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War and the growth of government☆

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ABSTRACT

This paper empirically examines how wars impact the size and scope of government using a panel of all wars from 1965 to 2010. Higgs (1987) gives us reason to believe that wars may permanently increase government size and scope while Olson (1982) describes how wars can dislodge interest groups and allow for market liberalizing reforms. We find that wars permanently expand the scope of government regulation but do not impact government size systematically across the countries we study.

1. Introduction

Wars destroy lives and capital while they are fought. But their impact on human suffering could last into the long run if they change a country's institutional environment. Institutions are an important fundamental cause of economic development (Rodrik et al., 2004) and a growing empirical literature supports the importance of an institutional environment of strong private property rights, a rule of law, and an environment of economic freedom for promoting long run growth (for surveys see: De Haan et al., 2006; Hall and Lawson, 2014). This paper examines how wars impact aspects of these institutions.

There is a large political economy literature that explains the existence of government policies as the result of the power of vested interests.[1] The role of ideas, which has gained more attention recently has long been assumed to play a role. Keynes even claimed the primacy of ideas, “The ideas of economics and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist” (1936: 383).

Crises impact both interests and ideas. Crises can lead to a change in policies “because prevailing interests may lose some of their legitimacy and because incumbents may be open to trying new remedies” (Rodrik, 2014: 203). In other words, crises can break the political equilibrium by changing the power of vested interests or changing peoples' ideas about how the world works and what policies a government should adopt.

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[1] See Mueller (2003) for a survey.

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Leighton and Lopez (2012) offer a comprehensive treatment of how new ideas result in political change that overcomes the forces of the status quo. In their treatment, ideas filter down from academics to public intellectuals and then on to public opinion. All the while, bottom up forces of nature and nurture also influence people's beliefs about the appropriate role of government in society. When bottom up and top down forces align, political change that changes the rules of the game can take place. These new rules will create new incentives and a new status quo.

War is one major form of a crisis that could impact the strength of interest groups and peoples' ideas about the proper role of government. Wars could influence the ideas of the intellectuals to help generate top down social change and/or war could be a bottom up influence on people's ideas about the proper role of government in other non-military areas of society. We empirically investigate how wars have changed the size and scope of governments over the last 40 years.

There are theoretical reasons to believe that war could either increase or decrease the size and scope of government. Higgs (1987) argued that the U.S. government's growth in the 20th century was caused by a “ratchet effect” stemming from crises. In times of crisis people demanded increased government services and interventions as their faith in the efficiency of markets is shaken or a larger government was needed to fight wars. According to Higgs, the scope of government is expanded during the crisis, but then after the crisis passes government does not revert all the way back to its pre-crisis size and scope (the ratchet effect). Higgs theorizes that both ideas and interests play a role in locking in the growth of government. Interests who benefit from the growth of government lobby to keep the new policies and individuals do not demand that the government revert to its original scope because they are more accustomed to the new role of the state.[2]

War could permanently expand the size of government for non-Higgsian reasons as well. When a country unexpectedly has a war imposed on it, that country might find it necessary to increase the menu of benefits available for veterans in order to induce more enlistments while not bearing the direct cost of those benefits during the war. After the war, the demand for these veteran benefits would naturally increase government spending and taxing, though there is no necessary connection here to the scope of government regulation as we measure it in this study.

Alternatively, Olson (1982, 2000) argued that major disruptions and crises, such as wars, remove entrenched interest groups and clear the way for productive reforms. Olson theorizes that interest groups form over time, as they solve collective action problems, and demand more public goods and pursue the cartelization of the economy. This implies that over time rent seeking will expand the size and scope of government. A war can shatter these interest groups allowing reforms that shrink the size and scope of government.

Both Higgs and Olson point to World War II for evidence in support of their theories. The case of the United States during WWII fits the narrative of the ratchet effect well, with government spending increasing drastically during the crisis of WWII and the Great Depression and contracting after the war ended. However, government spending and the size of the military never contracted to pre-WWII levels (Higgs, 1987).[3] Conversely, the cases of post-war Japan and Germany are described better by Olson's theory. Both Japan and Germany were plagued by economic stagnation and high inflation before WWII, but after massive destruction and the breakup of powerful interests, both countries had smaller governments and experienced impressive economic expansion (Coyne, 2008).

This empirical paper is not a “test” of either Higgs or Olson. We find both of their accounts compelling in the countries that they studied. Rather we are motivated by their theories to look at a broad cross section of countries to see how prevalent either ratchets in the growth of government or liberalizations following wars are.

Our study also relates to the broader literature on crises. A number of countries that have undertaken major liberalizations in the last twenty years. Ireland, New Zealand, and India, all experienced some form of financial crisis immediately prior to liberalization (Powell, 2008). Pitlik and Wirth go so far as to say, “A commonly shared wisdom among economists and political scientists is that crises promote the adoption of market-oriented reforms” (2003: 565). There are a few papers that have empirically examined whether financial crises impact the size and scope of government across a cross section of countries.[4] Pitlik and Wirth (2003) examined how GDP growth crises and inflation crises impacted the economic freedom scores of 57 countries over five year periods from 1970 through 2000 and found that deep growth and inflation crises were significantly correlated with increases in economic freedom. Similarly, De Haan et al. (2009) find that banking crises are correlated with decreases in the size of government, as measured by the economic freedom index, over five year periods.

However, Bologna and Young (Forthcoming) give us reason to doubt financial crises are correlated with increased economic freedom. They examine a panel of 70 countries from 1966 through 2010 using five different types of financial crises (banking, currency, inflation, internal debt, external debt) to see how they impact all five areas of the economic freedom index (size of government, legal structure and property rights, sound currency, freedom to trade internationally, and regulation) over 5, 10, and 40 year time periods. Most of their results were statistically insignificant. However, they did find that financial crises tended to be associated with a decrease in that country's government consumption to GDP ratio but they find crises are largely uncorrelated with other measures of economic freedom. However, over a 40 year period they do find that countries that spend more time in crisis tend to have less sound legal systems and protections for property rights.[5]

[2] Tullock (1975) explains how the transitional gains trap would lead interest groups to lobby to keep the increased size and scope of government in order to avoid losses, even if these interest groups that initially benefited from government expansion cease to earn above normal returns from the expansion.

[3] Holcombe (1993) argues that after taking account of the trend toward government growth through the 20th century that the depression/WWII ratchet is not statistically significant.

[4] A few other studies Bruno and Easterly (1996), Drazen and Easterly (2001), and Lora and Olivera (2004) examine whether crises are associated with improved economic performance which may indirectly measure a change in the size and scope of government or policy.

[5] Bologna and Young include intra-state conflicts (civil wars) as a contemporaneous control variable when investigating whether financial crises cause changes in freedom in subsequent periods. Thus, they do not investigate whether wars themselves, as crises, lead to changes in freedom in subsequent periods as our study does not do they examine other more numerous categories of war that we examine.