TOWARD A PEACETIME ECONOMY

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PREFACE

This study is designed to present an introduction to the subject of public planning in a peacetime economy. It is hoped that the information contained in it will be useful for policymakers concerned with the role of the national space program in a post-Vietnam context.

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"Is war necessary for the American economy?" "Could the United States afford disarmament?" Despite many setbacks, public and professional interest continues to be devoted to these vital questions. Some positive accomplishments tend to reinforce that interest. The nuclear test ban treaty was signed. A direct communications link (the so-called "hot line") between Moscow and Washington was established. The United Nations did adopt a resolution against weapons in space. The Antarctica Treaty was approved, setting that continent aside as a military-free science preserve.

The trend of international relations has not, of course, moved steadily toward the lessening of tensions. The expansion of the U.S. commitment in Vietnam is a current and strong reminder of the underlying external pressures for raising rather than lowering the level of American military preparedness. Nevertheless the subject of peace is one that continues to receive very considerable attention in the United States. For example, one of the most widely publicized sessions at the annual meeting of the Economics and Allied Social Sciences, held in Washington, D.C. in December 1967, dealt with "Economics of Arms Control and Disarmament".

Most of the studies of the economic importance of military programs yield optimistic results. In fact, the vast majority conclude
that war is not necessary for the American economy, living standards and growth rates would be higher in a peacetime environment than if military spending were to continue at high levels.

Unquestionably, any major program of arms reduction or disarmament in the future will give rise to short-run difficulties and immediate problems of economic adjustment. However, most professional studies show that these problems are not insurmountable nor are they novel to the American economy. After World War II and the Korean War, defense spending and military manpower were rapidly and successfully rechanneled to peacetime needs and pursuits. In addition to these postwar adjustments, the U.S. economy has constantly undergone transitions in a wide range of industries affected by changing technology and economic demands. Nevertheless, it is well understood that any transition to a more peacetime economy will not take place overnight or of its own accord. The United States, while working for an international disarmament agreement, is also making economic plans to ease the changeover to non-military production.

Previous Studies

A general disarmament agreement probably would create momentary apprehension concerning its potential economic impact in the United States, as well as in other nations. The effect, of course, would be felt first in defense industries and by defense workers and their communities. To dispel such fears, as well as to help develop appropriate policies for handling the serious problems involved, the U.S. government in 1961 established a Panel on Economic Impacts of Disarmament. This panel, whose members were economic experts drawn from universities, business, labor and government, concluded
that the nation could adjust its economy to any new situation created by a disarmament agreement.

The panel foresaw little danger that the adoption of the U.S. Program for General and Complete Disarmament, submitted to the United Nations, would provoke an economic depression. However, it stressed that advanced planning by government, business, labor, and other private organizations is required if the economy is to adjust smoothly to significant changes in military spending.

The group detailed the problems that would arise for individuals, companies, and communities heavily dependent on defense spending. It also described the types of action that would be necessary to overcome these difficulties. Pertinent measures include: (1) providing assistance for the retraining, temporary support, and relocation of defense workers, servicemen and their families, (2) re-converting and diversifying business enterprises previously engaged in defense work, (3) promoting the importation of new industries into areas hard hit by closing of defense plants and installations, and (4) initiating new publicly supported programs of national importance which could use existing defense resources, particularly in the fields of research and development.

While the U.S. disarmament panel was making its study, the Consultative Group to the Secretary-General of the United Nations was also at work on the same subject. Findings of both groups were reported within a few months of one another. The U.N. committee consisted of distinguished economists from 10 nations. Among the representatives were V.Y. Aboltin, Deputy Director of the Institute of World Economics and International Relations in the Soviet Union;
Oskar Lange, Chairman of the Economic Council in Poland; Wassily W. Leontief, Professor of Economics at Harvard University in the United States.

The findings of this body are especially noteworthy because they reflect an international viewpoint: "The Consultative Group is unanimously of the opinion that all the problems and difficulties of transition connected with disarmament could be met by appropriate national and international measures. There should thus be no doubt that the diversion to peaceful purposes of the resources now in military use could be accomplished to the benefit of all countries... And achievement of general and complete disarmament would be an unqualified blessing to all mankind."

Subsequently, at the request of the Secretary General, many members of the United Nations submitted material for consideration by the Consultative Group. The United States' study for the U.N. gave full recognition to readjustment problems that would follow disarmament, but page after page showed that the transfer of defense funds to commercial channels and publicly useful projects was not only highly desirable, but that the labor and capital formerly used in defense work could be absorbed without major economic reverses.

The materials submitted by the Soviet Union were also optimistic. The report asserted that to change from military to non-military production would present no economic problems for socialist countries. "Nor are there any insurmountable economic obstacles," the report continued, "to disarmament for the capitalist countries, including the United States."
Since the appearance of the U.N. report in early in 1962, the U.S. government has actively pursued a number of programs, aimed at alleviating already existing problems in the American economy, which could be adapted and expanded to cover specific problems arising from disarmament. These include retraining and relocating workers affected by automation or shifts of consumer demand, expanding and diversifying the industrial base of low income areas, and fostering research and modernization of some technologically backward industries.

**Earlier Defense Cutbacks**

Historical experience testifies to the ability of the American economy to respond in a healthy way to major reductions in defense expenditure. Although many observers doubted the ability of the U.S. economy to demobilize without serious problems after World War II, the transition took place swiftly and the country went on to the highest peak of prosperity in its history.

During World War II, defense outlays accounted for over 40 per cent of Gross National Product. In 1945 and 1946 military spending was reduced by 80 percent, a far more rapid reduction than envisioned in the step-by-step disarmament proposals currently being considered in the United Nations. This reduction was equivalent to about 30 percent of the GNP of the United States in 1945 and it is three times the present percentage of defense to GNP.

From June 1945 to June 1946 over nine million men were released from the armed forces, almost three times the present total of U.S. military personnel. Despite the size and pace of the post-World War II demobilization, unemployment immediately following the war rose only one and a half percentage points.
While defense spending fell, business investment more than doubled, and consumer outlays and non-defense government programs increased to fill much of the gap. The overall atmosphere of optimism within the country was sustained by the purchasing power and demand for goods which had accumulated during the war. The net result was that, despite the massive decline in military spending, the after-tax income of individuals actually rose immediately following the war.

U.S. reduction of military spending after the Korean conflict ended in 1953 was equally well absorbed by the economy. Tax cuts were again effective in maintaining consumer income and spending. By 1955, the overall level of economic activity had completely recovered, advancing to record levels. Unemployment did rise moderately in 1954, but then it declined significantly in 1955.

More recently, the leveling off in the total of defense spending in 1963-64 was accompanied by an actual rise in the national employment rate, indicating the continuing capability of the American economy to adjust rapidly at least to moderate declines in national security expenditures.

**Shifting to Peacetime Production**

Despite the record prosperity and affluence which the United States enjoys today, the recognized but unmet needs and desires of the expanding American population are so extensive that they could more than offset the loss of income and employment resulting from a major arms reduction or disarmament program. An important and obvious tool again would be a reduction in federal tax rates. Purchasing power made available to individuals and business firms by reducing
taxes would go into capital investment and current consumption. This approach was used successfully in 1964 and coincided with a reduction in the defense budget and curtailment of atomic energy operations.

There is no lack of projects to absorb the shift from defense to non-military production. On the one hand, American families have shown an increasing desire for more and better quality food, clothing, housing, recreation, health and higher education. On the other hand, there is a rising community need for better roads, urban renewal, area redevelopment, public health and other social services. The first type of demand is encouraged by tax cuts, the second by government spending. The problem is to find a proper balance.

The expansion of the federal government's civilian expenditures has tended to be confined by the large investment in defense needs. But the rapidly rising population of the United States continues to require rising amounts of basic facilities and services. For many of these programs, even when conducted by the state or local governments, financial assistance from the federal government seems to be increasingly necessary. For example, to accommodate the number of students anticipated by American colleges and universities in the coming decade, given the present ratios of classroom space and number of teachers to students, will require an increase in the current rate of expenditures by over twice the present level of $10 billion a year.

The key problem of adjusting to a peacetime economy would be to move rapidly enough to forestall a short-term economic recession.
Converting Defense Industries

Under the American system of free enterprise, the job of converting industrial production from defense to civilian uses would fall heavily on the private business firms who presently manufacture equipment for the armed forces. But making a changeover would not be new in American business and the problems would not differ basically from those which continually arise in a free economy. Today, as a matter of course in the business world, companies are constantly studying trends which will affect future demand for their products. Consumer demands change, population grows and shifts, and new technology replaces the old. On the basis of long-range studies of such problems, industries establish their research, development, and production programs. Many corporations involved in defense now devote special attention to planning for the specific problems of switching to products suitable for civilian use. Results are already evident.

The Boeing Company has adapted its military aircraft design and production capability to civilian aircraft production; airline fleets all over the world now use Boeing jet airlines and the company's commercial work now exceeds its total volume of war production. The McDonnell-Douglas Corporation, another giant of the aerospace industry, provides computer services to local educational institutions and many nondefense business firms. A recent example is helping junior colleges schedule classroom utilization and process student registration so as to increase the effectiveness of existing school facilities.

Other defense companies are helping hospitals with their paperwork problems, health departments with their administrative workloads,
and highway agencies with their long term planning. Such diversification efforts serve two purposes. First, they represent civilian benefits of the investment in military technology. Secondly, they reduce the dependence of individual defense plants, and their employees and communities, on military work.

Local governments have encouraged such efforts. The State of California awarded a series of contracts to local defense companies to encourage them to channel their efforts to air pollution control, social welfare problems, and other non-defense questions.

Colleges and universities, research institutes and private civic groups in many other states support similar projects. In fact, the economics of disarmament is a growing area in academic research with many scholars currently engaged in both theoretical and applied studies.

**Adaptability of American Labor**

The demonstrated flexibility of the American work force is one of the nation's major assets in adjusting to economic change. This would be true whether the need for change arises from the development of new industrial technology and shifts in civilian demand, or whether it is caused by defense mobilization or disarmament. Over the years, workers have moved voluntarily from one part of the United States to another. Many moves are to nearby areas, but others are over long distances. The increased population of the three Pacific Coast states from 1940 to 1960 is ample evidence of this shift. California's population, for instance, more than doubled -- rising from less than 7 million to over 15 million.

The experiences at specific defense plants in recent years is
both heartening and indicative of future trends. A survey of the persons laid off by the Boeing Company following the cancellation of the Pentagon's Dyna-Soar project revealed that the great bulk of employees quickly obtained positions with other private industries or with government agencies, research institutes or colleges and universities. Generally, the average salaries obtained by the newly rehired former defense workers were higher than what they were paid previously for doing military work.

Similar optimistic findings were reported by surveys of the former employees of the Martin-Marietta Corporation in Denver, Colorado, when missile production was terminated there. Analogous results were reported when the Republic Aviation Corporation in the New York area ended its production of military aircraft.

Some perspective is also helpful. The outlays of the Department of Defense only account for less than one-tenth of the Gross National Product of the United States and for a smaller proportion of the labor force. From a geographic viewpoint, most states and metropolitan areas are only slightly affected by the economic impacts of the defense program. Only a handful depend upon it for as much as a sixth of their employment.

A similar situation prevails in the industrial economy. Most large industries find the military market to be a relatively small one for them -- food, clothing, textiles, lumber, furniture, automobiles, mining, construction, machinery, wholesale and retail trade, and service establishments. Even among the biggest defense contractors, the majority look to civilian markets for the bulk of their sales.
Meanwhile, the Department of Defense has been strengthening its Office of Economic Adjustment. This unit was set up in 1961 to assist communities in changing from military to civilian production. Also, the U.S. Arms Control and Disarmament Agency is currently sponsoring a major series of studies dealing with various aspects of the question, how to help individual regions and industries make the successful transition to a peacetime economy.

**Peace in Vietnam**

In his January 1967 Economic Report, President Lyndon Johnson instructed the departments and agencies of the Federal Government to step up their "planning for peace". He specified that they take the following seven actions in order to prepare for reductions in defense spending:

"--to consider possibilities and priorities for tax reduction;
"--to prepare plans for quick adjustments of monetary and financial policies;
"--to determine which high priority programs can be quickly expanded,
"--to determine priorities for the longer range expansion of programs;
"--to study and evaluate the future direction of Federal financed support to our states and local governments;
"--to examine ways in which the transition to peace can be smoothed for the workers, companies, and communities now engaged in supplying our defense needs, and the men released from our armed forces."
Even though peace in Vietnam does not appear imminent, it may be of interest to examine the economic problems that would arise.

It is extremely difficult to speculate as to the nature and dimensions of a cutback in U.S. defense spending following peace in Vietnam and thus of the ensuing problems of economic adjustment. Various "scenarios" are possible, including a sudden oneshot cessation, a phased withdrawal, a decline at the same pace as the buildup, etc. It may useful to examine the most recent comparable experience, the expansion in U.S. military spending for Korea and the subsequent decline.

The Korean buildup lasted approximately three years, defense purchases of goods and services rising from a low of $13 billion in the second quarter of 1950 to a peak of $50 billion in the second quarter of 1953. In contrast to the three year length of the buildup, the cutback to the post-Korean low was achieved in half of that time. Defense purchases declined to $38 billion at the end of 1954 a year a a half later. This low point was, of course, substantially above the level of military spending immediately prior to the war.

By July 1968, the Vietnam buildup will have lasted three years. For purposes of analysis and illustration, let us assume that the war will end on July 1, 1968. Following the Korean experience, it is further assumed that the reductions will take place during the following year and a half and that the new post-Vietnam rate of military spending will continue to be higher than the level existing prior to the Vietnam buildup.

In order to overestimate rather than underestimate the potentially
adverse economic impact of reduced defense spending let us hypothesize that the decline in aggregate military spending will be $20 billion, two-thirds of the estimated aggregate Vietnam increase since the buildup began in 1965. The $20 billion postulated reduction is assumed to be phased out over an 18 month period in the same proportions as occurred during the post-Korean adjustment.

The absolute decline in U.S. military spending in the twelve month period July 1968 to June 1969 would, at initial examination, appear to be quite large, totalling $14 billion for the year. However, in relative terms, this would be a smaller proportion of the GNP than the cutback during the first year of the Korean demobilization -- less than 1.6 percent versus 2.0 percent. Also, the postulated amount of decline is less than the expansion between the first quarter of 1966 and the first quarter of 1967.

Hence, the initial adverse aggregate impact of peace in Vietnam, under the assumptions made here, would create problems of economic adjustment which are substantial, but similar to those which the American economy has successfully weathered over recent years. Certainly, if no action were taken to offset the deflationary impact of a reduction in military outlays in the neighborhood of $14 billion within the period of one year, it is likely that a substantial recession would ensue.

In considering alternative courses of action to deal with the initial economic problems that would arise with peace in Vietnam, it is useful to begin with the list of possible policy actions which is contained in the President's Economic Report.
Tax Reduction

There are many ways of reducing tax rates and thereby pumping additional purchasing power into the economy. Prior to the Vietnam buildup, there had been some public discussion of focusing the next round of tax adjustments on the lower brackets. Such action could have an important income redistribution effect. It would also constitute a decision to emphasize consumption at the expense of investment, insofar as the lower income groups spend an above-average share of their income for current consumption items and save proportionally less.

Conversely, if major attention were given to increasing tax incentives to business investment, this too would be more than a short-term policy to offset the deflationary impact of the military cutback, such action would also reduce or slow down the growth of the public sector and, also, favor investment and a more rapid long-term rate of economic growth at the expense of current consumption and a quick increase in consumer living standards.

Perhaps, an across-the-board reduction in income tax rates would be most neutral in terms of these various considerations. It would mean foregoing many of the other economic policy objectives. Yet, its relative simplicity and neutrality would tend to shorten substantially the lead times involved in preparing detailed Executive Branch recommendations and in obtaining Congressional approval.

Monetary and Financial Policy Adjustments

If there is any lesson to be learned from the economic experience of the Vietnam buildup, it is the need to take prompt action to offset the economic impacts of large and abrupt shifts in military
demand. The key question that would be faced is the appropriate mix of monetary and fiscal policies, such that they independently do not overcompensate nor is the Nation witness to the performance of an act of "After you, Alphonse," "No, after you, Gaston."

Rapid Expansions in Government Programs

There are many types of government expenditure programs which could be expanded in order to absorb the budget savings resulting from peace in Vietnam. Liberalized unemployment compensation, public assistance, and similar income-maintenance types of transfer payments might be among the actions most quickly implemented. However, a wide array of government purchase-type programs is also available and would compete for additional funding.

Of necessity, the latter will be programs already under way and for which expenditures can be increased rapidly. For example, the backlog of authorized civil public works is substantial. It is estimated that, as of June 30, 1968, planning will be complete on projects totalling $3 billion, for which construction contracts could be awarded promptly. For another $6 billion of projects, planning would be under way, but not completed. These funds would cover projects of the Corps of Engineers, Tennessee Valley Authority, General Services Administration, and Departments of Agriculture, Interior and Transportation.

Another category of programs whose expenditures could be increased fairly rapidly would be those using resources similar to those released by the military cutback. Potential possibilities of this nature include civilian space activities such as manned exploration of nearby planets and additional deep space probes,
completion of the development of a civilian supersonic transport aircraft, and advanced research and development projects.

**Long-Run Expansions in Government Programs**

The funds which would be made available from a reduction in military spending in Vietnam also could be used for a variety of government programs, the expansion of which might take considerably longer than either transfer payments or on-going construction projects. In this category of possible longer-run adjustment actions are three major types of programs:

1. Those primarily in the nature of investment in human resources, such as education, training, and health activities.

2. Those designed primarily to improve the physical environment, such as air and water pollution control and housing and urban development projects.

3. Those which utilize the advanced technology and systems analysis capabilities of military contractors, such as oceanographic research and development.

The kinds of public policy choices to be made here are primarily a matter of identifying and selecting among long-run goals and objectives. These are difficult considerations which current budgeting and other resource-allocation mechanisms in the public sector do not as yet come to grips with.

**Federal Aid to State and Local Governments**

Were the short-term, post-Vietnam adjustment efforts to emphasize exclusively a combination of tax reduction and expansion in direct Federal operations, such action might effectively result in the ability of the Federal Government to embark upon the block grant
or tax sharing which have been proposed to aid state and local governments in their fiscal problems.

Several key policy issues are involved here. To what extent should the Federal Government, rather than the states, determine the specific program areas to which state and local governments allocate Federal funds? Either expanding existing "tied" program-specific grants or embarking upon new ones would increase the influence of the Federal Government in this regard. In contrast, the proposals for block grants would have rather few strings attached to the Federal aid.

Aid to Veterans, Defense Workers, Areas, and Companies

The last category of adjustment actions is aid to veterans and to the workers, companies, and communities involved in defense work. To a substantial extent, the more general policy measures we have discussed would provide help to those directly and adversely affected by the economic consequences of a military cutback.

However, some pressures for special programs are to be expected on the basis of the Nation's experiences in prior defense cutbacks. Certainly there is ample precedent for generous assistance to disabled war veterans and to the dependents of those who lost their lives in the conflict. In addition, a Vietnam "G.I. Bill" already provides assistance for a rapid and successful transition to civilian life for many returning servicemen. However, many veterans with limited skills and from low-income groups may not be in a position to take advantage of these benefits.
Strategies of Economic Adjustment Actions

Important policy choices will have to be made both within as well as between the major categories of post-Vietnam economic adjustment actions. For example, tax reduction and government expenditure increases represent alternative means of generating civilian demands to utilize the resources which would become available. The choices are not likely to be "either - or" ones, but will involve some combination of the two. Hence, the public sector is not likely to contract by the full amount of the military cutback, which would be the case if all of the defense "savings" were utilized for tax reduction.

In choosing from among alternative public policies to adjust to peace in Vietnam, it may be helpful to keep in mind some fundamental criteria by which to judge specific policy suggestions.

One screening criterion could be consistency with national economic policies. That is, does the specific policy alternative promote full employment and rapid economic growth?

Another criterion could be consistency with standards of fairness and equity among various sectors of the economy and regions of the country. Does the suggested policy avoid singling out particular groups for special benefits not available to others in similar circumstances? This, of course, raises the question as to whether unemployed defense workers should receive more generous treatment than other unemployed persons.

A third standard might be consistency with efficient utilization of the nation's resources. Does the proposal avoid creating long-run inefficiencies in the economy when dealing with short-term problems? Any policy of maintaining obsolete defense facilities
in order to help specific localities would tend to run counter to this criterion.

A fourth principle might be consistency with emphasis on local and private initiative. Is the suggestion likely to encourage and assist, rather than replace, the efforts of those state and local governments and private organizations which attempt to offset the adverse economic consequences of the defense reductions? This, of course, opens up the whole question of private sector versus public sector orientation in a post-Vietnam economic adjustment program.

A final screening criterion could be consistency with the national security. Would the proposed action maintain the capability of the nation to respond effectively to future changes in the requirements of national security programs, whether total defense spending is increased or reduced further?

In its fundamentals, the task of national policy toward adjusting to the economic consequences following peace in Vietnam appears is clear: to set in motion increases in civilian demand sufficient to take up the slack which will arise as defense demands decline. Inevitably, of course, the problems arise in the implementation of the policy. How should the civilian demands be increased? When should these policies be implemented?

I suggest that an effective initial economic adjustment policy to peace in Vietnam would contain four major components.

1. A simple across-the-board reduction in Federal, individual, and corporate income tax rates, enacted hopefully at about the same time as defense contract placement rates begin to decline. This could be patterned, with algebraic signs reversed, on the recent
Presidential recommendation for a general increase in Federal income tax rates.

2. A general ease in monetary policies, consisting of open market purchases of treasury securities by the Federal Reserve System, and reductions in the discount rate, and lower reserve and margin requirements. A close coordination between central monetary and fiscal policy managers would be most helpful, of course.

3. An increase in governmental transfer payments, which do not involve the government itself in the market place. The liberalization of unemployment compensation is an obvious candidate. In the past, such action has occurred only after the onset of recessionary conditions. Perhaps, the necessary statutory changes could be adopted even prior to the cessation of hostilities.

4. An acceleration in the rate of existing programs, such as space exploration and construction of public works projects which already have been authorized, funded and designed. The purpose here would not be so much to raise the long-term level of such spending but to "bunch" project work during the crucial post-war adjustment period.

Once the transition to a high-level, prosperous peacetime economy is achieved, then public attention once again could be turned to the time-consuming, longer-run questions concerning the future structure of governmental resource allocation in the United States, e.g. Should a Heller-Pechman plan be adopted to share more of the Federal tax revenues with the hard-pressed state and local governments? Should new or expanded programs of scientific application be adopted, such as in the fields of space exploration,
oceanography, and environmental improvement? Should the tax structure be made simpler and more uniform (e.g. conforming more closely to the economic principle of equal treatment of equals)? Should the problems of the urban areas receive higher priority?

However, if the Nation fails to take prompt and substantial enough action to immediately and effectively utilize the manpower and other resources released in a post-war situation, then it may well also lose, at least for a time, the opportunity to make the relatively pleasant long-term choices involved in allocating rapidly growing potential public revenues. The choice instead may be between alternative crash anti-depression programs.

Certainly, the American economy would be in no danger of collapse if military spending drops substantially after peace is achieved in Vietnam. However, indecisiveness in initiating offsetting monetary and fiscal actions because of the inability to choose from a number of alternative possibilities could needlessly result in a post-war recession. The key to a successful post-Vietnam adjustment on the part of the American economy is initiating the offsetting increases in civilian demand promptly enough and substantially enough. To the extent that the initial actions -- on monetary policy, tax reductions, transfer payment increases -- maintain the overall viability and growth of the economy, it will be easier to carry on the longer-term task of reorienting the economy to more peace time pursuits; indeed, much of this task would already have been accomplished by the short-run actions.
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