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A NEW RECONSTRUCTION FINANCE CORP.: NO CURE FOR U.S. ECONOMIC ILLS

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INTRODUCTION

Bring back the Reconstruction Finance Corporation. This is the refrain found in a number of bills recently introduced in Congress which seek to cure America's economic ills by re-establishing a modern version of the Depression-era Reconstruction Finance Corporation.[1] The rhetoric backing these bills makes the RFC seem almost irresistible. The RFC proposed by Senator Ernest Hollings (D-SC), for instance, is to "rebuild the national infrastructure and restructure and revitalize basic industries; promote and facilitate short-run and long-run economic growth; and ensure the ability of the United States to compete in the world economy."[2] Adds Representative Frank Guarini (D-NJ):

> Our economic problems are very severe. They defy quick-fix solutions. This is why we need to approve the time-tested approach by establishing a Reconstruction Finance Corporation as the central feature of our economic development plans in the 98th Congress. The original RFC, created in the Depression, helped boost American productivity and employment for nearly two decades. It also returned a profit to the Government.[3]

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1 These bills include H.R. 134, introduced by Representative Frank Guarini (D-NJ); H.R. 1480 introduced by Representative Claude Pepper (D-FL); H.R. 1827 introduced by Representative Jamie Whitten (D-Miss.); H.R. 2612, introduced by Representative John Murtha (D-Pa.); H.R. 2847, introduced by Representative William Ford (D-Mich.); and S. 265, introduced by Senator Ernest Hollings (D-SC).

2 S. 265, pp. 1-2.

3 Congressional Record (House), January 3, 1983.

The broad political appeal of RFC legislation is indicated by the array of business and labor leaders supporting the concept, and by the fact that the bills introduced to date have been sponsored by members of Congress from many regions of the country.

In introducing his bill, Senator Hollings laid out the rationale of the RFC proposal as to:

> provide limited, temporary, and repayable assistance to cities and businesses to help them rebuild, repair, and remodel, so that our businesses can become competitive again and our cities can function efficiently again....
>
> We cannot afford to let the situation continue. We must not permit our basic industries--the foundation upon which we have built the world's dominant economic power--to wither and die. To abdicate the role we have established, to let it pass to the hands of other nations because we made a conscious decision to let it happen would mark one of the sorriest episodes in our economic history.[4]

Contrary to the admirable intentions of its sponsors, however, the evidence argues persuasively that an RFC would not reinvigorate the economy as predicted. Rather, it would merely insure political subsidies of faltering corporations, imposing yet another government drag on U.S. economic development.

THE RFC PROPOSAL

RFC initiatives are the centerpiece of calls for a national industrial policy. An RFC would be capitalized to the tune of $5 billion from general federal revenues and authorized to provide guarantees and loans at below-market interest rates to private firms and local governments.[5] The RFC would be directed by a board of seven trustees, each appointed by the President for a three-year term. Depending on the proposal, the RFC board might include, *ex officio*, specified government officials, such as the Secretary of the Treasury, the chairman of the Federal Reserve Board of Governors, or the chairman of the Council of Economic Advisors.

Under Senator Hollings's proposed RFC, a business would be eligible for aid so long as the governing board of the RFC could certify that it was "likely to become insolvent without such assistance, that its closure would adversely and severely affect the economy, and that credit is not otherwise available to the concern on terms and conditions that are conducive to its survival."[6]

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4 *Congressional Record (Senate)*, January 27, 1983, p. S454.

5 Earlier RFC proposals, tendered in 1982, called for a capitalization of $20 billion.

6 S. 265, p. 5.

Furthermore, to be eligible, businesses could be required to submit a "plan of reorganization and recovery which, in the judgment of the Board, is reasonably certain to restore such concern to profitability within the period for which credit or other assistance is extended."[7] The Hollings RFC apparently would permit making loans to firms that are expected to fail; the purpose would be to ease the transitionary pain felt by workers and communities when plants close in a restructuring economy.[8]

The amount of aid given to a firm might be restricted. Hollings, for example, calls for a ceiling of 5 percent of the "sum of (i) the authorized capital stock of the Corporation [that is, the RFC], plus (ii) the aggregate amount of the bonds of the Corporation authorized to be outstanding when the capital stock is fully subscribed" or 50 percent of the amount of aid required in the firm's "reorganization and recovery plan."[9] And the loans probably would be restricted to, say, ten years, and carry interest rates no less than the average market yield on U.S. government bonds and notes with the same maturity date.

Versions of the RFC concept--sometimes labeled an "Economic Development Bank," a "Regional Development Bank," or a "Technological Development Bank"--differ in the emphasis placed on aid to developing "sunrise" industries or to older "sunset" industries. But their common theme is that government should intervene in the investment and reinvestment process. New York investment banker Felix Rohatyn, a leading advocate of an RFC, has been quoted as saying, "I'm not sure there is any one blueprint. There are many roads that lead to Rome--as long as you're willing to intervene."[10]

The diversity of views over exactly how an RFC should be constituted, however, may prove to be the Achilles' heel of the movement. Representative Richard Gephardt (D-Missouri), an outspoken leader in the national industrial policy movement, has noted:

> To come in with a bill for an RFC, that's a fifth step. An RFC may be okay, but I think it's putting the cart before the horse. If you don't have a basic understanding that we want to starve these industries and nurture those, then the RFC will be a group without a consensus, a group without mandate. And it won't work.[11]

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7 <u>Ibid</u>., p. 6
8 <u>Ibid</u>.
9 <u>Ibid</u>., p. 10.
10 As quoted in Randall Rothenberg, "An RFC for Today: A Capital Idea," <u>Inc.</u>, January 1983, p. 48.
11 <u>Ibid</u>.

Harvard University Professor Robert Reich shares this concern. Reich strongly supported the RFC concept in his widely read book on industrial policy.[12] Yet he now questions its political viability, fretting that "[i]n many respects, the [RFC] bank conjures up the wrong image. It plays into the hands of those who say industrial policy is a disguised form of central planning. It sets up a straw man."[13] But when RFC proposals are predicated upon the view (a) that private markets have inadequately allocated capital, (b) that the federal government must become involved in investment and reinvestment decisions to alter the flow of capital between regions and industries, and (c) that the efforts of the RFC will be guided by national economic goals established by a "tripartite council" (composed of labor, government, and business leaders), the inescapable conclusion must be that the RFC would be part and parcel of a central, albeit limited, planning process. When proponents of the RFC are actively promoting central planning, a straw man is unnecessary. The RFC concept itself is full of straw.

PROBLEMS WITH THE RFC

The RFC is founded on a number of contentions that are highly questionable.

The State of the Economy

Proponents of the RFC apparently are concerned that U.S. economic problems are so severe that normal market processes cannot handle them. America, they say, is going through a major restructuring of industry--a rapid, if not haphazard, transformation from a manufacturing-based economy to a service-based economy. RFC advocates contend that the long-term trend in total employment in the U.S. is flat; that manufacturing employment and output are on a long-term decline; and that American businesses are unable to adapt to the new economic realities of accelerating capital mobility, technological change, and competitiveness in world markets. Proponents appear genuinely concerned that the recent recession is a preview of the nation's long-term economic fate, unless drastic and carefully orchestrated policy changes are made. As Professor Reich puts it:

> Since the late 1960s America's economy has been slowly unraveling. The economic decline has been marked by growing unemployment, mounting business failures, and falling productivity....
>
> America has a choice: It can adapt itself to the new economic realities by altering its organization, or

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12 Robert Reich, The Next American Frontier (New York: Time Books, 1983).

13 As quoted in Peter Petr, "Industrial Policy Is a Knot in the Democrats' Economic Plank for '84," Washington Post Weekly, November 7, 1983, p. 12.

> it can fail to adapt and thereby continue its present decline....Adaption will be difficult....A new consensus is difficult to achieve when each person seeks to preserve his standard of living but finds that he can only do so at the expense of someone else. But failure to adapt will rend the social fabric irreparably. Adaptation is America's next challenge. It is America's next frontier.[14]

The facts, however, do not bear out the dire predictions of national industrial policy enthusiasts:[15]

* Total employment in the U.S. rose by 50 percent between 1965 and 1980, up from the 35 percent increase in the previous 15-year period.

* Manufacturing employment has experienced ups and downs with the business cycle, but the trend has remained more or less level at about 20 million jobs.

* Manufacturing employment, as a percent of total jobs, will continue to decline between now and 1990, but according to projections from the Bureau of Labor Statistics, the absolute number of jobs will continue to rise at an average annual rate of 0.8 percent.

* The market value of manufactured goods, as a percent of gross national product, was no lower in 1980 than in 1970, shows George Mason University economist Thomas DiLorenzo in a forthcoming Heritage Foundation Backgrounder.

* The U.S. recently has experienced balance of trade deficits (and, incidentally, balance of service surpluses). Those deficits have been primarily in low-tech, low R&D products. America has also been experiencing a growing trade surplus in high-tech, high R&D products, a fact that should lead one to question the presumption that American businesses have lost their ability to adapt.

* The U.S. experienced serious economic difficulties during the 1970s; high unemployment and low productivity growth are two examples. However, the U.S. outperformed other European economies in terms of manufacturing employment--even though many of these nations long ago adopted national industrial policies.

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14 Reich, The Next American Frontier, pp. 3 and 21. For a critique of Robert Reich's work, see Dwight Lee, "The Flawed Logic of National Industrial Policy," Heritage Foundation Backgrounder No. 299, October 31, 1983.

15 The points made in this section are developed in detail by the author in "NIP in the Air: Fashionable Myths of National Industrial Policy," Policy Review, Fall 1983, pp. 75-87; and "The Great National Industrial Policy Hoax," a paper prepared for presentation in the Manville American Enterprise Lecture Series," College of Business, University of Notre Dame, November 17, 1983. See also Charles Schultze, "Industrial Policy: A Dissent," Brookings Review, Fall 1983, pp. 3-12.

Brookings Institution Senior Fellow Charles Schultze, economic advisor to Democratic presidents, sees a clear pattern:

> America has not been de-industrializing. Throughout the industrial world, economic performance in the 1970s did fall behind the record of the 1960s. But relative to the industries of other countries, American industry performed quite well by almost all standards.[16]

The RFC in History

The RFC is being proposed on the presumption that the original Reconstruction Finance Corporation, established by President Herbert Hoover in 1931, was successful in revitalizing the economy during the Great Depression and that a similar agency would be just as successful in revitalizing the economy now. But Herbert Stein, Senior Fellow at the American Enterprise Institute, points out that the RFC of the 1930s operated at a time when business was so depressed that the RFC could easily spot and promote profitable ventures. The task of determining which industries should be aided and lifted to the status of "winners" is not nearly so simple in the 1980s. Even assuming that the original corporation was successful, a newly-instituted RFC is not likely to mirror the experience of the 1930s.[17]

Clemson University Professor Clark Nardinelli disputes that even the original RFC was successful. A scholar of American economic history and the author of Part II of this Backgrounder, Nardinelli argues that the RFC of the 1930s contributed little to the country's recovery from the Depression, and that it was finally broken up in 1953 after years of scandals. The RFC's funds were all too often allocated on the basis of political friendship and bribery, rather than sound economic factors.[18] Nardinelli has characterized the track record of the RFC as a "sordid failure."

Furthermore, the activities of the original RFC were not terminated in 1953, only divided among several agencies. Most of these programs still exist in one form or another--and have been greatly expanded since the early 1950s. To establish another RFC would mean compounding the efforts of the original RFC--and compounding the destructive consequences.

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16 Schultze, "A Dissent," p. 4, who cites the work of Robert Z. Lawrence, a Brookings Institution senior fellow and author of a forthcoming book on deindustrialization myths.

17 From comments made at a forum on "National Industrial Policy: Seeking an Alternative Agenda," sponsored by the Heritage Foundation, September 24, 1983.

18 Clark Nardinelli, The Reconstruction Finance Corporation's Murky History," Heritage Foundation Backgrounder No. 317, December 21, 1983.

The Stock of Jobs

Proponents of the RFC contend that increased loans to targeted industries would add to the country's total stock of jobs.

But the underlying logic of this proposition follows the simplistic line of all so-called jobs bills. For example, when Congress considered the $5.7 billion appropriations bill for roads and bridges in 1983 (under the Highway Revenue Tax Act of 1982), it calculated that 320,000 construction jobs would be "created." It failed, of course, to calculate the number of jobs that would be destroyed by the accompanying nickel-a-gallon gas tax. Contrary to the proponents' claims, the RFC would merely extract funds from taxpayers, who ultimately would have to finance the loans and cover the interest subsidies. It would also hurt businesses in general, because the RFC would leverage private loans for its chosen objects of corporate welfare, thereby coopting funds for other firms. There is no reason to believe that, on balance, jobs would be created.

Indeed, there is reason to presume that the employment consequences of an RFC would be perverse. Many of the companies seeking government aid would be doing so because of noncompetitive wage demands of workers. For example, the steel industry--a likely candidate for RFC assistance--experienced a rise in relative wages of its workers during the 1970s, while the average productivity of steel workers fell. The effect of the RFC loans, in other words, often would be a redirection of investment funds from industries whose wages are competitive, and generally lower, to industries whose wages are noncompetitive, and generally higher. When this happens, the net effect would be a reduction in total jobs, since the demand for labor is inversely related to wages paid.

Loans and loan guarantees provided by an RFC, therefore, might well create and save jobs of workers in the targeted firms, but they would just as certainly destroy and jeopardize jobs of other workers in other industries. The only public offense of these latter workers would be that they remained competitive and did not need public assistance, and so were deemed capable of assuming the tax burden that accompanied subsidies for others. As Representative Gephardt has recognized, central to understanding the effect of an RFC is "that we want to starve these industries and nurture those."

The Political Bias of the RFC

Like the original RFC, any new RFC would tend to discriminate in favor of established industries, especially the larger ones, and against emerging industries. Proponents of the RFC advocate, in essence, substituting politics for markets in the allocation of investment funds; and votes, not future profitability, are what count in politics. Large established firms, through their workers and stockholders and network of suppliers and buyers, would have the votes to command the respect they need in the political arena. Small emerging firms in untested product lines, on the other hand, would lack the votes to sway the decisions of the RFC. Regardless of ostensible political independence, the Corporation would necessarily remain in step with the political drummers in Congress.

Chrysler was bailed out in 1979 not because it was the only employer that teetered on the brink of bankruptcy that year. Hundreds of thousands of other firms, whose total employment far exceeded that of Chrysler, went under and their fate was never considered by Congress. Rather, Chrysler was bailed out for one reason: it was a relatively large firm, with a relatively large number of votes represented in workers, stockholders, customers, and suppliers, scattered across the country and strategically important to a number of members of Congress.

Proponents of the RFC attempt to allay critics' fears by suggesting that safeguards will be devised to make lending decisions immune to political tampering. Yet there is nothing in the concept of the RFC that would appear to prevent the frequent intrusion of politics into the lending process. Certainly, the board of directors, responsible to the President or Congress, would heed the political drummers. In the Hollings proposal, a criterion for a firm to be eligible for assistance is that "its closure would adversely and <u>severely</u> affect the economy." Few small, emerging firms would by their closing "severely affect" the economy; only large firms are likely to fit that requirement. Also, as a general rule, the RFC would favor the status quo, sacrificing economic growth in the process.

The RFC, in other words, would effectively institutionalize the Chrysler bailout model. One can rightfully question the success of the Chrysler bailout, as James Hickel has--Chrysler may or may not have been "saved" by the bailout.[19] However, it is certain that one of the reasons the Chrysler bailout could be deemed a success was that Chrysler's workers, buyers, and suppliers were not saddled with the tax cost of bailing out similarly situated firms. If a large number of other firms facing financial exigencies had been pulled from the brink of bankruptcy along with Chrysler, then the Chrysler workers, customers, and suppliers would have had to shoulder a heavier tax burden. Chrysler workers and suppliers would then have been less able to accept the concessions demanded of them. And Chrysler customers would have been less able to buy the company's products.

<u>The Incentives of Firms</u>

Because of the subsidies implied in aid from the RFC, the incentive for firms to watch their costs and avoid financial

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19 James K. Hickel, "The Chrysler Bailout Bust," Heritage Foundation <u>Backgrounder</u> No. 276, July 13, 1983.

distress would, at the margin, be lowered. As a consequence, a new RFC could lead to much economic waste and to a reduction in the long-run competitiveness of those firms that believe they can secure federal aid when they need it. The growing demands likely to be placed on RFC resources should at some point cause the system to become overloaded. Also, these growing demands could mean that more and more of the nation's lending decisions would give way to the demands of politics, instead of economics. There is every reason to believe that the establishment of an RFC would have perverse effects on employment stability. Gradually, employment tenure would rely on political, rather than market, decisions; and Congress is notorious for changing its mind and contributing to economic instability in the private sector.

The Growth of Political Influence

The establishment of an RFC would increase the perceived relative profitability of political activity, that is, lobbying for government handouts. It should, therefore, cause firms to divert their scarce resources from productive market purposes to largely unproductive political (or transfer) purposes. Growth in the nation's output should, again, suffer.

THE FUNCTION OF THE MARKET

Advocates of an RFC fail to appreciate the mechanism already in place for the allocation of investment funds--the market. This is composed of millions of citizens who are constantly concerned with investing their funds where they will be the most productive. RFC proponents do not see that all firms have a grand opportunity to secure the funds they need for innovation and expansion; all they have to do is to convince investors that they are more worthy than others of credit or equity investment. RFC advocates do not understand that when funds are made available to one set of "targeted" firms, the funds must be drawn away from other firms that, in the absence of the government intervention, would have been judged more worthy.

A common presumption of RFC advocates is that politicians and government bureaucrats can choose "winners" more efficiently than the market. They assume, in effect, that the corporate intelligence of a relatively few people in Washington is greater than that of the millions of private citizens in the market, who, through the pricing system, constantly receive feedback on how others assess their investments. Such a presumption has no basis either in historical fact or in sound theory. In private markets and through changes in the value of their stock, firms receive a continuous market assessment of their performance. The information flow in politics, which depends upon votes taken only intermittently, is not nearly so clear and continuous.

The RFC bills contend that loans will be made on the basis of the recipient firms' propsective profitability. One is left to wonder how political operatives can more accurately assess the profitability of firms seeking aid than can market operatives, especially when the political operatives' personal incentives are not tied to the firms' profitability.

CONCLUSION

Few can dispute the desirability of more and better paying jobs. The revival of the Reconstruction Finance Corporation is a politically seductive means of achieving that end. However, it would be a mistaken means. An RFC would tend to centralize economic decisions and politicize them.

Adam Smith wrote a book that many students of social philosophy consider far more important than his Wealth of Nations. It is on moral philosophy, The Theory of Moral Sentiments. In it he wrote poignantly:

> The man of systems...seems to imagine that he can arrange the different pieces of a great society with as much ease as the hand arranges the different pieces upon the chessboard; he does not consider pieces upon the chessboard have no other principle of motion besides that which the hand impresses upon them; but that, in the great chessboard of human society, every single piece has a principle of motion of its own, altogether different from that which the legislature might choose to impress upon it.[20]

Proponents of an RFC have been seduced into believing that they, as "men and women of systems," can improve human welfare by simply rearranging the pieces of the industrial structure of the country. They think that, in effect, they are smarter than markets--that they are gifted with unusual powers of discernment. They tend to believe that, given the power of the purse incorporated in an RFC, they can construct a "better" society. Their efforts will fail--not because their intentions are misplaced, but because they simply are not, indeed cannot be, as smart as they think. Individuals have "principles of motions" that are altogether different from that which the RFC administrators might choose to impress upon them; and the efforts of such administrators to reinvigorate the national economy by way of an RFC will founder because they cannot know with any reasonable degree of accuracy what are the "principles of motions" of others.

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20 Adam Smith, The Theory of Moral Sentiments (Indianapolis, Indiana: Liberty Press, 1976), pp. 380-381.

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