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Consequences of Military and Foreign Policy Competition for Economic Development and the Growth of Big Government.



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Peter Bernholz

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1. Introduction

Πολεμος παντων μεν πατηρ εστι, παντων δε βασιλευς.
War is the father of all things, the king of everything.

Heraclitus

Nulla salus bello.
No good is in war.
Vergilius

The two quotes of the sages of antiquity have according to modern scientific understanding turned out to be more relevant than their authors probably suspected. On the one hand it is now widely agreed that the phenomenal development of the Western Civilization which is presently spreading over the whole world, has been caused by systems competition of many or several states, including military and foreign policy competition often culminating in wars.

As already Immanuel Kant emphasised:

Now the States are already in the present day involved in such close relations with each other that none of them can pause or slacken in its internal civilisation without losing power and influence in relation to the rest ... Civil liberty cannot now be easily assailed without inflicting such damage as will be felt in all trades and industries, and especially in commerce; and this would entail a diminution of the powers of the State in external relations ... And thus it is that, notwithstanding the intrusion of many a delusion and caprice, the spirit of enlightenment gradually arises as a great good which the human race must derive even from the selfish purposes of aggrandisement on the part of its rulers, if they understand what is for their own advantage (1784/1959: 31).

On the other hand, because of this development military preparations and wars are consuming ever increasing resources and the latter are leading to rising losses of life and destruction of property.

Subsequently I will first sketch the theory why military and foreign policy competition have been beneficial for economic development and the rise of the rule of law and democracy. Next I want to discuss several characteristics concerning the international game of power and point out their importance for the growth of government. After that some empirical evidence will be presented. Finally some conclusions will be offered.

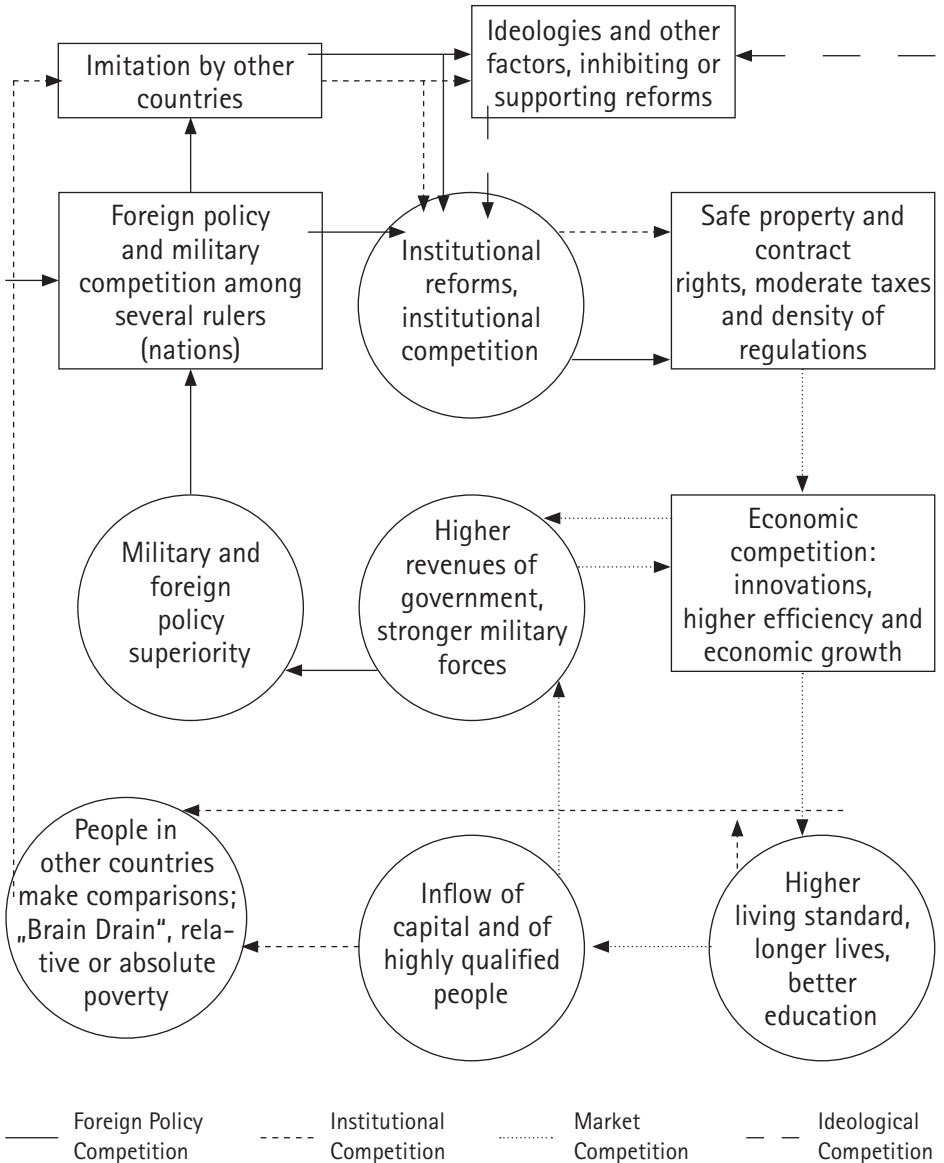
2. From Foreign Policy and Military Competition to Institutional and Market Competition

The analysis given by Kant provides some clues to answer the question:

Under which conditions can a prosperous and free society come into existence? Why should the ruling elite in an autocracy agree to strong and secure property rights, to minimal state intervention, to a strong limitation of taxes, and thus of its own powers to command and to take away goods at their own discretion? It seems that the 'New Economic Historians' and other scholars have tried with a certain success to answer these questions (Baechler, North and Thomas 1973; North 1981; Jones 1981). They have stressed that 'European disunity has been our good luck'. Feudalism with its many power centers developed during the Middle Ages and a split opened up between religious and temporal powers. A fierce rivalry arose among the many European rulers to extend and preserve their powers by foreign policy and military endeavours. This forced them to become interested in the well-being and loyalty of their subjects and in economic development to secure a greater tax base and thus stronger armies. However, economic development itself depended on establishing adequate property rights, a reliable legal system, free markets and limited taxes. As a consequence, those states were successful in this foreign policy and military competition in the long run who, by chance or by design, made the greatest progress in introducing such institutions. Thus competition among states forced on unwilling rulers a limitation of domestic powers. The development of competing legal systems, of the rule of law and of property rights was helped not only by interstate competition but also by the increasing separation of church and state, the preventing of a theocracy (Berman 1984). Because of these developments limited government and a pluralistic society arose in Europe as a pre-democratic achievement. First capitalism and later democracy were their progeny.

I have argued elsewhere (Bernholz 1995) that international competition among states is a driving force even until today, motivating rulers like in Japan in the Meiji Era, or Gorbatchew and Deng to limit their domestic powers with the purpose to strengthen their economies as a base of international power. Whether the reforms are adequate and thus successful is, of course, another question.

Figure 2.1
Systems Competition



It follows from the above that military and foreign policy competition among many or several states has led as a consequence to institutional competition for ever better institutional settings. Within such favourable frameworks market competition leading to greater efficiency, innovation and economic growth could develop (Figure 2.1). As a by-product of institutional and market competition rule of law and democratic societies were established.

But in democracies there are political forces working towards the erosion of the rules and institutions on which their success is founded. Shifting majorities in parliament, i.e., small minorities of the population, only inadequately controlled by rationally uninformed voters, can enforce their goals on the rest of the population. Since several parties compete for votes and need financial support to cover the expenses of their organizations and for election campaigns, one has to expect in time an ever-increasing sphere of government activities. Thus growing public expenditures, more and more regulations by government, tax loopholes and subsidies to special minority interests and pressure groups, flow from the incessant activity of legislative bodies. Such developments can happen because the majority of voters is rationally uninformed about most issues. This is true for all those issues concerning which decisions impinge only marginally on the situation of consumers or taxpayers, since in these cases they have little reason to incur the costs of informing themselves, given the negligible effect of individual votes on election outcomes. Thus protection of certain industries against foreign competition, the fixing of agricultural prices above market clearing levels, subsidies to coal or steel industry and the toleration or even promotion of cartels can be observed, though a majority of voters is hurt by higher taxes and/or prices. On the other hand, whenever changes like rent increases for housing are perceived by a majority of voters, since the expenditures for rents amount to a substantial part of their budgets, or if a majority of voters is aware that a redistribution of Incomes would benefit them, the government will take action in favour of the majority e.g., by introducing rent controls or income transfers (Downs 1957; Bernholz 1966, Meltzer and Scott 1983).

If the above arguments are correct, why is it that government activities are not increased at once under the pressure of political competition to a Nash equilibrium level in which each party maximizes votes, if such an equilibrium exists? Why does it take decades for government activity to rise to ever higher levels? Several reasons have been given to explain this empirical fact (for a recent review of the extensive literature and an empirical test of an overarching theory see Cusack and Fuchs 2002). Olson (1965, 1982) points out that since it is difficult to form interest groups because they provide public goods to their members, it takes time to organize them (see also Bernholz 1969). The more diverse the interests and the greater

the number of potential members, the more difficult the task and the longer the time needed to organize an interest group. As a consequence, cartels can only be formed and influence be exerted by potential interest groups on the political system after they have found enough time to be organized.

Bernholz (1966) has pointed out a second reason for the gradual extension of government, namely changes of the industrial structure brought about again and again by economic development. These changes threaten old industries, their capital owners and managers as well as the jobs and the wage level of the people employed by them. This leads to voter dissatisfaction and thus, under the pressure of political competition, to government intervention to maintain or to win the support of those voters and of their families who suffer from the changes in the industrial structure. A third reason sometimes mentioned in the literature is more or less closely related to the second:

„The need to keep in check the forces which might produce unemployment is not the only root of the expansion of government control over industry and trade, because the sheer growth of complexity of economic structures requires more co-ordination, and the number of tasks which cannot be left to private initiative – such as prevention of soil erosion, traffic control, smoke abatement and so on – grows incessantly“ (Andreski 1965, p. 355).

Finally, time is obviously needed to invent new governmental measures, to introduce and to pass new legislation, taxes and subsidies.

Let us turn next to the question, whether a free and democratic society with the rule of law can be maintained or be re-established after a degenerative development. It is true that there are some institutions like referenda and popular initiatives or the influence of public-minded advisors which are retarding the inexorable growth of government expenditures (as a percentage of GDP) and interventions (Frey/Kirchgässner 1994). But apart from perceived crises (Dur and Swank 1997) they seem not to be able to stop the growth of government and the erosion of individual rights, as evidenced by empirical developments during the last decades (Bernholz 1986, Weede 1986, Tanzi/Schuknecht 1997).

It follows from the above analysis that there exists an inherent tendency in democracies for government to grow. The situation, however, is different in situations which are perceived by the population and (or) politicians as crises. In such cases public-minded statesmen or advisors may have great influence, if their ideas succeed against competing simplifying ideologies. Examples are the success of the West German (ordo-)liberals after the catastrophe of the second world war (Peacock and Willgerodt 1989); the reforms by Mrs. Thatcher in Britain after it

had lagged more and more economically compared to other European countries and even been overtaken by Italy; or the drastic reforms first taken by the labour government in New Zealand after the extended welfare state based on a mainly agricultural economy had led the country into a deep unemployment, budget deficit and foreign exchange crisis.

Moreover, from the argument presented above, it can also be derived that a weakening of the relative foreign policy and military position of Great Powers caused by a relatively bad economic performance as a consequence of increasing government may be perceived as a crisis and lead to reforms in the direction of re-establishing more limited government.

3. Is there a Contradiction between the Positive Influence of Military and Foreign Policy Competition and the Waste of Resources through them.

The above arguments concerning the beneficial consequences of military and foreign policy competition for institutional and market competition seem to lead to a contradiction. For it appears to be obvious that rearmament and warfare are dependent on higher government expenditures and the introduction of military service for many people and of other regulations limiting the free decisions of citizens. These factors, however, must not only reduce individual freedom but also necessarily decrease efficiency, innovative capabilities and civilian economic resources. As a consequence economic growth and well-being should be reduced.

Though these obnoxious influences for economic growth cannot be denied, no contradiction is present if certain conditions are fulfilled. Namely, the beneficial institutional reforms as well as their positive consequences have to take place before armament and war expenditures and efforts are substantially increased. For then increasing outlays for military purposes can be based on a higher gross domestic product so that a lower share of GDP is necessary to cover them than in less developed countries whose institutional reforms have been lagging. This is especially the case if potential adversaries have been less successful to reform and if their economic potential it therefore falling behind. We can thus propose the hypothesis that the military expenditures as a share of total government expenditures and even of GDP should decrease in successfully developing nations in the long run. And if we look at long-term historical developments this seems to be confirmed by the empirical evidence for the former statement (Figure 3.1).

Though the same does not necessarily hold for the share of military expenditures in GDP, since the share of total expenditures in GDP has substantially risen since 1960 (Figure 3.2). Cusack and Fuchs (2002) show (pp. 13 f.), that this has in fact been the case for the average of 16 OECD countries from 1960 to 1995. And it is even confirmed for the USA for the period from 1969 to 1992, in which it became the only remaining superpower (Figures 3.3 and 3.4). But it should be understood

Figure 3.1
Development of Share of Military in Total Expenditures 1960-2003

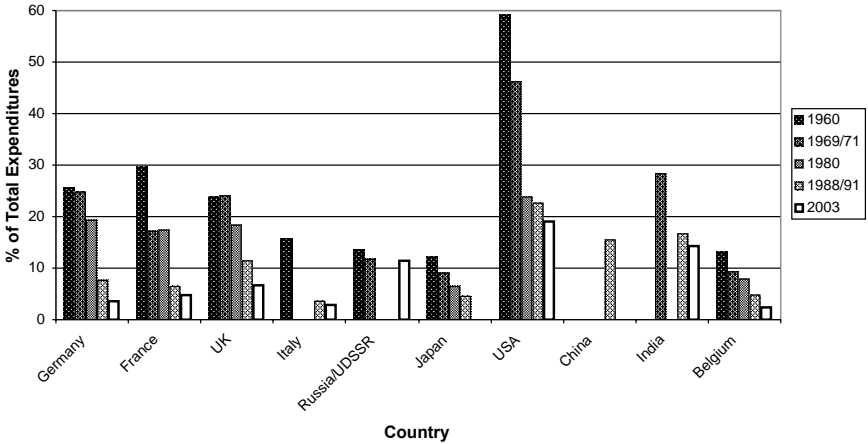
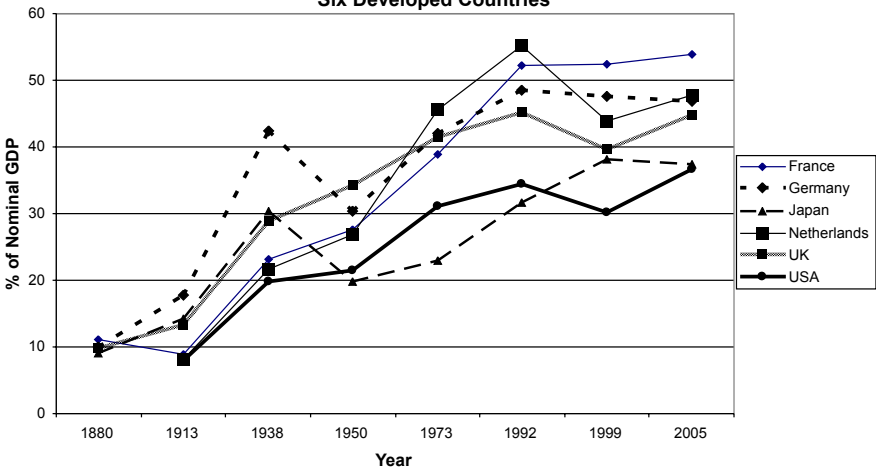


Figure 3.2
Development of Total Government as a Share of Nominal GDP, Six Developed Countries



that a decreasing share of military expenditures does not imply that they have not increased in absolute terms nor that this share did not rise in cases of actual warfare and that this might not have a lasting influence on the rise of total government expenditures as a share of GDP.

Figure 3.3 Share of Military Expenditures in GDP, 1913-2003

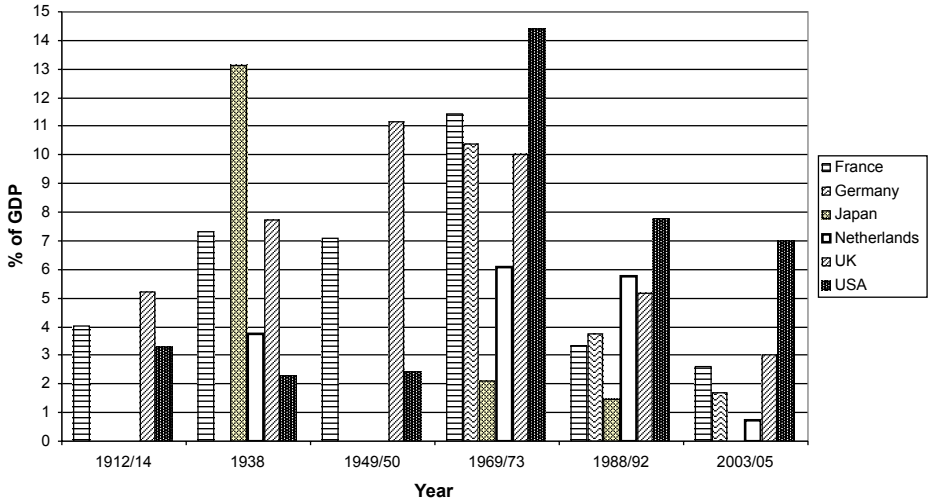
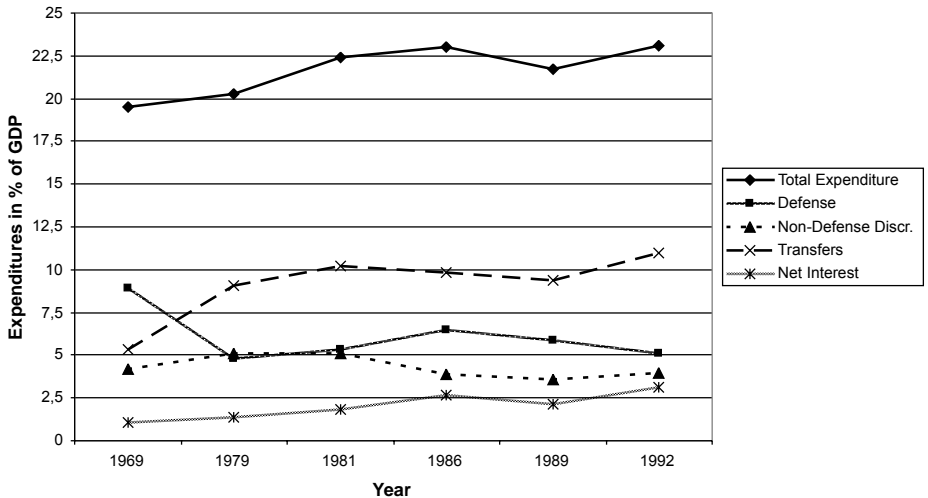


Figure 3.4: US Federal Expenditures as Percentage of GDP



We have derived a surprising result: The share of government expenditures for military purposes in GDP is reduced because of the beneficial results of military and foreign policy competition for institutional competition and therefore for economic growth. But does this mean that systems competition of this kind has also a negative influence on the share of total government outlays in GDP? This is still an open question, which we will try to answer later.

4. Factors Influencing the Relative Size of Military Expenditures of Different Countries

It has been shown that the growth of GDP per capita enables states to decrease the share of military expenditures in GDP without endangering their international power position. But this position in the international game of power is also influenced by other factors, which have to be considered next.

Let us begin by stating that small and even medium-sized countries cannot afford to keep up with the armament efforts of big nations. But what does „small“ and „big“ mean in the international system? A first approach to answer this question can be taken by looking at the factors which have historically determined that certain states became great powers. At first look it seems obvious that besides geographical position the size of territory and population and the state of econo-

Figure 4.1
The Ten Leading Economic Powers in 1820 and 1998 as Measured by the Shares of their GDP as % of World Total

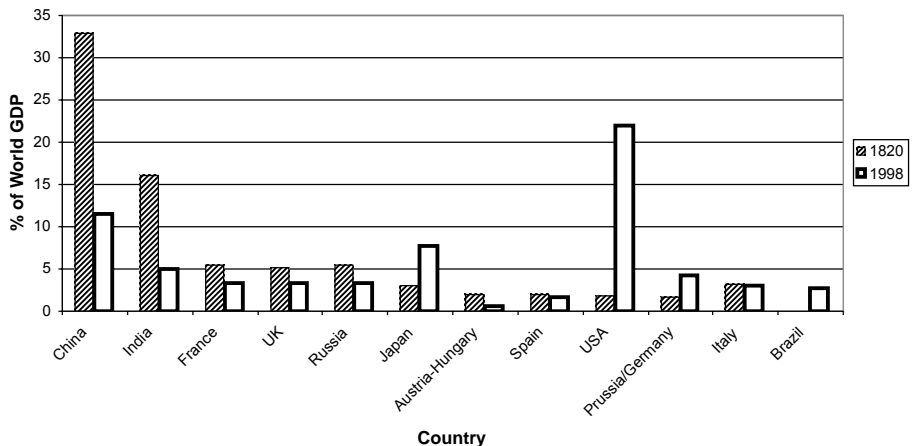
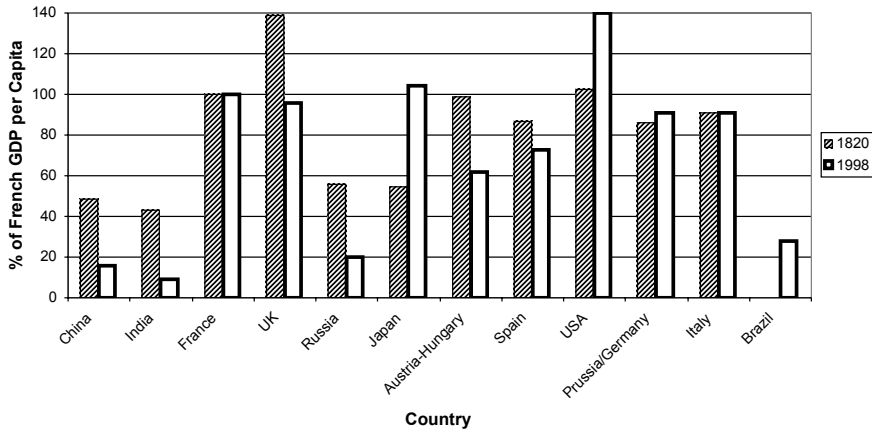


Figure 4.2
The Ten Leading Powers in 1820 and 1998 as Compared by Their
GDP per Capita in Relation to France



Source for Figures 4.1 and 4.2: Maddison (1995, 2001)

Comment: Italy was no nation in 1820, as was Austria-Hungary in 1998. For this year the figures for Austria and Hungary have been added. No GDP per Capita has been available for Prussia for 1820, so that for Germany has been taken. France was taken as a reference point in Figure 4.2, since it was the militarily strongest nation around 1800.

mic and technological development of nations should have been decisive. But it is interesting to note that empirically all Great Powers of the last two hundred years can be found by looking at only two factors, namely the sizes of GDP and of GDP per Capita. Figure 4.1 shows that all Great Powers in 1820 and 1998 belonged to the ten countries with the highest GDPs in the world. On the other hand, not all countries with the highest GDPs were Great Powers, for instance China and India in 1820. The reason for this can be easily understood by looking at GDP per Capita in Figure 4.2. Figure 4.1 also makes clear why the USA developed to the only remaining Superpower until 1998 and that Austria-Hungary and Prussia were rather weak Great Powers in 1820. The figures also suggest that with further rapid economic development China and India and perhaps Brazil are probable to become Great Powers within the next decades.

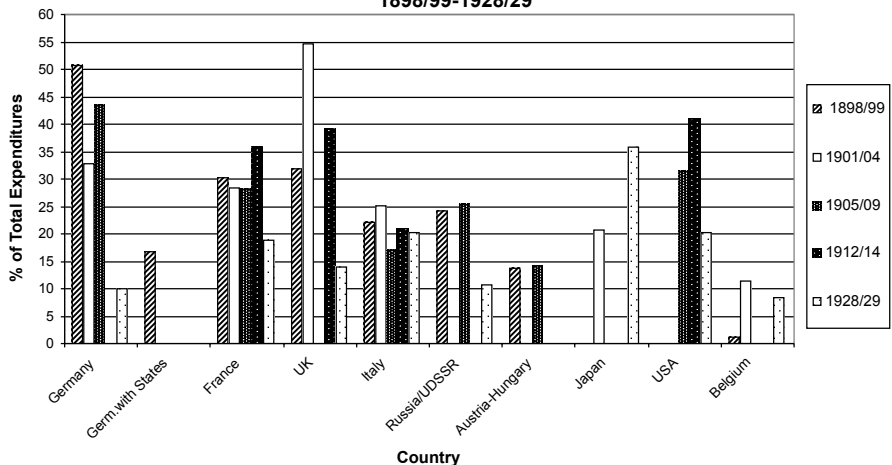
In spite of this result it is not advisable to underestimate the importance of the size of territory and population and the geographical position for the status of a Great Power. First the first two factors were largely responsible for the size of GDP before the industrial revolution. Second, the UK and Russia would have been

conquered by Napoleon and Hitler had they not been an island or so huge, respectively. Similarly, the USA could not have been defeated in 1820 in spite of its relative economic weakness compared to Britain and France because it was protected by two oceans against other Great Powers.

Our analysis implies that economically small countries, as measured by the relative size of their GDP, have scarcely a chance to obtain the status of Great Powers. But if this is true we have to expect that they will as a rule spend a smaller share of their expenditures for military purposes than the latter. Another factor which should influence this share is the geographical position of countries, since countries isolated by seas or which are of a large territorial expansion are less threatened by other Great Powers. Similarly, nations at the periphery of international systems are in better positions than those located in its center, since they are confronted by a smaller number of potential opponents (for historical evidence see Bernholz 1985, p.81; Collins 1978, 1986, p.187 f.; 1995, p.1555; Mc Neill 1963; Weede 1996, p.130). Finally, it has been shown by Zeckhauser that the strongest member in a coalition like the USA in Nato has to bear a relatively heavier burden of military expenditures than the other members.

Though careful empirical tests of these hypotheses are still necessary, the ad hoc evidence seems to support them. In Figure 4.3 we see that the strongest member of NATO, the USA, is distinguished during the period of the cold war by a far higher

Figure 4.3
Development of Share of Military Expenditures (For Some Cases 1898/99,
Including Expenditures for Colonies) in Total Expenditures,
1898/99-1928/29



share of military expenditures than its other members. And the share of military expenditures of a small country like Belgium is especially small. Note that Japan was a special case, since it has been disarmed after World War II and decided to demilitarise „permanently“. To be able to find some evidence that countries at the periphery and protected by seas or large territories enjoy a lower share of military expenditures we have to look at periods without a superpower or two opposing alliances like after World War II. An adequate time for this purpose is the period before World War I. As can be seen from Figure 4.4, the share of Germany as a central power is indeed higher than those of the peripheral Great Powers in the years before the war, with the only exception of Britain in 1901/04. The low share of military expenditures of Austria-Hungary as a central power seems to contradict the hypothesis, but in this case the far weaker economic base has to be taken into account (Figure 4.1). One warning has, however to be expressed. The shares of Germany and the USA may be somewhat too high, because only the figures for the federal government have been available. It is perhaps also revealing that in contrast to the continental powers the UK and the USA did not know the draft before World War I. Finally note also, that Belgium as a small country shows again a small share of military in total government expenditures during this period.

5. Hysteresis Effects of War-related Military Expenditures

We have now to turn to the question whether temporary disturbances increasing military expenditures like wars, arms races or other dramatic international tensions may lead to a permanent rise of the share of government expenditures in GDP. And this even given the fact that the military expenditures are themselves reduced after the international crisis has vanished. More than four decades ago a seminal paper by Peacock and Wiseman (1961) stated such a relationship concerning the growth of public expenditures in the UK. According to their view, in the absence of unusual events, citizens have fairly stable feelings about the tolerable level of taxation. But in times of emergencies like wars they are prepared to accept a higher level of taxation which before was thought to be intolerable. And when the disturbance has disappeared the acceptance of the higher level remains since voters have now adapted to it. Such disturbances thus create a so-called displacement effect which shifts public revenues and expenditures to new levels. As a consequence the government can now implement programs which it had thought to be desirable before, since military expenditures can be lowered when the crisis has vanished (for a short outline see Rowley and Tollison 1994).

During recent years this hypothesis has been analysed concerning its meaning and been empirically tested by several scholars (Henry and Olekalns 2000, Goff 1996, Legrenzi 2001, Lybeck and Henrekson 1989, 1990). The evidence is still not conclusive. Lybeck and Henrekson have stated, that the displacement hypothesis has not been falsified after thirty years of research, whereas Henrekson (1990) concluded that the evidence has been refuted for the two world wars for Sweden and the UK. On the other hand, Henry and Olekalns demonstrated that displacement has occurred in five cases in the United Kingdom since 1836. Goff has pointed to the in ' has b hl has b

of military and total public expenditures in GDP have been discussed. The following results were obtained:

1. Military and foreign policy competition of many or several states seem to have had favourable long-term influences in establishing institutional and market competition beneficial to economic growth.
2. This economic growth has led to a long-term reduction of the share of military expenditures in total public expenditures and in GDP even for Great Powers.
3. The emergence of Great Powers has at least in the last two centuries mainly been determined by their economic strength as measured by total GDP and by GDP per capita.
4. Other factors influencing the share of government expenditures are their size, their geographical position at the center or the periphery of the international system, and the protection offered by barriers like the sea. The share of small countries tends to be smaller, like that of countries protected by barriers or at the periphery.
5. Though the share of military expenditures decreases strongly after wars or severe international tensions, their increase during such periods of crises has possibly a long-lasting positive effect on the share of total public expenditures in GDP.

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