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Is the Nobel Prize a threat to U.S. security?

by David Goldman, Economics Editor

The past 20 years' crop of Nobel Economics Prize Winners were selected from one highly specific track, and, as a group, represent a deployment of the International Institute for Applied Systems Analysis in Vienna (IIASA). The extent to which the seal of competence in economics rests on a method associated with an organization which British foreign policy circles consider to be their inside track with the Soviet leadership bears greatly on the present crisis in America's military-strategic position.

Inside and outside the Pentagon, a barrage of economic analysis has hit the administration's defense program, with the general conclusion that the proposed level of increase in defense spending will be too inflationary, and too deficit-ridden, to succeed. With David Stockman's Oct. 20 admission in congressional testimony that the federal budget deficit in a "worst-case scenario" will reach $80 billion in the current fiscal year, the econometric conclusions now being reviewed at the Joint Economic Committee's hearings on defense spending have gained additional force. Faced with a unanimous verdict by the various Nobel Prize-winning schools of economic analysis, in the midst of the worst peace-time budget problems in American history, how can the defense program avoid going through the wringer?

The collaborators on this topic include a team at the Fiscal Policy Division of the Federal Reserve, using the Federal Reserve/Massachusetts Institute of Technology model associated with laureate Paul Samuelson and laureate Lawrence Klein, who helped build it before leaving for the Wharton School; the Data Resources, Inc. (DRI) spinoff from the Fed/MIT project; and the Defense Department's own Systems Analysis Group, headed by former United Nations economist David Blond, with consulting input from Data Resources.

After some weeks of leaking to reporters in hushed tones that the fiscal 1982 deficit would approach $80 billion, the Fed staff is now warning of a $100 billion deficit—just at the point that the OMB's David Stockman has caught up with the earlier estimate. On past experience, the $100 billion number will be mooted by administration economists within a month.

The New York Federal Reserve's first sally against the defense budget came with a James Capra analysis in the June *Quarterly Review*, arguing that the inflation rate on defense items would be substantially higher than the administration's 6 percent estimate through 1986, and drawing the conclusion that the budgetary implications would be far more severe than the administration had conceded. New work is in preparation analyzing the options available, considering the $100 billion budget deficit (which does not count an additional $20 billion in off-budget borrowing, which nonetheless equally forms part of the overall federal borrowing requirements.) The unpublished but internally circulated results thus far argue that the administration can: 1) ignore the rising budget deficit and accept the prospect of still-higher long-term interest rates and further economic decline; 2) attempt to cut the civilian budget, which it rules out as a political unlikelihood; 3) attempt to raise taxes, which the Fed evaluates negatively again on political grounds; or 4) cut the defense budget.

The defense budget options then divide into two sets of possibilities, i.e., cutting procurement or cutting op-

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erations and maintenance. Inflation will take care of the procurement side, the Fed argues, per the direction of the earlier Capra published work, because the rate of inflation will be so much higher than estimates, that purchases will be cut in real terms even if the nominal allocation remains unchanged! That leaves only operations and maintenance to be reduced, e.g., less flying time for aircraft, less steaming time for ships, fewer rounds of ammunition in practice, and so forth. "Of course, there is a great deal of concern about operations and maintenance, given all the talk about readiness," commented a Fed staff member. "But it's hard to put a dollar value on readiness, and that makes it the most likely candidate for cuts."

Meanwhile, in Oct. 19 testimony before the Joint Economic Committee, Data Resources economist George Brown presented the results of a computer simulation of the effect of defense spending on the economy, with largely negative overtones. Between now and 1986 the Reagan increases in the defense budget would result in $372 billion of budget deficits attributable to defense alone, and high (if slowly falling) interest rates would continue through the decade. In May, DRI President Otto Eckstein had presented considerably different results to a seminar conducted by the Pentagon's own systems group, for whom DRI built an econometric model and provided most of the relevant data. Eckstein's simulation argued that the defense-spending level then projected by the administration would have no serious inflationary consequences, because capacity utilization was sufficiently depressed to make additional real resources available for defense.

Dr. Brown explains the divergence between his results and those of the earlier Eckstein simulation by noting the change in Reagan administration economic policies, in particular, the Federal Reserve's emphasis on keeping the money-supply target within a narrow band of growth rates. This puts DRI and the Fed, as well as the commercial banks, who began their sally against the defense budget with a *Morgan Guaranty Report* article by James Fralick in May, on the identical track. Since the same narrow circle of IIASA-trained economists, swapping the same well-massaged data and programming techniques, control these bodies as well as David Blond's Pentagon outfit, a "consensus" has clearly emerged.

Nor is this merely a domestic issue. Since the annual meeting last winter of West Germany's Wehrkunde organization, which bears prestige comparable to the U.S. Retired Officers Association, German criticism of American policy narrowed itself down to one phrase: "High interest rates will, if they persist, turn the United States into a military dwarf." As the *Financial Times* of London noted in an Oct. 19 commentary on the next day's Nuclear Planning Group meeting in Scotland, American manufacturers who would be expected to enthuse over the Weinberger program are sitting on their hands; they do not see orders coming through until the mid-1980s, and fear that even these will fall victim to the OMB's budget axe. Western Europeans have feared that the United States will substitute the gimmickry of theater nuclear war for in-depth strategic preparation. To that extent, the blowup at the Oct. 20 Nuclear Planning Group event over the supposed willingness of the United States to permit a tactical nuclear war to occur in Europe runs back to the economic issues as well.

Issues of method

Both the Federal Reserve and DRI versions take as starting points: 1) continuation of the present Federal Reserve monetary policy; and 2) continued low growth of productivity, e.g. 1.25 percent annually in the DRI study, through the first half of the 1980s. In that sense the studies are fundamentally disingenuous, imposing a chosen "objective reality" upon economic processes, and then cranking out an already determined conclusion. If the chosen subject of analysis were, instead, the *nation's underlying capability for rearmament,* the results would have been substantially different.

First, as *EIR* has insisted for the past two years, and most analysts now admit (see Domestic Credit), the content of the Volcker program is *not* to reduce inflation, but to burden the productive sector with mushrooming interest costs, and redistribute investment away from increases in the nation's capital stock. Since such increases in capital stock, to the extent they enhance the economy's power over nature, are the one lasting anti-inflationary force in the economy, the result of the Federal Reserve's program is to increase the long-run inflationary bias of the economy.

That the United States government shall pay $110 billion in debt service during fiscal 1982 leaves little room for expansion of the defense budget, and neither the Federal Reserve nor DRI needs econometric models to forecast trouble.

The real issue is entirely different: Defense spending is an *overhead cost,* which removes wealth from the stream of productive investment. Whatever takes the form of tanks or missiles will, unlike machine tools or automobiles, not expand the capital stock or the labor force. Only to the extent that the capital stock and labor force compensate for the additional overhead cost through additional productivity can the economy afford additional defense spending. The present Reagan program costs 1.8 percent productivity increase per annum, by our calculations (to be presented in full in a coming issue), not much compared to the 4.5 percent p.a. productivity rise the United States achieved at the height of the NASA program. An economic methodology capable of conveniently editing out such criteria is, indeed, a threat to our national security.