

## **EIR**SpecialReport

# Why Reagan's 'demand-pull' recovery is failing

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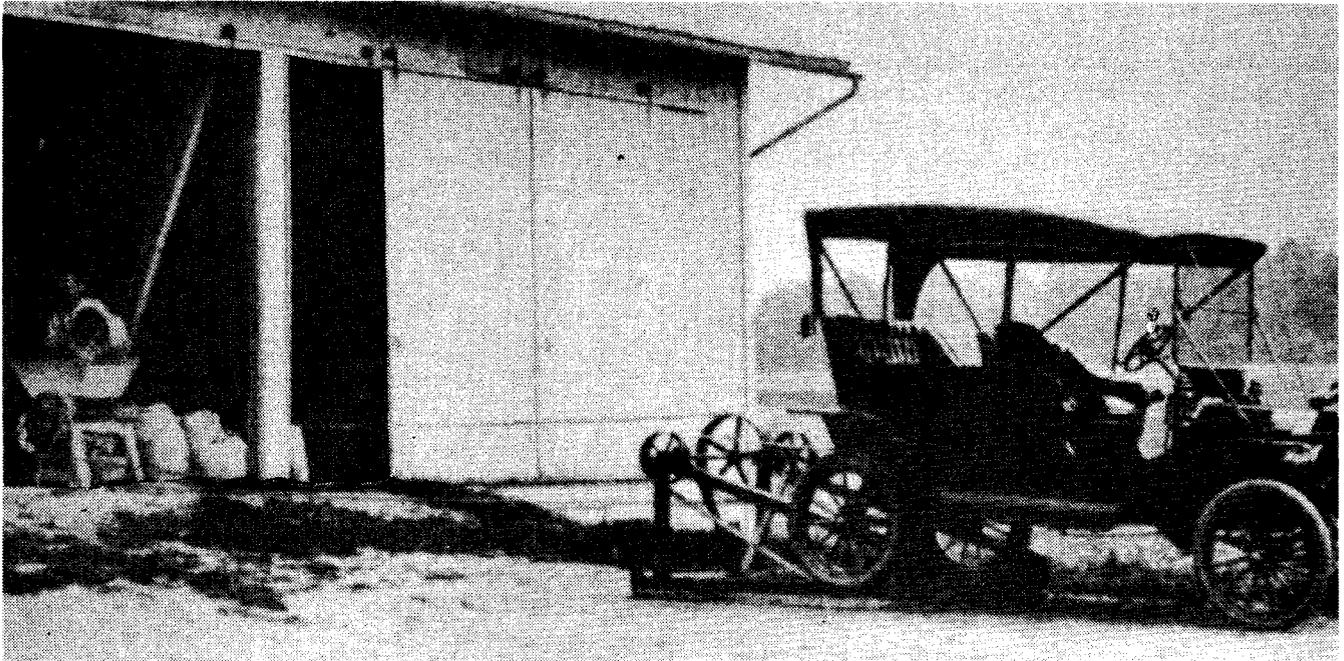
During 1983, through collaboration between the Reagan administration and the banking-system, cheaper credit was funneled into promoting credit-sales of automobiles, and to a lesser degree in prefabricated housing. A significant spurt in auto sales resulted, and also a temporary spurt upward in a few sectors of housing-starts. However, the level of physical output of the U.S. economy as a whole dropped by about 4%.

The Reagan administration had made the same kind of mistake the Eisenhower administration had made in launching the consumer-credit expansion of 1954-56—the expansion which pushed the U.S. economy into the deep 1957-60 recession, and elected Democrat John F. Kennedy President. The idea that funneling cheap credit into two or three key sectors of consumer-goods sales, including auto, will exert a multiplier-effect on the economy as a whole, is unfortunately one of those popularized myths of “barber-shop economics” which leads us back to new disasters each time some government puts them into practice.

This particular piece of “barber-shop economics” is sometimes called “demand-pull” dogma. The argument, briefly, goes more or less as follows.

“If more people are buying automobiles, then the automobile manufacturers are buying more from steel producers and other suppliers. The combined re-employment caused by the increased sales of auto manufacturers and those manufacturers' suppliers of materials, parts, and services, increases the total amount of wage-earners' income in the economy. More people will now buy more consumer-goods in all categories. In this way, a self-feeding upward spiral in the economy occurs.” That's the general dogma behind the illusory economic recovery of 1983: a 4% drop in physical-goods output. That's the same general dogma which pushed the U.S. economy into the deep recession of 1957-60.

The “demand-pull” doctrine is fairly compared to the argument that if a cow produces more manure, it eats more, which creates a demand for more grain-production: Therefore, the way to revive agriculture is to cause cows to produce more manure. Some Harvard professors might admire that sort of “logic,” but so far Mother Nature continues to be stubbornly unconvinced by any such Harvard-



Ford Archives

*Before the “demand-pull” economists took over the auto business, a car was considered a “consumer capital purchase” and was built to be functional and to last. The Model T Ford could be jacked up and used for farm chores, such as grinding grain, shown here.*

style sophistries.

Let’s look at some of the highlights of the way Arthur Burns lured President Eisenhower into organizing the 1957-60 recession. Let’s look at these first-hand, as this writer predicted the 1957-60 recession from his work as a management consultant during the 1954-57 period. One of this writer’s management-consulting specialties then was automobile marketing; let’s concentrate here on that part of the 1954-57 picture.

### **The financial accounting-hoax of 1954-57**

During that period, all franchised retail automobile dealerships were required to use standardized financial accounting procedures specified by the auto companies; this was part of the contractual franchise agreements. Although these required financial-accounting procedures differed slightly from auto-company to auto-company, in basic principles, they were pretty much the same.

Over the course of the 1954-57 period, from about 1955 onwards, highly successful automobile dealerships, in case after case, were losing money on their new-car sales, but making profits on their repair-business and used-car sales. The standard financial accounting statements appeared to show exactly the opposite effect; the worst financial accounting was Robert S. McNamara’s Ford Motor Company. So, although dealerships were often losing money on new-car sales, they increased their new-car sales-push, because misleading financial statements said that the new care sales and repairs were the successful parts of the business. Briefly, it worked as follows; I cite the not-untypical Ford dealership

case from that period.

First, when a dealership sold a new car below list-price, it usually wrote the sale up in the following way for financial-accounting purposes. The new-car sale was shown on the books at list-price; the discount allowed on the sale was buried in the used-car inventory, by inflating the value of the used-car trade-in.

In other words, if a \$200 discount was given on the new-car sale, this \$200 was added to the inventory-value of the used-car trade-in on that sale. The result was that the used-car was shown on the books at \$200 above the price the dealership could have purchased an identical used-car on the wholesale used-car market at that time. So, when the dealership sold the used-car, it often sold the used-car below the price the used-car was paid for, according to the books.

Second, some “flagship” Ford dealerships came up with a trick designed to fool new-car buyers. They offered the new car at a price which was actually \$100 or more above the standard list-price for the automobile. To create the illusion, the new car was packed with various optional accessories, and the value of these accessories was manipulated in a way intended to hide the inflation of the price from the prospective buyer. General Motors, Chrysler, and other dealerships felt compelled to copy this practice. This inflation of listed new-car prices was called then a “packed price.”

It didn’t really work. Competitive shoppers for new cars soon learned to ignore prices, and to concentrate on the amount they actually paid, after deducting the trade-in allowance on their used car from the price of the new car. So, the discount of the “packed” part of the listed price was simply added to

the discount, below true list-value, on the new-car sale. As a result, the faked values of used-car inventories on dealership-books simply zoomed by an additional \$100 or more, over the inflation of used-car inventories before the "packed-price" nonsense had been introduced. On the dealership's books, the losses on used-car sales zoomed.

Third, while this financial-accounting hokery-pokery was driving the dealership industry to the edge of insanity, a second bit of lunacy was running amok in the dealership industry.

In the first case, fraudulent methods of dealership financial-accounting, it was the automobile dealer who was hoodwinked by fellows such as Ford's Robert Strange McNamara. In the second aspect of the 1955-56 automobile-sales boom, it was the consumer who was successfully hoodwinked.

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*Henry Ford wouldn't have kept a fellow like Robert McNamara around his executive offices a single week.*

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The foolish customer, discovering that listed automobile prices really didn't mean much, concentrated on two points of the sale he as an ordinary buyer thought he could understand. The prospective new-car buyer asked himself two questions: "What is my cash down-payment? What are my monthly payments?" The result was the appearance of the 36-month financing of new-car sales. In numerous cases, the buyer's first 35 monthly payments were relatively low, but the last payment, the 36th payment, was a lalalooza, perhaps hundreds of dollars! The "sly buyer" who accepted such a contract thought somewhat like this: "Since I trade in my car every two years for a new car, that last big note will be swallowed up in my trade-in of this car for my next new car."

A fourth factor was at work, back in the automobile factory itself.

The mid-1950s were the beginning of an auto manufacturer's policy which we called "value analysis" back during the 1950s and 1960s; the same policy later became known as "cost-benefit analysis." The McNamaras who pushed this policy upon the 1950s auto industry, later pushed it into our Defense Department; in both cases, the result ruined the product.

There was a once-famous comic poem on the subject of the "Deacon's One-Horse Shay." According to the poem, the carriage (the shay) was "built to last for one hundred years and a day." In the poem, the Deacon who purchased this

horse-drawn vehicle was riding in it at the time the vehicle's warranty ran out; the vehicle fell apart. Fellows like the accountant McNamara brought the idea from this poem into the automobile industry back during the 1950s—but they shortened the warranty considerably; after a few years, the Detroit specimen would come flapping into your neighbor's driveway like a B-24 returning as lone survivor of a bombing-raid during World War II. Don't put anything into the car which will outlive the first major mechanical breakdown, if at all possible; this was called "value analysis."

The automobile dealership which sold a new car delivered from the factory (say in 1955) without spending up to \$100 a car in make-ready repairs might have had a very unhappy new-car customer coming back into the show-room badly bandaged and held up on his left-side by his neighborhood lawyer.

In the case of the new-car buyer who purchased a car on a 36-month financial plan, it was increasingly the case that, after about the first 24 months, the buyer owed more on the unpaid balance of the new-car purchase-loan than the price of a comparable used-car at the nearby used-car lot. In other words, the new-car buyer had a "negative equity" in the vehicle on the open market.

Such were the glories of the 1954-57 consumer-credit boom in the U.S. economy. This is broadly the "barber-shop economics" which the Reagan administration has been misled to confuse for a 1983 "upswing in the economy"—which, in fact, never really happened.

### **Henry Ford versus Robert McNamara**

Henry Ford wouldn't have kept a fellow like Robert McNamara around his executive offices a single week. Ford rightly defined his Model T and Model A as a "consumer capital purchase." The old Model T, an owner could ride to town, or jack up one of its hind wheels and use it to power a saw or run a piece of farm-equipment: a lot of owners did. The Model Ts were a lot tougher to "kill" than most of the types produced during the postwar period.

Then, General Motors came up with the policy of style-marketing, an idea pretty plainly borrowed from the Seventh Avenue ladies'-garment manufacturing business. Under pressure of General Motors' success, Ford began to shift to selling "the sizzle, not the steak," and even stubborn, engineering-minded Walter P. Chrysler was whipped into line. Rockefeller talked Ford into establishing the Ford Foundation, and letting Bertrand Russell's sidekick, Robert M. Hutchins, head the Foundation for a while. Things changed very much for the worse, and that's how Robert S. McNamara became a Ford executive.

Even so, during the first decades of the postwar period, the automobile executive running the production-side was an engineering-minded official, who either came from an engineering background, or had picked it up coming up from the

ranks through the tool-shop or the production-line. The diseases ruining the industry then came from the sales and accounting departments. The production executives would dig in their heels, but the fellows from Wall Street would point out to the company's directors that the important thing was maintaining a strong price-earnings ratio on the stock market, if the corporate raiders were to be kept at a distance; the production men grumbled, but gave in. Gradually, the kooks trained at places like Harvard Business School moved in to replace them.

The result? Recently, Japan's Toyota issued a report comparing the changes in investment-efficiency in U.S. and Japan auto production over the past 30 years. At the beginning of the period, U.S. auto-production was about eight times as efficient as Japan's; a dollar invested in U.S. auto-production would turn over about eight times as fast as in Japan's. Today, a dollar invested in Japan's auto-production turns over eight times as fast as in U.S. auto-production.

Now, the Harvard Business School types from Detroit are lobbying desperately in Washington, demanding that the U.S. punish Japan's auto industry for not being as incompetent as the current crop of U.S. industrial mismanagement.

Over the past period, U.S. Steel, for example, has not been investing much of its cash throughput in steel-production improvements. They've been doing such things as buying up coal mines that are not currently producing, plunging into other kinds of real-estate speculation, and so forth. They have been milking industrial production to pay for these outside speculative investments. In Japan, for example, the companies have been investing in production improvements, investing in exactly the new technologies which U.S. Steel and others have refused to use. Now, these U.S. mismanagers complain "Japan is unfair."

If those fellows at our major corporations had read the Bible, instead of wasting their time and money at places such as Harvard Business School, they would have learned better economics without leaving the Sunday-School classroom. There are better economics in the Book of Genesis, for example; then, Jesus Christ himself warned against foolish fellows such as these Harvard types in the parable about the investment of talents. There is just no excuse for what American mismanagement has done to our economy over the past decades.

Throughout the U.S. economy, consumers are getting less and less value in the new products they buy in most categories. Don't start arguing off-hand; follow a little simple reasoning.

Let us take the consumer's market-basket of needs for an average family-household. Next, take the total family-income available, after taxes and interest-payments are deducted. Now compare each product purchased, according to that market-basket, with the percentage of the total family-income which must be spent to buy that product. What are

you getting for that percentile of your income?

You say: "The product has been improved"? Let's take a closer look at that.

The total cost of a product is not only the purchase-price; you must add the cost of operating and maintaining that product over the product's useful life. This is the true price of possessing that product as a percentile of your total family-income.

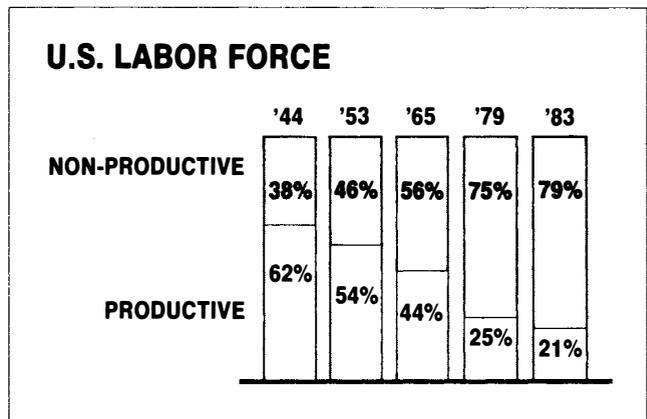
Now, how many years of use do you obtain from that product, compared with the similar product your family bought earlier?

Add in other considerations: Would your family have a better chance of surviving in a Detroit automobile purchased in 1972 or the typical compact purchased today? How far would you go on the spare tire sold with a 1972 car, as compared with the spare tire sold with a 1983 or 1984 compact?

Correlate all these obvious features of the cars according to Henry Ford's definition of his Model T: a consumer capital-good. Do the same for other "consumer durables" purchases. Compare this with the percentile of your family-income required to "possess" that category of product, in the past and now.

Now, let us look at this same fact in another way. Let us look at the total market-basket of consumer-requirements for all U.S. households. Let us compare the percentile of the total labor-force employed in producing each category of physical product included in that market-basket. Let us compare the total wages of the households purchasing those products.

Go a step further. Production of goods depends upon what is best called "basic economic infrastructure." This includes items which are traditionally supplied by economic activities of the federal, state, county, or municipal governments. Transportation, energy-production and distribution, fresh-water management, sewage systems, and basic urban infrastructure, including mass-transit systems, hospitals, schools,



police protection, fire protection, and so forth. Ignoring the services-component of basic economic infrastructure, considering only the tangible elements, the United States today is suffering at least a \$3 trillion deficit in infrastructure: About \$3 trillion would be needed to put the economy in the same shape as approximately 1969-70. Our economy is falling apart.

This means that there is an invisible cost buried in the price of everything purchased: That invisible cost is the proportional price of everything that is not being done to maintain infrastructure, farms, and manufacturing facilities—the price which would have to be added to the price of goods if we were paying to keep the economy from collapsing around us. Add that price into the price of the market-basket goods. You then begin to see the way in which the U.S. economy has been collapsing at an accelerating rate since Johnson introduced the swindle called his “Great Society” package. Johnson said it was to help “poor people”—how much has this policy improved conditions in the slums of our cities, how has this program reduced the percentile of poor in our population? It has been more than 15 years of swindles and foolishness.

The product you buy today is bigger and better than in 1967? Either you don't remember, or you are not thinking very clearly.

### **‘Post-industrial society’**

To get into the bare fundamentals of the problem—the reason the “demand-pull” dogma is absurd, keep your attention on the total U.S. labor-force. To arrive at a correct estimate of the costs of the physical goods in our market-basket, we must focus attention on the percentile of the total labor-force required to produce these goods.

Experience in teaching economic science shows that the easiest way to get the point across to any intelligent farmer, small-industry entrepreneur, or trade-union official (for example), is to ask them to think of the entire national economy as if it were a consolidated agro-industrial enterprise: one big agro-industrial firm. In that case, it is clear that the portion of the labor-force directly employed in production of physical goods (i.e., agricultural or industrial operatives), plus operatives employed in transport of goods and labor-force, add up to that part of total employment which corresponds to the direct costs of production. The rest of employment (plus unemployment) is “overhead expense” for the economy as a whole.

We should study the “overhead expense” of an economy as a whole in a way very close to the way one should study the overhead expenses of a firm: *indirect costs* of production services and direct supervision of production; *general management costs* of operations of production; *selling and related costs*; *unavoidable expenses*, which have no direct relationship to activities of production and selling, such as legal expenses; and expenses properly classed as *wasteful*, such as

unemployment. The problem is to keep the overhead expenses as a whole in line with production costs.

Since 1955, especially since about 1965, the U.S. economy as a whole has been guilty of almost criminal mismanagement of the growth of “overhead expense” as a whole. At the end of World War II, 62% of the labor-force was employed in the category of *operatives*; today, about 21% are employed so. This means that the overhead-expense factor in total employment has risen from 38% to 79% of total employment. In other words, the ratio of “overhead expense” per employee producing physical goods has risen from 38/62nds (61%), to 79/21sts (375%). This is without considering the burden of financial charges such as growth of interest-payments and increases of rental payments on account of purely-speculative appreciations of rents. More than 610% increase in overhead-expense burdens per operative: *This is only the rate of inflation caused by overhead-expense mismanagement alone!* To this we must add the inflation of prices caused by financial and ground-rent charges per-capita. No wonder inflation has zoomed over the past 16 years since Johnson's shift in U.S. policies.

We are not going to escape from this inflationary downward-spiral until the entire financial system collapses, as it did under President Herbert Hoover, or until we reverse the drift into “post-industrial society.”

It will accomplish nothing, attempting to sweat additional productivity out of a shrinking percentile of the labor-force employed as operatives. We must reverse the past decades' trends, and concentrate on increasing the percentile of the labor-force employed as operatives in industries and farms investing in advanced technologies of product-design and productive methods. This requires, chiefly:

1) Shutting down easier capital and credit flows into “overhead-expense” categories, excepting highly-skilled professional or semi-professional medical, scientific, and engineering services. This requires:

a) Large flows of credit for medium- to long-term investments, at low interest rates, into technologically-advanced production and production-capacity in agriculture, manufacturing, construction, transportation, and energy-production and distribution systems. Large volumes of such credit must be earmarked for either this or loans to development of other basic infrastructure by federal, state, county, and municipal governments.

b) The tax-burden must be shifted to fall heavily on speculative forms of non-production-related capital gains and ordinary income, away from households, farms, and industry.

c) “Federalizing” the Federal Reserve System, in conformity with Article I, Sections 8 and 9 of the U.S. Federal Constitution: The Fed is no longer allowed to control the creation of currency or credit; issuance of currency must be gold-reserve currency (at about \$750

per ounce of gold), and the Fed's inflationary "Keynesian multiplier" must be shut down.

2) Emphasizing investment in capital-goods production, rather than consumer-goods production. *Wage-earners' increased purchasing-power should be increased in the capital-goods and basic-infrastructure sectors.* Improved capital goods will improve the productivity of consumer-goods industries, meaning an increased supply of better-quality, more durable consumer-goods at reduced average social cost of producing those goods.

3) Markets for sale of high-technology capital-goods must be increased, by means including international monetary-system reforms designed to increase world-trade in capital-goods.

In other words, we must dump the "barber-shop economics" of "demand-pull," and shift to a "technology-push" approach. Some rule-of-thumb targets for national policy-making should include:

1) As rapidly as possible, employment in the overhead-expense (indirect cost) of research and development should be pushed up to about 5% of the total labor-force's employment.

2) By the end of the century, the percentile of the U.S. labor-force employed as operatives in agricultural, industrial, and basic-infrastructure categories of employment should be pushed back to the vicinity of 50% of the total.

In other words, double the average productivity of the economy solely by means of increasing the ratio of labor-force employed as operatives, and at the same time push investments in capital-goods based on high rates of R&D employment to between 7% and 10% increased productivity annually in operatives' categories, for a combined increase in average U.S. productivity of between four and five times by the close of the present century.

"Demand-pull" is trying to increase milk-production by concentrating on the wrong end of the cow—which may be normal for Harvard graduates, but is terrible in the real world.

The excessive growth of certain categories of overhead-expense should be treated as a cancer: Starve the cancer and nourish the healthy tissue, using selective credit and selective taxation policies of government to steer the flow of investments (and employment) in the needed directions.

## The auto industry in particular

Hoping for a recovery sparked by auto sales is foolishness on other grounds as well.

The need for private automobiles is determined by the number of family households in the market, and also by the number of family members in the average household. The rate of family-formation is down (in net of marriages and divorces, and rapid growth of homosexuality), and similar causes reduce sharply the birth-rate per female of child-bear-

ing age. The present inventory of automobiles in use represents a market which has already been saturated. The market-potential is therefore limited approximately to production of sufficient cars to provide needed replacements.

Additionally, from the standpoint of the health of the economy as a whole, it is insanity to produce automobiles designed to become relatively uneconomical to operate and maintain after a few years' use. We must get back to Henry Ford's Model T policy: End this mania with style-changes, and produce a high-quality, durable vehicle, relatively cheap to maintain, and also easily and economically adapted to incorporate improvements in accessories and replacement parts over a projected ten-year or longer lifetime of ordinary usage. This means producing fewer, and much better vehicles, a true "consumer capital good."

Instead of patching-up existing designs, as the lunatic "air-pollution" legislation and bureaucratic decrees of the past decade have forced auto manufacturers to do, produce a power-plant which is inherently more efficient, inherently far less polluting.

If we proceed sanely, the gasoline-diesel power-plants as now known will be out before the end of the present century. The alternatives are well known, and their general and economical application is merely a matter of developmental work.

This signifies that the unit-capacity for private vehicles' production by our automobile industry must level off at a lower level of output of units per year. This means, therefore, that we must concentrate now on a sane reorientation of the production capacity of the auto and associated industries, and of the labor-force of localities traditionally associated with that industry. High-technology mass-production of things badly needed in large quantities on a domestic and world-market scale is the general formula obviously to be applied.

Pumping up the auto-industry's sales, as a presumed "demand-pull" gimmickry for stimulating the economy as a whole, is just one more dose of the same old medicine which made the patient sick since the 1950s dosage with this poison.

The total amount of stimulant supplied by pouring new volumes of new-car-sales financing into the auto industry's sales is less than the amount of the added stimulant supplied. There is no "multiplier" effect under present conditions.

Meanwhile, the benefit of the upturn in 1983 auto sales has been widely exaggerated. By producing a poorer quality of vehicle at increased prices, and selling those vehicles in increased numbers, the auto firm's profits are temporarily increased significantly *one time*. The auto firms are helped a bit—temporarily—in this way, but the economy as a whole suffers. It is the lunacy of the Burns period under President Eisenhower repeated again, as farce. It merely makes the looming economic collapse bigger when that crash hits.

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*The graphs appearing in this Special Report were used by Mr. LaRouche in a Feb. 4 nationally televised broadcast, and were provided to EIR by The LaRouche Campaign.*