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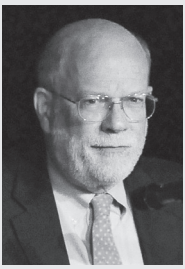
Economic Lessons from American History

John Steele Gordon

Author, *An Empire of Wealth: The Epic History of American Economic Power*



JOHN STEELE GORDON was educated at Millbrook School and Vanderbilt University. His articles have appeared in numerous publications, including *Forbes, Worth, National Review, Commentary,* the *New York Times*, and the *Wall Street Journal*. He is a contributing editor at *American Heritage*, where he wrote the "Business of America" column for many years, and currently writes "The Long View" column for *Barron's*. He is the author of several books, including *Hamilton's Blessing: The Extraordinary Life and Times of Our National Debt*, *The Great Game: The Emergence of Wall Street as a World Power*, and *An Empire of Wealth: The Epic History of American Economic Power*.

The following is adapted from a lecture delivered on February 27, 2012, aboard the Crystal Symphony during a Hillsdale College cruise from Rio de Janeiro to Buenos Aires.

America is still a young country. Only 405 years separate us from our ultimate origins at Jamestown, Virginia, while France and Britain are 1,000 years old, China 3,000, and Egypt 5,000. But what a 400 years it has been in the economic history of humankind!

When the *Susan Constant*, *Discovery*, and *Godspeed* dropped anchor in the James River in the spring of 1607, most human beings made their livings in agriculture and with the power of their own muscles. Life expectancy at birth was perhaps 30 years. Epidemics routinely swept through cities, carrying off old and young alike by the thousands. History tends to dwell on a small percent of the population at the top of the heap, but the vast mass of humanity lived lives that were, in the words of Thomas Hobbes, "nasty, brutish, and short."

Today we live in a world far beyond the imagination of those who were alive in 1607. The poorest family in America today enjoys a standard of living that would have been considered opulent 400 years ago. And for most of this time it was the United States that was leading the world into the future, politically and economically.

This astonishing economic transformation provides rich lessons in examples of what to do and not do. Let me suggest five.

1. Governments Are Terrible Investors

When the Solyndra Corporation filed for bankruptcy last summer, it left the taxpayers on the hook for a loan of $535 million that the government had guaranteed. In a half-billion-dollar example of how governments often throw good money after bad, the government had even agreed to subordinate the loan as the company's troubles worsened, putting taxpayers at the back of the line. In retrospect, it is clear that the motive behind the loan guarantee was political: to foster green energy, an obsession of the left. And that's the problem with government investment: Politicians make political decisions, not economic ones. They're playing with other people's money, after all.

History is littered with government investment disasters. The Clinch River Breeder Reactor, for instance, authorized in 1971, was estimated to cost $400 million to build. The project ran through $8 billion before it was canceled, unbuilt, in 1983. A half century earlier, the Woodrow Wilson administration thought it could produce armor plate for battleships cheaper than the steel companies. The plant the government built, millions over budget when completed, could not produce armor plate for less than twice what the steel companies charged. In the end it produced one batch—later sold for scrap—and shut down.

Going back even farther, to the dawn of the industrial age, consider the Erie Railway. In order to get political support for building the Erie Canal, Governor DeWitt Clinton promised the New York counties that bordered Pennsylvania (known as the "Southern Tier") an "avenue" of their own once the canal was completed. The canal was an enormous success, but as such it affected the state's politics. A group of politicians from along its pathway, the so-called Canal Ring, soon dominated state government. They were not keen on helping to build what would necessarily be competition.

A canal through the mountainous terrain of the Southern Tier was impossible, and by the 1830s, railroads were the hot new transportation technology. But only with the utmost effort did Southern Tier politicians induce the Legislature to grant a charter for a railroad to run from the Hudson River to Lake Erie through their counties. And the charter almost guaranteed economic failure: It required the railroad to run wholly within New York State. As a result, it could not have its eastern terminus in New Jersey, opposite New York City, but had to end instead in the town of Piermont, 20 miles to the north. It was also forbidden to run to Buffalo, where the Erie Canal entered Lake Erie, terminating instead in Dunkirk, a town 20 miles south. Thus it would run 483 miles between two towns of no importance and through sparsely settled lands in between—not unlike the current proposed California high-speed rail project, the first segment of which would run between Fresno and Bakersfield and cost $9 billion.

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The Erie Railway was initially estimated to cost $4,726,260 and to take five years to build. In fact, it would take $23.5 million and 17 years. With the depression that began in 1837, it soon became clear that only massive state aid would see the project through. So New York State agreed to put up $200,000 for every $100,000 raised through stock sales. Even that was not enough, however, and the railroad issued a blizzard of first mortgage bonds, second mortgage bonds, convertible bonds, and subordinated debentures to raise the needed money. This mountain of debt got the Erie completed in 1851, but it would haunt the railroad throughout its existence. Indeed, the Erie Railway would pass through bankruptcy no fewer than six times before it disappeared as a corporate entity in the early 1970s.

Why was the Erie Canal a huge success—it even came in under budget and ahead of schedule—that made huge profits from the very beginning, while the Erie Railway was a monumental failure? One reason was that canal technology was well-established and well-understood by the early 19th century. More important, the route of the Erie Canal was the only place a canal could be built through the Appalachian Mountains. Thus it would have no competition. And the reason the canal was built by government was that the project was simply too big for a private company to handle.

A very similar situation arose in the 1950s. Three decades before, a young U.S. Army captain had joined an expedition in which the Army had sent a large convoy of trucks from Washington to San Francisco, to learn the difficulties of doing so. They were very considerable because the nation's road network hardly deserved the term. By the 1950s, that young captain had become president of the United States and road-building technology was well understood. Dwight Eisenhower pushed a national network of limited-access roads through Congress, and the country has hugely benefitted from the Interstate Highway System ever since.

Both the Erie Canal and the Interstate Highway System are passive carriers of commerce. Anyone can use them for a fee, although many Interstates are paid for through the Highway Trust Fund. But a railroad is a business that can only be profitable with careful attention to the bottom line forced by competition. And governments are notoriously bad at running businesses because government businesses are always monopolies. Just remember your last customer-friendly visit to the Department of Motor Vehicles.

In addition to building infrastructure such as the Erie Canal and the Interstate Highway System, government can be good at doing basic research, such as in space technology, where the costs were far beyond the reach of any private organization. Only government resources could have put men on the moon. Nevertheless, I'm encouraged to see that the next generation of rockets is being developed by private companies, not NASA. That's a step in the right direction.

Unfortunately, we are headed the other way with the American medical industry.

2. Politicians Have Self-Interest Too

In 1992, New York State found itself $200 million short of having a balanced budget, which the state constitution requires. The total state budget was about $40 billion, so it could have been balanced by cutting one half of one percent—the equivalent of a family with an after-tax income of $100,000 finding ways to save less than 50 dollars a month.

So did New York cut its budget? Don't be silly. Instead, it had a state agency issue $200 million in bonds and use the money to buy Attica State Prison from the state. The state took the $200 million its own agency had borrowed, called it income, and declared the budget balanced. New York now rents the prison from its own agency at a price sufficient to service the bonds.

Had any private company sold, say, its corporate headquarters to a wholly-owned subsidiary and called the money received

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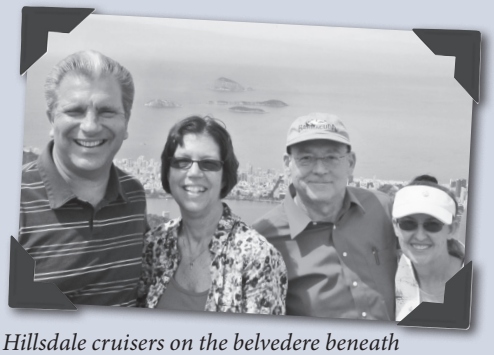

Hillsdale cruisers on the belvedere beneath Rio de Janeiro's Christ the Redeemer statue

Bing West, former Assistant Secretary of Defense in the Reagan administration, at a book signing following an on-board lecture

Hillsdale President Larry P. Arnn and guest speaker David Pryce-Jones enjoy a dinner at sea with Hillsdale cruisers

A shore excursion in Buenos Aires included a visit to La Recoleta Cemetery and the tomb of Evita Perón

income, its management would be in Club Fed. So why wasn't Governor Mario Cuomo or the state comptroller thrown in jail for what was a patent act of accounting fraud? Because government, unlike corporations, can keep their books as they please. And why must corporations obey accounting rules? In a beautiful example of Adam Smith's invisible hand at work, it was the self-interest of Wall Street bankers and brokers that produced one of the great ideas in American economic history.

In the 1880s the great Wall Street banks that were emerging at that time, such as J. P. Morgan & Co. and Kuhn Loeb, as well as the New York Stock Exchange, began demanding two new ways of doing business: First, listed firms, and those hoping to raise capital through the banks, were required to keep their books according to what became known as Generally Accepted Accounting Principles. There are many ways to keep honest books—and, of course, an infinite number of ways to keep dishonest ones—so it's important that all companies keep them the same way, so that they can be compared and a company's true financial picture seen. Second, these firms were required to have their books certified as honest and complete by independent accountants. It was at this time that accountancy became an independent, self-governing profession, like law and medicine.

But while J. P. Morgan was probably the most powerful banker who has ever lived, not even he had the power to force governments to adhere to Generally Accepted Accounting Principles and submit their books to independent certification. And because it is in the self-interest of politicians to cook the books—just as corporate managers did until Wall Street forced them to change their ways—they continue to commit accounting fraud on a massive scale. This is no small part of the reason that the federal government and many state governments are in financial crisis today.

In 1976 New York City went broke, thanks to spending borrowed money and hiding the fact by means of fraudulent accounting. The state refused to help until the city agreed to do two things: adhere to Generally Accepted Accounting Principles and have its books certified by independent accountants. What a concept! Needless to say, the state imposed no such discipline on itself. So here we are, 36 years later, and the city is in pretty good financial shape while the State of New York is a financial basket case, almost as badly off as California. Maybe New York City should offer to help the state—once, of course, it agrees to keep honest books.

3. Immigration is a Good Thing

Everyone living today in the United States either has ancestors who said goodbye to everyone and everything they had ever known, traveling to a strange land in search of a better life, or did so himself. That takes a lot of guts and a lot of gumption. Both are inheritable qualities.

The French and Spanish governments, far more authoritarian than the British, were very careful about who they permitted to emigrate to their colonies. They wanted no troublemakers, no dissidents, and especially no religious heretics. The British government, on the other hand, couldn't have cared less who went to its colonies. The result was a remarkably feisty mix of people. Many just marched to the beat of a distant drummer. More than a few arrived one jump ahead of the sheriff—and others one jump behind him, having been transported as criminals. But the bulk came of their own free will, and have been coming ever since, in hopes of finding a better and richer life. Even those who arrived as slaves, and thus had no choice about it, survived an ordeal that is utterly beyond modern imagination and passed that incredible strength down to their descendants.

But while immigration made this country, there has been a long history of anti-immigration in America, beginning as early as the 1840s when the Irish, fleeing the famine, began to pour into our burgeoning eastern cities. Western states later pressured the federal government to limit and even exclude immigration from China and Japan. In the 1920s we limited all immigration, trying to make the ethnic mix that was then in place permanent.

To be sure, we need to secure our borders. All sovereign governments have a right and a duty to decide who gets to come in. But it is entirely in our interest to allow in those who want to work hard and succeed, for that makes us all richer. And in a time when by far the most precious economic asset is human capital (a phrase not coined until the mid-18th century), turning away those who possess it makes no sense. In particular, current regulations regarding H-1B visas and visas issued to foreign postgraduate students at American universities often force the holders to return to their native countries after they finish their studies or the particular job for which they were admitted. Many of these highly educated and highly skilled people wish to stay. Instead of letting them, we send them back to work in economies that compete with us. That's nuts.

4. Good Ideas Spread, Bad Ones Don't

In colonial times we had a chaotic money supply. Britain forbade the export of British coins, so while American colonists kept their accounts in pounds, shillings, and pence, what circulated in day-to-day transactions was a hodgepodge of Spanish, French, Portuguese, and some British coins, warehouse certificates for tobacco and other products, paper money printed by the colonies—until the British government forbade that too—and even wampum, the form of money used by the Indians.

After the Revolution, the need to create a national money supply was an urgent task of the new nation. The question of what unit of account to adopt was a complex one because the colonists were accustomed to so many different, and often incommensurate, units. Robert Morris, who had done so much to keep the Revolution financially afloat, tried to bridge the differences by finding the lowest common divisor of the monetary units

encountered in each state, calculating this to be 1/1,440th of a Spanish dollar. He proposed that this unit be multiplied by 1000, making the new American monetary unit equal to 25/36ths of a Spanish dollar. Thomas Jefferson—whose role in this process amounted to his one and only positive contribution to the financial system of the United States—argued instead for simply using the dollar.

Once the dollar was chosen, it would have been natural to adopt the British system of dividing the basic unit into twenty smaller units, and those into twelve still smaller units, the way American merchants kept their accounts. The Spanish system in use in the colonies—cutting dollars into halves, quarters, and eighths, called *bits*—would have been a natural idea as well. But Jefferson advocated making smaller units decimal fractions of the dollar, arguing that "in all cases where we are free to choose between easy and difficult modes of operation, it is most rational to choose the easy."

That made Jefferson the first person in history to advocate a system of decimal coinage, and the United States the first country to adopt one. This was a very good idea, and, as good ideas always do, it quickly spread. Today every country on earth has a decimal currency system.

But if Jefferson's decimal coinage concept was a good idea that quickly spread around the world, another idea that developed here at that time was lousy: the so-called American Rule, whereby each side in a civil legal case pays its own court costs regardless of outcome. This was different from the English system where the loser has to pay the court costs of both sides.

The American Rule came about as what might be called a deadbeat's relief act. The Treaty of Paris (which ended the American Revolution) stipulated that British creditors could sue in American courts in order to collect debts owed them by people who were now American citizens. To make it less likely that they would do so, state legislatures passed the American Rule. With the British merchant stuck paying his own court costs, he had little incentive to go to court unless the debt was considerable.

The American Rule was a relatively minor anomaly in our legal system until the mid-20th century. But since then, as lawyers' ethics changed and they became much more active in seeking cases, the American Rule has proved an engine of litigation. For every malpractice case filed in 1960, for instance, 300 are filed today. In practice, the American Rule has become an open invitation, frequently accepted, to legal extortion: "Pay us $25,000 to go away or spend $250,000 to defend yourself successfully in court. Your choice."

Trial lawyers defend the American Rule fiercely. They also make more political contributions, mostly to Democrats, than any other set of donors except labor unions. One of their main arguments for the status quo is that the vast number of lawsuits from which they profit so handsomely force doctors, manufacturers, and others to be more careful than they otherwise might be. Private lawsuits, these lawyers maintain, police the public marketplace by going after bad guys so the government doesn't have to—a curious assertion, given that policing the marketplace has long been considered a quintessential function of government.

The reason for this is that when policing has been in private hands, self-interest and the public interest inevitably conflicted. The private armies of the Middle Ages all too often turned into bands of brigands or rebels. The naval privateers who flourished in the 16th to 18th centuries were also private citizens pursuing private gain while performing a public service by raiding an enemy's commerce during wartime. In the War of 1812, for instance, American privateers pushed British insurance rates up to 30 percent of the value of ship and cargo. But when a war ended, privateers had a bad habit of turning into pirates or, after the War of 1812, into slavers.

Predictably, the American Rule has spread exactly nowhere since its inception at the same time as the decimal coinage system. There is not another country in the common-law world that uses it. Indeed, the only other country on the planet that has a version of the American Rule is Japan,

where a very different legal system makes it extremely difficult to get into court at all.

The United States has more lawyers and more lawsuits, per capita, than any other country. But lawsuits don't create wealth, they only transfer it from one party to another, with lawyers taking a big cut along the way. Few things would help the American economy more than ending the American Rule. Texas reformed its tort law system a few years ago and the results have been dramatic. Doctors have been moving into the state, not out of it, and malpractice insurance costs have fallen 25 percent. And remember, good ideas always spread.

5. Markets Hate Uncertainty

The Great Depression that started in the fall of 1929 ended, at least technically, in early March 1933. The stock market, almost always a leading indicator, had bottomed out the previous June, down 90 percent from its high in September 1929. 1933 would be the second best year for the Dow Jones average in the entire 20th century, coming off, of course, a very low base.

But recovery was very slow in coming. Unemployment, over 25 percent in 1933, was still at 17 percent as late as 1939. Indeed, in 1937, when the economy suddenly turned south again, there was a problem: what to call the new downturn. Most people thought the country was still in a depression, so that word wouldn't do. But economists, delighted to have a problem that they could actually solve, came up with the word "recession," and that's what we have been using ever since.

Usually, when there has been a steep decline in economic activity, recovery is equally steep. The valley is V-shaped. That is what happened in 1920, when there had been a severe post-war depression and then a strong recovery. So why was the recovery so slow in the 1930s? One reason, according to an increasing number of economic historians, is that Franklin Roosevelt had a bad habit of changing his mind. While highly intelligent, he was no student of economics and seldom read books as an adult. So much of his program was, essentially, seat-of-his-pants policy. First there was the National Recovery Administration, which amounted to a vast cartelization of the American economy. When the Supreme Court threw it out—by a unanimous vote—FDR moved on to other remedies, including big tax increases on the rich.

But markets, which can function even in disaster with ruthless efficiency, hate uncertainty. When uncertainty regarding the future is high, they tend to tread water. As a result, there was what is known as a "strike of capital." While corporations often had large cash balances—General Motors made a profit in every year of the Great Depression—and banks had money to lend, there was little investment and few loans made. Both the banks and the corporations were too uncertain about what the government was going to do next.

That is precisely what is happening today. Banks and corporations have plenty of money. Apple alone is sitting on about $100 billion worth of corporate cash. And yet the recovery from the crash of 2008 has been tepid at best. The valley is U-shaped. Undoubtedly a big reason for that is the enormous uncertainty that has plagued the country since 2008. Will health care—one-sixth of the American economy—be taken over by the folks who run the post office? Will the Bush tax cuts be ended or continued? Will the corporate income tax go up or down? Will manufacturing get a special tax deal? Will so-called millionaires—who, when you listen carefully to what liberal politicians are saying, can earn as little as $200,000 a year—be forced suddenly to pay "their fair share"?

Who knows? So firms and banks are postponing investment decisions until the future is clearer. Perhaps the clearing will happen on November 6. ■

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