DEFENSE SPENDING AND THE ECONOMY

Statement of

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Mr. Chairman, I am pleased to be here today to discuss with you the Administration's proposed defense buildup and its potential effects on the economy.

Over the last several years, the United States has rapidly increased its defense spending, and the Administration proposes to continue that buildup in fiscal years 1984-1988. If the Administration's plans are carried out, budget authority for national defense would rise from $146 billion in 1980 to $433 billion in 1988. After adjustment for inflation, that represents real growth of 88 percent, or an average of about 8.2 percent a year. Outlays would grow from $136 billion in 1980 to $386 billion in 1988, representing real growth of 75 percent, or about 7.3 percent a year. The contemplated increases would raise defense outlays as a share of the Gross National Product (GNP) from 5.2 percent in 1980 to 7.7 percent in 1988--the share they held in the early 1970s.

The proposed buildup emphasizes investment, which includes procurement, research and development, and military construction. Budget authority for these investment accounts would grow from $51 billion in 1980 to $219 billion in 1988. This constitutes real growth of 169 percent, compared to an 88 percent real increase in the budget as a whole during this period. Because of the emphasis on investment, the defense buildup could have more effect on the goods-producing sectors of the economy than the overall growth rate suggests.

Several kinds of economic risks are associated with rapid increases in defense spending. First, there are risks to the general economy, particularly with regard to inflation, economic growth, and jobs. We believe that, at least for the next few years, this risk is not great; defense spending need not rekindle inflation or retard growth in overall employment.

Second, there are risks specific to the defense sector, principally those of higher weapons prices caused by bottlenecks in narrowly defined defense industries, unanticipated inflation, and other factors. Recent data suggest some progress in the difficult task of limiting weapons cost growth, although continued efforts are needed.

Finally, there is the serious risk that rising defense spending, if not offset by other policies, could increase federal deficits enough to choke off economic expansion in the longer run. If the defense buildup proceeds as requested by the Administration, it will be necessary to offset its impact on the deficit by raising revenues or cutting nondefense spending or both. Thus the defense buildup will require that resources be diverted either from other public programs or from private spending. The desirability of the buildup must be judged by weighing the requirements for national security against the importance of alternative uses of national resources.

DEFENSE SPENDING NEED NOT REKINDLE INFLATION

Today, the U.S. economy is apparently beginning a recovery from the longest and deepest recession since World War II. Over the next two years, CBO foresees economic growth, but at levels well below the average of the

past cyclical recoveries. The real level of GNP is expected to increase 4.0 percent from fourth quarter 1982 to fourth quarter 1983 and another 4.7 percent by the fourth quarter of 1984. Unemployment is expected to decline, but very slowly, still averaging 9.8 percent in calendar year 1984.

CBO expects inflation to continue to decline. Measured by the GNP deflator, inflation is expected to be about 4.7 percent in 1983 and 4.6 percent in 1984. Because of uncertainty surrounding monetary and fiscal policies and international financial markets, it is more difficult than usual to anticipate future economic developments. Nonetheless, current high rates of unemployment and low capacity utilization are expected to persist even as recovery gets underway. Combined with slow growth in agricultural prices and weakening energy prices, these factors should reduce inflationary pressures. It seems unlikely, therefore, that fiscal policy, including the planned rapid increases in defense spending, will rekindle inflation in the next few years.

Estimates of capacity utilization in defense-intensive industries support the conclusion. Defense production is concentrated in manufacturing industries. Capacity utilization in all manufacturing industries is now below 70 percent, and is expected to reach only 81 percent in 1985. This rate is below both the 85 percent threshold typically associated with full employment in the economy and the 83 percent rate achieved on average between 1948 and 1980. It is also well below rates achieved during previous military buildups.

There are, however, divergent trends within manufacturing. Capacity utilization rates in the defense-intensive, basic-materials industries--steel, nonferrous metals, fabricated metals--will remain far below rates achieved at previous business-cycle peaks. In the steel industry, for example, capacity utilization is not expected to exceed 80 percent in 1985, compared with a high of 96 percent in 1973. On the other hand, rates in the high-technology, defense-intensive sectors--the aerospace, electronics, and instruments industries—may well approach levels achieved during the business-cycle peaks of the 1970s. Capacity utilization in electronics, for example, may reach 87 percent in 1985, compared with previous peaks of 89 percent in 1979 and of 97 percent in 1965. Even though these numbers might suggest some tightness in industries such as electronics, sharp price increases seem unlikely because these are dynamic industries that previously have increased their capacity rapidly in response to higher demand.

Similar conclusions flow from probable labor-market developments. The defense buildup may contribute to future shortages of some scientists, engineers, skilled machinists, and tool-and-die makers--categories of workers that are heavily involved in defense production. But, in the next few years, these will be exceptional cases in a generally bleak labor market. Less than 3 percent of the work force falls into these categories, and employment data suggest that shortages of workers are not now pervasive even in these occupations.

All these results assume that the economy recovers sluggishly, in line with the basic CBO forecast. If, however, the private economy recovers more rapidly than currently forecast, then the proposed defense buildup--unless offset by other fiscal policies--would increase the risk of renewed inflation.

LITTLE RISK TO OVERALL EMPLOYMENT

Defense spending also need not adversely affect overall employment. Analysis suggests that an additional $10 billion spread across all types of defense spending would, in fiscal year 1983, create about 250,000 additional jobs; that same $10 billion spent purchasing an average mix of nondefense goods and services would also create about 250,000 jobs.

There may be some differences in jobs created if the spending is focused on a particular category of defense or nondefense spending. For example, an additional $10 billion spent entirely on defense purchases from industry would induce only about 210,000 added jobs. This result reflects the greater proportion of highly paid workers in defense industries. Similarly, spending on transfer payments--such as Social Security or other entitlements--would generate fewer jobs than average nondefense purchases. Nonetheless, these differences seem small enough to allow the Congress to safely ignore different effects on overall employment as it chooses between defense and nondefense spending.

SOME PROGRESS ON COST GROWTH, BUT RISK CONTINUES

Although bottlenecks in major defense-related industries seem unlikely, some may occur in smaller industries specializing in defense production. Growth rates will be high in many of these specialized, defense-intensive industries. After adjustment for inflation, median annual growth in 1983 to 1985 could be 7.5 percent in the 100 narrowly defined industries that are most involved in defense production. This is almost double the growth rate CBO projects for the economy as a whole. In some industries, annual real growth rates over these years could run as high as 20 percent. Production is currently depressed in many of these industries, however, and thus these high growth rates may not lead to bottlenecks.

Unfortunately, available data on capacity are too aggregated to permit analysis of possible bottlenecks in these smaller industries. Nonetheless, projected growth rates, when compared to trends in production in the recent past, suggest that 36 of the 100 industries will be well above their production trends by 1987. These 36 industries include predominantly ordnance, aerospace, specialty metals, parts of the electronics and instruments industries, and metal fabrications important for defense, particularly forgings. Together, the industries that are well above trend account for only 3.7 percent of GNP, which suggests that they will not contribute to widespread inflation. Defense production by these industries, however, accounts for 37 percent of all defense production by industry. This

indicates that capacity tightness in these industries could substantially affect weapons prices.

Bottlenecks are not, of course, the only factor in rising costs of weapons; indeed, they may not be the primary reason. Past studies have suggested many other causes, among them understatement of initial cost estimates, unanticipated inflation, changes in weapons design, and changes in the sizes of planned purchases.

A major priority of this Administration and the Congress is control of growing weapons prices. The Congress has enacted legislation requiring regular reporting of the size and reasons for large cost overruns. The Administration has begun to use higher deflators to project costs of procurement programs, thus recognizing that weapons price growth is likely to exceed inflation in the economy as a whole. The Administration also reports greater reliance on independent cost estimates in the planning process and greater attention to fostering competition in defense procurement.

The ultimate worth of these initiatives will, of course, be measured by their success in holding down growth in weapons prices. There are a few signs of progress. In the past, CBO has found that the defense budget did not contain enough funds to cover our best estimates of future inflation. Based on our current inflation forecast, the latest defense budget should come close to covering future costs of inflation, at least in 1984 and 1985. Thus, there is less chance that unfunded inflation will add to weapons prices.

Moreover, there may also be other signs of some progress on holding down growth in unit weapons costs. Our analysis of 60 systems in the 1984 budget shows that 25, or about 40 percent, have unit prices below those anticipated a year ago. Only 13 of 48 systems, or 27 percent, fell into this category in the 1983 budget.

On the other hand, important problems remain. Some 35 of the 60 systems that we examined in this year's budget did show growth in unit costs. For 22 of the 60 systems, the planned levels of orders were lower than those anticipated a year ago, and every one of these 22 showed increases in unit prices. Thus, the reductions in planned purchase levels, apparently in response to budget pressure, have contributed to unit price growth.

Moreover, weapons cost growth again added to defense costs. Changes in units prices of the 60 systems added $2.6 billion in budget authority, or about 1 percent, to the 1984 budget. These results, coupled with the history of unrelenting unit cost increases over the last 20 or more years, suggest that the Administration and the Congress should not diminish their efforts to bring cost growth under control.

SERIOUS RISK IN LONGER RUN IF BUILDUP FINANCED BY LARGE DEFICITS

The most important risk associated with the budget outlook, including the defense buildup, develops in the longer run, as the economy begins to approach full employment. If steps are not taken to narrow the gap between

taxes and spending, the American economy faces unprecedented risks. CBO's baseline forecast of outlays and revenues shows the federal deficit increasing from $194 billion in fiscal year 1983 to $267 billion in 1988. These baseline estimates assume that increases in defense spending are consistent with last year's budget resolution. The Administration's defense proposals are substantially higher in later years than the baseline estimates; substitution of the Administration's defense proposals in CBO's baseline would lead to a deficit of as much as $295 billion in fiscal year 1988.

Even when measured in relation to an expanding gross national product, the size of these deficits is startling. In fiscal year 1983 the deficit will be about to 6.1 percent of GNP, much of which is attributable to the recession. But in 1988, when we believe the recovery will be well along, the CBO baseline deficit would still be 5.6 percent of GNP--a percentage exceeding any recorded between 1947 and 1982.

Sensible policies to reduce these projected deficits require a multi-year plan. Since the deficits projected for 1983 and 1984 primarily reflect a sharply depressed economy, substantial budget tightening in the short run could jeopardize the projected recovery. Nonetheless, budgetary action is needed now, especially if an appreciable part of future deficits are to be reduced through lower federal spending. Federal spending, and particularly defense outlays, cannot be reduced significantly in the short run without major program disruptions. For example, in 1984 about 35 percent of all defense outlays will derive from contracts signed in previous years, and that

figure will rise to 43 percent in 1988 under the Administration's program. Another 37 percent of 1984 defense outlays will be used to pay military and civilian personnel; these outlays cannot be reduced quickly without firing large numbers of employees or imposing pay caps that risk adverse effects on recruiting and retention. Nor is the difficulty of making rapid federal spending reductions unique to defense. Thus, if federal spending is to be reduced efficiently in the mid-1980s in order to reduce federal deficits, the Congress must act this year.

How much should the deficit be reduced? One benchmark might be the 1981 deficit, which amounted to about 2 percent of GNP. In that year, unemployment averaged 7.4 percent, similar to the level CBO projects for 1988. If the federal deficit in 1988 were lowered $170 billion below CBO's baseline forecast, it would amount to about $100 billion, or 2 percent of 1988 GNP. To reach this deficit level in 1988, with changes concentrated in the years beyond 1984, it would be necessary to alter baseline estimates by reducing federal spending, or increasing taxes, by a total of about $475 billion over the next five years.

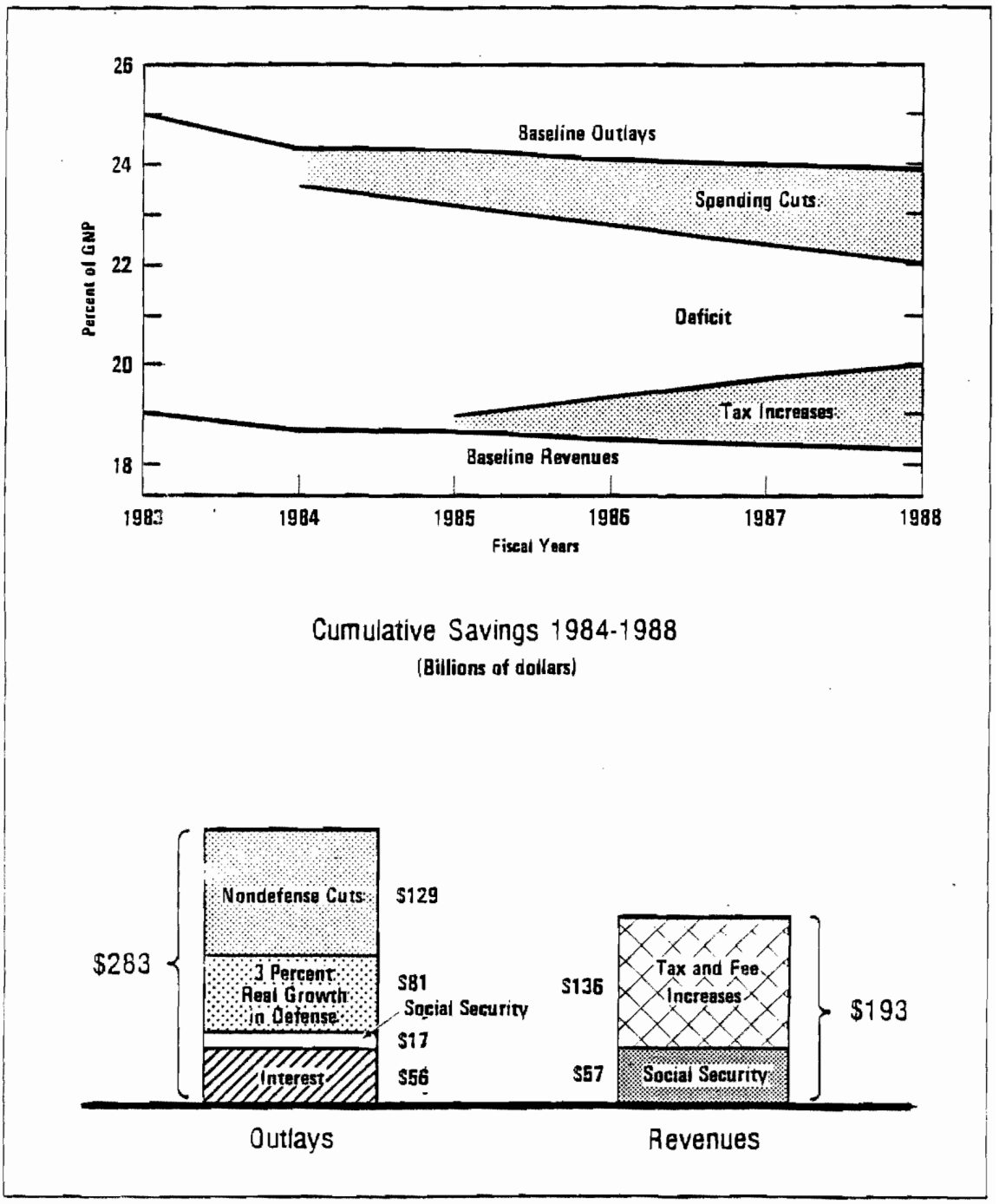
Achieving $475 billion in changes would not be easy. This is emphasized by an illustrative package of changes that would achieve the $475 billion with a mix of higher taxes and lower spending (see Figure 1). The package would eliminate the indexing of personal income taxes now scheduled to begin in 1985, thereby increasing tax revenues by $90 billion over the 1985-1988 period. This approach would also eliminate part of the

10 percent tax cut scheduled for this July, to achieve about $45 billion in added revenues. Adopting the recommendations of the President's Commission on Social Security would increase revenues by a total of $57 billion over five years. On the spending side, a cut of 2 percent a year below today's levels in all nondefense discretionary spending--that is, all programs except defense and major entitlements--plus other changes would reduce spending by $129 billion over five years. Reducing real growth in defense budget authority to 3 percent a year in 1984 and beyond would result in outlay savings over the next five years of $81 billion relative to the CBO baseline. (Relative to the Administration's budget request, which is higher than the CBO baseline, 3 percent growth would save $153 billion.) The recommendations of the President's Commission on Social Security would cut another $17 billion in spending. Finally, bringing the deficit down as these approaches suggest would reduce the interest on the federal debt by $56 billion over five years.

The point brought out by this illustrative package is that substantial changes must be made to bring the deficit down substantially. Moreover, this package makes changes in all areas of the budget. If large portions of the budget--such as Social Security, defense, or taxes--were essentially left untouched, then reductions in other areas would have to be much more drastic.

Figure 1.

Illustrative Package of Changes to Reduce Federal Deficits



CONCLUSION

Nonetheless, as I stated at the outset, the Congress must ultimately determine the need for defense spending by weighing alternative uses of resources against the threats to U.S. national interests and resulting defense requirements. Clearly, the U.S. economy can support the defense buildup proposed by the Administration. Under that buildup, defense in 1988 would take about 7.7 percent of GNP, similar to the level in the early 1970s. Moreover, the economy can sustain the defense buildup with little risk of rekindling inflation, at least in the next few years, and no overall adverse effects on employment.

The key question is how to pay for the buildup. Ultimately, the Congress must pay for it by reducing resources devoted to other areas--either taking from the private sector through increased taxes or from the public sector through further reductions in nondefense spending. If it does not, and instead finances the buildup by growing federal deficits, there is substantial risk of slowing economic growth or rekindling long-run inflationary pressures.