Chapter 3
Defense Expenditure and Economic Performance in SAARC Countries

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ABSTRACT
Governments in most of the nations aim to fulfil their requirements and protect themselves with the necessities of public life from the external threats, and also try to separate a significant portion for defense-related spending from the budget. But the impact of defense expenditures on economic growth is not apparent. It deserves an empirical investigation to explore the external effect of defense spending on the economic performance of the country. The authors choose six SAARC countries, namely Afghanistan, Bangladesh, India, Nepal, Pakistan, and Sri Lanka, where defense-related issues regarding internal security as well as external relationships with neighbor countries are the most significant to examine the relationship between defense expenditures and economic performance measured by GDP growth. The method of GMM estimation is applied in a dynamic panel structure of selected countries over the period 1970-2016. Empirical findings show that, besides some possible factors, defense spending has a positive and significant impact on economic growth in SAARC member nations.

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INTRODUCTION

The importance of defence and defence expenditure is a debatable issue. Military expenditure can affect an economy either positively through an expansion of aggregate demand or through crowding out of investment. Defence spending can stimulate an economy through the Keynesian mechanism especially in the period of high unemployment. According to Keynes, aggregate demand rises when there is more public funding. This will increase effective utilisation of capital stock which in turn lead to higher profit and may induce higher investment and ultimately higher growth rate. Both supply-side and demand-side theories collectively affirm the influence of public spending on economic growth in the modern study of economics. However, emerging debate is what kind of public spending and type of its impact that can be ascertained? In this perspective, military expenditure as one of the important components of public spending comes under the scrutiny.

According to Public economics, the defence is a public good. In economics context, markets either don’t produce public goods or produce inadequate quantities, and this is because of their non-excludability and non-rivalry status. Non-excludability means the consumption of the good by one individual doesn’t reduce the amount available for others while non-rival denotes difficulty of excluding someone from enjoying the benefits of public goods via the price system (Rosen, 1999). Intuitively, it becomes an automatic disincentive for private individuals to sufficiently provide public goods because suppliers find it tricky to reap the benefits of their investments. Economics theories, therefore, justify government intervention in the economy as a provider of defence, which is financed by non-voluntary taxes. However, just like private goods, the provision of defence is externality producing, the more armed the nation becomes, certainly the more negative externalities it poses to its adversaries and the more it sets up positive spillovers to its allies without market intermediation. In the home country, military experiments (like testing nuclear weapons) energize pollution to the magnitude of being a negative externality to other sectors of the economy (Sandler & Hartley, 1995).

Nonetheless, given the fact that a number of conflicts global-wise have ended by military victory, high military spending improves security which unleashes favourable climate for investment, trade and growth. Moreover, the worldwide experience of market failure credit military spending at high level as a therapy of countercyclical by enhancing aggregate demand (Military Keynesianism); and more controversy on policy fronts is likely to surface provided that the growing external threats dictate high military expenditure while the current inflationary pressure requires a decline in aggregate demand (Frank & Bernanke, 2001).

Still, disagreements on causality take roots as the rise in military outlays in fast growing or resource rich countries like China, India, Saudi Arabia and Algeria get connected to Wagner’s theory. In view of this, defence spending steps up because at higher output growth these nations have more resources to spend and more resources to be protected, which means higher economic growth ignites higher military expenditure (Albatel, 2002). Theoretical discussion of military expenditure just like any other fiscal component plus its security implication articulates a possible link between military outlays and economic growth. The empirical findings of the past have shown both positive and negative relationships, or in some cases, there is no relation between military expenditure and economic growth.

Central Intelligence Agency (CIA) ranking of military spending as a percentage of GDP shows that ahead of China, India and USA among the top spenders. As we know India belongs to SAARC group and China is an important neighbour of this group of countries. One of the reasons for the increases in military expenditure has been given as the countries’ endorsement of military oriented education, health,