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Economic Impact of Defense Budget Cuts

One purpose of the Reagan defense program is to improve the defense industrial base.

- We need to strengthen our defense industries in order to compete with the Soviets in strategic, conventional and power projection forces.
- The industrial base is now seriously deficient. Defense industrial capacity as a share of U.S. economic activity is now only half as large as in the pre-Vietnam era (see Table 1). Employment in the defense industries has dropped by 20 percent in the past 15 years. Moreover, there are major shortages in the supply of key components and raw materials.

A strong commitment by the Administration to sizable, sustained growth in military spending will contribute to strengthening the defense industrial base and to overall economic recovery:

- The prospect of an increased long-term Government demand for military hardware will stimulate investment and increase employment in defense industries.
- It will also encourage expansion in key supporting industries -- capital goods, electronics, semifinished and raw materials.
- But if the business community doubts the seriousness of the Administration's commitment, the incentives for new investment will be greatly reduced. The perception of a fluctuating (rather than a steadily increasing) demand for defense goods would be particularly damaging.

Defense spending has a different kind of economic impact than other Government expenditures have:

- It creates more direct demand for real goods and services. Defense accounts for nearly three-quarters of Federal Government purchases, but only about one-quarter of the federal budget.
- About 40 percent of each defense dollar is for hardware; only 5 percent of non-defense Government spending goes for direct purchases from industry.

The reduction in defense spending proposed by OMB would be costly in terms of revitalizing the industrial base:

- It could reduce employment in defense and related industries by more than 200,000.
- It would primarily affect procurement of weapons, reducing incentives for new capital investment and increasing unit costs by cutting production runs.
- It could lead to actual reductions in capacity in such critical industries as shipbuilding.

Table 1Defense Shares of U.S. Economic Output (Percent)

	<u>Pre-Vietnam</u> <u>(1965)</u>	<u>Current</u> <u>(1979-1980)</u>
GNP	9	5
Industrial Output	18	8
Electrical and Electronics Industries	22	11
Transportation Equipment (Excluding private automobiles)	55	38

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Next 4 Page(s) In Document Denied