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THE SECRETARY OF DEFENSE
WASHINGTON, D. C. 20301

APR 4 1975

Honorable John L. McClellan
Chairman, Committee on
Appropriations
United States Senate

Dear Mr. Chairman:

Your letter of March 14, 1975, requested our comments on the economic impact of a $9.6 billion reduction from the FY 1976 defense budget request for military functions. Before addressing the economic impact, I would like to comment briefly upon what such a reduction would mean in terms of the defense program trend. As you noted, there is real growth (that is, noninflationary growth after allowing for pay and price increases) of $.8 billion for the Military Construction and Family Housing Bill. For the Defense Appropriation Bill, taking account of all factors (details are presented in the first enclosure) the estimates would provide real growth of $3.8 billion. The total real growth in the two bills is thus $4.6 billion. A reduction of $9.6 billion from these estimates, then, would represent a real cut of some $5 billion in the defense budget from the depressed level of FY 1975.

The economic impact of such a cut would be severe. There would be a substantial loss of employment, beginning when the budget cuts were effected and building to a peak of about half a million jobs by the summer of 1976. The period of peak impact would continue into the spring of 1977. GNP would decline by about $18 billion, cumulative. This would include the $9.6 billion drop in defense production and an $8.4 billion drop in other areas, mostly consumption; investment would not change significantly.

The decline in GNP would produce a Federal revenue loss of about $4 billion, and the rise in unemployment would result in increased outlays for unemployment compensation of about $3 billion, both cumulative figures. There would also be increased outlays, which we cannot estimate, for welfare, food stamps, and for Federal retirement systems. The $9.6 billion defense cutback would thus be substantially offset by lost revenues and increased outlays. The deficit would not change significantly

Practically all of the $9.6 billion defense budget cut under consideration would involve payrolls in DoD or in industry. In addition to this direct hire, there are indirect employment effects, as employees spend their income. By contrast, most nondefense Federal spending is for transfer payments (social security, medicare, medicaid, food stamps, etc.). These transfer payments involve no direct hire, and affect employment only indirectly. Moreover, a reduction in the defense budget would have an assured economic impact, which would begin as soon as the Congress acted. Most of the nondefense job programs under consideration involve grants to states and local governments. There are obvious questions of timing, and of the extent to which such amounts create net additional new jobs as against paying people already employed or foregoing tax increases or bond issues. These are practical considerations which one must take into account in appraising the prospects for offsetting a defense cutback by increased spending for domestic programs.

There are sectors of domestic public spending (Federal, state and local) which have an employment impact, dollar for dollar, equivalent to that of defense. But we are not aware of any plan for expansion of such programs, contingent upon a reduction in the defense budget, to offset the defense employment cutback as it would occur. Also we see no reason why expansion of such programs would have to be contingent upon a defense cutback. It's unrealistic to expect that defense employment cutbacks could be offset by increases in other types of employment in the near term.

I believe that a defense budget reduction at this time would make our unemployment problem much worse than it would be if our budget were approved as submitted. Many have advocated defense budget reductions in the name of reordering our national priorities, maintaining that we could better use the resources for other purposes. If the defense budget is cut by $9.6 billion and, optimistically assuming an equivalent amount is made available elsewhere, there would still be a significant loss of production in the short term. Further, even if it were possible to offset a defense cutback, job-for-job and dollar-for-dollar, by increases in other sectors of the economy, it would still be necessary to consider whether such large-scale reductions were consistent with our national security requirements.

The $9.6 billion cutback you mention would involve a cut, in real terms, of some 6% from the depressed level of FY 1975, continuing the downtrend in our level of defense effort, in the face of a steady increase by the Soviets in defense resources. It is highly unlikely that large defense cuts at this time would help the economy and it is virtually certain that the military risk would be increased.

The second enclosure (enclosure B) presents more details on the economic impact of reductions in the Defense budget. This enclosure also responds to the specific question you raised concerning areas and sectors of impact and other points. If you require any further information in this regard, please let us know.

Sincerely,

JL Addabbo

ENCLOSURE A

FY 1975 AND FY 1976 SUMMARY, DEFENSE APPROPRIATION ACT
($ Millions)

	FY 1975	FY 1976	Constant Price Change
FY 1975 Appropriation (reflects proposed supplementals and rescissions)	83,925		
Annualize FY 1975 Pay Raises and Retired Pay CPI's	1,284		
Purchase Inflation at 11.5%	4,435		
FY 1975 in FY 1976 Submission Prices	89,644	97,798	+8,154
Prior-Year Shipbuilding Program Adjustments	+909	-2,269	
Program Totals After Shipbuilding Adj.	90,553	95,529	+4,976
Adjusted Program Totals in FY 1976 Submission Prices:			
Military Retired Pay	6,522	6,885	+363
Use of Prior Balances, Shelf Sales & Lapses, Net	-738	-58	+680
Liquidation of Prior-Year Obligations	48	163	+115
All Other	84,721	88,539	+3,818
Program Totals after Shipbuilding Adjustments	90,553	95,529	+4,976

Prior-year shipbuilding adjustments. The FY 1976 request includes $2,269 million to finance funding shortages from ships approved for FY 1975 and prior years. This provides no new ships for FY 1976. It is necessary, for comparability, to add $909 million to the FY 1975 column, to reflect full financing of the ships approved for that year. After these adjustments, the ships approved for FY 1975, and those requested for FY 1976 -- both fully funded -- are reflected in the totals on a fully-comparable basis.

Military retired pay. The $363 million increase reflects growth in the retired population.

Prior balances, shelf sales, etc. The 1975 Appropriation Act made specific transfers from prior balances in certain instances, and in other cases appropriation reductions were made upon the basis that programs could be supported through sales of material not requiring replacement (shelf sales). Moreover, transfers have been reflected in FY 1975, pursuant to authority in the 1975 Appropriation Act. The FY 1976 request reflects much smaller adjustments in these areas. These items appear in the financial schedules as negative items -- that is, as reductions to the amount of appropriations requested to finance a given level of program. The $680 million increase here does not represent program growth, but a change in the availability of prior-year balances and other financing sources.

Liquidation of prior-year obligations. The FY 1976 requests are to liquidate obligations incurred pursuant to contract authority in FY 1972.

ENCLOSURE B

ECONOMIC IMPACT OF REDUCTIONS IN DEFENSE BUDGET

Overall Employment Impact

Virtually all of a $9.6-billion reduction would come from payrolls in government or industry. Excluding military retired pay, the Defense budget is about evenly divided between (a) direct military and civil service payroll and (b) purchases of goods and services from industry. On the average, about 2/3 of industry purchases are for direct compensation of private sector employees, and 1/3 goes for indirect business taxes, interest, depreciation, and profits. The latter items also involve jobs, indirectly, but they also tend to be fixed expenditures so that a change in DoD purchases tends to involve compensation almost exclusively. Thus, virtually all of a $9.6-billion reduction in the Defense budget would reduce government or industry payrolls.

On the average, each $1 billion of payroll spending for civil service employment will involve 64,000 direct, full-time, full-year jobs in FY 1976. For industry payrolls, the figure will be about 60,000 jobs per billion.

Those figures are averages, and they would not apply to changes in payroll spending. Any employer, government or private, initially changes his workforce by adjusting employment at lower-than-average rates of pay. This is obvious when employment is increasing; one builds up a workforce by recruiting more people, normally at entry rates, which are about half of average rates. The same applies during cutbacks, for three reasons. First, when the workforce is falling, employers curtail recruitment, or cease hiring altogether. Second, most employers apply the "last-hired-first-fired" principle, which means that the junior employees, generally those at the lowest rates of pay, are the first to go. Third, even where senior employees are separated, they are entitled to long notification periods; separation and severance pay; payments for unused leave; and similar items; which means that the dollar savings per person separated for the first year or two are quite low.

It is necessary to consider not only direct effects of changes in payroll spending, but multiplier effects as well. Allowing for the fact that employment changes would occur at below-average rates of pay, and for the multiplier, the overall job impact would be about 125,000 jobs per $1 billion of defense spending.

The $9.6-billion budget cut considered here would involve spending changes over a period of time. We estimate that spending would fall about $2.8 billion in FY 1976 and about $4.2 billion in the next 15 months (the transition period and FY 1977, under the new designation). The remaining $2.6

billion falloff in spending would occur after FY 1977. The impact would begin in the latter part of this year, and would reach a peak by the summer of 1976. The peak would extend to the spring of 1977, with a decline thereafter. During the peak period, the spending reduction would be felt at an annual rate of about $4 billion. As noted earlier, the employment impact (direct and indirect) is about 125,000 jobs per billion. By the summer of 1976, the budget cut considered here would affect about 500,000 jobs.

Areas and Sectors of Impact

In measuring areas and sectors of impact, it is necessary to assume that the budget reduction would fall in those areas where program growth has been identified, without recognition of such factors as the prior-year funding deficiencies for shipbuilding and other items detailed in the first enclosure. It should be emphasized that this would not accord with our views on military need or long-run economics.

About 10% of this reduction would affect DoD's civil service payroll, and the remainder would affect purchases from industry.

Recall that about 500,000 jobs would be lost by the summer of 1976. This would include 40,000 direct civil service jobs, 360,000 jobs of people engaged in direct defense work in industry, and 100,000 jobs throughout the economy as a result of the multiplier effect.

As to the impact by states, the loss of $9.6 billion in payrolls (considering contracting, subcontracting, and direct defense civil service employment) is estimated as follows:

- Five states would probably be hit hardest -- California, Connecticut, Mississippi, Missouri, and Virginia. These states, together, would lose about $5 billion in payrolls.

- Michigan, Texas, and the state of Washington would lose about $1.5 billion in payrolls.

- Five other states would lose, collectively, about $1 billion in payrolls: Maine, Maryland, Massachusetts, New York, and Ohio.

- Of the remaining $2.1 billion in payrolls, some would involve states already named, but the amounts cannot be identified at this time. The balance would be distributed among other states.

The industries that would be hardest hit directly are aircraft (including airframes, electronics, and engines); shipbuilding; automotive (tanks and personnel carriers); and construction. The suppliers for these industries would also, of course, be hard hit. Indirectly, of course, there would be an impact throughout the economy.

The occupations hardest hit would include machinists, pattern and model-makers, sheetmetal workers, aircraft mechanics, carpenters, electricians, welders, steamfitters, pipefitters, and bricklayers. There would be a smaller numerical impact -- but a sharp impact in relative terms -- in certain professional areas: aeronautical, electrical, and mechanical engineers; physicists; and mathematicians.

Effect on Gross National Product

Cumulatively, there would be a decline of about $18 billion in GNP, with most of the impact being felt in 1976 and 1977. This would include the $9.6-billion decline in defense purchases, and an $8.4-billion drop in personal consumption expenditures as a result of the multiplier. Investment would be essentially unchanged. Thus, the U.S. would lose not only the $9.6 billion in military goods, but an additional $8.4 billion in automobiles, housing, appliances, and the kinds of goods and services that consumers buy.

A cumulative GNP loss of $18 billion would produce a loss in Federal revenues of about $4 billion. There would be added outlays for unemployment compensation of some $3 billion, and other increases in outlays associated with higher unemployment, which are difficult to estimate. These include outlays for food stamps and other welfare programs, and some increases in outlays under various Federal retirement programs. In terms of net budgetary effect, then, a $9.6-billion defense spending cut would be offset by a $4 billion revenue loss, some $3 billion in additional outlays for unemployment compensation, and other outlay increases of the type just mentioned.

Alternatives

If our economy were at full employment, defense spending would amount to about 5% of GNP -- the lowest share in 28 years, and very nearly the lowest share since before Pearl Harbor. With the economy at full employment, the burden of defense would be very clear: we would have to give up 5% of our real buying power, 5% of the income we could otherwise use for different purposes, in order to provide for defense. The programs proposed for FY 1976 are fully warranted on national security grounds and would be so warranted even under full-employment conditions -- that is, under conditions where we would clearly have to forego other things in order to provide for defense.

But the economy is far below full-employment today. We will lose an estimated \$244 billion of production in FY 1976 due to unemployment, \$249 billion in FY 1977, and \$235 billion in FY 1978. It is against this backdrop that we must assess a proposal to reduce the defense budget, and thereby government and industry payrolls, by such a large amount as \$9.6 billion. Considering multiplier effects, as we noted, such a cut would cause a GNP decline of some \$18 billion. At full employment, we could expect that a \$9.6-billion reduction in defense -- whatever its military consequences -- would at least mean that we could have \$9.6 billion more for other purposes. That wouldn't apply under present conditions: we would have \$9.6 billion less for defense, and \$8.4 billion <u>less</u> for other purposes.

Some insist that we could more than make up for that \$18 billion in lost GNP by transferring \$9.6 billion from defense to other programs. Two questions are pertinent: First, how sure can we be that we could equal or exceed that \$18 billion decline in GNP by further increases in nondefense programs? Second, assuming that \$9.6 billion in additional spending for certain domestic programs would create more than \$18 billion in GNP growth, why is it necessary to reduce defense programs, specifically, to free up the \$9.6 billion?

As to the first question, a number of allegations have been made recently to the effect that defense spending creates fewer jobs than other types of public spending. These allegations involve misuse of various data prepared by the Bureau of Labor Statistics. On the average, using comparable data and consistent methods of measurement, the number of jobs per billion of defense spending is about the same as for nondefense public spending, Federal, state, and local. We have checked this point in detail with the Bureau of Labor Statistics, and they concur in this assessment. In this connection, it is important to consider some practical aspects of defense and nondefense spending. As to defense, the \$9.6-billion reduction under discussion would be virtually 100% payroll. Consider the pattern of Federal nondefense spending (excluding debt interest):

- 56% goes for Federal transfer payments to individuals. About half of this is for social security. The remainder covers medicare and medicaid, unemployment assistance, veterans benefits, Federal Employee retirement, food stamps and other public assistance, railroad retirement, and housing payments.

- 19% is for direct payroll and industry purchases -- that is, it has an economic impact equivalent to the defense increment we are discussing.

- 23% is for grants to states and local governments. Of this, about 1/3 is then transferred to individuals, and about 2/3 goes for direct payroll and industry purchases.

- 2% is for lending, financing, and other transactions.

When one speaks, then, of offsetting the economic impact of defense cutback by further increases in other types of Federal spending, it makes an immense amount of difference what type of other spending he is talking about. Note, for example, that 56% of nondefense spending goes for transfer payments. Suppose, for example, that there were $10,000 available to spend, with a choice between (a) hiring an additional employee or (b) increasing the payments to a certain group of civil service retirees. If the latter course were chosen, there would be no additional direct employment, but some additional indirect employment as the retirees spent their additional income. In the first alternative, there would be one additional job to begin with (the employee that was hired) plus indirect employment as he spent his additional income. In the short run, the employment impact of direct hire is much greater than that of transfer payments.

About 23% of nondefense Federal spending is for grants-in-aid to state and local governments, and most of the proposals for expanded public service jobs would follow that route. Several factors should be considered. Timing is a significant factor. It's also necessary to consider how much of any additional spending would create net additional jobs, and how much would be necessary to pay people already employed, or to forego tax increases or bond issues. Cuts in the defense budget will begin having an effect upon payrolls almost immediately, and this will build to a peak by the summer of 1976.

We cannot assure ourselves that increases in spending for domestic programs will take up the slack fast enough to prevent a further increase in unemployment. Some have observed that 133,000 public service jobs can be created per billion of spending, and contrast this with a much smaller number, such as 60,000, for defense. The implication is that for every billion shifted from defense to nondefense we can increase employment some 73,000. However, these figures involve a comparison of entry rates of pay for nondefense with average rates of pay for defense. The defense figure, moreover, includes industry employment, and each billion of purchases has been discounted about 1/3 to cover depreciation, interest, taxes, and profits. If we correct for these factors -- compare entry rates with entry rates, and payroll dollars with payroll dollars --

the difference disappears. The regular military compensation (basic pay, quarters and, subsistence allowance, and tax advantage) for an E-1, the entrance enlisted grade, will be $6,387 in FY 1976, counting a 5% raise next October 1. The entrance civil service compensation averages about $7,600. That amounts to about 157,000 jobs and 132,000 jobs per billion, respectively. If one is considering changes in defense programs, these are the pay rates that are important because, for reasons already discussed, changes in employment (up or down) tend to occur, initially, at approximately the entrance rates of pay.

As to the first of the two questions: -- how sure are we that we could offset defense employment cuts by increases in other programs? -- there must be some very strong doubts. The employment impact of a significant defense cutback would be large, immediate, automatic, and assured. There are many uncertainties, and many possibilities for leaks and lags, in the areas of domestic spending that some would propose to offset the defense cutbacks.

That leads to the second question. Suppose that there were a $9.6-billion package that was equivalent to defense spending in terms of economic impact, which could be implemented quickly enough to offset the defense cutback as it occurred. Why would it be necessary to cut the defense budget to place such a program into effect? Many billions have been pumped into programs, and further billions are under consideration, which do not begin to approach defense spending in terms of employment and overall economic impact. Nondefense Federal spending (excluding debt interest) was estimated at $241 billion for FY 1976 and could well reach $290 billion if the budget total approaches $400 billion. That would be an increase of $50 billion from the February 1975 estimate, and an increase of $75 billion from the FY 1975 level. These spending increases, combined with large tax reductions, could easily produce a deficit of $100 billion -- double the estimate of last month. Total U.S. public spending (Federal, state, and local, net) will probably exceed $600 billion in FY 1976, up about $110 billion from the FY 1975 level. Nondefense spending will rise by over $100 billion, an increase for a single year that's greater than the total defense budget.

Thus, there are many billions in that array of spending increases which cannot remotely match, dollar for dollar, the employment and economic impact of defense budget reductions. There are obviously programs in the domestic sector which have a significant employment and economic impact. However, considering total government spending, it is not axiomatic that the defense budget must be cut to make room for growth in such areas.

Nor can we avoid considering the serious further deterioration in our national security posture which such a sharp cutback would entail.

Even if we could create new jobs in other sectors to match the numbers of workers who would be idled by a defense cutback, the programmatic question remains. Would the tasks that these people would be performing be of sufficient worth to offset the consquences of a sharp further cutback in our military strength?

If the defense budget is reduced by $9.6 billion, that will mean a real-term reduction of some 6% from the depressed level of FY 1975. It will continue the downtrend in our real level of defense effort, in the face of a steady Soviet uptrend. In a few years, these trends would lead to a Soviet edge of 2-to-1 in the real level of defense effort. Such a shift in the military balance, somewhere along that trend line, would produce a fundamental change in the international order -- a matter of the greatest consequence. The matter would be grave enough if we elected to follow such a course in the interests of our short-run economic well-being -- if we chose to devote less resources to defense so as to have more for other purposes. In the present instance, we wouldn't have even that excuse. Because if we cut the defense budget under present circumstances, we shall not have more for other purposes -- consumer spending and the rest. We shall have less. Some would advocate a $10-billion cut in the defense budget at a time when we have some $250 billion in productive capacity that we are not using. The implications of this, in terms of our capability to maintain the military balance over the years ahead, would be grave indeed.