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TOO CHEAP TO RULE: POLITICAL AND FISCAL SOURCES OF THE COMING AMERICAN RETRENCHMENT

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As implied by its evocative title, *The Frugal Superpower,* the theme of Michael Mandelbaum's recent book on grand strategy is retrenchment.[1] Mandelbaum argues that U.S. grand strategy is entering into a period of limited resources in which the U.S. will have no choice but to pull back from some international commitments. Mandelbaum is probably right: perceived fiscal constraints probably will drive U.S. retrenchment in the coming years. The U.S. situation driving this cutback is in some ways similar to the one experienced by Britain in the 1960s, when financial constraints forced Britain to abandon its global role. The reason for the coming American retrenchment is not, however, that the US cannot afford to maintain its current commitments, but rather that Americans refuse to pay for the government services—civilian and military—that they demand. America's long-term fiscal problem, and the coming American retrenchment, is primarily the result of domestic politics, not economics. The Republican policy of "starving the beast" will increasingly be starving the national watchdog; the Democrats will again turn to cutting guns to preserve funds for butter.

The U.S. does indeed face a massive fiscal problem, with a federal budget deficit estimated at 10.6 percent of GDP in fiscal year 2010, far more than in any year since World War II. The cause of this deficit, however, is not exclusively or even primarily defense spending. Even at a hefty $719 billion for fiscal year 2010—more than most of the rest of the world put together—the U.S. defense burden is still less than 5 percent of GDP, around where it was under Jimmy Carter. Thus even if the U.S. eliminated its defense budget altogether, the result would be to cut the federal deficit by less than half. Most of the deficit is the product of the recent economic downturn, which depressed tax revenues while motivating a short-term Keynesian fiscal stimulus. Most of the rest is the result of the tax cuts pushed through by President George W. Bush in 2001 and 2003, and renewed by Congress in 2010. In the long run, if Americans were willing to pay taxes at the rates they did under President Bill Clinton, while restraining the growth of domestic spending, they could afford to continue funding the Pentagon at current rates.

Ultimately, the central question for grand strategy, as is always appropriate, is one of priorities. The U.S. will eventually be forced to balance its accounts with some mix of tax increases and cuts in future nondefense spending; with somewhat more of either, it could also afford to keep its current force structure and most of its current defense commitments for decades into the future. The question should be: what gains in security and welfare can the U.S. achieve by doing so? Is the tradeoff worthwhile? The starting point for this discussion must be a clear understanding of what the fiscal problem is, and is not.

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[1] Michael Mandelbaum, *The Frugal Superpower: America's Global Leadership in a Cash-Strapped Era* (New York: Public Affairs, 2010).

THE BRITISH PRECEDENT

In a classic article, Harold and Margaret Sprout analyzed the withdrawal of British power from "east of Suez" in the late 1960s, and the United Kingdom's consequent reorientation from a global to a European power.[2] Sprout and Sprout show that the driving force behind retrenchment was not rising defense costs but rising social welfare costs. British social service expenditures, the Sprouts point out, rose from about 16 percent of GNP in 1957 to about 21 percent in 1966. In the same period British defense spending, already under 10 percent of GNP in 1957 (after the Korean War surge), declined quickly to around 7 percent, where it remained through the early and middle 1960s. Also contributing to the need for retrenchment were continuing balance of payments problems, which could be ameliorated by reducing the foreign spending associated with overseas military deployments.

The main reason for the retrenchment, in short, was that "military policies conflict[ed] with other national goals," primarily social welfare and consumer imports, spending on which commanded "a very high degree of consensus" in the aftermath of decades of austerity in the Depression and war years.[3] American officials argued at the time that Britain should continue to restrain consumer spending and government social programs to fund defense commitments, but responding to those demands was politically impossible for Britain. Britain's Labour government did, in fact, significantly reduce domestic spending in response to financial crises in 1966 and 1967: the 1966 cuts alone exceeded 1.5 percent of GNP and were described as the "biggest dose of deflation" ever in the United Kingdom.[4] But there were limits. The elitist politics that had made possible Victorian fiscal stringency—and an impoverished lifestyle for most Britons—was long gone, mass demands were effectively expressed in British politics, and those demands were for an end to austerity. British retrenchment therefore followed.

The U.S. has now reached the level of social spending that prompted Britain to retrench. By one measure, the British public sector took 39.6 percent of GDP in the 1965-66 fiscal year; the comparable proportion for the U.S. in 2009 was 42 percent.[5] Social service expenses in Britain in 1966 were 21 percent of GNP; U.S. *federal* "human resources" spending was about 17 percent of GDP in 2010, with state-level spending adding 5.5 percent of GDP more just for health and welfare spending. Though these numbers come from different data series and are not strictly comparable, the broad outlines seem clear: the U.S. social welfare burden today is comparable to the one that propelled British retrenchment in the 1960s.

U.S. public debt is also approaching 1960s British levels—though from the opposite direction as Britain. In 1930, Britain's aggregate state debt was equivalent to 190 percent of GDP[6]--a key reason for Britain's inability either to exert leadership in the global economy to avoid the Great Depression or to fund a military buildup in answer to Hitler's later in the decade.[7] By 1965, the situation had improved: aggregate state liabilities had skyrocketed—mostly due to World War II—but GDP had caught up, so state debt was now just under 100 percent of GDP.[8] The U.S. currently faces the opposite situation, with the national debt growing much faster than the economy. Still, the effect is to push the U.S. debt burden toward 100 percent of GDP, about where Britain's was when it moved to retrench. Two or three more decades of profligacy could well produce a situation like Britain in 1930 in which the U.S. was too weak to fix a major financial crisis. From this perspective, the threat to American economic leadership is significant enough that the U.S. must begin conserving its dwindling economic strength.

From the perspective of the British comparison, what is driving this skyrocketing American debt burden is inadequate taxation. Current U.S. social spending, as noted above, is comparable to 1960's Britain's. U.S. defense spending as a proportion of GDP is comparable to Britain's *after* its retrenchment—about 5 percent. But the British fiscal deficit in 1965 was only 0.8 percent of GDP because British government revenues nearly matched expenditures before the financial crises of 1966-67.[9] It is the lower U.S. tax burden, not the comparable spending burden, that is (along with sluggish economic growth) causing the U.S.'s yawning deficits.

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[2] Harold Sprout and Margaret Sprout, "The Dilemma of Rising Demands and Insufficient Resources," *World Politics* 20, no. 4 (July 1968), pp. 660-693.

[3] Quotations from contemporary observers in *Ibid.,* p. 682

[4] Quoted in Saki Dockrill, *Britain's Retreat from East of Suez: The Choice Between Europe and the World?* (Houndmills: Palgrave, 2002), p. 161.

[5] Data from British public spending is from "Datablog," *The Guardian,* http://www.guardian.co.uk/news/datablog/2010/apr/25/uk-public-spending-1963, accessed January 18, 2011. Data on U.S. public spending is from http://www.usgovernmentspending.com/downchart_gs.php?year=1900_2010&units=p&title=Spending percent20as percent20percent percent20of percent20GDP#usgs101, accessed January 18, 2011.

[6] B.R. Mitchell, *Abstract of British Historical Statistics* (Cambridge: Cambridge University Press, 1962), pp. 368, 395-403.

[7] On the fiscal constraints to a military buildup, see Christopher Layne, "Security Studies and the Use of History: Neville Chamberlain's Grand Strategy Revisited," *Security Studies* 17 (2008), pp. 397–437.

[8] B.R. Mitchell and H.G. Jones, *Second Abstract of British Historical Statistics* (Cambridge: Cambridge University Press, 1971), pp. 151, 162.

[9] B.R. Mitchell and H.G. Jones, *Second Abstract of British Historical Statistics* (Cambridge: Cambridge University Press, 1971), pp. 151, 162.

Table 1: Indicators of U.S. fiscal and financial position as percent GDP

	1976	1980	1984	1988	1992	1996	2000	2004	2008	2010*
Spending	21.4	21.7	22.1	21.2	22.1	20.3	18.4	19.9	21.0	25.4*
Receipts	17.1	19.0	17.3	18.1	17.5	18.9	20.9	16.3	17.7	14.8*
Defense	5.2	4.9	5.9	5.8	4.8	3.5	3.0	4.0	4.3	4.9*
Social	11.7	11.5	11.2	10.6	12.4	12.4	11.4	12.7	13.1	17.1*
Deficit	-4.2	-2.7	-4.8	-3.1	-4.7	-1.4	+2.4	-3.6	-3.2	-10.6*
Fed Debt	36.2	33.4	40.7	51.9	64.1	67.3	56.4	62.9	69.2	94.3*
Net Assets	+9.5	+13.4	+4.5	-3.2	-6.5	-5.9	-13.7	-19.5	-24.4	n/a
GSHA**	4.2	4.3	3.7	5.2	5.3	8.2	7.8	13.1	22.7	n/a

Sources: Office of Management and Budget (OMB), "Table 7.1—FEDERAL DEBT AT THE END OF YEAR: 1940–2014;" OMB, "Table 3.1—OUTLAYS BY SUPERFUNCTION AND FUNCTION: 1940–2014;" and OMB, "Table 10.1—GROSS DOMESTIC PRODUCT AND DEFLATORS USED IN THE HISTORICAL TABLES: 1940–2014;" accessed at http://www.whitehouse.gov/omb/budget/Historicals/ on July 9, 2009; Office of Management and Budget (OMB), "Table 7.1—FEDERAL DEBT AT THE END OF YEAR: 1940–2015;" OMB, "Table 3.1—OUTLAYS BY SUPERFUNCTION AND FUNCTION: 1940–2015;" and OMB, "Table 10.1—GROSS DOMESTIC PRODUCT AND DEFLATORS USED IN THE HISTORICAL TABLES: 1940–2015;" accessed at http://www.whitehouse.gov/omb/budget/Historicals/ on January 10, 2011; and Bureau of Economic Analysis, "Table 2. International Investment Position of the United States at Yearend, 1976-2008".

***Figures for 2010 are projections.**

****GSHA refers to Government Securities Held Abroad**

DIMENSIONS AND SOURCES OF THE U.S. FISCAL CRUNCH

The data in Table 1 above further demonstrate this point: current U.S. problems of budget and public finance are the result not of defense spending but primarily of irresponsible tax cuts in the last three decades, cuts which have caused a relentless decline in the U.S. financial position that now significantly constrains the resources the U.S. can bring to bear for any national task.[10] At the end of 1980, the gross U.S. federal debt was only about 33.4 percent of GDP, the U.S. net asset position (the value of American-owned assets abroad minus the value of foreign-owned assets in the U.S.) was positive, equivalent to 13.4 percent of GDP, and only 4.3 percent of U.S. government securities were foreign-held. The practice of Reaganomics, however, was that while taxes were cut (by 1.5 percent of GDP by 1992), aggregate federal spending was not: it was 0.5 percent of GDP *higher* in 1984 under Reagan, and in 1992 under George H. W. Bush, than it had been under Jimmy Carter in 1980. The result was an annual fiscal deficit that was running at 4.7 percent of GDP by 1992. After more than a decade of such deficits, the absolute size of the national debt had more than quadrupled, surging as a proportion of GDP to 64.1 percent, while the U.S. economy overall shifted from being a net creditor to a net debtor, with its net asset position equivalent to -6.4 percent of GDP. The Clinton administration teamed with a Republican Congress did manage to balance the budget, increasing revenues to 20.9 percent of GDP and cutting expenditures to 18.4 percent, reducing the national debt to 58 percent of GDP by 2000. However, huge trade deficits led to a continued hemorrhaging of assets, so the U.S. net asset position further declined to -13.7 percent of GDP. Still, given the budget surplus of 2.4 percent of GDP in 2000, the U.S. government could have increased defense spending to 5 percent of GDP—its current level—and still balanced the budget.

[10] For a powerful analysis of the self-indulgent politics that led to the current situation, see Andrew J. Bacevich, *The Limits of Power: The End of American Exceptionalism* (New York: Holt, 2009), pp. 30-66.

Instead of taking such a fiscally responsible course, the succeeding George W. Bush administration renewed the fiscal bleeding. Like Reagan, Bush increased the defense burden while decreasing the tax burden, generating large budget deficits as a result. Unlike Reagan, Bush also massively increased domestic spending and refused to reverse the tax cuts later in his tenure. The spending increases were huge—amounting to 2.6 percent of GDP by 2008—but the tax cuts were even larger, causing revenues to decline by over 3 percent of GDP from 2000 and 2008. Part of the increase in spending came in the creation of a new social entitlement, the addition of a Medicare drug benefit, that the Bush Administration grudgingly agreed to only on the condition that adequate measures to pay for it not be taken. The overall result was that by the end of 2008 the gross federal debt had swollen to 70.2 percent of GDP, the U.S. net asset position plunged to -24.4 percent of GDP, and 22.7 percent of U.S. government securities were held abroad. In effect, the entirety of the U.S. budget deficit in the Bush years was paid for by borrowing abroad, primarily from China and Japan, leaving the U.S. massively in debt to its two largest commercial competitors.

Along with these huge debts and deficits, the Obama administration inherited the worst recession since World War II. The combination of the Bush tax cuts and declining tax revenues in the recession reduced government revenue to less than 15 percent of GDP, its lowest level since 1950. At the same time, higher unemployment-related expenditures, the costs of bank bailouts, two wars and a massive economic stimulus package drove federal spending above 25 percent of GDP, a level exceeded only during World War II. The combination caused the federal budget deficit to surge to an estimated 10.6 percent of GDP for fiscal year 2009, again a post-World War II high, with the gross federal debt projected to swell to 94.3 percent of GDP by the end of that year. Defense spending at $690 billion including the cost of the wars in Iraq and Afghanistan represented 4.9 percent of GDP, equivalent to less than half of the deficit. The administration's hopeful 2009 projections were to slow the financial bleeding over the following three years, reducing the deficit to 3.4 percent of GDP by fiscal year 2012, estimating that by the end of that year the U.S. national debt would equal about 100.6 percent of GDP. The tax cuts passed by Congress at the end of 2010, however, probably made those targets unreachable.

Options for bringing the budget back into balance are outlined in the 2010 report of the "National Commission on Fiscal Responsibility and Reform" appointed by President Obama.[11] The report suggests increasing revenues to the level of the late Clinton Administration—roughly to 21 percent of GDP—while reducing spending to match. On the revenue side, the proposal is to *reduce* marginal income tax rates, increasing revenues by reducing tax deductions and expenditures, by broadening the tax base, and by increasing the gasoline tax modestly. On the spending side, the proposal is essentially to cap the growth in both domestic and defense spending to one-half the rate of inflation, allowing inflation and economic growth to erode the size of those expenditures in real terms and as a proportion of GDP. This would supposedly be achieved by eliminating duplicate and ineffective government programs, reducing Social Security and pension benefits for relatively affluent future recipients, and especially by shifting some Medicare costs from the federal budget to providers and patients.

These proposals are generally notable primarily for the modesty of the sacrifice requested. Tax proposals, for example, would replace the deduction for home mortgage interest with a tax credit of limited size, and limit the tax-exempt status of employer-provided health insurance premiums. Spending cuts would include a freeze on federal workers' pay and on hiring federal workers, and reductions in federal agricultural subsidies and student loan subsidies. The basic message matches the lesson of Table 1: if the U.S. could manage to be as responsible as Bill Clinton, it could balance its budget.

The most painful of the proposed spending cuts—reductions in future pensions (including Social Security) and in health care expenditures—are also the most necessary, as these are the categories of spending that are growing most rapidly. If entitlement growth is not restrained, the commission estimates that the national debt will increase to about 150 percent of GDP by 2030. Still, just listing the specific cuts proposed makes clear the extreme political difficulty of enacting them, as each involves tangling with one or more of the most powerful lobbies in Washington. To take one example, the retirees' lobby, which would oppose most of the cuts, was in the 2008 and 2010 election cycles the second-most generous funder of political campaigns of all sectors, behind only the legal industry.[12] Resistance to other cuts would come from the real estate industry (the 4th-ranked contributor), health and insurance industries (the 5th-and 9th-largest contributors), the education lobby (the 6th-ranked contributor), public sector unions, the agricultural lobby, and others. Worse, restraint in health care costs will eventually require decisions not to fund some expensive and ineffective procedures, an idea which now elicits not only fiscally heedless howls from the left, but also irresponsible charges about "death panels" from the right. On the revenue side, even the tradeoff of lower tax rates for reduced deductions is probably unacceptable to the Tea Party-influenced 112th Congress, where the House of Representatives has enacted budget rules that essentially rule out any changes in law that would increase government revenues. This is the context in which defense spending emerges as the first and easiest target for deficit reduction.

The resistance of the political class to both tax increases and domestic spending reductions is matched by similar sentiments in public opinion. According to one early 2011 poll, Americans by a two-to-one margin preferred reducing spending even on programs that benefited them to tax increases on themselves. When asked which of three big spending categories should be cut

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[11] The National Commission on Fiscal Responsibility and Reform, "The Moment of Truth," December 2010.
[12] http://www.opensecrets.org/industries/mems.php, accessed January 19, 2011.

first—Social Security, Medicare, or military spending—military spending cuts received majority support. Furthermore, these preferences cut across party lines: even Democrats preferred spending cuts to tax increases; and even among Republicans, more favored military spending cuts than cuts in Medicare or Social Security.[13] These views probably reflect ignorance of the scale of the spending cuts—on guns and butter—that would be required to balance the budget without tax increases. However, they do suggest strongly that the American public's priorities broadly parallel those of the 1960s British public: if cuts are necessary, cut military spending first.

CONCLUSION

The U.S. government needs to set its fiscal house in order. Most of its budget problems, however, have nothing to do with the defense budget, huge as it is. The structural deficit is the result primarily of combining large and growing health, welfare, and pension commitments with large tax cuts. As these fiscal trends intersect with rising concern about the budget deficit, defense spending is virtually certain to experience significant cuts without benefit of any serious grand strategic debate. The president's budget proposal for 2012 implies reducing defense to about 3.8 percent of GDP by 2015, and the budget commission suggested slightly deeper cuts, likely reaching or sinking below the Clinton-era norm of 3 percent of GDP in later years.

If current political trends continue, future fiscal policy will be a new Tea Party-influenced synthesis that systematically promotes national weakness even as its practitioners proclaim the opposite goal. Like Reaganomics, it will weaken the federal fisc, failing to close the budget deficit as the continued insistence on tax cuts will outweigh any restraint achieved on growing social spending. Like Reaganomics, it will weaken the basis of future economic growth by slashing the government spending on infrastructure, education, and research and development that is necessary to generate future economic growth in a high-wage economy. But unlike Reaganomics, it will also weaken the American defense posture, cutting defense spending and weakening the U.S. military as the fiscal situation grows more critical. This outcome will be no one's intention, but rather the result of the clash between the left's determination to maintain social spending and the right's determination to avoid tax increases. The "moderate compromise" has been short-sightedly to privilege consumption over investment, and to shift the burden of current consumption from current taxpayers to future ones.

In praising the source of ancient Athens's greatness, Pericles most of all lauded Athenians' "sense of duty". The weakness of this sense of duty is what characterizes the contemporary American political debate. The left sees a duty to care for the sick and needy, but fails to temper that with attention to the affordability of that care. The right praises those who take up the duty of national defense, but rejects the notion that paying for soldiers' salaries and weapons through taxes is also a patriotic duty. Instead, the "me generation" rules, demanding that the conservatives give "me" a tax cut, that the liberals give "me" government benefits, and if something must be sacrificed, let it be duty to future generations.

This climate will leave the U.S. with two grand strategic options. The first is to attempt to maintain existing commitments with declining resources at increasingly higher risk against rising challengers. This approach would be an exact parallel to recent fiscal policy, but when it was tried in the Pacific in the early 1940s, its costs were measured in blood and destruction as well as money. The alternative is to retrench from some overseas commitments, following blueprints like the Cato Institute's plan for a strategy of "military restraint" that would be sustainable at 3 percent of GDP.[14] Such a grand strategic retrenchment may seem attractive, and it is certainly better than overextension. While it may lead to political instability and even increased wars abroad, it saves money and does not cost American lives if the U.S. does not to intervene. On the other hand, retrenchment is foolhardy if the result is likely to be increased terrorism and piracy, wars in which the U.S. must intervene, or lost diplomatic leverage that yields closing commercial opportunities and defeat for American ideals. It would be useful to have the debate on the tradeoffs before the retrenchment becomes reality, but if the consensus of left and right is on the absence of a national will to pay for primacy, the decision may already have been made.

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[13] *New York Times*/CBS News Poll, conducted January 15-19, 2011, reported in *The New York Times*, January 21, 2011, pp. A11, A19.

[14] Benjamin H. Friedman and Christopher Preble, *Budgetary Savings from Military Restraint,* Policy Analysis no. 667 (Washington DC: Cato Institute, 21 September 2010)