# EIRSpecialReport

# LaRouche-Riemann model tackles Kemp-Roth bill

by David Goldman

The purpose of the Kemp-Roth tax bill, which would cut marginal tax rates across the board by 30 percent over three years, is *not* to stimulate economic growth as such, but to spur an investment shift from "sunset" economic sectors to "sunrise" economic sectors. Despite the usual garbling of the issue in the financial press, both supporters and detractors of the bill agree on that much. Treasury Undersecretary for Tax Policy Dr. Norman Ture told the National Governors Conference this on Feb. 18, to the consternation of Northeastern governors who obtain most of their tax base from "sunset industries." House Ways and Means Committee Chairman Dan Rostenkowski accepts Ture's formulation, but disagrees: the Illinois Democrat is looking for "targeted" tax cuts benefiting capital formation in heavy industries instead.

The tax debate has left out the essential underlying question concerning Kemp-Roth: Is a shift from "sunset" to "sunrise" industries, that is, from auto, steel, construction, and chemicals to electronics, energy exploration, and financial services, *desirable* or even *possible*?

Norman Ture, Jack Kemp, and their academic backers use the Delphic formulation "economic growth" to mean, instead, an aggressive shift of investment into supposed growth sectors, abandoning "smokestack industry" sectors which have fallen under the impact of tight money and depressed capital investment. But the LaRouche-Riemann computer model of the U.S. economy permits us to test their proposal against some basic real-world considerations.

*In fact, Kemp-Roth and its variants will produce an economic downturn.* The reason for this should become obvious the moment we turn from the old "hedonistic calculus" dressed up as "incentive theory" to the real economy.

Cuts in marginal tax rate are an *income redistribution program*, and, when inflationary "bracket creep" cancels out the net tax cut to zero, they are *only* an income redistribution program. Investors in more profitable sectors will recapture relatively more of their profits, and investors in less profitable sectors will not. Therefore Kemp-Roth will shift investments to sectors that

*Kemp goes down during a game with the Patriots.*

are now more profitable, away from sectors that are less profitable. That is the ABC of the program, as the administration's chief spokesman on tax policy, Dr. Ture, has stated point-blank.

However, the *monetarist dirigism* practiced by the Federal Reserve has rigged the game in such a way that industries heavily dependent on long-term credit are less profitable in the present environment, especially after the ravages of high energy prices. As Ture stated, these industries stand to be phased out.

The other usual name for this "sunrise shift" is the "shift to a postindustrial society," i.e. an economy flooded with high-speed facsimile transceivers, video telephones, word processors, and computers, which disdains to invest in steel, auto, machine tools, and so forth, except for occasional defense use. This is not unique to the "supply-siders," but fervently espoused by liberals such as Eli Ginzberg and Sen. Daniel Moynihan.

## Where 'sunrise' fails

Where the "sunrise shift" argument turns into pure insanity is made clear by one question: how does the *consumption* of these "sunrise" products help the economy to continue to exist in the future? An economy "based on playing basketball and going to the beach," the ideal economy once projected by chief "supply-side" guru Dr. Robert Mundell of Columbia University, cannot exist, any more than an economy based on administrative functions by consuming electronics.

The LaRouche-Riemann model is uniquely qualified to answer this question in depth. It treats the economy as if it were an engine, requiring fuel and maintenance, and operating at different efficiencies at different temperatures. To run the engine it is not enough to have a lot of Gross National Product. If this GNP consists of too much services, e.g. casino gambling and McDonald's stands, and not enough tangible goods, the economy will collapse. Eventually there will be no steel to build casinos and no beef to put in the hamburgers. It is also not enough merely to have a great deal of tangible goods. If we stop producing steel and produce electronic-based office equipment—which is what the U.S. economy has been doing for the past two years— we merely add to the tangible cost of the services, or *overhead* sector. We must both increase tangible wealth output and increase it according to the right mix of products. If we do anything else, the economy will disintegrate.

## The productivity question

What is striking about the performance of the U.S. economy, as shown in the Figures 1 and 2 taken from the Commerce Department's *1981 U.S. Industrial Outlook,* is that the more the U.S. economy has changed in the past 20 years, the more it has stayed the same. The first chart shows "Industry Sectors Ranked by Share of Total Domestic Output," in 1958 and 1978. The black bar represents the 1978 share, the gray bar 1958.

In this first graph, we see roughly the same proportions prevailing in the most important economic sectors as in 1958. Manufacturing has gained a couple of percentage points of relative contribution to the GNP,

wholesale and retail trade have gained about a percent, the financial sector gained a couple of percentage points, and other services about 1 percent. Government lost about three percentage points.

The second bar graph shows employment, and presents a wholly different picture. Manufacturing has lost in the 20-year comparison about 5 percent of the labor force, while services have gained about 5 percent. Government employment has shifted very little.

Productivity growth rates, of course, account for the discrepancy between the two pictures. On average, manufacturing productivity growth rose by 2.3 percent per year in the 1958-1978 period, not a great deal by international standards. In comparison with Japan, or the leading European countries, it is a disgraceful performance. But "productivity" in the services sector, that is, gross national product originating per hour worked, rose by only 0.77 percent per annum. Even though services swung ahead of manufacturing in employment terms with a 10 percent net shift during the 10-year period, the higher manufacturing growth rate

led to an even higher share of gross national product at the end of the period.

This should tell us something, namely, that if we dump large portions of our workforce into overhead, we have only created a growth sitting on top of a productive (tangible goods-producing) sector that has not shifted much in the past 20 years. If we had followed the Japanese example, and put our investment capital into improved industrial technologies and our workforce into higher-skilled positions, we would have seen a substantial change.

However, until the last recession began, the U.S. economy was running on roughly the same technology and product mix as in 1958. For the entire 1958-1978 period, the biggest gainer in terms of output was the auto industry, now the emblem of America's industrial weakness!

Now, Dr. Ture has told us, we will rectify the mistakes of the last generation (one of which is *not,* the numbers show, giving too much of our output to the government sector, which showed negligible change as

Figure 1

# Industry sectors ranked by share of total domestic output: 1978 and 1958

(percentages)

☐ 1978   ▨ 1958
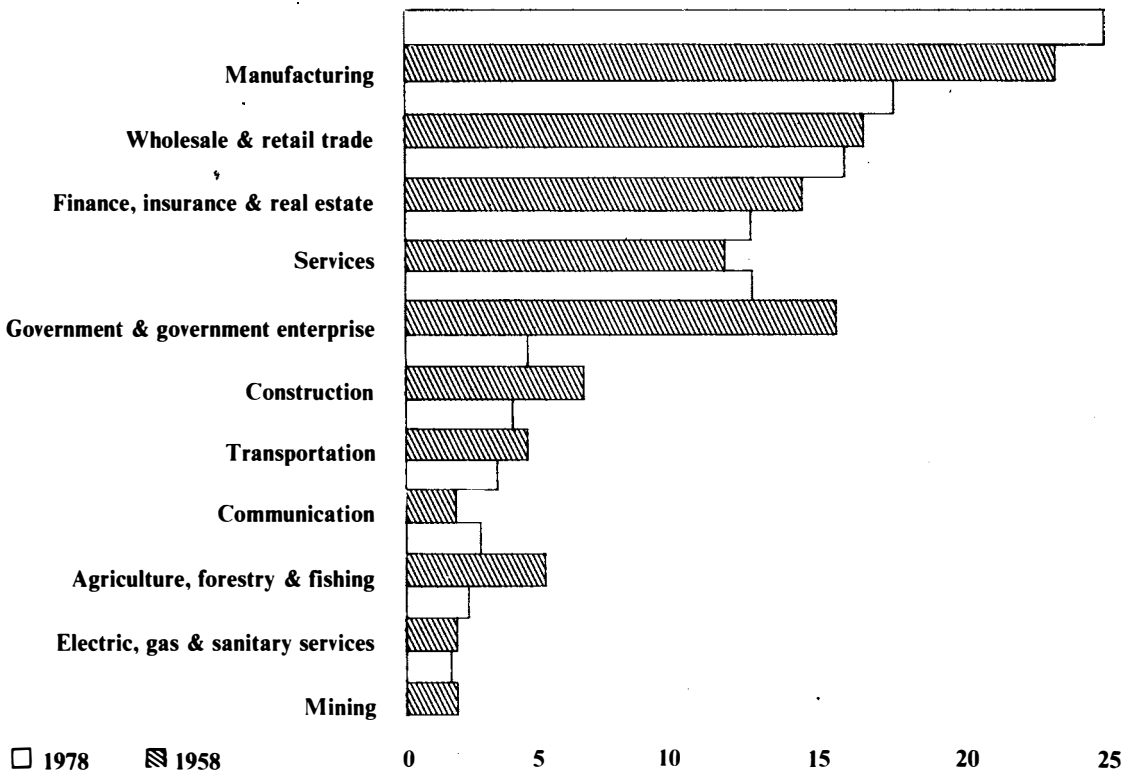
Source: *U.S. Industrial Outlook.* U.S. Department of Commerce Bureau of Industrial Economics.

a proportion of output or employment). We will abandon the unpleasant smokestack industries, and invest in electronics and oil drilling.

Where the "supply-side" model tries to pour reality down the sinkhole becomes obvious, after one simple question: will the "sunrise industries" produce the type of products required for economic growth?

From the vantage point of the physical economy, it makes no difference whether we spent our steel and machine tools drilling for oil in Oklahoma, or importing it from Saudi Arabia. We may wish to drill here for national security and other good or bad reasons, but it costs us steel, drill bits, pumps, pipe, and labor that Saudi oil does not.

If we produce more word-processors and computers, or "smart chips" for military or home-entertainment applications, is it the same as incorporating the same circuitry into numerically controlled machine tools? Obviously not. Using our machine tools to produce tanks, which have no further use in the economy, or to produce capital goods, have very different economic consequences in the real world.

All this is waved off by the "supply-siders," who are as happy illustrating economic growth with the example of professional football teams as they are talking about new steel mills. This form of economic hedonism, which dates from John Stuart Mill's rejection of the Smith-Ricardo distinction between "productive" and "nonproductive" forms of output, punches a gaping hole in the supply-siders' estimates.

## LaRouche-Riemann projections

*EIR* staff did the obvious to project the consequences of Kemp-Roth tax cuts, the Reagan budget, and the accompanying tight-money environment:

1) Investment was assumed to shift into the "sunrise sectors," e.g. electronic equipment, petroleum and gas, nonelectrical machinery, instruments, and so forth (citing the relevant Standard Industrial Categories distinguished in the model's 30-sector data base).

2) Each of the "sunrise industries" was broken down by four-digit SIC (U.S. Standard Industrial Cat-

Figure 2

**Industry sectors ranked by share of total full-time equivalent employment: 1978 and 1958**

(percentages)



□ 1978    ▨ 1958
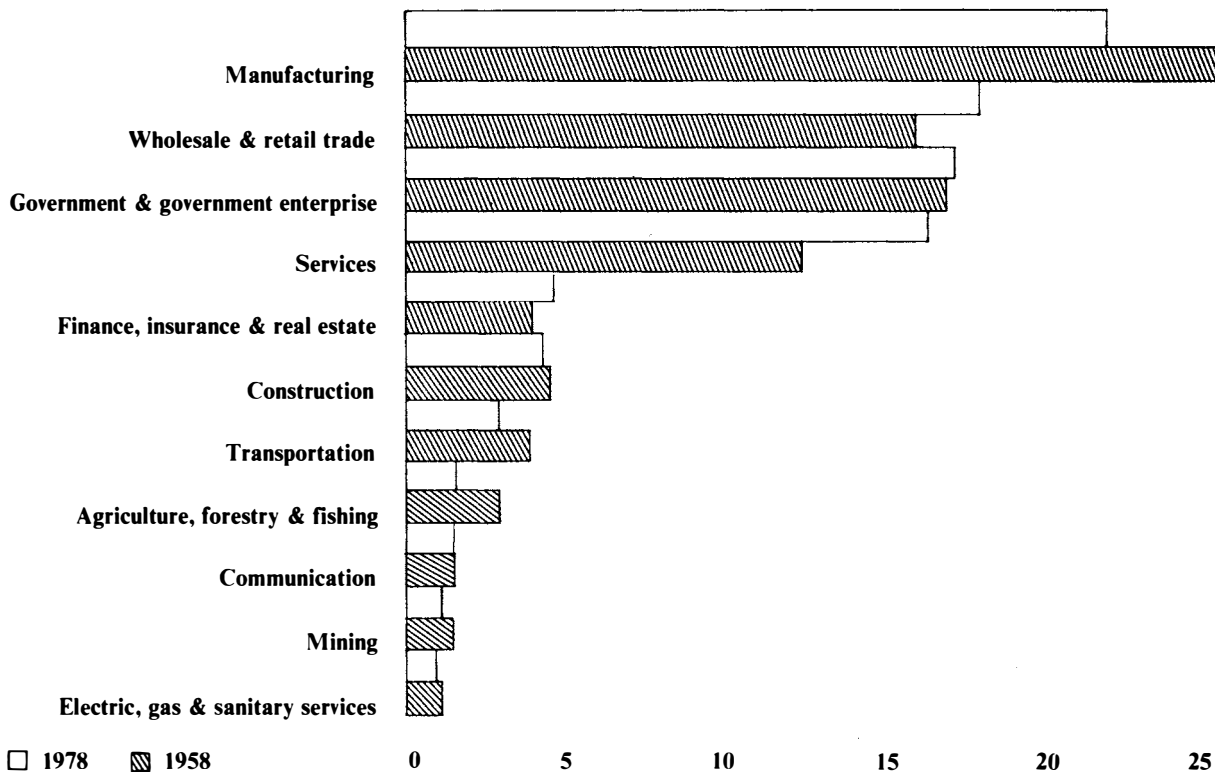
Source: *U.S. Industrial Outlook*, U.S. Department of Commerce Bureau of Industrial Economics.

**Figure 3**
**Surplus, total for all sectors**

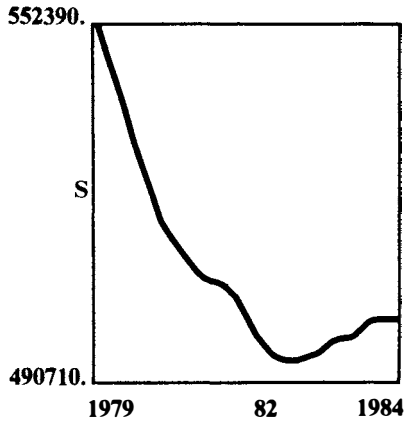552390.

S

490710.

1979  82  1984

**Figure 4**
**Overhead costs, total for all sectors**

561597.

N

503792.

1979  82  1984
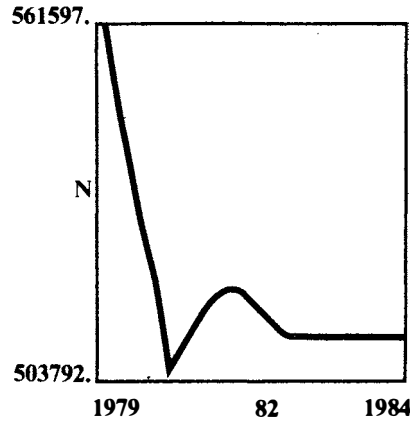
**Figure 5**
**Reinvested surplus, total for all sectors**

12056.

S′

−17802.

1979  82  83
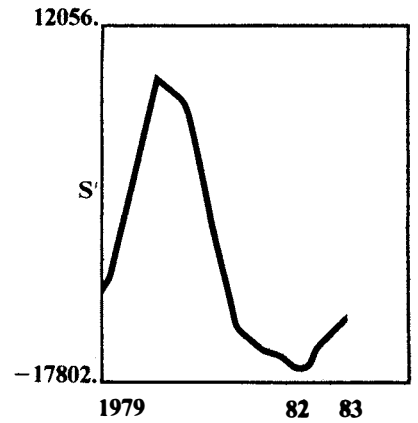
**Figure 6**
**Labor inputs, total for all sectors**

68797.

V

60281.

1979  82  1984
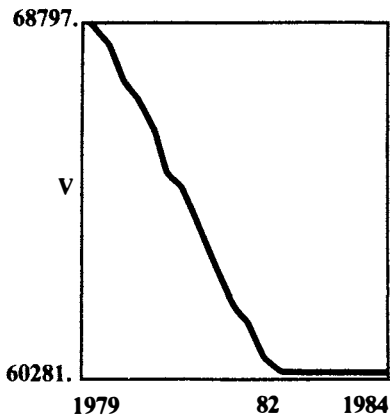
**Figure 7**
**Productivity (S/V),
total for all sectors, average**

8.

PR

7.

1979  82  1984
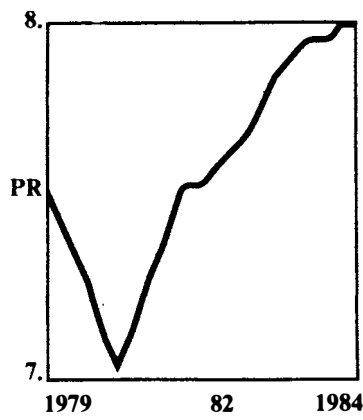
**Figure 8**
**Circulating capital consumption,
total for all sectors**

61983.

C1

556481.

1979  82  1984
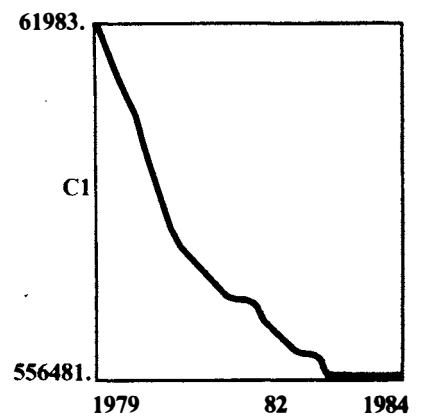
**Figure 9**
**Net capital investment,
total for all sectors**

29254.

CN

−15558.

1979  82  83
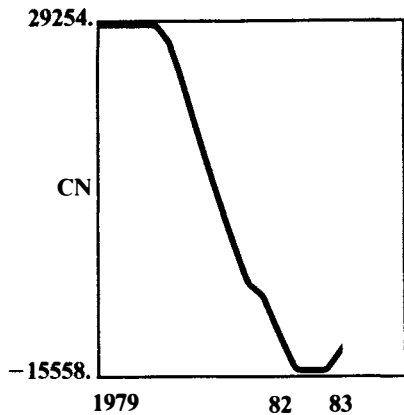
**Figure 10**
**Rate of surplus (S/(C+V)),
total for all sectors, average**

.740

B

.722

1979  82  1984
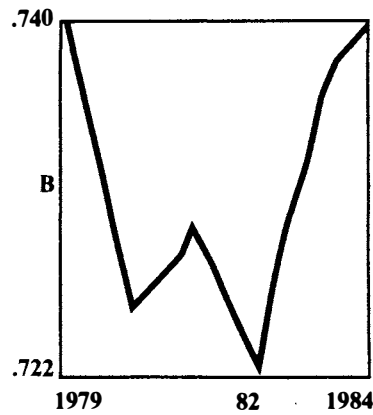
**Figure 11**
**Rate of reinvested surplus (S′/(C+V)),
total for all sectors, average**
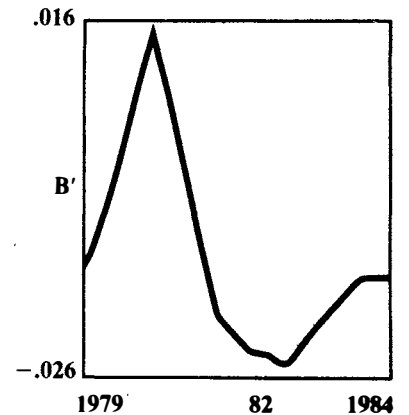
.016

B′

−.026

1979  82  1984

**Figure 12**
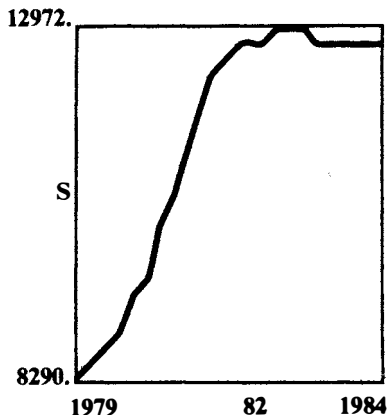**Surplus, petroleum and gas sector**



**Figure 13**
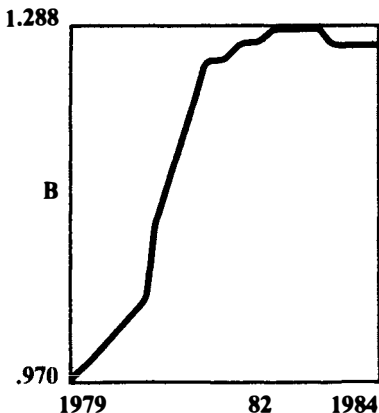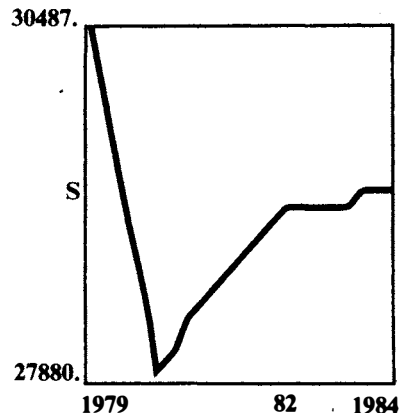**Factor productivity (S/(C+V)), petroleum and gas sector**



**Figure 14**
**Surplus, chemicals sector**



egory) codes to determine what proportion of its output represented goods that could be invested back into the economy, e.g. machine tools, and goods that represented contribution to overhead, e.g. office equipment.

3) The industrial requirements of the military budget, previously treated separately by *EIR,* were included.

4) The consequences of tight money policy on the most financially vulnerable sectors of the economy were further taken into account.

Programmed with these assumptions, the computer model solved 180 simultaneous differential equations for the U.S. economy, reflecting the output and investment-determining measures of 30 economic sectors. It balanced a rise in productivity—due to the shift in investment from less productive sectors like steel to more productive sectors like electronics—against the increase in production for overhead.

The results are presented in the accompanying series

of computer-generated graphs. Not only does the aggregate economy continue to fall, with a dramatic fall in the performance of the "sunset industries," but the sectors now enjoying boom conditions do not continue to do so for very long. The most buoyant, e.g. oil drilling and electronics, reach a growth plateau in late 1982 under these conditions. Only the sectors most immediately linked to the proposed rise in the military budget are able to keep rising, and even these rise at a much slower rate.

## The total economy

Figure 3, or total economic surplus, shows that the economy continues to fall through 1981 after the big fall during 1980 (the data shows average annual values, smoothing out short-term fluctuations). The weak recovery starting at the beginning of 1982 does not return total economic activity to even 1979 levels.

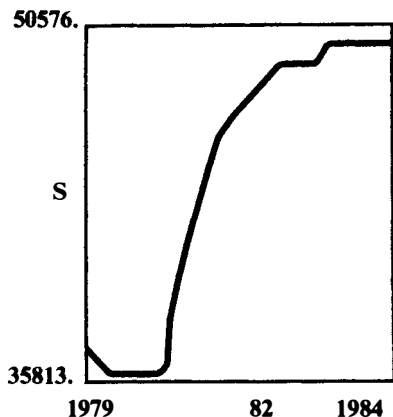**Figure 15**
**Surplus, electrical machinery sector**



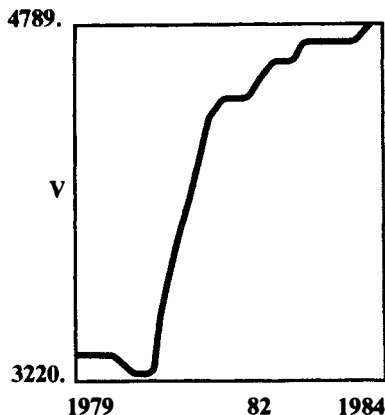**Figure 16**
**Labor inputs, electrical machinery**



**Figure 17**
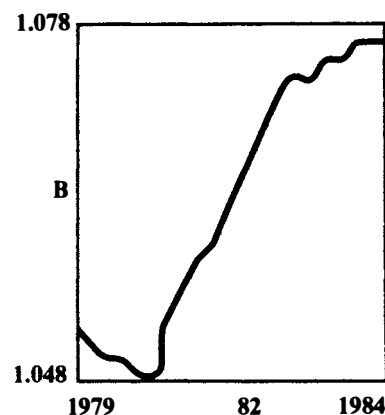**Factor productivity (S/(C+V)), electrical machinery sector**

**Figure 18**
**Surplus, nonelectrical machinery sector**



56431.

S

48373.

1979    82    1984

**Figure 19**
**Rate of investible surplus (S'/(C+V)), nonelectrical machinery sector**



.427

B'

−014

1979    82    1984
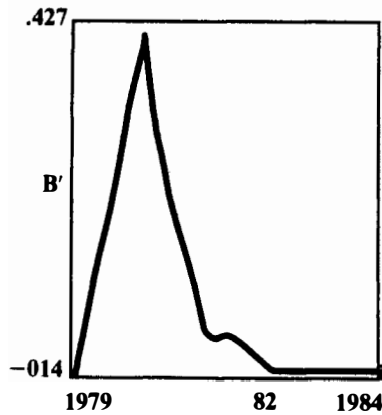
**Figure 20**
**Surplus, transportation equipment sector (including ordnance)**
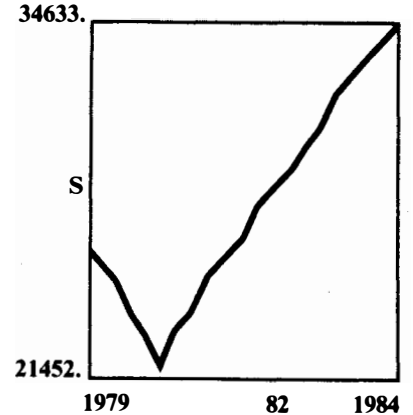


34633.

S

21452.

1979    82    1984

Figure 4, or total overhead expenditures, indicates why the total economy deteriorated despite the large (if short-lived) boost to productivity due to the shift in the investment mix. It shows that overhead costs, after falling during the 1979-1980 recession, continue high while other categories of output fall. In other words, the relative overhead cost increases.

It must be emphasized again that the *average annual values* portrayed "smooth out" fluctuations that may occur from quarter to quarter. Under present financial conditions, *it is likely that the entire drop in output will occur during the second and third quarter of the present year,* followed by a period of little change.

Figure 5 shows net disinvestment in the total economy, or a negative value for investible surplus (S'), from mid-1981 onwards.

Figure 6 shows labor inputs (V) falling from about $69 billion constant 1972 dollars to $60 billion. This

consumption figure translates into a *2 percent rise in the unemployment rate.*

Figure 7 shows the rise in productivity due to the *shift in the investment mix of the economy toward higher productivity sectors.* Productivity, or surplus per unit of labor input, rises from 7.0 to 8.0, an increase of almost 5 percent per year. However, this is an artificial rise in productivity, because it arises from a change in the composition of production and not real capital formation.

Figure 8 shows an absolute-volume decline in raw materials consumption from $62 billion constant 1972 dollars to $56 billion.

Figure 9 shows capital investment net of depreciation falling to a disinvestment position of $15 billion 1972 dollars per annum during 1982, followed by an insignificant recovery.

Figure 10 shows total factor productivity, or surplus

**Figure 21**
**Surplus, construction sector**
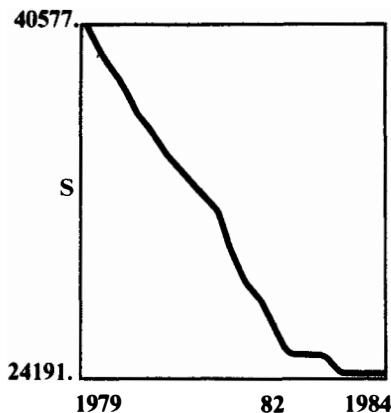


40577.

S

24191.

1979    82    1984

**Figure 22**
**Labor inputs, construction sector**



11502.

V

6625.

1979    82    1984
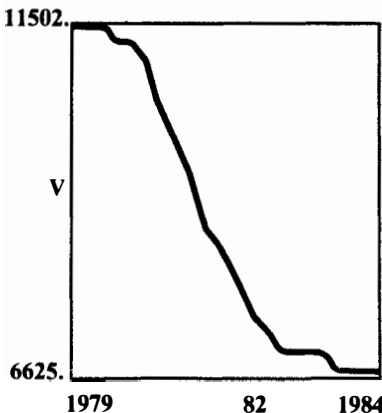
**Figure 23**
**Net investible surplus, construction sector**



839.

CN

−10.

1979    82   83
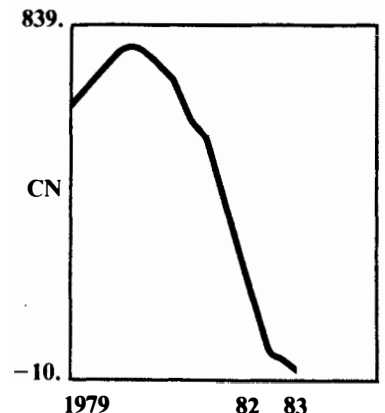
Figure 24
**Labor inputs, vehicles sector**



Figure 24 graph. Y-axis from 1059. to 2680., labeled V. X-axis years 1979, 82, 1984.
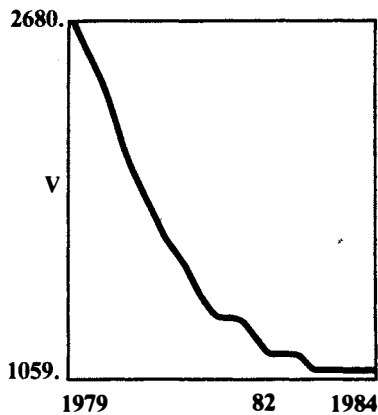
Figure 25
**Net investible surplus, vehicles sector**



Figure 25 graph. Y-axis from −149. to 1477., labeled CN. X-axis years 1979, 82, 83.
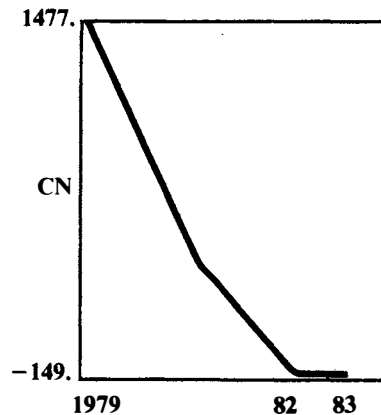
Figure 26
**Factor productivity, (S/(C+V)), vehicles sector**



Figure 26 graph. Y-axis from .429 to .573, labeled B. X-axis years 1979, 82, 1984.
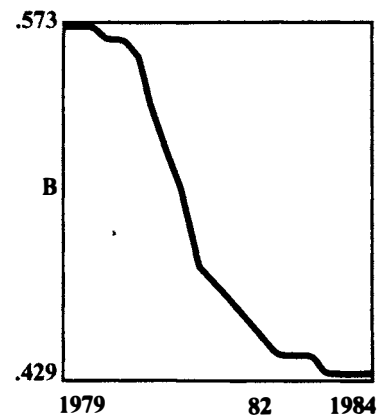
per unit of capital and labor input. The total growth is only between .722 and .740, a small increase.

Figure 11, or the economy's real growth rate (B′) shows a fall to a negative growth rate of about 3 percent bottoming out in 1982, but continuing to fall at a slower rate through 1983.

## Sectoral analysis

Simulation results for the individual sectors show the expected improvements in "sunrise" sectors and declines in "sunset" sectors—but not in the way that might be expected.

Let us review first the "sunrise" sectors, the presumed beneficiaries of the reduction in marginal tax rates.

Petroleum and gas, the boom sector which enjoyed a 60 percent increase in the rate of new drilling in the United States over the last six months, is shown in Figures 12 and 13 of computer-generated graphs.

Figure 12 shows a continued pattern of output gains, in the form of rising sectoral surplus, until 1982, when the increase stops dead. This is followed by a small decline in 1983 and 1984. The reason for the decline is that the economy as a whole, despite the preprogrammed investment preference for this sector, does not have sufficient total resources to maintain the investment program in oil and gas.

Figure 13 shows the leveling off of the total productivity factor of this sector.

Although not normally considered a "sunrise" sector, the chemicals sector is a major beneficiary of the rise in the military budget proposed by Defense Secretary Caspar Weinberger.

Figure 14 shows that total surplus in the chemicals sector continues to rise through the period of simulation, although total surplus does not recover its 1979

level of $30 billion 1972 dollars. The entire increase is attributable to increased military orders.

Electrical machinery, including computers and electronic components, is the star of the "sunrise industries." It is also the major beneficiary of the Pentagon budget, which will increase the electronic component of weapons procurement from 25 percent to 50 percent during the 1980s, according to industry estimates. Even this sector (Figures 15-17) is not able to sustain growth over the entire four-year period.

Figure 15 shows an initial spurt of growth. After a virtually flat 1979 and 1980, the electronics sector spurts to a 28 percent growth of surplus creation during 1981. But this is followed by a rapid leveling off, apparently because the total economy is not able to sustain continued investment in this sector.

Throughout this period, employment continues to rise, for a 50 percent rise over the entire period 1980-84, as shown in Figure 16. However, so much of the electronics sector's product constitutes an overhead drain, e.g. office equipment or military components, that the rise in this sector fails to stimulate overall economic growth.

Nonelectrical machinery benefits both as a result of the investment requirements of an expanded military budget, and as a result of the shift in investment patterns associated with the Reagan tax program. Projections for this sector are shown in Figures 18 and 19.

Figure 18 shows a strong recovery during 1981 to a surplus level well above 1979 levels, followed by an output stabilization in 1982.

Transportation equipment (excluding motor vehicles) is the only sector under the present simulation to maintain its growth rate under the combined scenario.

Figure 20 shows a fairly constant growth rate of the sector over the four-year period of about 15 percent per

annum after a short dip.

For the sectors of the economy which suffered worst during the last two recession years, the impact of continued high interest rates and limited credit availability is drastic. Construction, auto, and steel, the former standby sectors of the American economy, undergo rapid shrinkage in the computer simulation.

Figure 21 indicates that the construction sector will continue to decline during 1981 at roughly the same rate of fall as in 1979 and 1980, followed by stabilization at a low level in 1982. Largely due to the collapse of the homebuilding sector, the construction industry will produce 40 percent less surplus by 1982. Its employment will fall even more sharply over the period, by 42 percent, as shown in Figure 22. Figure 23 shows that the post-1982 stabilization will enable the sector to make only a negligible contribution ($302 million constant 1972 dollars) to economic growth, or a rate of investible surplus creation of only 1.5 percent.

Motor vehicles, whose projection results are shown in Figures 24-26, undergo a similar degree of shrinkage. Figure 24, showing labor inputs into motor vehicles, indicates a halving of the auto labor force by 1983. However, Figure 25 indicates that *the fall-off of surplus will be slower than during the last two recession years;* the percentage fall of surplus creation diminishes until the rate stabilizes in 1983. At this point the industry hits an apparent rock bottom, beyond which replacement demands for autos prevents any further decline. By the end of the period, the industry shows a $553 million constant 1972 dollars net contribution to economic growth.

Although the decline in output stops eventually, the auto industry's capacity to invest is severely diminished. This presumes that the auto industry's ability to run record losses, borrowing the difference, has reached an end. This implies a collapse of the retooling program by sometime in 1982, with grave consequences for the industry's future in the second half of the 1980s.

Iron and steel, not shown here, whose fall during the last recession year of 1980 was precipitous in any event, becomes a national disaster commensurate with the virtual shutdown of British steel under the Thatcher government. The drops in steel output and employment projected are extreme, but no greater than those we already witnessed in Britain during the past two years.

Electrical utilities does not fall into either the "sunrise" or "sunset" category. Its salient characteristic during the past 30 years has been steady growth in output and capital investment, although at slower rates during the energy-starved 1970s. This is as it should be, because electricity production is the most basic ingredient of industrial growth. For the first time during the summer of 1981, electricity consumption may fall below the previous summer's level—a dangerous state of economic affairs—according to a private study conducted by the Westinghouse Corporation. The utilities cannot maintain capital investment, or even present output levels, when the rate of return on utility investments is 11 percent and triple-A rated utility bonds cannot find buyers at 15⅝ percent.

Source: Figures 3-26, LaRouche-Riemann Econometric Model

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*Refundability/Transferability*

# Federal subsidies to decapitalize the U.S.

## by Leif Johnson

A core of liberal Republican senators don't want the Reagan administration's Kemp-Roth tax cuts, and indications are they will add to the chaos of the coming Kemp-Roth debacle in Congress.

The liberal Republican group includes John Danforth (R-Mo.), a member of the American branch of the elite Ditchley Foundation; John Chafee (R-R.I.), former secretary of the Navy who is the Senate cosponsor of the urban enterprise zones bill; John Heinz, a close associate of the Mellon family interests who is also a member of the Ditchley Foundation; David Durenberger, of Minnesota. Also associated with the group is Democrat Lloyd Bentsen of Texas.

They applauded the Stockman budget cuts. But they don't want tax cuts, because they have a plan to use those federal revenues.

The plan is variously known as refundability or transferability. The idea is to ease the remaining industrial companies out of industrial production and into financial services, real estate, insurance shells, electronic gadgetry, hotels and casinos, leasing, money funds, and other "postindustrial" activities.

Refundability and transferability promise to be such a large drain on the federal budget that they might explain why David Stockman has proposed to begin the phaseout of Social Security, the largest single federal outlay.

The plan is straightforward. Existing tax codes allow for three-year carry-back tax credits and seven-year carry-forward tax credits: companies can offset taxes in profitable years with losses in other years. As such, these provisions are necessary to preserve the capital of indus-