CBO TESTIMONY

Statement of
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NOTICE

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Mr. Chairman, I appreciate the opportunity to testify today on defense spending choices and their implications for the economic and budget outlook. Historic changes in world affairs have spawned a wide range of proposals for reducing U.S. defense spending. Although the desirability of spending reductions must be judged primarily on the basis of potential military threats, economic effects are also of concern.

Substantial reductions in defense spending would result in significant reductions in defense-related employment. Other economic effects will be heavily influenced by how the nation chooses to spend any additional peace dividend--for example, whether to lower the federal deficit, increase spending on public investment, or increase consumption. In choosing how to spend the peace dividend, policymakers will be caught on the horns of a dilemma. If devoted to deficit reduction or carefully chosen public investments, additional reductions in defense spending would help ease the nation's long-term economic concerns. These problems include stagnation in real wages, low growth in productivity, and a string of record-breaking budget deficits. Devoting the additional peace dividend to bringing down the deficit, however, would temporarily reduce economic growth and the creation of jobs in the economy as a whole.

Using the peace dividend to increase current spending on consumption--whether through broad-based tax cuts or consumption-oriented

public spending--would avoid much or all of the near-term pain for the economy as a whole. But long-term gains in productivity and per capita consumption would also be sacrificed. Inevitably, difficult choices will have to be made among the many competing uses for the peace dividend. As of now, there are far more claims for the dividend than there is dividend to be claimed.

My statement first reviews the overall outlook for the U.S. economy and budget and then focuses on the effects of defense spending cuts on that outlook.

THE ECONOMIC OUTLOOK

Six months ago, in August 1991, the Congressional Budget Office (CBO) and most other forecasters expected the recovery to be fully under way by the start of 1992. Although 1992 is now here, the recovery is not. What went wrong?

First, high vacancy rates for office buildings and rental housing continued to cast a pall over construction, which declined more than expected during the third quarter of 1991. Second, an unusually large share of the spurt in demand that occurred in the late spring and summer was satisfied by

imports rather than domestic production. Industrial production then weakened in the fourth quarter. Third, the disappointing growth in personal income and frequent announcements of job layoffs shook consumer confidence.

Although the low level of consumer confidence raises the specter of a double-dip recession, CBO believes that a recovery, albeit mild and delayed, is a more likely prospect. Retail sales, including sales of automobiles, have picked up, and construction activity has stopped falling. Recent growth in the money supply and declines in interest rates should allow the economy to gather steam by spring. A moderate recovery should take hold in the second half of the year and continue into 1993. The pace of recovery will be slowed, however, by structural adjustments in commercial real estate, financial services, state and local governments, and other sectors of the economy.

The Forecast for 1992 and 1993

CBO forecasts that real gross domestic product (GDP) in 1992 and 1993 will grow about 3 percent a year, slightly above the *Blue Chip* average of private-sector forecasts but only about half the rate that normally occurs in the first two years of recovery (see Table 1). This lukewarm performance will only

Table 1.
Comparison of Forecasts for 1992 and 1993

	Actual 1990	Estimated 1991	Forecast 1992	Forecast 1993
	Fourth Quarter to Fourth Quarter (Percentage change)			
Real GDP				
CBO	-0.1	0	2.8	3.3
Blue Chip	-0.1	0.2	2.3	3.1
Administration	-0.1	0.2	2.2	3.0
Implicit GDP Deflator				
CBO	4.2	3.2	3.1	3.2
Blue Chip	4.2	3.0	2.9	3.3
Administration	4.2	3.3	3.2	3.4
Consumer Price Index[a]				
CBO	6.3	3.0	3.4	3.6
Blue Chip	6.3	2.9	3.3	3.7
Administration	6.3	2.9	3.1	3.3
	Calendar-Year Averages (Percent)			
Civilian Unemployment Rate				
CBO	5.5	6.7	6.9	6.4
Blue Chip	5.5	6.7	6.9	6.4
Administration	5.5	6.7	6.9	6.5
Three-Month Treasury Bill Rate				
CBO	7.5	5.4	4.4	5.1
Blue Chip	7.5	5.4	4.1	5.0
Administration	7.5	5.4	4.1	4.9
Ten-Year Treasury Note Rate				
CBO	8.6	7.9	7.1	7.1
Blue Chip[b]	8.6	7.9	7.1	7.5
Administration	8.6	7.9	7.0	6.9

SOURCES: Congressional Budget Office; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators;* Department of Commerce, Bureau of Economic Analysis; Office of Management and Budget.

NOTE: The *Blue Chip* forecasts through 1993 are based on a survey of 50 private forecasters, published on February 10, 1992. These forecasts are reported on a basis that is consistent with the recent revision of the national income and product accounts.

a. The consumer price index for all urban consumers (CPI-U).

b. *Blue Chip* does not project a 10-year note rate. The values shown here for the 10-year note rate are based on the *Blue Chip* projections of the Aaa bond rate, adjusted by CBO to reflect the estimated spread between Aaa bonds and 10-year Treasury notes.

gradually reduce the hardships that the recession has brought to many parts of the country. The unemployment rate will remain high for some time, averaging close to 7 percent in 1992, since the recovery will only gradually entice discouraged, jobless workers back into the labor force.

CBO projects that inflation, as measured by the change in the consumer price index, will be 3.4 percent in 1992 and 3.6 percent in 1993 on a fourth-quarter-to-fourth-quarter basis. Excluding food and energy prices, the rate of inflation is projected to be 3.6 percent in 1992 and 1993, the smallest two-year increase since the mid-1960s, except for the period of wage and price controls. But that considerable achievement, it should be noted, has been purchased at the cost of low growth in wages and high unemployment.

Short-term interest rates will remain close to 4 percent in early 1992, but they are likely to rise modestly--to about 4.8 percent--by year's end. A further rise to 5.1 percent is expected in 1993 as the recovery continues and the demand for borrowed funds grows. The recovery is not expected to produce any large changes in long-term interest rates, however. The 10-year Treasury note rate, which is currently about 7.3 percent, is forecast to average about 7.1 percent in 1992 and 1993.

Projections for the 1994-1997 Period

CBO does not attempt to forecast cyclical fluctuations in the economy more than two years into the future. Beyond 1993, CBO makes projections based on trends in the labor force, productivity, and saving. Over the 1994-1997 period, CBO projects that the substantial economic slack left by the recession will be gradually eliminated through growth in real gross domestic product that averages 2.6 percent a year (see Table 2). In comparison, potential output grows at an annual rate of only 2.1 percent.

The relatively low rate of inflation the recession brought about and the tight monetary policy that preceded it are likely to persist through much of the 1990s. The consumer price index is projected to rise 3.6 percent a year. The implicit GDP deflator will grow a bit less rapidly, reflecting a continued drop in the price of computers and their increasing importance in the economy.

CBO's projections assume that real (inflation-adjusted) interest rates will remain below their levels before the recession. Long-term rates are projected to be flat, with short-term rates rising slightly after 1993. By 1997, real interest rates are projected to be about 1 percent below the average for the 1986-1989 period.

Table 2.
Medium-Term Economic Projections for Calendar Years 1992 Through 1997

	Estimated	Forecast		Projected			
	1991	1992	1993	1994	1995	1996	1997
Nominal GDP (Billions of dollars)							
CBO	5,671	5,931	6,337	6,714	7,104	7,520	7,961
Administration	5,675	5,926	6,307	6,712	7,141	7,589	8,054
Nominal GDP (Percentage change)							
CBO	2.9	4.6	6.9	5.9	5.8	5.9	5.9
Administration	2.9	4.4	6.4	6.4	6.4	6.3	6.1
Real GDP (Percentage change)							
CBO	-0.8	1.6	3.6	2.7	2.5	2.6	2.6
Administration	-0.8	1.5	3.0	3.0	3.0	2.9	2.8
Implicit GDP Deflator (Percentage change)							
CBO	3.7	2.9	3.2	3.2	3.2	3.2	3.2
Administration	3.7	2.9	3.3	3.3	3.3	3.2	3.2
CPI-U (Percentage change)							
CBO	4.2	3.3	3.6	3.6	3.6	3.6	3.6
Administration	4.2	3.0	3.3	3.2	3.2	3.2	3.1
Unemployment Rate (Percent)							
CBO	6.7	6.9	6.4	6.2	6.0	5.9	5.7
Administration	6.7	6.9	6.5	6.1	5.8	5.4	5.3
Three-Month Treasury Bill Rate (Percent)							
CBO	5.4	4.4	5.1	5.2	5.4	5.5	5.6
Administration	5.4	4.1	4.9	5.3	5.3	5.2	5.1
Ten-Year Treasury Note Rate (Percent)							
CBO	7.9	7.1	7.1	7.1	7.1	7.1	7.1
Administration	7.9	7.0	6.9	6.7	6.6	6.6	6.6

SOURCES: Congressional Budget Office; Office of Management and Budget.

NOTE: CPI-U is the consumer price index for all urban consumers.

How Does CBO's Forecast Compare with That of the Administration?

CBO's economic assumptions and those of the Administration show few significant differences. CBO forecasts slightly more robust growth in 1992 and 1993, but the Administration assumes somewhat faster growth in the 1994-1997 period. Both CBO and the Administration, however, assume almost identical rates of increase in the implicit deflator for gross domestic product. Thus, CBO shows a slightly higher level of nominal GDP in the short term but a marginally lower level in the long run.

The Administration is more optimistic than CBO about the outlook for inflation and nominal interest rates. As measured by the increase in the consumer price index, the Administration's forecast of inflation is 0.3 percentage points lower than CBO's in 1992 and 0.5 percentage points lower by 1997. The Administration's assumptions for interest rates fall below CBO's figures by similar amounts.

The similarity between the two forecasts may seem surprising, since CBO's forecast assumes current budgetary policies will continue, whereas the Administration's assumes that its budget and economic program will be enacted. In CBO's view, however, the Administration's program would add

little stimulus to the economy in the short term and would provide no appreciable boost in the 1990s. Some of the Administration's policies--notably, the reduction in income tax withholding, the investment tax allowance, and the credit for first-time homebuyers--could increase the rate of growth by half a percent or so in 1992 by moving spending forward from later years. At the same time, it would decrease the growth rate by a comparable amount in 1993. In the longer term, the Administration's budget proposals would at best have only small effects on the federal deficit, saving and investment, and the growth of the economy.

Policymakers may decide that they want to provide a more immediate stimulus to the economy. One proposal that has been advanced would feature cuts in taxes that are financed by reductions in defense spending. The amount of economic stimulus from such a policy depends on timing. If cuts in defense outlays fully offset the revenue loss associated with a tax cut, then the economy as a whole would receive little or no stimulus. The economy would be stimulated in the near term only if tax cuts occur early, thereby temporarily increasing the deficit.

CBO projects that the federal deficit will exceed $350 billion in 1992, setting a new record for the second year in a row (see Table 3). In relation to the size of the economy, the 1992 deficit will amount to 6 percent of GDP, just shy of the postwar high reached in 1983. By the mid-1990s, the deficit will drop back to about $200 billion, or about 3 percent of GDP.

If budgetary policies are not changed, that may prove to be the acme of success in deficit reduction. Without additional spending cuts or tax increases, improvement will cease, and the deficit is likely to grow faster than GDP in the second half of the decade (see Figure 1).

Yet the total deficit is not the most relevant measure for policy discussions. Its ups and downs obscure an underlying stability in federal fiscal policy. To appreciate the fundamental pattern, one must remove from deficit totals temporary factors such as the gyrations in the deposit insurance accounts and the allied contributions for the Persian Gulf War. Excluding these factors, the deficit peaks at 5 percent of GDP in fiscal year 1992 and then declines gradually to 3.0 percent by 1995. Even these estimates contain a cyclical element associated with the state of the economy. The

Table 3.
CBO Deficit Projections Assuming Current Policies (By fiscal year)

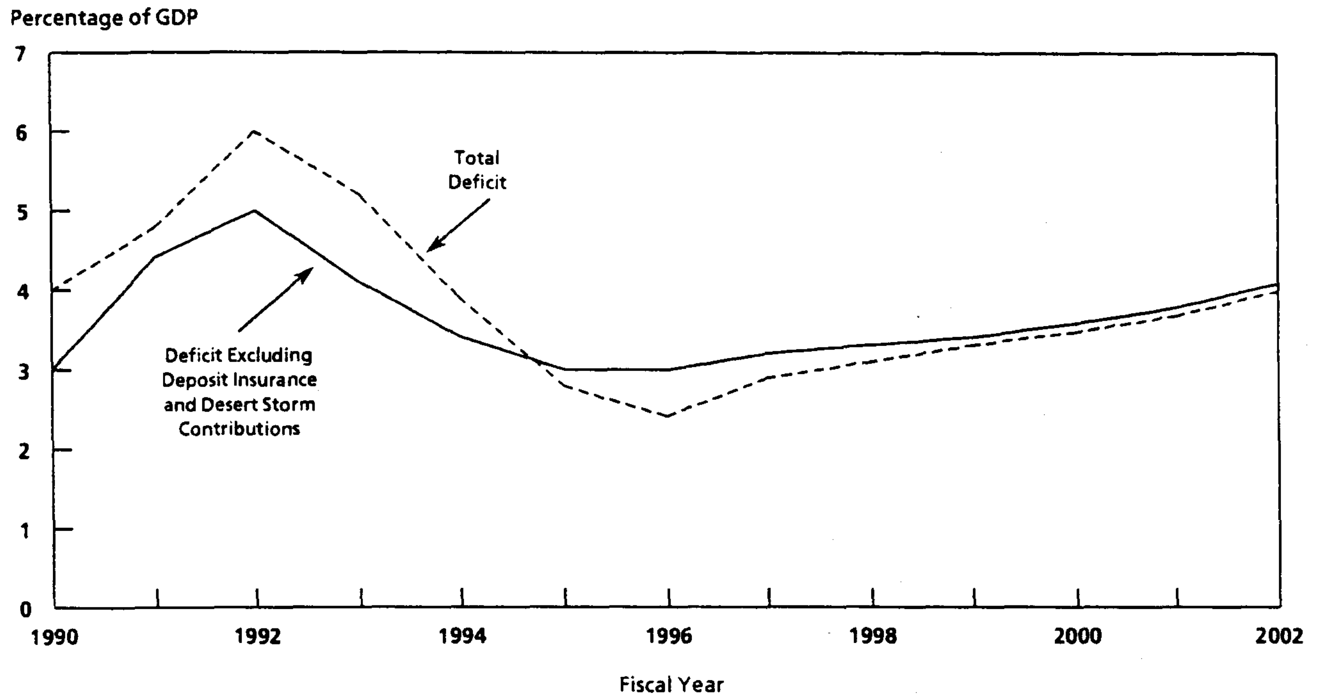
	1990	1991	1992	1993	1994	1995	1996	1997
				In Billions of Dollars				
Total Deficit	220	269	352	327	260	194	178	226
Deficit Excluding Deposit Insurance and Desert Storm Contributions	162	246	290	258	227	210	222	254
Standardized-Employment Deficit[a]	150	172	191	189	178	170	191	234
Deficit Excluding Social Security and Postal Service	277	321	404	391	337	281	276	335
				As a Percentage of GDP				
Total Deficit	4.0	4.8	6.0	5.2	3.9	2.8	2.4	2.9
Deficit Excluding Deposit Insurance and Desert Storm Contributions	3.0	4.4	5.0	4.1	3.4	3.0	3.0	3.2
Standardized-Employment Deficit[a]	2.7	2.9	3.1	2.9	2.6	2.4	2.5	3.0
Deficit Excluding Social Security and Postal Service	5.1	5.7	6.9	6.3	5.1	4.0	3.7	4.3
Memorandum: Gross Domestic Product	5,460	5,627	5,846	6,237	6,621	7,004	7,414	7,849

SOURCE: Congressional Budget Office.

NOTE: These projections are based on policies in place in December 1991. They do not include subsequent changes in income tax withholding and extended unemployment compensation.

a. Excluding deposit insurance and Desert Storm contributions. Shown as a percentage of potential gross domestic product.

Figure 1.
Federal Budget Deficit (As a percentage of GDP)



SOURCE: Congressional Budget Office.

standardized-employment deficit, which removes this cyclical component, reaches a low of 2.4 percent of GDP in 1995 and then starts to rise again.

The Administration's proposals would do little to alter the fiscal policy course set by the 1990 budget agreement. The budget attempts to meet the legal limits on discretionary spending for 1993 through 1995. It also proposes changes in direct spending programs and in tax revenues that, the Administration asserts, would result in small decreases in the deficit. By CBO's initial reckoning, however, those proposals may in fact slightly increase the deficit.

In sum, without further changes in budgetary policies, the federal deficit is likely to remain high by historical standards, even as the nation recovers from the recession and puts the deposit insurance fiasco behind it. Those budget problems, coupled with world events that have reduced threats to U.S. security, have spawned a wide range of proposals to cut the defense budget.

EFFECTS OF DEFENSE SPENDING ON THE ECONOMIC AND BUDGET OUTLOOK

Even before the Administration submitted its latest plan to cut defense, spending on defense was slated to fall sharply. In February 1991, the Administration submitted a plan for spending cutbacks. That 1991 plan would have left defense budget authority more than $350 billion lower during the 1993-1997 period compared with its real level in 1990, the last year of the Cold War. In other words, a large peace dividend was already built into the budget projections as of last year.

Describing Proposals for Further Cuts in Defense Funding

Compared with the 1991 plan, the Administration's latest budget plan calls for additional program-related reductions of $50 billion in defense budget authority, including cuts of $44 billion in the 1993-1997 period and a rescission of $6.6 billion in 1992. In addition, the Administration's latest budget reflects a $13 billion downward adjustment in 1993 through 1997 that was mandated by the Budget Enforcement Act because of lower than expected inflation. CBO has just received the detailed estimates associated with this latest budget plan. But most of the additional $44 billion in spending cutbacks would apparently occur in the defense investment accounts, which pay for

procurement, research and development, and military construction. Cutbacks in military personnel would be accelerated in the latest plan, particularly in 1992. By 1997, however, personnel levels would be similar to those the Administration proposed in its 1991 plan.

A number of Members of Congress have called for larger defense spending reductions. Those reductions have generally been measured against the Administration's 1991 plan before the downward adjustment mandated by the Budget Enforcement Act. By that measure, most of the Congressional plans call for reducing defense budget authority by between about $100 billion and $125 billion in 1993 through 1997, compared with the Administration's proposal to cut $57 billion.

The immediate issue facing the Congress, of course, is the level of defense spending in 1993. Compared with its 1991 plan, the Administration proposes additional defense program cuts of $8 billion in 1993. Including the reductions mandated by the budget agreement because of lower than expected inflation, budget cuts total $10 billion in 1993. Some of the alternative plans others have advanced call for substantially larger reductions in 1993.

Achieving a markedly larger reduction in defense budget authority in 1993 is feasible, but it will not be easy. For one thing, it is hard to reduce

budget authority in the first year by reducing the number of military personnel, even if agreement is reached on long-run force sizes that are substantially smaller than the Administration has proposed. Separating career personnel could actually increase personnel costs in the year in which the separations take place, largely because of the new incentives for voluntary separation the Congress approved last year. Cutting the number of newly entering personnel--which would be justified if long-run strength targets are reduced--offers first-year savings. The savings are small, however, because the pay of new recruits and newly commissioned officers is relatively low. Reducing the number of military personnel would eventually result in substantial savings, but not in the year in which the cuts are made.

Reductions in funding for operation and maintenance could be employed to achieve first-year savings. If the reductions in funding for operation and maintenance came substantially faster than the cuts in forces, it would mean reduced operating tempos, less training, and deeper maintenance backlogs. Thus, to achieve substantial cuts in funding for operation and maintenance, a decision must be made to accept lower peacetime readiness for some military forces.

Without such a policy choice, sharp reductions in defense budget authority in 1993 must be achieved largely by making deep cuts in

expenditures for military investment. Such large cuts in investment may be appropriate in view of reduced security threats. The Administration has, however, already proposed substantial cuts in investment funds in 1993. Larger reductions would require delays and cancellations of weapon and research programs beyond those the Administration has proposed. Moreover, reductions in most types of defense investment do not produce much immediate savings in outlays. Thus, it would be especially difficult to achieve large first-year cuts in defense outlays by cutting investment programs.

Estimating the Military Effects of Spending Cutbacks

How would substantial additional cuts in defense spending affect the size of U.S. military forces and how well those forces are equipped? An analysis CBO completed last October illustrates the potential effects. That analysis examined two illustrative reductions in defense spending. Compared with the Administration's 1991 plan, the larger of the two reductions totaled about $143 billion in the 1993-1997 period, only modestly bigger than some of the proposals being discussed today. The CBO analysis assumed that reductions in active-duty personnel were limited to 110,000 a year, which would minimize the likelihood of a large number of involuntary separations of career personnel. The analysis also assumed that reductions in day-to-day operating

costs (that is, funding in the operation and maintenance appropriation) were proportional to personnel cuts, to avoid reducing the per capita funds available for training and other readiness-related activities.

Under these assumptions, a reduction of $143 billion in defense budget authority in the 1993-1997 period would result in sharp cuts in the defense investment accounts. Compared with the 1991 plan, investment cutbacks in the 1993-1997 period would total $86 billion, almost twice the level the Administration apparently proposed a few weeks ago. These cutbacks would require delays or cancellations of weapon and research programs beyond those called for by the Administration.

Reductions in the number of military forces would also result. If reductions in military personnel were spread proportionally among the various services and types of military forces, then forces would eventually be reduced by almost 20 percent below the levels the Administration proposed. Those cuts would leave the military with 14 1/3 active and reserve Army divisions (compared with 18 under the Administration's latest plan), 10 Navy carriers and about 370 ships (compared with 12 carriers and about 450 ships), 21 1/2 Air Force tactical fighter wings (compared with 26 1/2 wings), and eight Marine Corps brigades (compared with 10 brigades).

Whether smaller and somewhat less capable military forces are acceptable depends on answers to a number of difficult questions. What are the likely regional contingencies that the United States will face in future years? Must this country prepare to contest more than one contingency simultaneously? How quickly would military forces be needed? How much overseas presence would be required in peacetime?

Answering these questions is not the focus of this testimony. The questions do, however, serve as a reminder that cuts in defense spending must be assessed based on expected military threats, not just on their economic effects.

Spending the Peace Dividend

There will be no shortage of ways to spend any added peace dividend. Indeed, comparing the economic problems confronting this nation with the range of defense cuts that have been suggested leads to a clear conclusion: the peace dividend will not be nearly large enough to go around.

Consider the issue of nondefense spending. Just to maintain nondefense discretionary budget authority at its 1992 real (inflation-adjusted)

level, reductions in defense budget authority of $135 billion might be required in the years from 1993 through 1997, compared with levels proposed in the Administration's 1991 plan. This calculation assumes that budget authority for federal discretionary spending declines through 1995 to comply with the limits in the Budget Enforcement Act. Beyond 1995, when the act no longer imposes limits, discretionary budget authority is assumed to remain constant at its real 1995 level.

Most of the defense cutbacks that the Congress has discussed would yield reductions in budget authority of no more than about $125 billion in 1993 through 1997, compared with the 1991 plan. Thus, most Congressional plans would not by themselves be sufficient to avoid real cuts in nondefense budget authority and also comply with the 1990 budget agreement, let alone provide for increases in selected types of domestic expenditures.

Consider also the problem of reducing the deficit. Unless there are further changes in budgetary policies, CBO's projection of the standardized-employment deficit--which removes the effects of cyclical fluctuations in the economy--will range between $170 billion and $234 billion in every year between 1993 and 1997. After 1997, the deficit is likely to grow even larger. If this projection proves accurate, standardized-employment deficits will total over $960 billion between 1993 and 1997. In comparison, the Administration's

latest budget plan projects additional savings of only $44 billion in defense budget authority during this period; reductions in the outlays that directly affect the deficit would amount to only $27 billion. Even the larger reductions some Members of Congress have proposed usually call for cuts in budget authority of no more than $125 billion in the 1993-1997 period. The associated reductions in outlays would eliminate only a small fraction of the standardized-employment deficit over this period.

These gloomy forecasts are not intended to minimize the importance of realizing an additional peace dividend. Further cuts in defense spending could be an important part of a package of changes aimed at solving the serious fiscal problems that confront the nation. But defense cuts offer little promise of being large enough to solve these problems by themselves. We will have to choose how to use the peace dividend.

Examining the Economic Effects of the Defense Drawdown

How that choice is made will in turn determine how defense spending cuts affect the economy. Eventually, the nation will clearly be better off if resources can be freed up through reductions in the defense budget without any increase in risks to national security. However, adverse effects on the

economy may occur while defense spending cuts are taking place. The nature and timing of these various economic effects depend on whether the peace dividend is used to increase investment or consumption.

Investing the Peace Dividend. Investing any additional peace dividend in the nation's future yields the greatest long-term gains. The additional dividend could, for example, be used to reduce the federal budget deficit. Since federal borrowing taps the savings of the private sector, reducing it will increase the portion of national savings that is available for private investment, eventually adding to productivity and incomes. Using the added peace dividend to fund carefully chosen federal investments would also eventually increase productive capacity. Such investments might involve improvements in infrastructure, as well as spending on research or training.

The long-term economic gains associated with investing the peace dividend could be substantial and permanent. Assume, for example, that the annual defense budget was reduced by $30 billion to $40 billion by 1997, an amount roughly equal to one-half a percent of GDP and similar in size to some of the reductions being discussed. If this cut were used to achieve a permanent reduction in the federal deficit, it could eventually result in an increase in per capita consumption for U.S. consumers of about 1.5 percent. The benefits would not begin for five to 10 years and would not be fully

realized for some years after that. But, once realized, they would be permanent.

While the defense spending cuts are taking place, however, devoting the peace dividend to deficit reduction could adversely affect the economy. Cutting defense spending results in a rapid reduction in income and employment both among military and civilian employees of the Department of Defense (DoD) and for the private industries that produce defense goods; it takes time, though, for the positive economic effects of reducing the deficit to yield benefits.

In the near-term, therefore, devoting defense savings to investment could result in a decrease in GDP and a loss of jobs. CBO estimates that reducing defense *outlays* by $10 billion could eliminate about 200,000 positions in the defense sector. The affected employees would include military personnel and civilians working for the Defense Department as well as private-sector employees who work for defense companies. A $10 billion reduction in defense *budget authority* would not have as large an immediate effect; it takes several years for cuts in DoD budget authority to manifest themselves fully as outlay reductions.

Not all of the workers affected by the defense drawdown would be added to the rolls of the unemployed. If their employers secure other business to compensate for the lost defense work, some would find their employment unaffected. Many others, who do lose their jobs, are highly skilled and would find other employment quickly. Moreover, using the peace dividend to reduce the federal budget deficit and thereby stimulating investment would gradually add to the demand for workers in nondefense industries. Thus, the reduction in overall employment would be temporary and, at its peak, substantially less than the number of defense-related jobs affected--in fact, probably less than a third of that amount.

The job effects associated with defense cutbacks are understandably of great concern. Defense spending cutbacks enacted for fiscal year 1993 would take place during a year when CBO and many other forecasters expect a lukewarm economic recovery, which heightens concerns about jobs.

Moreover, the adverse effects associated with defense spending cutbacks are not distributed evenly within the economy. The cutbacks in defense spending that some Members of Congress have proposed would affect most industries only modestly. For a handful, however, the effects would be more severe. Not surprisingly, those are industries for whom DoD is the major customer, including builders of combat vehicles, shipbuilders, and

ordnance manufacturers. Cutbacks in spending would also bring economic hardship to localities near military bases or defense plants that close.

As you debate defense spending cuts for the 1993-1997 period, however, consider these adverse job effects in relation to the size of the economy. In a typical year, the national economy creates some 1.85 million new jobs, far more than the losses that would result from most cutbacks in defense spending that are currently being debated. Thus, for the 1993-1997 period as a whole, cutbacks in defense spending would result in a slowdown in job growth, not a reduction in total employment. Moreover, if cutbacks in defense spending are used to reduce the federal deficit, the Federal Reserve might counterbalance the contractionary effect by reducing interest rates. Such a policy would offset some or all of the adverse effects on employment.

In sum, the short-run economic effects of spending the peace dividend on deficit reduction would be adverse, but with a promise of economic growth in the years to come.

Consuming the Peace Dividend. How would the outlook change if the dividend were applied to increasing consumption? As was true for investment, more than one way exists to consume the peace dividend. The dividend could be reallocated to domestic programs that provide benefits to

individuals. Alternatively, it could be used to lower personal income taxes through an increase in personal exemptions or deductible items. Although these policies differ in their distributive effects, economic analysis suggests that most of any peace dividend used for the purposes just mentioned would go to current consumption, not investment.

Additional cutbacks in defense spending, even if devoted to consumption, would result in job losses in the defense sector and in selected industries and geographic areas that are highly dependent on defense. But those losses would be largely offset by the expansion in employment that would come with additional consumption. At least to a first approximation, a typical dollar of spending devoted to defense creates about the same number of jobs as one devoted to typical nondefense activities.

Although devoting the peace dividend to increased consumption would avoid most of the short-run economic pain, it would also sacrifice much of the long-term economic gain. Of course, an increase in consumption--with no offsetting increase in risks to national security--is in itself an economic benefit. However, in contrast to a situation in which the peace dividend is used to reduce the deficit, consuming the peace dividend would not result in any permanent increase in productive capacity, GDP, and per capita income.

Instead, the resources once spent for defense would simply be shifted to other activities.

CONCLUSION

To paraphrase Secretary of Defense Dick Cheney, defense is not a jobs program. Cutbacks in defense spending must be judged primarily based on potential military threats. The economic effects of additional defense spending cuts are a legitimate concern, however, particularly because the United States may well face a period of sluggish economic growth.

In assessing economic effects, adverse near-term job impacts must be weighed against potential long-term gains in productivity and per capita consumption. Those gains will be realized only if the peace dividend is used to reduce the federal deficit or to finance carefully chosen public investments.