

17. The Cold War: Rent Seeking

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Corporate Political Action

Concern about corporate political action in military markets goes back to Engelbrecht and Hanighen (1934), and the U.S. Senate Munitions Committee investigations into **Merchants of Death**:

“An alliance of governments with war industries threatens to make the arms makers supreme in economic life and after that in government.”

U.S. President Eisenhower’s farewell speech (1961) reignited concern:

“Until the latest of our world conflicts, the United States had no armaments industry ... But ... we have been compelled to create a permanent armaments industry of vast proportions. Added to this, three and a half million men and women are directly engaged in the defense establishment. ...

“This conjunction of an immense military establishment and a large arms industry is new in the American experience. The total influence – economic, political, even spiritual – is felt in every city, every State house, every office of the Federal government ...

“In the councils of government, we must guard against the acquisition of unwarranted influence, whether sought or unsought, by the **military-industrial complex**.”

Corporate Political Action

Rent seeking: The idea of a military-industrial complex is of **joint political action** between contractors and purchasers to create and share a rent.

In the **rent-seeking society** (Krueger 1974) the government creates a monopolistic privilege (e.g. import license; or here a defence contract).

- Econ 101: There exists a rent (transfer from consumer to monopolist) and a deadweight loss.
- Econ 201: Agents compete politically to create rent opportunities for themselves, each being willing to invest resources in lobbying **up to expected value of the rent** potentially available.

Social losses from rent seeking may far exceed the deadweight loss triangle in neoclassical models.

In seeking rents, does business show **pro-war preferences**?

That's hard to answer in the abstract, so:

- Break the question down into a set of more specific questions that have empirical and historical answers (based on Harrison 2014a).
- Then home in on the interwar period and the Cold War.

Does Big Business Prefer War?

Do corporate owners value connections to power?

From Adam Smith, the point of a decentralized market economy was seen as separating wealth from power.

Does it do this in fact? **Not always.**

Do corporations lobby politicians and make self-interested political donations? **Yes, all the time** (e.g. Hillman et al. 2004).

Are political connections capitalized in market value? **Yes.**

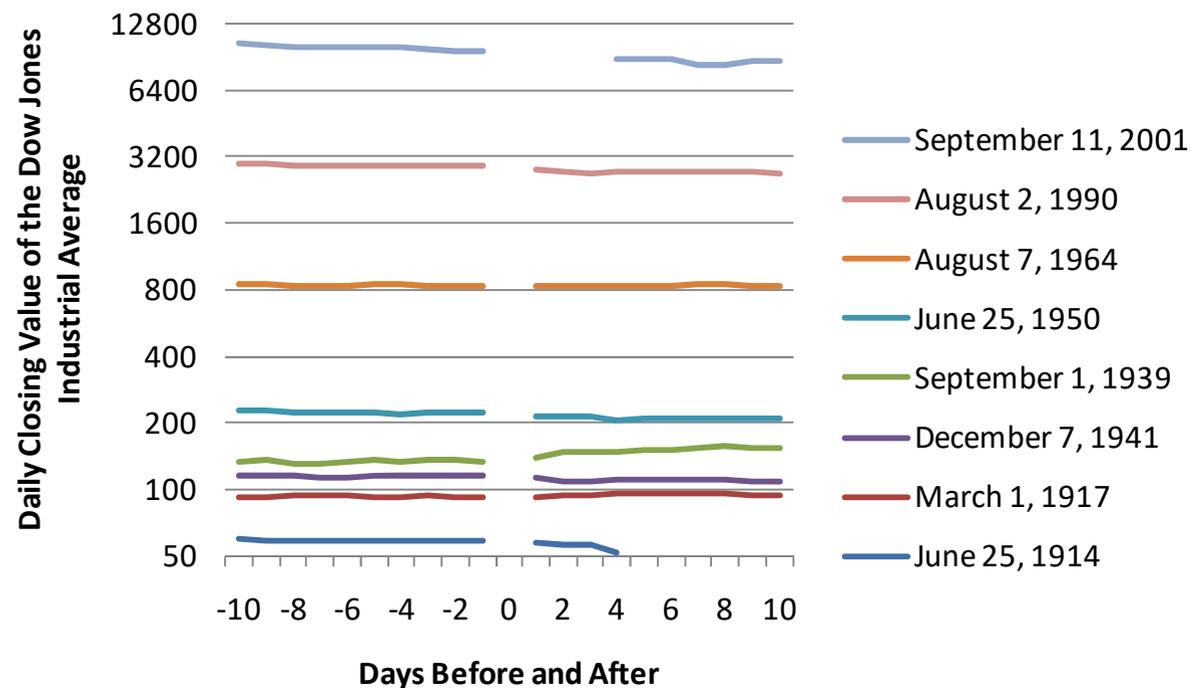
- In countries that are relatively corrupt (Indonesia, Malaysia), connections to the ruling party add value (Raymond Fisman 2000, Johnson and Mitton 2003).
- In the 2000 U.S. presidential election, when Bush beat Gore, oil and tobacco firms gained value and legal firms lost (Knight 2007).
- But that was policy differences, not connections; when VP Cheney suffered heart attacks, stocks of associated companies did not move (David Fisman et al. 2012).
- Some German firms that were linked to the Nazi Party before 1933 by donations or open support gained value when Hitler took power (Ferguson and Voth 2008) – but see more below.

Does Big Business Prefer War?

When war breaks out, some businesses will gain while others lose.

Does **business as a whole** (not just some businesses) **expect to profit** when politicians decide on war?

Daily closing values of the Dow Jones Industrial Average:



Source: Harrison (2014a); on WW1 specifically see also Ferguson (2006).

- Apparently not.

Does Big Business Prefer War?

When war breaks out, some businesses will gain while others lose.

Does **business as a whole** (not just some businesses) **actually profit** when politicians decide on war?

It's hard to tell because, in wartime, public finance and corporate finance became entangled (previous lecture).

Strong **beliefs** in war-profiteering in Britain and Germany in WW1 (Carsten 1982), accepted by some historians:

- “Not so much . . . the harnessing of big business to the machine of state, as ... the reverse” (Hardach 1977; also Kocka 1984).

Charges of German war profiteering and relative impoverishment in WW1 have been challenged.

Baten and Schulz (2005) explain appearance of rising inequality in Germany by:

- Failure to account for **inflation** in measuring real profits.
- **Selection bias** in the profits reported.
- A wider sample of big businesses shows real wages and real profits of German large-scale industry declining in proportion; the labour share in national income in 1917 was about the same as in 1913.

Independently, Ritschl (2005) reaches similar results based on comparing real wage and real output series.

Does Big Business Prefer War?

Were German business leaders **responsible for two world wars**?

Hugo Stinnes (1870-1924) and Gustav Krupp (1870-1950) provide cases of business support for wartime nationalism and militarism in Germany.

Stinnes (based on Feldman 2000)

- Shipping and mining interests.
- A conservative before 1914 who warned the Kaiser against war.
- Advised Ludendorff on organization of the German war economy and the economy of occupied Belgium.
- After the war helped found the conservative DVP and opposed the Versailles Treaty.

Krupp (based on Overy 1994)

- Steel and munitions.
- A monarchist until 1933, who warned Hindenburg against Hitler.
- Became pro-Hitler when Hitler took power.
- Became pro-war when war broke out.
- In wartime, became a willing accomplice in war crimes (e.g. Mommsen 2005).

Ex ante, no evidence of innate preference for war.

Ex post, support for war was a strategic choice, framed by political context, based on respect for authority, fear of losing property and status, and opportunity to profit.

Does Big Business Prefer War?

Were German business leaders **responsible for two world wars**?

Some German firms contributed to Hitler's election fund in 1933.

- German firms linked to the Nazi Party before 1933 by donations or open support gained stock value when Hitler took power (Ferguson and Voth 2008).
- But those that contributed were offered little choice (Tooze 2006).
- Even so, not all contributed, e.g. Hugo Junkers.

Still, open business opposition to Hitler's plans was exceptionally rare.

- But Göring versus the Ruhr industrialists in 1937 over autarky in steel (Overy 1994 and see previous lecture) is revealing.

What do we learn?

- **Political leaders** held the initiative ("primacy of politics") (Mason 1968; Overy 1994).
- This made the businessmen **willing accessories** in the making of war, but not principals.

The Interwar Period

Europe: Eloranta (2009) compares interwar defence markets of UK, Sweden, and Finland.

In each country, domestic firms aimed to maximize shares of domestic military equipment spending and minimize tax burdens by means of:

	UK	Sweden	Finland
• Direct access to decision makers	✓		
• Lobbying legislators	✓	✓	✓
• Political campaign funding			✓
• Collusion with government agencies			✓
• Public relations	✓	✓	✓
• Cartelization			✓

But were corporate efforts effective?

The Interwar Period

Four **western democracies**: Wilson and Eloranta (2010) review the interwar “Merchants of Death” (Engelbrecht and Hanighen 1934) controversy in relation to military procurement in USA, UK, Sweden, and Finland.

- Real military outlays ran at historically low levels after 1919.
- Did not respond counter-cyclically to the Great Depression.
- WW1 defence contractors typically diversified into civilian markets.
- Military procurement responded only to emergence of real new strategic threats after 1935.

Evidence that democratic institutions proofed procurement against rent seeking.

The Interwar Period

The United States: defence markets were insignificant before 1940 and businesses were often averse to involvement.

- American business in 1940 was distrustful of government, reluctant to invest in war capacity, and fearful that they would not be allowed to make money (Higgs 1993).

The price of U.S. business cooperation in 1940 (Higgs 1993):

- Dollar-a-year men in government.
- War Department orders based on direct negotiation rose from 13% (July 1939 to June 1940) to 74% (July 1940 to February 1941) while value rose tenfold.
- Contracts were cost-plus-fixed-fee.
- Depreciation tax allowances: write-off in 5 years, or less if demand was curtailed.
- Continuing reluctance to build specialized final-stage facilities was overcome initially through Emergency Plant Facility (government promise to buy), then GOCO: 50% to top 26 contractors.

Result: “Public risk, private profit.”

The Cold War

The United States: public risk, private profit.

Higgs and Trevino (1992) find U.S. defence contracting (1970 to 1989) was **inexplicably profitable** by “a huge margin”, controlling for risk.

$$MRET = 13.04 + \underbrace{34.63}_{11.79} \frac{D}{S} - \underbrace{40.65}_{14.78} \left(\frac{D}{S}\right)^2$$
$$R^2 = 0.19, SEE = 5.40, N = 39$$

- MRET (1970-1989) is market return on capital to shareholders
- D/S (1981-1983) is defence share of sales.
- One outlier (LTV) dropped.
- MRET is maximized when $D/S = 0.426$.

Does risk, approximated by β (coefficient of firm's return regressed on market return over time), justify excess return? Criterion is $\beta > 1$.

- For big defense contractors $\beta \rightarrow 1.2$ to 1.25 , so $\beta > 1$ but not significantly.

Note: Probably the econometrics, here and below, would not meet modern standards of statistical power or identification.

The Cold War

The United States: the pork barrel.

Higgs and Kilduff (1993) and Higgs (1994) describe interaction of American defence producers, politicians, and voters in the Cold War:

From\To:	D	P	V
Defence suppliers	---	Donations	Jobs
Politicians	Contracts	---	---
Voters	---	Votes	---

Results:

- The military budget oversupplied both national defence and private profit.
- Winners: defence suppliers; politicians.
- Losers: armed forces (supplied with equipment they did not want and could not use); taxpayers.

The Cold War

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How did they get away with it? Maybe there was **status quo bias** (Fernandez and Rodrik 1991).

- Gains from the defence pork barrel were clear and concentrated; losses diffuse and opaque.
- Promises to compensate losers for withdrawal of fiscal support not credible.

They got away with it, but only **up to a point**.

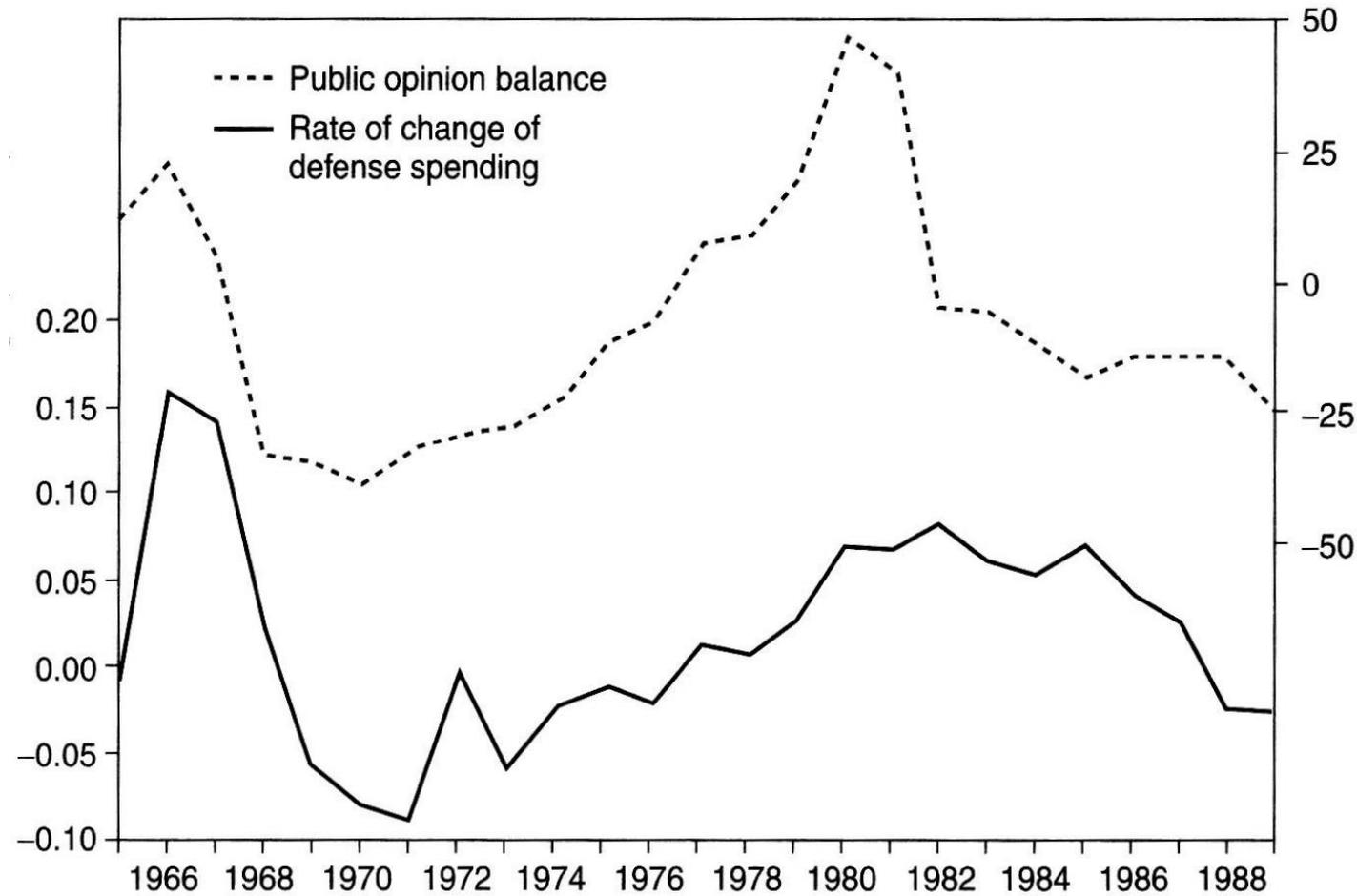
In the end, the power of the military-industrial complex was not unlimited.

Constraints were set by **voter resistance** to rising taxes and military casualties.

The Cold War

The United States: deaths and taxes.

Consider $\Delta(\text{Defence spending})_t = \alpha + \beta \Delta(\text{Public opinion balance})_{t-1} + \epsilon_t$



- The lagged balance of public opinion (RHS) on whether defence spending should rise or fall was the single most important factor in whether defence spending actually did so (LHS).

Source: Higgs and Kilduff (1993).

The Cold War

The United States: the power of the military-industrial complex had **limits**.

Higgs and Kilduff (1993): The balance of public opinion on whether spending should rise or fall was the single most important factor in whether it did so.

Politicians and business interests competed to **manage public opinion**—to persuade the public to accept the existence of security threats and shortfalls:

- Truman, containment, and Korean War.
- Kennedy/Johnson and Vietnam War.
- Carter/Reagan and the Soviet threat.

They sought to **manage** public opinion but could not **fix** it.

Two factors limited public support for the military and kept the military budget in check:

- Tax increases.
- War casualties.

In the context of a democracy with political competition and voting, deaths and taxes set **ultimate limits on power** of the military industrial complex.

Capitalism, Communism, and Defence

The story so far:

Are capitalist corporations interested in politics? Yes.

- Do they conspire against the public? Yes (from Adam Smith).
- Do they lobby politicians and make self-interested political donations? Yes, all the time.
- Do they lobby for external confrontation or conflict? Yes, conditionally: if political actors present the opportunity and the opportunity appears to offer profit, not otherwise.
- Do they willingly exploit the spoils of conquest or enslavement? Yes, conditionally.

So the **character of the state** and the **agency of politicians** are all important.

- Even more so when we ask:
- Can a military-industrial lobby be avoided through public ownership?

Capitalism, Communism, and Defence

Can a military-industrial lobby be avoided by public ownership?

Consider how Soviet **communism** differed from American capitalism.

Holloway (1980: 158) considered the proposition that:

“The Soviet Union does not *have* a military-industrial complex, but *is* such a complex. This is too sweeping a statement, but it does make the point that the history of the Soviet Union is so bound up with military power that it seems wrong to speak of a separate military-industrial complex acting within the state.”

Maybe military security was a **core objective** of Soviet rule (Kontorovich and Wein 1999; Kontorovich 2015).

Stalin’s policies of modernization and industrialization were driven by the belief that military power required strong economic foundations under a government political and economic monopoly (Harrison 2014b).

Capitalism, Communism, and Defence

Can a military-industrial lobby be avoided by public ownership?

Consider how Soviet **communism** differed from American capitalism.

- Soviet defence production facilities were owned and controlled by the state.
- **Secrecy** gave unaccountable power to political leaders and military-industrial interests.
- The postwar Soviet defence sector took a consistently larger share of national resources than the American one (Firth and Noren 1998).

There was a lack of constraints on the defence budgeting process.

- Soviet leaders secretly spent resources on defence without even counting them (Harrison 2008).

In other words, no one needed to lobby the Soviet rulers for more defence spending because **they wanted it anyway**.

What We Have Learned

The nature of a market economy is that it is **decentralized**.

For it to work well, economics must be separated from politics.

High defence spending and the military-industrial complex threaten to bring **politics back into economics**—big time.

- Centralizing the operation of capitalism.
- Power shifts from consumers to producers.
- Competition declines, everyone has bad incentives, and there is inefficiency.

In twentieth century history, this happened A LOT in time of war and war preparation.

When it happened, we see big business going happily along with it.

But this is not the same as taking the lead.

- Historically, political leaders decided between peace and war.
- Political leaders decided what role business should play and manipulated business interests to go along with it.

The historical record shows not how big business changed the nature of government, but **how big government changed business**—for the worse.

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