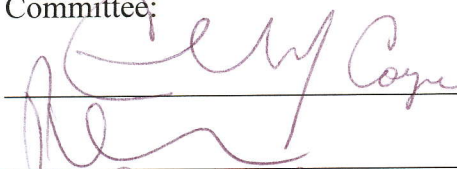


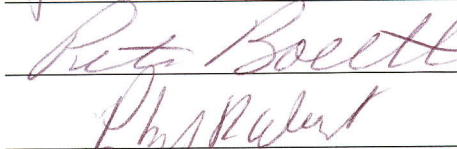
ECONOMIZING DEFENSE: ECONOMICS OF THE MILITARY-INDUSTRIAL
COMPLEX


by

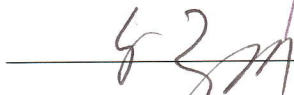
Thomas K. Duncan
A Dissertation
Submitted to the
Graduate Faculty
of
George Mason University
in Partial Fulfillment of
The Requirements for the Degree
of
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Economics

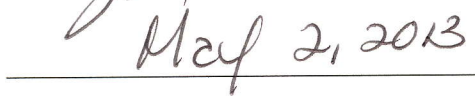
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Spring Semester 2013
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Economizing Defense: Economics of the Military-Industrial Complex

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DEDICATION

This dissertation is dedicated to my mother, Linda E. Duncan, for all the support she has given me in pursuit of my education, and to my father, Robert N. Duncan, who has motivated me to succeed throughout my life.

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ABSTRACT

ECONOMIZING DEFENSE: ECONOMICS OF THE MILITARY-INDUSTRIAL COMPLEX

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George Mason University, 2013

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The military-industrial complex has long been an economic and political factor in the U.S. economy. The amount of resources fed into this war machine is staggering. Since World War II, the U.S. has continuously spent vast sums on the military, creating what has been termed a permanent war economy. Even in times of peace, the armed forces are kept in a state of readiness under the auspices of foreign threats or the need to protect the industrial base. This continued preparedness begs two central questions: 1) what is the proper size and scope of the military and 2) what is the institutional arrangement under which we can be assured of achieving that proper size and scope? This dissertation addresses these questions, extending the literature on defense optimality and the institutional arrangements of national defense in the U.S.

The first essay considers the concept of national defense as a public good, which is the common reasoning for state provision of defense, and suggests that the optimal level of defense can be provided by the market. The second essay explores the

institutional arrangement that has arisen in the United States, namely the military-industrial complex and its permanent war economy, and the costs that result from the top-down approach to defense contracting. The third essay examines the way that institutional arrangement originated from the central planning of the New Deal and World War II and argues that today's permanent war economy is a function of the vested interests that arose via state management of those crises.

CHAPTER 1: Introduction

“[W]e 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. We annually spend on military security more than the net income of all United States corporations.

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. We recognize the imperative need for this development. Yet we must not fail to comprehend its grave implications. Our toil, resources and livelihood are all involved; so is the very structure of our society.”

- Dwight D. Eisenhower (1961)

Eisenhower’s (1961) Presidential farewell address stressed that “we have been compelled to create a permanent armaments industry of vast proportions”, admonishing future generations to “guard against the acquisition of unwarranted influence, whether sought or unsought, by the military-industrial complex.” His warning came as a response to the shifting nature of the national defense strategy since World War II, but it has not held off the advances of that influence. Rather than approaching the defense of the nation an exercise in responsiveness to threat, by the end of the war, the strategy had become one of constant preparation. The military and industry combined their efforts in an attempt to keep the U.S. forever in a state of readiness. Since the period of World War II, the great

military mobilizations of the economy have lead to continuous military spending, even in times of peace. Higgs (1987, 2004, 2005a, 2006, 2012) has argued the case for the ratchet effects of crises, played out through time as the complex captures greater influence in fits and starts as it reacts to a given moment of crisis. His argument has not been wrong.

The economics profession has not entirely ignored Eisenhower's admonition. There have been studies on the effects of free enterprise in response to entanglement with the defense industry (Raymond 1964). The creeping political influence of the military-industrial complex has been analyzed (Melman 1970, 1971, 1985; Higgs 1987, 2005a, 2012). Methods of financing American foreign policy and their influence on the U.S. economy have been studied (Rockoff 2012). More targeted studies have been undertaken to discuss the costs of continuing the permanent war economy in areas such as the draft (Oi 1967; Friedman 1976; Henderson 2005) and lost productivity in terms of Gross National Product as resources move from the private sector to the military (Russet 1971; Higgs 1993, 2006).

Yet despite these efforts, the United States has maintained a permanent war economy (Oakes 1944; Melman 1971, 1985; Bacevich 2010) through the latter half of the 20th century and well into the 21st. At the end of World War II, the strong popular sentiment that U.S. troops should return to their families created the necessity for a short-lived demobilization (Biddle 2007: 141). After five years of brutal war that ravaged substantial portions of the world, even the interests who had grown powerful during the war effort could not prevent the respite. Yet in only three years, the growth of defense spending began again, and the security state coalesced into a conglomerate of specialized

interests. Beginning the upward trend in 1948, defense spending topped \$400 billion by 1952, and it has not fallen to levels below \$350 billion for any year since.¹ In a single decade of the 21st century, spending reached nearly \$8 trillion.² National security, both in terms of dollars and mentality, has bled into nearly every aspect of American life (Turse 2008), creeping into nearly every federal department (Mueller and Stewart 2011), into humanitarian efforts around the world (Coyne 2008, 2009), and even into domestic policing efforts (Coyne and Hall 2013). The continuing costs of this permanent defensive (and offensive) effort are overwhelming, and the necessity of rethinking current strategies remains.

In rethinking current national security policies, there are three main issues that need to be addressed. Each is intricately tied to the other. Firstly, the conceptual aspect of defense generally must be taken into account. In an economic sense, what does it mean to have the optimal amount of defense and what are the fundamental problems of the standard analysis? Secondly, even if the theoretical arguments of optimal defense are accounted for, what are the institutional arrangements that are necessary for continually achieving the efficient level of security and is the current U.S. arrangement capable of that achievement? Thirdly, what are the influences that lead from a more efficient arrangement to a less efficient one, and how does the American public ward against the institutional distortions of that influence?

¹ Amounts in FY2010\$. Source: White House Office of Management and Budget, Historical Tables, Table 15.4.

² Includes years 2001-2011. Source: "U.S. Security Spending Since 9/11," National Priorities Projects, May 2011 [<http://nationalpriorities.org/en/publications/2011/us-security-spending-since-911/>].

This dissertation extends the literature on the costs of current national security strategies in theoretic, contemporary, and historical economic analyses. Chapter 2 considers the optimality conditions of national defense, and argues that if defense is a public good and suffers from the inefficiencies of free-rider problems, then national aggression must suffer similar coordination failures and free-rider inefficiencies. If state provision of defense is intended to offset market underprovision due to coordination problems, then the existence of an underprovision of aggression must imply that current theories call for a greater amount of defense than is actually necessary. Chapter 3 goes further to consider the current defense spending allocation methods in the contemporary United States, showing why the military-industrial complex with its administrative price setting will overshoot even theoretically determined levels of defense. In the absence of true economic prices and a system of profit and loss, decisions of allocation must be made through non-market means which are subject to “cheating” through rent-seeking activities. Once these non-market decisions are made, overshooting the optimal level of defense distorts the entrepreneurial opportunities of the market, leading to further discoveries in the military sector of the economy and fewer in the non-military sector. Chapter 4 accepts the opportunities to engage in rent-seeking and argue that the current structure of the military-industrial complex arose from a concerted effort of special interests (unions, industry, and the military) to capitalize on the crises of the Great Depression and World War II to institute a system specifically for purpose of collecting said rents. Chapter 5 concludes.

CHAPTER 2: Dividing Conquer

“In spite of all the arguments in favor of great military forces, no nation ever had an army large enough to guarantee it against attack in time of peace or to insure its victory in time of war. No nation ever will.”

- Calvin Coolidge (1925)

1 Introduction

It is not an uncommon thought that national defense is one of, if not *the*, main provinces of the state. Without the protective capacities of the government, society would collapse into the jungle, where the chaos of statelessness would ensure that life remains “nasty, brutish, and short”³. Without a designed or emergent state ordering, mankind would forever be in the state of nature, unable to advance as a society for fear of fellow man violently relieving the prosperous of their property. It is this concern for violence, or the inevitability of such violence, that leads social theorists such as Nozick (1974), Cowen (1992, 1994), Holcombe (2004), and Cowen and Sutter (2005) to argue that an ordered anarchy will inevitably become unsustainable, leading to the rise of the state as a means of mitigating conflict.

The driving force behind such arguments is the idea that absent the enforcement mechanism of government the individuals who compose societies will fail to cooperate in

³ Quoted from Thomas Hobbes’s *The Leviathan*, Chapter XIII.

their own defense. Thus, the state apparatus must either emerge as a protective entity or be imposed by a subjugating outside force. As Holcombe (2004: 326) argues, “[w]ithout government – or even with a weak government – predatory groups will impose themselves on people by force and create a government to extract income and wealth from these subjects. If people create their own government preemptively, they can design a government that may be less predatory than the one that outside aggressors otherwise would impose on them.” Voluntary or otherwise, the end result of the coordination problem is the adoption of government.

Yet what happens to the strength of this argument when coordination mechanisms are applied consistently to both defense and offense? If individual defenders are unable to coordinate with one another in order to save themselves from the pillaging and plundering of others, then those individuals who would initiate attacks must also suffer coordination issues when beginning an invasion. As it stands, the literature on national defense implicitly assumes an asymmetric situation whereby invaders may collude to initiate aggression, but defenders may not cooperate in the face of said aggression. However, if the public good, or free rider, problem holds true, then it must hold true in a symmetric manner. If national defense is underprovided on the market due to free riding, then aggression must also be underprovided on the market due to free riding. The extent to which the respective underprovision of each will offset the other is indeterminate, as it is difficult to measure the extent of unseen coordinative activity in either case, but this indeterminacy does not invalidate the theoretical claim that there will be less than the “efficient” amount of aggression provided by the market.

There are, of course, those who argue that an anarchic society is achievable. The idea of an anarchic ordering has been examined favorably by economists such as Friedman (1989), Rothbard (1996), Stringham (2005, 2007), and Leeson (2007). Anarchy as a system has been explored in detail in works such as Powell and Stringham (2009), Tullock (1972, 1974), and Buchanan (1975). While this current work does not decisively end the debate, it does issue a challenge to the strength of the traditional argument of the state as efficiency enhancing.

The remainder of this paper will be organized as follows: Section 2 will reexamine national defense as a free rider issue and make the argument for the similarities is aggression. Section 3 will further develop the argument of aggression as a market failure at the national level, due to the potentiality of divided spoils of war. Section 4 will explore more fully a historical case of where such free riding on aggression has occurred, using the example of the fall of the last Anglo-Saxon king of England and what became the beginning of the Norman Conquest. Section 5 will provide some implications and conclude.

2 Public Goods and the Coordination of Alliances

A public good is one of microeconomic theory's classic examples of "market failure". Market forces, through individual welfare maximization, will be insufficient to provide the optimal amounts of a public good necessary to maximize social wellbeing. As defined by Sameulson (1954: 398) a public good is one "which all enjoy in common in the sense that each individual's consumption of such a good leads to no subtraction from any other

individual's consumption of that good." There is little room to deny the fact that national defense is a public good, as it satisfies the textbook characteristics of both non-excludability and non-rivalry in consumption. In standard microeconomic theory, such a public good will necessarily be under produced and, as such, under consumed on the unrestrained market (see Samuelson 1954, 1955; Gould and Ferguson 1980: 463; Kreps 1990: 168).

As an illustration, consider the case of a voluntary defense fund whereby individuals within a geographic region are not required to pay for their shared defense through taxation. Instead, each individual member of the given society is able to choose whether he wishes to pay for the defense of that geographic area, with "payment" granted either through monetary means or through the act of joining the militia. Should all other members of the area choose to participate in mutual defense, then the individual who is unwilling to pay will still receive the benefits of the protective actions of the group. If the nation is secure, then the individual who did not volunteer to contribute to the fund is also secure, regardless of his decision not to pay. The individual has every incentive to free ride on the actions of the others in society. Concurrently, every other individual within that society faces the same incentive structure. Given those incentives to free ride, the standard solution is for government to impose a system of taxation upon the populace, in order to avoid individual shirking, and to provide for the national defense itself.

It has been argued elsewhere that state provision may not be the most efficient, or "best", solution to the problem of free riding for defense. Samuelson (1954), himself, recognizes the difficulty in determining the optimum taxation for public goods even as he

advocates that such an optimum does theoretically exist. Hummel and Lavoie (2007) and Holcombe (2008) acknowledge the motivational concerns inherent in the determination of the appropriate level of national defense. While these works, at least the latter ones, may contest the efficiency of the government solution, they do not directly contest the market failure aspect of national defense. The current article will continue in this regard, holding to the theoretic claim that due to collective action problems national defense will be underprovided on the market. Yet it is insufficient to conclude that defense will be underprovided and let that be the end of it.

In the midst of an exchange concerning the sustainability (or lack thereof) of a stateless society, Cowen and Sutter (1999, 2005) argue that libertarian anarchists' claims⁴ of cooperation outcompeting collusion in the unrestrained market suffer from a problem of asymmetric assumptions. In weighting the ability to cooperate as greater than the ability to collude, the anarchists in question impute too much of their own valuations onto the outcomes they favor. As Cowen and Sutter (2005: 109) note, "[i]f civil society can use norms to enforce cooperative solutions, that same society will be prone to certain kinds of cartels. In other words, cooperation-enhancing social features will bring bad outcomes as well as good outcomes." A similar argument can be made against the asymmetric assumption of non cooperation-enhancing social features. If the claim of national defense as a public good is centered on the economic concept that individual

⁴ Cowen and Sutter provide the asymmetry argument in their 1999 article in *The Review of Austrian Economics*. Caplan and Stringham (2003) provide a response, arguing that Cowen and Sutter do not properly distinguish the differing outcomes of playing a Prisoner's Dilemma and playing a Coordination Game. Cowen and Sutter (2005) offer a rejoinder to that critique. For the entirety of the debate, see *The Review of Austrian Economics* or Stringham (2007).

defenders will be unable to sustain cooperation in order to provide for their own security, then it must also be true that individuals cannot collude to form alliances (cartels) in order to provide for a heightened level of aggression. To claim one is to claim the other, as the same or similar organizational features must exist in either case. Therefore, in order for an aggressive action (i.e., attack) to take place, each individual must either overcome the same coordination problem faced by the defenders or the individual must be able to fully internalize the gains from the aggression.

It is important to note that aggression is not considered a public good from the standpoint of society as a whole. Violence is largely considered an economic “bad” from that viewpoint. However, when considering aggression from the standpoint of aggressors, then at least for those who desire to plunder and pillage the aggression takes on the characteristics of a public good. For those attacks in which all gains can be fully realized by the attacking party, aggression will commence. However, when such is not true, and the attacking party is unable to internalize the entirety of the gains, attacks will be underprovided. In order to illustrate this point, consider the hypothetical interactions between individuals involved in an alleyway mugging.

Firstly, consider the case in which there is a single mugger, whom we shall call Adam, and a single victim, whom we shall call Bob. Bob enters an alleyway at night, leaving the relative safety of the streetlamps. Once he is beyond said safety, Bob is set upon by Adam. Adam engages Bob in violent conflict, proceeding to use a nightstick and fists to subdue the victim. In this instance, Adam is able to claim victory over Bob and relieve him of his wallet, watch and all other possessions of worth. As Adam is the only

aggressor here, he is able to fully internalize the benefits of the attack. He desires to plunder Bob's riches, takes it upon himself to do so, bears the full costs of the aggression and reaps the full reward of his action.

Secondly, consider the case in which Adam is not alone in his desire to plunder Bob. A third individual, who we shall call Carl, is also interested in the riches that Bob currently possesses. In this instance, when Bob exits the relative safety of the streetlights, he is once again set upon by Adam. Adam once again engages Bob in violent conflict and subdues him. However, in this second case, as Adam is stripping Bob of his possessions, Carl, who has watched the struggle from a safe vantage point further in the alleyway, is able to take advantage of Adam's efforts and Adam's preoccupation with looting. While Adam is engaged in taking Bob's watch, Carl is able to come away with Bob's wallet. The end result is one where Adam, who initiated aggression and bore the full cost⁵ of his attack, is unable to fully realize the gains from his actions. Instead, Carl, who as remained risk free, or at least remained in a position of lowered risk, is able to free ride on the actions of Adam without bearing the cost of subduing Bob himself.

In the essence of symmetry, the necessity of which is described above, the free rider incentives that make Carl unable to come to Bob's aid also make Carl unable to come to the aid of Adam. In the simplified case of the muggers, the argument is that if Bob and Carl cannot *cooperate* to prevent Adam's aggression, then in the same vein, Adam and Carl cannot *collude* to ease the burden of aggression towards Bob. It is in

⁵ Costs in this case would be measured by Adam's risk of loss, his amount of pain received in the fight, his time spent in battle, etc.

Carl's interest to remain neutral during the conflict, waiting until Bob is sufficiently subdued and Adam is sufficiently engaged in the process of subduing or looting, and then acting to claim spoils. Once that point is reached, Carl will plunder as much as he is able from Bob.

3 The Spoils of War, Free Riding at the National Level

The concept presented in the previous section is not limited to the individual mugging. The simple framework can be expanded to encompass societal-wide situations. In a world of nation-states, issues of free riding and externalities can still exist with respect to the costs and benefits of aggression. Situations of conflict between three tribes or nations can exhibit the same characteristics as those of the mugger, albeit on a far larger scale.

At this point, we can discontinue discussion of examples where two nations interact. Though these interactions are analogous to that of Adam and Bob when only the two are present in the alleyway, it can be concluded that in the two nation game, the aggressor will invade whenever said nation is able to internalize the benefits of invading another so long as those benefits outweigh the costs of the invasion. Instead, we will focus on an expansion of the second case which involves the interactions of three nations. We can also, at the moment, discontinue discussion of situations in which nations either cooperate or collude for the reasons given in the previous section. As coordination is theoretically predicted to break down, the case of most interest is the one in which one nation engages in aggression upon another, but is unable to internalize the full benefit of that aggressive action. For the purposes of the forthcoming analysis, hypothetical nations

A, B, and C will correspond to the roles of hypothetical Adam, Bob, and Carl, respectively.

Suppose, then, that nation A undertakes an invasion of nation B. War is costly endeavor, for both the aggressor and the defender. The initial attacks upon B must necessarily weaken B, causing the nation expend scarce resources in an attempt to stave off the conquest of its people. Men and materials will be fed into the engines of war, withdrawn from the pool of resources to be used in future endeavors.⁶ If A is unable to complete the conquest *and secure its newest borders from those outside the engagement*, then each attack that weakens the military capabilities of B is in part a benefit to those nations that are currently *not* expending resources. The resources that A uses to weaken B, while nation C is content to wait and watch, is at least a partial benefit to C. Once B has been sufficiently weakened, C is able to enter B and escape with spoils of war, spoils C was able to gather in large part due to the military efforts of A. As a brief historical illustration, consider the outcome of the Seleucid (nation A) invasion of Bactria (nation B) in 167 BCE, and the gains that Parthia (nation C) was able to receive from the Seleucid initiative.

Following the death of Alexander the Great (323 BCE) without naming a successor, his former generals warred with one another for the throne. While none managed to achieve the full authority of Alexander, the wars resulted in a number of smaller states emerging under the fragmented leadership. Of these smaller states, one was

⁶ See Higgs (2006) for a discussion of the tradeoffs between “butter-sacrificing” versus “butter-enhancing” economic activity during military mobilizations.

to be controlled by the descendents of Seleucus I Nicator⁷ (Philips and Axelrod 2005). By 256 BCE Bactria—formerly one of the Seleucid controlled regions—had grown in power and prosperity through trade contracts with China and became an independent state (Philips and Axelrod 2005; Kohn 2007: 53). Over the next century, Bactria’s continued profitability helped it to remain strong, but it also incentivized surrounding states, such as the remaining Seleucid kingdom and Parthia, to take an interest. As Philips and Axelrod (2005: 160) describe,

the Seleucids invaded Bactria [in 167 BCE] with an army led by Eucratides (d. 159). They were met by Demetrius (200–167), the Greek-descended ruler of Bactria, who was unable to turn back the invaders. Demetrius was killed in action, and the Bactrians were routed. Eucratides assumed the throne of Bactria in the name of the Seleucid Empire, but the travails of Demetrius led to much disorder, a fact that Mithradates I (r. 171–138) of Parthia took advantage of by invading Bactria’s border regions around 167 and raiding Eucratides’ army. The nearly decade-long war that followed between Seleucid Bactria and Parthia proved inconclusive, save for some small gains by Parthia in the Turanian border region...

As Harmatta, et al, claim in describing the history of the war, the “Parthian ruler Mithradates I made clever use of these favourable [sic] circumstances. In the east he attacked Bactria and took from it a number of dependent regions” (1994: 128). As conflict erupted in Bactria, Mithradates I was able to take portions of Bactria while the Bactrian armies were preoccupied with the Seleucid invasion.

Of course, there is a range of benefits that may accrue to C. It could be that C attains an actual portion of land that formerly belonged to B, as was the case with the Bactrian example. There is also potential for more modest gains to C. These gains may

⁷ Seleucus I Nicator was born c. 358 and died in 280 BCE (Philips and Axelrod 2005).

come from a “smash and grab” tactic, whereby C uses the opportunity provided by A’s military intervention to raid the productive capacities of B. Though the payout to C may vary, it remains true that A expended resources at some cost to itself but was unable to retain the entirety of the property rights it sought to attain from that expenditure. Nation C is able to free ride on the efforts of A, taking advantage of the lack of security in the rights to the spoils.

There are also historical cases where the delineation of A and B are blurred. Even in these cases, though, the free rider aspect still exists. An illustration of this situation can be seen in 17th century Malaysia with the power struggles between Portugal (A/B), the Netherlands (B/A) and Aceh (C). It was during this period that “the Portuguese chased the Dutch out of Malacca and the Dutch did the same to the Portuguese in east Indonesia” and the “sultan of Aceh (or Achin)—an independent province in northern Sumatra—rushed to fill the vacuum” (Philips and Axelrod 2005: 8). While the Portuguese warred with the Dutch/Johor over their respective economic and colonial interests in Malaysia, the Sultan Iskandar Muda⁸ was able to consolidate the power of Aceh to control the region for a brief period. In Ricklefs’s (1993: 34) account, he describes how “Sultan Iskandar Muda established [Aceh] for a short time as the major power of the western archipelago” when “[i]n 1612 he took Deli, and in 1613 Aru” and “[i]n 1613 he also attacked and defeated Johor.”

Not long after it was taken by Aceh, Johor was able to reestablish its independence by gathering allies to its cause, “[b]ut Iskandar Muda’s aggressive

⁸ Sultan Iskandar Muda reigned in Aceh from 1607 to 1636 (Ricklef 1993: 34).

campaigns continued. In 1614 he defeated a Portuguese fleet in Bintain; in 1617 he took Pahang and carried its Sultan Ahmad Syah; in 1620 Kedah was conquered; in 1623 he again sacked the Johor capital; in 1624/5 he took Nias” (*Ibid.*). The Portuguese finally managed to bring about a major defeat of Iskandar Muda in 1629, largely ending Aceh’s expansion in Malaysia (*Ibid.*). Though the eventual outcome would go against Aceh, Muda was able to exploit the military efforts expended by the Portuguese and Dutch against one another and, for a time, plunder the region.

Other exploitations may last for much longer. The history of the Norman Conquest, whereby William the Conqueror became the king of England, is well known. Historians often focus on the Battle of Hastings in 1066, in which William’s invading force defeated the English defenders and secured the throne for the Normans. However, William was not the first foreign army to invade England that year. The Norwegians were able to land on English soil before him, but William was able to capitalize on their failed efforts in order to gain the English crown for himself.

4 The Fall of the Anglo-Saxons, 1066

After the death of Edward the Confessor⁹ in 1066, Harold Godwinson was crowned as the King of England. Edward fell ill in late 1065, entering a coma and succumbing to death on January 5, 1066. The following day, Harold took the kingship for himself. His reign would be fiercely contested and, as a consequence, short. Harold’s kingship lasted

⁹ Edward the Confessor reigned in England from 1042 to 1066. For more on the death of Edward and reign of Harold, see Giles (1914), Lawson (2003), and Thomas (2008).

only from January 6 to October 14 of the same year. His eventual fall would mark an end to the line of Anglo-Saxon kings of England as the Norman William would come to power. Though in the end he would lose the English crown, as well as his life, Harold would first successfully defend it.

4.1 Some Historical Context

While there is conflicting evidence as to whether or not the oath was made under duress, before the death of Edward, Harold gave his word to William I, Duke of Normandy, to support William's claim to the throne upon the reigning king's death¹⁰. Edward had once named William as his heir, though there is some evidence that Edward may have changed his mind in that regard during his later years of life¹¹, perhaps even naming Harold as the new heir (Thomas 2008: 23-25). Whatever the truth of rightful succession, Harold would renege on his oath to William after Edward's death, taking the throne for himself. Lawson (2003: 33) argues that "[b]y 1066, if not by the time of his visit to Normandy [a year or two previously], Harold had probably decided that he would take the throne whatever Edward's wishes" even though "[h]e had, of course, broken his oath to William

¹⁰ Lawson (2003: 26-33) explains several possibilities for the oath of Harold to support William on Harold's travel to Normandy in 1064 or 1065. It is known that Harold was captured by Count Guy of Ponthieu and imprisoned until William was able to secure his release. One possibility is that Harold was sent as an envoy of Edward to reconfirm William's claim to succession, and that he was captured by Count Guy as he landed in Ponthieu on his way to Normandy. A secondary possibility is that Harold traveled to Normandy to give his oath in order to secure the release of Godwin hostages held by William, was blown off course to Ponthieu. After William secured his release, Harold was encouraged to support William's claim in return for the release of said hostages. Yet another possibility, though Lawson argues its improbability, is that Harold was fishing in Channel and a storm blew him to Ponthieu, whereby he secured his release by pledging to support William.

¹¹ In 1054, Edward the Confessor had sent for Edward the Exile, possibly in order to name him as successor. It would take some time to find him, and he would not return until 1057. Within days of his landing in England, even before he could see the king, Edward the Exile died, leaving the succession in contention once again. (Henshall 2008: 164).

and must have known that he would have to fight to maintain his position”. The speed with which Harold had himself declared king hints that he either knew that his crowning would be contested or that he had no legitimate claim to the throne in the first place (Lawson 2003: 31-32). Whichever the case, the contestation would be forthcoming, though William would not be the only contender.

In the year preceding Harold’s coronation, his brother, Tostig, lost his earldom of Northumbria to rebellion and was exiled.¹² The Northumbrians ousted Tostig, replacing him with Morcar as the new Earl. Declaring Tostig an outlaw, Morcar combined his army with that of his brother, Edwin the Earl of Mercia, to force Tostig and his family into fleeing. King Edward supported both the ascension of Morcar and the exile (Lawson 2003: 32). After Edward’s death, however, Tostig returned to raid into Northumbria and Mercia, though the earls would manage to once again defeat him. In *The Anglo-Saxon Chronicles* the episode is recorded, describing how “came Tosty [Tostig] the earl into Humber with sixty ships; and Edwin the earl came with a land-force and drove him out. And the boatmen forsook him; and he went to Scotland with twelve vessels (Giles 1914: 138)”. The earls of Northumbria and Mercia, with the support of Harold, were able to

¹² The 1065 rebellion was not Tostig’s first experience with exile. The Godwin family had previously been banished or fled into exile in 1051. Godwine, father of Harold and Tostig, had married his daughter to Edward, supporting his succession to king. However, Godwine had previously been implicated in the death of Edward’s brother, Prince Alfred, the implication of which placed Godwine in a precarious political position. This position became more than precarious when, in 1051, Godwine refused an order from the king to lay waste to the township of Dover in response to a political challenge between the township and visitors from Normandy. Upon the refusal of Edward’s command, Godwine lost the support of his non-familial earls, causing him and his family to flee. Godwine and his family were able to rally support and return to England through the use of arms in the following year. The show of force was sufficient to lead Edward into making a deal with Godwine and restoring him to a place of favor. By 1053, upon Godwine’s death and Harold’s ascension to ruler of the Godwineson family, Tostig had gained the position of Earl of Northumbria. (Thomas 2008: 14-16)

soundly defeat Tostig, sending him to exile a third time (Thomas 2008: 32). While he was never a serious threat to Harold's claim of kingship, Tostig's defeat would become important. After the earls managed to send him from England again, Tostig fled to Scotland, where he would meet with the Norwegian king Harald Hardraada¹³ and pledge himself as the king's man. The Norwegian king would become far more of a threat to Harold than Tostig's small raids ever presented.

4.2 *The Battle of Stamford Bridge*

Not long after uniting with Tostig in Scotland, Harald Hardraada sailed into the Tyne with 300 ships (Giles 1914: 138; Lawson 2003: 36). Henshall (2008: 184) gives the approximate size of the invading Norwegian forces, noting that

Tostig only had his 12 remaining ships, though possibly some also from Malcolm, and Copsig his 17. Hardraada by contrast appears to have had some 300 vessels and around 10,000 or more men. It was obviously an uneven partnership in those regards. Tostig's real value was surely his local knowledge and no doubt a claimed support-base.¹⁴

On September 20, 1066, Harald engaged the earls of Northumbria and Mercia to the south of York, and with the aid of Harald's horde, Tostig was finally able to achieve victory of Morcar and Edwin. Though *The Anglo-Saxon Chronicle* provides only a general account of the battle, Lawson (2003: 36) describes how "the English made great slaughter, but themselves had a great number slain, drowned or put to flight, and that the

¹³ Giles (1914: 138) refers to Harald as Harold King of Norway and Harold the Fairhaired. For other references to the association of Tostig and Harald, see Lawson (2003) and Thomas (2008).

¹⁴ Henshall (*Ibid.*) notes that Tostig's claim of support was exaggerated, as the people of Scarborough rose to oppose the landing quickly, though the town's resistance was unsuccessful.

Norwegians remained in possession of the field”.¹⁵ With this victory, Harald was able to take hostages from York and begin his negotiations for pressing a claim to the throne of England.

In response to the Norwegian invasion, Harold, still king of England, gathered his army and quickly marched north. Harold’s army marched day and night, coming upon Harald’s army while it was still unprepared for the arrival of a new defense force. Leaving nothing to chance, Harold “had his personal elite-warrior housecarls with him, possibly as many as some 3000 mounted men. In addition he presumably gathered men along the way north” (Henshall 2008: 185). A notable 12th century historian, Henry of Huntingdom, documents that the English had superior numbers to the Norwegians by the time that they arrived at Stamford Bridge (Forester 1853: 209).

Due to his rapid response, arriving only five days after the defeat of his earls, Harold’s force was able to catch Harald and Tostig unaware on the east bank of the Derwent River. Harald, having just won the field, left part of his army behind as he went to negotiate with the leaders of the surrounding area. The Norwegian king had not expected Harold to have made the 200 mile march from southern England with such speed. He was surprised as Harold’s army presented itself on the field on September 25th. The ensuing losses were heavy on both sides. Henshall (2008: 286) argues that the element of surprise and the division of the Norwegian army were key factors in the battle, noting also that “Hardraada himself seems to have been killed relatively early, by an

¹⁵ Lawson (*Ibid.*) states that the Icelandic sagas, namely *King Harald’s Saga*, gives a more detailed account of the battle, but the authenticity of reports from the sagas are highly contentious, and that it is enough to note that the battle was fierce with great losses on both sides of the field.

arrow in the throat.” The remainder of Harald’s forces were called to the bridge and arrived late in the battle. Even these reinforcements were not able to turn the tide against the English, and the Norwegians were forced to retreat across the river¹⁶. Fighting continued late into the day, where “Harold Godwineson’s army suffered heavy casualties but won a decisive victory, slaughtering the majority of Harald’s warriors on the battlefield or as they fled to their ships” (Thomas 2008: 34-35).

By the end of the battle both Harald and Tostig had been slain, and Norwegian casualties had been exceptionally high. Of the three hundred ships that arrived with the initial invasion, only twenty four were needed to carry the remnants of Harald’s army home to Norway (Giles 1914: 138; Lawson 2003: 39; Henshall 2008: 191).¹⁷ Harold, having successfully defended his crown, returned to York to allow his army to rest and celebrate the great, though costly, victory of the Norwegian invaders. The king and his forces were still there three days later when William landed his army at Pevensey in Sussex, 200 miles to the south.

4.3 *The Battle of Hastings*

As Thomas (2008: 35) describes, Harold’s

¹⁶ Huntingdom describes the scene, recording “Being driven across the river, the living trampling on the corpses of the slain, they resolutely made a fresh stand. Here a single Norwegian, whose name ought to be preserved, took post on a bridge, and hewing down more than forty of the English with a battle-axe, his country’s weapon, stayed the advance of the whole English army till the ninth hour. At last some one came under the bridge in a boat, and thrust a spear into him, through the chinks of the flooring” (Forester 1853:209). Though the story may have some exaggeration, Henshall (2008: 188) notes that other historians, including the *Anglo-Saxon Chronicles* and William of Malmesbury, have stated that a lone warrior did manage to cause “disproportionately numerous casualties and a disproportionately long delay, which gave time to the Norwegians to draw up formations” (*Ibid.*).

¹⁷ At the end of the battle, Harold had mercifully allowed one of those ships to carry home Harald’s son, Olave, after Olave had pledged himself to peace with England (Giles 1914).

march north allowed William to land largely unopposed¹⁸ in southern England. On September 27 the Norman fleet left St. Valery, and on September 28 the Normans landed in Pevensey...Taking no chances, William's forces built a castle at Pevensey, using old Roman fortifications as a basis. The English did not dare to attack William's main force, so he moved without serious incident to Hastings.¹⁹

Harold responded to the new threat in much the same fashion as he did the last, marching quickly south to meet William's invasion force. The sizes of the armies gathered for the Battle of Hastings are largely suspect, with the range given anywhere from few than 10,000²⁰ to the unbelievable and impossible number of 1,200,000 in Harold's army alone (Lawson 2003; Thomas 2008).

The precise size of the armies is less important than the geographical position in which Harold had been left due to his northern venture. His army, even after gathering more levies on its way south, would have its core troops battered and exhausted from the forced day and night march north, the fierce and protracted battle at Stamford Bridge, and the subsequent forced march back to the south. Not only was the general shape of his army a concern, but Harold's absence had also allowed William to deploy his forces unopposed and assemble his defenses against Harold's approach.

Even with his disadvantages, Harold was able to seize the high ground early on and make use of his position.²¹ Seizing the ridge and deploying his infantry in a tightly

¹⁸ A small number of William's ships landed in Romney, away from the main force, and the English destroyed their crews, showing that the coast was not entirely undefended (*Ibid.*).

¹⁹ Thomas (2008: 35) also notes that upon arriving at Hastings, William's army built a "motte-and-bailey castle, which was basically a huge mound of dirt with a wooden tower on top and a courtyard below defended by fences and ditches."

²⁰ Fuller (1996: 167) estimates the number of Harold's troops as ranging from 6,300 to 7,500.

²¹ Thomas (2008: 39) notes that the "Battle of Hastings did not happen at Hastings but several miles away at a spot in the countryside now occupied by the beautiful village of Battle." The battle took place on October 14, after the march south.

packed formation allowed Harold to counter the advantage of William's greater cavalry strength. The Normans fought with heavily armored cavalry, but the ridge forced the horses to slow on their approach, diminishing their strength and effectiveness (Thomas 2008: 39). The battle, much like the previous one at Stamford Bridge, was hard fought with both sides of the field suffering high casualties. At one point during the fighting, it appeared that the Normans were on the verge of defeat. Word of William's death spread through the Norman army in demoralizing fashion, though the Duke had not actually died (Lawson 2003: 16; Thomas 2008: 40-41). As William's troops began to fall back, the English troops pursued in hopes of a similar ending to that of the Norwegians. Thomas (2008: 41) describes how "some of Harold's warriors pursued the Normans while others did not, and thus the Normans were able to turn back from their retreat and easily strike down many of their enemies" and how "this accidental strategy worked so well that William's men began pretending to flee in order to trap more unwary English fighters and weaken the English still further". As William rode back into the fighting, helm open to allow his troops to see his face and recognize that he still lived, the Norman force began to rally.

With his troops rallying at the sight of him, and the success of the tactic of feigning retreat, William's army was able to continue to weaken the English lines. Ultimately, though, it was the death of King Harold that would ensure the English defeat. The actual accounts of Harold's death are varied (Thomas 2008: 42), but what is known is that Harold's brothers, both earls, died earlier in the fighting. Harold's own fall left the English army virtually leaderless. They were able to rally one more time, but William's

forces overran them once again. As night fell, remnants of the English army were able to escape, though the main force had suffered a heavy cost through the Battle of Hastings. The fall of King Harold and the victory of William at Hastings would ensure William's eventual rise to the crown that Harold's oath was supposed to have granted him previously. The Norman Conquest would continue for some time, but after the devastating battle the most stringent defenses had already been overcome.²²

Given the historical notes of how hard fought the battle was (Morillo 1996; Lawson 2003; Henshall 2008; Thomas 2008) it is not improbable that had Harold's army been rested and at full strength, or had the English been present and able to inflict serious casualties on William's forces as they landed, the outcome of the invasion may have been quite different. There is evidence that William planned for such an occurrence, holding off from his attack and waiting until Harald's Norwegian army had inflicted sufficient damages to the English defenses²³. If so, William both allowed himself to take advantage of the Norwegian efforts and avoided providing the Harald the benefits of his own. In terms of the model from Section 3 above, Harald's Norwegian army (A) threw itself against the English forces (B), causing a weakening of Harold's defense. William's forces (C) were able to capitalize on these efforts, using the weakened position, both in

²² Thomas (2008: 44-45) describes the ease that the campaigns immediately following Hastings were won by William, including retribution at Romney for the losses of his ships upon landing. William was officially crowned on Christmas Day in 1066. From 1067 to 1071, there were a number of English revolts against the Norman kingship, but William was able to crush each rebellion with varying degrees of effort. By the last, in 1071, Norman rule was secured.

²³ Thomas (2008: 32) alludes to this possibility and "some historians" who argue it to be true, though he, himself, discounts its likelihood as William would have had difficulty keeping his intent a secret or keeping his army from suffering diseases during a long, intentional delay.

terms of military strength and geographical location, to initiate and conclude the Norman Conquest of England in 1066.

5 Implications and Conclusion

The military efforts of another can be greatly influential in whether or not one achieves a victory, even if that other is unaware of it. To think that such concerns are not known to parties involved would be to assume a great ignorance on the part of military leaders who have shown anything but. Skilled leaders of war will recognize the gains from having two enemies expending military resources upon each other. Those same leaders will also recognize that losses to themselves and the gains to their enemies should war be entered hastily. The examples given, as they are examples of when such wars took place and free riding actually happened, may seem to cut against the idea that fewer wars take place due to these externalities. However, the existence of a few counterfactuals merely illustrates the existence of the availability of free riding. It does not disprove the theory. There are counterfactuals to the breakdown in national defense as well, but the theory still holds in general.

One possible implication of the free rider problem as applied to aggression is that the size of the state matters for offensive as well as defensive purposes. While it is fairly evident that a strong military is better able to protect its corresponding nation, it is also true that a strong military is better able to secure the benefits of an offensive strike. The negative correlation between a large defense sector and the amount of foreign invasion into one's territory may also be offset to some degree by the positive correlation between

a large military sector and a domestic invasion into a foreign territory. The more fragmented and smaller nations are as a whole, the greater the likelihood is that an invading force will not be able to internalize the full benefit. The actual effect of this scenario would be indeterminate, given the interplay between sizes of A versus sizes of B versus sizes of C. It may be possible that smaller nation-states lead to higher probabilities of dividing the spoils, which leads to greater free rider problems and furthers the underprovision of aggression.

Another implication is that increases in technology may increase the level of spillover. A missile creates spillovers beyond its initial attack by weakening the recipient of the aggression. Destructive power, especially from a distance, may create further opportunities for observing nations to enter into the looting phase of attacks. Consider, for example, the entrance of the insurgency into Afghanistan and Iraq after the U.S. invasions. Each missile that falls weakens and distracts the defenders, allowing others to free ride on the U.S.'s resource usage.

The focus of this argument has been the asymmetry between the assumptions of externality arguments between defending and aggressing. To that end, the major implication of this line of research is that it is not necessary to have the "efficient" amount of national defense given that there will not be the "efficient" amount of national offense. Due to the very concern over the nature of free riding that leads many economists to be suspicious of the sustainability of ordered anarchy, that suspicion should be at least in part mitigated. If there is an inefficient amount of cooperation of a defensive nature, then the same free rider argument implies there is an inefficient amount

of collusion of an aggressive nature. The economic arguments have thus far been one-sided, but it is always a worthwhile endeavor to examine all sides of the issue.

CHAPTER 3: The Overlooked Costs of the Permanent War Economy
(Written with Christopher J. Coyne)

“In the councils of government, we must guard against the acquisition of unwarranted influence, whether sought or unsought, by the military-industrial complex. The potential for the disastrous rise of misplaced power exists and will persist.”

- Dwight D. Eisenhower (1961)

1 Introduction

In 2010, the United States government spent more on national defense (\$738.8 billion) than it did at the height of the Cold War spending in 1986 (\$572 billion), when the U.S. was competing in an arms race against the then superpower U.S.S.R.²⁴ Rather than facing the threat of a large, consolidated enemy such as the Soviet Union, the U.S. is currently focused on two foreign wars against smaller, decentralized enemies in Afghanistan and Iraq, as well as the seemingly endless transnational War on Terror. Of course, it is not only the public sector that has increased spending for defense purposes. Mueller and Stewart (2011: 4) indicate that private sector spending for homeland security has increased by \$110 billion between 2001 and 2011.

The business of ending terrorism is a thriving one, and Eisenhower’s military-industrial complex thrives along with it. Yet what is the true cost of this thriving

²⁴ Data Source: White House Office of Management and Budget, Historical Tables, Table 15.4. The monetary values are presented in 2010 US dollars.

complex, where the government and the private sectors intersect? The central argument of this paper is that the costs of that intersection have so far been understated, as they do not take into account the full forgone opportunities of the resources drawn into the war economy. The opportunity costs are far more extensive than those counted simply in defense spending budgets. Indeed, once the United States entered into the state of permanent war, starting with World War II, a new equilibrium was established whereby resources are continuously drawn from the non-military sector to support and advance military-related activities in what has become a “permanent war economy.” The permanent war economy leads to a reshaping of the private economy through a process that can be summarized as follows.

A state of permanent war leads, inevitably, to a larger military and more military expenditures. The redirected resources dedicated to the military sets in motion a process whereby private market activity is distorted as private actors respond to the opportunities presented by a state of permanent war and adjust their behaviors to take advantage of new profit opportunities. As the state of permanent war persists, the private economy becomes increasingly intertwined with the state. The result is a bloated corporate state and a less dynamic private economy, the vibrancy of which is at the heart of increased standards of living. Therefore, in undermining the private economy, the permanent war economy ultimately stifles the process of wealth creation harming the well being of citizens. The purpose of this paper is to flesh out how this distortive process operates. In doing so, we highlight a cost of the permanent war economy that is typically overlooked when discussing the costs of the U.S. military.

The concern over the military-industrial complex is not a new one. As the opening quote indicates, in 1961 President Dwight Eisenhower warned of the need to maintain vigilance against what he termed the “military-industrial complex.” Indeed, he explicitly recognized the rise of a permanent war economy when he noted that:

[W]e 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. We annually spend on military security more than the net income of all United States corporations.

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. We recognize the imperative need for this development. Yet we must not fail to comprehend its grave implications. Our toil, resources and livelihood are all involved; so is the very structure of our society.

Eisenhower’s warning came as a response to the shift in the way the nation’s defense had been undertaken since World War II. By the end of the war, the idea of defense had become one of constant preparation for future wars and foreign interventions rather than an exercise in response to one-off threats. The military and private industry combined their efforts in an attempt to keep the U.S. forever in a state of military readiness. As per Eisenhower’s speech this paper analyzes some of the “grave implications” of the military-industrial complex for the structure of the private economy.

The economics profession has not let Eisenhower’s words go entirely unheeded. Raymond (1964) argues that free enterprise becomes less free as it becomes more associated with the defense industry. In the name of national security, businesses dealing

in defense come under the direct scrutiny of the Pentagon and its industrial security officer, increasing the red tape and overall costs of doing business. Melman (1971) explores the role of Robert McNamara in centralizing the military-industrial complex beneath the Department of Defense and explains how political clout becomes the currency of the complex. The later work of Melman (1985) builds upon his earlier piece, giving an in-depth description of how the permanent war economy furthers the politicization of those involved in the complex. Higgs (1987; 2004; 2005a; 2006; 2012) describes how the state derives its power from historical crises, especially wars, growing in size to deal with each one and never quite giving up as much power as it gained once the crisis passes. This pattern gives rise to what he refers to as the “ratchet effect,” with incremental growth in state size and authority over time. Finally, Rockoff (2012) analyzes a century of American foreign policy to understand how these efforts were financed in order to understand how war has influenced the U.S. economy.

Neither has the idea of opportunity cost gone entirely unrecognized in the economics literature on national defense. Economists as early as Adam Smith recognized that war is a costly endeavor, and an empire that grows too large will find itself difficult to protect. In writing on the costs of protecting and enforcing British imperialism he notes, “The interest of this [military] debt alone is not only greater than the whole extraordinary profit which it ever could be pretended was made by the monopoly of the colony trade...” (Smith 1776: 180). The efforts to both protect and intimidate the satellites of the British Empire were bankrupting the Empire itself. In more modern economics, Oi (1967), and later Henderson (2005), acknowledge the understated costs of

the military draft that was kept in effect in the United States until 1973. Milton Friedman (1976), along with the aforementioned writings of Oi and Henderson, argue that the budgetary cost for military personnel during those draft years was understated due to its failure to take into account the opportunity cost in terms of the voluntary private employment forgone by the draftees.

There are also attempts to calculate the forgone opportunities of resources used in the military-industrial complex. Russett (1971) uses Gross National Product (GNP) calculations to estimate first the losses to productivity in the private sector and then the losses to investment in other areas of the public sector. Higgs (2006) constructs similar calculations of GNP to make the distinction between “butter-sacrificing” during military buildup and “butter-enhancing” during a demobilization period. He shows empirically that “[c]hanges in the [Government Military] and [Private] shares [of Gross National Product] were almost exactly offsetting. A trade-off equation fitted to the annual changes during 1948–89 has a tight fit ($R^2 = 0.814$) and shows that the implicit cost of a one-percentage-point increase in the military share was a reduction of one percentage point in the private share” (Higgs 2006: 132).

Yet even these previous works do not tell the full story. While mobilizations and demobilizations will have tradeoff effects, it does not speak to the full costs of a *permanent* war economy. The permanency of the war economy means that the distortions last far longer, and extend far deeper into the private economy, than those suffered in the emergency of actual war. An accounting measure of the economy cannot fully realize the foregone alternatives in entrepreneurial activity. The advent of the permanent structure of

the military-industrial complex introduces a situation that creates “pure profit opportunities that would otherwise have been absent” which “simultaneously reduce or possibly eliminate other opportunities for pure profit that might otherwise have existed” (Kirzner 1985: 144). The new equilibrium establishes incentives to further invest in military-related activities, creating further divergence from what would have been and thus greater costs in terms of forgone opportunities.

The remainder of this paper is organized as follows. Section 2 provides some indicators of the magnitude of the permanent war economy with the purpose of highlighting the resources that are redirected from the non-military to the military sectors. Section 3 explores the changing equilibrium in terms of Kirzner’s (1985) un-simulated, stifled and superfluous discovery processes, then analyzes the encroachment of the permanent war economy upon the non-military economy in terms of the dynamics of interventionism (see Mises [1920] 1990, [1929] 1996, [1949] 2007; Ikeda 1997, 2005). Section 4 concludes with the implications of our analysis.

2 The Permanent War Economy

In his analysis of American foreign policy over the past several decades, the historian Andrew Bacevich (2010) concludes that the U.S. has been in a state of “permanent war.” This state, which began during the Second World War, is defined by a global military presence and projection of power through constant foreign interventions under the rhetorical guise of maintaining international “peace and order” (Bacevich 2010: 14). This state of permanent war is sustained

by a massive military complex which consists not just of the existing government bureaucracy, but also of think tanks, lobbyists, security experts, and businesses that provide the complex with technocratic advice and resources to maintain its global presence. To begin to understand the magnitude of this reality, consider the following data.

The United States routinely spends more on defense than any other nation. To be more accurate, the United States is responsible for nearly half of all world military spending. Friedman and Preble (2010) and the International Institute of Strategic Studies (2010) show that U.S. transactions in 2008 accounted for 48 percent of military spending around the globe for that year. Figure 1 provides a breakdown by region.

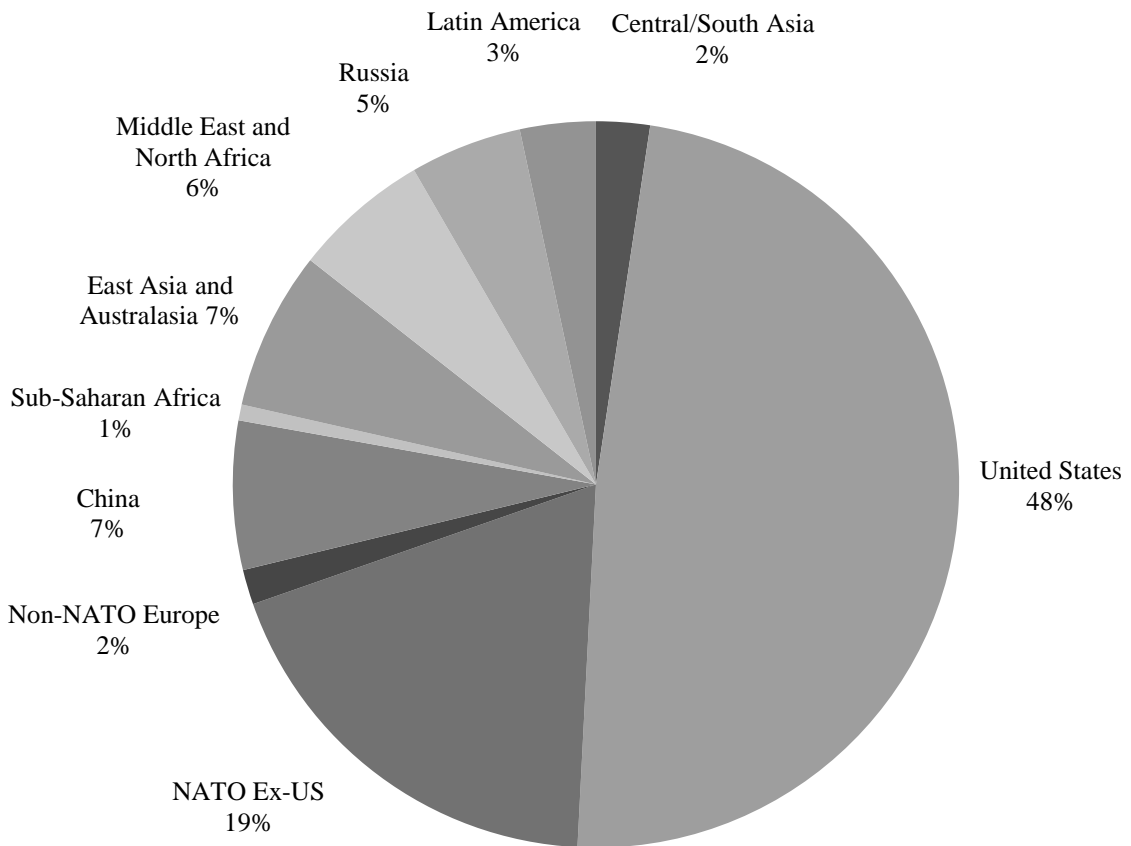


Figure 1: Global Military Spending²⁵

The next highest spender is the conglomeration of U.S. allies under North Atlantic Treaty Organization (NATO) which, even as a collective organization of developed nations, still accounts for 29 percent less military spending than does the U.S. by itself.

Next, consider annual defense spending by the U.S. Since the demobilization following World War II, defense spending has shown an upward trend, though there have

²⁵ Source: International Institute of Strategic Studies, *The Military Balance 2010*. See, also, Friedman and Preble (2010: 4).

indeed been some periods of spending decline. As Figure 2 shows, however, there is a sharp increase from 1948 into the early 1950s from just over \$100 billion to more than \$400 billion per year; since that spike, defense spending has never dropped below \$350 billion per year. The U.S. spent more on defense in 2010 than it spent in 1986, the height of the Cold War, by over 29 percent. Put simply, there has been a nearly 30 percent increase in spending to fight a variety of enemies not classified as a world super power, as the Soviet Union was through the 1980s.²⁶

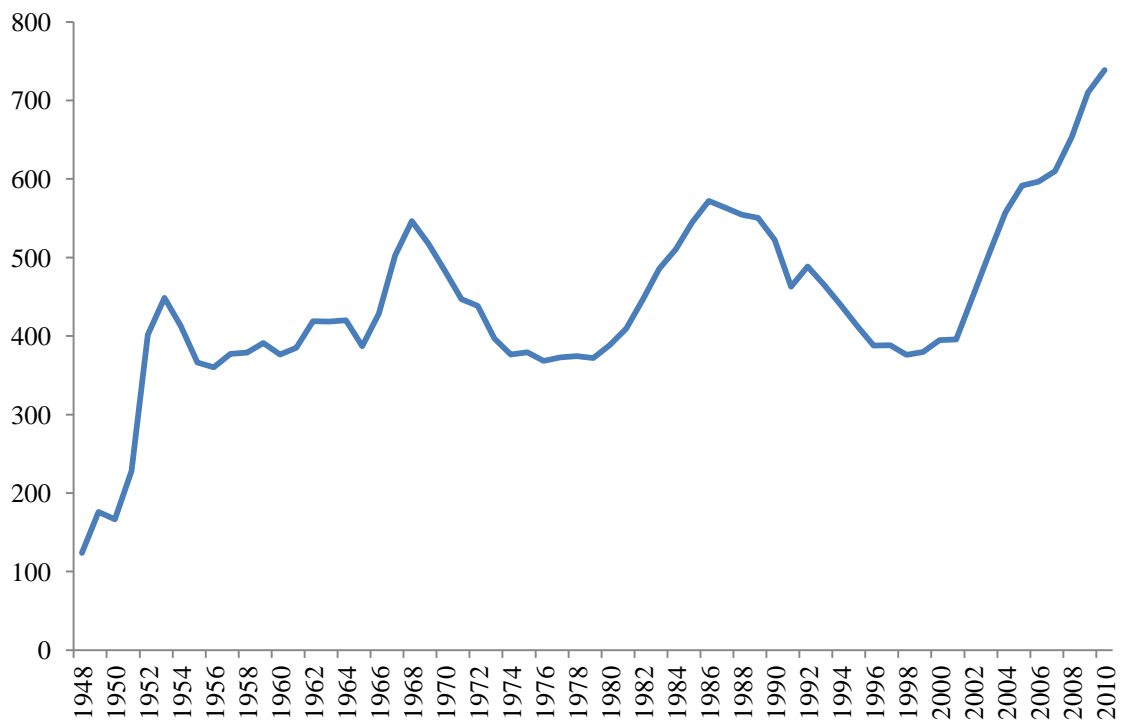


Figure 2: U.S. Defense Spending 1948-2010 (billions of 2010\$)²⁷

²⁶ Note that the current enemy combatant forces, those of Iraq and Afghanistan, are from the region of the Middle East. Figure 1 shows that in 2008, the entire Middle East region, combined with that of North Africa, accounted for only 6 percent of global military expenditures, some 42 percent less than that spent by the United States.

²⁷ Source: White House Office of Management and Budget, Historical Tables, Table 15.4.

Separated by decades, the United States has spent 38 percent more between 2001 and 2010 than between 1991 and 2000. It has spent 12.5 percent more in that same decade than between 1981 and 1990, when the Soviet Union was considered a serious military and nuclear threat. In the decade since 2001, the official Department of Defense budget has grown at an average “rate of more than 12 percent every year” compared to non-defense discretionary spending which has grown at a rate of “8 percent per year” (Preble 2009: 8). To provide some context, in the decade prior to 1986, during the arms race, the average annual rate of growth of discretionary defense spending was 6 percent.²⁸

The increase in military expenditures should not be mistaken as a simple increase due to ongoing wars. While the wars in Iraq and Afghanistan have, of course, greatly impacted the level of defense spending, direct spending on these efforts does not account for all of the defense-related growth. As Table 1 indicates, since the 9/11 attacks there has been substantial growth in spending on areas such as the Pentagon base budget, nuclear weapons, and homeland security.

²⁸ Percentage calculated from the White House Office of Management and Budget, Historical Tables, Table 8.7. The date range used is 1979-1986, in an attempt to give a time span equitable to that used by Preble (2009). Using the full decade, from 1976-1986, the average increase falls to 4 percent each year.

Table 1: Defense Spending 2001-2011 (2010\$)²⁹

| | Total Spending | 2001 Amount | 2011 Amount | % Increase 2001-2011 |
|------------------------------|-------------------------------|------------------------------|------------------------------|-------------------------|
| <i>Pentagon Base Budget</i> | \$5.5 trillion | \$357.7 billion | \$510 billion | 43 |
| <i>Nuclear Weapons</i> | \$226.4 billion | \$15.3 billion | \$18.4 billion | 21 |
| <i>Iraq and Afghan Wars</i> | \$1.34 trillion | \$20.2 billion** | \$162.8 billion** | 707** |
| <i>Homeland Security</i> | \$625 billion* | \$19.7 billion | \$67 billion | 240 |
| <i>Atomic Energy Defense</i> | \$204.45 million ^a | \$15.92 million ^a | \$20.28 million ^a | 27 ^a |

The expansion of funds spent on homeland security has been immense, increasing over 240 percent over the course of a decade. In conducting their cost-benefit analysis of the homeland security industry, Mueller and Stewart (2011: 81) note that between 2001 and 2009,

Some 44 percent of this expenditure is devoted to preventing and disrupting terrorist attacks through policing and intelligence efforts, and another 46 percent to protecting the American people, critical infrastructure, and key resources, while 9 percent is devoted to responding to and recovering from incidents. Funding goes to the DHS, the Department of Defense, the Department of Justice, the Department of Health and Human Services, the Department of Energy, and 26 other federal agencies...

²⁹ Source: "U.S. Security Spending Since 9/11," National Priorities Projects, May 2011. [<http://nationalpriorities.org/en/publications/2011/us-security-spending-since-911/>]. *NOTE: This figure includes \$161 billion funded through the Pentagon's "base" budget. Total "non-defense" homeland security spending is \$464 billion. **Source: Belasco (2011). Belasco (2011) gives the 2001 Amount for the Iraq and Afghan wars as a combined total for FY 2001-2002, meaning % Increase given here is understated. ^aNOTE: Calculated from the White House Office of Management and Budget, Historical Tables, Table 3.2.

The funds going into most of these different departments and agencies show an increase for the given time span. In tracing only “homeland security”-related spending, Mueller and Stewart (2011: 2) show that between 2003 and 2011, there has a 61 percent increase from the Department of Homeland Security, a 126 percent increase from the Department of Defense, a 31 percent increase from the Department of Health and Human Services, an 82 percent increase from the Department of Justice, and a 256 percent increase from the Department of State.

It is also interesting to note from Table 1 that spending on nuclear weapons has risen 21 percent over the past decade, though neither Iraq nor Afghanistan is capable of producing its own nuclear weapons.³⁰ U.S. expenditures on atomic energy defense activities have increased by approximately 27 percent throughout the 2001-2011 period, and although Table 1 only spans the most recent decade, there has been an increase of approximately 37 percent in atomic defense spending since the high point of the 1986 arms race.³¹ These increases have taken place even though the use of nuclear weapons has not become a staple of modern warfare, having only been actively used militarily by the U.S. during World War II. As both the case of nuclear weapons and of atomic energy defense illustrate, the state of permanent war in the U.S. has led to a permanent war economy whereby a variety of military programs are sustained and expanded even if the benefits of maintaining, and certainly increasing, those programs are unclear.

³⁰ Mueller and Stewart (2011: 66-70) give a brief historical account of the fear of atomic terrorism and explain why those fears are largely exaggerated.

³¹ Percentage calculated from the White House Office of Management and Budget, Historical Tables, Table 3.2. In 1986, the U.S. spent \$14.8 million, inflation adjusted, on atomic energy defense.

Of course, resources drawn into the war economy are more than just the dollars spent as constant war preparation also shapes the constitution of the labor force. Consider, for instance, that according to the Bureau of Labor Statistics, in 2008, the Defense and Homeland Security departments made up nearly 49 percent of civilian employment in the federal government.³² The U.S. military alone has 1,580,255 men and women on active duty, with the Army carrying the brunt of that force with 662,232 in service.³³ Beyond those men and women listed as “active,” there are 11,035 civilians and 864,547 reservists in military employ. Each of these men and women represents a valuable economic resource in terms of education and the alternative opportunities he or she could find in the private, non-military workforce.

As these data indicate, the state of permanent war consumes significant resources. These resources are redirected from the private, non-military sector into the military sector creating a permanent war economy. However, the measures in this section are insufficient to show the true cost of the complex, as an accounting measure of the economy cannot fully realize the foregone alternatives in entrepreneurial activity. The essence of this point is captured by Higgs (1993: 34) who notes that “by diverting workers and resources to a bloated, privileged, anticompetitive procurement complex, war buildups have actually *reduced* the American capacity to invent, innovate, and enhance productivity along nonmilitary lines.” As costly as the finite military buildups

³² Excludes the U.S. Postal Service and defense oriented organizations such as the CIA, where such information is classified for reasons of national security. See Table 1 here: [<http://www.bls.gov/oco/cg/cgs041.htm>].

³³ Figures for the remainder of this paragraph are drawn from the International Institute for Strategic Studies’ *The Military Balance 2010*.

are to the health of the non-military economy, it is the continuing presence of the industrial-war complex that has long-lasting distortive effects on the process of private, productive economic activity.

3 The Overlooked Perils of the Permanent War Economy

In general, Kirzner (1985: 136) argues that government interventions into the private economy “generate new (unintended and undesired) processes of market adjustments that produce a final outcome even less preferred than what might have emerged in the free market.” The interaction between the military and the private economy, from which resources are pulled to finance the former, has the same effect as other government interventions in that the permanent war economy creates an entirely new set of market and pseudo-market circumstances. The nature of these new circumstances results in entrepreneurs engaging in alternative, unproductive entrepreneurial activities which undermine the efficiency of the market economy.

3.1 The Fundamental Problem of Economic Calculation

In recent years, Secretary of Defense Robert Gates has made the suggestion that the Department of Defense must be more cognizant of the way in which it undertakes military procurement (Gates 2009, 2010; Gates and Mullen 2011). For example, in a press release dated April 6, 2009, Gates stated that his “department must consistently demonstrate the commitment and leadership to stop programs that significantly exceed their budget or which spend limited tax dollars to buy more capability than the nation

needs.” The following year, Gates reiterated the need for a more economical approach to military spending, stressing his hope that “Congress will work with us to reduce *unnecessary costs...*”³⁴ (Gates 2010, emphasis added). Though the rhetoric used suggests a turn towards greater efficiency, these statements do not address the fundamental economic questions of how much military capability the nation needs or, along the same vein, what constitutes necessary versus unnecessary costs for obtaining those capabilities.

Implicit in Gates’s desire to reduce “unnecessary costs” is the importance of achieving allocative efficiency when making procurement decisions.³⁵ Resource scarcity necessitates a method of choosing among tradeoffs, whereby the purpose of said method is to ensure that in making that choice resources are allocated to their highest valued use. In a general, stylized sense resource allocation can be achieved through one of two ways. Either resources are allocated through individual exchange within a market setting, or they are allocated by administrative authority, e.g., central planning. These two options have dramatically different implications for the efficiency of outcomes.

³⁴ Gates (2010) makes this statement in reference to the Congress’s previous actions that hamper resource reallocation within the Department of Defense for political reasons. The full quote reads, “I’ve also authorized each of the military departments to consider consolidation or closure of excess bases and other facilities where appropriate. This is obviously a politically fraught topic. Currently, Congress has placed legal constraints on DOD’s ability to close installations. But hard is not impossible, and I hope Congress will work with us to reduce unnecessary costs in this part of the defense enterprise.” For a fuller explanation of Congressional restrictions on base closures, see Twilight (1990).

³⁵ One counter to the claimed desire for “maximizing social welfare” is that Gates, and the defense industry in general, are seeking to maximize security rather than welfare. However, such a counter would only push the frontier of the argument outward to beg the question of how much security is demanded. Consumers do not demand 100 percent security at the expense of all else, as is evidenced by the fact that people continue to drive to work or walk across the street. Consumers want to maximize security subject to a budget constraint. The question of the efficient tradeoff between security and all other goods remains fundamentally an economic question of social welfare maximization.

Under a market arrangement, goods and services are exchanged via the actions of voluntary buying and selling. Producers and consumers coordinate their activities based on the feedback mechanisms of monetary prices and profit and loss. These mechanisms allow economic actors to engage in economic calculation, because on the unhampered market, prices provide a common denominator with which individuals can calculate relative values of alternative goods and services, and a system of profit and loss provides feedback as to whether or not resources are being channeled to their most socially valued use.³⁶ When an output generates a profit on the market, this signals to the producer that the resources are being used in a valuable way from the standpoint of consumers; the corollary is that should an output be produced at a loss, the signal is sent that what has been created is not as valuable as the alternatives toward which the resources could have been put. The constant feedback of this profit and loss system generates an outcome in which the diverse plans of disparate economic actors are coordinated into socially desirable outcomes. The market alternative appreciates that the knowledge of the optimal use of scarce resources is not given *ex ante*, but instead must be discovered through the process of individual choice (Mises [1920] 1990, [1922] 1981, [1949] 2007; Hayek 1945; Thomsen 1992).

Under the administrative, or centrally planned, arrangement, resources are allocated to produce outcomes according to the administration's preferences rather than the demand of the consumers. The central planner asserts his plan over the disparate plans of other individuals, based on a predetermined end of his own. This exercise relies

³⁶ For further discussion of the unhampered market, see Mises ([1949] 2007).

on the top-down imposition of plans rather than on the emergent discovery and coordination that takes place in markets. As the output at the end is not sold for a market price, but rather is distributed based on the overarching plan, the system of profit and loss is unable to provide a sufficient method of determining social welfare calculations. Instead, planners must rely on alternative measures in an attempt to approximate the same results, methods which do not provide the same information as that generated through the market process (see Hoff 1949; de Soto 2010).

The method of resource allocation for the defense industry falls much closer to the centrally planned, administrative arrangement. The Defense and Homeland Security Departments, the President, and the Congress come together at various stages of the budgetary approval process to decide on both the level and direction of funding and the goals of the national security sector. Within the bounds of the budgetary decisions, contracts are negotiated between the Departments and the individual defense firms. Elberton Smith ([1991] 1959), the official historian of the U.S. army's economic mobilization during the World War II period, notes these centralizing tendencies as he chronicles the military buildup immediately prior to the Second World War. In describing this tendency, he argues that,

As the nation moved rapidly through the defense period into a wartime economy, many of the functions of the traditional price system were supplanted to an unprecedented degree by direct controls. The allocation of basic industrial materials, to facilitate both the creation of industrial capacity and the production of finished munitions, was accomplished increasingly by administrative decisions and procedures stemming directly from the character of national war production objectives ([1991] 1959: 311).

The reliance on central decision making in military-related matters is one that persists to this day. However, if efficiency concerns are relevant this arrangement is problematic because as Higgs (2006: 133) notes, “no one knows the production function for national security” and the optimal level of defense is not a given. Rather than relying on the market feedback mechanisms to ensure that consumers are getting the level of security they demand, the level of security is determined administratively and asserted over the consumers who have no, or at best a weak, avenue of recourse should that level prove undesirable. The nature of the budgetary process does not allow for profit and loss in the economic, or market, sense.³⁷ And while the administration may cancel (reduce) or grant (increase) funding for specific defense programs, these decisions are based on the central plan rather than on market information which is crucial for reallocating scarce resources to their highest valued uses. As such, there is a military-to-market disconnect which allows unnecessary costs in the form of misallocated resources to persist for significant periods of time due to the absence of information regarding higher value-added resource allocations.

This is problematic because persistent resource allocations lead to broader distortions within the market process, well beyond the initial transfer of resources from

³⁷ Even the relative values at work in the war economy are suspect. In critiquing the conventional use of national income and product accounts data as a measure of defense spending impact, Higgs (2006) provides a further discussion of the market-military disconnect, arguing that “because the prices paid for defense goods and services generally are not—and, in some cases, cannot be—determined within a competitive market framework, all such prices are suspect. What do they mean? Is there any reason to suppose that they approximate consumers’ marginal rates of substitution or producers’ marginal costs? If not, why should the actual prices paid be regarded as appropriate weights for the purpose of aggregating physically incommensurable goods and services?” (2006: 133) While the prices exist, they do not convey the same information as those determined via the unhampered market. Rather, the prices here operate in more the accounting sense than in the economic one.

the private to the military economy. The nature of this distortive *process* can be understood as follows. The lure of profit created by the new, military-related, opportunities draw talented entrepreneurs from the private to the military sector. In pursuing these initial profit opportunities, entrepreneurs create entirely new profit opportunities in the military sector. As Holcombe (1998: 46) argues, “[e]ntrepreneurial ideas arise when an entrepreneur sees that the ideas developed by earlier entrepreneurs can be combined to produce a new process or output” and “acts of entrepreneurship create an environment within which innovations build on themselves” (1998: 47). In other words, with each new entrepreneurial discovery comes an array of future profit opportunities.³⁸ In the context of military activities, consider the example of unmanned aerial vehicles (UAVs) or “drones.”

Originally developed to mitigate the fatality risk of surveillance (and attack) on military targets, drones have become increasingly utilized by the Department of Defense overseas. The existing and perceived capabilities of the drones, combined with the lure of profits from an expanded use of UAVs in other ways have led the members of the UAV industry to actively seek to expand the drone market. The result has been an increase in the non-military use of drones not just internationally, but also domestically. Not only are

³⁸ To reiterate, the argument here is not to say that the defense sector cannot increase defense outputs; it can and often does as is evidenced by the increased spending in homeland security. However, as there is no method for determining whether such outputs are socially valued, when investments in the defense industry continue, above the socially optimal level, the military economy becomes and continues to be over-capitalized*. The over-capitalized defense sector provides resources for further entrepreneurial discoveries, both in terms of new defense programs and technological advances in currently operating ones, which are above the “market rate”** of military entrepreneurship. *Note: For a fuller explanation of the function that economic loss serves as a check on over-capitalization, see Rothbard ([1962] 2001: 463-469). **Note: “Market rate” here refers to the rate of entrepreneurial discoveries that would be established under the alternative market-oriented institutional arrangement.

drones now being used to patrol the U.S. borders³⁹ (Schultz 2011), but they are also being outfitted for “dozens of nonmilitary uses...ranging from law enforcement to firefighting to wildlife monitoring” as well as “news coverage, mapping and agricultural applications” (Pasztor and Emshwiller 2012). Entrepreneurs are continuously exploring new ways of refining and exploiting current drone technologies for their specialized markets, even going so far as to invest significant resources in creating demand for their product among the national and local governments (Schulz 2012)⁴⁰. The expanded use of drones, in turn, has led to the subsequent opportunities in the form of a secondary, drone-related industry built around training, consulting, and support services (Neild 2012). The drone industry, as well as this secondary industry, has invested significant resources in lobbying governments to secure contracts for their services (Bennett 2012; Stone 2012). As this example illustrates, there is a multiplier effect associated with entrepreneurial activity.

While this multiplier effect of entrepreneurial activity is a positive force for economic growth and improved well being in a market setting due to efficiency-enhancing innovation, in the administrative setting there is no guarantee that the same entrepreneurial activity will yield benefits from an efficiency standpoint. Should the discovery process begin with a distorted profit opportunity, additional connected

³⁹ Schultz (2011) reports on the increasing use of unmanned aerial vehicles along the U.S.-Mexico border in an attempt to reduce breaches of said border.

⁴⁰ Schulz (2012) notes the strategic difference between General Atomics Aeronautical Systems, who provides the Predator drones to the Department of Homeland Security, and AeroVironment, “that builds much smaller ‘mini-drones,’ which fit a growing demand by emergency responders, firefighters, and law enforcement agencies.” Though both companies do sell within the defense industry, they are investing resources into making their products more marketable domestically, as well.

discoveries can lead to greater resource misallocations which persist for prolonged period of time with no mechanism for correction. Even if we assume that the initial military-related activity is value-added in terms of providing effective defense, which is a large assumption absent economic calculation as a feedback mechanism, that initial activity will generate future profit opportunities which may very well fail to be value added as future entrepreneurs seek to capture the windfall profits through the political, as compared to the market, process.⁴¹

As further illustration, consider the claim that the U.S. reaction to the terrorist attacks of September 11, 2001, has led to government inflation of security threats (Mueller 2006; Mueller and Stewart 2011). The previous figures, given in Table 1, show the marked increase and continued increasing trend in protective measures taken by the Departments of Defense and Homeland Security since the 9/11 attack. The total increase since 2001 has been approximately 240%, yet Mueller and Stewart (2011: 40-55) find no upward trend in the risk of a U.S. citizen's death as a result of a terrorist attack, and possibly a decreasing trend since 1998. In fact, shortly after incurring the initial losses from 9/11⁴², private insurance firms reentered the terrorism insurance market, and

by 2009 the median terrorism insurance premium for a \$303 million property had more than halved to only \$9,541 per year. This represents a conservative measure of expected loss or risk, and a simple back-calculation in the risk equation suggests that the insurer estimates the

⁴¹ The political process will be explored more fully in section 3.2.

⁴² Mueller and Stewart (2011: 23-24) note, "In the immediate aftermath of the 9/11 attack in which insured losses reached \$35 billion, most insurance firms placed terrorism exclusions on their policies. Since then, however, the U.S. government implemented the Terrorism Risk Insurance Act to provide 'a temporary window of reinsurance relief to help insurers manage the ongoing risk of terrorism.' With that, insurance firms reentered the terrorism insurance market..."

likelihood of a terrorist attack on a property to be very low: less than one in 30,000 per year (2011: 24).

The authors then question why the Department of Homeland Security is unable to estimate terrorism risks while the private sector is both capable and “willing to risk its own money on the validity of the estimate” (2011: 24). The answer to this question lies in the difference between the private sector economy and the administrative nature of the military-industrial complex discussed above. Under a market setting, where the price and profit and loss mechanisms are functioning, the over-assessment of risk would be competed back to more reasonable levels. As Mueller and Stewart (2011: 23) argue, the “insurance industry has a distinct financial imperative to understand terrorism risk.” However, the war economy does not provide the same recourse to the mechanisms found in the non-military economy.

The case of terrorist insurance market is somewhat unique in the defense industry in that the estimates of the private insurers provide a market rate for security alongside administrative approximation of risk premiums. The disparity is striking, and it is suggestive of what may be a typical disparity between the social welfare maximizing rate of security provision and the rate at which the military-industrial complex provides defense. From this overabundance of state granted funds come opportunities to collect with such entrepreneurial efforts as developing Advanced Imaging Technologies (AIT)

scanners for use in airports⁴³, refining technologies for the domestic use of Unmanned Aerial Vehicles⁴⁴, and reengineering strategies for dealing with nuclear bomb threats⁴⁵.

When the defense sector reacts to situations in such a way, the administrative decision making procedure does not provide the same heavy-handed correction as the market's economic loss function. More importantly, when the military sector is providing above the social welfare maximizing level of security on a *permanent* basis, the lack of a proper feedback mechanism remains *permanently*. Absent such feedback, the abnormal availability of resources already being diverted into the war economy will reinforce the entrepreneurial process as it leads to ever increasing entrepreneurship in the national security sector.

It is not only problematic that the epistemological indeterminacy, due to the lack of market pricing and profit and loss, establishes a situation in which there is potential to overestimate the optimal level of defense; it is further problematic that this situation is ever-present due to the structure of the military-industrial complex. Not only may responses to crises be overblown, but there is also no method of discovering errors in periods where crises are absent. Higgs's (2006) "butter-sacrificing" economic activity continues well beyond the military buildup, and when "people abandon their otherwise

⁴³ As Mueller and Stewart (2011: 148) note, the "TSA began rolling out the scanners in 2009 and says it plans to procure and deploy 1,800 of them by 2014 to reach full operating capacity at all checkpoints in the United States... We can infer then that the full quota of 1,800 units will cost approximately \$1.2 billion per year". The authors then perform a risk assessment, computing the marginal gain in security to be well below the value of the price tag for these machines (Mueller and Stewart 2011: 149-152).

⁴⁴ See previous citation to Pasztor and Emshwiller (2012). Also, the non-profit research organization Public Intelligence (2012) provides a map of current and future drone sites, found at <http://publicintelligence.net/dod-us-drone-activities-map/>

⁴⁵ For more on the overreaction of federal agencies to nuclear threats post-9/11, see Mueller and Stewart (2011: 166-171).

most-valued forms of production..., socially valued outputs are lost (Higgs 2012: 22)” continuously. Of course the costs of these diverted resources can never be calculated since they entail a counterfactual of what would have happened absent the windfall profits associated with the war economy. However, given the high level of adaptability and efficiency promoted by private markets, relative to the inefficiencies of the political marketplace (which will be further discussed below), it is reasonable to conclude that this reallocation of entrepreneurial talent from the private economy to the war economy results in efficiency losses.

3.2 *Rent-Seeking Replaces Market Competition*

The previous subsection stressed the epistemological perils due to the lack of a functioning market system in the defense sector. Yet the political process that replaces the market process has its own method of functioning and generates a set of incentives distinct from those generated in market settings. Though the questions of *what* to produce and *how much* to produce continue to lack an economic solution, there does exist a mechanism for deciding *who* will produce a given good. In other words, a system of competition still exists within the permanent war economy, even if it is not one that necessarily leads to economically efficient outcomes. This competition, however, is not driven by the wants of private consumers, but instead by the desires of government bureaucrats who are ultimately responsible for making decisions regarding who will supply military-related goods and services. In response to the incentives created by the political process, private producers redirect resources from meeting the wants of

consumers, to meeting the wants of bureaucrats. This further undermines the dynamism of the market economy by weakening the link between production and the satisfaction of consumers wants.

As an example to illustrate this logic, consider Lockheed Martin's F-35 Joint Strike Fighter (JSF) program. Originally launched in the 1990s, and given an extra boost under the Clinton administration in 1994, the JSF program was intended to create a multiservice fighter aircraft designed for use across the lines of Navy, Air Force, and Marines, as well as for sale to the United Kingdom who wished to use the F-35 to replace the British Sea Harriers (Preble 2009: 43-44). The availability of windfall profits for this program has been substantial. As Preble describes,

Given the large number of potential customers, both by the three branches of the U.S. military and in foreign markets, the JSF contract was expected to be the most lucrative in the history of military aviation. Not surprisingly, the competition to design and build the aircraft was intense. Lockheed Martin and its development partners were awarded the contract in October 2001, beating a team led by Boeing (Preble 2009: 44).

Yet in an administrative institutional arrangement that does not allow for a true market competition, this intense competition takes place through politics rather than on the margins of price and profit and loss.

In summarizing the rise of the military-industrial complex, Higgs (2007: 308) suggests that in the defense economy post-World War II, "deals came to turn not on price, but on technical and scientific capabilities, size, experience, and established reputations as a military supplier – vaguer attributes that are easier to fudge for one's friends". Melman (1985: 35) describes the war economy's political competition as a

system in which “military-industrial firms compete with each other, but, in their race for fresh contract and capital grants from the Pentagon managers, they do not vie for who can achieve a lower product price and cost but rather who can compete best in terms of a display of ‘competence’.”⁴⁶ He concludes that “while military-industry firms compete, often in much the same fashion as division managers under a central corporation, in their Pentagon-dominated world ‘competence,’ including political clout, is the coin of competition rather than the price-quantity contest that is more characteristic of civilian firms” (Melman 1985: 35).

To use the F-35 program as further illustration, one can see the steps taken by members of the defense industry in order to ensure their “political clout” is sufficient to the task of attaining contracts. In attempting to make themselves more attractive to the Pentagon, both Boeing and Lockheed Martin engaged in rounds of mergers and acquisitions to expand their political base. Hartung (2011: 20-21) summarizes these mergers and acquisitions, describing Boeing’s purchase of fellow defense industry McDonnell Douglas⁴⁷ and Lockheed Martin’s partnership with both British Aerospace and Northrop Grumman. He notes that

[a]lthough Boeing was able to beef up [with] McDonnell Douglas... British Aerospace came over to join the Lockheed Martin Team. This gave Lockheed Martin a leg up in persuading Britain to weigh in on its behalf.

⁴⁶ Melman (1985: 35) defines competence as “the readiness and ability of the particular firm to satisfy the Pentagon’s requirements in the judgment of its top management. It means its ability to collaborate with the Pentagon-level administrators to turn out the sort of product that the Pentagon wants with regard to details of product designing, testing, producing and servicing.”

⁴⁷ McDonnell Douglas was an early contender in the competition for the JSF contract. The firm was attempting to salvage the forthcoming losses from both its F-15 and F-18 fighter programs, both of which were to be replaced by varying versions of the new F-35 JSF. Once McDonnell Douglas fell from competition, the firm offered itself to Boeing in order for Boeing to stay competitive with Lockheed Martin (Hartung 2011: 20).

It is one thing to have a given state or senator in one's corner. It is quite another to have a sovereign state and longtime U.S. ally like the United Kingdom ready to go to bat for you (2011: 21).

Lockheed Martin further sealed its victory by reaching out to partner with Northrop Grumman, offering the large defense firm “at least 20 percent of the work on the plane. This agreement gave Lockheed Martin even greater pork barrel clout and created a vested interest in key districts and states where Northrop Grumman had operations” (Hartung 2011: 21). Having managed to spread its political ties over a greater area, Lockheed Martin managed a successful contract campaign.

Given this method of achieving contracts—one based on continuous lobbying and sycophancy—once programs are started they become notoriously difficult to cancel. An array of vested interests emerges, and both firms and members of Congress with ties to where these firms operate will fight for continuation in the face of waste or irrelevancy in terms of use of output. Even Secretary of Defense Robert Gates has noted this concern in his attempts to prioritize the war economy as discussed earlier.⁴⁸ However, it is not *only* a matter of sustaining programs. The concerns are even greater. To re-center the argument in terms of our prior discussion of economic calculation, there are two main points.

The first point is that without a meaningful market price and a system of profit and loss, it becomes unclear to what extent existing programs are aiding in security versus the extent to which they exist for purely political reasons. Even for all the fierce competition and restructuring that took place for the JSF contracts, the central economic

⁴⁸ Though Gates does make note of the fact that the defense industry has a propensity to become filled with largess, the institutional arrangement remains one that facilitates this process. Even as he closes down one Lockheed Martin program, the F-22, Gates also boosts the F-35 program in order to avoid some of the political conflict (see Gates 2009; Hartung 2011: 14-15).

question was forgotten. As Preble (2009: 45) asks, “how urgent is the need for the next-generation fighter...?” What is the added value of the newly created fighter in terms of military capabilities? There is some indication that the increase is minimal when one takes into account the fact that such fighters are “facing only a hypothetical enemy in a future war for air supremacy...[while]... actual foes like the Taliban and al-Qaeda don’t have an air force and are not interested in acquiring one (Preble 2009: 48).” However, the incentives of Lockheed Martin and Boeing were still directed towards competing for the contract, and once it became apparent that additions to the workforce would be available within their Congressional (or national, as with British Aerospace) district, political persons had the incentive to support whichever side offered a better advantage in terms of increased employment, regardless of the necessity for a JSF or which firm would be a more economically efficient producer.

The second point is the fact that the available windfall profits will lead entrepreneurs to seek out those gains via the political process which has long-term distortionary effects.⁴⁹ In writing on the perils of institutional arrangements as a determinant of economic development, Coyne, Sobel and Dove (2010: 335) argue that “[w]here institutions encourage nonproductive activities, entrepreneurs will tend to exploit those opportunities. In doing so, they create subsequent non-productive opportunities. Each non-productive activity has a multiplier effect contributing to further

⁴⁹ This second point is similar to the one made in section 3.1 above, yet it is important to stress that the section above spoke of the shift in entrepreneurship as one in which entrepreneurs attempt to generate demand for products that are inputs into national security. The following exposition will describe the shift in entrepreneurship as one in which the entrepreneurs are more concerned with capturing rents for their own firms and/or political aspirations rather than having concern for actual security.

decline.” The process of discovery is no less important in the permanent war economy. With each new nonproductive activity, further avenues of nonproductive activity are provided.

As a way of illustrating this point, consider the example above, whereby the entrepreneurial discovery was made that linking programs to the politics of job creation was one way of gathering support for the sustainability of a defense program. While Lockheed Martin certainly did not originate this tactic in their appeals for the lucrative JSF contract, the firm was engaging in a tactic discovered previously within the military-industrial complex. This discovery has led to a variety of such endeavors, whereby efforts will be spent to construct new such technologies that can be sold as increasing the work force rather than as an input into national security. The same phenomenon can be seen in the lobbying attempts of the previously mentioned UAV industry. In her article on the drone lobby, Stone (2012) notes the comments by Association for Unmanned Vehicle Systems International (AUVSI) President Michael Toscano, where he argues the case for drone construction based on job creation, with AUVSI estimating that “drones would create 23,000 new jobs by 2025”. The margins on which security is impacted need only be loosely tied to the program, as once it is accepted, a defense program finds Congressional support even as it enters the “perennial procurement and contracting cycle, going back many decades, of adding layer and layer of cost and complexity onto fewer and fewer platforms that take longer and longer to build...” (Gates 2009).

4 Conclusion

Our analysis has several implications. First, the costs of the war economy have been underestimated due to the lack of consideration for the full implications of a distorted private market economy and the negative effects on its vibrancy. The distortion is not a temporary effect, but one that has a lasting structural impact in both the military and non-military sectors. The permanency of the war economy ensures that resources will continuously be misallocated so long as the trend towards the alternative equilibrium remains. As the military-industrial complex lacks a mechanism for meaningful economic feedback and correction, once the economic activity has been set in motion, there is no true method of correction.

This leads to the second implication, which is that the permanent war economy is self-extending. Throughout time, those misallocations will continuously build upon one another. The permanent war economy is self-extending because one profit opportunity creates several new, subsequent opportunities. A variety of ideas, each requiring a differing type or amount of resources, are involved in constructing new and better defense technologies. The discovery of a more technologically advanced radar system will create a further demand by the Departments of Defense and Homeland Security as the administrative decision makers seek marginal gains in the effectiveness of the radar without knowing whether those gains are economically worthwhile. If that demand is not reflective of an actual market demand for defense, then each additional unit created will be a further hindrance to economic efficiency.

A third implication is that the very institutions established to ensure national security and the resulting prosperity threaten to erode it. As mentioned in the

introduction, the burden of excessive defense was recognized as early as Adam Smith. The efforts to protect the British Empire were proving to be the very undoing of that empire. The pressures of supporting the war economy were corrupting the private economy such that the costs of protection were destroying the very institutions that the defense was supposedly safeguarding. How far different is the British situation from the one faced by the United States today? The peace and prosperity that the military is supposed to defend is at peril, with that prosperity receding into the recesses of the war economy rather than being directed toward satisfying the wants of the people.⁵⁰

As Mises ([1949] 2007: 659) argues, “[t]he government has no more ability than individuals to create something out of nothing. What the government spends more, the public spends less.” The permanent war economy cannot remain on the outskirts of the non-military economy in a neutral fashion. A mixed economy tends towards a fully controlled one until the point of crisis is reached (Ikeda 1997, 2005). The U.S. may be quickly approaching such a crisis, given its current levels of government spending and government debt. The defense spending will play its role in such an event. Yet even should the critical point not yet be reached, the diverted resources, both in terms of capital and the ingenuity and entrepreneurial spirit of the human mind, will be lost to non-military applications. The U.S., and the world as a whole, will be all the poorer for it.

⁵⁰ Mueller (2006) gives a compelling history of the events after 9/11, showing how the reactions of the security industries and political entities has pushed the American public even further from that peace and prosperity.

CHAPTER 4: The Origins of the Permanent War Economy
(Written with Christopher J. Coyne)

1 Introduction

In response to the 2008 financial crisis, then White House Chief of Staff Rahm Emanuel gave the advice: “You never want a serious crisis to go to waste. Now what I mean by that, it’s an opportunity to do things that you think you could not do before” (Seib 2008: 1). While it was quoted in the 21st century, it was the 20th century that lived the motto. President Franklin Delano Roosevelt most assuredly did not let his crises go to waste, and he had two major events—the Great Depression and the Second World War—which allowed him to consolidate power into his administration. Indeed, between the two great catastrophes of the 1930s and 1940s (and into the 1950s as Harry Truman took office), there emerged a consensus on the two largest problems that the United States faced: foreign threats to U.S. security and domestic unemployment.

By the end of the war, the institutional foundations were established that would intricately entwine these two problems into a single solution: tying the employment of labor and resources to defense spending. The result has been the creation of what has been termed a “permanent war economy,” whereby resources are continuously pulled from their productive uses in the private economy and poured into the military and its

industrial allies, all done under the pretense of ensuring both national defense and employment.

As early as 1944, even before the war had reached its conclusion, Oakes (1944) predicted the emergence of a permanent war economy. Defining the term such that “*a war economy exists whenever the government’s expenditures for war (or ‘national defense’) become a legitimate and significant end-purpose of economic activity*” (Oakes 1944: 12; Italics in original), he contended that a system of permanent war expenditures was a natural outgrowth of the capitalist system, as military spending would come to be regarded as the dominant form of reducing unemployment in the post-war period. According to Oakes (1944: 14), “Capitalist society is forever seeking a ‘stable and safe’ equilibrium – one which eliminates unemployment or, at least, reduces it to negligible proportions (‘stable’); and one which is generally acceptable or, at least, politically workable (‘safe’).” The war, according to Oakes, would provide an opportunity for politicians and capitalists to work together to achieve this equilibrium and maintain their privileged positions within the capitalist structure in the post-war period. Similarly, Vance (1951a: 40) argued that “the continued preservation of the capitalist mode of production, a system that has long outlived its historical usefulness, demands ever-increasing state intervention which must take the form of the Permanent War Economy.” According to this line of reasoning the maintenance of the capitalist system requires ever-increasing state spending and entanglements with private economic activity.

The purpose of this paper is to provide an alternative explanation for the origins of the permanent war economy. Instead of viewing the emergence of the permanent war

economy as a natural step in the evolution of the capitalist system, we emphasize the combined efforts of the interest groups (unions, industry, military, and politicians) that arose in the context of the dual crises of the Great Depression and World War II. As such, our explanation emphasizes that the permanent war economy is not a problem of capitalism, but instead a problem of government and constraints upon government interventions into the private economy. From this perspective the permanent war economy was not implemented to save capitalism, but instead resulted from narrow interests pursuing their own agendas in the context of an interventionist government.

In any good crisis, there are multiple parties ready to take advantage of the state of emergency (Higgs 1987, 2004, 2005a, 2006, 2012). During the depression and the war that followed, there arose a partnership between industry, the military, and the political sphere. The crises opened the pockets of the State, and a variety of interests groups found a way to advance its interests: unions with jobs, industry with profit, military branches with budgets, and politicians with votes and lobbying stemming from the combination of interests. These crises, combined with the State's monopoly over military provision, created the opportunity for these interests to influence the trajectory of economic activity in a lasting, and self-serving, manner. The average citizen and tax payer has been the one to be shorted, and he is powerless in the face of the interests aligned against him. The military-industrial complex that Eisenhower (1961) warned of has become a vast network of expanded political power, enlarged profits, and increased State authority. Indeed, national security, in terms of dollars, mentality, and interests, has bled into nearly every aspect of American life (Turse 2008), creeping into nearly every federal department

(Mueller and Stewart 2011), into humanitarian efforts around the world (Coyne 2008, 2013), and even into domestic policing efforts (Hall and Coyne 2013).

There has been a lasting impact on the structure of private industry, as well. For example, the top 10 contractors of 2011, led by Lockheed Martin Corp. and Northrop Grumman, brought in revenues of \$47.7 billion⁵¹, earning from their defense contracts nearly 30% of what their civilian counterparts, corporate giants such as Exxon Mobile, Microsoft, and Wal-Mart Stores⁵², earned from their multinational operations. As these federal funds filter through subcontractors and supportive non-military firms and organizations, the federal defense impact on the private sector is both broad and deep, influencing “professional and business services, financial, information and administrative services, retail trade, leisure and hospitality services, education and health services, construction, and other manufacturing” (Fuller 2011: 1).

This paper contributes to three interrelated strands of the current literature. Firstly, we explore the origins of the permanent war economy (Oakes 1944; Vance 1951a, 1951b, 1951c, 1951d, 1951e, 1951f; Baran and Sweezy 1966; Vatter 1985) and provide an alternative explanation. We emphasize that the permanent war economy is not the result of capitalism, but instead the result of government interventionism and the resulting cronyism between an activist government and private interests. Secondly, we extend the literature on the distortionary effects of the permanent war economy (Russett 1971;

⁵¹ Source: “2011 Washington Technology Top 100: Top 100 Defense Revenue,” Washington Technology. Retrieved from: [<http://washingtontechnology.com/toplists/top-100-lists/2011.aspx?Sort=Top-100-Defense-Revenue>]

⁵² Source: “Fortune 500 Top Companies: Most Profitable,” CNN Money. Retrieved from: [<http://money.cnn.com/magazines/fortune/fortune500/2011/performers/companies/profits/>]

Melman 1970, 1971, 1985; Higgs 2006; Duncan and Coyne *forthcoming*) by linking its origin to vested interests. Thirdly, we provide insight into the link between military spending and employment (Keynes 1933; Oakes 1944; Melman 1985: 15; Vatter 1985: 14; Fuller 2011) by addressing the combination of the first two. At its outset, the permanent war economy was not instituted to be the savior of capitalism, but rather as the intrusion of government and for the gain of the interest groups who advanced their own agendas.

The remainder of the paper will be organized as follows. Section 2 will briefly survey the literature on rise of the permanent war economy and the claims of capitalism's failure. Section 3 will map the combination of interests that formed in the 1930s-40s to take control of the militarized economy. Section 4 will provide some implications and conclude.

2 The Military Keynesian Zeitgeist

The Great Depression had been a bitter and long-lasting event, and it had shaken the core beliefs about the way the U.S. economy worked.⁵³ The United States spent a decade in economic crisis, far longer than the recessions that had come previously. Citizens, intellectuals, and policymakers began to think that capitalism had failed them, and that

⁵³ Higgs (1987:161-162) details the severity of the economic collapse: "Between 1929 and 1933, real GNP per capita fell by more than 30 percent... Wholesale prices dropped by about 30 percent... Production of consumer durables fell by 50 percent, producer durables by 67 percent, new construction by 78 percent, gross private domestic investment by almost 90 percent. Unemployment ultimately reached 25 percent of the labor force, and perhaps one in three of those who still had jobs in 1933 was working reduced hours... Banks failed in great waves... While [farmers] continued to produce about the same physical amounts, the prices they received for their products plummeted by more than 50 percent."

the only means of recourse to a failing market was the increase of state intervention, and even large scale intervention may only be a short-term solution. The severity of the depression “greatly strengthened the belief that similar catastrophic economic breakdowns were inevitable in the future” (Baran and Sweezy 1966: 3) and “the need for government to play a larger role suddenly became acute” (*Ibid.*: 159). Yet even the New Deal programs of Roosevelt, extensive though it was, did not appear to be lifting the economy from its slump. When prosperity returned with the war effort during World War II, the narrative that arose was that war-related work could solve the problem of unemployment on an ongoing basis (Oakes 1944; Baran and Sweezy 1966: 161; Melman 1985: 15-16; Vatter 1985: 14; Kennedy 1999; Smith 2007: xiii). As Melman (1985: 16)⁵⁴ later argues “[w]ar work made business boom and brought economic opportunity, better living and money in the bank to almost all who participated in it” showing Americans at the time that “the economy could produce guns and butter, that military spending could boost the economy and that war work could be used to create full employment.” In order to explain the recovery, economic arguments of the time combined strands of Keynesianism and Marxism to create the narrative that prosperity could be generated by using the defense funds to shore up flagging economic capacity, creating a system that would be referred to as state capitalism.

The Marxist interpretation of the Great Depression was that it was the natural outcome of the capitalist system, arguing that “the present situation, briefly stated, is that

⁵⁴ Melman (1985: 15-16) does claim that World War II ended the Depression, but he has argued that the military spending since has had deleterious effects on the economy as a whole (Melman 1970, 1971, 1985).

capitalism has reached a new impasse. All the methods previously employed to halt, at least temporarily, the abysmal decline in the rate of profit have outlived their usefulness” (Niebyl 1940: 234). Prior to the war, that interpretation appeared to be true, as “[m]assive civilian government spending was tried as a stimulus in the 1930’s, and failed” with “1929 and 1939 government expenditures on non-defense purchases and transfer payments nearly doubled from \$9.1 billion in 1929 to \$17.8 billion in 1939” only to have “GNP in the same period slumped from 104.4 billion to 91.1 billion and unemployment rose from 3.2 per cent to 17.2 per cent” (Reich and Finkelhor 1973: 188).

Yet with the onset of war and the seemingly rising prosperity⁵⁵, the critical failure of capitalism narrative shifted to argue that if the U.S. would not move to the acceptance of socialism (Strachey 1938: 142-159; Oakes 1944: 17), then it may be possible to postpone the capitalist collapse by the dual strategies of smoothing business cycles through the Keynesian⁵⁶ framework of government deficit spending and stimulus (Kalecki 1937, 1943, 1945; Carter, Kazakevich, and Lamont 1939: 519; Howenstien

⁵⁵ Reich and Finkelhor (1973: 188) cite as evidence that war spending led to recovery that “[b]etween 1939 and 1944 military spending increased from 1 billion to 77 billion; GNP shot up in the same years to 211.4 billion.” The use of GNP and unemployment accounting to suggest that World War II created widespread economic prosperity has been challenged. In response to Melman’s (1985: 15) claim that the war allowed for the U.S. to produce more of both “guns and butter,” Higgs (2006: 89) argues that this claim “fails to take sufficiently into account the understatement of actual wartime inflation by the official price indexes, the deterioration of quality and disappearance from the market of many consumer goods, the full effect of the nonprice rationing of many widely consumed items, and the additional transaction costs borne and other sacrifices made by consumers to get the goods that were available.” If one calculates the actual consumption data, absent the truncated production for goods meant for the war effort, “real consumer well-being during the war... declined” (*Ibid.*; see also Friedman 1976; Vedder and Gallaway 1991; Higgs 1992). For a greater explanation on how prices and production were distorted during the rearmament and war periods, see Henderson and Nelson (1941) and Smith ([1959] 1991).

⁵⁶ Both Marxism and Keynesianism granted the failure of *laissez faire*. The policies tried through the 1930s, especially the later 1930s, were stated in the language of Keynes, but the Keynesian models overlapped with those of the Marxists. Both held the idea that capitalism required government spending to be sustainable (see Fan-Hung 1939).

1945; Millet 1947: 29-30; Rosen 2005: 176) and by opening foreign markets through U.S. imperialism (Strachey 1938: 101-105; Lamont 1939: 253; Pierson 1942: 234-235; Vance 1951a; Hossein-Zadeh 2006: 41-44). Thus, the permanent war economy must be the natural course of capitalism in its crisis stage. The argument emerged that full employment must be the goal of government intervention (Pierson 1942: 229; Howenstein 1946), since “private capitalism is no longer capable of providing full employment” (Williams 1941: 58).

Defense spending was viewed as a convenient solution for increasing state funds due to defense’s popular acceptance as opposed to other forms of deficit spending. As early as 1933, Keynes acknowledged the power of military spending, advising Roosevelt that “stimulation of output by increasing aggregate purchasing power is the right way to get prices up” and “in a slump governmental Loan expenditure is the only sure means of securing quickly a rising output at rising prices. That is why a war has always caused intense industrial activity. In the past orthodox finance has regarded a *war as the only legitimate excuse for creating employment by governmental expenditure*” (Keynes 1933: 1; emphasis added).⁵⁷ And in 1939, as World War II loomed, Keynes gave his famous BBC radio address, “Will Re-armament Cure Unemployment?” in which he predicted the permanent war economy as a silver lining to war when he argued that “the grand experiment has begun. If it works, if expenditure on armaments really does cure

⁵⁷ Alongside this statement, Keynes (1933) commends Roosevelt for the force of political his political power that allowed him to “cast off such fetters” and be “free to engage in the interests of peace and prosperity the technique which hitherto has only been allowed to serve the purposes of war and destruction.” Later authors, to be discussed, would suggest that though the fetters had been loosened, they were still not sufficiently cast off until the war.

unemployment, I predict that we shall never go back all the way to the old state of affairs... Good may come out of evil. We may learn a trick or two, which will come in useful when the day of peace comes” (Moggridge 2010: 193).

This idea is one that has been carried throughout scholarship on the changing role of the state.⁵⁸ In 1939, Carter, Kazakevich, and Lamont argued that “[c]apitalist economies have always depended on an adequate flow of money income to keep them functioning at full capacity” and that “if spending on the New Deal model... is rejected, spending on something like the German model is bound to take place” (1939: 520).⁵⁹ Kelecki (1943: 324-327) noted that the U.S. public, especially the industrial leaders, dislike government interference for employment and the measure taken to ensure it, but that this dislike disappears when spending is used for armaments. The argument that emerged was that the defensive aspect was what allowed Roosevelt to spend at the levels needed for economic recovery (Oakes 1944; Reich and Finkelhor 1973: 188; Romer 1992, 2009).

In the midst of the war effort, concerns were growing that the removal of the military funds that accompanied the end of the war would lead back into economic collapse (Hirsch 1944: 122; Rosen 2005: 211). During the hostilities, the “problem of

⁵⁸ In the 1970s, Paul Samuelson argued that the failure of civilian spending lay with the political realm, noting that the citizenry “cannot *ideologically* stomach the political moves” outside of a defensive effort. In his words, “[a]n economically illiterate electorate may less reluctantly use the tools of the new economics for war than for peace purposes” (Samuelson 1973: 180). Markusen (1986: 498) also notes that military spending is a convenient political back door for Keynesian policies.

⁵⁹ In fact, the German model became a guidepost for how to overcome popular resistance to government spending, with the argument that in “Germany government spending has been developed on such a tremendous scale that the country is actually suffering from a shortage of labor and material equipment” (Carter, Kazakevich, and Lamont 1939: 520). As Kelecki (1943: 327) notes, in Germany, the “dislike of Government spending, whether on public investment or consumption, is overcome by concentrating Government expenditure on armaments.”

whether or not there existed a ‘lack of investment outlets’ as the ultimate reason for our inability to attain ‘full employment of resources’ in times of peace” had disappeared in the “course of the war economy” (Feiler 1942: 145). Arguments were made that war spending should continue after war’s end in order to smooth the transition (Slichter 1945: 161; Rosen 2005: 211).⁶⁰ Even after the brief period of demobilization, during which the economy had not returned to depression (Vedder and Gallaway 1991), the fear of economic collapse absent defense spending did not disappear (Hoover 1948: 399; Daugherty 1951: 46; Brady 1952: 43). The reasoning of economists who supported the continuation of defense efforts was that if “all the danger of war with Soviet Russia were permanently to disappear” and “deficit in the international payments of the rest of the world with the United States were like-wise to disappear,” then “the possibilities of a depression’s being thus engendered would be tremendous” (Hoover 1948: 399). Thus, the Cold War that followed World War II would allow the spending necessary to continue to postpone the collapse of the capitalist system as only military spending could do.

What has been downplayed in the existing discussions of the origins of the permanent war economy is the role that narrow interests played in taking advantage of the government interventions in response to the dual crises of the GD and WWII. The following pages will illustrate that it is not the saving of capitalism that brings about the military-industrial complex, but rather the selling of capitalism to those interests.

⁶⁰ Slichter (1945: 161) himself argues against the idea of continuing employment in war production, but notes the trend in the literature. Rosen (2005: 211) notes that “[w]ith the depression following the Great War a cautionary experience, John Kenneth Galbraith and Alvin H. Hansen envisaged a second postwar surge of demand followed by a severe downturn brought on by a decline in expenditure for consumption and investment” and argued that “the government should supplement private spending and investment by deployment of a shelf of public investment projects planned ahead at a minimum of six years.”

3 The Central Role of Special Interests

Though the economic mobilization for World War II would see a more rapid increase in federal spending, the Roosevelt administration was not inactive before 1939. In his first 100 days in office, FDR pushed through a record number of bills, citing the emergency and the need to respond to depressed wages and joblessness (Higgs 1987: 172-180; Smith 2007: 305-332). As Smith (2007: 332) notes, within the first 100 days, “Roosevelt had sent fifteen messages to the Hill, and Congress had responded with fifteen historic pieces of legislation.”⁶¹ These legislative actions, and those that would continue throughout the 1930s, became the foundations for the New Deal. They also became the foundations for the increasing role of government in the U.S. economy.⁶²

The legislative outpouring and political arbitrage spawned programs such as the Agricultural Adjustment Act⁶³, the National Industrial Recovery Act⁶⁴, the Tennessee

⁶¹ The list of legislation, provided by Smith (2007: 332) is as follows: the Emergency Banking Act on March 9; a revised Volstead Act on March 16; the Economy Act of March 20; Civilian Conservation Corps of March 31; the Federal Emergency Relief Act of May 12; the Agricultural Adjustment Act of May 12; the Emergency Farm Mortgage Act of May 12; the Tennessee Valley Authority Act of May 18; the Truth-in-Securities Act of May 27; the “abrogation of gold clauses in public and private contracts” of June 5; the Home Owners’ Loan Act of June 13; the Glass-Steagall Banking Act of June 15; the Farm Credit Act of June 15; the Railroad Coordination Act of June 15; the National Industrial Recovery Act of June 16.

⁶² Higgs (1997: 566) notes that the New Deal did not actually end the Great Depression, citing that “[d]uring the 1930s, private investment remained at depths never plumbed in any other decade for which data exist” and explaining that the New Deal kept the economy depressed due to the regime uncertainty created from the number of programs Roosevelt enacted.

⁶³ Smith (2007: 317-318) describes the Agricultural Adjustment Act as “the first genuine New Deal measure to Congress, an agricultural bill intended to raise farm income by reducing agricultural surpluses through a system of domestic allotments. Farmers would be paid directly by the government not to produce crops beyond the allotment set by the secretary of agriculture.”

⁶⁴ The NIRA was similar to the AAA, providing Presidential authority to create licensures and control imports in order to control the level of prices. It also provided legal support to unionization and established the Federal Emergency Administration of Public Works that would be headed by General Hugh Johnson, once Army liaison to the War Industrial Board during World War I (Higgs 1987: 177-179).

Valley Authority Act, and the establishment of the Civilian Conservation Corps, all geared towards putting American back to work. With each of these legislations came a wave of new government agencies and programs meant to contend with depression. As a “government program, particularly at the federal level, almost always confers substantial benefits on a relatively small group while at the same time spreading the costs widely (and hence thinly) over the population at large” (Friedman and Friedman 1984: 35-36), each of these programs formed its own “iron triangle” of beneficiaries, legislative backing, and bureaucratic administration (*Ibid.*: 42). It is within this context that several key interest groups took advantage of government interventions to secure benefits for their members. In doing so, these interests provided the origins of the permanent war economy.

3.1 The Military

The connection between New Deal employment programs and the military is not a difficult one to make. The level of employment that can be produced via the military branches has a direct effect upon the budget that each branch is allotted. Prior to World War II, the budgets of the service branches rose during mobilization and war and fell during demobilization and peace. While defense spending still exhibits a similar pattern today, the fall is not nearly as severe as that of the demobilizations prior to the Second

World War.⁶⁵ However, it is not just the war that causes this reduction in severity. The “necessity” of the military budget for employment was realized early in the New Deal.⁶⁶

One of Roosevelt’s first attempts to raise the general employment level was the establishment of the Civilian Conservation Corps in 1933 (Kennedy 1999: 144; Maher 2002: 436; Smith 2007: 319-320; Pfaff 2010: 1).⁶⁷ The Corps would have a profound impact on the way the military viewed the unemployment problem, as well as lead to its own iron triangle. With the dual goal of increasing employment and reclaiming the nation’s forests, the program was one of the largest and most popular make-work programs of the New Deal. Between 1933 and 1943, 2.5 million men participated in the Corps. The structure of the program was such that

men, ages eighteen to twenty-five, would live in government-built camps, food and clothing would be provided, and the pay would be a dollar a day. Enlistment would be for six months, with possible renewals up to two years. The Labor Department would recruit the men, the Army would run the camps, and the Forestry Service would supervise the work (Smith 2007: 320).

With its role of running the camps, the “U.S. Department of War (Army) had the enormous responsibility for enrollee administration, transportation, housing, food, clothing, supplies, medical care, education, discipline, physical conditioning, and recreational activities” (Pfaff 2010: 6). In terms of participation, the program boomed.

⁶⁵ See White House Office of Management and Budget, Historical Tables, Table 15.4.

⁶⁶ In response to the Army’s participation in the Civilian Conservation Corps, to be discussed below, Robert Fechner in 1935 wrote to General Douglas MacArthur upon the General’s retirement for Chief of Staff, stating, “I have repeatedly paid public tribute to the part that the War Department has played in this great undertaking, and I am convinced we could have never made a success of it had it not been for the wholehearted enthusiasm of the Army to do the best possible job in carrying out every part of the program” (James 1970: 425).

⁶⁷ Smith (2007: 320) notes that Roosevelt had previously employed conservation work to raise employment when he was governor of New York, and that in his acceptance speech for the Presidency he promised to “put a million men to work fighting soil erosion and reforesting the landscape.”

Congress voted the Corps into existence on March 31, and by April 6, the first 25,000 workers had already been enrolled for the conservation project to begin at Camp Roosevelt in the George Washington National Forest. Within a three month period, “an astonishing 300,000 men from all over the country had been enrolled, transported, and settled in almost 1,500 camps” (Pfaff 2010: 7).

The Army was able to benefit greatly from its role in the program. Upon taking office as President, Roosevelt had pushed a deficit reduction plan through Congress (Smith 2007: 314-316). In his attempt to secure the federal government’s credit, the bill supported cuts to a number of items on the federal budget, including cuts to the Army budget.⁶⁸ The Army cuts, though budgeted, would never emerge as it found protection through involvement in the employment program. As Smith (2007: 322) notes,

[a]fter the economy measure was passed in March 1933, FDR and the Bureau of the Budget zeroed in on the Army to absorb a significant portion of the cuts. The 1934 military budget was to be slashed by \$80 million, roughly 51 percent. But the necessity to get the CCC up and running placed a premium on military experience. Not only was the Army budget spared, but many reserve officers were recalled to active duty to manage the camps.

One of the ways the Army was able to increase its active budget was to suggest that, rather than the planned tent camps previously proposed, the Corps needed a more permanent housing structure of wooden buildings. Harold Ickes, director of the Public Works Administration, kept a tight rein on the public works funds allocated to the

⁶⁸ These cuts would also include reductions in salaries for both Congress and the President (Smith 2007: 314-316).

military⁶⁹, and “[s]ince the funds were set up for relief purposes, Ickes largely determined how they would be used and gave priority to projects employing large numbers of workers” (James 1970: 431). The Army, supported by the American Forest Products, Inc. industry group, argued for the addition of these constructed living spaces, convincing Roosevelt of the policy change when “[b]oth entities advocated that the use of frame buildings would create jobs in the lumber and construction fields” (Pfaff 2010: 7; see also Otis, Honey, Hogg, and Lakin 1986: Chapter 2).⁷⁰ With the additional construction, by “November 1933 the CCC boasted that more than 40,000 carpenters utilizing 300 million board feet of lumber would be building CCC camps in 46 states. The potential benefit to the lumber industry was obvious; however, related manufacturing and construction businesses would share in the profits as well” (Otis, Honey, Hogg, and Lakin 1986: Chapter 2).⁷¹ The Army also took steps to ensure local support of the project, contracting “with local labor to construct camp buildings in order to promote good public relations with the camps’ surrounding communities” (Pfaff 2010: 7).⁷²

⁶⁹ Ickes, who was also the Secretary of the Interior, “seemed to get diabolical delight from dangling before... MacArthur prospects for large sums from the P.W.A... though the actual obtaining of funds from that agency proved painfully slow” (James 1970: 430).

⁷⁰ Maher (2009: 88) also notes that the Association of State Farmers gained benefits from the Corps, passing “a resolution urging the CCC to institute forestry instruction in enrollee camps throughout the country.” Roosevelt responded by approving funds for the program through the Office of Education to hire 1,800 Forestry advisors for the camps (*Ibid.*: 88-89). When the plan for a more generalized educational system arose, General “MacArthur quickly modified a plan presented by the federal commissioner of education to make sure that the War Department would have the final word on ‘the outlines of instruction, teaching procedure, and the type of teaching materials for use in the camps’” and “often interfered with the instruction by forbidding discussion of ‘dangerous issues’ and ‘radical doctrines’” (James 1970: 423).

⁷¹ Quoted from Chapter 2 of Otis, Honey, Hogg, and Lakin (1986). *The Forest Service and the Civilian Conservation Corps: 1933-1942*, United States Department of Agriculture Forest Service. Retrieved from U.S. National Park Service: [http://www.nps.gov/history/history/online_books/ccc/ccc/]

⁷² The campaign for local support was successful enough that “in a random sampling of more than 200 letters written to the CCC in the mid-1930s by residents of towns and villages, a remarkable 85 percent requested additional camps or the maintenance of nearby camps already in existence” (Maher 2009: 116).

While saving the Army budget was one immediate outcome of the military's role in the Corps, it was not the only benefit it would see from the program. War veterans flexed their political power to secure themselves employment in the Corps as well. In May 1933, a "bonus Army" of veterans from World War I approached the Roosevelt administration in an attempt to secure their pensions for wartime service.⁷³ The pensions were not scheduled for payment until 1945, but having suffered in the depression, veterans were increasingly demanding the payment in advance. In order to address the situation, Roosevelt turned Fort Hunt, Virginia into a short-term veterans' camp, providing the bonus army with "[f]ood, tents, medical care, and transportation to and from the Capitol so the veterans could lobby" (Patton 2005: 163).

In order to appease the veterans, Roosevelt agreed to a compromise proposal by the veteran's administrator General Frank T. Hines, who suggested that rather than paying the full bonus, the Roosevelt administration could select veterans and place them in special Corps camps with the promise of a dollar a day (Salmond 1967: Chapter 2; Patton 2005: 163). While there was some initial disagreement, the veteran bonus army acquiesced to the compromise once it became clear that Roosevelt intended to close the temporary camp at Fort Hunt (Patton 2005: 163-164), and on May 11 Roosevelt issued *Executive Order No. 6129*, which "authorized the enrolment of 25,000 war veterans into the Corps, with no age or marital limitations imposed" (Salmond 1967: Chapter 2). Once

⁷³ This was not the first "bonus Army" to approach Washington, but the second. The first had descended on the federal government in the summer of 1932. The veterans, hit with the depression, sought to gather their pensions early, as payment was not due until 1945, however, the former soldiers on their first attempt "had been met instead by guns, bayonets, and tear gas" (Salmond 1967: Chapter 2).

it had achieved these gains through its political force, the veteran army became another vested interest in that it was unwilling to see that achievement disappear.

The veterans working with the Corps would again find political strength when it came to the term limits on Corps service. With an initial limit of six months, the veterans faced discharge by the fall of 1933, and

it was clear that separation from the Corps almost always meant unemployment... Faced with the possibility that discharged and then unemployed CCC veterans would bivouac in Washington for a third time... the Administration extended the veterans' time limit for service in the CCC. Late in 1933 the service limit was extended to nine months and in March 1934 when an 'April exodus' was expected, the Administration extended service to a year (Patton 2005: 164).

When the year time limit of employment was slated to expire, the veterans again threatened to march the bonus army on Washington. In return for not marching, Roosevelt indefinitely suspended the time limit on June 27, 1934 (*Ibid.*: 164-165).

The Corps came under threat once in the interwar period, when, with the coming of the 1936 election year, Roosevelt "intended to reduce the number of participants in hopes of reining in Government spending and presenting a more balanced Federal budget. The President wanted a cutback to 450,000 enrollees by June 1, 1936, and a corresponding closure of about 950 camps" (Pfaff 2010: 12). However, the camps provided \$5,000 to \$7,000 per month into local economies, making the politicians of each district very loath to allow the closures (Maher 2009: 136-137). Rather than meeting with success, Roosevelt met resistance from even his own party members, who argued for the Corps' "continuation at the increased levels. On March 14, 1936, two Tennessee Democrats, Speaker of the House Joseph Byrns and Representative Samuel McReynolds,

presented a petition to Roosevelt with the signatures of 233 House members requesting that he discontinue the proposed massive closure of the camps” (Pfaff 2010: 12).⁷⁴ The administration yielded to these political pressures, ensuring that “all existing camps were to be maintained and closed only when work projects were completed” (*Ibid.*).

Between the Army’s support from the forestry supply industry and local workers, the veterans’ increased political power via continuous threat of marching, and the support of the politicians who wanted to ensure a steady source of income into their districts, the Civilian Conservation Corps had enough leverage to survive into the war period, when the Army would no longer need the Corps to ensure its budget (Pfaff 2010: 15). Yet the military would not forget the power that it could wield by entwining itself with assured employment. By 1938, the direct funding that the Army would receive from the Works Progress Administration and the Public Works Administration, under which the Corps was founded, a sum of “\$250 million, about equal to the annual War Department budget over the previous 15 years” (Larrabee 1987: 108).⁷⁵ In an acknowledgement of the increased power that such ties brought⁷⁶, upon becoming deputy chief of staff in 1938,

⁷⁴ Maher (2009: 205-206) notes that the Society of American Foresters “hired a professional lobbyist, Charles Dunwoody, to coordinate efforts to defeat the proposal. Such actions helped bring farmers and ranchers into this ‘Forest Service lobby.’”

⁷⁵ Larrabee (1987: 108) also notes that “PWA funds, at Roosevelt’s insistence, had built two aircraft carriers, *Enterprise* and *Yorktown* for the Navy.” So the Army was not the only section of the military that was receiving benefits from the Roosevelt’s make-work programs. Kennedy (1999: 252) adds a light cruiser, named *Vincennes*, to the list of naval works programs.

⁷⁶ James (1970: 425-226) summarizes these ties that arose under MacArthur’s term as chief of staff, stating, “It had been politically expedient for the War Department to cooperate fully in the President’s pet project, and the Army’s efficiency in handling the C.C.C. had brought the military establishment more favorable publicity than any of its activities since the World War. Both MacArthur and the New Dealers found themselves in anomalous positions regarding the C.C.C. The President and the coterie of liberal advisers around him were indebted to the Army and its conservative generals for the organization and administration of the first and probably the most successful relief program of the New Deal. MacArthur and his military

George Marshall⁷⁷, who would later devise the Marshall Plan, “was displeased with how little advantage had been taken of the opportunities offered by the relief programs” (*Ibid.*). It was an oversight that future military leaders would fail to repeat. Of course, the military was not the only beneficiary of the New Deal programs or the war mobilization that followed.

3.2 *Labor*

One of the struggles Roosevelt faced in enacting his war policies in the late 1930s was the necessity of securing the support of the American labor movement. Throughout the 1930s, there were two opposing and competing forces in labor: strong isolationism and pro-foreign interventionism. While isolationist agricultural and service unions feared that their members would take the brunt of another war in terms of the draft and wage controls that would emerge should the U.S. enter into an economic strategy of foreign intervention (Roberts 1995: 29-30; Roberts 1995: 151), the arguments for active interventionist policies stemmed from the industrial unions that had early ties to military production.⁷⁸ As early as 1932, well in advance of the economic mobilization of the 1940s, sections of the labor movement favored a policy of rearmament, even though they remained strongly opposed to actual participation in foreign wars. While they did not

advisers, on the other hand, found in the C.C.C. a lever for prying funds for the Army from the President and Congress.”

⁷⁷ Marshall also involved himself in the Corps, establishing and supervising 19 camps throughout the Southeast in the interwar period (Larrabee 1987: 108). He would be promoted to General and nominated by Roosevelt for Army Chief of Staff in 1939 (Larrabee 1987: 96).

⁷⁸ Rearmament policies found early support from unions in the Los Angeles area, who had strong ties to the military through contracts to the area’s airplane industry (Markusen, Hall, Campbell and Deitrick 1991: 84-91).

want union members sent to fight on foreign soil, the interventionist members did see the economic benefits of preparedness.

During the 1932 AFL Convention the International Association of Machinists advocated a resolution whereby the “United States naval strength be built up to the maximum levels permitted under the 1930 London Treaty” (Roberts 1995: 34). In making his case before the gathered convention, Machinists’ delegate N. P. Alifas (AFL 1932: 394) cited the importance military spending on the unemployment grounds, arguing

What we need in this country now is work, and it seems to us that pursuing a building program of this kind is the logical thing to do in a period of depression... This matter affects practically every industry in the country. We are informed that the materials which go into the building of vessels for the navy come from practically every state in the union. It involves the production of steel, copper, tin, wood, and even cotton cloth, and the people who earn wages where these things are being produced, will purchase commodities which involve every conceivable line.

Despite the apparent gains for the Machinists, the economic gains to the other sections of the union were not yet enough to overcome the resistance of the isolationists. The resolution did not pass at the convention.

Though the gains were not enough to persuade the general votes of the convention, the AFL’s stand against the Machinists did not last long. In only a few months after the convention’s decision, the Federation’s Executive Council “came out in favor of a \$300 million naval appropriation that would bring United States naval strength up to levels authorized by the 1930 London Treaty” (Roberts 1995: 35). Even though the convention had recently ruled the argument inadequate, the “Executive Council cited the

justification that it would save existing jobs and create new ones,” and the AFL would “portray future military construction programs as victories for organized labor” (*Ibid.*).⁷⁹ For most of the decade following, the AFL appeared content to hold both a position in favor of disarmament and a position in favor of a military buildup. The challenge that Roosevelt would face in the future was how to create the proper incentives to ensure that isolationist resistance was overcome in the late 1930s and that a unified labor movement would support his armament policies.

While there was not an absolute consensus, as mentioned above, the labor movement did not generally support U.S. involvement in foreign affairs after World War I. Aside from the fears of the draft and wage controls mentioned above, the isolationists of the labor unions also rejected the notion that war preparations would benefit the movement, arguing that costs of war far outweighed any gains in employment and that the employment that would be created would only be temporary and unsustainable at war’s end (*Ibid.*: 171).⁸⁰ By the end of the first war, the American Federation of Labor, and later its splinter and rival the Congress of Industrial Organizations, had moved to a position of defending domestic programs that aided labor rather than advocating foreign

⁷⁹ AFL President William Green is quoted as saying: “Anti-war policies that wipe out men’s jobs without adequate provision for their future are not the way to peace” (Roberts 1995: 35).

⁸⁰ Roberts (1995: 171) notes the “concerns of labor isolationists that United States involvement in the war would have adverse economic and political repercussions on the country. Notions that the war would create a job boom were dismissed. The great profits to be realized from the war by big business would not trickle down to the worker, they argued. Consumer prices would skyrocket. Transfer of government funds from the Works Progress Administration and other federal jobs programs to the War and Navy Departments would, in fact, eliminate much employment. A huge national debt would be incurred, they said, that would inhibit prosperity. Extension of credit to the Allies would reduce the availability of capital for domestic business recovery. Even industries that might be buoyed by the war would collapse at war’s end, thereby ushering in a new depression. Far from anticipating more jobs and higher wages in a wartime economy, a substantial portion of the labor community was convinced that intervention would lead to economic hardship.”

military entanglements. It would not be until the late 1930s, as late as 1941 for the CIO, that the two union organizations would come to a consensus on a more active and interventionist foreign policy (Roberts 1995). The road to that consensus did not come to fruition absent self-interest.

Early into the New Deal, Roosevelt knew he would have to appeal to the unions for support, and labor would come to be an integral part of the New Deal Coalition as the direct benefits of Roosevelt's domestic programs were realized. In the initial maneuvering to get the Civilian Conservation Corps established, Roosevelt encountered resistance from the labor movement, where the unions began to politicize the idea that the Corps was the administration's attempt to create fascism in the U.S. (Maher 2009: 107-108). One of labor's main concerns was that the Corps would be used to train skilled workers, un-unionized, who would later compete for work with union members (Maher 2002: 438; Maher 2009: 79). In order to gain the support of labor for his project, Roosevelt appointed Robert Fechner, who at the time was vice president of the AFL's Machinist Union, as director of the Civilian Conservation Corps program (Stiles 1954: 267; Salmond 1967: Chapter 2; Smith 2007: 321; Pfaff 2010: 6).⁸¹

Fechner's appointment managed to satisfy two political needs for Roosevelt. The first is that Fechner, being a labor man, assuaged the unions' outcries by ostensibly giving them a position of power to oversee the camps and ensure that their interests were

⁸¹ Roosevelt also arranged for personal tours conducted by himself and AFL President William Green to ensure that he continued to ingratiate himself to labor's top members (Smith 2007: 321).

being taken into account.⁸² The second is that, in choosing Fechner, Roosevelt had appointed a director with labor backing that would, in fact, defer to both the Army leadership and Roosevelt's personal involvement (Salmond 1967: Chapter 2). The attachment to the Corps was one of the ways in which the military and labor became entwined, but the true gains of military spending would come later as the economic mobilization began. Labor's continued gains from the New Deal would make sure that the unions were in position to benefit by the time war came.

The support of labor for Roosevelt, and his need of their support, led to union entrenchment in the New Deal Coalition, and one of the concessions that labor would extract from the administration was the enactment of the National Industrial Recovery Act of 1933 and, later, the National Labor Relations Act of 1935.⁸³ Written into the two acts was the explicit legal right for workers to organize and engage in the practice of collective bargaining, providing federal support to union practices.⁸⁴ Though the NIRA would later be ruled unconstitutional by the Supreme Court, it had a major early influence on the strength of the labor movement. Between the act's jobs programs and the federally enforced right to organize, union membership surged,⁸⁵ creating an even more

⁸² The American Federation of Labor would join with the Forest Service lobby when the program was threatened by Roosevelt's reorganization plan (Maher 2009: 206).

⁸³ The National Industrial Recovery Act was ruled unconstitutional on May 27, 1935 by unanimous Supreme Court decision (Higgs 1987: 188), which struck its protection of collective bargaining along with the other parts of the legislation. In response, Senator Wagner reintroduced the National Labor Relations Act that strengthened the union position still further (*Ibid.*: 191). See also (Higgs 1987: 178; Higgs 2005b: 10; Smith 2007: 358).

⁸⁴ The later Fair Labor Standards Act of 1938 aided union ambitions still further as it "stipulated regulations of minimum wages, maximum hours, and working conditions" (Higgs 1987: 191).

⁸⁵ In a speech at the 1933 AFL Convention, held only a few short months after the Act was passed, Green acknowledged that "[w]e are witnessing a sight that even the old, tried veterans of our movement never saw before. From every city and every town and every hamlet, from the Canadian border line to the Gulf of

valuable political ally for Roosevelt and making labor more willing to follow Roosevelt's political lead. As the administration turned its attention fully towards war at the end of the decade, the growth of labor's political influence and the flood of federal defense spending available to those with such influence would pull labor into full support of military programs.

Labor's support for the war effort crept through the movement in the same direction as the availability of military spending. The unions that first changed their political direction with regards to rearmament were those that first realized the benefits to themselves of government contracts. The first of the unions to be swayed toward defense spending were those that operated in the heavy industry, where the benefit from defense funding would be the greatest (Roberts 1995: 151). In the late 1930s, the sentiment spread from the Northeast and the South, with strong support coming from the Los Angeles unions (*Ibid.*: 191-192) who were already benefitting from the connections between southern California's aerospace industry and military funding (Markusen, Hall, Campbell and Deitrick 1991: 84-91). Tensions in the labor movement persisted, with resistance to armament led by the agricultural and service industries (Roberts 1995: 150), until 1940, when Hitler's Nazi Germany overran much of Europe.

Roosevelt was able to capitalize on the fear caused by Europe's fall to initiate a deal to provide destroyers to Britain in return for bases closer to U.S. shores⁸⁶, enact

Mexico and from historic Boston to the Golden Gate, the workers are marching, organizing, keeping step, coming with us into the great American Federation of Labor" (AFL 1933: 8).

⁸⁶ The Destroyers for Bases Agreement was among Roosevelt's most hotly contested actions, as it was the beginning of the President accessing his War Powers outside of an official declaration of war. For the

restrictions on trade with Japan, and institute a peacetime national draft (Rutherford 1939: 9; Higgs 1987: 199-201). However, even with Roosevelt's increased authority due to the nation's fear, the unions were able to wring concessions from the administration. The boycott of Japan and Germany had been longtime goals of the AFL as it sought promotion of its "Buy American" campaign (Roberts 1995: 108-109), so in that labor's and the President's interests were aligned.

With the institution of the draft, until the attack on Pearl Harbor, union political power and the isolationists in Congress were able to force Roosevelt into the provisos that troops would be kept in the Western Hemisphere and that deferments would be granted for men employed in "essential jobs" (Rutherford 1939: 9; Higgs 1987: 199-201). Even as he gave his famous "Arsenal of Democracy" speech, in which he would promise armament support for Britain, Roosevelt (1940) was careful of union interests, working to negotiate with the unions to avoid strikes by declaring that "[i]f our capacity to produce is limited by machines, it must ever be remembered that these machines are operated by the skill and the stamina of the workers" and "Government is determined to protect the rights of the workers" since "workers provide the human power that turns out the destroyer, and the planes and the tanks." In return for a promise to forgo striking, the union leadership secured promises of federal protection for workers (Roberts 1995: 267).

With the fear of Germany and Roosevelt's power both growing, federal spending capacity also grew. The floodgates of federal money were once again opened by the crisis

ensuing legal debate, see Burlingham, Thacher, Rublee, and Acheson 1940; Borchard 1940; Briggs 1940; Fenwick 1940; Jackson 1940; Wilson 1940; Wright 1940.

of war in Europe that American's were increasingly unsure that they could avoid. By the summer of 1941, unions everywhere⁸⁷ were realizing the gains to be had from ties to the growing defense efforts. The increased spending led to opportunities the unions could not ignore⁸⁸, and

[l]abor groups that had discounted the prospect of a job boom early in the war started clamoring for defense contracts. Munitions factories, construction of army camps, and ancillary endeavors from highways to housing to mining for strategic minerals offered employment. Moreover, job-creating civil projects, such as airport improvements, suddenly could be justified and funded in the name of national defense (Roberts 1995: 201).

Formerly anti-intervention unions began to turn on their isolationist politicians, those who had once been allies in their opposition to rearmament policies, unhappy with the politicians for their failure to secure defense contracts in union districts.⁸⁹

Of course, as great a draw as the new contracts were, it was not just spending that would benefit the unions. As U.S. involvement in World War II began in earnest, labor's

⁸⁷ As Roberts (1995: 201-202) notes, "All manner of unions envisioned the prospect of more paydays because of the defense program. The American Federation of Teachers (AFT) did not resolve to support intervention until 1941 and in August 1940 more than 200 of its locals expressed overwhelming opposition to getting involved in the war. Yet in the same month the AFT's Executive Council sought to tie greater spending in education to the defense effort. 'Whereas public education is the front line of defense of the American democracy,' the Executive Council proclaimed, expanded education programs were needed to teach democratic values, promote good citizenship, and bolster the morale of the country's youth during a time of great national peril."

⁸⁸ For example, the AFL was able to convert a number of its domestic programs into a repackaged defense program. As Roberts (1995: 266-267) documents, "for years the AFL had urged the federal government to fund low-cost housing... as a powerful stimulus to the economy and an important source of jobs. It even tended to see defense spending as being in conflict without housing appropriations. By 1940, the conflict was resolved. The AFL gave a new name to an old program, as it championed increased federal spending for defense housing... Providing low-cost housing for [defense industry] workers... could suddenly be justified in the name of defense. Without adequate housing, the argument went, workers' efficiency would be impaired and defense production would suffer."

⁸⁹ Roberts (1995: 201) notes that "Montana unionists typified the changing mood of labor isolationists. Initially opposed to the war and to defense spending, they turned to berating isolationist United States Senator Burton Wheeler – a longtime ally – for failing to secure defense contracts for the state. Even the strongly anti-interventionist Chicago Federation of Labor saw economic benefits to be derived from Roosevelt's defense policies."

necessity only increased. The unions were quick to realize their growing authority and explicitly moved to use it to their advantage. In their analysis,

[t]he war effort needed labor's support. In return for that support, and to make that support effective, labor needed morale-building guarantees: that living standards would be protected; that unions would be able to grow; that an equitable tax system would be developed; that profiteering would be checked; that social security would be broadened; that unemployment would be cushioned; and, above all, that labor would take its rightful place in policymaking bodies (Roberts 1995: 265).

The labor movement would not achieve all of its goals, but it did make large strides. Union leaders were able to court both industry and politics with their newfound power through defense. Labor, using the crisis of war and its federal backing, was able to force its way into high profile corporations where it had previously been thwarted, companies such as Bethlehem Steel, Republic Steel, and Ford Motors (*Ibid.*: 281). Pursuant to the National Labor Relations Act, “the government enforced a ‘maintenance of membership’ rule, which helped the unions to add some four million new members to their ranks—an increase of approximately 40 percent—during the war years” (Higgs 2005b: 10).⁹⁰

The war effort and unions’ political clout also ensured labor involvement in the higher ranks of government programs that were created throughout the war. Leading union members pushed their way into positions on the National Defense Mediation Board, a tripartite agency designed to settle disputes between labor and industry during

⁹⁰ Higgs (1987: 216) describes the “maintenance of member” program, supported by the National War Labor Board, as follows: “Where and open shop had existed and the union was demanding a union shop, the board provided that during a fifteen-day ‘escape period’ any worker could resign from the union and retain his job. After the escape period, union members had to remain members and pay dues for the lie of the contract, and the union remained the exclusive collective bargaining agent at the workplace no matter how many nonunion workers subsequently became employed there. Employers did not like this; they considered it a union shop in disguise.”

the war, and the National War Labor Board, which had similar goals to the Mediation Board (Roberts 1995: 280). As price controls were enacted, unionist Sydney Hillman was able to secure a place on both the National Defense Advisory Commission and the Office of Production Management (Higgs 1987: 203; Roberts 1995: 280), which enabled him to instigate the withdrawal of defense contracts from companies that violated the National Labor Relations Act (Roberts 1995: 281). AFL's Joseph Keenan and CIO's Phillip Clowes were appointed to the War Production Board (Roberts 1995: 280).

Union inclusion on these agencies and war boards allowed labor to find exemptions for its own wages even as price controls were enforced elsewhere in the economy. Labor leadership “finagled constantly to push wages and other compensation above the limits the government had set in an effort to restrain the wage-price spiral that its inflationary monetary policy was causing” (Higgs 2005b: 10), and “[b]etween the end of 1940 and the end of 1944, average hourly straight-time earnings increased about 40 percent while weekly earnings went up about 80 percent” (Higgs 1987: 215). Not only did labor ensure that their wages were higher, they also found that with their new position of influence, “small businessmen approached labor executives as supplicants, appealing for their support in obtaining defense contracts and raw materials” (Roberts 1995: 280). As the war proceeded, union leaders, not wishing to give up their influence, ensured that “[t]ripartitism – the equal representation of business, government, and labor – became the guiding principle underlying the numerous agencies that the federal government established to handle defense-related matters” (*Ibid.*: 280) and, through the political strides made by labor leaders, “when the World War II ended in 1945, organized labor

held a far more secure and stable position in the United States than it had held before the war” (*Ibid.*: 281). This secure position ensured that labor would play a key role in the permanent war economy well after the end of the war.

3.3 *Industry*

Though industry would eventually become a central player in the tripartitism during World War II, business leaders, much like the leaders of labor, were a vested interest that Roosevelt had to bring on board with his rearmament program. Also like labor, industry did not project a unified stance against rearmament. There were a few businesses before 1940 willing to let the War Department test their munitions capabilities,⁹¹ and the air industry, with its success at gaining contracts during World War I and in continuing those contracts afterward, was less opposed to accepting government funding.

The air industry, unlike other munitions, could use government contracts to produce the same products as their private production, without having to reconvert factories to military production. The air industry was also one of the first to recognize the gains that the link to unemployment could provide. When Lockheed Aircraft Corporation’s profits declined in 1934, Robert Gross, who had invested heavily in Lockheed, approached the “Roosevelt-created Reconstruction Finance Corporation for a revolving loan of \$150,000” and “debuted the arguments that were to figure so

⁹¹ Rutherford (1939: 4) documents how the National Defense Act of June 16, 1938, established a process of “educational orders” whereby the “Secretary of War is authorized to select qualified commercial manufacturers and give them small contracts for noncommercial items of munitions such as guns and ammunition, so that these manufacturers will be reasonably familiar with the problems involved in manufacturing these articles in time of war.”

prominently in later debates over government aid to the company – creating jobs and preserving the industrial base” (Hartung 2011: 39-40).

While there were gains in the specific air industry, industries role in the permanent war economy would begin more generally with the actual mobilization rather than the New Deal, and they would have to be paid well for participation in the buildup. Unlike labor, the New Deal had not been favorable towards industry,⁹² and industry did not have the same willingness to work with Roosevelt. The public also had a special aversion to military industries during the interwar period.

At the end of World War I, a strong sentiment arose through the U.S. that the profits of industry⁹³ had been the reason for American entry into the war.⁹⁴ According to this view, the only ones to profit from armed conflict were those who used the war to

⁹² The depression had shattered public confidence in industry leadership, and those who spoke out against Roosevelt’s deeply intrusive economic policies were branded “slackers” and worse, with the blame for the economic collapse laid on the shoulders of business (Higgs 1987: 179; see also Higgs 2006: 47-48; White 1949: 159). Those who had become wealthy through industrial profits often came under fire from the New Deal redistributive policies. In 1935, Roosevelt sought the implementation of what he referred to as a “wealth tax” in with the passage of the Revenue Act of 1935, a progressive income tax bill that opposition would refer to as the “soak-the-rich” tax (Kennedy 1999: 275-278). The bill would be amended with the Revenue Act of 1937 to close loopholes found in the tax system. Roosevelt also implemented a tax on undistributed corporate profits, which taxed the savings of corporations in an effort to “create incentives to distribute profits in the form of higher wages or dividends, thus stimulating consumption” (*Ibid.*: 279). Business leaders viewed this tax as looting their “rainy day” funds and making it more difficult to invest in industrial infrastructure absent bank involvement (*Ibid.*: 280). The combination of these taxation policies deepened the mistrust of industry for Roosevelt.

⁹³ Koistinen (1967: 390) notes that during World War I, “[a]ctually, if not nominally, industrialists awarded contracts to themselves and their colleagues. Small groups of businessmen admittedly engaged in collusive activity - activity sanctioned by the government.”

⁹⁴ The general sentiment is reflected in Engelbrecht’s and Hanighen’s (1934) *Merchants of Death*, a study in World War I war profiteering, becoming a bestseller in the year it was published. Engelbrecht and Hanighen (1934: 178) argued that “the profits reported were simply colossal. Du Pont paid a dividend of 100 per cent on its common stock in 1916. The earnings of the United States Steel Corporation for 1917 exceeded by many millions the face value of its common stock, which was largely water. In 1916 this same company reported earnings greater by \$70,000,000 than the combined earnings of 1911, 1912, and 1913. Bethlehem Steel paid a stock dividend of 200 per cent in 1917. U. S. Treasury figures show that during the war period 69,000 men made more than \$3,000,000,000 over and above their normal income. Almost immediately the cry of profiteering went up.”

protect their foreign economic interests and those who grew rich selling arms and equipment to government to arm their soldiers. A deeply anti-business streak entered into American thinking and politics, with the military industry leaders being labeled “merchants of death” (Higgs 2005b: 7; Higgs 2006: 41). This sentiment was captured by Major General Smedley Butler, a twice over Medal of Honor recipient, who wrote that,

War is a racket. It always has been. It is possibly the oldest, easily the most profitable, surely the most vicious... Out of war a few people make huge fortunes. In the World War a mere handful garnered the profits of the conflict. At least 21,000 new millionaires and billionaires were made in the United States during the World War. That many admitted their huge blood gains in their income tax returns. How many other war millionaires falsified their tax returns no one knows (Butler 1935: 1).

The public sentiment that the First World War had been fought for the profits of businessmen was pervasive enough that Congressmen found it politically advantageous to push the anti-war campaign against industry.⁹⁵ The Vinson-Trammel Act of 1934 specified restrictions on the level of profits that a manufacturer could receive for military production in wartime (White 1949: 165; Higgs 2006: 52).⁹⁶ Another governmental response was the formation of the Nye Committee, a Senate committee, lead by Gerald Nye, charged with investigating whether or not World War I had been fought in the name of defense or in the name of profits.⁹⁷ As the investigation progressed, the committee pushed for price controls, high industrial taxes, and the removal of Navy shipyards from

⁹⁵ Higgs (2006: 46) comments that in calculating the risk of rearmament, industry feared that government might, “as it had after World War I, file suits after the war for recovery of funds advanced to stimulate investment in war facilities.”

⁹⁶ Higgs (2006: 52) notes that the Merchant Marine Act of 1934 similarly limited the profit margins of industry.

⁹⁷ See United States Senate, *Art & History: Senate Stories 1921-1940, “Merchants of Death”*. [Retrieved from: http://www.senate.gov/artandhistory/history/minute/merchants_of_death.htm] The Nye Committee would conduct 93 hearings involving more than 20 witnesses. The committee’s efforts led to the institution of the neutrality acts of the 1930s.

private hands (Roberts 1995: 28). While the Nye Committee ended largely unsuccessfully in its policy endeavors, the attempts increased the risk that business faced in getting into defense manufacturing.

The risks were already substantial. Industry leaders feared not just the political backlash of rearmament, but also the economic damage to their own companies that could result from the conversion process. After the war buildup for World War I, many industries had built up excess production capacity, no longer usable after war's end and especially throughout the depression, and were loath to repeat the process for a second war buildup (Yntema 1941: 375-377; Higgs 2006: 45-46). War products were not easily convertible to consumer goods, and idle factories were a drain on the industry. Not only would resources for the war effort have to be pulled from the production of consumer goods, but the resources would also need to be the "cream of the industry" to provide the highest quality war materials (Rutherford 1939: 8). When the administration's shift in focus from New Deal to war buildup came in 1940,⁹⁸

[p]rivate capital... was yet understandably timid at the prospect of investment in defense industries because of the risk involved. The sense of risk may well have been heightened by the long period of friction between the New Deal and the financial community. Only if this risk could be offset by substantial inducements was private capital likely to be available for defense financing in sums approaching the large amounts believed necessary (White 1949: 159).

The substantial inducements were forthcoming, though, as no modern great war could be fought without substantial industrial capacity.

⁹⁸ Higgs (2006: 47) cites a *Fortune* poll as late as October 1940 where 59 percent of businessmen were still hesitant to enter the defense industry.

Two of the first concessions the Roosevelt administration made to industry were the legislative acts of June 28 and July 2 that authorized the military branches to negotiate their own cost-plus-fixed-fee contracts with their chosen industries (Higgs 2006: 49). These acts had two major effects on the procurement process: 1) they removed the preceding process of open advertisement and competitive bidding for defense contracts, whereby bidding became contract negotiation with firms⁹⁹, and 2) they gave the military branches sweeping authority to negotiate with contracts with the firms with which they had the closest connections. These changes alone were dramatic.

Industry responded positively to the gains of the cost-plus-fixed-fee program. These contracts gave government assurance that all costs would be covered with an additional 7 percent fee for each commission, ensuring there would always be a profit to production. The change to interacting with specific branches, combined with the lack of oversight, also further afforded the opportunity for further budget and profit deals. The negotiation system led to a procurement process whereby “deals came to turn not on price, but on technical and scientific capabilities, size, experience, and established reputations as a military supplier – vaguer attributes that are easier to fudge for one’s friends” (Higgs 2007: 308; see also Elberton Smith [1991] 1959: 311). Once the “price” became determined by the administrative decision of the branches, firms did not have to vie for who can achieve a lower product price and cost but rather who can compete best

⁹⁹ Higgs (2006: 49) notes the dramatic shift in procurement: “In the fiscal year ending in June 30, 1940, the War Department had made 87 percent of its purchases through advertising and invitations to bid. During the following eight months, the department spent ten times as much and placed 74 percent of the contracts, by value, through negotiation.”

in terms of a display of ‘competence’¹⁰⁰ and in terms of “political clout... rather than the price-quantity contest that is more characteristic of civilian firms” (Melman 1985: 35).

Cost assured contracts were not the only concessions the Roosevelt administration made in order to attract business interest in war production. Industry leaders were still concerned with the problem of excess capacity. Building specialized plants to increase production of war materials was costly, and there was little assurance of the plants’ viability in the post-war period. In order to incentivize plant production, the Advisory Commission to the Council of National Defense (NDAC), headed by U.S. Steel’s chairman Edward Stettinus, General Motor’s president William Knudsen, and Sears’s executive Donald Nelson (Higgs 2006: 44), instituted a program of Emergency Plant Facility contracts, whereby a contractor financed the acquisition of a plant with the government promise to reimburse the contractor fully within 60 month time period (White 1949: 171-173; Higgs 2006: 57).¹⁰¹ The Emergency contracts also reorganized the financial structure by allowing reimbursement payments to private banks, freeing up industry to take on loans that were federally backed (*Ibid.*).

A second strategy employed to promote industrial plant acquisition was enacted through the Defense Plant Corporation, a subsidiary of the Reconstruction Finance

¹⁰⁰ Melman (1985: 35) defines competence as “the readiness and ability of the particular firm to satisfy the Pentagon’s requirements in the judgment of its top management. It means its ability to collaborate with the Pentagon-level administrators to turn out the sort of product that the Pentagon wants with regard to details of product designing, testing, producing and servicing.”

¹⁰¹ The contract also came with a promise by government officials that the plant would not be used for “business or commercial purposes” which ensured that the government owned facilities would not become competitors in industry after the end of the war (White 1949: 173; Higgs 2006: 57).

Corporation.¹⁰² Under this strategy, the federal Corporation bought the industrial plants and leased the productive capacities to private industry for production purposes. The DPC allowed for two types of lease agreements: 1) plants were acquired by the DPC and leased to outright to the contractor, and 2) the contractor held a rental agreement based on sales volume, with the contractor paying rent at a rate of 80 percent of sales capacity over a five year period, which practically meant that the DPC was assuming partial non-repayment risk if the plant was not able to work at capacity (White 1949: 175-76: see also Yntema 1941: 373-374; Higgs 2006: 58-59).¹⁰³

Having used its influence on the NDAC and the RFC to enact both the Emergency Plant Facility and the Defense Plant Corporation, industry ensured that the federal government assumed the lion share of the risk for industrial plant acquisition, allowing the profits of the actual product to accrue to business with tax payers holding the downside. Not only did industry negotiate for more risk-free profits, but business leaders were also successful at legally gaining a greater profit margin. The Second Revenue Act of 1940 removed the previous Vinson-Trammel Act and the Merchant Marine Act. While it did raise corporate taxes and impose an excess-profits tax, the Act held enough loopholes that “[e]ighteen leading aircraft companies... managed to earn profits of almost 26 percent on their net worth in 1940; and despite booming business, only five of twelve integrated steel companies had to pay excess-profits taxes for that year” (Higgs 2006:

¹⁰² The Defense Plant Corporation was a subsidiary of the Reconstruction Finance Corporation, which was head by Jesse Jones, a Democratic Texas banker and businessman (White 1949: 161; Higgs 2006: 59).

¹⁰³ In the following year, 1941, the authority of the Reconstruction Finance Corporation would be expanded so that lease agreements could be offered to any industry “necessary for the national defense,” including railroads, commercial aircraft, and any other industry for which a claim could be made (White 1949: 180-181; Higgs 2006: 59-62).

53). Where the military would see its budget expanded and labor see its employment rise, industry would see its profits soar.

4 Implications and Conclusion

By war's end, all three interest groups, the military, labor, and industry, had experienced the greater monetary and political gains offered by the crises of depression and war, and they would be in a position to ensure that war economy, and their gains, survived. The iron triangle was complete, with the vested interests of “[b]ig business, including its powerful friends and representatives..., and the newly but vastly empowered military establishment together”, which “formed a potent political faction” (Higgs 2006: 73). As “[u]nions could not afford endlessly to neglect their immediate self-interest”, organized labor also remained “a junior partner in the postwar complex” (Koistinen 1973: 477). Though the popular sentiment for a respite from the war effort was too great to prevent a short-lived demobilization, American military planners were already looking at the Soviet Union as the source of the next crisis with which to exert their influence (Biddle 2007: 141). With only a short pause to gather its strength, the military-industrial complex found itself attempting to influence the policy against a potential threat that would last for over four decades. And, in the post-9/11 world, the military-industrial complex has again shifted focus to the transnational “War on Terror” which has further extended and sustained the permanent war economy. Indeed, as Mueller (2006) shows, an entire “terrorism industry” consisting of consultants, counter-terrorism experts, and pundits has emerged in the wake of the 9/11 attacks (see Mueller 2006).

The rise of the permanent war economy, however, was not a necessary outgrowth of capitalism. Indeed, the central implication of our analysis is that rather than the permanent war economy being the natural outcome of capitalism, it is, in fact, the natural outcome of opportunities created by governments in response to crises of depression and war (real and perceived). These responses had two effects. One, it led to an increase in the scale and scope of government interventions into the private economy. Second, it created the conditions for cronyism through private-public partnerships of well-placed interests.

When the constraints on government are removed or weakened, narrowly-focused special interests are able to influence government policies and interventions to benefit their members at the expense of the average taxpayer. As crises lead to increased government authority, the interests become entrenched and do not allow economic activity to fully return to its previous state of economic activity (Friedman and Friedman 1984; Higgs 1987, 2004, 2005a, 2006, 2012). This leads to the expanded role for state intervention in contrast to the system of free enterprise and capitalism rather than in support of them. When the state begins to incentivize the production of military goods, it does so at the expense of the goods the American consumer actually wishes to purchase (see Duncan and Coyne *forthcoming*). It is this logic which underpins the origins and perpetuation of the permanent war economy. The solution, to the extent that one exists, must deal with those vested interests that perpetuate the narrative of an untouchable military budget.

CHAPTER 5: Conclusion

The military-industrial complex has thus far not been contained. It has become a vast network of centralized control and vested interests. In the current climate of budgetary crises, defense spending will continue to be a topic for discussion. This dissertation extends the literature on the political economy of the military-industrial complex to have that discussion take more account of the costs and political maneuvers that are involved in the continuation of the permanent war economy. The current notions of the budget cuts must take seriously the idea that defense spending is not untouchable.

If political contacts or “clout” determine the dispersion of the rents through the military procurement system, then the permanent war economy may not only be producing inefficient amounts of military products that are necessary for national defense, it may also be producing in substandard areas of industry. The areas that produce the most contracts or the most benefit to the interest groups will be the areas that receive federal funding, rather than the areas for which the funds good be distributed to ensure a cohesive national security strategy. The permanent war economy is not just a transfer program. Not only does the rent-seeking process come with its standard deadweight loss inefficiencies, but the resources that go into the military are also pulled from the more productive capacities of the private economy. This reasoning also implies that the

contemporary claims of economic collapse should the defense spending be reduced may be responses from the vested interests rather than claims of economic certainty.

Given the vast amount of federal funding that is dispersed throughout the military-industrial complex, and the long-term influences the complex has on both the economic activity of the United States and its approach to foreign policy, it is vital that economists and policy-makers are not too quick to assume that current levels of defense spending are necessary for the continued health of the economy as a whole. While the interest groups are a powerful force, it may be the case that not only would the economic health of the U.S. not suffer from a reduction in spending, but that productive activity geared towards the satisfaction of actual consumer demands would lead to greater well-being of American citizens and the world as a whole.

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