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In his inaugural address of January 1961, President John F. Kennedy pledged that the United States would "pay any price, bear any burden, support any friend, oppose any foe to assure the survival and success of liberty."[1] This eloquent statement of our national policy epitomized the staunch anticommunist sentiment of the country during the height of the Cold War. Over the thirty years since then, the world has changed dramatically, with the most unexpected changes occurring recently. Accurate projections of the remarkable developments in the former Soviet Union eluded the most prescient followers of international affairs. On the domestic scene, the fiscal realities of a *$4 trillion* gross federal debt and annual federal budget deficits exceeding *$2 hundred billion* have made President Kennedy's inaugural pledge a part of our history rather than a road map for the future.

The "threat" as known since the late 1940s and upon which our national security strategy had been based was radically altered with the dissolution of the former Soviet Union and the Warsaw Pact. Defense planners now face a different challenge than during the post–World War II period of "containment."[2] The challenge now is to prepare for non-specific and changing threats that require robust response capabilities. This imposing task is further complicated by the fact that fewer dollars are available for defense.

The vulnerability of defense funding in both the near term and into the foreseeable future reflects a growing change in national priorities (and national possibilities), to an extent which has not been seen since the post-Vietnam era.

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Moreover, the United States appears to be at a watershed in its economic and military history; it is a time when decisions based on political popularity (e.g., consumer tax cuts) or short-term expediency may result in ceding our leadership role in economic and military affairs to other countries or coalitions.

As we move into the twenty-first century, the United States has many difficult near-term fiscal decisions to make to ensure its continued preeminence in world economic affairs. That preeminence is increasingly tentative, as other nations become more and more powerful in economic terms. Our failure as a nation to keep pace with the productivity gains of foreign rivals casts doubt over our future economic competitiveness—a competitiveness that has been challenged increasingly during the last twenty years.[3]

In 1964 President Lyndon Johnson could still proclaim, "We are the richest nation in the history of the world. We can afford to spend whatever is needed to keep this country safe and our freedom secure. And we shall do just that."[4] Such statements are no longer to be held sacred; a new reality exists.

The major contention of this article is that the United States has entered a period wherein our national policy and military strategy decisions are in large part constrained by economic factors. This study addresses that new reality by discussing the economics of national defense, the "peace dividend," and the national impacts of the defense build-down.

Given the heavily strained financial condition of the United States (including huge budget, trade, and current-account deficits), many claims vie for the attention of senior government decision makers and the public. None has higher priority or greater significance than our current and future defense requirements and finding the resources to fund those requirements. In a time of unprecedented federal budget deficits, which the country has seemingly lost the ability to control, a popular perception is that the Department of Defense (DoD) budget provides a singular opportunity to move toward financial solvency at the national level. In the parlance of the times, there are great expectations that dramatic reductions in the DoD budget will yield a very large source of funds known as the "peace dividend." Unfortunately, this apparent cornucopia is based more on wishful thinking than on rigorous analysis.

There have been many assertions over the years by a variety of fiscal analysts as to the impact of defense spending on the economy. A common notion has been that defense spending does not have the same beneficial economic effects as non-defense federal spending. Thinking in this area has been revised as more accurate measures have been developed.[5] For instance, it is now generally held by most economists that federal defense and non-defense expenditures have about the same effects on employment. As one considers defense spending, recognized benefits accrue in the pricing of dual-use (i.e., military-civilian) commodities, in spin-off technologies, and in infrastructural investment.

However, a full discussion of those benefits and how they differ from non-defense public investment is beyond the scope of this article.

An understanding of both basic and derivative economic relationships is essential to making informed public policy decisions. This is especially true as the nation attempts to recover from its second-longest post–World War II recession. Yet many defense economic relationships are quite complex and have successfully resisted precise (or, in some cases, any) quantification despite the attention of some of the country's most capable economists and defense analysts. In important areas, the best the experts can sometimes do is arrive at notional or qualitative agreement.

With regard to national defense, the continued military superiority of the United States (barring a major turn of events in the Commonwealth of Independent States) is assumed even under the most dramatic budget reductions.[6] Yet, many considerations militate against a "business as usual" approach. The rate of change in our military structure (and in our national security strategy) rivals the dramatic changes seen in our former principal adversary. Reaction to these dramatic changes is manifested daily, as each service struggles to adjust to the realities of a radically altered threat environment coupled with austere funding.

On a larger scale, the relative certainty inherent in a bipolar (i.e., the United States and the Soviet Union) world has been supplanted by the vagaries inherent in multipolar arrangements of influence and military power. The world, in economic and geopolitical senses, has changed fundamentally since the height of the Cold War—and the rate of change has accelerated beyond our ability to analyze events and their consequences.

Our confidence in existing military capabilities is based principally on assessments of the remaining "Soviet" threat. Warsaw Pact security arrangements have disintegrated, completely altering the threat environment from that faced by the U.S. since the late 1940s. As the Office of Technology Assessment assessed in October 1991, "The threat of overwhelming surprise attack is gone. Estimates of warning time have increased from two weeks to as much as two years. . . . This change is now believed irreversible, in the strict sense that the Soviets will not be able to return to the situation that they once enjoyed, and an important buffer of Eastern and Central European states now exists. . . ."[7] This "buffer" comprises a *cordon sanitaire*, if you will. More importantly, the former Soviet Union is no longer "the" threat but has been relegated to a lesser status of only one of the potential threats to be planned for.

The Essential National Policy Questions

Budget problems faced by the United States have ripple effects that extend beyond national borders. The linkage between fiscal realities and our role among nations becomes inextricable as the growing interdependencies of the global economy are felt. The most relevant question in a geopolitical sense is whether the United States should continue its role of world leader, perhaps seeking to expand its influence as an "internationalist" nation, or should choose to retrench toward isolationism. A fundamental issue is whether existing (and foreseeable) fiscal conditions will dictate our foreign policy, our military strategy, and our role among nations.

Despite current domestic budget problems, we are well advised to review our own history and "discover" that isolationism in the twentieth century has done little to secure our national interests. Such retrospection may well reveal that prior U.S. attempts at international noninvolvement have served not to deter but to encourage external discord and foreign aggression. A policy characterized by "Fortress America" thinking would be not only naive and potentially dangerous but also counterproductive in the new world economy. The United States is now formulating policies which will have impact in the early twenty-first century and beyond. We must do this with considerable circumspection, remembering the lessons of the past, while recognizing the unique historical opportunity to influence positively the future.

Defense Economics

The relationship between economic conditions and national security takes on increasing significance with each passing year. Greater recognition of that relationship is no doubt related to the unabated cuts in the defense budget. Those cuts represent a radically different environment than that experienced in the funding-rich Reagan years.

Some Concepts. The origins of "economics of defense decision making" are to be found mostly in the early 1960s, when systems analysis techniques were proliferated throughout the defense sector by Secretary of Defense Robert McNamara. Not since that time have those engaged in defense economics and defense analysis been so well positioned to contribute to both DoD and national policy decision making.

Definitions of defense economics *per se* are hard to come by.[8] There is no standard definition in any economics textbook or in any Defense Department publication. By its broadest measure, defense economics encompasses an exceptional range of topics: from assessing the macroeconomic impact of the defense budget, to applying microeconomic analytical techniques to military construction proposals; from determining optimal (and affordable) force structures, to developing cost-quantity relationships for specific weapon systems acquisitions; from estimating the economic impact of military base realignments, to charting a course for the integration of defense "human capital" into the civilian economy. All of the above, and considerably more, fall under the rubric of "defense economics." Fortunately for defense economists, the forecasting of macroeconomic variables (which some view as both the *raison d'être* and the *bète noire* of economics) generally falls under the purview of econometricians and is neatly sidestepped by defense economists.

Defense Economic Theory. Historically, defense economics has faced the conundrum, at the "macro" level, of how to evaluate the benefits of national defense, given the enormous costs involved. The conundrum derives from the exceptional difficulty of assigning dollar values to (i.e., monetizing) benefits derived from defense expenditures. At the extreme, how does one quantify the benefits of avoiding a war between the superpowers? At the "micro" level, the issue is frequently one of cost-effectiveness—which turns out to be a much more straightforward analysis, since the benefit issue is normally assumed away or addressed qualitatively.

In the language of economics, national defense is known as a "public good," or something from which society as a whole benefits. Though society as well as the individual in the United States benefits economically from national defense in that, for instance, it allows the existence of free enterprise, there are insufficient private market incentives to generate adequate funds for defense. That is, it is highly doubtful that contributions in the $200–300 billion range would be raised voluntarily. Hence, there are strong economic foundations for having the central government provide defense funding through taxation.

National defense has unique characteristics which result in "market inefficiencies." Technically, the DoD is a "monopsonist" buyer (one with great control over market demand) that faces a host of "oligopolist" sellers (a relatively small group—defense contractors—who collectively can affect supply and, indirectly, pricing). As a result, the price mechanism cannot play its typically equilibrating role of determining optimal, or at least efficient, allocation of resources. In other words, some very fundamental assumptions of competitive markets are violated in the defense environment.

"Pure competition," or in some instances even a semblance of competition, is typically absent from the defense market. The result is a market structure that is inherently inefficient. An additional factor is that performance-driven requirements are inescapable in the military environment (unless one is willing to field forces armed with technologically inferior weapons). Among the consequences of the underlying defense market structure and performance requirements are exceptionally low production rates, which lead to high unit costs. This, of course, does not address the complications imposed by acquisition procedures that are constrained (for the most part) to an annual funding process, or the encumbrances imposed by small-business considerations. With the current and pending build-down in military forces, economic inefficiencies are likely to be exacerbated rather than ameliorated as uneconomical production quantities become more common.

The National Security Strategy

There is a direct linkage between defense program funding and our National Security Strategy, which embodies the basic security policy statement of the United States. Our security strategy was last articulated formally by President George Bush in August 1991. According to the president, the United States has four basic national interests and objectives:

• The survival of the United States as a free and independent nation, with its fundamental values intact and its institutions and people secure.

• A healthy and growing U.S. economy to ensure opportunity for individual prosperity and resources for national endeavors at home and abroad.

• Healthy, cooperative, and politically vigorous relations with allies and friendly nations.

• A stable and secure world, where political and economic freedom, human rights, and democratic institutions flourish.[9]

Inherent in this strategy is the transition from our Cold War policy of containment to a new emphasis on response to regional contingencies.[10] There have been significant changes in our national strategy since the era when the concepts of "mutually assured destruction," "first-strike capability," and "flexible response" were part of the prevailing nomenclature. Dramatic effects in all aspects of military planning have resulted. The revised strategy, which faces a gauntlet of congressional challenges for acceptance and funding, will result in unprecedented changes in military doctrine.

The Defense Budget Picture

As of this writing (May 1992), the Bush administration is seeking $267.6 billion in DoD budget authority for fiscal year 1993.[11] This represents a reduction of $9.9 billion (a cut of seven percent in real terms, i.e., adjusted for inflation) from the budget passed by Congress for fiscal year (FY) 1992. The administration's budget proposal also affects the funding for the DoD's Future Years Defense Plan (FYDP), reducing budget authority by $63.8 billion compared to last year's. The reductions comprise $50.4 billion in cuts to defense programs and $13.4 billion in adjustments stemming from the Omnibus Budget Reconciliation Act of 1990 (specifically from provisions of that legislation known as the Budget Enforcement Act, which invoked funding changes based on the 1991 rate of inflation.)[12]

Though substantial, the administration's proposed reductions in defense spending pale in comparison to the reductions proposed by others (see the following section, on alternative funding proposals). However, the administration's proposals serve as a reasonable baseline for extrapolating potential consequences for the U.S. military budget. Using the administration's proposals, the DoD budget will decline, in real terms, by four percent per year throughout the FYDP (1993–1998). By 1997, the cumulative impact of many sequential years of "negative real growth," or real decline, will result in a DoD budget that is thirty-seven percent lower (in real terms) than the peak year of budget authority, 1985.

Some historical perspective is gained if one realizes that the administration's proposed 1997 DoD budget (again, considered unrealistically optimistic by many) will provide roughly the same buying power as the 1960 defense budget. The magnitude of the current defense build-down is unprecedented since the dramatic reductions following the Vietnam War. In addition, we have also seen a considerable shift since those days in the allocation of available defense dollars, particularly since the introduction of an all-volunteer force, which has resulted in fewer dollars (in percentage terms) being available for weapon systems and spare parts.

Alternative Budget Projections. The administration's FY 1993 budget request and its FYDP projections may indeed prove overly optimistic as increasing pressure is applied by Congress to cut defense more quickly. National defense, involving "discretionary expenditures" rather than legally mandated "entitlements," is an especially attractive target for budget cuts. The vulnerability of defense funding is a result of the annual appropriations process for discretionary programs, a process from which entitlement programs are exempt. Table 1 summarizes the range of proposals made by legitimate sources, legislative and others, and provides some insight into just how much budget authority is at stake over the course of the FYDP.[13]

As can be seen in Table 1, the most severe reductions proposed for defense spending would reduce the DoD budget by over $340 billion under the FYDP (the difference between the president's February 1991 plan and the funding levels proposed by Representative Conyer's Working Group). The defense budget is receiving enormous attention both from entities that are typically involved in the budget process and from those who have found in it a new forum to express personal concern (or pursue personal agendas). Those typically involved—e.g., the Congress, the DoD, the Office of Management and Budget, the Congressional Budget Office, and "think tanks" such as The Brookings Institution—have been joined by many legislators in assessing the appropriate funding levels for defense.

Notwithstanding the heightened national interest in the defense budget, all concerned should keep clearly in mind that the appropriate amount of funding

Table 1

Proposals for Defense Spending, FY 93-97: Budget Authority (billions of current-year dollars)

	FY 93	FY 94	FY 95	FY 96	FY 97	Total FY 93-97
Feb 91 Bush Plan	290.9	295.0	297.9	300.3	304.9	**1,489.0**
Jan 92 Bush Plan	280.9	281.7	284.4	285.7	290.6	**1,423.3**
Sen. Gramm	276.8	277.9	280.9	–	–	–
Sen. Kennedy	279.0	277.0	276.0	273.0	269.0	**1,374.0**
Sen. McCain	283.9	277.6	271.7	265.9	259.5	**1,358.7**
CBO II	284.0	278.9	271.7	261.4	250.0	**1,346.0**
Lawrance Korb	275.0	270.0	265.0	260.0	255.0	**1,325.0**
Rep. Panetta	273.6	264.4	262.3	258.3	253.1	**1,311.7**
Stein/Kaufmann	282.1	272.0	262.1	252.5	235.8	**1,304.5**
Steinbruner	272.0	254.1	237.3	221.9	208.6	**1,193.9**
Conyers Working Group	263.0	256.6	232.6	209.8	185.0	**1,147.0**

Source: Defense Budget Project, *Preliminary Review of the FY 1993 Defense Budget Request*, January 1992, table 1.

for defense must be based on realistic assessments of current and future threats to our national security.

Personnel and Force Structure Implications. From a force-structure and personnel perspective, the changes on the immediate horizon have dramatic effects on each service. From a post-Vietnam peak of 2.2 million in FY 1987, active-duty military will be down to 1.6 million by 1995, a reduction of about twenty-five percent below FY 1987.[14] Similarly, reserve personnel levels will be about twenty percent below FY 1987 levels. All services are actively seeking volunteers to leave the military, offering them a range of separation incentives aimed at active duty personnel of all ranks. Moreover, the Office of the Secretary of Defense (OSD) is energetically involved in future "force shaping." From an economic perspective, recent OSD actions imply serious analysis of personnel issues. Such analysis in OSD is unprecedented in the recent past and may presage other changes to come.

The force structure currently being proposed by the administration, as articulated by the Chairman of the Joint Chiefs of Staff, General Colin Powell, in the fall of 1991, is depicted in Table 2.[15] By any measure, these are huge reductions in military capability which would never be contemplated were it not for the dissolution of the Warsaw Pact. Moreover, the reductions shown must realistically be viewed as "best-case" from the perspective of the status quo force structure. That is, the alternative DoD funding levels discussed in the preceding section would result in yet greater reductions. If one uses the mid-1980s force structure goals, the forthcoming reductions are even more

Table 2

	Proposed Force Structure 1990	1997	Percent Reduction
	Active Forces		
Ground			
Army Divisions	18	12	33
Marine Brigades	9	7	22
Naval Forces			
Aircraft Carriers	13	12	8
Carrier Air Wings	13	11	15
Ships	545	448	18
Air Forces			
Tactical Fighter Wings	24	15.5	35
Strategic Forces			
Land-based ICBMs	1,000	550	45
Sea-launched Ballistic Missiles	608	432	29
Strategic Bombers	228	181	21
	Reserve Forces		
National Guard Divisions	10	6	40
Marine Brigades	3	3	0
Carrier Air Wings	2	2	0
Tactical Fighter Wings	12	11	8

Source: Statement of General Colin Powell before the Subcommittee on Defense, House Committee on Appropriations, 25 September 1991.

precipitous. It was not so long ago that the Navy argued vehemently that a minimum of six hundred ships were necessary to prosecute its prescribed wartime missions. Similarly, the Air Force sought and was moving towards forty tactical fighter wings to fulfill its own missions.

On the civilian side of the force structure question, the DoD is the largest employer of federal civilian employees and arguably possesses the greatest human capital of any employer in the world. One need only consider the many outstanding research scientists, engineers, computer experts, etc., employed by the Department of Defense. Advanced pure and applied research is being conducted at DoD labs and university facilities that no company (or other country) can afford, either in human skills or physical plant. Here, too, however, budget realities are hitting home as large reductions in work force levels are planned.

Based on the administration's 1993 budget proposal, DoD civilian employment is projected to decline to 904,000 by FY 1997, or to about twenty percent below its FY 1987 peak.[16] The planned decreases in civilian employment reflect both shrinking U.S. military personnel levels, based on the reduced threat, and

DoD management improvements (otherwise known as "Defense Management Review Decisions"). Most of the planned civilian reductions will be accommodated through normal work force attrition, as the DoD seeks to avoid "Reductions in Force" (RIFs). However, there will be some displacement of personnel due to base realignments and consolidation of activities.

Both more dramatic and more rapid will be the impacts on the private-sector defense work force. The Congressional Budget Office estimates that 600,000 defense jobs will be eliminated by 1995. Of these, 400,000 are considered direct defense jobs—i.e., workers at plants that make weapons or other products for the DoD, provide goods or services for military bases, do research, or perform legal, business, or transportation services paid for directly by the DoD. The remaining 200,000 workers typically supply goods or services to defense contractors.[17] The displacement of defense workers will have disproportionate effects on states and localities that are defense-dependent. Projections show, however, that displaced defense workers can be integrated over time into non-defense industries, provided that major contract cancellations and funding reductions are phased in gradually.

Overall, between active duty and civilian DoD personnel, plus the impact on defense contractors, approximately 1.1 million jobs will be lost in the defense sector by 1995. Many of the workers involved have sought-after technical skills and can readily be assimilated into the non-defense work force. Nevertheless, the current recession will make transitions quite painful for many.

On the macroeconomic level, Congress must be wary of "building-down" defense too precipitously. Heeding the call for excessive and immediate cuts to defense will surely contribute to slowing, and perhaps imperiling, the economic recovery. Beyond that, there is the potential for irreparable damage to the defense industrial and technology bases. Most of the risk in this area lies in the dissipation of hard-to-replace human capital, the capital which has allowed the United States to gain and maintain the lead in the most advanced defense applications. Teams possessing great technical skills, once dispersed, can be exceptionally difficult to reconstitute under "surge" conditions.

The Base Force Concept

While large reductions in overall force size are assured, no rational defense analyst goes so far as to propose unilateral disarmament. The Chairman of the Joint Chiefs has repeatedly described the "base force" as the minimum necessary to meet enduring U.S. national security needs.[18] The requirement for forces that could be reconstituted to meet a renewed Soviet-scale threat will be a fundamental one for the indefinite future.

From a planning perspective, the emphasis on potential "mid-intensity conflicts" and "major regional contingencies" is gaining in stature. In its *Joint*

Military Net Assessment for 1991, the DoD identified in 1991 five major types of contingencies on which to base potential deployments. The scenarios identified are assumed to occur with little advance notice (several days in some cases) and consist of the following: war escalating from crisis in Europe, a major regional contingency in Korea, another major regional contingency (perhaps in the Middle East), a lesser regional contingency, and a counterinsurgency or counterarcotics operation.[19]

Beyond the "base force," General Powell has identified seven "core competencies." These capabilities would enable the United States to counter a wide range of potential, yet nonspecific, threats. They include the ability to maintain global "situational awareness," paralyze an enemy's fighting power, defend against a ballistic missile attack, maintain access to air and sea lanes and space, forward-deploy forces, assist in humanitarian relief and law enforcement, and preserve a defense industrial base.[20]

Integration of the DoD and National Budget

Thus far, this article has concentrated on the projected effects on the defense budget of the unfolding military build-down. We have alluded to the exceedingly complex environment faced by defense planners, one comprising nonspecific and changing threats. Such uncertainties are widely acknowledged, and a considerable portion of national intelligence resources are now focused on defining future military scenarios. Current thinking indicates that a future security environment of yet greater complexity is inevitable as the proliferation of nuclear weapons among second and third-tier military powers becomes an increasing problem.

However, with the disappearance of the Warsaw Pact, it is the condition of the U.S. economy that has taken center stage in the minds of many policy makers. The result is that the DoD budget has become increasingly *fiscal-driven* as opposed to *threat-driven*. This revised approach to DoD budgets is a radical departure from that of the mid-1980s, when fiscal considerations, both near and long-term, were given relatively little weight as the United States engaged in its largest peacetime military buildup. That buildup was the stated objective of the Reagan administration (and was, for the most part, supported by Congress); it was to be an unmistakable message to the Soviet Union that the U.S. would never accept a subordinate military position. The costs of containment and of the 1980s buildup, whatever they were (and the number is in the trillions), will have been money well spent if the probability of global nuclear war has been reduced to near zero.

The good news is that the Reagan policy and the containment policy of his predecessors worked, and worked very well. The Soviet Union and the Warsaw Pact essentially imploded and no longer pose anywhere near the military threat that they once did. When the U.S. Air Force stood-down its intercontinental bomber force in late 1991, no clearer message could have been sent that we no longer viewed the Soviet Union as an immediate threat to national security. (It should be noted, however, that the bomber stand-down had a primarily symbolic meaning, as the remaining legs of the "triad," intercontinental and sea-launched ballistic missiles, are still capable of quick response.) The bad news is that the 1980s defense buildup did cost an enormous amount of money and contributed, as did other programs and tax policies, to a significant fiscal imbalance for the United States.

The Budget Deficit and National Debt. The considerable investment the United States has made in national defense over the last four decades represents "sunk costs." The relevant questions now have to do with how to keep adequate force levels while adjusting to severe fiscal constraints. Some insight into the extent of present fiscal difficulties is gained by looking at historical trends of the federal deficit, the national debt, and the gross domestic product.[21] Note that "Debt" in Table 3 reflects Gross Federal Debt, that is, debt held by the public rather than total debt (which includes intergovernmental holdings of government debt, i.e., transfers with little macroeconomic impact). Further, "Deficit" as depicted in Table 3 represents the "total deficit," which is the summation of "on-budget" and "off-budget" accounts (which include the large surplus in the Social Security Trust Fund) and reflects thereby the actual federal deficit more accurately.

As can be seen in Table 3, the federal deficit as a percent of Gross Domestic Product (GDP) increased dramatically during the Reagan defense buildup of the mid-1980s, from 2.6 percent in 1981 to 5.3 in 1985. Similarly, but with a lag effect, the Gross Federal Debt held by the public increased from less than 30 percent of GDP in the early 1980s to over 40 by the mid-1980s and is now approaching 50 percent. Interest payments alone on the Gross Federal Debt exceed $200 billion for FY92, or 13.5 percent of total federal outlays. It is of some interest to note that were it not for these enormous interest payments on the federal debt, and funding for the savings and loan crisis, *the federal budget would be in balance.*

Financing the Deficit: The Impacts. The large federal deficits run by the United States have had increasingly perverse effects on the economy. The private bond markets, which in reality establish market interest rates, have come to respond only hesitatingly to actions by the Federal Reserve Board. For example, recent dramatic cuts in the federal funds rate (and discount rate) have had little effect on long-term interest rates; hence, the "yield curve" (the difference between short-term and long-term federal interest rates) is exceptionally steep. In addition, long-term "real" interest rates (nominal rates minus inflation) are exceptionally high. The current wisdom as to the reason for high "real" interest rates is that

Table 3

Year	Deficit	Debt	GDP	Deficit % of GDP	Debt % of GDP
	(in billions of current dollars)				
1980	73.8	709.3	2,708.0	2.7	26.2
1981	79.0	784.8	3,030.6	2.6	25.9
1982	128.0	919.2	3,149.6	4.1	29.2
1983	207.8	1,131.0	3,405.0	6.1	33.2
1984	185.4	1,300.0	3,777.2	4.9	34.4
1985	212.3	1,499.4	4,038.7	5.3	37.1
1986	221.2	1,736.2	4,268.6	5.2	40.7
1987	149.8	1,888.1	4,539.9	3.3	41.6
1988	155.2	2,050.3	4,900.4	3.2	41.8
1989	153.5	2,190.3	5,244.0	2.9	41.8
1990	220.5	2,410.4	5,513.8	4.0	43.7
1991	268.7	2,687.2	5,671.8	4.7	47.4

GDP: Gross Domestic Product

Source: Economic Report of the President, February 1992, pp. 298, 385.

private investors are looking closely at the budget deficit and at the effectiveness of fiscal policy in deficit reduction. Our inability to control the deficit and the fears of out-year inflation ("inflationary expectations") have served to undercut the effectiveness of monetary policy (that is, of actions by the Federal Reserve Board). The old adage, "you don't fool the bond market," is proving axiomatic; financial market analysts clearly do not like what they see in federal attempts at deficit reduction.

Perhaps the most damaging aspect of running large federal deficits is the adverse impact on national savings, in particular on personal savings. Savings form the basis of investment (capital formation), which in turn is essential for productivity gains. Due largely to the series of high annual federal deficits, national savings in the United States has been depressed for many years. Personal savings, a component of national savings, is currently in the three-to-four-percent range in the U.S.; this contrasts with personal savings rates in Japan and Germany in excess of ten percent. As a result of lower national and personal savings rates, the United States has had a paucity of investment in the manufacturing sector and for public infrastructure.

The higher savings rates, and concomitant higher investment, of our economic rivals has afforded them greater gains in productivity than the United States has experienced. The result has been a persistent weakening in U.S. competitiveness. This information is not new, and there are no easy solutions for these problems; simply put, unless the United States increases its rate of savings and reduces governmental requirements for deficit financing, future generations will suffer the consequences in the form of reduced standards of living. Financing the federal deficit will become a more serious drag on the U.S. economy should foreign investors find more attractive returns in overseas markets, thereby increasing the domestic burden of financing it. This phenomenon has already been seen in the fall of U.S. short-term interest rates. Foreign investors can now get higher returns in European financial markets, where the credit demands of rebuilding eastern Germany have driven interest rates upward.

The Peace Dividend. The concept of a "peace dividend" began to surface in the late 1980s as news of internal problems in the Soviet Union became more widespread and as the perception of that country's role as a major threat began to dissipate. Clamoring began in certain circles for dramatic reductions in the U.S. defense budget. National leadership took a more prudent position and adopted a "wait-and-see" approach as the Berlin Wall came down and the Warsaw Pact disintegrated. Resistance to immediate force reductions was well founded; it was in fact unassailable, given the uncertainty and volatility found in the countries involved. Although the United States offered some unilateral force reductions, we were (and remain) rightfully interested in *quid pro quo* actions on the part of former adversaries.

The difficulty of assessing the potential peace dividend is multifaceted. One can argue that the United States has in fact enjoyed a "peace dividend" since 1989, the year when significant changes began in Eastern Europe. Using this approach, it is legitimate to contend that reductions in the defense budget since 1989 have served to reduce the deficit below what it otherwise would have been. (This is a sobering thought as the country contemplates an "on-budget" deficit of $290 billion for FY 1992.) For example, if one looks at the FY 1989 DoD baseline, expressed in 1993 dollars, the administration's current proposal represents a reduction of $523 billion from planned levels through FY 1995; this amount could conceivably be claimed as the administration's peace dividend. Is this the correct approach to quantifying the peace dividend? Perhaps—but not if one accepts the plausible contention that the notion of a peace dividend is *illusory* so long as the federal budget *is not in balance*. These are but two of the many legitimate interpretations of the peace dividend and merely highlight the range of opinion.

On a practical level, the defense budget, which has been reduced in real budget authority in every year since 1985, is still seen by many congressmen as the most attractive source of discretionary funds to be used elsewhere. Some advocates of this perspective view DoD funds as a path for further deficit reduction and press for dramatic near-term reductions in the DoD budget. However, defense funds are also seen by many as a potential funding source for expanded domestic programs.

An alternative use of the "peace dividend," one cautioned against by most serious analysts, is to provide for tax cuts or tax credits. The idea is that modest one-time or short-term tax relief would stimulate the economy to "grow" out of the current recession. However, experience gained from previous tax cut and tax credit attempts (for consumers) has shown that these actions are generally ineffective and have actually worsened the budget deficit.[22]

A further consideration is that under the Budget Enforcement Act of 1990, a set of rules prescribes limits on overall spending levels of discretionary funds and on the transfer of such funds. The Act has prevented the "peace dividend" from being spent on non-defense discretionary programs or tax reductions.[23]

The Challenges Ahead

There are imposing challenges ahead for the nation and particularly for the Defense Department. I submit that the most immediate and most essential task for the DoD is to gain the confidence of Congress that current threat assessments are realistic. There is a perception that the department is actively searching out potential threats and seeking new missions in order to mitigate force reductions. Some in Congress view even the "base force" as excessive, claiming that it is predicated on a concatenation of events that is highly unlikely to occur. With the political vulnerability of "discretionary" defense spending, it is of paramount importance that Congress embrace DoD (and other defense agency) threat assessments as genuine. Without credible proposals that tie believable threat assessments to program dollars, the department's funding will remain at considerable risk.

At the national economic policy level, the United States must commit itself to deficit reduction or face major constraints on domestic policy options, as well as future low productivity, reduced standards of living, and the ultimate cession of economic preeminence to foreign rivals. Commitment to deficit reduction can no longer take the euphemistic forms of the past (e.g., the Deficit Reduction Act of 1986), where target reductions gave way to "innovative accounting" and then to changes in the law when reductions proved too difficult to achieve.

Reducing the budget deficit will require cuts in the defense budget; of this there can be no doubt. From the DoD perspective, the goal is to make rational, phased cuts that increase the "tooth to tail" ratio and yet provide for the rapid reconstitution of forces. However, and more significantly, reducing the deficit will require increasing revenues: increasing, *not* decreasing, taxes and placing realistic limits on domestic entitlement programs. The idea of increasing taxes is anathema to many and is particularly difficult to implement while the country is recovering from a recession; yet it is a treatment necessary for the long-term survival of the patient. Similarly unpopular in some circles are "means testing" for entitlement programs and the taxing of certain benefits. Popular or not, these actions are necessary to restore fiscal control to a budget situation that is currently out of control. It appears that the only tax "cuts" truly worth considering would be those designed to encourage investment, e.g., investment tax credits and a reintroduction of accelerated depreciation schedules (perhaps some variant of the Accelerated Cost Recovery System).

In his *National Security Strategy of the United States*, President Bush stated that "national security and economic strength are indivisible."[24] In a world characterized by a global economy, in which national borders and geographic distances are becoming less relevant, the United States cannot afford to be an international bystander. We must make every effort to take and maintain leading roles in technology and manufacturing and to prevent the results of our enormous research and development efforts (both government and privately sponsored) from being sold or given away. The issue of technology transfer will continue to be problematic and deserving of attention at the highest levels.

Finally, if the United States chooses to remain a superpower, or even a great power, it must continue to have the military capability to project power quickly and effectively. One need only review the recent Iraq-Kuwait conflict and ask what other nation would have taken the lead, and invested the resources, to stop aggression. How long would it have taken a coalition of other nations, who, as it was, benefited enormously from our efforts, to bring substantial forces to bear without our leadership? Would other countries have even tried military intervention, or would the world now be facing energy prices determined in Baghdad? These questions, and others, deserve real consideration as the rush to cut defense spending becomes increasingly based on emotion rather than rationality.

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