Economic warfare hits U.S. defense capability

Carol White analyzes the destruction of our military-industrial infrastructure by the budget-cutting fanatics.

In irregular warfare, one of the key flanks is the destruction of the enemy's logistical and industrial capabilities in depth. Such attacks can range from outright sabotage by special forces (such as the trial runs by assets of the Soviet KGB in West Germany—the Green terrorists—against the Wackersdorf nuclear reprocessing site and the electric power grid in general in May 1986), to subversion from within the government itself. Such is the present case in the United States, where a pro-Soviet faction is intent upon dismantling the defense capabilities of the Western Alliance.

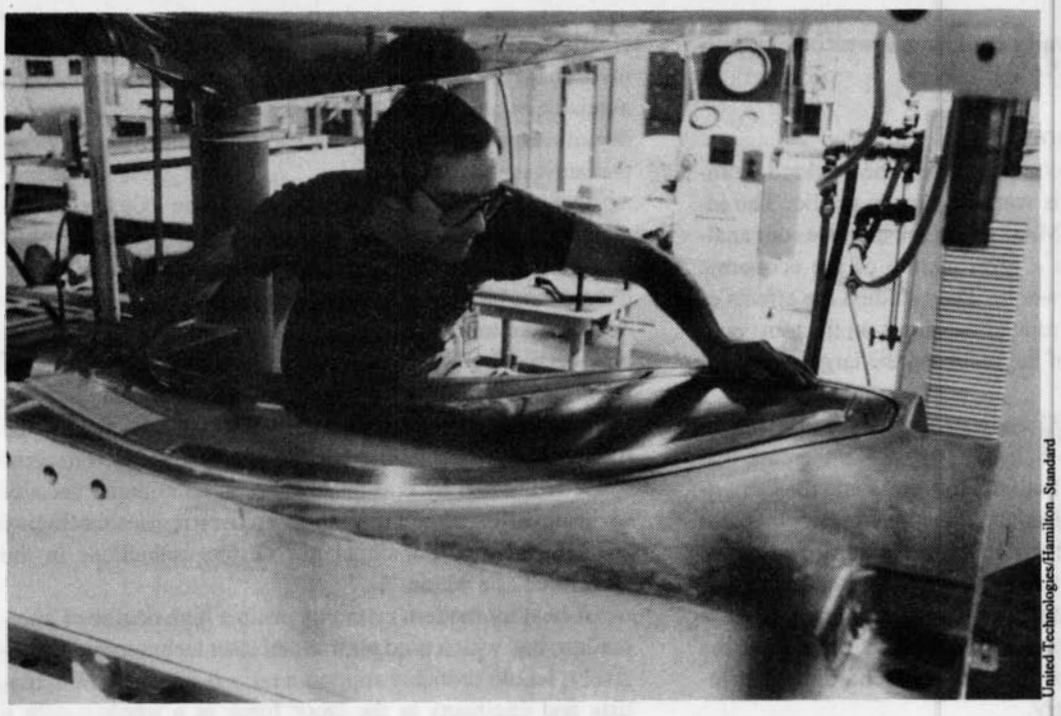
The currently scaled-up attacks against the Pentagon and the defense industries, are a case in point. Occurring at a time when the economic position of defense is particularly shaky, they aim to immediately paralyze the procurement process, but they also threaten its continued viability. The weakness of the industry comes at a time of general economic contraction; however, the industry itself has been the target of systematic attack from within the same Reagan administration, which otherwise opted—at least in the President's first term in office—for a strong defense.

The present attack is by no means the first. The existence of allegedly fraudulent accounting practices by the major corporations, has been the occasion over the past several years for reorganizing procurement practices. That it was Pentagon accounting procedures themselves, which were responsible for how costs were assigned to different products, was considered beside the point. While the development costs associated with building a nuclear submarine might be defrayed in such a way as to increase the "price" paid for toilet seats, it was the submarine as a whole which was being purchased, not a market basket of separate items.

In the current political climate, any excuse presented the opponents of a strong defense with an opportunity to whittle away at defense expenditures. Oversight provisions were increased to the point that a ludicrous situation now exists: For every five procurement agents of the 50,000 working in defense, there are two oversight officers supervising them and the contractors they deal with. Furthermore, a climate was created in which matters which would normally be litigated in civil proceedings were treated as criminal.

Corporate officers were deemed *criminally liable* for failure by any individuals whom they supervised, to interpret revised accounting procedures for any such offenses. General Dynamics was the test case. The frivolous prosecutions of the top management of the corporation for an alleged conspiracy to defraud the government by their accounting of overhead (despite the fact that no pecuniary benefit to the company accrued) was used to discipline the entire industry. The case was eventually dropped, but the point had been made—and in the process the career of James Beggs, by then head of the National Aeronautics and Space Administration (NASA), was destroyed.

The federal budget has been used as a more indirect, but equally effective device for directing policy. For example, the Strategic Defense Initiative (SDI) essentially has been reduced to a research program by Congress, which has used the budget crisis to mandate revectoring the program away from a multi-layered shield against ballistic missiles. Not only did the Congress finally vote a sharply reduced SDI budget—$3.7 billion compared to the $6.3 billion originally



United Technologies/Hamilton Standard

On the chopping block: America's aerospace and defense industry. Here, a technician from Hamilton Standard removes a propeller-fan blade from a resin injection system.

requested—but they have demanded that former Defense Secretary Caspar Weinberger's program to deploy a first stage of the system by the mid-'90s be scrapped.

In its place, a showcase deployment of 100 obsolete missiles is to occur around Washington, D.C. This system, named by its advocate, Sen. Sam Nunn (D-Ga.), the Accidental Launch Protection System (ALPS), will in all likelihood itself be scrapped. It is so fundamentally flawed, that it could not protect the nation's capital from even one missile launched from a submarine on a depressed trajectory. In a related action, money has been removed from the Directed Energy department's program to build a nuclear-pumped x-ray laser. This program would have incalculable benefits for the civilian economy, but its primary purpose was to destroy missiles in the boost phase, at the time they are both most vulnerable, and located over the enemy's own territory.

Thus, while in Moscow, President Reagan insisted to General Secretary Gorbachov that he would not sacrifice the SDI to an arms agreement, this vow has been reduced to mere rhetoric by the unchallenged abuse of the budget process by the Congress.

The budget as a political tool

As we reported in our last issue, this capability was put into place at the beginning of President Reagan's first term in office. The Office of Management and Budget spawned the President's Council on Integrity and Efficiency (PCIE) which was chaired by the deputy head of the OMB. Its purpose was only thinly disguised by its ostensible anti-corruption mandate. Former White House Chief of Staff Donald Regan describes how OMB interventions into government were deliberately targeted for political purposes, rather than to further efficiency and better management in government.

In his book *For the Record,* (page 154), Regan writes about the then head of the OMB: "[David] Stockman was possessed of one simple idea. He believed that the federal budget should run the economy and thereby shape social policy. This was a philosophical position designed to be executed by bureaucratic means. His plan of action was correspondingly simple: By controlling the flow of money into the Cabinet Departments, the Director of the Office of Management and Budget would starve certain programs."

The President's Blue Ribbon Commission on Defense Management (Packard Commission) played a similar role, whatever the intentions of its authors. The measures which were implemented, ostensibly to improve auditing procedures in the Pentagon and control cost overruns, created a climate calculated to stifle the defense industry.

The recommendations of the Commission were submitted in final report form to the President in April 1986, but many of the reforms which they suggested were implemented well before then. These measures have already had a devastating effect upon the industry, particularly affecting smaller firms and subcontractors, which are being driven out of the market.

Recently a study of the impact of these and related measures, which had been commissioned by defense-related industries, has been released by the MAC group, which describes itself as a faculty-based international general management consulting firm. This report was widely circulated in the Congress, and stimulated a review of some of the pinpointed abuses; however, the latest round of alleged pro-

curement scandals may well derail such a welcome adjustment.

The MAC group report

EIR warned of the incompetence of the Packard Commission when its proposals were first made public. The information gathered by the MAC group substantiates our analysis. Unhappily, it paints a grim picture of the economic status of the industry as a whole. They studied the effects of procurement reforms and related measures on the most economically viable section of the industry, the largest contractors.

The authors of the MAC study are academics from places such as Harvard Business School. They make the case that from 1984 to the present, both the Congress and the Department of Defense have introduced changes in procurement regulations and management practice, ostensibly to eliminate the possibility that the government would improperly defray corporate expenses. In practice, the cumulative effect of these changes has been disastrous. Added to this have been the unhappy effects of the tax "reform," which eliminated investment credits for industry.

The group summarized their findings as follows:

"The return on investment on the programs analyzed would have been less than the return necessary to preserve shareholder value. Put simply, there would have been no financial reason to bid the programs.

"Profits will be substantially reduced—by an average 23% on the companies' defense business.

Companies will be forced to borrow heavily, but the additional financing required will, for some companies, likely exceed the amount that can be borrowed.

"The additional financing required to fill the gap caused by the changes—$8.5 billion—is equivalent to 50% of the total 1985 equity of the companies in our study. For the industry as a whole amount will be many times larger.

"Almost half of the financing requirement is due to changes in the tax law that reduce tax deferrals using the completed contract method.

"New stock issues are an unlikely source of capital because defense industry stocks are depressed and the market is reluctant to invest in an industry with declining profitability and which is faced with decreasing defense budgets.

"The apparent increased use of fixed price-type development contracts and fixed price-type production commitments before development is a major risk factor contributing to capital market uncertainty concerning the industry."

Productivity and the viability of the economy

The latter two points in the MAC group's report completely refute the absurd claims that the defense industries are the beneficiaries of superprofits. As the authors of the report are at pains to point out, were this the case, then investment funds would be available to the industry; but clearly the financial community does not believe that such investment is profitable, and therefore will not make funds available except at extremely high premiums. Defense stocks do not sell well on the open market either (and this was before the latest scandal).

Defense, and in particular the aerospace industry, is crucial to the viability of the economy as a whole, because of its role as a test bed for the most advanced technologies. For example, while the ratio of scientists and engineers to productive workers in the manufacturing industries as a whole was 4.1% in 1985, in aerospace the figure was 30%. In a healthy economy, which fostered increases in productivity, the former figure might reach as high as 10%. Ironically, the figure of 30% of scientists and engineers employed in aerospace is inflated by present depression conditions, because of the unwillingness of the industry to let irreplaceable highly trained technical personnel go, despite reductions in the workforce as a whole.

A healthy modern economy, with a high degree of automation, one which used plasma and laser technologies extensively, would probably support a ratio as high as 10% scientists and engineers in the labor force as a whole—with a sharp reduction in the numbers of those employed in overhead-service categories. Such an economy would also raise the number of goods-producing workers, from the present ratio of around 20% of the labor force to somewhere in the neighborhood of 55%.

In an appendix to *EIR*'s *Quarterly Economic Report* published in the fourth quarter of 1986, Lyndon LaRouche discussed the essential role of increasing productivity in maintaining the viability of an economy. With stagnation, the equipotential of nature cannot be maintained, and this is reflected immediately in the higher cost of mining and refining key basic resources, and the failure to maintain the infrastructure necessary to agricultural and industrial production. Clearly, a failure to maintain a technological edge leads in short order to the kind of competition which the United States now faces from Japan.

LaRouche wrote:

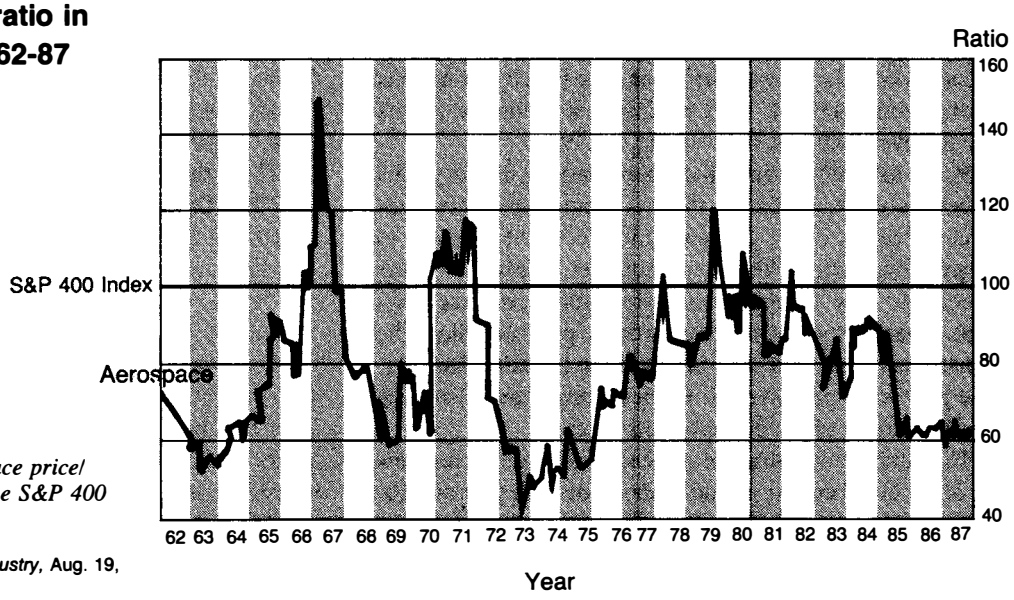
"In the last analysis, improved economic performance is always an increase in the productive powers of labor. This improvement is expressed as more of a better quality of product per capita. Competent analysis of cause and effect in an economic process, measures 'increase of the productive powers of labor,' in physical, rather than financial terms of reference. In fact, we measure increase of the productive powers of labor as a function of increase of productive powers of labor, a 'self-reflexive function.' "

In that same quarterly report, there was a detailed review of the effect of the Apollo program as a science driver for U.S. industry as a whole. The role of the defense industry as a science driver is similar. The following description is taken from *EIR*'s report:

"When President John F. Kennedy launched the Apollo

FIGURE 1

Falling price/earnings ratio in aerospace industry, 1962-87



Standard & Poor (S&P) aerospace price/ earnings composite relative to the S&P 400 Index.

Source: Paine Webber, *Aerospace Industry*, Aug. 19, 1987, updated January 1988.

program in 1961, the stagnant U.S. economy needed some driving economic process that would cheapen the cost of production throughout industry. Investment in the Apollo program and the post-Sputnik missile buildup, provided this driver for the economy so that, by the achievement of set national goals, it forced the economy as a whole forward, into capital investment to implement more advanced technology.

"The effects of the Apollo program on the U.S. economy show that goal-oriented programs in defense and aeropsapce drive economic recovery and subsequent growth in two distinct ways.

"First, by requiring that capital goods industries develop and produce the most advanced possible equipment and systems to attain a goal within a specific period of time, such as a manned Moon landing, the very initiation of such a program sends the entire economy into a capital investment boom that increases the amount of capital equipment available per industrial operative—that is, increases the capital-intensity of the economy as a whole. This capital investment has the immediate effect of boosting productivity throughout the basic industrial sectors of mining, manufacturing, construction, and utilities, as technology developed by previous programs, but not yet implemented, is infused into the econonmy. To produce such a 'tidal' wave of economic impact, the Apollo program had to be accompanied by the enactment of Kennedy's tax and other incentives for capital investment.

"The second type of 'economic driver' effect produced by goal-oriented defense and aerospace programs, flows from the propagation of the technology developed by the program throughout the entire economy. This effect, which lags behind initiation of the program by as much as several years, will, if followed through, produce productivity advances of a qualitatively higher order than the first, and thus amplify the economic impact of the program."

The squeeze is on

Today we see precisely the opposite effect. The cumulative effect of the attack on defense industries, in combination with the growing economic depression, has "leached" productivity out of the system. Worse is still to come, as the authors of the MAC group report predict. They describe, in the following stark terms, the effects upon productivity of the changes already implemented as a result of the Packard Commission recommendations: "The changes could slow the rate of technological growth and result in a loss of technological leadership, because of:

"Less independent research and development (the 'seedbed' of ideas that has historically permitted DoD to choose from among a variety of developmental weapons concepts). Low-risk technology alternatives, with competitions based on cost rather than technical excellence.

"An inability to attract the best people, as industry R&D budgets are reduced and the industry shifts to a low-cost, low-risk mentality. The changes will result in a less efficient industry. Cutting back on capital investment is mortgaging the future, slowing down the industry's ability to improve production efficiency."

We already see the consequences described above, in the case of SDI. The defense sector has lobbied for the introduc-

tion of systems such as ALPS, amd similar earlier schemes proposed by Gen. Danny Graham (ret.), simply because use of such off-the-shelf technology demanded less initial outlay on development. The MAC group report also includes a section on how the industry has been squeezed by reductions in their profit margins. They estimated a decline in profits from defense contracts, on average, of 23%.

While lowered tax rates have benefited the industry, this has been more than offset by the loss of investment tax credits, and changes in the tax law which force the industry to declare profits before the end of a contract. Furthermore, the government has lowered what are called progress payments—payments in advance for work in progress. Since the industry has great difficulty in attracting outside financing, these payments are essential. Profit margins have also been directly reduced under the new procedures.

The study shows that the greatest pressure on contracts will occur in the middle period—about the 10th year of a 20-year contract—so that we have yet to see the full weight of the new policies on the economy. (Also of course, most contracts were negotiated before the "reforms.") Should the industry be forced to accept outside financing—at high rates because of its high-risk status—then these costs will ultimately be passed on to the "customer," i.e., the government, in higher prices; or, as is happening now, fewer and fewer contractors will be able or willing to bid on unprofitable government contracts.

The national defense budget for Fiscal Year 1986 increased by only $3.4 billion. Not only was this the smallest increase since 1976, but it failed to meet the rate of inflation, which the DoD estimates at $8.3 billion for purchases and $4.1 billion for civilian and military pay. Furthermore, the recent tendency of the Congress to mandate specific project lines, has resulted in a mismatch of funds and required outlays. As a result there was a freeze instituted in May, which furloughed certain personnel.

There has also been a freeze on spending for RDT&E (research, development, testing, and engineering), which has recently been lifted to allow spending up to the amount of 75% of the average monthly amount spent over this fiscal year. This has adversely influenced various fledgling high-technology areas, such as the new high-temperature superconductors.

In November 1987, the U.S. Chamber of Commerce conducted a survey which corroborated the findings of the MAC group, but emphasized the conditions faced by smaller contractors.

On April 14, 1988, Jeffrey H. Joseph testified before the Subcommittee on Defense Industry and Technology of the Senate Armed Services Committee, reporting on the Chamber of Commerce's conclusions. Excerpts from his testimony follow:

"Reductions in progress payments, requirements for up-front financing for special tooling and test equipment, revised profit policy, cost sharing on major systems development, and the routine use of fixed-price type contracts for development work have led to a serious drain on industry resources. This has resulted in an economic environment that has had a disproportionate effect on subcontractors and small businesses that are the foundation of our defense industrial base. These resources otherwise could have been of greater benefit to the nation.

"The Chamber conducted a survey in November of 1987 of 10,000 federal government prime and subcontractors to measure the impact of these recent procurement policies at the "grass-roots" level. These contractors . . . were selected at random . . . and represent approximately 15% of all federal contractors in the Federal Procurement Data Center's fiscal 1986 data base . . . 89% are from businesses with fewer than five hundred employees. Eighty-six percent are suppliers to DoD. Overall 22% from services, and 17% from construction. . . ."

More than 50% of the respondents who provided goods or services to DoD indicated that, in the future, their companies will curtail investment in capital equipment and research and development. This is particularly dramatic when compared to the finding that over the past three years, 74% of these companies had increased their investments.

They attributed their decision to the "combination of pressures on profit margins, lack of financing resources, program instability, excessive government oversight, and the availability of better opportunities in commercial markets. In fact, 42% indicated that they actually experienced a decrease in profitability on their government sales over the past five years. Other policies cited included government use of fixed-price type research and development contracts, required up-front capital investments, and potential loss of technical data rights."

Another feature cited, which makes these contracts unattractive, is the government assertion of proprietary rights over research which the companies themselves had financed (at least in part) in the hope of winning long-term contracts.

A sidelight on the present situation is the fate of so-called black programs—highly secret defense contracts. They have helped to sustain the industry even under the present, aversive conditions; however, by their nature they are not open to general oversight—and therefore Wall Street has been unwilling to take them into account in judging the profitability of a company. As the situation worsens economically, will pressure mount to declassify certain information?

Aerospace a paradigm

In its March 14, 1988 issue, the magazine *Aviation Week* reviewed the status of the industry. While their long-term forecast was not pessimistic, they reported that sales of aircraft, engines, and parts are set to fall 5.1% this year, to $40.2 billion, which is the first such fall in real dollar terms, in a decade. A further 3.2% drop is forecast for 1989, before

sales stabilize in 1990 at $39.7 billion. These predictions, in our view, are far too sanguine—unless there are major political changes—because we are presently headed for a far worse depression than that of the 1930s.

The Aerospace Industries Association predicts a decline in employment in the industry in 1988. The figure which they suggest is a slight drop of only 1,000 workers; however, reports from people working in the industry suggest that considerably more than 10,000 workers in the major contractors alone are presently facing unemployment. According to the Association's estimate, employment in the military aircraft sector, which dropped from 454,000 in December 1986 to 445,000 last December, will continue to fall to 423,000 by the end of this year.

They offset this figure by rises in the numbers of scientists and engineers to be employed—they forecast an increase of 4,000, and steady employment in the space side of the industry, which rose by 3,000 last year. All of these figures do not reflect the chill from the latest round of scandals, nor possible effects should START negotiations be finalized.

Armed Forces Journal International, in its June 1988 issue, summarizes the views of top stock brokerage houses. These are completely coherent with the picture assembled by the MAC group. "We are no longer recommending defense stocks. The defense acquisitions process has gotten worse lately. . . . The business has been poisoned." That's the assessment of F. Randall Smith from the investment counseling firm of Train, Smith.

Last August, Salomon Brothers was recommending that investors buy Martin Marietta stock, but this was the first such aerospace buy recommendation which they had made in a year. Even with electronics stocks being a hot item in the market, Prudential-Bache concluded in a March industry update: "We believe it is still way too soon to buy defense electronics stocks."

One reason for their pessimism about the future of the industry, is that at the same time that contracts are being stretched out, the industry is being forced to invest a higher and higher proportion of its own money. For example, in 1987 engine and airframe contractors were forced to pour $353 million of stockholder profits into developing the space plane, as compared to only $232 million from NASA and the Air Force together.

The same picture is true in the case of the Army's new LHX helicopter, which has absorbed $538 million of industry's development funds, compared to the Army's investment of only $464 million. This contract has had its launch date postponed by six months on several occasions. In order to finance these contracts, the industry has gone to outside financing, but at very high cost—especially compared to the rates at which the government could have borrowed and then advanced the funds.

The former head of the Office of Federal Procurement Policy told the *Armed Forces Journal* that he figured this shift in financing to industry will cost taxpayers more in the long run. He estimated that the $600 million in V-22 production tooling charges which the Navy insisted that Bell Helicopter and Boeing fund, but which they will not recover for at least nine years until the plane is into production, will cost the government 50% more in the end.

The MAC group ended its report with the comment:

"A final, important, lesson of the 1984 to 1987 changes is that the Congress should not permit the introduction of extensive and signficant adjustments to procurement policy of this type without substantive impact assessments. While DoD claims it wants a strong and healthy defense industrial base, it does not appear to have an internally consistent vision of the set of policies that would produce this result.

"In reassessing the policies we have discussed, DoD should explicitly consider what type of defense industry it believes the country will need in five or ten years. Armed with some idea of what this implies in terms of capacity, technology, and human resource skills, it will be better placed to make changes that have a positive impact on the industry."

The question might equally be raised, whether Congress and certain policymakers are far less naively incompetent than the authors of the report suppose. On the principle of *cui bono,* one may infer that the U.S. defense capability, and with it that of the Western Alliance, is being deliberately gutted, in favor of a global New Yalta deal with the Soviets.