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Impact of Military Expenditure on Economic Growth: Encouraging or Constraining?

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Abstract

Security is a form of guarantee that needs to be given by the state to its citizens. This fulfillment can be realized through the provision of national defense for all citizens. Nevertheless, military expenditure as a source of providing national defense needs attention. This is caused by its unproductive nature when compared to other sectors such as agriculture, banking, industry, and others. This study aims to analyze the effect of Military Expenditures on the level of Economic Growth. Furthermore, this study also analyzes the effect of interactions between Military Expenditure with other variables such as Population, Foreign Direct Investment (FDI), Political Stability, and Rule of Law, to see their indirect effects on Economic Growth. This study uses secondary data and covering 27 selected Lower-Middle Income Countries from 2002-2018. Furthermore, this study uses dynamic panel data analysis with the System Generalized Method of Moments (GMM) method. The Military Expenditure in this study does not significantly influence Economic Growth. However, it was found that Military Expenditure had a positive and significant influence on Economic Growth when interacting with other variables.

Key words : National Defense, Military Expenditure, Economic Growth, System-GMM

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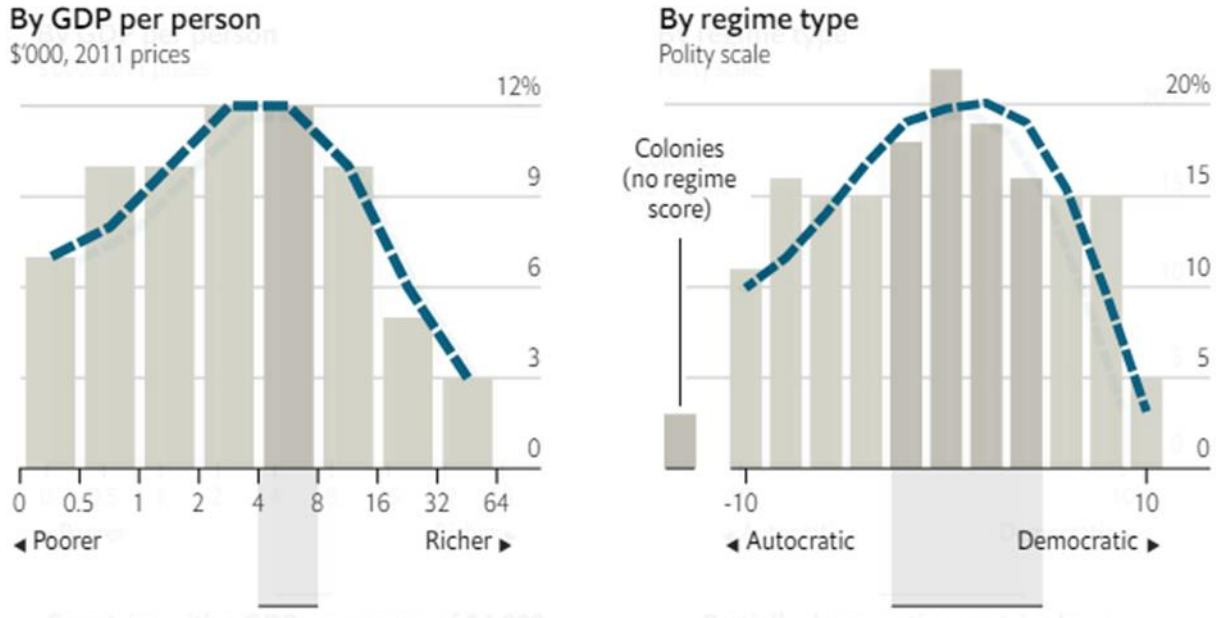
INTRODUCTION

Security is an important element in the running of a country. Guaranteed security will encourage various activities to run well, from the economic, political, social, and other fields. If security in a country is not well guaranteed, internal to external conflicts will probably occur. To prevent this, we need a system that can minimize unwanted conflicts through National Defense.

National Defense is a security system that aims to protect all citizens from threats that come from within and outside the country. In the realm of the public economy, National Defense is included in the Pure Public Goods category (David, 2014; Rosengard & Stiglitz, 2015). Pure Public Goods have two main characteristics, namely (1) Non-rival consumption, indicating that the goods or services consumed will not affect the benefits received by others in obtaining the same benefits; (2) Non-excludable means that the benefits of public goods can be felt or enjoyed by anyone, without exception.

The role of policy in the military field does not only arise when a country is facing war. One of the goals is to create a sense of security for its citizens and protect their sovereignty from internal and external threats (Kollias, Paleologou, Tzeremes, & Tzeremes, 2018). Furthermore, one of the most important elements in the implementation of a country's military policy is the level of spending used. Countries with vulnerability to the emergence of war will allocate more of their Public Expenditure compared to countries that have a much better level of security (Rahman & Siddiqui, 2019).

War-prone countries have several tendencies. Countries that are in the spectrum of a fully autocratic or full democracy system and middle-income countries have a relatively greater tendency to war (The Economist, 2018).



Source: Peace Research Institute Oslo; Uppsala Conflict Data Program; Centre for Systemic Peace; Maddison Project Database; iCasualties.org; World Bank; The Economist
Information: The image is quoted from the analysis of The Economist entitled *"Which Countries are Most Likely to Fight Wars?"*

Figure 1. Statistics of Countries Experiencing War 1900-2017

Based on Figure 1, it can be seen that countries with middle income, or in the range of USD 4,000-8,000 are vulnerable to conflict with a percentage of 12%. Countries that are under government systems that adhere to systems between autocracy and democracy are also more prone to conflict with a figure of around 18%. Therefore, the provision of National Defense is deemed necessary to maintain stability and defense from various forms of conflict that may occur.

Determination of military spending by a state government, of course, takes into account various things. However, the increase in military spending to maintain stability and security in various countries has often received criticism from economists. One of these public sectors is considered as an unproductive sector because of its nature that cannot produce goods and services such as the industrial sector, agriculture, banking, and others (Clements, Gupta, & Khamidova, 2019; Hou & Chen, 2013). Furthermore, Clements (2019) emphasizes that this expenditure can also lead to a decrease in investment from the private sector. In the empirical realm, spending in the military sector is seen as being able to erode resources that can be used for sectors capable of spurring Human Capital development (Olumuyiwa & Olalekan, 2014).

The main focus of economics is about scarcity and choice, in which resources are limited, and the choice to allocate them is a must. In this context, Public Expenditure which is also intended for other sectors is ultimately also influenced by spending in the defense sector. This reflects that there may be trade-offs between sectors - such as the military with health or education. Moreover, there is too much expenditure for sectors that cannot produce goods or services directly like the defense sector. Therefore, military spending must continue to be considered

Several expenditure routes in the military sector can affect the economy (Dunne, Smith, & Willenbockel, 2005). The path is divided into three categories. First, the Demand Effects will operate through the level and composition of expenditure. An exogenous increase in military spending would increase demand, and if there was remaining capacity, it will reduce existing unemployment. The limited government budget will make the increase in spending in the military sector financed by cutting another public spending, increasing taxes, and making loans. Second, the Supply Effect operates through the availability of factors of production - such as labor, physical capital, social capital, and technology - that determine the total potential output. Third, Security Effects work through protection for society as well as their rights from domestic and global threats that can threaten the operation or work system of the market, as well as incentives to invest and innovate.

Regardless of its relationship to economic growth, spending on the military provides one benefit in the form of stability for a country, as well as security for its citizens. The realization of conductivity from the existence of National Defense also contributes to supporting harmonious economic activities (Block, 2003). At the very least, security guarantees will reduce uncertainty or psychologically will increase a person's confidence or courage to carry out economic activities in the short and long term, such as investing.

Conductivity created by the existence of a national defense system through military spending can have an impact on other components related to investment. The military sector can also complement the role of institutions in carrying out their duties to maintain political stability and complement regulations/laws. This is of course based on the

actual function or role of the military sector itself.

Other studies also reveal the determining factors, which can affect spending on the military field. There are several factors such as the quality of institutions to the threats a country may encounter. Töngür, Hsu, & Elveren (2015) conducted a study in 1963-2000 that focused on the determinants of military spending. The research shows that countries with more democratic regimes will tend to spend relatively low military spending compared to other political regimes - Social Democracy, Conservative Democracy, One-Party Democracy, Dictatorship, Military Dictatorship, Civil War, Communist. Then, inequality is also associated with an increasing number of Military Expenditures.

Albalate, Bel, & Elias (2012) conducted a study for 157 selected countries in 1988-2006 to find determinants of military spending. The results of this study indicate that presidential democratic systems spend more than parliamentary systems on defense, while their interaction with majority general election rules reduces the burden of defense.

The role of military spending to support economic activity has also been highlighted. The political instability that may occur due to the less than the optimal role of the military can hinder the flow of foreign capital. Nazeer & Masih (2017), explained that political instability in Malaysia during the 1984-2013 period hindered the entry of Foreign Direct Investment, which would then have an impact on the level of economic growth in the short and long term.

This study aims to analyze the effect of military spending on the level of economic growth in 27 selected Lower Middle-Income Countries in 2002-2018. Furthermore, this study also analyzes the influence of the interaction between Military Expenditure and other variables such as Population, Foreign Direct Investment (FDI), Political Stability, and Law Enforcement, to see the indirect effect on Economic Growth.

METHOD

In this study, there are 2 (two) types of variables, namely the independent variable and the dependent variable. The dependent variable in this study is Economic Growth, while the independent variables include Military Expenditure, Population, International Capital Flow, Political Stability, and Rule of Law. The operational definitions of each variable are as follows: 1) Economic Growth (Y): a long-term increase in the ability of a country to provide a wider variety of economic goods to its population (Jhingan, 2012); 2) Military Expenditure (X_1): an indicator that measures how many economic resources are allocated for military activities (SIPRI, 1999); 3) Population (X_2): Population, in general, can be defined as several residents or people who live in a certain area. In this study, the Population Growth Rate which indicates the condition of the population in a country is used to proximate the Population variable; 4) International Capital Flows (X_3): International capital flows are the capital flows in and out of a country. This capital inflow is recorded in the capital account, which will later affect the balance of payment. This study uses Foreign Direct Investment (FDI) to proxies the international capital flows into a country; 5) Political stability (X_4): a situation where there is no civil conflict accompanied by violence, as a result of good governance; 6) Rule of Law (X_5): a condition where the rules of the community, ownership rights, contracts/agreements, police, and courts can be obeyed and implemented properly.

This research uses secondary data. The data used in this research is Panel Data. The data consists of cross-section and time-series data. There are 27 countries, in the period from 2002 to 2018 in this Panel Data. The data

obtained for this study came from various internet pages. The following is the source and size of each variable in this study:

Table 1. Data Source

Num.	Variable	Variable Symbol	Unit of Measure	Data Source
1.	Economic Growth (%)	EG	Percentage (%)	World Bank
2.	Military Burden (% of GDP)	ME	Percentage (%)	Stockholm International Peace Research Institute (SIPRI)
3.	Growth of Population (%)	POP	Percentage (%)	World Bank
4.	Foreign Direct Investment, Net Inflows (% of GDP)	FDI	Percentage (%)	World Bank
5.	Political Stability and Absence of Violence/Terrorism	POL	Unit	World Bank
6.	Rule of Law	ROL	Unit	World Bank

In this study, an analysis was carried out to see the effect of Military Expenditure on Economic Growth. There are several other supporting variables to help explain the effect of Military Expenditure on Economic Growth. The dynamic panel data model will be used in this study, and it would be reflected by the System-Generalized Method of Moment (GMM). Specifically, the regression specifications are as follows:

$$EG_{it} = \beta_o + \delta_1 EG_{i,t-1} + \beta_1 ME_{it} + \beta_2 POP_{it} + \beta_3 FDI_{it} + \beta_4 POL_{it} + \beta_5 ROL_{it} + \beta_6 (POP*ME)_{it} + \beta_7 (FDI*ME)_{it} + \beta_8 (POL*ME)_{it} + \beta_9 (ROL*ME)_{it} + u_{it} \quad (1)$$

The subscript of "t" represents the year, whereas "i" represents the country. EG is the dependent variable that represents Economic Growth. Meanwhile $EG_{i,t-1}$ **r**epresents the Lagged Dependent Variable (LDV) or Economic Growth in the previous year. The independent variable consists of ME, POP, FDI, POL, ROL, and several interaction variables.

Before interpreting the result, the dynamic panel data model also needs to go through several tests to obtain unbiased and consistent estimation results. The GMM assumption testing includes The Serial Correlation Detection Test and Instrument Validity Testing.

Statistical calculations on hypothesis testing Serial Correlation Test following the normal distribution of *P-Value*. When the value is bigger than α, so H_o that mentions there is no serial correlation problem is accepted. But, when the value of *P-Value* is smaller than α, so H_1 that mention there is serial correlation problem that can't be accepted.

After doing The Serial Correlation Detection Test, we have to do Instrument Validity Testing. The purpose of this test is to find out whether the use of instrument variables exceeds the number of parameters assumed is declared valid. If the value of *J-Statistic* is bigger than α, so H_o that mentions the instrument variables are valid is accepted. But, if the value of *J-Statistic* is smaller α, so H_1 that mentions the instrument variables are valid can't be accepted.

RESULTS AND DISCUSSION

Based on Table 2, it can be seen that the number of observations (N) in this study was 459. In this table, it can be seen that the minimum, maximum, and average of each variable. This figure is obtained from each variable, taking into account the coverage of 27 countries and 17 years of observation time. It can be seen that the group of countries with lower middle income has an average military expenditure of 1.56% of GDP. The lowest figure is 0.27% with a maximum point of 4.7%.

Table 2. The Descriptive Statistics of Independent Variable

Variable	N	Min.	Max.	Mean	Deviation Standard
ME	459	0.27	4.7	1.568279	0.9662412
POP	459	-0.994	3.711	1.572261	0.934187
FDI	459	-37.15	43.91	3.454292	4.695461
POL	459	-2.5	1.172	-0.59507	0.740335
ROL	459	-1.617	0.653	-0.57708	0.455857

*Source***:** Result of Data Processing from STATA 14

The dynamic panel data estimation tool that is often used is the Generalized Method of Moment (GMM). In several similar studies - analyzing the effect of military spending on economic growth - GMM is applied to estimate existing models. Rahman & Siddiqui (2019) researched the Generalized Method of Moment (GMM) technique with data from 1998-2017 covering 85 countries to determine the relationship between National Defense and Economic Growth. Baltagi (2005) and Roodman (2006) state that the heteroscedasticity and autocorrelation problems that may arise in static panel data models can be overcome by using dynamic panel data models.

Table 3. Results of Dynamic Panel Data Regression

Independent Variable		SYS-GMM
C	Coefficient	0.1161096
	t-Statistic	1.87
	Prob.	0.061 ***)
EG (-1)	Coefficient	0.2140467
	t-Statistic	1.80
	Prob.	0.002 *)
ME	Coefficient	-3.409362
	t-Statistic	-0.69
	Prob.	0.461
POP	Coefficient	-5.471605
	t-Statistic	-2.66
	Prob.	0.008 *)
FDI	Coefficient	0.304178
	t-Statistic	3.08
	Prob.	0.002 *)
POL	Coefficient	0.032413
	t-Statistic	1.24
	Prob.	0.214
ROL	Coefficient	-0.0811438

Independent Variable		SYS-GMM
	t-Statistic	-1.28
	Prob.	0.200
	Coefficient	288.4687
POPxME	t-Statistic	3.28
	Prob.	0.001 *)
	Coefficient	-15.4199
FDIxME	t-Statistic	-2.17
	Prob.	0.030 **)
	Coefficient	-0.5934569
POLxME	t-Statistic	-0.49
	Prob.	0.626
	Coefficient	5.1384
ROLxME	t-Statistic	1.96
	Prob.	0.340
AR (2)		-1.00
(P-Value)		0.319
J-Statistic		0.564

Source: Result of Data Processing from STATA 14

Note: (i) *) significance at a = 1%; **) significance at a = 5%; ***) significance at a = 10%

Like the static panel data model, the dynamic panel data model also needs to go through several tests to obtain unbiased and consistent estimation results. The GMM assumption testing includes the serial correlation detection test and instrument validity testing.

To see the serial correlation problem, it is necessary to compare the *P-Value* with α. If the *P-Value* is greater than α (0.05), then H_o which states there is no serial correlation problem that cannot be rejected. Based on table 3 it can be seen that the value is 0.319, so the value is greater than α. So, it can be concluded that there is no serial correlation problem.

After that, the instrument validity test can be determined by comparing the *J-Statistic* value with α. If the value is greater than α (0.05), then H_0 cannot be rejected, which states that the instrument used is valid. It can be seen that the *J-Statistic* value is greater than α, with a value of 0.564. Based on the assumption testing that has been done, the estimation model can be used.

Based on the estimation results, it can be seen how the effect of each independent variable on the dependent, including the interaction between the independent variables. The test can be done by comparing the Z_{stat} value with a predetermined significance level. If the Z_{stat} value is lower than the level of significance, which means that the independent variable has a partial influence on the dependent variable.

In the process of estimating the dynamic panel data model, a Lagged Dependent Variable (LDV) is obtained, namely the previous year's economic growth. With a lag of 1 (one), the Previous Year's Economic Growth has a positive sign coefficient and a probability level of 0.002. This figure is significant at α = 1% level. This shows that, partially, the previous year's Economic Growth variable has a significant

effect on the current year's Economic Growth variable.

The Military Expenditure variable has a probability of 0.491. This figure is not significant at α = 5% level. That is, the Military Expenditure variable partially does not have a significant effect on the Economic Growth variable. Gerace (2002) states that the low ratio of military expenditure to GDP is the reason why the results are not significant. This makes military spending not strong enough to have an impact on economic growth. If you look back at Table 2 on Descriptive Statistical Analysis for all variables, it can be seen that the average ratio of military expenditure to GDP for the lower-middle-income group is only 1.568279%, this figure is relatively small when compared to the total GDP as a whole.

Although it has a negative and insignificant direction of influence, Military Expenditure shows changes in results when interacting with other variables such as Population, FDI, Political Stability, and Law Enforcement. When Military Expenditure interacts with Population, different results are obtained. Based on the estimation results of dynamic panel data using the one-step GMM system, a coefficient of 0.5065146 is obtained, with a probability value of 0.001. So it can be concluded that the interaction between the Population variable and the Military Expenditure variable has a positive impact on the level of economic growth in the selected 27 Lower-Middle Income Countries. In fact, with a probability value of 0.001, this variable is significant at the level of α = 1%.

Interaction of Military Expenditures with Population variables shows a positive and significant effect. This reflects that the level of population growth that is guaranteed safety through strengthening the defense system can have a positive impact on a country's economy. Furthermore, this can happen if people in a country can carry out their economic activities calmly, without thinking about threats, because their safety has been guaranteed by the government through the military sector (College, 2016). The community can freely carry out economic activities such as carrying out the production of goods or services, investing, carrying out trade activities, and others properly. In the end, this will have a positive effect on a country.

Security guarantees with increased military spending do not always show results that can spur the economy. Based on this research, an increase in military spending can inhibit the inflow of foreign capital. The FDI variable that interacts with the Military Expenditure variable shows a negative coefficient. Based on the estimation results, a coefficient of -15.4199 is obtained, with a probability value of 0.030. So it can be concluded that the interaction between the FDI variable and the Military Expenditure variable harms the level of economic growth in the selected 27 Lower-Middle Income Countries. This indicates that Military Expenditure can impede the entry of FDI to boost a country's economic growth.

Aziz & Khalid (2019) reveal that an increase in military spending in a country indicates a risk related to the return from investment due to possible threats. Wisniewski and Pathan (2014) also state that a government that continues to increase military expenditure to run its government system will tend to inhibit the entry of FDI into the country concerned. This was also confirmed by Drezner and Hite-Rubin (2016) who emphasized that an increase in Military Expenditure could be considered an unfavorable climate for investing for foreigners. The role of the military in facilitating the entry of FDI does not always lead to good results. The involvement of the military in dealing with the complexity of disputes with residents often creates new conflicts. Moreover, if repressive measures are

imposed, this can of course trigger a mass movement to fight back.

The mass movements that may arise as a result of the participation of the military's role seem to illustrate that various problems of stability cannot always be answered by a good defense system. This can be created by solving problems that may not involve violence, such as negotiation systems. In this study, the Political Stability variable that interacts with the Military Expenditure variable shows a negative coefficient. Based on the estimation results, a coefficient of -0.5934 is obtained, with a probability value of 0.626. So it can be concluded that the interaction between the Political Stability variable and the Military Expenditure variable has an insignificant effect on the level of economic growth in the selected 27 Lower-Middle Income Countries. This shows that the good political stability of a country is not always supported by massive military intervention.

Stability is often encouraged because of the welfare in society, as well as social conduciveness that upholds the principle of tolerance. Regional as well as national scale conflicts in several regions have caused disputes that will never end, as a result of military intervention. The death toll, the disappearance of citizens, and the arrests can be other sources of instability. Things like that could lead to distrust of the government.

The instability that may arise can of course be prevented. This can be realized if the regulations or legal systems in a country can be followed properly. So that various kinds of violating actions can be prevented. Even actions that have violated the rules can certainly be acted upon according to the applicable law. The role of the military in complementing the quality of institutions will certainly have an indirect effect in society, or even at a broader level such as globally. In this study, the Law Enforcement variable that interacts with the Military Expenditure variable shows a coefficient of 5,138, with a probability value of 0.340. This shows that Law Enforcement in selected 27 Lower-Middle Income Countries with the support of the military sector can have a positive impact on the economy.

Military support for law enforcement is emphasized more in measures to prevent the occurrence of irregularities of rules such as 'cunning' practices in economic activities (College, 2016b). Often at the borders between countries, some actions do not comply with the law, such as smuggling of goods, violation of territorial boundaries, to illegal trade, which of course need to be addressed. Therefore, law alone is not enough, and other components are needed to complement it such as military support.

CONCLUSION

Based on the estimation results, it can be concluded that the Military Expenditure variable has a negative influence on Economic Growth even though the results are not significant. However, the interaction between these variables and other variables shows different results. The interaction between Military Expenditure and Population shows a significant positive result on Economic Growth. Besides, the interaction between Military Expenditure and the Rule of Law also has a positive direction of influence on Economic Growth. Meanwhile, the interaction between Military Expenditure variables with FDI and Political Stability has a negative coefficient.

The variable Foreign Direct Investment (FDI) has a positive and significant effect on economic growth. Statistically, the Military Expenditure variable has a negative and insignificant coefficient on Economic Growth.

Then, the Population variable also statistically has a negative and significant influence on Economic Growth. Likewise, the Rule of Law variable has a negative and insignificant direction to Economic Growth. Likewise with the Political Stability variable has a positive and insignificant direction to Economic Growth. Besides, the previous year's economic growth as a lagged dependent variable (LDV) also had a significant positive effect on economic growth for the current year.

The Military Expenditure variable has a statistically insignificant direction of influence on Economic Growth in selected 27 Lower-Middle Income Countries. The low ratio of Military Expenditure to GDP is the reason why this variable has no significant effect on Economic Growth.

There is one important limitation in this research. This research specifically does not discuss the conflict conditions of each country (classified as a conflict area country or not). Hence, we can't see the further effect in the conflict area.

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APPENDICES

Table 1. Country List

Country List		
Angola	Honduras	Nigeria
Bangladesh	India	Pakistan
Bolivia	Indonesia	Papua New Guinea
Cabo Verde	Kenya	Philippines
Cambodia	Kyrgyz Republic	Senegal
Cameroon	Lesotho	Tunisia
Egypt	Moldova	Ukraine
El Salvador	Mongolia	
Eswatini	Morocco	
Ghana	Nicaragua	