Lecture III: Government Regulation of Corporations

As we have seen, many large corporations owed their birth to government subsidies. The flip side of that public investment came in the late 1800s in calls for regulation of these businesses once they had grown to dominate their economic sectors. The railroads were the largest American corporations at the beginning of the 20th century and were on their way to being some of the most heavily regulated. Attempts to consolidate the companies in order to achieve economies of scale (and to end costly competition) led to anti-trust cases, the most important being the Northern Securities case of 1904. In this case James J. Hill, owner of the Great Northern Railroad, and J.P. Morgan, the financier and majority stockholder in the Northern Pacific Railroad, agreed to buy up the stock of the smaller Chicago, Burlington and Quincy Railroad in order to monopolize rail traffic in the American Northwest and to obtain access to the Chicago market served by the CB&Q. This move was countered by Edward Harriman, owner of the Union Pacific Railroad, who also tried to acquire the CB&Q. The Hill-Morgan move succeeded, however, and the combined railroads came under their management through the creation of the Northern Securities holding company. Holding companies, or "trusts," were essentially corporations established to own the stock or controlling interest in other companies, they were "corporations of corporations." As such they existed largely on paper, since they had no actual operating responsibilities. They allowed a small group of very rich men to own a controlling interest in nominally independent companies.

The Northern Securities Company was established during the McKinley administration, but after his assassination in 1901 Theodore Roosevelt came into the presidency and took a much more active role in combating what he and other Progressives considered trusts or monopolies. The Sherman Anti-Trust Act of 1890 had given the Federal Government the power to sue entities considered "conspiracies in restraint of trade." In other words, a corporation that so dominated a particular market could be prosecuted and broken up by court order if the government could show that its owners were "conspiring" to prevent competitors from entering the market or were using their monopoly power to charge unreasonable prices for their goods and/or services. The government's prosecution of the Northern Securities case reached the Supreme Court in 1904 and in a 5 – 4 decision, the justices agreed with the government that the Northern Securities Corporation was an illegal conspiracy as defined in the Sherman Anti-Trust Act and its dissolution was ordered. The three railroads – the Great Northern, the Northern Pacific, and the CB&Q thus returned to being separate corporations and remained so until 1969, when they were joined with the Santa Fe Railroad into today's BNSF Railroad. By 1969, of course, the railroads had lost their monopoly of freight and passenger traffic in the affected areas due to the advent of automobiles, trucks and airplanes.

Roosevelt eventually decided that breaking up large corporations made little sense. These large businesses, he believed, enjoyed "economies of scale," and served the public interest by providing goods and services more cheaply and efficiently than many smaller, competing businesses. In his campaign in 1912 seeking a come-back as president after the term of his successor Howard Taft, Roosevelt advocated a "New Nationalism" which, among other things, would have established in the government a Department of Corporations whose function would be to oversee these large economic units and to make sure they did not take advantage of their market power to squelch competition or to bilk consumers. Needless to say, this idea went nowhere. The Wilson administration which took office after the 1912 election became even more active in prosecuting anti-trust cases than Roosevelt (or Taft) had been. Wilson believed in the virtues of free market competition in which many small to medium size companies competed for customers thereby ensuring that goods and services would be delivered at the lowest price. This vision of classical free market economics hardly described the growing concentration of power in the U.S. economy at the time. Ironically, it wasn't Wilson's Department of Justice that prosecuted the Standard Oil Company as a trust under the Sherman Act, but in fact his Republican predecessor, William Howard Taft. Standard Oil lost its attempt to retain control over his local operating companies when the Supreme

Court ordered the "Trusts" dissolution in 1911. Several other trusts were broken up during the period from 1900 to 1914 – including one controlling the import and refining of sugar and another that dominated the manufacture and sales of tobacco products. Attempts by capitalists to create monopolies, something warned against by Adam Smith already in the late 1700s, remains a problem for the American economy up to the present day. History seems to indicate that the break-up of large corporate monopolies rarely has the desired effect of increasing competition and lowering prices. New companies entering the market often achieve this end more effectively than government action and the invention of new, innovative products and services often undercuts old monopolies. In areas such as transportation and telecommunications history shows that dissolution of monopolies (such as the Northern Securities or, later, the AT&T dissolution) precede eventual reconsolidation of businesses into monopolistic or, at least, oligopolistic units. The deregulation of the airlines starting in the late 1970s led to a period of rapid proliferation of small carriers followed by a slow but steady consolidation of the American air transport market into essentially four large airline systems – American, Delta, United, and Southwest. The railroads likewise have resolved into four large freight carriers – CSX, Norfolk Southern, Union Pacific, and BNSF. For many years it looked like the American automobile market would remain dominated by "the Big Three," GMC, Ford, and Chrysler, but the flood of foreign-made brands has completely upended that picture and highlights the fact that, unlike airlines and railroads, or even telecommunications, automobiles are not a "natural monopoly." Nor, of course, is the oil business.

In many instances regulation has replaced the push for dissolution of large, monopolistic corporations. The railroads long suffered under the strict regulations of the Interstate Commerce Commission which dictated freight rates and passenger fares as well as the railroads ability to abandon unprofitable services. These private corporations paid (and still pay) local taxes on thousands of miles of railroad lines while their unregulated competition enjoyed almost cost-free access to the public highways. Although highly subsidized at their inception, railroads have never had the continuing subsidy their competition receives from taxpayer provided highways or government subsidized airports and air traffic control. Although trucking companies pay road taxes and airlines pay to use airport facilities, the railroads must pay a far larger share of their revenue to maintain their tracks and pay property taxes on all of their facilities. These inequities do not explain the shift from railroads to highways and air travel, of course. The convenience of point-to-point delivery of trucks and the speed of air travel for lengthy journeys easily explains (along with the obvious savings of personal automobile transportation) why the once dominant railroads now account for so little passenger traffic and only about 40 per cent of the intercity freight transport total. These changes, rather than government regulation, are what transformed the way Americans travel and move goods.

Taxation of Corporations

The U.S. has had a federal income tax on corporations since 1909 and it was institutionalized with the ratification of the 16th amendment to the Constitution in 1913. Most states and some localities levy their own corporate or business taxes. The corporation is viewed as a "person" and, as such, subject to taxation. The percentage of federal revenue derived from corporate taxes has steadily declined over the years and as of 2019 was only 6.6 per cent, down from 9 per cent in 2010 (and a high of 30 per cent in the 1950s). Corporations, like individuals, do everything they can to lessen their tax liability, including holding much of their money overseas in lower tax countries.

Corporate Secrecy

Businessmen have always practiced discretion when discussing their operations, fearing disclosure of company business could give competitors valuable information, or would undercut plans they might have for such things as mergers or acquisitions. In fact, "insider information" has always been an essential element of business success. A large industry has grown up aiming to plumb the hidden aspects of corporate affairs in order to alert prospective investors (or the IRS) about the true state of a particular business. Dun & Bradstreet reports and the services of Moody's or Standard & Poor are essential to anyone contemplating a large investment in a company. A huge industry of business consultants seeks to provide businesses with outside – but confidential – advice on their operations and with recommendations for actions to enhance profitability. Stock brokerages and investment advisers of all sorts constantly examine business reports and market conditions to advise their clients on the risks and rewards of a possible stock purchase. Even with all of this seemingly constant examination, however, most corporate decisions are closely held and "transparency" is actually a dirty word. Corporations pay public relations and advertising firms large sums of money to provide them with an imposing façade behind which the often murky and messy operations in the executive suite take place. A corporation's relations with its creditors – bankers and bond holders – are almost like a patient's relationship with his doctor. It would be highly unethical for any of the interested parties to divulge any worrisome developments.

The investing public generally only finds out about the inner workings of a corporation when the company is undergoing some kind of crisis and "outsiders" with large holdings or disgruntled executives go public with their concerns or complaints. In some cases the corporation's board of directors may feel obliged to call for the CEO's resignation, but more frequently the board and the CEO "circle the wagons" and attempt to fight off the hostile outsiders or internal whistleblowers. All the time, both the corporate leadership and those seeking change must keep an eye on the company's stock price, which has come to represent the most essential measurement of management success (or failure).

Federal Bankruptcy Law

As noted in Lecture II, legal incorporation is usually a state-managed operation. Bankruptcy, however, is the responsibility of the federal courts. Our nation's bankruptcy laws are unique in their liberality toward the failed business and its managers. Historically, businessmen in Britain would never seek to get out from under their debts by declaring bankruptcy except as a last resort. As Adam Smith noted in his book *The Wealth of Nations*: "Bankruptcy is perhaps the greatest and most humiliating calamity which can befall an innocent man. The greater part of men, therefore, are sufficiently careful to avoid it." But this care to avoid bankruptcy did not cross the Atlantic, it seems. Writing of America during the canal and early railroad boom of the 1830s and 1840s, Sobel notes: "Foreigners were amazed at how easy is was to go bankrupt in America, and how blithely the Americans seemed to take what, for them, was the disgrace of failure." (Sobel, p. 35) America was (and still is, in many respects) the land of risky speculations with a large percentage of new businesses suffering bankruptcy within a few years of their establishment. Of course the great majority of bankruptcy cases are individuals who find themselves with far more debt than they can pay, often a result of our national penchant for easy credit.

American bankruptcy law protects corporate managers from criminal or financial penalties by turning the assets of the corporation over to a receiver once management has given up on trying to make the business solvent. Unfortunately, by the time the company declares bankruptcy, insiders will have sold off their stock holdings before they become completely worthless and may have rewarded themselves with large severance payments from what remains of the business. In one of the largest bankruptcies in recent history, in 2002 United Airlines sought court protection under Chapter 11 of the bankruptcy code, making its stock worthless and canceling its pension plan, leaving thousands of retired employees with no income and sacrificing thousands of other active employees, who lost their jobs and the prospect of retirement pensions. Delta Airlines and American Airlines, the other two major air carriers in the U.S., followed United into (and out of) bankruptcy, but have managed to maintain their pension plan obligations. Earlier, other airlines such as Pan American and Trans World, never did emerge from bankruptcy and liquidated, with their routes and some of their personnel being acquired by the surviving "Big Three." These corporate deaths or near deaths are a normal part of the airline business, which is subject to wide variations in demand and suffered from the catastrophic decline in air travel following the 9/11 terrorist attacks. Today, most American airlines remain in business largely due to enormous government subsidies as they struggle through the covid-19 pandemic.

During the 1970s a similar rash of railroad bankruptcies necessitated federal government intervention to save this vital part of the nation's infrastructure. Now, with essentially four railroad systems and four airline systems (United, Delta, American, and Southwest), the American transportation network has reached the point of oligopoly, where new entrants to the business are unable to challenge the preeminence of the existing companies. Where, in the past, J.P. Morgan or some other big financier would have headed up a consortium of bankers intent upon reorganizing an industry in order to reduce competition and increase profits, the federal government intervenes to prop up the various pillars of the corporate economy when they show signs of collapse which could endanger the entire American economic system. On a smaller scale, private equity firms have been doing much the same thing for a number of years: acquiring, merging, downsizing, and liquidating businesses which have ceased to produce viable returns but still retain assets worth preserving or selling off. Frequently the employees of these businesses pay the highest price for these corporate failures.