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GUNS AND BUTTER

How War's Expense Didn't Strain Economy

Foreign Lending, Lessons From LBJ; How Long Will It Last?

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WASHINGTON -- Since President Bush took office, he's boosted annual defense spending by 50% -- including $500 billion over five years for fighting in Iraq and Afghanistan -- and doubled spending on homeland security. At the same time, he's cut taxes, expanded Medicare to cover prescription drugs, approved $100 billion to clean up after Gulf Coast hurricanes, and signed bills that spend a little more each year on domestic programs.

For years, critics said it couldn't last, backed by some historical precedent: President Johnson is blamed by many for triggering inflation in the 1970s by spending on both guns and butter.

- **The Issue:** President Bush has managed to wage a war, cut taxes and boost other spending without triggering Vietnam-era inflation.
- **The Background:** The spending spree has been aided by foreign borrowing and a strong economy.
- **What's Next:** While economically painless so far, war and military spending will soon collide with looming entitlement obligations.

But this time, it's been nearly painless. Inflation is in check. The federal budget deficit is down from its 2004 peak, and rests near its historical average of 2% of gross domestic product, a measure of the nation's total output. Long-term interest rates are relatively low.

What's Mr. Bush's secret? Ingredient one: strong revenue growth driven by an economy distinguished by surging profits and rising incomes at the top, which are taxed more heavily than incomes at the bottom. Ingredient two: tax cuts and spending increases, which arrived when the U.S. economy needed a boost. Ingredient three, and perhaps the most significant: the willingness of foreigners to lend to the U.S., which finances the budget deficit without pushing up interest rates at a time when Americans don't save very much.

"This situation is what you'd call an exorbitant privilege," says Menzie Chinn, a University of Wisconsin economist. "We've gotten a pretty good deal so far."

No one knows when this bonanza might end, although end it must. For the coming year, Mr. Bush is expected to shave costs from programs and agencies unconnected to defense. In the future, the flow of cash from foreign lenders could dry up. Health care and Social Security could swamp the federal budget. In the shorter term, the combination of military spending and tax cuts could collide with spending priorities outlined by the capital's newly empowered Democrats.

For now, the budget the president will offer today essentially counts on continued good luck. Both he and Congress recognize that neither the war in Iraq nor the buildup in homeland-security spending is a one-time-only expense. Both sides are talking about the need for a larger military, a sharp contrast to the decline in post-Cold War defense spending that helped produce Bill Clinton's surpluses.

Mr. Bush's budget estimates Iraq and Afghanistan over the next two years alone will cost about $300 billion, and analysts say the five-year price tag could reach $500 billion. Mr. Bush is seeking to add 92,000 troops to overall Pentagon forces over the next five years. Democrats are even more eager to increase homeland-security spending than Mr. Bush. Indeed, the Congressional Budget Office last week estimated a bill the House has passed to improve aviation security and implement other recommendations of the 9/11 Commission would cost $21 billion over six years, a sum equal to roughly half the Department of Homeland Security's current annual budget.

Democrats also have a long list of other domestic priorities to fund, which include lower student-loan rates and more science and health research. They've pledged to balance the budget and adhere to rules that require tax cuts and benefits increases to be offset somehow.

"It will be hard to attain those goals because of the squeeze that the defense budget, and in particular that the cost of war in Iraq, is placing on us," says House Budget Committee Chairman John Spratt, a South Carolina Democrat. "These expenditures at this sort of level are consequential -- they necessitate trade-offs."

In the budget for fiscal 2008, which begins Oct. 1, Mr. Bush has said he will show how the deficit can be eliminated by 2012 without raising taxes. The budget will give the administration's best guess (about $141 billion) at the cost of Iraq and Afghanistan for 2008, a departure from past practice, and what one administration official calls "a plug number" for 2009 -- an estimated $50 billion -- but nothing beyond that.

The president is also expected to project spending less, in inflation-adjusted terms, on annually appropriated spending outside of defense and homeland security. Much of that squeeze is expected to come in proposed freezes or cuts to federal agencies and programs.

"It's going to be the tightest budget we've seen," says Brian Riedl, a budget expert with Heritage Foundation, a conservative think tank. He predicts a call for "freezing most discretionary programs for the next five years."

The big problem, however, remains the government's entitlement programs. Treasury Secretary Henry Paulson says the budget deficit is "well below where anybody would have expected it to be several years ago" despite the costs of war and hurricanes. He credits a strong economy and record tax receipts.

But he warns of "a looming collision with entitlements," and adds: "I have no doubt we will deal with it. But the longer we wait to deal with it, the more expensive and the more painful it's going to be to do it."

Some academic economists are beginning to gauge what the sums spent on Iraq could have financed -- a down payment on a Social Security fix, for instance. Nobel laureate Joseph Stiglitz predicts Iraq will cost at least $1 trillion, assuming troops are withdrawn by 2010. "Half that sum would have put Social Security on a firm grounding for the next 75 years," he wrote last year in a paper. "If we spent even a small fraction of the remainder on education and research, it is likely our economy would be in a far stronger position."

Comparisons to Vietnam are tempting but Iraq isn't, at least yet, as costly as Vietnam, when compared to the overall economy. It's running about $100 billion a year, or about 1% of GDP. By the time it was over, Vietnam cost the equivalent of about $660 billion in today's dollars.

Overall defense spending today is higher than it was during Vietnam, when adjusted for inflation, but is just about 4% of GDP. That's an increase from when Mr. Bush took office, but far from the Vietnam peak of 9.5% of GDP in 1968, and less even than the 1980s Cold War buildup. Even with the planned troop surge, the U.S. will have about 160,000 troops in Iraq, well below the 550,000 Vietnam peak.

Lyndon B. Johnson

It was the combination of military spending and President Johnson's "Great Society" programs -- Medicare health insurance for the elderly and Medicaid for the poor -- that many say led to the "Great Inflation" of the 1970s. Like Mr. Bush, Mr. Johnson at first tried to fund the war through supplemental spending bills, a move historians and contemporaries believe was aimed at cloaking the true costs so Congress wouldn't scale back his ambitious domestic agenda. Inflation, which had been below 2% in the early 1960s, was running at above 6% in 1970. By 1970, the U.S. was in a recession.

Vietnam-era defense spending added fuel to an economy that was already running at full employment and producing at capacity. Mr. Johnson resisted calls for tax increases to reduce the inflation risk, fearing Southern Democrats would instead insist on cutting social programs. The Federal Reserve, partly under pressure from Mr. Johnson, but also because it mistakenly believed the economy had spare capacity, was reluctant to raise interest rates. To control inflation, it had to raise rates higher later on. By the time Mr. Johnson imposed a 10% surcharge on individual and corporate income taxes in 1968, it was too late.

Although the government borrowed heavily in the 1960s, most of its borrowing came from inside the U.S. Interest rates rose as a result. The yield on 10-year Treasurys, a benchmark interest rate, began the 1960s at 4.72%; it ended the decade at 7.65%. But the private sector saved enough to offset government borrowing, and the U.S. economy was a net lender to the world.

This time, interest rates haven't risen as much, because foreigners, particularly in Asia, are eager to lend to the U.S. economy at fairly low rates. The economy as a whole is a heavy borrower from the rest of the world.

In fact, the U.S. government is particularly dependent on the willingness of foreigners to lend it money. As of November 2006, foreigners owned about $2.2 trillion of U.S. Treasury securities -- or about 52% of the public debt not held by the U.S. government, compared with about 20% in the early 1990s. (The total U.S. debt, which includes what the government owes itself, is about $8.7 trillion.)

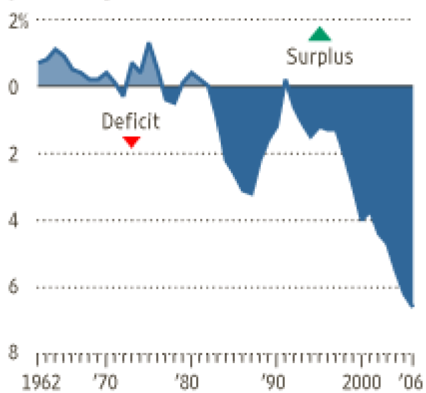
Mr. Bush's ability to sustain spending and tax cuts depends largely on the willingness of foreigners to continue lending the U.S. money. Mr. Chinn, the economist, says that at some point, global investors will lose their appetite for ever-larger amounts of American debt. That would trigger a decline in value of the U.S. dollar and an increase in interest rates.

"So far it's not a problem because foreigners are willing to lend, but you've got to wonder what happens when the rest of the world says, 'We're tired of taking paper that loses value pretty quickly,' " says Mr. Chinn.

Foreign Friends

Amid spending and war, the U.S. has become indebted to the rest of the world.

Current account balance as a percentage of GDP



Note: The current account is a measure of how much the U.S. borrows from or lends to the rest of the world.
Source: Commerce Department

The Bush era upturn in defense and homeland-security spending came not during a 1960s-style boom, but in a lull in the U.S. economy, which had tumbled into recession even before the Sept. 11, 2001, attacks. That meant the economy had plenty of slack to absorb increased government spending without sparking inflation. Lee Price, an economist who until recently was research director at the Economic Policy Institute, a liberal Washington think tank, says defense spending created 1.3 million private-sector jobs between 2001 and 2005 while all other private-sector employment fell by 1.2 million.

At the same time, the Bush administration cut taxes in 2001 and 2003 on individuals, dividends, capital gains and estates, among other areas. The administration and some economists credit the cuts with spurring economic growth, saying they provided incentives to business to invest and buoyed consumer spending.

The moment of economic slack may be in the past, which raises the specter of inflation. Unemployment is about as low as the Fed will tolerate, and there are some hiring bottlenecks of the sort that were common during Vietnam. "We're starting to see tightening up in the high-tech market, and people who were tied up with defense or homeland security are not available," says EPI's Mr. Price.

War has other costs, too. Some companies are struggling to keep jobs open for military reservists. A 2005 Congressional Budget Office report found that "some businesses may absorb the loss of personnel at little cost, but others may experience slowdowns in production, lost sales or additional expenses as they attempt to compensate for a reservist's absence." The problems are more severe for small businesses or those that employ highly specialized workers, the CBO said.

At Fallon Ambulance Service in Quincy, Mass., more than 20 of the company's 500 full-time employees are reservists, and several have been deployed for stints lasting as long as two years.

"It does at times put a strain when we have large deployments," says Stephanie Eastwick, director of human resources for the family-owned company.

In the end, it may be Johnson's ballooning programs that prompt tough decision making. The government has expanded greatly since the 1960s and has made all sorts of promises to pay benefits, particularly to older Americans, in coming years. As war costs preoccupy official Washington, the retirement of the baby boom generation is growing closer; the oldest boomers turn 60 this year. There is no sign of a political consensus on changing Social Security, which has expanded since Roosevelt launched it, or on making more affordable Mr. Johnson's health-care programs.

Social Security, Medicare and Medicaid already consume 36 cents of every dollar that the government spends, about $1.2 trillion this year, and are growing faster than the economy as a whole. Defense accounts for about 20 cents of every dollar, up from 16 cents when Mr. Bush took office in 2001, more than the government spends on education, transportation, scientific research and housing aid combined.

"We can continue doing what we're now doing subject to foreigners being willing to finance it but eventually it's going to do us in because Medicare and Social Security are going to overwhelm the budget," says Charles Schultze, a Brookings Institution economist who was among Jimmy Carter's advisers.

The Fed is watching carefully, the lessons from the 1960s inscribed in the minds of today's policy makers. "There were plenty of signs in the 1960s that inflation was accelerating, yet monetary policy wasn't fundamentally changed," says former Fed Governor Edward Gramlich. "Today, [the Fed] would be more alert and is more likely to react forcefully to signs of accelerating inflation."

---- Greg Ip contributed to this article.

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