December 21, 1983

THE RECONSTRUCTION FINANCE CORPORATION'S MURKY HISTORY

INTRODUCTION

A modern version of the Depression-era Reconstruction Finance Corporation (RFC) is a favorite proposal of national industrial policy advocates. The RFC channelled federal money into selected industries and regions for more than two decades. It was an earlier age's attempt by government to allocate credit and pick winners. Five bills (S.265, H.R. 134, H.R. 1480, H.R. 1827, H.R. 2612) designed to revive the RFC already have been introduced in the 98th Congress. As Richard McKenzie notes in Part I of this study, the RFC concept has many inherent flaws. The history of the original corporation indicates strongly that it would be a serious mistake for Congress to consider reestablishing the RFC. The history and economic consequences of the RFC imply that, even under the most favorable circumstances for its success, a new RFC would not enhance the productivity or efficiency of the American economy.

A BRIEF LOOK AT THE RFC

President Herbert Hoover first proposed the establishment of the Reconstruction Finance Corporation in December, 1931.[1] The RFC Act was approved on January 22, 1932, and the corporation began operations almost immediately.

The RFC was based on and descended from the War Finance Corporation (WFC) of 1918-1929.[2] And just as the WFC had been

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1 The establishment of the RFC is discussed in Herbert C. Hoover, Memoirs, Vol. 3 (New York: MacMillan, 1952), pp. 107-111.

2 See Gerald D. Nash, "Herbert Hoover and the Origins of the Reconstruction Finance Corporation," The Mississippi Valley Historical Review, December 1959, pp. 455-468.

created to deal with the emergencies caused by World War I, the RFC was created to deal with the emergencies caused by the Great Depression. Hoover regarded the corporation as a temporary organization; yet it survived until 1953.

Although Franklin D. Roosevelt had considered doing away with the RFC during his campaign, after his election he moved to strengthen the corporation as part of his New Deal.[3] His most significant action with respect to the RFC was his appointment of Jesse H. Jones as chairman.[4] A conservative Houston businessman, Jones had been one of the original Democratic members of the board of directors. Although he nominally ceased to be chairman when he became Federal Loan Administrator in 1939, Jones effectively controlled the RFC from 1933 to January 1945, when he left government service.

When Jones became Secretary of Commerce in 1940, the RFC became part of the Commerce Department. The corporation was run by Jones in an authoritarian, paternalistic manner, and his wishes were always acceded to by the other directors.

Under Jones, the RFC became involved in an extraordinary variety of enterprises.[5] The corporation organized the Commodity Credit Corporation, for instance, and used its loans to help raise the prices of numerous agricultural products. The Federal National Mortgage Association, the Electric Home and Farm Authority, the Export-Import Bank, and the Disaster Loan Corporation were all at one time among the subsidiaries of the RFC.[6] The corporation even purchased gold when the Roosevelt Administration attempted to drive up the price of that metal.[7]

During World War II, the corporation became involved heavily in war production and the purchase and stockpiling of strategic materials.[8] Its main subsidiaries for these purposes were the Defense Plant Corporation, the Defense Supplies Corporation, the United States Commercial Company, the Rubber Reserve Company, and

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3 The role of the RFC in the New Deal is described in Arthur M. Schlesinger, Jr., The Age of Roosevelt, Vol. 2 (Boston: Houghton Mifflin, 1958), pp. 425-433. Also, see Franklin D. Roosevelt, The Public Papers and Addresses of Franklin D. Roosevelt, Vol. 2 (New York: Random House, 1938), pp. 398-403.

4 For a highly favorable biography of Jones, see Bascom N. Timmons, Jesse H. Jones (New York: Holt, 1956).

5 See Jesse H. Jones and Edward Angley, Fifty Billion Dollars (New York: MacMillan, 1951), and Timmons, Jesse H. Jones, especially pp. 222-233.

6 Many of these subsidiaries were later transferred to other departments or made independent.

7 See Jones and Angley, Fifty Billion Dollars, pp. 245-254.

8 The activities of the Defense Plant Corporation, the most important wartime RFC subsidiary, are described in Gerald T. White, Billions for Defense: Government Financing by the Defense Plant Corporation during World War II (University, Alabama: University of Alabama Press, 1980).

the Metals Reserve Company. Wherever possible, the RFC lent funds to private industry to carry on war production and purchases. But when private action was not feasible, the RFC built plants and purchased materials itself.

In addition to its war-related activities, the corporation continued its operations in the civilian economy. One of the most important of these activities was its intervention to help the Office of Price Administration's (OPA) attempt to keep consumer prices from rising. The RFC subsidized the production of meat, bread, and other commodities whose costs of production exceeded the price ceilings set by OPA.

Under the direction of Jones, the RFC maintained its independence and a fair degree of bipartisanship. Jones even managed to maintain the independence of the corporation after he had become a member of Roosevelt's cabinet, though this may have been due to his dislike of many, perhaps most, of the policies of the New Deal.[9] According to Arthur M. Schlesinger, Jr.,

> [the] RFC, in short, took on the character not of the First New Deal but of Jesse Jones. Instead of providing a basis for economic planning, it became an enormously astute and versatile financial exercise conducted on private principles if under public auspices and with public money.[10]

By January 1945, Roosevelt had had enough of Jones's independence and nominated Henry Wallace, then Secretary of Commerce, as his replacement. Congress, however, refused to approve Wallace as a Federal Loan Administrator and de facto head of the RFC.[11] The RFC was removed from the Commerce Department and became an independent agency.

Despite its nominal independence, the RFC lost its bipartisan nature after the war and became embroiled in a series of bribery and corruption scandals. According to a Senate investigation of 1951, securing an RFC loan through the Democratic National Committee had become a common practice.

The Democrat-controlled Senate of 1951 recommended reform, and when the Republicans came to power in 1953, they moved quickly

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9 Jones entitled a section of his autobiography, "I Was Not a New Dealer." The book contains many passages critical of Roosevelt and the New Deal. See Jones and Angley, Fifty Billion Dollars, pp. 255-311.

10 Schlesinger, The Age of Roosevelt, Vol. 2, p. 433.

11 Jones contributed to the rejection of Wallace by testifying against his confirmation. See Edward L. Schapsmeier and Frederick H. Schapsmeier, Prophet in Politics: Henry A. Wallace and the War Years, 1940-1945 (Ames, Iowa: Iowa State University Press, 1970), pp. 120-124, and Norman D. Markowitz, The Rise and Fall of the People's Century (New York: The Free Press, 1973), pp. 130-135.

to abolish the RFC. The RFC Liquidation Act of 1953 terminated its lending authority and abolished the corporation, effective June 30, 1957. The remaining functions and outstanding loans of the RFC were transferred to the Housing and Home Finance Agency, General Services Administration, Small Business Administration, and Treasury Department. Over the course of its existence, the RFC had lent approximately $13 billion and spent many billions more on a wide variety of programs.

THE RFC AS AN EMERGENCY FINANCIAL INSTITUTION

The four most important peacetime activities of the RFC were loans and investments in financial institutions, direct business loans and investments, loans on agricultural commodities, and loans to aid in financing self-liquidating public works projects. Table 1 provides a summary of RFC activities from from February 2, 1932, to January 19, 1941.

The agricultural and public works expenditures were actually part of larger New Deal programs in those areas and so should not be assessed apart from the programs as a whole. Analysis of the RFC, therefore, should focus on the economic effects of the financial and direct business expenditures of the RFC.

The RFC and the Banking Crisis

The RFC initially attempted to encourage recovery by making low interest loans to private financial institutions. It was hoped that these private institutions would then re-lend the funds. In 1932, the RFC lent close to $1 billion to commercial banks. Although the rate of bank failures temporarily slowed down after the corporation began lending, this was probably a coincidence.[12] By early 1933 banks again began failing at an alarming rate, and RFC loans failed to avert the banking crisis.[13] The ineffectiveness of the RFC was most apparent in February 1933, when the banks in Michigan collapsed despite the efforts of the RFC directors to save the leading banks of Detroit.[14] The situation deteriorated around the country until Roosevelt, on March 6, declared a bank holiday.

The RFC failed to halt the banking crisis for three principal reasons. First, and probably most important, the forces leading to collapse may have been too great to be counteracted by the funds made available by the RFC. Between October 1929 and March 1933 the nation's basic money supply fell from $28 billion to $19

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[12] See Milton Friedman and Anna Jacobson Schwartz, A Monetary History of the United States, 1867-1960 (Princeton: Princeton University Press for the NBER, 1963), pp. 320-321.

[13] See Lester V. Chandler, America's Greatest Depression: 1929-1941 (New York: Harper & Row, 1970), pp. 66-90.

[14] See Jones and Angley, Fifty Billion Dollars, pp. 54-71.

TABLE 1

Loans and Investments of the RFC from February 2, 1932, to January 19, 1941

	Amount (millions of $)	Percent of total
Loans on cotton, corn, tobacco, and other commodities	830.0	10.2
Loans for distribution to depositors in closed banks	1,030.8	12.5
Loans to railroads	795.7	9.7
Loans to drainage districts	91.1	1.1
Loans to public school authorities	22.9	0.3
Loans to business	241.1	2.9
Loans to banks and trust companies	1,138.4	13.8
Loans to Federal Land Banks	387.2	4.7
Loans to mortgage loan companies	519.0	6.3
Loans to agricultural and livestock credit corporations	191.6	2.3
Disaster loans	12.0	0.1
Loans for self-liquidating construction projects	463.1	5.6
Loans to insurance companies	90.7	1.1
Loans to joint stock land banks	24.7	0.3
Loans to Rural Electrification Administration	150.5	1.8
Loans on preferred stock in banks and insurance companies	79.8	1.0
Loans to Secretary of Agriculture	37.0	0.5
Loans to Export-Import Bank	25.0	0.3
Other loans	25.8	0.3
Purchases of preferred stock, capital notes, and debentures of commercial banks	1,197.8	14.6
Purchases of securities from Public Works Administration	640.6	7.8
Other purchases	11.1	0.1
Loans and purchases in aid of national defense	62.1	0.8
Total	8,220.5	100.0

Source: The Public Papers and Addresses of Franklin D. Roosevelt, Vol. 2, (New York: Random House, 1938), pp. 403-404; Vol. 7 (New York: Random House, 1941), pp. 99-100.

billion,[15] and between 1929 and 1933, gross national product fell from $103.1 billion to $55.6 billion.[16] In the face of such a massive collapse, the billion dollars lent by the RFC may simply have been too little.

The second reason for the ineffectiveness of the RFC was that it usually took the strongest assets of a troubled bank as security for the loan.[17] This adherence to sound banking practice deprived banks of assets needed to meet further demands for cash. The banks needed capital, but the RFC did not provide it.

A third reason that RFC loans were ineffective was that they were publicized. Information that a bank had received an RFC loan was correctly regarded by depositors as a sign that the bank was financially weak. The ensuing panic often put the bank in worse condition than before the loan was made. Indeed, many banks refused to apply for loans, believing that the damage from publicity would outweigh the direct financial benefits of the loan.

The banking system's need for capital was finally met by the Emergency Banking Act of March 9, 1933, which authorized the RFC to invest in the preferred stock capital notes and debentures of commercial banks. Subsequently the RFC invested over $1 billion in such instruments--equal to about one-third of total bank capital in 1933. The RFC eventually invested in over 6,000 banks.

The biggest surge in RFC investment came with the passing of the Banking Act of 1933, which established federal deposit insurance. All banks that were members of the Federal Reserve System were required to have their deposits insured by the Federal Deposit Insurance Company (FDIC). Nonmember banks could be admitted upon the approval of the FDIC, but many of the 9,000 nonmember banks that applied for membership were not financially sound enough to qualify. The RFC invested in those banks and thus played an important role in launching the FDIC.

The various banking reforms, and the FDIC in particular, are generally credited with establishing a sound national banking system by the mid-1930s. The RFC played an important role in this restoration of the banking system. Its success can be inferred from the fact that its loans and investments in financial institutions had virtually ceased by 1939. Only $133 million (11 percent) of the $1.2 billion the RFC spent purchasing bank capital was spent after October 23, 1937. No loans to banks were made after that date. By the beginning of World War II the greater part of the corporation's banking investments had been retired, and as Jesse Jones proudly pointed out, the interest and dividends

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15 Friedman and Schwartz, A Monetary History of the United States, pp. 712-713.

16 U.S. Department of Commerce, Historical Statistics of the United States, Colonial Times to 1970, Part I (Washington, D.C.: Government Printing Office, 1976), p. 224.

17 Friedman and Schwartz, A Monetary History of the United States, pp. 330-331n.

on the loans and purchases eventually yielded a substantial accounting profit.[18] Its own obsolescence, then, demonstrated the success of the RFC as an emergency financial institution.

THE RFC AS A NATIONAL INVESTMENT BANK

The only direct business loans the original Act empowered the RFC to make were railroad loans. The inclusion of such loans was primarily for financial reasons; insurance companies, savings banks, and other institutions held several billion dollars in railroad bonds. Jesse Jones took particular interest in the railroad loans and imposed his own conditions on the railroads. These conditions often included reorganization and new management.[19] The railroads were to remain the largest industrial borrowers from the RFC.

Despite the end of bank failures and panics after 1933, commercial banks were slow to increase their business and industrial loans. Fearing another banking crisis, banks steadily increased the percentage of total assets held in the form of cash assets and decreased the percentage of assets in loans.

Jones was not prepared to wait for bankers to adjust to FDIC. He believed that "there was no longer any valid excuse for a bank to cram its vault with idle cash which borrowers could be using with profit all around."[20] If the banks would not make business and industrial loans, then the RFC would. In June 1934, Congress authorized the RFC to make loans to business and industry.

With its expanded lending powers, the RFC became, in effect, a national investment bank. Jones favored making industrial and business loans that would be profitable. The purpose of many of the business loans, he said, was to keep people at work in a period of massive unemployment. At times, this goal was in conflict with the principle of profitability. The result was that the RFC avoided risky, potentially profitable investments but also avoided what Jones called the "Santa Claus giveaways" favored by some members of the Roosevelt Administration.

The balance sheet on business loans, then, is not as impressive as that on banks. Jones's highly sympathetic biographer admitted that the RFC's small business loans showed a rate of loss of 10 percent, the greatest of any peacetime RFC endeavors.[21] Repayments of RFC business loans always lagged behind those of other loans.

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18 The "profits" resulted from the fact that the RFC acquired interest-free funds from the Treasury and then lent the funds at close to market rates of interest (usually 4 percent).

19 See Jones and Angley, Fifty Billion Dollars, pp. 105-145.

20 Ibid., p. 52.

21 See Timmons, Jesse H. Jones, pp. 229-231.

Scale of RFC Lending to Business

As Table 1 shows, the total amount lent to business by the prewar RFC was comparatively small and had at most a trivial effect on economic recovery. This may have been due to the inability or unwillingness of Jones to find suitable investments. Although a more vigorous loan program might have done more to fight the Depression, it might have simply led to greater losses.[22]

After World War II and the departure of Jesse Jones, the RFC greatly increased its loans to business and industry. In the postwar years, over half of the RFC's funds were channelled into such loans. The postwar era also was marked by greatly increased private lending to business and industry, so although the absolute amount of RFC loans increased, their relative importance decreased. Beryl Sprinkel has estimated that the share of loans from government agencies (mainly the RFC) in all business credit fell from 3 to 4 percent in 1940 to less than 2 percent in 1950.[23] The end of high unemployment and declining fears of further financial panics caused banks to lose their fear of making loans. The RFC adjusted to this improving situation by no longer making business and industrial loans in the absence of private credit. The policy was for the RFC to make loans that private financial institutions might have made at higher rates of interest.

The Distribution of RFC Lending to Business

The justification for this type of RFC lending during the postwar era was that it was necessary in order to help small business. Small businesses paid higher market interest rates than

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22 The RFC should not be singled out for the inadequacy of its efforts to counter the Depression. The consensus among economists and economic historians is that New Deal spending was not particularly expansionary. The classic paper on the subject is E. Cary Brown, "Fiscal Policy in the Thirties: A Reappraisal," American Economic Review, December 1956, pp. 857-879. See, also, Larry C. Peppers, "Full Employment Surplus Analysis and Structural Change: The 1930's," Explorations in Economic History, Winter 1973, pp. 197-210. On the countercyclical role of the RFC, see Beryl Wayne Sprinkel, "Economic Consequences of the Operations of the Reconstruction Finance Corporation," The Journal of Business, October 1952, pp. 211-224. The view of many economists today is that the main economic effects of the New Deal occurred in the long run rather than the short run. See, for example, Gary M. Walton, ed., Regulatory Change in an Atmosphere of Crisis: Current Implications of the Roosevelt Years (New York: Academic Press, 1979).

23 Sprinkel, "Economic Consequences of the Operations of the Reconstruction Finance Corporation," pp. 220-221.

large businesses; the RFC closed the "credit gap" by making loans to small businesses at below market rates.[24]

The alleged purpose of RFC loans was in sharp contrast to the reality. In fact, most of the funds of the RFC were lent to large businesses. For example, of the $349 million lent in 1949, the largest 93 loans accounted for $200 million, or 57 percent of the total.[25] In Table 2, RFC loan authorizations by size of loan are given for the years 1948 and 1949. Loans in the small business category ($25,000 or less) accounted for 53 percent of total loans but only 5.3 percent of total funds. More than three quarters of RFC funds were distributed in the form of large business loans ($100,000 or more). Indeed, in 1949 the RFC lent more money ($44 million) to one company (Kaiser-Frazer automobiles) than it lent to small businesses in 1948 and 1949 combined.

The RFC was mainly making business and industrial loans to firms that could acquire funds nowhere else--at least at the same highly favorable terms. The loans were usually made at 4 percent interest, a rate at which these firms could not have acquired private funds. The RFC, in other words, was making highly risky loans without charging a risk premium. Since the interest rate was not being used to allocate RFC funds, the quantity of loans demanded exceeded the quantity supplied, and some nonmarket method of allocation had to be adopted to handle the excess demand for loans. Although its directors claimed that it was the "public interest" that dictated what loans were made, another form of credit rationing was actually used. According to a Senate report of 1951,

> many RFC loan applications in the past 2 years have been approved by the Board of Directors without any apparent affirmative reason. In fact, many applications have been approved by the board notwithstanding the existence of persuasive reasons why loans should not be made.[26]

The Senate report found that

> certain Washington attorneys and certain other people were unduly influential with officials of the RFC. In some instances the reports have been received in sworn

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24 The existence of the credit gap was discussed at great length before the Senate Committee on Banking and Currency in 1951. See U.S. Congress, RFC Act Amendments of 1951: Hearings Before the Committee on Banking and Currency, United States Senate, 82nd Congress, 1st Session (Washington, D.C.: Government Printing Office, 1951), pp. 43-88.

25 Ibid., p. 199.

26 U.S. Congress, Favoritism and Influence: Interim Report of the Committee on Banking and Currency Pursuant to Senate Resolution 219, 82nd Congress, 1st Session (Washington, D.C.: Government Printing Office, 1951), p. 5.

TABLE 2

RFC business loan authorizations 1948 and 1949, by size

Size of loan	Number	Per-cent	Gross Amount	Per-cent	RFC Share	Per-cent
$5,000 and under............	1,309	16.2	$3,827,439	0.4	$3,687,271	0.5
$5,001 to $10,000...........	1,090	13.5	8,488,939	1.0	7,592,435	1.0
$10,001 to $25,000..........	1,894	23.3	33,847,186	3.9	29,032,663	3.8
Total, $25,000 and under....	4,293	53.0	46,163,564	5.3	40,312,369	5.3
$25,001 to $50,000..........	1,597	19.7	62,010,992	7.2	52,635,996	6.9
$50,001 to $100,000.........	1,303	16.1	102,304,275	11.9	86,843,373	11.5
Total, $100,000 and under...	7,193	88.8	210,478,831	24.4	179,791,738	23.7
$100,001 to $200,000........	381	4.7	58,512,468	6.8	51,058,428	6.8
$200,001 to $500,000........	326	4.0	102,742,739	11.9	89,456,978	11.8
Total, $500,000 and under...	7,900	97.5	371,734,038	43.1	320,307,144	42.3
$500,001 to $1,000,000......	98	1.2	71,184,016	8.3	63,752,124	8.4
Over $1,000,000.............	102	1.3	418,453,702	48.6	372,980,638	49.3
Grand Total............	8,100	100.0	861,371,756	100.0	757,039,906	100.0

Source: U.S. Congress, RFC Act Amendments of 1951: Hearings before the Committee on Banking and Currency, United States Senate, 82nd Congress, 1st Session (Washington, D.C.: Government Printing office, 1951), p. 340.

> testimony which asserts that for a sufficient fee these people would give assurance, where no one else could, that matters pending before the RFC would have a successful outcome.[27]

The funds of the RFC, then, were allocated by bribery.

The Corruption of the RFC

The principle figures in the scandals that surrounded the postwar RFC included Donald Dawson, Walter Dunham, William Willett, E. Merle Young, and Joseph Rosenbaum.[28] Dawson was President Harry S. Truman's assistant in charge of personnel and was closely associated with the Democratic National Committee. Dunham and Willett were directors of the RFC who owed their jobs to Dawson. Young was an RFC examiner until 1948, when he resigned to become an employee of the Lustron Corporation on the day that the loan he had arranged for them was approved. Young's main duty for Lustron was apparently to work for the Democratic National Committee during the election of 1948. After the election, Young served as an informal broker between the RFC, the Democratic National Committee, and Rosenbaum, a Washington lawyer who frequently represented loan applicants.[29]

The method of operation of the postwar RFC can be seen in the handling of its loan to Central Iron and Steel Company.[30] Because of the questionable financial practices of its parent company (Barium Steel Corporation), the initial application was scheduled for rejection by the examiners. Willett, however, appointed a substitute examiner and the loan was granted. The RFC lent a total of $6.3 million to Central Iron and Steel over the objections of all examiners and reviewers--with the exception of Hubert B. Steele, the substitute appointed by Willett! One month after the loan was authorized, Steele resigned from the RFC to take a job with Rosenbaum, who had represented Central Iron

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27 Ibid.

28 Ibid., p. 5-8. For a good short summary of the RFC scandals, see Bert Cochran, Harry Truman and the Crisis Presidency (New York: Funk and Wagnalls, 1973), pp. 246-248. For a detailed and critical study of the scandals, see Jules Abels, The Truman Scandals (Chicago: Henry Regnery, 1956), pp. 70-122.

29 This brief sketch cannot do full justice to the relationships among the principals in the scandals surrounding the RFC. For example, Alva Dawson, wife of Donald Dawson, was an employee of the RFC. Loretta Young, the wife of E. Merle Young, was a secretary on the White House staff. The interrelationships among those connected with the RFC were so complex that the Senate Subcommittee attached a chart illustrating them to its report, Favoritism and Influence.

30 See U.S. Congress, Favoritism and Influence, pp. 9-10.

and Steel in the negotiations. He received $5,000 from Rosenbaum on his first day on the job.[31]

The corruption and bribery attending the Central Iron and Steel loan was not an isolated instance. Just four of the questionable loans investigated by the Senate accounted for $123 million. All of the questionable loans together may well have accounted for a majority of RFC loan commitments. The corruption uncovered by the Senate was by no means just a small blemish on an otherwise respectable corporation.

Economic Consequences

In contrast to its lending policies, the economic effects of the postwar RFC are fairly easy to determine. The RFC caused capital, raw materials, and land to be allocated to enterprises that could not have obtained those resources in the market. The market (correctly) believed that enterprises such as Kaiser-Frazer automobiles would probably fail.[32] Given the high employment that marked the postwar years, the resources used by the firms supported by the RFC would evidently have been used for other, more productive activities. By allocating resources according to nonmarket criteria, the RFC thus served to reduce the productivity of the economy and reduce the pace of job creation. The amounts involved, however, were small relative to the total financial capital market. So the reduction in productivity effected by the RFC must therefore have been correspondingly small.

CONCLUSION

The activities of the Reconstruction Finance Corporation were complex and coincided with major economic and political upheavals in the U.S. An overall assessment, therefore, is difficult. As an emergency financial institution, the RFC was successful, especially after March 1933. As a national investment bank, however, the RFC was a sordid failure. It is surprising, then, that most of the recent proposals to revive the RFC do not envision it as an emergency financial institution, but as a national investment bank.[33] These proposals can only be based on what the RFC might have been--not what it was.

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31 The practice of RFC employees leaving to go to work for former clients or their law firms had become so common that laws prohibiting the practice had been proposed. See U.S. Congress, RFC Act Amendments of 1951, p. 35.

32 The relations between Kaiser-Frazer and the RFC are summarized in U.S. Congress, RFC Act Amendments of 1951, pp. 173-176.

33 For example, see Robert Reich, The Next American Frontier (New York: Times Books, 1983). For a summary of the major proposals, see Richard B. McKenzie, "National Industrial Policy: An Overview of the Debate," Heritage Foundation Backgrounder No. 275, July 12, 1983.

Economic historians, especially "new economic historians," frequently use counterfactual propositions in their attempts to explain and interpret the past. A counterfactual is an event contrary to fact, though perhaps possible. The counterfactual is an explicit way of looking at what might have been or at what might be. The appropriate counterfactual in this case is that the RFC was not corrupt. Further assumptions would be that its director or directors were solely concerned with the public interest and that the RFC enjoyed the confidence of Congress--one that held true for the Jones era. Under these assumptions, could a revived RFC make a positive contribution to the productivity of the American economy?

There is no simple answer to this question. It is probable, however, that even an RFC meeting all the assumptions of the counterfactual would face three difficult problems:

a) Political Pressure

Even an uncorrupt RFC would be subject to pressure to make (or not make) certain loans. With the growth and increasing sophistication of special interest groups, this problem would be even greater for a present-day RFC than it was for the original corporation. Indeed, if the RFC were to be revived on a large scale, it is quite possible that firms would be founded for the express purpose of influencing government loan policy.

b) Definition of "Public Interest"

In designing loan policies, the "public interest" can mean different things to different people. For example, it might mean encouraging industry in New England or supporting small business. The original RFC interpreted public interest broadly enough to justify loans to pool halls, breweries, professional baseball teams, and rattlesnake farms.[34] Even the corporation's staunchest supporters during the 1951 Senate hearings seemed confused about what RFC investment policy was supposed to accomplish.[35]

c) High Risk Loans

A third problem for an RFC would be its function of making loans to firms that could not find financing elsewhere. Since there are thousands of financial institutions in the economy, by the time a firm applied for an RFC loan, a wide consensus would probably exist that the loan was not a good one. In making the loan, the RFC would in a sense overrule the market. Now it is certainly possible that in some instances the RFC would be right and the market wrong. It is difficult, however, to accept the proposition that such instances would be frequent.

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34 U.S. Congress, RFC Act Amendments of 1951, pp. 91-94.
35 See ibid., pp. 22-34, for an example of this confusion.

In sum, the question of whether an RFC would be good for the economy depends for an answer upon whether it is preferable for the market to allocate resources or for the director (or directors) of a government agency to allocate resources according to some nonmarket criterion. The problems associated with nonmarket allocation would lead most economists to prefer the market.

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