THE SPECULATION ECONOMY

How Finance Triumphed Over Industry

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An Excerpt From

The Speculation Economy: How Finance Triumphed Over Industry

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Published by Berrett-Koehler Publishers

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PROLOGUE

A recent survey of more than four hundred chief financial officers of major American corporations revealed that almost 80 percent of them would have at least moderately mutilated their businesses in order to meet analysts' quarterly profit estimates. Cutting the budgets for research and development, advertising and maintenance and delaying hiring and new projects are some of the long-term harms they would readily inflict on their corporations. Why? Because in modern American corporate capitalism the failure to meet quarterly numbers almost always guarantees a punishing hit to the corporation's stock price. The stock price drop might cut executive compensation based on stock options, attract lawsuits, bring out angry institutional investors waving antimanagement shareholder proposals and threaten executive job security if it happened often enough. Indeed, the 2006 turnover rate of 118 percent on the New York Stock Exchange alone justifies their fears.[1]

The problem has been noticed. In 2006 two of the nation's most prominent business organizations, The Conference Board and the Business Roundtable, published reports decrying the short-term focus of the stock market and its dominance over American business behavior. They each suggested a variety of solutions to allow executives to manage their businesses for the long term in a manner they saw fit without constantly having to answer to the market's insistent demands for continuous price appreciation. The problem of business short-termism caused by the link between executive incentives and the stock market has become a popular subject of discussion in business, academic and policy circles. It was the central problem that I addressed in a book of my own in 2001.[2]

There is little question that short-term market behavior has created an increasingly troublesome business problem over the last twenty-five years.

But the stock market's pressure on business and business's response is nothing new. The short-termism of the late 1990s and early twenty-first century simply is an exaggeration of a quality that was embedded in the American economy a hundred years ago. The typical public corporation we know today, what I will call the giant modern corporation, was created during the merger wave of 1897 to 1903. It gave birth to the modern stock market. As it did, it transformed speculation from a disruptive game, played by a few professionals and thrill-seeking amateurs that from time to time erupted into a major frenzy, into the very genetic material of the American stock market, American business and American capitalism.

The roots of the modern American stock market lie in the creation of the giant modern corporation. Born of the seeds of destructive competition that seemed to threaten the future of industrialization in late-nineteenth-century America, the giant modern corporation provided a solution that at first promised to stabilize new businesses and maintain the upward trajectory of industrial growth. But the stock market that it brought into being quickly came to be the main thrust behind business, the power behind the boardroom. The stock market started as a tool that helped to create new businesses. It ended by subjugating business to its power.

The modern stock market became an exacting taskmaster for American managers. It came to drive their investment, operating and planning decisions, and the path of American economic development itself. The market transformed from an institution that served businessmen by providing the means of making things and selling things. It became instead a thing apart, an institution without face or form whose insatiable desire for profit demanded satisfaction from even the most powerful corporations it created. In the end, the modern stock market left behind its business origins and became the very reason for the creation of business itself.

The significance of the market's development was not fully appreciated by regulators of the time. Controlling the perceived monopoly power of giant trusts was the issue of the day. Thus it was through the lens of monopoly that most contemporary observers and almost all lawmakers understood every aspect of the merger wave that created the giant modern corporation, including its causes, the legal forms it assumed, questions of operating efficiency and management and, perhaps most important of all, how the new corporate combinations were financed. While commentators were close to unanimous in locating the underlying cause of the merger wave in businessmen's at-

tempts to control the often destructive competition that came to plague many of the new industries of the industrial century, they were equally unanimous in their agreement on its immediate and proximate cause—the opportunities it created for financiers to create wealth for themselves.

Destructive competition had been a problem for years. But it was only during the last few years of the nineteenth century that business distress combined with surplus capital searching for investment opportunities, changes in state corporation laws, and the creative greed of private bankers, trust promoters and the newly evolving investment banks created the perfect storm that shifted the production goals of American industry from goods and services to manufacturing and selling stock. Within twenty years the strong ripples of the merger wave had transformed the nineteenth-century industrial corporation into the giant modern corporation, and the stock market into the focus of American business life. While regulators were embroiled in questions of monopoly, the speculation economy subtly took form.

The history of the creation of the giant modern corporation and the modern stock market is complex. It is a story of industrial development, intellectual transformations, innovations in law and finance, rapidly changing social trends and the federal government's attempts at regulation. By the end of the period all of the ingredients for the modern stock market were in place and the major regulatory outlines of the securities laws that would be passed a decade hence had been laid out in Congress. Those laws took the speculation economy as a given.

The legal and regulatory changes of this period were driven by transformations in finance and the stock market. Waves of watered stock created by the giant modern corporation brought average Americans into the market for the first time. The instability of these new securities and the corporations that issued them provided enormous opportunity, both intended and not, for ordinary people and professionals alike to speculate, leading sometimes to mere bull runs and sometimes to widespread panic. This type of speculation had long existed in American markets. Whether or not the merger wave had taken place, whether or not the financial and business transformations had occurred, this type of speculation would almost certainly have continued.

New conditions brought with them a new kind of speculation. Modern historians understand speculation in terms of the type I have just described, the type of speculation that characterized market bubbles in 1899 and 1901, 1928 and 1929, the mid-1960s, and 1998 through 2000, among others. But the lasting kind of speculation as it was understood by some perceptive observers at the beginning of the last century was speculation intrinsic in the

capital structure of American corporations. This second type of speculation permanently changed American business and the way it was regulated. It created an economy inseparable from speculation. That economy was embedded in a market characterized by increasing numbers of small common stockholders.

The modern stock market developed in three distinct stages. The first was the direct product of the merger wave, which drew substantial numbers of middle-class investors into the market for the first time. Starting with railroad bonds, which were considered the only truly safe corporate investment, they began to buy the somewhat riskier preferred stock of the new industrials, and sometimes even the highly speculative common stock, as investment opportunities multiplied through the beginning of the twentieth century. They came and they stayed, some of them, through the Rich Man's Panic of 1903. They were joined by others, sobered by the financial carnage but faithful to the new finance. Together they built a bull market that lasted until early 1907.

Writers and thinkers from many walks of life began to come to terms with the changes the new economy had brought to America. This they did by reaching back to what they had known from an earlier time, by reinventing the stock market as a new form of property, a property that could fill the evaporating role of the land and small business in classical American life and thought. Leaders, progressive and conservative alike, joined to encourage their countrymen to own this new property, hoping to restore greater equality of wealth and build a strong defense against creeping socialism. I exaggerate only a little to say that this idea of corporate securities as the new family farm helped to legitimate the stock market as an American institution, even as the plutocracy continued to dominate it.

The modern market continued to develop in the wreckage of the Panic of 1907. Nineteen-eight marked a year of strong market recovery, although recovery masked the beginning of a broad economic depression. The market first rose and then dropped by a quarter in 1910 to a plateau where it held tenaciously until 1914. Like mammals in the age of disappearing dinosaurs, small investors increased their numbers, held their securities and began to pick among the bargains that were the leavings of the plutocrats. Common stock began to be considered safe for investment, and its higher promised returns made it an attractive alternative to preferred stock and a favorite with small investors.

The third and final stage of the modern market's development began

with the reopening of the New York Stock Exchange in December 1914 after months of darkness that fell as the guns of August roared. Not until April did the party really get going but, when it did, it erupted in a roaring bull market that continued straight up until the "return to normalcy" in 1920. It was sobered by only one bad year when the United States entered the war and had to figure out how to finance its own participation.

This was a different market than those that had come before. Brokers were honing their sales tactics and, by 1919, the securities arms of national banks, like "Sunshine Charley" Mitchell's National City Company, were driving the development of retail brokering into branch offices from Manhattan to Middletown. Individual investors found themselves more comfortable with common stocks as war prosperity brought high returns from companies churning out war materiel. And the Liberty Bond drives of 1917 and 1918 created 25 million new American investors. The brokerage industry watched, salivating, anticipating the day when the Iowa farmer no less than the New York lawyer realized he could do better than to take the bargain-basement interest on his Liberty Bonds and turned them in for a share of the new corporate boom economy. A long year of depression followed Harding's election and, in 1922, the great bull market of the 1920s began to take flight.

Like the modern stock market, securities regulation, as one of several federal responses to the dislocations caused by the merger wave, also grew in three steps. While each phase looked to disclosure as its central regulatory device, each had a distinctly different goal and used the tool of disclosure for a distinctly different purpose. Naturally there was overlap. But what we recognize as modern securities regulation, consumer-type investor protection, did not become its purpose until after the First World War.

The first phase of securities regulation grew out of federal attempts to regulate monopoly by controlling the watered stock created by the combinations of the merger wave. This was the antitrust phase of securities regulation and ran from the beginning of the century until 1914. Antitrust reform proposals and the related federal incorporation movement tried to compel corporate disclosure of financial information in order to reveal the true values of corporate capitalizations to help the federal government identify and prosecute monopolies under the Sherman Antitrust Act. The United States Bureau of Corporations, created as an investigatory body in 1903, embodied this antitrust policy. The securities market was of no particular concern in its own right.

The second step in the development of securities regulation, antispecu-

lation regulation, overlapped the antitrust phase. It began almost immediately following the Panic of 1907 and continued in full force until its failure in 1914. From that point on it reemerged in fits and starts until it reached fruition in the Securities Exchange Act of 1934. Like the antitrust phase, the antispeculation stage was driven by the effects of the watered securities that flooded the market following the merger wave. But this time the goal was not to regulate monopolies. Rather it was to protect American financial stability, and particularly the banking system, which was episodically threatened by financial institutions' taste for stock speculation of the traditional type, either directly or by making large and highly profitable margin loans to brokers and speculators. Disclosure again was emphasized, but again as a regulatory tool. The purpose of disclosure during this second stage was to enable regulators and banks to control overcapitalization in order to maintain the safety of bank portfolios, not so much for the security of any individual bank but for the safety of the system as a whole.

The final development of securities regulation aimed at consumer protection. It began with a model of Wilsonian progressive legislation, proposed after the war by the Capital Issues Committee in a form that would serve as the matrix for the Securities Act of 1933. This was the modern type of mandatory disclosure, grounded in a philosophy that providing information to individual investors would allow them to make self-reliant, informed investment decisions and keep the market efficient, safe and stable. While the first stages of securities regulation were grounded in the new collectivism of the early Progressive Era, this final phase philosophically was born of the unique combination of individualism within collectivism that characterized Wilson's brand of progressivism. It was also the stage of securities regulation that institutionalized and legitimated the speculation economy.

The story proceeds as follows: The first three chapters describe the creation of the giant modern corporation, the legal changes that made it possible and the financing techniques that created the modern stock market. Chapter Four examines the first stage of the development of the modern stock market, paying particular attention to the way that social and cultural changes helped to legitimate the stock market as part of American society. Chapters Five through Seven trace the federal government's attempts to make sense of the economic transformations created by the giant modern corporation, showing an evolution from antitrust to the beginnings of securities regulation, all thematically unified by the dominant focus on corporate securities at each stage. In Chapter Eight I show the shift in the quality of the market

during its second stage of development from the end of the first decade until the First World War as ordinary Americans turned from investing primarily in bonds and preferred stock to embracing speculative common stock as a favored investment vehicle. Chapter Nine examines the first failed attempt at federal securities regulation during the early Wilson administration and the way that it began to establish the conceptual bases and, in a crude way, the regulatory mechanisms for the successful regulation that would be passed by the New Deal Congress following the Great Crash of 1929. Chapter Ten concludes the history with a look at how the federal government's need for massive financing during the war and the Liberty Bond drives that satisfied it created new ways of marketing securities and a giant new class of investors and potential investors, even as federal moves toward securities regulation completed their conceptual development toward consumer protection. I conclude by reflecting briefly upon the development of this story over the succeeding eighty years and its consequences for the future of American business and the American economy.

ONE

THE PRINCIPLE OF COOPERATION

The creation of the giant modern American corporation was not a slowly evolving process. Individual proprietorships, partnerships and corporations gradually grew in size and number throughout the Industrial Revolution of the nineteenth century. But what we have come to know as the modern American corporation, the giant, publicly held corporation, appeared in a flash. America collectively turned around one day and was staring at the balance sheet of U.S. Steel.[1]

THE GIANT MODERN CORPORATION

The large corporation was already in late adolescence by the time of the great Chicago World's Columbian Exposition of 1893, that wonderfully quirky celebration of technological achievement and cultural progress that raised the curtain on a devastating four-year depression. The fruits of industrialization on display there had grown from saplings planted many decades before, produced by the large businesses dotting the landscape from Boston to Baltimore, from Pittsburgh to St. Louis and beyond. They had arrived by means of one of the greatest engines of the American economy, the railroads, whose tracks sprawled across the continent, north and south, east and west. The industrialization that had begun at the turn of the nineteenth century had been kicked into high gear by the insatiable material demands of the Civil War and gave birth to factories from which flowed steel, farm machinery, packaged meat, beer, wheat flour and sewing machines; mines that brought forth copper enough to wire the country for newly generated electricity; oil refineries that lighted homes from California to Europe; great dry goods empires and the Sears Roebuck catalogue. Left to themselves, these remarkable businesses might well have grown, financed with debt and their own retained earnings, created new products and services and supplied America's wants

and needs for evermore. But the large corporations of the nineteenth century were soon to become the raw materials of a new kind of business, a business created for finance rather than for production.[2]

The businesses of the industrializing nineteenth century were, more often than not, organized as partnerships or closely held corporations. The stock of these enterprises was owned by the founders and their families or a small group of friends and business associates. Standard Oil was owned by Rockefeller and the refiners and suppliers he bought out. Carnegie Steel was a series of partnerships. Only the railroads and a very small handful of industrials issued stock that traded on the markets in any volume. The machinery of finance was in its infancy. When industrial corporations needed money, they dipped into their earnings, went to the bank, or sold bonds.[3]

The giant modern corporation was a phenomenon distinct from the forms and processes of industrialization. Its reasons for being were different from those of the nineteenth-century corporation. Earlier enterprises in the age of industrialization were built to take advantage of improvements in shipping, or new production technologies, or new ways of marketing or packaging. The giant modern corporation was created for a new purpose, to sell stock, stock that would make its promoters and financiers rich.[4]

It took only seven years. In the space of that explosive period, from 1897 to 1903, the giant modern American corporation was created by the fusion of tens, and sometimes hundreds, of existing businesses. The new corporations that emerged from this merger wave transformed the very nature of American business.

The inspirations that first drove businessmen to abandon competition to combine the plants that became the great corporations were business problems. Destructive competition threatened the success, and often the existence, of some of the new industries. Efficiencies of size and efficiencies of management prompted the combination of others. Cooperation was the solution. The great nineteenth-century trusts were the result. Before very long, these business motivations were combined with a different goal. That goal was to manufacture stock.[5]

Corporations created for this purpose transformed the structure of American corporate capitalism. They dumped huge amounts of new stock on the market, dispersing ownership from small numbers of men who managed their businesses to hundreds, and then thousands, and then hundreds of thousands of men and women who invested their savings in small blocks of bonds and stock. Although it would take a while to realize their promise, they forever changed the nature of the American economy by distributing the ownership of corporate wealth across the growing middle class. They

also transformed American law and politics, leading the federal government to blossom from a small and undistinguished institution of limited domestic powers to a sovereign state that found, in the regulation of business, a central reason for being.[6]

The creation of the giant modern corporation gave birth to a new class in American society, the capitalists. There existed men who were called capitalists well before the 1890s, men who provided the funds to finance new enterprise. Their wealth came from the profits of land or from trade, and sometimes from the industrial plants they created. The businesses they financed were run, for the most part, by industrialists for industrialists. There were of course the rogue plungers and speculators in corporate stocks and bonds who found their wealth by gambling with the business lives of railroads. But men like these were a sideshow. The business of business was business.[7]

Matters had changed by 1903. Still there remained industrialists of the classic mold, but John D. Rockefeller was growing wealthier in retirement as an investor and Andrew Carnegie had sold his empire into the combination created by the very embodiment of the new breed, J. Pierpont Morgan. The nineteenth-century industrialist was *passé*. As Carnegie put it, "he and his partners knew little about the manufacture of stocks and bonds. They were only conversant with the manufacture of steel." J. P. Morgan and his men knew little about steel, but they were masters of the manufacture of stocks and bonds.[8]

The world of American business belonged to this new breed of capitalist. J. P. Morgan, John R. Dos Passos, the Moore brothers and Charles Flint became the symbols of modern American capitalism. These were the men who released billions in securities by rearranging the companies created by the captains of industry. When John "Bet a Million" Gates decided to create American Steel & Wire, he did not do it by building blast furnaces and rolling mills. He did it by buying almost thirty different plants, from Everett, Washington to Worcester, Massachusetts, using stock as his currency and taking stock as his profit. The giant modern corporation was created for the sake of finance.

The giant modern corporation did more than transform business into finance. It also displaced classical ideas about American individualism. Collective in its very nature, it complicated American social thought born in notions of fervent independence, of rugged individualism. It spread across the landscape cooperative enterprises that organized a new kind of social spirit even as it threatened to subjugate the individual. While it roiled the social order, it nevertheless seemed to pave a road back to older ways of thinking. In its creation of a new kind of property, corporate stock, it put forth

a substitute for the traditional ownership of land and small enterprise, the iconic yeoman farmer, the traditional opportunity of the frontier. The stock market was the new frontier and Americans were eager to explore it. The giant modern corporation made Wall Street our wilderness and corporate stock our grubstake.

THE RISE OF FINANCE

The Industrial Revolution was a different phenomenon from the consolidations that created the giant modern corporation. American industrialism started from a base of relatively small owner-operators before the Civil War. A few important American business corporations can be traced as far back as the beginning of the nineteenth century. These were mostly local companies, locally owned and locally managed, even if their raw materials came from the cotton plantations of Mississippi, even if their products were widely sold and even if their stock was sometimes traded on the Boston Stock Exchange. Business use of the corporate form really blossomed in the 1840s and 1850s with the expansion of railroads, with their special needs for large amounts of permanent capital and the protection of limited liability. The stock of many railroads traded on exchanges, but more often than not it was controlled by a small group of insiders. As the railroads grew, they came to be financed largely with debt. When railroad stock traded in any great volume, it almost always meant that different factions were clawing for control or speculators were toying with the stock.[9]

The factory system itself appears to have been firmly established by the 1840s and 1850s. Significant growth took place between the end of the Civil War and 1890, with perhaps the greatest increase in the number of factories from 1879 to 1889. The class of wage earners grew from just over 2 million in 1869 to 4.25 million in 1889.[10]

While industrialization created new jobs, especially from around 1880 on, the creation of the giant modern corporation did relatively little for workers. Almost 53 percent of the gainfully employed population worked in agriculture in 1870, and only 19 percent in manufacturing, 39.5 percent when transportation, mining, construction and trade are included. The number of employees engaged in manufacturing, mining, construction transportation and trade had grown to exceed those employed in agriculture by 1890. But this increasing dominance of manufacturing and related industries was already in place by the time of the merger wave. Manufacturing jobs increased at a fairly steady rate during the last two decades of the century, by 33.4 percent between 1880 and 1890 and 34.2 percent between 1890 and 1900. During the decade following the merger wave, manu-

facturing jobs continued to increase, but at a rate of 30 percent, a slower rate of increase than occurred during the preceding two decades. The merger wave's role in job creation was insignificant.[11]

The merger wave did not create many new manufacturing jobs. It did not even create new factories. The jobs and the factories were already there. The giant modern corporation was an aggregation of existing factories, already fully staffed. The financial imperative that created the giant modern corporation created stock, not jobs. Only in finance and real estate, insignificant employers before 1900, were substantial numbers of jobs created by the merger wave.

The giant modern corporation combined existing jobs and factories under a single corporate umbrella. But it had an enormous financial impact. Although difficult to determine with precision, its magnitude seems to be beyond dispute. According to one contemporaneous study by Luther Conant, Jr., the total capitalization of American industrial combinations of plants with capital greater than $1 million was $216 million in 1887. It had grown over twenty times to more than $4.4 billion by 1900. Slightly over $1 billion of this had been added before the crash of 1893. Relatively little occurred during the following depression, but from 1896 to 1900 almost $4 billion of capitalization by combination was added to American industry. Hans Thorelli's later study, based on slightly different criteria, showed $262 million in combination capitalization in 1893 rising to an aggregate of almost $3.9 billion in 1900, with another $2.3 billion added by 1903. Neither study included railroads, the dominant industry, or public utilities. Thorelli excluded the portion of corporate capitalization represented by bonds, but Conant showed that bonds were a relatively small percentage of combination capitalization.[12]

John Moody, in his 1904 book, *The Truth About the Trusts*, calculated that "the aggregate capitalization outstanding in the hands of the public of the 318 important and active Industrial Trusts in this country is at the present time no less than $7,246,342,533," representing the consolidation of almost 5,300 individual plants. Two hundred thirty-six of these trusts had been incorporated after January 1, 1898, and represented more than $6 billion of his estimated capitalization. Adding public utility and railroad combinations, Moody calculated a total capitalization of almost $20.4 billion, comprising 8,664 "original companies." Ralph Nelson, whose numbers set the modern standard of analysis and are based upon a more restricted definition of merger, calculated 2,653 "firm disappearances by merger" with a total capitalization of $6.3 billion between 1898 and 1902. Turn-of-the-century economist Edward Meade pointed out that between 1898 and 1900 alone, 149 large

business combinations comprising plants in every industry were formed with an aggregate capitalization of $3.6 billion, including Standard Oil of New Jersey, "the United Fruit Company, the National Biscuit Company, the Diamond Match Company, the American Woolen Company, the International Thread Company, the American Writing-Paper Company, the International Silver Company, The American Bicycle Company, and the American Chicle Company," as well as combinations in whiskey, tobacco, beer, coal, iron, steel and chemicals, among others. And all this was before the creation of the first billion-dollar corporation, U.S. Steel, in 1901. No matter how you look at it, the financial economy created by the merger wave was like a tidal wave crashing over American society.[13]

With all of this new capitalization, the value of stock in the hands of Americans rocketed. Individual (nonagricultural) and nonprofit net acquisitions of corporate stock increased from $105 million in 1897 to a peak of $715 million in 1902, declining to $475 million in 1903, the year of the Rich Man's Panic that effectively called an end to the merger wave. Net acquisitions of corporate and foreign bonds were $58 million in 1897 and $82 million in 1903, with major concentrations ranging from $287 million to $465 million in 1899 and 1902, respectively.

The effect was more than dollars. The merger wave created dramatic increases in the number of shares of stock traded throughout the nation. Seventy-seven million shares were traded on the New York Stock Exchange (NYSE) in 1897, almost all of them issued by railroads. Trading volume reached 176.4 million shares in 1899 and, after a brief decline to 138.3 million in 1900, charged up to 265.6 million in 1901, fluctuating between a low of 161 million and a high of 284.3 million shares during the succeeding decade. At the end of that decade, the number of industrial stocks listed on the New York Stock Exchange passed the railroads for the first time and stock ownership had begun to be widely dispersed among Americans.[14]

"Industry is carried on for the sake of business"

The dominance of the stock market over business in American economic life was foreseen by Thorstein Veblen even as the events that would cause it were unfolding. Veblen understood concepts like value and profit in terms of human behavior; what people did, instead of what people made, was the real key to understanding profit. This led him to develop a critical distinction between "industry" and "business." Industry was the physical process of making things. It involved factories, raw materials, workers and end products. The industrial process developed to increase productive efficiency and coordinate among the various intricately related aspects of manufacture. In order

best to serve the community, the various industrial processes had to be kept in balance. It was the businessman interacting through business transactions who was to maintain this balance. The business transaction was something different from the process of industry.

Veblen observed that "industry is carried on for the sake of business, and not conversely." Businessmen were driven by the chance for future profits. And the businessman, in contrast to the industrialist, found those profits in disturbing the balance of the system, the industrial equilibrium, which his transactions ideally were supposed to maintain. By creating these disturbances among the corporations of industry, he could make much more money for himself than he could earn from the mere profits of production. Just as a grain speculator could make money whether the market was good or bad, so the businessman could profit whether industrial profits were high or low. The community's well-being, its need for industrial stability and its dependence upon the products of industry were of no concern to the businessman. Indeed, maintaining that community in balance would deprive him of these opportunities for gain.

In order to achieve his ends, the businessman had to "block the industrial process at some one or more points." For example, businessmen seeking to form combinations would first have to make it difficult for the industrial components to remain independent. The goal was to freeze out competitors or drive them toward bankruptcy.

Who were these businessmen? After all, Veblen's distinction between industry and business as well as his attention to combinations were based on the realization that many independent industrial plants owned by individuals or small groups existed throughout the country. And there were industrialists who were content to stick to their knitting. But the description of the true businessman, the businessman whose goal was to arbitrage industrial imbalances that he himself created, "seems to apply in a peculiar degree, if not chiefly, to those classes of business men whose operations have to do with railways and the class of securities called 'industrials.' "

Veblen saw corporate securities as the principal tool for industrial disruption. Dealings in railroad securities were for manipulation, consolidation and control. This was no less true in the late 1890s for industrial combinations than for railroads, as industrial combinations came together through the medium of stock. Thanks to an increasingly developed market, these securities could be far more easily manipulated by overcapitalization, speculation and the like, than entire factories could be.

Veblen understood the developing domination of finance over industry. "From being a sporadic trait, of doubtful legitimacy, in the old days of the

'natural' and 'money' economy, the rate of profits or earnings on investment has in the nineteenth century come to take the central and dominant place in the economic system. Capitalizations, credit extensions, and even the productiveness and legitimacy of any given employment of labor, were referred to the rate of earnings as their final test and substantial ground." As he further wrote: "[T]he interest of the managers of a modern corporation need not coincide with the permanent interest of the corporation as a going concern; neither does it coincide with the interest which the community at large has in the efficient management of the concern as an industrial enterprise." The interest of managers, including corporate directors and large stockholders, was "that there should be a discrepancy, favorable for purchase or for sale as the case may be, between the actual and the putative earning-capacity of the corporation's capital." Business in the giant modern corporation was not about industry. It was about arbitraging the stock.[15]

LAISSEZ-FAIRE

Before the giant modern corporation could be created, the social, intellectual and legal environments that would make it acceptable had to develop. The story of the end of the nineteenth century is thus a story of the shift from *laissez-faire* in economic and social thought to an appreciation of, and desire for, more collective and cooperative forms of endeavor. It is a story of deteriorating business conditions that imperiled the new industrialization as railroad and then industrial overbuilding and competition appeared to threaten to create a few giant monopolies and put every small operator out of business. And it is the story of how businessmen tried to cooperate in the face of laws that made cooperation all but impossible until New Jersey, for reasons of its own, came to fix it. It is a story of the transformation from competition to cooperation that fertilized the ground in which the giant modern corporation took root.[16]

The social and intellectual environment in which the giant modern corporation flourished helped to rationalize changes in public thinking about the respective virtues of competition and cooperation. The transformations in American life that came along with accelerating industrialization caused social and economic dislocations as the old doctrine of *laissez-faire* impeded effective regulatory redress. Well-known social and political upheavals, characterized by the Grange movement, Populism, labor agitation, Socialism and religious movements like the Social Gospel, were one result. Another was a fervent defense of the old order in new terms, from the Social Darwinism of William Graham Sumner to its reconceptualization and humanization in Andrew Carnegie's Gospel of Wealth. The ferment led to larger pop-

ular concern, and also to iconoclastic scholarly debate within academic circles by young scholars educated in, or under the influence of, the collective spirit of Germany. These young economists provided much of the intellectual apparatus necessary to legitimate the new order and for that reason alone they are important. But they are important for another reason, too. Among their number was the young Professor Woodrow Wilson who, as president of the United States, would help transform some of this thinking into economic regulatory policy.[17]

The doctrine of *laissez-faire* dominated the America of the middle century. Following the Civil War, economists, businessmen and public intellectuals adopted the idea in a version more extreme and inhumane than that of Adam Smith or John Stuart Mill. Business was, for the most part, unregulated. Social services that could deal with economic dislocation existed, if at all, only by virtue of charity. The war economy had hastened industrialization and the pursuit of wealth became a widespread goal. Andrew Carnegie's "Gospel of Wealth," William Graham Sumner's *What Social Classes Owe to Each Other* and Supreme Court jurisprudence all provided variations on an idealized theme of an unregulated society of business in which competition created benefits for society and riches to the victorious. It did not hurt that *laissez-faire* had religious foundations deep in American and British Protestantism for, as John Maynard Keynes noted in *The End of Laissez-Faire*: "Individualism and *laissez-faire*. This was the Church of England and those her apostles."[18]

But in real-life America, and especially in the America of railroad men and new industrialists, *laissez-faire* was a dangerous idea. Riches were fleeting and ruin quite frequent. The promised benefits hardly showed. Wall Street financiers and modest Midwest farmers decried *laissez-faire* as a practical ideology as they saw how disastrous competition could be when applied to the conditions of modern American business. Grangers in the West howled as railroad rates threatened to absorb their profits even as they watched large millers and meatpackers ship their goods at much lower rates. Oil producers in Pennsylvania were forced to succumb to Standard Oil's domination of the railroads. The damaging effects of increasing urban poverty and unsafe working conditions stimulated reformers motivated by humane concerns. Even as the Sumners and Carnegies preached their gospels, churchmen, philosophers and economists were writing a new one. *Laissez-faire* as a way of life was in its death throes.[19]

Laissez-faire was a philosophy. It was a way of economic thought that, like the American ideal of individualism itself, derived from Enlightenment ideas upon which the republic was based. The Lockean idyll of individual

freedom and individual property went hand-in-hand with the classical economic ideas of Adam Smith. If the appropriate actor in American political and social life was the individual, pursuing his interests as he saw fit, the appropriate actor in economic life was likewise the individual, pursuing his economic goals as he saw fit, all in competition with other individuals doing precisely the same thing.

This individualism had a sacred provenance, for it expressed the foundational American principle of equality as much as it did its partner ideal of freedom. If the goal was to liberate all men to pursue their interests, the practical corollary in a nation of justice was that individuals were roughly equal in their opportunities. In the absence of rough equality, freedom for all would rapidly lead to dominion by some and increasingly less equality for others.

Tied to the ideal of individualism was the sanctity of private property. Property's almost mystical power in American social thought derived from the notion that it was the extension of the individual, the product of the individual's motivations, interests, talents and efforts. Private property was also the basis for wealth, wealth produced by the nominally free economic activity that domesticated property, increased its value and indirectly boosted the welfare of all. It was the medium through which individuals exercised their freedom, a freedom expressed through unhindered competitive transactions with other individuals. Individualism, in its idealized form, meant much more than the pursuit of wealth—it also held the freedom to express one's own ideas, practice one's own religion, set one's own life goals. But it was the relationship between freedom and equality, and the individual's pursuit of happiness through economic activity, that laid the foundation for mainstream mid-nineteenth-century thought.

THE RISE OF INDUSTRIAL COMPETITION

Americans experienced conflict between these ideals and the reality of an industrializing America in which some people had more than others, whether as a result of birth or talent, effort or luck. The problem was less pronounced before the Civil War, at least to the extent that one ignores the hard-to-ignore issue of slavery. That was a time when the overwhelming majority of white, male Americans lived mostly as small farmers, merchants or tradesmen, although there were regional disparities in wealth concentration, with middle Atlantic and north central states dominating other regions.[20]

Americans' opportunities to acquire great wealth began to increase following the Civil War, at first slowly and then with increasing speed. Among the first were the railroads, often monopolies, which also created larger mar-

kets for those who owned land or did business in the favored locations where depots were located. Farmers had new outlets for their crops; merchants had new outlets for their wares; manufacturers had new outlets for their products. And investing in the railroads themselves made men rich.

The railroads did not go everywhere at first. From 1830 to 1840, aggregate track mileage increased from 23 miles to almost 123 times that amount. These lines were, for the most part, local or regional, and mainly served to supplement existing canals. Most of them were fairly short lines, sometimes connecting with other short lines to span longer distances radiating out from Boston, New York, Philadelphia and Baltimore. Funds were raised by local subscription and by debt, which was mostly sold in New York and Europe.[21]

Railroad construction exploded following the Civil War. Seventy thousand miles of track were in operation by 1873, which grew to almost 200,000 miles by 1900. At the same time, new technologies increased the productivity of farmers. Factories began to churn out combines and threshers and harvesters to help them increase their crops. Modern refrigerator cars, developed in 1881, permitted the safe and efficient shipment of beef from the Midwest to the East Coast. The explosion of railroad construction created an insatiable demand for steel. The growth of cities led to the need for massive amounts of lumber and, later, steel for building and kerosene and natural gas for energy. Inventions like the telegraph, the ticker tape and the telephone provided businessmen with almost instantaneous means of communication. Electric power led to the invention of new conveniences and comforts for modern life, providing new entrepreneurial and manufacturing opportunities. The railroads' development of national markets also gave birth to new kinds of merchants, sellers of branded commodities such as oats, soap and tobacco, and catalogue houses that could capitalize on new economies of scale because of quick shipping and communication technologies. Big business started to grow.[22]

These new opportunities attracted interest from people in all walks of American life. And so first with the railroads, and then with other businesses that could now expand their markets thanks to the new transportation facilities, competition erupted, competition wholly in the grain of the American ideal. Even as this competition led to the burgeoning industrialization that disturbed the earlier relative income equality, and even as relative equality in the ownership of property was transformed into the increasing concentration of wealth in the hands first of individuals and then of corporations, the courts, especially the Supreme Court, continued to hold competition as sacred. The problem was that competition was destroying business.

The American ethic was individualism. Its economic expression was

laissez-faire competition. But in the age of the railroads, as in the age of growing industry, the American ethic of individualism created a tension with American prosperity that required combination to sustain itself. The incomes and comfort of increasingly large numbers of Americans were coming to depend upon the railroads and new industry. Americans' real *per capita* income grew almost 45 percent between 1879 and 1899. In order to allow people to realize the benefits of new businesses, and in order for businesses to be able to take advantage of this new wealth, they had to survive. Survival increasingly required cooperation. But the law demanded that they compete or, more precisely, made it very difficult for them to cooperate. Unless a way to facilitate cooperation could be found, the American economy confronted a severe threat, a threat that existed because of a legal culture that still embraced an outdated ideology.[23]

THE PRINCIPLE OF COOPERATION

The assault on traditional ideology began to develop at around the same time that railroads were experimenting with various forms of cooperation, all of which turned out to be ineffective and legally unenforceable. *Laissez-faire* philosophy had come under attack on a number of fronts by the late 1870s. The Social Gospel movement confronted the Gospel of Wealth. Economically sophisticated clergymen, led by Washington Gladden, preached that the restoration of Christian ethics could remedy the damage done by the unbridled and unregulated pursuit of wealth. And a group of young economists, coalescing in the mid-1880s, were deeply affected by this religiously based social movement and the turmoil they saw around them. Many of them had studied in Germany and were heavily influenced by the historicist school of economic thought. The ideas of that school arose from the history of social development and accompanying ideas of collective solidarity, deeply grounded in time and place. As one of their number, Edwin Seligman, succinctly wrote in 1886: "The modern school, the historical and critical school, holds that the economic theories of any generation must be regarded primarily as an outgrowth of the peculiar conditions of time, place, and nationality under which the doctrines were evolved, and that no set of tenets can arrogate to itself the claim of immutable truth, or the assumption of universal applicability to all countries or epochs."[24]

Troubled by the inhumane implications and universalistic claims of *laissez-faire*, these young economists developed a belief in both regulation and cooperation. Most of them acknowledged the importance of competition, but the competition of their imagination was a civilized competition, a sort of competition that was grounded in a society more organic than tra-

ditional American individualism acknowledged, a society that ameliorated the horrible casualties of unrestrained battle. Some saw the evolution of industrial society itself as leading to a new kind of competition, a competition of groups against groups, of corporations against corporations, rather than of individuals against individuals or even individuals against corporations. All acknowledged the urgent need for some kind of cooperation in both business and society. And all saw the need for a degree of state intervention that would regulate competition in a manner consistent with the more humanistic values they were introducing into American economic thought. Many were frustrated as they faced rejection by an older school of American economists, a school steeped in David Ricardo and John Stuart Mill and hewing to the orthodoxy of *laissez-faire*. But, at least in the beginning, they fought back.[25]

In the spring of 1885, members of this group discussed the need for a new association that would counter the old orthodoxy by committing itself to the independent scientific study of economics. Liberated from political ideology and preconceived prejudice, they would encourage "perfect freedom in all economic discussion." Among them were Henry Carter Adams, E. J. James, John Bates Clark, Edwin Seligman and Richard T. Ely. They were joined by Ely's former Johns Hopkins student, Woodrow Wilson, a young political scientist just about to embark upon his new academic career.

Ely, perhaps the most radical of the group, drafted a prospectus that he, along with Adams and James, sent out, inviting a larger group of economists and fellow travelers like Gladden and Cornell President Andrew White to a meeting. It was scheduled for early September in Saratoga Springs to coincide with the annual meeting of the American Historical Association. At four o'clock on the afternoon of September 8, 1885, the session was called to order in the Bethesda Parish Building for a discussion of the objects and platform of the new American Economic Association (AEA). Among the members of its original council were Woodrow Wilson and Lyman Abbott, the latter of whom succeeded Henry Ward Beecher as pastor of the famous abolitionist Plymouth Congregational Church in Brooklyn and would become a close friend, editor and informal advisor to Theodore Roosevelt.

The platform as presented began: "We regard the state as an educational and ethical agency whose positive aid is an indispensable condition of human progress. While we recognize the necessity of individual initiative in industrial life, we hold that the doctrine of *laissez-faire* is unsafe in politics and unsound in morals; and that it suggests an inadequate explanation of the relations between the state and the citizens." The statement captured the group's spirit, but its language was hotly debated. Some of the members

agreed with it precisely as written. Some rejected strict *laissez-faire* but did not like the implication that they were opposed to unregulated competition in all circumstances. Indeed, all members of the group thought that some degree of competition was important. Some thought *laissez-faire* was generally acceptable in times past but that modern economic circumstances had made the doctrine impractical. A very few asserted a continuing belief in *laissez-faire* although, as in the case of Benjamin Andrews, it was tempered by a humanism found in the moral theories of Adam Smith that seemed to have been abandoned in the new industrial world. In the end, the final "Statement of Principles" retained its first sentence dealing with the indispensability of the state to aid "human progress," but dropped the following sentences decrying *laissez-faire*. The complete denunciation of *laissez-faire* was defeated. But the doctrine was on its deathbed.[26]

The new economists often disagreed on details but unanimously held the principle that the age of economic cooperation was arriving and that the government was, at a minimum, a necessary midwife. A few examples of the individual thinking of the AEA's charter members will help to fill in the contours of the new economic thought in America. The writings of Clark, Adams, Ely and Seligman stand out, especially for their emphases on the positive benefits and normative desirability of the shift from competition to cooperation.

Clark, who taught Thorstein Veblen at Carleton College, would return more closely to free market ideas as the century closed. Indeed, he achieved his lasting fame with his writings on marginal utility theory and a return to the centrality of competition. But in the late 1870s and 1880s, Clark's thinking embraced what he referred to as "true socialism." His was not the political socialism that was popular in Europe, a centralizing socialism at odds with the structure of American government. It was instead a socialism based on the rather modest notion that property rights were grounded in social organizations rather than individuals. The object of property rights was to distribute wealth on the basis of justice, not to the survivor of harsh competition. Clark called this a "practical," not an ideological, socialism, a statement of fact about the ultimate direction in which the American economy was moving. The corporation, itself a social organization capable of being endowed with property rights, was its leading actor.

So Clark claimed to describe the world as he saw it. But he also approved of this new direction. Cooperative ownership and production were the markings of a much more advanced state of society than free market competition. Competition would not, and should not, be abolished. But in the new world of cooperation, competition would take place between collec-

tive institutions such as corporations rather than between individuals, even if this meant that competition would wind up as something "latent or residual" instead of an actual state of economic affairs. The possibility of competition would be enough to preserve the benefits of competition without its dangerous flaws. Traditional views of competition might have been appropriate for the age of liberation in which the work of Adam Smith emerged, but realities had changed. The evolution of society into a higher order meant that a new economic principle had to be found. Clark called it "the principle of cooperation."[27]

Adams, while acknowledging that *laissez-faire* contained "some truths," harshly criticized it as "illogical" and unscientific. Society was the proper object of economic study, and society included both the individual engaged in business and the state itself. Competition was neither malevolent nor beneficent but had to be evaluated "according to the conditions under which it is permitted to act." Adams approved both of appropriately measured competition and of Clark's worldview, and set out the general principle by which governmental regulation of industry should be evaluated: "It should be the purpose of all laws, touching matters of business, to maintain the beneficent results of competitive action while guarding society from the evil consequences of unrestrained competition." This included permitting monopolies to exist, because monopolies could be highly beneficial to society while regulation could prevent their excesses. Adams's work would echo twenty-five years later in Woodrow Wilson's regulatory program.[28]

Wilson's teacher was the most controversial of the group. As one historian described him, "Wherever he turned, Ely seemed to step on somebody's toes." It was Ely who had drafted the original AEA platform, and he took perhaps the strongest position among his colleagues against *laissez-faire*. He was also one of the greatest proponents of the humanization of economics and emphasized historicism and induction over the more formal approach of classical economics. Ely at times expressed his views (including his appreciation of Marx) so forcefully that he was accused of being a socialist. It was a label he correctly rejected.

In his 1889 *An Introduction to Political Economy*, Ely identified sociology as the master social science, with political economy as a subdivision within the broader study of society. Christianity itself "offers us our highest conception of a society which embraces all men, and in that conception sets us a goal toward which we must move." Society was an organism, and the ideas of political economy could not be considered separate and apart from that organism. To his credit, Ely did not claim to be writing a comprehensive

treatise, and the list of readers he thanks—Franklin Giddings, John Bates Clark, Woodrow Wilson and Amos Warner, as well as his research assistant, John R. Commons—suggests from the beginning a work perhaps more ideological than positive.

Ely drew a sharp distinction between monopolies and trusts, accepting and even praising the latter as big businesses seeking the gains of economies of scale and therefore greater efficiency. Indeed, while Ely understood competition as "the foundation of our present social order" and believed that it functioned best among large enterprises, he argued that the "moral and ethical level" of competition needed to be raised. But, despite his approval of competition, Ely, like Clark, saw the evolution of society as heading in the opposite direction. As he put it, "cooperation is the great law of social growth." Yet the interdependence among men and their differential status required even cooperation to be regulated. Only regulation could lead to the realization of "freedom and individuality" that were at the heart of the American ideal.[29]

Edwin Seligman, noting the "serious defects" in free competition, made his colleagues' arguments for cooperation appear to be more consistent with traditional thought by dressing the new collective theories in classical economic form. Classical economists argued that the individual, working in his own self-interest, incidentally produced benefits for society. Seligman observed that corporate combinations also worked for their own benefit. But while "[t]hey better their own condition, in so doing they often better the public condition." *Homo economicus* became, in Seligman's thinking, the economic group. Besides, combinations existed and monopolies were facts. They had already so shifted the price system that prices were set by the "artificial manipulation" of the combinations and not by free competition. This was often to the public good, but there were evils to be prevented. While bemoaning the relative inefficacy of the Interstate Commerce Commission, Seligman argued that it provided a good regulatory model for trusts that ought to be improved upon and followed.

Clark, Adams, Ely and Seligman, like others of their young colleagues, each had different visions of the principle of cooperation. But the new economists almost unanimously agreed that cooperation had become a necessary principle of economic organization and that competition had to be controlled if it were to be preserved at all. Even the conservative Arthur Hadley, who would soon join the AEA, wrote that "[a]ll our education and habit of mind make us believe in competition." But industrial cooperation was inevitable and necessary.[30]

THE NEED FOR COOPERATION

The new economic thinkers, attuned as they were to social problems, were keen observers of business. The greatest business reality in America during the mid-1880s was the self-destruction of the railroads. And the most significant barrier to their self-preservation was the absence of legal devices that could allow them to cooperate effectively.

The railroads had grown up in an era of free competition, although ironically many were granted monopoly power within some range of their roads. The trouble was that free competition proved too much in the face of rapid industrialization and concentrating wealth. In their eagerness to take advantage of increasing market opportunities, and as new operators entered the market, the railroads became heavily overbuilt, with parallel lines crisscrossing the countryside and converging on the major cities in the East and Midwest. This overbuilding produced competition with a vengeance, competition that many of the roads could not handle. One of their significant business characteristics was that they had high fixed costs for track maintenance, rolling stock and personnel, as well as substantial debt service obligations on the large volume of bonds they issued to finance their construction and expansion. In order to pay these costs, let alone make a profit, they needed to generate revenue from passengers and freight. With too many lines serving the same routes and thus competing for the same customers, this was a difficult goal to accomplish. It was not long before railroad lines were so numerous and covered so much parallel territory that their operators had to engage in self-mutilating rate wars simply to stay alive.[31]

Shippers between St. Louis and Atlanta had their choice of twenty different routes as early as the 1870s. In the budding days of Standard Oil, when many of the nation's refineries were centered in Cleveland, Rockefeller had a warm-weather choice between shipping over the Great Lakes and using the Lake Shore Railroad. The Lake Shore was happy to accept Standard's guaranty of sixty full cars every day in exchange for deeply discounted rates. The Erie, the Great Atlantic, the New York Central and the mighty Pennsylvania all fell before Rockefeller's ability to fill their cars. He even managed to demand kickbacks from the Pennsylvania's shipment of other people's oil.

Too many lines, rebates to customers who filled cars, differential rates for long- and short-haul shipping and out-and-out price gouging by lines on some routes in order to generate the cash to support others became the pricing practices of the entire industry. Railroads dropped their freight rates to such low levels that they often could not cover fixed costs. Bankruptcy and reorganization became a rite of passage in a typical railroad's life.[32]

While the railroads were struggling to survive they were helping to destroy competition in a different way. Businesses that were big enough shippers could command bargain rates, adding significant cost savings to the tools that let them dominate their industries. The rails were a road to monopoly.[33]

In 1901, surveying the enormous popular and scholarly literature about trusts that had appeared from 1897 to 1901, economist Charles J. Bullock described a class of trust literature dealing specifically with the relationship between the trusts and the railroads. He quoted one author as noting that "the trusts have the railroads by the throat," and another as classifying discriminatory railroad rates as "most prominent among ... [the trusts' evils]." The United States Industrial Commission in its Final Report in 1902 noted: "There can be no doubt that in earlier times special favors from railroads were a prominent factor, probably the most important factor, in building up some of the largest combinations.... The evil effect of such discriminations upon the rivals of the combination is self-evident." And among the recommendations of the Bureau of Corporations in its Report of 1904 was "prohibition of discriminations by public service companies."[34]

The railroads were the first of America's large corporations, and thus the first to face the problems of excessive competition. Manufacturing and the extractive industries followed as technology increased production (and fixed costs) and railroads expanded product markets from localities and regions to large sections of the nation. Within a short period of time industries throughout the country were fighting one another to keep their shares of the market. Competition might have produced efficiency. But it often produced destruction. Cooperation was the solution.[35]

A significant portion of American industry was in hypercompetitive pain. A way to cooperate had to be found. One method that might appear obvious in modern times would have been to combine the corporations that owned the railroads or competing factories, or perhaps to form a single corporation to buy up competing properties. But those solutions were not available. The constraints of nineteenth-century law were, for the most part, preclusive.

THE LIMITS OF COOPERATION

The railroads had brought with them the first widespread use of the corporate form of conducting business. The corporate form provided advantages that were unavailable to sole proprietorships and partnerships. Corporations provided the best means of bringing together the large amounts of capital necessary to build the railroads, and later other large businesses, by allowing them to issue massive debt under the protection of the limited liability of their shareholders while at the same time permitting the shareholders to re-

tain control through their ownership of common stock. The corporate form also made it easy to transfer stock ownership and change personnel without disturbing the capital structure. And it allowed the centralization of management that was an essential key to the growth of giant corporations. All of this created a means of consolidation. But the restrictions on consolidation imposed by state corporation laws made any sort of widespread cooperation using the corporate device difficult if not impossible.

Corporations were the creations of the individual states. What the state created the state could restrict and, as a general matter, the states restricted the powers of corporations to join forces or freely grow for a number of reasons. Not the least of these was to keep within the states the businesses upon which they increasingly came to rely for jobs for their citizens and tax revenues for their services. Even as railroads crossed state lines, the corporations that owned them could not freely cross state lines to join with other corporations. The common result was that lines in one state were owned by a corporation in that state and connected at the state border with a line owned by a different corporation in the adjacent state. This not only prevented consolidation, but also for a time created problems for management and the technical standardization of railroads. Different lines owned by different corporations often used different gauge track. At least until the mid-1880s, a train arriving in Virginia from New York or Pennsylvania might have to empty its passengers and freight into the Virginia cars in order for the passengers and freight to continue.[36]

A lingering mistrust of corporate privilege and a growing fear of monopoly led states to restrict corporations' abilities to combine even within individual states and to operate interstate businesses. Capitalization, and thus the ability to grow by means of outside financing, was limited. Nineteenth-century ideas about corporate personhood constrained judicial interpretations of the purpose clauses of corporate charters so severely that corporations usually were not allowed to own stock in another corporation. Notions about the nature of incorporation itself led to requirements almost impossible to meet before corporations could combine by merger or consolidation. By the 1880s, state corporate law restrictions were supplemented by state antitrust laws, with at least fourteen in effect by the time Congress passed the Sherman Act. The obstacles to cooperation were substantial.

Businesses attempted to use other devices, again led by the railroads. Railroads tried to form pools. The pools consisted of railroad managers coming together and appointing a central coordinator to determine rates or allocate traffic. Starting as early as the middle 1850s, but concentrated in the 1870s, some of the pools actually held together for a time. The pool

formed by William Vanderbilt under the so-called 1873 "Saratoga Agreement" lasted for six months. The far more successful Southern Railway & Steamship Association was created in 1875 with a formally appointed director to allocate traffic and lasted for a decade. Other pools came and went but never were enduring, and rate competition always returned as pool members, drawn by their own greed, defected. There was little the other pool members could do to prevent this. Under the common law dealing with restraints on competition, the pools were unenforceable.

As the pools continued to fail, businessmen tried to devise ways to create what were generally referred to as "communities of interest." These were often enforced by intercorporate investments—cross-holdings of stock—to satisfy the members' self-interest. There might be enough business for everyone if business simply could be rationalized in a way that distributed the opportunities more evenly. But, as with the pools, the problem of maintaining these communities of interest was real. The competitive impulse always remained; cooperation might persist for a while but, even with intercorporate stockholdings, the incentives to cheat and defect could be irresistible.[37]

STANDARD OIL AND THE TRUST

There had to be a way to make cooperation legally effective. Corporations were generally prohibited from owning the stock of other corporations, a rule which, together with restrictions on size, purpose and fundamental changes like mergers, made the corporate device unavailable to solve the problem. The pooling agreement was unstable. Communities of interest were difficult to assemble. Both were hard to maintain and unenforceable in court.

The first significant solution was discovered by oil. The American petroleum industry had experienced dramatic competitive problems during the late 1860s and early 1870s, with overproduction in the fields and refining overcapacity in Cleveland, Pittsburgh, the Allegheny Valley, Philadelphia and New York. The Pennsylvania Railroad's Tom Scott tried to resolve the problem by engaging with a small group of refiners, including John D. Rockefeller, and the major trunk lines in the region to create the South Improvement Company, a device to monopolize and control the industry. The South Improvement Company became a political and industrial nightmare that collapsed before it ever engaged in business. But Rockefeller, who understood the benefits of combination, was beginning his plan to rationalize the oil industry by acquiring it.

Standard Oil spent the 1870s expanding its business and, significantly, buying new companies and properties in the major oil refining and producing states. By 1879, the Standard group was a hodgepodge of corporations,

wells, refineries, pipelines and other assorted assets, loosely organized and difficult to manage. Ohio corporate law made it almost impossible for Rockefeller and his associates to assemble these properties in an economically and managerially rational form. The law prohibited Standard from owning the stock of corporations in other states, and its charter limited its business only to refining, shipping and selling petroleum. The business had grown more complex than that, and Standard Oil of Ohio itself, the flagship corporation, owned substantial properties in Pennsylvania, Maryland and New York, in addition to Ohio.[38]

Rockefeller and his associates already controlled the oil industry. But their control was dispersed. As he acquired the companies that built his monopoly, Rockefeller achieved a modest degree of centralization by placing their stock in trust, usually with Henry Flagler as trustee. But this kept the businesses separated and without a centralized management.[39]

In 1879, Samuel C. T. Dodd, then a relatively obscure Cleveland lawyer described by one contemporary as being "so fat that . . . he was the same size in every direction," and said to possess questionable legal ethics, had come into the Standard Oil orbit. He was "a wizard at contriving forms that obeyed the letter but circumvented the spirit of the law." In 1882 Dodd, together with Rockefeller and Flagler, came up with a solution. Separate Standard Oil companies were incorporated in Ohio, New Jersey, Pennsylvania and New York to own Standard's properties in each of those respective states. This would centralize all of Standard's property in those states and keep the property separate by state. The owners of each corporation's common stock put that stock in a trust, a perfectly lawful device designed for people who wanted to put the legal control of their property in faithful hands while retaining its economic benefits. The stockholders received trust certificates in exchange for their shares. The formal consequence of this arrangement was to unify the stockholders while the corporations were kept technically separate. The trust was born and with it a name that was used to refer to large corporate combinations of every legal stripe for decades, whether or not they actually had the legal form of the trust (and most did not).[40]

While the trust was a recognized legal device and therefore safer than the pool, it was not without risk. It complied with the letter of the law but, used as a device for accomplishing the otherwise illegal goal of uniting different corporations under the same control, it was an obvious subterfuge. Courts came up with reasoning to destroy it. In 1890, New York's highest court declared H. O. Havemeyer's Sugar Trust illegal by looking through the technical unification of the shareholders to the combined corporations and holding that corporate combination was beyond the constituent corporations'

powers. This was followed by the Ohio Supreme Court's more direct breakup of the Standard Oil Trust in 1892. Although only a handful of technical trusts were formed, they seemed to be the last best hope for cooperative business. Now, again, business combination became difficult if not impossible. A new way to combine corporations, to promote cooperation, had to be found.

The pools and communities of interest were illegal or at least unenforceable. The trust was in jeopardy. The corporation was a form subject to significant limitations, especially for interstate businesses. The legal devices that made combination possible had yet to be invented. But the need for a legally effective cooperative business device was clear, and the social acceptance of business cooperation was growing. Beyond pockets of populist demagoguery, the death of *laissez-faire* had been proclaimed by economists and the reality of the American business landscape. The influence on a wide cross-section of the population—progressive reformers, businessmen and even some labor leaders—was decisive. Americans from all walks of life now began to see the new attempts at combination as the inevitable evolution of American capitalism and sometimes as beneficial to consumers and workers, even as they worried about the power of the trusts. The public increasingly was concerned with ensuring economic order so business could grow, not without competition, but with orderly competition that took account of the need for cooperation and prevented ruin.[41]

And New Jersey was poised for discovery.[42]

this material has been excerpted from

The Speculation Economy:
How Finance Triumphed Over Industry

by Lawrence E. Mitchell
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