The Effect on the U.S. Economy of Changes in Defense Spending

Testimony to the

Committee on Armed Services of the U.S. House of Representatives

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Thank you, Mr. Chairman. I am very pleased to have the opportunity to testify to this Committee. Although I have testified to Congressional committees for more than 30 years, this is the first time that I have appeared before this important committee.

In your invitation you asked me to comment on the effect that reductions in defense outlays will have on total economic activity, i.e., on the GDP of the United States. I am happy to do that but I want to begin with a few words about the larger subject of the national security consequences of reductions in defense spending.

Defense Spending and National Security

In considering the appropriate size of the defense budget, it is of course important to recognize the immediate threats to the United States and to our allies from Iran, from North Korea, from rogue states and from various terrorist groups. There is also the current challenge in cyberspace from espionage directed at industrial and national security targets and from the risk of cyber attacks on our basic infrastructure.

But defense spending today must also relate to the more distant risk from China's future military policy. China is now a poor country with per capita income less than one-fifth of our own. But since China has more than four times the U.S. population, China's total GDP will equal that of the United States when its per capita income reaches only one-fourth of the U.S. level. Even if China's growth rate slows significantly from its current level, its total GDP will exceed ours in less than 15 years.

A country's total GDP determines its potential military budget. The current Chinese political leadership is concentrating on promoting economic growth to raise the standard of living of its people and to deal with the very large inequality that

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exists between different groups within China. But China is also developing every aspect of its military capability.

The quality of China's military force is not currently up to U.S. standards. But China's defense budget will grow with its GDP. It is important for the United States to recognize that future generations of Chinese leaders could use its larger GDP to pursue more aggressive policies.

America's defense policy and our defense budget should therefore focus on the future generations of Chinese civilian and military leaders and should recognize the virtual certainty of China's growing economic power. The United States should maintain a military capability such that no future generation of Chinese leaders will consider a military challenge to the United States or consider using military force to intimidate the United States or our allies.

China's future military spending and its weapons development will depend on China's perception of what the United States is doing now and what we will do in the future. If we show a determination to remain invincible, China will not waste resources on trying to challenge us in an arms race. But if we keep cutting defense budgets, the Chinese will see this as an indication of U.S. weakness now and in the future.

China is in many ways a resource-poor country that depends on imports of oil, iron, and other raw materials as well as on imports of food to feed its people. That is not likely to change. China is therefore now buying oil in the ground around the world and arable land in Africa to grow food for the Chinese people. Some countries in the past have used military force to gain secure access to such materials. China's future leaders should not be tempted to follow that path.

It is important that our allies and friends like Japan and Korea and Singapore and Australia see the commitment of the United States to remain strong and to remain present in Asia. Their relations with China and with us depend on what they can expect of America's future military strength.

The Navy has a particularly important role to play in this, including the Navy's presence in international waters to enforce freedom of the seas, naval visits to Asian ports, and joint exercises with the navies of other governments.

We cannot postpone implementing a policy of future military superiority until some future year. We have to work now to develop the weapon systems of the future. We have to maintain the industrial and technological capacity to produce those weapon systems. We have to make it clear by our budgets and by our actions that we are the global force now and will continue to be that in the future.

While reducing fiscal deficits is very important, that task should not prevent the

federal government from achieving its primary responsibility of defending this country and our global interests, both now and in the future.

Defense Spending and GDP

I will turn now to the narrower economic question of how cuts in defense spending affect U.S. GDP.

Since government spending on defense is a component of GDP, the immediate direct effect of a one billion dollar reduction in domestic defense spending is to reduce our GDP by one billion dollars. The resulting reduction in pay to military personnel and in compensation to the employees of defense suppliers then causes their spending as consumers to decline. If defense suppliers expect the reduced level of defense spending to be sustained, the defense suppliers will also cut their demand for equipment. The total effect of the one billion dollar reduction in defense spending is to reduce GDP by more than a billion dollars, perhaps about two billion dollars.

I based this calculation on a reduction in domestic defense spending. To the extent that some of the reduced defense spending is overseas and on locally purchased goods and services, the impact on U.S. GDP will be proportionately less. But since about 90 percent of defense spending is domestic, the calculation of a two dollar reduction in U.S. GDP for every dollar reduction in defense spending is probably a good estimate.

Any reduction in future budget deficits and in the resulting level of the national debt will also raise the confidence of businesses and households, leading to increased consumer spending and business investment, thus raising current GDP. Since a similar effect would result from legislated reductions in future deficits achieved by cutting any form of government spending or by raising revenue, we can ignore this "confidence effect" in comparing the impact of reductions in defense spending with the effect of other spending cuts or tax increases that have the same effect on future deficits.

The direct effect on GDP of changes in defense spending is larger than the corresponding effect of most other potential changes in government outlays. For example, outlays for unemployment benefits are not in themselves a component of GDP. They lead to increased GDP only by raising the consumer spending of the individuals who receive those benefits. While a high percentage of those cash benefits will be spent, it will certainly be less than a dollar of spending for every extra dollar of unemployment benefits. Some of the consumption purchased with the unemployment benefits would otherwise have been paid for out of reductions in household savings. And of course some of the consumer spending would be on imports, further reducing its effect on GDP.

A change in unemployment benefits also affects GDP by altering the incentive to remain unemployed. Reducing the maximum number of weeks of unemployment

benefits will induce some individuals to find work sooner, thereby raising GDP. The resulting increase in total employment is difficult to estimate at a time when total employment is limited by the weakness of aggregate demand. Some of those who are induced to find work because of reduced UI benefits may just prevent others from finding work. The overall effect on GDP of reducing UI benefits will be the net effect of the reduction in consumer spending and the increase in weeks worked. The direct impact on GDP of a one billion dollar reduction in unemployment benefits will certainly be less than the direct effect of a one billion dollar reduction in defense outlays.

Transfers from the federal government to state and local governments are also not a component of GDP. Reducing such transfers only alters GDP to the extent that doing so causes those governments to reduce their spending or raise their taxes. If cutting a billion dollars in transfers to state governments causes them to cut their domestic spending by one billion dollars, the immediate effect on GDP would be the same as cutting one billion dollars of defense spending. But if the state governments offset some of the reduction in funds from Washington by using their "rainy day" funds or temporarily running a deficit, the effect on GDP would be less. Similarly, if the states raise taxes to pay for some of the outlays that had previously been financed by transfers from Washington, the effect on GDP would be smaller.

My comments this morning about the effect on GDP of changes in defense spending and other forms of government outlays focus on the direct effects on <u>demand</u> for U.S. goods and services as measured by GDP. That is the appropriate focus in the short run at a time when unemployment rates are high and we are far from full employment. Over time, the American economy will return to full employment, or, more technically, to the level of unemployment that can persist without causing a higher rate of inflation. Changes in defense spending in the context of full employment must be balanced by changes in other components of GDP.

I hope that these remarks are helpful to you and your colleagues as you consider the important tasks of deficit reduction and of protecting our national security.

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