

DEFENSE SPENDING AND THE ECONOMY

Statement of
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Mr. Chairman, I am pleased to appear before your Committee today to discuss the potential effects of sharply increasing defense spending. As you know, the United States has already begun, and will probably continue, a substantial buildup in defense spending. Last March, the Administration announced its plan to seek real increases in defense budget authority of 7 percent annually between fiscal years 1983 and 1986. The first and second budget resolutions for fiscal year 1982 also assumed 7 percent real growth in 1983 and 1984. If defense budget authority does indeed grow at this rate through 1987, then budget authority will rise from \$246 billion in 1983 to \$422 billion in 1987. Outlays will rise from \$215 billion to \$373 billion.

Two kinds of risks are associated with such rapid increases in defense spending. First, there are the risks to the general economy, particularly with regard to inflation and economic growth. Second, there are risks that are specific to the defense effort. In my remarks today, I would like to present the Congressional Budget Office's (CBO) assessment of how serious those risks are. Overall, the CBO has come to the view that the risks of worsening inflation are not great, but that the effects of the federal deficit on economic expansion could be quite severe, giving rise to a need for either deeper cuts in federal spending or higher revenues from taxes. In addition, the buildup could

possibly lead to higher prices in the defense area itself, pointing to a need for measures to help minimize procurement costs.

DEFENSE BUILDUP NOT NECESSARILY AN INFLATION RISK

There are several reasons why CBO's analysts believe the planned defense buildup need not rekindle inflation. The current CBO economic forecast, based on continuation of current budget policy, shows the present recession continuing through the first quarter of 1982 and followed by a cyclical upswing in the remainder of the year. That upswing will carry forward through 1983 and into 1984. The recovery, however, will be slow by past standards, keeping the unemployment rate high and the economy operating below capacity at least through 1984. The CBO forecast projects a continued significant moderation in the inflation rate, even with increased defense spending.

Projected Level of Defense Spending Precedented

Even after the buildup, the level of defense spending as a percentage of gross national product (GNP) will not be unprecedented. In every year from 1955 to 1962, defense spending accounted for more than 8 percent of GNP, and by today's standards, those were years of remarkable price stability. If defense budget authority grows at a real annual rate of 7 percent, then the share of GNP going to defense will rise from its current

level of about 6 percent to about 7 percent by 1987. The federal government can certainly afford to devote 7 percent of GNP to defense, provided we pay for the defense effort either by reducing spending in other portions of the budget or by increasing revenues.

Slack in the Economy

Another reason why current policies--including increased defense spending--need not reverse the current downward trend in inflation is the sizable margin of idle capacity in the economy. At 8.9 percent, the national unemployment rate is now well above all benchmarks for full employment. And at 73 percent, the utilization rate of manufacturing capacity is far below both its historical average of 83 percent and the still higher estimates of optimal use.

Such slack in the economy may also help the Defense Department meet its military manpower requirements without need for further special pay raises. As a result of both the weak economy and the large pay hikes already implemented, each of the military services now seems likely to meet both its numerical recruiting goals and the Congressionally mandated standards for recruit quality. This success should continue, barring unforeseen increases in recruit requirements or decreases in recruiting resources.

Moreover, there may be even more slack in the economy than CBO anticipates. Although a more vigorous recovery cannot be ruled out, many forecasters believe that there is a substantial likelihood that economic growth will be weaker than shown in the CBO forecast. Weaker growth could occur if a restrictive monetary policy leads to credit conditions that are tighter than are implied in the CBO forecast.

Bottlenecks Unlikely in Major Defense Sectors

Capacity Trends. The CBO's analysis of demand and capacity in sectors of the economy that produce relatively large amounts for defense (so-called defense-intensive sectors) further supports the contention that the defense buildup is unlikely to rekindle inflation. Eight major industrial sectors supply at least 3 percent of their output for defense production, either directly as finished products or indirectly as raw materials and components (see Table 1). Between 1982 and 1984, growth in many of these sectors will be rapid by historical standards, both because of the stimulative effects of increased defense spending and because of the projected general recovery of spending from its present slump. Nonetheless, our analysis suggests that, despite rapid growth in demand, these sectors will continue to operate through the middle of 1984 at capacity utilization rates below those achieved at recent cyclical peaks (see Table 2).

TABLE 1. DEFENSE RELATED OUTPUT OF MAJOR U.S. INDUSTRIES

Industry	Percent of Total 1980 Production
Ordnance	61.1
Transportation Equipment	15.9
Aerospace	(35.0)
Shipbuilding	(47.0)
Electrical Equipment and Components	11.3
Radio and Television	
Communications Equipment	(46.0)
Mining	6.8
Instruments	6.3
Primary Metals	5.8
Iron and Steel	(4.9)
Nonferrous	(6.7)
Petroleum Refining	5.6
Fabricated Metals	3.3

NOTE: The industry-wide average is 3.2 percent.

To be sure, if defense spending remains on the 7 percent annual real growth path, a few major sectors--such as the electronics equipment industry--may, by the end of 1984, actually exceed the operating rates achieved at cyclical peaks in the 1970s. But there will be only a few, and none should be basic-materials sectors that could spawn widespread inflationary pressure. Let me illustrate further with brief remarks on specific industries.

TABLE 2. OUTPUT GROWTH AND CAPACITY UTILIZATION IN DEFENSE INTENSIVE INDUSTRIES
FOR 1981-1984, PROJECTIONS AND HISTORICAL COMPARISONS

Components	Output Growth (Annual percentage rates)			Capacity Utilization Rates (percent)						Average 1948-80
	Forecast	Average	Actual	Actual	Forecast	Cyclical Highs				
	1982-84	1948-80	1971-73	1980	1982	1984	1978-79	1973-74	1965-66	
Aerospace and Shipbuilding	11.2	5.6	14.5 <u>a/</u>	87	78	87	89	74	92	73
Instruments	8.4	6.2	12.1	83	78	88	87	88	90	82
Electrical Equipment and Components	11.0	6.5	15.2	85	80	90	89	87	97	83
Fabricated Metals	6.5	3.1	9.8	73	72	79	84	85	87	79
Iron and Steel	10.0	1.3 <u>b/</u>	12.8	70	76	89	86	98	94	84
Nonferrous Metals	9.3	3.5 <u>b/</u>	11.9	80	75	89	92	96	100	85
All Manufacturing	7.9	4.1	9.5	79	76	83	86	88	91	83

NOTE: Projections based on approximately 9 percent annual real growth in defense outlays through 1984.

a/ 1977-1979 growth rate.

b/ 1948-1979 average growth rate.

Analysis of Certain Major Defense-Related Industries. In

the primary metals industries--with the possible exception of aluminum and certain low-volume nonferrous metals--bottlenecks will probably not develop during the next few years. In the steel industry, for example, capacity utilization is projected to improve from today's depressed level of about 65 percent to between 84 and 90 percent by 1984. This would still be well below the very tight conditions of 1973-1974, when utilization rates often stood near 100 percent.

Production in the aerospace industry is now moving sideways, with expanding military orders being offset by a slumping commercial market. Commercial orders are expected to turn around following the recovery in the general economy. Most analysts believe, however, that for the next few years, the aerospace industry will have ample capacity to handle all of its orders. One indication of this is that aerospace employment currently stands more than 14 percent below its 1968 peak. Even according to forecasts more optimistic than CBO's, it will take more than a few years for employment in this sector to reach that earlier level.

Most of the shipbuilding industry will have abundant plant capacity and manpower for the near term, though problems still remain for the construction of some nuclear-powered vessels.

Commercial shipbuilding is declining rapidly, and it is not expected to recover soon because of the collapse of the market for large tankers.

In the electronics industry, some tightness could develop in part because of the substantial growth in the use of electronics in weapons systems. But no extended problems are foreseen in such a dynamic sector that is increasingly pressed by foreign competition.

Labor Shortages. Even with adequate capital facilities, shortages of skilled labor could arise. There is some evidence that the defense buildup may exacerbate already existing shortages of some types of engineers and computer scientists, as well as of skilled machinists and tool and die makers.

That such shortages of skilled labor would have a major effect on inflation seems unlikely, however. The occupational categories in which shortages might develop are exceptions in a generally weak job market. Moreover, supply may be responding quite dramatically. The National Center for Education Statistics projects that, despite declining college enrollments, the number of college students graduating with degrees in engineering will increase by nearly 40 percent between 1979 and 1985. The number with bachelor's degrees in computer and information science expanded by 67 percent between 1972 and 1978.

MORE SERIOUS RISK OF FINANCING BUILDUP AS DEFICITS WIDEN

A more serious problem arising from the planned defense buildup is that increasing spending in this area--at a time when the growth of revenues has been curtailed--can result in a widening of the federal deficits, continuation of high interest rates, and sluggish economic growth. This strongly suggests that the Congress must pay for any defense buildup by reducing resources devoted to other areas--taking either from the private sector through increased taxes or from the public sector through further reductions in nondefense spending.

The problems derive from budget initiatives taken in 1981. Last year, the Administration and the Congress boosted defense spending while also sharply reducing tax burdens and curbing growth in nondefense spending. The combination of higher defense spending and lower tax revenues cost more than the nondefense spending cuts saved. The CBO projects that, if no further changes are made, federal deficits will reach record levels in future years. Even robust economic growth, which the CBO does not forecast, would not stop the deficits from widening.

While deficits are increasing, the Federal Reserve--with encouragement from the Administration--continues to pursue a stringent anti-inflationary policy. In the face of growing deficits and associated strong federal demand for credit,

continued tight monetary policy could result in high interest rates that might severely limit economic growth.

At the end of this week and later on, as we receive and review the Administration's budget, the CBO will provide the Congress with specific examples of potential changes in budgetary policy. Although none of the specific changes outlined will be without some adverse effects on federal programs, the risks inherent in widening deficits will make Congressional consideration of such changes essential.

COST GROWTH--ANOTHER MAJOR RISK

Cost growth in weapons systems has long been a serious problem for the Defense Department; the planned buildup could exacerbate the problem. For one thing, the availability of added funds could take pressure off of efforts to hold down costs at the very time when it is important that waste in defense spending be minimized.

Also, the data we presented earlier--which suggest adequate capacity in major industrial sectors that do large amounts of defense business--may mask shortfalls in capacity to produce specialty items for defense. Unfortunately, the data available are simply too aggregated to assess the particulars of such potential problems. The importance of bottlenecks for such

specialty items is also difficult to judge. But bottlenecks, if they do occur, could mean that price growth may diminish more slowly in weapons systems than in the economy as a whole.

Moreover, defense cost growth is usually evaluated on the basis of data reported in the Selected Acquisition Reports (SARs), and those data reflect more than cost growth caused by economic problems. The SARs reflect such factors as initial underestimates of weapons costs, effects of unrealistic estimates of inflation, and delays in procurement. These problems must be dealt with by measures other than fiscal and monetary policy.

The Defense Department has already made some changes to help curtail cost growth. The Congress has also made changes, such as approving greater authority for multiyear contracting and requiring reports when cost increases occur. And there may be some further actions that the Congress could take.

Encouraging Better Planning for Inflation

In recent years, the Defense Department has budgeted too little for increases in weapons prices. This had led to what the department calls "stretchouts"--namely, production at lower rates over longer periods. Stretchouts can be costly because they drive up overhead costs per unit purchased.

In past budgets, the Defense Department has used Administration forecasts of the GNP deflator for estimating increases in

weapons costs. This procedure has been inadequate, both because Administration projections of the GNP deflator have tended to be optimistic, and because weapons prices in recent years have outpaced general inflation.

The Congress could deal with part of this problem by encouraging--or directing--that the Defense Department use forecasts of deflators reflecting the particular mix of goods purchased. The CBO and others have developed such forecasts.

More realistic estimates of defense prices could sharply increase defense budget projections. For example, if the Administration's planned purchases as of the last mid-session review had been reestimated using CBO's projections of defense deflators, defense budget authority would have been higher by \$4 billion in 1982 and by a total of \$81 billion over the next five years.

Improving Congressional Oversight of Weapons Cost Increases

The information on weapons-systems' cost increases now reported in the SARs often comes too late to allow the Congress much opportunity to consider alternatives to systems that have risen sharply in cost. The Congress could seek earlier warning by requiring that the department include in the SARs some of the more timely cost and performance data now submitted by contractors.

Increasing Competition Through "Second Sourcing"

The Defense Department now procures many weapons systems from a single supplier. Costs might come down if the department considered more of those systems for so-called "second sourcing"--that is, the use of more than one contractor to manufacture a particular product. A number of studies suggest that this technique has at times yielded savings approaching 30 percent.

Second sourcing is not appropriate if small purchase sizes and high fixed production costs make it prohibitively expensive to use more than one supplier. Where appropriate, however, the Congress may wish to encourage second sourcing by insisting that the Defense Department consider it whenever formulating a procurement strategy, and by amending the law to encourage second sourcing whenever it might cut costs. Current law encourages second sourcing only when it can improve the department's ability to produce weapons quickly during wartime.

Encouraging Economical Purchase Size

The size of a purchase can be very important to defense costs. If contractors build facilities capable of producing at a certain rate, but then produce fewer weapons, the fixed overhead can result in much higher unit prices. For this reason, the

Congress might consider requiring that the Defense Department report on the economical size of purchase of existing systems and the costs of deviating from those levels.

CONCLUSIONS

In summary, a major defense buildup is already under way, and it will probably continue. CBO's assessment suggests that the buildup need not rekindle inflation. It could, though, retard economic growth by contributing to deeper deficits--and in turn, to high interest rates. There is also the risk that the defense buildup will exacerbate cost growth of weapons systems. To minimize this risk, the Congress may have to take additional steps to improve defense price performance.