Banks and State Public Finance in the New Republic: The United States, 1790–1860

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The U.S. Constitution, by taking away the power of the states to issue paper money, removed a major source of flexibility in state public finance. In their search for new sources of revenue and fiscal flexibility, the states discovered that the banks they chartered could fill the gap. Investment earnings and tax revenues derived from banks soon became major elements of state public finance. We discuss the nature of these early business-government relationships and provide the first systematic assessment of their relative importance in state finance.

Adoption of the Constitution in 1788 created potential problems of public finance for the states of the union. The new plan of government removed the states’ powers to tax imports and exports. It also took away their rights, developed in practice during the previous century, to issue paper money. Paper money issues provided an important element of flexibility to colonial and state governments—and also to the national government during the American Revolution. These issues could be used to finance government activities during military emergencies and in economic depressions, when the cumbersome and protracted collection of traditional taxes on property and polls was not feasible. Paper issues were used as well to fund loans and grants to individuals and institutions for purposes deemed worthy. Paper money also supplied a medium of exchange for the growing economy at low resource costs. The money-issuing practices of American colonial and state governments were so widespread and popular that they have been described as a system of “currency finance.”

Although the states lost taxing and money-issuing powers as a result of the Constitution, they also gained financially under its early opera-
tion. Most of their debts, legacies of the Revolution, were assumed by
the new federal government in accordance with Hamilton’s plan.
Moreover, the settlement of state accounts in 1795 benefited all of the
original states, whether they were creditors or debtors. The “creditor”
states were paid their balances due in income-yielding federal securities.
The “debtor” states were not required to—and did not—pay the
corresponding amount of balances owed. Thus, by the mid-1790s a
heavy burden of debt had been removed from all of the state govern-
ments. In the following years they were able to provide basic govern-
ments and service their small remaining debts with no real difficulty.
What was not replaced or provided for in the new scheme of
constitutional government was the flexibility of currency finance. Prop-
erty and poll taxes were sufficient to provide minimal state governments
but remained cumbersome and unpopular. The states were thus left
without the financial ability to provide for more than basic governmental
functions. A substitute for currency finance soon appeared, however,
and was adopted quickly by some of the states and more slowly by
others. The substitute was banks. The ability to create money has an
economic value, as the colonies and states learned when they practiced
currency finance. Although the states could no longer legally create
money after 1788, they could charter banks that created money. The
problem for the states thus became one of finding ways to appropriate
some part of the value of banking privileges.
The literature of U.S. banking history pertaining to the era of state
banking from the 1780s to the 1860s is rich, but it has tended to neglect
the role banks played—or were forced to play—in state public finance.
In an anecdotal way it is known that banks paid a tax here and a bonus
or a bribe there for the privileges granted in their state charters. It is also
known that on occasion states owned stock in banks and perhaps even
owned and operated banks. But the questions usually addressed in the
banking history literature have to do with the private and public
functions of the banks themselves. Seldom has the focus been on the
questions of how and to what extent banks were involved in state public
finance.
We are currently engaged in a project to reconstruct on a quantitative
basis the history of U.S. state and local finance, emphasizing the
relatively dark statistical age before 1900. An impression from our work
thus far is that the states’ substitution of “bank finance” for “currency
finance” deserves the attention of economic historians. We here review
how and to what extent each of the thirteen original states and also

2 Two summary accounts of bank-and-state financial relationships in the antebellum period are
given by J. Van Fenstermaker, The Development of American Commercial Banking, 1782-1837
(Kent, 1965), chap. 3; and John Anthony Muscalus, “The Use of Banking Enterprises in the
Maine and Vermont turned state-chartered banks into integral components of their public finances between 1790 and 1860. We also present quantitative estimates of the importance of bank-derived revenues in each state’s public finances.

HOW THE STATES USED THE BANKS

Early American states turned the banks they chartered into instruments of state finance in two broad ways—by investing in banks and by taxing them. Investment was relatively more important in the early antebellum decades; taxation became more important in the later ones.

State investment in banks could take the standard form of purchasing shares either when a bank was launched or later in time. A few banks were wholly owned and operated by some states. Others chartered banks with the stipulation that shares be reserved for state purchase at later dates; in some cases the shares were eventually purchased and in others states sold their rights to purchase shares at par value. Shares were reserved not only for state governments but also for other worthy institutions such as schools and colleges; these institutions often obtained their funds for investment in banks by means of lotteries granted by the states.

The most common form of bank taxation was a levy on bank capital. But bank dividends, deposits, and profits were also taxed. Another common practice was to require banks, at the time of granting original or renewed charters, to pay lump-sum bonuses to the state or, less commonly, to worthy non-state institutions. Bonuses, payments for the right to engage in banking under state charter, were essentially franchise taxes. But in some cases they took the form of stock, resulting in a mixing of the tax and investment categories of the relationship between state and bank.

The New England States

Massachusetts provides the clearest example among the states of the harnessing of banking to state public finance. Investments in the Union Bank chartered in 1793 and the Boston Bank a decade later totaled $1 million, making the state in 1812 the owner of more than one-eighth of the banking capital of Massachusetts. The shares were liquidated after the War of 1812 to discharge war debts, and the state ceased to be an investor in banks. But a tax of 1 percent per year on bank capital was

3 State governments also obtained frequent short-term loans from banks, but such normal banking operations, although obviously a substitute for currency finance, were seldom required in bank charters. Such loans, although convenient, were not a part of the state revenue base, and so we ignore them here.

introduced in 1812. With banking growth it became the main generator of state revenue. From 1820 to 1860 the bank tax typically provided half or more of all ordinary (that is, excluding borrowings) state revenues. State finances were in such excellent condition that the traditional state tax on property and polls was not collected between 1826 and 1830, 1832 and 1834, and 1846 and 1853.5

Connecticut invested state funds in bank stock starting in 1803, and it imposed a tax, paid by the state’s banks, on shares of stock owned by non-residents in 1814. The flow of bank dividends and taxes into the state’s treasury made up a share that rose from about one-tenth of revenues in the early years to about one-third in the early 1850s. The tax portion was relatively minor until the 1850s when a savings bank tax on deposits was imposed and when bonus taxes on new banks or banks increasing capital, previously paid to particular enterprises or institutions, were paid into the state treasury. In the late 1850s, the bank contribution to ordinary state revenues approached 50 percent.6

Ordinary state revenues, however indicate only a part of the Connecticut bank finance story. The state’s School Fund, established in 1795 with proceeds of Western Reserve land sales, began in 1814 to invest in bank stock. School Fund holdings of bank stock reached $200,000 in 1834 and a peak of $429,000 in 1856, constituting some 10 to 20 percent of the fund’s $2 million of capital in these years.7 Further, between 1814, when a bank was first required to pay a bonus, and 1854, when all bonuses were paid into the state treasury, numerous “off-budget” bonuses were paid to various institutions ranging from Yale University to the Connecticut Retreat for the Insane. The state also required banks to subscribe to stock in transportation companies and to lend to other causes deemed worthy.8 We do not have a detailed account of the off-budget bonus taxes, but casual inspection of the sums involved suggests that they approached or exceeded the ordinary tax and dividend revenues from banks, at least in some years.

Rhode Island levied a tax of 0.33 percent on bank capital in 1804, but the state’s banks lobbied successfully for its repeal the following year. The tax was revived in 1822 at the greatly reduced rate of 0.05 percent (50 cents per 1,000 dollars of stock at par). The rate of tax was increased from time to time, reaching the 1804 level in 1853. In 1831 a tax of 2.5 percent on increases of capital was imposed, and bonus taxes of 1.5 to

5 Ibid., pp. 141–42.
7 Muscalus, “Use of Banking Enterprises.” Lack of annual detail on School Fund revenues precludes us from incorporating these revenues in Table 1.
8 A partial listing of bonus and other requirements that were imposed by Connecticut on banks in this era is given in William F. Hasse, Jr., A History of Money and Banking in Connecticut (New Haven, 1957), chap. 3.
2.5 percent of capital were part of some bank charters. During the last two antebellum decades Rhode Island typically received one-half to three-quarters of its revenue from bank taxes and dividends.

**Maine** banks were taxed before statehood in 1820 when the District of Maine was a part of Massachusetts. The State of Maine continued the tax on bank stock. In 1831/32 a small amount of bank stock ($29,000) was purchased with monies received from the federal government for War of 1812 claims. This provided a dividend for the next quarter-century. From 1833 on, the bank tax was dedicated to support of schools. With the exception of a few years, bank-derived revenues provided 10 to 20 percent of Maine's ordinary revenues excluding borrowing.

**New Hampshire** invested $25,000 in the New Hampshire bank chartered in 1792, but the state treasurer's annual reports show receipt of bank dividends only from 1832 to 1841 and in 1846. A half-percent annual tax on bank capital in the state was enacted in 1821, and the proceeds were placed in a Literary Fund. The fund cumulated to $64,000 in 1828, when it was distributed to towns for support of common schools. Subsequent bank tax receipts were similarly distributed. As in Maine, bank revenues were usually 10 to 20 percent of combined ordinary and Literary Fund revenues between 1822 and 1860.

**Vermont** incorporated the Vermont State Bank in 1806, but its only capital was an advance from the state treasurer to buy plates and paper for manufacturing bank notes. The bank experienced difficulties a few years later, and the state had to levy a land tax to pay its bills. This is the clearest example we have found of the substitution of bank finance for currency finance; the differences in this case were minimal. In 1818 Vermont imposed in the charter of the Bank of Burlington a tax of 6 percent on profits. In 1825, the tax was extended to all banks and dedicated to a School Fund which was invested in bank stocks. Investments were suspended in 1833, and the state began to borrow from the fund to meet current expenses. By 1845 the state had borrowed most of the money in the fund. After determining that the School Fund as then managed would not be sufficient to provide much schooling, Vermont decided to cancel its debt to the fund by abolishing it. Vermont made less use of banks as instruments of public finance than any other state in our sample.

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**The Middle Atlantic States**

*New York* was among the first states to charter a state bank, and the state was an active user of banking charters to obtain a financial interest in the operation of banks within the state. Bank dividends reached substantial levels in the late 1810s. By 1830, however, the state general fund had completely liquidated its bank stock to meet current expenses.\(^{14}\) A Literature Fund and other special funds held some bank stock, but state borrowing from those funds depleted them to the point that they provided an insignificant share of revenues by the late 1830s. The only significant source of revenue derived from banks after 1830 was a bank tax, begun in 1839, used to underwrite a Bank Department. The bank tax was not intended to be a revenue producer; it was merely a user fee for the services provided to banks by the state.

*New Jersey* did not become involved with banks in a large way until 1811 when it imposed a tax on bank capital. The state at that time also began to purchase small amounts of stock in state-chartered banks, stocks that were held by the school fund. Bank dividends were a small but steady source of revenue until the late 1820s. The primary income earner was the bank capital tax, generating upwards of $10,000 annually until 1829 at which time the revenues from the tax were transferred to the school fund. Capital tax revenues grew steadily to over $30,000 by the 1850s, supplemented by occasional payments of bank bonuses. As a share of state revenue, however, banking sources reached their peak in 1831, when they supplied 32 percent of all state revenue. After that time bank revenues continued to grow, but were supplanted in importance by revenues from other state investments, particularly railroad stocks.

*Pennsylvania*’s significant holdings of bank stock comprised a major source of state revenue. Beginning in 1794, with the subscription of $1 million to the stock of the Bank of Pennsylvania, the state relied heavily on bank revenues for income. The state became a major holder of bank stock, receiving a peak total of $313,034 in bank dividends in 1815. Pennsylvania also received a number of large bank bonuses. In 1817 the state levied a tax on bank dividends. After fiscal crises during the 1830s, when the state was forced to liquidate its bank holdings, the dividend tax became a major source of revenue, yielding roughly $100,000 annually in the 1840s and over $200,000 in the 1850s.

*Delaware*’s bank revenues became the fiscal mainstay of state government. The state gradually built up its holdings in the Bank of Delaware and in the Bank of Pennsylvania. It was a large shareholder in the Farmers’ Bank which became the repository for state funds, particularly the federal surplus distribution much of which was put into interest-bearing bank accounts. The Fund for Establishing Schools was

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prominent in early bank investment, followed by the general state fund after 1810. By the late 1840s, revenues from banks were fully 70 percent of all state revenues.

Maryland had a long association of banking and state government, but early records unfortunately are more difficult to obtain than for most states. The state reserved the option to purchase stock in every bank it chartered, which it began to do in 1803 when it purchased 220 of its 600 reserved shares in the Bank of Baltimore. By 1811 it owned shares in every Baltimore bank. In 1819, the first year for which we have a reliable figure, the state earned $28,000 in bank dividends, a revenue consistently maintained into the early 1840s. This represented a capital investment of over $500,000 in the banks.

Maryland's early bank charters were timed to expire in 1815. The state then offered the banks a multi-part package, including extension of their charters until 1835. The law had several provisions. First, a tax of $0.20 on every $100 of paid-in capital was levied annually, the proceeds going to the Free School Fund. This tax was renewed and remained in effect until 1863, providing approximately $20,000 each year to the School Fund. A second provision required state-chartered banks to subscribe to the Cumberland Turnpike Road. Similar schemes to finance other public improvement projects were floated in subsequent years. The banks' capital subscriptions do not appear as state revenues, but Maryland banks did invest $1.5 million in public improvements. A third provision, was the granting of a monopoly to the existing Baltimore banks. The state agreed not to charter new banks in Baltimore until 1835, later extended to 1845 when the banks agreed to finance another turnpike project.

Bank dividends and the tax on bank capital provided between 18 and 25 percent of all Maryland revenue until the 1840s.

The Southern States

Virginia's government maintained close ties to the state's banking industry from the establishment of the Bank of Virginia in 1804 to the Civil War era. Ownership of bank stock, supplemented periodically by the issue of additional bank stock to the state, provided dividends that

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15 Bryan notes that "The bank reports made to the state Treasurer before 1828 were not published, and the statistical material for this period is quite unsatisfactory.... The original reports were destroyed 'with all that other rubbish,' as a state officer informed me." Alfred Cookman Bryan, History of State Banking in Maryland (Baltimore, 1899), p. 8. Hanna compiled his revenue and expenditure series for the years before 1825 from scattered reports in the Journals of the House and Senate. Unfortunately for us Hanna found it "necessary to exclude entirely the receipts from the Bank Tax of 1814, the product of this tax having been transferred directly to the 'Free School Fund' and not entered in the regular statements of the treasury." Hugh Sisson Hanna, A Financial History of Maryland, 1789–1848 (Baltimore, 1907), p. 127.

were the major source of bank revenue. They comprised roughly 10 percent of state revenues from the 1820s up to the end of the 1840s. Most of the state’s bank stock was held by the Literary Fund and the Fund for Internal Improvements, the former financing local schools and the latter public works, primarily canals.

North Carolina reserved the right to subscribe to some stock in the state’s first banks, those of Cape Fear and New Bern, which were chartered in 1804. The actual investments were made in 1807 and dividend revenues commenced in 1808. In 1814 North Carolina levied an annual tax of 1 percent on the par value of all the stock of the two banks owned by individuals. Stock of a third bank, the State Bank of North Carolina, was exempt from the 1814 tax because the state owned a larger part of it. Also in 1814 the state extended the charters of Cape Fear and New Bern banks, and took still more shares in their increased capitalization, partly as bonus and partly in return for giving its own treasury notes. From that time forward North Carolina was a major investor in its state banks and bank dividends typically were a quarter or more of ordinary state revenues. The bank tax provided another 10 percent of revenues until it was reduced in 1834. A Literary Fund, established in 1826, received the state’s bank stock in 1837. Augmented by further purchases with federal surplus funds, the fund’s bank stock comprised some two-thirds of its $1.7 million capital in 1838.

 Income was sufficient to enact a plan for common schools in 1839. Bank-derived revenues increased steadily into the late 1850s.

South Carolina established the Bank of the State of South Carolina in 1812 as a totally state-owned bank. The bank was capitalized with all of the assets of the state treasury, which consisted of U.S. Government debt, bonds and notes due the state, and the stock owned by the state in the two Charleston banks. Although the bank was founded to aid planter interests, there were legislative pressures to make profits. Further, by 1824 the legislature saddled the bank with responsibility for the payment of interest and principal on the state’s public debt. The bank’s profits do not appear as revenues in the treasurer’s reports but instead were paid into a sinking fund. For comparative purposes we have added the sinking fund revenues to the other state revenues to estimate total revenues.

Banking revenues, which consisted primarily of the State Bank earnings, accounted for slightly less than a quarter of total revenues during the 1820s with the share increasing to approximately one-third

during the 1830s through the mid-1850s, except for the later half of the 1830s when the share was slightly over 40 percent. Bank revenues declined in importance to 25 percent during the later half of the 1850s.

Georgia in its early years of statehood generated more than enough revenues through taxation, payments from the United States, and the sale of land to cover the average expenses of government. The surpluses were invested in bank stock with the intended “important advantages of simplicity and safety—of certain and easily realized income to the state, with a large and permanent utility to the trade and business of the people.”20 By 1818 Georgia had invested in banks a total of $1,005,000.21 Bank investments provided large surpluses in subsequent years. Ancient sources of revenue were dismantled and taxes reduced, yet a balance of nearly $35,000 remained in the Treasury at the end of 1828. For the next ten-year period, 1829 to 1838, bank dividends totaled $745,861.22

Bank revenues provided an increasing proportion of total state revenues from the early years of investment until the 1840s. The proportion of total revenues increased from roughly a quarter during the 1820s to nearly one-half during the early 1830s. During the later half of the 1830s, bank revenues actually provided a majority of state revenues. The use of banks as a rich source of revenue, however, was not without drawbacks. In 1821 Georgia instituted a policy of earmarking particular revenues to specific objects of expenditure; dividends on bank stock, for example, were earmarked for internal improvements, leaving little for other purposes. The policy worked without problem as long as economic expansion generated an increasing flow of bank dividends. This was the case in the 1820s and early 1830s, when large revenue surpluses and the prospect for future surpluses led the state to dismantle its traditional tax-based revenue system. In the late 1830s, however, economic contraction reduced the flow of bank dividends at the same time that public land sales were exhausted as a source of revenue. Georgia then attempted to solve its fiscal crisis by drawing on bank credit. The burdens placed on the Central Bank of Georgia to finance the public sector, including construction of the state-owned Western and Atlantic Railroad, could not be handled. When the Central Bank was unable to maintain its notes at par, it failed and had to be liquidated in the 1850s.23 Georgia’s reliance on bank revenues was greatly curtailed after the 1830s.

20 Report of the Commissioner appointed by Authority of the Legislature, on the Subject of the State Finances (Milledgeville, 1839), p. 11.
21 Ibid., p. 12.
22 Ibid.
23 Muscalus, “Use of Banking Enterprises,” p. 70.
SHARE OF STATE REVENUE DERIVED FROM BANKS

Our estimates of the shares of bank-derived revenues for the fifteen states by five-year periods 1794/95 to 1856/60 are presented in Table 1. The data underlying the estimates for the most part are taken from the annual financial reports of state governments. The revenue concepts employed are “ordinary revenues” net of loan transactions. Thus, we count bank dividends, taxes, and bonuses but not bank loans as bank-derived revenues, and we exclude loans from any source from ordinary state revenues. For most but not all states and years we have been able to calculate these desired magnitudes.

The data are incomplete in several ways. We have not yet located some of the earliest state financial reports. For example, we know from other sources that Massachusetts earned large bank dividends in the two decades after 1793, but we have no annual statements of total revenues for these years. Further, our data for some states include special fund (for example, school fund) revenues as well as general revenues, whereas data for other states include only the latter. As our work progresses we expect to refine the estimates in each of these areas, and to present and analyze the data in greater detail than is possible here.

What do the preliminary data indicate? In the 1830s Albert Gallatin said that Pennsylvania’s bank investments starting in 1793 allowed the state “to defray out of the dividends all the expenses of government without any direct tax during the forty ensuing years and till the adoption of the system of internal improvement, which required new resources.” The evidence of Table 1 shows that this was somewhat of an exaggeration. Nonetheless, Pennsylvania along with Massachusetts, Connecticut, Rhode Island, Delaware, North Carolina, South Carolina, and Georgia did rely for extensive periods on significant amounts of bank revenue—a third or more of all ordinary state revenues. Vermont, New York, and Virginia were the only states not to have derived at least 20 percent of their revenue from banks in at least one quinquennium. For all states and all years surveyed here, about one-fifth of state revenues were derived from banks. The intimate relationships between banks and state public finances in the early decades of the republic are evident. Future research should explore in more detail the implications and ramifications of these early business-government relationships. In particular, it would be useful to have a better understanding of state-to-state and regional variations in the exploitation of banks for public revenue, and of the effects of this exploitation on the nature of the emerging U.S. banking system.

As cited by Bray Hammond, Banks and Politics in America, From the Revolution to the Civil War (Princeton, 1957), p. 165.
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**Sources:** The basic sources of revenues and bank-derived revenues for all states are the annual reports of state financial officers: treasurers, comptrollers, and auditors. Titles of officers and reports vary across states as well as within states across years; precise sources for individual years are available from the authors. We have also consulted several secondary sources that were based on the state documents.

Substitution of bank-derived revenues for currency finance did not occur immediately in the states upon the adoption of the Constitution. State-chartered banks were new institutions and they developed slowly before the War of 1812. But already in the 1790s a few states were discovering the possibilities banks afforded for adding revenue to the state treasury. In these early years the main function of bank-derived revenues was to keep traditional state taxes low or even, in a few cases, nonexistent.

After the War of 1812 came the era of improvement. In it all of the states either began to turn their banks into sources of continuing public finance or extended the uses they already had made of them. Revenues derived from banks could be used for all sorts of public purposes; aid to education appears to have been the most popular, followed by transportation projects and a continuing desire to keep traditional taxes low. Banks as new institutions gained legitimacy from their relationship to the states, while the states themselves gained significant portions of their public revenues.

What were the political and economic implications of taxing banks instead of issuing state paper money or taxing general property? Politically, the conferral of bank charters by state legislatures in the early years was, and was widely viewed as, a privilege granted to a few favored persons or groups of people. The states could appropriate some of the value of this privilege through bonuses, state investments in bank stock, and requirements that banks finance worthy public and private institutions. Privilege had its obligations, and these obligations allowed the funding of public projects that otherwise would have required higher general taxes. Before 1787, when the states (and colonies) had issued paper money, all of value of the money creating privilege presumably went to the polity. The trend we see in moving from initial chartering bonuses and partial state investment in bank shares toward both general taxation of banks and freer granting of bank charters can be interpreted as a move toward restoring the status quo ante Constitution as well as toward democratizing banking. The one constant in all this history of state paper money, state investment in banks, and state taxation of banks was the desire to expand public functions while keeping general taxes on persons and property low. As democratic political economy, bank taxation had special appeal: the incidence of taxation seemingly was shifted from persons and property in general to privileged, monied institutions. When banking became less privileged and more competitive, this notion was easily transformed into one holding that corporate business owed its fair share of public taxes.

In addition to these general considerations, some details of the early state experience are instructive in regard to the development of Amer-
ican public finance. Taxes such as Connecticut’s on bank shares owned by non-residents were a recognition that this type of intangible property could escape state property taxation in a federal system. That Connecticut’s banks paid the tax is an early example of source withholding. Rhode Island’s levying of a higher tax on increases of bank capital than on bank capital itself could be construed as embodying the principle of progressive taxation. Maryland’s reserved option to purchase shares in the banks it chartered is an early example of the creation of financial rights, although its grant of a monopoly to existing banks in return for their support of state projects was less forward looking. State experiments in taxing banks set precedents for later taxation of business in general.

The close relationship between banks and state finances arose after the transition from Confederation to Constitution had taken from the states the fiscal flexibility that came with the power to issue state money. After 1860 the advent of the National Banking System created another transitional problem for state finances because it restricted what for many states had become a major revenue source. We hope to explore the implications of this later transition in American state public finance in future work.