5 Federalism, Capitalism, and Economic Growth

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Capitalism has been the engine of American prosperity and the source of the most basic political conflicts that changed the course of the nation. Government supervision is an essential part of any capitalist economy for two reasons. Government administers the laws, institutions, and policies that foster the expansion of free markets. Government also receives demands for policies that mitigate the damaging effects of free markets on citizens, such as unemployment, poverty, and pollution. Because government must nurture free markets at the same time that it must mitigate their effects, conflicts over the way government should supervise capitalist development are persistent and intense in all capitalist democracies like the United States.

Federalism has helped make the American variety of capitalism different from that in other nations by allowing these economic conflicts to spill onto two battlefields. Americans have fought about not only how government should supervise market-driven economic development, but also over which level of government—the Federal government or the states—should supervise it. Because the Constitution gave the states the power to govern most aspects of American markets, states drove early American economic development by constructing the basic rules for market expansion. Even though the Federal government played a greater role in setting basic rules for free markets between the Civil War and the 1930s, the states actively managed the transition of the United States to a predominantly urban industrial economy. Federalism in this period helped distinguish American capitalism from that in other nations by fostering the large corporation, the policing of business behavior, and the fragmentation of business's political interests. Reformers in the New Deal, the 1960s, and the 1990s accepted corporate-driven, free market capitalism as an established fact, and policy-makers at both the national and state levels have worked to harness corporations as vehicles to cushion the impacts of dynamic markets on real people. Federalism generally has shored up the political influence of individual American businesses, while it also has contributed to confrontational regulations that foster exceptional antagonism between business and government.

Federalism is by no means the sole cause of the uniquely American path for governing the economy. Many other factors have contributed. American society often demands less of government because it is so wealthy, opportunities to advance seem abundant, immigrants have diversified the nation, and class conflict has been subdued. American core values are traditionally liberal, emphasizing freedom, free markets, self-reliance, and limited government, leaving relatively little space for socialism or conservative authoritarianism. The separation of legislative, executive, and judicial power encourages the separation of taxes and spending, undermining support for government action.[1] Federalism alone is not a sufficient explanation of American economic governance, but it is a pervasive factor that is necessary for understanding the path of economic governance in the United States.

Why Economic Development Matters

As political scientist Graham Wilson observed, the United States "has long had a reputation as the most capitalist of the advanced industrialized countries."[2] Free market capitalism transformed the United States from a scattered collection of frontier farming colonies into the world's leading economy, distinctive for its unsurpassed wealth, dynamic growth, and global corporations.[3]

Capitalist economies do not develop naturally; governments have nurtured them with laws protecting property and contracts, tax and tariff schemes that benefit business, and public infrastructure to encourage commerce. Historian Colleen Dunlavy described this public role in capitalist growth as government's "structuring presence."[4] Economist Karl Polanyi argued that governments created free markets by actively extending property rights, enforcing business agreements, and breaking down barriers to buying and selling. Governments used their power to turn land, labor, and capital into marketable commodities. Governments also encouraged commerce by fostering roads, canals, railroads, and air travel to extend commerce. Very often, private business sought and supported these government policies. Ambitious economic entrepreneurs themselves often have taken the lead in demanding government policies that make their efforts to build private enterprise more successful. As the economy became larger and more complicated, the task of maintaining and managing free markets became more complicated and has required ever more government involvement.[5] American state and national governments have been actively involved in nurturing the nation's economy in all these ways from the start.

But economic growth results in constant, often wrenching change in nations like the United States. Whole industries rise and fall as the economy churns, elevating new goods, technologies, businesses and jobs, while marginalizing or eradicating other industries, technologies, business firms,

and jobs. Economist Joseph Schumpeter argued that this ongoing process of "creative destruction" was inherent in capitalist growth. Creative destruction allows the economy continually to reinvent itself and become more productive.[6] In a democracy, creative destruction that accompanies capitalist growth makes it likely that a large number of voters will reward government leaders who try to stop, slow, or mitigate those consequences of capitalist growth that harm or threaten them. While entrepreneurs seek a favorable and largely unfettered environment for investment, citizens who risk losing their jobs, or those who must survive without any income because of their age or disability, often demand government help. Moreover, businesses in vulnerable industries often seek government restrictions on markets to protect them from damaging competition.

Recognizing these cross pressures, Polanyi identified a *double movement* in capitalist development: pressure for unfettered markets on the one hand, and efforts to mitigate the effects of market-driven economic growth on the other. Governments nurture markets, but their success causes uncertainty and turmoil, sparking "a deep-seated movement ... to resist the pernicious effects of a market-controlled economy."[7] Government, then, is placed in the middle of this double movement, receiving demands that markets be left alone and that markets and capitalists be brought under more control. Nowhere was this "double movement" more conspicuous than in the United States, where democracy took root early and widely, and where political parties and interest groups mobilized to use democracy to both grow the economy and to mitigate its effects.

Governing capitalism, then, is central to the core questions of politics: who gets what, when, and how.[8] James Madison recognized the economic roots of politics in the *Federalist*, observing that the "most common and durable source of political factions

> has been the various and unequal distribution of property. Those who hold and those who are without property have ever formed distinct interests in society. Those who are creditors, and those who are debtors, fall under a like discrimination. A landed interest, a manufacturing interest, a mercantile interest, a moneyed interest, with many lesser interests, grow up of necessity in civilized nations, and divide them into different classes, actuated by different sentiments and views. The regulation of these various and interfering interests forms the principal task of modern legislation, and involves the spirit of party and faction in the necessary and ordinary operations of the government.[9]

Conflict over government's role in the economy has shaped more aspects of American political development than any other conflict. Struggles to change the advantages and disadvantages distributed by market-driven economic development have taken many specific forms. Taken together, these struggles have been passionate and unremitting. They emerge as

clashes between labor and capital, between different regions of the country, between sectors of the economy and between industries.

In any democracy, successful economic development cannot simply be *economically* viable and efficient. To succeed, economic development must be *politically* viable and efficient as well. Successful economic development requires a workable balance of contending political forces pressing for market expansion and the mitigation of markets' unwelcome impacts.[10] Federalism has played a critical role in making the governance of the economy in the United States politically viable.

How Federalism Affected American Economic Development

In the United States, where these endless and ever-present conflicts played out on the double battleground of federalism, the division of national and state power favored the promotion of market expansion and inhibited efforts to mitigate the impact of those markets. Political fights over economic development were fought out, first, over the appropriate role of any government toward markets and business, and second, over whether the state or national governments should perform this role. As Chapter 2 discussed, the national government lacked the Constitutional tools of economic management, and could not generally police markets and safeguard citizens until the 1930s. The national government did have some important tools for encouraging market expansion, including the power to generate substantial revenues through tariffs, the ability to use tariffs to increase the cost of foreign goods and thus reduce foreign competition for U.S. manufacturers, and control of vast public lands. States had the authority to use the tools of economic management, but the states were exposed to substantial competition from other states, and could not effectively limit these interstate competitive pressures. State efforts to restrict business or redistribute profits created an unusually swift, strong, and harsh political backlash. The states' exposure to economic competition from other states, then, encouraged states to use these tools much more readily to aid business growth than to restrict it—although some states pioneered American efforts to regulate capitalism.

Federalism, then, had two effects on the management of American economic growth. First, it allowed those who opposed government efforts to restrict market expansion to dig in behind states' rights and oppose the expansion of national power to mitigate the effects. Federalism in the United States tended to be "market-preserving": it limited the ability of American public officials to restrict business and to redistribute wealth from those who profited from capitalism to others.[11] But, second, the very fact that federalism encouraged the growth of strong private enterprises also encouraged public policies that treated business as a hostile adversary.

Economic Development in the Early Republic

States managed most of the American economy before the Civil War, and the national government played a relatively small role. Some national leaders called for a much more active Federal role. The first U.S. Secretary of the Treasury, Alexander Hamilton, pressed for the national government to centralize the control of public credit, to establish a national bank, and to use a host of tools to encourage the expansion of American manufacturing.[12] The U.S. Supreme Court, guided by Chief Justice John Marshall, ruled that potential national power was broad, and it further narrowed all states' power to interfere in interstate commerce and corporate law.[13] Several congressional leaders advocated an active national government program for investing in internal improvements, such as canals and roads, to knit the economy together nationally. Representative Henry Clay of Kentucky advocated an "American System" that would maintain a national bank, impose high tariffs, and use the proceeds from the tariffs to build infrastructure.[14]

But political party competition helped put the brakes on the expansion of Federal authority.[15] Thomas Jefferson's Democratic-Republican Party and its successor, the Democratic Party rebuilt by Andrew Jackson, blocked an active Federal role in the economy. Instead, these national leaders reinforced the *state* management of economic growth. State control of economic development served the political needs of the Democrats because it allowed Southern and Northern states to develop slave and free economies, respectively, without fracturing the party's electoral coalition by nationalizing the slavery issue. Democratic-Republican presidents James Madison (1809–17) and James Monroe (1817–26), and Democrats Andrew Jackson (1829–37), James K. Polk (1845–49), Franklin Pierce (1853–57), and James Buchanan (1857–61) prominently vetoed important congressional bills authorizing Federal involvement in building and maintaining highways, canals, and colleges.[16] Jackson fiercely battled the Second Bank of the United States, refusing to extend its charter and distributing its assets to state banks.[17] By eliminating this bank, Jackson's Democratic Party allowed the states to regulate banks to suit the political needs of local politics and economic development.

This decentralized economic management put the Northern states in charge of guiding the early stages of American industrial growth. These states took command of market expansion in the early republic because most of economic growth occurred within areas that were small enough for states to control, because the states had enough authority and experience to govern growing economic activity, and because the national government found it politically expedient to let the states occupy the field.[18] Each state adopted different laws and rules for private enterprise, creating a somewhat different economic environment than that in neighboring states.[19] Each state implemented rules about products, packaging, urban

markets, roadways, riverways, ports, gambling, liquor, and other activities. States licensed auctioneers, tavern keepers, and ferries as virtual agents of the state.[20]

While the states' policies differed, these states generally privileged the expansion of markets and fostered private entrepreneurship. Most important, states provided legal charters for corporations, documents that spelled out the legal rights and responsibilities of incorporated businesses and other organizations. These charters limited the corporations' liability to lawsuits and taxes. During these years, the states expanded the use of corporate charters, from banks, and canal, turnpike, and bridge companies, to manufacturing enterprises, utilities, and railroads. By the 1840s, states were beginning to enact general corporation laws to expand these benefits more widely.[21] For the states, corporations were vehicles of the public interest that would increase wealth within the state and provide other benefits as well. For example, Connecticut in 1819 required manufacturers to teach child-employees reading, writing, and arithmetic. State-chartered banks aimed to ensure private investment and stable currency and credit. Before 1863, these state banks provided most of the nation's currency.[22]

To make their state more attractive to business, states often gave away or subsidized water, land, timber, and minerals for private interests, and allowed private interests to use the power of eminent domain to obtain even more land.[23] States competed with neighboring states to attract investment and new enterprises to drive their economic growth. This competition encouraged states to subsidize or privilege private enterprise and to keep business regulation in check.[24]

States' governments also invested heavily in large infrastructure projects to foster economic growth. New York state's ambitious Erie Canal, approved just months after Madison's veto of national public works funding, became an enormously profitable state government initiative that aided New York producers at the expense of out-of-state interests. The canal dramatically strengthened the economic power of New York City and helped make Chicago the commercial hub of the Midwest.[25] Other states emulated New York with a wide range of ambitious canal, highway, and railroad projects. All these efforts required state government planning for economic growth and market expansion.[26] In the decades before the Civil War, American states acted more vigorously than the government of Prussia in funding—and even owning outright—major capital works such as canals and railroads.[27] The financial panic of 1837 caused many of these state projects to fail, forcing several states to default on the debts they incurred to build them. Exposed to intense interstate competition and under pressure from investors, many of the states (eventually all but one) imposed strict limits on their annual budget deficits and spending. At the same time, states also began to invest in higher education, motivated in part by the explicit desire to retain students and to develop the skills of their citizens.[28]

By 1860, Northern states were building a commercial and manufacturing economy distinct from the Southern plantation economy. Only forty percent of Northerners still worked in agriculture, compared to eighty-six percent of Southerners. Northern cities were growing rapidly, and investment in Northern manufacturing was outpacing the South.[29] Southern states lacked the investments in transportation and education that were helping drive Northern growth.[30] As civil war tore the nation apart, the Northern economy, guided by the state governments, was poised to grow explosively.

Federalism, Giant Corporations, and Antitrust, 1860–1900

Markets burst across state boundaries after the Civil War. Railroads crisscrossed state lines, visibly nationalizing American markets. Between 1860 and 1916, railroad mileage in the United States expanded from 30,000 miles (already half the railroad mileage in the world) to 250,000 miles. Railroads vastly expanded markets for American iron, steel, coal, wheat, corn, processed meat, and manufactured products, both within the United States and beyond it.[31] Because of the immense size of the market for American products, many other enterprises such as Standard Oil, International Harvester, General Electric, Carnegie Steel, and American Telephone and Telegraph expanded on a colossal scale.[32]

Political parties and courts both promoted national rules that encouraged this nationalization of markets and constrained the backlash against it. After winning the presidency and Congress in 1860, Republican Party leaders used the national government to build high tariff barriers to protect Northern industry, to enforce the controversial gold standard (fixing the value of American currency to gold, to attract investors and fuel capitalist growth), to distribute public lands to railroads and homesteaders (thus transferring millions of acres of public land into private markets), and to fill the national courts with judges usually opposed to restrictions on national markets.[33] Federal and state court decisions often favored the nationalization of markets and deflected state efforts to restrict the impact of market expansion. In cases such as *Santa Clara County* v. *Southern Pacific Railroad Company* (1886), the U.S. Supreme Court interpreted the Fourteenth Amendment as a guarantee of corporate rights (equating corporations with individuals) and limited public restrictions on individual businesses.[34] Both Republicans and Democrats supported such decisions.[35] These rulings "extended the formal authority of Congress at the expense of the states, despite the intense pressures from below."[36] The courts, in effect, were creating a "no man's land" in which neither the states nor the national government could interfere with the expanding free market.

Market expansion, in turn, made it increasingly difficult for states to contain the further expansion of markets, or balance the "double movement" of capitalist growth with policies that regulated economic change. While

the states continued to promote private enterprise, many found that the growing presence of out-of-state enterprises, along with competition with other states, was limiting their latitude to regulate business. States continued to offer tax exemptions and subsidies to favor particular enterprises, and like the Federal government, they gave away substantial public land to the railroads. Coal increasingly fueled the nineteenth century American economy, and "each state had its own energy policy—which, taken together, created a highly fragmented and somewhat chaotic regulatory regime that encouraged the production and consumption of vast quantities of coal," according to historian Sean Patrick Adams.[37] Harry Scheiber concluded more generally that "highly important, localized activities such as mining or lumbering were placed in a position to virtually control political power," especially in the newer Western states.[38]

Railroads posed the greatest challenge to the states' economic authority and sparked new state experiments with economic regulation. With billions of dollars of capital and thousands of workers, railroad corporations were the first huge private enterprises that transcended state borders. The large railroad companies and the tycoons who ran them seemed to have limitless resources, boundless political influence, and few scruples. To reduce competition and increase their profits, some railroads created "pools," legal agreements to keep rates high. Angry farmers and citizens hurt by these practices demanded that state politicians use government power to stop them. The Granger and later the Populist movements put forward proposals to rein in the railroads.[39] These movements flared most intensely in the Midwestern, Southern, and Western states, on the edge of the nation's manufacturing core. Illinois and Minnesota initiated railroad commissions to set maximum railroad rates in their states. These commissions sought to reduce the railroads to another state constituent whose demands for profit could be balanced against the economic demands of other constituents.[40] Initially, the U.S. Supreme Court upheld Illinois' right to use their regulatory powers in this way.[41] Soon, however, the Court changed its interpretation of state laws and blocked their interference in the railroad market that was indispensable for the growing economy. In the case of *Wabash, St. Louis and Pacific Railway Company* v. *Illinois* (1886), the Supreme Court ruled that states could not interfere with interstate railroad rates and that "it is always in the power of congress to make such reasonable regulations as the interests of interstate commerce may demand, without denuding the states of their just powers over their own roads and their own corporations."[42]

As soon as the Court disarmed the states of their power to regulate these railroads, Representative John Reagan (D-TX) proposed a national law to police unfair railroad behavior. Congress quickly enacted the Interstate Commerce Act in 1887 to neutralize the economic weapons that railroads had used to escape state control. This law established the first national regulatory agency, the Interstate Commerce Commission (ICC), and gave

it the authority to challenge the prices that interstate railroads set for freight. Separate Supreme Court decisions made it impossible for railroads to cooperate in setting minimum prices to guarantee profits.

In response, many railroads simply merged into corporations that were large enough to control their costs. These mergers, in turn, increased the burden on the ICC to keep rates reasonable. Thus, federalism and growing corporations set in motion a sequence of events that encouraged even larger, stronger corporations, and at the same time, encouraged the state and national governments to take a more adversarial role toward these corporations.[43]

The late-nineteenth century "double movement" now took the form of larger corporations and adversarial public regulation when it extended to all the notorious large private businesses, or the "trusts." At this time, European governments tolerated or even encouraged business cartels, which involved organized cooperation among businesses to control prices, production, and wages and maintain them at stable levels beneficial to all the participants in the cartel. Cartels allowed businesses in competitive industries such as machinery, coal, or textiles to remain independent and all the firms to enjoy increased profits.[44] But the rules of American federalism at this time prevented American firms from using government to enforce similar "pooling" agreements on prices and production. American state and Federal courts would not enforce such agreements. Even if states attempted to help enforce the agreements, they could not protect employers inside the state from predatory competitors beyond the state's boundaries. Federal courts usually struck down state efforts to use taxes and other policy tools to protect instate businesses, on the grounds that such laws interfered with interstate commerce.[45]

In response to these circumstances, American states pioneered antitrust policy. Instead of managing business collusion, as in Europe, states actively tried to stop the trusts from controlling prices and production. If federalism made it impossible to control collusion, they could instead prevent it, and try to force more market competition over which they *could* exercise some control. Twenty-one states enacted constitutional or statutory prohibitions on trusts by 1890. These state laws, in turn, made it obvious that some national law was required to police interstate trusts that lay beyond the power of the individual states. Congress addressed this gap with the Sherman Antitrust Act of 1890, declaring illegal "[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce *among* the several states … " (emphasis added) The Sherman Act made it clear that states, not the national government, controlled corporate law.[46] While other countries allowed and even encouraged cartels, then, federalism steered the United States to try to outlaw the very behaviors that made cartels attractive to business.

Because states still controlled corporate law, however, any one state could gain a tremendous economic advantage over its neighbors simply by

changing its laws to *encourage* trusts while the other states strengthened corporate regulations. A business-friendly corporate law would allow a trust to change itself from a loose, illegal agreement into a tightly controlled, unified corporation legally chartered by a single state. Such a large corporation would escape antitrust prosecution, while having the power to control prices and production even more effectively than a trust. New Jersey, close to New York City and Philadelphia, immediately took advantage of its strategic location by relaxing its corporate laws and enticing large firms to seek New Jersey charters. In 1895, the Supreme Court reinforced New Jersey's strategy, ruling that the Sherman Act could not be applied to manufacturers, even if their products were distributed across state lines.[47]

Public regulation of corporations now drained away through the gaps in state and national government authority. Twenty-nine competing industrial concerns consolidated from 1895 through 1898; sixty-three consolidated in 1899, and fifty-seven more between 1901 and 1903. Most of these newly consolidated corporations, and all the largest ones (including U.S. Steel, American Sugar Refining, and Standard Oil)—1100 corporations in all—incorporated in New Jersey.[48] New Jersey's success increased the competitive pressure on other states, such as New York, to relax their corporate laws as well.[49] Delaware eventually made its corporate law more attractive than that in New Jersey, and today remains the corporate home for tens of thousands of U.S. and offshore corporations.

American federalism, then, encouraged the paradoxical American response, Polanyi's "double movement" in U.S. capitalism. First, federalism advanced the expansion of the market economy and the construction of the American corporation, an institution which enjoyed more power than individual firms in Europe. Second, however, federalism and the rise of the corporation encouraged American governments to channel the backlash against market expansion into antitrust, an adversarial regulation of business behavior without parallel in comparable nations. American federalism, then, helps explain two distinctive features of American capitalism: the giant corporation and antitrust. These features framed the public supervision of the economy in the twentieth century.

The Progressive Era, 1900–33

The corporations that were emerging at the start of the twentieth century became vehicles for managing "double movement" in the United States. In the Progressive Era, Americans began to disagree strongly over the degree of corporate freedom necessary for driving economic growth. Republican President Theodore Roosevelt, the first president to take office after the great merger movement, explicitly advocated presidential power to negotiate this conflict. He sought a Bureau of Corporations that would provide more discretionary power for the executive branch to govern corporate behavior. But American corporations did not need or want the national government

gaining such power over their future. Without business support within his own party, Roosevelt's proposals failed. Instead, a kind of political "natural selection" favored a more confrontational approach. Roosevelt's efforts to prosecute large corporations' behavior (followed by those of his hand-picked successor, William Howard Taft) seemed more acceptable and successful.[50]

Taft's successor, Democrat Woodrow Wilson, approached corporations from the perspective of the Southerners, Populist-inspired farmers, and union leaders that constituted his party's political coalition. Wilson's administration updated the party's strategic use of federalism: it provided an expedient political glue that held together an anti-corporate coalition in economically diverse states. Wilson moved to establish stronger national control of corporate conduct while reinforcing state-level business powers. At the national level, Wilson attempted to neutralize corporate advantages by enforcing market discipline. The Clayton Antitrust Act (1914) and the Federal Trade Commission Act (1914) aimed to broaden Federal power to police corporate behavior. The Federal Trade Commission Act, like the earlier Pure Food and Drug Act (1906), could protect consumers from interstate business predators that the states could not reach. For the Democrats, this strategy preserved decentralized economic power and potentially enabled the states to better control it. The Democrats complemented these reforms with the Federal Reserve Act (1913), establishing more government control of the financial system, but organized into decentralized regions to allow the regional Federal Reserve banks to tailor financial policy to the needs of different areas of the nation.[51]

Meanwhile, the states were expanding their capacity to regulate business. State financial laws aimed to help domestic state interests, and also to keep private finance dispersed and thus easier for state governments to manage. A number of states prohibited banks from establishing branches, thus fragmenting banking to the community level. State-chartered banks outnumbered national banks by two to one in the Progressive Era (though they had only one third of the deposits of the national banks). States deliberately set requirements for new banks lower than Federal requirements to induce new banks to seek state rather than Federal charters. On the Great Plains, states reinforced the decentralized banking system by implementing deposit insurance in the early 1900s, aiding the growth of small banks.

The states also exercised complete regulatory jurisdiction over the important insurance and securities industries. Many states either encouraged or required insurance companies to reinvest within the state those assets acquired from state policy-holders. Texas's 1907 "Robertson law," for example, offered lower tax rates to insurance companies that reinvested seventy-five percent of their reserves in the state of Texas. In the absence of any Federal rules for trading corporate stocks, almost all the states enacted "blue sky" laws between 1911 and 1931, establishing state regulation of stock and other securities offerings inside the state. "Blue sky" laws permitted

state regulators to prohibit the sale of certain securities, thereby serving the interests of both state consumers and the small banks and securities firms in each state. To prevent out-of-state retailers from crowding in-state merchants, six states passed laws between 1929 and 1931 to prevent the incursion of out-of-state retail store chains on domestic stores.[52]

The states governed natural resources and energy in a way that balanced economic growth and the interests of state voters. Between 1907 and 1914, most states created public utility commissions (PUCs) to regulate electricity, gas, telephones, and urban rail transit.[53] These commissions balanced the interests of utility companies and state consumers in setting rates, customer service requirements, and corporate profit rules. During a 1919 Chicago streetcar strike, for example, the Illinois public utility commission granted workers a higher wage and permitted the lines to charge higher fares to cover the costs.[54] Texas expanded the jurisdiction of its Railroad Commission to include oil production and pipelines. The discovery of a massive East Texas oil field in 1930 stimulated too many wells and too much oil. Oil prices collapsed. In response, Texas gave its Railroad Commission the power to stabilize prices by setting production limits (called "prorating") for each oil well. The Commission's prorating rules served the interests of the many Texans who derived oil royalties from individual wells. Texas's regulations also raised oil prices nationwide.[55]

The New Deal, 1933–45

Catastrophic depression and the disintegration of American capitalism swept Franklin Roosevelt and large Democratic majorities into power in 1933.[56] The nation's economic product fell by almost half, and unemployment hit unprecedented levels. Business seemed caught in an unbreakable cycle of cost cuts and layoffs that seemed to be out of control. Heavily in debt because of the expansive construction of roads, schools, and other projects in the 1920s, the states slashed budgets for public works. The collapse of private and public construction swelled the ranks of the jobless.[57]

Initially, Roosevelt's New Deal program moved to stabilize economic sectors by authorizing the businesses in each major industry to regulate themselves, with national enforcement of their agreements. The National Industrial Recovery Act (NIRA) authorized national cartels in more than five hundred industries, from coal and steel to umbrellas and licorice. Each industry developed a code of fair competition aimed at limiting price, production, and wage cuts. But these efforts were failing by 1935. In that year the Supreme Court, specifically aiming to protect "the domain of state power," struck down the NIRA as an unwarranted interference with the states' regulatory authority.[58] Lower courts in the Federal judicial system had issued sixteen hundred orders by 1935 to prevent Federal officials from carrying out acts of Congress.[59]

After the collapse of its support for these business cartels, the New Deal returned to the Democratic formula of the Progressive Era: expanding national efforts to police business conduct while underwriting state regulatory prerogatives in key markets. By the late 1930s, Assistant Attorney General Thurman Arnold and the Justice Department revived antitrust prosecutions against corporations.

The Federal government issued regulations that ensured a substantial state role in managing the economy. According to historian William Childs, new Federal regulations "maintained regulatory authorities in the states *and* mandated cooperative action between state and national regulatory commissions."[60] The Public Utility Holding Company Act of 1935 broke apart the large interstate utility holding companies, enabling states to have more control over electricity and natural gas.[61] The Connally Hot Oil Act of 1935, written in response to death of the NIRA, supported the oil states' control of production by prohibiting interstate transport of oil produced in violation of state prorating quotas. This law allowed Texas, Oklahoma, and Louisiana to coordinate oil production among themselves, and to stabilize prices to benefit the oil industry within their own states.[62] The 1935 Motor Carriers Act extended Federal regulations from railroads to trucks and interstate buses, but also required the national government to preserve state regulation of motor vehicles as much as possible (a provision that also protected racial segregation in transportation in the South).[63] The Federal Communications Commission established national regulation of interstate and international telephone and telegraph transmission, but left intrastate phone regulation to the states. A Federal Civil Aeronautics Board regulated most of the airline industry, but allowed states to regulate the intrastate airline service (California later did so). The Robinson-Patman Act prohibited chain stores and large retail stores from extracting price concessions and using price discrimination against small businesses and suppliers, reinforcing the existing state anti-chain-store laws.[64] A new Federal Securities and Exchange Commission (SEC) supervised corporate securities and the stock exchanges, but state securities commissions would examine many stock issues before the SEC, influence SEC decisions, and participate in some investigations.[65]

While many New Deal rules depended on Federal–state cooperation, others nationalized the governance of parts of the American political economy. National deposit insurance indemnified depositors. The national government extended Federal charters to savings and loans. The Banking Act of 1935 centralized the Federal Reserve System and strengthened the independence and authority of its Board of Governors and its Chairman. The Glass-Steagall Act required commercial and investment banks to separate, and it prohibited commercial banks from underwriting most securities. Glass-Steagall also required state chartered banks to join the Federal Deposit Insurance Corporation as a condition of participating in the Federal Reserve System.[66] The New Deal established a more centralized

governance of agriculture through price support measures and output controls linked to soil conservation programs. The Tennessee Valley Authority (TVA) aimed to use national power to develop electricity and modern farming in one of the nation's poorest regions.[67]

Even these nationalizing efforts left the states with continued responsibilities. The Glass-Steagall Act allowed commercial banks to continue underwriting securities issued by state and local governments. Federal law underwrote state financial regulation by subjecting national banks to the different rate ceilings imposed by the various states. The TVA relied heavily on existing state and local agencies to implement plans; in the South, this delegation of responsibility reinforced racial segregation. The insurance industry remained almost entirely subject to state supervision.

Liberal Supervision of Capitalism, 1945–81

After Franklin Roosevelt's death in 1945, liberal ideas about economic governance dominated national economic policy for over thirty years. Democrats controlled Congress for most of the thirty-five years after World War II, and held the presidency more often than Republicans. In the 1950s, moderate Republican President Dwight Eisenhower implicitly conceded that the Federal government would not shrink to its pre-New Deal size, and in the 1970s, President Richard Nixon promoted active public management of the economy.[68] Keynesian ideas of national economic management of the economy were widely accepted by the 1960s. As prescribed by the British economist John Maynard Keynes, more Federal spending and lower taxes could stimulate the economy, while lower spending and higher taxes could slow it.[69] Such a fiscal policy affected overall spending and taxes, but would not interfere with private decisions about how business would invest its money.[70]

Expanding notions of rights and risk after World War II increased popular support for more regulation of business. In every case, state governments initially grappled with these concerns (as in antidiscrimination laws in Chapter 4). For example, California passed the first statewide air pollution regulations in 1947. But interstate exposure to economic competition limited the scope and strength of such efforts across the states, leaving such regulation very uneven nationally. While most states had enacted air pollution legislation by 1963, for example, most state laws also aimed to protect the state's attractiveness to business. Pennsylvania's law, for example, provided that state clean air measures not "unreasonably obstruct the attraction, development, and expansion of business, industry, and commerce in the Commonwealth." Michigan, Wisconsin, and Missouri—three leading auto manufacturing states—lacked any air pollution laws at all.[71] Because the costs of specific environmental regulations often are narrow and potentially deep in particular states, it is not surprising that some states have pioneered environmental laws while many states neglect

environmental enforcement.[72] Business sometimes took a lead in complaining about the resulting patchwork of state regulations and in demanding more uniform national standards. Automobile manufacturers, for example, voiced strong concerns about manufacturing different cars to meet different pollution requirements in each state, and pressed instead for a single set of national automobile pollution rules.

By the 1970s, the pressure for social regulation and frustration with states' efforts had resulted in a flood of new Federal business regulations. Congress enacted laws to eliminate discrimination, enhance occupational safety and health, protect employee retirement, reduce environmental hazards, and protect consumers. As political scientists Richard A. Harris and Sidney M. Milkis pointed out, these regulations explicitly aimed to restrict business discretionary behavior and to "minimize the prospects of business exercising undue influence in the administration of regulatory affairs."[73] These laws established many new Federal agencies, including the Environmental Protection Agency, the Consumer Product Safety Commission, the National Highway Traffic Safety Administration, and the Occupational Safety and Health Administration. These agencies affected the lives of most Americans, from the air they breathed to the water they drank, the cars they drove, the workplaces where they labored, and the items they purchased with their income.[74] These laws also multiplied adversarial confrontations between Federal regulators and business. Since the states already occupied many regulatory fields, many of these regulations delegated to the states a significant role in implementation.[75] For example, the Clean Air Act of 1970, usually viewed as a leading example of national command and control regulation, depended on State Implementation Plans (SIPs) to guide the regulation of power plants, factories, and other stationary sources of air pollution.[76] States adopted some uniform laws to guide the economy, most notably the Uniform Commercial Code, which is the basis for commercial contracts, payments, shipping, and warranties.[77]

Technological change and economic expansion were making it more difficult for states to continue to exercise state authority over many lines of business. Pressures mounted to loosen state-level financial regulations. Satellites and computers globalized and accelerated financial transactions, while they encouraged more complicated financial instruments. In the 1960s, Texas already had relaxed savings and loan regulations and allowed thrifts to invest in more speculative real estate ventures. By the late 1970s, rising prices were squeezing thrift institutions that found themselves burdened with long-term, low interest home loans. States reduced or eliminated prohibitions on branch banking, and eased other financial regulations. State and Federal regulators allowed thrifts to enter new but riskier loan markets. A 1978 U.S. Supreme Court decision made it impossible for states to prevent out-of-state credit card companies from soliciting business within their state, causing a repeat of the turn-of-the-century interstate race of regulatory laxity. South Dakota and Delaware deregulated interest

rates and relaxed other banking rules. South Dakota enticed Citicorp to establish a national credit card center in Sioux Falls. Delaware's governor then traveled around the country to lure similar credit card operations to his state.[78] Credit card companies became the engine of Delaware's economy for the next two decades. By the mid-2000s, lending institutions in Delaware held forty-three percent of total credit card loans made by insured depository institutions.[79]

Conservative Supervision of Capitalism, 1981–2009

The expanding scope of national regulation provoked growing business opposition, and this business mobilization contributed to the success of Republican candidates beginning in the late 1970s.[80] Republicans held the White House for all but eight years from 1981 to 2009, and held a majority in at least one house of Congress during six of the eight years of Democrat Bill Clinton's presidency. Republican leaders aimed to reduce economic regulations (a process that began under Democrat Jimmy Carter in the late 1970s).[81] In practice, however, the Republican administration responded favorably to frequent business demands that the national government retain regulatory authority and preempt more restrictive state laws. Business preferred conservative national regulations to liberal state regulations, and to varied state laws. An industry official explained the preference for conservative national regulation: "I would rather deal with one [F]ederal gorilla than 50 state monkeys."[82]

Conservative nationalism flowered fully in the late 1990s and early 2000s. The Financial Services Modernization Act of 1999 (the Gramm-Leach-Bliley Act, named for its Republican sponsors) repealed New Deal era banking law and preempted states from prohibiting any of the banking activities allowed by Federal law. Gramm-Leach-Bliley also pressured states to relax regulations on insurance companies. In 1996, the Federal Energy Regulatory Commission's Order 888 forced more utilities to purchase wholesale power from independent providers, and placed substantial competitive pressures on the states to deregulate electricity. Pressured by this competition and lured by the hope of reducing consumer costs, more than a dozen states deregulated electrical utilities (although California's subsequent energy crisis slowed momentum for electricity deregulation). The Telecommunications Act of 1996 required state regulatory commissions to admit new entrants into local telephone services. The Public Company Accounting Reform and Investor Protection Act of 2002, enacted after the Enron scandal, expanded Federal control over corporate law.[83] The Energy Policy Act of 2005 transferred responsibility for electrical transmission and liquefied natural gas to the Federal government.

Despite four generations of policy nationalization, today the American states remain important managers of the American economy. States continue to regulate major parts of the economy, manage infrastructure, administer

public education, and strive to attract business investment.[84] The states and, under state supervision, the local governments have developed creative fiscal instruments for encouraging economic development projects.[85] According to political scientist Kenneth Thomas, state and local governments spent forty-seven billion dollars in investment incentives in 2005.[86] State attorneys general, who are often upwardly mobile elected officials, very actively fight to control out-of-state firms that adversely affect in-state constituents. State attorneys general have pursued antitrust actions against Microsoft, pharmaceutical manufacturers, and recorded music distributors. Most notably, when state attorneys general in the 1990s sued tobacco companies for damages to citizens' health, they helped engineer a master national agreement to settle the case.[87] The antitrust lawsuit against Microsoft was joined by the attorneys general of twenty states, including major software and Internet centers California and Massachusetts (but notably not the Attorney General of Washington state, Microsoft's corporate home). At the same time, market nationalization and globalization has increased opportunities for business to shop among jurisdictions offering favorable business laws.[88]

The financial crisis of 2008 underscored the importance of the states in the American economy. The collapse of insurance giant AIG occurred against a backdrop of state, rather than national, regulation of the insurance industry. Representative Paul Kanjorski, chairman of a key oversight subcommittee in the House of Representatives, said that "The [F]ederal government really has no insight, no information, and no regulatory authority of any significance over insurance."[89] Instead, "States alone continue to have the primary authority to regulate insurance today. For that reason, Congress has historically only passed insurance legislation to respond to a crisis, address a market failure, or adopt narrowly-focused insurance reforms ... "[90] It is very revealing that the first important investigation of AIG was conducted by New York state Attorney General Andrew Cuomo.[91]

Federalism and the American Variety of Capitalism

Federalism helped guide the unique path of economic governance in the United States. Federalism is not the sole cause of the exceptional course of America's response to the "double movement" of capitalist growth and the mitigation of its consequences. It has been a necessary factor that has with others—such as traditional liberal ideology, social mobility, national affluence, and the separation of government powers—shaped the path of American economic policy.

Today, different capitalist nations supervise capitalism in different ways, and among these nations, the United States stands out for the latitude it allows business, and its confrontational and litigious approach when it does interact with business.[92] As political scientist David Vogel wrote in

1978, "[w]hen all the myriad instances of governmental support of business have been accounted for, the American state remains, by virtually every conceivable qualitative and quantitative criteria, the least interventionist in the advanced industrial world."

> The United States is virtually the only capitalist nation which engages neither in an incomes policy, wage-price controls, nor in national planning; and the degree of state participation in production is smaller in the United States than in virtually any other nation in the world—industrial or nonindustrial. To the extent that the United States has moved toward establishing institutions or mechanisms that make some sort of public economic policy possible, i.e. the enactment of the Federal Reserve System to supervise private banking or the establishment of the Council of Economic Advisors to legitimate fiscal policy—it has done so far later than any other industrial system. The American state still lacks essential information about the basic functioning of the economy and even if that information were available the fragmentation of authority and power within the [F]ederal bureaucracy would make any coordinated government policy extremely problematic.[93]

Many European nations have encouraged more business collaboration, leadership by peak organizations of business and labor, and national guidance of the economy. However, in the United States, business is more fragmented, pluralistic, and lacks central, powerful organization—that is, business is part of the American pluralist interest group system (Chapter 3). Paradoxically, however, while American businesses have had more freedom than counterparts abroad, American regulations often have been more rigid and confrontational than in comparable nations.[94]

The federal system, and the opportunities of a vast national market, encouraged the evolution of an exceptionally resilient form of business, one that became both a vehicle for balancing American capitalism and a target of adversarial regulation.[95] It also encouraged the states to experiment with regulations of business behavior, an approach to mitigating the consequence of markets that became institutionalized in Federal government policy. The Constitution's distribution of power created a double battleground for business supervision, a battleground that political parties and interest groups exploited in a way that encouraged the unique development of American capitalism. Federalism's role in shaping the path of modern government activism began to take clear shape during the Progressive Era.