

Capital Sinks, White Elephants, and 'Hayeks': Assorted Examples

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(5-2)

Capital sinks, white elephants, and "Hayeks": assorted examples

1. 22 May 93, LAT p.A3.

a) London's Waterloo Station dedicates new station, designed to be terminus for Chunnel, Paris-London Express. 2 problems:

There is no high-speed roadbed from Chunnel to London. France has one, but must slow down in Eng.

Govt. decided to route trains elsewhere, to St. Pancras Sta., overruling British Rail Mgmt.

b) Major opens 6-lane Limehouse Vehicular Tunnel. 1.1 miles, $500m, most expensive per mile in British history. Idea, to link Canary Wharf Docklands project to The City. It completed the 7 mile Docklands Highway, costing another $520m.

Problem: Canary Wharf Docklands project is not renting up. (Maybe it will now?)

2. In 1994 they opened the "Chunnel," linking France and England by train.[1] The Japanese are linking northerly Hokkaido with the main island of Honshu with an even longer tunnel under Tsugaru Strait - probably an expensive mistake, but we'll see. These things are long a-building. Let's play "what-if." ("What-if" is as instructive to play as "I should have zigged when I zagged," and a lot cheaper.)

What if construction cost is $500m/year for 14 years, financed at 11%. This is followed by $250m/year for 7 more years, financed at 9% (lenders get more confident as you near the end).

[Afterthought, from new info. LAT, 21 Sept 95 D6. My guesstimate was closer than I thought. Eurotunnel, owner and operator of this major work (remember Thatcher and her "privatization"?), has debt of $12.4b. It froze interest payments, Sept. 14. Stock closed at $1.73/share, having opened at $10.10 in 1/94 when the tunnel opened. French banks financed 20% of it; Japanese banks 20-25%. Current thinking is to give creditors half the equity. [I doubt the banks will settle for so little.]

3. LAT, 17 Dec 93 A30

Kakuei Tanaka dies. Was PM, 1972. Dominated Liberal Democratic Party for 13 years. Voters threw it out, 7/93.

Was master of money politics, manipulating iron triangle.

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[1]"Continent no longer isolated," reported the London Times.

Mastered the bureaucracy: not simple in Japan.

Came from small town, Niigata, up north. Showered it with p.w.: bullet train extension, power plant, highways, rail station. They kept reelecting him from Niigata, 16 times.

Spread infrastructure throughout Japan. Comprehensive "Plan to remodel Japanese archipelago." Bridges, dams, roads, rails. Inflation results, esp of land prices. Some ambitious projects: Hokkaido tunnel; Tsukuba science city; Narita airport; Seto Ohashi bridge to Shikoku. Overall plan never completed (of course: they never are).

Came from construction industry, and got half his major contributions from it (an "American heritage," alas).

1983, caught in Lockheed scandal.

4. "The further one must reach into the future to find a potential saving, the less likely is one ever to realize that saving." -- Covvey and McAlister, 141.

5. TPE 1984, 17 June F4

NY State Capitol (19th Cent) took over 32 years to build, longer than the great pyramid of Cheops. Cost more than U.S. Capitol.

A patronage factory. Boss Tweed was in the legislature, 1867- . Enormous funds spent on fine stones, high ceilings, the "Million Dollar Stairway" entrance, carvings, ornaments, vaulted ceilings, etc. Styles inspired by additions to Louvre, done for Nap. III.

1888 they aborted final dome, when chunks of concrete began falling on desks below. But 1867 + 32 = 1899 completion! Long enough to drain K from 2 business booms!

Not very functional: later, to meet office needs, they added mezzanines, and tempo offices "parked like boxcars in once-grand hallways." Bricked over windows; neglected cleaning, etc.

100 years later, Rocky spent $2b on adjacent "Empire State Plaza." Also a patronage factory.

Now, 1984, planned rèstoration is to take 10-15 years, cost $25m 1983 dollars.

6. LAT 5 Feb 94, F6.

Yerba Buena Gardens devmt., S.F.: 30 years in the talking,

20 years in the making. Not done yet.

7. LAT 2 Feb 94 p.1

New Denver airport is 6 mos. behind sked, and $1b over early cost estimates. Brainchild of former Mayor Federico Pena, now Secy, U.S. Dept of Transportation.

Denver voters approved it 1987. Was to cost $1.7b - now $3.2b. Was to use no tax $s - passenger fees, instead. Stapleton was 64 years old, crowded, embattled over polln. and airspace, and flight delays in bad wx.

New airport is 28 mi from CBD; Stapleton is 7.

Continental used Denver as hub, but now is cutting back, leaving United with monopoly. This could raise passenger fees to $7/ticket, 3x nat. ave. Continental says operating costs are higher at new airport.

Uses 53 s.m.! (So? that is 33,920 acres!)

New Denver is expected to generate $23m, first year of operation. (= $678/acre). That is .72% of $3.2b cost!

Has BBB bond rating, the lowest investment-grade rating, with S&P.

(Note how tax financing lets you start paying on bonds right away, before operating revenues come in. Some banker types would prefer revenue financing, because it lets capitalized interest build up, increases bond business.)

Pena got contributions from contractors and S&Ls speculating in land near the airport. New Mayor, Wellington Webb, accedes to airlines' demands for luxuries, and a ballyhooed capital-intensive, labor-sparing baggage handling system which may not work.

March 8, Stapleton closes, goes on market for redevmt. New Denver has no name yet, except "Federico's Folly."

8. LAT 6 Feb 94 A1. Technol. lemons by U.S. Govt.

Iuka, MS, isn't much, but NASA plant to build more powerful booster rockets for space shuttle is 20 miles from it, on Yellow Crk., Tishamingo Cty. 1,200 acre site, Piney woods country. After $1.5b, NASA is walking away, due to budget cutting, partial funding.

Earlier, TVA walked away from unfinished nuke, same site, $1.2b.

Also, sits on Tenn-Tom canal, near junction with Tennessee R. Finished, but hardly used, hasn't brought ec. devmt. as hoped.

To match NASA, local authorities spent to improve schools, hospitals, sewers, roads.

Waxahachie, TX, supercollider site. Cost est. soared from $2b to $11b, was scrubbed, after 14 mi of tunnel built.

Nuclear airplane project. Air Force and AEC sunk >$1b; scrubbed by JFK, 1961.

Air Force sunk $1.7b into its own Manned Orbiting Lab, dropped it. Similarly, a proposed space glider named "Dynasoar" - how fitting!

Transportation sunk $1b on an SST; Congress aborted.

1960s, NSF started to drill hole through earth's core (Mohole?). Quit when cost soared to $100m (peanuts, in this league!).

Energy Dept sunk $3.5b building Ohio plant for enriching uranium. Price of uranium plunged; scrubbed, 1/3 done.

Energy Dept., $1.7b on Clinch R. breeder reactor, plus >$7b on breeder tech, scrubbed (did energy vested interests knife this one?).

1970s, $billions on Synfuels. Killed by Bush Admin. (another oil industry hatchet job?)

Star Wars, sunk $30b, then killed by degrees.

Space Station, is to cost $30 to build, and operate for 10 years. It may now survive, by going international.

When JFK proposed going to moon, he called for full funding commitment or scrub it now. Such good examples are the exception.

9. BW 14 Feb 94:62-3

Wash logrolling taking form of goldplated federal bldgs.

... Atlanta has 30% office vacancy rate. Yet, Atlanta Federal Center plowing ahead, to open in 1997, to house 8,000 workers. Cheaper alternative would be to lease vacant space, now a bargain. (This violates rule I once observed, that public products must not compete with private ones. Perhaps that is why office-building boondoggling is now provoking strong reaction, exemplified by BW article.)

... New Fed courthouses are built at ave. $230/sf, vs. $96 for comparable state or local court.

10. For some relief and contrast, here is a good example of how to save and recycle capital.

In W.W. II, govt needed more electrodes for welding. Offered to finance new plant for Lincoln Electric. Instead, James F. Lincoln showed competitors how to speed production with advanced methods. (Moley, Am. Cent. of John C. Lincoln, p.93.)

Double K-saving! Instead of sinking K into a plant, have less inventory/output ratio!

11. Winners and Losers, Canal Boom Era, eastern U.S.A., 1820-40. Some history lessons on how and how not to manage capital.

I. Key determinant of activity was the ability to raise long-term capital.

a. To begin, canal promoters used the credit of the states. This was an innovation, initially successful in NY State, then widely followed (but without the same wisdom, prudence, and natural advantages). NY used a statewide property surtax to put the credit of the State behind the canal bonds. In 1827 they ended the surtax, thus entering the "moonbeam" phase of the land boom, as described in Cornick, Premature Subdivision and its Consequences. In 1842, hard-hit by depression, they revived the surtax to bail out the canal and save their credit.

OH followed NY successfully. It used its State credit to back loans, and levied an annual tax on property to service the loans. After 1836 it came to grief by having begun an overambitious statewide program of "regional equity." Still, it completed its program, the only state to do so. Its canals carried mostly Ohio traffic. Ohio was closely settled before the canals came, thanks to the N.W. Ordinance, its New England settlers and their traditions, its having been settled during the Jeffersonian period of land sales on credit, 1801-20, when small farmers had a chance. In result, Ohio was a Union powerhouse in the Civil War for industry and troops.

b. They also used the power of banks to print money (issue bank notes).

i) In several cases, they joined a bank with a canal co. Land grants were also involved: the banks' "capital" (net worth)[2] was the land granted to the canal co.

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[2]The word "capital" means dozens of things, varying with the context. In classical economic theory, land cannot be capital, they are mutually exclusive classes. In banking, however,

Then the banks made loans to people to buy land, so the bank notes were secured by land collateral. Thus, both the "capital" and the other assets of the bank were land.

ii) The B.U.S. was a special case, much overworked by historians. After Jackson dumped it, Phila. captured it and forced it to finance the PA system. PA extracted an outright grant of $2m, plus $7m loans.

c. The boom ended when capital-flow dried up.

d. Those whose projects were early and/or small and finishable and profitable survived, were able to recover capital and keep going. Capital recovery provides a continual source of new capital. Others lost out:

-- late starters (Indiana, IL);
-- those with moonstruck payout plans (Indiana, PA, C&O). Mostly, these were too long (IN), too difficult to build (PA), too goldplated (C&O), or too pioneering (IN, IL);
-- those with too many parasites (IL).

e. Much of the capital was imported from Europe. Capital import begins with paper transactions, but takes the real form of an import balance. This was facilitated by lower tariffs, after 1833 (a response to the "Nullification Crisis" of 1832).

f. Few could know or forecast when capital markets would dry up.

i) Worldwide markets involved

ii) Few understand capital markets. Most think capital is just paper. Life should be so easy! In fact, there is a physical limit that can be overdrafted. Capital is formed and conserved only by the difficult, rare, and fragile self-discipline of thrift.

iii) Few seem to understand how overpricing land misdirects investing in such ways as to immobilize capital, "benching" it, so to speak, out of the game.

iv) A by-product of widespread racing, with its burst of investing, is general euphoria, warping the judgment. President Andrew Jackson's Thanksgiving Day Proclamation in 1835, while not without cause, nicely displays the euphoria of boom times.

> "We thank Thee for the burning rock recently discovered in the wilds of Pennsylvania which, added to the water power of New England, will materially reduce the burden

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capital means net worth, and may consist of any asset.

of manual labor ... We thank Thee for the absence of unemployment ... no willing worker shall ever be begging for bread ... there will be none to freeze, starve, or be beset by the fear of want this winter or the winters yet to come."

II. Kinds of winners, and their characteristics.

Basically, investment winners are "revolving funds" that actually do revolve, by getting early payoff.

a. Trunklines with best routes. Erie Canal; Delaware and Raritan (linking Phila and N.Y. Harbor, like the Jersey Turnpike today).

b. Trunklines that also serve as their own feeder lines.

This was the Erie, tapping its own route, the Mohawk Valley. As the Erie progressed incrementally, each stage generated its own traffic. Payout didn't wait until completion. The pot o' gold was not just at the end of the rainbow, but along each segment. Promoters and historians have obscured this by writing of "tapping the far-flung western trade," but that analysis is too temptingly dramatic, too easy, and misleading. It was mainly local Mohawk Valley trade that paid off the Erie. It is also true, and greatly important, that it tied the mid-Atlantic with the growing northwest, but it was its local success and strength that made that possible.

Ohio's several n-s canals enjoyed the same advantage, because parts of Ohio were closely settled before the canals came. (Cf. Trudy Wischemann's study of how SP R.R. in California's San Joaquin Valley chose routes to serve areas already closely settled, to generate traffic.)

c. Short coal lines. D&H, 1829 (hit Hudson at Kingston).

d. Key short passages. The Soo, linking Lakes Huron and Superior, 1855; Louisville's by-pass of rapids on the Ohio R.; the Illinois & Michigan Canal (but not until next cycle - it was premature in 1836); Welland Canal, 1829.

e. Short lines focusing on a hub. Boston r.r.s. Network of roads around Nashville. PA's system of turnpikes and bridges preceding its canal fiasco: it had 56 turnpike corps. by 1825. Pittsburgh's short radials.

Atlanta, "resisting seduction by the siren magic of distant trade" (love that purple rhetoric of the Old South!) was the hub

of a coherent state road and rail system that made good returns.[3]

The brains, judgment, and leadership that created the compact radial systems around Atlanta, Nashville, Richmond, Mobile, and other places, would have made the south invincible in peace and war, had it not been for slavery and the plantation system of agriculture. These aborted the natural economic interchange between city and country that nursed along northern industry so well. They also forced southern leaders into their posture of continental imperialism, spreading the whole population thin over more territory than it could defend. Many of their people moved to growing towns and cities north of the Ohio, where they bred future Union soldiers and leaders like Abe Lincoln.

f. Technical innovation, timely and appropriate.

1817, the Pittsburgh Pike, a road replacing mere trails.

Riverboats replacing roads. (Fulton's Clermont, 1807, puts steampower on rivers; 1824, case of Gibbbons v. Ogden, broke riverboat monopolies, opened rivers and the Great Lakes to competition.)

Erie Canal besting competing rivers (the Miss. and the St. Lawrence), from 1825.[4] It also, however, complemented Great Lakes shipping unleashed by Gibbons v. Ogden decision, 1824.

Rails besting canals. B&O completed, 1853, obsoleted C&O Canal.[5] Penna. R.R. in the 1850s used the same route as the failed State Canal, and bested the Erie Canal while N.Y. again fell behind technologically, too wedded to its wonderful Erie Canal.

Clipper ships. In this era, Boston and Providence and other New England ports, rather than turn west, sunk their capital into ocean vessels, another whole story. Baltimore did

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[3]Atlanta's sound planning later turned to her destruction. General Sherman burned Atlanta precisely because it was so important. No one said life is always fair.

[4]This is an odd one, technologically, since the canal boats were drawn by mules plodding along a towpath, while the "older" form of transportation was now using steam. Canals were an ancient technology in Europe and Asia, they were only new in the U.S. at this time.

[5]Another factor here is that the C&O Canal leads only to Washington, which never developed as anything but a political city. The B&O used the Potomac route upstream, but then headed n.e. to Baltimore. There was also the C&O R.R.

both. In 1830 Britain reopened the West Indies to U.S. shipping. Steamships already existed, but for 30 years clipper ships, both English and American-built, were still faster. They linked Boston with San Francisco and China. Whaling and fishing, too, kept these sailing cities busy. New England also developed industries using water power. Its interior lines were short, unspectacular, and solvent.

g. Simple short lines between cities. SC had several, e.g. Charleston to Columbia. CT had New Haven-Hartford R.R., which succeeded even though completed in 1838, a bad time. The key word is "completed." The losers were lines left unfinished when the lights went out on new capital issues after 1837.

h. Low rates, marginal-cost pricing. This occurred in states that decided to promote canals using tax power: NY, OH. The Erie Canal was a famous bargain for shippers, tapping an elastic demand. In MD it was not the State, but the City of Baltimore, that underwrote Baltimore's external circulation, the B&O R.R. Baltimore also underwrote the Susquehanna Canal, raiding Pennsylvania's rich Susquehanna Valley. For the other extreme, see under "Losers," (g).

i. Lines serving territory already settled. These were also called "exploitive" projects. In MA they were called "dowager" lines because, like a rich widow, they required no handouts.

III. Kinds of losers, and their characteristics

a. Parallel imitators playing catch-up, "a day late and a dollar short." Good principles are so easily twisted and misapplied! The PA State Canal; the Indiana Canal, using Wabash and Maumee Rivers; the Hoosac Route in n.w. Massachusetts; the Stump House Mountain Tunnel route, SC.

b. Gold-plated monuments, overdesigned, long a-building while technology raced ahead elsewhere. Worst case was the C&O Canal. It was "built not just for the present generation, but for all ages yet to come," proclaimed its rhetoricians, but it was obsolete before it was ready to use. "Prompter completion, less elaborate, would have given a longer period of usefulness," tersely quoth its epitaph. (Cf. modern nuclear generating stations, e.g. in WPPSS.)

c. Postmature completions, after others had won the race. E.g., Chesapeake and Delaware (cutting thru narrow neck of Delmarva Peninsula). This was Philadelphia's best route to Pennsylvania's own Susquehanna Valley, but they were too slow: Baltimore got there first, while PA money was being squandered on the moonstruck Juniata line to Pittsburgh.

d. Hosts with too many parasites. Cross-subsidy is the

political price paid for state financing. All canals suffered from this, even the best, the Erie. The strongest ones earn enough surplus to tolerate this; others were bankrupted and destroyed.

"Simple justice to the regions" was the motto of legislators from remote hilly counties wanting a cut of the pie. It is the American version of "French equity." The surpluses generated by the sound lines are dissipated, in whole or part, to build sub-economic lines in losing territory.

PA was a prime example of "Garbage-can Socialism." That describes a system where private firms get to run the turnstiles, while governments get to build the losing feeder lines (and then get blamed for being "inefficient," whether they are or not). By 1842, ran up debt of $42m, huge for its times. Cf. cost of Erie Canal, $7m.

VA, too, dissipated much of its surpluses on subeconomic local lines. So did MD, but MD had the advantage of being smaller. It also got federal aid for its C&O Canal. Meantime, Baltimore wisely went it alone.

e. "Opening up new lands," with "promotional" (as contrasted with "exploitive") lines. Promotional lines, built ahead of demand, often could not meet debt service while waiting for demand to materialize. The very presence, or just the promise, of the line normally caused speculators to overprice lands, waiting for the kill.[6] Actual settlers and producers, who would generate paying traffic, would then leapfrog over them, seeking cheaper lands. NY and OH offset this by taxing the land, which also served to hold down canal tolls. Western New York and Ohio were settled by New Englanders, who traditionally settled compactly. Their culture, compared with others, was hostile to land speculation.[7] Elsewhere, high tolls stifled demand and drained canal finances.

f. Vested interests in old technology. Riverboat interests, who once monopolized our rivers, opposed canals. The old south, with its many navigable rivers, was wedded to its romantic "steamboat-round-the-bend" culture. Even progressive

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[6]Henry George went to the gist of this anomaly, writing of a later railroad boom. "The first effect of the land grant is to hasten settlement by getting a railroad built; the second effect is to retard it by raising the price of lands." Henry George, 1871, Our Land and Land Policy, p.28.

[7]This was far from automatic. In New York State the settlers struggled for decades with the Hudson Valley aristocracy and big city financiers, a long and fascinating story. Gov. DeWitt Clinton was the political genius who found their common interest in the Erie Canal.

NY, after its Erie Canal triumph, opposed the next wave of innovation, the railroad, and fell behind its rivals PA and MA, which it had just overwhelmed.

g. Overpricing services. It is hard to believe now, but Pennsylvanians believed in 1830 that their State canal would bring in enough revenues not just to pay for itself, but to let all other taxes be eliminated. It was to support the whole State - they dreamed of a taxless state! Accordingly, they set the toll rates too high, and discouraged traffic.

They did not invent that notion out of nothing. President John Quincy Adams in 1828 had forecast such a future for the Federal government, based on developing the west and selling public lands. It was in the air. They could look across the Delaware R. and see the State of NJ actually making good money from its canals, which were short and rich, because NJ is small, and strategically located. Its D&R Canal, chartered by the State, paid tonnage taxes. Thus, States can collect $ by leasing out their eminent domain. D&R Canal provided much of NJ state rev for the next 40 years. It was a money-tree, like finding oil. PA could also see NY making money on the Erie. Their mistake was to think they had equally good routes.

h. The fallacy of comprehensive planning. Then, as now, there is something gripping and compelling about a "comprehensive" plan for the whole state. All the interdependent pieces are fitted into a whole, beautifully coordinated.

The trouble with such plans is, they do not allow for staging, and natural growth. The demand is not there all at once, it dribbles in slowly, one settler at a time. Likewise, capital is not available to build all at once. Given that, priorities are needed: one reach or region should develop first, others wait. Comprehensive planning seldom allows for that, especially when logrolling legislatures get ahold of it.

Many states, like Illinois, drew up comprehensive statewide plans. In practice that meant, each year, a little money spent here, a little spent there, and not enough spent anywhere to complete a project and get it going to recover the capital sunk in it.[8] The young Abe Lincoln, lawyer and legislator, was active seeking State aid for navigation on the Sangamon River in his district.

i. Excessive e-w emphasis, when more economic routes were n-s. Each state wanted to establish its own route to the unorganized western lands, and was leery of becoming colonialized by more urban states to its north or south.

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[8]In the 1920s California developed a comprehensive water plan, the "Marshall Plan," for irrigation and city water supply. Only a small part of the original Plan was ever built.

Rivers and valleys on the east and Gulf coasts mostly run n-s. Beginning in Maine, there are the Penobscot, Kennebec, Merrimack, Narragansett, Thames, Connecticut, Housatonic, Hudson, Delaware, Susquehanna, Patapsco, Patuxent, Potomac, Shenandoah, Rappahannock, York, James, Roanoke, Cape Fear, Yadkin (Pee Dee), Catawba (Wateree), Congaree, Santee, Broad, Savannah, Altamaha, etc. Running south to the Gulf are the Suwanee, Chattahoochee, Apalachicola, Escambia, Alabama, Tombigbee, Pascagoula, Pearl, Sabine, etc. Angling into the Mississippi are the Big Black, Yazoo, Red, White, St. Francis, Ouachita, etc. Some of these routes should have been more developed and used.

j. Exclusive or over-reliance on distant targets and far-flung colonies. E.g., CT's Farmington Canal was projected to link New Haven with the St. Lawrence, going north up the Connecticut R. It got as far as Westfield, MA, 1829; never paid a dividend; and soon gave way to the Hartford-New Haven R.R., completed in 1838. Other, more notorious examples have been given: Maumee-Wabash, Philadelphia -Pittsburgh via Juniata V., Richmond - Ohio River, etc.

In Summary, the problem that makes losers losers is that they are "non-revolving funds," or sinks of capital. Capital goes in, but never comes back out. Virginia was an example. Interest on the James River debt ate up the fund. It was called, in the language of the times, "a moth on the fund, in violation of the principle on which created." The principle was that the fund should revolve. Thus, the fund was moth-eaten and lost before it ever financed a canal or a rail to the Ohio, its original objective.[9]

11. A "winner" is not always more socially useful than a "loser." A postmature line is a winner because demand is there panting for it, but the early settlers may have lost a lot in the meantime. That describes the Delaware and Raritan Canal, opened in 1829. The route was so profitable in prospect that a private firm paid the State of NJ a big sum up front for the R.O.W., and also shared tolls with the State, and made out anyway. Those are good clues that it should have been opened sooner, in the general interest. Ideally, then, a canal (or other transportation line) should be opened in sync with private land development, so neither loses time waiting for the other.

That is the exception, however. Most of the reasons given

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[9]How does a revolving fund work? I once belonged to a Committee of economists that published a book a year. We began with a stake of $10,000. As each book sold out it returned $10,000 for the next. Thus, over several years, we published nine books: $10,000 financed $90,000 of work. That is how capital is supposed to work. It stops, however, when a product fails to sell.

above why winners are winners, and losers are losers, remain just as valid in the big picture as they seem in the small.