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Cold War II

Are the managerial elite evolving into a crisis-generating entity?

At the beginning of 1945, Allied troops were recovering from the Battle of the Bulge, and German troops were still on the offensive in some major theaters. Dozens of V-2 rockets were falling on London and Antwerp daily. The Soviet army had made it only as far as Warsaw. Mussolini was still in power and the Yalta Conference had not taken place. In the Pacific, plans were being made to recapture the Philippines and Burma. The Manhattan Project's atomic bomb, of course, was still a closely guarded secret.

At the time, George Orwell penned these prescient lines in *The Coming Age of Superpowers*:

Already, quite visibly and more or less with the acquiescence of all of us, the world is splitting up into the two or three huge super-states forecast in James Burnham's *Managerial Revolution*. One cannot draw their exact boundaries as yet, but one can see more or less what areas they will comprise. And if the world does settle down into this pattern, it is likely that these vast states will be permanently at war with one another, though it will not necessarily be a very intensive or bloody kind of war. Their problems, both economic and psychological, will be a lot simpler if the doodlebugs are more or less continually whizzing to and fro. If these two or three super-states do establish themselves, not only will each of them be too big to be conquered, but they will be under no necessity to trade with one



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another, and in a position to prevent all contact between their nationals. Already, for a dozen years or so, large areas of the earth have been cut off from one another, although technically at peace.

In October 1945, he would coin the term "Cold War," but the idea is explained more clearly here. What's interesting is that none of the conditions normally cited to explain the Cold War existed at the time, and none were mentioned in the essay. There was no mutually assured destruction, only the USA was close to a bomb, and Orwell didn't know it. The world was as weary of war as it is possible to be. There was no history of animosity among the likely victors of WWII (unless you count France as one of the Allies), and no important territorial or political

disputes. The Allies might argue about how to split up the spoils of war, but none had designs on each other's land. They didn't agree on a theory of government, but there didn't seem to be much need for them to do so. Moreover, while a split between the Soviet Union and everyone else seemed plausible at the time, who was the third superpower going to be?

The book by James Burnham mentioned as forecasting the rise of superpowers was published even earlier, in 1941. In some ways that makes more sense. The world was at war, and had yet to face the full horrors of that. A division of the world into Capitalist, Fascist, and Communist blocs seemed reasonably likely, and each bloc had an overwhelmingly dominant leading nation. At the time of writing, Hitler had not invaded Russia and he never invaded England, Japan had

not bombed Pearl Harbor, the battles were being fought outside the territories of the belligerents, and the war seemed to be a contest to expand spheres of dominance rather than for the major participants to conquer each other.

However, none of these factors were cited by Burnham as reasons for a Cold War. He based his prediction instead on a global rise in a managerial elite that displaced an older elite based on ownership in the same way that the Capitalist elite had displaced feudal aristocracy centuries before. The Capitalist economy was increasingly dominated by huge public corporations, with power vested in managers, not shareholder-owners. Under Fascism, the government set corporate policy, and under Communism, the State owned and controlled the entire economy. In all three systems, the State was growing larger and more powerful, further restricting the meaning of private ownership. Who owned something mattered less than who managed it, who regulated it, and who taxed it.

Let me be clear that I am neither endorsing this view, nor offering an opinion on whether the system described is a good idea or a bad one. I'm only interested in why Burnham thought the rise of a managerial elite obviously led to a world of a small number of superpowers, and why Orwell thought those superpowers would be at a permanent cold war. And the reason I'm interested is that the prediction came true, and if Burnham and Orwell were correct, the reasons for it remain valid today. On the other hand, if the Cold War was a product of nuclear terror and ideological conflict, or of specific historical events and personalities, then there's less reason to expect a Cold War II.

We all know why managers like their spheres of power to grow—why corporate managers like to merge and conglomerate, why bureaucrats want bigger budgets and more powers—because it increases their wealth, both tangible and intangible. One countering force is technological. The entire information-processing resources of the world in 1945 were probably insufficient to process, say, the UK VAT or Exxon's payroll system. But Burnham argued that technological advances, even those that would appear to increase individual autonomy, had been ruthlessly pressed into

service to enlarge the scope and scale of managerial power.

So, with technological constraints loosening constantly, why wouldn't all power merge into a single World Council of Everything? Because, according to Burnham, managers need conflict to justify their power. In the old days, the local Baron took your money to protect you against the Baron next door who wanted to rob you. Then Capitalists came along and cut your wages because otherwise the Capitalist next door would undercut on prices and your job would go away. Now managers needed crises in order to dispense with annoying things like shareholder desire for return on investment and political ideas like "consent of the governed." Natural disasters, economic crashes, and social problems were fine up

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to a point, but there are limits to the power that can be demanded in order to fight these things, especially if you can't actually reduce their frequency or severity. The only unlimited source of conflict is another managerial superpower. Burnham predicted that certain forms of private wealth, democracy, and freedom would be maintained for cosmetic purposes but that true ownership, popular control, and liberty would disappear.

Now let's zoom through the next 65 years. We see the rise in managerial power everywhere, and the development of a two-superpower world (with China as an independent force somewhat below the superpower level). The powers avoid direct military confrontation, but foment all sorts of crises all over the world in attempts

to expand influence and weaken the other. Unprecedented levels of military spending, especially by powers at no serious risk of being invaded, eventually bankrupt the Soviet Union (the USA, while nominally solvent, has spent more money on weapons of mass destruction than the total value of everything in the country today excluding real estate). At that point Cold War I ends, and the world seems to embark on a reduced-conflict path to global prosperity and freedom. Dictatorships fall, socialist tendencies are severely pruned in the USA and Western Europe, and established giant corporations either fail, are broken up, or slim down to compete with entrants. Private capital alternatives to public ownership flourish—private equity funds buy public companies, venture capital start-ups

outcompete public companies, personal retirement accounts replace giant defined-benefit pension funds, and the financial industry disintermediates to allow direct transactions between providers and users of capital, even at the retail level. Technology, especially mobile telephones and the Internet, empower individuals rather than managers. Two billion people leave poverty. Of course, this is by no means a universal phenomenon, and there are plenty of opposing trends and events.

Nevertheless, it seems that the Wicked Witch that blighted two generations is dead.

From this perspective, it is disturbing that most of the volatility in the market over the last couple of years comes from uncertainty about the resolution of political crises in major devel-



oped countries. Will the USA default or shut down its government? Will the Euro collapse? These and other political squabbles have repeatedly gone to the brink before some temporary compromise is reached to hold things together for a month or two. The stage is dominated by the shouting of angry radicals on both sides, there is little civility, rationality, or compromise. Nothing gets fixed, we just get complicated patches that start breaking down before they are signed. The resulting market gyrations have dwarfed moves caused by changes in assessments of future real economic activity.

I have gradually come to the conclusion that this is not a temporary state of affairs. These crises are not a result of stubbornness or miscalculation, they are necessary to maintain the social order. Further, I think it will take about a decade of them to achieve any sort of stable result. You see, the managerial elite did not disappear with the Berlin Wall. It had some setbacks in some places, but it sprang up in new ones. The creation of the Eurozone is an obvious one. China became less bureaucratic rather than more, but it grew so much in wealth and power that it added to the total amount of managerial control of the world. An oil-funded, Islamic-based movement has not gained either the internal cohesiveness or total strength to be labeled a superpower, but not for lack of trying. An environment-based “Green” movement seemed near to grabbing control of a very significant chunk of global economic assets for a scientific-bureaucratic elite a few years ago, but has seen its power decline recently. With less publicity, a global healthcare system is having somewhat more success. Improved communications technology has been a powerful counterweight to advances in managerial control, but managers have come up with ways to neutralize or even exploit the innovations.

Before going further, let me emphasize that I don’t think managers are all bad. They bring rationality to affairs and, up to a point, increase efficiency. Managers are nothing but agents with technical qualifications. The world needs agents, and managing the principal/agent problem is just one of the frictions of life. Large and sophisticated organizations require technical skills to manage. Like everyone else, managers will work to expand their wealth and power. Properly harnessed, this

ambition can be part of the energy that drives social progress. If managerial elites grow too large or start acting too elite, they will generally be brought down by the resulting inefficiency. The fatal problem begins when the elites grow large and powerful enough to manufacture crises that feed their further growth, even if they are not effective in responding to the crises. At that point they become a cancer to society. I think that has happened, and as a result, we are seeing the beginning of Cold War II.

As with Cold War I, the many individual crises have a unifying theme. The elite in G-7 governments has promised far more than it can possibly deliver. There is some maximum amount of GDP the government can extract from the economy. People disagree about what that amount is, but it’s clearly less than 100 percent. Official tax figures grossly understate the extraction. They do not include all sorts of fees, tolls, and fines. They often omit some levels of government or quasi-government organizations. They do not cover the indirect effect of tax deductions. For example, when the government allows a tax deduction for municipal bond interest, it makes it seem as if it is collecting less in taxes and spending less in interest. But there’s no economic difference between a taxable municipal bond paying 6 percent on which an investor pays half in taxes, versus a municipal bond paying 3 percent in tax-free interest. Either way, the government pays and the investor gets 3 percent, but if the interest were taxable, both reported taxes and reported expenditures would be higher.

Any time the government gives someone a \$100 tax deduction to get them to do something that costs them, say, \$50, it lowers reported taxes paid, but economically represents the same thing as the government taxing \$100 and overpaying for whatever they got the person to do. Government regulations are also hidden taxes. The government could slap a \$1 tax on incandescent light bulbs and use the revenue to subsidize florescent bulbs, or accomplish the same thing by forcing companies to raise the price of incandescent bulbs. It’s the same economic effect, but the latter method does not show up in taxes. Any time the government makes people stand in line, fill out a form, or do anything else, it uses up economic value that

could be harnessed in the private economy.

Future promised expenditures are also grossly understated. They do not include full pension and healthcare benefits, sometimes these things are missing altogether, and sometimes they are reported under unrealistic actuarial assumptions. They ignore contingent liabilities like loan guarantees and subsidized flood insurance. Expenditure projections do not include future program growth, either by the natural process of politics or unexpected events like wars and natural disasters. Expenditures never include the cost of private sector entities that do nothing but interact with the government: tax accountants, regulatory lawyers and consultants, compliance specialists, lobbyists, and so on.

This problem is exacerbated by huge government debts. If interest rates go up, the precarious fiscal balance becomes obviously unsustainable, which pushes rates up more and leads to fiscal disaster. Political bodies that have never been able to avoid large deficits using honest accounting, are going to have to find ways not only to balance the budget, but to pay down the accumulated debt to sustainable levels, perhaps half current levels.

Okay, everyone already knows this, and has known this crisis was coming for years. I had hoped, along with a lot of other people, that some kind of sensible compromise would be reached. There’s a lot of pain coming and it would be easier to bear if spread around fairly. In fact, there’s not even much doubt about what the compromise will look like. The poor are not going to pay off the debt, they don’t have the money. No middle class in a democracy has ever paid more in taxes than it has received in direct government payments and services (I mean things like Medicare and education for children that people would buy out of pocket if the government didn’t give them away free, not general public goods like military protection or roads). So the rich are going to have to pay off the debt, and they will because they have the most to lose in a default. But the rich aren’t going along with this unless there are caps on middle-class benefits. Medicare payments will be capped and social security will be means-tested (that is, only paid to people who need the money to get above the poverty line). Government pensions will be haircut and cost-of-living increases will

be slashed. Taxes will be simplified, exemptions and deductions eliminated. Unfortunately, the poor, as always, will lose what little they have. I'm speaking in terms of the United States but the general picture is the same in all G-7 countries.

There is no alternative to this deal. No one seriously believes you can tax the rich enough to pay for currently promised middle-class entitlements without destroying the economy. No one seriously believes the rich will allow a debt default, revolution, or anarchy. There is some negotiating room at the margin, but the basic terms are set. To get in the ballpark, the USA will need about a 25 percent increase in taxes (this is harder than it looks because some conservatives passionately believe that current taxes are extortionate), and a 25 percent cut in spending and regulation, that is, a true 25 percent shrinking of government (this is harder than it looks because some liberals have visions of massive expansion of government), sustained over decades. There may be some negotiating room at the margin for more taxes and government or less of both, and good news in technology, diplomacy, or economic growth might ease things a bit, but the basic picture is clear. And, again, I think everyone pretty much knows this.

So why all the crisis-mongering? Because although the destination is preordained, the path to get there is not. We could have a grand social bargain supported by a solid majority of citizens, as fair to everyone as possible when there are more liabilities than assets, and voted in by legal means. Or we could have a series of crises that require expansions of managerial power. For example, G-7 governments cannot pay for current pension and healthcare promises with any level of taxation, the only alternatives are renegeing on promises or expropriating wealth, either of which strengthen the managerial elite at the expense of rule of law. Both of them also lay the groundwork for further crises, especially if the government can arrange both to renege and expropriate. Not only will the crises provide the excuse for managers to seize new powers, but they will also provide the opportunity to subsidize allies and impoverish opponents.

Debt provides more opportunities for crisis. When interest rates increase, governments will take actions that cause inflation, which is a form

of renegeing on promises and guarantees further increases in interest rates. This will cause budget disasters, which will be dealt with by default (selective of course, for the benefit of allies) and financial repression (banks forced to buy government debt at above-market prices, interest rate caps, financial transaction taxes, *ex post facto* taxes and regulations, price controls, short-selling and CDS-buying bans, and so forth). All of this will be accompanied by the assumption of powers without firm legal basis or even in clear violation of the law, bypassing of Constitutional provisions, "emergency" resolutions, and other assaults on managerial constraints.

Before you dismiss this as the ravings of a paranoid lunatic, well okay, even though you've already dismissed this as the ravings of a paranoid lunatic, I want to make clear that I do not believe

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in a vast or conscious conspiracy. Rational, intelligent, well-intentioned managers, acting independently, are going to take reasonable-seeming steps that lead to these and other crises. We've watched them do it for two years, and it's getting worse.

Consider the perspective of a corporate or government manager. She finds herself in a position where it is impossible to fulfill legal mandates. People have more claims than she has money to pay them, or two rules made for different reasons conflict, or some bad situation is occurring that she lacks the resources to prevent. She can do nothing, as she has no legal alternatives, and lets events take their course. This is like declaring bankruptcy, or abstaining, or standing

aside. Managers who do this are not rewarded. Moreover, it takes personal discipline. People like to help, especially people with the inflated sense of competence that comes from a career spending other people's money and wielding institutionally granted power.

Her natural reaction will be to find a way to use the conflict as an excuse to expand her legal powers. Perhaps she can get away with doing this on her own, or perhaps she will kick the matter upstairs where it will combine with other demands for more power. But this piecemeal process will not lead to global solutions, at best only to local patches, and in many cases the unintended consequences will cause other crises. Moreover, it will create legal uncertainty. No one will know what the rules are, or when they might change. Uncertainty leads to conflict, as people jockey to use it to their

advantage. Conflict leads to new crises. Managers who take the most aggressive actions in response to the biggest crises will gain the most power, and natural selection will cause the managerial elite to evolve into a crisis-generating entity.

This will not lead to anarchy and disaster, for one simple reason. Things are actually pretty good for a solid majority of people in all G-7 countries. They are living longer than anyone in human history, with less pain, disease, hunger, crime, injustice, repression, or uncertainty. They live rich cultural lives, whether their tastes are high or low. They are surrounded by wonders of technology, which come better and cheaper every year. They are pretty risk-averse, especially the most

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important group in this struggle, the old. The old have most of the money and consume most of the benefits. Also, especially in the USA, people have friends and relatives on the other side. A new college graduate may grumble about paying social security taxes for benefits she will never receive, but she doesn't want her grandmother's Medicare cut. A retired policeman won't be happy when cost of living increases are eliminated from his pension, but he wants his son's business to be free enough from regulation and taxes to be profitable. Although there seem to be two sides, whether you consider it young versus old, or net taxpayer versus net benefit recipient, or private sector versus government, there aren't a lot of committed partisans and different issues cleave the population in different ways. People will compromise when push comes to shove.

So when events push things to the brink, a popular consensus should emerge to allow normally unthinkable political actions. People have too much to lose to allow things to fall apart, just as neither the USA nor the Soviet Union wanted to destroy the world in Cold War I. But just as with Cold War I, the indirect crises cannot be staged. If either side comes to believe the other side will not let everything collapse, it will ratchet up demands until things do collapse. This is a classic game theory situation, a Cold War II. And since managers have to relinquish control to be credible, no one can predict the outcome with confidence. We cannot ignore the possibility that things will get pushed too far. A radical may seize power, or civil institutions may break down under the stress of battle.

Therefore, my prediction is that politically induced volatility will be the rule in the future. Investors will have to worry more about politics than the real economy. The value of the dollar or the Euro, tax rates on investments, solvency

of governments, financial repression, attacks on rule of law—all will cause more price movements than changes in real activity or interest rates. On the other hand, we expect each crisis to be resolved. This could lead to extreme range trading, a fair description of what we have seen over the last couple of years. Prices move a lot, but stay within wide limits, wide limits but firm ones.

I don't expect this to last forever. At some point, my guess is in about a decade, we'll figure out the right size of government. We'll have sustainable debt levels and budgets, and perhaps even honest government accounting. The private sector will be big enough and free enough to provide the jobs, the goods, and innovations to keep most people reasonably happy. The government will be big enough and powerful enough to provide the jobs and power to keep the managerial elite satisfied, and also to keep the peace and to deliver enough social services to keep civilians satisfied. I suspect the pressure of shrinking will make government more honest and efficient.

My fear is that the casualty in all of this will be personal freedom and rule of law. We will be ruled by thrifty socialists. Unlike earlier socialists, the new breed will have learned to limit expansion, keeping the private economy healthy and social expectations reasonable. They will be better at the job of running things. But there will be no separation of powers, the same people will make, enforce, and interpret the law. There will be no true rights, or rather, so many "rights" that none of them can be absolute. Power will be allocated rationally, it will not flow from the people. Things will be reasonably well run and comfortable, but the liberal ideal born in the Enlightenment will be dead. We may see that China, and perhaps other countries, will evolve to a similar place from the opposite direction.

There is a much better solution, without the risk of disaster, without the lost decade of constant crises, and without the trading of freedom for comfort. We could strike a grand social bargain, within the strictures of existing political institutions. We could elect representatives committed to a sustainable grand bargain with equally shared pain, and passionately committed to liberty and law. I honestly believe almost everyone would support such a bargain. Sure, everyone will feel that the deal was stacked against their interests, but that is a small price to pay for peace. Settle the conflicts, write off the losses, and get on with life.

I think that the latter scenario is possible, at least in the United States. It has the advantage of being about five years behind the Eurozone, and maybe 20 years behind Japan. That allows it to see the result of internal cold wars in other countries, and perhaps resolve to do better. The USA is also less influenced by the non-governmental managerial elites in the world. US citizens have both more to lose and more to gain by compromise, and the society is less stratified. It also has a better demographic profile and the advantage of more immigrants (legal and illegal) who can represent a swing constituency without vested interests.

World War I provided the final end to feudal power and left Capitalism in control of the world. WWI also inaugurated the rise of the modern managerial elite, which led to World War II. WWII led to Cold War I, during which the managerial elite gained power at the expense of Capitalism. The end of CWI was a victory for Capitalism, but apparently only a temporary setback for the managerial elite. We now appear to be starting Cold War II, which should result in some kind of peaceful co-existence of capitalists and managers, of principals and agents, of people who want to do as they please but often make stupid choices and people who generally make smart choices but want to make them for everyone else. May CWII be short...

REFERENCE

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