

# **THE ROLE OF THE STATE IN INDUSTRIAL RESTRUCTURING: CAPTURED BY THE STATE, THE INVISIBLE MARKET HAND IS POWERLESS**

**(Comments based on Professor Wally Struys Paper)**

*Elena Leontjeva*

*President of the Free Market Institute, Vilnius, Lithuania*

The paper by Professor Wally Struys investigates the role of the state in industrial restructuring with the example of the armament industry and its conversion. Although the author emphasises that he is “a fervent defender of market economics and private initiative”, he eventually comes to the conclusion that “whether visible or invisible, the hand should be helping” (meaning the hand of the government) and that “it would be dangerous to consider that the mere market economy will resolve all problems”.

## **Is There Room for the Market in the Armament Industry?**

If the role of the state is to be analysed consistently, it is necessary to distinguish between the demands of people in the market and demands originated by the government. The demand created by the government is not private demand. It may lead to the emergence of a marketplace, but not a genuine market with its essential attributes.

The armament industry is one of those cases when private demand on the market is substituted by a centrally dictated order. There are no mechanisms to test whether this order and the whole process it sets off meet final consumers’ preferences and whether citizens are willing to pay a given price for a given product. The armament industry thus represents a genuine domain of the state, a domain based on government orders as to what to produce, what resources to use, what prices to charge, and even to whom to sell and to whom not to sell.

Even if some fragments of a market are present, they do not constitute an order. Consequently, there is no point in analysing market operation and failures in this industry, or in justifying the need for government intervention, as Professor Struys does in his paper. Balancing sympathies between the role of the market

and the state in the armaments industry is just a way of deluding ourselves that this industry is based on market rather than state fundamentals. There is just one maxim to be noted: introducing market principles rectifies defects of the sector to some degree, but does not remove them altogether.

### **Is Privatisation of the Armament Industry a Remedy?**

Privatisation, if fully implemented, is a remedy for post-socialist nations. Privatisation should not be limited to state property and interventions in the industry and services. Privatisation should embrace those functions currently performed by the state which can and must be either bought on the market or carried out at the family or community level. Privatisation may be implemented in two steps if adopting it in total is too complicated under certain conditions. The first step should aim at privatising the suppliers of certain services (e.g. schools in case of education, hospitals in case of health care, etc.) while retaining redistributive financing through the state budget. The second step should involve privatisation of financing, or in other words, people should start paying directly for the services they use. If a certain part of society cannot pay for such services as primary education or health care, these public services (based on redistribution) may be preserved for specific and, as a rule, small groups. Inability of narrow groups to live in market conditions should not prevent most people from satisfying their needs in the marketplace.

Transition to a free market in the armament industry, too, would require not only privatisation of suppliers, but also privatisation of financing. These would mean switching from “state defence” to “self-defence”. Obviously, there is little chance of such a switch in today’s world. Therefore, defence from foreign invasion is likely to remain different from other (fully privatisable) functions currently performed by the state. It is most likely that military defence will be provided by the state until free market policies ultimately uproot militarism (see **What may oust armaments and militarism?** below). What effect then may partial privatisation have on the military sector?

Let us compare the products of the defence and armaments industry with those offered by other sectors, e.g. education. In privatised education it is the consumer, and not state officials, who evaluate, influence and control the service. Privatisation (even after the first step) shifts to the consumer real decision-making as to the quality of service provision. In a privatised armaments industry, however, this would fail to materialise. There will still be the same “consumer”, namely officialdom deciding on military expenditures and on the qualities and quantities of arms to be procured. Privatisation of armament suppliers would only partially help to improve the system. To advance further, termination of protectionism and globalisation of armaments are essential.

Professor Struys highlights in his paper problems related to the financial basis of military production. “In a genuine commercial market, the entrepreneur

anticipates future demand in order to produce a good that allows him to make an interesting profit. As a consequence, he is not attracted by production that requires important investment and that be moreover subject to a discontinuous demand. These are however precisely the characteristics of defence production!" The paper, however, does not inquire into alternative attractions that are created in the military sector, attractions that lead to a consistent inflow of capital and a fairly good return. It does not explore how private producers resolve the problems of "the high expenses involved", "uncertain and belated return", "harmful cyclical fluctuations aggravated by deficient military demand", how they compete and what costs these processes inflict on society.

Since the armaments industry is a mixture of state and market mechanisms with no room left for the final consumer - the citizen - to control the system, such phenomena as corruption, expansionism, inefficient use of resources are only natural. Allowing market forces into this domain helps resolve or alleviate some of the problems, but not eliminate them altogether. It is therefore not the market to be blamed for these evils and it is not the state that might help by intervening. As long as there is war and preparation for war, these evils will exist.

### **What may Oust Armaments and Militarism?**

What are the main factors that may lead to a drop in public expenditures on military needs? Professor Struys mentions in his paper, though with little satisfaction, that the end of the Cold War caused a significant decrease in military expenditures. He also mentions that budget limitations are an important consideration in cutting defence budgets. "Financial deficits, budgetary substitutions and the economic crisis have more affected decision-making than pure security preoccupations." Well, if huge military expenditures eventually caused large-scale economic crises, if wars mercilessly destroyed all the fruits of division of labour, it is then historically justified that military decision-making has been shifted to economic rather than security considerations.

In the long run, constraints on militarism will be determined not only by the degree of people's willingness to surrender resources, but also by the degree of willingness to cease economic protectionism and lean upon free trade. Protectionism rests on the fallacy that people cannot prosper economically except at the expense of other nations. As Ludwig von Mises noted in his fundamental work *Human Action*, "The philosophy of protectionism is a philosophy of war".

The history of the last century is the history of a struggle between protectionist policies and free trade. It is also the history of the bloodiest wars of civilisation and the most successful and broad free trade arrangements. Free trade implies a need for peace, and as nations are broadening their free trade relations, they are making their case for peace. However, the reality is that free trade unions

as we know them today apply protectionist regimes towards non-member countries. The positive tendency is that free trade zones are expanding and may become global in the long run. If, however, this expansion is halted at some point, the possible resolving of economic problems in military ways will become more hazardous than ever before. Peaceful co-operation may become sustainable and demilitarisation thorough only if free trade comes to be the global ruler of nations.

### **What Should Guide Conversion and True Privatisation?**

If the need for armament decreases or a shift from domestic production to international procurement takes place, one can speak about the conversion of the military sector. It's not at all an invention of this century - in the Bible Isaiah asks "How to beat swords into ploughshares?"

The need for conversion automatically prompts the need for privatisation - if no specific military production is delegated to an enterprise, there is no point in keeping that enterprise state-owned. Conversion may be conducted in two basic ways - by re-assembling a former military producer and selling separate parts of it to private owners or by privatising the whole enterprise. The first method should be used, as a rule, if a military producer can produce nothing but armaments. Under such circumstances re-assembling is the only way to terminate military production.

Speaking about conversion as a mean to reallocate resources, Professor Struys comes to the conclusion that "The state has an important regulating and initiating role to play and must implement policies making it possible to reallocate resources, to convert, to teach new activities and to provide new capital goods." The author does not spell out what kind of policies would lead to the reallocation of resources that he would favour. It is indisputable, however, that whatever the essence of these policies is, reallocation originating from government policies will not be market-oriented. Based on government rather than market signals, such reallocation will fail to create an undertaking that would be able to succeed on the market. Most probably, such "reallocation" will cause a need for constant intervention by the government. Feeling responsible for a firm restructured under its guidance, government will continue to protect it by resorting to all different kinds of intervention - government procurement, "supportive" prices, subsidies, tax benefits and so on.

If the aim is market reallocation of resources, market forces should be allowed to do the job. It may take some time, it may - and most probably will - bring different results than one might imagine. But that will be the only rightful reallocation, the only truthful return to the market. If a market is properly deregulated and there are conditions favourable for efficient use of capital, reallocation will happen quickly enough. Otherwise, there will be a traditional "lack of capital" and the transition will be vague and slow. It is not the market,

again, to be blamed for the slow adjustment of enterprises, but unfavourable conditions to undertake economic activities and to follow market signals. Professor Struys maintains that “Even in the West, the acquisition of defence equipment takes place in a very specific environment because the basic economic principles are not the same on all markets”. Basic economic principles are the same on all markets. It is regulations imposed by national governments that differ!

To summarise, the armaments industry will remain a state domain so long as the orders are formulated by the state. Privatisation of armament suppliers helps resolve some but not all problems. Open market policy is a key to successful privatisation of suppliers. For the armament sector to be converted completely into peaceful production, free trade among nations is instrumental. When conversion takes place, military enterprises have to be re-assembled or privatised. Privatisation should mean deregulation and removal of any government interventions; changes that will take place under such conditions will be market-oriented. If the state gets involved in restructuring, it prompts a continuous need for further interventions. It will fail to provide for a market order and to achieve an efficient allocation of resources.

It is incorrect to attribute certain market failures to the armament sector and to assign to the government the role of helper. Finalising his paper, Professor Struys attempts to ascribe to the government the very phenomena of the invisible market hand. One should be aware, however, that detached from the market, the invisible hand becomes powerless. For those turning away from socialism this maxim is too important to be ignored.