

An hourglass-shaped graphic with a globe inside. The top bulb is dark blue, and the bottom bulb is light blue. The globe is a darker shade of blue. The hourglass is centered on the page.

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The Economic Effects of Spending on Homeland Security

Brian W. Cashell, Government and Finance Division

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Abstract. One direct result of the terrorist attacks of September 11 is that the cost of domestic security has risen. That increased cost is likely to be in the form of increased outlays on the military, as well as increases in spending for domestic law enforcement, public safety, and private security services. Some industries, such as the airlines, will be more affected than others but there will be nationwide effects because domestic security is a public good and much of the increased cost will likely be borne by taxpayers.

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The Economic Effects of Spending on Homeland Security

Brian W. Cashell
Specialist in Quantitative Economics
Government and Finance Division

Summary

As a result of the terrorist attacks of September 11 the cost of domestic security has risen. The only straightforward way to measure the cost of “security” is to add up the expenditures for labor and capital that are devoted to the provision of security. In the case of air travel, security services paid for by the airlines are an intermediate good; that is, they are an input to the production of air travel rather than output, and are not counted separately in gross domestic product (GDP). The money spent on security is a cost of production and so would be reflected mainly in the price index for air travel, and in overall price indexes to the extent that air travel contributes to total production. Because of the increase in labor and capital required to produce a safe trip, the productivity of airlines would also suffer a one-time decline. The same is true for security expenditures by any firm engaged in the production of other goods and services. In contrast, when the government pays for security services, it is as a final consumer and those expenditures are counted explicitly as part of GDP. Any increase in those expenditures will thus appear as both nominal and real contributions to GDP. The only enduring effect will be a shift in the share of employment and of expenditures devoted to security. Relative to the size of the overall economy, these costs are likely to be fairly small. This report will not be updated.

One direct result of the terrorist attacks of September 11 is that the cost of domestic security has risen. That increased cost is likely to be in the form of increased outlays on the military, as well as increases in spending for domestic law enforcement, public safety, and private security services. Some industries, such as the airlines, will be more affected than others but there will be nationwide effects because domestic security is a public good and much of the increased cost will likely be borne by taxpayers.

In light of the current international political environment, it seems likely that many of the factors motivating the demand for increased domestic security will persist for some time. Given that there is going to be a sudden and substantial increase in spending on public safety and security what, if any, are the macroeconomic consequences likely to be?

Measuring “security”

Assessing the effects of higher costs for domestic security on the overall economy illustrates some of the limitations of existing measures of economic activity. The standard measure of overall economic activity is gross domestic product (GDP). GDP measures the market value of goods and services produced in the United States. It measures only the value of current production.

Although GDP may be the most comprehensive measure of our national standard of living, it necessarily falls short as a measure of national well-being. Many items are left out because they are difficult to measure, or because there is no market in which values are established. One example of that would be the loss in our collective sense of security after September 11.

There is no simple way of measuring the level of “security” itself. Moreover, an important goal of spending on security is the sense people have that they are safe as they go about their lives. There is not even a unit of measure that allows for an accounting of that sense of security. The only straightforward way to measure “security” is to add up the expenditures for labor and capital that are devoted to the provision of security. The effort to regain whatever sense of security the nation enjoyed prior to the attacks is going to require a considerable increase in expenditures. But the effect of those expenditures on GDP will depend on where they are spent.

How security does (and does not) affect GDP

The value of goods and services that are included in GDP is based on the price paid by the final user. In the case of airline security, the product being consumed is a trip. If the cost of that trip rises because of the need for more spending by the airlines for airport security, that raises the price of the trip without changing any of its characteristics.¹

While the nominal value of the production of air travel may rise, other things being equal, it would be attributable to increased production costs. In fact, the real value of the production of air travel is likely to fall as consumers respond to the rise in price. Because of the increase in labor and capital required to produce a safe trip, the productivity of airlines would also suffer a one-time decline. To the extent that consumers absorb the higher cost of air travel, they would either have to reduce spending for other goods and services or reduce their saving.

In the case of air travel, security services paid for by the airlines are an intermediate good, that is, they are an input to the production of air travel rather than output, and are not counted separately in GDP. The money spent on security is a cost of production and so would be reflected mainly in the price index for air travel, and in overall price indexes to the extent that air travel contributes to total production. The same is true for security expenditures by any firm engaged in the production of other goods and services.

In contrast, when the government pays for security services it is as a final consumer and those expenditures are counted explicitly as part of GDP. Any increase in those

¹ This ignores the cost of waiting longer in line for more rigorous airport security screening.

expenditures will thus appear as both nominal and real contributions to GDP. That is not to say that the net effect would necessarily lead to a permanent increase in GDP. Any increase in spending on security by the government must either be at the expense of other spending, higher taxes, or increased government borrowing.

Similarly, individuals may increase their demand for personal security services. These expenditures will be reflected in total GDP, but they would be at the expense of purchases of other goods and services, or be paid for by reducing household saving. Individuals will also bear a part of the cost of increased security in a way that will not be captured by conventional economic statistics. For example, if security screening in airports takes longer than it used to, the additional time it takes for airline passengers to complete their trips reduces the quality of the service and thus raises its real price.

Overall effect

Unless and until conditions change, the increase in the cost of “security” is likely to persist. That increased cost will either be reflected in higher prices for affected goods and services, which would reduce real incomes, or in increased public sector spending. If increases in public sector spending are financed by higher taxes, that reduces disposable income. If they result in cuts in other categories of spending, that would reduce the incomes those outlays supported. If they are financed by borrowing then, other things being equal, interest rates will rise thus dampening those sectors of the economy that are sensitive to interest rate fluctuations.

In the end, the net result is likely to be a small temporary reduction in productivity growth due to the increased labor and capital required to increase security, and as the increase in the cost of those goods and services which require higher security expenditures to produce filter through the economy. The increase in labor and capital required to produce safe air travel is likely to be a once-and-for-all change; thus any effect on productivity is likely to be short lived. In the long run, other factors will determine the rate of growth of productivity in the production of air travel. The only enduring effect will be a shift in the share of employment and of expenditures devoted to security. Relative to the size of the overall economy, these costs are likely to be fairly small.²

² It is also possible that there could be occasional market disruptions because of the continuing threat of additional terrorism.