Defense budget: the last prop for U.S. industry

by David Goldman

Congress will return from its summer recess to face incontrovertible evidence that the federal budget deficit for the fiscal year starting on Oct. 1 will exceed, by at least $30 billion and perhaps $100 billion, the Gramm-Rudman-Hollings deficit limit of $144 billion. The Democratic-controlled House of Representatives will take immediate aim at the President's defense budget, which the House already refused to accept immediately before leaving for vacation.

If the House Democrats are able to cut, or even slow, the increase of defense spending, the last prop holding up American industry will come crashing down. Defense Secretary Caspar Weinberger can take an ironic sort of credit for whatever remains of U.S. industry. A glance at Commerce Department data for manufacturing orders demonstrates, without question, that the administration's defense buildup now supports 40% of U.S. durable-goods manufacturing activity, and 53% of all capital-goods production. Durable goods are the core of the American economy, and capital goods are its driver. Excluding the economic fluff, more than half of the economy's core capital-goods production depends upon the defense sector.

Since an important part of the Pentagon's increased spending funds research and development in the high-energy physics required to shoot down incoming Soviet ballistic missiles, the long-term benefits for U.S. productivity are incomparably larger than the short-term support for manufacturing due to defense procurement. In other locations, *Executive Intelligence Review* has evaluated the economic benefits of the Strategic Defense Initiative, whose associated technologies promise a revolution in every field of industry. What is more surprising, is that the scale of the military's support for the economy has already become huge by peacetime standards. It is not that the military has grown, but that the civilian economy has collapsed around it.

That is a remarkable transformation. Back in 1980, the last full year of Jimmy Carter's presidency, defense capital-goods orders were a mere 20% of manufacturers' total unfilled orders. During 1981, the first year of the Reagan administration, this rose to 23%. By 1984 it had risen to 37%, to 39% in 1985, and 40% as of May 1986.

What is most remarkable in this development is the fact that total manufacturers' unfilled orders, after inflation, are 3% *lower* now than they were in 1980. Using the Commerce Department's own dubious inflation data, the $318.797 billion of manufacturers' unfilled orders of 1980 rose to $371.866 billion in May of 1986, an increase of 16%. But inflation for durable goods, the Commerce Department says, amounted to 19% over the same period. In other words, the apparent 16% increase in unfilled orders was, in reality, a 3% decrease.

However, the Commerce Department's numbers have been proven to be fraudulent; the government adds a spurious "quality adjustment factor" to eliminate price increases supposedly justified by improvements in the product. A good rough guess is that the after-inflation decline in unfilled orders is closer to 10% than 3%.

The inescapable conclusion is that Secretary Weinberger's defense buildup saved the United States from a 30% decline of durable-goods output. Defense orders, as a percentage of the total, rose from 20% to 40%, while overall orders declined by 10%. Except for the defense sector, the economy had entered a tailspin equivalent to the production declines of the worst of the 1930s.

To be precise, the unfilled-orders data reflect the activity of the durable-goods sector, rather than manufacturing as a whole, for the simple reason that producers of non-durable goods do not maintain the same sort of orders backlog as durable-goods producers. Therefore, when we speak of a 30% decline in output, we refer to the core capital-goods and related engineering sectors of the economy, rather than industrial production as measured by the Federal Reserve's catch-all industrial production index. Even if that index were not manipulated, as it is, for political purposes, the Federal Reserve's measure fails to capture what drives the economy in the first place.

Apart from imports, defense spending has kept the United States economy from plunging into an outright crash of production—until June of this year, judging by data available for basic industry. That is to say that Japan and the Pentagon are the only friends American industry still has. If we consider that net imports (i.e., the trade deficit) made up 18% of America's total physical consumption during 1985, as well as 25% of total capital-goods purchases, the picture becomes considerably worse. Had the United States not been in a position to buy goods from the rest of the world at much less than their home production cost, and not been able to borrow \$150 billion per year to finance these purchases, physical production in the United States would have fallen by something less than the 18% of total consumption that imports provide.

However, White House Chief of Staff Donald Regan proposes to remedy the present economic disaster by getting rid of both props to this economy. Regan is notoriously hostile to defense spending, and, with Secretary of State George Shultz, acts as Secretary Weinberger's principal adversary inside the White House. He is also the author of the lunatic effort to "talk down the dollar," which brought the U.S. currency down by 40% against the West German mark and Japanese yen during the past year.

The present economic disaster can be traced, in fact, to the dubious success of Donald Regan's efforts, aided and abetted by Treasury Secretary James Baker. The United States now pays considerably more for a smaller volume of imports; the trade deficit, as a result, has risen from \$150 billion last year to \$170 billion this year. However, the physical volume of imports is roughly 10% less. Since much of our import bill appears as production inputs for U.S. manufacturing, the result is a decline of manufacturing activity.

That makes the defense sector all the more important, and its role has increased proportionately. During the second quarter of 1986, defense spending totaled \$69 billion, or \$3 billion more than during the previous quarter, or \$12 billion more at an annual rate.

How long can it last?

The areas of increased spending are precisely those which help the economy the most: weapons procurement, operations and maintenance (including provision of spare parts), and research and development. Despite efforts to sequester Defense Department funds under the Gramm-Rudman law, Weinberger has used spending authority, especially for R&D, left over from previous years, to get around the budgetary constraints. Whether he will be able to do this next year depends on whether the President can push his defense budget through Congress undamaged; that, in turn, depends on the outcome of this November's congressional elections.

The major financial institutions are well aware of what the Pentagon has done, and warn that Secretary Weinger won't get away with it for long. Salomon Brothers wrote in an Aug. 4 report:

> The Department of Defense generally receives a larger dose of spending authority than it will use in a single year. Some of the budget authority is then carried over as "unobligated" funds that may be spent in subsequent years. In the early 1980's, defense budget authority grew so rapidly that spending could not keep up, leaving in its wake a large storehouse of unspent or 'unobligated' funds. In operations and maintenance, the Department of Defense appears to be exhausting its fiscal 1986 spending authority at an unusually rapid clip and, in this category, will carry less unused budget authority than usual into fiscal 1987. . . . By disbursing this year's authority more quickly and drawing on funds held over from prior years, the Department of Defense has buoyed fiscal 1986 spending, effectively nullifying this year's Gramm-Rudman-Hollings restrictions. Note, however, that the same device may be less powerful in future years. A pickup in the drawdown of operations and maintenance authority can only raise spending temporarily, while the storehouse of unobligated research and development funds must be exhausted eventually. Consequently, although defense spending may continue to grow faster than defense budget authority in fiscal 1987, the overshoot may be reduced.

Salomon gives the following table showing the comparative growth rate of budget authority and outlays:

	Budget authority	Outlays
1980	13.8%	15.2%
1981	25.1%	17.5%
1982	20.2%	17.7%
1983	13.2%	13.3%
1984	8.2%	8.3%
1985	11.2%	11.3%
1986	−2.6%	8.2%
1987	1.8%	4.8%

The Defense Department is still working off the President's political successes of the early 1980s, and the spending authority that derived from them. Without a fundamental change in the composition of the incoming Congress, both America's defense, and defense-related economy, will be devastated during 1987.