# LEARNING BY NECESSITY:

### GOVERNMENT DEMAND, CAPACITY CONSTRAINTS, AND PRODUCTIVITY GROWTH

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1 March, 2022

#### Abstract

This paper studies how firms adapt to large demand shocks when facing capacity constraints. I show that increases in government purchases raise total factor productivity measured in quantity units (TFPQ) at the production-line level. TFP responds more to demand in plants facing tighter capacity constraints, a phenomenon I call "learning by necessity". The evidence is based on newly digitized and detailed data on production, productivity, and capacity utilization from several archival sources on US World War II aircraft production. Shifts in military strategy provide an instrument for aircraft demand at the production-line level. I provide suggestive evidence that plants adapted to surging demand by improving production methods, outsourcing, and combating absenteeism. I outline a simple theory of learning by necessity to show why firms at high utilization rates may be more inclined to invest in productivityenhancing measures. The study speaks to a long historical debate on whether demand factors can affect productivity growth.

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## 1 Introduction

How do firms satisfy increased demand for their products when facing tight capacity constraints? The conventional answer is that they cannot do so because firms' capacity is unaffected by demand. An alternative view posits that firms can and do respond to demand shocks through increased productivity and that demand pressures induce innovation that circumvents capacity constraints. This is a common interpretation of the performance of the US economy during the Second World War: Although the US was at full employment by the time Pearl Harbor was attacked, munitions production nevertheless surged through a "learning by doing" process. Munitions industries were producing larger quantities of aircraft, ships, and tanks by the end of the war than was thought possible at its onset and did so at lower cost and prices. This paper revisits this canonical setting to investigate how government purchases affected productivity and whether plants' capacity constraints played a role in inducing productivity growth. The main finding is that plants took active measures to increase total factor productivity in face of surging demand and particularly so if a plant was already operating at high rates of capacity utilization. I refer to this phenomenon as "learning by necessity".

Studying the effects of fiscal policy and capacity utilization on productivity confronts us with substantial data challenges, because productivity and capacity utilization are both notoriously difficult to measure.<sup>1</sup> Given the urgent wartime production needs, the US War Production Board (WPB), military procurement offices, and industry associations maintained exceptionally detailed data at the production line level. These are particularly detailed for aircraft manufacturing, which peaked at 10% of pre-war GDP (see Figure 1c). Firms and the government kept track of physical measures of output, direct manufacturing labor hours in production (as opposed to payroll and separated from overhead labor costs), physical measures of capital, and direct measures of capital and labor utilization. This study builds on several merged archival sources on aircraft production from the WPB, War Manpower Commission (WMC), Army Air Force (AAF), and National Aircraft War Production Council, some of which haven't been used for empirical analysis since the war.

The question at hand also poses an identification challenge because government purchases were certainly directed to plants whose productivity was booming.<sup>2</sup> To address this concern, I use the national output of broad aircraft types in each month as a ("leave one out") instrument for aircraft demand in each production line (plant×aircraft model) in that month. Procurement was indeed channeled to plants the military and government expected to be more productive, *within* broad aircraft types. However, the historical narrative outlined in Section 3 strongly suggests that

<sup>&</sup>lt;sup>1</sup>See Syverson (2011) on productivity and Basu *et al.* (2006) and Fernald (2014) on capacity utilization and its relationship to productivity measurement.

<sup>&</sup>lt;sup>2</sup>See Scott-Kemmis & Bell's (2010) critique of endogeneity of procurement in estimating the magnitude of learning by doing effects.

the allocation of national procurement *across* these broad aircraft types (e.g. the decision of whether to buy more fighter or more bomber aircraft) was driven by military strategy and the progress of the war rather than production efficiency in any particular plant. Instrumenting the monthly production in each individual production line with national production in all other plants producing the same broad aircraft type gives variation in demand that plausibly comes from strategic military needs rather than other factors driving plants' productivity.<sup>3</sup> I find that a quantity-based, and capital utilization adjusted, measure of Total Factor Productivity (TFPQ) increases by one third of a percent for each additional percent of aircraft demand in the average plant.

I then use a triple difference-in-differences IV framework to see how the transmission of government demand differs depending on plants' capacity constraints (measured at the beginning of the war). I measure capacity constraints using several separate, and imperfectly correlated, indicators: capital utilization based on detailed shift-utilization data; labor utilization (weekly hours per worker); and high-wage labor markets. The first two are direct measures of capital and labor utilization at the plant level, while the latter is a price-based indication of the general tightness of local labor markets. Wages are taken as the average wage rate in the labor market, excluding aircraft industry plants.<sup>4</sup> Estimates show that when a plant receives more orders, productivity grows by more in plants initially facing greater capacity constraints.<sup>5</sup>

How did plants increase their productivity to meet increased demand when facing capacity constraints? Histories of the US World War II production drive point to several channels; the most commonly cited are as follows. First, production methods in the aircraft industry changed dramatically over the war years. The most prominent improvement was the move from job-shop production methods (custom and nearly handmade production) to production line methods (standardized products, interchangeable parts with smaller tolerances). Second, the airframe industry moved from mostly in-house production to greater reliance on outsourcing and subcontracting parts of the production process. Third, management made a concerted effort to improve working conditions and worker morale, thus reducing absenteeism and turnover. I provide suggestive evidence in Section 5 that all these factors were in play. High utilization, high-demand plants were more likely to adopt new production methods, outsource production, and reduce absenteeism. The evidence is based on newly collected data on production technique improvements, produc-

<sup>&</sup>lt;sup>3</sup>Of course, it is possible that other plants receive more orders to replace lower production coming from the line in question due to a negative productivity shock in that line. However, these instances would be the non-compilers in the first IV stage, as is the intent of the empirical strategy.

<sup>&</sup>lt;sup>4</sup>Wage controls were in place, but I use wages at the beginning of the war, when wages were still adjustable, as an indicator of labor market tightness. Of course, wages could reflect productivity, I show that plants in high wage regions had initial productivity no higher than those in low-wage areas.

<sup>&</sup>lt;sup>5</sup>Initially capacity-constrained plants were on average older, but I show that the results are driven by heterogeneity in capacity constraints rather than in this confounding factor. Constrained plants appear similar to less-constrained plants on other dimensions and are mainly plants whose demand was front-loaded, leaving them little advance notice to build up their capacity.

tion outsourcing, and worker absenteeism from archival sources and contemporary accounts in local news sources.

The paper concludes with a simple theory of learning by necessity. It shows that if utilization costs are convex, plants will be more willing to incur innovation (or technology adoption) costs to increase productivity when demand is high. However, the theory highlights that what matters is not demand growth, but the level of demand relative to existing capacity. Demand therefore induces endogenous technological progress particularly when utilization rates are already high: learning by necessity.

World War II has some advantages in studying this question empirically. First, the Second World War brought the largest cyclical increase in government consumption and investment in American history. Government consumption and gross investment rose from 9% of GDP at the war's onset to 44% of GDP in 1945, declining again to 16% by 1948. (See Figure 1a.) By the time the US officially entered the war in late 1941 and the war production drive took off in earnest, the economy was at full employment (Figure 1b).<sup>6</sup> However, given the large sectoral shift to wartime production, there were large differences in slack across plants and regions at the onset of the production drive. This variation helps shed light on the interaction between public demand, productivity, and capacity utilization that is the theme of this investigation. Second, it is rare to observe production at high utilization rates except in wartime (and more recently, in a pandemic) and the wartime experience allows us to investigate how producers circumvent capacity constraints that may previously have been viewed as hard limits. Third, the careful wartime data collection efforts have left us with abundant information about production, productivity, and production techniques.

There is a voluminous academic literature studying the effects of government consumption and investment on the economy, including research that uses military spending to identify government spending shocks.<sup>7</sup> Unlike much of the extant literature, this article doesn't focus on the

<sup>&</sup>lt;sup>6</sup>Gordon & Krenn (2010) argue that the economy had no excess capacity by 1941 so that the scope for Keynesian fiscal expansion was already exhausted. See Long (1952) for a discussion of the effects of the war on aggregate employment.

<sup>&</sup>lt;sup>7</sup>The literature on the effects of fiscal policy is too large to cite in full, but Ramey (2011a, 2016, 2019) reviews the methodological progress and the evidence using aggregate and sub-national data. Chodorow-Reich (2019) narrows in on evidence based on cross-sectional (regional) and panel data. Barro (1979), Ramey & Shapiro (1998), Barro & Redlick (2011), Ramey (2011b), and others have used US military spending as instruments for US government consumption and investment shocks. Nakamura & Steinsson (2014) extend this analysis to a panel setting. Auerbach *et al.* (2019) study the effects of modern military procurement on regional output, but don't focus on productivity. Fishback & Cullen (2013) use regional data to study the longer term impact of World War II public spending on economic activity and find limited long-run impact. Rhode (2000) studies the effects of wartime spending on the Californian economy. Jaworski (2021) study product improvements in the interwar US aircraft industry, but their focus is on the role of patent protections, rather than demand, on innovation. There is of course an extensive literature on other economic implications of the war, including on gender (Goldin & Olivetti 2013), management (Giorcelli & Bianchi 2020), and R&D (Gross & Sampat 2020). See Rockoff (2012) and Fishback & Jaworski (2016) for reviews. Brunet (2021) uses World War II procurement data to study the effects of government spending on output and employment across US states.

aggregate effects of public expenditures (the "fiscal multiplier"), private consumption, or unemployment but rather on the effects of fiscal policy on productivity and its dependence on capacity utilization.<sup>8</sup> The existing literature on the macroeconomic effects of fiscal policy is mostly silent on these questions. In recent years, debates have emerged as to whether the effects of fiscal policy differ depending on the degree of slack in the economy–an important consideration when using fiscal policy as a stabilization tool.<sup>9</sup> This study uses production-line level variation and a new identification strategy to estimate the effects of government demand on productivity shows that effects depend on the degree of capacity utilization at the plant level.

Research in the immediate post-war period documented learning by doing (LBD) in aircraft (Middleton 1945, Asher 1956, Alchian 1963, Rapping 1965) and shipbuilding (Searle 1945) industries. These studies show a positive correlation between plants' cumulative output their output per hour worked. More recent work shows that these learning effects are far smaller after controlling for capital (Thompson 2001). This is an important qualification, given the massive capital investments and plant expansions during the war (see Figure 2).<sup>10</sup> Much of the LBD literature is formulated via a learning curve, first observed by Wright (1936), who noted that aircraft manufacturers became more productive with accumulated production. The observation of a learning curve became ingrained in the post-war conventional wisdom and was one of the motivating facts of the endogenous growth literature (cf. Lucas 1993). Learning by doing and economies of scale both imply that fiscal policy or other sources of demand may increase firms' productivity either cyclically or persistently.<sup>11</sup> The possibility that demand may affect productivity has been a topic of theoretical interest in a more recent literature (Benigno & Fornaro 2018, Moran & Queralto 2018,

<sup>&</sup>lt;sup>8</sup>The focus on the production of military contractors in this study makes it unsuitable to investigate the "fiscal multiplier". The fiscal multiplier depends on whether the this production crowded out or stimulated non-military production in other plants, a question explored by Higgs (1992) but is hard to assess with data on production for military use alone.

<sup>&</sup>lt;sup>9</sup>Using time-series methods, Auerbach & Gorodnichenko (2012, 2013) argue that multipliers are substantially larger in recessions. In contrast, Owyang *et al.* (2013) and Ramey & Zubairy (2018) find little support for higher multipliers in the US in times of slack in the economy, using military spending shocks as the identifying variation.

<sup>&</sup>lt;sup>10</sup>Field (2008) paints an even less rosy picture, showing that World War II TFP was lower than in the inter-war period. He argues in Field (2018) that the war led to substantial mis-allocation that lowered post-war productivity.

<sup>&</sup>lt;sup>11</sup>See Romer (1994) for a review of the early literature on endogenous growth, particularly Arrow (1962), who was the first to provide a theory of learning by doing and Young (1991), who synthesizes learning by doing with the later endogenous growth literature. See also Akcigit & Nicholas (2019) for a more recent review. Jones & Manuelli (2005) summarize a theoretical literature on the effects of fiscal policy on endogenous growth, but this literature typically focuses on the the effects of government size in explaining long-run growth differences across countries. An earlier literature hypothesized that demand could induce innovation: see Romer (1987) for a review; more recent estimates of induced innovation in the context of energy efficiency can be found in Newell *et al.* (1999) and Popp (2002). Hickman (1957) was an early contribution to this literature and linked capacity utilization to incentives for capital investment, known at the time as "the acceleration princple". The importance of market size on productivity has also been emphasized in the literature on international trade and innovation (Acemoglu & Linn 2004; Finkelstein 2004 De Loecker 2007, 2011; Atkin *et al.* 2017), but these focus on the long-run, as opposed to business cycle frequency and don't speak to importance of capacity utilization. A literature in macroeconomics has estimated returns to scale in aggregate production functions (Hall 1990, Burnside 1996, Basu & Fernald 1997).

#### Anzoategui et al. 2019, Jordà et al. 2020).<sup>12</sup>

However, learning curve estimates in this early literature are based on correlations, with the obvious problem that plants with greater productivity growth will have accumulated larger volumes of output over time.<sup>13</sup> I demonstrate in Section 3 that reverse causation isn't merely hypothetical, but can be shown to be an important driver of the correlation between productivity and experience in the data. In contrast, I use strategic shifts in demand for broad aircraft types as a source of variation in production that isn't driven by a specific plant's productivity. Further, I control for both a physical measure of capital and capacity utilization. I go beyond the existing literature in investigating heterogeneous effects of experience on productivity, showing that "learning by doing" primarily occurred when plants faced tighter capacity constraints. Finally, most existing work on learning by doing gives little indication as to how it is that plants enhance productivity as experience accumulates. The historical narrative of airframe plants and the findings in Section 5 show active measures taken by plants to improve production methods, supply chains, and labor relations, rather than a passive learning process.<sup>14</sup>

The paper also relates to a literature on capacity utilization, its response to demand shocks, and as a confounding factor in productivity measurement (Burnside & Eichenbaum 1994, Basu *et al.* 2006). This paper shows that TFPQ grows in response to demand shocks (and is procyclical) even controlling for increased utilization, with real productivity gains, not merely reflecting mismeasurement. Additionally, plants with high rates of utilization see relatively higher productivity growth when faced with rising demand, indicating a richer interaction between the business cycle, capacity utilization, and productivity than previously documented.

In recent years, policy debates have emerged on the limits to non-inflationary monetary and fiscal stimulus. These have often been framed in the context of the slope of the Phillips Curve (cf Hazell *et al.* 2020) and the trade off between unemployment and inflation. Some have also speculated that allowing factor markets to operate under "high pressure" may stimulate productivity

<sup>&</sup>lt;sup>12</sup>There is a separate literature that investigates whether demand factors lead to productivity growth in the very long run. Allen (2009) argues that agricultural productivity during the English agricultural revolution of the 18th century was induced by greater demand for foodstuffs of a growing urban population. Habakkuk (1962) and the modern literature on directed technical change (cf. Acemoglu 2002) suggests that high wages (relative to the cost of capital) lead to labor-saving innovations. The Second World War studied in this paper was an episode where *both* capital and labor were insufficient relative to the enormous demands imposed by the government. I find that firms adjust through other margins as a result, such as new production methods and improved labor relations. A different interpretation of this episode is one of directed technological change, where the scarce factor was skilled labor and the innovations allowed low-skilled workers to preform tasks previously performed by highly skilled manufacturing workers. (Cf. chapter 5 in Taylor & Wright 1947 and chapter 6 in Craven & Cate 1955).

<sup>&</sup>lt;sup>13</sup>See Benkard2000 and Levitt *et al.* (2013) for more recent contributions that use instrumental variables approaches. The former studies a single modern aircraft plant and uses lags of global GDP and oil prices as instruments for demand. The latter studies a single automobile plant and uses the cumulative production of other shifts as an instrument for the cumulative production of a given shift.

<sup>&</sup>lt;sup>14</sup>Thompson (2010, 2012) discusses the distinction between passive learning and active measures to improve productivity as scale increases and the debate on whether the later should be referred to as "learning by doing".

and innovation. (See the discussion in Bernstein & Bentele 2019, who point to a dearth of evidence on this question). This paper sheds light on this question in the context one of the highest-pressure periods the US economy has seen: the production war effort of World War II.<sup>15</sup>

The remainder of the paper is organized as follows. Section 2 describes the data and the historical and institutional setting. Section 3 lays out the empirical strategy with the main results shown in Section 4. Section 5 gives a historical discussion and empirical evidence of the actions taken by plants to increase productivity. Section 6 outlines a simple model of productivity growth in face of high demand and high capacity utilization. Section 7 concludes.

## 2 Data, Institutional Setting, and Historical Context

World War II led to the largest cyclical increase in public consumption in US history. Figure 1a shows government consumption as a percent of GDP in the US from 1929 to today. The Second World War stands out as the single largest shock to government purchases.<sup>16</sup> The analysis that follows focuses on aircraft purchases, certainly narrowing the analysis to a single sector. However, aircraft was the single largest expenditure item in the military budget and became the largest industry during the war. Figure 1c shows that aircraft procurement peaked at ten percent of prewar GDP, a share of GDP that is comparable *total* defense spending at the peak of the Vietnam War. In May 1940, after the fall of France, President Roosevelt set an ambitious objective of producing 50,000 planes during the war.<sup>17</sup> At the time, this was viewed as a nearly impossible task, with economists Robert Nathan and Simon Kuznetz estimating that the US didn't have the productive capacity to meet this aim.<sup>18</sup> In actuality, the US aircraft industry produced twice this number of aircraft in 1944 alone (War Production Board 1945 p. 10). Procurement of aircraft (and other war materiel) increased during 1940-41, but only took off following the attack on Pearl Harbor in December 1941; it peaked in 1943. The aircraft industry was a young industry: the average firm was founded in 1927 and the average plant was founded in 1934.

Procurement was under the purview of the relevant military branches, in this case the Army Air Force (AAF) and the Navy. During the war, procurement was also coordinated with the War Production Board (WPB), which provided the overall strategy for the war production effort. The

<sup>&</sup>lt;sup>15</sup>There is a legitimate question as to whether the wage and price controls of World War II limit the external validity of this context to more recent high-pressure economic environments. As I discuss in the following section, price controls didn't apply to aircraft manufacturers and productivity growth lead to price *declines* of complete aircraft.

<sup>&</sup>lt;sup>16</sup>Neither the recent Covid-related relief programs nor recently passed and currently-debated spending bills change this picture. The former were mainly transfers rather than government consumption or investment. The latter are spread over eight to ten years, so that they will amount to less than 2% of annual GDP even if passed in full.

<sup>&</sup>lt;sup>17</sup>Fireside chat, May 26 1940. (See Smith 1991 page 129 for a discussion.)

<sup>&</sup>lt;sup>18</sup>Wilson (2018) p. 178. This what part of what has been called the "feasibility dispute", where military commanders demanded munition production beyond what contemporary economists believed was feasible. See Nelson (1950) pp. 376-81, Brigante (1950), and Smith (1991) p.154.

AAF divided the country into six regional procurement districts, with district commands managing procurement in each region. Because of the importance and ambition of the aircraft production schedule, procurement of airframe, motors, and propellers was separated from the general Army Supply Program and was managed by a special agency, the Aircraft Resources Control Office, in Dayton Ohio. This agency dealt directly with the industry and the War Production Board. The AAF base at Wright Field (later Wright-Paterson) monitored aircraft production and aircraft modification to meet the AAF's strategic needs. The majority of contracts were Cost Plus Fixed Fee (CPFF), whereby the suppliers' (audited) costs were reimbursed and augmented with a pre-negotiated payment per aircraft delivered. However, because of concerns of war profiteering, markups were restricted by law (to 4% by the end of the war), many contracts were renegotiated ex-post, and most aircraft manufacturers' profit margins were lower than they were before or after the war<sup>19</sup>. Aircraft firms, their subcontractors, and their suppliers were exempt from wartime price controls. Wages were regulated and frozen at their March 1942 levels. Wages did increase during the war, but all wage increases required government approval (Smith 1991 pp. 399-403). Prior to the war, most aircraft were made to order based on detailed specifications of the procuring agency. These production methods were untenable given the quantities of aircraft demanded in wartime. The demand shock was truly remarkable, with Boeing, Lockheed and several other manufacturers producing one hundred times more aircraft in 1944 than in 1939 (Smith 1991 p.293). The industry as a whole saw a 1,600% increase in aircraft produced, with the complexity of aircraft also increasing. To facilitate mass production, the AAF and WPB agreed to purchase standardized aircraft models from aircraft manufacturers. These were then modified in army or navy modification centers to the exact specifications of the procuring agency. This aides productivity analysis as one can be more confident that an aircraft of a specific model and mark coming off of a specific production line had the same specifications. The following section outlines in detail how purchases were allocated across plants, which is central to identifying the effects of aircraft demand on plant productivity.

The analysis in this paper draws on a number of archival sources, primarily from the archives of the WPB, the War Manpower Commission (both at the National Archives, College Park, MD), the Air Materiel Command of the AAF (Air Force Historical Research Agency–AFHRA, Maxwell Air Force Base, AL), and the National Aircraft War Production Council (Truman Library, Independence, MO). While several of the sources have been used in previous research, I have digitized new materials and matched several data sources. Some data, including capacity utilization measures, have not been used in previous research. Here, I briefly outline the data sources for the variables used in the analysis that follows. Full details are provided in the data appendix.

The main productivity measures are from the Aeronautical Monthly Progress Reports (AMPR),

<sup>&</sup>lt;sup>19</sup>Smith (1991) pp. 248-293. See Wilson (2018), chapter 4, for a history of contract re-negotiations

collected by the AAF headquarters at Wright Field. The WPB and AAF carefully monitored the production of war materiel. All aircraft manufacturers were required to provide monthly reports on their production progress. The data are for assembly of complete "standardized" aircraft (precustomization and modification). The AMPRs were used to monitor production against plans, to ensure that manufacturers were utilizing capacity, and to monitor costs for CPFF contracts. For these reasons, aircraft manufacturers were frequently audited to ensure accurate reporting.<sup>20</sup> Reporting requirements and methodology were uniform across plants and extremely detailed. Figure A.1 in the appendix shows the standardized forms that all manufacturers had too fill.<sup>21</sup>

The AMPR includes monthly plant by aircraft-model data for all wartime aircraft manufacturers. 61 plants produced 83 different aircraft models leading to 204 plant-by-model pairs. To ease exposition, I will slightly abuse terminology in what follows and refer to a plant-by-model combination as a "production line", although some plants ran several production lines for the same model. Aircraft models are narrowly defined in the data and all design changes are noted. I dropped a small number of plants and production lines that produced fewer than 100 aircraft cumulatively or operated for less than 6 months, as they don't provide sufficient production-line level variation for the subsequent analysis.<sup>22</sup>

The point of departure for productivity measurement is the variable "Unit Man Hours: Entire Plane". Plants reported the number of direct worker-hours that entered into the production of the last plane delivered in each calendar month. This includes only workers directly involved in manufacturing; overhead was separately reported as "indirect workers". The measure includes hours worked in sub-assemblies, so that it gives a consistent comparison when producers outsourced parts of the production process. The variable gives hours per physical units of output and at the product level (thus addressing the multi-product plant problem). While there are clear advantages to measuring productivity at the aircraft level, the last aircraft may be unrepresentative of the plant's average productivity. For sake of comparison, I calculated monthly labor productivity by dividing the number of aircraft delivered by payroll hours for manufacturing workers. This is the standard methodology to calculate labor productivity in physical units. The two measures show very similar patterns. However, comparing the two measures highlights the advantage of

<sup>&</sup>lt;sup>20</sup>District procurement offices were assigned to monitor these reports and were given formulae to detect misreporting. Wilson (2018) documents (p. 176) that as many as 60 military and GAO auditors could be on site to monitor production at a single airframe plant. See "AMPR Questionnaire for use in Making In-Plant Audits of Basic Labor Statistics" (AFHRA archives, Reel A2050, starting on slide 1128) and "Basic Labor Statistics–How to Maintain Them", ibid, starting on slide 1179

<sup>&</sup>lt;sup>21</sup>The AAF also gave plants a 150 page document with minute detail on how to report production, productivity, capacity utilization, and other data in a uniform format. The document, ATSC Regulation No. 15-36-3, can be found in the AFHRA archives, Reel A2050, starting on slide 850. See also San Diego Air and Space Museum (SDASM) archives Box 34 to see how a specific manufacturer (Consolidated Vultee) adopted these procedures internally.

<sup>&</sup>lt;sup>22</sup>The AMPR begins reporting in 1941, but has only 60% coverage prior to 1943. Coverage is 100% starting in January 1943, which was also the initial production date for a large share of production lines.

direct aircraft-level productivity measurement. The typical aircraft took more than a single month to build and the AMPR required the aircraft-level measure to incorporate hours in all production months.<sup>23</sup> In contrast, dividing the number of aircraft by current hours worked creates a mismatch between delivery time and production time and particularly misstates productivity at the beginning or end of a production batch. (The former shows many workers producing little output and the latter the opposite.)<sup>24</sup>

The AMPR provides a physical proxy for capital. It gives quarterly observations of the floor space utilized in production in each plant. The measure includes only floor space actively used for production and therefore incorporates capital utilization to some extent. It excludes office space and other non-production facilities but includes any yard space used for production. A quantity-based measure of the capital stock has several advantages. Structures were the largest component (60%) of capital investment in the airframe industry during the war. Expenditure on structures confounds variation in land prices and construction costs across regions (expenditure on structures) with real differences in the capital stock (physical structures). Second, capital expenditure data requires an estimate of the initial capital stock. In contrast, floor space is measured in square-feet, giving a stock, rather than a flow, measure of the quantity of structures in use.

The capital stock is relatively slow-moving in the data and I interpolate quarterly floor space to give a monthly measure of physical capital per plant. While production, labor inputs, and productivity are measured at the production-line level, capital is at the plant level. I allocate capital across production lines to equate the capital to labor ratio across all production lines within a plant, as would optimally occur with a standard constant returns to scale production function. Using product-level labor inputs, TFP is measured residually from a Cobb-Douglas production function with a capital share in production of  $\frac{1}{3}$ . Capital measured in physical units (as opposed to investment) only responds moderately to identified shocks so that results should be robust to other mappings from labor productivity to TFP.

Figure 2 shows the time series of aircraft production, hours worked, and capital (floor space) in the average production line, from 1942 to 1945, all relative to their January 1942 values. Production is shown as number of aircraft in the top panel and in total aircraft weight in the bottom panel. For

<sup>&</sup>lt;sup>23</sup>Documents from Convair, the largest wartime producer, show that bombers required 45 to 90 days to build, depending on the model (SDASM archives, Box 17).

<sup>&</sup>lt;sup>24</sup>The number of monthly aircraft delivered by plant and model is given in the AMPR. The same information is available in Civilian Production Administration's *Official Munitions Production* (OMP). This post-war document recorded all major munitions procured by all military branches during the war at monthly frequency. It gives the number of aircraft "acceptances" delivered to the military by model from each aircraft plant. This document is slightly more comprehensive than the AMPR, with the latter reaching 100% coverage only in January 1943. I use this source to fill in observations missing from the AMPR and to cross-check the AMPR's data. For those months and production lines where both sources report aircraft deliveries, the two sources correspond closely. The AMPR is used as the primary source for monthly production and the OMP is the secondary source, used only in months when AMPR data are unavailable. This approach maximizes coverage, but results are robust to using either of the individual sources.

contemporary researchers, this latter measure was the common way to adjust for larger aircrafts' greater production complexity (larger aircraft are both heavier and require more assembly). The figures give prima facie evidence of the great increase in productivity during the war. Hours worked and capital grew in tandem by a factor of close to 2.5 (roughly 0.9 log units). In contrast, the number of aircraft produced increased by a factor of 3.5 (1.25 log units). This suggests a TFP increase of 35%, if the industry production function is homogeneous of degree one. The increase in TFP measured in units of aircraft weight is even more dramatic: roughly 250%. The strong correlation between labor and capital justifies using a production function with a constant capital share over time.

The detailed data collected in the AMPR also give a rare account of capital and labor utilization in all plants in the nation's largest industry. The statistics include the number of work shifts per day, the number of daily hours in each shift, and the number of monthly worker-hours active in each one of the shifts per month. From these, I calculate shift utilization, which was used to assess capital utilization during the war and suggested by Basu *et al.* (2006) as a measure of capital utilization. A plant's capacity in a given month is assessed using the number of *scheduled* working hours in the first (Monday morning) shift (always the most active shift) as indicative of full production potential in that week. Full capacity is then measured as the number of weekly work hours that would result if the plant were active 24 hours a day at full production potential (i.e. with the same number of workers per hour as the first shift). Capital utilization is the ratio between *actual* monthly work hours and full capacity.<sup>25</sup> The AMPR also includes monthly reports of average weekly hours per worker, which I use as a measure of labor utilization.<sup>26</sup>

Figure 3 shows the evolution of capital and labor utilization in the median airframe plant. Capital utilization was high and rising in the first year of direct US involvement in the war, peaking at 52% by the end of 1942. This is perhaps an unremarkable capital workweek by 21st century standards, but this was well above typical pre- and post-war utilization rates of around 35% (60 hours per week). The arrival of the "year of production" in 1943 (Klein 2013) sees a surge in aggregate productivity (Figure 2), but a rapid *decline* in capital utilization through the remainder of the war. This is a first indication that the observed productivity surge was not merely high

<sup>&</sup>lt;sup>25</sup>Wartime reports and the data suggest that the use of second shifts, night shifts, and Saturday shifts were the main source of variation in capacity utilization both over time and across plants. Of course, there is also variation over time within plants in the number of hours employed in the first shift. However, this will already be captured in the capital to labor ratio.

<sup>&</sup>lt;sup>26</sup>Shift utilization is imperfectly correlated (with a coefficient of 0.5) with hours per worker. Shift utilization may seem like a reflection of labor utilization but it is better thought of a measure of capital utilization. For example, the Martin plant in Omaha had very high average weekly hours per worker (51.3) in early 1942, because many of its workers worked 7 days a week. However, it had very low capital utilization (37%) because the plant mostly worked 9-to-5, with very few workers in a limited evening shift and no night shift. In contrast, workers in the Douglas plant in Santa Monica worked 40 hours per week, but had a high capital utilization (65%) rate because the plant spread its 15,000 workers nearly evenly over 3 shifts a day (operating 6 days a week).

utilization masquerading as TFP. Instead, it appears that productivity growth substituted for high utilization rates, allowing plants to decrease utilization. The bottom panel of Figure 3 shows that workers were also strained early in the war, with the average worker in the median plant working nearly 50 hours a week in 1942. Like capital utilization, labor utilization declines sharply in 1943, stabilizing at around 45 hours a week.

# 3 Empirical Strategy

Estimating scale effects in production, learning by doing, and the effects of public demand on plant productivity pose an empirical challenge. Productivity is one reason why some plants gain larger scale, accumulate more experience, and attract more procurement contracts. Hence simple correlations between productivity and scale aren't necessarily informative of demand's causal impact. The post-war learning-by-doing (LBD) literature reported correlations between cumulative output and output per worker as reflecting a "learning curve". In doing so, researchers implicitly presumed that wartime procurement reflected a demand-shifter that traced the supply curve or production function. However, procurement wasn't randomly allocated across plants and time and the government likely purchased more aircraft from those plants it believed could deliver, i.e. ramp up production and increase productivity, in relatively short order.

Reverse causation isn't merely a theoretical possibility. It is also very likely. Figure A.2a in the appendix shows a scatter plot each production line's (log) cumulative output up to VE day, May 1945, against its (log) labor productivity 16 months earlier (the farthest back one can go without losing newer production lines). The strong correlation between *past* productivity and cumulative output *at the end of the war* obviates the point that high-productivity plants accumulated more production. Productivity is highly auto-correlated in the data, as seen in Figure A.2b in the appendix. Current productivity is correlated with past productivity, which is in turn correlated with, and likely causes, cumulative production, which is often taken as a proxy for experience or learning. To add to the challenges of estimating an experience curve, production is autocorrelated, so that *cumulative* production is highly correlated with *current* production (Figure A.2c), making it difficult to disentangle "learning by doing" from scale effects.<sup>27</sup>

In the analysis that follows, I instrument the monthly production of each individual production line (plant-by-model combination) with the aggregate production of all other production lines producing the same broad aircraft type in that same month. This approach relies on the assumption

<sup>&</sup>lt;sup>27</sup>Table A1 in the appendix shows results of learning by doing OLS regressions in our context. They include time and production line fixed effects. When controls for current and lagged production are added, there is no statistically significant correlation between cumulative production and productivity. This illustrates the challenge of disentangling experience and scale effects.

that demand for broad aircraft types (e.g. bombers vs. fighter planes) was determined primarily by strategic considerations, not relative productivity in their manufacture. This contrasts with demand for specific aircraft models within a broad category (e.g. B-24 vs. B-17 bombers), or plants (Douglas vs. Boeing), where procurement may well have been affected by plants' relative expected productive capacity.

I divide aircraft into five broad types: bombers, communications, fighters, trainers, and transport and include a sixth category for other specialized aircraft. The instrument  $I_{mpt}$  for demand  $D_{mpt}$  for aircraft model m in plant p in month t is given by  $I_{mpt} = \sum_{\pi \neq p} \sum_{\mu \in \mathbb{M}_m} D_{\mu\pi t}$ , where  $\mathbb{M}_m$  is the set of aircraft models of the broad type that includes model m. The first stage of the 2-stage least squares specification is given by

$$D_{mpt} = \gamma I_{mpt} + \text{controls} + \text{FE} + \text{lags} + u_{mpt}.$$
 (1)

Impulse responses of the second stage of the regression are estimated using local projections (Jordà 2005). At each horizon *h*, the response of productivity  $y_{mp,t+h}$  to aircraft demand  $D_{mpt}$  is estimated as  $\hat{\beta}_h$ , arising from the regression

$$y_{mp,t+h} - y_{mp,t-1} = \beta_h \widehat{D}_{mpt} + \sum_{\ell=1}^L \delta_\ell^D D_{mpt-i} + \alpha_t + \alpha_{mp} + \text{controls} + \varepsilon_{mpt},$$
(2)

where  $\hat{D}_{mp,t}$  is predicted aircraft demand from (1).  $\alpha_t$  and  $\alpha_{mp}$  are time and plant-by-model (production line) fixed effects, respectively. Two-way fixed effects imply that we are comparing the differential productivity growth over time across production lines and gives estimates a difference-indifferences interpretation. Reported regressions include L = 6 monthly lags of aircraft production. Controlling for the lagged explanatory variable is common practice in time series econometrics and turns out to be important to eliminate pre-trends in the impulse responses. Once one controls for lags of production there is little difference between cumulative production and current production, but formally the regressions estimate the effects of current production scale, rather than experience, on productivity. We will revisit this distinction shortly.

Instrument relevance requires that the timing of production is correlated across production lines producing the same type of broad aircraft. Relevance is borne out in F statistics reported in the IV regressions in the following section. Non-compliance could arise if a plant lost orders to others because of low productivity and this is precisely the variation that the instrument attempts to discard. Conversely, the instrument discards idiosyncratic surges in production in an individual production line, which may be caused by higher productivity. The exclusion restriction requires that the national demand for other models of a broad aircraft type, or for the same model in other plants, affects the (relative) subsequent productivity growth in the the production line in question only through the demand directed to that production line.<sup>28</sup>

In assessing the validity of the instrument, let's consider the source of variation it captures. This is illustrated in Figure 4, which shows the average number of aircraft delivered per production line in four aircraft types: bombers, fighters, transport, and training. The figure shows that the four categories saw very demand different fluctuations, which have known historical interpretations. Early war production was for lend-lease assistance to US allies in Europe. In terms of aviation, this primarily came in the form of fighter aircraft (e.g. for the Battle of Britain), leading to a boom in fighter production in 1940-1941. Fighters were also used as escorts for US merchant ships during this period. US direct involvement in the war began in December 1941. US military strategy in the immediate aftermath of the attack on Pearl Harbor anticipated a heavy reliance on aerial bombing (as exemplified by the Battle of Midway in summer 1942), leading to an inflection in the demand for bomber aircraft in 1942 and surge in demand in 1943.<sup>29</sup> Demand for transport aircraft took off only later, in the ground operations phase of the war: transport aircraft supported the island-hopping operations in the Pacific and facilitated the invasion of Italy in 1943.<sup>30</sup> Demand for fighter aircraft surged again in 1943, as can be seen in the figure, when it became apparent that both bomber and transport aircraft benefited from fighter escorts.<sup>31</sup> Trainer aircraft were naturally required more in the early war years than later in the war.

A threat to identification would arise if these relative demand shifts were due to differential expected productivity growth across broad aircraft types. The historical literature gives strong indications to the contrary: Strategic considerations were paramount in determining procurement schedules for broad categories of munitions. In September 1943, a report by the WMC on *Manpower Problems in the Airframe Industry*<sup>32</sup> notes that

<sup>&</sup>lt;sup>28</sup>Stock & Watson (2018) add a third identifying assumption for local projections IV estimation, lead-lag exogeneity: the instrument may not be correlated with leads or lags of errors, in our context  $E[I_{mpt}]\varepsilon_{mpt+j}|X_{mpt} = 0$ , for all  $j \neq 0$  where  $X_{mpt}$  are controls. They suggest an informal test: the instrument should be unpredictable in a regression on the lags of the outcome variable, in this case productivity. Indeed, conditional on the controls (which include six lags of demand), 12 lags of productivity are uncorrelated with the instrument. This is related to the requirement that there be no pre-trends, which will be reported in the following section.

<sup>&</sup>lt;sup>29</sup>Edgerton (2012) claims that US military planners only fully appreciated the full import of bombers for military strategy during the Battle of Britain, but that British leadership was relying on strategic bombing as central to their strategy. This meant that the UK was relatively self-sufficient in bomber production and the US only had to produce bombers massively with their direct involvement in the war.

<sup>&</sup>lt;sup>30</sup>See AFHRA Reel 1009, p. 1608 "Airborne Missions in the Mediterranean" on the use of C-47 transport aircraft for glider and paratrooper landings in operation Husky, Landbroke, and Fustan in Sicily. On the importance of transport aircraft in the North Burma campaign, see Taylor, Joe G., 1957, Air Supply in the Burma Campaign, USAF Historical Studies No. 75, USAF Historical Division, Maxwell Airforce Base, reel K1009.

<sup>&</sup>lt;sup>31</sup>Major Lesher, Lee A. (1988). "The Evolution of the Long-Range Escort Doctrine in World War II" United States Air Command and Staff College. Support for this doctrine was gaining traction and led to increased fighter demand in early 1943. But an important inflection point was a failed AAF strategic bombing mission on Schweinfurt, Germany in August 1943. The targets were beyond the range of fighters and led to a loss of 60 out of 376 participating bombers. Strategic bombing was curtailed for several months as a result and the view that bombers must receive fighter escort became entrenched for the remainder of the war. See also Baxter (1946) for a similar argument.

<sup>&</sup>lt;sup>32</sup>War Manpower Commission, Sep 1943, National Archives College Park.

The primary purpose of the periodical overhauling of aircraft schedules is to shift emphasis from one model to another in the light of combat experience and military needs.

Towards the end of the war, a WPB report<sup>33</sup> looks back and summarizes:

In 1944, our war production had to meet front-line needs, constantly changing with the shifting locales of warfare, the weaknesses and strengths demonstrated in combat, and our inventiveness as well as the enemy's. Less emphasis was placed on increasing quantities of everything required to equip an army, a navy, and an air force, and more on those specific items needed to replace battle losses and to equip particular forces for particular operations.

The same report narrows in on aircraft production:

The complex causation of program changes is illustrated by the aircraft program. Each quarterly aircraft schedule represented a cut under its predecessor. In part this reflected lower than anticipated combat losses... [In 1944, t]he demand for four-engine long-range heavy bombers, transport vessels and heavy artillery ammunition rose dramatically during the year, while the need for training planes, patrol vessels, mine craft, and radio equipment fell off in varying degrees.

In summary, procurement of broad categories of aircraft was mostly driven by strategic needs, not aircraft plants' expected productivity. Of course, procurement agencies carefully monitored plant-level productivity and purchased aircraft within these broad categories from plants they viewed most able to deliver. But this source of variation is discarded, rather than captured by, the instrument. Further, technological improvements and new varieties of aircraft may have moved demand across aircraft models within broad categories (from "heavy" B-17 to "very heavy" B-29 bombers, for example), but unlikely across the broad categories we consider (B-17 bombers to P-39 fighter aircraft), as they were hardly good substitutes in terms of military operations.

# 4 Government Demand and Productivity Growth

The framework introduced in the previous section is now used to estimate the dynamic response of output per hour worked to a 1% increase in demand. The local-projections impulse response is shown in Figure 5. The shaded area in this and subsequent figures give 90% and 95% weak-instrument robust confidence bands.<sup>34</sup> Regressions include time and plant-by-model fixed effects

<sup>&</sup>lt;sup>33</sup>WPB Production in 1944

<sup>&</sup>lt;sup>34</sup>The instrument is sufficiently strong, by standard criteria, with a heteroskedasticity-robust (Montiel Olea & Pflueger 2013) F-statistic exceeding 20 at the 12-month horizon (F-statistics for subsequent regressions are reported in the figure notes). In any case, I follow Andrews *et al.*'s 2019 recommendation and report weak-instrument robust standard errors (Finlay & Magnusson 2009) in all figures.

and are normalized to be relative to productivity at month -1. Responses therefore reflect the relative increase in labor productivity at each horizon in a production line receiving 1% higher demand, as predicted by the instrument described in the previous section. The specification controls for six lags of (the logs of) production, of the capital to labor ratio, and of total hours worked. Labor productivity increases by around  $\frac{1}{3}$  of a percent per each percent increase in demand, within the first 12 months. Estimates become very noisy beyond the reported horizon because of the decreasing sample size. It is therefore difficult to ascertain how persistent the responses are. Figure A.3 in the appendix shows the relative response of production itself to the 1% (relative) increase in demand. The initial shock to aircraft demand leads to a persistent surge in production. Figure 5 should therefore be seen as reflecting the response of labor productivity to a one-off increase in demand with a half-life of roughly a year.<sup>35</sup>

The strong correlation between current and accumulated output, noted in Section 3 and shown in Figure A.2c in the appendix, makes it difficult to disentangle learning effects (responses to cumulative production) from scale or demand effects (responses to current production). Once we control for lagged demand in (2), a shock to one is nearly identical to a shock to the other.<sup>36</sup> Nevertheless, Figure A.6a in the appendix shows the impulse response of identified demand shocks when controlling for cumulative experience (the log of the production line's cumulative production, Experience<sub>mpt</sub> = log ( $\Sigma_{s=0}^t exp(D_{mpt})$ )). Results are similar to the baseline specification. In contrast, Figure A.6b shows the response of labor productivity to a 1% increase in experience, a traditional LBD regression, controlling for current output.<sup>37</sup> The response of labor productivity to "experience" is extremely transient.<sup>38</sup>

Increases in production and in output per hour worked were associated with massive investments in facility expansions as we saw in Figure 2. Although the figure shows that aggregate hours worked grew at a similar pace to capital, thus leaving the capital-labor ratio constant for the average plant, it is possible that the relative growth in labor productivity in certain production lines is

<sup>&</sup>lt;sup>35</sup>Figure A.4 in the appendix shows labor productivity's pre-trend before the shock to demand and no pre-trend is apparent (but with large standard errors). Figure A.5 in the appendix shows the OLS version of the baseline IV regression. The responses are larger in the short run, consistent with an upward biased OLS if demand was directed to plants with more potential for productivity growth. Results here and in all subsequent specifications are nearly unchanged if production line fixed effects are replaced with linear or quadratic production-line specific time trends.

<sup>&</sup>lt;sup>36</sup>Their magnitude is different, however, in a log-log specification. A one percent shock to cumulative output is far larger than a one percent shock to demand, when measured in number of aircraft. Regressions on cumulative output also put a greater emphasis on shocks early in the war because they are measured relative to cumulative production, which increases over time.

 $<sup>^{37}</sup>$ To make the two regressions comparable, we instrument for experience using the cumulative equivalent of the instrument outlined in the previous section, i.e. we instrument cumulative demand for aircraft in production line *mp* in month *t* using the cumulative national production of aircraft of the same broad type, excluding the production line in question. The validity of the instrument is less obvious in this case, because it is plausible that the cumulative demand for and production of bombers relative to fighters, to take an example, was determined by relative technological progress. This concern is less acute at the higher frequencies exploited in our main estimates.

<sup>&</sup>lt;sup>38</sup>The larger scale of the short run response is expected given that the magnitude of a 1% shock to *cumulative* production is enormous compared to a 1% shock to *current* production.

confounded with relative increases in the stock of physical capital per worker. Figure 6 shows the response of TFP to a 1% increase in relative demand, with the fixed-effects IV specification of (1) (2). The increase in TFP is of similar magnitude to that of labor productivity.<sup>39</sup> Capital is measured through the use of *active* floor space that already accounts to some extent for capital utilization, but the regression also controls for capital utilization, measured by shift utilization as outlined in Section 2. The impulse response reflects an increase in TFP above and beyond cyclical increases in productivity arising from higher rates of utilization as in Basu *et al.* (2006).<sup>40</sup>

Labor productivity and TFP are measured in physical units (TFPQ) so that responses reflect an increase in aircraft produced rather than changes in prices or markups. Model fixed effects reflect very narrowly defined models, with aircraft models re-coded at every design change. This means that results also largely control for (major) product quality changes. Plant-by-model fixed effects also control for any (persistent) quality differences across plants producing the same model. Given the enormous increase in the size and quality of aircraft over the war, estimates shown here are likely lower bounds to quality-adjusted demand-induced productivity growth.<sup>41</sup>

Recent research has warned of potential bias in two-way fixed effects regressions, particularly if treatment effects are heterogeneous. An estimator proposed by de Chaisemartin & D'Haultfoeuille (2020) corrects for this bias, but requires a set of groups (in our case production lines) whose treatment status doesn't change from period to period, a condition that doesn't apply in this setting, where production typically changes every month in every production line. Instead, I apply a modified version of Goodman-Bacon's (2021) recommendation to compare production lines that were treated early with those that were never treated. He shows that biases are more likely to arise with (late) comparisons between groups that were treated late with those treated early. Plants received procurement orders throughout the war and it is therefore impossible to separate production lines into those treated early and late. However, Figure A.8 in the appendix shows impulse responses in a specification that offers a partial solution to the concern. It interacts the leave-one-out instrument of the previous regressions with a dummy variable equalling one in first half of the sample. This instrument compares production lines facing (relative) demand shocks early in the war. The instrument ignores variation between production lines facing greater demand later in the war with those receiving less demand late in the war, but which possibly saw high demand early on, and therefore carry-forward their productivity gains induced by early-war demand. This is an informal application of the Goodman-Bacon (2021) methodology to a setting with continuous, as opposed to discrete, treatment status. Results are similar, albeit with wider standard errors, allaying to some

<sup>&</sup>lt;sup>39</sup>TFP is calculated as the residual from a Cobb-Douglass production function with a capital share of  $\frac{1}{3}$ , where the capital stock is adjusted for capital utilization. Results are similar when simply controlling for capital per hour worked.

<sup>&</sup>lt;sup>40</sup>The responses are very similar when excluding the control for capital utilization. See Figure A.7 in the appendix.

<sup>&</sup>lt;sup>41</sup>Results might overstate productivity growth if demand pressures caused plants to cut corners and produce lower quality aircraft.

extent the concern that the baseline results were biased due to heterogeneous treatment effects.<sup>42</sup>

### Government Demand, Capacity Constraints, and Productivity Growth

Having documented how demand affects productivity in the average aircraft plant, I now show important heterogeneity in responses to increased demand. The focus will be on the role of capacity utilization, what I have called "learning by necessity". To begin with, I consider capital utilization: The dummy variable  $c_p$  is assigned a value of one if plant p had an above average initial value of capital utilization.<sup>43</sup> A triple difference in differences estimator gives the differential effects of demand depending on initial capital utilization:

$$y_{mpt+h} - y_{mpt-1} = \beta_h^{3D} [\widehat{D_{mpt} \times c_p}] + \omega_h \widehat{D}_{mpt} + \text{lags} + \text{controls} + \text{FE} + \varepsilon_{mpt}^{3D}.$$
(3)

As in (2),  $\hat{D}_{mpt}$  gives demand for aircraft of model *m* from plant *p* in month *t*, predicted by the instrument in the first stage of the two-stage least squares. However, the coefficient of interest is now  $\beta_h^{3D}$ , on the interaction between demand and the capacity constraints indicator  $c_p$ . Demand  $D_{mpt}$  and its interaction with capacity constraints  $c_p$  are jointly projected on the leave-one-out instrument  $I_{mpt}$  and its interaction with the capacity constraint dummy in a first stage analogous to (2). The capacity constraints dummy itself is excluded as its variation is absorbed by plant by model fixed effects. FE represents month and plant-by-model (production line) fixed effects.

Figure 7 plots the local projection impulse response: the estimated  $\beta_h^{3D}$  coefficients. This represents the response of productivity to a one percent increase in demand (predicted by the instrument) in plants with higher initial capital utilization relative to those with initially low utilization. High-pressured plants show a larger increase in both labor productivity (top panel) and TFP (bottom panel). The magnitudes are substantial with TFP growing by  $\frac{1}{5}$ % more in plants that were initially more constrained.

Investigating high pressure on labor, as opposed to capital, we use two metrics to evaluate labor shortages. Labor utilization is measured a the plant level as the average hours per worker in a plant. Local wages are another indicator of labor market pressures. Table A2 shows that these various metrics of capital and labor shortages are correlated but these correlations aren't perfect. High wages could of course reflect high productivity rather than labor shortages. However, wages were regulated during the war and the government typically only approved wage increases when

<sup>&</sup>lt;sup>42</sup>When restricted to the first half of the sample, the instrument becomes weak, leading to wider weak-instrument robust standard errors. The horizon in the figure is restricted to 12 months, with first stage F statistics declining rapidly with the horizon.

<sup>&</sup>lt;sup>43</sup>I take the first available observation for each plant, which is typically the first month they delivered aircraft for the war production drive. This initial date differs across plants. Setting the dummy based on the January 1943 value or the average value over the war gives similar results.

plants faced substantial labor shortages. This is evident from the last row of Table A2 which shows a strong correlation between wages in 1942 and a dummy variable taking on a value of one if the plant was located in a county classified by the War Manpower Commission (WMC) as facing labor shortages.<sup>44</sup> Furthermore, the wage rate used is the average wage in the labor market *excluding* plants in the aviation industry. Figure A.9 in the appendix shows that plants with above-median hours per worker early in the war (January 1943, a month chosen to maximize coverage) saw relative increases in TFP when facing increased demand, but the effects aren't statistically significant. In contrast, when using local wages early in the war as external measure of labor shortages, we see large increases in TFP following a demand shock. Results are similar when using the WMC's classification to identify counties with labor shortages.

While demand shocks are identified through the instrument, capital utilization isn't randomly assigned.<sup>45</sup> The triple differences specification in (3) absorbs differences in productivity *levels* in plants with different constraints through plant (by model) fixed effects. It is nevertheless possible that plants with greater initial capital utilization responded more to government purchases because of a factor correlated with initial capital utilization.

Table A3 in the appendix compares plants with above and below median capital utilization (and labor market tightness). The first row shows labor productivity growth from 1943 to 1945. If anything, plants with initially low capital utilization rates saw greater productivity growth during the war, although the differences aren't statistically significant. The greater productivity growth of high-utilization plants seen in Figure 7 therefore reflects an increase in productivity *conditional* on a demand shock, not a general trend of faster productivity growth in those plants. There is also no statistically significant difference in firm age, the number of aircraft produced in January 1943, the initial level of productivity, the unit cost of aircraft, average aircraft wingspan, and the cumulative amount of public financing received during the war, when comparing plants with high and low initial capital utilization.<sup>46</sup>

One correlate with capital utilization does stand out: Plants with high capital utilization were older on average. This is in the context of a very young industry: the average plant was founded in 1934. But low capacity utilization plants were even younger and were founded in 1938 on average. Indeed, older plants were more likely to have high capital utilization early in the war because they were the first to receive orders and were still to ramp up their capacity to meet the wartime

<sup>&</sup>lt;sup>44</sup>The WMC classified each labor market in the US into four categories each quarter, with 1 representing the tightest labor markets and 4 representing markets with labor surpluses (unemployment). Nearly half of the production lines in this study were in counties of the first category and an additional 30% were in the second. The dummy in question takes on a value of one of the plant was in a county classified in the first category.

<sup>&</sup>lt;sup>45</sup>Capacity utilization was indeed an important consideration in procurement decisions. See for example Fairchild & Grossman (1959) chapter VI.

<sup>&</sup>lt;sup>46</sup>Plants in low wage counties received more public financing, but this goes in the wrong direction to explain the higher productivity growth of high-wage plants following a demand shock.

challenge. Capacity utilization could therefore merely capture plant age. It is certainly plausible that young plants respond differently than old ones to demand shocks. However, most narratives go in the opposite direction: One might expect young plants to benefit more from demand, being at a stage when they are bearing the initial fixed costs of production, still on the steep portion of their learning curve, and still familiarizing their customers (in this case the government) with their newer products (see Foster *et al.* 2016).<sup>47</sup>

Figure A.10 in the appendix investigates this confounding factor, repeating the triple-difference regressions, now controlling for plant age and the interaction between plant age (captured by a dummy equalling one if the plant is of above median age) and demand. This allows for the possibility that older plants, rather than plants with high utilization, saw greater responses of productivity growth to demand.<sup>48</sup> The figure shows slightly *larger* differences between high and low utilization plants when controlling for these additional terms, indicating that capital utilization, not plant age, is the relevant dimension of heterogeneity. Plant age itself slightly *decreases* the impact of demand on productivity growth in this specification. Young plants appear to benefit more from increased demand as anticipated in the discussion above.

## 5 Mechanisms: What Plants Did to Increase Productivity

How, then, do capacity-constrained plants increase production in face of surging demand? A voluminous historical literature has studied the productivity "miracle" of the wartime production drive. This includes contemporaneous accounts, institutional histories of wartime agencies and military commands (cf. War Production Board 1945, US Civilian Production Administration 1947, and multiple volumes by each branch of the military), eye-witness accounts of key participants in the war production drive (cf. Nelson 1950, Janeway 1951, Jones & Angly 1951), and later histories (cf. Herman 2012, Klein 2013). Many of these accounts put emphasis on the mobilization of labor and capital, witnessed in Figure 2, but even contemporary observers pointed to increases in (total factor) productivity, beyond the accumulation of factors of production. Many explanations have been offered for this increase in TFP. I focus here on four explanations that appear to have the largest historical consensus, in that each is either suggested or dismissed as a contributor to the productivity surge in nearly every major historical work on the topic.

First, and perhaps most familiar to economists, is the "learning by doing" hypothesis, suggested by Wright (1936) prior to the war and formulated theoretically by Arrow (1962) in the post-war period. As Thompson (2010) points out, the term "learning by doing" can lead to some

<sup>&</sup>lt;sup>47</sup>This last factor is less relevant in the context studied here because these were young plants of established firms and were typically producing aircraft that were also being produced in other plants of the same, or another, firm.

<sup>&</sup>lt;sup>48</sup>The cross-sectional distribution of plant ages is fully absorbed by production line fixed effects. The plant-age control is equivalent to controlling for plant-specific time trends.

confusion, because it is sometimes used as catch-all description for the variety of ways plants' productivity may grow with time or experience. He makes a distinction between passive learning and active learning. We have already entertained the possibility of passive learning in the previous section. Figure A.6 in the appendix showed that current demand affected productivity above and beyond experience and that there is little sign of an enduring experience effect once controlling for current demand. Further, the experience curve alone gives no explanation for the faster learning curve in high-utilization plants, which suggests that managers may have taken active measures to raise productivity, when high demand hit capacity constraints. The remaining factors I investigate are active measures in this category.

The second contributor receives the greatest attention in historical analyses of the war production drive. This is the move from "job shop" production methods to "line" production methods. In their seven volume history of the Army Air Forces in World War II, Craven & Cate (1955) write that "The most conspicuous improvement [in the aircraft industry] was the switch from handwork methods to those of mass production" (p. 385). Before 1940, aircraft production was a handicraft process. Aircraft were custom made to the client's (mostly the US- or a foreign-government's) specifications, limiting the pace of production. Visiting the Consolidated Aircraft factory in San Diego–a plant that in retrospect produced the greatest number of planes–George E. Sorensen, a Ford Motor Company executive, observed: "Here was a custom made plane, put together as a tailor would cut and fit a suit of clothes" (Sorensen & Williamson 1957). Mass production methods had already been in use in the automotive industry for decades, but management in the aviation industry insisted that these methods couldn't be adopted in the more complex process of airframe assembly, where each aircraft required hundreds of thousands of separate parts. As Klein (2013) puts it: "Nobody had yet found a way to bring mass-production techniques to airplane building, and prospects for doing so did not look promising" (p. 71).

The war modernized this industry. Aided in part by advice (and management hired) from the automotive industry, the aircraft industry adopted new production methods over the course of the war. Klein (2013) describes the innovation thus: "Mass production of anything consisted of a few well-defined principles. The first step was to break the product down into as many interchangeable parts as possible. Those parts could then be manufactured in quantity and fitted together on an assembly line where the machines were arranged in proper order" (p.67). This was both driven and enabled by the surge in demand for their products: "The rush of orders finally compelled many [aircraft] companies to rethink how they made their product" (Klein 2013). Craven & Cate (1955) concur that the industry "remained a handwork industry until the enormous demands of 1940-41 forced a conversion to mass-production methods." They contrast this to the the pre-war period, when "business [orders from the government] was too erratic to encourage plant expansion or the

adoption of elaborate production-line techniques." In a post-war study of production problems in wartime aircraft manufacturing, Lilley *et al.* (1955) write: "In peacetime, the aircraft industry had had no opportunity to acquire familiarity with line production techniques; these techniques were not needed to meet peacetime production demands and were not used because of their high cost at peacetime volumes of output" (p. 2).

Line methods required new equipment but not all technological progress was embedded in capital and much of the progress was organizational.<sup>49</sup> Here is how Lilley *et al.* (1955) (p. 40-41) describe the transition to line production methods:

The most dramatic evidence of line production in 1944 was the arrangement of equipment in both airframe and engine plants so that a progressive sequence of operations could be carried out. This arrangement of equipment constituted the fist element needed to achieve quantity production. Channels were established so that production could flow without the back-tracking so characteristic of job-shop work....

Controlled flow was the second important element needed to achieve the peak production of 1944. Steady flow along the final assembly lines required careful production control in the assembly, subassembly, and fabricating departments. Scheduling assumed new prominence. In order to supply assembly lines with the thousands of parts entering into aircraft production, and enormous amount of detailed clerical work was required...

The third essential element in the peak production year of 1944 was the careful balancing of operations in each production line... [T]he various feeder and final assembly lines were so geared together that each production line turned out the right number of components to maintain balance with the others.

It is difficult to verify these narratives empirically because there is no existing systematic account of production method improvements. In order to quantify their importance, I have catalogued mass production methods in the World War II airframe industry to fill in this gap. The catalogue is based on narrative accounts in contemporary newspaper articles and corporate annual reports. Press reports of the modernization of aircraft plants are surprisingly detailed in a wartime context. My research team and I searched a variety of news sources for terms related to upgrades in production techniques. The search terms included the name of the aircraft firm (with plant location verified in the body of the article) and terms indicating modern production technology (MASS and PRODUCTION appearing within 5 words from each other; ASSEMBLY and

<sup>&</sup>lt;sup>49</sup>Indeed, they were often associated with hiring new middle management from the automotive industries. This resonates with the Acemoglu *et al.*'s (2020) finding that hiring innovative managers is associated with radical innovation in modern data.

LINE within 5 words; PRODUCTION and LINE within 5 words; AUTOMOTIVE). All relevant articles were then read by a research assistant and a count variable was incremented by one at the first mention of a new production technique. For example, an October 1941 Business Week article identified through this procedure states that "The Glenn L. Martin Co. factories in Baltimore, MD. have set up a mass-production technique new to aircraft manufacture — a belt-conveyor line... The line has already cut man-hours on these subassemblies in half... to speed bomber production." The "Mass Production" count variable is then increased by one for the Martin Baltimore plant in October 1941.

The sources included the digital archives of main national (business) publications (New York Times, Wall Street Journal, Business Week, Fortune). Local newspapers were found through internet archival sources Chronicling America and Newspapers.com. Finally, we used Mergent Archives to search the annual reports of all aircraft companies for which such reports were available, and included any self-reported moves to modern production line methods.

Figure A.11a in the appendix shows the how new production methods were introduced over time. The figure shows the average count of mass production techniques introduced in aircraft plants and the share of aircraft plants reporting any mass production techniques up to that date. By the end of the war, nearly half of aircraft plants had modernized their production, with the average modernizing plant introducing 3 new production techniques.

The higher frequency methods used for the analysis of demand and productivity are less suited to analyze the evolution of methods. These are large changes in production that may be stimulated because of past, current, or anticipated demand. Nevertheless, Figure A.12 in the appendix shows suggestive evidence that technology adoption was associated with both the volume of production and capacity constraints. Plants that had above-average capacity utilization at the beginning of the war adopted three times as many new production methods over the course of the war; plants that accumulated above-average demand for aircraft over this period introduced 50% more production methods.<sup>50</sup>

Outsourcing was a third factor to which contemporary reports attributed large productivity gains. Aircraft plants of the 1930s produced most aircraft parts in house. However, with the introduction of mass production techniques, with interchangeable parts produced with narrow tolerances, it became possible to farm out parts of the production process to feeder plants. These plants produced specified parts of the aircraft–wingtips, for example–that were then transported to the airframe assembly plant, which integrated these parts in to the final assembly. Taylor & Wright (1947) (p. 75) describe this managerial practice, new to the airframe industry, writing:

<sup>&</sup>lt;sup>50</sup>There is also an association in a difference-in-differences sense, so that plants with high cumulative production were more likely to introduce new production methods if they were initially capacity-constrained, but this result isn't statistically significant, possibly due to the small cross-sectional sample of plants.

One ingenious form of expansion was the multiplicity of small feeder plants nurtured by the major companies in small suburban or rural communities, miles away from the congested central plants... Trucks brought fabricated parts from the main factories, and returned with the completed assemblies. Tooling made the pieces fit, no matter where they originated.

Craven & Cate (1955) (p. 25) continue: "The prime contractors had not used before 1939 the system of purchasing parts and sub-assemblies, so common among other industries, and in general they had little liking for it... This system allowed the use of a pool of unskilled labor... but it put a heavier burden on management and proved more difficult to schedule accurately than had previous methods." They add that this greater managerial burden was a cost not worth bearing until the scale of wartime demand made it viable: "It was not until 1940 that the volume of production required reached a point which seemed to justify putting official pressure on the industry to overcome its reluctance," they write (p. 546), indicating that in some cases it was War Production Board officials (often from the automotive industry) that nudged management in aircraft firms towards more outsourcing. A memo from the War Production Board to the National War Aircraft Council (a private-sector consortium of aircraft manufactures) urges greater reliance on outsourcing: "Most of the aircraft plants on the West Coast have recently developed feeder shops, employing 250 to 500 people... Turnover and absenteeism in these shops are at a minimum. We would suggest a further probing into the possibilities of sub-contracting a greater proportion of work."<sup>51</sup>

As the war progressed, outsourcing to more distant feeder plants was used to overcome labor shortages in the tight labor markets of many aircraft plants: "The dispersal of subcontracts outside the critical area [of tight labor markets] was encouraged, with the result that in September the Boeing Company placed subcontracts for approximately 40 percent of its work and made plans to let out subcontracts for an additional 20 percent." (Fairchild & Grossman 1959, p. 132). FigureA.11b in the appendix shows the increasing reliance on sub-contracting during the war. It shows the share of worker-hours in the production of each aircraft that was conducted in feeder plants, in the median aircraft plant. This increased dramatically from 10% to 30%, beginning immediately with the demand surge following the attack on Pearl Harbor. Formalizing this argument, Figure A.13a shows the response of the percent of outsourced production in the triple-difference specification of (3). It shows a temporary (roughly 1-year) but massive (10 percent of work-hours) increase in outsourced production following a 1 percent increase in aircraft demand (predicted by the leaveone-out instrument) in plants that were initially operating at high capital utilization relative to

<sup>&</sup>lt;sup>51</sup>Irving J. Brown and Roy L. Reuther (Aircraft Labor Office, War Production Board) to Clinton S. Golden and Joseph D. Keenen (War Aircraft Council), August 25, 1943. *Box 7, Archives of the National Aircraft War Production Council, Truman Library.* 

others.

While high-pressured plants used outsourcing to meet production demands, it doesn't necessarily follow that outsourcing increased productivity. There were some outsourcing skeptics at the time: "Some aircraft manufacturers remained skeptical as to the utility of subcontracting. They found it a singularly complex operation which sometimes placed a load on management as great or greater, it was argued, than that which it was supposed to relieve." (Craven & Cate 1955 p. 548). In their post-war post-mortem, Lilley *et al.* (1955) (p. 67) conclude:

At first glance, subcontracting appeared to be a very attractive method of utilizing the long experience of nonaircraft companies in large-scale production while minimizing the disadvantage of their lack of technical know-how in the aircraft field... In actual experience, however, subcontracting was not so successful in relieving the management load o the old-line companies as might have been anticipated... Many of the executives interviewed expressed the view that subcontracting was more trouble that it was worth."

Lilley *et al.*'s (1955) main objections include the managerial burden of supervising feeder plants, particularly in face of frequent aircraft design changes and lower quality of production in feeder plants leading to many rejections and multiple inspections. It is hard to conceive of a compelling natural experiment to settle this dispute. Outsourcing was caused by increased demand and high pressure, which affected productivity through other channels.<sup>52</sup>

Relations between labor and management in munitions industries was extensively documented both during the war and in post-war histories. The War Manpower Commission was assigned not only with directing workers to high-priority job markets and firms, but also with ensuring that high priority firms are able to retain their workforce. Many of these studies claim that improved labor relations–the fourth factor I investigate–was an important determinant of labor productivity. Economic theory has also emphasized the role of labor effort as a source of labor efficiency at business cycle frequencies. (Leibenstein 1966 refers to this as "X-efficiency" and Shapiro & Stiglitz 1984 and Yellen 1984 discuss pecuniary motivations to provide work effort). Strain on workers and worker dis-satisfaction are certainly plausible drags on productivity in the context of a high pressure economy with workers working 50 to 60 hours a week at a quarter of all plants in 1942.

Histories of the war economy emphasize the labor problem in this heated economy. Klein (2013) writes:

<sup>&</sup>lt;sup>52</sup>Output per hour worked in the AMPR incorporates hours worked in feeder plant, so that this measure of productivity isn't mechanically affected by outsourcing. In contrast, the data only provides measures of physical capital at the "mother plant". TFP measurement therefore implicitly assumes that feeder plants had the same capital to labor ratio as the mother plant, likely overstating the capital intensity of the entire supply chain: Production in feeder plants was less capital intensive. However, there is no correlation between labor productivity and outsourcing, so that the (lack of) correlation between productivity and outsourcing isn't driven by this potential bias.

Absenteeism remained a serious problem despite dogged efforts to curb it. Fortune called it "The New National Malady." The aircraft industry seemed especially prone to it. On the day after Christmas [1943], 26 percent of all Boeing employees failed to show up for work, as did 11,000 workers at Douglas. The following month the Bureau of Labor Statistics estimated absenteeism for all industries at about 7 percent, many times the normal rate in peacetime.

Figure A.11c in the appendix corroborates these anecdotes. The median plant lost 5% of worker hours due to absenteeism at the beginning of the "year of production" of 1943, but around 7% by its end (with a spike to 9% in December 1943. Absence rates decline substantially through 1944, coming back down to 5% by 1945. Taylor & Wright (1947) describe the problem of absenteeism:

To maintain delivery schedules, companies were forced to hire more workers than were needed, knowing that a percentage of them would be absent every day. But a time came when this "safety margin" of surplus workers could no longer be recruited. The factories had to reduce absenteeism or reduce the output of planes.

The quote shows again the role of demand in inducing changes, in this case in labor relations. At low levels of demand, plants could combat absenteeism by hiring more workers. But at higher levels of demand, management had to confront the absenteeism problem itself.

Frequent turnover was also an impediment to production. Quit rates fluctuated substantially throughout the war and peaked at nearly 6% of the median plant (Figure A.11d). A report written by Douglas Aircraft management writes of the costs of turnover<sup>53</sup>:

Mass labor turnover constitutes the industry's most serious manpower problem. The reduction of this turnover would relieve the pressure on present and future manpower requirements. Another advantage would be the greater efficiency that results from employees who remain on the job because the cumulative experience of these trained workers would not be lost by the individual plants.

The quote illustrates how "learning by doing" isn't merely passive. It requires management action to limit turnover and allow the "learning" to be retained. Aircraft manufacturers took a host of actions to tackle the absence and turnover crisis. Financial incentives were employed:

The tens of thousands of workers in Grumman Aircraft Corp. plants on Long Island have proved conclusively that the Nation's manpower problems can be solved simply

<sup>&</sup>lt;sup>53</sup>Experience Incentives: Undated report by Douglas Aircraft, prepared for the National War Production Council, Box 8, Archives of the National Aircraft War Production Council, Truman Library

by working a little harder. With more pay as an incentive, Grumman in the past six months has increased production 40 per cent with fewer workers and at far less cost per plane. (Washington Evening Star, March 10, 1943)

But higher wages were only one of many tools used to retain workers and ensure they show up:

Many and ingenious were the devices used to cope with the problem. Factories sent telegrams to the homes of absentees, inquiring after their welfare and telling them how they were needed in the war. Others sent visiting nurses to make first hand check-ups... Surveys searched for the causes of absenteeism... Working conditions were improved... Transfers to new jobs were arranged when work was uncongenial or unsuitable... Safety engineers fought to cut down absences caused by accidents... Ryan Aeronautical in San Diego reduced absenteeism by twenty-four percent by publishing [charts] in the company magazine and in daily papers... revealing the peaks and lows of daily attendance... Convair [initiated] a sweepstakes for employees with perfect attendance records, with prizes totalling \$10,000 in War Bonds every month. (Taylor & Wright 1947, p. 137)

Absence rates among women workers was nearly twice that of men. Many women entered the workforce for the first time during the war and faced a difficult balancing act without adequate childcare facilities. Many plants funded childcare facilities to ameliorate this problem. The mass migration into tight labor markets created a housing shortage. Management lobbied for new housing construction and payed for busses to transport workers to and from more distant places of residence.

There is no direct mechanical relationship between absence and productivity, because the latter is measured in aircraft per hour worked and doesn't include the hours lost to absence. Further, notice that the historical discussion focuses on how absence limits production, not productivity. The effect of absenteeism on productivity is less straightforward. On one hand, worker absence could disrupt production, lowering remaining workers' productivity. On the other hand, absent workers may have otherwise been less productive than average ("negative selection"), so that their absence increases average productivity.

How does a high pressure economy affect quits and absence? All else equal, we'd expect these rates to *increase*. In contrast, Figure A.13 shows that both *declined* under high pressure. It repeats the triple-difference IV regression, with absence rates and quit rates as the outcome variables. Both rates decline in plants with (initially) high hours per worker upon receiving increased demand. The surprising result that labor problems didn't increase in these high pressured plants may indicate that management actions taken when the plant was under duress were enough to offset these

pressures.

We admittedly don't have a complete view of what plants did to increase productivity under pressures and multiple factors are likely in play. Rapid productivity growth when new production lines were initiated, and abundant testimony of observers, suggest that some form of institutional learning was important. Plants adopted new mass production methods when faced by new demands and/or hitting capacity constraints. The new methods will certainly have increased, and are correlated with, productivity growth. Pressured plants outsourced production to feeder plants but it is unclear whether this outsourcing increased productivity over the entire supply chain. Finally, absenteeism and turnover are associated with lower productivity and there are indications that plants took action to curb labor dissatisfaction when problems came to a head.

# 6 A Theory of Learning by Necessity

Under the duress of high demand and high rates of utilization, plants took active measures to increase productivity. These measures were costly, even when the techniques were adopted from more mature industries. Beyond financial costs, the quotes in the previous section evince the managerial and organizational costs, and perceived risks of new techniques. The premise of this paper is that plants are more likely to take this leap when facing high demand and more so when already operating at high capacity.

I now outline a theory of "learning by necessity" that expounds this view. Plants adopt productivity enhancing methods when their benefits justify their adoption costs. With process innovations of the sort we are investigating, the benefits manifest in increased production capacity and lower production costs. If operating at high capacity is costly (formally, if utilization costs are convex), cost reductions will be more beneficial when demand is high relative to existing capacity. New techniques are therefore adopted and higher productivity growth will follow, when demand is high relative to installed capacity.

The intuition of the model can be fully captured in a one-period model, which I outline here. A full calibrated model can be found in Appendix B. The full model shows that the insights are not particular to a static model and give some quantitative sense of model predictions of the productivity gains in World War II.

In this model, a plant operates using a Cobb-Douglas production function of the form

$$Y_t \le z \left(H_t L_t\right)^{\alpha} \left(U_t K_t\right)^{1-\alpha},\tag{4}$$

where z is total factor productivity,  $L_t$  the number of workers,  $K_t$  the quantity of physical capital,  $H_t$  hours worked as a fraction of a full week and  $U_t$  the work week of capital (capital utilization). Both utilization variables range from zero to one. In the dynamic model, the plant can only adjust capital and labor over time and faces adjustment costs if it wishes to do so. The static model presented here takes these costs to the extreme and both these factors of production are in fixed, pre-determined, quantities. In contrast, the plant can choose labor and capital utilization,  $H_t$  and  $U_t$ , respectively, but faces convex costs to utilization. Concretely, monthly wages  $w(H_t)$  are not only increasing, but also convex in hours worked. Overtime pay was prevalent (typically at a 50% premium) in the aircraft industry, so that the marginal cost of work hours was increasing in the length of the work week. Similarly, capital may depreciate more when highly-utilized, so that the cost of capital utilization is a convex function  $\delta(K_t)$ .

The production function and the plant's decision problem that follows are similar to those in Basu *et al.* (2006), with one twist. The plant begins with a traditional technology from which it derives total factor productivity  $z = z^T$ . (I use the term "technology" generically for all factors affecting TFP). After the plant receives demand  $Y_t = \bar{Y}$  for its product, it chooses not only how intensively to utilize workers and capital, but also whether it wants to pay a cost A to adopt a new (modern) technology with TFP  $z = z^M > z^T$ . This simple discrete jump will be undertaken if the savings in utilization costs exceed the adoption cost A.

Given its chosen technology, the plant chooses utilization  $H_t$  and  $U_t$  so as to minimize utilization costs

$$\min_{H_{t},U_{t}} w\left(H_{t}\right) L_{t} + \delta\left(U_{t}\right) K_{t}$$

subject to satisfying demand  $\bar{Y}$ 

$$z\left(H_{t}L_{t}\right)^{\alpha}\left(U_{t}K_{t}\right)^{1-\alpha} \geq \bar{Y}$$
(5)

Optimal utilization equates the marginal cost of utilizing the two factors:

$$w'(H_t)H_tL_t = \delta'(U_t)U_tK_t.$$
(6)

Marginal costs of both forms of utilization increase in tandem and are both increasing in the term

Demand/Capacity = 
$$\frac{\bar{Y}}{zL_t^{\alpha}K_t^{1-\alpha}}$$
. (7)

This term scales demand by the plant's current (maximal) capacity. It follows directly from (5) that this ratio determines–and increases–utilization. Hence it increases marginal utilization costs in equilibrium.

A surge in demand  $\bar{Y}$  increases utilization and marginal costs and more so the lower is TFP z, because the demand is pressing against lower productive capacity, as in (7). This is illustrated

Figure 8a, which shows cost curves: utilization costs as a function of demand  $\bar{Y}$ . The two curves represent high and low values of TFP, corresponding to the modern and traditional technologies, respectively. Costs are convex by assumption and the gap between the two is increasing in demand, per (5) to (7). The figure shows that the cost savings due to technology adoption is increasing in demand. Technology is optimally adopted if the gap between the two curves is larger than the adoption cost *A*, so when demand is sufficiently high, all else equal.

But this is only part of the story. It isn't merely the absolute level of demand, but rather demand relative to the plant's capacity that determines where we are along the cost curves in the figure. Utilization is endogenous, but equations (5) and (7) indicate that it is a sufficient statistic in equilibrium for demand pressures relative to capacity. A plant operating at low levels of utilization will be on the flat portion of the cost curves in Figure 8a, where an increase in demand  $\bar{Y}$  will have little impact on costs and therefore on technology adoption. In contrast, a plant operating at high utilization will be further to the right along these curves, were an increase in demand has a larger impact on marginal costs and on the benefits of technology adoption. Here a demand shock is more likely to tip the scales towards the modern technology.

This is shown in Figure 8b, which now shows the cost savings due to technology adoption (the gap between the curves in Panel A) as a function of utilization. Utilization is of course endogenous, but governed by initial capacity, as in (7). The gains to technology adoption are increasing and convex in utilization, so that technology adoption is more likely, and more so in face of surging demand. This is the theoretical counterpart of the triple difference in differences specification of Section 4 and describes "learning by necessity" in a nutshell.

Basu *et al.* (2006) use a similar framework to show that *measured* TFP will increase when demand is high. This is because utilization increases with demand but is typically unobserved in the data, giving the semblance of higher output with the same means of production. The theory here suggests that not only measured, but *actual* TFP may increase with demand, now because high utilization induces firms to adopt productivity-enhancing measures. This is supported by the empirical results, where TFP adjusted for capital utilization increases in demand, and more so when utilization is high .

Details of a dynamic version of the model are available in the appendix; I comment here on some insights it provides beyond the static model presented here. At a first glance, the assumption of fixed factors of production may seem restrictive: It may appear that technology is adopted only because it is the plant's only resort to expand capacity. However, under the reasonable and common assumption that plants face convex costs to hiring and capital adjustment, hiring and investment are merely another costly margin of adjustment. These marginal adjustment costs will also increase when demand is high relative to existing capacity, and high demand hitting low

capacity will ultimately compel a plant to adopt the modern technology.

One caveat can be gleaned from the dynamic model. It is only *unanticipated* demand shocks that lead to technology adoption. If a demand surge is foreseen or ramps up gradually, the plant can spread capital adjustment and hiring costs over time, never requiring high utilization nor large marginal adjustment costs. In this case, the plant may optimally choose to increase capacity using the traditional technology rather than adopting the new one. This alerts us not to over-learn the policy implications of the empirical findings in this paper. The theory implies that an unanticipated and large demand shock could lead to technological progress. However, an economy that is systematically running "hot" will benefit less, because plants will expand their capacity rather than their technology to adapted to anticipated high high.

The quantitative results of the calibrated model are given in Figure A.17 in the appendix. The model is calibrated to features of the aircraft industry in World War II and the simulation asks the following question: How much would a plant be willing to pay for a technological improvement that increases TFP by 35% (the TFP growth of the average aircraft plant over the course of the war) during the Second World War? Given the unprecedented demand surge of World War II, the cost savings from technology adoption are remarkable. A plant at the 75<sup>th</sup> percentile of aircraft demand faces such immense pressure that it would be willing to pay two thirds of the entire net present value of *all future costs* to boost TFP by that magnitude. This compares to one quarter of all costs for a plant at the 25<sup>th</sup> percentile of demand: large, but far below the high-pressured firm. This cost gap increases in initial utilization (demand relative to initial capacity in the model), the learning by necessity effect.

## 7 Conclusion

A traditional view of the transmission of fiscal policy (and demand shocks more broadly) posits that increased demand increases output as firms soak up under-utilized employment or capital, either within or outside the firm. The neoclassical view predicts that production will increase due to increased labor supply. Both theories would suggest that cyclical increases in demand can do little to expand output when the economy is at very high rates of utilization, nor can they affect productive capacity. Indeed, this was the common view at the onset of the Second World War, reflected in the "feasibility dispute," where economists warned that the economy could not sustain the planned war production drive, while the military insisted that it must.

This paper sheds new light by showing that slack does indeed play an important role in plants' responses to increased public demand. Bringing evidence from the Second World War, we see that plants with rates of capacity utilization that would normally be viewed as "overheating" met the production challenge through productivity increases. They did so not merely through passive

learning, but by active investments in new production methods, improving working conditions, and experimenting with different supply chain management techniques.

The evidence in this paper is based on archival data on airframe production during the Second World War, the largest shock to public spending in US history. Can an episode so distant in history have implications to the modern economy? Of greatest concern is whether the wartime price and wage controls dampened inflationary pressures that would appear in a similar peacetime setting. The aircraft industry was in fact exempt from price controls during the war. Nevertheless, the price of aircraft *declined* dramatically during the war, indicating that productivity gains were more than sufficient to counteract inflationary pressures due to high demand. Further, the mechanisms through which plants confronted high demand are available to plants in peacetime and imply that the aggregate supply curve isn't entirely vertical, even at high utilization rates. While demand pressures no doubt leads to inflation, this study suggests a silver lining. Businesses that are strained may find ways to enhance productivity when facing exceptional demand. Nevertheless, the question merits further investigation in peacetime to see how valid the results remain in other settings.

While world wars will hopefully remain a rarity, there are lessons from wartime in the age of Covid-19 and wars in Eastern Europe. The pandemic has affected different sectors of the economy differently, with some showing substantial excess capacity and shortages arising in others. Geopolitical risks and sanctions put a different set of supply constraints on firms worldwide. While such constraints are real, the findings in this paper suggest that private sector firms can at times find ingenious ways to overcome them.

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Figure 1: Government Spending, Unemployment, and Aircraft Procurement in the Second World War



Note: Panel (a) shows government consumption expenditure and gross investment as a percent of GDP in the US since 1929. Source: Bureau of Economic Analysis and the author. Panel (b) shows the US unemployment rate from the great depression to the US formal entry into the Second World War. Source: NBER Macrohistory Database. At the onset of hostilities in Europe, the unemployment rate was still above 15%. By the time the US formally entered the war, the economy was at full employment. Panel (c) shows annualized government aircraft procurement as a percent of pre-war (1939) GDP. Source: War Production Board Listing of Major War Supply Contracts, BEA, and the author. Government spending on aircraft alone exceeded 3% of GDP.

Figure 2: The Aggregate Aircraft Production Function Capital, Labor, and Output





(b) Capital, Labor, and Weight of Aircraft Produced, Indexes

Note: The figures show aggregate inputs to and outputs of production in the airframe industry. Capital is the aggregate quantity of physical capital used in production, proxied by active floor space in airframe plants. Hours are aggregate hours of workers in direct aircraft manufacturing. Panel (a) measures output as number of aircraft. Panel (b) measures output as aggregate aircraft weight. Values of all variables are normalized to 1 in January 1942.





Note: Panel (a) shows shift utilization for the median airframe plant, estimated as described in Section 2. Panel (b) shows hours per worker in the median airframe plant. Source: AMPR and the author.



production line producing fighters, bombers, transport aircraft, and trainers (listed from darkest to lightest shaded lines). Differential demand for the aircraft types was driven by different strategic needs as the war progressed. The identifying assumption is that different production trajectories across plant types was driven by Note: The figure illustrates the instrument described in Section 3 and summarized in equations (1) and (2). It shows monthly aircraft production in the average this differential demand, not other productivity drivers. Fighter aircraft were more prominent in lend-lease acquisitions by US allies in 1941, leading to a boom and bust in their production in 1941-42. Bombers were more central to the US war strategy and saw an inflection point after Pearl Harbor and again in 1943. Transport aircraft become increasingly important later int the war to supply troops when the US had "boots on the ground" in Europe and the Pacific. Trainers were obviously more important earlier in the war. fighter aircraft saw a resurgence mid-war with increasing realization that bomber and transport aircraft benefited from having tighters as escorts. See historical narrative in Section 3









Note: The figure shows the response of TFP to a one percent shock to aircraft demand. The shaded areas show 90% and 95% Finlay & Magnusson (2009) weak-instrument robust confidence intervals. Estimates are based on local projections, with aircraft demand instrumented with the instrument described in Section 3, and laid out in equations (1) and (2). First stage Montiel Olea & Pflueger (2013) F-statistic at 12-month horizon = 52.

Figure 7: Response of Output per Hour Worked and TFP to a 1% Shock to Aircraft Demand in High Capital Utilization Plants (relative to Low)



Note: The panels show responses of (a) (log) aircraft per hour worked and (b) TFP to 1% shocks to aircraft demand at month zero in plants with above median initial capital utilization relative to those with below median utilization. The shaded areas show 90% and 95% confidence intervals. Estimates are based on local projections, with aircraft demand and its its interaction with initial capacity utilization jointly instrumented by the instrument described in Section 3 and its interaction initial capacity utilization. The specification includes month and plant-by-model fixed effects. First stage F-statistic at 12-month horizon = 16 and 27 in the top and bottom panels, respectively.  $\frac{46}{46}$ 



technology with TFP of  $z^M > z^T$ . The gap between the curves gives the (gross) cost savings obtained if the modern technology is adopted. While the X-axis shows Note: The panels show cost curves arising from the theory of learning by necessity outlined in Section 6. Panel (a) shows production (utilization) costs as a function of demand Y. The top curve represents a cost function using a traditional technology with TFP of  $z^{T}$ . The bottom curve represents a cost function using a modern demand, what matters is demand relative to (maximal) production capacity. Panel (b) shows the cost savings of modern technology adoption as a function of capital utilization. Utilization is endogenous, but uniquely determined by-and monotonically increasing in-demand relative to existing capacity.

# A Appendix Figures & Tables



Figure A.1: AMPR Form Filled by an Airframe Manufacturer

Note: Sample page from Aeronautical Monthly Progress Report (AMPR) form filled out by Consolidated Vultee Aircraft Corporation, San Diego, in April 1943. This was a standardized form filled out by all aircraft manufacturers during the war. The sample comes from AMPR No. 4, which gives details on shift utilization. Source: Consolidated Vultee archives, San Diego Air and Space Museum.

Note: The figure shows scatter plots at the plant-by-aircraft model level. Panel (a) gives (log) cumulative production up to May 1945 (VE-day) against (log) aircraft in May 1945 against (log) aircraft per hour worked in January 1944, showing strong autocorrelation in productivity. Combined, these two panels show that past productivity is confounding the correlation between current productivity and cumulative production, often viewed as an indication of learning by doing. Panel (c) gives cumulative production up to May 1945 against production in the single month of May 1945, showing the strong strong autocorrelation of production. This last per hour worked in January 1944, showing that past productivity is correlated with later cumulative production. Panel (b) gives (log) aircraft per hour worked panel illustrates the challenge in disentangling the effects of current output (scale effects) and cumulative output (experience or learning effects) ø (c) Cumulative and Current Production ŝ 3 4 (log) Output: May 1945 N 'n



Figure A.2: Autocorrelation in Output And Productivity







Figure A.4: Pre-trends in Labor Productivity and TFP

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Note: The panels show responses of (a) labor productivity and (b) TFP to 1% shocks to aircraft demand at month zero. The shaded area shows 95% confidence intervals. The shaded areas show 90% and 95% Finlay & Magnusson (2009) weak-instrument robust confidence intervals. Estimates are based on local projections, with aircraft demand instrumented with the instrument described in Section 3, and laid out in equations (1) and (2). First stage Montiel Olea & Pflueger (2013) F-statistics at 12-month horizon = 30 and 52, respectively. Negative horizons are before the shock to demand and show pre-trends, evaluating differential trends of plants receiving a demand shock at time zero.





Note: The panels show responses of (a) labor productivity and (b) TFP to 1% shocks to aircraft demand at month zero. The shaded areas shows 90% and 95% Newey-West confidence intervals. Estimates are based on OLS local projections, as in (2).





(a) Response to Demand, Controlling for Cumulative Output (Experience)



(b) Response to Experience, Controlling for Current Production

Note: Panel (a) shows the response of (log) aircraft per hour worked to a one percent shock to aircraft demand, with aircraft demand instrumented by the instrument described in Section 3, and laid out in equations (1) and (2). The regression includes a control for cumulative production in production line  $\text{Experience}_{mpt} = \log (\Sigma_{s=0}^t \exp(D_{mpt}))$ . First stage F-statistic at 12-month horizon = 33. Panel (b) shows the response of (log) aircraft per hour worked to a one percent shock to Experience<sub>*mpt*</sub>, with this variable instrumented by the equivalently constructed cumulative instrument as in (1). First stage F-statistic at 12-month horizon = 24. The shaded areas show 90% and 95% Finlay & Magnusson (2009) weak-instrument robust confidence intervals.









limits bias that could potentially arise when comparing plants receiving demand late in the war ("late treatment") with plants receiving demand early in the war ("early treatment") in months late in the war, following Goodman-Bacon (2021). First stage Montiel Olea & Pflueger (2013) F-statistic at 5-month horizon = 9, at Note: The figure shows the response of TFP to a one percent shock to aircraft demand. The shaded areas show 90% and 95% Finlay & Magnusson (2009) weakinstrument robust confidence intervals. Estimates are based on local projections, with aircraft demand instrumented with the instrument described in Section 3, and laid out in equations (1) and (2). The leave-one-out instrument is interacted with a dummy equaling one for months in the first half of the sample. This specification 10-month horizon = 5.

Figure A.9: Response of TFP to a 1% Shock to Aircraft Demand in Tight vs. Looser Labor Market Conditions



(b) Heterogeneity Based on Local Wages

Note: The panels show responses of TFP to 1% shocks to aircraft demand at month zero in plants with tight labor conditions relative to those with looser labor conditions. Panel (a) shows response in plants that had above median hours per worker at the beginning of the war relative to those below the median. Panel (b) shows plants in labor markets with above median wages (for our sample: wages were above the national median in most regions in our sample) relative to those below the median. The shaded areas show 90% and 95% confidence intervals. Estimates are based on local projections, with aircraft demand and its its interaction with initial capacity utilization jointly instrumented by the instrument described in Section 3 and its interaction infitial capacity utilization. The specification includes month and plant-by-model fixed effects. First stage F-statistic at 12-month horizon = 26 and 25 in the top and bottom panels, respectively.

Figure A.10: Response of Productivity to a 1% Shock to Aircraft Demand in high vs. low capital utilization plants: Controlling for Plant Age



Note: The panels show responses of (a) (log) aircraft per hour worked and (b) TFP to 1% shocks to aircraft demand at month zero in plants with above median initial capital utilization relative to those with below median utilization. The shaded areas show 90% and 95% confidence intervals. Estimates are based on local projections, with aircraft demand and its its interaction with initial capacity utilization jointly instrumented by the instrument described in Section 3 and its interaction initial capacity utilization. The specification includes month and plant-by-model fixed effects and controls for plant age and the interaction between demand and a dummy equaling one if the plant was above median in age in January 1943. Negative horizons are before the shock to demand and show pre-trends, evaluating differential trends of plants receiving a demand shock at time zero. First stage F-statistic at 12-month horizon = 6 and 7 in the top and bottom panels, respectively.



Figure A.11: Factors Affecting Productivity in Airframe Plants (Time Series)







Figure A.12: Adoption of Mass-Production Methods by Capacity Utilization and Demand

Figure A.13: Responses to a 1% Shock to Aircraft Demand in High Utilization Plants (relative to Low)



Note: The panels show responses of variables to 1% shocks to aircraft demand at month zero in plants with above median initial capital or labor utilization relative to those with below median utilization. Panel (a) shows the response of the share of hours worked outsourced to feeder plants in high vs. low (initial) capital utilization plants. Panel (b) shows the response of the percent of hours lost to absenteeism and panel (c) the response of the percent of the workforce quitting each month, both in high vs. low (initial) hours per worker plants. The shaded areas show 90% and 95% confidence intervals. Estimates are based on local projections, with aircraft demand and its its interaction with initial capacity utilization or hours per worker jointly instrumented by the instrument described in Section 3 and its interaction initial capacity utilization or hours per worker. First stage F-statistic at 12-month horizon = 19, 11, and 2 in panels a to c, respectively.

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Model response of a plant to an unanticipated increase in demand announced in 1938, and matched to the production path of the average airframe plant in World War II. Full model presented in Appendix B. The top panels give the capital stock and number of workers as a multiple of the post-war steady state (calibrated to match the average of 1944-48 in the data). The bottom two panels give capital utilization in percent and hours per worker (in hours).





Model response of a plant to an unanticipated increase in demand announced in 1938, and matched to the production path of 25<sup>th</sup> percentile plant ("low demand"). Full model presented in Appendix B. The top panels give the capital stock and number of workers as a multiple of the post-war steady state (calibrated to match the average of 1944-48 in the data). The bottom two panels give capital utilization in percent and hours per worker (in hours).



Figure A.16: Model Simulation: Low Capacity Utilization Plant

Model response of a plant to an unanticipated increase in demand announced in 1938, and matched to the production path of the average plant, but postponed by two years, reflecting a plant whose demand peaked in 1945 rather than 1943. This matches the utilization rate of the 25<sup>th</sup> percentile plant. Full model presented in Appendix B. The top panels give the capital stock and number of workers as a multiple of the post-war steady state (calibrated to match the average of 1944-48 in the data). The bottom two panels give capital utilization in percent and hours per worker (in hours).





Panel (a) gives the cost savings achieved from adopting a technology that increases TFP by 35% in the model of Appendix B. Savings are given as a fraction of the net present value of all variable costs over the 100 years of model simulation. The four scenarios, from left to right, are high initial utilization and low demand; high initial utilization and high demand; low initial utilization and low demand; low initial utilization and high demand. High and low demand and high and low utilization are set to match the 25<sup>th</sup> and 75<sup>th</sup> percentiles, respectively, of these two variables. Panel (a) gives the difference between the high demand and low demand cases (as a percent of the NPV of costs) for the high (left bar) and low (right bar) utilization scenarios. These are the differences between the second and first bars and the fourth and third bars, respectively.

	(1)	(2)	(3)	(4)	(5)	(9)	(2)	(8)
Cumulative output	0.382*** (0.0105)	$0.406^{***}$ (0.0111)	$0.322^{***}$ (0.00377)	$0.294^{***}$ (0.00540)	0.326*** (0.00596)		0.278*** (0.00967)	0.0147 (0.0113)
Current output						0.268*** (0.00670)	$0.0574^{***}$ (0.00930)	0.0426*** (0.00490)
Time FE		×		×	×	×	×	×
Plant FE			×	×				
Plant*Model FE					×	×	×	×
Lagged productivity Observations	2553	2553	2553	2553	2553	2491	2491	X 1906
Standard errors in parenth	leses							

Table A1: Correlation Between Productivity and Cumulative Output

\* p < 0.05, \*\* p < 0.01, \*\*\* p < 0.01

and current and cumulative output (7) on productivity. Column (8) adds 6 monthly lags of the dependent variable (output per hour) to the regression of both output measures on productivity. Both current and cumulative output are correlated with productivity, even with the most saturated set of fixed effects. The correlation Note: The table OLS regressions of (log) aircraft produced per hour worked on (log) cumulative production, in a panel of production lines. Column (1) has no controls. The following columns include fixed effects for time (2); plant (3); time and plant (4); time and plant-by-model (5-8). Columns regress current output (6); between productivity and cumulative output becomes insignificant when controlling for the lagged dependent variable.

			T	2
	Capital utiliza- tion	Hours per worker	Wages	Labor market priority
Capital utilization	1			
Hours per worker	$0.47^{***}$	-		
Wages	0.11	0.11	1	
Labor market priority	$0.29^{*}$	0.10	$0.42^{***}$	1
* $p < 0.05$ , ** $p < 0.01$ , *** $p$	v < 0.001			

Table A2: Correlation Between Measures of Aircraft Plants' Capacity Constraints

\* p < 0.05, \*\* p < 0.01, \*\*\* p < 0.01

Note: The table gives correlations between various indicators of capacity constraints. The variables are capital (shift) utilization, hours per worker, wages in the local labor market (excluding aircraft plants), and a dummy equaling one if the Manpower Commission classified the labor markets as facing labor shortages. Sources: AMPR, War Production Board, War Manpower Commission.

	Capital	Utilization	Hours	/Worker	Wa	ges	MM	AC
	Low	High	Low	High	Low	High	2-4	1
Δ‰ Output per Worker	127	104	100	115	117	103	111	108
Firm Age (Months)	175	195	183	189	181	193	184	188
Plant Age (Months)	60	139***	123	96	106	108	88	$132^{*}$
Hours per Pound	4.6	3.1	3.6	3.4	3.7	3.3	4.3	2.8
Airplanes Produced	44	81	85	60	82	59	63	75
Unit Cost (000's \$)	113	111	94	130	93	129	92	126
Wing Span (Meters)	21.4	20.1	20.5	20.5	20.9	20.1	21.1	20.1
Public Plant Financing (mln \$)	8.2	10.4	7.7	10.9	12.2	7.0*	9.8	9.3

Table A3: Summary Statistics: Airframe Plants by Capacity Constraint Measures

Note: Summary statistics for airframe plants along sample splits reflecting different dimensions of capacity constraints. These are (1) capital utilization as measured by shift utilization, (2) weekly hours per worker, (3) county-level wages, and (4) War Manpower Commission local labor market classification (1 to 4, decreasing in labor shortages). "High" columns give averages for plants above median by the metric in question in January 1943. Averages are for January 1943, except for plant financing (cumulative to January 1945), and growth in aircraft per worker (log change from Jan 1943 to Jan 1943). Asterisks reflect statistical significance of the t-test of differences between the two categories: \* p < 0.05, \*\* p < 0.01. Sources: AMPR War Production Board War Manufacturing Facilities Authorized, and the author.

## **B** A Dynamic Model of Learning by Necessity

This appendix gives a dynamic version of the model in Section 6. A plant operates using the production function (4) defined in the main text. The length of a period t is one year. Plants can invest (or dis-invest) in new capital  $I_t$  and hire (or lay off) workers, with  $D_t$  denoting the net change in workers employed. Capital and labor evolve according to the following two constraints:

$$K_{t+1} \le I_t + (1-d) K_t;$$
 (8)

$$L_{t+1} \le L_t + D_t; \tag{9}$$

where *d* is the capital depreciation rate. The plant rents capital  $K_t$  at an interest rate  $r_t$ , a rate that also serves as the plant's discount rate. In addition to the convex cost to capital and labor utilization, described in the main text, there are also adjustment costs to investment  $I_t \equiv K_t - K_{t-1}$  and hiring (or firing)  $D_t \equiv H_t - H_{t-1}$ . These costs are given by  $K_t J (I_t/K_t)$  and  $w_t L_t \Psi (D_t/L_t)$  respectively, where J(.) and  $\Psi(.)$  are both convex functions; and  $w_t$  are annual wages per worker.

Wages have two components. There are monthly fixed costs to employ a worker of  $W_t$ , and each worker is paid annual wages of  $w(H_t)$  that are a function of annual hours. A linear function would represent hourly wages, while a convex function would represent wages that are increasing in hours worked, e.g. overtime pay.) Hence  $w_t = W_t + w(H_t)$ . The static model merely posited labor costs that are convex in hours; here we anticipate a calibration where this convexity arises due to overhead costs per worker  $W_t$  and overtime pay that will be reflected in the relationship between hourly wages and hours worked  $w(H_t)$ .

The plant faces a discrete choice at time zero between one of two technologies  $z = z^M$  or  $z = z^T$  (modern or traditional), with  $z^M > z^T$ . Using the traditional technology is free (or a sunk cost), but using the modern technology incurs an adoption cost A (which could incorporate the net present value of any recurring costs to the technology's use).

The model has perfect foresight. A model with uncertainty would yield qualitatively similar results, but may lead to a smaller probability of adopting the modern technology depending on the nature of the uncertainty (about the duration of the war, the magnitude of the shocks, demand in the post war period). As we will see, the war shock gives such large incentives to upgrade technology that it would overwhelm any such hesitations and is unlikely to change the qualitative predictions of the model. With this in mind, the plant's cost minimization problem is

$$\min_{D_{t},L_{t+1},I_{t},K_{t+1},H_{t},U_{t},z_{t}\in\{z^{T},z^{M}\}}\sum_{t=0}^{\infty}\prod_{j=0}^{t-1}\left(\frac{1}{1+r_{j}}\right)\left[\begin{array}{c}W_{t}L_{t}+L_{t}w\left(H_{t}\right)+\\L_{t}\left[W_{t}+w\left(H_{t}\right)\right]\Psi\left(D_{t}/L_{t}\right)+\\K_{t}\delta\left(U_{t}\right)+K_{t}J\left(I_{t}/K_{t}\right)+r_{t}K_{t}\end{array}\right]+AI(z=z^{M})$$

s.t (4) and (8) (9). I(.) is an indicator function that takes on the value of 1 if the modern technology is chosen and zero otherwise.

The first order conditions (on  $D_t$ ,  $I_t$ ,  $L_{t+1}$ ,  $K_{t+1}$ ,  $H_t$ , and  $U_t$ , respectively) are as follows:

$$\Psi'(D_t/L_t) = \frac{\lambda_t^L}{W_t + w_t(H_t)}$$
(10)

where  $\lambda_t^L = \frac{\tilde{\lambda}_t^L}{B_t}$  and  $\tilde{\lambda}_t^L$  is the Lagrange multiplier on (9) at time *t* and  $B_t \equiv \prod_{j=0}^{t-1} \left(\frac{1}{1+r_j}\right)$ .

$$J'(I_t/K_t) = \lambda_t^K,\tag{11}$$

with  $\lambda_t^K = \frac{\tilde{\lambda}_t^K}{B_t}$  and  $\tilde{\lambda}_t^K$  representing the Lagrange multiplier on (8).

$$w_{t+1} \left[ 1 + \Psi \left( D_{t+1}/L_{t+1} \right) - \frac{D_{t+1}}{L_{t+1}} \Psi \left( D_{t+1}/L_{t+1} \right) \right]$$

$$= \lambda_{t+1}^{L} - (1+r_t) \lambda_t^{L} + \alpha \frac{z \left( H_{t+1}L_{t+1} \right)^{\alpha} \left( U_{t+1}K_{t+1} \right)^{1-\alpha}}{L_{t+1}} \lambda_{t+1},$$
(12)

where  $\lambda_t$  is the Lagrange multiplier on (4).

$$\delta(U_{t+1}) + J(I_{t+1}/K_{t+1}) - \frac{I_{t+1}}{K_{t+1}}J'(I_{t+1}/K_{t+1}) + r_{t+1}$$
(13)  
=  $(1-d)\lambda_{t+1}^{K} - (1+r_t)\lambda_t^{K} + (1-\alpha)\frac{z(H_{t+1}L_{t+1})^{\alpha}(U_{t+}K_{t+1})^{1-\alpha}}{K_{t+1}}\lambda_{t+1}$ 

$$L_{t}w'(H_{t})\left[1+\Psi(D_{t}/L_{t})\right] = \alpha \frac{z(H_{t+1}L_{t+1})^{\alpha}(U_{t+1}K_{t+1})^{1-\alpha}}{H_{t+1}}\lambda_{t+1}$$
(14)

$$K_t \delta'(U_t) = (1 - \alpha) \frac{z \left(H_{t+1} L_{t+1}\right)^{\alpha} \left(U_{t+1} K_{t+1}\right)^{1-\alpha}}{U_{t+1}} \lambda_{t+1}$$
(15)

The first order conditions above apply for any value of z and the plant chooses the modern technology if it leads to cost savings greater than A.

The first order conditions equate the marginal costs of capital and labor utilization and both of these to the marginal costs of capital and labor adjustment. The former two costs are static, while

the latter have dynamic implications. An increase in demand in the distant future can be accommodated by gradual accumulation of factors of production, incurring only small marginal adjustment costs in each period along the way, and without necessitating large increases in utilization at any stage. In contrast, front loaded demand, or a large MIT-style demand "shock", will require large factor adjustments and the plant will optimally increase utilization to limit adjustment costs. The plant will choose the modern technology if the net present value of these costs are high. Because costs are convex, they will be higher if unanticipated and concentrated in early years.

#### **Functional Forms**

We assume the following functional forms for adjustment costs. Adjustment costs for capital and hiring/firing take on standard quadratic forms:

$$J\left(\frac{I}{K}\right) = \frac{\varphi}{2}\left(\frac{I}{K} - d\right)^{2}.$$
$$\Psi\left(\frac{D}{L}\right) = \frac{\psi}{2}\left(\frac{D}{L}\right)^{2}.$$

Capital utilization costs take the form

$$\delta\left(U\right) = \delta_0 \frac{U}{1 - U},\tag{16}$$

which bounds utilization between zero and one in equilibrium. Labor utilization costs reflect the most salient convexity in utilization of labor hours, overtime pay:

$$w(H) = \bar{w}[H + \omega(H - FT) \Xi(H > FT)], \qquad (17)$$

where  $\omega$  is the overtime rate, *FT* is full-time weekly hours, and  $\Xi$  is an indicator function equal to one if hours exceed full time and zero otherwise. Because labor costs are piece-wise linear in hours, hours may be unbounded in equilibrium. I impose a limit of 80 hours per week.

#### Calibration

The model will be simulated so that that it begins from a steady state calibrated to features of the pre-war aircraft industry, is then hit but a one-off, unanticipated shock matching the features of World War II, and then converges to a new steady state (with a higher level of TFP) that matches features of the post-war economy. The model is parametrized to match the post-war economy and initial conditions are then adjusted to shrink the industry to its pre-war levels.

Parameter		Value	Method	Target
d	Depreciation rate	0.08	external	Post-war estimates
r	Real interest rate	0.03	external	Post-war value
W	Fixed costs per worker	$= 0.25 \bar{w} FT$	external	25% overhead per worker, typical estimates
$\bar{w}$	Hourly wage	0.658	internal	To match $\bar{H} = FT = 0.24$ to a 40-hour work week (out of 168 hours), full time
ω	overtime rate	0.5	external	Typical 50% overtime rates in aviation industry
$\delta_0$	K Utilization cost param.	0.0967	internal	to match $\bar{U} = 0.36$
				1.5 8-hour shifts, 5 days a week, post war average
α	labor share	$\frac{2}{3}$	external	Typical value in the literature
$\phi$	K adj. cost param.	1.2	internal	To match 1.2 log point decline in capital stock 1944-48
$\psi$	L adj. cost param.	0.975	internal	To match 1.65 log point decline in capital stock 1944-48

#### Table A4: Calibration

I normalize the the stock of capital, labor and TPF to one,  $z = \bar{K} = \bar{L} = 1$ , in the post-war economy steady state. Most remaining parameters are calibrated externally. Parameters of the utilization cost functions can be calibrated to match post-war utilization rates exactly in steady state. Capital and labor adjustment costs are zero in steady state, but govern the rate of investment and hiring along a dynamic path. They are calibrated to match the rate of capital dis-accumulation labor force decline in the airframe industry following the war. Table A4 shows calibrated values and calibration targets. Steady state variables are denoted with bars. Aggregate data on the preand post-war airframe industry are from Kupinsky (1954) and Lee (1960).

### Simulation

The plant in the model is confronted by a sequence of aircraft demands  $Y_t$ , matched to the actual production path during the war. For the average plant, this is set as follows. With  $z = \bar{K} = \bar{L} = 1$  (normalized to 1) and hours worked and utilization set at the targets shown in Table A4, the postwar steady state level of production is  $\bar{Y} = 0.274$ , from (4). Demand  $Y_t$  in all other years is set relative to this index, and taken from the data. Specifically, this gives  $Y_{1938} = 0.1$ , which we treat as initial conditions and assume that the airframe industry had this level of production in the pre-war steady state. TFP in the average plant grew by 35% during the war (see Figure 2). Accordingly, we set TFP in the pre-war period to z = 0.75. Capital and labor utilization rates are the same in the pre-war steady state. This implies  $K_{1938} = L_{1938} = 0.3$ , 30% of their post-war value, which is also consistent with the data. In 1938, at its pre-war steady state, the plant is informed of the future demand it will face in all future periods. For simplicity we ignore the Korean War, and the plant expects to be at the 1944-48 levels of aircraft demand for the remainder of history.

Simulations compare a scenario when the plant chooses to invest in the modern technology, which increases its TFP to one, as in the post war steady state, to a scenario where it retains its pre-
war level of TFP of  $z^T = 0.75$ . In the former case we assume for simplicity that the productivity gains come immediately, so that z = 1 throughout. We begin with the latter case, the counterfactual where no investments in new production techniques are adopted.

Figure A.14 shows how a plant facing the average demand facing World War II aircraft plants responds to this demand shock, absent any increase in TFP during the war. The demand shock is enormous, with production peaking at 25 *times* its pre-war levels. Although capital and labor adjustments are costly, the plant has no choice but to rapidly accumulate capital and hire workers, even knowing that it will have to dispose of the capital and lay off the workers after the war. Capital and labor grow more than 6-fold, compared to a roughly 3-fold increase in the data, partly because the simulation doesn't allow plants to increase TFP. This demonstrates the massive costs that would be incurred absent productivity-enhancing measures. As in the data, the simulated firm accumulates factors gradually, to economize on adjustment costs. It is therefore compelled to utilize capital and labor intensely early in the war, until the newly installed capital and hired labor comes online, at which point utilization can decline to normal levels again, as in Figure 3. Capital utilization costs are convex according to (16), and marginal costs are equalized across all margins.<sup>54</sup> Higher productivity *z* would lower these adjustment and utilization costs and might justify the fixed cost to technology adoption A.<sup>55</sup>

FigureA.15 repeats this exercise, but now for a plant with lower demand. Specifically, it scales the war shock down by 28% to match the the production of the plant at the 25% percentile. The lower demand implies that the plant needs to expand capital and employment "only" four-fold and can do so with lower utilization. Capital utilization peaks briefly at almost 60%. In comparison, the average plant in Figure A.14 had has such utilization rates throughout the war. Lower demand leads to a substantially lower net present value of costs, giving a smaller incentive to adopt the technology.

Figure A.16 now brings demand back up to that of the average plant and simulates the case of low capacity utilization. Utilization is endogenous and one needs to consider an exogenous force driving utilization. In the data, high utilization plants were those whose demand was front-loaded, leading to high utilization early in the war. To replicate this in the simulation, I give the plant a 2-year "advance notice" of the demand. This is sufficient to match the initial capital utilization of the 25% percentile plant. The advanced notice allows the plant to ramp up capacity more gradually, economizing on adjustment costs. The plant utilizes capital less intensely and also

<sup>&</sup>lt;sup>54</sup>Labor utilization costs are convex, but piece-wise linear, so that hours worked shoot up dramatically–more so than in the data. This may indicate that labor utilization costs are convex beyond the costs of overtime pay.

<sup>&</sup>lt;sup>55</sup>The figure also shows very low utilization in the post-war period because demand has declined, but plants still have an overhang of capital and workers from the the war. This is consistent with the minor recession in the US economy in late 1945 and early 1946. In the model, as in the data, utilization rates return quickly to normal.

saves on utilization costs. This plant will have lower costs and less of an incentive to adopt the modern technology.

Relating these simulations to the triple difference specification in Section 4, I conduct the following experiment. The model is simulated with low and high demand; with low and high utilization; and with or without adopting the modern technology, as described above ( $2 \times 2 \times 2$  simulations in total). High and low demand are matched to the 75<sup>th</sup> and and 25<sup>th</sup> percentile plants representing demand that is 2.9 times higher and 28% lower than the average plant, respectively. High and low utilization are matched to the 75<sup>th</sup> and and 25<sup>th</sup> percentile plants in terms of utilization. I then calculate the cost savings arising from technology adoption in all four scenarios, that is the cost difference between the high and low TFP simulation in each case. This gives the plant's (maximal) willingness to pay to obtain a 35% TFP increase, as observed in the average plant during the war.

Figure A.17a shows the results. All bars give the net present value of the savings a plant obtains by adopting a technology that increases TFP by  $\frac{1}{3}$ . These are given as a fraction of the net present value of variable (capital rental, wages, adjustment, and utilization) costs, calculated over a 100year horizon. The first two bars from the left are simulations of a high utilization plant; the next two bars are a low utilization plant. In each case, the bar on the left is the case of low demand and the bar on the right the case of high demand. The first feature that stands out is the sheer magnitude of the bars. Costs in the 6-year wartime period are so large that technology adoption could lower the plant's net present value of costs by as much as 70% *over the course of an entire century*. A second result is the big difference in costs, and therefore cost-savings due to technology adoption, depending on demand. A high demand plant is willing to pay more than twice as much as a low demand for the modern technology. Finally, willingness to pay is increasing in utilization.

Figure A.17b represents this same information a triple difference-in-differences. It gives the difference in savings (due to high rather than low TFP, as a percent of the net present value of costs) between the high- and low-demand scenarios, for simulations with high and low initial capital utilization. High demand incentives technology adoption, and more so at high rates of utilization, as in the empirical results of Section 4.