The Economics of War

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MANY PEOPLE think that war is good for an economy. Princeton economist Paul Krugman, for example, wrote that the terrorist attack of September 11 "could even do some economic good" because it would lead to increased spending to replace buildings. This is false.

This war may be justified, but the spending on war, the physical resources devoted to war, are not themselves a benefit; they are a clear, and often large, cost. The reason is simple: These resources would have been used in other ways and now we must give up those uses.

Even for the United States, which generally manages to fight on other people's territory, war has a high cost. The most obvious cost is death. Gen. Douglas MacArthur once said, "Old soldiers never die; they just fade away." But the line should really be old soldiers never die; young ones do. World War II, for example, cost the United States more than 400,000 lives, almost all of them people under 40.

Another obvious drain of war on the economy is the diversion of resources from productive, peaceful activities to military ones. We are often told that World War II was a boom time for the U.S. economy. If measured by the unemployment rate, that was true. In 1944, for example, at the peak of World War II-related production in the United States, the unemployment rate hit a low of 1.2 percent. But that doesn't mean Americans were better off. In fact, in 1944, the average American was worse off than they were during the worst part of the Great Depression a decade earlier. How so?

In 1944, the government spent 42 percent of the U.S. Gross National Product on war. Money spent on airplanes, guns, jeeps, tanks, bullets, bombs and manpower, and the resources that the money bought, are a drain on the economy. The resources are used for war material, almost all of which gets destroyed, instead of being used for the other uses that people value. So the 42 percent of GNP spent on the war was a cost to the economy. By contrast, Gross National Product in 1933, the worst year of the Great Depression, was "only" 35 percent below the level it would have been had the economy been at full employment. During the peak of World War II, in other words, a higher percentage of GNP was lost to the war than was lost due to high unemployment in 1933.

Actually, the gulf between World War II well-being and Depression era well-being is even wider because the percentage of GNP spent on war understates the war's true cost. The reason: price controls.

During World War II, the federal government imposed price ceilings on virtually all goods used in the war effort -- gasoline, rubber, nylon, food and most important, manpower, so it could buy them at artificially low prices. Because the prices the government paid for goods were artificially low, government expenditure on these goods at the below-market prices understates the true cost of the resources the government used. Therefore the apparent 42 percent of GNP spent on the war actually represents more than 42 percent.

War has another major cost, as economist Robert Higgs has noted in his book, "Crisis and Leviathan": it hurts economies by giving governments the opportunity and the excuse to take on new powers -- powers they don't fully relinquish when the war is over. During World War II, for example, the income tax, which previously had applied only to high-income people, was imposed even on low-income people. The federal government also introduced withholding to make it easier to collect tax money. After the war, income taxes remained a "normal" part of everyone's life, as did income-tax withholding. Flush with revenue, the government found other things to spend the money on, including nuclear weapons and welfare. This reduced economic well-being because a dollar spent by government typically produces much less value than a dollar spent by the person who earned it -- government spends money much less carefully than we spend our own money.

Retaliating against foreign attackers may be desirable, but doing so is costly. We should not kid ourselves by labeling as a benefit what is, in fact, a cost.