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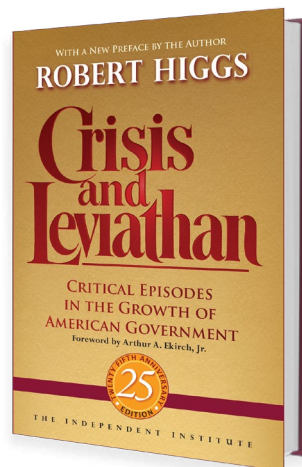
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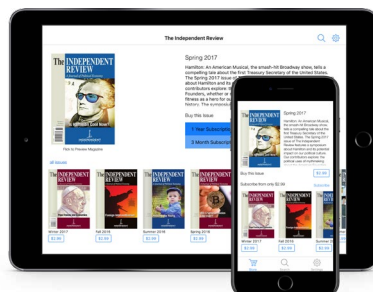
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The Fall and Rise of Laissez-Faire in the United States, 1789–1900

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BURTON W. FOLSOM JR.

Are free markets doomed to fail? Michael Munger and Mario Villarreal-Diaz suspect that they are. In “The Road to Crony Capitalism,” these authors argue that inherent weaknesses in laissez-faire create long-run tendencies toward crony capitalism. “[I]t is at least possible,” they claim, “that cronyism is *intrinsic to* and not *separable from* capitalism” (emphasis in the original). Thus, capitalism may have “a tendency—it’s not inevitable or irreversible, but a tendency nonetheless—to devolve into crony capitalism.” In other words, “the question of our age . . . is simple: If real capitalism exists, is it *sustainable*? Or does capitalism in a democracy always devolve into corporatist cronyism?” (emphasis in the original).

To address these important questions, let’s look at U.S. history from its beginning in 1789 to 1900. “A page of history is worth a volume of logic,” as Justice Oliver Wendell Holmes observed in *New York Trust Co. v. Eisner* (256 U.S. 345 [1921]). If we do so, we see that the United States did not, as Munger and Villarreal-Diaz imply, “devolve into corporatist cronyism” but jumped into it immediately in George Washington’s presidency. Let me first outline the fall of laissez-faire in the United States from 1789, its first year as a nation, to the Civil War era, two generations later. The crony capitalism began with tariffs and a central bank and then expanded into

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ever-larger federal subsidies, first to fur trading and then to road building, steamships, and railroads.

The trigger for America's first federal interventions was President Washington's secretary of the Treasury, Alexander Hamilton, who quickly secured a tariff on imports, some of which was justified to protect "infant industries." But as economic historian William Letwin has observed, "The infant industries of 1789, which were supposed to need protection only until they learned to stand on their own feet, were not infants thirty or forty years later, and yet tariff protection was still requested and granted" (1961, xx, 14–15).

Next, Hamilton proposed that a large central bank, the Bank of the United States, be trusted with the revenue from the tariff. More crony capitalism would be inevitable here because one-fifth of the directors of this bank would be appointed by the government, and the Bank of the United States would be encouraged to make loans to businesses approved by the board. In other words, the directors of the bank could and did loan money to friends or others with political influence.

With some crony capitalism under way, Hamilton then issued a "report on manufactures" in which he defended direct subsidies, or "bounties" as he called them, to new industries. Hamilton labeled these subsidies "one of the most efficacious means of encouraging manufactures, and . . . in some views, the best." In fact, he insisted, "There is no purpose to which public money can be more beneficially applied, than to the acquisition of a new and useful branch of industry" (quoted in Letwin 1961, 16–18).

With the door open to federal intervention, Washington chose to create and subsidize a government-operated fur-trading company. Fur trading involved mainly beaver pelts, which were converted to hats that Americans sold widely around the world. Fur trading nicely fit Hamilton's definition of "a new and useful branch of industry" to be supported, but Washington was even more concerned with national defense. Indians were crucial in trapping beaver and selling their pelts; the president wanted Americans, not the British in Canada, to dominate the fur trade to prevent British encroachment on American land. In 1795, Washington secured \$50,000 from Congress as emergency money to operate a series of fur-trading "factories" throughout the Northwest Territory (modern-day Ohio, Indiana, Illinois, Michigan, and Wisconsin) and the American South. These fur factories would, Washington hoped, "bring in a small profit, . . . and fix them [the Indians] strongly in our interest." In later years, Congress raised the subsidy to \$300,000, a large expense for a new nation and one that tested the government's ability to run a profitable business.¹

Here is how the government fur-trading system worked. The Office of Indian Affairs used the subsidy to set up the trading posts (usually near military forts), stock them with goods, and pay American agents to buy, store, and transfer furs from the

1. See Prucha 1986, 31–40.

trading posts to Washington, D.C., where they would be sold at auction to “bring in a small profit,” as President Washington expected.

Almost from the start, however, the fur-trading factories struggled. Private American traders and the British actively competed for the Indians’ business throughout the Great Lakes area. And the private American traders captured the bulk of the fur trading on the American side of the Great Lakes. The Office of Indian Affairs steadily lost market share because its leaders often stocked their factories with items they wanted the Indians to buy rather than with items the Indians actually wanted. Thomas McKenney, who was appointed to head Indian Affairs in 1816, especially campaigned for the Indians to become farmers, not hunters, and he filled the factories with hoes and plows—as well as with Jews’ harps and even a Chinese Mandarin dress to “amend their heads and hearts.” The Indians, in response, traded with the British and private American traders, who gladly sold the Indians what they really wanted: muskets, powder, blankets, whiskey, and pots and pans.²

Among the American traders, John Jacob Astor emerged as the largest. In fact, his business greatly surpassed that of the subsidized factories after 1808. Astor accepted Indians as they were and valued them as fur trappers. He wisely hired agents to live with the Indians, extend them credit when needed, and supply them in trade with the best muskets and blankets on the market. Reaping an abundance of furs, Astor then developed a worldwide trading network. He sold beaver hats to fashionable Europeans and bear rugs to the Chinese for warmth in their unheated houses. He would bring back various imports from Europe and tea from China.³

With Indian Affairs’ market share dwindling, Thomas McKenney urged Congress to ban private fur trading. When that failed, he tried to get Congress to impose high licensing fees on all private American fur traders. “Armies themselves,” McKenney argued, “would not be so effectual in regulating the native Inhabitants as would a state of dependence on the Government for their *commercial intercourse*.” Sure, McKenney admitted, a monopoly “embraces the idea of compulsion,” but “the power over the Indians is coveted [*sic*] only for their good—and also to prevent them from doing harm.”⁴

Astor, in self-defense, urged Congress to investigate the government-subsidized factories and to abolish them if they were shown to be irrelevant. John C. Calhoun, the secretary of war, agreed with McKenney that “[t]he [fur] trade should, as far as practicable, be put effectually under the control of the Government.” But he obliged Astor by appointing Jedidiah Morse, a neutral observer and Congregational minister, to go into Indian country and report on the government factories. Morse, after extensive investigation, concluded “that the Factory system . . . does not appear to me to be

2. See Viola 1974, 2, 5, 25–26.

3. See Haeger 1991, 42–56, 99–102, 105, 185–88, 205–43.

4. Viola 1974, 57, emphasis in the original in the quotation given.

productive of any great advantage, either to the Indians themselves, or to the Government.” That conclusion was enough for Congress. The Senate voted seventeen to eleven to end the government fur factories, and the House soon followed. On May 6, 1822, President Monroe signed the bill turning all fur trade over to private enterprise.⁵

Tariffs, banks, and fur companies would not be the only areas of early government intervention in the young American economy. Internal improvements would be next. In 1806, shortly after the Louisiana Purchase, Congress passed and President Thomas Jefferson signed a bill to build a “National Road” to connect the East Coast with the interior of the new Louisiana Territory. Those who favored the road argued that it was an emergency “post road” for mail delivery and thus was consistent with Article 1, section 8, of the Constitution. But would the National Road—which would eventually stretch from Cumberland, Maryland, to Vandalia, Illinois—be economically sound? After more than seven hundred miles and \$7 million in construction costs, the National Road proved not to be economically sound or even very helpful to westward settlement. By 1850, it was little used, and soon after that it was almost abandoned. What went wrong and why?

Three problems inherent in government funding help explain why the early U.S. venture into internal improvements failed.

First, when government money is used to build a road, political decisions, not economic ones, dictate where it is built. In other words, congresspersons with political pull will try to draw the road to their district, whether that route is economically sound or not. As the National Road moved north and west from Cumberland to Wheeling, (West) Virginia, it detoured through Uniontown and Washington, Pennsylvania. Why? Because Jefferson’s Treasury secretary, Albert Gallatin, lived in Uniontown, and he persuaded Jefferson to swing the road there. Gallatin also urged Jefferson to run the road on a northern detour into vote-rich Washington County during an election year. “The county of Washington,” Gallatin wrote Jefferson, “with which I am well acquainted, having represented it for six years in Congress, gives a uniform majority of about 2000 votes in our favor and that if this be thrown, by reason of this road, in a wrong scale, we will infallibly [*sic*] lose the State of Pennsylvania in the next election.” Jefferson responded curtly, “A few towns in that quarter [of Pennsylvania] seem to consider all this expense as undertaken merely for their benefit,” but he nevertheless sanctioned Gallatin’s detours.⁶

Second, when the government builds a road, it will cost more than if entrepreneurs build it. The National Road was built with stone (crushed and solid), and it became one of the most expensive roads, if not the most expensive, in the United States. For example, the privately funded Lancaster Turnpike, also built with stone, cost \$7,500 per mile—versus the \$13,000 per mile spent for the National Road. The builders of the

5. See Morse 1822, 13–15, 56; Benton 1854, 20–21; Viola 1974, 59, 68–69; Folsom and Folsom 2014, 13–31.

6. See Jordan 1966, 79.

Lancaster Turnpike were spending their own money and had to spend it wisely, or the tolls would not cover their expenses. Those in charge of the National Road, by contrast, were political appointees, described by one newspaper editor as being “as numerous as the locusts of Egypt.” Funded with taxpayer dollars, the National Road never charged tolls, so it never had to turn a profit.⁷

Third, because no one owned the National Road, no one had a strong stake in building it well or preserving it once it was finished. Almost every firsthand account we have suggests that the road was shoddily constructed. Even in its heyday, it was never fully paved; it always had gaps and always needed repairing.

For example, Lieutenant Henry Brewerton of the Corps of Engineers inspected the road in Ohio and found inferior mortar and materials in its construction and tree stumps scattered throughout. Brewerton echoed those who claimed the road fell into disrepair faster than it could be built. Western travelers moaned constantly about the bumpy rides, the steep grades, and the mudslides. David Shriver, the superintendent of the road, complained that travelers stole bridge walls, milestones, and building materials. Lucius Stockton, who traveled the whole of the road and tried to run a passenger service on it, said, “Generally speaking the surface is entirely destroyed, or sunk under the foundation. . . . In one place the foundation itself has been carried away.”⁸

Finally, even Congress could no longer vote to continue funding for the National Road. Representative John Campbell of South Carolina asked, “Who can suppose that the opening of roads by the government is necessary to attract the farmer to the virgin soil of the West?” (quoted in Folsom and Folsom 2014, 6). Other roads, built by the states or by entrepreneurs, also brought immigrants westward, as did the Ohio River. The U.S. government, therefore, began to privatize the road in the 1830s by giving pieces of it to the states in which it was located.

Sad to say, the various states in the union did not learn from the dramatic failure of the National Road and the decision to privatize it. Most states launched systems of state-funded internal improvements—and most of these projects also failed and often had to be privatized as well. Economic historian Carter Goodrich estimates that 70 percent of expenses for canals in the United States were borne by state governments. According to Goodrich, some of these structures, such as the Erie Canal, got off to a profitable start, but most states (including New York) way overbuilt canals, and these states ultimately spent much more than they ever received in tolls and other revenue (1967, xvi).

Not only canals but the steamships that eventually plowed through the waters of rivers and oceans were soon subsidized by the U.S. government. Early American politicians continued to be optimistic that federal support would spur successful industry and propel the United States into world economic leadership. The real problem,

7. See Taylor 1951, 30.

8. See Jordan 1966, 98–99.

many congressmen believed, was not with the subsidies but with finding the right people to receive them.

With the development of the steamship, Americans could travel from New York to Liverpool, England, in less than two weeks, instead of the usual two months the journey took for sailing ships. England began subsidizing its own Cunard steamship line, and Americans assumed that government-supported travel was the wisest course of action. Congress picked Edward K. Collins to take charge of the route from New York to Liverpool and back to New York. He had already achieved some success with a New York to New Orleans route, and he seemed to be among the most experienced steamship operators to subsidize in this time of so-called emergency. Congress gave him \$3 million down and \$385,000 a year in 1847 to set rates and to deliver people, commerce, and mail across the Atlantic Ocean.⁹

The results were again disastrous. With large subsidies, Collins had little incentive to be efficient. He built four enormous ships that looked good but traveled poorly. Collins fitted them with elegant saloons, ladies' drawing rooms, and wedding berths. He covered the ships with plush carpet and brought aboard fancy olive-wood furniture, marble tables, flexible barber chairs, and French chefs. Collins stressed luxury, not economy, and his ships used almost twice the coal of Britain's Cunard line. Few immigrants could afford Collins's high ticket prices, and so his ships often had many empty berths.

To cover his costs, Collins sought even greater federal aid. He lavishly dined and entertained President Millard Fillmore, cabinet members, and influential congressmen. Collins also hired William W. Corcoran, perhaps the most effective lobbyist in Washington, D.C. Congress dutifully voted to increase Collins's subsidy to \$858,000 a year. Representative John C. Breckinridge of Kentucky said that Collins won the large increase in his subsidy "by the most powerful and determined outside pressure I have ever seen brought to bear upon any legislative body."

Just as Astor challenged McKenney in the fur trade, so Cornelius Vanderbilt entered the steamship market against Collins. At first, Vanderbilt offered to do what Collins did for about half of his subsidy. When Congress said no, Vanderbilt decided to challenge Collins even without federal aid. "The share of prosperity which has fallen to my lot," said Vanderbilt, "is the direct result of unfettered trade, and unrestrained competition. It is my wish that those who are to come after me shall have that same field open before them." He then startled observers by charging lower rates than Collins for mail, passengers, and freight. And he managed to make profits!

Vanderbilt won his customers first by making better-quality ships (which needed fewer repairs) and by innovating with efficient beam engines instead of Collins's side-lever engines. Then Vanderbilt moved to capture cheap passenger traffic by introducing a no frills third-class travel and by hiring "runners," who advertised Vanderbilt's

9. All of the information and quotations concerning the U.S. government's steamship endeavors come from Folsom and Folsom 2014, 33–50, 6–10.

discounts far and wide. With volume business and lower fixed costs, Vanderbilt captured high economies of scale and thrashed Collins in head-to-head competition. Vanderbilt was gratified because he had said, “It is utterly impossible for a private individual to stand in competition with a line drawing nearly one million dollars per annum from the national treasury, without serious sacrifice.” But he did it.

Collins was chagrined at this development. When two of his ships sank, killing more than four hundred passengers, he cajoled a new subsidy from Congress to build another ship to compete with Vanderbilt. Unfortunately, Collins built the new ship so poorly it made only two trips and then had to be sold at auction for a huge loss.

Even Collins’s friends in Congress could defend him no longer. Senator Judah P. Benjamin of Louisiana said, “I believe [the Collins line] has been most miserably managed.” Senator Robert M. T. Hunter of Virginia went further: “The whole system was wrong; . . . it ought to have been left, like any other trade, to competition.” The free-enterprise view prevailed in 1858, and Congress revoked Collins’s aid and left him to compete with Vanderbilt on an equal basis. The results: Collins quickly went bankrupt, and Vanderbilt became the leading American steamship operator.

Despite the glaring failure of federal aid to Collins, Congress did not learn its lesson. American politicians still believed that laissez-faire alone would never close the gap in economic growth with Great Britain. The problem, in this view, was not the giving of subsidies for steamships; the problem was that Collins was the wrong choice to receive them. With better choices, many politicians still believed, America would get better results.

In 1859, the year after Congress halted aid to Collins, Abraham Lincoln, candidate for president, was pondering the most colossal subsidy of them all—funding a transcontinental railroad to connect California with the East.¹⁰ He just needed to find the right man and then win the presidency. After careful investigation, Lincoln found Grenville Dodge, an expert railroad man with much experience in the West. “Dodge, what’s the best route for a Pacific railroad to the West?” Lincoln asked. Dodge drew out his plans, and when Lincoln became president, he urged Congress to pass the Pacific Railroad Act, which created the Union Pacific (UP) and Central Pacific (CP) Railroads. These two railroads would lay track from Omaha, Nebraska, to Sacramento, California, and compete for federal subsidies and federal land for each mile of track completed.

Lincoln was brilliant in his understanding of natural rights but ignorant of economics. He had confidence that federal dollars used to build his transcontinental railroad would be well spent. “If the subsidies provided are not enough to build the road,” Lincoln told Congressman Oakes Ames, a major stockholder in the UP, “ask double, and you shall have it.” The UP and CP, then, would compete for government largess. The line that built the most miles would get the most cash and the most land, which, of course, could be sold. In this arrangement, however, the incentive was for

10. The details and quotations in this description of the building of the transcontinental railroad are from Folsom and Folsom 2014, 75–95.

speed, not efficiency. The two lines spent little time choosing routes; they just laid track and cashed in.

The subsidies shaped the UP builders' strategy in the following ways. They moved west from Omaha in 1865 along the Platte River. Because they were being paid by the mile, they sometimes built winding, circuitous tracks to collect more cash. Also, Nebraska winters were long and hard, but because Dodge was in a hurry, he laid some track on the ice and snow anyway to get his subsidies more quickly. Of course, the line had to be rebuilt in the spring. And by pushing rail lines through unsettled land, the transcontinentals invited Indian attacks, which caused the loss of many lives and further ran up the cost of building. No wonder some observers estimated the actual building cost as almost three times what it should have been.

As the UP and CP entered Utah in 1869, the competition became fiercer and more costly. Both sides graded lines that paralleled each other, and both claimed subsidies for this mileage. As they approached each other, the workers on the UP, mostly Irish, assaulted those on the CP, mostly Chinese. In a series of attacks and counterattacks, including the use of boulders and gunpowder, many lives were lost, and much track was destroyed. With the threat of a federal investigation looming, the two lines finally agreed to meet at Promontory Point, Utah. There they joined tracks on May 10, with hoopla, speeches, and the veneer of unity. After the celebration, however, both of the shoddily constructed lines had to be rebuilt and sometimes relocated, a task the UP didn't finish until five years later. As Dodge said one week before the historic meeting, "I never saw so much needless waste in building railroads."

But the officers of the UP and CP were personally in good financial shape because they created their own supply companies and bought materials for their roads at high prices from these companies. The UP, for example, needed coal, so six of its officers created the Wyoming Coal & Mining Company. They mined coal for \$2 per ton and sold it to the UP for as high as \$6 a ton. Even more significant, the Credit Mobilier construction company, which was also run by UP officials, made a fortune by supplying iron and other materials to the UP at exorbitant prices.

After construction was completed, the UP and CP, even with 44 million acres of free land and more than \$61 million in cash loans, were near bankruptcy. The U.S. national debt in 1860 was a little more than \$60 million—so the UP and CP were a greater cost to the United States than its entire national debt at the beginning of the decade when the roads were conceived.

Many people then and now have pointed accusing fingers at the UP with its Credit Mobilier company and its wasteful building. But this misdirects the problem. The subsidies themselves dictated the building strategy and dramatically shaped the outcome. Granted, the leaders of the UP were greedy and showed poor judgment, but the presence of free land and cash tempted them to rush west and then made them dependent on federal aid to survive. And when the UP gave discounted (and sometimes free) stock in the UP to key politicians in Congress, that guaranteed the continuing flow

of cash into the shaky UP enterprise. The cry of “emergency” had created another federally subsidized disaster.

In *Crisis and Leviathan* (1987), Robert Higgs observes that crises—or supposed emergencies—are often excuses to increase the power of government to try to solve the crises. We see examples of that tendency early in U.S. history, and we can see them again later with the growth of government after the Great Depression and World War II. But not so after the crisis of the Civil War and the emergency funding of the transcontinental railroads: after the 1860s we see a remarkable movement toward, not away from, laissez-faire.

The period from the late 1860s to 1900, known as the Gilded Age, would be the most laissez-faire era in U.S. history. Two things helped the forces of limited government to prevail. First, the failure of the railroad subsidies was both visible and colossal—as noted, the federal money spent on the UP and CP alone was greater than the entire U.S. national debt in 1860. And it was a cumulative failure, right on the heels of the disastrous steamship subsidies. Thus, the forces for economic intervention were overwhelmed by these examples of failure.

Second, and perhaps more important, the botched subsidies had left very few protected bureaucrats in place to argue for more aid. By contrast, in the twentieth century, when New Deal programs failed, millions of constituents remained eager for more federal involvement. For example, the Agricultural Adjustment Act of 1933 paid farmers not to produce on part of their land, but when the Supreme Court struck down the act, millions of farmers lobbied Congress for more of the same—and they got it. In 1870, no such constituency was in place to lobby for new subsidies.

Thus, the catastrophe of a lavishly subsidized UP going into a series of bankruptcies sobered up Congress. Now the context of federal subsidies was made clear. The fur factories, the Collins steamship line, and the UP and CP had required ever-increasing federal aid, and all of them were ever-increasing disasters. The huge debt from these railroad subsidies, combined with the larger debt (and damage) from the Civil War, imperiled America’s future. More Americans than ever before came to believe that if the United States were ever to become a serious economic force in the world, it would have to be done in free markets with very limited federal aid. That became somewhat of a consensus among leading Democrats and Republicans alike.

To help ensure that Congress would not be tempted to seriously intervene in future economic development, President Ulysses Grant worked to eliminate the federal income tax. An income tax had become law during the Civil War to help pay its costs, and the tax had been continued after the war so that it could be used to subsidize the UP and CP. In 1872, Grant finally succeeded in getting Congress to abolish the income tax. He also worked to improve American finances by securing a law to back with gold the \$400 million in greenbacks the U.S. government had already issued to help pay for the

Civil War. He also vetoed a bill to issue more greenbacks, which could have encouraged more government spending.¹¹

The Democrats tended to be on board with Grant's efforts to limit government spending. Grover Cleveland, the only Democrat president in the Gilded Age, issued 414 vetoes during his first term alone. Perhaps his most famous veto denied a \$10,000 federal subsidy to East Texas farmers whose crops had experienced a ruinous drought. After issuing his veto, Cleveland urged private charities, not government, to assist the Texas farmers—which in fact occurred when much more than \$10,000 in private relief flowed into East Texas.

During the Gilded Age, Congress did pass some tariffs and gave help to the silver industry, but interventions were few. By limiting the role of government, the United States achieved twenty-eight straight years of annual budget surpluses after the Civil War. The national debt plummeted from almost \$3 billion in 1866 to less than \$1 billion in 1893.

What were the achievements of entrepreneurs during this era of limited government?¹² In a word, spectacular. James J. Hill, for example, validated the decision to halt subsidies to transcontinental railroads when he built the Great Northern Railroad, which streaked from St. Paul, Minnesota, to Seattle, Washington, with no federal aid. "Our own [Great Northern] line . . . was built without any government aid, even the right of way," Hill bragged. And he arguably had the best-built railroad in America, which easily survived the Panic of 1893 while the other transcontinentals suffered calamity and even bankruptcy.

Even more impressive, the inventors and developers of the Gilded Age unleashed creative skills not imagined before the Civil War. For example, Christopher Sholes started by securing a patent for the typewriter in 1868. Alexander Graham Bell made history by inventing the telephone in 1876. Thomas Edison was the greatest inventor of the age. In the 1880s, his discovery of how to light homes with electricity changed the world. Edison also invented both the phonograph and movie film to entertain Gilded Age audiences. Finally, Henry Ford operated his first car in 1896, which later transformed American life.

Paving the way for these entrepreneurs was the dramatic success of John D. Rockefeller and Andrew Carnegie in dominating world markets in oil and steel. Consumers all over America were blessed not only by lower prices for kerosene and railroad travel but also by the huge increase in jobs created by these two wealthiest men of the Gilded Age. Rockefeller's Standard Oil Company refined more than half of the oil used in the world, and Carnegie was not far behind in his steel production. By 1900, the United States had surpassed Great Britain as the greatest economic power in the world.

One last comment. The triumph of *laissez-faire* lasted only one generation. The shift from the relative *laissez-faire* of the Gilded Age to the sharply increased government

11. See U.S. Census Bureau 1975, 1104.

12. The details of the achievements of the Gilded Age come from Folsom 2018, 64–67, 83–100.

intervention of the Progressive Era (1900–1920) would again be spurred by cries of emergency. This time the necessity started with the invention of the airplane for national defense. England, Germany, and France were subsidizing experiments with airplanes, which supposedly put the security of the United States at risk. Two presidents—William McKinley and Teddy Roosevelt—again believed they and other experts could pick the best man to invent an airplane. This time they chose Samuel Langley, and he used his subsidy to unsuccessfully launch two planes. In 1903, nine days after his second failed launch, the Wright brothers, two unknown bicycle mechanics with \$2,000 of their own money, flew the first airplane at Kitty Hawk, North Carolina. “We have not thought of asking financial assistance from the government,” Wilbur Wright announced.¹³ But others would be asking for government to tax large incomes, regulate the railroads, break up large corporations, and build highways—and constituencies of beneficiaries emerged to exploit these ideas and shred laissez-faire.

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13. See Folsom and Folsom 2014, 117–38.