REVIEW ESSAY

The New Economy (Pre)Dux; or, What History Teaches Us About the Wired World

ANDREW RUTTEN

Historians can't help but smile every time they hear another pundit pontificating on the new economy. Historians know that there is no new thing under the sun, at least not yet. If they want to understand "the" new economy, they don't seek out the latest word on network externalities, path dependence, or technological lock-in. They don't worry whether the code wants to be free, whether open source really is better, or whether it's WindowsXP or the iBook that is really just another marketing ploy designed to confuse consumers. Instead, to understand *this* new economy, historians turn to the original new economy, the one the railroads created over the past two centuries. After all, whatever looks new in the past two decades—bubbles, busts, merger manias, managerial malfeasance, fights over network standards, imported labor, and intellectual property—the railroads had in abundance. They even had the hype, which may be the most important reason we should get our history right.

Although the trope of the railroads as the original new economy is well known, the truth of the matter is not. Many who chatter about such things only repeat myths that were debunked long ago. Such mistakes are especially egregious in discussions of

Andrew Rutten is a lecturer in the Department of Political Science at Stanford University.
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the consequences of the new economy for law and policy, where even the relatively well informed are apt to be ignorant, taken in by ancient propaganda from long-forgotten battles. James Ely's *Railroads and American Law* (2001), a compact but comprehensive tour of the tangled marriage of law and locomotives, from the very beginning to today, should do much to remedy our ignorance.

In presenting this history, Ely writes as a lawyer and a historian, rather than as an economist or a political scientist. He emphasizes the particular and the contingent, rather than the general and the necessary. This approach keeps him grounded in facts, and it saves him from drawing the wrong lessons. Luckily for the reader, it doesn't keep him from pointing out the follies of others; along the way, he hoists many theorists on the petard of what really happened. Nor does it make him dry and boring; Ely is not from the "if you pile up enough facts, you'll have a story" school of history. Along with the facts, he reveals several deep and profound truths about the political economy of law and policymaking in the United States. Because these truths continue to shape policy, it is useful to be reminded of them; and because they are messy, the truths that Ely tells are likely to be unpopular and annoying to all who seek easy answers. For this reason alone, the book is important.

The Economics of New Economies

The parallels between the rail economy and the wired economy are obvious. Both work their magic indirectly. Just as there's no thrill to just riding a train, there's no thrill to just being on-line. People want to go on-line for the same reason they want to ride a train—they want to go somewhere, and trains (or the Internet) get them there more cheaply than do the alternatives. In other words, both allow people to get more bang for their buck, whether at work or at play. The results range from making existing markets work better (the Chicago Board of Trade and now Expedia) to creating whole new markets (before trains, there was no reason to put resort hotels in the middle of New Hampshire; before eBay, there was no reason to have rare bookstores in rural California).

Since the 1820s, new-economy theorists have taken the simple fact of lower transportation costs as the basis for their claim that these technologies will make all things new. Because both rails and the Internet can move many different sorts of things, it seems obvious that the gains from using them will be spread across the economy. Thus, the revolution.

Economists have long known that this story, though true at some level, exaggerates the amount of money saved by the switch from canals and horses to railroads. In the 1960s, a generation of scholars, led by Robert Fogel (1964) and Albert Fishlow (1965), worked hard to estimate the "social savings," the increase in national product, that the railroads caused. In spite of much wailing and gnashing of teeth about the details of the estimates, however, most historians now agree with the general point that railroads didn't matter much—that even if they had never been invented, the American economy would have looked much the same.

A moment's reflection about the arithmetic of gross national product (GNP) shows that it's no surprise that railroads didn't matter all that much. The reason is simple: the GNP of the United States is so big that it dwarfs any of its components. When you divide a small part of one of those components (such as the gains from using railroads instead of canals) by all of GNP, you get a small fraction. Surely sometime in the next fifty years, the Internet will have its own Fogels and Fishlows, who will do the accounting right only to discover that contemporary rhetoric once again outstripped reality.

From this perspective, the truth about new economies becomes a bit of a yawner. It's all fairly antiseptic, a matter of technology shifting a bunch of cost curves. In the long run, after all the dust has settled, we are all better off, but not by as much as we might have thought. The fights over law and policy seem at best beside the point and at worst something to be regretted, as merely having delayed the inevitable. The lesson of history thus is the need to reduce interference with the market as much as possible.

Readers of Ely's book will know that in the real world it is the economists' stories that are largely beside the point. From the earliest days, projects that made sense were stalled, and those that made no sense were pursued. As a result, economics by itself throws little light on the history of railroads and railroad policy. From failures of standardization, to failure to double-track, to subsidization of competing modes, and to protection of union jobs in the face of competition, railroad history is littered with missed opportunities and actions that didn't maximize anyone's wealth. This history can be understood only by recognizing that, as Keynes might have put it, we live in the short run, forever.

Not Everyone Wins

The history of railroading (and by extension, the future of the wired economy) reflects an often overlooked feature of market economies: the dual role of diversity. Since Adam Smith, economists have recognized that diversity brings blessing. As Smith pointed out, we are richer because we are diverse. Without diversity, there would be no gains from trade and no reason to prefer society to autarky. However (as Smith himself makes clear), it's not that simple. Trade, no matter how beneficial, isn't automatic. Trading is hard business, and people need a reason to do hard things. In a market economy, the threat of competition provides the reason: if someone can do the job better than you, you will be out of a job.

This truth applied especially to railroads. From the very beginning, railroads created all sorts of winners and losers. By offering to move goods more cheaply than their competitors, railroads hurt those competitors, from canal companies to other railroads. And because the railroads (like canals) had to run along fixed routes, they served some parties more directly than others. Those near the railroad gained relative to those far from it; those in rail centers, where roads competed for their business, gained relative to those near only one line. In response to these changes, people moved to new regions, took up new jobs, and faced new climates. As Joseph Schumpeter would say, because of railroads, late-nineteenth- and early-twentieth-century America was constantly swept by gales of creative destruction in which the new pushed aside the old.

In the economists' story, the constant resupply of losers has little effect. On the blackboard, you have two ways of responding to competition. Either you beat it by lowering price (or by raising quality) or you go out of business. And if you go out of business, you reenter the labor market through a mysterious process. Although this approach helps us to understand many questions, it obscures the answer to other, equally important questions. It's an especially bad way to answer the question, "How do new technologies affect the path of economic growth over time?" In the real world, losers can do much more to beat the competition. In particular, they can turn to the government.

As Ely shows, railroads had an amazing ability to create the sort of losers who would turn to government for relief. For example, since the first track was laid, many Americans developed acute cases of "railroad fever." Among their symptoms was the unshakeable conviction that getting a railroad in their neighborhood would create a sure path to prosperity. This conviction often developed into delusion, as people refused to consider whether anyone could profit from building and operating the road that they wanted. In the world of economists, the capital market would cure this delusion, forcing people to confront reality by refusing to fund crazy projects. However, in Ely's world (the *real* world), things aren't so simple. The economists were right; many of these projects *were* crazy, the sort of thing that no sane person would invest in. As Ely also shows, however, such craziness didn't stop those who knew that they were right, that they had a sure thing on their hands. Instead of giving up, they kept looking for money and often ended up turning to state and local governments.

The result was a cycle of optimism, retrenchment, regulation, and avoidance, as citizens turned to government for the funding they couldn't get in the market and for bailouts when things turned sour. The eventual result was new laws aimed at keeping government out of such debacles in the future. For those with the fever, however, the regulations were just another obstacle to be overcome. Often they found the loopholes they needed, setting in motion yet another cycle.

The fever's delusions fueled the demand for government in less direct ways as well. For example, those without capital to invest directly in railroads often invested in them by moving to places they shouldn't have occupied, an important example being the farmers who looked at the Great Western Desert and saw lush fields begging for the plough. When their dreams turned into nightmares, they often concluded that they'd been done in by others, such as railroads. To protect themselves, they turned to government to bring the malefactors to heel.

Even many of the winners thought of themselves as losers. Railroading brought new challenges to business, such as coordination across huge distances, among large workforces and numerous investors. The problems couldn't always be handled economically by existing methods, so the industry was marked by a long period of experimentation as the railroads tried to solve problems from financing to hiring workers. Thus, it's not surprising that for much of our history the law of everything from bankruptcy to worker safety to labor relations was the law of railroading. Because each solution benefited some parties more than others, the various participants in the railroads themselves seldom agreed on the one best way to do things.

That the railroads created many losers (or, perhaps more accurately, people who thought of themselves as losers) explains why there was so much law involving railroads, but this explanation doesn't account for why we got some laws and not others. In particular, it can't explain why the laws passed were so complex and contradictory as to be incoherent, with everyone from farmers to bondholders winning at least some of the time. To understand this aspect, we need to follow Ely into the *political* economy of railroad law.

Institutions Matter, So Who Wins Depends on Where They Play

After the spectacular failures of the "big" experiments of the twentieth century, it's hardly news that institutions—the humanly devised rules of the game—matter. By any defensible measure, markets and limited government are more conducive to human flourishing than any other way of organizing society, but the impact of institutions doesn't stop there. As Ely shows, institutions matter "all the way down." Even small differences in institutions can lead to large differences in choices.

In the polity, as in the economy, diversity does the work. Diversity means that more trades are feasible. In plain English, the more diverse the citizenry, the more winning coalitions they can form, with each coalition built on a particular set of deals. These deals reflect the compromises that each member made—what each gave up to win. Because of these compromises, it is likely that the result is a package that no one person or group thinks is best; and because many different deals might be devised, the compromise that finally prevails is contingent rather than necessary.

In the face of this contingency, we can make sense of history only by reflecting on institutions, which play a key role in determining why politicians make one deal rather than another. We can't understand any particular decision about railroad law without understanding the institutions used to create it. In Ely's story, the key institutions include the federal system, with its multitude of states; the system of separated powers, which gives distinct jobs (and decision-making processes) to legislatures, executives, and judges; and the formalities of presentment, which require both houses of the legislature and the executive to agree before a bill can become law.

The variety of institutions matters because who wins and who loses varies across institutions—a Chicago court may decide the same case differently than an Omaha court, and they both may decide it differently than a federal court. State legislatures and state courts are more likely to be parochial, favoring fellow citizens over eastern capitalists, whereas Congress will take a broader view, favoring some regions at the expense of others. Of course, which region wins depends on the particulars of representation in the House and the Senate.

To complicate matters, all these institutions interact with each other. Throughout his book, Ely notes that with regard to the railroads these interactions had particular importance for the courts. Early on, the courts enjoyed a great deal of formal autonomy, crafting large chunks of railroad policy through the common law. However, as the nineteenth century wore on, legislatures chipped away at the common law, replacing judge-made law with legislation. More often than not, the replacement was deliberate, as politicians stepped in to "fix" legal doctrines that vexed powerful constituents. The result, as Ely makes clear, is that the courts came to play a smaller and smaller role in making railroad law.

Is There Any New Thing Under the Sun?

Anyone with strong feelings about policy toward the new economy will find Ely's book frustrating. For those who want government to do more and to do it better, the book suggests that this outcome just won't happen. The numerous examples of obviously stupid policies, many of them adopted again and again and again with seemingly no regard for the record of failures, undercut anyone's assumption that a bit of fancy economics will matter. Stripped of all the particularities of this place or that issue, Ely's story shows that good sense doesn't have much of a constituency. Nothing in the book suggests that this condition will change soon.

For those who think that government ought to do less and do so now, Ely's book suggests that this outcome, too, is unlikely. The problem isn't that Americans love big government or that they don't understand the benefits of markets or that they envy those who succeed. Certainly, some Americans do all of these things. More important, however, many Americans who have lost out in the market think they have been cheated. They see themselves as special, as exceptions to the rule; they believe that their grievance is just, that they (and perhaps they alone) should receive an exemption. Because many of us feel this way, the result is precisely the hodge-podge of intervention that Ely describes. The problem again is political—small government, like sensible policy, doesn't command the votes.

There is, however, another lesson in Ely's book. To see it, we need to turn back to economics. When we do, we see that in spite of all of these crazy policies, we still did pretty well. Certainly, we would be even richer if we'd had better government, but we might have done much worse, too. To the extent that the history of railroad law was the inevitable consequence of democratic politics, it may be the price we pay to avoid the sort of human disasters that plagued many other counties over the past two centuries.

Perhaps there *is* something new under the sun. Perhaps the Good Book is wrong when it says that "in much wisdom is much grief: and he that increaseth knowledge increaseth sorrow." Perhaps Churchill was right when he said that democracy is the worst form of government, except for all the rest.

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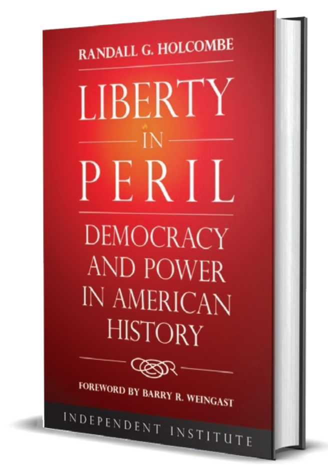

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