# Costs of Arms Sales Undermine Economic Gains
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Back to Previous Page

One of the benefits of the end of the Cold War has been a sharp decline in the value of the international arms trade. But with the removal of Cold War competition as a driving force behind arms sales, economic rationales have assumed greater importance.

The Clinton Administration in 1995 issued a Presidential Directive (PDD-34), stating that maintenance of the domestic defense industrial base was an objective of arms exports. In addition, the Administration instructed the Commerce and State Departments to assist the Pentagon and private firms in these efforts. This was the most explicit statement by any U.S. administration of the economic importance of arms sales. According to Arms Control and Disarmament Agency reports, the global arms trade dropped from a peak of $82.4 billion in 1987 (in constant, 1995 U.S. dollars) to $26.7 billion in 1994, before rising in 1995 to $31.9 billion, fuelled by post-Gulf War arms purchases.

## Economic Gains Appear to be Overstated

Arguments positing substantial economic gains from arms sales focused on macroeconomic benefits in terms of positive balanceof- payments effects and domestic job and income creation, and microeconomic benefits in terms of expanding markets and allowing firms to achieve more efficient levels of production. In both cases, however, the net gains appear to be overstated, largely because the economic costs and benefits of the arms trade tend to flow to different sets of decision makers.

The positive macroeconomic effects of arms sales have been undermined by the growth of offsets. The United States exports far more military goods and services than it imports — $15.6 billion as opposed to $1 billion in 1995. Over the last several decades, and especially in the 1990s as massive excess supply has turned the arms trade into a buyer’s market, purchasing nations have increasingly demanded substantial offsets as a condition for undertaking an arms purchase.

Offsets are of two types: direct offsets require the selling firm to grant subcontracts, technology transfer or direct investment to the buying country’s military firms, while indirect offsets require the selling firm to find markets for the buying country’s non-military exports or obtain technology and investment funds for the buyer’s civilian industries. A U.S. Department of Commerce survey found that offset commitments amounted to 81 percent of surveyed arms transfer agreements in 1995 with indirect offsets growing the fastest. Not all offset agreements come to full fruition, but the rising trend in the number and value of offset agreements seems clear: The growth of offsets, and especially the growth of indirect offsets, makes the macroeconomic impacts of arms sales less clear.

Indirect offsets tend to increase civilian imports into the United States or expand technology and capital flows to the arms-buying countries. Thus, while arms producing companies and regions receive benefits, in terms of revenues and profits for firms and jobs and income for regions, U.S. firms and regions in the importcompeting industries would tend to lose while their potential competitors in the arms buying countries receive an injection of capital and technology. The macroeconomic stimulus to the arms producers is lower than it would have been in the absence of offset requirements.

There is also ambiguity in evaluating the microeconomic benefits. Production of weapons systems typically requires very high research and development (R&D) and capital costs which then require large production runs to

amortize these fixed costs and achieve learning economies. The same scenario confronts many high-tech civilian products. The difference is that arms markets tend to be subject to more restrictive budget constraints while maintaining a demand for rapid technological innovation and a variety of product lines. The result has been rising unit costs for most weapon systems, which only exacerbates the effects of the budget constraint. A widely proposed solution to this dilemma is an expansion of export sales.

Some countries, such as France, include projections of export markets in their decisions regarding arms production, and design weapons with export demand in mind. The United States tends to treat export markets as add-ons, a source of revenue after domestic needs have been met. Until recently, the government collected a recoupment fee to repay R&D outlays, but intense competition in today's buyer's market led firms to lobby successfully both the Bush and Clinton Administrations to waive these fees. Thus, one objective of arms exports, to compensate the government for fixed costs, is not being met.

In addition, arms exports are costly. Beyond the production and market costs borne by firms, William Hartung of the World Policy Institute has calculated that the United States government is spending over $7 billion per year to support the arms trade, in the form of maintaining a governmental support apparatus, supplying existing military equipment and personnel to arms exhibits, direct grants and aid to states to finance arms purchases, and the costs of loan subsidies and loans that are forgiven. With U.S. arms sales running at about $12 billion to $15 billion per year, these governmental outlays are 50 percent or more of the revenue received. It is hard to see how costs of this magnitude can be justified in economic terms.

**Macro and Microeconomic Impact of Arms Sales Suffer**

Both the macroeconomic and microeconomic impacts of arms exports suffer from a separation of the costs and benefits. Offsets mean that the economic stimulation is received by one set of firms and regions while the costs are increasingly borne by a different set. In addition, arms producing firms gain revenue and profits from arms exports while the fixed costs of R&D and capital investment, and many of the variable costs of marketing and subsidizing buyers, are absorbed by the government. If the costs and benefits of arms exports were internalized within the same set of decision makers, U.S. arms exports would likely be considerably smaller.

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