CEPR Fact Sheet
The Cost of War

ECONOMICS AND THE ELECTIONS

The Recession and the War in Iraq

The Iraq War has imposed serious costs on the U.S. economy. However, the war cannot be blamed for the recession that is now hitting the economy. This recession is attributable to the collapse of the housing bubble. This collapse has both decimated the housing sector and destroyed almost $2.6 trillion in housing bubble wealth, more than $35,000 for every homeowner in the country.[1]

Key Facts

- This recession was caused by the housing bubble, not the war
- War costs are roughly 1% of GDP
- Iraq War spending, while initially providing a boost to the economy, soon becomes a drain that leads to job loss
- Higher military spending eventually causes the trade deficit to rise – almost $90 billion over a ten year horizon

The collapse of the bubble has caused housing starts to fall off more than 50 percent from their peak in 2005 and sales to fall by more than 40 percent. The housing sector has contracted from 6.3 percent of GDP in the fourth quarter of 2005 to just 4.1 percent of GDP in the most recent quarter.

More importantly, the loss of housing wealth is forcing homeowners to cut back on their consumption. When house prices were soaring earlier in the decade, many homeowners used their newly created equity to sustain their living standards. They borrowed against their equity almost as fast as it was created. Now that house prices are falling, many homeowners no longer have equity in their home against which to borrow.

As a result, consumption has ground to a halt in the last three months and the economy is shedding jobs. The economy now risks a downward spiral with further job loss both weakening consumption and further weakening the housing market, possibly causing prices to decline even more rapidly. Making matters worse, millions of families are seeing their homes foreclosed. This means both that the families are losing their homes and also that banks are taking large losses on their mortgages. With bank losses likely to run close to $1 trillion, the ability of the financial system to make new loans and to support the economy is being seriously threatened.

This recession is quite easily and obviously explained by the collapse of the housing bubble, which had its origins in the stock market bubble in the mid 90s. It was very easy to recognize the bubble by the unprecedented run-up in house prices and the sharp divergence between sale prices and rents.[2] It was an extraordinary failure of public policy that the Federal Reserve Board, the Bush administration

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[1] This figure is based on the 10.2 percent nominal decline in house prices shown in the Case-Shiller nation index since the second quarter of 2006. This nominal decline translates into a 13.3 percent real decline. The value of housing wealth is taken from the Federal Reserve Board's Flow of Funds, Table B.100, Line 4.

[2] See Baker. D. 2002. "The Run-Up in House Prices: Is It Real or Is It Another Bubble," Washington, D.C.: Center for Economic and Policy Research [http://www.cepr.net/index.php/publications/reports/the-run-up-in-home-prices-is-it-real-or-is-it-another-bubble/]

and the various financial regulatory agencies did nothing to try to stem the growth of the housing bubble or clamp down on the irresponsible and predatory loans that helped to feed its growth. The collapse was an inevitable result of the growth of the bubble and any competent economist should have been able to recognize that the economy would eventually see the sort of situation it now faces.

The war has a negative impact on the economy, but its effects are more gradual and build-up over time. Essentially the war drains resources from productive use, so that the economy has less productive capacity than it would otherwise. The impact of this drain of resources becomes larger the longer the war goes on.

The economic effects of the war are felt in two ways. Several estimates show the war's costs as already exceeding $1 trillion, or $3,300 for every person in the country. This figure is the budgetary cost of the war, the tax dollars that go to pay for soldiers, weapons, as well as medical care and other benefits. However, the war also imposes a cost on the economy, in the sense that it reduces the overall size of the pie and the number of jobs.

The reason why the war reduces growth and employment is straightforward; it drains resources from the economy. The money that is used to pay for housing and feeding our soldiers in Iraq, as well as supplying them with weapons, could have instead been used in the civilian economy. The drain is most apparent when we impose a tax to pay for the war. Taxes would pull money out of people's paychecks, giving them less money to spend and less incentive to work.

Of course we did not raise taxes to pay for the war; instead the government borrowed the money. Borrowing doesn't change the fact that the war imposes a drain on the economy, it just changes the mechanism. As a result of the drain imposed by the war, interest rates are somewhat higher than they would otherwise be. Higher interest rates will discourage investment, which reduces employment and also means that the economy will be less productive in the future. The negative effects of spending on the war will get larger the longer the war continues.

To get an idea of the size of these negative effects, the Center for Economic and Policy Research commissioned Global Insight, one of the country's leading economic forecasting firms, to project the economic impact of increased military spending over a long period of time. We asked them to model the impact of a sustained increase in military spending of 1 percent of GDP (about $145 billion at present), which is somewhat less than current spending on the wars Iraq and Afghanistan.

While the model shows that increased spending initially provides an economic boost, the spending soon becomes a drain on the economy.[3] By the tenth year increased military spending is projected to lead to a loss of 460,000 jobs. Twenty years of increased military spending is projected to lead to a loss of 670,000 jobs.

The construction and manufacturing sectors are projected to be hardest hit. After ten years they are projected to lose 140,000 and 90,000 jobs, respectively. After twenty years, the job losses in construction rise to 210,000, although they remain at 90,000 for manufacturing.

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[3] The results from the projections are discussed in Baker, D. 2007. "The Economic Impact of the Iraq War and Higher Military Spending," Washington, D.C.: CEPR [http://www.cepr.net/index.php/publications/reports/the-economic-impact-of-the-iraq-war-and-higher-military-spending/].

The model also projects that higher military spending leads to a large increase in the trade deficit. The increase in military spending is projected to raise the annual trade deficit by almost $90 billion after ten years and more than $130 billion after twenty years. Over a twenty year horizon, the increase in defense spending would add more than $2 trillion to the country's foreign indebtedness.

In short, the model shows that an increase in defense spending, comparable to what we've seen with the wars in Iraq and Afghanistan, will lead to fewer jobs, especially in construction and manufacturing, and a considerably larger trade deficit. The Global Insights model is just one model of the economy, but almost any other model would produce similar, and quite likely larger, projections of economic harm.

While the costs shown by this model are substantial, they cannot explain the sort of collapse that the economy is now experiencing. The war has certainly left the country less well prepared to deal with this situation. If resources had not been diverted to the war, we could have a better infrastructure and capital stock, as well as a better educated and trained workforce, and less government and foreign debt. If we had not spent so much money fighting the war in Iraq we would be better prepared to deal with the collapse of the housing bubble and to get the economy back on its feet. However, the war did not cause either the housing bubble, nor its collapse, and therefore cannot be blamed for the recession.