

Government 1521
Bureaucratic Politics:
Government, Military,
Social and Economic Organizations

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Lecture 18:
Organizational Transformation and Corruption

Richard White:
“Information, Markets and Corruption”

➤ What is corruption?

“The corrupt buy or sell what was not supposed to be for sale – a vote, for example, or public property. They turn to personal advantage their legal status as trustees of persons or property. Or they grant only to a privileged few what is purportedly available to all or available only through open and fair competition.”

➤ How do modern organizational forms permit it, and what do they do to deter it?

RRs – system building

1870s-1880s: Managers versus investors

System-building: Jay Gould (Penn RR): by 1881, controlled the Kansas Pacific, Missouri Pacific, Missouri, Kansas & Texas, Wabash, Lackawanna, Central of NJ, NY&NE, and Erie (VH, 160).

Strategy: in order to finance security debt, need to control traffic and divert it to your own roads.

Later, Vanderbilt (as response to Gould)

Still later...Union Pacific (Gould, then Charles Francis Adams), Central Pacific, Southern Pacific (Collis Huntington), Santa Fe (William B. Strong).

Central Pacific Railroad “The Associates” or “Big Four”



Leland Stanford
President



Collis Huntington
VP



Mark Hopkins
Treasurer



Charles Crocker
Construction
Supervisor

Central Pacific Railroad

Crucial because it was first transcontinental RR
(with Union Pacific, Promontory connection
point).

Often ignored because Union Pacific was involved
in Credit Mobilier scandal.

How Did Corruption Work?

1. K investment requires issuance of securities
2. Urban banking houses (Jay Cooke & Co, Fisk and Hatch) issue the securities
1867: \$0.416B
1874: \$2.230B
1890: \$5.055B
3. Railroads over-hype their operations, accrue debt, mask it.

How Did Corruption Work?

Then, three ways to turn debt into profit:

4. Insider contracts funnel money from stockholders and lenders "into the pockets of the inner clique who controlled the Credit Mobilier." [Sell bonds at face value (below market value) to politicians, other elites.]
5. Pocket money and evade legal penalties
6. Corrupt a corporation for the long term: CP transform debts of Associates' properties into cash, cash goes to Associates (in others' names)

In all cases, cook and burn the books.

"Continuous" Corruption

Such corruption drained funds from the Central Pacific, but it also shows the complications and contradictions that arose within corporations as they tried to rationalize and bureaucratically order their internal affairs while obfuscating and concealing their financial dealings. Managers, accountants, and bookkeepers quickly realized that the men who headed such corporations were not necessarily interested in the welfare of other stockholders or bondholders. W. Milner Roberts, the chief engineer of the Northern Pacific, complained of the suspicious and extravagant contracts negotiated to build the road. "If contracts are to be made from 'policy,' that is one thing," he wrote Jay Cooke, "but I can do it better under such a system as would be best for the pecuniary interests of the stockholders and bondholders."

"Continuous" Corruption

In similar situations, corporate employees saw their own opportunities. Before closing down the Contract and Finance Company in the early 1870s, Huntington sent J. O'B. Gunn to examine the books. The Associates knew what they did not want Congress to find in those books, but what Gunn found surprised them. It took him only a few hours to find "where [John] Miller had stolen \$300,000." It took longer to find that between \$750,000 and \$900,000 (the Associates made various estimates) was missing. John Miller, as it turned out, was not really John Miller—he was Ambrose Woodruff. The Associates got back roughly \$400,000, but the rest was gone for good. The books needed to convict Miller/Woodruff were the same books that had the potential to convict the Associates if Congress inspected them. Since Miller/ Woodruff knew too much, the Associates never prosecuted him.

Presaging the Panic of 1873

“The enormous amount of European capital sent to this country of late years (a great deal of which has been wasted in extravagance and ill spent in wild cat enterprises such as Railroads through deserts—beginning nowhere and ending nowhere) bearing interest which has heretofore been reinvested here but now will probably be remitted together with heavy trade balances against this country will all tell on our gold supply. To meet this demand we probably have less than at anytime within the last 25 years, so that the whole thing looks very serious to me indeed.”

Panic of 1873

There was a sense that the 1873 crisis had revealed deep flaws, not just in the financial system, but in a larger cultural order. *Bankers' Magazine* might attack the “reckless credulity” of European investors, but American investors had been similarly deceived. In the wake of the panic of 1873, the *New York Sun* described the two most disturbing parts of the crisis: the failures of trust and of information. Large numbers of small investors had traded safe U.S. bonds for risky Northern Pacific bonds sold by Jay Cooke and Company. They had trusted not only the representations made about the safety of Northern Pacific securities but also the counsel of presidents and cashiers of banks in country towns who were paid commissions by Cooke to encourage such exchanges. Their trust had been violated. Most disturbingly, those deceived were “the intelligent classes, who read newspapers, mingle in affairs, and have constant access to information.”

Journals and newspapers raised the question of who had been hurt, but there was a connected issue. Had their losses secured a larger good: a national railroad network? Had corruption in effect worked for the benefit of the nation?

Who Lost?

1. **Small Investors**
2. **Overbuilding: We All Lost**

“The second issue was whether corruption had been necessary to lure investors into making investments that were good for the nation but that they would have shunned had they possessed accurate information.

...This argument makes two assumptions, at least about the transcontinentals. First, that corruption built them and, second, that building them was a good thing. The corruption of the 1870s did not add a single new route across North America. The Texas and Pacific and the Northern Pacific defaulted and were not completed. The Memphis, El Paso and Pacific was a total failure, as was the Atlantic and Pacific Railroad. The Union Pacific/Central Pacific near-monopoly (supplemented by the Southern Pacific) remained intact until the completion of the Northern Pacific in 1883.”

Overbuilding: We All Lost

That the country needed a transcontinental railroad is not the issue; the question is whether the country needed any or all the routes promoted during the 1870s or the chaotic development that corruption helped deliver. The argument that corruption was necessary to build any transcontinental puts the burden of proof on those arguing for the efficacy of corruption. Since only one road was completed before 1883, the question boils down to the Central Pacific and the Union Pacific. Corruption may have been essential to turning such men as Collis P. Huntington, Leland Stanford, and the other Associates into millionaires, but it does not follow that it was essential to the building of the first transcontinental. Corruption could be integral to the Pacific road, continuing long after the road's completion, without necessarily being essential to its existence.

White:

Need to Integrate Corruption into Our Understanding of the Corporate Organization

If corruption was integral to the building and operation of the transcontinental railroads, then our usual ways of understanding those enterprises fail us. Yes, the railroads engaged in market competition; yes, they were subsidized enterprises; yes, they eventually became rationalized products of a visible managerial hand. But market competition, subsidies, and managerial rationalization cannot alone or in combination describe how the system actually worked—all leave out corruption. Corruption was never so simple as businessmen seeking to improve their bottom line; the corrupt often prospered at the expense of the firms they ran. Corruption produced winners and losers and tangible results.

Which Brings Us To...

Enron

An echo of the Central Pacific.

Debts and losses placed in "Offshore" accounts that are withheld from the official accounts.

Need a co-conspirator: in this case, Arthur Andersen.
