In this article, Jeffrey Garten, Dean of the Yale School of Management, warns of the mismatch between America's economic policies and its "mushrooming overseas commitments." In order to finance the global fight against terrorism and the arduous process of nation-building in places like Afghanistan and Iraq, Washington will have to drastically alter its current economic policies, says Garten, who held foreign policy and economic positions in the Nixon, Ford, Carter and Clinton administrations. He argues that President Bush's proposed tax cuts have to be cancelled, that caution must be taken to ensure that homeland security measures do not stifle productivity and competitiveness, and that Washington must pursue a multilateral economic policy. - YaleGlobal

The Cost of an Empire

Why America Cannot Afford its Foreign Commitments without Drastically Changing its Domestic Policy

Jeffrey E. Garten
YaleGlobal, 2 April 2003

NEW HAVEN: No one can confidently predict how America's foreign policy will unfold in Iraq and beyond when the guns fall silent, nor how successful it will be. But if we take President Bush at his word, the U.S. will wage a relentless campaign to politically transform the Middle East, rid the world of tyrants possessing weapons of mass destruction, and fight global terrorism from the caves of Afghanistan to the jungles of the Philippines and Colombia. One thing then is certain: current economic policies will be unable to finance America's mushrooming overseas commitments.


Home and abroad: Can America ignore the growing deficit at home and be the world's policeman? (Photo (left) Copyright © 1992-2001 Anatol Filin, (right) AFP Photo)

Within the first week of the Iraq war a number of Democratic and Republican Senators demonstrated their concern about this predicament by passing a resolution that cut the administration's proposed tax breaks in half - from $726 billion to $350 billion. The administration said the breaks would stimulate the economy, but critics were worried more about the deficits that would ensue. It would be a big mistake, however, to think that this measure was even remotely proportional to the fiscal requirements of the years ahead.

Supporting the ambitious foreign policy objectives means that changes in fiscal policies will have to be much more dramatic. But that's not all. Washington will have to give much more attention to the competitiveness of the economy. America's international economic strategy will have to shift to a more wholehearted multilateral style. It is not at all clear, however, that such changes in economic policy could be forthcoming from this administration, for they would constitute a radical u-turn in philosophy and direction.

But let's withhold speculation on what the administration will do and ask what it should do if it is determined to successfully exercise American power in the preemptive and unilateral way that it is doing now. What would the framework for its economic efforts look like?

George W. Bush is the first president ever to attempt to reduce taxes in wartime.

First, all tax cuts would have to be canceled. Think of it this way: George W. Bush is the first president ever to attempt to reduce taxes in wartime. His administration is proposing doing so while simultaneously acknowledging that they don't know how long the Iraq war will last or what the subsequent humanitarian and reconstruction needs will look like. Moreover it is clear that the administration doesn't know how the situation in North Korea will unfold; it doesn't know the full parameters of the war on terrorism; and most experts believe that the all-important homeland security defenses are woefully under-funded. A few months ago, before virtually any these incremental foreign policy and domestic security costs were accounted for, the projected budget deficit for next year was more than $300 billion, and for the period 2003-2010 it added up to more than $1 trillion. In late March, the Congressional Budget Office, reflecting updated numbers, was throwing around projections of twice that amount. And none of this includes some $25 trillion of liabilities coming due for Social Security and Medicare programs for soon-to-be retiring baby boomers.

The implications of these deficits are both financial and highly political. Investors could assume that the U.S. will go into such enormous debt that its only way out would be for the federal reserve to tolerate - indeed encourage - inflation in order to erode the burden of debt service on the money that Washington needs to borrow to fund its deficits. This in turn could cause foreign holders of dollars to sell them, forcing the Federal Reserve to increase rates to make holding U.S. assets more attractive. Meanwhile, bond holders, fearing huge fiscal deficits, will demand higher interest rates to purchase future U.S. Treasury obligations. Higher rates would undermine the U.S. economy and set back prospects for generating tax revenues, creating a vicious downward cycle in America's ability to afford what it needs.

In the absence of a dramatic effort to reduce fiscal deficits, moreover, the U.S. would be headed for a vicious guns vs. butter debate that will poison and paralyze all political discussions. Already there are complaints from politicians about the cost of rebuilding Baghdad when Baltimore is hurting. As in the Vietnam years, we could be headed for politically explosive trade-offs between foreign and domestic priorities. A divisive struggle at home would undercut support for any administration's efforts abroad, unless American security is more clearly and immediately threatened than it now seems to be.

A second priority is for Washington to review its policies relating to competitiveness and productivity. One reason is that while U.S. productivity has been high this past decade, it hasn't been high enough to ensure sufficient tax revenues for financing foreign obligations. Another is that new imperatives of homeland security could impede America's dynamic economy if special policies are not implemented to avoid the growth of a siege economy.

The current estimate of budget deficit does not include $25 trillion liabilities coming due for Social Security and Medicare programs.

Here are some areas in which Washington, Wall Street and corporate America should be concerned when it comes to preventing counter-terrorism measures from undercutting productivity: constricting the immigration of skilled workers; curtailing the dissemination of scientific research; inadvertently impeding commerce through measures to secure ports, telecommunications, energy, and transportation. As Deborah Wince-Smith, president of the Washington-based Council on Competitiveness told me, "If homeland security is just about guards, gates, and guns, it will drain our competitiveness."

A third policy change should come in the global arena. Unlike in the military sphere, America is not strong enough to pursue a unilateral economic policy. Trade, finance, and technology have all become too intertwined across borders. The U.S. has become highly dependent on foreign governments and private investors to finance its rising current account deficits and debts. In early 2003, for example, America has been borrowing over $2 billion a day from foreign sources to fill its gaps between imports and exports. Add to this the enormous financial burdens coming down the road for overseas nation-building and reconstruction and it's easy to see why Washington would greatly benefit from more financial burden sharing with other countries.

It is extremely urgent now that Washington attempt to pursue a stronger multilateral economic diplomacy than it has since the administration came into office. Just for starters, the Doha Round of trade negotiations is stalled; transatlantic financial negotiations relating to banking regulations have become increasingly contentious; harmonization of accounting regulations and antitrust procedures are in need of a push, too.

Unlike in the military sphere, America is not strong enough to pursue a unilateral economic policy.

In this explosive situation, the administration ought to take a leaf out of the book of President Franklin D. Roosevelt during the darkest days of World War II. FDR recognized that the success of the post war era would be both new security and economic arrangements. He made Washington the focus of both. The administration should do likewise now, calling together the Group of Seven industrial nations immediately to get multilateral economic policy back on course - and with a new determination to prevent military tensions from spilling over into the global economy.

In 1989, Yale historian Paul Kennedy traced the fates of nations that once presided over large empires, such as Spain, the Netherlands, France, and Great Britain. He showed how each lost its grip and declined because of an inability to build and sustain economies that were capable of financing foreign policy ambitions. Unless something changes in America - either its foreign policy or its economic policy - does it not appear that we are headed down this very path?

Jeffrey E. Garten is dean of the Yale School of Management. His latest book is The Politics of Fortune: A New Agenda for Business Leaders.