Opinion: Why U.S. Defense Spending Has Reached Its Peak

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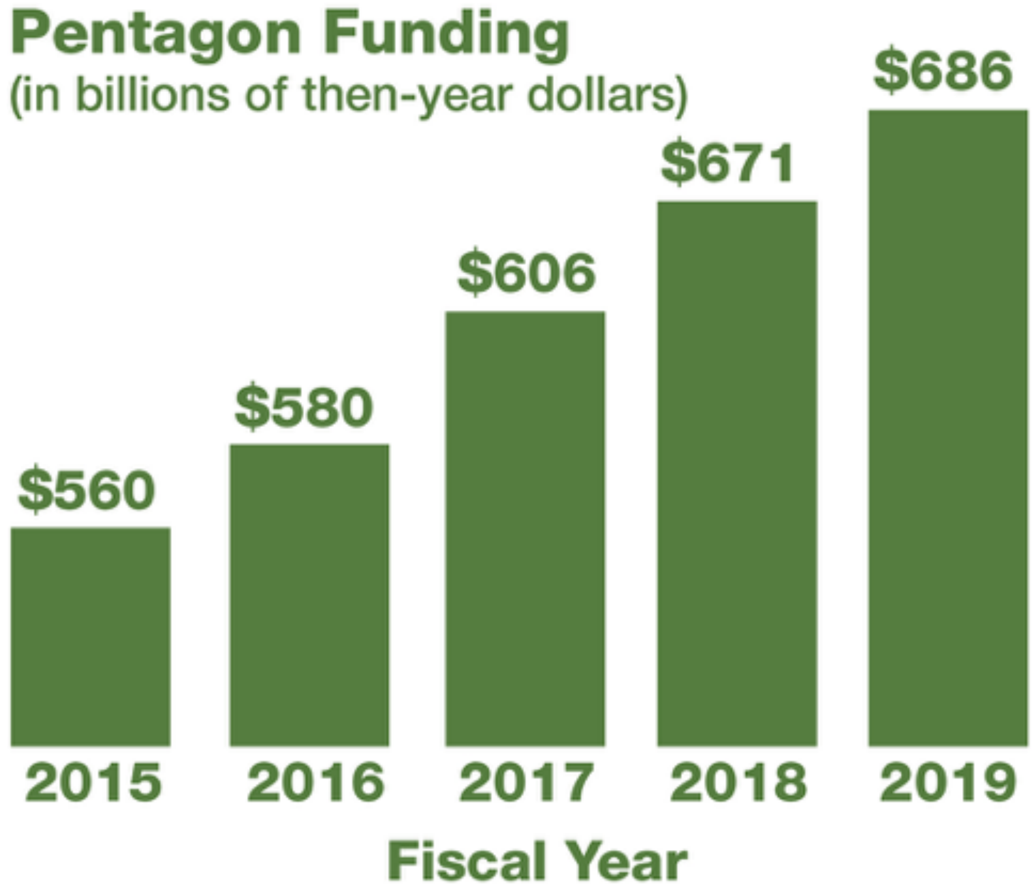
A convergence of indicators suggests the recently passed defense appropriations act will mark a peak for U.S. defense spending. Even the Trump administration's own outyear defense-spending projections grow at an annual rate of only 2%, which is just enough to keep pace with the White House's inflation expectations—and below those of the Congressional Budget Office.

Still, other indicators suggest inflation will erode the purchasing power of future defense appropriations more deeply. To borrow a phrase from the oil patch, we are approaching "peak defense," an outlook of flat-to-declining U.S. defense budgets across the next decade. How we prevent this trend from imposing a commensurate diminution of U.S. defense capabilities is the compelling work that lies before defense planners, military professionals and Congress.

At the end of September, President Donald Trump signed into law the defense appropriations act for the fiscal year that began on Oct. 1. The act is remarkable for two reasons. For the first time in more than a decade, Congress passed a full-year appropriation for defense ahead of the start of the fiscal year (an achievement made easier by passage in February of the Bipartisan Budget Act, which relieved appropriators of the caps on discretionary spending that had stymied timely resolution of federal spending bills since 2011). The 2019 defense budget also is really big: $686 billion for the Pentagon, a figure more than 20% above the 2015 trough of the current cycle and also higher on a constant-dollar basis than even the heights of defense spending in the Cold War.



Regardless, fiscal realities from which Congress and the administration have taken a holiday over the past two years will begin to pinch defense spending. *The New York Times*' recent front-page story, "As Debt Rises, the Government Will Soon Spend More on Interest Than on the Military," provides an overview of the fiscal outlook based on new estimates of the Congressional Budget Office. They indicate that by 2020 the cost of paying interest on the national debt will have roughly doubled from when Trump took office in 2017 and will exceed the level of discretionary defense spending within five years. Recall, too, that next year's debate over the 2020 defense budget will not enjoy relief from the Budget Control Act caps on defense discretionary spending, which for 2020 are set at least $80 billion below what is likely to be the administration's base-budget request.

These indicators converge about a month ahead of congressional elections that poll watchers believe may result in a Democrat-controlled House of Representatives and even possibly a change in control of the Senate. While the once-tidy correlation of Democratic politics with resistance to higher defense spending is an anachronism, Democratic control of either chamber of Congress would add political power to the economic pressures on defense spending in the next decade. Asked in September about the level of defense spending in the appropriations bill that Congress was about to pass, Rep. Adam Smith (D-Wash.), the ranking member of the House Armed Service Committee, was unequivocal: "I think the number's too high, and it's certainly not going to be there in the future."

No matter which party prevails in November, there is almost certain to be an economic reaction to the loose-money 115th Congress. Earlier this month, the yield on the benchmark 10-year Treasury note jumped 20 basis points above 3% following a speech by the Federal Reserve chairman in which he said that tightening of monetary policy had "a long way" to go before the inflationary urges given fuel by the 2017 tax cuts and expansionary 2018-19 expenditures had been neutralized.

The 10-year Treasury note is referred to as a benchmark because it serves as a common measure of baseline risk for investing in everything from private homes to corporate expansions. In a country where an entire generation of homeowners have never paid more than 6% per annum for a mortgage, or of business executives whose cost-of-capital hurdle rate has never exceeded 10%, the political effects of rising interest rates on federal spending may be swift and sharp.

Depending on the full magnitude of the discrepancy between flat-to-declining budgets and the growth on which Defense Secretary James Mattis' strategy is staked, fiscal tightening will require at least a restructuring of the defense program that includes an unprecedented reform of how much "bang" the Pentagon gets for its "buck." Failing that, it will require resetting the defense strategy altogether.

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