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Introduction

Claudia Goldin and Gary D. Libecap

Government intervention is perhaps the most universal institutional change in the development of modern economies. Yet there is considerable debate on the relationship between economic development and the expansion of government. The relationship has been viewed as causal, but both directions have been emphasized. To many, government fosters economic growth. To others, economic growth, because of increased capturable rents, provides incentives for government to expand, and more government, it is asserted, stifles growth. This volume explores how interest groups affected the development of government policies, how particular ex ante institutional arrangements altered the form of government regulation, and how the necessity for coalition formation often transformed the structure of regulation and legislation. The eight papers in this volume were presented at a preconference (in Tucson, AZ, on 30–31 October 1992) and a conference (in Cambridge, MA, on 20–21 May 1993) on historical political economy.

Our goal is to examine the ways constituent groups emerged and demanded government action to solve perceived economic problems such as exorbitant railroad and utility rates, bank failure, the financing of government, falling agricultural prices, the immigration of low-skilled workers, and workplace injury. The papers are case studies of the origins of government intervention in the economy, which we have termed "the regulated economy." As such they provide a means of observing the process by which governmental economic policies are formed. Because these policies remain with us today, the case studies allow for a comparison of the historical issues that gave rise to the policies

Claudia Goldin is professor of economics at Harvard University, director of the Development of the American Economy Program of the National Bureau of Economic Research, and a research associate of the National Bureau of Economic Research. Gary D. Libecap is professor of economics at the University of Arizona and a research associate of the National Bureau of Economic Research.

with those that have kept them in place. One can also inquire whether the institutions devised in the past are still appropriate.

To get a sense of just how pervasive government is in the economy, consider the following. Total government expenditures as a fraction of GNP rose from about 7 percent in 1900 to about 40 percent in 1990. Government purchases as a fraction of GNP rose as well, although at a lower rate, from about 5 percent in 1900 to just under 20 percent in 1990. Prior to 1900 government, as a proportion of GNP, grew in the United States mainly because of its expansion at the state and local levels. In 1900 localities accounted for about 55 percent of total expenditures, the federal government 35 percent, and the states a mere 10 percent. By 1940, on the eve of World War II and after the inception of the New Deal, the federal government was about 45 percent of total expenditures, the states were about 25 percent, and the localities 30 percent. Today the federal government is about 60 percent of total expenditures, with the states and localities at about 20 percent each.

Thus the pattern for government intervention in the economy in the United States involved an initial expansion of local and state government, with a large increase in the spending of localities toward the end of the nineteenth century. Government then proceeded to grow steadily as a fraction of GNP, and with that growth came the centralization of both spending and revenue raising. Given the history of the structure of government, it should not be surprising that interest-group demands for economic regulation often began locally, then moved to the state level, ultimately focusing at the top, the most centralized, tier.

But data on the expenditure and revenue surely understate the influence of government on the economy. Regulatory policies, transfer programs, various types of legislation, and judicial interpretation affect economic behavior far beyond what budgets and staffing levels alone would indicate. Well-defined property rights, for example, can do more to foster economic efficiency than elaborate policies can.

These papers are an effort to better understand the historical development of government intervention. The expansion of government is viewed in terms of the usual measures of government size as well as the influence government has had on the economy. The political process, constituent groups, their representatives, and prior institutions play central roles in each of the analyses. Government policies are interpreted in these case studies as responses to the demands of constituent groups that seek the coercive power of government for economic gain or other goals. The political strength of the groups depends on their cohesiveness, wealth, and size. The meshing of disparate interests by political parties and politicians determines the timing, content, and economic impact of regulation. The papers are sensitive to the complex routes by which government policies ultimately have emerged. Besides examining the various factions involved in the origins of regulatory policies, the authors explore the

linkages to other government policies and to precedents established at other levels of government.

The contributions can be grouped under several headings, although there is considerable overlap. How well constituency interests are reflected in legislation and how consensus building affects the timing and content of legislation are directly addressed in most of the papers. Mark Kanazawa and Roger Noll look at railroad regulation; Werner Troesken explores gas utility regulation; Claudia Goldin examines the forces behind immigration restriction; and Price Fishback and Shawn Kantor examine workers' compensation. But Keith Poole and Howard Rosenthal caution us that no piece of legislation can be viewed in isolation. Coasian (or other) trades within the legislature are the means of consensus building, and thus constituent interests ought not be viewed in a narrow context.

Other papers reveal how preexisting policies, institutions, and economic market structures shape legislation and regulatory activity. John Wallis, Richard Sylla, and John Legler demonstrate how the initial structure of banking determined how the states would later raise revenue through bank regulation. Charles Calomiris and Eugene White detail how preexisting state banking regulations shaped the passage of federal legislation in the 1930s. Elizabeth Hoffman and Gary Libecap show why regulation for monopoly might fail in one setting while succeeding in another.

The origins of regulation that began at the state and local levels are explored in several of the papers. Regulation often filtered upwards from local agencies to the state and ultimately to the federal level (as in railroads and public utilities). In other cases (for example, workers' compensation) regulation remained at the state level, but was ultimately embraced by all states. Troesken's contribution directly confronts the issue by looking at the movement of coal-gas regulation from the local to the state level. Kanazawa and Noll explore why states regulated railroads, whereas Poole and Rosenthal analyze similar legislation at the federal level.

Kanazawa and Noll remind us that, although federal railroad regulation and the enactment of the Interstate Commerce Act in 1887 have received considerable attention (see, for example, Poole and Rosenthal, chap. 3), government regulation of railroads began two decades earlier at the state level. They examine the political economy of railroad regulation in a key Granger state to test versions of the economic theory of regulation. The Illinois Constitution, revised in 1869/70, contained explicit provisions for railroad regulation that were voted on both in public referenda and by delegates to the constitutional convention. By analyzing the votes, Kanazawa and Noll can identify which economic interests supported or opposed the establishment of regulation in Illinois.

Illinois was the first state to establish a permanent economic regulatory agency (later involved in *Munn v. Illinois*), and because it was in an intermediate stage of railroad development by 1870, Kanazawa and Noll can explore the

perceived effects of regulation on further railroad investment. The authors find, using the referendum votes, that regardless of the structure of the local railroad market (undeveloped, competitive, monopoly) rural communities overwhelmingly supported regulation, suggesting that voters believed rate regulation would redistribute income from railroads to shippers. Yet support for regulation was far weaker in counties having no railroad service, suggesting that those constituencies feared regulation would retard the extension of rail lines. The votes at the constitutional convention, however, reveal that local interest groups had less influence there. Not unexpectedly, the better-organized and well-financed railroads were more influential in the convention voting than in the referendum.

Troesken traces the evolution of coal-gas regulation in Chicago, following the movement of the industry from unregulated and competitive conditions, to municipal regulation, and finally to state regulation, all from 1878 to 1913. The adoption of state regulation and the creation of a state regulatory agency in Chicago mirrored a broader pattern across the states. Between 1907 and 1922 thirty states created public utility commissions. By examining an early utility that moved from unfettered competition to municipal regulation, and ultimately to state regulatory control, Troesken reveals the underlying determinants of a process that may have determined the transition in other states.

During the competitive period in the nineteenth century, entry was promoted by the introduction of technology that lowered minimum-efficient firm size. Incumbent firms, according to Troesken, organized to restrict entry through the Gas Acts, as they were called. These laws effectively blocked new entry by requiring unanimous approval of all property owners before additional gas lines could be installed. Existing firms could easily bribe just one property owner to oppose a potential entrant. Not surprisingly, under the Gas Acts no new firms entered the Chicago market. The laws also removed the common law obstacles to merger and consolidation. As consolidation proceeded, the city council was pressured by consumer groups to regulate rates and eventually ordered a 25 percent rate cut. Although the mandated rates were reversed by the courts, they gave the industry an incentive to find a less onerous regulatory body. Local interests were likely to be less well represented at the state level, where the well-organized and better-financed gas utility industry could expect to do better. Hence, the industry lobbied for state regulation. State regulation was initiated in 1913, and under its jurisdiction prices increased.

The most studied piece of American regulatory history is the establishment of the first regulatory agency, the Interstate Commerce Commission. Poole and Rosenthal revisit the politics that brought about that agency, but their main objective is to reveal the dynamics of interest-group politics. Although all papers in the volume examine constituent interests in some manner, Poole and Rosenthal take a rather different approach. They argue that the political coalitions doing battle over government regulation are based on long-term, broadly

based preferences regarding the economic structure of the United States, what one might term "ideological" preferences.

These coalitions go beyond narrowly defined special economic interests and are rooted in the major political parties of their era. Indeed, a critical role of the political party is to group legislators with similar ideologies and to facilitate trades among them. Individual politicians must be responsive to immediate constituent interests, and Poole and Rosenthal do not argue that these demands are unimportant. Rather, they assert that by the time a roll call vote is taken, many of the trades that respond to constituent interests and maintain a party's coalition have already been made. Hence, the vote will follow party lines, and it may be difficult to discern a simple relationship between economic interests and voting behavior.

Poole and Rosenthal use a spatial model of congressional voting in which each legislator is represented by an ideal point, determined by that legislator's votes on all previous and subsequent legislation. The positions of all ideal points maximize the likelihood of predicting legislators' votes. The voting space is divided by a cutting line, and ideal points that cluster to one side of it are predicted to vote yea, whereas those on the other side are predicted to vote nay. The dimensions are abstract in theory, but in practice one can infer their meaning. The first dimension is clearly political party, and the second dimension is often urban-rural. (Two dimensions are sufficient.) Poole and Rosenthal find long-run, consistent patterns of political behavior among legislators.

The authors use this spatial framework to examine Senate and House voting on railroad regulation in the nineteenth century that culminated in the passage of the Interstate Commerce Act of 1887. For railroad regulation the subject was complex, and by the time the issue reached Congress, the question was the degree of regulation, not whether there should be regulation. According to Poole and Rosenthal, the battles were over shades of regulation, and the positions of individual legislators were mapped broadly into the existing party structure rather than into more narrow economic interests.

Wallis, Sylla, and Legler return the discussion to regulation at the state level. But rather than focusing on private constituent interests, they look at those of the state government itself. They argue that taxes and revenue-enhancing regulations could have been set to maximize the revenue the state received from the industry. In the nineteenth century, states derived close to half their revenue from bank sources. States chartered banks, taxed bank capital, and regulated the industry in myriad ways. The type of initial tax or license influenced regulations adopted subsequently. When the state restricted bank charters, for example, it could tax away the monopoly rents it created. If, instead, a state government imposed per unit taxes or ad valorem taxes on the banking industry, Wallis, Sylla, and Legler argue, it would acquire a fiscal interest in promoting the industry's output, sales, or both. But when the state taxed bank capital or owned stock in banks, it had an incentive to encourage bank profits.

Each of the means of raising revenue gave the state a different interest in banks and in bank capital.

The fiscal interest, therefore, in theory determined the type of regulation. In practice the authors find, using their recently compiled data set on state finances, the interests of state governments were one of several important determinants of banking regulation. Regulations varied across regions and within regions over time with changes in fiscal interests and as banking regulation negatively impacted the state's economy.

Much current federal government regulation derives from the New Deal period. Voters clamored to the government for relief during the Great Depression. New opportunities emerged for interest groups to organize more effectively and for political entrepreneurs to advance their agendas. Legislation was enacted and administrative agencies were formed to design the details of regulation, often with the close cooperation of the industry to be regulated. These institutions remain today, a legacy of the New Deal, with powerful interest-group support and entrenched bureaucracies, even though most of the initiating conditions have long since passed.

Federal deposit insurance became law in 1933, and Calomiris and White explore this enduring legacy of New Deal banking legislation. Federal deposit insurance originated at the state level, but the state experiences were apparently disasters. In the years prior to its national passage, deposit insurance had little broad voter appeal and only lukewarm support from small, rural, unit banks. It was vehemently opposed by large, branch banks and within the Roosevelt administration. Federal deposit insurance had long been viewed as special interest legislation and was repeatedly rejected by Congress over a period of fifty years.

State deposit insurance, note the authors, was enacted in states with unit bank laws, small banks, and high bank-failure rates. All state deposit insurance schemes went bankrupt in the 1920s. Between 1886 and 1933, 150 bills were introduced in Congress to establish federal deposit insurance, but only one, that in 1913, had a roll call vote. Thus Calomiris and White examine the source of support for the legislation by analyzing the states of the bills' authors. The bills were championed by representatives from states with disproportionate numbers of rural unit banks that were vulnerable to failure. They were precisely the states that had enacted their own insurance schemes, all of which became deeply troubled. The authors also examine the 1913 roll call vote in the House of Representatives and find that unit banking, small average bank size, and high rates of bank failure were all associated with support for legislation. States that expected to benefit from cross-subsidization of risk in national deposit insurance supported the legislation, whereas those having stable banking systems opposed it. In 1933 federal deposit insurance was adopted with near unanimity, and its alternative for stabilizing the banking sector—nationwide branch banking—was rejected.

Calomiris and White argue that the passage of federal deposit insurance cannot be explained as an emergency measure conceived in haste to resolve an ongoing crisis. Rather, the policy was engineered by a political entrepreneur, Representative Steagall (of the Glass-Steagall Act that inaugurated deposit insurance), who took advantage of changing circumstances in the 1930s to promote deposit insurance. Unit banks, which had pushed for deposit insurance, were weakened economically and politically by the Depression. But influential urban states came to favor deposit insurance in response to bank failures. Thus deposit insurance was passed and has remained with us since, although just prior to passage it had little widespread appeal.

Another area of lingering federal New Deal regulation is in agriculture. Hoffman and Libecap examine the marketing agreement provisions of the Agricultural Adjustment Act of 1933 (AAA). Faced with rapidly falling relative agricultural prices and farm income, the AAA was passed to cartelize the industry. Until the 1930s there was no consensus that the federal government should intervene in agricultural markets to raise prices. But with the Depression and a rural-dominated Senate, the view was promoted that a prosperous farm sector was a linchpin to rapid recovery in general.

In basic crops, such as wheat, corn, and cotton, acreage reductions were implemented to reduce supplies, whereas for specialty crops, such as oranges, interstate shipment restrictions were adopted under marketing agreements. Marketing agreements generally called for statewide shipping quotas, commensurate with estimated demand at a target price. In 1933 there was optimism that such tools could quickly solve the farm problem. But cartelization efforts failed to achieve parity price levels. Instead the government was forced by the end of the 1930s to devise alternative policies to enhance demand through price supports and the direct purchase of agricultural surpluses to raise prices to parity levels. These are the policies, rather than those outlined by the AAA in 1933, that remain today.

Hoffman and Libecap examine why cartelization failed in a "best case" example. With relatively few orange producers and shippers (compared with grains, for example) in just a few regions of the country, cartelization as outlined by the orange marketing agreements seemed assured in 1933. Yet heterogeneous interests in Florida and California and the distributional consequences of the quotas blocked acceptance of the agreement in Florida. Six years of negotiations between the Agricultural Adjustment Administration and the Florida industry failed to devise quotas to compensate those who expected to be harmed and to be consistent with the cartel's goals. Evasion and new entry were rampant. Similar problems were encountered in other crops, and cartelization was gradually replaced as the principal instrument of agricultural regulation.

Two of the papers address a fundamental shift in regime. One explores the movement in the United States from open immigration to its regulation and

restriction around World War I. The other explores the reasons behind workers' compensation laws. Both demonstratc the influence of interest-group pressures in shaping the content and timing of policies.

Immigration from Europe to the United States was virtually unrestricted until the passage of the literacy test in 1917. With that law and the quotas that were to follow beginning in 1921, immigration into the United States became considerably more restricted. As Goldin shows, the forces leading to the quotas took shape by the 1890s, when the first literacy test amendment to an immigration act was voted on. A variety of interest groups shaped immigration policy, including organized labor (through the American Federation of Labor and the Knights of Labor), business groups (such as the National Association of Manufacturers), both old and new immigrants particularly in American cities, and rural America, which had long before, in the 1850s, turned vehemently nativist.

According to Goldin, a coalition that opposed unrestricted immigration nearly triumphed in the 1890s. Because it was largely a reaction to the depression of the 1890s, it was unstable. The coalition, in somewhat altered form, resurfaced in the early 1900s when the combined effects of the declining political power of immigrant groups and falling real wages for lower-skilled workers after 1910 led to renewed pressure for restriction. The South turned anti-immigrant, after opposing restriction, and much of rural America remained nativist. The final battleground for restriction was in the nation's cities.

To analyze the economic and political factors behind the votes on the literacy test, Goldin provides an in-depth analysis of city-level wage data by occupation and industry from 1890 to 1923 to determine the possible economic bases of support for restriction in American cities. The wage data reveal substantial and rising negative effects of immigration on both laborer and artisan wages from the late 1890s to the early 1920s. The timing of the wage effects corresponds to the rise in negative sentiment toward open immigration just prior to World War I. Goldin finds that congressional voting on immigration restriction in 1915 was linked to the strength of the negative wage effect and to the proportion of the population that was foreign born in a House member's district. These factors pulled in two opposing directions—an increase in the foreign born heightened sentiment to keep the door open, yet a rise in their numbers led many workers to oppose immigration because of wage and employment effects. In the end the anti-immigrant forces won, in part because of the diluted political strength of the foreign born, the mounting economic pressure for controls, and the increase in nativist sentient with World War I.

Kantor and Fishback provide another example of state regulation and major regime shift in their analysis of Missouri workers' compensation between 1911 and 1926. Workers' compensation was one of the leading Progressive Era reforms and marks the beginning of social insurance in America. It changed the legal system governing accident compensation to one of shared strict liability. The laws, which still remain at the state level, were adopted rapidly across the

United States in the early part of the century, although they varied, and continue to vary, in coverage and benefits. For example, some states initiated state insurance arrangements for workers' compensation, while others relied on private insurance companies. Further, the state programs differed as to whether they were voluntary or compulsory and administered by appointed commissions or the courts. Kantor and Fishback argue that these varying attributes were determined by the relative strength of interest groups having a stake in the legislation—insurance companies, state officials, organized labor, employer groups, and lawyers. Hence, in their analysis, the authors examine how interest-group pressures in Missouri affected both the timing and content of the workers' compensation law.

Missouri provides an interesting case study, in part because the state has an anomalous history regarding workers' compensation. Legislative voting and public referenda on the issue were drawn out over sixteen years in Missouri, considerably longer than in other states. But this rather curious history allows the historian to investigate how competing interest groups shaped the proposed legislation. The analysis suggests that interest groups were better able to guide legislation than they were to influence referenda outcomes. Organized labor, for example, advocated a state insurance fund and high benefit levels, but these attributes were repeatedly rejected by voters. As long as workers' compensation legislation was referred to voters, no state insurance scheme with high benefits could be adopted. Indeed, to obtain final enactment, the state insurance provision was jettisoned, and benefit levels were lowered. Comparing legislative votes with referenda results also allows Kantor and Fishback to see whether elected representatives followed their constituents' wishes and how voting behavior changed as provisions were modified during the 1920s.

The papers in this volume have, to various degrees, examined aspects of governmental (local, state, and federal) intervention and the determinants of the timing, content, and administration of regulatory policies. The emphasis has been on the emergence of interest-group demands and the response of politicians to them. Constituent groups pressured government for particular economic policies—immigration restriction, regulation of railroad and municipal utility rates, workers' compensation, bank taxation and regulatory policies, deposit insurance, and the fixing of agricultural prices. With many different interest groups and demands on politicians, the enactment of any piece of legislation required trades to achieve a majority consensus. As Poole and Rosenthal point out, these exchanges took place within long-standing political coalitions. If interest groups were unstable or if conditions were not ripe for generating cohesive stands, then legislation would be delayed, its content would be modified, or it would not be administered as initially planned. Several of the papers demonstrate these points in terms of immigration restriction, the passage of workers' compensation, and agricultural regulation. Further, responding to constituent demands in some cases required shifting regulation across government jurisdictions, as in the move from municipal to state utility regulation

described by Troesken and in the development of railroad regulation, moving from the state to the federal level, as in the papers by Kanazawa and Noll, and Poole and Rosenthal.

By emphasizing the endogeneity of interest-group demands and accompanying political bargaining, the volume's case studies reveal much about the relationship between politics and governmental economic policy. The case studies show that all aspects of government intervention are influenced substantially by interest-group politics. By their very nature, however, the case studies are less able to address whether governmental actions promoted or hindered economic development. It seems clear that governments have not been immune to the economic effects of their policies. Wallis, Sylla, and Legler's study of state banking regulation reveals that, when regulations significantly retarded economic growth, state governments changed their methods of raising revenue. Yet government policy can be a durable legacy that affects economic behavior and performance long after the initiating conditions have disappeared. Regulatory institutions, once in place, establish and direct rents to particular groups, create vested interests with a stake in regulation, and make policies difficult to adjust or abolish. For instance, once U.S. immigration quotas were enacted in 1921 (and refined to 1929), the law was virtually unchanged until a major turnaround in policy in 1965. Similarly, federal deposit insurance, which Calomiris and White argue was not as effective as nationwide branch banking would have been in the early 1930s, has remained an enduring characteristic of U.S. federal bank policy.

Whether or not government intervention enhances aggregate economic welfare depends in large measure on whether interest groups will mobilize to promote Pareto improvements. Where the net average benefits of interest-group organization and lobbying for such changes are substantial, political pressure for more optimal policies seems likely. This would be the case, for example, if the socially costly aspects of regulation impacted a small, well-defined group, which would then have an incentive to organize to change the law. But where the social costs are broadly spread and the private benefits narrowly directed, no constituent group may be able to organize effectively to counter narrow interests. This condition seems to explain the durability of many financial and agricultural regulations despite evidence that they inflict serious costs on most in the economy. The size and incidence of the net benefits or costs of regulation, of course, vary widely. Accordingly, an assessment of the overall impact of government on economic performance will require many case studies of the kinds offered here to determine whether, on net, government intervention promoted or retarded economic growth.

Another question for subsequent research is whether the underlying politics of regulatory policy have changed over the past hundred years. Significant government intervention, especially at the federal level, took place only after 1880, and much of the expansion of government has been a twentieth-century phenomenon. But why did it take so long for government to become a significant

part of and actor in the economy? Do interest groups ask more of government now than before, and if so, why? Or are we observing the cumulative effects of long-term interest-group demands? These and other questions about the government and the economy await further research efforts along the lines provided here.

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