

BY ROBERT J. BARRO

WHY THE WAR AGAINST TERROR WILL BOOST THE ECONOMY



STIMULUS:
Increased government spending at levels of around 2% of GDP should help the U.S. avoid recession in 2002

There is still a lot of uncertainty about how the U.S. military effort in Afghanistan will affect the U.S. economy. To analyze the likely economic impact of the war, I think of the current action as analogous to U.S. wars of the past. My main conclusion is that the current war will be expansionary and will, therefore, help the U.S. economy recover from its current slowdown.

If we consider World War II, Korea, and Vietnam, we have examples of large, medium, and small wars. In World War II, peak military spending in 1944 was 60% to 70% of prewar gross domestic product. During the Korean War, spending peaked at around 11% of GDP in 1952, and during the Vietnam War, it peaked at about 2% of GDP in 1968. The evidence is that economic activity expanded during each war but by less than the amount of wartime spending. My estimate is that each \$1 worth of military outlays led to a 60¢-to-70¢ increase in GDP. To put it another way, while military spending raised output, there was no free lunch. The spending had to be paid for by decreases in other forms of spending, especially business investment (and by more work effort).

The economic effect of the Gulf War is harder to isolate because military spending rose by only about 0.3% of GDP. The economy was in a recession in 1990, before the war started in January, 1991. Economic growth resumed by the second quarter of 1991 but remained low until 1992. The analysis from the other three wars suggests that little of the recovery stemmed from the Gulf War.

SPENDING HIKES. For the current war effort, if we sum up the likely near-term added expenditures for the military, domestic security, and reconstruction of New York City, we get at least 1% of GDP. This calculation is likely to underestimate added wartime spending because we will probably also see a long-term reversal of the "peace dividend" that resulted from the end of the cold war. During the Clinton Administration, from the end of 1991 to the end of 2000, defense outlays fell from 6.2% of GDP to 3.8% (and the number of military personnel declined by around 1 million).

Given the insecurity of the post-September 11 world, I would expect a long-lasting increase in defense spending. If the U.S. responds as it did during the Reagan Administration's defense buildup of the early 1980s, defense spending would rise another 1% to 1½% of GDP over a one- to two-year period. Thus, the overall spend-

ing stimulus from the war on terror will likely be similar to the extra 2% of GDP that was expended at the peak of the Vietnam War. Using the kind of economic response mentioned before, where GDP rose by 60¢ to 70¢ for each dollar of military outlay, this stimulus is likely to help the economy avoid a recession in 2002.

Not all aspects of wars are favorable to economic activity, of course. Consumers' perceived increased risk of flying, for example, lowers the demand for air travel, and the perceived higher risk of terrorism likely reduces business investment. However, negative effects were also present in previous wars, including worries about Japanese invasion of the U.S. mainland during World War II and about Soviet missiles during the cold war. Nevertheless, the net effects of previous wars on U.S. GDP turned out to be positive.

NO BAILOUTS NEEDED. One concern about the current situation is all the nonsensical proposals in Washington for fiscal stimulus beyond the expenditures for national security and the reconstruction of New York. It seems reasonable to regard security in airports and on airplanes as public goods that should be supervised and perhaps partly financed by the federal government. But there is no economic rationale for general bailouts or subsidies of airlines, insurance companies, the steel industry, agriculture, and so on. After all, it is not only during tranquil times that we ought to rely on free markets rather than the government to allocate resources. If the risky new world means that air travel is less safe or that threats of domestic terrorism are greater, then the unfettered market will generate less air travel and higher insurance rates. This may also mean fewer functioning airlines and some reorganizations of ownership. These seem to be the correct outcomes, at least until our government succeeds in reducing the various threats.

On the tax side, one thing we surely do not need is more rebates, which were never a net economic stimulus. Accelerating the planned tax-rate cuts would be fine, but limiting these to lower-income people makes no sense in terms of encouraging economic activity. Any further changes in tax policy should be aimed squarely at improving incentives for households and businesses to produce and invest.

Overall, I expect the U.S. economy to expand during 2002. But it is possible that the government will come up with a fiscal package that is bad enough to prolong the slowdown.

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