

An overview of military expenditure economics essay



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Military expenditure and foreign direct investment have interrelationship between each other. Military expenditure has both positive and negative effect to the foreign investment as it depend on countries cases. One of the consequences of military expenditure to the economy of the countries is investment effect. The tradeoff between military expenditure and investment is an increase in the defense spending make higher government borrowing and thus absorb the fund that government used to investment would reduce. This is called an opportunity cost that countries need to accept in order for them to allocate more budgets to the military sector. While the positive effect of military expenditure are the introduction of modern skills, strengthen economic infrastructure and reduce the unemployment rate.

How military expenditure can reduce the FDI? This is through the less attractiveness of the country because high military expenditure indicates the country spending less on growth and development. In that case, foreign investors will not invest their money in that country. The consequences are it will affect economic growth as FDI is a main engine for the developing countries to finance their investment for the purpose of expanding their economy.

There is no consensus among analyst to date the interrelation of military expenditure and foreign direct investment as it yield mixed result.

Muhammad Khan, et. al (2011), public spending which defense spending can retard the effect of FDI on economic growth if the percentage of defense spending is beyond 6% due to the higher involvement of government role in economy activity.

1.2 An Overview of Military Expenditure

Military expenditure can be defined as all costs that countries use for military activities such as armed forces, equipped for military operations, military space activities, procurement, military research and development, and military aid (SIPRI). All countries need to measure their military expenditure in order to know the burden of military spending in the economy. Moreover, the government can give more priorities to the sectors that should focus more such as education and health by comparing the military spending with the other sector. Military spending can measure the level of peacefulness for the countries and also can indicate the power of the countries. For the researchers, they can study the effect of military spending on the economy such as the impact on growth and economic variables, the tradeoff and the determinant of military expenditure.

In 2010, world military expenditure is increasing 1.3% in a real term over 2008. On average, for year 2011 about sixty-two countries increase in their military spending while sixty-two countries are decreasing. For the period 2002 until 2011, the trend for military spending shows a rapid growth in North America which is increasing almost 109% of the real term. From this figure, 75% of it is accounted for by the USA. From year 2000 until 2011, the increasing of military spending for East Asia is 69% while Central and South Asia is just 62%.

In the United States, the military expenditure shows a decreasing trend because of the withdrawal of US armed forces from Iraq and Afghanistan. In addition, the US government wants to reduce the burden of debt. So the US has to cut the budget for the military sector. While in Europe, because of their

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economic crisis, majority of countries have to cut down their defense spending. In Western Europe, most of the country start to cut that budget since 2010 while most of the countries in central and Eastern Europe, they start cutting that budget since 2009 as they are the weaker economies in Europe.

Figure 1. 0 Biggest decrease in Europe military spending . Sources from SIPRI Press Material, 2011

Russia is the third largest of world military spenders and the budget for military spending is increasing 9. 3% in 2011. Russia also plans to increase this defense spending about \$749 billion on military equipments, R&D and arms force. Furthermore, Russia plans to replace 70% of Russia's mostly Soviet-era military equipment with modern weaponry by 2020 (SIPRI Press Material, 2011).

Military spending in Asian countries saw an increasing trend especially for China which likely to overtake Europe. The increasing of military spending in Asian countries is more than 3% in real term for year 2011. According to John Chipmante who is director general of the International Institutes for Strategic Studies (IISS) this is due to rapid economic growth and strategic uncertainty. China shows the rapid increase in military spending by 170% in real term since 2002. This spending at least gives some good impact to China such as increase in salary and also provide a better condition for the defense sector in term of equipment and quality of arms force.

This condition contributes to the increasing India's military spending by 66% in real term since 2002. Taiwan also increase their military spending but in <https://assignbuster.com/an-overview-of-military-expenditure-economics-essay/>

small scale while Japan shows a decline trend. In average, the other Asian countries like Philippines, Vietnam, Thailand and Cambodia are likely had a similar upward trend of military expenditure (SIPRI Press Material, 2011)

Figure 1. 1 Share of World Military Spending for the Top 10 Spenders, 2011.

Sources from SIPRI Press Material, 2011

The figure above shows the shares of world military spending for the top 10 spenders in year 2011. 41% of world military spending is accounted for USA while China is the second largest which is 8. 2% then followed by Russia (4. 1%), UK (3. 6%), France (3. 6%) and others.

Malaysia was ranked moderate to low in the defense budget transparency compared to others developing countries that scored moderate and low like Indonesia, China and Pakistan. Ministry of Defence in Malaysia is a fourth largest that financed by government after Ministry of Education, Ministry of Higher Education and Ministry of Health. In Malaysia budget 2012, the budget spending for military expenditure will reduce by RM100 billion if compared to year 2011 amounted RM13. 823 billion.

Figure 1. 2 Malaysia's Military Expenditure (% of GDP)

The figure above shows the military expenditure in percentage of GDP for Malaysia from year 1988 until year 2010. Every year, the government tries to cut the spending on this sector. In year 2009, Malaysia cut the military expenditure almost 50% due to the economic downturn. Navy is affected from the cutting budget where the budget for arm procurement decreased from RM811. 12 million to RM100 000 and followed by Army where the

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amount of decreasing was RM1167.77 million. Meanwhile, Air Force having an increase budget because of purchasing of new type of utility helicopters.

There have a link between military expenditure and military capability but there can be other factor that intervene the link between both of them. High military expenditure can contribute to high military capability for the countries. Even though the country has high level of military expenditure but they use that for maintaining excessively large army, this would not contribute to the high level of capability. If the country try to reduce the size of arm force but they give better training and have equipment that suitable in the modern conflict, the country can develop high military capability. This shows how well the mix between personnel and equipment expenditure in military. Beside that the military capability also depends on efficiency on handling the military expenditure. If the country has poor planning on that expenditure or has corruption in the management, that spending will not generate military capability.

1.3 An Overview of Foreign Direct Investment

Countries need investment in order to develop their own countries as well as economy which can be obtained through public and private funding.

Unfortunately, this amount is not enough and need to find the other financial sources outside the country's boundaries. Therefore, foreign direct

Investment becomes important for the development of the countries. Many empirical studies have proved that to those countries that opened to FDI has higher growth rate and give positive impact to economic development. To make this happen, government need to attract foreign investors by made

changes in their policies. There have two type of FDI which are:

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Direct Investment: investment made by the foreign countries in order to have influence on the development of a firm's long term strategy.

Portfolio Investment: investment made through bond, share in order to obtain short term profitability.

As mentioned before, FDI can bring many benefits to the economy such as can stabilize the capital flow, become more productive as there are many competitors, generate employment, transfer of technologies and can fill the saving gap between the required funds for growth and the internal saving capacity of a country. Moreover, FDI is a crucial factor of the country's degree of economic globalization and integration into world economy (Marial et al., 2009). Demekas et al. (2005) states that FDI can be the vehicle for the country to finance their external current deficit as FDI are a non debt creating financial commitments.

The amount of increases of FDI inflow for three sub regions including East Asia, South-East Asia and South Asia was 24% in 2010. Figure 1.3 below shows FDI inflow to ASEAN countries for year 2010 where Malaysia was the third largest recipient after Singapore and Indonesia. FDI inflow into Singapore was increased from US\$15.3 billion to US\$38.6 billion in 2010 while for Indonesia, the country also had a strong growth from US\$4.9 billion in 2009 to US\$13.3 billion in 2010. An increasing trend for all ASEAN countries in their FDI inflow was due to the growth in domestic demand and strong expansion in private sector activities (Malaysia Investment Performance, 2011)

Figure 1.3 FDI Inflows to ASEAN Countries in 2011. Sources: MIDA
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Foreign direct investment (FDI) is part of Malaysia engine of economic growth. In 1980s, Malaysia is one of the countries in the world that produce the primary product such as tin, rubber and palm oil. Then, year by year Malaysia starts to expand the market in heavy industries. According to Prempeh (2003), Malaysia becomes more attractive in term of the flow of FDI because of several factors such as the undervalued of Malaysia's Ringgit, low cost of labor supply and low inflation rate.

Malaysia inflow of FDI has an increasing trend start from 1970 until 1994. After that, the amount of FDI inflow shows a decreasing rate because of the great recession in 1994 and it start to recovery in late 1978. In 1983, Malaysia FDI decline due to the world recession and electronic crisis and the amount of reduction was recorded about RM500 million compared to the year 1982. After Government of Malaysia implement Industrial Master Plan (IMP) in 1986- 1995, FDI inflow has increased by RM126 000 million in 1993. Malaysia faces a drop in FDI again in 1994, 1997 and 2001 due to the Asian financial crisis and incident of September 11, 2001 respectively.

According to Minister of International Trade and Industry, Datuk Seri Mustapa Mohamed, the FDI for last year (2011) is the highest where the amount is RM32. 9 billion has been recorded. This is due to the Economic Transformation Programme (ETP) which attracted many foreign investors to invest in Malaysia. The major foreign investment is come from Japan, Singapore, Netherlands and Taiwan. Even in year 2010, there has been a wave of FDI flows into Malaysia amounted RM20. 3 billion where most of this figures is go to the manufacturing sectors. There have measure to increase FDI and investment that government already done. Part of them are <https://assignbuster.com/an-overview-of-military-expenditure-economics-essay/>

empowering Malaysia Investment Development Authority (MIDA) to attract investment, benchmarking Malaysia's attractiveness, reducing corporate and personal income taxes to selected industries, easing regulator burden and providing industry tailored incentives.

All these shows that investors' confident toward Malaysia's opportunity business and Malaysia is on track to achieve the investment target by year 2020 where the goal is RM1. 2 trillion under ETP. From this, the employment opportunities can be create where about 149 496 jobs can be offered to the citizen. Out of the total investment, 55. 4% is come from domestic investment and the rest (44. 3%) is from FDI. The figure below shows the Malaysia's FDI inflow from year 1980 until 2009. In year 2009, the FDI in Malaysia fell sharply due to the United State financial crisis that happened in 2008 which have negative impact to the inflows and outflows of FDI. But it recovery in 2010 after government announced the liberalization measures aimed at luring investment.

Figure 1. 2 Malaysia FDI Inflows

Figure 1. 3 below shows total investment approved in Malaysian economy for the year 2011. The total investment approved was amounted RM148. 6 billion and about 4964 projects was approved in Malaysia due to the Economic Transformation Programme (ETP) and also New Economic Model (NEM). This is expected to create 149496 job opportunities in Malaysia including all investment that approved in service, manufacturing and primary sectors. For service sector, there has an increasing rate up to 75. 5% and the amount was RM64. 4 billion. This can generate about 43, 784 jobs from this

sector. For the manufacturing sector, the amount of investment increase to RM56. 11 billion compared to 47. 2 billion in last year (2010) and for the primary sector, it contributes 18. 9% of total investment in Malaysia.

Figure 1. 4 Total Investments Approved in the Malaysian Economy in 2011.

Sources: MIDA

Figure 1. 5 below represent the investment and employment in project approved for year 2006 until 2011. From year to year, Malaysia was record higher foreign investment compared to the domestic investment. This showed that Malaysia was a competitive investment location for foreign investors. From 100% of total investment approved in Malaysia, 61% was foreign investment. There have decline in total investment in 2009 but yet still foreign investment greater than domestic investment.

Figure 1. 5 Investment and Employment in Project Approved, 2006-2011.

Sources: MIDA

The major sourced of foreign investment were come from Japan, Korea, USA, Singapore and Saudi Arabia. Japan was the largest investor with RM 10. 1 billion and mainly in E&E products. Korea was the second largest investors with RM5. 2 billion and mainly in manufacture of lithium ion batteries. Unites State was the third largest investors with RM2. 5 billion and mainly in diversification project for manufacture of electronics, bio and chemical. Singapore was focus in the food manufacturing and E&E industries while Saudi Arabia was focus in manufacturing of polycrystalline silicon.

1.4 Problem Statement

Questions have been raised about the effect of military expenditure on economic growth. The opportunity cost for military expenditure can be an important thing that countries must be note in order to know the effect of that spending to the growth of the countries. There must be a tradeoff or an opportunity cost for the countries if they focus more on military expenditure as it is an unproductive expenditure. The reason for this argument is government will take some portion of resources away from the other economic activities like investment, health and education which those are all the productive expenditure. But from the other perspective, military expenditure also has their own role to the economic such can strengthen economic infrastructure, reduce unemployment and can encourage fully utilization of the existing production facilities.

Deger and Sen (1995), Devarajan et al. (1996), Glomm and Ravikumar (1997), Shieh et al.(2002), Luca Pieroni (2004) claims that high level of military expenditure can retard the development as the resources can not be allocated to the better use. According to Collier (2001) in the World Bank Policy Research Working Paper, found that on average the country growth rate will reduce which lead to decreasing about 20% level of income when the country double the military expenditure. According to Hamid Davoodi et. al (2001), reduction in international tension will lead to reduce in military spending and thus increase the nonmilitary spending in total spending.

However, the world still continues to spend more from the total budget on military sector. As increase in military expenditure will reduce the saving and reduce the investment because higher defense spending make higher
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government borrowing thus absorb funds that would otherwise have gone partly to investment. Degar (1986) found that military expenditure and investment have negative effect as increase in military spending may cause higher inflation and taxation. In the long run, it can impede the growth of Malaysia economy. By reducing excessive defense spending, the country can use it to provide short term economic stimulus where it can be as a precautions when the country facing recession. In addition, reducing military expenditure will not cause job losses (in term of army).

All these factors above can affect the Foreign Direct Investment (FDI) come to countries. One of the main reasons the reduction of FDI inflow is the country is less attractive and not offer better return to them. If the countries spend more on military, the foreign investors feel that the country has less attraction as we spending less on economic development. Moreover, less resources that will contribute to the development of human capital in which this factor has a favorable impact on inflow of FDI. Less human capital development shows that the country has less supply of skilled labor even though they have abundant of labor force. This view is supported by Sharma and Gani (2004) who state, "...increase in FDI are associated with slight improvement in human development." Thus, it may lead to other consequences because FDI inflow played as one of the main engines of economic growth. Most of developing countries face shortage of capital to finance their investment. So, to solve that problem they need to attract as much as FDI to their countries. This is called crowding out effect or opportunity cost in order to increase military expenditure.

In Malaysia, military expenditure is decreasing over year while FDI is fluctuate over year, but starting 2009 FDI is plumped and already exceed the investment target. All these can give positive impact to the Malaysia economic growth theoretically. The relationship between military expenditure, FDI and economic growth has attracted interest for the economist to investigate since it yielded mixed result on different cases of countries and there is no specific prediction about the relationship between them.

As such, in the case of Malaysia, this study wants to know whether there have long run relationships between military expenditure, FDI and economic growth and causal effect between them.

1. 5 Research Objective

The research study should have objective because it is important thing to researcher in guiding her in order to achieve the reason why and purpose of doing the research. The purpose of this study is dividing into two categories:

The general objective is to study the long run relationship between military expenditure, FDI and economic growth.

The specific objective is to determine the causal effect between military expenditure and FDI.

1. 6 Research Question

There are several research questions that has been developed regarding the problem statement occurred. The research questions can be:

What is the long run relationship between military expenditure and FDI on economic growth?

What is the causal effect between military expenditure and FDI?

1. 7 Significance of the Study

The impact of military expenditure on economic growth is an arguable issue that is increasing in military spending may absorb fund that would otherwise have gone partly to investment which in turn lead to inefficient resources allocation. The correlation between military expenditure, FDI and economic growth is a crucial issue since military is important to protect the security of country and FDI also important for developing countries like Malaysia.

This study makes a contribution to the existing studies on military expenditure and economic growth. In spite of the importance of causal relationship between military expenditure and growth, defense spending also has an impact on the investment of the country. Therefore, analyzing the interwoven between military expenditure, FDI and growth is the contribution in this study.

1. 8 Organization of the Study

The paper is organized as follow. In section 2, there provide the literature review of the effect military expenditure on FDI and growth. Section 3 will explain the methodology used in this studies. Section 4 will explain about the findings and last section (section 5) will explain about conclusion and recommendation for this study.

CHAPTER 2: LITERATURE REVIEW

There are various empirical studies on the military expenditure and FDI on economic growth.

2. 1 Military Expenditure

The first serious discussion and analyses of the relationship between military expenditure and GDP growth emerged during the 1970s by Emile Benoit (1973). His study was focus on forty four less developed countries (LDCs) and found that military expenditure has positive relationship with economic growth. However, Nicole Ball (1983) argues that military expenditure can not contribute to higher growth. After that, Benoit (1978) revise back and found two effect of military expenditure on growth which is positively and negatively. The negative effect is military expenditure absorb the resources from productive activities while the positive effect is it can reduce the unemployment, improve infrastructure and involve in research and development (R&D).

Deger (1981) points out that increase in military expenditure reduce the fund that should be used for the formation of human capital. This view is supported by Muhammad Khan, et. al (2011) who studies a time series analysis of public spending, FDI and economic growth for Pakistan from 1975- 2008. He state that public spending give negative impact to economic growth due to large proportion of budget is use for defense spending, thus it can neglected the human capital. As the result, it can impede the growth.

Deger and Smith (1983) traces that the higher military spending can retard the economic growth of that countries. This is because the military spending

will take a portion of capital equipment that will use for consumption and investment as these can slow the growth of economy. In less developed countries, Deger (1986) claims that there is negative relationship between both variables as military spending can give bad impact to investment and also can not generate saving for the countries. Moreover, Dunne et al (2002) investigated the relationship between military spending, investment and economic growth in small industrializing economies. He used panel data method and found that military spending can harm growth by give negative impact to investment.

According to Dunne (2010), who investigates about military expenditure spending and economic growth in Sub Saharan, he found that military spending give negative impact to economic growth in both short run and long run. For the case of Egypt and Israel, reducing the military spending can improve the economic growth. While in the case of Syria, the shifting resources from military to civilian spending will not enhance growth unless the civilian can produce productive activities (Suleiman Abu-Bader, 2005).

Many studies about this issue were found that the higher military expenditure led to lower economic growth (Deger and Sen, 1995; Devarajan et al., 1996; Glomm and Ravikumar, 1997; and Shieh et al., 2002). This is supported by Luca Pieroni (2004) that the economic growth will down if the public expenditure is getting increase because there are potential that government using the resources for unproductive public sector such defense spending. In average, increase in military expenditure will reduce the growth of economy especially for poor countries. This is because they import the military equipment so when they increased the spending, the opportunity <https://assignbuster.com/an-overview-of-military-expenditure-economics-essay/>

cost that they may bear is less development for their countries (Paul Collier, 2006).

Kalakech et al. (2009) claims that defense expenditure and growth has negative correlation in the long run and insignificant in the short run.

According to Shieh et al (2002), who studied about the impact of military burden on long run growth and welfare, there have three channels that military can affect the private investment. First is through budgetary crowding out effect. Increase in military spending can cause the fund that will use for having better infrastructures become less. As the quality of infrastructure decrease, it can lower the production of private output and decrease the resources of investment. Skabic and Orlic (2007) and Botric and Skuflic (2006) found that the development of infrastructure is important to attract more inflow of FDI to the host country but it contrary in the case of Africa. Nnadozie and Osili (2004) study on United State's outflow of FDI to Africa, they point out that the roles of infrastructures have less important to attract FDI. Second is through spin off effect. Higher military expenditure can increase the home weapon stock. Thus, it increases the private production and also can promote investment. Third is through resources mobilization effect. It can increase private investment by reducing consumer current consumption in order to have higher future utility.

High military spending significantly retard the economic growth and if the country reduces the spending, it would not affect the security of the country (Khilji, 2005). Beside that, Henderson (1988) claims that high level of military spending can lead to poverty through unemployment and inequality. This view is support by Tang et al. (2009), who find that the unemployment rate <https://assignbuster.com/an-overview-of-military-expenditure-economics-essay/>

in low and middle income countries increasing when the military spending increase. Numerous studies have attempted to explain that increase in military spending can cause income inequality due to different income payment to workers in military and civilian sector (Abell, 1994; Melman, 1974; Carson, 1987). This is because workers in hi-tech industries can get high income and spending on hi-tech weaponry generates relatively fewer employment gains, especially for minorities and other disadvantaged individuals who do not possess the requisite education or skills to work in the defense industry or related research activities (Carson, 1987).

It can not be conclude that increase in military expenditure can harm the economic growth. As analyzed by Deger and Sen (1983), military expenditure have positively and negatively correlation with growth. For positive correlation, military expenditure can increase aggregate demand and creating new technical progress while for the negative correlation, military expenditure can affect investment, saving and balance of payment. This is in line with Hassan et al. (2003). He investigates the effect of military spending on growth and FDI in five South Asian Regional Cooperation Council (SAARC) countries from year 1980 to 1999. He found positive relationship between military spending and economic growth.

Baker (2007) investigated the impact of the Iraq war and higher military spending on US economy. The result shows that military spending can enhance the economy in the short run by boosting demand, providing more employment and increasing in output. The bad impact for high military spending can be seen in the long run which after 10 years the country imposed higher defense spending. High inflation can lead to increasing the <https://assignbuster.com/an-overview-of-military-expenditure-economics-essay/>

long term interest rate and these can cause lower in investment. Moreover, high real interest rate helps to push up the dollar currency which can lead to lower export and higher import as the imported goods become relatively cheaper than their own goods. In this case, the government will face larger current account deficit and lead to larger foreign debt.

In the case of USA, the government increase their military spending after the 11 September 2001 attack and give impact to the economy. High level of military expenditure increasing the US debt and reduce the productive capital. Beside that, the raising of interest rate can lower the private investment. Even though the increasing in military expenditure can contribute some good impact such as the stimulate effect of government purchase and high foreign saving through high interest rate, but all these cant recover the loss from impose high level of military expenditure (Edward, 2011).

Military spending did not directly harm the economic such as disturb the government to provide better health and education but it can induced economic stimulation. This is because military spending not only as a source for increasing an aggregate demand but as a protection for foreign investment and give profits for defense contractors (Baran and Sweezy, 1996). Military spending can enhance the security of the countries, thus it can promote more foreign investment come to that countries. In the other cases Gold (2005) reported that military spending can improve the demand stimulation but in a small percentage and it happen by coincidence rather than by volition.

Higher level of military expenditure can retard the human development.

Nabe (1983) study about the effect of military expenditure on social development (in term of education and health) for twenty-six African countries from 1967 to 1976, he claims that military expenditure give negative impact to social development. However, Verner (1983) carried out an investigation on the effect of military expenditure on education in 18 Latin America and the result showed that only one country has negative tradeoff, ten countries have positive tradeoff and the other seven countries have no significant tradeoff. It means that not all countries have the same cases and it's depending on how the spending of military sector has been used. Military expenditure can builds human capital if parts of the spending are used for education and training for army, discipline and so on.

Furthermore, it can improve welfare and productivity if this spending is used for revamping the economy during crisis such as floods, tsunami, attacks from terrorist and so on.

Sharma and Gani (2004) study about The Effect of FDI on Human Development for middle and low income countries for the period from 1975 to 1999. They predict that military expenditure has negative relationship with human development that contributes to less FDI. This is because of high level of military expenditure indicates less activity for enhancing human welfare and productivity. Thus, it will cause reduction in FDI inflow as foreign investor less interested to that country. However, the result shows that the positive relationship between both variable. The reason is defense sector provide major employment and the income effect raise human development. Thus, attract the FDI inflow to that country.

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Labor resources are one of the importance factors to generate more FDI. Zenegnaw (2010) study the determinant of FDI from the demand side, he claims that the more African countries spend on human capital, the more FDI they can attract to flow to their countries. Li and Liu (2005) pin points that the interaction of strong human capital with FDI can give strong impact to economic growth for the country.

Borensztein et al (1998) shows that a country can get fully benefits from FDI when the country achieves certain level of human capital and FDI are a complementary with human