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# 3. Bursting through state limits. Lessons from American railroad history

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One fact must be accepted ... the railroad system has burst through State limits. (Charles F. Adams, Jr., 1871)

## INTRODUCTION[1]

As the twenty-first century opens, the significance of 'nationality' in the economic world has become exceedingly fuzzy. Although experts on globalization disagree on the finer points of definition and evidence,[2] indicators point to financial markets as the seedbed of revolutionary change. Driven by liberalization of markets and electronic networks, world financial markets have expanded at an astounding pace. Cross-border transactions in bonds and equities involving US residents grew from 4 percent of American GDP in 1975 to 213 percent in 1997, with corresponding rates even higher in European countries.[3] Meanwhile, currency market turnover *per day* rose from $150 billion in 1985 to $1.26 trillion in 1995. As Andreas Busch concludes in a recent survey, 'changes [in some financial markets] have taken place at breathtaking speed and of a spectacular magnitude'.[4] As the 1990s came to a close, border-crossing seemed to reach even deeper into national economies. Between 1991 and 1998, the value of cross-border mergers and acquisitions in Organization for Economic Cooperation and Development (OECD) countries increased more than sixfold.[5] In the space of two years – 1996 to 1998 – direct investment inflows in OECD countries more than doubled.[6] As national borders have become increasingly porous, the largest firms have also come to rival whole nations in capitalization – Microsoft's market capitalization in late 1999, for example, equaled the entire annual GDP of Spain.[7]

When border-crossing becomes the norm and firms rival governments in size, what happens to the power of national governments to regulate business? This question has bedeviled scholars at least since the rapid growth of multinationals in 1970s, and in the last decade the literature on 'globalization' has mushroomed. But the scholarship on the regulation of global business focuses





almost exclusively on twentieth-century developments.[8] The full dimensions of the political dilemma facing nation-states today can be seen with special clarity, this chapter suggests, in the American experience with railroad regulation in the nineteenth century. American corporations were – and still are – the creations of the state governments,[9] and the long-distance railroads chartered in the 1830s and 1840s constituted the nation's first 'big businesses'.[10] Commanding unprecedented amount of capital, they became the first truly interstate businesses in the US – the first to cross state borders routinely and frequently. Their novel character, in the words of one observer, brought 'a constant succession of surprises' – not least of which was a fundamental challenge to a long tradition of state-government regulation of transportation rates.[11]

This chapter explores the decades-long conflict over railroad regulation – especially rate regulation – in the United States. It shows how and why that conflict propelled US business regulation from the state to the national level between the 1830s and the 1880s. Understanding the political dynamics underlying the shift from state to federal regulation in the American past provides important insights into the prospects for a corresponding global shift from national to international regulation in the twenty-first century. In a nutshell, the prospects are exceedingly dim.

## THE NINETEENTH-CENTURY AMERICAN EXPERIENCE

The starting-point of the American story lies in the decades before the Civil War. This was not – as many mistakenly think – an era of '*laissez-faire*'.[12] It is true that the first federal regulatory commission, the Interstate Commerce Commission (ICC), was not created until 1887. But business regulation in the US did not suddenly begin with the birth of the ICC. Because of federalism – that is, decentralization of power in the state governments – much of the action in the nineteenth century actually took place at the state, not the national, level and therefore has tended to be overlooked.[13] At the state level, a remarkably vibrant tradition of government activism prevailed.

Not hamstrung by the constitutional debates that the federal government's initiatives inevitably sparked, the antebellum state governments promoted and regulated economic activity with great energy. Several generations of scholars have now deepened and enriched our understanding of this critical aspect of American history. Best-documented are the states' promotional efforts. '[I]n no other period of American history', in the words of George Rogers Taylor, 'has the government been so active in financing and actually promoting, owning, and controlling banks and public works including turnpike, bridges, canals, and railroads'. Equally energetic, though nearly forgotten, were the states' regulatory

efforts, often delegated to local governments. As William J. Novak argues in a recent study, 'a plethora of bylaws, ordinances, statutes, and common law restrictions regulat[ed] nearly every aspect of early American economy and society'.[14]

Among their traditional powers, the states' right to regulate common carriers was one of the most important, widely exercised, and well established.[15] Here the public interest was regarded as inherent, even when a firm's capital lay in private hands. In traditional forms of transportation – turnpikes and canals – public policy distinguished between *tolls* paid for use of the road- or waterway and *carrying charges* for transporting passengers and freight. On turnpike and canals, a multiplicity of stagecoach operators and canal boat owners transported passengers and freight. Thus competition among multiple carriers could be relied upon to keep carrying charges within bounds. But those who owned the roadway or canal itself usually enjoyed a monopoly. The state legislatures, therefore, took care to regulate their behavior, usually by setting maximum tolls for use of the road- or waterway. The states' right to do so went unquestioned. They also had the means to do so in the corporate charter itself. Companies were normally incorporated individually in special acts passed by the legislature, so it was generally in the provisions of that legislation – the corporate charter – that the legislature regulated companies. The states' jurisdiction was adequate to the task, finally, since enterprise remained relatively small in scale.

This tradition of state regulation ran abruptly into trouble, however, in the face of technological change. Railroad construction began in earnest in the US in the 1830s. By the end of the decade, American railroads totaled some 4500 kilometers; by 1850, they had more than tripled in length to 14 400 km. Total railroad investment, meanwhile, climbed from an estimated $96 million in 1839 to $301 million in 1850. The density of track was greatest in New England, but railroad development proceeded apace in all parts of the country. The largest firms soon commanded capital in the tens of millions of dollars. Then suddenly, between 1851 and 1854, four great trunkline railroads, linking eastern cities with the western hinterlands, reached completion. As the trunklines extended their reach westward, the 1850s experienced a railroad-building boom without precedent. By 1860, the combined length of American railroads had more than tripled again to 49 000 km, while investment soared to $1.15 billion. The railroads had become the first billion-dollar industry in American history. By 1880 American railroad track totaled nearly 150 000 km, representing an investment of some $4.7 billion dollars.[16]

Almost as soon as railroad construction began, it brought a rapid succession of unprecedented problems. One was the sheer physical size of their operations. As had become apparent by the late 1840s and unmistakable by the early 1850s, the new long-distance roads increasingly crossed state lines, thus literally exceeding the states' reach. Further growth in the 1850s and 1860s only compounded the problems. Charles Francis Adams, Jr., stated the matter baldly in 1871, as he weighed solutions to the problem: 'One fact must be accepted ... the railroad system has burst through State limits'.[17] By that time no one could dispute the fact.



But the problems ran deeper, for the new technology also upset prevailing legal norms regarding competition. Many railroad experts initially assumed that freight and passengers would be transported on the railroads by many competing carriers, as they had on canals and roadways. But safety considerations quickly ruled this out. As British railroad expert Dionysius Lardner explained in 1850:

> It soon became apparent ... that this new means of transport was attended with qualities which must exclude every indiscriminate exercise of the carrying business. A railway, like a vast machine, the wheels of which are all connected with each other, and whose movement requires a certain harmony, cannot be worked by a number of independent agents. Such a system would speedily be attended with self-destruction.[18]

Thus competition among carriers could no longer be relied upon to keep carrying charges to a minimum, as they traditionally had. As the railroad network expanded and filled in, moreover, the long-distance railroads inevitably began to compete directly with one another. In their annual report to the shareholders in 1851, the directors of the Baltimore and Ohio Railroad, one of the trunklines, expressed surprise to find themselves suddenly in competition with lines as far away as Boston.[19] This, too, was exactly the opposite of what had characterized canals and turnpikes. Where carriers had traditionally competed among themselves to offer service on monopolistic roadways, in other words, the long-distance railroads now monopolized carriage on their own routes but competed against each other for traffic. The assumptions underlying traditional regulation had been completed upturned. As one observer later put it, 'The law was thus brought face to face with a most perplexing problem'.[20]

Compounding regulatory problems, the railroads were also the first to engage in rampant rate discrimination – that is, they offered different rates to different shippers. Rate discrimination was a competitive tool spawned largely by their unprecedented cost structure. Railroads were very capital-intensive enterprises, and many of the costs entailed in running a railroad – for example, maintenance of depots and track, administrative expenses, insurance, interest, even staffing – did not change appreciably with an increase in the volume of traffic or the distance it traveled. In the language of economics, they enjoyed increasing returns to scale.[21] As early as 1840, the directors of the Boston and Worcester Railroad reported that they were charging higher rates per mile for shorter trips because the 'freight once loaded in the cars ... might be carried to the termination of the line at as little cost at least, as it can be delivered at any of the intervening stations'.[22] High fixed costs created extraordinary pressure to lower unit costs

by increasing the total volume of traffic or the distance it traveled, for this had the salutary effect of spreading fixed costs over larger and larger quantities of goods or passengers. Thus the railroads offered special, low rates to large-scale shippers, to long-distance shippers, and to those located at points where different companies competed for traffic. This was exactly the opposite of the pricing strategy upon which the legislatures' traditional chartering policy as well as the common law had been predicated. Both were oriented to the problem of unfairly high rates, not unfairly *low* rates.

In short, the railroads – the 'high technology' of their day – put the American states in difficult straits: their jurisdiction no longer matched the scale of enterprise, while the novel competitive behavior of the railroads threw into question the basic principles underlying traditional regulation of transportation rates. In these new circumstances, their right to regulate at all became a matter of bitter political dispute for the first time.

In the ensuing, decades-long battles over railroad regulation, the locus of power – and, therefore, the site of conflict – shifted around the American political structure numerous times before finally moving to the national level in the 1880s. In tracking these moves, it is helpful to think of the American political structure as a matrix (Figure 3.1) defined by the separate levels and branches of government. Unlike a unitary, bureaucratic structure, the American

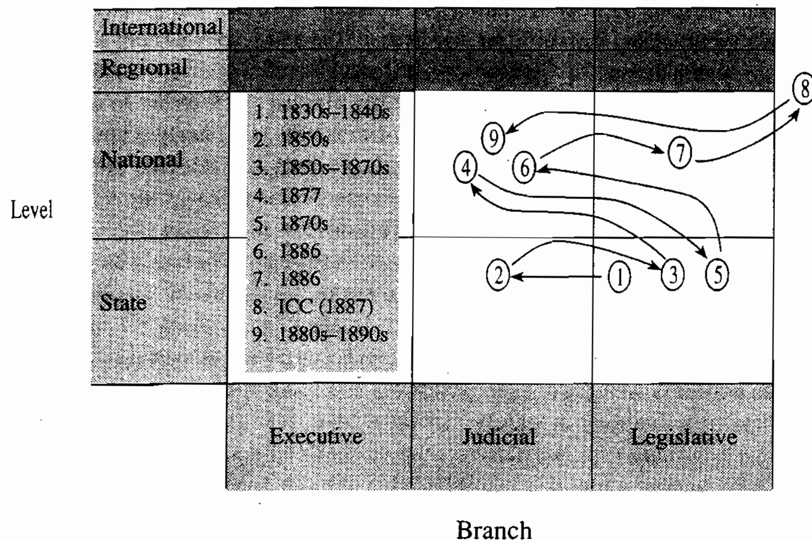


*Figure 3.1* *Sites of conflict in the American political structure: railroad regulation, 1830s to 1880s*



political structure was fragmented both by federalism, which split power between two levels of government, and by separation of powers, which divided it among branches. As the history of American railroad regulation amply demonstrates, a fragmented structure has the desired effect of diffusing power, but it also ratchets up the overall level of overt political conflict. Political issues remain perpetually unsettled as long as the possibility exists of pursuing a more favorable resolution in another branch or at another level of government.

In the nineteenth century, the fractures designed into the American political structure gave business interests, in Harry Scheiber's words, alternative 'routes of escape' from hostile state legislation.[23] In conflicts over railroad rate regulation, these tactical moves took three forms: what might be termed *jurisdiction jumping*, that is, shifting the site of conflict to a more favorable geographical jurisdiction; *branch jumping*, that is, seeking a favorable resolution in another branch of government; and *level jumping*, that is, moving the conflict to a different level of government.

Until the late 1840s, competitive conditions in the railroad industry were subdued, and regulatory power remained firmly in the hands of state legislators – see '1' in Figure 3.1. But, when competition among long-distance lines heated up and rate discrimination increased abruptly in the late 1840s and in the early 1850s, shippers who experienced unfavorable rate discrimination turned to the state courts (1→2) for a remedy. Their complaints centered on the special, low rates that the railroads offered certain shippers to increase the volume of traffic or the distance it traveled. But the state courts could offer little help, for the legislatures, as noted, had followed tradition in specifying only maximum rates. Neither could the common law provide relief, for it, too, was oriented to the problem of high rates, not rate-cutting. Thus conflict necessarily shifted back to the state legislatures (2→3) in the 1850s and intensified, as the traditional understanding of rate regulation completely unraveled.

In political battles in the 1850s and again from the late 1860s into the 1880s, railroad interests sought to fend off regulation by adroitly exploiting the fractures in the American political structure. One means of escaping hostile legislation was to shift jurisdictions by moving to a more benign political environment. Of course, existing companies were well anchored by their physical capital, so railroads and their defenders normally invoked the specter of capital flight in other ways. Regulation would scare off additional investment in railroads, they argued, thereby inhibiting further development of a state's transportation network. One B.B. Taylor, an opponent of railroad regulation, put the threat bluntly in 1874: 'Such legislation will, of course, stop all further improvement by associated capital'.[24] In a different formulation, critics of regulation warned that railroad traffic would be diverted around the regulating state, thus depriving it of valuable commercial ties and trans-shipment business. Such arguments were heard as early as 1850 in Rhode Island, a small state and

thus particularly vulnerable to the diversion argument. But even the most extreme of threats – the physical removal of an existing company – was not unheard of. Political economist Richard T. Ely reported in 1900 that Chicago railroads had once 'proposed ... to leave Chicago and build another city in adjacent territory to escape what [they] regarded ... as oppression on the part of the city'.[25] During the last half of the century, the threat of jurisdiction jumping became generalized in the US. The prospect that corporations would flee to more lenient states tended to hold the states' regulatory impulses in check, giving rise to a dynamic that has become known as a 'race to the bottom'.[26] In a report on trusts at the turn of the century, the US Industrial Commission summed it up neatly: 'whenever any State has put conservative restrictions upon corporations ... other States have taken advantage of the situation and enacted such liberal laws that corporations have removed to them from other States'.[27]

As an alternative to jurisdiction jumping, railroad interests could pursue one of the other two tactics, depending on the circumstances. They could try to shift the level of conflict upward from the state to the national level or to shift it from one branch of government to another. In the early 1870s, four midwestern states passed so-called Granger laws to regulate railroad and warehouse rates. In their battles against the Granger laws, the railroads combined the two tactics by challenging state legislation in federal courts (3→4). Other industries soon adopted both tactics, level and branch jumping, as tactical weapons in their efforts to fend off adverse regulation. Speaking, in effect, of repeated level jumping within the judicial branch, Democratic presidential candidate William Jennings Bryan expressed his frustration with it in 1899: 'When you prosecute a trust in the United States court it hides behind state sovereignty', he complained, 'and when you prosecute it in the state court it rushes to cover under federal jurisdiction'.[28]

In the 1870s, the site of conflict over railroad rate regulation shifted again between the federal courts and state legislatures. Beset by declining prices and intensified competition, especially after the panic of 1873, the railroads found themselves embroiled in political conflict on all sides. The large midwestern railroads lost their initial bid to have the federal courts declare the Granger laws unconstitutional. In the spring of 1877, the US Supreme Court upheld the states' rights to regulate rates. Battles over rate regulation continued unabated, therefore, in the state legislatures (4→5), as several more states responded by passing Granger laws. This, in turn, prompted railroad companies to combine branch and level jumping, once again, by seeking aid in federal courts (5→6). By the late 1870s, Congress had also begun to look seriously at the option of national regulation.

Meanwhile, from the 1870s on, the railroads also did their best to privatize regulation by putting their own house in order. Various groups of railroads sought to end ruinous competition by setting common rates and dividing up their business in voluntary 'pools'. The discriminatory nature of the common rate structures they periodically hammered out added fuel to the political fires, as did the special rebates they offered to selected shippers. But self-regulation of rates proved impossible, since the companies' agreements were not enforceable in court. Intensive rate wars broke out repeatedly. Transportation rates fluctuated wildly. The disastrous war of 1876–77, for example, drove down rates on the trunklines between the Midwest and the Northeast by as much as 85 percent. The railroads did reach a collective agreement to cut wages in the summer of 1877, but this move unexpectedly precipitated the 'Great Strike', the most extensive labor unrest the country had seen, quelled only when federal troops stepped in.[29]



As political conflict and rate wars accelerated in the 1880s, the railroads launched a new, two-pronged initiative to regulate themselves. Increasing pressure in the state legislatures as well as in Congress galvanized railroads nationwide to form an effective national association, which they organized in 1886 after nearly 40 years of failed efforts. The new American Railway Association did not tackle rates but moved quickly to standardize equipment and operations across state lines. Designed to head off impending legislation at the state and national levels, these initiatives produced, among other things, the United States' standard time zones. Meanwhile, even as efforts at collective rate-making continued, the trunklines developed an alternative strategy – 'system-building'. Where the railroads had earlier developed regional alliances with adjacent railroads, this was a defensive move that entailed buying up adjacent lines and building new ones over a much larger area. The result was self-contained, interterritorial monopolies. In the 1870s, the Pennsylvania Railroad built the first such 'megacorp', in Alfred Chandler's words, and others followed suit in all regions of the country in the 1880s.[30]

Abruptly, however, the seemingly interminable political battles over the state legislatures' regulation of interstate rates came to an end. In the fall of 1886, the Supreme Court reversed itself, declaring in *Wabash v. Illinois* that the states could not regulate traffic across state lines. Once again, this shifted the site of conflict over rate regulation, now lodging it squarely in Congress (6→7). If Congress failed to legislate, interstate rates would not be subject to any regulation at all. Conditions in the industry undoubtedly encouraged the Court's change of view, for the new systems under construction clearly outsized the state governments. In fact, by the mid-1880s, almost everyone – the railroads included – agreed on the need for national regulation of the industry, though they differed on the specifics.[31]

Thus spurred to action, Congress quickly forged a compromise after more than a decade of hearings and debates. Within months, it passed the Interstate Commerce Act, creating the United States' first independent regulatory

commission (7→8), its ostensible 'independence' denoted by its position to the side of the traditional American political structure. Railroad rates were to be 'reasonable', companies had to publicize their rates, and personal discrimination was prohibited. The act outlawed pooling, which the railroads would have preferred to have legalized, but it did not prohibit collective rate-making and its provisions regarding distance-based discrimination (long- and short-haul rates) were vaguely worded, thus open to widely different interpretation. ICC commissioners, five in number and appointed by the president to six-year terms, had subpoena power and could initiate proceedings. If a company resisted its rulings, the ICC could call on a US circuit court for help.[32]

But it was too little, too late. The first ICC commissioners tread carefully, and even then the inevitable legal challenges came, for the wording of the act provided great leeway for reinterpretation in the courts. At every turn, the Supreme Court favored a narrow interpretation of its power that, in Stephen Skowronek's words, 'reduced the ICC to a mere statistics-gathering agency'. Thus regulatory power in the 1890s effectively shifted back to the federal courts (8→9), where the prevailing judicial sentiment and machinations on the part of the railroads hobbled the ICC for years.[33]

In the late 1880s, meanwhile, conditions in the railroad industry deteriorated. The strategy of system-building – undertaken largely at the urging of speculators, according to Chandler – proved very expensive and promoted extravagant overconstruction. This made the industry's traditionally precarious condition even worse by increasing fixed costs (above all, interest on debt) beyond the ordinarily high levels that had characterized the railroads from the beginning. As a result, the roads became even more vulnerable to economic downturns and rate cutting than they traditionally had been. The results of system-building were twofold: on the one hand, construction of 75 000 miles of railroad in the 1880s alone; on the other, foreclosure sales during the economic depression in the mid-1890s of some 40 000 miles of road – in Chandler's words, 'the most massive set of receiverships in American history'. It took concerted intervention by J.P. Morgan and other Wall Street bankers to reorganize the industry on a firmer footing.[34]

Thus, over the middle decades of the nineteenth century, conflict over rate regulation shifted repeatedly between branches and levels of government. The *form* that regulation of interstate rates should take remained hotly contested as the century came to a close. But what had been settled was the *level* at which it would be hammered out. Henceforth, it was a matter for the national, not the state governments, to determine. Creation of the ICC thus signaled not the end of *laissez-faire* but a new era in business regulation, one in which the reach of the law again – ineffectual though it was – at least matched the reach of enterprise. As large-scale, capital-intensive firms became common in other sectors of the economy, passage of the Sherman Anti-Trust Act in 1890 reinforced and generalized the upward shift in regulatory power that conflict over railroad rates had set in motion decades earlier.



But even settling the question whether the federal government would regulate an industry that had clearly come to exceed the boundaries of the states took a remarkable length of time. More than 30 years elapsed from completion of the first trunkline railroads in the early 1850s to passage of the Interstate Commerce Act in 1887. Because it offered conflicting interests multiple avenues of redress, the American political structure, in effect, facilitated and encouraged adversarial relations, both between government and business and among business interests themselves.[35] It also protracted the inherently difficult process of addressing the novel and perplexing competitive problems that the railroads introduced.

Over those 30 years – and well beyond – the lack of effective regulation of railroad rates worked to the advantage of some and to the disadvantage of many others. The principal winners seem to have been those, whether shippers or consumers, who benefitted from the special, low rates that the trunkline railroads offered in their scramble to attract traffic. The speculators involved in system-building, if they gambled right, also reaped benefits. But the roster of losers was much larger. It surely includes those shippers and passengers who were located at points where the trunklines did not compete, and those who traveled or shipped locally, all of whom paid higher rates. It includes investors who lost out in the turbulence that repeatedly beset the railroad industry – not to mention the railroad companies themselves. 'System-building proved costly to individual roads', Chandler concludes, 'and to some extent to the national economy as well'.[36] Among the losers in the 1880s and 1890s must be counted the vast number of stakeholders in the railroads that went bankrupt in the 1880s and 1890s – not only investors but employees and customers as well.

More intangible social costs, though difficult to measure, might at least be noted. The low rates that prevailed for long-distance transportation, as Gerald Berk suggests, surely spurred a centralization of economic activity in a relatively small number of urban areas.[37] Had non-discriminatory rates prevailed, the American economy might have entered the twentieth century with a more decentralized economic landscape. The low rates offered to large shippers, according to observers at the time, also exacted a cost by promoting the growth of abnormally large firms – the largest in the world by the turn of the century. This view was expressed both at the Chicago Conference on Trusts in 1899 and before the US Industrial Commission, which conducted hearings on the 'the subject of "Trusts," or Industrial Combinations' in 1899–1900. A number of witnesses attributed the rise of excessively large firms such as Standard Oil to discriminatory railroad rates. In the words of one observer, 'It is in the railroad companies that the greatest danger lies', for their discriminatory rates formed the basis on which 'the large trusts or combinations' accumulated 'their wealth and power'.[38] Although it is impossible to tally up the costs precisely, it seems

quite likely that the United States paid a very high price for its lengthy failure to regulate railroad rates.

## LESSONS FROM THE AMERICAN EXPERIENCE

Are national governments today any better positioned to regulate global business than the American state governments were when business first 'burst through State limits' in the nineteenth century? As a template for understanding contemporary dilemmas, the railroad experience helps to pinpoint the special problems that national governments confront today – ones that are likely to prove their undoing as well. First of all, the political dynamics to which the global political structure gives rise today are very much like those that characterized the nineteenth-century US. The difference is mainly in the mix of defensive tactics available to business interests. Because political institutions at the international level are even weaker than those at the national level in the nineteenth-century US, branch and level jumping as 'avenues of escape' from hostile legislation are less of a factor today. The most useful – and widely used – tactic is jurisdiction jumping, now among nations rather than states.

Like nineteenth-century firms threatening to move to another American state, present-day firms have made good use of this threat in lobbying for more favorable legislation. In Britain, where the tactic is known as 'flagging out', trucking companies threaten to move to the Netherlands to escape increases in fuel prices and license fees.[39] The Swedish company, Ericsson, recently announced plans to move its headquarters to London to escape high income taxes at home. Meanwhile, four large German firms are threatening to leave if the government goes through with planned tax changes.[40] In the United States, the National Foreign Trade Council, representing hundreds of American multinationals, is lobbying for changes in the US tax code. In 1962, it reported, 18 of the world's 20 largest corporations were headquartered in the US, but now only eight remain – 'mainly because of companies moving abroad', according to a news report. Several executives also testified before a US Senate Finance Committee hearing in 1999 on 'International tax issues relating to globalization'. An Intel official maintained that his company would probably not have incorporated itself in the US, if it had had a better understanding of US tax laws.[41] Undertaken internationally, jurisdiction jumping – or, in today's parlance, engaging in 'regulatory arbitrage'[42] – takes on special potency, even if only threatened.

The opportunities for jurisdiction jumping, moreover, seem even greater now than they were for nineteenth-century railroads. The most dynamic sectors of the global economy – finance, computers, communications technology – are not tied as closely to physical place as nineteenth-century railroads and manufacturing firms were. As a recent report on debates about capital flight in Sweden put it, 'the problem for Sweden is that many of its new industrialists ... feel less committed to their country. Their assets are not factories or famous brands but highly mobile professionals'.[43] In the so-called 'new economy' of the twenty-first century, in other words, international jurisdiction jumping takes on added potency and, as many fear, may well result in a global 'race to the bottom'.[44]



To be sure, at least one scholar has argued, to the contrary, that trade liberalization does not necessarily undercut national regulatory standards and can even strengthen them. In political scientist David Vogel's language, it is possible for nations to 'trade up'. The ensuing 'race to the top' he dubs the 'California effect', in contrast to the 'Delaware effect', his metaphor for the race to the bottom. But his argument offers very limited grounds for optimism. As he notes, it applies only to the regulation of products, for the costs of producing environmentally- or consumer-friendly products are relatively small and can give their producers a comparative advantage in the regulated market. But it does not apply to the regulation of production, since labor standards, for example, would impose higher costs. And whether it translates well to financial regulation is not obvious. Even more discouraging, trading up depends for its success on strong international institutions that enable rich and powerful members of a trading group to raise the standards of other groups.[45] This is precisely what is missing at the international level. Rampant jurisdiction jumping today, therefore, is much more likely to result in the traditional 'trading down' of regulatory standards that occurred in the nineteenth-century US.

By analogy with the railroad experience, secondly, national governments today are also facing the kind of momentous technological changes that heighten political conflict. The new technology of the railroad proved so unsettling in its time not merely because company operations quickly transcended state borders, but because they also turned upside down the traditional assumptions on which rate regulation had been based. With the stunning development of new communications and computer technologies in the last decade, border-crossing increasingly occurs by electronic means – the analog of the railroads' discriminatory rates.

For regulation, the novelty of this new technology centers on the placelessness of transactions in cyberspace. Regulation of all kinds has always been tied firmly to physical space – to geographically-defined jurisdictions. But interaction in cyberspace is not tied firmly to place. The server with which a web browser interacts could be located anywhere. As legal scholars David R. Johnson and David Post write, 'The rise of an electronic medium that disregards geographical boundaries throws the law into disarray by creating entirely new phenomena that need to become the subject of clear legal rules but that cannot

be governed, satisfactorily, by any current territorially based sovereign'.[46] Cyberspace thus threatens to subvert traditional conceptions of regulation at least as much as the peculiar competitive behavior of the railroads did in the nineteenth century. As the basic principles underlying regulation come up for grabs, national governments grappling with the thorny jurisdictional issues raised by electronic enterprise, like the American states when they first confronted interstate business, are likely to find their basic right to regulate challenged as never before.

What, then, are the prospects that political conflict will force a shift in regulation from the national to the international level, as it did from the state to the national level in late nineteenth-century America? When the shift occurred in the US, two factors worked in tandem. Most railroad companies had finally aligned themselves with other economic interests in favor of national regulation; then the US Supreme Court foreclosed jurisdiction and level jumping by declaring regulatory power to lie uniquely in the hands of Congress. What are the prospects that similar developments will smooth the way for a shift to international regulation?

Widespread interest in creating some kind of international regulatory framework certainly exists today, as it did in the nineteenth century. Despite the views of free-market enthusiasts, market participants realize that a healthy capitalist economy requires a stable legal framework or economic life quickly takes on Hobbesian qualities: 'nasty, brutish, and short'. The interstate railroads caught vivid glimpses of the disorder into which an under-regulated economy could rapidly descend during the tumultuous rate wars of the late nineteenth century, just as the global financial sector did in the 1990s during the Asian and Russian financial crises. Like late nineteenth-century railroad men, who came to favor some kind of national regulation, a number of top executives today are urging concerted action to strengthen the legal framework governing international financial markets. In early 1997 Thomas A. Russo, managing director and legal counsel of Lehman Brothers, issued a resounding call for global financial guidelines. They are sorely needed, he argues, because 'trillions of dollars chang[e] hands daily in the global financial arena without a universal gatekeeper'.[47] Later that year, the Group of 30, a self-described private organization of 'very senior representatives of the private and public sectors and academia',[48] published a study calling both for more effective self-regulation by core financial institutions and for more co-ordination of national policies. 'There is an inherent contradiction in the national supervision of global firms in global markets', said the group's co-chair, John G. Heimann of Merrill Lynch & Co. The Group of 30's study group concluded that 'the global operations of major financial institutions and markets have outgrown the national accounting, legal and supervisory systems on which the safety and soundness of individual institutions and the financial system rely'.[49] Speaking of accounting standards, General Electric's comptroller takes a similar view: 'Global standards are inevitable', says Philip Ameen. 'We, like every multinational, have an incentive and we will certainly embrace them' (Waters 1999). Meanwhile, the G-7 countries have moved to strengthen supervision of global markets, while the OECD is seeking to develop international standards of corporate governance.[50] Thus, one indispensable ingredient – an alignment of public and private interests in favor of some kind of international regulation – seems to be emerging.



But if a consensus is emerging, it is aimed largely at self-regulation and at the harmonization of national policies, not at building an international regulatory structure. The Group of 30's study envisaged corporate and government officials engaging in a co-operative endeavor. The accounting standards praised by General Electric are being developed by the International Accounting Standards Committee, an umbrella association representing two million accountants around the world. And when Thomas Russo of Lehman Brothers called for global financial standards, he regarded self-regulation as imperative: 'Because there is no omnipresent regulator in the sky (because none has worldwide jurisdiction), there is only one viable solution to firms' flying under the regulatory radar: We should develop universally applicable voluntary standards'. Legislative regulation has been difficult to harmonize within nations, let alone across nations, he argues, while 'the task of revamping global financial regulation has proved insurmountable' (Russo 1997). Instead, he advocates extending worldwide the model of the Derivatives Policy Group, a voluntary initiative of the six largest US investment banks. Whether the voluntary model can indeed be extended successfully across national borders remains to be seen, of course, since the structures and byways of banking differ dramatically from country to country.

The crux of the matter, as Russo suggests, is the absence of an 'omnipresent regulator in the sky' (Russo 1997). Nothing comparable to the US federal government in the nineteenth century exists on an international scale today. By present-day standards, of course, the federal government was relatively weak in the 1880s. But the basic governmental structure nonetheless existed, as did, more importantly, the written constitution on which rested the Supreme Court's decision to lay regulation of interstate business at the door of Congress. Although a variety of international agencies have been created and recreated since the Second World War, refashioning them into an international structure comparable in strength even to the US federal government in the 1880s is a formidable task. The prospects of institution building on this scale are dim, indeed. Thus, as national governments struggle with problems very similar to those that confronted the American states in the nineteenth century – jurisdiction shifting and subversive technological change – global businesses will be

forced to rely on self-regulation for the foreseeable future. If the financial crises of the 1990s should recur, competitive stresses will make voluntary initiatives as difficult to sustain now as they were when American railroads tried self-regulation in the 1880s. Perhaps then the political will can be mustered to create a sturdy framework of regulation on an international scale. Until then, if the American experience offers a reliable guide, the losers will far outnumber the winners worldwide.

## NOTES

1. This is a revised and expanded version of Dunlavy (1999).
2. For a sampling of the multidisciplinary literature, see Busch (2000). On the growth of American multinationals, see Wilkins (1974).
3. Bank for International Settlements (1998), Table VI.1. Percentage increases for German, French, Italian, and Canadian residents, measured against their home country's GDP, were even higher, ranging from 253 percent (Germany) to 672 percent (Italy).
4. Busch (2000), pp. 40–41 and Table 6.
5. OECD, 'New patterns of industrial globalisation: cross-border mergers and acquisitions', http://www.oecd.org//dsti/sti/industry/indcomp/act/mergers.htm.
6. OECD (1999), Table 1. Direct investment outflows advanced by 76 percent.
7. Morgenson (1999).
8. An early, influential work on the regulation of multinationals was Barnet and Müller (1974). For the recent literature, a good starting-point is Busch.
9. Exceptions were the first Bank of the United States and its successor, the second BUS. Otherwise, Congress did not charter corporations until the Civil War.
10. See Chandler (1965); Chandler (1977), pp. 81–121.
11. Nimmo (1881).
12. For two recent arguments to this effect, see Dunlavy (1994a), pp. 18–19, 97, 126–27, and Novak (1996), pp. 2–8.
13. Local governments also promoted and regulated business, but they did so only under powers granted them by the state governments. The principal division of power was between the state governments and the federal government.
14. Taylor (1951), p. 383; Novak (1996), p. 1; Dunlavy (1994a), pp. 45–144. For an overview of the literatures, see John (1997), pp. 347–80.
15. This paragraph and the characterization of shifts in regulatory power in the following paragraphs are based largely on Dunlavy (1994a). Additional footnotes are used only for sources not found there or for quotations. My understanding of the political dynamics at work was strongly informed by Miller (1971) and Scheiber (1975). 'Common carriers' were transportation providers who offered their services to the general public.
16. Data for 1880 are from US Bureau of the Census (1960), Q15, Q33.
17. Adams (1871), p. 34. Thanks to Eric Morser for bringing this source to my attention.
18. Lardner (1850), p. 503.
19. *Twenty-Fifth Annual Report* ... (1851), pp. 3–4, 18–23.
20. Hadley (1886), p. 31.
21. See Hadley (1886), p. 40; Ely (1887), pp. 261–2. Both cite Henry C. Adams for his classification of industries by returns to scale.
22. *Report of the Directors of the Boston & Worcester Rail Road* ... (1840), pp. 7–8.
23. Scheiber (1975), pp. 115–16.
24. Taylor (1874), p. 502.
25. Ely (1900), pp. 260–61.
26. See especially Grandy (1993).



27. Quoted in Grandy (1993), p. 14.
28. *Chicago Conference on Trusts* ... (1900), pp. 502–3.
29. Kolko (1965), pp. 7–20; Chandler (1977), pp. 133–43.
30. Chandler (1977), pp. 145–71.
31. Kolko (1965), pp. 34–41. Kolko's argument that railroad interests dominated the ICC has been much disputed, but his narrower point that the railroads generally supported federal regulation of some kind by the mid-1880s stands. For a sensible discussion of the economic interests at stake, see Skowronek (1982), pp. 125–31. As early as 1850, railroad men in New England would have preferred to have government aid in dealing with industry problems – at that time, the aid of the state legislatures – but, again, only if they could have it on their terms. See Dunlavy (1994a), pp. 175–6.
32. Hoogenboom and Hoogenboom (1976), pp. 12–18; Skowronek (1982), pp. 148–9.
33. Skowronek (1982), pp. 150–60 (quotation from p. 151). On the ICC's fate from 1887 to the 1970s, see Hoogenboom and Hoogenboom (1976).
34. Chandler (1977), pp. 171–85 (quotation from p. 171); Berk (1994), pp. 47–72. Berk tends to equate fixed costs with debt, which has some validity for his period but not earlier. On the novel problems generated by corporate debt, see 'The borrowing power of corporations', *The Nation*, June 8, 1871, p. 398.
35. Scholars have largely overlooked these structural origins of the adversarial pattern of government–business relations in the US. Instead, the conventional explanation locates their adversarial character in the notion that the growth of big business in the US, unlike in Europe, preceded the growth of the state. See Thomas K. McCraw (1984), 'Business and Government: The Origins of the Adversary Relationship', *California Management Review*, **26**, 33–52.
36. Chandler (1977), p. 147.
37. Berk (1994), pp. 75–149.
38. Industrial Commission, *Preliminary Report on Trusts and Industrial Combinations, Together with Testimony* ... , House Doc. No. 476, Part 1, 56th Congress, 1st sess., p. 1190. For further examples, see Dunlavy (1994b), pp. 41–9. About the same time, the political economist Richard T. Ely noted the following observation in a German newspaper (the *Frankfurter Allgemeine*): 'the reason why private monopolies like those in the United States did not exist to a great extent in Germany was that the railways there were State railways, and that all producers and dealers were treated impartially'. Ely (1900), p. 234.
39. Cowell (1999), p. C4.
40. 'European taxes: excise exiles', *The Economist*, March 6, 1999, p. 59.
41. 'Congress attacked over "uncompetitive" tax rules', *Financial Times* (US edition), March 26, 1999, p. 22.
42. See, for example, Russo (1997), sec. 3, p. 14.
43. Burt (1999), p. 20.
44. On the traditional, negative view of the 'race to the bottom', as well as more recent, positive assessments, see Grandy (1993), pp. 98–103; and Mark (1995), pp. 69–73. As both authors note, hardly anyone disputes the general dynamic in American history. Scholarly controversy centers on whether its consequences were (and are) harmful or beneficial. Among those who take a positive view is economist Roberta Romano, who cites 'the benefits produced by state competition for corporate charters – a responsive legal regime that has tended to maximize share value'. She advocates a system of 'competitive federalism' in securities regulation today, which entails 'a menu-approach to securities regulation under which firms elect whether to be covered by federal law or the securities law of a specified states, such as their state of incorporation'. She would extend the menu to foreign issuers, who could choose among not only American federal or state laws but also the laws of other nations (Romano 1998, pp. 143–217; quotations from pp. 145–6). This would indeed 'empower investors' (or at least some of them), but at the expense of other stakeholders. Underlying such approaches is a conviction that markets necessarily produce socially optimal outcomes, which is a matter of dispute.
45. Vogel (1995), pp. 1–8.
46. Johnson and Post (1996), pp. 1367–78 (quotation from p. 1375). Legal scholars and lawmakers are just beginning to grapple with this new challenge. For insights, see the web page

(http://www.abanet.org/buslaw/cyber/) of the 'Committee on the Law of Cyberspace', which the American Bar Association's Section on Business Law established in late 1995.
47. Russo (1997).
48. See http://www.group30.org/about.htm.
49. Group of 30 (1997).
50. Schlesinger (1997).

# 4. Origins of the myth of neo-liberalism: regulation in the first century of US railroading*

**Timothy Dowd and Frank Dobbin**

> Laissez faire ... has taken an exaggerated hold on the public imagination, and has been regarded as a fundamental axiom of economic science, when it is in fact only a practical maxim of political wisdom, subject to all the limitations which experience may afford. (Arthur Twining Hadley 1903 p. 14)

## INTRODUCTION

Neo-liberalism has two components. One is historical, and it revolves around the idea that advanced economies – particularly those of Britain and the US – developed under conditions that are best characterized as *laissez-faire*. The other is definitional, and it revolves around the idea that one group of industrial policies can be defined as 'non-interventionist' (that is, those that reinforce the unabated competition of free markets) while another group can only be defined as 'meddlesome' (that is, those that contravene free markets). Neo-liberalism combines these components as follows: Britain and the US became economic giants by allowing free markets to build their respective economies and by embracing non-interventionist policies. Other nations have obtained – or will obtain – similar results by following the examples of Britain and the US. Put another way, neo-liberalism posits that economic reality conforms to transcendent laws and policies that reinforce such laws lead to growth and prosperity. This position has gained staunch support in segments of academia and government (see Adams and Brock 1991; Eisner 1991; Sciulli 1999; Shonfield 1965; Yonay 1998).

Much scholarship reveals that neo-liberalism is at odds with the reality that it describes. Classic analyses reveal that the initial burgeoning of the British and US economies occurred under policies that were antithetical to free markets (see Goodrich 1960; Handlin and Handlin 1947; Polanyi 1944). Comparative research finds that nations have attained advanced economies and prosperity under a variety of policies, including those that neo-liberals would clearly label