

WAR AND OUR ECONOMY

Conflict Will Worsen Downturn in North Carolina

Summary: The ghastly terrorist attacks in New York City and Washington will have overwhelmingly negative consequences for the nation's economy, despite the foolish suggestions of some that it will result in a net stimulus. North Carolina's economy promises to be particularly hard-hit by troop deployments and faltering investor and consumer confidence. Now is the time for state leaders to dedicate themselves to strengthening the economy, not weakening it through massive tax hikes.

Following the disastrous attack on New York, Washington, and our country, the purveyors of economic quackery have begun spilling gallons of ink in describing how they think this mess will affect the United States economy. One of the most prominent views to emerge, and also the most wrong-headed, is the idea that the destruction of the World Trade Center and all the wealth that was embodied in it will be good for the economy.

According to Timothy Noah, writing for Slate.com, "in seeking to harm America, terrorists will probably end up making it more prosperous. They can make us die, and they can make us weep, but they can't make us poor."¹ And in the words of economist Larry Kudlow, "we may lose money and wealth in one way but we gain it back many times over when the rebuilding is done." Kudlow states that "in economics, it's called the broken window effect."² In fact, Kudlow is not only ignorant of economic theory but he is also ignorant of economic terminology. The "effect" that he describes is actually known as the "broken window fallacy" — from the destruction of wealth comes prosperity. It is the same ignorance of economics that leads some to conclude that wars are good for economies.

The "broken window fallacy" stems from the observation that when wealth is destroyed, through war, natural disaster, or, as told by 19th century French economist Frederick Bastiat, a hoodlum throwing a brick through a shop window, it is usually replaced. As the story goes, in replacing this destroyed wealth, jobs are "created." Money is spent on hiring construction workers, plumbers, electricians, glaziers (in Bastiat's original story) etc. In turn employment and economic activity is stimulated in all the industries that these people do business with, in the industries that those people do business with, and so on.

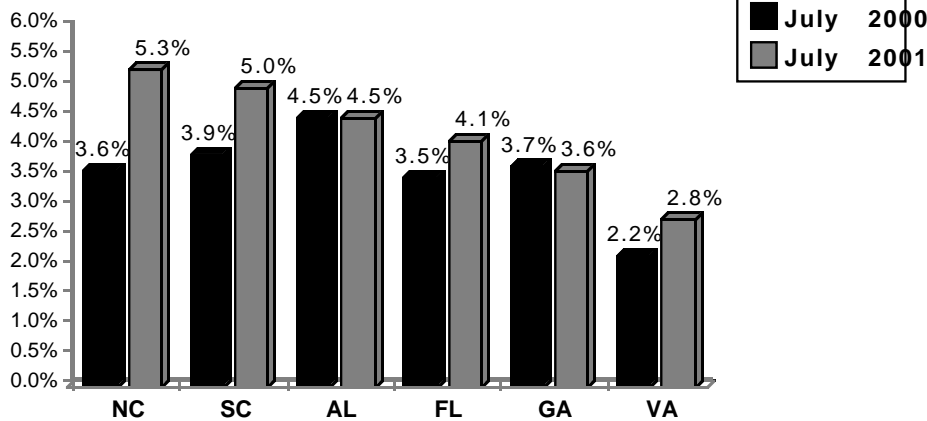
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Jobless Rates: Ranking and Change, July '00 to July '01

SOURCE: U.S. Bureau of Labor Statistics



This is why Kudlow concludes that from the ashes of the World Trade Center we will gain back the lost wealth "many times over" and Noah concludes that we will actually end up being "more prosperous." Noah also suggests that some of the growth will come from government spending. "We live in a very wealthy nation that responds to horrible disasters by spending large sums of money," he wrote. "In this case, the spending will come from both the private insurers and from the federal government's Federal Emergency Management Agency"³

The problem with this argument is that it ignores what economists call *opportunity costs*. In other words, the analy-

sis assumes that all the resources that must go into rebuilding the WTC and the Pentagon would, if the terrorists were not so kind as to destroy these buildings, lie idle. This is a ridiculous assumption. In fact, the resources would have gone elsewhere in the economy. Consider the massive sums that insurers must now dole out to pay claims. This money would have been invested in the insurers' portfolios of stocks and bonds. It would have been used in productive ways, such as building homes and businesses or inventing new lifesaving drugs. The resulting improvements in our lives are now lost as a result of the attacks. The same is true with any money that is spent by FEMA or other government agencies. Taxpayers, if allowed to keep this money, would be spending it on themselves or their families, or saving and investing it. It is truly goofy economics to assume that if the government doesn't make use of the money, the people who they must first take it from would simply be doing nothing with it. The true absurdity of the "broken window fallacy" is that if it were true then we could simply make the entire economy wealthy by constructing buildings, blowing them up, and then rebuilding them.

In this particular situation, where many thousands of obviously productive and hard working people have lost their lives, invoking the broken window fallacy has wider implications. What was lost in this terrorist attack was not just physical capital, like tall office buildings, but massive amounts of human capital. Kudlow and Noah, in their assessment of the situation completely discount the future productivity of those whose lives were lost. This is productivity that is gone forever. It is human capital that can never be rebuilt and that would have been productive for many years to come. To say that the economy will be better off because of the terrorist attack is equivalent to saying that the economy will be better off without these thousands of human minds and bodies and their productive output.

Implications for North Carolina

The economic losses will be felt across the nation and probably the world. Resources will be redirected both to rebuilding what has been lost and to fighting the coming war. Materials, manufactured products, manpower, technology, taxes, and private donations will flow from North Carolina and other states to support the effort. As noted above, these are not resources that would otherwise be idle but would be employed in producing the goods and services that North Carolinians and others desire. In our state, because of the large presence of military personnel, communities like Fayetteville, Jacksonville and Goldsboro will be hit particularly hard. As troops stationed in these communities are deployed businesses will lose customers, profits will fall and layoffs will occur. This will put new strains on an unemployment rate that has been continuously getting worse over the last 12 months. In fact, as shown above, North Carolina not only has the highest unemployment rate of any Southeastern state, over the last 12 months it has had the largest increase in unemployment in the Southeast.

The destruction of wealth can never be good for the economy, whether the destruction occurs because of natural disasters, terrorists, or street hoodlums. And certainly war, which is clearly the most destructive force invoked by man, should never be considered a stimulus for growth.

— Dr. Roy Cordato, Vice President for Research and Resident Scholar

Notes

¹ Timothy Noah, "Will Terrorism Resuscitate the U.S. Economy?" found at <http://slate.msn.com/code/chatterbox.asp?Show=9/12/2001&idMessage=8279>.

² As quoted in David Seifman and Lisa Marsh, N.Y. Urges Bizmen: Stay!" NYPOST.COM, 9/17/01. Found at www.nypost.com/business/2229.

³ Op. cit. at note 1.