6, 1788; Federalist #51. Society must first create a Hobbesian Leviathan, and next figure out how to control it. I am currently writing a book, *Leviathan Denied*, that challenges both Hobbes and Madison on these points.

<sup>10</sup>Pettit’s discussion of republicanism is very interesting, and captures essential elements of the republican philosophy. I am not convinced that he has developed a persuasive political economy of republicanism, that is, a theory of republican government that actually works in

We can put a government with the power to coerce everyone into the figure, which produces a society that looks like Figure 2. I dwelled on the nature of horizontal balance in Figure 1, because you can immediately see that there can be no vertical balance in Figure 2, that is a balance between the government and the elite groups, unless somehow the elite groups are themselves coordinated to defend themselves against the government. This puts society back to the situation where there must be equality amongst unequals to ensure elite coordination, and that is the logic of the horizontal balance in Figure 1.

The founding generation thought, or hoped, that they had figured out the solution to the balance problem, but they had not. Consistent with their 18<sup>th</sup> century republican heritage they saw a distinct threat to balance coming from political manipulation of the economy. Very quickly after independence and then the formation of the second national government, they were confronted with the necessity to deal with economic questions, and found the old inherent tendency to use the economy to build political coalitions and, in particular, political parties was still in operation. They found that control over their new government would be subject to the same manipulation that they had revolted from Britain to escape. Almost certainly the larger element that democratic elections played in the structure of American politics made manipulation of the economy for political purposes worse, not better. As contests for control of governments, both national and state, moved from intra-elite contests to much wider, more populist, elections, outcomes became much more unpredictable.

The two figures are abstractions. Americans and British citizens certainly thought that the British government looked something like Figure 2, although they had complicated ideas

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society.

about the balance of interests that limited government that may have looked more like Figure 1. The United States took deliberate steps towards a distinctively constituted government with the new national constitution in 1787, something that looked more like Figure 2 than Figure 1. Anti-federalist opposition to the constitution was firmly grounded republican theory, how was this new and more powerful government to be controlled?

States also moved toward more explicit governments, although expectations were probably that the existing elite groups would continue to dominate state governments. Immediately, groups within the polity began to organize not just to contest elections, but to create economic privileges. Canal parties and bank parties were the two most prominent examples. As states wrestled with the dual problems of governing themselves and providing economic investments in the kind of public goods their citizens demanded banks and canals, as Callender argued in 1902, they found themselves inextricably caught up in factional conflict. Promoting banks and canals required states by the very nature of the investments that they wanted to make, make some groups better off than others.

In the end, the solution states adopted, and the national government did not or could not adopt, is represented by the black bar in Figure 2. The bar represents impersonal rules, rules that “treat everyone the same.” The problem of horizontal intra-elite competition and coordination that is such an ongoing problem in Figure 1, becomes worse in Figure 2 if the government is effectively available to serve the interests of the groups that happen to control it. What states figured out, eventually, was limiting the things that governments could do was very difficult, because it was often possible to get a majority or a super-majority to override the limit. On the other hand, limiting government by restricting the ability of government’s to discriminate

between different groups, for example, requiring governments to give bank charters to both Federalists and Republicans, turned out not only to limit government but to create the social dynamics that led people in growing numbers, both elite and otherwise, to support the impersonal rule. In the case of banks, it was free banking or general incorporation laws for banking. But the principle had much wider implications. The key was limiting the discretionary ability of governments, particularly legislature, to discriminate between groups (or individuals). This had both an active component, anyone could get a bank charter, and a passive component, any individual was free to do certain things without the interference of the government.

In the simplest terms, the founding generation hoped that the political mechanism embodied in the state and national constitutions would enable them to construct virtuous republics in which the tendency for factions to manipulate the economy for political purposes could be curbed. Those expectations were frustrated almost immediately. In the no-mans land that the American republics occupied, where the (limited) commitment to electoral democracy and curbs on explicit aristocratic pretension hampered the ability of elite groups to construct coalitions stabilized by interlocking rents, Americans began to realize their new political world was better represented by Figure 2 than Figure 1. The threat that democratic government posed to economic interests was heightened by the absence of old pre-existing social organizations and norms, like the *corp intermediare* to serve as a bulwark against systematic corruption. The Americans were in the process of building their own *corp intermediare*, and those who worried that they would not be in on the privileges cried corruption.

The solution, adopted piecemeal through the 1830s and wholesale in the 1840s, was to implement a series of institutional changes that implement the bar in Figure 2. Government

discretion, particularly legislative discretion, to differentially treat different groups was shut down on several key economic and political dimensions. While this could be justified *ex post* as limiting the ability of governments to interfere with individual freedom, the negative liberty articulated by Constant and Berlin, it was something quite different. It was the imposition of impersonal rules for forming organizations, chartering cities, and a whole host of other activities in an explicit attempt to change the dynamic interaction of economic and political forces. It is easiest to see these changes in banking, to which we now turn.

### **III. Banks**

Banking, finance, and monetary policy are inextricably linked in early 19<sup>th</sup> century America and have been important in American Economic History from the very beginning of the discipline. Dick Sylla has made significant contributions and for me as a young economic historian two papers stood out: "American Banking and Growth in the Nineteenth Century: A Partial Review of the Terrain" in 1972 and "Early American banking: the significance of the corporate form" in 1985. The first is a review article of the reprint of Fritz Redlich's *Men and American Banking*, and indirectly of Schumpeter's *Business Cycles* and *The Theory of Economic Development*, in which Dick questions the soundness tradition in economic and banking history. The soundness tradition emphasized the weaknesses of early American banking, that echoes the concerns about corruption and banking so prevalent at the time: "The appeal of the [soundness] tradition must therefore rest on its castigation of fraud and dishonesty in banking matters. But it appears to have over-magnified both the extent of these evils and their historical import to the point where it has stood in the way of reasoned economic analysis of banking history in a growth

and development framework.” (Sylla, 1972, p. 204) Dick emphasized the importance of the early banking system for mobilizing and deepening capital, both to finance commerce, trade, and industrialization. This was a major accomplishment of the American economy before the Civil War that deserves recognition as exceptional and unique in the historical record, not something to be degraded and despised.

The second paper point to the critical connection between banking and the emergence of the corporate form in the United States, particularly the importance of free banking laws or, what is more widely known as general incorporation laws. The United States was the leader in opening access to the corporate form in the western world and so in human history. Dick’s subsequent work with Bob Wright has given quantitative significance to the conclusion.

Both papers articulated the successful institutional developments in the American economy that, in a way, are American inventions. These developments were not simply American. They become characteristic of modern development in any developed society over the next 200 years. The papers had a profound effect on me and continue to do. My research continues to be oriented toward understanding why the United States succeeded in creating a modern developed economy and polity, and largely within the framework of the “corporate form” paper.

The banking literature did, in fact, move in the direction that Dick predicted. Substantial research has shown that the banking system in the United States did pretty well. Hugh Rockoff’s work shows that free banking and wildcat banks were not the disaster that the soundness tradition portrayed. Peter Temin rescued the Bank of the United States and the state banking system from responsibility for the Panic of 1837 and the Crisis of 1839 (with Peter Rousseau

dissenting on some margins). There were still problems. Unit banking created too many small banks, the fractional reserve system was subject to periodic panics and almost certainly aggravated cyclical instability of the American economy. As Bordo, Redish, and Rockoff have argued in a series of papers (2015, 1996, and 1994) comparing the US banking system with the Canadian system, a banking network with a smaller number of larger banks might have been significantly more stable. At the 2013 Southern Economics Association meetings I commented on an early draft of the 2105 paper, and gave Hugh Rockoff a bad time for ignoring the role of politics. As Hugh is commenting on this paper at the conference, I am due for payback. But I also have the opportunity to deliver on the question I asked about their paper: what was the role of politics in shaping the structure of the banking system in the United States? Why did the shape of the banking system play a part in institutional solutions that made democracy work in America?

I take as given that the banking system in general promoted economic growth and ignore the Jacksonian claims that banking was, in and of itself, an unmitigated evil. I also assume that most banks did not systematically defraud either the state governments or their customers, although there were undoubtedly banks that did. I first ask whether there was the appearance of systematic corruption in banking, of the use of bank chartering and fiscal policies to create coalitions that could dominate state or national politics? Then I ask whether there was systematic corruption, was there fire as well as smoke? The answer to both questions is yes. I touch briefly on the well-known case of the First Bank of the United States and the banking system that developed under the Albany Regency in New York up to 1837. Less well known, but equally important is the Federalist monopoly on banking in Massachusetts up to 1812, and

the history of the first banks in Arkansas in 1837. I close with Andrew Jackson and the Second Bank of the United States.

The political crisis that after Hamilton proposed the First Banks of the United States is well known. In the *Report on the Public Credit*, Hamilton suggested that “If all the public creditors receive their dues from one source... their interests will be the same. And having the same interests, they will unite in support of the fiscal arrangements of the government.” As Lance Banning said of Hamilton’s logic: “It is hard to imagine how by deliberate intent, Alexander Hamilton’s economic program for the new republic could have been better calculated to exacerbate these [commonwealth] fears... they inevitably brought to mind the entire system of eighteenth-century English governmental finance, with all the consequences that entailed for minds shaped by British opposition thought.” (1978, p. 128)

Was Hamilton attempting to systematically corrupt national politics? I suspect not. The long quote from Hume recounted earlier suggests a reasonable alternative view in which strengthening the executive in relation to the legislative branch could be seen as maintaining balance. In the 1790s, the national constitution and the state constitutions could be interpreted as giving undue weight to legislatures (Wood, 1969, but also Kruman, 1997). What is certain is that the bank was a tipping point in the political contest within the administration that resulted in the formation of a competitive political party by Jefferson and Madison. By 1792, Madison could see his ideas about the extended Republic overturned. Not only did the Federalist party control all three branches of the national government, but a faction within the party had become ascendant.<sup>11</sup> The irony of forming a political party to oppose the actions of a political faction

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“the success of the Federalist Party in gaining control of all three branches of the national government called into question the fundamental premise of the Madisonian federalism

were not lost on Madison, who wrote a series of articles that appeared in the *National Gazette* defending the formation of the Democratic-Republicans.<sup>12</sup> Madison's logic parallels the depiction of republican thought from the previous section:

In every political society, parties are unavoidable. A difference of interests, real or supposed, is the most natural and fruitful source of them. The great object should be to combat the evil: 1. By establishing a political equality among all; 2. By withholding unnecessary opportunities from a few to increase the inequality of property by an immoderate, and especially an unmerited, accumulation of riches; 3. By the silent operation of laws which, without violating the rights of property, reduce extreme wealth towards a state of mediocrity and raise extreme indigence towards a state of comfort; 4. By abstaining from measures which operate differently on different interests, and particularly such as favor one interest at the expense of another; 5. By making one party a check on the other so far as the existence of parties cannot be prevented nor their views accommodated. If this is not the language of reason, it is that of republicanism. (Madison, *National Gazette*, Jan. 23, 1792, as reported in Banning, 2015).

The problem of equality among unequals appears in the first days of the new republic. Would competition between political parties be the solution to maintaining balance?

Massachusetts was a leading state in the movement to charter banks and expand the financial system following the revolution. As Dick noted in his 1985 paper, while Massachusetts

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of 1787-8: that durable factious majorities would be far less likely to coalesce at the national level of politics...." Ferejohn, Rakove, and Riley, 2001, , p. 3.

<sup>12</sup>

"A final aspect of these essays is worth remark, since it represents a strain in Republican thought which we encounter again and again: it is the effort to reduce the issue between the two sides to a dispute over the merits of republican government. Today this seems a false question; the issues of funding, assumption, the bank, taxation, and foreign policy seem real and substantial enough without superimposing on them an artificial quarrel over a question of monarchy and hereditary power which all but the tiniest handful of Americans agreed. But the exaggerated passions of both sides can be understood if we remember that most politically conscious Americans were acutely aware of being involved in a political experiment in republicanism that was attended by difficulties of the most acute kind and that might face many hidden and unpredictable pitfalls. Both sides were nervous about the stability of republicanism in an extensive federal union pervaded by many differences of sensibility and interest." Hofstadter, 1968, p.p. 84-5.

started out limiting banks, partly to protect the state's financial investment in the first bank it chartered, " After 1820, Massachusetts had essentially free banking in the general sense of that term, and the state remained a leader in terms of numbers of incorporated banks and capital invested in banking enterprises for several decades." (p. 111) Dick, John Legler, and I (1994) explained the variation in the number of banks across states by the interaction of taxation and regulation. Massachusetts levied a tax on bank capital in 1812, which by the 1830s generated roughly half of Massachusetts state revenue (Sylla, Legler, and Wallis, 1987). In contrast, Pennsylvania received a substantial amount of its revenue from selling bank charters and dividends on the bank stock it owned.<sup>13</sup> Pennsylvania had many fewer banks than Massachusetts, because of its fiscal interests encouraged them to limit entry to make charters more valuable and dividends higher. Massachusetts also had more banks than New York, where a political faction was manipulating the granting of bank charters for political purposes, discussed below.

We did not know where the tax on bank capital came from, however. The standard sources, Handlin and Handlin (1945, 1969) and Dodd (1954) noted when the tax came into force, but not why. Several years ago a graduate student of mine, Qian Lu, began looking into the history of how access to organizations opened in the United States and he started with Massachusetts.<sup>14</sup> What Lu found was surprising. In 1810, Massachusetts had granted 22 charters to banks, all but one of the banks was dominated by Federalists. Democratic-

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See Anna Schwartz, 1947, for a discussion of banking in Pennsylvania.

<sup>14</sup>

Qian's dissertation was completed in 2014. See Lu and Wallis, 2016, for an analysis of the Massachusetts data.

Republicans complained that they could not get bank charters and they continued to petition the legislature for charters, but none were forthcoming. In the legislative session of 1811-1812, for the first time in Massachusetts history the Democratic-Republicans controlled both houses of the legislature and the governorship (Eldbridge Gerry). In 1812, all of the bank charters of existing banks, with one exception the original Massachusetts Bank, were set to expire. The banks petitioned the legislature for charter renewals. The Democratic-Republicans, in the majority for the first time, refused to recharter any of the existing banks. Instead they chartered a new State Bank. The directors of the new State Bank were all Democratic-Republicans. The new bank was reform bank. It was a very large bank, \$3 million in capital, \$1 million owned by the state. A key reform element was the imposition of tax of ½ a percent on the capital of the State Bank, intended to generate a fiscal return to the taxpayer rather than lining the pockets of Federalists elites. In that, the capital tax was very successful. The second reform element was a provision requiring all subsequent banks chartered in the state to include the tax on bank capital. The bank capital tax was included when the Federalist banks were rechartered in 1812 (the Federalists regained control of the Governorship and the Assembly in the elections of 1812.)

Qian dug further. He was able to identify the names of all the bank presidents and directors of the Boston banks, as well as the names of the presidents and some directors of banks outside of Boston, in the Massachusetts Almanacs. He linked the names of the bank directors to the members of the state legislature. To our surprise, between 75 and 80 percent of all the bank presidents and directors we could identify before 1812 had at one time in the past, or would in the future, serve as a state legislator. The Federalist party in Massachusetts was systematically

corrupt. The bankers and state legislators were not just associated with one another in a political coalition, they were the same people.

As Dick suggested, by the 1820s, Massachusetts had adopted an essentially free banking regime, without a free banking act that allowed anyone to get a bank charter through an administrative procedure (a general incorporation act for banking was passed in 1851, but few new banks were chartered under the act, they already had open entry). The state moved to the situation depicted by the black bar in Figure 2. In a series of acts mirroring the provisions of the act creating the State Bank in 1811, the legislature standardized all banking charters and eventually required that any new charter than contained a provision not in an existing charter, would automatically apply to all existing banks. In 1829 the state passed a general regulatory act requiring all bank charters to be the same.<sup>15</sup> Massachusetts had not only created open entry into banking, it created impersonal rules for banking as well.

Two aspects of the political debate in Massachusetts deserve a bit more attention. First, the struggle was not between an elite moneyed interest and the masses of people. The Democratic-Republicans not getting bank charters before 1811 were just as elite as the

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<sup>15</sup>New bank charters formally became standardized on February 29, 1829 with the passage of the general regulatory act: "An Act to Regulate Banks and Banking." The Act required "That from and after the passing of this Act, every Bank which shall receive a Charter, from or by the authority of this Commonwealth, and every Bank whose Capital shall be increased, or whose Charter shall be extended, shall be governed by the following rules, and subjected to all the duties, limitations, restrictions, liabilities and provisions, contained in this Act." Massachusetts, 1831, Chapter XCVI, "An Act to regulate Banks and Banking," Section 1, pp. 145.

That language appeared in bank charters as early as 1821, Worcester Bank. Massachusetts, 1821, Chapter 26, "An Act to incorporate the President, Directors, and Company of the Worcester Bank."

Federalists who got them. In addition to the State Bank, Massachusetts also chartered the Merchants Bank of Salem, in 1811. Joseph Story, who was named an Associate Justice of U.S. Supreme Court in 1811, was a director of the Merchant Bank. Story served as the Merchant's Bank's President from 1815 to 1835 (while also serving as Associate Justice). Benjamin Crowninshield, the first President, was a director of the BUS branch in Boston and a director of the home bank in Philadelphia. Crowninshield stepped down in 1815 when he became Secretary of the Navy. These were politically powerful moneyed elites who, nonetheless, found themselves shut out of banking by the political dynamics of early 19<sup>th</sup> century Massachusetts. The contests over banking were not between moneyed elites and Jacksonian egalitarian populists, they were intra-elite conflicts at heart with a large dash of democratic rhetoric on the surface.

The second aspect is the very loose relationships between party identification and support for, or opposition to, banking. There were Federalist bankers and Democratic-Republican bankers. Although the Democratic-Republican opposed the creation of a national bank, they were not, *per se*, against banking. Banking was very often a partisan issue, both at the national and at the state level. Yet, the pro- and anti- banking positions were not consistently identified with one party or the other. Both parties in Massachusetts were pro-banking, but the supporters of only one party were able to get charters. Andrew Jackson was clearly anti-bank in 1832 and later, but there were plenty of Democrats in the House and Senate and throughout the country who supported banks. There were states dominated by Democrats with banking systems dominated by Democrats. Pro- and anti- bank forces in a given state were much less the creatures of party, than they were created by internal division within commercial and political

elites using state policies to favor one elite group or coalition over others. Political parties, on the other hand, were often creatures of the divisions within elite factions, there were often pro- or anti-bank factions in the same party. New York, right next door to Massachusetts, developed a banking party tied to the Democratic-Republicans and against the Federalists, shortly after the Federalist bankers dominated Massachusetts politics and banking. The desire to identify pro- and anti- banking leanings with political parties has caused some distortions in the political history.<sup>16</sup>

Howard Bodenhorn (2006) has recently told the story of how the Albany Regency, a political machine organized by a group of New York politicians that included Martin Van Buren, used the chartering of banks to build a political organization that dominated New York politics for several decades. The Albany Regency was part of the Democratic-Republican coalition that became known as the “Bucktail” party (for wearing bucktails in their hats), that became a key element in the Democratic party in the late 1820s. The story has been told before, particularly by Benson (1961), but not by a scholar who understands banking as well as Bodenhorn and is able to speak directly to the earlier generation of banking scholars who saw the New York Free Banking Act of 1838 as the result of egalitarian Jacksonian Democracy, (particularly Redlich, 1969 and Hammond, 1957). The Regency took advantage of a provision in the 1821 New York constitution requiring a two-thirds majority in both houses to charter a bank. Only the Regency coalition was able, in some years, to get a two-thirds majority and when they did, they gave bank

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<sup>16</sup>

For example, Sharp (1970) understands that important developments in banking occurred at the state level, but showing the link between the Democratic party and anti-bank sentiments is the goal of his book, *The Jacksonians versus the Banks*. This distorts the history by only focusing on divisions that are limited to partisan divisions, not coalitions within elites.

charters only to their political allies. In 1829, under the guidance of the Regency, the legislature created the Safety Fund, under which banks paid premiums of 6% of their capital into an insurance fund. The number of banks increased after 1830, but as Bodenhorn shows, New York still remained “woefully financially underdeveloped compared to its financial rivals.” (p. 239) As well, divisions within the Bucktail Democrats began to appear in the early 1830s.

In the wake of the Panic of 1837 and the election of a Whig legislature, a coalition of Whigs, Anti-Masons, and Locofoco’s combined to pass the Free Banking Act of 1838.<sup>17</sup>

Although party divisions played an important role, as well as the general movement toward more open and egalitarian policies, the move toward free banking was pushed by elite and middle-class interests who had been unable to crack open the Regency coalition.<sup>18</sup> Bodenhorn reaches

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“Ultimately, free banking represented the confluence of Anti-Masonic populism, Democratic pragmatism, and pro-business American Whiggism.” Bodenhorn, p. 232. A proposed “repeal of the Safety Fund system came from a Democratic splinter group known as the Loco-Focos (or, sometimes, the Equal Rights Party). These were mostly tradesmen and small entrepreneurs in New York City who believed that the current system threatened their economic well-being. They believed that economic independence was based on property ownership.... And more than anything else, equality of opportunity implied equality of access to bank credit. The elimination of chartered commercial banking and its replacement with private banking was the best means to achieve this end.” Bodenhorn, p. 250.

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“But Anti-Masonry had little to do with radical agrarianism. Instead, it was the political manifestation of a growing discontent among western merchants about lack of access to banks and bank credit.” Bodenhorn, p. 247. “Indeed, support for Anti-Masonry was stronger in townships with more improved acreage, higher population densities, and higher values per acre. Anti-Masonry’s leaders were mostly drawn from the middling to upper classes of western and southern New York—regions where the transportation and financial revolutions had not yet fully arrived.” p. 248. “Anti-Masonry’s appeal and, therefore, its political legitimacy grew because reasonable men believed that Freemasonry disproportionately influenced the administration of justice (Vaughn 1983). Several sheriffs, prosecutors, judges, and other officials involved in the investigation and prosecution of the crime were Masons. Most discharged their duties fairly and impartially, but others manipulated the system to protect fellow Masons. Formisano and Kutolowski (1977, p. 153) conclude that a widespread conviction that there had

the conclusion that “Free banking—and, later, general incorporation— was but one consequence of the leveling impulse in New York” as do all of the histories that I know. The actual enactment of the Act the result of a coalition not of leveling interests, however, but a coalition of middle and upper class groups who found themselves faced with a government like Figure 1, where intra-elite competition led to influential groups losing their influence. Those groups experienced “unequal treatment of equals.” In New York, as in Massachusetts, the solution was to tie the hands of the legislature and require them to offer the same corporate privileges in banking to any group that met minimum requirements through an administrative procedure.

Arkansas became a state in 1837, and in more than one way it at the opposite end of the country from Massachusetts and New York. In 1837, the state invested in two banks, the Real Estate Bank of Arkansas and the State Bank of Arkansas. Neither bank was a financial success, and both banks suspended payments in 1841 on state bonds issued on behalf of the banks. After a lengthy lapse, Arkansas made some restitution on its bonds in 1869, but the state essentially repudiated the remainder of its debts. In 1885, the state amended its constitution to prohibit further payment on the 1830s bonds: “The General Assembly shall have no power to levy any tax, or make any appropriations, to pay either the principal or interest, or any part thereof, of any of the following bonds of the State, or the claims, or pretended claims, upon which they may be based...”

We know quite a bit about the operation of the Real Estate bank. As a result of wrangling over repayment of the debt, the state Accountants audited the bank’s books in 1856.

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<sup>19</sup> been “a systematic corruption of justice . . . was far from fantastic.” p 246.  
Arkansas Constitution of 1875, as amended effective January 14, 1885. Wallis, NBER/Maryland Constitution project.

Worley (1950) analyzed *The Report of the Accountants*. The Real Estate Bank was designed to benefit a small group of wealthy Arkansas landowners. Stockholders purchased stock with mortgages on their land, and then had privileged borrowing rights at the bank: “The stockholder could not only borrow first but pay back last; stockholders could borrow for twenty years, non-stockholders for only ten... Actually only 284 individuals became stockholders. The charter of the bank provided the legal foundation upon which a system of privilege was built which operated for the benefit of this small group.” (Worley, p. 405). In 1842, the stockholders owed the Bank \$1,499,671.90 compared to only \$423,571.56 owed by non-stockholders.<sup>20</sup> There is clear evidence that the bank regularly allowed stockholders to purchase stock with mortgages based on over valued assessments of land value. The bank eventually foreclosed on mortgages for land that was appraised in 1837 at \$856,335, which later sold for only \$80,235.<sup>21</sup> Those stockholders were able to purchase ten times more bank stock than they could have had their lands been truly valued, and stockholders were able to return to the bank and obtain loans for new land purchases.

The evidence that the Real Estate Bank and the state government was controlled by a small group of interconnected families is overwhelming. John Wilson was the Speaker of the House and first President of the Real Estate Bank. Wilson was forced to resign from both position when he stabbed and killed Representative Joseph J. Anthony on the floor of the House on December 4, 1837. Anthony and others had earlier challenged Wilson’s method of

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<sup>20</sup>

See *Report of the Accountants*, p. 27 and Worley, p. 414. I have been unable to obtain a copy of the *Report of the Accountants*, and so repeat Worley’s citations and page numbers.

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*Report of the Accountants*, p. 85 (Worley, p. 406).

apportioning shares in the stock of the bank. When Anthony rose to speak on that day, to make a point that he was never allowed to voice, Wilson crossed the floor of the House, drew a knife, and stabbed him dead. Wilson was charged with murder, but was never convicted (Worley, pp. 409-11). The Sevier family provided a critical link: "Political control, and therefore bank control, was to a remarkable extent in the hands of a group of related families. The group's influence during the state banking period was centered in Sevier's political prestige. The related families were variously known as the 'Bourbon Dynasty,' 'Sevier's hungry kinfolks,' or simply as 'the family.'" (Worley, p. 413) Just as in New York, bank chartering was a tool of political manipulation for the benefit of a small faction that controlled the political system. It was systematic corruption.

The repudiation of the Arkansas bonds was linked to the establishment of the Real Estate Bank. In the wake of the state default, the *Arkansas State Gazette* commented: "We believe that the people of Arkansas would stand direct taxation *for State purposes* as cheerfully as any people in the Union; but that we should be taxed to pay the debts of the most *aristocratic* monopoly of land holders in the United States is unbearable." An elite group manipulated economic benefits to obtain, and maintain, political control.

Arkansas, New York, and Massachusetts were not alone. Of the \$115 million in bank capital in southern and western states in 1837, perhaps as much as \$60 million had been invested by state governments.<sup>23</sup> There were monopoly, or near monopoly, state banks in Indiana,

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February 17, 1841, as quoted, with emphasis, in Worley, p. 423.

<sup>23</sup>

The \$60 million is estimated simply by taking the amount of state debt issued to invest in banks. See Wallis, Sylla, and Grinath "Sovereign Debt."

Missouri, Illinois, Alabama, and Arkansas.<sup>24</sup> Banks owned completely or largely by state governments dominated the banking systems in Kentucky, Florida, Mississippi, and Tennessee -- these four states also chartered other banks in which the state did not invest. States throughout the west and south either prohibited entry altogether by creating a monopoly state bank(s), or created a few banks with enormous advantages over their competitors because of the scale of state investment and the state's financial patronage.

I saved Andrew Jackson for last. Jackson changed the American Presidency by asserting his position as the only official elected by all of the people to significantly increase executive power in relationship to legislative power. Jackson's veto of the bill rechartering the Second Bank of the United States played a pivotal role in the shift of power. Jackson's opposition to the Bank was not, initially a party issue, it was a personal one.<sup>25</sup> When Jackson told Democrats in Congress to support his veto or suffer his wrath as a party leader, then his veto became a partisan and party issue in the presidential election of 1832. Pro-bank Democrats throughout the country remained pro-banking and continued to play key roles in state promotion of banking. But times were changing.

Jackson devoted almost half of his farewell address on March 4, 1837 to the question of currency, banking, and corporations.<sup>26</sup> In light of the brief history presented here, Jackson's

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The state was the primary owner/investor in both of the two banks in Illinois and the two banks in Arkansas (Arkansas is discussed in the next section). The state bank in Alabama dominated state finances and the banking system, see Brantley, *Banking in Alabama*.

<sup>25</sup>

See Remini, Sharp, and .....

<sup>26</sup>

Richardson, 1897. *The Messages and Papers of the Presidents (With Additions)*. The farewell address is on pages 1511 to 1527, and banking takes up from page 1520 to the end. of

descriptions of the danger facing democracy echo the fears of faction and corruption of the founding generation, but an echo that comes back in a different key.

In reviewing the conflicts which have taken place between different interests in the United States and the policy pursued since the adoption of our present form of Government, we find nothing that has produced such deep-seated evil as the course of legislation in relation to the currency. (p. 1520) It is one of the serious evils of our present system of banking that it enables on class of society – and that by no means a numerous one – by its control over the currency, to act injuriously upon the interests of all the others and to exercise more than its just proportion of influence in political affairs. (p. 1524) The mischief springs from the power which the moneyed interest derives from a paper currency which they are able to control, from the multitude of corporations with exclusive privileges which they have succeeded in obtaining in the different States and which are employed altogether for their benefit; unless you become more watchful in your States and check this spirit of monopoly and thirst for exclusive privileges you will in the end find that the most important powers of Government have been given or bartered away, and control over your dearest interests has passed into the hands of these corporations.

The paper-money system and its natural associations – monopoly and exclusive privileges – have already struck their roots deep in the soil, and it will require all your efforts to check its further growth and eradicate the evil. The men who profit by the abuses and desire to perpetuate them will continue to besiege the halls of legislation in the General Government as well as in the States, and will seek by every artifice to mislead and deceive the public servants. (pp. 1525-6). You have no longer any cause to fear danger from abroad; your strength and power are well known throughout the civilized world, as well as the high and gallant bearing of your sons. It is from within among yourselves – from cupidity, from corruption, from disappointed ambition and inordinate thirst for power – that factions be formed and liberty endangered. It is against such designs, whatever disguise the actors may assume, that you have especially to guard yourselves. (pp. 1526-7)

Jackson's message is not about the inevitability of different and unequal interests that must somehow be balanced; it is not about the operation of those forces within government that must be balanced; it is about the effects of the moneyed interests on the government, who "will seek by every artifice to mislead and deceive the public servants." Jackson lives in the world of Figure 2, not Figure 1. He draws on the terminology of the founders, but he speaks a different language. In Jackson's rhetoric, one homogenous elite group is arrayed against the people.

Jackson's message is about the necessity to abolish special and exclusive privilege else Americans "find that the most important powers of Government have been given or bartered away, and control over your dearest interests has passed into the hands of these corporations." Jackson is a democrat, not a republican. He is a modern, not a founder. That text could be cut and pasted into the text of any number of editorials in the wake of the Citizen's United decision.

Economic historians are familiar with Jackson's ideas. Indeed, as Dick Sylla suggested in his review of Redlich's book that perhaps the time was coming, 1972 no less, that we could begin to move past the "castigation of fraud and dishonesty in banking matters," and begin to consider the role of banks in promoting growth and development. But getting past Jacksonian rhetoric is not enough. In none of the state histories discussed here did Jacksonian egalitarian democrats rise up and demand the end of banks and paper currency. In each state, disaffected "middling and upper class" were upset by the abuses of a class of people just like themselves. They were losing in the game of political competition and were unable to garner the benefits and privileges that their peers were receiving because those privileges were instrumental to the maintenance of a political machine or coalition. They were facing systematic corruption, the use of economic privileges to form and hold together a coalition on the basis of rents that required limited access, for some groups to be excluded.

Democracy made intra-elite competition more virulent and unpredictable than elite competition under the aristocratic patronage of the British Whigs. Americans either needed to go backwards to the older system, which few if any wanted to do, or they needed to fix the way democracy worked. Just how that was to be done lay in the seeds of the Massachusetts solution worked out after 1812.

#### IV. Banks and Democracy

The rhetorical power and normative force of Jackson's appeal against privilege and in favor of equality has lost none of its force since the 1830s.<sup>27</sup> But it can very easily lead us to lay the rise of American democracy at the feet of Jacksonian populism, a triumph of the masses over the elites. Since, with exception of Thomas Paine and some strains of Thomas Jefferson, the founding fathers all feared the kind of corruption that resulted from intra-elite competition becoming unbalanced. We need to go some distance as economic historians before accepting the idea that the emergence of open entry into the corporate form in banking resulted from the triumph of an egalitarian political ideology. There are lots of history out there that suggest that equality triumphed including a lot of economic history. But such an interpretation misses the natural political economy of Dick Sylla's insight that early 19<sup>th</sup> century American banking was not fraudulent, dishonest, and corrupt but actually contributed to economic growth *and political* development. The question seems to be how it did so, because the seeds were not planted in what Alexander Hamilton or the founding generation wrote, did, or said.

In 1811, Massachusetts was looking down the throat of a politically induced collapse of their financial system. The situation in Massachusetts was unique, as all such situations are. The kind of political shock that occurred in Massachusetts would not be surprising to us, parties lose elections all the time and governments change partisan hands. It was, however, the first time it had happened in Massachusetts and the results were extraordinary.

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<sup>27</sup>I will not attempt to sort out how an appeal to small government is being used to promote the interest of financial and other large corporations in the first decades of the current century, just note that the ideas still have power.

In every society, the configurations of political coalitions continuously adjusts to changes in circumstances. The social, political, and economic systems in Britain and France in the 18<sup>th</sup> century had developed considerable resilience in the face to such changes, but the resilience was built into the rents that privileged groups enjoyed. The fear of civil war, so clearly expressed in the 18<sup>th</sup> century, was a fear of situations where rents disappeared for some groups, either by chance or because of manipulation, leading some groups to cease coordinating and perhaps leading to civil war. Whig fears of corruption were not based on the fear that the rents were being obviously and systematically manipulated.

In all three state cases presented here – Massachusetts, New York, and Arkansas – political groups manipulated the economy to maintain control of the polity. The unfortunate comments of Alexander Hamilton in the Report on the Public Credit merely gave the appearance of intending such manipulation, yet they gave rise to severe anxiety about the course of American democracy. Very few of the new political innovations in the initial American constitutions worked to limit systematic corruption. The 19<sup>th</sup> century is full of complaints about corruption. Unfortunately, economic historians have a particularly bad ear for such complaints: didn't people realize the industrial revolution was underway and growth was just around the corner? We know how the story ends, what were they worried about?

What these historians fail to see about the complaints is what Bailyn saw about the ideological debates that led to the Revolution: people were not paranoid, they really believed that they were in danger of tyranny and slavery. The corruption they feared really existed and threatened their political arrangements. We have not extended the same courtesy to the early 19<sup>th</sup> century. In part, this is because our histories focus almost exclusively on the national

government. For reasons that the example of the two Banks of the United States make clear, it was difficult, almost impossible politically for the national government to pursue policies or projects that involved significant manipulation of or investment in the economy. The proponents of investments were too liable to charges of corruption. In the end, when two geographic groups accused other of systematically corrupting the process of national government, the grand evil conspiracies of both the North and the South, the Civil War resulted.

At the state level it was possible to work out arrangements between groups that facilitated state involvement in the economy. There were many dimensions to this involvement, but as Callender pointed out in 1902, by far the largest financial commitment was to investments in canals and banks. There is a parallel history of transportation infrastructure (Wallis 2005) that by no means exactly traces out the history of banking. In no state was infrastructure as profitable to either state governments or private investors as banking. In no states did potential investors come to state governments, with money in hand willing to pay the states for transportation charters, as they did in bank charters in the Northeast (Wallis, Sylla, and Legler 1994). As the Massachusetts Federalists and the New York Albany Regency Bucktails knew, bank charters were a license to print money and a way to tie together commercial and economic interests in a network of credit relationships. Banks, particularly when only one bank served a community or a segment of the economy, were marvelous instruments for coordinating the political preferences of men. States did not resist the temptation to use banking to assemble and integrate a political coalition.

The Massachusetts legislative and historical records in the 1810s are not as clear as the records of state legislatures and governors reports in the 1830s when states began investing in

canals, or in the state constitutional conventions in the 1840s when states began mandating that legislatures pass general incorporation acts, as well as changing the way that states borrowed and taxed. Whether Massachusetts expected that moving to free entry for banks with the same corporate privileges would prevent the political manipulation of banking that occurred under the Federalists before 1811, and perhaps avoid another crisis like 1811, is not clear. What is clear is that they moved to a partially *de jure* partially *de facto* open entry banking regime after 1813. Gradually Massachusetts and other New England states moved towards a general incorporation institutions for more than banks, but a wide range of economic and social organizations, and did so through legislation. States in the rest of the country moved toward similar economic institutions, often preceded by constitutional changes (Wallis, 2005).

Creating economic institutions that allowed any one to enter banking and to enjoy both the supports and restrictions of laws governing the operation of their banks and organizations was explicitly designed to achieve political, not economic, ends. Free banking does not result from an inevitable unfolding of the founder's ideas, it is a hard won solution to a set of serious problems when a society decides to choose and regulate its governments through majoritarian democracy. For the most part, neither political nor economic history has seen the problems that democracy poses for economic development, despite the importance of rent seeking in political economy. If an economic investment or rule benefits a minority of the population it can be used to influence the interests of that group and coordinate the group within a political coalition. Voting exacerbates intra-elite competition, it does not reduce it. Americans came to understand this in the 1830s, and in the 1840s they moved to solve the problem by limiting the discretionary power of state legislatures to give economic privileges to some groups and not others. The

institutional form was a “general” incorporation act or a “general” law, that is, a law that applied equally to everyone. Under a general law, the rules governing entry into a line of economic, social, religious, or political activity were the same for everyone. It was open entry.

The limits on the discretion of the legislatures had a direct and an indirect effect, both of them powerful. The direct effect changed the dynamics of the legislative process by reducing the ability of legislatures to create benefits for small groups that would ease the process of reaching legislative compromise along. Both legislatures and voters had to be clearer about the intent of laws or projects, and to agree in a more transparent way about the costs and benefits of political actions. Second, and I suspect in the end more important, allowing open access to organizations changed the political dynamics in the larger society within which politics functions. Banks, businesses, canals, railroads, schools, churches, and towns were allowed to form in a sometimes chaotic mix of what earlier economic historians have called creative destruction and a release of energy. This new energy went into increased economic activity and growing income, but it also went into a more active, competitive, and broad based political activity.

By themselves, democracy and election do not produce modern development. Modern development occurs when political institutions are paired with economic institutions in a way that made democracy sustainable. A competitive economy is necessary for a competitive polity. In the United States, experience with banking taught the states a series of lessons. It was banks, and democracy.

Figure 1

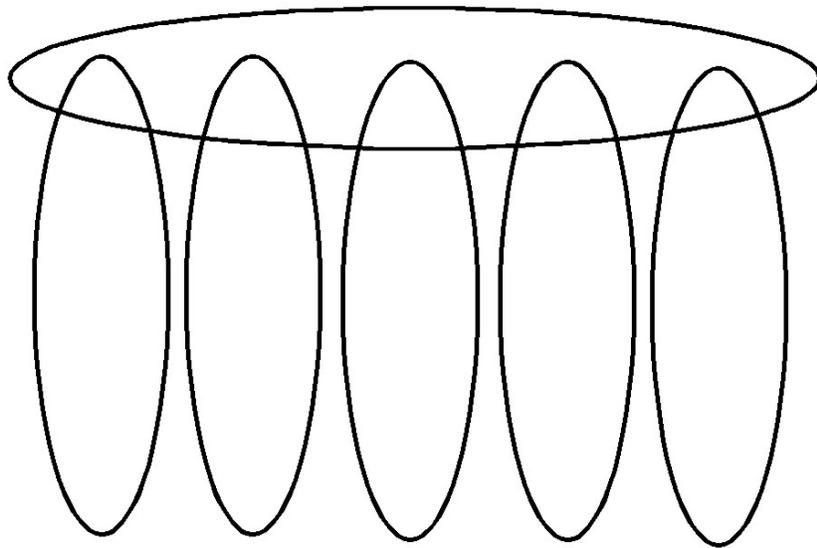
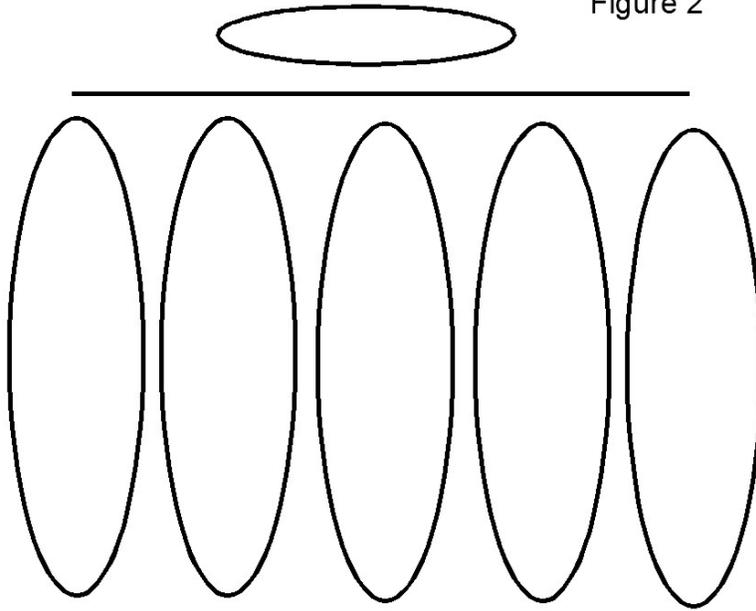


Figure 2



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