Regulation between Legal Norms and Economic Reality

Edited by
GÜNTHER SCHULZ,
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herausgegeben von

Albrecht Ritschl, Mathias Schmoeckel,
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Intentions, Effects, and Adaption: The German and American Experiences

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and William J. Hausman

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Foreword

Regulation and Deregulation lie very much in the focus of social sciences, economics and law as much as of practical political action. At present the attention is directed mostly towards the current situation and the national state. The historical experience and the intercultural dimension, in contrast, could help to deepen our understanding and to sharpen and enrich the arguments and insights. That was the starting point for an international Conference held in Washington at the German Historical Institute, March 31st to April 2nd 2011, analyzing the German notion and the American concept of regulation from a comprehensive historical perspective.

The conference united both established and younger scholars from the United States, Germany, Switzerland, and Israel to analyze constitutional and legal frameworks, as well as to investigate the development of markets and the political influence of market participants. Situated at the intersection of legal and economic history the contributions focus on the regulation of natural monopolies in network industries such as railways, energy, and telecommunications.

Variations in citation style in the present volume due to different national and discipline-specific cultures of citation were retained intentionally.

The editors would like to thank all contributors to the symposium as well as to the present volume and all participants in the discussions – furthermore the German Ministry of Education and Research for funding the three years lasting research project "Designing Freedom – The Implications of Historic Legacy and Standardization on the Regulation of the Economy", from which many of the German contributions came, and especially Rolf Geserick; Hartmut Berghoff, the director of the German Historical Institute, Washington, DC, as host of the conference, and his staff; Boris Gehlen for conceptual preparation and Cathrin Gehlen (née Kronenberg) as well as Julia Maier-Rigaud and Heiko Braun for planning and organization.

August 2013

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National Regulatory Traditions? Introductory Remarks

BORIS GEHLEN AND GÜNTHER SCHULZ[1]

"Indeed, the question […] of how the railroad industry generally has to be regulated by law, raises such major difficulties, that one might say - the more one deals with these questions, the more one is at a loss for an answer."[2]

Of course, one should not start this conference volume as fatalistic as the General Secretary of the *Deutsche Handelstag* (German Association of Chambers of Commerce) Alexander Meyer in 1875 on the occasion of the first big debate about regulating or nationalizing the German railroads. But his words imply that overcoming market failure in general and the regulation of natural monopolies in particular, that is in the focus of this volume, are both relevant and complex, that it has a historical and a modern dimension, and that there are numerous perspectives: historical, political, economic, and jurisdictional perspectives – to name just a few.

This volume tries to figure out, how much truth lies in Alexander Meyer's observation and aims to identify concepts, interests and obstacles in German and American regulatory discussions then and now. The volume presents the results of a conference that was based on the cooperation between the German Historical Institute, Washington, D. C. and the interdisciplinary research project "*Designing freedom – The implications of historic legacy and standardization on the regulation of the economy*".

This project was funded by the German Federal Ministry of Education and Research from summer 2009 until November 2012 and was carried out jointly by *Mathias Schmoeckel*, *Frank Schorkopf*, *Günther Schulz* and *Albrecht Ritschl*. The project combined three fields of research: history, economics and law. It was split up in eight sub-projects, which had different scientific origins but are all aiming to conceive the economic and legal dimensions of regula-

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[1] With thanks to Cathrin Gehlen for her editorial support of these introductory remarks and to Niels Krieghoff and Ines Borchert for their support with the English translation.

[2] Original quotation: „*In der That bietet die Frage, […] wie überhaupt das Eisenbahnwesen gesetzlich zu regeln sei, so grosse Schwierigkeiten dar, dass man behaupten könnte, je eingehender sich Jemand mit diesen Fragen beschäftigt hat, desto mehr ist er um die Antwort verlegen*.", (M.[EYER] 1875, P. 133).

tion, as well as analyzing its historical and cultural dimensions. They bring together actors from different backgrounds and with different perspectives: public authorities, interest groups as well as scientists from finance, economics and law. They analyze academic and administrative discussions as well as negotiation strategies and conflicts of interests. This allows them to visualize both traditional and historic influences in order to identify potential resistance to the concept of regulation and, consequently, point out possibilities for further adjustment in order to overcome such resistance.

Regulation as a historical phenomenon seems not only to influence markets or market behaviour but has a strong social impact as well. Moreover, it is a transnational phenomenon – especially considering that these days economic knowledge is globalized much more than in the past, and transfer of knowledge plays an important role. The basic problem this volume concentrates on – the reaction on market failure caused by natural monopolies – is quite similar in both Germany and the United States. But as *Mathias Schmoeckel* explains, the paths of development diverge. Maybe they look similar in the present, but from a historic point of view, the differences are dominant.

Though the terms regulation and deregulation are currently on everyone's lips, in many instances it is being overlooked that regulation, in its strict (economic) sense, is a concept to control or to induce competition in markets. Natural monopolies are the most prominent application of regulation; after all, efficient competition cannot emerge by itself in such cases. Due to historical reasons, opinions vary greatly as to what exactly constitutes regulation. For German legal scholars, the term regulation is almost exclusively reserved to network industries such as railways, telecommunication and electricity (Schmoeckel 2009; Fehling/Ruffert 2010). In the U.S., however, the term regulation frequently encompasses all government actions designed to influence the behavior of market participants (Stiglitz 2010, Balleisen/Moss 2009).

By the end of the 19th century, it became blatantly clear in both the USA and Germany that in order to overcome natural monopolies and market failure, these monopolies needed to be regulated. Attempts to solve the natural monopoly problem ranged in between two extremes: on the one hand there was government regulation of private companies and on the other hand government provision or nationalization. The U.S. government chose to federally regulate private companies. This decision had important implications on antitrust legislation as well: most prominent are the Sherman Anti-Trust Act in 1890 and the Clayton Act in 1914. At the same time the path taken in Germany and most of Continental-Europe was that of state provision in the form of government monopolies (Millward 2005; Clifton/Comin/Diaz-Fuentes 2011). This pattern can be first observed in the railway sector (Phillips 1965; Ziegler 1996; Michalczyk 2010). This is later followed – with modifications – by the telecommunications sector (Wilson 2000; Hesse 2002; Kurth/Schmoeckel 2012) as well as the electricity sector (Stier 1999; Hausman/Hertner/Wilkins 2008).

Even though the United States and Germany were facing identical challenges and the network industries developed in a similar manner, both countries decided to embark on markedly different paths. Existing research suggests that political reasons are the cause for this divergence. This is clearly visible in the case of railways. While the Prussian government decided to nationalize the railway industry due to political, fiscal and military considerations and due to deliberations regarding the country's economic structure (Ziegler 1996), the American government decided against nationalization, citing, amongst other reasons, the administration's lacking capacity to administer government entities of such dimension (Phillips 1965). In the case of the electricity industry, diverging political interests of companies, local governments as well as the federal government were the main forces which prevented a coherent regulatory framework (Hausman/Neufeld, in this volume).

Consequently, regulation can generally be seen as the outcome of a bargaining process between stakeholders – in particular between enterprises, the scientific community, as well as the local and federal governments (Stigler 1975). While this approach to regulation has been studied in several sectors, there has not been a systematic analysis whether this political capturing of the concept of regulation – for example the steering of markets in the natural monopoly case – has really influenced legislation processes, and what it implied for the effectiveness and efficiency of markets.

Indeed, such discussions also provide a reflection of the contemporary understanding of the role of government and of its normative conceptions: in Germany, markets were a means to foster a common public interest – the so-called *Gemeinnützigkeit* respectively *Gemeinwohl* (nonprofit and/or public welfare); in the United States, the freedom of choice for market participants was the ultimate goal of regulation. Such blueprint viewpoints, however, obscure the numerous interdependencies, which can only become visible through a transatlantic dialogue. For example: while the discussion of regulation had its origins in Great Britain and in Germany – with the Prussian Railway Act of 1838 – a comprehensive regulatory attempt was first implemented in the United States with the Interstate Commerce Commission in 1887. This is not surprising, given the fact that the American mastermind in regulatory affairs, Henry Carter Adams (Adams 1883), had studied in Berlin with Adolph Wagner and was well aware of the discussion in Germany. In turn, the depiction of the German economic model in Hayek's work as "the road to serfdom" (Hayek 1944), significantly influenced, if not the American deregulation debate after World War II itself, then at least the general economic discourse about state intervention and market organization. As of the 1970s, the German academic debate was again greatly influenced by the American role-model, especially in telecommunication (Picot 2008; Frei/Süß 2012). These ideas were imported mainly by German economists and legal scholars who had been studying in the United States. Since the 1980s the concept of regulation has been undergoing considerable changes in Germany and it is challenging the traditional model of a social economy. Instead, the American model has been gaining support; rather than the government owning and controlling certain key enterprises, the American approach prefers to regulate industries – industries which are made up by private enterprises.

Yet even before then, the German economic regime had already been altered significantly due to the American occupation of Germany. The American model of antitrust legislation and the decartelization and decentralization policy after World War II influenced the German discourse about competition policy at least indirectly. The *Gesetz gegen Wettbewerbsbeschränkungen* of 1957 (Act against Restraints on Competition), on the one hand aimed for a structural break in the market system: competition instead of organization. On the other hand it perpetuated the government monopolies in the network industries in order to better serve the common public interest. Thus, the American model of regulating network industries was not adopted in 1957. Revealingly a dissertation on this issue dealing with the history of law is called "Antitrust in a German Way" (Murach-Brand 2004) and refers to a phenomenon that legal scholars call legal transplant: ideas are incorporated but also customized to the existing institutional order.

Such an adaptation of the American model of regulation in Germany and Europe is, however, a sign of increasing institutional congruence. At the same time it is also possible to witness the persistence of national regulatory traditions. The relationship between these two forces can only be explained historically. But for that, much more expertise is needed. Economists can provide knowledge about efficiencies of regulatory systems; legal scholars can explain constitutional und juridical limitations – then and now. And perhaps engineers (as well as economists) could illustrate interactions between innovations and economic systems, but this might go too far at this point.

As a first step this volume analyzes the German versus the American concept of regulation from a comparative historical perspective, using natural monopolies as the main focus of study. After all, it is only the transatlantic dialogue, which can explain why (1) different paths have been chosen, given similar problems and (2) how practical knowledge of regulating natural monopolies influenced the discussions and the legislation.

To become more specific, some systematic aspects shall be outlined in note form, which seem most relevant to describe regulation and its complexity. Most of these questions were seized by the authors but some were not discussed extensively. However, they might still help to understand the emergence of regulatory regimes as well as their continuity:

1. Both, Germany and the USA were and are federal states. But while the USA was a nation state before their industrialization, in Germany national unification and economic growth were simultaneous processes. Did this have an impact on different market designs?

2. However, German history is a history of two integration processes: the national integration in the 19th Century and European Integration after World War II. Were these more or less unique integration processes or is integration a driving force in regulatory history? Which role do integration and political negotiations play in the convergence of markets? Moreover, which role do external impacts play in general? For instance, Americanization and Europeanization are common catchphrases for the (economic and mental) development in Germany after World War II.

3. In Germany, the war economy in the two World Wars significantly influenced the debates with regard to state interventions: To what extent did fundamental breaks in (German) history have both short and long-term effects on regulatory designs? Is there a more coherent development in the US due to the lack of fundamental breaks?

4. This leads to the next question: What should regulation aim at? Competition and public welfare are probably the most obvious (contrary) aims, but what about fiscal, military, security, and labor market reasons?

5. Is there a relation between regulatory regimes and the market actors? Does the fact that you have a share of public companies in the markets lead to a different solution than having only private investors? Which role does capital play in general? In Germany, for instance, during the early stages of industrialization as well as after World War II, investment capital was lacking. Could this be an explanation, as to why the state had to step in?

6. How did changing knowledge influence regulation? The knowledge about economic processes as well as technical knowledge probably changed the understanding of particular markets. Especially technology thrusts lead to social and economic reflections. How and where was knowledge generated? In the markets, at universities or in public administrations? How do those actors interact in regulatory legislative processes? Political consulting, interest groups, think tanks and others often prepare regulatory decisions. When were their suggestions successful, when unsuccessful?

To simplify our approach to regulation – if this is possible at all – we have had decided to focus this volume on the intersection of legal and economic perspectives. On the one hand the constitutional and legal frameworks are analyzed; on the other hand the development of markets and the political influence exerted by market participants are investigated. Of particular interest are the formative periods of 1870/80 and 1930/35, which were major decision points as to which regulatory path to take. Furthermore, the period after the Second World War until the 1980s shall also be examined. It was then that the deregulation discussion took a firm hold in the United States. At the same time the American concept of regulation was replicated in Germany and the European Economic Community. Naturally, all of these points lead to the greater question about regulation in its cultural-historical context – the general principles underlying public regulatory policy in law, economics and society as well as existing path dependencies.

As the comparison of the social intentions, economic effects and legal adaptation of regulation and its rules in Germany and the United States is the central objective of this volume, the articles deal either with the German or the American perspective followed by a complementary paper – with the exception of *Alfred Mierzejewski's* and *Johannes Rüberg's* article, which are already comparisons. For bringing these two perspectives together the papers are supplemented by corresponding comments.

The first articles give a general overview of some core regulatory problems when describing the German and the American experiences. *Mathias Schmoeckel* compares the German and the American legal response to "big business". Next, *Markus Wagner* explains and subsequently compares the nations' different regulatory philosophies and how they have diverged considerably from one another since the early twentieth century.

The following articles deal with legal norms and the establishment of path dependencies between the late 19th and the first third of the 20th century. *Frank Schorkopf* analyzes the constitutional principles that have addressed regulatory questions since the foundation of the German Reich in 1871. *William Novak* portrays the decline of a world of local, common-law self-government and the rise of a considerable modern administrative state regulatory apparatus in the United States. Completing these mainly legal perspectives with concrete examples of regulation in both countries *James W. Ely Jr.* investigates the U.S. railroad regulation in the nineteenth century, while *Boris Gehlen* shows that regulatory concepts of interest groups for railway, telecommunications, and electric industry legislation between 1871 and 1935 ranged between the poles of regulation and nationalization.

The regulatory discourses after World War II are the core subject of the next paper. *Marc Levinson* shows "an unnatural monopoly": He characterizes the evasion of existing regulations as a driving force in U.S. transport deregulation. Transport in this case does not only mean railroad traffic but also water, air and road transportation.

The final articles challenge the comparative perspective by mainly underlining the differences between German and American market organizations since World War II. *Alfred C. Mierzejewski* compares "apples and oranges", which means in this case the historical development of railways in the United

States and Germany, while *Johannes Rüberg* tells the "Tale of Fraternal Twins: German vs. U.S. Telecommunications in the 20th Century". *Klaus F. Gärditz's* article comments on "The Creation of Regulated Competition Markets and the Rise of Bureaucratic Autonomy in the German Law of Telecommunications". *William J. Hausman* and *John L. Neufeld* present several attempts to organize electricity regulation in the United States beginning in the late 19th and ending in the early 21st century. *Alexandra von Künsberg-Langenstadt* describes the reasons for the great powers of persistence in the monopolized electricity industry in Germany between 1950 and 1980.

Finally, there is some evidence that *Alexander Meyer* was right. In a historical perspective neither a simple answer emerges how to overcome market failure best, nor can a typology of regulatory arrangements be depicted. As always in history contingency is, of course, a relevant explanatory factor for certain regulatory regimes. But beyond that this volume implicitly illustrates that probably "best practices" in markets not only depend on appropriate economic models but on social and political legitimation as well: As long as regulation allows for a generally accepted market output, market efficiency seems to be of minor importance.

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Liberty *in* or *for* the Market? The Legal Response to "Big Business" in the United States and Germany

MATHIAS SCHMOECKEL

A. Introductory Considerations: "Big Business" and Economic Success

Economically, the 20th century is marked by the growth of the U.S.-American market and the economic leadership of the United States and the West. The reasons behind the rise to precedence can be accounted for in numerous ways. Moreover, many nations are contained within the western world, as well as a plethora of legal systems, all which have provided for the flourishing of this economic development. Different states must be analysed in order to find out whether and to what extent economic strategies cause highly profitable economies. In this paper, the focus will lie on the United States of America and the Federal Republic of Germany. Each of their legal frameworks will be examined, specifically as to how they provide for the structures of the market. The economic expansion of both nations in the 20th century was connected in many ways. It is well known that Germany exerted a very significant influence upon the United States – primarily in the early 20th century, and vice versa following the Second World War.[1] The topic, however, will centre on the conflict of big business and the free market system.

In the second half of the 19th century, a new economic problem surfaced in both countries. Namely, when many of the big railway companies went bankrupt in the 1850's and 1860's suddenly certain entrepreneurs rose to unheard of importance. To this day, industrialists such as John D. Rockefeller, Andrew Carnegie and J.P. Morgan are recognized more than some presidents, Andrew Johnson, Rutherford B. Hayes or Chester A. Arthur to name a few. These industrialists created "giant corporations" and thereby

[1] E.g., the German economic "historical school" influenced many Americans in the first half of the century, cf. Rodgers 1998, p. 83. For the "Americanization" of German economy after 1945 cf. Berghahn 2010, p. 71.

introduced a new type of business, commonly called, “big business”.[2] Around the year 1900, these big firms formed some of the most profitable branches ever to be seen. Contrary to the businesses that went before, they distributed goods to the consumer over the entire country. This is true for the United States (Jaeger 1973, p. 15) as well as for Germany.

On the one hand, this new business model was a threat to the free market. Consider the Vanderbilt and Rockefeller monopolies, both possessing unheard of wealth. A worse example was set by the crook Jay Gould who avoided imprisonment by successfully bribing public officials to change legislation to his advantage. In 1869 he began buying up all the available gold, and, thanks to his connections in Washington, prevented government intervention. When the government eventually sold some of its gold to reduce its inflated price, Gould had already sold off his gold for maximum profit (Kurzlechner 2008, p. 17). In some ways, the rise of big business threatened the free market, perhaps even constituting criminal actions, as their lobbying could even influence legislation.[3]

On the other hand, such new enterprises made new ways of trading and production possible. Especially in the United States, the newly constructed railroad and telegraph networks contributed to this phenomenon (Chandler 1977, p. 485). The organization of trains, the efficient movement of goods and passengers, providing for the safety of the transport, as well as further developing the network through building or buying other companies demanded very different skills from the staff. Furthermore, in order to make a network attractive, one has to build it up as fast as possible. Therefore, companies were forced to grow fast. Alongside the expansion of a company, a centre for research and strategy was also essential. The new management structure of big businesses led to constant imbalances and tensions in the workforce. Leading managers became a necessity in the administration of large enterprises (Chandler 1977, pp. 487, 489). The United States in particular became the seed-bed of managerial capitalism.

Branches with cost intensive developments particularly profited from this evolution. The development of new networks demanded new dimensions of capital. Additionally, technological and physical knowledge of new products was needed. The big companies dominated nearly all forms of major production i.e. railways, cars, weapons, even the new productions of colours, and artificial fertilizer were subsumed by big businesses. Largely, the expensive new procedures of production were implemented in the fields of technology, chemistry, and physics. In these fields, highly trained specialists must be hired by companies in order to achieve success,

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[2] For a good description of this new type of business corporations and economic activities cf. Kurzlechner 2008, p. 15.

[3] For an economic evaluation of lobbyism cf. Becker 1983, pp. 371–400.