

## Covering the Cost of War

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# Covering the Cost of War

An international finance expert and the author of *The Price of Liberty: Paying for America's Wars* describes the problems with current U.S. fiscal policy, and how to adjust the country's spending for present and future global battles.

by Art Kleiner

A robust national defense system has as much to do with the strength of a nation's finances as it does with the strength of its military. Few people understand this as well as Robert D. Hormats. A leading expert on international finance, a vice chairman of the Goldman Sachs Group Inc.; a veteran of numerous presidential administrations; and author of the recently published book *The Price of Liberty: Paying for America's Wars*, Hormats has gone back through American history to track the financial underpinnings of the wars of the United States. His conclusion: Generations of American leaders have understood the critical relationship between financial strength and the ability to protect national interests, but that relationship is currently in danger.

Hormats sat down with *strategy+business* recently to discuss how the U.S. — or any government — can finance an appropriate level of military readiness in the future without jeopardizing its independence or standing.

**S+B:** This is a very timely book. One question it raises is, How can past wartime leaders teach us how to prepare for the long war on terror?

**HORMATS:** The best leaders throughout U.S. history have explained the true cost of national security to the American people. The best results come when leaders

are very candid about what the threats are and what the cost of meeting those threats would be.

Wartime financing is not just about raising money. It also involves engaging Americans in the war effort, and capturing their hearts and minds so that when troops are sacrificing abroad, Americans are not immune from that sacrifice. During World War I and World War II, little children bought war stamps with nickels and stuck them in books. The point wasn't to raise money — the government didn't need those nickels and dimes — it was to establish this sense of engagement.

Neither Woodrow Wilson during World War I nor Franklin D. Roosevelt during World War II knew how much the wars were going to cost at the outset, but once they concluded the wars were going to be a lot more expensive and last longer than they anticipated, they were willing to make major changes in the U.S. financial system to pay for each war and explain why these changes were necessary. Conversely, when the true cost is hidden from the American public, like it was during Vietnam and the current war in Iraq, leaders lose credibility.

In the current war in Iraq and the broader war against terrorism, except for those who serve in the military and their families, Americans have not been asked to do anything. It could have been an opportunity for the president to introduce a bold policy for energy taxes and

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energy independence, or to get control over nonessential domestic spending, such as earmarking. Anything that showed there was some measure of sacrifice.

**S+B: What difference would that have made?**

**HORMATS:** First of all, remember that the Iraq War was very popular at the beginning. It was popular because Saddam Hussein was such an evil character and because it was initially successful. If the president had used that popularity to, for instance, add to his tax cuts a request that Americans pay a small tax to ensure wounded veterans received adequate medical treatment, this could have given people a sense that they were somehow identified with the troops fighting the war.

The point of this book is not to be critical of George W. Bush or of Congress. Instead, it's to ask what our future will look like after the Iraq War. Suppose, for example, that we withdraw and then pull back from national security spending, as we did after Vietnam? Then what happens if we aren't prepared for a future threat? To date, no one has been candid with the American people about why funds will be needed for a long time to meet national security requirements, what the costs are, and what the longer-term implications could be.

**S+B: Can't we maintain our current level of defense spending?**

**HORMATS:** It's a difficult but manageable challenge. The budget deficit is only US\$150 billion, which is small by historical comparisons. The war itself is not difficult to finance. It's a relatively small portion of GDP. Other parts of the budget, particularly in entitlements, will pose a financial problem. They will become so large that they

will put a squeeze on discretionary spending, which includes the military. You have to find a way to ensure that entitlements such as Social Security and Medicare don't encroach so much on the rest of the budget that they limit national security spending, education spending, and all other aspects of domestic spending.

**S+B: Among entitlement reform, taxation reform, dealing with the war, and addressing the deficit, which comes first?**

**HORMATS:** To start, we need to reign in tax subsidies, just like Ronald Reagan did in the 1980s. At that time, the tax code was rife with corporate subsidies, and Reagan pared them out of the system. Unfortunately, many have come back. Cutting corporate subsidies could bring in revenue without having a negative impact on growth.

Another issue that needs to be addressed is the imbalance of funds available for Social Security and Medicare. Without reform, these systems will develop increasing gaps between money coming in and money going out to beneficiaries. You simply can't allow outlays to rise and inflows to barely increase. It just widens the imbalance.

Finally, adjustments have to be made to the national security budget to deal with terrorism and other new threats. This means phasing out old programs that are unnecessary in the current environment and doing more in intelligence and in homeland security and maybe a little less in conventional military spending.

**S+B: Given what we've seen of entitlement reform over the past 25 years, what realistic expectation could there be that policies will be changed?**

**HORMATS:** That's what worries me. If you go back to earlier situations when the country faced crisis, leaders were able to institute wrenching changes. For instance, both an income tax and the greenback currency were established during the Civil War, ideas that were inconceivable in 1850. And during World War II, taxes were raised to levels that were unimaginable in 1940. The point is that with strong leadership we're capable of making very dramatic changes to the system.

In fact, Bush did take leadership on the Social Security issue. But he didn't present the problem before he presented his proposed solution. If he had taken six months to have a robust national dialogue on the need for reform and then presented his fix, he would have had a far better chance of acceptance.

Roosevelt spent a large portion of time during the war explaining to Americans why they had to make these sacrifices. That's what the Fireside Chats were about. He explained what was going on, why people were called on to participate in rationing, why they should buy war bonds, and why they should have their mother or their aunt or their daughter work in the war factories. There was an education process that Roosevelt understood.

**S+B:** Almost every problem you've highlighted is visible to the American public – and other countries have their counterparts. What do people need to understand to be a part of the solution?

**HORMATS:** The political system produces chronic short-term thinkers. We need to build incentives into the system to encourage long-term thinking. You don't hear political leaders talking or thinking long-term because the bad things may not happen on their watch.

If you project what happens if our energy depend-

ence goes from 60 percent, as it is today, to 80 percent, the vulnerabilities are enormous. People also need to understand the consequences of a budget deficit that rises dramatically because entitlements mushroom, and other programs get squeezed, or taxes are raised, or borrowing goes up — which pushes interest rates up. They need to see what happens if you don't make adjustments.

If you see the longer-term issues, you develop a sense of clarity. Politicians need to have the intellectual capability to address some of these problems and point the way with reasonable solutions. And at this point in history, they don't need to be wrenchingly awful solutions. But if we wait 10 years, they may have to be. +

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## Resources

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Robert D. Hormats, *The Price of Liberty: Paying for America's Wars* (Times Books, 2007): The book on which this article is based evaluates war spending throughout U.S. history. [www.amazon.com/dp/0805082530](http://www.amazon.com/dp/0805082530)

Robert D. Hormats, "War Costs Money. Why Can't Politicians Say So?" *Washington Post*, May 6, 2007: Not being upfront about the cost of war can negatively affect the nation. [www.washingtonpost.com/wp-dyn/content/article/2007/05/04/AR2007050402558.html](http://www.washingtonpost.com/wp-dyn/content/article/2007/05/04/AR2007050402558.html)

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