How does military economy work?

The military economy revolves around finding the optimal resource allocation among defense and other functions of the government. The primary goal is to find the ideal size of the defense budget with respect to the sizes of other budgets that are managed by the public body or from the field of disarmament, arms conversion, sealift and civil defense.

According to Adam Smith, the concept of free market still holds its significance and is supported by various economists. The free market economy is a mechanism which ensures the economic growth, whereas the government is responsible to regulate the public expenditures along with the country development and its defense. The security of the country is a major concern, the spared ratio for defense spending changes from time to time depending on the conflicts in the surrounding countries.

The Classical school of thought contends that an increase in military expenditure is likely to retard the economic growth. This argument is based on the premise that higher military spending implies a lower level of private investment and domestic savings, and lower consumption due to lower aggregate demand. This can be specifically explained as follows. A higher level of military spending will lead to an increase in the interest rate, which will crowd out the private investment.

On the other hand, some theories suggest that the military expenditure can impact the economy of a country and its growth positively through the demand effect. An increase of military spending will increase the prosperity of the country and its employment rate, thanks to a rise of demand. It is link to the Keynesian multiplier effect, introduced by Richard Kahn in the 1930s, that states that every exogenous rise in government expenditure will decrease unemployment and increase growth, no matter the form of expenditure. However, the extent of this effect, and some potential others, will depend on the way this expenditure will be financed.

Similarly, an increase in military expenditure can change the industrial output thanks to the input-output effect, but it, as a consequence, also modifies the input. Factors of production such as labor force, natural resources or capital can be heavily changed when the government has the desire to increase its military capacity. Some resources previously used by civilians or by other branches of production are transferred to the military field. This could destroy profoundly resources of a country (especially during war times). Research and development investments can also be made to improve the military capacity of production. It could then have positive impacts on other production fields. Moreover, more workers will be employed, which might reduce the unemployment rate, but this might also reduce their productivity when they return to a non-military sector of employment, or the unemployment rate could rise again dramatically when the military use will decrease. As a consequence, an increase of military expenditure can create a large variety of economic impacts and externalities, positive and/or negative.