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PRODIGALS AND PROJECTORS: AN ECONOMIC HISTORY OF USURY LAWS IN THE UNITED STATES FROM COLONIAL TIMES TO 1900

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ABSTRACT

During the Colonial era usury laws in the United States were strict both in terms of the maximum rate that could be charged and the penalties that would be imposed. In Massachusetts in eighteenth century, for example, the maximum rate was 6 percent, and both principal and interest were forfeited if usury could be proved against the lender. The laws were eased during the early national period, and in many states they were repealed, although the United States never completely abandoned its system of usury laws. By 1870, when a limited reaction set in, the liberalization had reached the point where the great bulk of commercial transactions must have been largely unaffected by the usury laws, at least in non-crisis years. Two factors seem to have been paramount in producing the liberalization: changes in ideas about the effectiveness of government regulation in general and about the effectiveness of usury laws in particular, and competition among the states for capital. This history suggests that the usury laws, when tightly drawn, may have had a larger impact than economic historians have generally recognized.

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1. Why Should Economic Historians Study Usury Laws?[1]

With a few notable exceptions, such as Friedman (1963) and Glaeser and Scheinkman (1998), usury laws have been ignored by historians and economists writing about the financial history of the United States. Many of the classic financial histories of the United States do not even mention them. Yet there are a number of good reasons for studying usury laws. For one thing usury laws are, arguably, the most ubiquitous forms of economic regulation. They are mentioned in the Bible and the Koran. There were usury laws in ancient Rome, although not in classical Athens (Finley 1953). And, the medieval canonists developed a detailed theory of usury. Usury laws have not been confined to countries influenced by European cultural traditions. In India, during the Buddhist period, it was recommended that interest be limited to 15 percent per year on secured loans and to 60 percent per year on unsecured loans. Seth (1955, 6). In traditional China the maximum rate was 3 percent per month, and the penalty for charging more was 40 to 100 blows with the light cane. (Alabaster 1899, 550-51). Usury laws, moreover, have been the subject of classic works of literature, such as “The Merchant of Venice.” The usury laws in England were repealed in 1854 (although legislation protecting borrowers was reinstated at the turn of the century), but in the United States they were continued in many states down to the present day.

Usury laws, unlike most other forms of economic regulation, are relatively easy to quantify. During the period of concern here they usually took the form of a maximum rate, a round number: 0, 6, 10, etc. The penalties for evading the usury laws, moreover, although often neglected in discussions of the law, were also easily quantified. The penalty was typically forfeiture of interest and principal, forfeiture of interest alone, or something similar. By taking a standard loan contract we can reduce these disparate penalties to a common denominator. To be sure, usury laws sometimes included provisions that are not easily quantified. The maximum legal rate, for example, might differ among lenders or by type of loan, and criminal penalties might be imposed. But for the most part, the usury laws can be quantified, allowing us to draw a long-run picture of the history of usury laws, and to make generalizations about the determinants of the history of usury laws that may carryover to less easily quantified forms of regulation.

The level of the rate of usury, moreover, may give us some insight into the common rate of interest for times and places when market quotations are scarce. Indeed, in some cases the rate of usury may be a more accurate reflection of the common rate, than the quotations normally relied upon, which are often the rates on government bonds, or other atypical instruments. The usefulness of the rate of usury as a proxy for the common rate of interest would depend on how usury rates were determined in relation to the bulk of credit transactions. So an understanding of the political economy of maximum rates can contribute to their usefulness as a record of rates.

The main reason economic historians neglect usury laws is the conviction that they are easily evaded and therefore have no effect. Suppose a borrower and lender want to contract a loan at 30 percent interest when the legal maximum is 10 percent. What is to stop the borrower from signing a bond that says that 10 percent is to be paid on $100 (a legal contract), while in fact receiving only $85 in cash, or perhaps paying a "fee" of $15 for the services of arranging the loan?[2] The answer is nothing. The suggestion then, is that the legal maximum has no effect.

Alternative means of evading the laws, moreover, are legion. Perhaps one of the most frequently used ways of evading usury laws is by hiding a usurious payment as charge for late payment. One of the earliest stories I have seen about this form of evasion in the United States is said to have occurred in Virginia in 1760. The legal maximum was 5 percent. But interest at 10 percent could be charged on a bill of exchange that was refused. A "gentlemen of some means," it is said, agreed to draw a bill on a firm in London that he did not know so that his banker could charge 10 percent. Unfortunately, the firm on which the bill was drawn recognized the name of the drawer, assumed that he intended to open a relationship, and so accepted the bill. The banker complained that he had been tricked by being given a good bill instead of a bad one! (Kirkland 1865, vol. 1, 217.) [3]

Although these ways of evading the law, and many similar devices, provide a good deal of protection to the lender – courts are generally unwilling to set aside a signed contract, unless they have a strong motive for doing so – evasive devices do not reduce a lender's risk from the law to zero. True the lender has, as Shylock says, his bond. But should a borrower refuse to pay, and offer usury as a defense, a judge is always in a position to believe the testimony of the borrower and whatever evidences the borrower can offer, as Shylock found when he finally had his day in court. The risk that the borrower will escape paying, a risk that cannot be reduced to zero as long as the law is on the books, is bound to have some effect on the behavior of borrowers and lenders.

I now believe that when maximum rates were low, and penalties high, usury laws had a substantial impact on the structure of lending. The effects of usury laws on capital formation or the distribution of income, however, will not be our initial focus. Instead, the narrative will focus on uncovering the determinants of changes of usury rates and penalties.

Nevertheless, as is often the case in economic research, a light focused on one target illuminates others.

Today, usury laws are still important, but mainly as consumer protection laws. The laws at issue in the current controversy over the extremely high rates charged for “payday loans” -- small loans typically due at the next payday and secured by a postdated check or by an agreement that permits a bank to deduct principal and interest from a paycheck -- have their roots in nineteenth century usury laws discussed below.[4]

The remainder of the paper is structured as follows. Section 2 discusses the history of thought about usury laws through the period of liberalization in the nineteenth century. Section 3 discusses the repeal of the British laws, an important precedent for the United States. Section 4 discusses the changes in U.S. usury laws in the nineteenth century from a quantitative perspective. Section 5 discusses the debate over the usury provision of the National Banking Act, which throws a good deal of light on the relationships among ideas, the western advance, and other factors that influenced the liberalization of the usury laws. Section 6 discusses some of the evidence that suggests that the economic historian’s working assumption that the usury laws had no effect needs rethinking. Section 7 draws some conclusions. The narrative is written as if two factors -- changing ideas about the efficacy of usury laws, and competition among states for capital -- explain the changing structure of the usury laws. But the evidence for correlation, it must be admitted, is much stronger than the evidence for causation. Perhaps what follows is best regarded as a listing of the candidate hypotheses.

2. The Changing Intellectual Climate

The evolution of usury laws paralleled, and I believe to some extent was produced by, changes in ideas about usury. A brief sketch of history of the “high theory” of usury laws will therefore be a useful way of setting the stage for the history U.S. usury laws that follows, and of describing one of the explanatory factors. Broadly speaking we can distinguish two strands of support for usury laws: moral arguments that can be traced to the Bible and to the ancient Greek philosophers, and economic arguments that can be traced to the mercantilists and (of all people) to Adam Smith. The erosion of these supports for usury laws coincided with liberalizations of the law.

The evolution of religious and philosophical ideas about usury could fill many volumes.[5] Here I will simply summarize some of the ideas that seem to have survived to influence American lawmakers. The Old Testament, as is well known, prohibits interest taking among the Jews, although not between Jews and non-Jews. There are three passages. In two, the prohibition on taking interest follows admonitions to be charitable toward the poor, and so seems connected mainly with charity toward the poor. But the most famous passage, Deuteronomy 23:19, appears to be more general: "You shall not lend upon interest to your brother, interest on money, interest on victuals, interest on anything that is lent for interest. To a foreigner you may lend upon interest…" This passage became the basis for the belief of the early Christians and the medieval church that the prohibition on usury should be extended to all Christians. And it left the way open for the Jews living among Christians to become moneylenders. The New Testament also contains passages that seem to tell against lending at interest, particularly Luke 6:35: “Lend freely, hoping nothing thereby.” It has been suggested by Taeusch (1942, 313) that the survival of usury restrictions in the

United States, although as we will see in a greatly attenuated form, as opposed to their repeal in Britain can be traced to the greater influence of old-testament fundamentalism in the United States.

The tension between the stark religious doctrine that the lending of money among brothers was immoral and the needs of a commercial economy for credit produced the development of a complex usury doctrine that legitimized interest under a number of names.[6] Thomas Aquinas thought that compensation for actual loss (*damnum emergens*) was permissible, and he discussed although with hesitation compensation for cessation of gain (*lucrum cessans*). Other exceptions included compensation for damage caused by the failure to return payment at the agreed time (*poena conventionalis*). According to Cunningham (1905, vol. 1, 258) this exception, an obvious way of evading the usury prohibition, took a prominent place in medieval transactions.

The struggle over the morality of interest taking changed abruptly with the Protestant Reformation. Benjamin Nelson (1969) describes the revolution. Although some of the preaching of the reformers was opposed to taking interest, the reformers ultimately abandoned the idea of creating a "New Jerusalem" – with the implication that Christians would be forced to follow the ancient prohibition against lending at interest. Nelson sees Calvin as the key figure because he clearly stated that the rules about taking interest that bound the ancient Israelites, although perhaps right for their time and place, were not binding in a modern society. Religious thought had progressed, in the apt subtitle of Nelson's book, *From Tribal Brotherhood to Universal Otherhood*.[7]

The other tradition that left a residual in nineteenth-century thinking was that of the ancient Greek philosophers. Aristotle and Plato believed that money was barren. With other forms of capital, cattle for example, we can see the natural multiplication, but not with money. The taking of interest, therefore, was unnatural, and to be prohibited. Centuries later Alfred Marshall was still devoting space in his *Principles of Economics* to refuting this argument. Marshall explains at length why lending a horse (clearly a form of capital that is naturally productive) is no different than lending money.

Secular thinking about usury laws (in the English speaking world) can be traced in a trajectory of key contributions reaching from mercantilist writers, in particular Sir Josiah Child, who strongly endorsed usury laws to John Stuart Mill, who denounced them as a religious superstition. To mercantilist writers such as Child (1668) it made good sense for the state to control the rate of interest. Child believed that low interest rates were the soul of trade. He noted that interest rates were low in Holland, which was clearly a prosperous nation. And he argued that much good had come from the official lowering of the rate of interest in England from 10 to 8 per cent in 1623, and from 8 to 6 per cent in 1660. (See table 1 for the English rates.) The argument was that lowering interest rates prevented the "dissipating class," usually men of property who could borrow on the security of their land, from competing with the merchant class. The King, Child noted, would have to pay a higher rate than the merchant class, because the lending to the King was risky, but lowering rates for the merchant class would lower rates for the King as well.

Child's analysis was not universally accepted. (Ryan 1924, 46-7). Sir William Petty wrote a tract opposed to Child's stand on usury laws. And John Locke attacked Child's position as well. Locke pointed out that there were no usury laws in Holland and that low interest rates there were the result rather than the cause of prosperity. Locke did note, however, that usury laws might be useful in preventing the indolent from dissipating their fortunes, a point taken up by later supporters of usury laws. Nevertheless, Child's essay showed that there was a mercantilist as well as moral case to be made for usury laws, and Child's essay appears to have influenced later writers.

Sir James Steuart, discussed Child's ideas in his magnum opus, *Inquiry into the Principles of Political Oeconomy* published in 1767. Steuart agreed with Child that regulating the rate of interest and thereby channeling funds to the merchant class was a good idea. But he objected to a sudden and violent pulling down of the official rate, of the sort that had happened in 1623 and 1660. All sorts of problems would be created if this were tried again, especially if the rate was forced below the rate in rival countries, notably the Netherlands. Instead, Steuart recommended a rate sufficiently above the conventional commercial rate "so as to leave a reasonable latitude for gentle fluctuations above it."

Adam Smith, although critical of much in Steuart, famously took a similar position on the rate of interest.[8] Too restrictive an interest ceiling would be a mistake; but a ceiling that was above, but not too much above, the market rate would prove beneficial. For the underlying reasoning, we can do no better than to quote Smith (1979 [1776], 357).

> The legal rate, it is to be observed, though it ought to be above, ought not to be much above the lowest market rate. If the legal rate of interest in Great Britain, for example, was fixed so high as eight or ten per cent, the greater part of the money which was to be lent, would be lent to prodigals and projectors, who alone would be willing to give this high interest. Sober people, who will give for the use of money no more than part of what they are likely to make by the use of it, would not venture into the competition. A great part of the capital of the country would thus be kept out of the hands which were most likely to make a profitable and advantageous use of it, and thrown into those which were most likely to waste and destroy it. Where the legal rate of interest, on the contrary, is fixed but a very little above the lowest market rate, sober people are universally preferred as borrowers, to prodigals and projectors.

By prodigals Smith meant people who had the wherewithal to borrow large sums of money for consumption purposes, perhaps the dissipated son of a rich landlord.[9] And by projectors, in this context, he meant entrepreneurs raising money for wild and improbable schemes. Smith does not say what examples he has in mind when he speaks of projectors. Steuart mentioned the Mississippi and South Sea bubbles in this context, and presumably Smith would have included them in a list of foolish schemes touted by projectors, although it would have been typical of Smith to have more current examples in mind as well.[10]

The point in time that economic opinion swung decisively against usury laws can be dated with accuracy: the publication of Jeremy Bentham's *Defense of Usury*. Cast as a series of letters, the first was postmarked *Crichoff, in White Russia, January 1787*. It was a tour de force – passionate, detailed, logical, and filled with rhetorical flourishes. Bentham covered most of the points that would be covered in a modern textbook: (1) Usury laws prevent mutually beneficial trades among informed adults, (2) usury laws force desperate borrowers into the hands of unscrupulous lenders where the borrowers pay higher rates than they would in an unfettered market, rates that insure against the risk of nonpayment occasioned by the usury laws themselves, (3) the usury laws are often evaded in ways that add to the costs of doing business, and so on.

Bentham recognized that no argument against usury laws could succeed that did not take on Adam Smith, and so the last of his letters was addressed to Smith. Bentham thought it unlikely that prodigals would be affected by the lifting of usury laws. As long as a prodigal still had property to offer as collateral he could borrow on the same terms as others. Once his capital was exhausted, he could only rely on friends and on the delivery of goods by tradesmen; borrowing money would be nearly impossible at any rate of interest. It was on the issue of projectors that Bentham worked the hardest. Smith favored usury laws because they kept money out of the hands of foolish projectors. Progress, Bentham asserted, had been the result smart projectors. Where would we be, Bentham asks, what would our living standards be today, if it had not been for the projectors in the past?

On the latter issue, Bentham attempted to quote Smith against himself. In the *Wealth of Nations* (1979 [1776], 131) Smith argued that wages would be higher in industries in which new firms were established frequently because in those industries *projectors* would have to entice workers away from existing firms by offering higher wages, and there would be some inertia of wages paid at the existing firms. To illustrate his point Smith contrasted Birmingham, which specialized in industries where demand arose from fashion and fancy, and where wages were high, with Sheffield, which specialized in industries where demand arose from necessity, and wages were low. To Bentham this meant that Smith had labeled Birmingham a "projecting" town and Sheffield an "unprojecting" town. Bentham then argued that projecting must be a good thing because Birmingham was more prosperous and growing faster than Sheffield, and therefore on his own evidence Smith should concede that laws designed to reduce projecting were a mistake. Smith might well have replied that since Birmingham's industries had developed under the existing usury law, Birmingham's affluence was evidence that moderate usury laws did not discourage sound projectors.

John Stuart Mill, in his *Principles of Political Economy* (1920 [1871,1848], 926-930, 1004), describes the laws as having "originated in a religious prejudice against receiving interest on money" and notes, that "this restriction though approved by Adam Smith, has been condemned by all enlightened persons since the triumphant onslaught made upon it by Bentham in his *Letters on Usury*." Thus between Adam Smith and John Stuart

Mill, "weighty" opinion had turned 180 degrees against usury laws. This period, as we will see in the next section, also witnessed the abolition of usury laws in Britain, and the liberalization of usury laws in the United States.

Mill was the last of the great British economists of the nineteenth century to devote considerable space in his textbook to the discussion of usury laws. In part of course this was because the repeal of the usury laws in 1854 made discussion of them a moot point. Marshall's *Principles*, as we noted above, deals with the notion that there is something different about lending a horse than lending money, but does not deal with Smith's arguments. Arthur Cecil Pigou's *The Economics of Welfare* does not even mention usury laws.

What lay behind the change in opinion about usury laws? To some extent, of course, the change in thinking about usury laws was simply a part of a much broader intellectual revolution that was reflected in economics in the rise of Laissez Faire, and in politics in increased concern for democracy and personal liberty. In other words, the fall of the usury laws in England, and their liberalization in the United States, was part of the same wave of trust in Laissez Faire that helped bring down the Corn Laws, and eliminate other restrictions such as those on the price of bread, the export of machinery, and the emigration of skilled labor.

Were there economic changes that lay behind the change in thinking? According to Keynes, *The General Theory* (1965 [1936], chapter 24, 351-353), keeping the rate of interest low was good policy prior to the nineteenth century because, in Keynes's terminology, the "marginal efficiency of investment" was low. The industrial revolution raised the marginal efficiency of investment and changed the balance of costs and benefits of usury laws. More worthwhile investment opportunities existed. One can see this in the examples used to support or oppose usury laws. Sir James Steuart reached back to the South Sea and Mississippi bubbles to show how dangerous projectors could be, and why it would be a good idea to keep money out of their hands. John Stuart Mill (1920 [1871,1848], 930) pointed to George Stephenson, the railway entrepreneur, who could not have brought his plans to completion, Mill claims, without the ability to borrow at high interest rates. In Keynes's phrase, when we read Bentham's letter to Smith we may be "hearing the voice of the nineteenth century speaking to the eighteenth century."

Today, we casually accept the idea that the government should regulate the rate of interest indirectly through the operations of a central bank. Yet the idea that the government should regulate interest rates directly through usury laws seems foreign. Prior to the nineteenth century, however, monies were as much international as national, and the ability of government banks, such as the bank of England, to influence interest rates was extremely limited. In such a world the main national instrument for regulating the rate of interest was the rate of usury. The rise of national currencies controlled by national banks created an alternative mechanism for controlling interest rates. It was now possible to eliminate usury laws without giving up all governmental control over interest. And the new institutions would have maximum influence, if their efforts to raise interest rates were not inhibited by usury rates. In the United States, as we will see below, the decisive pressure to liberalize the usury laws did not come so much from the eastern projectors of new industrial firms, as from the western projectors of new agricultural settlements.

Defense of Usury was an immediate and long lasting hit.[11] In England it received favorable reviews and was endorsed by important political figures. Potentially the most important, of course, was Adam Smith, and here hangs a tale. It was reported to Bentham that Smith had told a friend that "*Defense of Usury* was the work of a very superior man" and that Smith had *seemed* to admit that Bentham was right. Bentham wrote to Smith trying to draw a formal concession. But Smith, who by then was very ill, did no more than send Bentham a copy of the *Wealth of Nations*. Smith's recantation never became a reality.

We cannot know for certain whether if Smith had been in better health, he would have changed his mind on usury laws, or what the effect would have been. Bentham himself (1952-54 [1787], 189), in his letter to Smith thought that a declaration by Smith against usury laws, especially considering Smith's earlier support of them, would be worth many votes. "We should have the Irish Chancellor of the Exchequer abjuring his annual motion [to reduce the rate of interest in Ireland] in the face of the House, and L [or]d Hawkesbury who, it has been said, is Mr. Pitt's tutor in this wise business, quietly and silently putting his papers and calculations into the fire." A similar conjecture is not out of place, it seems to me, for the United States. Banking and interest regulation were debated repeatedly in the United States over the coming century. As influential as Bentham's arguments were, the weight of Adam Smith remained on the side of those who would maintain controls on interest rates. Liberalization of the usury laws might have moved further and faster if the name of Adam Smith could have been enlisted in the cause.

The positive reception of *Defense of Usury* was international. In France, the *Defense* was translated by someone in Mirabeau's circle, and may have influenced the debate over French usury laws then in progress (Stark 1952, 28-29), although the French economists had already made known their opposition to usury laws. In Ireland Bentham's tract seems to have been widely read in Dublin in 1788 when a reduction in the rate of usury from 6 percent to 5 percent was under debate.

Bentham was also influential in the United States, although the extent of his influence is, inevitably, difficult to measure. Bentham received a letter (Stark 1952, 30-31), which reported that "The influence of your writings has already been extensively felt in the United States." The letter went on to catalog attempts to repeal the usury laws in Mississippi, Alabama, Virginia, and New Hampshire as evidence of the triumph of Bentham's principles.[12]

Morton J. Horwitz (1977, 237-245) investigated the legal literature of the period 1780-1850. He found that the attacks on usury laws that were written during this period reflected Bentham's ideas, and often mention Bentham explicitly. Horwitz (1977, 242) observes, for example, that Thomas Cooper's notes to his 1837 edition of the *Statutes of South Carolina*, comment that "The public notions on the subject of usury have been totally changed by Jeremy Bentham's brief treatise on the subject…." The defenses of usury laws that Horwitz examined, on the other hand, appear to have gone back to moral, just-price considerations, rather than the mercantilist defense. As we will see below, however, hints of the mercantilist doctrine can be seen in the Civil War debate over the usury provision of the National Banking Act.

Most of the economic writers covered in Joseph Dorfman's (1946) classic survey of the antebellum era appear to have been disciples of the British economists, and were opposed to usury laws. The Reverend John McVickar, who published his *Outlines of Political Economy*, a commentary on J.R. McCulloch, in 1825 was strongly opposed to usury laws. Langton Byllesby, who Dorfman (1946, 640) identifies as a Ricardian Socialist, published his *Observations on the Sources and Effects of Unequal Wealth*, which includes a statement condemning usury laws, in 1826. Stephen Simpson published his *Working Man's Manual: A New Theory of Political Economy* in 1831, which argued that "usury laws are reprehensible." The Reverend Francis Wayland, President of Brown, published perhaps the first free trade textbook in the United States in 1837, and included a condemnation of usury laws. Dorfman (1946, 760). Jacob Newton Cardozo, editor of the *Southern Patriot*, who Dorfman (1946, 857) called the South's ablest economic thinker, opposed usury laws and called for "freedom of banking." George Opdyke's *Treatise on Political Economy* was published in 1851. Opdyke was an enthusiastic follower of John Stuart Mill, and followed Mill in denouncing usury laws. (Dorfman 1946, 755-58). In 1864 Arthur Latham Perry, a follower of Bastiat, wrote a series of articles on political economy for the *Springfield* [Massachusetts] *Republican*, which Dorfman (1946, 981) identified as an influential paper. Perry thought usury laws were a mistake, and he was especially critical of the attempt then under consideration to limit National Banks to 7 percent, an episode that will be considered in more detail below. Perry's articles, moreover, came a short time before Massachusetts repealed its usury laws.

Indeed, all the antebellum American authors discussed by Dorfman, with the exception of Alexander Bryan Johnson who thought that low interest rates brought about by usury laws would be good for labor, were strongly opposed to usury laws. It is not surprising, perhaps, to find the usury laws being liberalized during a period in which weighty opinion was so opposed. Of course, weighty opinion by itself is often insufficient to change the law. Economists have often united in their opposition to high tariffs or other restrictions on international trade to little effect. Below we will turn to another force at work, the effort by western states to attract capital. But first we will look at the similar liberalization that was taking place in Britain.

3. The Liberalization of the British Usury Laws

It is important to note that British laws underwent a similar liberalization at about the same time, and that the liberalization in Britain has been attributed partly to ideological and intellectual developments. Table 1, which I have compiled from various sources, summarizes the history of British usury laws. The modern history of British usury laws began in 1545 when a maximum rate of 10 percent was set. Although the law was couched in terms of the old exceptions to the church's prohibition of interest taking, it seemed to recognize a new economic reality: Cunningham (1905, 152). Interest was again prohibited in 1551, a law that Adam Smith (1979 [1776], 106] attributed to "religious zeal." But this prohibition was soon reversed, and in 1571 the maximum rate of 10 percent was restored.

As suggested by the reversals in the law, there was considerable debate in England during the sixteenth century about the morality of interest taking, (Tawney 1925). Shakespeare's exploration of the economics and morality of usury, *The Merchant of Venice*, was written in 1596.[13] Although disagreements about the morality of interest taking were intense during the sixteenth century, Cunningham (1905-7, 159) concludes that by 1604 "the revolution in public opinion was complete, and that the practice of lending money for moderate interest was at last regarded as entirely reputable."

As shown in table 1 the maximum rate was lowered to 8 percent in 1624, to 6 percent in 1660, and to 5 percent in 1713. Adam Smith (1979 [1776], 106) thought that these reductions had been made "with great propriety," and that the changes seem to "have followed and not to have gone before the market rate of interest." This is where things stood when Bentham wrote his case against the usury laws: a maximum rate of 5 percent and a penalty of three times the principal and interest.

The next major change appears to have occurred in 1833 when usury limits were eliminated on bills of exchange with less than three months to run. This break may have been due to the problems created by the 5 percent rule for bill brokers during the crisis of 1825. The usury laws were finally repealed in 1854. The need for the Bank of England to raise its discount rate in times of crisis, a need that became increasingly clear as the Bank's operating procedures took their classic nineteenth century form, may have played a role in the repeal. The development of the joint stock company – limited liability was introduced in 1855 – may also have been a factor. Bond issues would have been more difficult if companies were legally barred from paying more than 5 percent. The transition from regulated credit markets to unregulated (or at least indirectly regulated) markets, moreover, cannot be divorced from the general movement toward Laissez Faire in England, as manifested by the famous repeal of the Corn Laws in 1848.

The English example, as Louis Robinson and Rolf Nugent (1934, 29) point out, was soon followed by the repeal of the usury laws in a number of European countries: Denmark (1855); Spain (1856); Sardinia, Holland, Norway, and Geneva (1857); and Saxony and Sweden (1864). Canada also followed in 1858. Robinson and Nugent attribute all of these repeals to the spread of Laissez Faire in general and to Benthamite ideas about usury in particular, and to the example of Britain. Perhaps the international repeal movement also owed something to the fear that a country that did not follow suit would risk losing capital to Britain and to the countries that had repealed. The repeal movement in the United States occurred during a similar period, and this fear, as well as the ideological pressures cited by Robinson and Nugent, seems to have been at work.

4. The Liberalization of U.S. Usury Laws

The basic source for the usury laws to 1890 is George K. Holmes (1892), and Holmes and John S. Lord (1895), which summarize the legal history of the usury laws in the United States to that date. Where I have been able to check these account against studies of individual states, or tables presented in legal journals, Holmes and Lord appears accurate, although slight discrepancies in dating do emerge. When I found discrepancies I have followed Holmes and Lord, to provide a consistent set of estimates.

Figure 1 plots the average maximum rate of interest in the United States as a whole, and in the thirteen original colonies, from 1750 to 1890. The averages are simple unweighted means: Massachusetts and Rhode Island count as equal observations. The number of states, of course, is steadily growing so that the population on which the national average is based is continually changing. Some laws distinguished between the maximum rate permitted when no rate was specified in the contract, and the maximum rate when the rate was stated explicitly. The data plotted here reflect the latter. A complication, of course, is that some states, such as California, permitted any rate so long as the rate was specified in the contract, and some states repealed their laws altogether. My convention was to use 13.01 percent as the rate for these states when computing the national average. Twelve percent was the highest maximum among most states, although rates as high as 20 percent were permitted under certain laws, so this convention assigns a rate 1 percent above a relatively high rate to those states that repealed their usury laws. Figure 1 also shows the average excluding states that repealed.

Evidently, there is a good deal of inertia in these rates. Massachusetts, to take an extreme example, established a rate of 8 percent in 1641. This was lowered to 6 percent in 1693 where it remained until the usury laws were repealed in 1867, a period of 174 years![14] Nevertheless, there is a clear picture of change when we take the long view and look at the national average. Maximum rates began to trend upward after the Revolution, peaked in the 1870s, and then trended downward toward the end of the century. There was, in other words, a considerable relaxation of the usury laws, measured by maximum rates, between the Revolution and the 1870s.

Market interest rates began trending downward in the 1870s, so this may have been a factor leading to the cutback in usury rates.[15] But the explanatory factors I have been stressing also began to change. The ideological tide in the United States began to turn against Laissez Faire. The precursors of the Populists and the leftwing of the labor movement were making themselves felt. And as the frontier disappeared, the desperate need of new communities for mortgage money no longer overrode all other considerations in the determination of policies toward financial markets.

Figure 2 plots the average penalty. My convention was to assume a loan of $100 and excess interest of 10 percent, and then to measure what the lender lost if found guilty of usury. For example, if the maximum rate was 6 percent, and the penalty was forfeiture of principal plus interest, then the total penalty would be $116: $100 of principal, $6 of legal interest, and $10 of usury. On the other hand, if the penalty were simply forfeiture of usurious interest, the figure plotted would be $10.

The penalty is probably a more sensitive indicator of the pressures at work in the legislature than the maximum rate. As indicated above, maximum rates tended to be sticky, perhaps because an attempt to raise the maximum rate would be a red flag that would provoke a public outcry. A lessening of the penalties, on the other hand, may have been welcomed by the business community, but neglected by the general public. Massachusetts, again, is a good example. The penalty set in 1693 was forfeiture of principal and interest ($116 for the standard contract.) This was lowered to three times the interest ($48 for the standard contract) in 1826, and to three times the excess interest ($30 for the standard contract) in 1846: liberalization of the penalty but not the rate, which remained at 6 percent.

Changes in the penalties of this magnitude would have had a significant effect on the incentives facing lenders, even at relatively low levels of default risk. Consider the following example. The rate of usury is 6 percent. Two potential loans are available to the lender. One can be made at the rate of usury and the return will be sufficient to cover the risk of default. The alternative can be made at a higher rate but has the added risk of five percent that the borrower will default and win on the defense of usury. What rate on the second loan will provide the same expected value as the first loan, which could be made at the legal maximum? If the penalty were forfeiture of three times the principal and interest, a traditional eighteenth century penalty, the required rate would be 24.71 percent.[16] If the penalty were simply forfeiture of principal and interest, the required rate would be about 11.58 percent. If the penalty were three times the interest, the required rate would be only 7.06 percent.

It is evident from figure 2 that there was a general downward trend in the average penalty beginning after the Revolution and continuing into the 1870s. This Figure, perhaps even more than Figure 1, provides evidence for a general liberalization of the usury laws.

It is sometimes thought that the first repeal of the usury laws was in Massachusetts in 1867. Massachusetts, it is true, was the first of the Eastern states with a large financial center to deregulate. So this was a signal event. But as shown in Table 2 repeal was a nationwide phenomenon that began in regions of recent settlement, where interest rates were high and the desire to attract additional investment from the East was strong. The first repeal was in Alabama in 1818, followed by Illinois in 1819, and Florida in 1822. The first repeal that lasted more than a short time was California in 1850. The Massachusetts repeal has been attributed to the stirring speech against the usury law in the Massachusetts legislature by Richard Henry Dana Jr.[17] (Ryan 1924, 60-62). One may be skeptical -- it is a good working hypothesis that legislation is determined by interests and not by speeches -- but it was a superb speech.

Dana recounted all of the economic arguments against usury laws, making them vivid to his audience by appealing to experiences with which they would have been familiar. Dana also appealed to the academic opponents of usury laws: Bentham, John Stuart Mill, Wayland, Smith (based on the alleged capitulation to Bentham), and others. And Dana (1881 [1867], 51-52) discussed the danger that capital would move to areas with higher or no maximums. In this context he mentions the high midwestern rates and the gap between New York (7 percent) and Massachusetts (6 percent). The latter gap, he assured his fellow legislators, while too small to interest investors with small sums to lend, would be more than enough to interest investors with large sums to lend.

Under the 1850 California law, as under a number of similar statutes, as noted above, no limit was imposed on contracts in which the rate of interest was explicitly stated. If no rate was specified in the contract, however, the maximum interest allowed was 10 percent. The penalty in the latter case, if more than 10 percent was charged, was relatively light. The borrower could, however, refuse to pay more than 10 percent, and the lender could not sue to recover the excess. Once the interest was paid, however, the borrower could not sue to recover the amount in excess of 10 percent. This law retained some measure of protection for the unwary while generally freeing commercial transactions from restrictions. Indeed, by specifically sanctioning any rate that the parties agreed to, the law preempted an attempt by a borrower to invoke a common-law anti-usury tradition, and so provided lenders with more protection than if no law was in place.

Although the trend toward deregulation shown in Charts 1 and 2 is clear, individual states sometimes, as shown in Table 2, reversed course, depending on current economic circumstances. Lawrence Friedman's (1963) study of Wisconsin tells a story that was probably typical, at least for the areas of recent settlement. During the territorial period Michigan's maximum of 7 percent applied. The land boom of the late 1830s led to dissatisfaction with this rate. Potential farmers were anxious to acquire land even if it meant borrowing at rates above 7 percent. The result was an increase in the legal rate to 12 percent if the rate was explicitly stated in the contract. The rate was still 7 percent if no rate was stated explicitly. In 1849 the usury law was repealed. Any rate was legal so long as it was stated explicitly. A land boom, and hence the need for mortgage money, once more was the driving force. Repeal, however lasted only two years. Low wheat prices and the drain of labor to California resulting from the Gold Rush put farmers in a bad mood. In 1851 the legislature, looking for a way to respond to widespread discontent, reinstated the 12 percent maximum, and imposed a stiff penalty. Usurious contracts were void and the lender had to return 3 times the excess interest. In 1856, in the midst of a long economic expansion, the penalties were reduced. Now only the excess interest was voided, and the borrower had to make a tender of the principal before the usury defense could be invoked. In 1862 hard times occasioned by the outbreak of the Civil War, and the resultant closing of the Mississippi, led to a reduction of the maximum rate to 7 percent. In 1866 a postwar land boom led the legislature to increase the rate to 10 percent where it remained for the rest of the century.

Samuel Rezneck (1950, 505) noticed a similar phenomenon in the east. A financial panic, such as the panic of 1857, hardened attitudes. When market rate pushed through interest ceilings merchants and bankers were persuaded that usury laws were disruptive and demanded repeal. But opponents of high interest rates also mobilized, and in some cases were successful in defeating attempts to repeal the usury laws.

What had undone the usury laws? One factor I believe, as I argued above, was the spread of confidence in Laissez faire in general, and Bentham's critique of usury laws in particular. It was hard to argue for usury laws when all the best economic authorities starting with Bentham and Mill opposed them, and when Britain, the most advanced nation, was eliminating them.

In addition, there was the competition among the states for capital. One piece of evidence for the role of interstate competition is shown in Figures 1 and 2. The 13 original states clearly lagged behind newer regions in the process of liberalization both in terms of raising rates and in terms of reducing penalties. Figure 3, which shows maximum rates by regions, illustrates the point in another way. Liberalization began in the South and Midwest. New England eventually liberalized after the Civil War. But the Middle Atlantic States held to their tough usury maximums.[18]

The liberalization did not end with the repeal of the usury laws. Instead, the pattern was, typically, one of relatively light penalties and usury ceilings that reflected conditions in local markets. The pattern of usury ceilings for the postbellum period, thus ended up similar to the pattern of regional rates made famous in Davis (1965), at least in terms of the ordering of the regions.[19]

Friedman (1963, 517) documents a number of cases in which the fear of a capital drain to states with more liberal usury laws was brought up in legislative debates. For example a legislative committee in Connecticut in 1871 “painted a picture of money fleeing to Massachusetts,” where the usury law had been repealed in 1867. The following year Connecticut repealed its usury law, although repeal proved to be short lived. The desire to promote expansion of the capital market will also show up when we look at the debate over the usury provision of the National Banking Act in section 5.

It would be natural to conjecture, along the lines of Keynes's discussion of Bentham, that the liberalization of the usury laws in the United States was a response to industrialization and deepening financial development. Financiers would be strongly opposed to usury laws and their influence would increasingly win out against the interests of debtors. The influence of finance can be seen at various points in our story. But if this were a major factor, we would observe the liberalization occurring first in the Eastern financial centers. New York would be leading the way. But this was not the case. The political economy of the New York usury law has been traced by Mary Ann Romano (1989, 163-

210). In 1837 New York had passed a fairly stiff law that included possible criminal penalties (a fine and imprisonment) as well as the civil penalties (loss of principal and interest) that were typical and on which I have been focusing. In subsequent years the business community steadily pushed for a repeal or at least a liberalization of the law. But it was not until the 1880s that they had any real success. [20] The opposition came from rural areas of the state that believed that funds would move toward New York if it were not for the leveling effect of the usury law. There is a clear contrast here between the interests of the settled agricultural regions of New York, which could offer collateral with well established values and could therefore benefit from usury laws, and the interests of the newly settled agricultural regions that could compete for capital only by offering to pay high rates. Liberalization of the usury laws in short, was mainly the result of western boosterism, a way of attracting capital to the frontier, rather than a response to the growing needs of the business or industrial communities.

At the end of the nineteenth century, enthusiasm for further liberalization waned, and a new concern arose: the small household loan. Robinson and Nugent (1934, 40-42) locate the growth of this market as an urban and postbellum phenomenon by looking for advertisements for small loans in newspaper advertisements, although pawn broking, of course, was an ancient phenomenon.[21] These were small loans taken out by the urban poor and secured by furniture or salaries. Extraordinarily high rates of interest were common. Rates of 10 percent per month were considered "reasonable." Usury laws, if applicable, were ignored. The loan sharks, as they were known, drew the attention of reformers. Newspapers ran stories detailing the evils of the small loan market. Philanthropic organizations were set up to address the problem by making low interest loans and by becoming involved in cases where lenders were pressing borrowers for repayment.

It was obvious to the reformers that traditional usury laws that limited rates on all loans would be inappropriate to deal with the small loan problem. The solution, it was felt, was a law that licensed firms making small loans and limited them to rates that assured reasonable profits. An 1895 statute in New York was regarded as a model. Only chartered lenders could make small (less than $200) loans. On these loans lenders were limited to 3 percent per month for the first two months, and 2 percent per month thereafter. Violation of the law was made a criminal act. After all, the lender was not an ordinary businessman, but rather a "loan shark." Under the New York law a reward of $250 could be paid for evidence of a violation. By 1911 twenty-two states had passed small loan legislation, although the Russell Sage Foundation, which had been active in promoting reform, doubted how effective these laws really were. The small loan laws reflected the moral justification for usury laws, and conceded the broad range of interest rates to the market. Although we have not tested the maximum rates in the small loan laws, it seems likely that they would reflect the pattern described by Glaeser and Scheinkman (1998): a more unequal distribution of income would imply a more restrictive usury law.

5. The Usury Provision of the National Banking Act

In general the usury laws, then as now, were state laws. The question of rate restriction did come up, however, when the Federal government chartered the First and Second Banks of the United States, and when it established the national banking system. Alexander Hamilton recommended a maximum rate of six percent for the First Bank of the

United States, and this limit was included in the charter. His argument was mercantilist: Low rates were good. A violent reduction of rates would do more harm than good, but a gentle nudging of rates downward couldn't hurt. (Miller 1924, 319). The Second Bank also was limited to 6 percent. (Krooss 1969, pp. 311, 469).[22] The Bank of England, at that time was limited by the British usury laws to 5 percent, and the authority of the British model may have influenced the Americans.[23]

The issue of usury laws at the Federal level came up again during the Civil War when the United States set up the National Banking system. The debate that ensued over usury restrictions for the National Banks opens a window on to the mix of ideas and interests that were shaping usury laws.

At the outbreak of the Civil War the Federal Government created the famous greenback dollar. It proved to be surprisingly popular with the general public because it provided a uniform currency (a bill that had the same value no matter where it was spent) and with the government because it provided revenue. The commercial banking system that had produced the paper money before the war, moreover, was in disarray in the Western states because banks there had circulated notes backed with bonds issued by southern states, and these were now of doubtful value. The problem before the Congress then, was how to create a currency that would have the benefits of the greenback -- uniformity, safety, and seignorage for the government -- that would at the same time be the basis after the war for a private currency backed by gold. The answer was the National Currency Act of 1863, creating the National Banking system.

In creating the National system Congress had to face the question of what, if any, usury restrictions would be placed on the banks. One might assume that since the Republican Party was a pro-business, pro-creditor Party it would have opposed lending restrictions. After all, in the postbellum era the Republican Party would be the defender of gold standard orthodoxy. The National Currency Act, however, contained a tough usury provision. The law of 1863 provided that the maximum rate that could be charged by a National Bank would be "such rate of interest or discount as is at the time the established rate of interest for delay in the payment of money, in the absence of contract between the parties, by the laws of the several states in which the banks are located." The penalty was "forfeiture of the debt."

This was a strict usury provision on two counts. First, many usury laws in the western states set a lower rate when no rate was specified in the contract than when the rate was named explicitly, presumably to protect the unwary borrower. In Illinois the maximum was 6 percent when no rate was specified; 10 percent when the rate was specified. Iowa was the same as Illinois. In Michigan the maximum was 7 percent when no rate was specified; 10 percent when the rate was specified. California called for 10 percent when no rate was specified but permitted any rate so long as it was named in the contract. Forfeiture of the whole debt was also strict. Many western states had much lower penalties. In Illinois the penalty was forfeiture of the whole interest, but not the principal. In Indiana the penalty was simply the return of the "usury," the interest over the maximum. In Iowa the interest over 6 percent went to the School Fund.

How did this provision get into law? The National Banking System as a whole was the brainchild of Salmon P. Chase, the first Secretary of the Treasury under Lincoln. Chase recommended the system in very general terms in the *Treasury Report* issued in December 1861. He argued for the new system partly on practical grounds, it would give additional support to the market for federal bonds and additional flexibility in arranging federal payments, and also on idealistic grounds, that it was a permanent reform that would establish a uniform currency without the danger of inflation from a paper currency. Indeed, Andrew McFarland Davis in his classic account of the National Banking Act concludes that the establishment of a permanent uniform national currency was Chase's primary motive.[24] He had expressed his desire for such a reform as early as his inaugural address as governor of Ohio 1856. Chase's report was forwarded to the House of Ways and Means Committee where several hands, in particular Congressmen E.G. Spaulding of New York and Samuel Hooper of Massachusetts seem to have been worked on turning Chase's suggestion into law.[25]

Exactly which of these men wrote the tough and complex usury section is not known. But the evidence seems to point to Hooper. Hooper was a banking theorist as well as banker and Congressmen. He had written articles comparing banking legislation in different states, and would have been aware of the inclusion of separate interest maximums for contracts in which no explicit mention of a rate was made, and of different types of penalties. Hooper also favored strict usury laws. Fritz Redlich in his classic *Molding of American Banking* also attributes the usury provision to Hooper, probably for the same psychological reason that I do: Hooper was the theorist. Redlich, however, fails to distinguish between the hybrid 1863 usury provision, and the provision calling for a uniform 7 percent which Hooper (as we shall see) incorporated in his amended 1864 bill. This mistake led Redlich to deduce that the usury provision had simply been copied from New York's free banking law, which was not the case.

The Spaulding-Hooper bill was not introduced in the House, however, because of the opposition of Thadeus Stevens who preferred the greenback as a way of establishing a uniform currency. The bill eventually became law after being introduced in the Senate by John Sherman. The debate over the bill was intense, but the usury provision, per se, was not discussed. This is hardly surprising. At issue, or so it seemed, was the future monetary system of the United States. In this context the usury provision was a secondary issue. But once the National Currency Act became law in June 1863 the shortcomings of the usury provision were felt.

The usury provision of the National Currency Act of 1863 was criticized along two conflicting lines. (1) The law was inequitable across national banks in different states. It permitted a national bank in a state with a high usury ceiling such as California to charge a higher rate than a national bank in a state with a lower ceiling such as Maine. Critics who stressed this point generally favored a uniform rate of six or seven percent that would apply to National Banks in all states. (2) The law was inequitable across state and national banks within a state. A state bank in say, Illinois could charge as much as 10 percent (if the rate was stipulated in the contract) and the penalty if they charged more was merely forfeiture of the interest. A national bank in the same state was restricted to 6 percent, the rate in Illinois when no rate was specified in the contract, and the national bank was subject to the loss of both principal and interest if the law was violated. Critics of the law of 1863 who stressed this point generally preferred making the national banks subject to state rules on usury.

Hugh McCulloch, the widely respected former president of the State Bank of Indiana, became the first Comptroller of the Currency -- head of the National Banking System.[26] He stressed the first criticism of the usury provision in his First *Annual Report*. Instead of the current provision he suggested a maximum rate of 7 percent for all national banks, and a penalty of forfeiture of the interest.[27] McCulloch also acknowledged the second criticism, that a uniform rate across national banks would work to the disadvantage of national banks in the high interest rate regions of the West. But he took the view that high rates often encouraged reckless banking. McCulloch, believed that the success of the State

Bank of Indiana, where he had risen to prominence, was the result, partly, of its charter, which included a limit of 6 percent on the interest the bank could charge. (Harding 1895, 118). McCulloch noted, moreover, the peculiar property of the usury provision of 1863 that it left the setting of the usury rate in the hands of the state, but left the penalty in the hands of the federal statute. He recommended as a second best solution that if the state was allowed to fix the rate of interest, it also be allowed to fix the penalty.[28]

McCulloch's reason for supporting usury laws is evidently the same as Adam Smith's: Usury laws keep the money away from prodigals and projectors. The similarity of their views, of course, does not necessarily mean that McCulloch was influenced directly by Smith. Smith's views probably reflected a working tradition among bankers to which McCulloch was also an heir. Nevertheless, McCulloch's position suggests that the mercantilist case for usury laws was still far from dead, even at mid-century.

What seems to have done in the strict usury provision in the 1863 Act, and the milder, but still tough alternatives proposed by McCulloch, wasn't Bentham's arguments, but rather a more practical problem: Getting banks to convert from state to national status. The problem was pointed out in the lead article in *Bankers Magazine* (Ketchum 1863) published a few months before Congress began debating a revised version of the Banking Act. The author, Hiram Ketchum, stressed an important practical consequence of the different treatment afforded state and national banks under the usury provision in the 1863 act: State banks, particularly in the West, were reluctant to join the national system, because they could charge higher rates as state banks. Ketchum's recommendation was that national banks be permitted to charge the highest rate allowed in any state, or be free of all controls.

An important piece of evidence supporting Ketchum's claim that western state banks would not convert until they could compete on the same basis as state banks that didn't convert, or other intermediaries, comes from a report made by one of Jay Cooke's bond salesmen. Cooke was the Treasury Department's chief agent in the sale of government bonds during the Civil War. In November 1863 he received a letter from his agent in Michigan outlining the reasons for the slow sale of government bonds to potential national banks. In part the agent wrote the problem was:

> The low rate of interest permitted – seven per cent only in Michigan, whereas state law permits 10 per cent. (by contract) and throughout the greater portion of the state the actual rate is 1 ½ to 2 per cent. a month. …Quite a large amount of 5-20's [a federal bond, 5 percent per year for 20 years] are now held by bankers and others in interior towns of Michigan and still more will be purchased for the use in banking under the Act…the hope being strong that the coming Congress will allow interest to be charged on loans in accordance with state enactments… Oberholtzer (1907, 357).

McCulloch's recommendation of a flat 7 percent for all National Banks, however, was far from dead. He was strongly supported by a committee of bankers from New York who lobbied McCulloch and the House Ways and Means Committee, probably in the first weeks of March 1864.[29] The interest of the New York bankers in a national 7 percent maximum is clear. New York's state usury law set a maximum of 7 percent. State banks and National banks would be on a par in New York, and conversion to the national system would be unimpeded. In the west, however, bankers would prefer the state system, and access to state usury laws. The national banks of New York would come to dominate the system. And if note issue were confined to national banks, it would be the notes of the New York national banks that would circulate throughout the country.

Although I have seen no explicit evidence, it is likely that the committee of bankers also lobbied for a clause permitting the Secretary of the Treasury, or some similar authority, to suspend the usury laws in major financial centers during a crisis, a policy that McCulloch supported.[30] Such flexibility would have been important for bankers who could still remember the levels reached by interest rates during the Panic of 1857.

In any event McCulloch's recommendation of a uniform 7 percent interest rate ceiling was incorporated in the bill introduced in the House by Samuel Hooper in April 1864. Here it was strongly criticized by Congressmen from the Western states who emphasized the inequality between state and national banks that would develop in their states if a uniform rate were adopted. Blaine (of Maine!) offered an amendment substituting the language "[the maximum rate of interest] established by law in the state where the bank is located" for the uniform rate. Blaine's purpose was actually to restrict the national banks in Maine to the state interest ceiling of 6 percent. But he was strongly seconded by Cole of California who argued that there would be a great disparity between the then current rate in California of 2 percent or more per month and the uniform 7 percent rate in the House bill. Cole finished his speech by endorsing Blaine's proposal:

> Mr. Cole. …"In New England the rate of interest is six percent; but it is not so in the western states. In Iowa it is different; and there is no reason for creating this discord by establishing a rate of interest for States different from what prevails there by their own laws. Therefore I am in favor of striking out the section [providing for a uniform rate], thereby leaving the matter entirely under the control of the several States. That is the proposition of the gentleman from Maine. He proposes to leave it to the local legislation of the several States entirely."
>
> Mr. Blaine. "Entirely."[31]

Other Congressman supported Cole's point that a uniform rate would discourage conversion to national status or the settling up of national banks in high interest rate states. Higby of California went so far as to claim that no national banks would be set up in his state where high rates of interest were the norm. He himself was paying two percent per month at that very moment![32] Blaine's amendment was adopted, but as it turns out it did not provide the actual text of the law of 1864. In a peculiar turn of events a second amendment limiting the rate of interest to 6 percent was adopted leaving the usury section in a confused state. This version of the Currency Act was later tabled, and a second bill, again incorporating a uniform rate, was introduced in the House.

The actual source of the usury formula in the Act of 1864 was a Senate amendment proposed by the Senate Finance Committee. I have not seen any direct references to what happened in the Finance Committee. But we do know that in January 1864 Jay Cooke dispatched his brother Henry to talk with John Sherman, the chairman of the Finance Committee, and Salmon Chase, the Secretary of the Treasury, about needed revisions in the law. And the next month Sherman's Finance Committee reported out a series of amendments to the 1863 law including the language of the 1864 usury section which allowed the national banks to follow the usury law of the state where the bank was located. It may be that the Finance Committee rejected the uniform rate in favor of a rate to be determined by state law partly as a result of Cooke's lobbying effort.[33]

This amendment was debated in the Senate on May 5 with the Senators going over much of the same ground as the Representatives had earlier. Grimes of Iowa complained that National Banks in one state could end up charging more than national banks in neighboring states.[34] But Trumbull of Illinois argued that state banks would not convert unless given equal freedom to lend under the national characters. He told the Senate that leading bankers from Chicago had made this point to him.[35]

Senator Henderson of Iowa then raised the point that in his state note issuing banks were under a lower interest-rate ceiling than private lenders.[36] Several attempts were made to amend the usury section to make the rate applying to state banks the relevant rate. But there were objections. Some states, for example, did not create banks of issue. Perhaps most telling was the brief interjection by Lane of Kansas who pointed out that in his state private bankers took advantage of the higher ceiling for private lenders and yet issued notes that circulated as money.[37] Evidently, limiting the national banks to the rate permitted under state law for incorporated banks of issue would discourage entrepreneurs from setting up national banks in Kansas because they could not offer investors the same return as private bankers.

It is possible that his remark rang a bell with Sherman. In 1850 Ohio (Sherman's state) had passed the so–called "ten percent interest law" that allowed private lenders 10 percent while banks of issue were limited to 6 percent. The law produced a number of unfortunate consequences. (Huntington 1915) For one thing state chartered banks largely abandoned discounting home paper and concentrated on bills of exchange payable out of state because fees for "exchange" were not easily attacked under the usury laws. More important for our purpose, the ten percent law discouraged investment in banks of issue. Investors in Ohio preferred putting their capital into private banks or banks chartered in other states. The result was that the currency in Ohio contained a large admixture of notes issued by private bankers and by banks in other states. Indeed, the ten percent law was the major cause of the lack of uniformity in Ohio's currency that Chase complained of during his inaugural address as Governor of Ohio in 1856, the position he held before becoming Secretary of the Treasury. (Huntington 1915, 450) The ten percent law was abandoned in 1859.

In the end, Fessenden of Maine, another key member of the Finance Committee, cut the debate short by offering to fix up the amendment. When Sherman reported the new wording two days later it contained the phrase, "except that where by the laws of any State a different rate is limited for banks of issue organized under State laws, the rate so limited shall be allowed for associations organized in any such State under this act." The effect of Fessenden's rewording, on close reading, was to give the national banks favored status. They could take the rate permitted private investors if that rate was higher, or use the rate allowed to banks of issue if that was higher. Nothing like the disaster that had occurred under Ohio's ten percent law could now occur under the national banking act. This wording was adopted without further debate.[38] Evidently, the desire to get capital flowing into the National Banking system in the Western states had triumphed over any lingering regard for usury laws.

6. Did Liberalizing the Usury Laws Have Any Impact?

I have been concerned so far with the usury laws as a case study in the causes of economic regulation. It is natural to ask whether the liberalization of the usury laws had any impact on the economy. The conventional wisdom among economic historians, as noted above, seems to be that usury laws have no significant effect because they were easily evaded. The borrower and lender simply wrote a contract that hid the usury. But for a number of reasons the history of the usury laws developed above and other evidence developed by economic historians makes me skeptical of the conventional wisdom.

(1) Usury laws are inherently popular because they speak to fundamental ethical concerns. Why liberalize them if they have no economic effect? Why, to be a bit more specific, should legislators have risked the wrath of a large segment of the public who believed that usury was immoral by raising maximum rates or lowering penalties if the only

savings to the business community was the ink on loan contracts? Yet as we have seen, legislators persistently did make the effort to liberalize the laws.

(2) The conventional wisdom assumes that judges can't or won't see beyond the legal document placed in front of them. Judges do, of course, put a lot of weight on signed documents. Nevertheless, there must be some risk when a usury law is on the books that a judge will be sympathetic to the borrower, and willing to believe whatever proofs of usury the borrower can muster.

(3) In most circumstances the effects of liberalizing moderate usury laws are likely to be hard to see: the reallocation of some capital from lower risk to higher risk investments. But when abrupt and far-ranging changes are made in the usury laws the results will be visible. Two examples from our narrative are the difficulties that arose from the Ohio 10-percent law and from the attempt to establish a uniform rate in the National Currency Act (1863).

(4) Leslie Pressnell's classic study, *Country Banking in the Industrial Revolution* (1956) shows that British usury laws appear to have had (Pressnell is careful not to go beyond his evidence) an important effect on country banks in England during the eighteenth and early nineteenth centuries. (Pressnell 1956, 285-88, 316-21, and *passim*). Rather than change their lending rate when equilibrium interest rates rose above the usury rate, and thus risk writing contracts that could not be enforced, country banks responded by changing the length of loans.[39] Pressnell (1956, 321) concludes that: "The relaxation of the usury laws in fact introduced into the money market a flexibility much greater than is immediately visible: against higher rates of interest, bankers could discount longer bills, or allow clients to draw for shorter periods than had hitherto been possible." Clapham (1970, volume 2, 15) writng

about the period before 1833 says that while bill brokers might have circumvented the usury law by charging a commission, and private bankers might have done so by requiring compensating balances, "that was not for the Bank [of England]; and so it suffered."

(5) Lance Davis's classic study of the financing of the New England textile mills argued that the usury laws in Massachusetts were "fairly well observed, at least by the major institutional lenders, until the mid 1850s." (Davis 1960, 3) The tendency, that Davis observed, for the usury laws to lose their effect as mid-century approached may have been due to the reduction in the penalties in Massachusetts discussed above. Similarly, Barry Eichengreen's study of the mortgage rates at the end of the nineteenth century (1984) found some impact from usury limits, when the limits were relatively low, on mortgage rates. And Ken Snowden (1988) found additional evidence of an impact on mortgage rates in urban markets.[40] It seems likely that the impact of usury limits would have been larger earlier in the century when penalties were higher.[41]

(6) Eugene White generously gave me access to the data for his study of the California Bank of A. Levy (2001). Levy was lending money in a state that permitted any rate so long as it was stated explicitly in the contract. A rate of 10 percent applied when no rate was stated explicitly. It turns out in White's sample that if, say, 10 percent had been made the maximum rate, then 15.4 percent of Levy's loans by count and 30.7 percent by value would have been illegal. Would Levy have continued to place such a large fraction of his funds in loans that could be challenged in court, or would have reacted as Adam Smith suggested, and lent a larger proportion to lower-risk borrowers at a lower rate? Economic historians have become increasingly aware of the importance of the law when it comes to

other forms of property rights – bankruptcy law, the law of negotiable instruments, etc. – why should usury laws be an exception?

(7) The most visible sign of an impact from the usury laws would be in the courts. And here one must concede the evidence is mixed. Robert Wright (2001, 29-41) undertook an exhaustive examination of colonial records and found no evidence of the usury defense. His unequivocal conclusion is that the colonial usury laws were a dead letter. On the other hand, there is evidence from the nineteenth century that the usury defense was invoked from time to time, and that the courts took the law of usury seriously.

I looked at the Supreme Court Cases involving usury in the nineteenth century. There were simply too many cases to read if one looked at lower courts, and the Supreme Court would reflect the national picture. A reading of the cases suggests that there were about 60 cases before the Supreme Court between 1800 and 1900 in which usury laws played a significant role in the case, about one every 1.6 years. (There were many additional cases in which the law of usury was cited in the course of the argument by way of analogy.) The number of cases fluctuated somewhat from period to period. The 1830s (10 cases) and the 1870s (also 10 cases) and the 1890s (14 cases) stand out. These were also, of course, periods of economic distress.

The amounts involved were substantial in today's money. Dundas v. Hitchcock (1851) began with a bond for $620,530.96 written in 1838 ($11, 700,000 in 2001 using a Consumer Price Index). In *the Bank of the United States v. Herbert G. Waggener, George Wagley and Alexander Miller* (1835) the case arose from a $5,000 obligation paying 6 percent purchased by the Bank of the United States in 1822, but paid for with notes of the Bank of Kentucky which were then depreciated from 30 to 40 percent in the market.

($75,000 in 2001 using a Consumer Price Index – and ignoring the depreciation of the notes). *Levy v. Gadsby* (1805) began with a note for $1,436.62 created in 1797 ($20,000 in 2001 using a Consumer Price Index).

The Supreme Court, as might be imagined, was asked to settle a variety of thorny legal issues. In a few cases these were simply technical legal questions that could have arisen under other laws, for example the proper instruction of juries. Most of the cases, however, meant settling the law of usury. In a number of cases the old question of whether various devices constituted prohibited attempts to evade the usury laws played a prominent role in the case. In *the United States v. Waggener* (1835) the loan made by the Bank of the United States was legal on the face of it (6 percent as required by the bank's charter) but usurious when the depreciated market value of the Bank of Kentucky notes was taken into account. Reading between the lines, there seems to be a suggestion that the borrowers may have had the usury defense in mind when they insisted on the Bank of Kentucky notes. In *United States Mortgage Company v. Sperry* (1891) the issue was whether unpaid interest added to the principal could in some way render the original loan usurious. In Cockle et al. v. Flack et al. (1876) the case involved a meat packer in Peoria who had borrowed from a merchant in Baltimore who also charged a commission for selling the final product. The commission was charged whether or not the product was sold. The question was whether those commissions were a dodge for evading the usury law. In *Call v. Palmer* (1885) the issue was whether an agent who exacted a separate commission could render the contract between the principal and the borrower usurious. In *Wheeler v. National Bank* (1877) the case revolved around a bill of exchange on which it was alleged the bank had charged an excessive amount for exchange in order to evade the usury law.

As might be imagined, conflicts among usury laws in different states had to be resolved. In Tilden v. Blair (1874), for example, the case centered on a bill that was drawn in one state on the resident of another. The bill was accepted in the second state and returned to the first state where it was negotiated for a price that would have implied usurious interest in the second state but not in the first. The creation of federal institutions also created the need for Supreme Court interpretations. Fleckner v. the President, Directors, and Company of the Bank of the United States (1823) addressed the six percent usury provision of the charter of the Bank of the United States. A number of cases including *Tiffany vs. National Bank of Missouri* (1872) and *National Bank v. Johnson* (1881) were aimed at settling the interpretation of the usury provision of the National Banking Act and its amendments.[42] The willingness of the Supreme Court to hear these cases shows that it took the proper structuring of the usury laws seriously.

7. Conclusions

Usury laws are not, at the moment, at the top of the political agenda, although there has been some concern with "payday" loans. We should not, however, ignore usury laws on that account. Economic regulation and deregulation is a hardy perennial. And usury laws provide a good case study of how economic regulation is shaped through the interaction of economic ideas and economic conditions. During the colonial era the United States, like Britain, had a strict set of usury laws. Maximum rates appear relatively low to a modern eye, and penalties for violating the laws appear tough. During the Antebellum period, however, these laws were gradually liberalized or repealed, although some states clung to their laws, and the system has never been abandoned.

Part of the explanation for the liberalization is the rise of faith in Laissez Faire, and more particularly in Bentham's case against the usury laws. The influence of ideas on legislation is always difficult to prove. But it seems plausible that at the margin the strong consensus among economists, using the term broadly, that Bentham had won the theoretical argument must have had an impact. As one dogged supporter of usury laws in Wisconsin was forced to admit he "did not believe in the principle of free trade in money – not because he could reply to the arguments of those who were in favor of it – they had all the arguments in their favor" but because "experience has taught us that it is unjust." (Quoted in Friedman 1963, 556).

Ideas, however, are not the whole story. As late as the Civil War there was a nearly successful attempt to incorporate a maximum lending rate that would have been applicable nationwide in the National Banking system despite the free market consensus among economists. Competition among the states for capital was also important in undermining the usury laws. Engerman, Haber and Sokoloff, (2001, 25) have argued recently that voting restrictions were eased in western states in order to attract settlers. Similarly, usury laws were eased in order to attract capital. This was especially true in the early days of settlement when uncertainty produced high interest rates and potential farmers needed mortgage money to buy land. The fear that capital would leave a state that maintained tough usury laws was a powerful argument in the hands of those who favored an unfettered capital market.

Table 1. A Chronology of British Usury Laws		
Date	Maximum Rate	Penalties/Comment
Before 1545	0%	Lending at interest was practiced, however, often by members of groups that were not restricted by the usual social norms. From the time of Richard I the law recognized, generally, although not continuously, that Jews were lending at interest and regulated the rate. In 1233, for example, Henry III set the maximum rate that could be charged by Jews at two pence per pound per week, a simple rate of about 43 percent, or about 54 percent when compounded. The Jews were expelled in 1290.
1545	10%	Forfeiture of three times the principal and interest, fines, imprisonment, and ransom at the King's pleasure.
1552	0%	Forfeiture of principal and interest and fines, imprisonment, and ransom at the King's pleasure.
1571	10%	Forfeiture of three times the principal and interest and fines, imprisonment, and ransom at the King's pleasure. Courts would not enforce recovery of more than the principal.
1624	8%	Forfeiture of three times the principal and interest.
1660	6%	Forfeiture of three times the principal and interest.
1713	5%	Forfeiture of three times the principal and interest.
1833	Usury limits removed for bills of exchange with 3 months or less to run; part of the Bank Charter Act. This law frees the Bank of England to raise its discount rate.	
1854	Final repeal of the Usury laws. By this time only limits on rates charged on mortgages secured by land remained on the books.	
1900	Moneylenders Act restores the defense of usury.	
Sources and Notes: This table has been compiled from various secondary sources, such as Smith (1979[1776], 106), Holdsworth (1903, volume 8, 110-113), Robinson and Nugent (1935, 28-29), and Jones (1989). It is intended merely to provide a broad-brush picture of the liberalization of the British laws.		

Table 2. Chronological History of the Repeal of U.S. Usury Laws in the Nineteenth Century

Year in which the usury law was repealed	**State**
1818-1818	Alabama
1818-1821	Mississippi
1819-1832	Illinois
1822-1829	Florida
1831-1832	Indiana
1832-1832	Florida
1849-1851	Wisconsin
1850	California
1851-1852	Iowa
1851-1859	Minnesota
1852-1881	New Mexico
1854-1862	Oregon
1854	Washington
1855-1860	Nebraska
1859-1859	Kansas
1860	Louisiana
1861	Nevada
1862	Colorado
1864-1870	Idaho
1865	Arizona
1865	Montana
1865	North Dakota
1865	Rhode Island
1866	Florida
1866-1876	South Carolina
1867	Massachusetts
1868-73	Arkansas
1869	Utah
1869	Wyoming
1870	Maine
1870-75	Texas
1872-1872	Connecticut
1873-1874	Georgia
1873-1874	Mississippi
1877	Connecticut
1881	North Dakota

Source and Notes: (Holmes 1892, 436-442). The table includes states in which there existed a maximum rate when no rate was specified explicitly in the contract. If a range of years is shown, the repeal was subsequently reversed prior to 1890.

Figure 1
Average Maximum Rate of Interest, 1750-1890

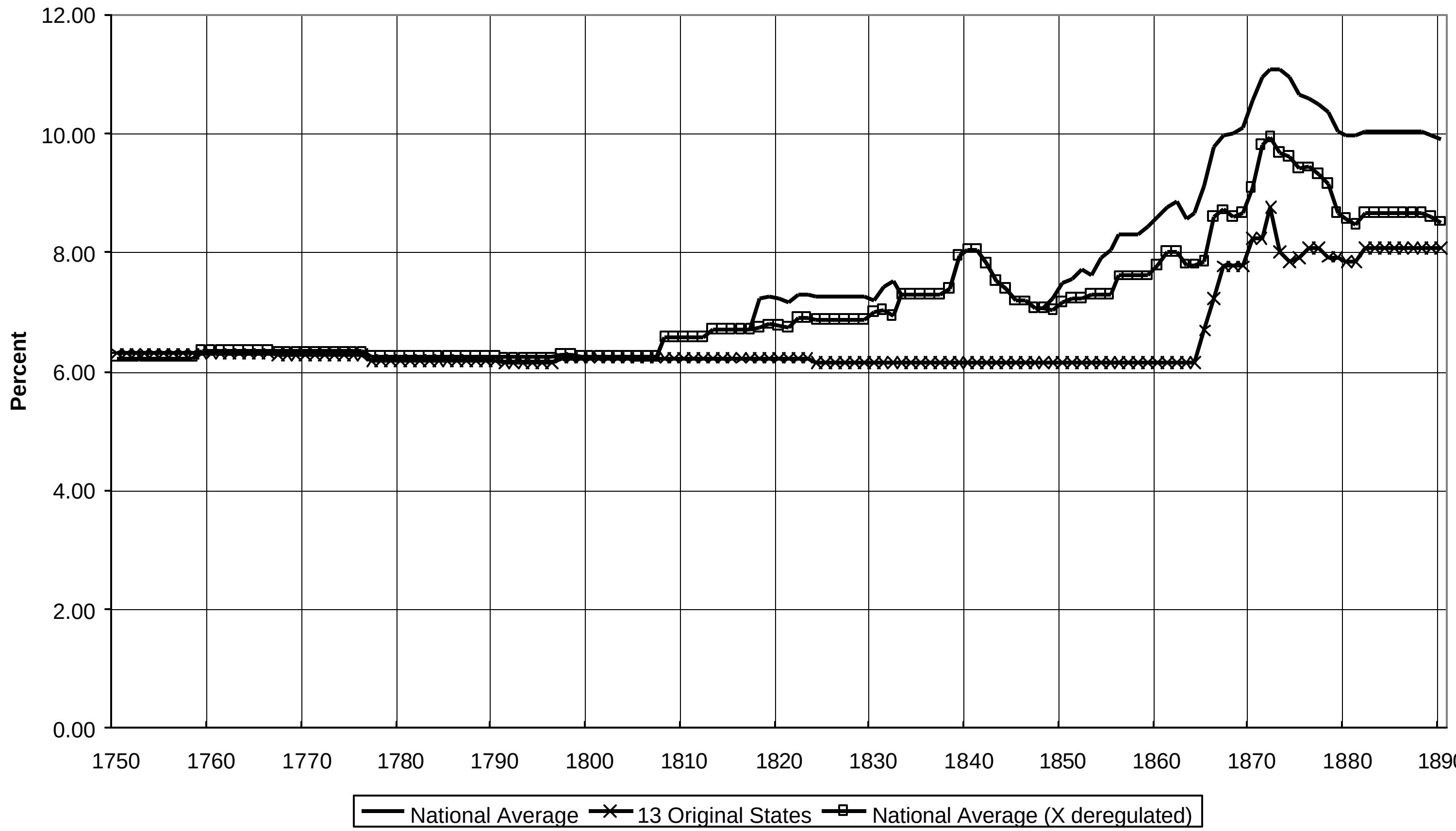


Figure 2
Average Penalty, 1750-1890
($ penalty if $10 usury is charged on a $100 loan)

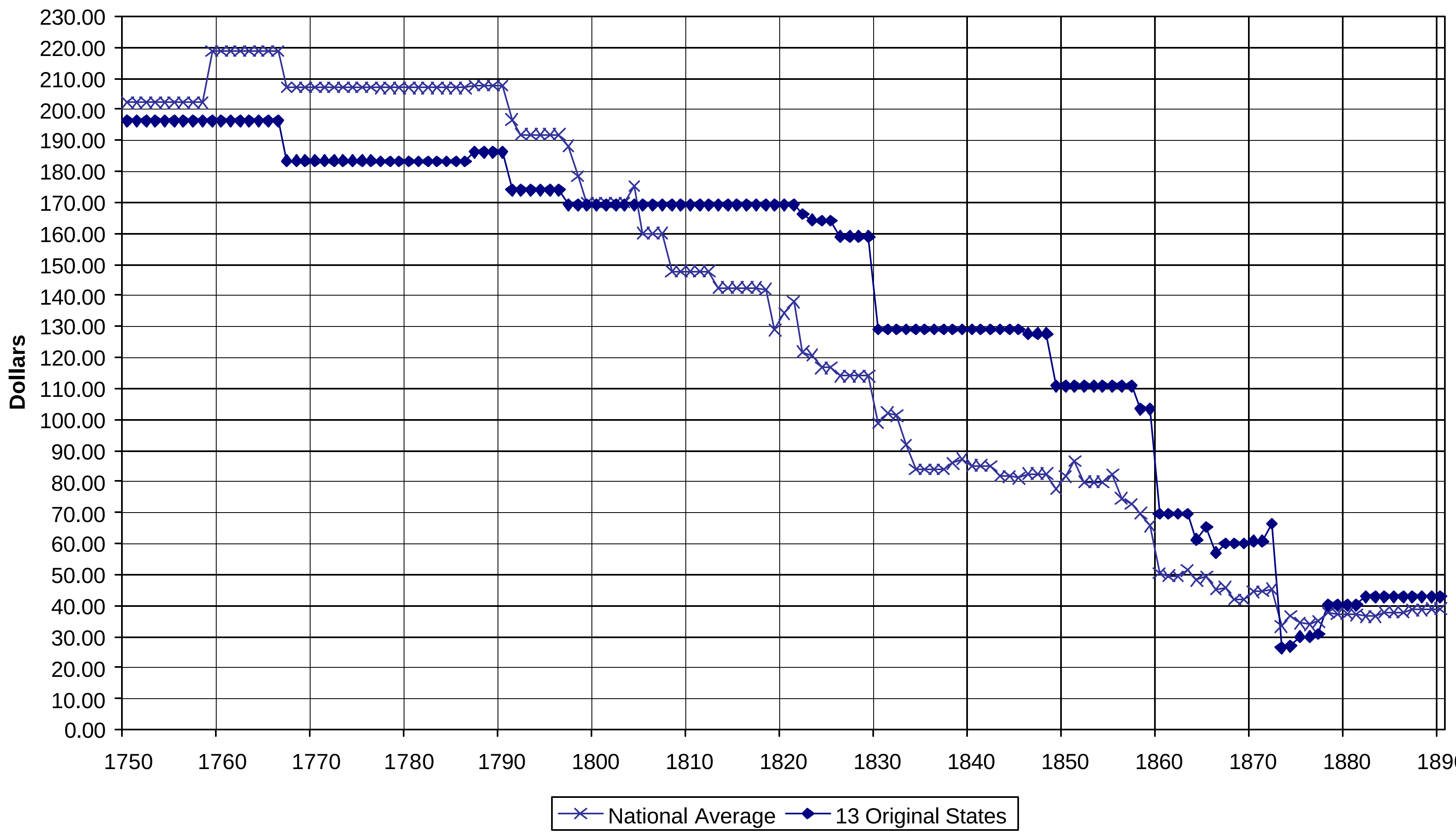
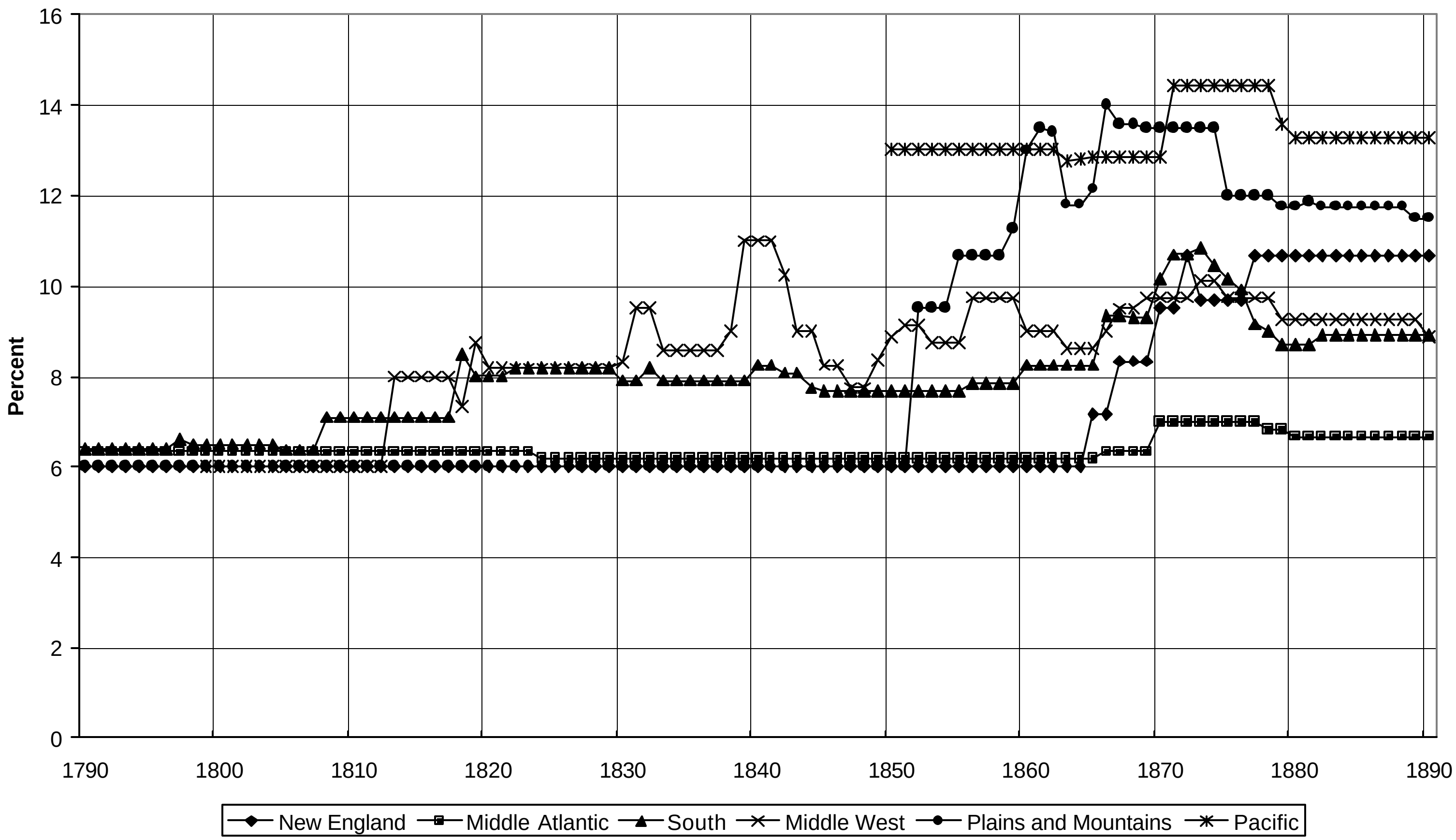


Figure 3
Maximum Legal Rate of Interest, 1790-1890, by Region



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Notes

[1] I wish to thank Eugene White for sharing his Bank of A. Levy data, and Zorina Khan for helping me get started on the court cases on usury. They, along with Howard Bodenhorn, Michael Bordo, and Ira Gang, also made a number of helpful suggestions for improving a previous draft. I am also grateful for the chance to present the paper at a seminar at Rutgers and at the seminar in honor of Stanley E. Engerman held at the University of Rochester.

[2] This tactic known was known as “note shaving” in nineteenth century America.

[3] The use of protested bills to evade Virginia's usury laws is also mentioned in Farnam (1938, 91).

[4] Payday loans are discussed in “Risky Business: Exploiting a Loophole, Banks Skirt State Laws On High Interest Rates,” By Paul Beckett, *Wall Street Journal*. Friday, May 25, 2001, 1+. Some lenders rely on national banks for their capital because national banks can charge interest rates based on the law of the state where the bank is located rather than where the borrower is located. The origin of this arrangement is discussed in section 5.

[5] Glaeser and Scheinkman (1998, 23-36) provide a wide-ranging summary.

[6] I have relied mainly on Noonan (1957) and Nelson (1969).

[7]Nelson's emphasis on Calvin was vigorously challenged by George (1957).

[8] Although Steuart was clearly Smith's bête noire, it is one of Smith's affectations that he never cites Steuart by name.

[9] Richard Brinsley Sheridan's classic, "The School for Scandal," a play about a prodigal son, complete with Jewish moneylender, was first produced on Drury Lane in 1777.

[10] Smith's departure from Laissez Faire in this case, as in similar cases, has continued to attract the attention of economists and historians of economic thought. See, for example, Blitz and Long (1965), Jadlow (1977), and Stiglitz and Weiss (1981). The latter provide a rationale similar to Smith's. These and other interpretations are discussed in Paganelli (2003), who argues that although modern economists have sympathized with Smith, they have not really understood him because Smith was willing to stipulate permanent misperceptions of reality, an assumption at variance with modern economic thinking. In the present case, the willingness of prodigals and projectors to enter into contracts that reduce their wealth is a case in point.

[11] The reception of the *Defense of Usury* is described in Stark's introduction to the economic writings of Jeremy Bentham (1952-54, 26-33).

[12] Usury laws were actually repealed only in Alabama and Mississippi, and then only for a time.

[13] Kish-Goodling (1998) provides a superb overview of the economic meaning of the play, and a number of suggestions for using the play as a tool for teaching monetary economics. Shakespeare's father John, it turns out, had been prosecuted for usury in 1570 the last year of the prohibition, a not uncommon occurrence in those days. (Thomas and Evans, 1984). In one of two cases he was fined 40 shillings. It is not certain how the other case was resolved; Shakespeare's father may have settled with his informer. Peter Levi (1988, 18-20) attributes the prosecution to John's political enemies.

[14] Colonial usury laws are discussed in Farnam (1938, 88-91).

[15] Macauley's unadjusted index of the yields of American railroad bonds averaged as follows. (U.S. Bureau of the Census, 1975, series X476.)

1860-69 7.70
1870-79 7.14
1880-89 4.95
1890-99 4.35

[16] The calculation was made by setting $1+u = (1+d)(1+i) - 2d(1+i)$, where u is the rate of usury, d is the added risk of default with a successful usury defense, and i is the required rate on the riskier loan. The formula was then modified as needed to take account of the other penalties. This example abstracts from the cost of going to court and other complications that would affect lending decisions, and is intended merely to dramatize the consequences of the reduction in penalties.

[17] Today, Dana is best remembered as the author of *Two Years Before the Mast.*

[18] In 1882 New York, removed the ceiling for Demand Loans over $5,000 and secured by collateral. This was probably a response to the growth of the call loan market.

[19] Causation, of course, might well have run in both directions, from market rates to usury rates and from usury rates to market rates.

[20] In a famous case in New York in the late 1840s the New York Dry Dock Bank refused to pay a loan of about $225,000 that was due the American Life Insurance and Trust Company on the grounds that the loan was usurious. The courts upheld Dry Dock's refusal. As a result the New York legislature passed a law in 1850 preventing corporations from interposing the usury defense. Although on the surface this looks like an anti-usury law, it is if anything an anti-bank law. (Ryan 1924, 58-60).

[21] The next two paragraphs are based on Robinson and Nugent (1934), which summarized the material developed in a number of Russell Sage foundation publications on the small loan problem.

[22] It is not obvious, however, from reading the charter what if any penalty Congress intended if the Banks should charge a higher rate. The Supreme Court eventually dealt with the issue.

[23] David Ricardo later criticized the application of the usury restriction to the Bank of England because it prevented the Bank from limiting credit expansion by raising the discount rate. This was part of his criticism of the Bank's excessive issue of paper money during the restriction specie payments that accompanied the Napoleonic wars.

[24] Davis (1910, 106-112). Hammond (1970) provides an overview of the political and economic forces that led to the establishment of the National Banking System.

[25] Davis (1910, 55-62).

[26] He would soon be appointed Secretary of the Treasury.

[27] *First Annual Report of the Comptroller of the Currency*, as reported in *Banker's Magazine*, New Series XIII (February 1864), pp. 621-624.

[28] *First Annual Report of the Comptroller of the Currency*, as reported in *Bankers Magazine*, vol. XIII, February 1864, p. 621.

[29] *Merchant's Magazine*, vol. L (April 1864), p. 309.

[30] *First Annual Report of the Comtroller of the Currency*, 623-24.

[31] *The Congressional Globe*, 38th Cong., 1st sess., p. 1353.

[32] Ibid., 1374. Statements such as these are, I must admit, somewhat inconsistent with the picture of an integrated antebellum capital market painted in Bodenhorn and Rockoff (1992). We did, however, qualify our argument by pointing to the frontier, and arguing that beyond the frontier rates did seem to be higher, reflecting uncertainty surrounding investment in regions of new settlement. So at least to some extent, these statements can be reconciled with the evidence of integrated markets in the East in Bodenhorn and Rockoff (1992).

[33] Oberholtzer (1907, 358). The only insight into the work of the Finance Committee that I have found is a remark by Sherman in the Senate. He said that he initially favored a flat maximum rate but the committee found that it would "create so many disputes and rivalries and troubles" that he was forced to yield.

[34] *The Congressional Globe*, 38th Cong., 1st sess., 2123.

[35] Ibid.

[36] Ibid., 2126. Banks of issue were public banks in the sense that they operated under characters providing for limited liability and other privileges granted by the state legislature.

[37] Ibid.

[38] *The Congressional Globe*, 38th Cong., 1st sess., 2143.

[39] This is another instance of the Smith effect. If lenders are unable to charge long-term borrowers a premium, lenders will allocate more of their funds to the short-term market.

[40] Initially, Snowden seems to have been a bit skeptical about the potential impact of usury laws. See Snowden (1987) and Eichengreen (1987).

[41] Recent works by John Munro (2001) and Emily Tan (2003) in different ways have questioned the assumption that the medieval usury laws were a dead letter.

[42] The latter cases have been cited in recent court cases concerning the charging of credit card interest by national banks.