Reviving Capitalism

Lessons from the Near-Death and Rebirth of American Railroads

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EXECUTIVE SUMMARY

Free market capitalism, the system that has made possible the prosperity we enjoy today, has been in retreat over the last century. Government's share of U.S. GDP has continued to grow—save for a few interruptions—while the regulatory burden on businesses has steadily expanded. In 1890, total government spending accounted for about 6 percent of the U.S. economy. Today, that figure is almost 34 percent—approximately $6 trillion total at the federal, state, and local levels—with another $1.88 trillion in regulatory compliance costs.

This retreat has been caused in part by the failure of business leaders to defend the moral legitimacy of their companies and products, and indeed, of capitalism itself. Businesses are good at communicating how they advance the interest of their various economic partners—providing consumers a wide array of products, employees with competitive wages, suppliers with a reliable customer, and investors with a return on investment. But they are much less expert at conveying how private enterprise also advances societal cultural values.

The result is widespread popular support for top-down government regulation of the economy. To push back against, and even reverse this trend, business leaders need to gain the societal legitimacy needed to fend off political predation. In short, continued success in the marketplace increasingly requires successful promotion of economic freedom in the public policy arena.

This case study sketches out one such successful effort in the freight railroad industry's response to political intervention over the last century. The political and economic history of American railroads suggests that regulatory restrictions can be reduced as well as expanded. It also offers

concrete lessons on how other types of businesses might respond to government overregulation and gain greater economic freedom in general.

Success in the policy arena requires entrepreneurial and intellectual investments in promoting economic freedom, just as investment in promoting one's products leads to success in the marketplace. This essay clarifies the nature of such investments, the rationale for business leaders to join in the fight for economic liberty, and why such efforts may offer attractive economic returns.

INTRODUCTION

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This essay is organized in four sections, reflecting different eras of this story:

The first section, "From Free Markets to Regulation: Early 19th Century to 1887," covers the era prior to and immediately after railroads were first regulated. At first, rail industry leaders resisted regulation, but then saw it as inevitable and hoped that "rational" regulation might offer some benefits.

"Slow Death under Regulation: 1887 to 1960" deals with the long era of tightening regulations. Industry had fatalistically accepted regulation, and sought merely to moderate its worst impacts, but found itself increasingly hobbled in its attempt to compete with other shipping methods.

"The Liberalization Renaissance: 1960s to Today" discusses the trends that allowed liberalization and its consequences. The accommodationist approach noted above lasted until the industry, having recognized the futility of gaining relief from powerful regulators and finding some allies in the intellectual and business world, sought and gained liberalization.

The concluding section, "Lessons for Broader Liberalization," draws lessons from the railroad deregulation story to provide key insights on how one might build the case for liberalization in other sectors of the economy—both innovative firms operating at the economic frontier and mature ones operating in an already politicized environment.

Businesses face threats in the political world. Business leaders should plan and respond accordingly, considering investments that might improve their operating freedom.

FROM FREE MARKETS TO REGULATION: EARLY 19TH CENTURY TO 1887

Railroads and steam locomotives were first introduced at the beginning of the 19th century in England, and came to the United States by the 1820s. As a new industry operating in uncharted economic and political waters, railroads faced few regulatory hurdles in those early decades. Relying on the competitive disciplines of the market, rates, the size of firms, and best practices were largely determined by the policies of

Railroads shrunk the world, allowing producers and consumers to interact over much greater distances.

railroad investors and managers and the preferences of consumers.[5] Under that relatively laissez-faire system, the rail sector grew rapidly, creating large benefits for the nation.

Railroads revolutionized transportation in America—in a classic case of economist Joseph Schumpeter's concept of "creative destruction." In most areas, rail shipments displaced existing canal transit services. The reduced transportation costs made possible by rail networks allowed for much greater quantities of materials to be assembled in one spot, which in turn allowed construction of much larger scale production facilities, against which local producers found it harder to compete.

Railroads shrunk the world, allowing producers and consumers to interact over much greater distances. They helped unify the American market. They also significantly influenced the location decisions of firms in other industries, such as warehousing and wholesaling.

As rail expanded and mergers created large regional networks, some populist politicians stoked fears that the railroads' size would enable them to "exploit" shippers and farmers, presumably by exercising their alleged monopoly power. Large businesses were novel in that era and often viewed with suspicion by large segments of the public.

Americans liked the "creative" element of rail but became increasingly concerned about its "destructive" element. Those concerns were exacerbated by the complex and often confusing financing and pricing strategies required in a decreasing-cost industry like rail transport. The high fixed costs of building a rail network mean that declines in traffic require those costs to be spread over a smaller customer base. In such industries, marginal cost pricing would have led to bankruptcy.[6] Railroads sought forms of diversity pricing, adjusting rates based on the likelihood that higher fees would discourage use. Railroads faced complex problems: gaining charters, determining appropriate financing methods, seeking to translate those realities into viable shipping rates, and deciding whether to merge with other rail lines or grow internally.

These factors led to growing state movements calling for government regulation of the railroad industry. Farmers sought lower shipping rates. Populist politicians called on government to "do something." Government responded.

New Hampshire was the first state to create a railroad commission in 1844.[7] Over the next four decades, nearly two-thirds of the states followed.[8] For the most part, these state railroad commissions focused on preventing fraudulent financial practices, promoting rail safety, and enforcing compliance with state laws.

Northeastern state commissions were often merely advisory, having only the power to recommend that a state attorney general initiate an investigation.[9] In contrast, regulators in Midwestern and Southern states often had the power to resolve rate disputes, and their decisions were enforced via the courts.[10] These Midwestern and Southern railroad commissions provided the template for the future federal regulatory framework.

Even as advocates of regulation were becoming more powerful, the rail sector itself flourished.

Railroad operations across state lines with different state regulatory bodies made rail pricing even more complex.

Moreover, the federal government viewed rail as an "infant industry" in need of subsidies and provided significant land grants along new routes, leading to overcapacity and poorly structured rail networks that followed subsidies rather than the shortest path. In this complex environment, rail executives sought to stabilize rates crafting various cartelization schemes that rarely proved stable.

This federally encouraged overexpansion led to consolidation, as failing railroads either shut down operations or were acquired by successful ones. The complexities of pricing and operating in a frontier industry resulted in rate wars, track abandonments, and bankruptcies. Shippers widely agreed that railroad competition led to unequal treatment of different localities and resulted in arbitrary rate hikes and depressed commodity prices, and therefore only regulation could achieve fair and equitable rates.[11]

Yet, even as advocates of regulation were becoming more powerful, the rail sector itself flourished. Between the creation of the first state railroad commission in 1844 and the creation of the Interstate Commerce Commission in 1887, operating railroad mileage mushroomed from 4,377 to 149,214 miles.[12] This network growth enabled the settlement of large swaths of Western land and established Chicago as the nation's agricultural trading hub.

Shippers often argued that the years preceding federal regulation were characterized by steep hikes in freight rates. The reality is more complicated. *Nominal* rates fell dramatically, but much of this period saw price deflation. Controlling for the price level produced a much slighter decline in inflation-adjusted freight rates, although year-to-year price variations could be quite large. More recent analysis found that rate regulation failed to reduce prices, though it did reduce price volatility.[13] Commodity price declines, in part due to increasing commercialization in agriculture, along with poor weather and general inexperience on the part of small farmers, appear to have been largely responsible for farmers' vocal discontent during this era.[14]

Research also suggests that farmers were less politically influential than popular histories have claimed.[15] The real force for rail regulation emerged from the shippers lobby, especially Western wholesalers. Unlike farmers, this group had resources and political connections. Former Interstate Commerce Commission member and economist Marcus Alexis argued that industry seeking political favors, rather than remedying alleged market failures, was the driving force behind federal railroad regulation:

> Rail executives were concerned about "rate wars," secret concessions, and rebates. Attempts to stabilize the industry by a series of cartel-like pooling arrangements were of limited success. Shippers were unhappy with practices which resulted in rate

As rail efforts to cartelize failed, some rail executives also came to view federal regulation more favorably.

> instability (not necessarily higher rates because rates were on the average declining) and [the fact that some short hauls were more costly than long hauls]. …. The struggle over the form that Federal regulation would take is a classic in terms of the pursuit of economic interests, or rent-seeking behavior.[16]

Popular and political support for regulation continued to grow. And as rail efforts to cartelize failed, some rail executives also came to view federal regulation more favorably. On the eve of the enactment of the Interstate Commerce Act, few opponents to comprehensive federal railroad regulation remained. The few who did, however, made a last ditch effort. New York Railroad Commission member John O'Donnell argued for market competition rather than political regulation: "If a railroad runs through a favored territory, and another road is built in opposition to it, let it fail if it cannot compete."[17]

Another financial analyst, Henry Varnum Poor, a founder of the firm that became Standard & Poor's, argued that fictitious capitalization—caused largely by firms chasing government subsidies and engaging in other corrupt practices—had caused overcapacity and rate volatility. He urged Congress to reject regulatory intervention, arguing that the market would more quickly correct these woes. In Poor's assessment:

"Our Governments, State and National, have very little genius or faculty for the supervision of railroads."[18]

Then in 1886, the U.S. Supreme Court ruled in *Wabash, St. Louis & Pacific Railway Company v. Illinois* that Illinois's law imposing common carrier requirements on interstate rail movements violated the Constitution's Commerce Clause.[19] Congress then moved to federalize regulation, passing the Interstate Commerce Act the following year.[20] That Act created the Interstate Commerce Commission (ICC) and imposed the first federal industrial regulatory regime.

SLOW DEATH UNDER REGULATION: 1887 TO 1960

The struggle between the Constitution and politics persisted after the creation of the Interstate Commerce Commission. The Supreme Court ruled that the Constitution barred state common carrier regulation that impedes interstate commerce. Subsequent Supreme Court rulings upheld the Interstate Commerce Act, but curbed the ICC's enforcement powers, finding that Congress had not explicitly given the ICC power to set rates.[21] In response to what was perceived as a judicial defanging of the ICC, Congress decided to enact legislation that might survive legal challenge. This resulted in Congress enacting a series of laws between 1903 and 1913 that ratcheted up the ICC's scope and enforcement powers over short- and long-haul price discrimination, firm entry and exit, ratemaking processes, investments, and shipper-carrier dispute resolution.[22]

Shipping interests became even more forceful in calling for government regulation of railroads. In response, the ICC moved to regulate more aggressively, treating the rail industry as a politically controlled cartel.

However, the railroads retained considerable influence over the resulting regulations. To some Progressives, as later argued by historian Gabriel Kolko in his book, *The Triumph of Conservatism*, this meant that the ICC had been "captured" by the very industry it was charged with regulating.[23] Kolko saw regulation as benefiting the railroads, providing a political cover for the industry's "monopolistic" pricing policies. At the same time, regulators faced the "knowledge problem" described by the Nobel Prize-winning economist Friedrich Hayek—that only railroad operators actually understood the industry's economic and technical challenges.[24] Thus, regulators with little knowledge of network economics and industry practices were forced to seek advice from the railroad managers.

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This regulatory environment began to hamstring the railroad industry in its efforts to respond to customers' growing and changing demands. This problem was acute at times. When World War I broke out and port-bound traffic spiked,[25] the ICC refused industry requests for higher rates needed to reallocate resources and attract additional investment.[26] Instead, President Woodrow Wilson, a staunch Progressive, nationalized America's railroads in 1917 under the authority of the Army Appropriations Act, passed the previous year.[27] The railroads would remain under government management for the rest of the war. Ironically, shortly after nationalization, the federal government increased freight rates by nearly double the request made by the railroad industry a year earlier.[28]

The problems encountered during the World War I nationalization led to the quick re-privatization of the railroads after the war. The Transportation Act of 1920 returned the railway networks to the private sector, but did little to gain the industry operating freedom. And while the ICC did seek a less adversarial approach,[29] the 1920 Act's treatment of asset valuation and what it deemed a "fair return" on those assets were poorly structured. Given that the value of an asset is in part determined by its expected rate of return, this resulted in circuitous and meaningless asset valuations. That encouraged inefficient investments and offset the benefits to industry of a less hostile regulator.[30]

Moreover, rail now faced competition from a rapidly expanding motor carrier industry. Rapid industry consolidation was one response. During the 1920s, miles of railroad owned fell from 252,845 in 1920 to 249,433 miles in 1929, a decline of 1.35 percent.[31] The number of operating railways fell from 1,085 in 1920 to 809 in 1929, a decline of more than 25 percent.[32]

Railroads, like most American industries, were caught off guard by the Great Depression. Industry revenues fell by more than 50 percent between

1929 and 1933.[33] This led President Franklin Roosevelt and Congress to pursue another legislative overhaul for rail. The result was the Transportation Act of 1940.[34] While intended to "recognize and preserve the inherent advantages" of various transportation modes, the Act encouraged a destructive industry practice known as "umbrella ratemaking," which forced healthy railroads to keep their rates artificially high to protect their less healthy competitors.[35] Eventually, this became one of the industry's most significant regulatory burdens. With the outbreak of World War II, these costs were masked by lucrative wartime contracts and government rationing of gasoline and tires, which restricted motor carriers.

Following the war, the collapse of intercity passenger rail travel and declining market share for freight railroads led to renewed concern over the long-run health of the industry. At a 1948 conference of industry financial analysts, journalist and economist James G. Lyne warned that the regulated rail sector was crippled in its efforts to address increased 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."[36]

Between 1945 and 1955, inflation-adjusted passenger revenue fell by more than 70 percent, while rail's share of intercity freight traffic fell from 69 percent to under 50 percent.[37] Despite their losses to trucking industry competitors, railroads were still forced to cross-subsidize passenger service. It was during these postwar years that the industry and outside financial analysts began to question the wisdom of heavy regulation of transportation.

In 1955, the Presidential Advisory Committee on Transport Policy and Organization issued a report recommending that Congress abolish umbrella ratemaking and curtail the ICC's power. President Dwight Eisenhower wrote that he had "become disturbed by many assertions to the effect that government policies were helping to 'ruin' our railroads."[38] In response, Congress attempted to solve these problems by passing the Transportation Act of 1958. Unfortunately, vague legislative drafting resulted in few material changes and the Act was widely regarded as a failure by the railroad industry, scholars, and members of Congress.

THE LIBERALIZATION RENAISSANCE: 1960s TO TODAY

The failure of the Transportation Act of 1958 did not deter reformers. Though fearful of ICC retaliation, the railroad industry began to publicly criticize the moribund state of affairs. For instance, Association of American Railroads Vice President Walter J. Little denounced stultifying economic regulation as "one of the greatest deterrents to industrial progress we have to face."[39] Still, through the 1960s, the industry attempted to compromise with the government, seeking at least some degree of rate freedom from what was termed the "dead hand" of the ICC.[40]

Rail regulation had produced numerous problems, which became more obvious in the postwar years. The longstanding ICC practice of determining rates based on the value of the goods shipped, rather than the cost of the shipment, led to high-rate rail losing market share to speedier, lower cost trucking, especially following construction of the Interstate Highway

System.[41] It became increasingly clear that declining rail traffic volume could not justify such large rail capacity. Yet regulations forbade the track and service abandonments necessary to rationalize the networks.[42]

In addition, rate regulations were blocking innovation. In 1961, the ICC rejected Southern Railway's request for a 60 percent rate reduction in order to attract the traffic volume required to profitably operate new "Big John" aluminum hopper cars for transport of dry bulk commodities, which allowed far greater efficiencies at high capacity.[43] The ICC's decision sought to preserve the rate differential between rail and water-borne carriers and protect the existing market shares of each mode of transport, as was the ICC's interpretation of its mandate under the Transportation Act of 1940. In 1965, the Supreme Court overruled the ICC and allowed the requested rate reduction, but the delay had cost Southern four years of increased traffic—and profits.[44]

In this climate, academic and even government reports began to recognize the dangers facing the railroad industry if major regulatory reform was not pursued.

In 1960, economist James C. Nelson authored a widely read article in *The American Economic Review* that laid out the problems facing the railroad industry.[45] 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."[46] Other economists such as George W. Hilton[47] and Ann F. Friedlaender followed suit, finding the ICC to be a harmful cartel that was now eating its own.[47]

Following President John F. Kennedy's election in November 1960, former Civil Aeronautics Board Chairman James M. Landis delivered the *Report on Regulatory Agencies to the President-Elect*, which was highly critical of U.S. regulatory bodies' widespread inefficiencies.[49] In 1961, the Senate Committee on Interstate and Foreign Commerce published a report by John P. Doyle, former director of transportation for the U.S. Air Force.[50] The Doyle report highlighted the regulations stemming from the 1940 Transportation Act that disadvantaged railroads. It also predicted dire consequences for the railroad industry by the mid-1970s if nothing was done to remedy these problems.[51]

By the early 1970s, the two prevailing Washington attitudes toward the railroads were either nationalization or liberalization.

Such reforms did not appear imminent, unfortunately, and railroads, in an effort to shore up their finances during the 1960s, sought to diversify into more lucrative sectors of the economy.[52] By 1970, more than half of the major railroads were held by conglomerates.[53] One example is the Penn Central Transportation Company—though it ended up filing for bankruptcy in June 1970 (the largest corporate bankruptcy in history until the Enron collapse in 2001).[54]

By the early 1970s, the two prevailing Washington attitudes toward the railroads were either nationalization or liberalization.[55] The railroad industry was fearful of nationalization and began seriously advancing the liberalization agenda.[56] But many in government doubted the rail industry could survive in private hands. That view led President Nixon to enact a series of emergency measures. Government-created Amtrak—in effect a nationalized intercity passenger service—began operation in May 1971.[57] Freight rail was freed from some of the burdens of cross-subsidizing passenger service, but Amtrak was given preferential access to the freight rail networks and the law did nothing to permit rail pricing freedom.[58]

However, the Nixon administration also began employing a number of strong proponents of liberalization. John W. Snow joined the Department of Transportation in 1972 and stayed there for several years until President Ford appointed him to head the National Highway Traffic Safety Administration.[59] Snow, a lawyer with a Ph.D. in economics, believed deregulation offered the only viable path forward for America's transportation sector. He assembled a coalition inside and outside government, spending the rest of the decade building support for a then-radical idea.[60]

Continued problems led President Nixon, in 1974, to sign into law the Regional Rail Reorganization (3R) Act.[61] The 3R Act required the development of a long-range rail network plan, which became the 1975 Final System Plan.[62] One important recommendation was to capitalize the new government-owned railroad, the Consolidated Railroad Corporation (Conrail). Conrail would provide rail service in a 17-state area in the Northeast and Midwest, acquiring the assets of the Penn Central and six other bankrupt railroads.

But this continued tinkering was increasingly recognized as inadequate by both politicians and industry. In 1976, that led President Gerald Ford to sign into law the Railroad Revitalization and Regulatory Reform (4R) Act.[63] The 4R Act adopted the Final System Plan from the previous year and provided Conrail needed capital. While much of the 3R Act, as well as the 4R Act's capitalization of Conrail, can be accurately characterized as steps toward nationalization, the 4R Act had some decidedly liberalizing provisions.[64] The destructive ICC umbrella ratemaking practice was finally abolished and the ICC gained authority to exempt certain traffic from rate regulation.[65]

The 4R Act also legalized contract rates that were exempt from common carrier requirements and brought fresh produce transportation services into the market.[66] These were the first major attempts by Congress to legalize and legitimize competition-based pricing. Unfortunately, the 4R Act failed to provide the relief many had expected.[67]

When President Carter took office and Snow left government, he joined the American Enterprise Institute, where he published works touting transportation deregulation.[68] Fortunately, Carter embraced these trends, most notably with the appointment of Cornell University economist Alfred E. Kahn as chairman of the Civil Aeronautics Board. Kahn, a staunch proponent of deregulation who is now known as the father of airline deregulation, succeeded in persuading Congress to pass the Airline Deregulation Act in 1978.[69] He also mentored other deregulation proponents inside government, laying the groundwork for surface transportation deregulation.

The battles over deregulation of airlines and motor carriers set the stage for comprehensive transportation deregulation during the Carter administration.

The railroad industry had long been hesitant to criticize its regulator. But when the ICC rejected a number of requests for rate freedom from the Southern Pacific, Illinois Central Gulf, and other railroads, the industry adopted a much more pro-liberalization strategy.[70] A year after enactment of the 4R Act, the railroad industry began more aggressively challenging existing regulations, arguing that this was essential if Congress wished to avoid the collapse of the private rail sector and its likely nationalization. John Snow, by then an active member of the Association of American Railroads' deregulation study group, bluntly stated in 1978 that he would press for "substantial deregulation of railroads in five years" and that the private railroads "simply can't live with the kind of regulation the ICC is dishing out."[71]

The battles over deregulation of airlines and motor carriers set the stage for comprehensive transportation deregulation during the Carter administration.[72] The appointment of economist Darius Gaskins, who had served under Alfred Kahn at the Civil Aeronautics Board, as ICC chairman underscored the growing consensus that more significant transportation regulatory reforms were necessary.[73] In addition to shepherding the pro-competitive regulatory reforms enabled by the 4R Act, Gaskins made a concerted effort to drive anti-reform staff from the ICC bureaucracy.[74]

These trends encouraged the Association of American Railroads to develop and promote a comprehensive, 14-point deregulatory plan in 1979.[75] This culminated in the passage of the Staggers Rail Act of 1980, which largely liberalized the rail industry. It gave railroads broad economic freedom, the right to price their products competitively, to meet trucker and barge competition, and to offer higher quality service. "Just-in-time" shipping services were one result, allowing railroads to regain traffic long lost.

Unlike airlines and motor carriers, though, the primary purpose of railroad deregulation was not to benefit consumers. Rather, the decline of the railroad industry had become so serious that policy makers made no secret that the primary aim was to save the private railroads from extinction and preserve private sector ownership and operation of U.S. railways. 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[.][76]

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"[77] and "to reduce regulatory barriers to entry into and exit from the industry,"[78] among other provisions.

Price freedom was an important factor in producing lower rates, but so was the increased ability for railroads to exit and abandon low-value service and track.

The Staggers Act's most significant reform elements relieved railroads from the burdens that had weakened their ability to compete with other transport modes for over 40 years. Rigid rate regulation had greatly distorted railroad operations, leading to anemic productivity growth and a generally moribund industry climate.[79]

Shippers protested at the time, but they benefited along with railroads.[80] Two years following the enactment of the Staggers Act, real freight rates had declined by 4 percent.[81] Five years after Staggers, the real price decline was 20 percent.[82] By 1990, real freight rates had fallen by 44 percent.[83] The improved economics of railroads encouraged two railroads, CSX and Norfolk Southern, to split the network of a by-then-privatized Conrail in the following decade, and then merge it into their two respective networks.[84]

Price freedom was an important factor in producing these lower rates, but so was the increased ability for railroads to exit and abandon low-value service and track.[85] This led to a wave of consolidation, such that by

1999, much of the industry had merged into four large railroads.[86] This rationalization of capacity spurred a more than 400-percent increase in railroad employee productivity and a 79-percent decline in train accident rates since the Staggers Act.[87]

Deregulation under the Staggers Act continued until most ICC functions had been eliminated. In 1995, Congress abolished the ICC and replaced it with a more limited regulator, the Surface Transportation Board.[88] Today's modernized railroad industry is healthy, earning a 9.2 percent return on investment from 2000 to 2013.[89] These financial improvements encouraged railroads to invest more than half a trillion dollars into their network upgrades since 1980.[90] Moreover, the railroads achieved these gains largely with their own internal funds. A 2011 study by the Government Accountability Office found that freight railroads were the least subsidized when compared to truck, air, and waterway freight transportation.[91]

Critics of deregulation, including some industrial shippers and their political allies, continue to seek a reversal of these reforms. If successful, this would threaten the gains of the partial deregulation of the railroad industry and would result in a decline in the quality and cost-effectiveness of rail services. And the residual regulatory power of the Surface Transportation Board provides re-regulation proponents a possible ally within government. Concerns regarding the continuation of this residual regulation led economists Curtis Grimm and Clifford Winston to argue for completely abolishing the STB in a 2000 Brookings Institution study.[92]

LESSONS FOR BROADER LIBERALIZATION

The history of the regulation and subsequent liberalization of America's railroads shows that meaningful policy change takes time and sustained effort. State efforts to regulate intrastate rail lines provided a template for later federal regulation. Liberalization was delayed by the fact that discontent early over the results of federal rail regulation led to more restrictive regulation, rather than to rethinking the wisdom of such regulation.

While unfortunate, this should not be surprising. Time was needed for the failures of political regulation to become obvious. The railroads themselves only slowly realized the burdens of such regulation, while shippers initially saw regulation as beneficial. However, when those policies led to low-quality transportation services, shippers joined the call for liberalization.

In addition, the intellectual and political environment during much of this period was dominated by pro-regulatory forces. Only as new voices emerged did liberalization become a viable policy option. Given the benefits of rail liberalization, rail management might have sought out intellectual and economic allies to help promulgate the intellectual and moral case for liberalization much earlier. They eventually did so, but only after a great cost had been borne by their sector and the U.S. economy at large.

Factors outside the rail industry also drove this process. The economic problems facing the rail provided a sense of urgency, as neither Congress nor the White House wanted to assume management responsibility for a bankrupt rail network.

A growing economy led to greater and higher quality transportation needs and increased competitive pressures from barge lines, mine mouth electricity generation, and trucking. Regulations meant that rail lacked the flexibility needed to win back lost business via innovation or incentive contracts. As shippers realized this problem, more came to favor liberalization.

Other liberalization moves were underway that helped ease the path of deregulation. Airlines were also subject to regulation of their fares and routes by another regulatory agency, the Civil Aeronautics Board. All interstate and international flights fell under this supervision, but *intrastate* flights were exempt from federal rules. Thus, when Sen. Edward Kennedy (D-Mass.) held hearings on airline competition in January 1976, he pointed out that fares for intrastate instate flights in California and Texas were significantly lower than for flights of comparable length that crossed state lines. The fare from San Francisco to Los Angeles, for example, was roughly half that from Boston to Washington.[93] This disparity, for which there was no other reasonable economic explanation, allowed everyone to understand how transportation regulations might be actually harming consumers, and helped change the politics of liberalization.

And, of course, people matter too. Presidents Ford and Carter appointed reformers to key regulatory and advisory positions—including the staff of the President's Council on Economic Advisors and the ICC—who championed liberalization.

Views on deregulation were changing within academia as well. Chicago school economists, then ascendant, helped popularize their skepticism of the long-held view that "market failures" were ubiquitous and made government regulation necessary. They reviewed many of disparaged rail practices that had prompted regulation and found many actually enhanced efficiency. They further undercut the case for regulation by refuting the notion that railroads faced no private competitive regulatory pressures.

Public choice theorists found that regulations often had been used to distribute favors to some politically privileged group. Nobel laureate economist George Stigler developed the theory of regulatory capture, which holds that those in the regulated industry would come to unduly influence the policies of that regulatory agency.[94] As noted, that phenomenon was present in the early days of railroad regulation, when regulators were forced to call upon the industry for advice. Later, however, the agency was often "captured" by shipper interests. One possible reason for that may be that shippers were located in every political jurisdiction, and thus had greater political clout than the less numerous and more geographically concentrated railroad firms. Public choice analysis highlighted these problems and led to decreased support for economic regulations.

Moreover, many free market economists, such as University of Chicago economics professor Sam Peltzman, proved able proselytizers, eager to see their "dry" academic findings become part of the public policy debate.[95]

Liberalization is rarely total.

Beginning in the 1970s and continuing through today, these arguments began to reach the public via the work of free market public policy organizations, including the American Enterprise Institute, Cato Institute, Council for a Competitive Economy, Heritage Foundation, and others.

Note that liberalization is rarely total. Railroads were significantly deregulated, but are still subject to the decisions of the Surface Transportation Board. And during the long era of political control, whatever monopoly power the sector obtained flowed to the most politically influential elements of the rail sector. A major winner in that process was organized labor. Featherbedding (retention of obsolete positions) continued after the Staggers Act.[96] Firemen, who tend the fires in steam engines, actually lingered into the early 1990s on diesel-powered locomotives, a generation after steam locomotives had been almost completely phased out in the U.S.[97]

The path to liberalization was incremental. Many attempts were made to tinker with top-down political management of the industry, and all ended in failure. Hopefully this experience will at least shorten the time required to push back against future government intervention into other areas of the economy.

CONCLUSION

The decades-long saga of the rail industry's regulation and liberalization teaches us several important lessons.

- Premature surrender is not wise. Businesspeople must move away from the fatalistic view that regulations are akin to forces of nature that cannot be fought or influenced.
- Victory in the political arena requires building alliances that influence both the economic and the intellectual and moral forces in a particular issue area.
- Reformers need to understand and address the arguments that have been used to make the case for government regulation—including "market failure" arguments, narratives about the "unsafe" working conditions, the "exploitation" of workers or suppliers, and others.
- Businesses need to leverage their key cooperative partnerships—customers, employees, suppliers, and investors—to build support in the political as well as in the economic sphere.
- To gain legitimacy, business leaders—at both the firm and trade association level—should craft a sector narrative to provide a positive story of the firm, the technology, and the sector to the citizenry.
- A significant investment in liberalization can be legitimate and even profitable. Such an effort would involve developing effective educational campaigns, seeking out allies in both

the economic and policy worlds, and mobilizing an informed cadre of economic partners.

- Wealth creators have allies in the intellectual community who favor economic liberty. There is now an array of think tanks, advocacy organizations, university research centers, and business school projects providing intellectual ammunition and encouragement for those interested in telling the story of how their business works and why its success is good for investors, employees, and society at large. Find those allies and help them gain the knowledge to better make their general case relevant to your specific situation.
- Capitalists can join the liberty struggle as activists as well as businesspeople. Many CEOs and entrepreneurs face difficult time constraints in fitting yet another series of tasks into their busy schedules, but being an advocate of free markets does not require taking on a second job. Every interview, trade association presentation, annual report letter, or public appearance is an opportunity to put forth a pro-free market message that legitimizes enterprise and the role of business as beneficial to everyone in society.

If the share of the U.S. economy controlled by government is ever going to diminish, it will require an alliance of businesspeople and their intellectual allies—both Doers and Thinkers—to make it happen. Capitalism cannot be defended without capitalists, entrepreneurs, managers, and investors joining the fight.

Dynamic businesses always create economic disruption. The perceived chaos of a rapidly evolving marketplace will prompt opportunistic politicians and ideological activists to call for just a few more rules to smooth out the market's rough edges. Smart managers need to be ready with a response before that happens. Confusion about business practices and pricing strategies can create an opening for activists and regulators to try to "fix" nonexistent problems. Companies—and entire industries—need to be proactive in explaining how their business works, starting with its extended shareholder parties but also reaching out to the wider public beyond their customers.

In the case of the railroads, it took the partial collapse of the industry to convince both politicians and industry leaders that liberalization was a better course than continued government regulation. More than three decades later, the railroad industry is still in the process of rationalizing after half a century of neglect. Business leaders would be wise to learn from these mistakes.

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