# Slow Train Coming?

## Misguided Economic Regulation of U.S. Railroads, Then and Now

*By Marc Scribner*

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### Executive Summary

The last few decades have seen tremendous improvements in the U.S. railroad industry. After a century of severe regulation nearly brought the United States railroad industry to ruin, policy makers in the 1970s began a process that ultimately resulted in the Staggers Rail Act of 1980, which largely deregulated the industry. But that has not put an end to the political fight over freight rail.

Beginning with the enactment of the Interstate Commerce Act of 1887, the federal government increasingly regulated railroad ownership, operations, and investments in the United States through the Interstate Commerce Commission (ICC). While initially the ICC had little power to enforce rulings, it was subsequently granted significant ratemaking, entry and exit, and operational authority due to the efforts of the Progressive movement.

Once railroads became heavily regulated, innovation slowed and American railroads began their long decline. During World War I, the heavily regulated railroads were nationalized by President Woodrow Wilson. After the war, the railroads were returned to private management—albeit in the context of a stultifying regulatory environment.

In the 1930s, new competition from motor carriers and more advanced waterborne transportation began costing the railroads passengers and freight. The U.S. railroad industry enjoyed a brief resurgence during World War II, as tires and gasoline were tightly controlled for consumers and the military relied heavily on the railway network to move goods and troops.

Yet following World War II, the railroads continued their decline. By the 1960s, it had become apparent to all that the industry was in dire straits. It was during this decade that economists, regulators, and politicians began seriously considering deregulatory relief—as the alternative, widely discussed at the time, was outright and permanent nationalization of the nation's railroads.

Following the 1970 bankruptcy of the Penn Central Railroad—the largest bankruptcy in U.S. history until it was eclipsed by Enron in 2001—Congress and the Nixon administration began advancing a deregulatory agenda. In the meantime, the federal government created Amtrak to take responsibility for unprofitable passenger movements and Conrail to assume control of freight rail operations in the Northeastern U.S.

Finally, in 1980, Congress passed the Staggers Rail Act, which largely deregulated the railroads. Since 1980, America's railroads—and indeed their customers and consumers—have enjoyed large gains. These include steep declines in real freight rates and train accidents, and a massive increase in railroad worker productivity. Unlike other modes of transportation, the railroad industry has financed these improvements—to the tune of $500 billion since the Staggers Act.

But some shippers are upset with the market rates they must pay to access rail carriers' private networks. The most vocal are bulk commodity shippers in the West and Midwest, who may lack access to inland waterways and may be served by only one or two railroads. They allege that railroads are using their market power to extract monopoly rents and that federal regulators must step in to resolve this problem.

These claims are not new and they are baseless. These shippers are pushing a set of policies that will ultimately harm railroads, shippers, consumers, and the overall U.S. economy. This report examines the

history of railroad regulation, deregulation, and recent attempts to reverse deregulatory progress, and recommends potential legislative remedies if the shippers in question were to succeed in ratcheting up economic regulation of the railroad industry.

## Introduction

The last few decades have seen tremendous improvements in the U.S. railroad industry. After a century of severe regulation nearly brought the United States railroad industry to ruin, policy makers in the 1970s began a process that ultimately resulted in the Staggers Rail Act of 1980, which largely deregulated the industry. But that has not put an end to the political fight over freight rail.

Average shipping rates have dramatically fallen since 1980, but some shippers are upset with the market rates they must pay to access rail carriers' private networks. The most vocal are bulk commodity shippers in the West and Midwest, who may lack access to inland waterways and may be served by only one or two railroads. They allege that railroads are using their market power to extract monopoly rents and that federal regulators must step in to resolve this problem.

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The regulation of railroad operations, investments, and rates began in earnest during the early 20th century. While the history of railroad regulation is complicated and varied with respect to phenomena such as interest group capture, one constant stands out: Each new regulatory action was preceded by the unintended negative consequences of existing regulation. In other words, more regulation was perceived during the first half of the 20th century as being the only remedy for failed regulation.

As has become understood by a growing number of modern network industry observers and theorists, employing the blunt tools wielded by regulators runs serious risks. In the name of promoting competition or protecting the welfare of consumers, very often the real results run counter to these best of intentions.

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## The Birth of Railroad Regulation and Its Unintended Consequences

The first railroads in the United States were chartered in the 1820s.[1] For the next two decades, the industry was largely unregulated. In 1844, New Hampshire became the first state to create a railroad commission.[2] By 1885, 24 states and the Dakota Territory had established similar regulatory bodies.[3]

For the most part, these early commissions were primarily tasked with safety and financial inspection and to ensure rail corporations were in compliance with existing state laws. Some, mostly in the Northeast, were purely advisory, meaning in the face of a violation by a railroad they could at most inform and recommend action to the state attorney general.[4] Others, mostly in the Midwest and South, *In an effort to shield their businesses from competition, a number of railroads and railroad-supporting interests began to lobby for federal regulatory action.*

had the power to directly enforce their rulings through the courts.[5] These Midwestern and Southern railroad commissions also often had the power to issue orders in rate dispute cases, and they provided a framework for future federal regulation of interstate railroad operations.

Following the creation and heavy subsidization of the first transcontinental railroad in the 1860s, populist opposition over alleged predatory practices in the industry began to grow. In an effort to shield their businesses from competition that led to widely varying rates, a number of railroads and railroad-supporting interests began to lobby for federal regulatory action.[6]

By the 1870s, the National Grange of the Order of Patrons of Husbandry (the Grange), American farmers' chief special interest group at the time, gained significant power in several Midwestern states.[7] They successfully convinced states to regulate the railroads,[8] but their call for railroad regulation was most powerfully trumpeted by wealthy Midwestern merchants and wholesalers, not the typical family farmer.[9]

The Grange alleged the railroads discriminated against small, regional businesses, as railroad rates were often higher for shorter distances than for longer ones. But what the Grange identified as unfair business practices, contemporary industrial organization scholars would recognize as the economics of network industries. As network industries such as railroads face huge sunk costs and therefore face a heightened risk to adequate returns, traffic movements that best utilize network capacity reduce exposure to this risk.[10] Many short-distance routes also had very little demand.

Railroads also enjoy economies of density—cost efficiencies from increases in traffic on the existing network, which is tied to the geographic concentration of production.[11] A larger railroad is able to access more diverse markets and move more goods to those markets, which reduces the impact of varying operating risk across certain markets and regions. This helps keep freight rates lower and more stable.

It is a common historical misconception that calls for railroad rate regulation stemmed from absolute high rates—"price gouging" behavior by monopolists. On the contrary, calls for regulation were driven by rate fluctuations often experienced during rate wars between rail carriers. In fact, real rail rates fell dramatically in the preceding decades.[12] The rate wars resulted in prevailing rates well below marginal cost in a number of corridors, which even led to some railroad executives to endorse legislation and regulation designed to stabilize rates.[13]

After a Supreme Court case greatly limited states' ability to regulate railroads,[14] Congress stepped in by creating the Interstate Commerce Commission (ICC) in 1887, the first national industrial regulatory body in the United States.[15] Congress declared that all freight and passenger rates “shall be reasonable and just,” without defining those terms, as determined by the ICC.[16] The law also restricted price discrimination over long- and short-distance trips, as well as pooling contracts between railroads.[17] Subsequent United States Supreme Court decisions greatly weakened the ICC’s enforcement powers.[18]

Near the end of the 19th century, the populist Grange allied with the growing technocratic Progressive movement. In 1903, Congress passed the Elkins Act, with their support.[19] The law forbade railroads from offering rebates to large corporations and required railroads to adhere to their published rates. However, the Elkins Act did not give the ICC power to enforce its “reasonable” rate determinations. The Elkins Act, like the Interstate Commerce Act before it, did not provide it any criteria for defining “reasonable” and therefore did little to calm the pro-regulation cries from the Grangers and Progressives.

### Roosevelt I: Populism and Opportunism

President Theodore Roosevelt sought to right the alleged wrongs done by businessmen such as James J. Hill of Great Northern Railway and later Northern Securities Company fame. Hill, known as “The Empire Builder” during his time, broke the transcontinental railroad mold by constructing his Great Northern Railway from St. Paul, Minnesota, to Seattle, Washington, without taking the government subsidies which virtually all of his competitors had.[20]

Unlike many of his rent-seeking competitors, Hill was a foe of not only subsidies, but of the government intervention and cronyism that was rampant in the industry.[21] Unsurprisingly, this earned him few friends in Washington. Attorney General Philander Knox suggested to Roosevelt that his administration should go after an easy (read: less politically powerful) target to establish his trust-busting credentials.[22] They settled on Hill’s Northern Securities, which the Supreme Court ordered separated in a controversial 5-4 decision.[23] This set the tone of the government’s policy toward railroads for the next decade.

In 1906, Congress passed and President Roosevelt enthusiastically signed the Hepburn Act into law, which extended ICC authority over other facilities such as terminals and pipelines, strengthened Elkins provisions related to price discrimination, and authorized the ICC to set maximum freight and passenger rates.[24] It imposed price controls that greatly devalued railroad stocks, increased market volatility, and

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set the financial stage for the Panic of 1907, which was later used to justify the creation of the Federal Reserve System in 1913.[25] In 1910, President William Howard Taft signed the Mann-Elkins Act, which strengthened the Hepburn Act's maximum rate-setting provisions and the original Interstate Commerce Act provisions on short- and long-haul price discrimination.[26]

Those concerned with regulatory overreach did not completely fail in reversing some of the Hepburn Act's expansions of the ICC's authority. One Mann-Elkins provision that sought to restrain the ICC's power was the creation of the Commerce Court,[27] which was tasked with reviewing ICC rulings and overturning those that were found to be unreasonable. By late 1911, the Commerce Court had reversed the majority of ICC rulings that had come before it,[28] making it highly unpopular among anti-railroad interests, such as the Progressive Party, which advocated the Court's abolition in its party platform.[29] They got their wish in 1913, when following a bribery scandal that involved a Court judge, Congress passed the Urgent Deficiencies Act, which abolished the Commerce Court and placed ICC review jurisdiction with federal district courts.[30]

This reorganization reduced the level of expertise in the scrutiny of ICC rulings, even as it strengthened the ICC's power over the railroad industry. It could not have happened at a worse time. The following year, the First World War broke out in Europe and American companies started supplying the belligerents.[31] Yet with Germany's unrestricted submarine warfare on merchant ships in the Atlantic, ocean carrier capacity on the East Coast of the United States became greatly constrained.[32] These factors resulted in a great increase in railroad freight traffic, leading to serious congestion problems in many corridors, particularly those servicing export traffic bound for East Coast ports.[33]

### Unintended Consequences

The railroad industry, shippers, and government officials recognized that congestion problems needed to be resolved. Unfortunately, several laws and regulatory decisions had greatly restricted the ability of railroads to respond to market conditions and add capacity where it was most needed. Pooling equipment and facilities could have eased the traffic crunch in the short run, but the Interstate Commerce Act explicitly prohibited the voluntary pooling of railroad resources. In 1917, railroads appealed to the ICC for a 15 percent general rate increase to help offset some of the rising costs associated with wartime traffic and afford them the opportunity to raise the revenue necessary to invest back into network enhancements.[34] The ICC rejected their request.[35]

That same year, President Woodrow Wilson, frustrated with the growing railroad network inefficiencies during the war, nationalized the entire railroad industry.[36] On December 28, 1917, the newly formed United States Railroad Administration took over American railway operations.[37] The agency immediately pooled all railroad equipment and facilities, and six months later increased freight rates by 28 percent.[38] Federal control of America's railways continued for the rest of the war until the Esch-Cummins Act, commonly known as the Transportation Act of 1920, was enacted in February 1920, returning railway operations to the private sector.[39]

The Transportation Act of 1920 was highly controversial. The intent of Congress was to introduce stability into the railroad industry, largely through the use of rate-setting regulations, rather than try to protect those allegedly harmed by rates deemed "excessive" by regulators. This was a dramatic reversal in mission. Congress allowed the de-nationalized railroads a "fair return" of 6 percent. If the rate of return exceeded this threshold, half of those revenues were required to be deposited in a special recapture fund meant to insure against less profitable times, as the funds would be used to issue loans to weaker railroads at a 6 percent interest rate.[40]

The law had a perverse impact on both railroads and shippers. When rates of return were below 6 percent, the ICC regularly denied railroads' requests to *reduce* rates after 1922—decisions that went against the interests of both the railroads, who were now competing with motor carriers, and shippers.[41]

The Transportation Act's fatal flaw is its "fair return" provision, which was premised on the assumption that railroad assets had been accurately and consistently valued. They had not been.[42] To illustrate the inherent problem with this sloppy regulatory mandate, consider that rate of return is partially a function of the value of assets. Yet the value of assets is also partially a function of rate of return. These circuitous determinations had little basis in reality and various parties easily disputed their accuracy at every turn.[43]

The ICC's shift in mission following the Transportation Act of 1920 generally led it to become a more benign regulator, and one that tended to side with railroad interests.[44] Post-1920, it was far less likely to interfere in track abandonments, expansions, right-of-way acquisitions, mergers, and matters involving railroad securities.[45] While this era was characterized by far less aggressive ICC action than the years before World War I, it was still one of heavy-handed regulation, as state regulations and regulatory bodies varied.

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**Roosevelt II: The Great Depression and the New Deal**

The Great Depression hit the railroad industry harder than other sectors. The industry was unable to shield itself from downward demand pressures, due to its high fixed costs and increasing competition from other modes of transportation, particularly motor carriers using state-subsidized roadways. Rail revenues fell by more than 50 percent between 1929 and 1933.[46]

In response, Congress passed and President Franklin D. Roosevelt signed into law the Emergency Railroad Transportation Act of 1933 in an attempt to coordinate the industry and take advantage of any available efficiencies.[47] This new law created the office of the Federal Coordinator of Transportation to carry out its objectives, which included encouraging facilities and equipment pooling and consolidation.[48] It exempted railroads from antitrust laws, shifted the rate-setting principle from fair return based on fair value to one that emphasized rates' impact on traffic,[49] and gave the ICC sole authority over railroad mergers.[50]

President Roosevelt convened a series of committees in an attempt to address the railroads' dire financial situations.[51] The reports from these committees recommended new bureaucracies, bailouts, and studies.[52] In a sign of the times, not once was a deregulatory position advanced.

Between 1920 and 1940, the number of U.S. railroad companies declined by 47 percent from 1,097 to 574.[53] Most of this decline can be attributed to small railroads with less than 1,000 miles of track, which led to track abandonments.[54] Taken together, it became clear to Congress and the administration that another overhaul of laws governing railroads was needed.

On the eve of World War II, Congress passed the Transportation Act of 1940. This new law began by stating the National Transportation Policy, which ordered the ICC to "provide for fair and impartial regulation of all modes of transportation subject to the provisions of the Act, so administered to *recognize and preserve the inherent advantages of each*" [emphasis added].[55]

The problem with such a decree is that the "inherent advantage" of a given mode was open to such broad interpretation that the ICC could defensibly justify essentially any action. To illustrate this problem, consider that for a given traffic movement, one mode could enjoy a cost advantage while another could enjoy a service advantage. For example, for consumer goods, motor carriers enjoy a service advantage[56] given that roads allow door-to-door shipping that railways simply cannot, but railroads generally retain a cost advantage in moving these goods, particularly over longer distances. An arbitrary ICC decision of a mode's "inherent advantage" could thereby severely harm another mode in moving the same traffic.

In an attempt to counteract the ability of the ICC to pick modal favorites through its ratemaking powers, the law required the Commission to consider the effect of a rate change only on the traffic of the carriers for which the rate applied.[57] In reality, this generally meant forcing stronger carriers to keep their rates higher than they otherwise would in order to protect their weaker competitors. This practice, known as umbrella ratemaking, would eventually become one of the most significant regulatory burdens impacting the railroad industry. The burden of proof in showing reasonableness in all rate proceedings was now placed on the railroads, when previously it had only been placed on the railroads in proceedings involving proposed rate increases.

The law included a deregulatory provision, albeit a minor one. It abandoned the requirement in the Transportation Act of 1920 that railroad consolidations conform to a pre-drawn ICC plan. The Complete Plan of Consolidation that sought to combine private railroad companies into a handful of government-determined regional carriers was dead.

The Transportation Act of 1940 also created a temporary, three-member Transportation Investigation and Research Board.[58] The Board, which was independent of the ICC, was tasked with developing a centralized national transportation plan that considered railroads, motor carriers, and domestic water carriers, the latter of which were brought under the ICC's regulatory authority by the law. Very little came of this body, due to its convoluted mission and the outbreak of World War II.

The expansion of the ICC's regulatory authority to cover waterborne transport was not nearly as significant as it first appears. The 1940 law specifically exempted most bulk dry and liquid shipments from regulation, which in practice meant little active regulation of the industry because this exemption applied to the vast majority of waterborne traffic.[59] As such, motor and water carriers were burdened with significantly less government intervention, while they also continued to receive far more direct government support—heavily subsidized roads for motor carriers and essentially an unpriced open commons of public canals, rivers, and lakes for water carriers—compared to the railroads, which owned and maintained rights-of-way, track, and rolling stock.

This obstacle was briefly lowered for the railroad industry in the run up to and during World War II, during which railroads enjoyed relative prosperity. Between 1938 and 1939, rail freight tonnage increased from 771.862 million

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to 901.669 million, with tonnage rising to over 1 billion for the remainder of the war, peaking at 1.491 billion in 1944.[60] Railroad revenues enjoyed a similar trend. Between 1938 and 1939, rail industry revenue increased from $2.901 billion to $3.297 billion, and it also peaked in 1944 at $7.087 billion.[61]

Railroads' fortunes were boosted by an increase in traffic due to the movement of war materials and military personnel, as well as gasoline rationing and a rubber tire shortage, which led to a passenger and freight modal shift from motor carriers to railroads.[62]

On December 18, 1941, less than two weeks after Japan attacked Pearl Harbor, President Roosevelt established the Office of Defense Transportation (ODT) to coordinate wartime traffic.[63] The railroads, given their renewed prosperity and having learned from their nationalization experience during World War I that fighting the federal government in such a situation is futile, cooperated with the ODT.

During the war, a conflict developed between the ICC's ratemaking powers and the Office of Price Administration's (OPA) price control policies. The ICC contended that the Interstate Commerce Act superseded the agency's powers while the OPA argued that the ICC's rate increases impeded its price stabilization goals.[64] While the OPA had authority to impose price ceilings on all goods and services other than agricultural commodities, courts ruled that Congress did not give the OPA authority over other federal agencies, upholding the ICC's wartime rate increases.[65]

These trends continued for the rest of the war, but the railroad industry's renewed prosperity proved temporary.

### The Great Decline Continues

Throughout the first half of the 20th century, the ICC gained power over emerging network industries such as pipelines,[66] telecommunications,[67] motor carriers,[68] and domestic waterborne carriers.[69] Economists and social theorists at the time enthusiastically endorsed strict antitrust policies to ensure competition. These simplistic theories later fell out of favor among economists, due to the lack of empirical support for welfare-enhancing competition policy enforcement in the scholarly literature[70] and the recognition of network industry peculiarities—especially the fact that the enjoyment of benefits from network effects and the positive externalities associated with increasing access and use require some degree of market concentration that far exceeds that of textbook perfect competition.[71] Yet, the legislation enacted—and the resulting regulations promulgated—during this period stayed in place well after serious flaws became evident.

Following World War II, railroads' fortunes again began to decline.

Subsidized competitors were able to undercut railroads' rates and carriers were unable to sufficiently specialize on cost-effective bulk shipments due to the ICC's power to set minimum rates and requirement to continue service to low-profit areas. Economists and industry insiders began expressing concerns that these supposedly pro-competitive mechanisms were actually harming the railroads' ability to compete. Journalist and economist James G. Lyne warned at a 1948 conference of financial analysts that, in the face of increasing competition from motor carriers, "[T]he railroads can meet truck competition equitably only if they are very greatly relieved from the excessive regulation from which they are now suffering."[72]

This is illustrated in the ICC's continued use of value-of-service and equalizing discrimination price regulation. Value-of-service pricing means that higher-valued traffic faced higher rates (regardless of any cost differences in moving freight of different values due to relative densities and thus relative per unit costs).[73] This also meant that for decades, railroads had been forced to charge higher rates for manufactured products than for bulk cargo such as coal, lumber, and grain. In effect, this amounts to a subsidy for motor carrier traffic of manufactured products.

The inefficiencies caused by value-of-service ratemaking and the harm done to the railroad industry became far more serious as motor carriers gained an ever-greater modal share. As law and economics scholar Richard Posner notes, "[O]nce there was a good substitute service, the method ceased to have a rational basis, at least under the usual views of regulation, since the price of the commodity shipped bears no necessary relation to the adequacy of trucking as a substitute for transportation by rail."[74]

Regulations intended to equalize discrimination also created network inefficiencies by forbidding the charging of different rates to different shippers and for different shipment sizes. Costs may vary across shippers even when the freight moved is the same, as some locations are simply more costly to service than others and smaller shipments generally have higher per-ton costs.[75] In addition, the ICC had regulated carrier entry and exit since the enactment of the Transportation Act of 1920. In the case of railroads, the negative impact on efficiency was due to high artificial barriers to exit, as state regulators consistently denied railroads' requests to reduce service to or abandon unprofitable markets.[76] Equalizing discrimination led to a large amount of cross-subsidization that otherwise would not have taken place.

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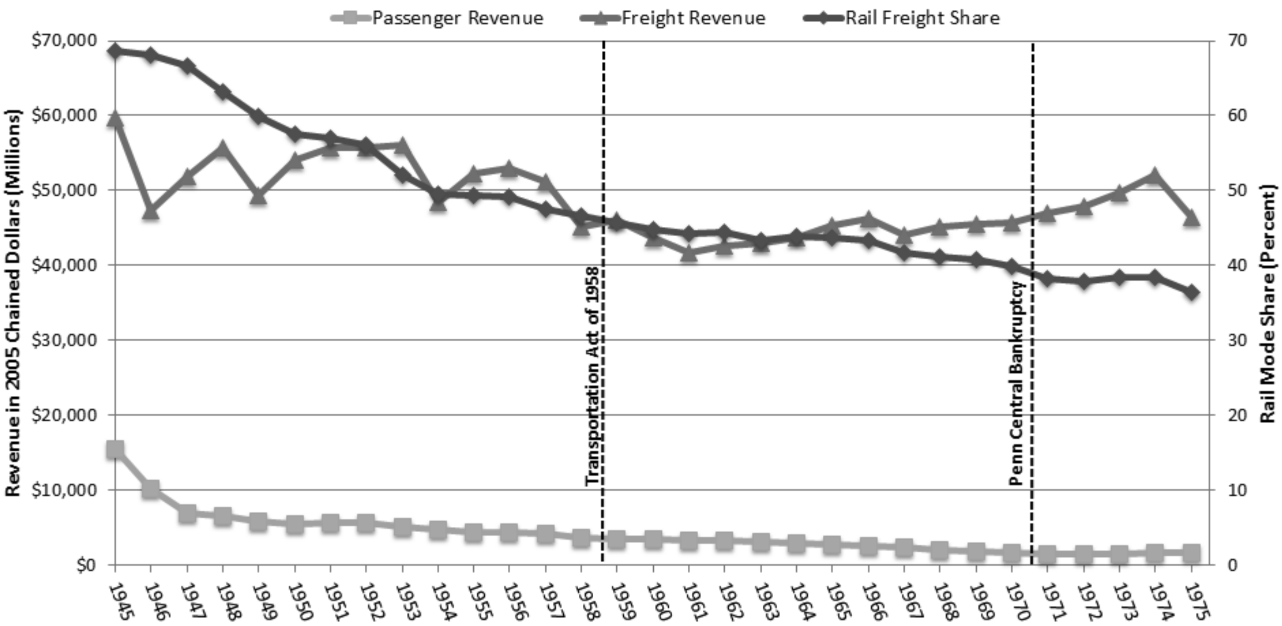
### Political Tide Begins to Turn

By the 1950s, it had become clear that a half century of misguided regulation

**Figure 1.** U.S. Railroad Passenger and Freight Revenues, and Rail Mode Shares, 1945-1975




*Source: U.S. Census Bureau,* Statistical Abstract of the United States, *various years, Tables: Volume of Domestic Intercity Freight Traffic, By Type of Transportation; and Railroads—Summary Statistics.*

had taken its toll on the industry. As Figure 1 shows, the government provision of highway and inland waterway infrastructure allowed carriers of those competing modes to gain ever-increasing shares of passenger and freight traffic. In the 10 years from 1945 to 1955, real passenger revenue in the railroad industry fell by 71.1 percent and real freight revenue by 12.5 percent, while rail's share of intercity freight traffic fell from 68.7 percent to 49.4 percent.[77]

The first official federal government acknowledgment that the transportation sector was being harmed by overregulation came during the Eisenhower administration. In 1955, the Presidential Advisory Committee on Transport Policy and Organization (commonly known as the Weeks Committee, after then-Secretary of Commerce Sinclair Weeks) issued its findings to the president. The Weeks Committee report found that overregulation was harming the railroad industry and recommended that Congress revise the Interstate Commerce Act and National Transportation Policy. It suggested two main changes in federal transportation regulatory policy:

1) Allow for freer rates by curtailing ICC's prescriptive ratemaking; and

2) Eliminate the protection of competitors' traffic as the primary principle in rate regulation, the practice known as umbrella ratemaking.[78]

While the Weeks Committee ultimately did little to directly influence public policy in the 1950s, it was significant in that its report to President Eisenhower represented the first serious official recommendation of *less* regulation as a means to improve the health of the railroad industry.

Congress's next attempt to address deteriorating conditions in the railroad industry was the Transportation Act of 1958.[79] For the first time, the ICC was granted jurisdiction over passenger rail service discontinuances, a power previously held by the states.[80] The state-based regulatory system had mandated that railroads continue unprofitable service on many low-demand routes.[81] The ICC was more likely to approve discontinuances quickly, which helped ease some of the financial stress faced by the railroad industry at the time.

The 1958 law also provided up to $500 million in federal loan guarantees for railroad capital improvements, subject to ICC review.[83] This provision, the clearest attempt by Congress to directly aid the railroad industry, was underutilized. By 1961, only $86 million had been borrowed.[83]

The Transportation Act of 1958, paying lip service to the Weeks Committee's call for abolishing the prevailing umbrella ratemaking regime, amended the Interstate Commerce Act's so-called rule of ratemaking, adding:

> In a proceeding involving competition between carriers of different modes of transportation subject to this Act, the Commission, in determining whether a rate is lower than a reasonable minimum rate, shall consider the facts and circumstances attending the movement of the traffic by the carrier or carriers to which the rate is applicable. Rates of a carrier shall not be held up to a particular level to protect the traffic of any other mode of transportation, giving due consideration to the objectives of the national transportation policy declared in this Act.[84]

But as economic historian George W. Hilton pointed out in 1969, the result of this vaguely worded amendment did nothing to solve the umbrella ratemaking problem and likely added confusion to ratemaking by the ICC, an agency he regarded as a destructive government cartel.[85]

Beginning in the late 1950s, researchers began to call for deregulation of the transportation sector.[86] In 1960, economist James C. Nelson authored an influential article in the *American Economic Review* that laid out the problems facing the railroad industry.[87] Nelson concluded that deregulation "can no longer be delayed" and that the Transportation Act of 1958 failed to end the ICC's "[p]rotection of socially inefficient carriers [and] agencies."[88]

This trend in academia was augmented with growing political recognition of

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the transportation regulatory morass. In December 1960, former Civil Aeronautics Board Chairman James M. Landis delivered the "Report on Regulatory Agencies to the President-Elect," which was highly critical of widespread inefficiencies in U.S. regulatory bodies.[89] In 1961, the Senate Committee on Interstate and Foreign Commerce published a report from the Special Study Group on Transportation Policies in the United States under the direction of John P. Doyle, former director of transportation for the Air Force.[90] The Doyle report highlighted the regulations stemming from 1940's National Transportation Policy that disadvantaged railroads while exempting from regulation most motor and waterborne carrier traffic. It also predicted dire consequences for the railroad industry by the mid-1970s if nothing was done to remedy these problems.[91]

### ICC, Police Thyself

In an attempt to shield itself from growing criticism, the ICC reorganized itself in 1961, strengthening the office of the chairman and creating the supervisory office of vice-chairman.[92] In terms of substantive policy reform, however, very little changed. The ICC continued to engage in destructive umbrella ratemaking that not only prevented competition and disadvantaged railroads, but also began to clearly hold back innovation.

One case particularly stands out. In attempting to preserve waterborne traffic's rate differential, the ICC rejected Southern Railway's 1961 request for a 58 percent rate reduction after the company had developed the far more efficient Big John aluminum hopper car to replace standard boxcars for grain transport.[93] In 1965, the Supreme Court overruled the ICC and allowed the requested rate cut, but this had cost Southern four years of potential business. This also underscored the fact that federal regulation was stifling technological innovation in the railroad industry.[94]

During much of the 1960s, the ICC was generally permissive of railroad mergers. The largest was the February 1968 merger of the Pennsylvania Railroad and New York Central Railroad, which were joined in January 1969 by the troubled New York, New Haven and Hartford Railroad as a condition of the ICC's merger approval, into the Penn Central Transportation Company.[95] Given the continued heavy regulation that disadvantaged rail in the face of competing modes—which drove rail freight revenues so low that they could no longer cross-subsidize passenger service—the consolidated company's financial picture did not improve.

Following the trend of other railroad firms Penn Central's management created a holding company, the Penn Central Company, in an attempt to diversify into other less regulated and more profitable sectors in the hope of using earnings to rehabilitate the railroad's deteriorating infrastructure and rolling stock.[96] By the end of 1970, 54 percent of Class I railroad assets were held by conglomerates.[97] Unfortunately, the overall sluggish economy meant that these non-railroad investments performed little better than the core railroad assets.

Facing ever-increasing losses, Penn Central petitioned the ICC in March 1970 for permission to discontinue 34 passenger trains, the largest single "train off" request ever submitted.[98] The Penn Central Transportation Company soon set another record when it filed for bankruptcy in June, which was the largest corporate bankruptcy in U.S. history until it was eclipsed by the 2001 Enron collapse.[99] But even in bankruptcy, it was unable to free itself from passenger service mandates. In September, the ICC granted Penn Central 14 passenger train discontinuances of the 34 requested.[100] It refused to permit discontinuances of the other 20 trains, claiming that "the public interest would be better served" by mandating unprofitable passenger service.[101]

A month after the ICC's Penn Central "train off" decision, President Richard Nixon signed into law the Rail Passenger Service Act of 1970 in a desperate attempt to revitalize rail travel.[102] RPSA established the quasi-private National Railroad Passenger Corporation—commonly known as Amtrak—which took over passenger service for railroads who happily joined it through the transfer of passenger rail operations and the purchase of common stock (the federal government continues to hold all preferred stock). As one railroad executive remarked at the time, Amtrak primarily served as "a sentimental excursion into the past for legislators over 50."[103] The railroads were no longer cross-subsidizing unpopular and unprofitable passenger service, but total nominal taxpayer subsidies since Amtrak began operations in May 1971 are now approaching $40 billion.[104]

In the early 1970s, Northeastern U.S. railroads were facing dismal prospects and regulatory relief did not yet appear in sight. After a number of bankruptcies, including Penn Central, Congress became worried that the Northeast was on the verge of losing all meaningful rail service and fears of outright nationalization spread throughout the industry.[105] Railway net income continued its multi-decade downward trend, as Figure 2 indicates. Figure 3 highlights the weak return on investment that kept markets bearish on the railroad industry and why the railroads had trouble just remaining solvent.

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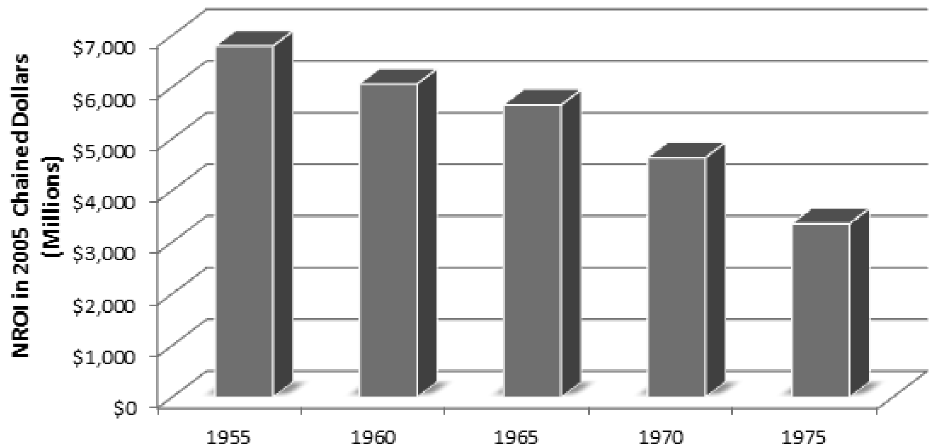
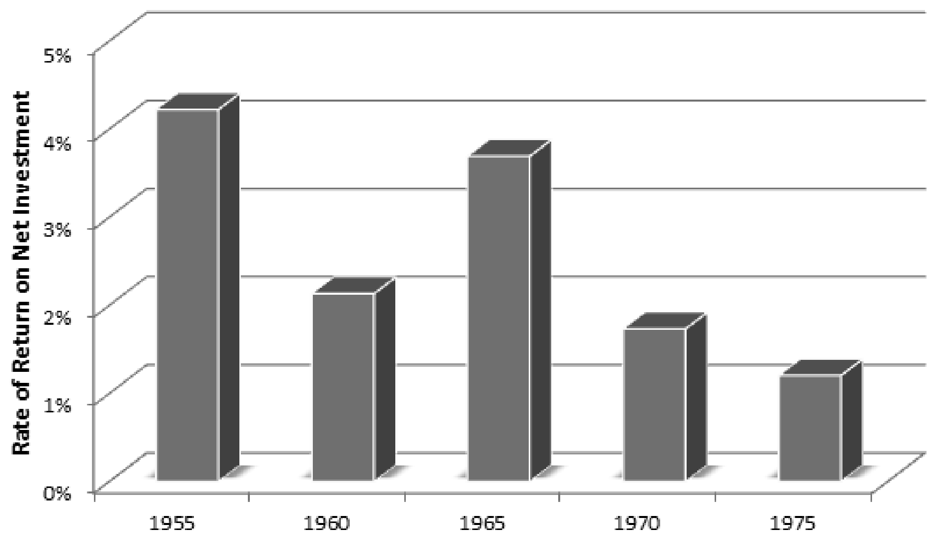
**Figure 2.** Net Railway Operating Income, 1955-1975




*Source: Association of American Railroads, "Net Railway Operating Income,"* Railroad Facts, *November 2011, p. 17.*

**Figure 3.** Rate of Return on Net Investment, 1955-1975




*Source: Association of American Railroads, "Rate of Return on Net Investment,"* Railroad Facts, *November 2011, p. 18.*

## The Death and Life of Great American Railroads

In early 1974, President Nixon signed into law the Regional Rail Reorganization (3R) Act.[106] The 3R Act created the United States Railway Association (USRA), which was instructed to develop a Final System Plan for the emergency federal operation of Northeastern freight rail service. In August 1975, USRA published the long-range plan, which recommended the capitalization of the Consolidated Railroad Corporation (Conrail) and that Conrail take over responsibility for rail operations previously undertaken by Penn Central and six other bankrupt railroads in the affected 17-state Northeast/Midwest service region.[107]

On February 5, 1976, President Gerald Ford signed into law the Railroad Revitalization and Regulatory Reform (4R) Act.[108] The 4R Act represented the first concrete shift in federal policy away from treating increased regulation as an industry panacea. While it adopted the USRA's Final System Plan and capitalized Conrail, which took over freight service in the Northeast, several other 4R Act provisions were decidedly pro-market.[109]

- Title II reformed the ICC's rate-making functions, including the most important provision that permitted the ICC to exempt certain traffic from rate regulation if it determined such regulation "is not necessary to effectuate the national transportation policy declared in this Act, would be an undue burden on such person or class of persons or on interstate and foreign commerce, and would serve little to no useful public purpose."[110]
- Title II ended the destructive ICC practice of umbrella ratemaking—well after it had supposedly been abolished by the Transportation Act of 1958—by providing that rates equal to or in excess of the variable cost of a service could not be found to be so low as to be "unreasonable" or "unjust."[111]
- Title II allowed for a "zone of reasonableness," within which railroads could adjust their rates up or down by 7 percent per year without bearing a heavy burden of proof with respect to ICC rate reasonableness determinations.[112] In the same vein, rates could not be said to be unreasonably or unjustly high unless the ICC determined that a rail carrier had "market dominance" over the traffic in question.[113] Unsurprisingly, the ICC's methodology for determining "market dominance" became one of the most contested provisions of the 4R Act.

Other 4R Act deregulatory measures included Title III, which reformed the ICC's internal practices and instructed the agency to report to Congress with suggested additional rulemaking proceeding reforms,[114] and Title IV, which mandated that the ICC make final decisions regarding mergers no later than two years after the merger application's original submission.[115]

The 4R Act's clear deregulatory character was a harbinger for future reforms enacted during the Carter administration. Supporters of deregulation were disappointed by the ICC's heavy-handed use of "market dominance" determinations to reject requested rate increases, but use by the ICC of the 4R Act's rate regulation exemption provision proved more promising.

*The Railroad Revitalization and Regulatory Reform Act represented the first concrete shift in federal policy away from treating increased regulation as an industry panacea.*

*Deregulation continued to gain adherents through the end of the 1970s.*

Since the enactment of the Interstate Commerce Act in 1887, railroads had been required to publish their rates and the Elkins Act of 1903 required railroads to adhere to them in dealings with all customers. This meant that railroads were forbidden from entering into contracts to provide specific rates to specific shippers. As previously noted, many movements made by motor and water carriers were exempt from such common carrier regulation.

Significantly, the ICC's interpretation of the 4R Act resulted in the legalization of contract rates and the deregulation of fresh produce rail transport.[116] Transport of fresh produce by truck had long been exempt from rate regulation under the Motor Carrier Act of 1935, which put rail at a severe disadvantage.[117] The ICC even created a contract advisory office after railroads failed to immediately take advantage of the new regulatory freedom. As railroad regulation scholar Richard D. Stone notes, "This action by the ICC was nothing short of incredible. Here was a case of the ICC lessening rail regulation and then going so far as to create an advisory service to encourage the use of the instrument."[118]

Deregulation continued to gain adherents through the end of the 1970s. President Jimmy Carter signed the Airline Deregulation Act in 1978, which phased out price controls and regulatory entry barriers in the commercial aviation sector, eventually leading to the elimination of the Civil Aeronautics Board in 1984.[119] Motor carrier competition and rate regulation also faced growing criticism, which ultimately resulted in the Motor Carrier Regulatory Reform and Modernization Act in 1980 that largely deregulated the trucking industry.[120]

President Carter was not initially keen on ending the ICC's stranglehold on surface transportation, naming Nixon ICC appointee and attorney A. Daniel O'Neal as ICC chairman in 1978.[121] O'Neal was first a defender of ICC policy, but soon became a proponent of significant regulatory reform.[122] The Carter administration reversed its position on surface transportation regulation and in 1979, President Carter appointed economist Darius B. Gaskins as ICC chairman, who continued the procedural reforms enabled by the 4R Act and led the effort to drive opponents of deregulation from the ICC bureaucracy.[123]

In this (unfortunately rare) deregulatory climate, Congress and the Carter administration took up their most ambitious project: broad and dramatic deregulation of the railroad industry. This effort culminated in the Staggers Rail Act of 1980, which eliminated or significantly reduced freight rail regulation.

Unlike airlines and motor carriers, though, the primary purpose of railroad deregulation was not to benefit shippers and consumers. Rather, the decline of the railroad industry became so serious that policy makers made no secret that the primary aim was to save the private railroads from extinction.

These goals were clearly spelled out in the Staggers Act's introduction:

> The purpose of this Act is to provide for the restoration, maintenance, and improvement of the physical facilities and financial stability of the rail system in the United States. In order to achieve this purpose, it is hereby declared that the goals of the Act are … to reform Federal regulatory policy so as to preserve a safe, adequate, economical, efficient, and financially stable rail system … [while] assist[ing] the rail system to remain viable in the private sector of the economy[.][124]

In the same way the 4R Act prompted the unprecedented ICC action of advocating for contract rate exemptions, so too was the Staggers Act extraordinary in its stated intent: to preserve private sector ownership and operation of U.S. railways. Title I laid out the U.S. government's rail transportation policy. It expanded on the stated goals by explicitly adding that the purpose of the law was "to minimize the need for Federal regulatory control over the rail transportation system and to require fair and expeditious regulatory decisions when regulation is required"[125] and "to reduce regulatory barriers to entry into and exist from the industry,"[126] among other provisions. This further underscores Congress's intent to improve the standing of rail carriers—something that has largely been lost on shippers and interest groups who now support reregulation of the railroad industry.

*The decline of the railroad industry became so serious that policy makers made no secret that the primary aim of deregulation was to save the private railroads from extinction.*

The Staggers Act's most significant reform elements related to ratemaking, as railroads had been disadvantaged relative to other transport modes for over 40 years. Rigid rate regulation had greatly distorted railroad operations, which led to anemic productivity growth and a generally moribund industry climate.[127]

Title II of the Staggers Act exempted most movements from ICC rate reasonableness determinations. Such maximum rate regulation would only to apply in cases when 1) railroads were determined to have "market dominance," and 2) rates exceeded a cost-recovery percentage threshold, initially set at 160 percent of variable cost and which rose over a four-year period to a maximum of 180 percent.[128]

In adopting provisions aimed to increase railroads' freedom to set rates, Congress again made clear its intent in the Staggers Act conference report:

> The purpose of this legislation is to reverse the decline of the railroad industry, which has been caused, in part, by excessive

*The gains enjoyed by carriers, shippers, and consumers in the decades following the Staggers Act are obvious and significant.*

> government regulation. The conferees believe that by allowing the forces of the marketplace to regulate railroad rates wherever possible the financial health of the railroad industry will be improved and will benefit all parts of the economy, including shippers, consumers, and rail employees.[129]

Congressional critics with ties to shipping interests, most notably Sen. Jay Rockefeller (D-W.V.), have downplayed this congressional intent by suggesting that the Staggers Act was actually an attempt to balance the narrow interests of carriers and shippers. While it is true that the Staggers Act did not completely deregulate the railroad industry and that shippers retained some protections against alleged anti-competitive behavior on the part of rail carriers, the stated purpose of the law was to liberalize railroad operations.

In 2007, Sen. Rockefeller, who has introduced legislation aimed to reregulate the railroad industry at various times in the past, went so far as to incorrectly claim that federal regulators' supposed duty to promote his favored shipper interest groups "has been ignored, or at least subsumed into [regulators'] fervor to see the railroads profitable."[130] On the contrary, as was noted above, Congress unequivocally stated that deregulation, while primarily aimed at saving the private railroad industry from extinction, was being promoted to "benefit all parts of the economy, including shippers, consumers, and rail employees." However, these expected benefits to shippers were to be residual of the deregulatory efforts aimed at improving the health of the railroad industry.

History has proven the Congress of 1980 correct and Sen. Rockefeller wrong. The gains enjoyed by carriers, shippers, and consumers in the decades following the Staggers Act are obvious and significant. Since 1980, the United States has enjoyed:

- A 45-percent decline in average inflation-adjusted rail rates (defined as revenue per ton-mile);[131]
- A more than 400-percent increase in railroad employee productivity (defined as ton-miles per employee);[132] and
- A 76-percent decline in train accident rates (defined as train accidents per million train-miles).[133]

Following the enactment of the Staggers Act, Conrail began to turn a profit and was privatized in 1987.[134] A decade later, Norfolk Southern and CSX agreed to split Conrail's assets, ending Conrail as a Class I carrier.[135]

Since the Staggers Act, the industry has invested more than $500 billion of its own funds back into its railroad networks, unlike other modes of transportation that rely on large government subsidies.[136] According to a 2011 study from the Government Accountability Office, conservative estimates suggest that "freight trucking costs that were not passed on to customers were at least 6 times greater than rail costs" and that rail receives the lowest net government infrastructure subsidies when compared to truck, air, and waterway freight transportation.[137]

Despite this, a vocal minority of shippers continues to call for regulatory and legislative changes aimed not only to restrict market-based rate setting but to roll back several decades of deregulatory progress. These policy alterations range from forced traffic switching among railroads to curtailing the jurisdiction of the ICC's replacement agency, the Surface Transportation Board (STB), in matters of railroad industry competition policy, such as merger approval. Their goal is the propagation of politically determined, sub-market rates.

### The Specter of Reregulation Haunts America's Railroads

Critics of deregulation, namely some industrial shippers and their political allies, have not let up on their call for reversing the deregulatory trend that followed enactment of the Staggers Act in 1980. The policies proposed by this lobbying axis ignore the great gains following partial deregulation of the railroad industry and would most certainly result in a general decline in the quality and cost-effectiveness of rail services if adopted. Concerns regarding the status quo regulatory environment led economists Curtis Grimm and Clifford Winston to argue for abolishing the Surface Transportation Board in a 2000 Brookings Institution study.[138]

Writing in *Regulation* magazine three decades after their influential 1981 article on the Staggers Act originally appeared in the publication,[139] economists Douglas W. Caves, Laurits Christensen, and Joseph A. Swanson note how their cautious optimism of regulatory reform turned out to have greatly understated the resulting social benefits due to the railroads' increased rate freedom:

> As it turned out, the post-Staggers freight railroad industry has proven adept in providing new and more efficient services, and nimble in adjusting to changing commodity mixes through time. However, in 1980 the eventual tremendous growth in both intermodal and coal traffic could hardly have been anticipated. We were aware of the Burlington Northern's expansion into the coal fields of the Powder River Basin, but we had no idea of the Santa Fe's subsequent expansion of its "TransCon" line from Los Angeles/Long Beach to Chicago. Both cases required massive capital

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*A number of shippers and their powerful allies in Washington continue to call for disastrous "reform" measures designed to benefit their narrow short-term interests.*

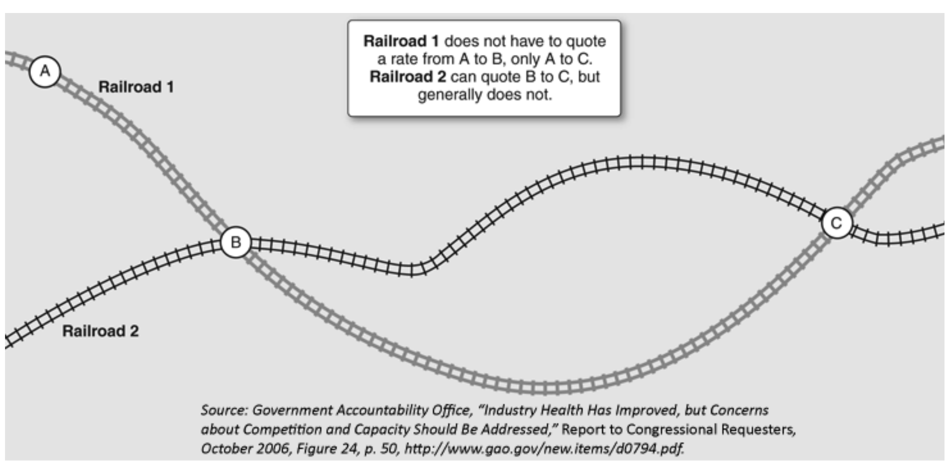
> expenditures to be cost-effective, and neither would prove popular with Wall Street equity analysts. In each case, the respective railroad's ability to contract privately with its shippers proved critical to funding the capital programs that expanded capacity. To be certain, it is those contracts that provided assurance that the capital expenditures would, through time, be made.[140]

Furthermore, the expected political backlash against deregulation never appeared, at least on the scale and with the intensity which they feared:

> We appear to have been too pessimistic regarding the level of political pressure directed at reversing some aspects of the 1980 legislation. The Staggers Act did allow regulatory relief to protect captive shippers, and thus was not total deregulation. But the Interstate Commerce Commission and its successor agency, the Surface Transportation Board, have been conservative in the exercise of oversight authority and have shown deference to the market, as called for by the Staggers Act. […] There were immediate calls to "re-regulate" and some of those calls continue today. However, a broad spectrum of commodity shippers have benefited from lower rates since the Staggers Act was signed and, accordingly, the voices of the disgruntled have been far fewer and less demanding than we expected.[141]

While the calls for reregulation have been fewer and further between than many had anticipated, a number of shippers and their powerful allies in Washington continue to call for disastrous "reform" measures designed to benefit their narrow short-term interests against the interest of railroads, most shippers, and most importantly, consumers.

**Figure 4.** Bottleneck Rates

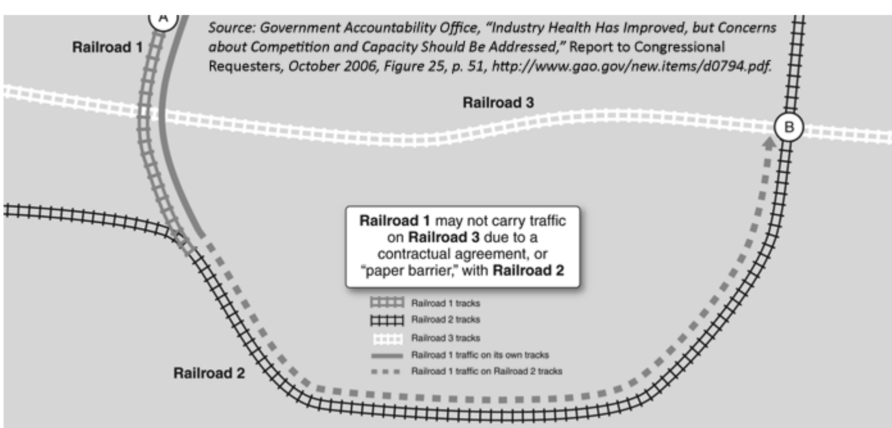


In recent years, a number of bills were introduced in Congress seeking renewed heavy-handed regulation of rail carriers. The Railroad Competition and Service Improvement Act of 2007 (RCSIA), introduced by Rep. James Oberstar (D-Minn.) and Sen. Rockefeller, attacked deregulation on a broad front and included the use of three provisions that have become particularly contentious in the battle between carriers and disgruntled shippers.[142]

First, RCSIA sought to force bottleneck carriers—those that serve either an origin, destination, or both with little or no competition on one segment, known as the bottleneck segment, but do face competition on other segments, known as the non-bottleneck line (see Figure 4)—to allow another railroad to provide service to shippers, while also denying the bottleneck carriers the option to carry the freight for the entire trip.[143] This provision, known as "quote a rate," allows a non-bottleneck carrier to offer rates to shippers for just the competitive segment of track and—ignoring the bottleneck segment owner's operating risk—forces bottleneck carriers to offer a rate for only the less competitive segment. In essence, railroads would become more like public utilities that lack meaningful control over their assets and operations. "Quote a rate" likely would make many bottleneck segments unprofitable to operate due to the de facto rate ceiling it imposes, meaning the Class I carriers—those railroads with operating revenue of at least $250 million annually, subject to inflation adjustments—would be more likely to sell the bottleneck segment or sell it to a non-Class I carrier than they otherwise would be.[144]

Second, RCSIA sought to prohibit "paper barriers."[145] These provisions are often included in contracts when Class I railroads sell or lease segments to non-Class I railroads. The purchasing smaller carrier is forbidden from interchanging traffic with any Class I railroads that are not the original seller (see Figure 5). The elimination of

**Figure 5.** Paper Barriers



paper barriers compounds the hardships railroads would experience under the “quote a rate” provision by making the segments in question more difficult to sell or lease. This too could lead to more track abandonments by Class I railroads and the loss of service to those shippers.[146]

Third, RCSIA would require forced access by mandating the use of reciprocal switching agreements (see Figure 6). Reciprocal switching occurs when one railroad interchanges railcars with another railroad. Railroads sometimes enter into reciprocal switching contracts voluntarily when the service benefits outweigh the costs, although many railroads that used reciprocal switching agreements in the years following enactment of the Staggers Act have since merged.

Section 104 of RCSIA would have eliminated the Surface Transportation Board’s discretion in mandating reciprocal switching, amending 49 U.S.C. 11102(c) by replacing “may require” with “shall require.” This would effectively make forced access an entitlement, by removing the “public interest” requirement for approval of forced access requests. Section 104 also sought to codify that the STB “shall not require that there be evidence of anticompetitive conduct by a rail carrier from which access is sought.”

Under reciprocal switching, impacted shippers would face rates closer to variable costs, but these rates would reflect neither the large capital costs nor the inherently higher risk due to the presence of sizable sunk investments. This danger has been highlighted by economist Jerry Hausman.[147] Weakening ownership rights by expanding the use of reciprocal switching in the name of competition and enhanced access would ironically likely reduce rail access in the future, as railroads would face diminished incentives to invest in infrastructure that serves only a small number of shippers.

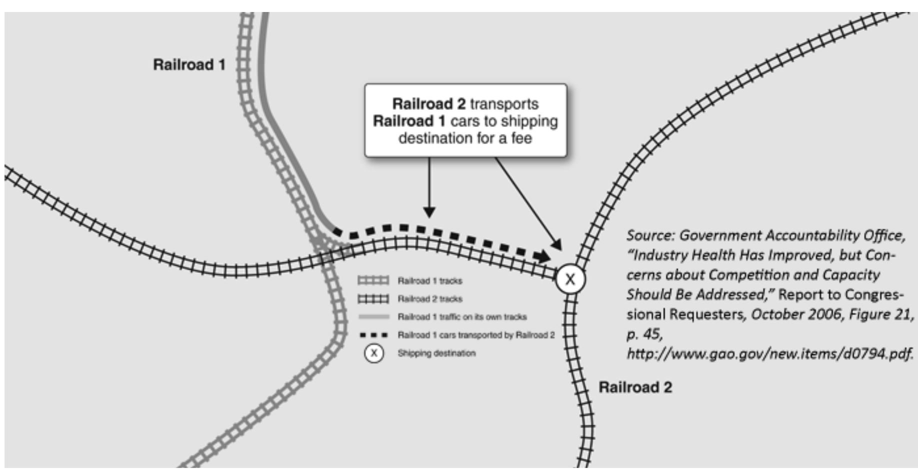



**Figure 6.** Reciprocal Switching

Reregulatory policies to ostensibly promote competition in fact serve to reduce the return on investment and thus the incentive to modernize and expand network facilities to meet changing traffic patterns and commodity mixes. The $500 billion the railroad industry has reinvested into its networks since the Staggers Act is of its magnitude because deregulation allowed owner-operators to behave as market agents, rather than as bureaucrats' pawns.

The disgruntled shipper minority will never admit it, but the main reason why they lack whatever level of competition they would deem sufficient is that there is simply not enough demand for rail service for a competing railroad to justify investing in the area.

Legislation introduced in 2011 by Sens. Rockefeller and Kay Bailey Hutchison (R-Tex.) was similar to RCSIA, albeit weaker.[148] Other recent legislation in Congress has focused on another competition policy—the railroads' limited antitrust exemption—and would have ended the STB's role as the primary jurisdiction for merger approval cases and opened the door for misguided antitrust attacks from the Department of Justice and Federal Trade Commission.[149] So far, all of these reregulatory legislative endeavors have failed, but major regulatory proceedings before the STB have focused on bottleneck issues, particularly reciprocal switching.

Captive shippers understandably would like to pay less. However, while restricting shipping rates—particularly when the regulation relies on a cost-based rate—might temporarily be a boon to some shippers, the long-term impact of further restricting market-based rate-setting would harm railroads, shippers, and consumers.

Demand for Class I freight service is expected to increase substantially during the coming decades.[150] Limiting the ability of railroads to recoup capital costs in the most efficient manner possible would lead to decreased investment in new technologies and additional capacity that will be required to keep rates down in the long-run.

Some have speculated that recent shipping rate increases since 2004 are the result of suboptimal monopolistic behavior on the part of railroads. A study commissioned by the STB found that recent increases in revenue per ton-mile (RPTM) were not the result of an alleged "increased exercise of market power by the railroads."[151] Instead, the study found that these RPTM increases were due to increases in railroads' generic costs, primarily the price of fuel.

If demand along current bottleneck segments were to increase, it is more likely that additional railroads would invest in infrastructure and enter the market. But captive shippers are essentially demanding that railroad

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*Captive shippers are essentially demanding that railroad competition be somehow enhanced using blunt and anti-competitive regulatory tools such as rigid price controls.*

competition be somehow enhanced using blunt and anti-competitive regulatory tools such as rigid price controls.

It is difficult to believe that competing railroads would have a greater incentive to woo a small number of customers over even slimmer pickings under cost-based rate ceilings. Uncertainty about or an inability to recoup capital costs would make investors leery of financing similar upgrades in the future. Thus, adding additional regulatory burdens to the industry would only serve to reduce societal welfare for the limited benefit of a minority of shippers.

The STB announced on January 14, 2011, that it was opening a proceeding to "receive comments and hold a public hearing to explore the current state of competition in the railroad industry and possible policy alternatives to facilitate more competition, where appropriate."[152]

In this proceeding, two shipper groups led the charge against what they considered unreasonable rates: Consumers United for Rail Equity (CURE) and the National Industrial Transportation League (NITL).

CURE's complaints have largely remained constant over the years.[153] The shippers it represents simply do not want to pay market rates for their freight movements. While this is understandable, it does not justify their narrow, self-serving lobbying for government intervention. CURE's rent-seeking advocacy betrays a deep misunderstanding of economic theory as it relates to network industries and competition policy.[154]

George Priest, John M. Olin Professor of Law and Economics at Yale Law School, has argued that while most "[a]ntitrust analysts and courts are presumptively suspicious of the possession or extension of market power," this suspicion "[i]n the context of a network industry" is "inappropriate" because it ignores "positive externalities generated by network participation."[155] Priest continues, "Thus, many of the traditional presumptions with respect to industrial practices and industrial structure are not available and are even counterproductive in the context of networks."[156] Priest goes on to call for a complete reorganization of contemporary antitrust understanding with respect to network industries.[157]

An error often made when analyzing the efficiency of markets is the assumption that public policy can easily address market failure or other perceived market imperfections. In reality, the net social costs of government failure in attempting to remedy suboptimal market outcomes frequently outweigh the costs of the alleged market failure itself. As New York University economist Lawrence Wright has astutely noted, "governments are not omniscient"[158] and they "may not be the benevolent neutral entities of textbooks."[159] On the contrary, regulatory bodies are frequently captured by commercial interests, which then drive socially harmful, anti-competitive policies. As a result, "the efforts of government to fix the potential problems of networks may well go awry."[160]

Shippers have challenged the discrimination among firms in freight rate-setting by arguing that these practices undermine social welfare. However, economic historian Marc Levinson argues that this sort of discrimination in the railroad industry is not only welfare-enhancing, but that "the end of the ban on discrimination was the most important result of the deregulation of freight transport."[161]

NITL's understanding of the underlying economics of network industries is similarly colored by an outdated view of network industries and regulation. However, NITL went beyond CURE's mere misunderstandings and petitioned the STB to open a rulemaking proceeding regarding reciprocal switching standards.[162]

In its petition, NITL requested that the STB initiate a rulemaking to replace the current regulations governing access and replace them with a new dedicated part of the Code of Federal Regulations to lay out the conditions for mandatory reciprocal switching.[163] At its core, the NITL proposal seeks to force reciprocal switching arrangements by removing the present requirement that abuse of market power must be found to mandate such practices. The proposal would mandate reciprocal switching if the following four conditions are met:

1) The shipper or shippers would be served only by a single Class I railroad;
2) There is no effective intermodal or intramodal competition for the freight movements in question;
3) "A working interchange" exists or could exist within a "reasonable distance" of the shipper's or shippers' facilities; and
4) Mandating reciprocal switching is feasible and safe, and would not unduly hamper the affected carrier's ability to serve its shippers.[164]

The first condition tells us little about market conditions, while the third and fourth—in addition to the vagaries of "reasonable," "feasible," and "unduly"—depend on a determination of lack of effective competition under the second condition. Unsurprisingly, it is under this second condition where NITL seeks to make most of its mischief.

The second condition, as summarized by NITL in its proposal to the STB, states:

> The petitioner shows that there is no effective inter- or intramodal

*The net social costs of government failure in attempting to remedy suboptimal market outcomes frequently outweigh the costs of the alleged market failure itself.*

> competition for the movements for which competitive switching is sought. There would be no consideration of product or geographic competition. There would be a conclusive presumption that there is no such effective competition where either: (a) a movement for which competitive switching is sought has an R/VC ratio of 240% or more; or (b) the Landlord Class I carrier has handled 75% or more of the freight volume transported for a movement for which competitive switching is sought in the twelve months prior to the petition seeking switching.[165]

In other words, regulators are not to take into account potentially relevant information related to product or geographic competition, which can surely impact a carrier's investment, risk assessment, and service charges in a variety of ways throughout the network. Worse, under NITL's ideal competitiveness standard, any rates at or exceeding a revenue-to-variable-cost ratio of 240 percent will automatically be found harmful. This arbitrary standard not only ignores the wide variation in risk to sunk investments across network segments, it would rely on the outdated and oft-criticized Uniform Rail Costing System to make determinations under it.[166]

The second standard, the 75-percent-or-more carrier market share, smacks of biting the hand that feeds. It is likely that many of the segments in question were constructed by carriers and operated for the specific disgruntled shippers. As was noted above, the risk of these low-demand segments is quite large and it would only take the exit of one or a couple of shippers from the market to render the segment unprofitable. This would deter future railroad investment aimed to increase capacity for shippers with similar characteristics and would ultimately harm rail carriers, shippers, and consumers by reducing network efficiency and access.

Instead of having the STB rely on actual evidence of abuse, NITL proposes that regulators should be permitted to make arbitrary and capricious determinations based on faulty data in order to allow its members to extract short-term rents from rail carriers. The current regulations, while far from perfect, are superior to the blatant rent-seeking contained in NITL's dangerous proposal.

The proceeding is currently open.[167] If the STB agrees with NITL and ceases to be "conservative in [its] exercise of authority,"[168] as Caves, Christensen, and Swanson describe the ICC's and STB's general regulatory worldviews following the Staggers Act, it may indicate that the STB has definitely outlived its purpose and should be abolished by Congress.

## Conclusion

The long and unfortunate regulatory history of the U.S. railroad industry offers a cautionary tale against the siren song of increased economic regulation heard so frequently in Washington.

History and practice show that even the best intentioned regulators—those who seek to balance the interests of involved parties—will still lead to a distorted market that will undermine the prosperity and growth not only of those directly impacted by the regulations, but of the economy as a whole. The near-death of the railroad industry in the 1970s was the result of these best of intentions.

This is not to say that balance, explicitly highlighted in the Staggers Rail Act of 1980, is not something to be considered. But the public interest is not served by acquiescing to the demands of self-interested parties mainly concerned with the short-term impact on a narrow category of economic interaction. Rather, paramount in serving the public interest is considering the underlying peculiarities of the industry in question, as well as its long-term viability.

Even the most disgruntled shippers would be hard-pressed to dispute that the U.S. has benefited greatly from the partial deregulation that resulted from the 4R Act and Staggers Act. Real freight rates are still far below the heavily regulated rates of the 1970s, despite the recent uptick due largely to fuel price increases, and carriers have enjoyed productivity growth far exceeding the economy as a whole. That shippers seeking government-driven rate relief do not dispute the repeated findings that there is no evidence of market abuses by carriers underscores the fact that calls for reregulation are primarily rent-seeking activities.

While the temptation to right perceived wrongs of the market is a powerful impulse for many, it should be at the very least tempered with knowing that the error costs of government action frequently exceed the alleged costs of a lack of competition. As we have learned from the regulation of network industries, particularly railroads, these costs can not only be enormous, but persistent and stultifying over many decades.

Restoring rate freedom to rail carriers was one of the most positive economic policy reforms of the second half of the 20th century. It would be a shame for self-interested short-termism to trump the clear economic benefits of deregulation.

*The long and unfortunate regulatory history of the U.S. railroad industry offers a cautionary tale against the siren song of increased economic regulation heard so frequently in Washington.*

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