Government and the Economy

6

In August 1963 more than 200,000 people came to Washington, DC, and heard Dr. Martin Luther King Jr. give a speech that marked the peak of the civil rights movement and is today as memorable as Lincoln's Gettysburg Address. "I have a dream that my four little children will one day live in a nation where they will not be judged by the color of their skin but by the content of their character," King told the crowd.

By mobilizing huge marches, challenging racial discrimination in the courts, provoking mass arrests by peacefully violating discriminatory laws and practices, and lobbying Congress for policies to rectify racial inequality and poverty, the civil rights movement transformed America. During the 1960s, new laws made the denial of equal voting rights and the barring of equal access to public accommodations and employment illegal. Deliberate policies to segregate schools by race came under attack by the U.S. Justice Department. Partly in response to the civil rights movement, President Lyndon Johnson inaugurated the "War on Poverty" in 1965.

Did the new policies make a difference? During the 1960s the pay gap between African Americans and others narrowed. But it had narrowed in the 1950s, too, before the civil rights movement. And it is difficult to say how much of the improvement in the 1960s was due to new policies and how much resulted from the fact that the demand for labor was rapidly expanding during that decade (partly due to government spending on the war in Vietnam). The less well-off generally do better when the unemployment rate is very low.

In at least one area, however, the causal connection between civil rights activism and improvement of the lives of African Americans is clear. In 1964 African-American babies were twice as likely to die in infancy as were European-American babies. During the next seven years the infant mortality rate among African Americans fell by more than a quarter (from 41 to 29 deaths per 1,000 live births). During the same period, the ratio of African-American to European-American infant mortality fell by a third, having risen during the fifteen years before 1964.

The improvement in the health of black infants was especially great in the poorest parts of the South, where, prior to the civil rights movement, access to medical care had been segregated and the facilities open to blacks had been inferior. After passage of the 1964 Civil Rights Act, medical facilities were integrated, and this brought about a significant improvement in the quality of medical care for black citizens. Especially large improvements for black infants were made in reducing deaths from easily treatable causes such as diarrhea and pneumonia.

The connection between the civil rights movement and infant mortality makes it clear that government policies matter. Government can affect the way the economy works, and it is no less true that the economy has a big impact on how the government works. This chapter explores the relationship between the government and the economy.

As we have argued in previous chapters, a capitalist economy operates on the basis of a set of principles, or "rules of the game," designed to organize commodity production for profit using wage labor and privately owned capital goods. Governments, on the other hand, are organized according to different principles, a different set of rules. These rules make possible collective action. Governments—or government leaders—act on behalf of the entire population of a nation, and their actions can be enforced on all those under its jurisdiction.

The main idea of this chapter is that *government, especially democratic government, operates on different principles from those of a capitalist economy, and each shapes how the other functions.* This central idea is expressed in four key points:

1. *The* $\boxed{\textit{rules of the game}}$ *are crucial, and are of two main kinds: those that determine how the government functions* (in a democratic government, how that democracy works) *and those that determine how the economy functions. The government affects the economy; but the economy also affects the government.*
2. *A democratic government can ideally be thought of as a process in which the people collectively provide for their own welfare.* Ideally, policies are decided by all. And whether or not everyone participates in decision-making, all are equally subject to those policies, which mandate both rights and obligations backed up by the power of the government to compel compliance. This differs from interactions in the capitalist economy.
3. *Government activities (making and implementing laws, regulations, policies, and programs) have consequences for the distribution of income, wealth, and welfare.* These activities include collecting taxes from people and organizations, as well as paying them benefits or subsidies as provided by law; providing services, or contracting with firms or other organizations to provide goods or services; making many kinds of rules regarding rights, democratic processes, and other matters, and enforcing and implementing them; and managing government-owned resources like land, mineral deposits, timber and water resources, and so forth.

Level & existence of taxes shows public sphere's foundational role

4. *Capital owners and labor (or the public) each try to influence government policy to shift the distribution of income, wealth, and welfare in their favor.* Because workers are in the majority, and in a well-functioning democracy should therefore be able to defend their welfare, capital owners sometimes adopt extraordinary strategies to assert their interests. Therefore, *to ensure that the public interest is served requires an active democratic process with widespread popular participation.*

Rules of the Game: Government and the Capitalist Economy

The government of a country is in the unique position of being able to make rules and then exercise the power to compel both individuals and organizations to follow those rules. No other agent can legally force a person or organization to comply with its wishes unless the agent has already signed an agreement with that individual person or organization. This government monopoly on the use of the power of police and the courts to ensure that people comply with the law is what motivates both owners of capital on the one hand, and workers organized on behalf of their economic interests on the other, to advocate strongly for laws in their favor. Each wishes to have on its side the power of government to compel compliance with the law; neither wishes to be compelled to obey laws that appear contrary to its interest.

For example, most employers want to be able to hire or fire workers at will. But workers want protection against being fired (or not hired) because of pro-union sentiments and activity, or because of characteristics irrelevant to the qualifications needed to do the job, such as race, religion, nationality, sex, sexual preference, and so on. Rules often redistribute income and wealth by serving the interest of one class over the interest of another, or over the public interest. So proposed changes in rules are likely to be fiercely contested. A good example is changes during the nineteenth century in the way corporations could legally function.

The Emergence of Modern Legal Forms of Corporate Business

As capitalism was developing into its modern forms throughout the nineteenth century, owners of capital from time to time saw opportunities to increase their power and profit if they could succeed in changing the laws in their favor. Sometimes this meant seeking new legislation; sometimes it meant winning court decisions overturning previous rules and replacing them with rules more favorable to business ambitions; and sometimes it meant securing action by the executive branch in favor of capital owners. Any of the three main branches of government—legislative, executive, and judicial—might be involved. One such change was intended to reduce the risk of investing in a business, and thereby to encourage potential investors to put more money into business enterprises.

Initially, in the early nineteenth century, many businesses were partnerships. Putting money into a business as a partner meant taking responsibility for the business's debts, however large they might grow. So becoming a partner in a business was taking considerable risk; you could lose your shirt. An alternative to forming a partnership was to incorporate a business—that is, to establish a corporation and issue stock, with approval of the corporation's charter by the legislature. This could spread ownership of the assets of the business more widely. However, in this period buying stock in a corporation did not necessarily alter the amount of risk an investor faced. The prevailing legal philosophy was that stockholders could be held liable for at least some of the debts of a business in which they invested, beyond the value of the shares of its stock that they purchased.

To say that an investor in a corporation has **limited liability** means that the investor is not legally responsible for the debts of the corporation. The most the investor can lose if the corporation's stock value falls to zero is the money the investor paid to buy shares of stock.

Limited Liability

The key new legal concept that changed this situation in the nineteenth century was the principle of **limited liability** for investors in corporations. This idea was that those who provided investment funds to a corporation by buying shares of stock in it (and so becoming stockholders) would thereby risk only the dollar amount of value of the stock, but would not incur any legal responsibility beyond that if, for example, the business failed. If the corporation went bankrupt, the value of the shares of stock would typically fall to zero, so stockholders would lose the money they had invested; but they would lose nothing else, and in particular could not be made to help pay the debts of the corporation.

In the early nineteenth century the principle of limited liability was not yet widely accepted in the law. However, by about 1860 in the United States, laws were on the books in most states establishing that corporate stockholders did enjoy limited liability. This naturally made it easier to convince potential investors to invest in a corporation chartered in one of these states, and so attracted new funds to the corporation that it could use for investment. This helped capitalism to flourish in the last half of the nineteenth century. In the United States, over a century later, limited liability was extended by law even to partnerships that were not corporations, in the form of the "limited liability company" or LLC, which is now quite widely used.

The main point of this story is twofold. First, government has the power to alter the conditions under which businesses operate—including the degree of risk faced by those who get involved in business enterprises. This is a strong incentive for capital owners to press, in all branches of government, for laws and regulations favorable to their activities. Second, historically, once capital owners envisioned new ways to increase their profits and power that required only a change in laws or regulations (the rules of the game), they did persistently press to get such changes. In other words, the development of the capitalist economy itself, opening up new possibilities for profit, inspired capital owners to press for changes in laws, regulations, and court interpretations of the laws.

Corporate Personhood

The next major change was to define a corporation as a legal person. After the Civil War the Fourteenth Amendment, ratified in 1868, said:

> Section 1. All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; **nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.** (http://www.archives.gov/exhibits/charters/constitution_amendments_11-27.html; emphasis added)

For two decades from about 1868 to 1886, lawyers for corporations sought to get the courts to agree that a corporation was a *legal person*, and therefore entitled to share equally in these already established legal rights of *natural persons* (human beings). These included, for example, the right for a corporation to buy stock in another corporation (something only human beings were permitted to do up to that point), the right to privacy, and the right to equal protection under the law (that is, equal with the protections accorded to human beings). Their arguments relied in part on the fact that corporations had already been frequently described as "artificial" persons in legal contexts. They tried to argue that corporations were entitled to the protections accorded to all other persons, namely human beings. But the courts repeatedly rejected such arguments, so that for two decades no court decision recognized corporations as legal persons.

Then a sequence of events took place which Thom Hartmann recounts in his book *Unequal Protection* (2004): The idea that a corporation was indeed a legal person appeared in the unofficial notes accompanying the Supreme Court's 1886 judicial decision in *Santa Clara County v. Southern Pacific Railroad Company*, even though the official decision did not give the idea of legal personhood of corporations any credence. From there this unofficial language somehow leaked into legal doctrine and began to be treated as a precedent, and the principle was then established in official Supreme Court decisions in the following years. (Hartmann discusses whether the unofficial notes in the 1886 decision were a simple clerical error, or may possibly have been intentional.) By 1889 the Supreme Court had officially ruled that a corporation is a legal person entitled to due process of law and to equal protection under the law. Corporations then quickly took advantage of their newly acquired legal status to secure legal decisions that (1) struck down prohibitions against corporate political campaign donations and lobbying, relying on the legal right of "persons" to free speech; (2) struck down laws requiring a corporation to open its books as a condition of getting a legislative charter, on the grounds that a "person" has a right to privacy; and, (3) using the idea that "persons" were protected against discrimination, successfully overturned a law in Florida that charged a lower business license fee to small businesses than to chain stores.[1]

From Competition to Monopoly

One impact of this change in the rules was on the ability of businesses to form monopolies, or at least large firms that combined many of the firms previously competing within an industry; such a move typically allowed the combined entity to charge higher prices and reap higher profits. However, until the late 1880s definition of a corporation as a legal person, the best available procedure for doing this was cumbersome. To be sure, an individual human being could own several businesses, or buy controlling shares of stock in several businesses. But almost the only way in which businesses as such could join together was the one initiated by oil magnate John D. Rockefeller in the form of the first *trust*, the Standard Oil Trust, in 1882. The way it worked was that corporations that wanted to join the trust would sell their stock to a board of trustees that headed the trust, and would receive in exchange an equal value of certificates in the trust itself, along with rights to receive any dividend payments that the trust might decide to pay out of the profits it earned. In that way all the businesses participating in the trust were dependent on it, and it was the board that ran the trust. In all forty-one firms were part of the Standard Oil Trust, under a board of trustees of nine, including Rockefeller. The oil trust consolidated, and in a sense legitimized, the immense power that to some degree Rockefeller had already concentrated in his hands. Now one enterprise could smooth out the boom-and-bust cycles in oil prices and profits, making production in some sense more efficient—but at the same time extraordinarily profitable. Monopoly took the risk out of the oil

[1]Thom Hartmann, *Unequal Protection* (Rodale, 2004), 120–21; Chs. 6–7 of the book are the source for much of this account of changes in nineteenth century legal principles regarding the evolution of the forms and status of corporations.

business by replacing *competition* with *command*. This benefited owners of capital in the oil industry, but hurt both the public and other industries that bought oil as an input into their own production.

Up until 1886 or a little later, another option for combining the efforts of two corporations was for corporation A to become a holding company, owning corporation B, by buying B's stock. The snag was that at that time only natural persons—human beings—were permitted by law to buy stock. True, a state legislature could in principle make an individual exception and pass a bill expressly approving the holding company arrangement; but public sentiment was running strongly against monopolies, and this was generally not a viable option.

Some states responded by passing laws against the formation of trusts ("antitrust laws"). Trusts, which to the public (and to small companies not included in the trusts) meant monopolies with far too much power, also provoked a response at the federal level, and the Sherman Anti-Trust Act was passed in 1890. By 1892, successful legal action by the state of Ohio forced the Standard Oil Trust to dissolve. But Standard Oil of New Jersey (SONJ) was by then able to become a holding company, and after 1899, when state law was changed to allow a corporation to buy stock in a corporation established in a different state, SONJ expanded its holdings, moving in the direction of the kind of sprawling corporate structure we know today. A few years later, though, a federal antitrust case was brought against Standard Oil, leading to a 1911 court decision breaking it up. At this stage in history, some combination of the public interest, the interests of smaller competitors not included in the monopoly, and the interests of businesses that were buyers of oil, prevailed.

From National to Transnational

A **transnational corporation** (TNC), or multinational corporation (MNC), is a firm earning profits on its global operations by locating its corporate entities, called **affiliates**, in multiple countries, in whatever combination of sites yields the highest profit for the global corporate structure as a whole, based on the wages, materials costs, markets, government policies, taxes and subsidies, and local markets for relevant outputs that exist in various locations.

The legalization of holding companies also had an enormous long-term impact in allowing the growth of transnational corporations. A transnational corporation is one whose corporate structure includes entities, or affiliates, in multiple countries. The global management maximizes overall profits by deciding where to locate its activities based on wages, materials costs, markets, government policies, taxes and subsidies, and local markets for relevant outputs.

A transnational corporation typically consists of a headquarters firm (for example, in the United States) that owns a portion, often a majority, of the stock of each of various **affiliates** (also corporations) in other countries. Although corporations were already creating holding companies by the turn of the twentieth century, it took some time for the full possibilities of transnational corporations to be realized. This was in part because even the basic technology of international communications was still in its infancy; telegrams could be sent across the ocean via cables laid in the nineteenth century, but trans-oceanic cables for telephone communications were first laid in the 1950s. Only well after World War II did the majority of large capitalist enterprises in the United States become transnational.

So it was that the early nineteenth century principle that corporations should only be granted existence if they served the public interest became gradually transformed into the principle that corporations had their own independent rights, with little or no general obligation to take account of the public interest, as long as they did not explicitly violate the law. And if corporate activity conflicted with the law, in some cases it was eventually not the corporations, but the law itself, that ended up changing. As we will see in Chapter 7 as well as Chapter 19, the role of corporations in the economy continued to shift.

An **affiliate** is a corporate entity in which the parent corporation holds enough shares to give it control, which usually means it holds more than 50 percent of the affiliate's voting stock (some shares of stock carry with them the right to vote on company policies; others do not).

As recently as the 1980s, when some corporate executives violated laws during the savings and loan debacle (discussed later in this chapter), many of them ended up serving prison time for fraud and other crimes. In contrast, in the last decade, following the subprime crisis and Great Recession, even when corporations had violated the law, they paid fines often in the billions of dollars, but the executives who carried out or oversaw the illegal activity generally did not suffer penalties. This is due not mainly to changes in the law, but to changes in the ways in which the laws were and are enforced (which is also part of the rules of the game).

History thus confirms that rules and rule changes matter. Rules that allowed a capitalist to attract investment made a big difference in how fast a corporation could grow. Later rules that evolved from corporate personhood to make holding companies legal allowed controlling a large linked group of enterprises through a legal ownership network, and this magnified what one entrepreneur, or a group of entrepreneurs, could do. The world was thereby transformed—and the sheer size of such firms increased the challenge for democratic institutions to regulate such firms in the public interest.

Democratic Government as Collective Provision for the General Welfare

At its best, democratic government can be thought of as a process by which the people collectively provide for their own welfare. Ideally, rules and policies are deliberated and decided by all, and all are equally subject to those rules and policies, which define general rights and obligations, as well as rights and obligations within specific government programs like Social Security and Medicare. The two aspects of this democratic process, namely, the *collective* nature of the decisions and the *compulsory* nature of compliance with those decisions, are both necessary for the whole positive result: that the people together indeed, as the preamble to the U.S. Constitution says, "promote the general welfare, and secure the blessings of liberty" to this generation and the next.

Interactions involving government differ in this respect from interactions in the capitalist economy. In a capitalist economy, at least in theory, interactions are meant to be voluntary exchanges. A person or firm makes a decision to buy or not to buy, to sell or not to sell, at a particular price. An employer decides whether or not to hire a job applicant, and an applicant decides whether or not to accept a job offer. Nothing about this is compulsory within the bounds of the capitalist economy, although there are usually clear differences in how much power each participant in the exchange has—a topic to be discussed at length in Chapter 12.

But property, contracts, torts are legally enforced

The fact that in and of themselves, exchanges in a capitalist economy are voluntary creates a need and a role for government, to bring into play both the public interest, and the interest of all business enterprises taken together. Even advocates of small government tend to agree that government should protect property rights by preventing and penalizing theft. Most people would agree that fraud should also be illegal and should be prosecuted. This is because, under capitalism, nothing prevents sellers from overstating the value of what they offer for sale, or failing to tell the whole truth about the qualities of an item or a service for sale. Nothing, that is, except the danger that the seller will gain a bad reputation, and lose future sales—a possibility that was perhaps a greater danger in small pre-capitalist communities than in the big cities of today. Moreover, the majority of business enterprises may well have an interest in preventing fraud, for two reasons. One is that households are more likely to spend money freely if they feel sure that any defective product or service will be made good—replaced, or the purchase price refunded. The second is that businesses themselves may sometimes be misled or defrauded by suppliers, and they, too, want the assurance that they will be compensated for flaws in products or services they buy.

Similarly, in the absence of government rules against discrimination on the basis of race, sex, or other characteristics of the applicant, firms are free to hire whomever they please. In a capitalist economy, in a certain sense everyone is on his or her own. What democratic government potentially brings to this scenario is greater fairness and equality, and lower risk of personal or business disaster, than would be produced by the capitalist economy in the absence of government.

Government also is a vehicle for promoting the general welfare. As early as the late nineteenth century in some European countries, notably Germany, governments initiated old-age pensions and some forms of publicly supported health care. Before the United States legislated Social Security in 1935, pension programs had already existed in many European countries for decades. Similarly, collective provision for health care is now very widespread among countries at the U.S. level of average income and even far below—because it reduces the cost of medical care to everyone by largely eliminating costly paperwork; the population pays taxes, and the government simply provides health care free, or largely free, to patients. The United States stands almost alone among countries at its income level in lacking universal health care.

Universal pension and health programs, except for their enormous size, bear a strong resemblance to ways in which people have gathered together locally in developing countries to provide for their own welfare. Everyone in a local mutual assistance group, for example, regularly contributes a small fixed sum of money weekly, and when someone needs the money for an emergency (injury, illness, funeral, or other need), that person is allocated some of the money by the group. Some labor unions also originated in such mutual aid societies. The advantage of such arrangements is that, by spreading the risk, it greatly eases the worries of those who otherwise would have nobody to rely on but themselves. Insurance is less risky when the risk is pooled among a large number of people. A considerable share of the growth of government among the highest-income countries is accounted for by growth in programs that "promote the general welfare" through supporting the elderly—who are now more numerous relative to the nonelderly population, because advances in medicine and public health allow people to live longer. Of course, other major expenditures by governments, including programs that "provide for the common defense" (another quote from the Preamble to the U.S. Constitution), are also a significant factor in government spending, a topic that will be taken up in Chapter 19.

Government and the Distribution of Income, Wealth, and Welfare in the Nineteenth Century

Every American high school student knows the 1800s as the era of building canals and railroads. And the 1860s and early 1870s brought the transcontinental railroads that unleashed economic growth by connecting distant reaches of the country with one another. Now agricultural implement factories could send their products nationwide; in this period, farming using animal-drawn plows became widespread. In turn, the expanded markets for agricultural equipment stimulated further innovations that drove productivity increases such as those shown in Figure 1.1 for 1830–1890.

Railroads etc. were private corp.

Government played an enormous role in the building of both canals and railroads.[2] In the first half of the nineteenth century, state and local governments donated much land, and also invested funds, first in canal construction and then in local and regional railroads. An estimated 70 percent of the money that went into funding canals came from public sources, while up to 1861 about 25 to 30 percent of the entire investment in building railroads also came from public funds. Mostly the source was state and local governments in places where businesses expected to benefit from new transport facilities. State and local governments also gave about 300 million acres of land to railroads.

Although available data show federal government revenue and spending at the end of the nineteenth century at around 3 percent of GDP or less (although in the Civil War it is estimated to have risen to around 7 percent), the federal government gained control of vast tracts of land in areas where railroads were projected to be built. It did this in part through negotiated treaties with Plains Indian peoples (until 1871, when Congress forbade future treaties)—and despite the Indians' view that the land belonged to no one. The tens of millions of bison who were central to Plains Indians' way of life were decimated in a few decades by the railroads and settlement of the West, while the Indians resisted, but were defeated.

Until 1862 the federal government's contribution was mainly to give relatively small amounts of land to the states, which the states often granted to railroad-building companies as part of a package of subsidies linked to the obligation to actually complete the rail lines. In the 1860s, federal government subsidies came to the fore with ambitious plans for a transcontinental railroad. Congress judged that a massive multi-state project requiring building rail lines through remote areas and over mountain ranges was too risky to attract sufficient private capital. So beginning in 1862 it gave the railroad companies hefty financial subsidies, plus 10 square miles of land for every mile of track that a railroad building company committed to construct, in exchange for a legal commitment to finish the project within a specified time period. Some builders failed to meet their commitments, and about one-sixth of the 175 million acres that the federal government granted to the railroad companies in this period was forfeited back to the government as a result. Still, the majority of the railroads were built as planned.

Railroad Financing: Public and Private Gains

What lessons can we learn from this episode about the relationship of the government to the economy? First, some kinds of government intervention can benefit both private business and the public. If government subsidies to railroads had appeared to be simply gifts to private business, benefiting the railroads but not the public, they would likely have garnered less legislative support. Railroads allowed small towns with new access to a transport network to flourish, and allowed new inventions (like agricultural implements) to spread quickly to all parts of the country, thus rewarding

[2]Much of the following discussion is based on the detailed account in Carter Goodrich, *Government Promotion of American Canals and Railroads 1800–1890* (Westport, CT: Greenwood Press, 1960).

innovation. Private business unquestionably benefited, but there were also benefits to the public. Economic growth cheapened consumer goods, both directly by reducing the cost of transporting them, and indirectly by making available better tools to produce them. This stimulated production and employment.

Of course, in assessing the overall benefit to the general public, we need to take into account not only the benefits the public received, but also the costs the public indirectly paid when governments, supported by taxpayers, gave land and loans to the railroad companies. If loans were repaid, or the government purchased railroad stock that later paid dividends over and above the cost of buying the stock, then the government's decisions did not entail a loss to the public. In fact, though, where state and local governments subsidized railroads by buying shares of railroad enterprises, they more often than not ended up breaking even or losing money. The federal government also was not a big winner, and quite possibly not a winner at all, given that the valuable land it donated multiplied in value due to the building of the railroads, and the proceeds mainly went to railroad stockholders and owners rather than being returned to the public coffers.

At the same time, many of those who ran railroad companies—and in some cases did so without putting in much of their own money—became stupendously rich, and public subsidies certainly helped them do this (especially in this era before income taxation). Those who made a considerable part of their fortune from railroads included Leland Stanford, who founded Stanford University, and Cornelius Vanderbilt, who founded Vanderbilt University. Vanderbilt is said to have been the second wealthiest man in history after John D. Rockefeller, with Vanderbilt's fortune at his death variously estimated at $140 to $200 billion in today's dollars, more than the wealth of the richest person in the world today. And there were many more.

The second lesson, then, is that while government spending can create public benefits, it can also have effects—sometimes small, sometimes large—on the distribution of income, wealth, and welfare. Extreme inequality of wealth and income arose in the last half of the nineteenth century (The Gilded Age). It was driven in part by extraordinary government generosity to private railroad companies, in part by the absence of income and inheritance taxes, and in part by lobbying and bribes that persuaded legislators to act in the interests of owners of capital. This polarization of income and wealth had far-reaching effects on the future development of capitalism.

The third lesson is that, in light of the lucrative gains to be made from business enterprises when laws, policies, and programs are designed in favor of business, owners of capital have a powerful incentive to spend funds to shape legislative, judicial, and executive decisions in their favor. Stories of bribery and business influence on politics in the era of railroad-building are rife, including at the state and local levels. But none is more spectacular than the story of the Union Pacific Railroad, which oversaw the building of the eastern portion of the transcontinental railroad in the 1860s.

While the details can be read in other sources, in brief the story is this: The directors of Union Pacific set up a firm called Credit Mobilier of America to carry out the construction of the railroad and to finance itself through issuing stock. The Union Pacific directors completely controlled Credit Mobilier, but led everyone to believe that it was an entirely independent entity with which Union Pacific had an arm's-length contractual relationship. The two enterprises got both loans and land grants from Congress, together amounting to over $100 million in value. Yet the entire cost of construction was just over half that amount, so that the profit made on the whole project amounted to $44 million in dollars of that time (about $60 *billion* in today's dollars). A news exposé in 1872, followed by an investigation, revealed that in 1867 a congressman whom Credit Mobilier had made its head distributed shares of Credit Mobilier stock to various other members of Congress at below its then-current market price, in exchange for their votes favoring the company's fortunes. Ultimately as many as thirty members of Congress were found to have received shares of stock, which ended up paying lavish dividends. Yet much of what Union Pacific directors did was technically legal, and virtually no one received a penalty: some congressmen were censured, but apparently no one was jailed.

In this instance, what owners of capital sought to influence was government decisions about a specific project, rather than permanent rules about government or the economy. Yet these government decisions, which we include here as changes in the rule of the game, sharply altered the distribution of income and helped lead into a stage of capitalism in which large corporations and large fortunes held sway.

Other Rules: Winners and Losers

Though the land grants and generous loans to railroads are a particularly striking example, in fact nearly everything the government does has some kind of distributional effect: someone gains or someone loses, or both. Laws and programs may specifically increase the profits of some business sector, or may specifically help workers or poor people. Even those designed to benefit the general population (such as legislation in favor of clean air, or in favor of safety in trucking) may benefit some more than others, and impose costs on some but not others.

For example, capital owners or the wealthy (two groups that overlap considerably) typically gain disproportionately when the government reduces or eliminates inheritance taxes (estate taxes), because inheritance taxes are typically imposed only on large estates. The wealthy also tend to be the ones who gain when government reduces personal income taxes on high incomes, and when the government lowers capital gains taxes (taxes on gains from buying assets cheap and selling them dear), because the incomes of the rich consist to a much greater extent of gains from trading assets than is true for those with lower incomes. All these types of changes have been implemented in the United States in recent decades, a topic that will be explored further in Chapter 19.

On the other hand, workers benefit from a higher minimum wage, as well as from low interest rates on credit cards, home mortgage loans, and other lending. They also benefit from strong labor rights, including overtime pay for long workdays or work weeks, generous maternity and parental leave policies, holiday pay, sick pay, and employer health benefits (at least in the United States, one of the only high-income countries that does not provide health care to the whole population with low or zero fees). There have been some gains for workers in recent decades, but at the same time many losses. The purchasing power of the minimum wage has fallen since the 1970s (see Chapter 7), and many kinds of labor rights have been rolled back, or remain far more limited than in European countries with similar levels of income.

In fact, it is striking that, although workers, not owners of capital, are the large majority of the population, nevertheless the rule changes during about the last four decades have tended to be more in favor of capital owners and the wealthy than in favor of the bottom 90 percent of income earners. Taxes fall less heavily on the rich than in the past; real hourly wages stopped growing in the 1970s in the United States. We have seen in previous chapters that inequality of wealth has been growing. This is in part because government has changed its rules and practices in such a way as to shift income, wealth, and welfare toward the "haves" and away from the "have-nots," as well as toward corporations and away from labor. But is it inevitable that "them that has, gets"? Of course not; it depends on how strong a democratic movement the majority are able to mobilize. When capital owners want to shift the rules governing the economy in their own favor, part of their strategy is typically also to shift the rules that govern the democratic process in their favor. Therefore, to avoid a continuing shift in the rules of the game in favor of rich and the owners of capital, and against the interest of the rest, requires an active democratic process and a vigilant public.

Consider an example that touches on both rules that benefit capital owners and rules that benefit the rest of the population. In the United States in 2003, Congress passed a new feature of Medicare (the program that provides subsidized medical care mainly for those sixty-five and over): Medicare, Part D, an insurance program for purchases of pharmaceutical products. The plan then went into effect in 2006. A startling provision of the bill was that it prohibited the federal government from negotiating with drug companies for discounted prices, although in the past it had been customary (and sensible) for bulk purchasers to expect to bargain successfully for price discounts. It was startling because tying the federal government's hands and forbidding bargaining for lower prices was clearly not in the taxpayers' interest; instead, it was a gift to the pharmaceutical companies. In late 2004 a *New York Times* editorial[3] publicized the fact that the congressman whom it identified as the "chief architect" of the bill had taken a position as the principal lobbyist for the pharmaceutical industry. Such a move was legal for a member of Congress as long as the mover did not lobby congressional colleagues for a period of one year; even so, he was still permitted to socialize with members of Congress and to make campaign donations. But why does the rule only prescribe a one-year moratorium on lobbying for such a person, and not, for example, five years? Where there are those who seek to influence, there are also those willing to be influenced, for a reward. But the rules of democratic government could and should be structured to guard against such influence. Making sure that happens is the job of a vigilant public actively involved in democratic decision-making.

Contention Between Capital and Labor over Rules

Because the rules are so important, as the story of the legal emergence of corporate capitalism shows, capitalist enterprises (and sometimes their industry associations) often strategize to change the rules in their favor over a period of years or decades. They may either seek to change the rules governing the economy, or to change the rules governing the workings of democracy. Changing the rules of democracy may be indirect, but in the long run may reap more gains for owners of capital.

There are numerous recent examples. One is changes in the rules about campaign financing. If campaigns are publicly financed, as some advocate, there is less opportunity for the wealthy to control the democratic process. If campaign

[3]"The Drug Lobby Scores Again," *New York Times*, editorial, December 17, 2004. http://www.nytimes.com/2004/12/17/opinion/the-drug-lobby-scores-again.html?_r=0

ads, even issue-oriented ads, are outlawed unless publicly financed, then this limits the weight of wealth in democracy further. But the 2010 Supreme Court ruling in the case *Citizens United v. Federal Election Commission*, a 5–4 decision, overturned certain campaign finance rules passed by Congress in 2002, and allowed independent nonprofit corporations to have an enormous impact on election campaigns, particularly through television advertising. The decision now also applies to for-profit corporations, associations, and labor unions. It paved the way for a manyfold multiplication of the role of the wealthy in political campaigns, with dramatic results.

Problematize the claim that Citizens United also allows unions to finance such ads

Another example is efforts at the state level to redraw legislative districts to favor one party. If one party manages to get control of a legislature and redraw congressional districts, it can in principle semi-permanently alter the political landscape. As a hypothetical example, imagine a state with ten congressional districts and a population of 5 million voting age citizens, of whom 3 million (or 60 percent) are registered in the Green Party, and 2 million (or 40 percent) are registered in the Purple Party. In such a state, if the Purples temporarily get a legislative majority (perhaps due to low voter turnout in an off-year election), they might well prefer to redraw districts, putting half the Greens (1.5 million of them) into three districts of half a million Greens each, in each of which they would be 100 percent of the voters. They would then distribute the other 1.5 million Greens evenly over the remaining eight districts, where with about 214,000 voters per district (= 1,500,000/8) they would make up 43 percent of the 500,000 voters in each district. All 2 million Purples would be distributed evenly over those seven districts, so that with about 286,000 voters in each district (= 2,000,000/7) they would form 57 percent of the 500,000 voters in each district. (Of course this redistribution would happen through redrawing the district boundaries rather than by actually moving people physically from one district to another.) The three 100 percent Green districts would, of course, elect Greens. But the remaining seven districts would usually elect Purples. In this way a minority party with 40 percent of registered voters could win 70 percent of the seats in Congress (seven out of ten districts). If they did this in enough states, they might not only have enough seats to pass whatever legislation they wanted in Congress, but also have a two-thirds majority sufficient to override any presidential vetoes. Of course, legislative redistricting can only be done every decade or so, and can be challenged as unfair in the courts, sometimes with success, so it is not a sure thing. But it is clearly in use at present as one of a number of tools by which a minority party can gain long-term control of a legislature. The point, once again, is that the rules matter. A method of voting that ruled out such schemes would be more likely to preserve democracy than one vulnerable to them. Such concerted efforts, especially if well funded, have a good chance of succeeding, in part because the general population may not be aware of contention over the rules, as these efforts are often carried out away from the public eye.

Implications for economy!

Of course, workers and their organizations also can, and sometimes do, seek favorable legislation, and there have been numerous examples. One was the Fair Labor Standards Act of 1938 that limited work hours and mandated additional pay for hours worked above the standard work day or week. Still another was the Occupational Safety and Health Act of 1974, which established standards and inspection procedures to try to assure worker health and safety on the job. A highly organized and well-informed populace, relentlessly advocating for a fair set of rules that fosters democracy, can win rules that favor both democratic government and a fair economy. But it is always a struggle.

Voter Turnout in the United States and Around the World

A key problem for the democratic process, and therefore for the welfare of the large majority of the population, has been the fact that, particularly in the United States, many citizens who have the right to vote have not been exercising this right. Figure 6.1 shows that in the United States the share of eligible voting-age citizens actually voting in presidential elections fell from an average of 78 percent from 1872 to 1896 to an average of just 58 percent from 1900 to the present. For example, in the 1872 presidential election, 77 percent voted. In the 1896 election, when the agrarian populist William Jennings Bryan challenged the eastern establishment, 80 percent voted (Bryan lost). As for midterm elections, voter turnouts were typically lower than in presidential elections, but also fell from an average of 65 percent in 1870–1898 to an average of 43 percent during 1900–2014.

Voter turnout fell sharply in the twentieth century. One cause was that southern states imposed poll taxes and absurdly difficult "literacy tests," to prevent African Americans from voting. In the 1920 and 1924 presidential elections, a low of 49 percent voted. Even in the 1936 election, seen as a referendum on FDR's New Deal, only 61 percent of eligible voters cast ballots (FDR won by a landslide). In the 1980 election, when the conservative counterattack against New Deal policies came to fruition, only 54 percent of those eligible voted for Ronald Reagan or Jimmy Carter. In 1996 and 2000, barely half of those eligible to vote went to the polls; so in 2000 George W. Bush won with the votes of less than 26 percent of the voting-age population.

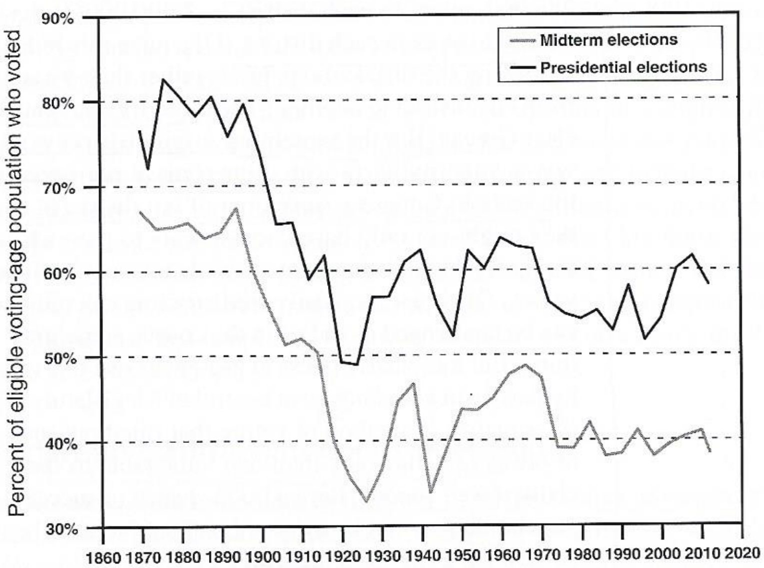

FIGURE 6.1 The American voter: An endangered species?

The data are for the percentage of all eligible voters who actually voted. Note that these figures may be inconsistent with other reported voter turnout data because of differing definitions of voters (did they cast a ballot at all? or: did they cast a vote for president?) and of the group of which they are a share (the whole voting age population? only voting age citizens? or only those voting age citizens who have registered to vote?).

Sources: Michael P. McDonald, "National General Election VEP Turnout Rates, 1789–Present," United States Elections Project. Accessed June 24, 2017, available at http://www.electproject.org/national-1789-present.

Many other countries have higher—in many cases consistently higher—average voter turnouts, however. As Figure 6.2 shows, during 2002–2014 nations as different as Bolivia, Costa Rica, Iceland, and South Africa had higher voter participation rates than the United States. About a dozen countries both make voting compulsory and enforce that law, usually with exceptions such as for elderly persons. Of the countries shown in the figure, Argentina and Australia have, and enforce, compulsory voting.

Of course, low voter turnout in the United States is not evenly distributed among citizens. As Figure 6.3 shows, the lower the family income, the less likely it is that a citizen of voting age in that family actually went to the polls in November 2012; and this pattern has been true for decades. In families with incomes above $100,000, 77 percent of their members who were citizens of voting age reported voting in the 2000 presidential election; but among the poorest of the poor (families with incomes below $10,000), only 47 percent of eligible citizens actually voted. The inset chart within Figure 6.3 shows that participation in the 2012 presidential election was higher for employed persons than for the unemployed, and higher for whites and blacks than for Hispanics or Asians.

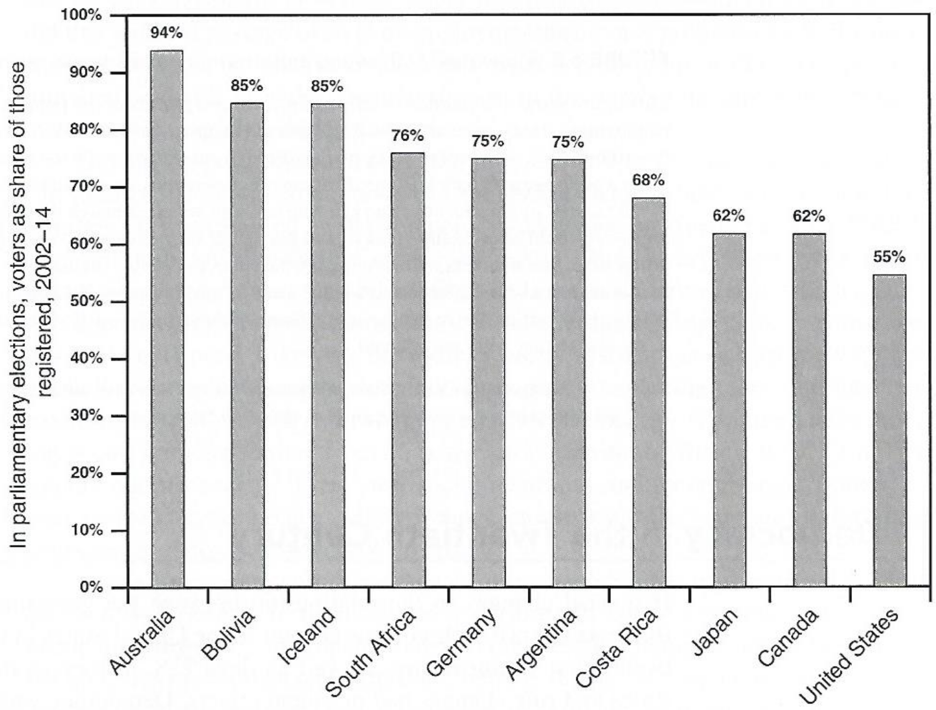

FIGURE 6.2 Voter turnouts around the world.

For selected countries, voter turnouts for parliamentary elections are averaged over 2002–2014, including all parliamentary elections, whether or not they coincided with election of a president or other chief executive. Voters are counted as a percent of all those registered to vote. Both Argentina and Australia have compulsory voting laws, and enforce them; the other countries shown do not.

Source: Data from International Institute for Democracy and Electoral Assistance, "Voter Turnout," available at http://www.idea.int/data-tools/data/voter-turnout.

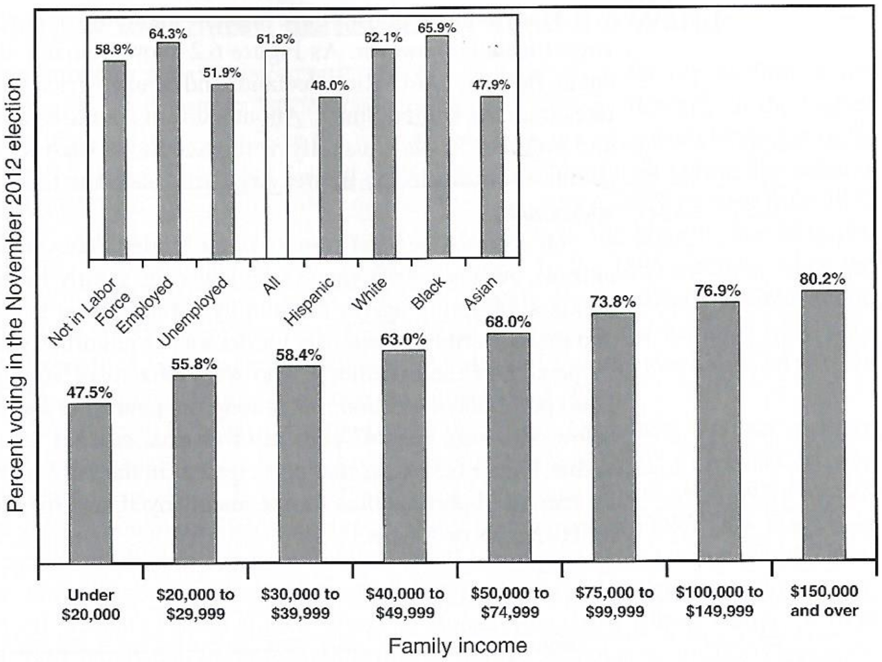

FIGURE 6.3 Who votes? U.S. voting patterns in the presidential election of 2012.

This figure shows the fraction of citizens in various segments of the population, by family income, employment status, race, and ethnicity, reported to have voted in the U.S. presidential election of November 2012. Voter turnout can be measured in various ways: by the number voting as a percent of the voting age population (some of whom are noncitizens, or not registered to vote), or as a percent of the number of citizens of voting age who actually voted (although those citizens who have not registered could not actually vote), or as a percent of the number who are registered to vote (a smaller group still). The numbers in this figure are based on the second method: for each category, the number in that category who self-reported having voted in the November 2012 election, divided by the number of citizens of voting age in that category. Some of those surveyed did not answer the question either yes or no, and so they were not counted.

Source: U.S. Bureau of the Census, Current Population Survey, November 2012 and November 2014, Tables 4b, 6, and 7; available at https://www.census.gov/data/tables/2012/demo/voting-and-registration/p20-568.html

Democracy in the Twentieth Century

Historical changes in the relationship between the government and the economy illustrate the principles of this chapter in the United States in the twentieth and early twenty-first centuries just as well as does U.S. history of the nineteenth century. Rules and rule changes had profound effects. Democracy was used as a way collectively to promote the general welfare. Changes in the rules affected the distribution of income, wealth, and welfare among people and between the owners of capital and workers. And contention over the rules often fell along class lines, with the large majority, the workers, having to use the democratic process actively just to defend their incomes and welfare against proposals to reduce them. As income and wealth inequality grew from about the 1970s on, the contention over the rules of the game also grew, and the rules changed in ways that predominantly disadvantaged workers and advantaged the owners of capital.

The Great Depression of the 1930s was a personal disaster for many. With a quarter of the workforce unemployed at the height of the Depression, many families were reduced to poverty. The banking crisis of 1933 pushed the economy deeper into depression, and led almost at once to new regulations prohibiting commercial banks (those that took deposits from the public and made loans to the public) from engaging in the risky business of trading in securities. Likewise, the desperation of poverty generated both social unrest and widespread support for new laws that protected the rights, wages, and working conditions of wage workers, along with new social programs like Social Security that provided old-age pensions. These new rules reflected the sentiment that if people became unemployed and poor because of economic forces larger than themselves which they were largely powerless to reverse, then the government should take care of them and help them get back on their feet. The idea of using democracy to provide for the general welfare through the minimum wage, social security, workers' compensation (insuring workers against on-the-job injuries) and job-creating programs like the Civilian Conservation Corps was key to helping people survive the Depression. Such programs were also important in helping people through the recent Great Recession.

And just as businesses in the nineteenth century were able to secure the principle of limited liability for corporate stockholders to reduce the risks they faced, so too, for workers, did the New Deal reduce the risks associated with unemployment. It did this with the passage of state unemployment insurance programs by half a dozen states, and then a national unemployment insurance program in 1935. The program provided, and still provides, income support in the form of unemployment benefits to persons who qualify under state rules.

To help support child nutrition, the program Aid to Families with Dependent Children (AFDC) was also created in the 1930s, helping both children and their families. (It was replaced by the Temporary Assistance for Needy Families (TANF) program in the mid-1990s.) To reduce the risk of losses to depositors when a bank failed, a new law created the Federal Deposit Insurance Corporation, which insured that deposits up to a specified amount would be replaced if the bank in which they were held collapsed. Likewise, the social security system was created in 1935, with workers and employers paying into it during a person's working years, entitling them to draw a monthly check after they retired. Social Security is credited with reducing poverty among seniors from 45 percent to 9 percent by lifting about 13 million seniors out of poverty.[4] These new social insurance and income support programs were created between one and four decades later than similar programs in European countries at comparable levels of income.

Just as nineteenth century events were used to explain the principles of this chapter, so too can events in recent decades illustrate the same concepts. In the 1980s, under the presidency of Ronald Reagan (1981–1989), Congress deregulated a particular category of financial institutions, namely savings and loan institutions (S&Ls, or "thrift" institutions). These alternatives to ordinary commercial banks existed mainly to collect people's savings, put them into savings deposits that paid a reasonable interest rate, and lend the money out for home mortgages and other purposes.

Other features of the financial sector were deregulated as well. Regulation Q, which had limited the interest rates that banks and S&Ls could pay on various kinds

[4]Paul N. van de Vater and Arloc Sherman, "Social Security Lifts 13 Million Elderly Americans out of Poverty," Center on Budget and Policy Priorities, August 11, 2010, available at http://www.cbpp.org/research/social-security-keeps-20-million-americans-out-of-poverty?fa=view&id=3260.

of deposits, was lifted on S&Ls, and interest rates were allowed to rise. This and other changes in laws and regulations had an enormous impact. Within a very few years many S&Ls went bankrupt, and government regulators then discovered that widespread fraud was a central causal factor. Although many thousands of those who ran the thrifts were investigated, and around a thousand of them were prosecuted, convicted, and sentenced, some also accumulated considerable wealth.

Reagan also led the way in getting Congress to reduce the top income tax rate on the highest incomes from 70 percent to 28 percent over the course of his administration (later the 28 percent rate was raised again, but only slightly). This and other measures—along with the deep 1982–1983 recession, with over 10 percent unemployment at its peak—contributed to a worsening of inequality of both income and wealth. The rich began getting much richer, while the incomes of the rest stopped growing.

The government continued to deregulate the financial sector in the 1990s, culminating in 1999 with the repeal of the main Depression-era law, the Glass-Steagall Act, that had separated commercial from investment banking and thus insulated the public from the risky activities in which investment banks often engaged. (Investment banks manage the sale of new stock issues for corporations, as well as the sale of various kinds of securities such as corporate bonds.) Chapter 18, on crises and the 2007–2009 Great Recession in particular, will explain in detail the implications of this major change in the rules of the game. Changes in regulations, along with dangerous innovations in unregulated financial markets, also contributed to swelling financial sector profits to over one-third of all reported profits in the U.S. economy. Briefly, along with other developments such as the increasing creation of new kinds of financial assets, and the refusal to regulate them, all these changes ended with house prices rising to levels that were far too high, causing a bone-jarring crash in the prices of both houses and financial assets, and triggering a steep economic downturn from which the majority of the population suffered far more than the wealthy.

From 1980 on, further changes in rules made inequality still worse. Estate taxes (inheritance taxes) had in the past reduced inequality. The estate tax has been gradually reduced: in 2001, estates of over $675,000 were subject to estate taxes at a rate of about 50 percent, while in 2015 only estates of over $5 million were subject to estate taxes of 40 percent (after deductions and so forth). There also exist schemes for circumventing such taxes, although not all the wealthy take advantage of them.

Another feature of the last few decades that has also involved important rule changes has been major agreements on trade, investment, and other issues. Of these, the best known are the North American Free Trade Agreement (NAFTA) of 1994 and the (1994) agreements that created the World Trade Organization in 1995. Both of these agreements granted new powers and protections to transnational corporations, a topic that will be discussed in Chapter 15, and in Chapter 19, which continues this discussion of government and the economy.

Conclusion

Capitalist economic activity operates under principles that will be spelled out further in the coming chapters, especially Chapter 10. Yet it does not operate independent of government. Government defines what it can or cannot do, and because of this, capital owners seek to shape what rules the government imposes—what bills are legislated, what orders are issued by the executive, and what court decisions are made.

All these affect profitability of enterprises by affecting how enterprises compete with one another, how capital owners are permitted to treat workers, what rights people have and what additional rights citizens have. These all affect what is produced, how it is produced, and how the product is distributed among the population.

We have focused mainly on nineteenth century examples of these principles in order to lay the groundwork for Chapter 7's discussion of the stages of capitalism and varieties of "social structures of accumulation." Three additional very important functions of government will be discussed in Chapter 19: taxation and benefits, government contracting, and certain new supranational rules that have increasingly been embedded in agreements on international trade, investments, and other issues, in some cases bypassing or overriding decisions made by national governments.

Suggested Readings

Daniel Altman, *Neoconomy* (New York: Perseus Books, 2004).

Samuel Bowles and Herbert Gintis, *Democracy and Capitalism: Property, Community, and the Contradictions of Modern Social Thought* (New York: Basic Books, 1987).

James K. Galbraith, *The Predator State* (New York: Free Press, an imprint of Simon & Schuster, 2008).

Carter Goodrich, *Government Promotion of American Canals and Railroads 1800–1890.* (Westport, CT: Greenwood Press, 1960).

Thom Hartmann, *Unequal Protection: How Corporations Became "People"—and How You Can Fight Back* (San Francisco, CA: Berrett-Koehler, 2nd edition, 2010).

Godfrey Hodgson, *More Equal Than Others: America from Nixon to the New Century* (Princeton: Princeton University Press, 2004).

Peter Lindert, *Growing Public: Social Spending and Economic Growth Since the 18th Century* (Cambridge, UK: Cambridge University Press, 2004).

Adam Przeworski, *The State and the Economy under Capitalism* (New York: Harwood, 1990).

Adam Przeworski, Michael E. Alvarez, Jose Antonio Cheibub, and Fernando Limongi, *Democracy and Development: Political Institutions and Well-Being in the World, 1950–1990* (Cambridge, UK: Cambridge University Press, 2000).