Jimmy Hoover?

By Seymour Melman

Intended or not, Jimmy Carter's new budget, with its unprecedented $125.8 billion for the military, will intensify inflation and other economic decay. It reminds us that there was a lesson in the inability of President Herbert Hoover and his advisers to fathom the causes of the Great Depression. Apart from intention, wrong assumptions about economic behavior produce not only scientifically incompetent theories but also policies that fail. The result of Mr. Hoover's assumptions are known. The Carter mechanism, while still in process, is predictable.

After 1929, the decline in industrial production was concentrated in the capital-goods industries. Orthodox economists, ignoring contrary evidence, expected that prices would fall in all industries as a result of falling demand. In due course, low prices of capital goods (machinery, structural steel, cement) would attract the attention of investors who would start buying new plant and equipment. Then production and employment would rise to yield a new business prosperity. Hoover's counsel that prosperity is "just around the corner" made sense within *laissez-faire* theory.

But Mr. Hoover and his aides erred in assuming that prices of capital goods would fall with lower market demand. For the managers of firms making capital goods had been learning to stabilize the prices of their products independently of market demand, the better to maximize profits even as sales fell. So the classic attraction of low capital-goods prices for new investment did not appear, and neither did an upturn in industrial production and employment. Finally, President Hoover, an accomplished engineer-administrator, cut a hapless figure as the economy collapsed — inexplicably to him and his advisers.

President Carter now causes interest rates to rise so that borrowing money will be more expensive; so that consumers and investors will buy less; so that, finally, prices will rise less, or even fall. This strategy assumes that prices are set mainly by supply-demand interactions. But the cost-plus model for industrial pricing, widely practiced in the military economy, initiated many managers into ways of setting price and maximizing profit without minimizing cost. Indeed, since the mid-1960's, industrial firms have been setting prices so as to cover costs, and cost increases, plus a desired profit rate. Furthermore, while some goods, such as moderately priced housing, are in short supply, price inflation has extended over endless goods that are relatively abundant.

The Carter policy assumes that if firms are confronted with shrinking markets, managers will strive to cut costs and prices, the better to compete for a share of the remaining market. But cost minimizing has become increasingly difficult since 1965 as growth in industrial productivity has collapsed under the impact of the capital and technology drain to military industry. For more than 13 years, firms have been transferring cost increases to their prices. We now have (in a study, "Inflation Under Cost Pass-Along Management," by Byung Y. Hong) statistical measures of the strength of this mechanism as a primary predictor of United States price inflation. Under cost pass-along, a shrinking market for industrial goods will mean that fixed costs of production and administration will be assigned to fewer products sold. The higher fixed costs per product will be added to prices. Under cost pass-along, the Carter strategy (if successful in shrinking purchases) would produce price increases.

Mr. Carter's policies stress guidelines on wages and prices, not on profits. The unstated assumption is that profits fuel productive capital investment. However, corporation and Government managers have been showing diminishing commitments to developing production occupations in the United States. During the 60's and 70's, profits have been heavily invested abroad and in quick-return opportunities at home, while the Government has lavished funds on its military firms. This has left United States civilian industry to decay, with resulting noncompetitiveness, plant closings and unemployment.

Some economists, believing that a Federal budget deficit is a spur to inflation and worse, propose less Federal spending — except for the Pentagon. Actually, a Federal deficit owing to heavy productive investment, as in efficient steel mills, shoe factories and railroads, would soon be repaid by the revenues that would grow with new United States-based production. All these effects would be counter-inflationary.

By contrast, President Carter proclaims that military spending should be increased by $11.3 billion while civilian activities are held stable or cut. This policy takes no account of the fact that military industry is the focal point of institutionalized inflation fueled by the Pentagon's cost- and price-maximizing routines. As chief executive of the military economy, Mr. Carter controls the throttle of the United States economy's main inflation and unemployment engine. He now plans to open that throttle even wider. Will Jimmy Carter be Herbert Hoover II?

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Note: Byung Y. Hong, Inflation Under Cost Pass-Along Management, Praeger Publishers, N.Y., N.Y., March 1979.