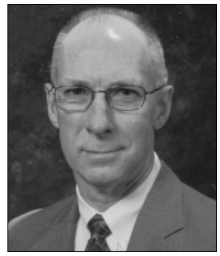
When the Government Took Over U.S. Investment



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.