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# MACROECONOMIC STRATEGY IN WARTIME

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## Abstract

In 2001–02 the United States has been hit by two quite different shocks, terrorism and recession. As usual in time of war, national defense is the highest priority for use of the country's resources. Although the opportunities for international warfare are limited, the challenges to the homeland are virtually unlimited. The president's fiscal year 2003 budget includes \$48 billion additional for the military and \$38 billion additional for homeland defense. Given the gravity of the threat, it is hard to understand why new expenditures are not undertaken as soon as and as large as possible. This would also be timely for stimulus to the economy, more effective than tax cuts and other proposals — with the nation in peril, the country is ready to make sacrifices, not to enjoy further tax reductions. Pearl Harbor in December 1941 occurred with the economy not yet recovered from the Great Depression, with unemployment still 10 per cent. Expenditures for war were increased sharply and rapidly, and full employment was restored in 1943.

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The US economy suffered two quite distinct shocks in year 2001. First was the business cycle recession, raising unemployment from four to six percent and depressing production, prices, incomes, and asset values — familiar events which Americans had been spared most of the previous decade. Recovery is coming, it is generally agreed, revival of Demand for goods and services by consumers, businesses, governments, and foreign customers. Supply is no problem. The nation has the workers, materials, productive capacity and technology to respond to much higher demands.

How stimulate spending? By still lower interest rates? The Federal Reserve cut its key rate eleven times last year, from 6 percent to 1.75 percent. Or should the Fed husband those remaining 175 basis points of the Federal Funds rate for possible future needs? It seems weak strategy,

deliberately keeping monetary policy too tight. To avoid a liquidity trap, the Fed should try to lower longer term rates and loosen bank credit.

By cutting taxes again? A large cut, estimated to add up to \$1.6 trillion in this decade and permanently to deprive the federal government of two of the 16 percentage points of national incomes it now collects. Later last year refunds of \$300 per federal income taxpayer were distributed. Debate continues on further federal fiscal stimulus to demand.

The second blow was the terror of September 11, wholly beyond expectation and experience; it is still potentially terribly dangerous and costly. The worldwide war against terrorism and the protection of the homeland are the highest priority uses of the nation's resources today. President Bush has proposed in his budget for fiscal year 2003 (which begins October 2002) additional military spending of \$48 billion (about 1/2 of 1 percent of GDP) and new outlays of \$38 billion (4/10 of 1 percent) for homeland security. To protect the American people against terrorist attacks, to the degree of safety we took for granted before September 11, if at all possible, will take large expenditures for many years. At stake are buildings, airways, railroads, ships, ports, communications, theaters, stadiums, utilities, highways, bridges, public health, mail deliveries, . . . almost every aspect of civilized life.

Why does the President delay acceleration of appropriations and spending for war on terrorism and homeland security until next fiscal year? Start now! By fortunate happenstance, these measures would also be very good anti-recession demand stimuli. Other stimuli, most of those debated by President and Congress, would contribute nothing to the nation's prime priorities. Indeed dollar for dollar government purchases of goods and services augment demand more than the tax cuts and dollar subsidies generally discussed, of which the recipients will generally choose to save at least part. And of course the direct demands of government are followed by the further spending of those who receive income by meeting the governments' needs — the once famous Keynesian multiplier.

The urgency of action on homeland security is especially great because much of the agenda

is the job of state and local governments. The challenges and opportunities for these governments are critical. They will need to cooperate with each other and with the federal government. Yet the recession has drastically cut state and local revenues, while their politics and constitutions keep them from borrowing. President Bush and his Homeland Director should engineer generous new grants to state and local governments, meeting their regular responsibilities as well as the new needs of homeland security. It is important to sustain Medicaid and to attach to it financing of prescription drugs.

Further tax giveaways to individual and corporate taxpayers would be most inappropriate at this time. For one thing, it is quite uncertain that much of them would be spent while stimulus is needed. They would be temporary, and the beneficiaries other than the poor and liquidity-constrained might prefer to save funds for the future. Anyway it is an illusion to expect that a temporary burst of spending will jumpstart the economy like an automobile battery or prime it like a pump. The state of American business is probably little different today from what it would have been without the \$300 or \$600 income tax refunds of 2001. More important, the President is calling on the American people to make sacrifices to win the world war and protect the homeland. They are willing, indeed eager. Surely those sacrifices do not include still a third set of tax cuts within this president's young term. At this rate, with tax cuts the invariable prescription for whatever ails the national economy, there won't be any taxes left to cut. The advocates of tax cuts allege that tax rates are the highest in history. But it is illegitimate to count social insurance contributions because these are transfers from person to person and are not used to finance government activities.

President and Congress are right to place the emergencies post 9/11 ahead customary concerns of fiscal prudence, letting the federal budget go into deficit and the federal debt to rise. One function of federal deficits and the path of the debt is to share costs and hardships equitably across generations. It is reasonable to shift some of our present burdens to taxpayers of coming decades. The straightforward way to do this is to offset some of today's urgent expenditures and deficits by suspending some of the tax cuts scheduled for later years in the legislation of 2001.

If 9/11 type disasters had occurred during the full employment, steady growth, and prosperity of the 1990s, then the new demands of war and homeland security would have had the same priority, but the labor and other resources required would have had to be drawn from other uses. That would have entailed tight money and high interest rates and restrictive fiscal policy as well, including most likely tax increases. It would have been painfully obvious, as it is not now, that the disaster imposed sacrifices on the American people. If and when full recovery from the present recession somehow occurs, our economy will be in that situation. The Kennedy–Johnson tax cuts of 1964–65 worked as intended to restore and sustain full employment but they overstimulated demand once the burdens of the Vietnam war took priority. Now too it could easily happen that tax cuts welcome in present circumstances will turn out to be embarrassingly excessive in more prosperous times, given the burdens and threats of terrorism. This is especially true given the political obstacles to raising tax rates once reduced, even when the cuts were initially advertised as temporary.

This is no time for an ideological campaign to reduce the shares of government activity in the economy. Let governments handle the requirements of world terrorism and homeland security they can do best. Inevitably they will buy most of the goods and services they need from the private sector. But if it's better that airport screeners be public employees, so be it.

The attack on Pearl Harbor December 7, 1941 was, like the terrorist attacks of September 11, 2001, a wake-up call, suddenly focusing the nation on its vulnerability to foreign enemies. The President, Franklin D. Roosevelt then, George W. Bush now led the nation's response.

In both cases the economy happened to be performing below par at the time of attack. In 1941 the American economy had still not recovered from the Great Depression of 1929–33. Although the 1929–30 levels of production and income had been restored, unemployment at ten percent remained stubbornly high. A setback to the recovery had occurred in 1937–38. Like George W. Bush today FDR needed both economic stimulus and war fighting. On both counts economic mobilization was the answer, and FDR wasted no time. He asked immediately for new military appropriations of more than \$100 billion, in an economy with 1941 GNP of \$125 billion, of which federal purchases

amounted to only \$17 billion, \$14 billion for defense prompted by worries about Europe.. American industry responded with miracles of innovation and production, notably ships by Henry Kaiser and planes by Howard Hughes. Car and truck factories were converted to tanks and jeeps. The manpower of the armed forces expanded quickly thanks to the draft, selective service already in force. GNP grew by 12 % from 1941 to 1942, 18 percent the following year. By 1943 labor shortage had displaced unemployment, which fell to 4.6 % In 1942 and to 2% the next year. Price and wage controls and rationing were necessary to keep inflation in check. By 1945 half of United States GNP was war production but what was left for civilian use exceeded the whole of pre-Depression GNP.

There can be no doubt that expansion of government spending on goods and services can provide “stimulus” in the process of carrying out the nation’s priority programs. However, maybe the economy needs more demand stimulus than it needs added military spending. This could be a matter of debate. The technology of a two-ocean Second World War is a lot more demanding of manpower and other resources than what we have seen of the international war on terrorism. Perhaps this will change drastically by taking seriously missile defense, dear to the president’s heart. Otherwise homeland protection would be the main challenge and stimulus.