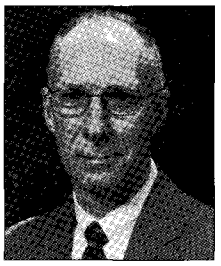
When the Government Took Over U.S. Investment



BY ROBERT HIGGS

In the oft-quoted final chapter of *The General Theory of Employment, Interest, and Money*, John Maynard Keynes concluded that if we are to avoid a chronic tendency toward economic depression, the state will have to undertake, among other things, "a somewhat comprehensive socialisation of investment . . . though this need not exclude all manner of compromises and of devices by which public authority will co-operate with private initiative."[1] Fortunately, in the long term this ill-founded policy proposal was not embraced outright in either the United Kingdom or the United States. For several years, however, during World War II, the U.S. government did carry out a "somewhat comprehensive socialisation of investment," whose effects most economists, then and afterward, have misunderstood.

In mid-1940, the U.S. government initiated a serious program to prepare for war. Between June 1940 and December 1941 about $36 billion was made available to the War Department alone—more than the Army and Navy combined had spent during World War I. As Secretary of War Henry L. Stimson remarked, however, "the pinch came in getting money turned into weapons." The United States possessed enormous potential to produce munitions, but early in 1940 its munitions industry was, in Donald Nelson's words, "only a token industry," and by comparison with the munitions industry of Japan or any of the great European powers, "a pigmy." To succeed, the rearmament program somehow had to "enable American industry to make the heavy capital commitments, plant expansion, and organizational changes essential to large-scale armament production."[2]

In 1940 and 1941 the government placed heavy reliance on measures to induce private enterprises to invest in war-related industrial capacity by granting tax concessions and by adopting new procurement rules—cost-plus contracts, advance payments, and other measures—to shift risks from the arms suppliers to the taxpayers.[3] Businessmen, however, were reluctant to invest heavily in the projects the war planners deemed most urgently needed, and ultimately, especially after the declaration of war in December 1941, the government resorted for the most part to directly financing the build-up of war-related capital; that is, it resorted to what had been called, during the war of 1914–18, "war socialism."

For net national investment considered in its entirety, the government completely displaced private investors during the war. According to National Income and Product Accounts data for the years 1942–45, *net* private investment was minus $6.2 billion, and *net* government investment was plus $99.4 billion.[4] Although economists have credited this government investment with various positive contributions to wartime and postwar economic growth, the bulk of it had little or no value beyond its immediate contribution to winning the war. Thus this episode dramatically exposes a fundamental, but false, assumption that underlies the official data on capital formation—namely, that *all* expenditures for durable producer goods or munitions form genuine capital.

Of the government's vast wartime expenditures for "capital formation," almost $14 billion went to build so-called command installations—bases, training facilities, ammunition depots, staging areas, induction centers, prisoner camps, and a great assortment of other strictly military facilities.[5] At least 90 percent of the government's *net* investment of $85 billion for durable military *equipment* in 1941–45 went to purchase items such as combat airplanes, tanks, warships, guns, ammunition, and other such purely military durable goods, which had little, if any, value in peacetime activities.

Of the amounts spent on manufacturing facilities,

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which accounted for approximately 90 percent of the government's wartime *industrial* investment of $17.2 billion (gross), the bulk flowed into a handful of industries: aircraft engines, explosives and shell-loading, shipbuilding and repair, ammunition, guns, machinery and electrical equipment, petroleum and coal products, combat and motorized vehicles, and machine tools.[6] As economist Glenn McLaughlin concluded in 1943, "In general, the proportion of public financing has been at a maximum for those industries whose expansions have been most disproportionate to probable postwar needs; . . . specialized war plants . . . possess questionable peacetime value; . . . [and] some of the special-purpose machinery will be worthless for peacetime operations."[7] Validating this assessment, a 1946 study by an analyst for the Board of Governors of the Federal Reserve System concluded, "Prevailing opinion seems to be that about two-thirds of the Government owned war plants will not be adaptable to postwar production."[8]

Postwar auctions of plants the government had built during the war confirmed these assessments. In general, the bidders offered no more than a small fraction of what the government had spent to construct the facilities. For example, the Maritime Commission, which had "decided to finance the emergency [ship]yards as if they were arsenals" because "it was believed that they would have little or no postwar value," discovered that, indeed, after the war, "shipyards were a drug on the market," and "only a few found purchasers willing to pay even 12 per cent of what the yards cost."[9] The Navy's enormous accumulation of new and expanded shipyards had similarly little value after 1945.[10] Likewise, the War Department's huge accumulation of aircraft-building plants represented a drastically excessive capacity for satisfying the anemic postwar demand for aircraft, and hence it had little value.[11]

Unsustainable Distortions

Besides producing unsustainable distortions in the sectoral and industrial composition of the capital stock, the government's investment program created distortions in its locational distribution that reflected, in part, wartime security concerns and, in part, adjustments to other forms of government-induced wartime distortions, for example, those in available energy supplies. McLaughlin remarked in 1943, "Many war plants throughout the country will be physically appropriate for the manufacture of civilian products but geographically inappropriate."[12]

In sum, most contemporaries greatly exaggerated the heroic achievements of the wartime socialization of investment, as have subsequent historians and economists. In large part, they simply failed to appreciate how much of the "capital" took strictly military forms. Even the industrial investments, however, proved largely ill-suited for making a valuable contribution to postwar civilian production: they were too concentrated in the wrong industries and in the wrong locations for postwar purposes. The wartime socialization of investment served a definite purpose in helping the U.S. military-industrial complex to triumph over the nation's enemies in World War II, but beyond that, its achievements had little, if anything, to recommend them.[13]

1. New York: Harcourt, Brace and World, 1936, p. 378.
2. Henry L. Stimson and McGeorge Bundy, *On Active Service in Peace and War* (London: Hutchinson and Co., 1947), p. 166 (Stimson quote); Donald M. Nelson, *Arsenal of Democracy: The Story of American War Production* (New York: Harcourt, Brace and Co., 1946), pp. 34–35 (Nelson quotes); Elberton R. Smith, *The Army and Economic Mobilization* (Washington, D.C.: U.S. Army, 1959), pp. 129 (Smith quote), 219.
3. For description and evaluation of these measures, see Robert Higgs, *Depression, War, and Cold War: Studies in Political Economy* (New York: Oxford University Press, 2006), pp. 37–56.
4. For data sources and calculations, see ibid., pp. 84–85.
5. Smith, pp. 444, 448.
6. Glenn E. McLaughlin, "Wartime Expansion in Industrial Capacities," *American Economic Review* 33; Supplement (March 1943), pp. 100–109.
7. Ibid., pp. 109, 114, 116.
8. Frederick C. Dirks, "Postwar Capital Formation and Its Financing in Manufacturing and Mining Industries," in *Private Capital Requirements* (Postwar Economic Studies No. 5) (Washington, D.C.: Board of Governors of the Federal Reserve System, 1946), p. 14.
9. Frederic C. Lane, *Ships for Victory: A History of Shipbuilding under the U.S. Maritime Commission in World War II* (Baltimore: Johns Hopkins Press, 1951), pp. 108–09, 117.
10. Ibid., p. 397.
11. Higgs, p. 91.
12. McLaughlin, p. 117.
13. For a detailed analysis, see Higgs, pp. 81–100.

Government-Mandated Fuel-Efficiency Standards

BY MICHAEL HEBERLING

Government mistakes have long lives. In response to the energy crisis of the 1970s, Congress passed the Energy Policy and Conservation Act. This legislation had two major objectives: 1) Reduce our overall consumption of petroleum and 2) reduce our dependence on foreign oil (meaning OPEC). The means to accomplish this was CAFE, Corporate Average Fuel Economy. Under CAFE automobile manufacturers were required to produce cars that averaged 18 miles per gallon. For light trucks the standard was 15.8 MPG. There was some flexibility. Every car (or truck) did not have to meet the standard. However, the average of all models (small, medium, and large) had to meet or exceed the standard. Failure to do so would result in a fine of $55 per car for every MPG shortfall. CAFE initially took effect with the 1978 models. The standard was increased in 1985 to 27.5 MPG for cars and to 20.7 MPG for light trucks. The light-truck standard will increase to 22.2 MPG in 2007.

As happens so often, the results of the fuel-efficiency program were opposite of the stated objectives. By reducing the per-mile cost of driving, it became economical to drive more. Forget carpooling and public transportation. The significant savings in MPG (114 percent improvement for cars and 56 percent improvement for light trucks) were more than offset by an increase in the per capita miles driven (through more leisure driving and living farther away from the workplace). So instead of seeing a drop in oil consumption, there was *a significant increase*. In 1975 U.S. consumption of oil was 14.4 million barrels per day. Today, we consume 18.7 million barrels per day. Given this revelation, it should not come as a surprise that oil imports did not decrease as predicted but *increased*. In 1975, before CAFE, we imported 37 percent of our petroleum requirements. According to the government's *Monthly Energy Review* of July 2005, with CAFE we now import 64 percent. CAFE neither reduced America's use of foreign oil nor lowered our consumption of gasoline.

Even if the masses had done what the elite class wanted (that is, drive less), it is unlikely the results would have been much better. Conventional wisdom assumes that most of a barrel of petroleum becomes gasoline for automobiles. Actually, gasoline accounts for less than half (44 percent) of the petroleum end-products. Some of the other end-products include: petrochemicals (such as plastics), jet fuel, diesel fuel, kerosene, propane, and home heating oil.

When the CAFE standards took effect in 1978, the initial impact was benign. Because of the high gas prices, consumers already strongly preferred high-mileage cars. There was no need for a mandate because consumers and the auto industry were responding to market conditions. In 1981 prices peaked at an inflation-adjusted $3.07 a gallon. After that, real gas prices started to plummet. By 1986 they had fallen to the lowest levels in 30 years. As a result, American consumers were abandoning the small cars for their true love: Big Cars. Unfortunately, Phase II of CAFE was just kicking in. The federal government was now pulling the auto industry and the consumer in opposite directions. By law the auto industry would be punished if it provided products that the consumer wanted. The industry had no choice but to pursue the following suicidal strategy: Overcharge for the big cars consumers demanded in order to restrict

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