The economics of the wars in Iraq and Afghanistan and the Global War on Terror

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Introduction

In June 1967, Les Fishman wrote a paper called The Economics of Vietnam. He calculated the costs to the federal government of supporting the French in Indochina from 1955-1965 and then of pursuing the war from 1965 to the time of writing. He analysed the economics and impact of the spending on the war: the short-term 'Cost-benefit' effects;; the multiplier effects (or lack of them) of military spending; the effect on the balance of payments; the changes in cross-border investment to and from the US and the impact on the US's reserves and therefore its ability to continue to act as the world's banker.

It is a wide-ranging paper, connecting the war with the US role in the world economy, as well as the domestic economy. It concludes that the investment in containing communism through the Marshall Plan and post-war military deployments, maintaining 'peaceful coexistence' with the Soviet Union had a high return, keeping the Soviet Union at bay for relatively small outlays. The return on the investment in Vietnam, confronting China militarily through South East Asia was likely to be low. On the short-term return, he made the startling point that the total economic investment by US citizens in South East Asia stood at the time at $600 million, equivalent to the cost of 6 days of the Vietnam war. At the same time the distortion of the federal budget towards the war effort reduced spending on social programmes and therefore contributed to reduced social stability at home.

This paper attempts to apply some of Les's analysis to the current wars. While Iraq ('Operation Iraqi Freedom') is the major war being fought by the US, it must be seen together with the war in Afghanistan ('Operation Enduring Freedom'), the Global War on Terror and the expansion of the Homeland Security budget: all a consequence of, or at least coming after the attack on the Twin Towers in 2001.

The contexts of the two periods were different: from 1964 the US government attempted a Keynesian approach to the macro-economy, using tax cuts to stimulate the economy, but trying to balance the federal budget over the economic cycle. The US Administrations since 2001 have not pursued such a policy, as they increased spending on the war at the same time as cutting taxes, not for Keynesian reasons to stimulate economic growth at the bottom of the cycle, but for 'supply side' reasons, to encourage the very rich through tax cuts. The government deficit increased from 1965, according to Les, because of overestimation of the positive economic effects of the war spending. The deficit increased after 2001 because of a policy of cutting taxes and increasing expenditure. The

[1] Thanks to Phil McManus, Sun Laixiang and Damian Tobin for their help

US's position in the world was also different: China was still a largely agricultural poor country, the Soviet block was the main political competitor and the US was self-sufficient in oil.

The cost of the wars

Vietnam

The loss of life in the Vietnam war is estimated as:

US and allied Troops killed in action	58,148
Died in captivity	114
US veteran suicides after war	9,000
Vietnamese civilians	4,000,000
Vietnamese military casualties	1,100,000
Cambodia and Laos civilian deaths	3,000,000

Total cost of operations in Vietnam and SE Asia: $150 bn. The current equivalent is about $1 trillion.

Iraq, Afghanistan and GWOT

The number of people killed has been subject to controversy: Iraqi civilian casualties are not counted, but estimated by sample interviews with survivors[2]. US military deaths (2003-mid 2008) were 3970.

Iraqi civilians reported casualties are 71-77,000 but the Johns Hopkins survey estimates the additional deaths from 2003-2006 at 654,965. This figure is arrived at by interviewing a sample of survivors and extrapolating: it is an estimate of the additional deaths over the normal mortality rate. 91.8% of these deaths are caused by violence.

Deaths of civilian oil workers are estimated at 1000, journalists and media workers 152, British military 174, other allies 133. In Afghanistan there have been 868 coalition deaths, of whom 507 US. Civilian casualties from the bombing are estimated at 5000.

In addition there have been 2 million internally displaced people in Iraq and 2.2 million displaced to neighbouring countries.

News reports have recently claimed that the cost of the Iraq etc. wars are equivalent to that of Vietnam. Boots on the ground are the main cost driver in these wars. While aerial bombardment was/is used in both, the massive scale of the carpet bombing and use of napalm in SE Asia has not been repeated[3]. The US has (2008) 180,000 troops in Iraq, including the 30,000 additional troops

[2] Gilbert Burnham, Riyadh Lafta, Shannon Doocy and Les Roberts, 'Mortality after the 2003 invasion of Iraq: a cross-sectional cluster sample survey', Johns Hopkins Bloomberg School of Public Health, 2006

[3] Aerial bombardment as an instrument of control over civilian populations was pioneered by the newly formed (British) Royal Air Force in Iraq from 1921. (see Toby Dodge, 'Inventing Iraq', Columbia University Press, 2003)

brought in for the 'surge'. Its allies have 13,000 (of which 7,100 UK). The 'International Security Assistance Force (ISAF) in Afghanistan has 43,000 troops, in addition to 17,000 from the US. With the addition of 190,000 'contractors' in Iraq, people on the ground in both wars number about 453,000. In Vietnam at the peak deployment in 1969 there were 543,482, plus 100,000 or so contractors.

The US government has allocated $645[4] billion to military operations up to 2008, plus an additional $200 billion for 2008, including veterans costs, in Iraq, Afghanistan and other wars (this is equivalent to the 'incremental cost' of Vietnam in Les's paper, rather than the gross military spending), of which 70% for Iraq. Joe Stiglitz[5] has made an estimate of the cost at $3 trillion, by including interest payments in additional to the actual costs, and by adding in the medical costs of looking after injured veterans.

In addition to the costs of the wars, funds were allocated to reconstruction: between 2001 and 2006, $24.7 billion in Iraq and $7.4 billion in Afghanistan.[6]

The other expensive consequence of the reaction to the destruction of the Twin Towers was the establishment of the Department of Homeland Security, with 166,234 employees and an annual budget of £42 billions (in 2008).

One way to compare the two expenditures is by expressing them as their proportion of GDP: Vietnam/SE Asia average costs were equivalent to 17% of GDP, Iraq/Afghanistan annual cost is 13% of GDP.

The immediate 'cost-benefit' effects

Oil

Of course the Iraq war has nothing to do with oil. Donald Rumsfeld said so in February 2002: "We don't take our forces and go around the world and try to take other people's real estate or other people's resources, their oil. That's just not what the United States does. We never have, and we never will. That's not how democracies behave."

Iraq has 115 billion barrels of proven oil reserves (cf Saudi Arabia's 264 billion) and 110 trillion cubic feet of natural gas. To develop the production of oil, the Kurdistan Regional Government entered concession agreements with oil companies for the reserves in Kurdistan. In June 2008 the Iraqi government opened up a competition to 35 companies to bid for contracts. The first extraction contract, for oil worth about $3billion over 20 years, was signed with China National Petroleum Corporation. No doubt the major companies will before long be operating in Iraq, but surely on better terms for the Iraqi's than the old Iraq Petroleum who were thrown out by Saddam Hussein.

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[4] Joseph Stiglitz and Linda Bilmes, 'The Three Trillion Dollar War' London: Allen Lane, 2008
[5] 'The Three Billion Dollar War', p. 32
[6] Amy Belasco, 'The Cost of Iraq, Afghanistan and other Global War on terror Operations since 9/11', Congressional Research Service, Library of Congress, September 2006

One result and possible motivation for the war will likely be the permanent stationing of US troops and private security personnel in Iraq and Turkey, offering better security for US oil supplies. Care was taken from the beginning not to damage oil infrastructure. One scenario for Iraq if and when the invading troops leave includes a long drawn out civil war. Oil interests will be served by the presence of large numbers of security contractors, in much the same way as mines and other installations are protected in unstable sub-Saharan countries by private armies of mercenaries and security businesses.

If we were to take a narrow view of the motivation, we could ask: what is the cost of the Iraq war per barrel of known reserves? Assuming Stiglitz's $3 trillion total cost of the Iraq war and 115 billion barrels, the answer is $26. While nobody could have made this calculation in 2003 before the invasion, since nobody could forecast the cost, it is interesting that the world price of oil at that time was $27.

Contractors

One difference between the Vietnam/SE Asia war and the current ones is the extent of the participation of contractors in the war effort. Since 2003 there have been many reports on the award of contracts without competition to service companies like Halliburton and security companies such as Blackwater, on the lack of controls and basic delivery of services in exchange for large sums of cash. A report in August 2008 by the Congressional Budget Office suggests that the total sum paid to contractors in Iraq since 2003 has been $85 billion. In 2008 there are 190,000 contractors' personnel in the field, roughly one for each soldier. The ratio in Vietnam was 1 to 5 soldiers. The contractors are not just engaged in 'support' activities (food, logistics, accommodation), they also have a big role in security, guarding individuals, convoys, bases and do many of the tasks that military personnel would normally do. Nor, according to the GAO, are they any cheaper than directly employed military personnel. In some respects they are like a private army of mercenaries. They certainly look like mercenaries:

Blackwater staff

The economic impact of using contractors rather than directly employed people is through the generation and use of profits by the contractors: if these profits are invested in extending the companies' war contracting activities the effect is neutral. If the companies invest in other operations, in effect the payments by the government become a subsidy on capital investment by the companies.

The use of US based contractors for repair and reconstruction work in Iraq slowed any effort to restart the Iraqi economy. While up to 50% of the population were unemployed, US contractors were importing labour from Nepal and elsewhere to minimise their costs.

Opportunity Costs

To put the war spending in the perspective of the rest of the federal budget in 2008[7]:

Total mandatory outlays	$636.9 billions
Total discretionary funding (inc. $479 billion on defence)	$941.4 billions
Estimated of annual running costs of Iraq and Afghanistan wars (in addition to the regular defence spend)	$200 billions

Within the mandatory segment of the budget, Medicaid cost $211 billion in 2008, Medicare $391 billion.

The opportunity cost of the war is of course an infinite array of alternative uses of the money. The reduced spending could be used to reduce the deficit, or reduce taxes or a combination of the two. Alternatively it could be used to improve the health care, education and life chances of the population, not just at home, but also in other countries.

Barack Obama is keen on pointing out the opportunity costs of the spending on the war. In July 2007 he told a town hall meeting in Des Moines, Iowa: 'For those living in Iowa's 3rd Congressional District [which includes Des Moines] the cost of the war in Iraq will be $756.6 million through 2007. This total is equivalent to providing health care for 238,693 adults and 339,808 children; equipping 851,323 homes with renewable electricity; hiring 17,489 elementary school teachers; offering 134,819 scholarships for university students; creating 113,832 Head Start places for children, building 89 new primary schools; recruiting 18, 745 public safety officers; and hiring 12,676 port container inspectors.'

The political impact of the economic consequences of the war are more likely to be felt in relation to the impact on other government programmes than on the economic impact on the economy. Poor coverage and quality in health programmes for 1/3 of the population, lack of investment in education for that same segment of the population are as significant in creating alienation and disaffection as low pay and unemployment.

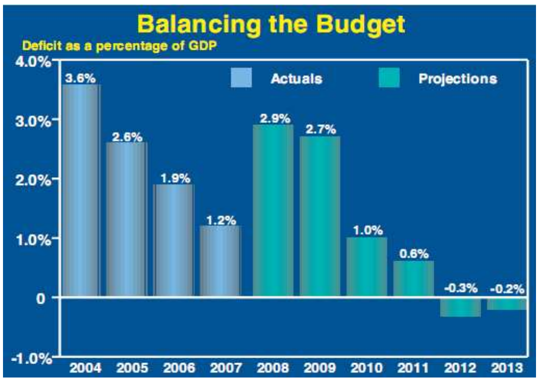
[7] Office of Management and Budget, White House: 'The Budget for Fiscal Year2009'

The impact on the US economy

Multiplier effects of war expenditure

Les made the argument that increased spending on defence would only induce economic and employment growth if there was spare capacity in the economy. At the time of Les's paper unemployment was around 4%, by the end of the war it had increased to 8.4%. At 2001 unemployment was 4.3%, in 2005 5.2% and by July 2008 it had risen to 5.7%.

One impact of the wars has been on the US government deficit. In 2000, the US public finances had a surplus of 2.5% of GDP, and the 2001 estimates were for an increase in the surplus to 4.5% of GDP, or $635 billions. While the deficit was then reduced, by 2008 there was a deficit of $357 billion or 2.5% of GDP. The fiscal deterioration was about $1 trillion, or 7% of GDP. The mandatory element of the budget (Medicare Medicaid etc.) is in surplus (although projected to go into deficit for demographic reasons). The following chart is from the US Budget 2009:



The budget projects an increase in the deficit in 2008 for these reasons:

"The 2008 deficit is projected to be $410 billion, or 2.9 percent of GDP, and the 2009 deficit is projected to be $407 billion, or 2.7 percent of GDP. The primary reason for increasing deficits in the near term is the President's economic growth package and an expected slowing of receipt growth, due to an expected reduction in corporate tax receipts from recent high levels. Another reason for increases in the projected near-term deficits is increasing defense and emergency spending."[8]

Auerbach et al[9] estimate the components of the deficit growth during the GW Bush presidency thus: 47% is due to tax cuts; 28% to defence and homeland security spending increases and the rest to other discretionary spending growth. The deficit growth was mitigated by the arrival of lower interest rates on government debt.

While the budget predicted an eventual reduction in the deficit, and its elimination by 2012, since the budget was published, the government announced $100 billion dollars of tax rebates, to try to stave off recession, adding a quarter to the projected 2008 deficit of $410 billion.

[8] Ibid, p.16

[9] Alan Auerbach, Jason Furman and William G Gale, 'Facing the Music: the fiscal outlook at the end of the Bush administration', Brookings Institute, May 2008

Dean Baker ran the 'Global Insight' macro-economic model to project the impact of increased defence spending on a range of variables.[10] The main results of increased spending were a positive impact on most of the variables in the short term, with negative results from year 5 onwards. A summary appears in the following table.

Differences Between High Military Spending Simulation and Baseline Forecast (Annual Rates) 5 years	5 years	10 years	15 years
Real GDP (billions 2000$)	80.8	-13.3	-11.3
GDP Deflator (percentage points)	0.6%	0.6%	0.7%
10-Year Treasury Note Yield (percentage points)	0.68	0.94	1.06
Nonresidential Fixed Investment	-1.0%	-1.0%	-1.1%
Industrial Production	0.4%	-0.5%	-1.0%
Light Vehicle Sales (thousands)	-192.2	-323.3	-472.0
Residential Fixed Investment	-1.3%	-3.6%	-3.5%
Housing Starts (thousands)	-17.9	-46.2	-38.4
Exist. House Sales (thousands)	-128.4	-247.9	-271.1
Exports	-1.9%	-1.5%	-1.8%
Imports	2.0%	1.5%	2.2%
Current Account Balance (Billions 2000$)	-90.2	-72.5	-83.8
Payroll Employment (thousands)	177.3	-464.0	-515.3

Baker, p.6

In addition to the negative impacts on the variables we have already looked at, the increased spending has negative impact on vehicle sales, house purchases etc. Baker also modelled the impact on jobs by sector, with the results shown in the following table.

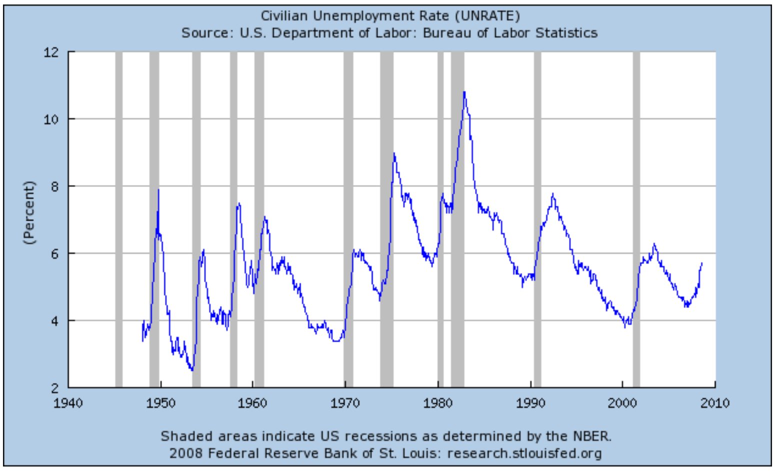
[10] Dean Baker, 'The Economic Impact of the Iraq War and Higher Military Spending', Washington DC: Centre for Economic and Policy Research, May 2007

Lost Jobs Due to Higher Military Spending (Thousands)	5Years	10 years	15 years
Total	178.7	-467.7	-519.4
Construction	8.5	-144.2	-166.1
Manufacturing	-44.2	-95.2	-97.2
Durable Manufacturing	-37.7	-64.2	-67.6

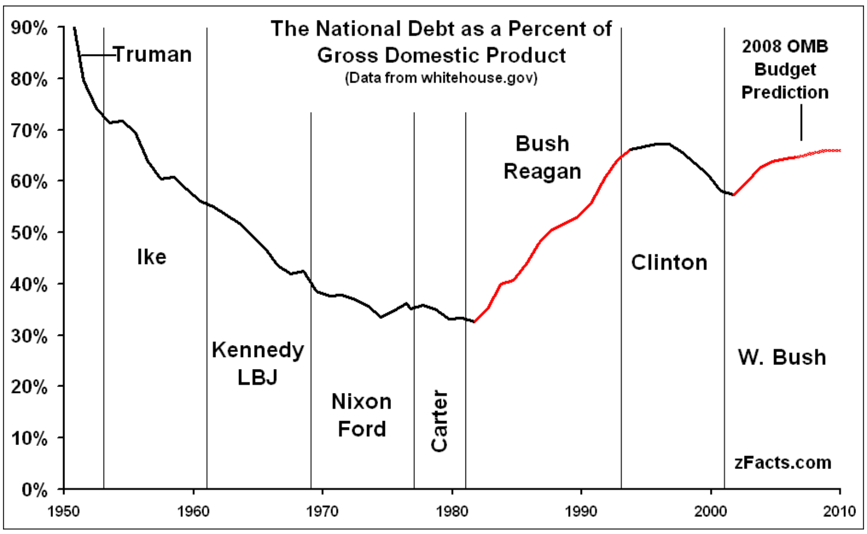
Baker, p.7

After an initial increase in jobs, the increased spending is predicted to have a negative impact later.

The data for the unemployment rate show s a peak in unemployment in 2003 at 6.3%, then a fall to the bottom rate of 4.4% in 1st quarter 2006. Whatever the causes of these fluctuations, it is clear that the steady growth in the deficit and decline in the value of the dollar since 2000 has not resulted in full employment.

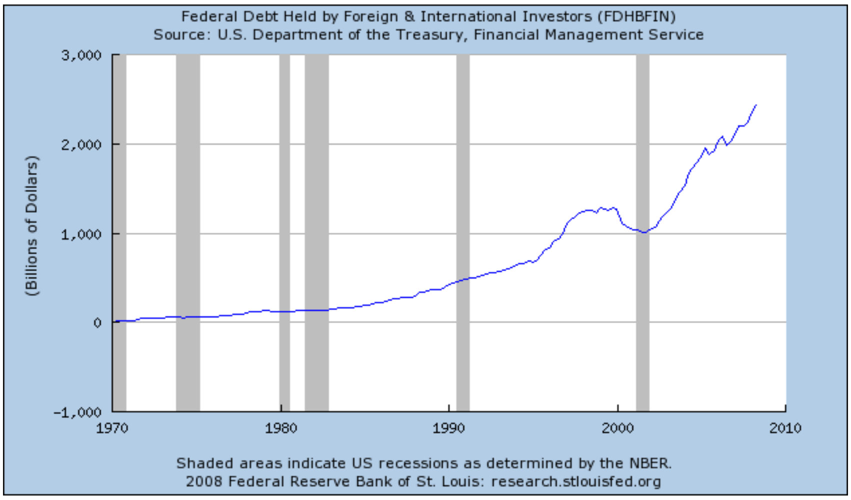


The national debt has grown steadily since the end of the Clinton presidency, as it did during Bush senior and Reagan's time :



While outstanding debt at 65% of GDP is high by US historical standards, it is less than the Eurozone aggregate debt ratio (72%), although higher than the Maastricht treaty's ambition of 60% or less.

The deficit has been financed by borrowing from domestic and overseas bond buyers. The main overseas lenders are in China and the Gulf states. Accumulated overseas holding of US debt is shown in the next chart.



One and a half trillion dollars of overseas held debt have been added since the invasion of Afghanistan. In 2008, twice as much government debt is held domestically, about $5trillion.

Les's paper looked at the multiplier effect of increased spending on investment through the savings rates of the individuals who received the spending as incomes, soldiers, contractors and so on. Attention in the current conflicts has been focused on the impact of the deficit, and the financing of the deficit by selling bonds overseas, on the investment rate through its effect on company profits. The bonds are bought in large part by China and the sovereign funds of the oil producers in the Gulf. The huge net cash flows resulting from China's trade surplus in manufacturing and the Gulf's income from oil at $100+ per barrel cannot find sufficient productive investments with a positive net present value at home, at least in the short term. In the case of China, the cash flowing into companies is augmented by a very high (by international standards) personal savings rates. In the case of the sovereign funds, investments are made to spread the countries' economic activities when the oil finally runs out, some within their territories, some by acquiring real and financial assets in other countries. In the case of China, the People's Bank of China collects private holdings of dollars and stores the state's dollar assets to prevent them causing inflation and threatening the value of the Yuan. In both cases, very large sums are used in the purchase of US dollar bonds, both government and private, along with stocks, real estate, mineral assets and so on. China is acquiring dollar assets (in 2008) at the rate of $25 billion per month and had in March 2008 $1.86 trillion in dollar assets, a 40% increase over 2007[11].

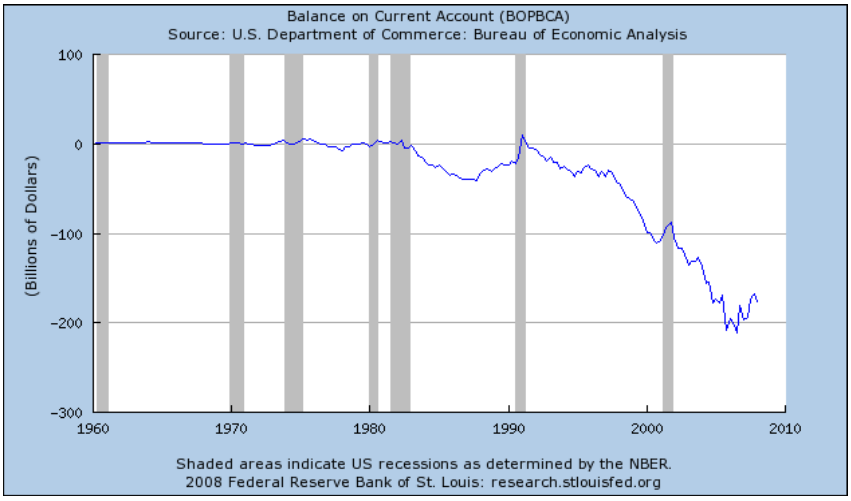
These investments do not depend on the savings rates of individuals, and inward investment to the United States and Europe do not depend on the savings rates of domestic earners. Capital is flowing from the rest of the world to the 'developed' economies: 'The fact that developing countries as a group are net capital exporters contrasts with expectations based on mainstream economic

[11] People's Bank of China data

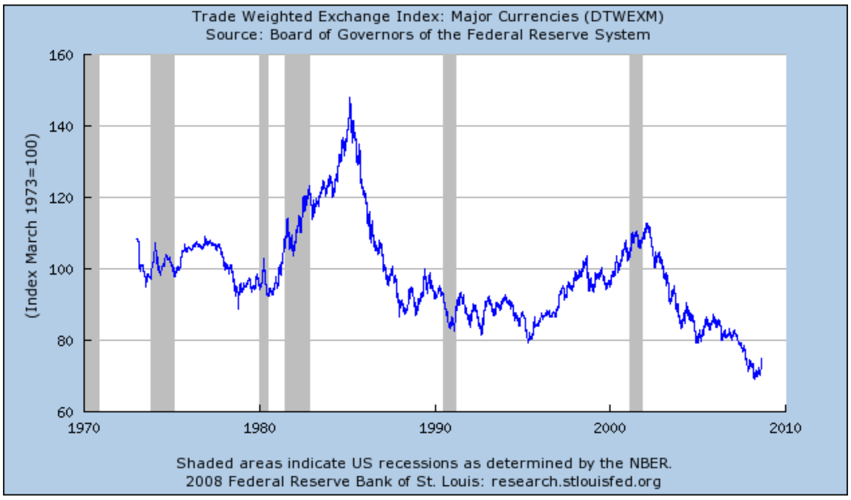
theories, that with open capital markets capital would flow from rich to poor countries, attracted by higher rates of return. What is even more surprising in light of mainstream theory is that, on average, developing countries that are net exporters of capital also tend to grow faster and to have a higher investment ratio than developing countries that receive net capital outflows.'[12]

The link between domestic savings and investment that Les put at the centre of his analysis is not the main determinant of investment in the USA. The deficit financed by foreigners with excess cash represents a free ride for the American people: they consume imports and finance wars using money borrowed from China and the oil producers. Investments continue to happen at home, also using in large part finance from China and the Gulf.

Consuming goods produced elsewhere generates a deficit on the balance of payments, roughly equal to the size of the budget deficit:



One consequence of the rapid expansion of dollar debt has been a decline in the dollar exchange rate. The following chart shows a trade-weighted index of the dollar against a selection of major currencies.



[12] UNCTAD, 'Trade and development report', United Nations, September 2008

The Impact of Iraq etc. wars on the US position in the world

The need for China and the Gulf states to acquire dollar assets will remain while dollars are the favoured currency for trade and investment. Dollars will continue to be favoured if the dollar retains its value. The maintenance of the dollar does not depend on the strength of the US economy, rather the behaviours of the people managing the funds generated by the oil and manufacturing surpluses. Currently it is in their interests to support the dollar and to maintain its position as the world currency. It is not in China's or the Gulf states' interests to see a collapse in credit or in the value of the dollar.

With regard to the United States' political position in the world, both sets of wars generated allies and enemies. The Vietnam war divided US's allies and reduced US support more than any other action since World War II. While in 1967 it still looked as if the US could possible 'win' in Vietnam, as the Vietnamese people, supported by their allies resisted high level bombing as well as fierce ground fighting, the protests against the war spread throughout the US and the world.

The Iraq and Afghan wars have provoked less united protest, although there were very large demonstrations at the beginning of the war. Stiglitz attributes the difference between the Vietnam opposition and the opposition to the current wars inside the US to two factors: the fact that the current armed forces consist only of volunteers, and the fact that the war has been funded entirely by borrowing, so not directly affecting people's personal finances. Other reasons may be the scale of the casualties, and the difference in the treatment of the civilian populations in the two wars: indiscriminate carpet bombing of civilians, including people in countries neighbouring the country being invaded is never likely to be popular.

The wars have, however, alienated most of the Moslem world and is seen in many other parts of the world as a great threat to world peace. Iraq, especially, has divided Europe between a small group of supporting nations and a large group, including France and Germany, against. Afghanistan is a different case, with many more nations contributing troops on the ground through ISAF. However, in 2008, with a resurgence of Taliban strength and increase in poppy production, the establishment of a pro - western self - sufficient government in Afghanistan seems as remote as it was when the invasion began.

Will the wars improve the security of the United States? It is unlikely that either war has reduced the strength of support for Moslem extremists. Pakistan's border area with Afghanistan and Afghanistan itself provide places where armed extremists can be recruited and trained. Iraq provides a place where young men can go and fight Americans and other non-Moslem soldiers, in a way that was not available to them under Saddam's reign.

Whether the war improves the US's fuel security depends in part how things work out in the Iraq oil fields. There seems no doubt that the war has contributed to the world price of oil and therefore reduced the US's fuel security, as a net importer of oil.

The budget and balance of payments deficits and the resultant drop in the value of the dollar may have weakened the US's position as the world's banker (as Les described it in 1967) and reduced its economic strength. The extensive overseas holding of US government bonds may improve relations with the governments of the countries where those bonds are held, although unless there is a new world currency, it is in everyone's economic interest to support the dollar.