Testimony
House Arm Services Committee
Hearings on Economic Consequences of Defense Sequestration
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My name is Peter Morici, and I am an economist and professor of international business at the University of Maryland. Prior, I served as Director of Economics at the United States International Trade Commission. I thank you for this opportunity to testify on Economic Consequences of Defense Sequestration.

Today, I would like to discuss with you the broader economic consequences of further cuts in U.S. defense spending, as opposed to specific industry or regional impacts. These are largely systemic.

Should the United States fail to maintain military strength necessary to meet its international security responsibilities, as well as those that may be posed by a surging Chinese presence in the Pacific, the international economic institutions that define the rules of the game very likely will change in ways more hostile to American economic institutions, political culture and values, diminishing prospects for U.S. economic success and independence.

The United States offers the world a clear prescription for economic prosperity and the protection of human rights—free markets and democracy. Yet, with the U.S. economy withering and the U.S. ability to project power prospectively diminished, U.S. prescriptions appear increasingly less efficacious abroad.

China offers the world a very different model for economic development and personal security. Its autocratic government intervenes considerably in economic decisions to promote wide ranging development goals, and it limits personal freedoms to ensure domestic order and stability. “Occupy Wall Street” would almost certainly not be tolerated in China and would likely not be permitted to emerge with Beijing’s tight censorship of internal communications. Suppression of such movements supports its strategy for tight economic management, quite in addition to maintaining the Communist Party’s grip on political power.

China openly flaunts the letter and spirit of international economic rules intended to foster free and open markets, and severely limits intellectual dissent. With its state-directed economy growing at breakneck speed and America struggling, a U.S. failure to maintain a military adequate to meet China in the Pacific will almost assuredly result in other emerging nations embracing, albeit reluctantly or enthusiastically and in varying measure, China’s model for economic development and governance.

International institutions—like the WTO—are consensual, and interpret and make new rules by consensus. Perforce, those rules will follow the tide of sentiment among more successful nations, and the United States and its Atlantic allies will become more isolated and somewhat marginalized. History teaches power balances do change, and often losers are preoccupied with internal squabbling and chaotic dysfunction, and ultimately surprised.

Without a strong economy and military capable of meeting the emerging challenge posed by China in the Pacific, American values and the U.S. economy cannot succeed.

Origins of Budget Challenges

During the closing days of World War II the United States—in partnership with Britain, Canada and others—crafted an international economic system intended to promote democracy and economic globalization. The premise was clear—democracies, integrated by trade and investment, would be much less inclined to war. Military competition would be replaced by economic competition.

On the economic side, the United States encouraged the formation of the European Community, which grew into the European Union, and promoted globalization through the WTO, IMF, World Bank, and regional and bilateral trade and investment agreements. The West—as defined by the OECD economies—is so intensely integrated today that the notion of armed conflict among those nations is absolutely absurd.

On the political/security side, the United States became the *de facto* global defender of free markets and democracy by forcing the permanent disarmament of the third and fourth largest economies—Japan and Germany—leaving only stalwart foes—China and Russia--as potential challengers on the global stage.

Victory in the Cold War—without comparable contributions from the Japanese and German economies—came at a heavy price. And now, dealing with global terrorism and a more muscular China poses new perils and costs that Americans, weary of leadership, seem unwilling and perhaps unable to bear.

Successive rounds of GATT/WTO negotiations substantially liberalized trade among the OECD nations, and granted preferential market access in advanced industrialized countries to developing regions. Through special and differential treatment the latter economies have generally obtained open access to the United States, Canada and EU but are permitted to maintain high tariffs and administrative barriers to western exports, and subsidize domestic industries in endlessly imaginative ways.

Through the 1990s, the North American and European economies were so much larger and stronger that they could afford to give away industrial activities and jobs, even when the dictates of sound economics and comparative advantage would indicate wiser choices, to promote development in less fortunate areas of the world. However, the emergence of China, and to a lesser extent India, Russia and Brazil, has changed all that.

By virtue of China's size and ambitions to exert greater influence in the Pacific and to change the rules of international competition, this calculation about the relationship between western and developing nations becomes patently false and foolish.

China abuses the WTO system and flaunts free-market principles with high tariffs and domestic institutions that systematically block U.S. and EU exports, aggressive subsidizes for domestic industries, intervention in currency market to ensure an undervalued yuan and artificial cost advantages for its goods, and unfair rules for foreign firms that establish production in China to sell there.

All of this has imposed a large and growing bilateral trade imbalance that destroys millions of U.S. manufacturing jobs, transfers valuable U.S. technology cheaply to China, greatly diminishes U.S. R&D, educational attainment and potential growth, and makes the United States less capable of maintaining defense capabilities necessary to meeting its security obligations and accomplishes its legitimate security goals.

Successive Administrations have tried diplomacy to open Chinese markets and end currency manipulation and mercantilism more generally, but when rebuffed, they have cautioned Congress against concrete action, and pursued more ill-fated diplomacy.

Large American multinationals, which have invested in China to serve the market, have become clients of Beijing's protectionism. Invested in Middle Kingdom mercantilism, they council Presidents and Congressional leaders against taking concrete measures to counter China's unfair practices—to the point of even denying members of Congress the opportunity to vote on such measures. Those actions of self-directed capitalism have broad consequences for the health and vitality of the U.S. economy and ultimately national security.

On the global stage, failure to meaningfully confront Chinese mercantilism, after diplomacy has failed over and over again, makes the United States appear foolish, weak and inept, a civilization overtaken by one with a better economic model and a more competent government.

Domestically, the United States has needlessly increased its dependence on expensive foreign oil by failing to develop abundant domestic resources and implement more effective conservation measures. Failure to develop domestic energy creates ***no*** environmental benefits. It merely shifts the drilling to the Persian Gulf and other unfriendly venues where environmental risks are no better managed, and helps finance global terrorism. It is a fool's journey into the darkness.

Economists agree: the U.S. economy can't get out of its funk and grow robustly, not because Americans can't make things cost effectively and well, but because demand for what they make is inadequate.

There is no mystery about it. The trade deficit with China and on oil account for the nearly the entire $550 billion U.S. trade deficit, this deficit poses a significant drain on the demand for U.S. products and is the single the largest barrier to economic recovery.

President Obama has said on more than one occasion China's currency policy hurts the U.S. economy and slows its recovery. The reasoning is simple. Every dollar that goes abroad to purchase Chinese consumer goods that does not return here is lost purchasing power that could be creating jobs. The same applies to high priced oil.

Cutting the trade deficit in half would jump start the U.S. economy, create up to 5 million jobs and lower the unemployment rate to about 6 percent. Without confronting Chinese currency manipulation and broader protectionism with concrete actions and without raising domestic oil production from less than 6 million barrels a day to 10, the U.S. economy won't grow fast enough, and taxes will be inadequate to finance an adequate defense and vital domestic services.

Simply, the trade deficit—China and oil—is as much responsible for the U.S. budget crisis—through slow growth—as overspending and other cost issues.

Cost Issues, Overspending and Popular Myths

The U.S. economy and government faces cost issues too. The U.S. health care system is more expensive and provides less favorable outcomes than more cost effective private systems abroad, for example in Holland and Germany. Much the same may be said for U.S. education.

Health care and education are hugely uncompetitive by global standards, and account for huge portions of combined U.S. federal, state and local spending. Most recently rising health care costs, coupled with a shrinking private sector and tax base, is now crowding out education spending.

Together with rising Social Security outlays, mandated by an unrealistic retirement age fixed at 66, the outsized cost of health care and education have required curtailing basic government activities and targeting for cuts spending categories the United States simply must undertake to compete.

Funds are lacking to adequately maintain roads, bridges and waterways, and to replace National Weather Service satellites essential to monitoring and forecasting severe weather. And, the United States has ceded manned space flight to China and Russia.

Advocates of the burdensomely inefficient health care and educations systems have perpetuated the ***myth*** that too much defense spending is the problem—that is simply not the case.

In 2007, with two wars raging and the Bush tax cuts in place, the deficit stood at $161 billion, while in 2011, it will be about 1.3 trillion. Total government outlays are up about

$847 billion, when no more than $62 billion are necessary to accommodate inflation. How can defense spending—with a baseline budget of $553 billion in 2011—be responsible? It only accounted for about 11 percent of the $847 billion increase.

Moreover, if Congress would simply cut by half the additional spending since 2007, it would accomplish a total of more than $4 trillion in budget reductions over ten years.

The ***myth*** also persists that the United States spends too much on defense and winding down the wars in Iraq and Afghanistan will create great dividends. It won't. Congress may have appropriated funds for those wars, but it is clear those wars, as well as other conflicts, have been even more expensive that those budget outlays indicated.

U.S. defense systems are aging and becoming less functional and effective. Examples have been cited of sons manning fighters once flown by their fathers. Ask yourself how effective your staffs would be with 15 year old computers and if you would want to fight a cyber attack with such antiquated hardware.

And defense capabilities are thinner. The number of USAF fighters is down form 3602 in 2000 to 1990 today, and will be reduced to 1739 at current funding levels. Navy ships are down from 316 to 288, and will have to be reduced to 263 at current funding levels. Sequestration would require cutting these figures even further and reducing the number of Army maneuver battalions by 30 or 40 percent.

Changes in the nature of threats and the global economic power balance—who will have economic power—will require more not fewer resources to protect U.S. strategic interests and preserve the influence of U.S. values—democracy and free markets—in the world.

Cyber warfare and arming China, which is building a blue water navy to challenge the United States in the Pacific, do not shift U.S. security challenges from one venue to another but rather add to those challenges. For example, U.S. and allied dependence on Middle East oil will continue for at least another generation—even with best efforts to develop domestic fossil fuels and alternative energy resources—and U.S. naval assets cannot be depleted in the Gulf Region to counter a Chinese buildup in the Pacific. Moreover, economic and political upheavals in Europe and North Africa will make the U.S. naval presence in the Mediterranean and North Atlantic even more vital.

The ***myth*** persists that China will not be able to challenge the United States anytime soon. After all China's ***reported*** military expenditures—at current exchange rates—is only about 17 percent of U.S. baseline outlays, but China does not have troops, aircraft and naval assets tied up around the world with established commitments. Moreover, China's currency is widely acknowledged to be undervalued, making comparisons of spending at current exchange rates deceptive.

Using IMF Purchasing Power Parity exchange rates, China's ***reported*** military spending in 2011 becomes $148 billion or 27 percent of the U.S. base budget. Based on the growth of spending over the past two years, with sequestration, China's military spending would be 37 and 43 percent of U.S. levels in 2013 and 2015, and 66 percent in 2021. Without sequestration, it would still be 60 percent of U.S. levels in 2021 and could effectively match U.S. spending in the late 2020s.

Also U.S. budget problems are much worse than Congress anticipates. The President's February budget assumed economic growth in the range of 4 percent for 2011 to 2016. Even in the more euphoric days of 2010, private sector economists were not assuming those kinds of figures.

Even if the Joint Select Committee reaches a consensus on budget cuts acceptable to both chambers, slow growth will compel another budget crisis after the 2012 election and then others further down the road.

Hard Realities

America must address the world as it finds it, not as intellectuals and advocates tell us it should be.

Hard reality number one is the interactions between the health of the U.S. economy and these budget discussions are disquieting.

The United States is not in a Greek spiral—at least not yet—but cuts in defense and nondefense spending will slow growth at a time when demand for what the private economy produces is weak and a second recession that could thrust unemployment into the teens threatens. Most certainly, budget cuts will breed slower growth, lower tax revenues and the need for more cuts, until Washington finds ways to get the private economy growing.

If Washington can't find a way to instigate private sector growth—specifically, if it can't muster to challenge Chinese mercantilism and unleash development of domestic energy resources—and the nation continues on the assumption that budget deficits can be tamed with large contributions from defense, real effective Chinese defense spending will surpass U.S. defense spending in the next decade.

The United States has many established assets—ships, planes and such built in the past—that will continue numerical superiority in the ability to project power, but those will be increasingly old assets or the numerical superiority will decline more rapidly from retirements of assets. China's assets will be newer and growing in number.

The ***myth*** persists that China's military will be technologically inferior for a long time. Don't bet on that if the U.S. industry and R&D keeps moving to China through investments by GE and others, and the U.S. hollows out its defense industrial base through program cuts to meet unrealistic budget targets.

Slashing defense spending because the Congress can't agree to confront Chinese mercantilism and develop domestic energy to rekindle economic growth, and to cut and reform the domestic spending that has built up over the last four years, and the tables will turn in the Pacific sooner than you think.

Then, China's violation of the norms and rules of the economic system put in place by the United States and western powers after World War II will spread like an epidemic through the developing world, troubled places in Southern Europe, and so forth.

China's mercantilism, anti-democratic values and soft approach to civil and human rights making will be seen an attractive comprehensive package, necessary for ensuring economic prosperity and personal security. The rules of the game, as defined by international institutions, will follow those broader sentiments, and Americans and their values and institutions will become isolated and unable to compete.

America will be more isolated and dramatically weakened. Marginalized, it will resemble Italy ***or*** Greece. Charming and quaint but hardly able to independently sustain its standard of living or ensure its own security, ***or*** worse bankrupt and at China's doorstep for a bail out.