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The Republicans' "Contract with America"

Making the mid-term election national, rather than a series of local contests, would seem to be the key to the House Republicans' hopes of regaining control after 4 decades as a minority. Despite the hype, their stated goals are quite modest. Nevertheless, a return to "divided government" could bring us ever so slightly back to the Founding Fathers' vision of a Congress that wields the power of the purse to restrain the executive.

On September 27, some 350 Republican candidates for the U.S. House of Representatives gathered on the steps of the Capitol Building in Washington, D.C. There they signed a list of proposals that they pledged to bring before the House early next year, if their party wins a majority in next month's election.

A Republican House?

Of course this is a big "if." The Republicans have not held a majority in the House since 1955, and they have elected the Speaker only twice (in 1947 and 1953) for the last 31 Congresses. The party out of power in the White House normally gains in the House at the mid-term election (an average of 26 seats in "off year" elections since World War II). More often than not, these "swings" have reflected disaffection with the party in power arising from the recessions or economic slowdowns that commonly occur in the middle of Presidential terms.

To come off as winners in 1994, the Republicans will have to achieve a net gain of 40 seats, well above the average for "off year" elections. Yet even in a year when the economy has been expanding nicely, surprisingly few analysts are willing to rule out a Republican victory.

There are several reasons for this. An unusually large number of Democratic Congressmen have decided to retire this year — it is easier for Republicans to win an "open" seat than to defeat an incumbent. Gerrymandering to produce black majorities in some Southern districts (reapportioned on the basis of the 1990 census) may have rendered the remaining white-dominated districts more conservative. Many Southern districts that went for Clinton, a Southerner and "New Democrat," and a Democratic Congressman in 1992 may go Republican now that it has become apparent that Clinton is little different from an "Old Democrat." Elsewhere, the absence of economic distress as a major issue could lead to a low voter turnout, which would work to the Republicans' advantage. Needless to say, however, the most important thing the Republicans have going for them by far is the unpopularity of President Clinton.

As a result, the Democratic candidates have been doing their best to live up to Tip O'Neil's motto ("All politics is [*sic*] local.") — focusing on the personalities and issues in their districts, telling Bill (and Hillary) to stay away, etc. Conversely, it is in the Republicans' interest to raise the voters' sights to the national level (where Bill Clinton will appear in the cross hairs). Presumably, this was what the event on the Capitol steps was about.

The Newt Deal

The mini-platform that the Republican candidates signed was the work of Rep. Dick Armey of Texas and Rep. Newt Gingrich of Georgia. Mr. Gingrich is in line to succeed the retiring Republican leader of the House. He will become the Speaker if the Republicans win. At the ceremony, Gingrich asserted that:

> If the American people accept this contract, we will have begun the journey to renew American Civilization. Together we can renew America. Together we can help every American fulfill their [sic] unalienable right to pursue happiness and to seek the American dream. Together we can help every human across the planet to seek freedom, prosperity, safety, and the rule of law. That is what is at stake.

Despite the overblown rhetoric, the list of items that the Republican candidates agreed to push as soon at they take over is quite restrained. It includes a hodgepodge of tax breaks: a $500 tax credit per child regardless of income, elimination of the "marriage" penalty, more favorable depreciation rules for business, lower capital gains taxes, and breaks for Social Security recipients and savers. This list also calls for a Constitutional amendment to require a balanced budget (with a three-fifths vote of both houses of Congress needed to raise taxes), term limits for members of Congress (and making Congress subject to the laws it enacts for everyone else), tort reform, and nonspecific calls for lower welfare spending, a stronger military, and increased use of the death penalty.

Our position on the balanced budget amendment has long been that it would do little to address the basic problem of excessive government. Experience has shown that the politicians can be very creative and inventive in determining what is and is not considered part of the budget. Many states, such as Massachusetts and New York, must have balanced budgets, but they still have run up massive indebtedness.

Even the notion of a super majority to "increase taxes" is not as clear cut as it sounds. For example, would a proposal to change to a "flat" income tax (say 20 percent, with enlarged exemptions), which might raise more revenue than the current system, be deemed a tax increase or a decrease?

In any event, it appears that the balanced budget amendment was included on the list because it played well with "focus groups." In a way this is regrettable, because it has enabled critics to harp on the tax proposal while ignoring the substantive issues that the Republicans have addressed (such as term limits, making the losers pay the legal bills of the winners in civil suits, etc.). A focus on such

issues would do much to raise the debate to the National level.

The critics do have a point: the goals of cutting taxes and balancing the budget seem to be in conflict. The fact of the matter, however, is that no amount of tinkering on the revenue side of the ledger is likely to have much effect on the deficit. Since World War II, Federal receipts have fluctuated in a range of roughly 18-20 percent of GDP, under widely differing rate schedules. The problem of the deficit has arisen because spending has accounted for 23-25 percent of GDP during recent years. Even if it could be done, balancing the budget via the "root canal" method of extracting another 5 percent of GDP from taxpayers is not attractive to the voters or to the politicians of either party. Spending is clearly the problem, but neither the Republicans nor the Democrats have much to say on the subject.

No matter how loath our politicians are to admit it, *all* areas of Government spending are riddled with waste. The bureaucracy is swollen with layers of managers, unneeded in the information age. Executives are hamstrung by civil service rules. Much of our defense spending is not for items wanted by the Pentagon, but for jobs in favored Congressional districts. Procurement and construction contracts are bloated by rules and restrictions. An so on and so forth. Such waste may be curtailed to some extent by streamlining and reforms, but it pales in comparison to what is paid out for income security to persons who are far from destitute. Government transfer payments (payments not made for services or goods) that are received by those in poverty are a distressingly small proportion of the total.

Interest may be seen as pure waste (as it reflects the politicians' prior profligacy) but, as long as we sustain continued deficits, it will continue to increase and crowd out other budget outlays. This is the fundamental problem that the politicians of both parties are failing to address.

Divided Government Again?

When the Founding Fathers provided for a separation of powers in the U.S. Constitution, they anticipated that there would be factions within the Government. However, the rigid party structure that has evolved probably would have astounded the framers. The major U.S. parties are far less ideological than their counterparts abroad (and their positions on major issues such as trade and "states' rights" have drifted nearly 180 degrees during the past century). Cynics may conclude that the Republicans and Democrats are little more than conspiracies to get at the "boodle" of Government power, patronage, contracts, etc.; but, to the extent that there is a broad difference between them it is that Democrats believe in the efficacy of Government in many areas where Republicans do not.

Our present difficulties arose when Republicans controlled the executive and the Democrats controlled the legislative branch, *i.e.*, when those who didn't really have their hearts in making Government work were in charge of making it work, while those who believed in more Government were in charge of the appropriations.

The Republicans have learned from the bitter experience of twenty elections. They are thus avoiding the question of spending during this campaign — to the point of asserting that they have no intention of cutting Social Security, even before the Democrats have accused them of it. Nevertheless, the evidence suggests that a Republican controlled House of Representatives would be in a better position to exercise the power of the purse to restrain an enthusiastic executive branch — the role envisioned by the Founding Fathers — than we have had for a long time. ❑

Voo Doo II ... *Not!*

Laura Tyson, chairman of the President's Council of Economic Advisors, characterized the Republicans' plans as "voo doo II," implying that it was simply a restatement of Ronald Reagan's 1980 strategy, which George Bush then called "voo doo economics." However, tax cuts were only one aspect of the Reagan program (the other two were spending cuts and decreased regulation, which the current Republican proposals hardly mention). Moreover, the goal of the Reagan tax cuts was to reduce the marginal tax rates, whereas (except for capital gains) the Republicans now simply want to eliminate some of the more bizarre features of the tax code.

As far as we are aware, no one genuinely believes that couples should pay more taxes if they are married, that the personal exemption for dependent children (which is worth less to lower-income families) even begins to cover the cost of child raising, or that it is fair to tax inflation-induced capital gains at the same rates as other income. Recent attempts to eliminate such inequities from the tax code have failed, not because Congress has it in for married persons, children, or long-term investors, but because the Government "needs the money."

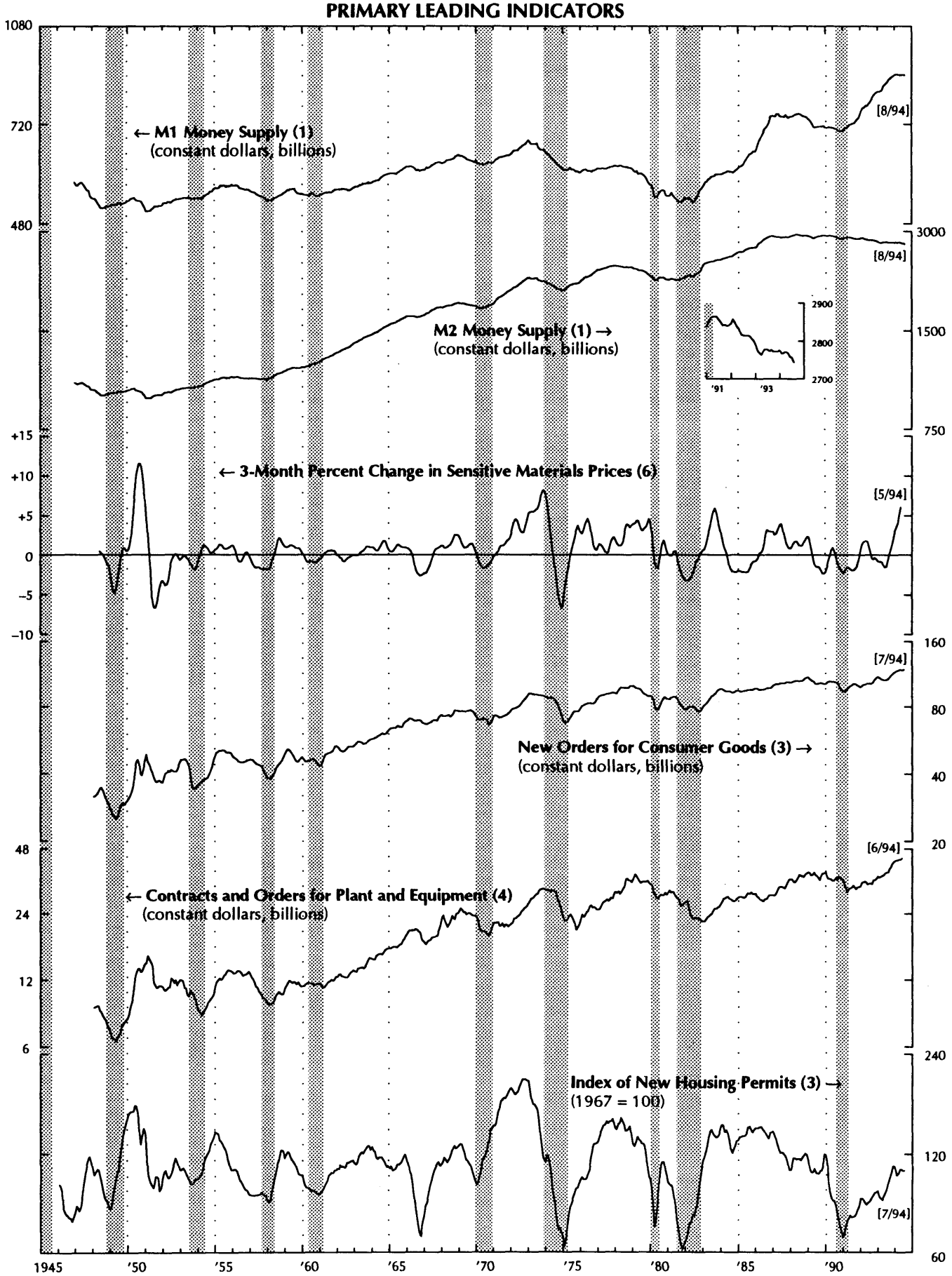
Not even the most fervid "supply-sider" would argue that such steps to make taxes fairer would do anything but reduce receipts. This means that most of the Republicans' current tax proposals are not at all like the Reaganites' 1980 "voo doo" assertion that reducing the rates on the highest incomes would lead those subject to the top rates to pay more taxes.*

The exception to this is capital gains taxes. The Republicans mention both lower rates and indexing as a means of providing relief to investors. It seems clear that lowering the rates could lead to higher revenue, at least in the first year, as many investors would realize gains that they are reluctant to take at the higher rates (this was the experience of the 1978 and 1981 gains tax cuts). On the other hand, no one has the faintest idea of how indexing capital gains would affect receipts. Clearly, revenues would decrease if investing patterns did not change, but the relief of indexing could prompt even more investors to "cash in."

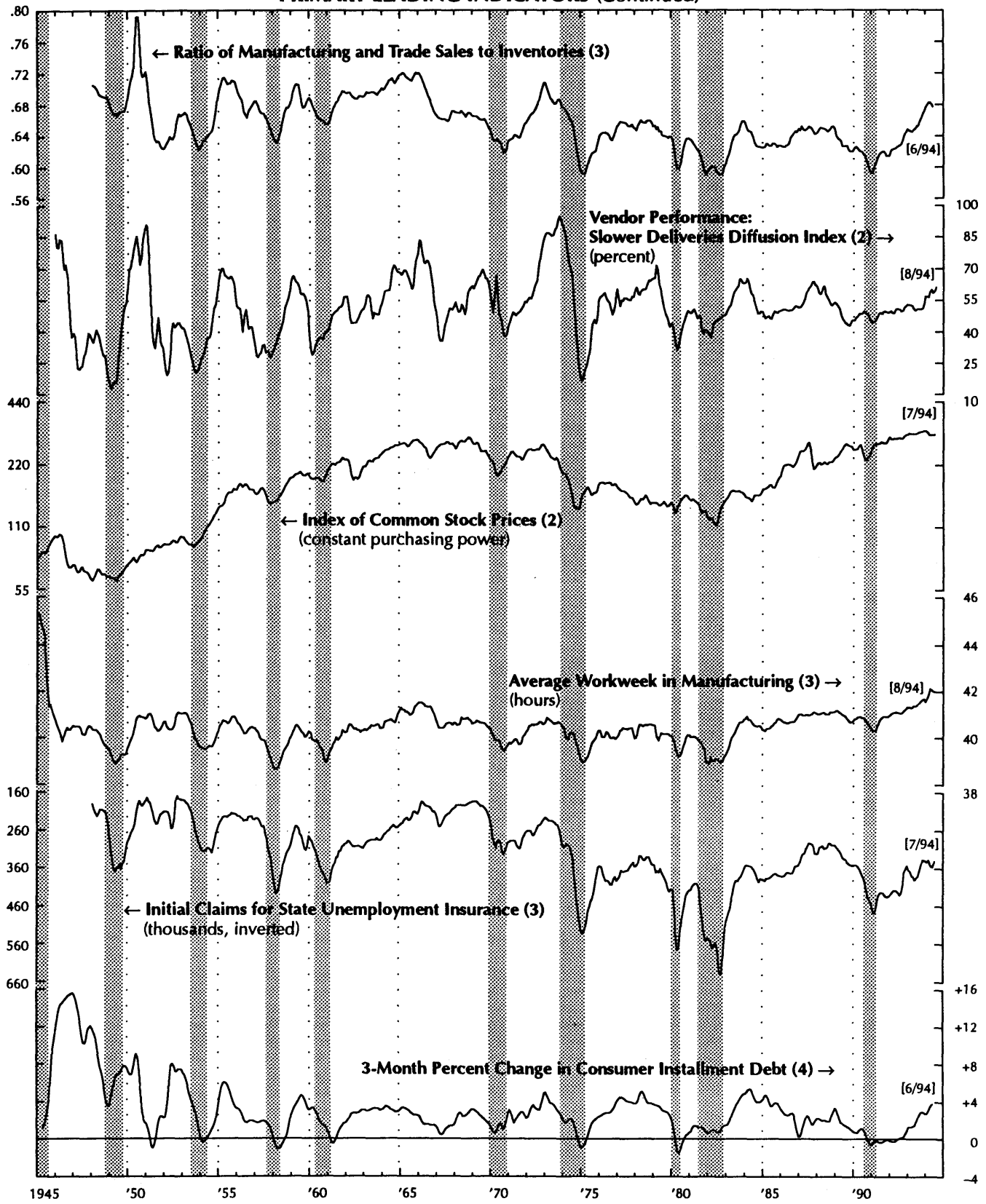
Our own view is that indexing would simply bring justice to the taxation of capital gains. On the other hand, a lower differential rate would not only represent a far cruder means of allowing for the ravages of inflating, but also would be an invitation to a revival of the abusive "tax shelters" of the past. Converting ordinary income into long-term gains via elaborate legal and accounting devices is what tax shelters thrive upon.

* This "voo doo" actually came through. The "rich" did declare more income and pay more taxes after the rates were lowered. Unfortunately, the other legs of Reagonomics crumpled — the Reagan (and Bush) budgets calling for lower spending were pronounced "dead on arrival" by the Democratic Congress, and regulations continued to proliferate.

PRIMARY LEADING INDICATORS

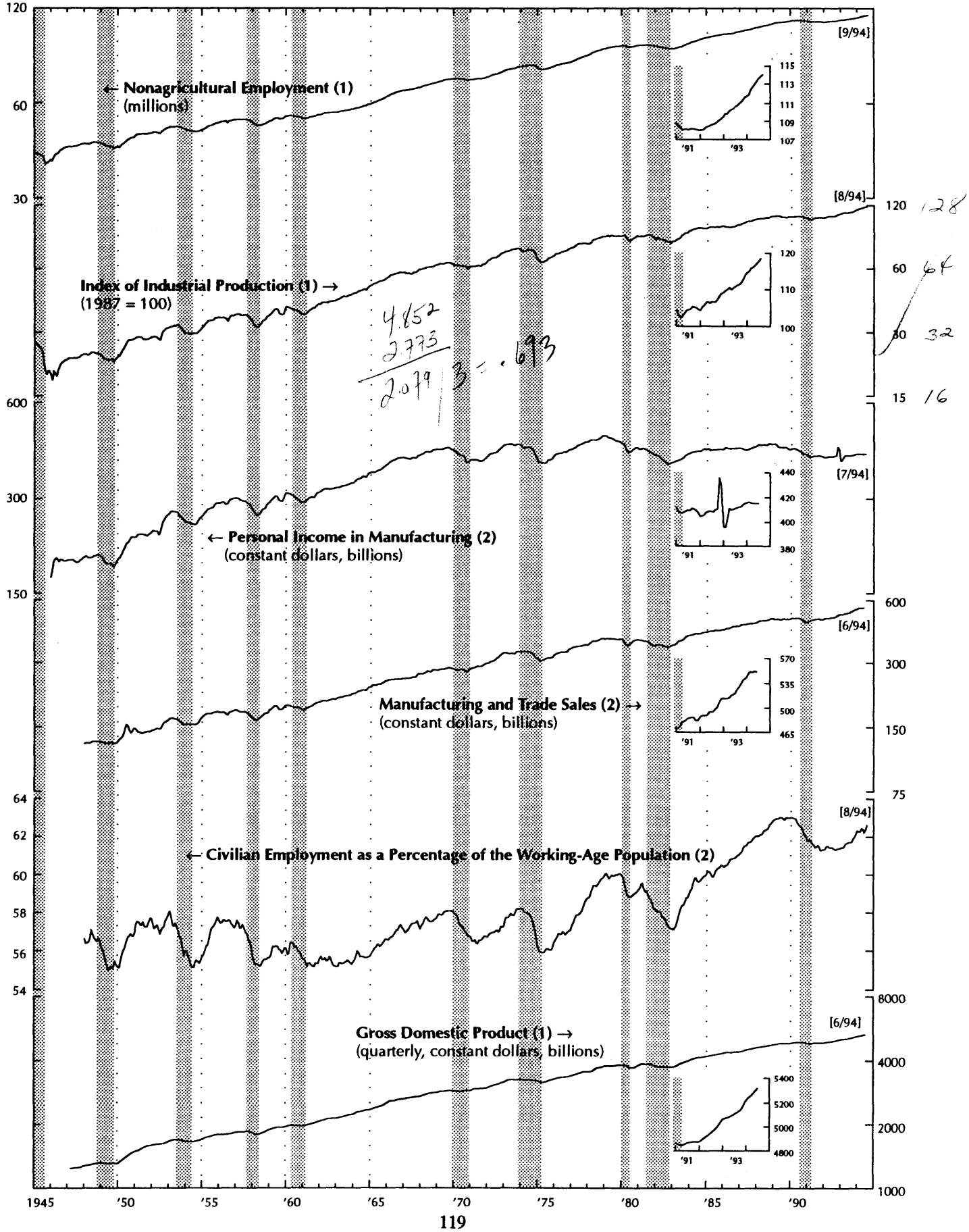


PRIMARY LEADING INDICATORS (Continued)



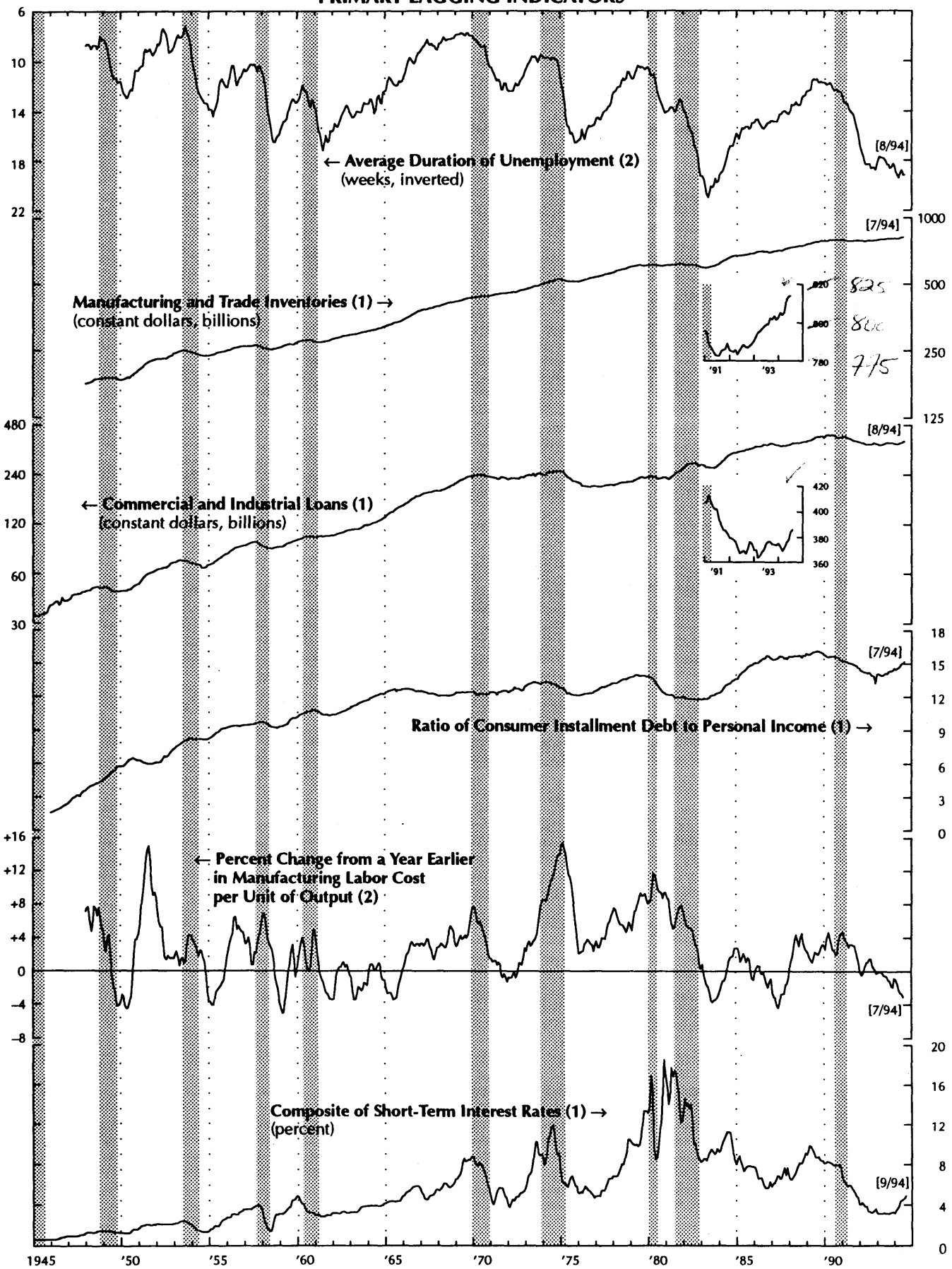
Notes: 1) Shaded areas indicate recessions as dated by the National Bureau of Economic Research. 2) The number in parentheses next to the name of a series is an estimate of the minimum number of months over which cyclical movements of a series are greater than irregular fluctuations. That number is the span of each series' moving average, or MCD (months for cyclical dominance), used to smooth out irregular fluctuations. The data plotted in the charts are those MCDs and not the base data. The number in brackets is the latest month for which the moving average is plotted. 3) The insets in selected charts show recent trends more clearly. These insets have arithmetic scales, even when the main chart is plotted on a ratio scale.

PRIMARY ROUGHLY COINCIDENT INDICATORS



4.852
2.773
2.079 / 3 = .693

PRIMARY LAGGING INDICATORS



BUSINESS-CYCLE CONDITIONS

The current expansion has overcome its early weakness and there are few signs as yet that it will end any time soon. Lately, however, the leading indicators have posted mixed results, and the prospects for continued expansion could change quickly. Also, the lagging indicators are showing their strongest growth to date in this cycle, so the potential development of obstacles to further expansion now warrants serious consideration.

Five of the 12 primary leading indicators reached cyclical highs in our latest review: the *change in sensitive materials prices*, *new orders for consumer goods* (new orders and all other dollar-denominated series are reported in constant dollars), *contracts and orders for plant and equipment*, *vendor performance* (the percentage of purchasing managers reporting slower deliveries from suppliers), and the *change in consumer installment debt*. The cyclical highs in new orders, contracts and orders, and vendor performance ended brief downturns in those series and removed doubts about the ongoing expansion of new orders. All five series now are clearly expanding.

The *M1 money supply* fell in August to its lowest level since last December. M1 has not fallen much from the all-time high it reached in March, but its failure to reach new highs has raised doubts about its cyclical status. Similarly, the failure of the *average workweek in manufacturing* to reach new highs has generated uncertainty about its ongoing expansion. Although the factory workweek stood at a remarkable 42 hours in September, the series has been flat since June and its 3-month moving average has declined from the postwar high it reached in April. M1 and the average workweek both are appraised as probably expanding, downgraded from clearly expanding last month.

The *ratio of manufacturing and trade sales to inventories* fell sharply in July, producing a second consecutive decrease in its 3-month moving average. The decline in the moving average, although brief, warranted downgrading the ratio's cyclical status from probably expanding to indeterminate.

Overall, 89 percent (8 out of 9) of the leaders for which a trend is evident are expanding, down from 90 percent (9 out of 10) last month. Our cyclical score, based on a separate analysis of the leading indicators, rose to 82 from the score of 81 reported last month. The charts below plot the trends of these two summary measures. At their current levels, these measures suggest that the prospects for continued expansion remain strong. There is, however, a substantial degree of uncertainty about the leaders' trends. Three series are appraised as cyclically indeterminate, and there is some doubt about the expanding trends of three others. Given this uncertainty, the outlook for continued expansion could change quickly, especially if strong growth among the lagging indicators (see below) continues unabated.

Among the primary roughly coincident indicators, the latest reports put four series at new cyclical highs: *nonagricultural employment*, the *index of industrial production*, the *civilian employment to population ratio*, and *gross domestic product* (GDP). The Commerce Department's final estimate of second-quarter GDP put overall economic growth at a solid 4.1 percent annual rate, revised upward from 3.8 percent. All four series remain appraised as clearly expanding. *Manufacturing and trade sales* also remains clearly expanding, despite a 1-month decrease in its moving average.

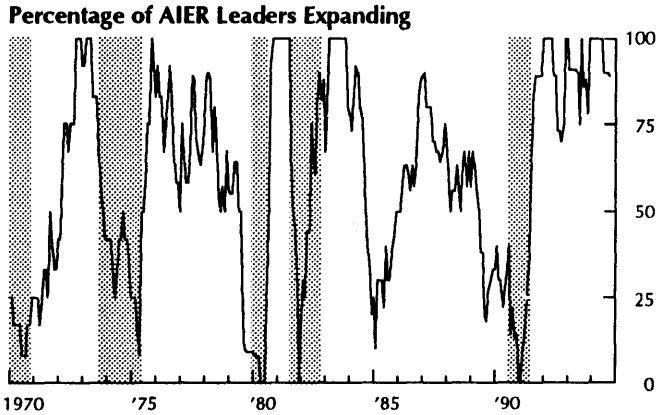
Personal income in manufacturing has decreased slowly but steadily since February. The latest decrease, in August, produced the fifth consecutive decline in the series' 2-month moving average, prompting a reappraisal of its cyclical status. Appraised as probably expanding last month, personal income in manufacturing now is cyclically indeterminate. Despite the reappraisal, the percentage of coinciders expanding stands at 100 (5 out of 5), unchanged from last month, when an expanding trend was evident for all six coinciders.

Among the primary lagging indicators, one series improved and four others reached cyclical highs. The moving average of the *average duration of unemployment*, an inverted series, remained above its April low for a fourth consecutive month. This development cast doubt on the series' continuing contraction, prompting an upgrade of its cyclical status from probably contracting to indeterminate.

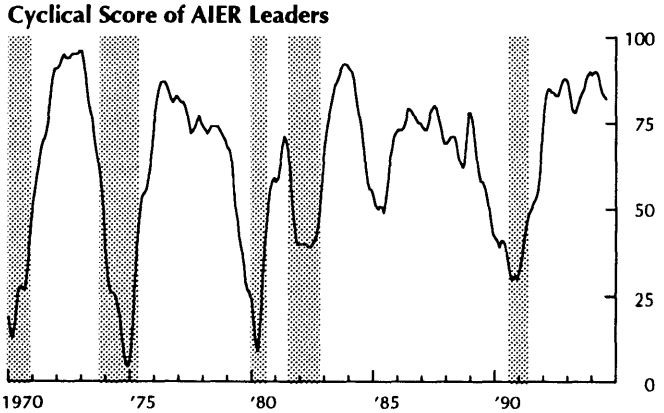
The latest reports put *manufacturing and trade inventories*, *commercial and industrial loans*, the *ratio of consumer installment debt to personal income*, and our *composite of short-term interest rates* at cyclical highs. All four series remain clearly expanding, as they have been since our August review of the indicators. Previously, four or more lagging indicators had not been appraised as clearly expanding in any review since November 1989.

Given the improvement in the average duration of unemployment's cyclical status, 80 percent (4 out of 5) of the laggers for which a trend is evident are expanding, up from 67 percent (4 out of 6) last month. This increase, together with the four cyclical highs noted above, has produced the clearest and strongest signs of expansion among the laggers to date in this cycle. This strength can persist for many months before obstacles to continued expansion develop (bloated inventories, excessive debt-service burdens, rising labor costs, and falling productivity, for example), but the possibility of those symptoms of maturing expansion now

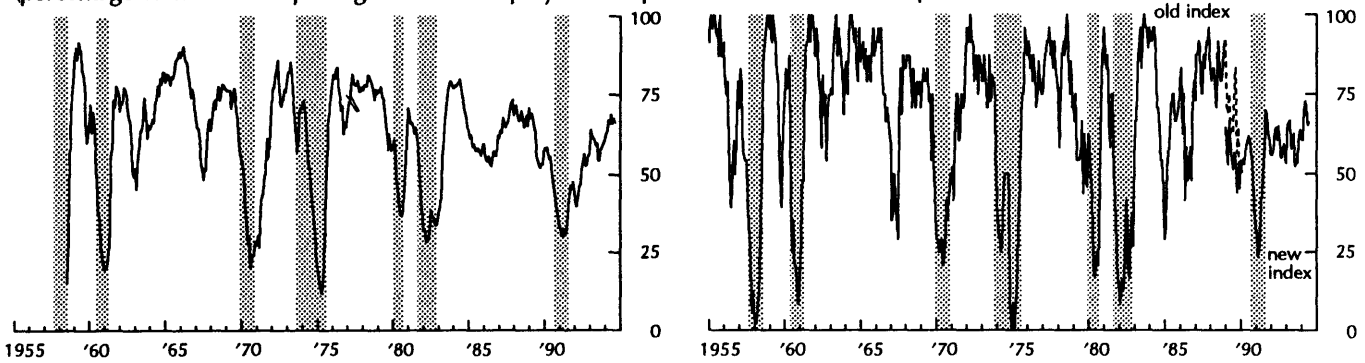
Percentage of AIER Leaders Expanding



Cyclical Score of AIER Leaders



Diffusion Indexes of Nonagricultural Employment (left) **and Industrial Production** (right)
(percentage of industries reporting increased employment or production over 6-month spans)



Note: Data points for both indexes are plotted in the final month of each 6-month span. Sources: Federal Reserve Board Industrial Production release (industrial production new index); Commerce Department (industrial production old index and nonagricultural employment index).

merits more serious consideration than it did just a few months ago.

Gasping for Breadth?

Although the strength among the laggers causes some concern, much of the available evidence suggests that considerable room for expansion remains. Such evidence includes the breadth of the expansion — the percentage of industries participating in the overall growth — which has been unusually narrow to date. As the charts above illustrate, diffusion indexes of employment and industrial production are just beginning to approach the peak levels of previous business cycles.

Typically, between 75 and 90 percent of industries report increased production over 6-month spans during expansions. The diffusion index of industrial production has yet to exceed 75 percent in the current cycle, and did not exceed 70 percent until April. Similarly, industry participation in employment growth has leveled off between 70 and 80 percent during previous expansions, but it did not approach those levels in the current cycle until this year (and has yet to exceed 70 percent).

There is, of course, no guarantee that the indexes will return to their historical norms. Although business cycles all share the same broad outlines, each has its unique features and unprecedented occurrences. It is plausible that the current expansion could mature and lapse into recession without ever "firing on all cylinders." The historical evidence argues against such a scenario, however. Even during the weak and short-lived 1980-81 expansion, the diffusion indexes managed to attain their traditional levels before the onset of recession.

That the higher percentages recorded in previous cycles were sustained for extended periods suggests that a long period of continued growth can be expected if the current cycle repeats the patterns established in previous cycles. Furthermore, the breadth of expansion is correlated with the rate of economic growth. For example, both diffusion indexes have risen, especially this year, as the pace of expansion has accelerated. The low levels of the diffusion indexes by historical standards suggest that growth could accelerate even further if those indexes return to their historical norms. ❑

Statistical Indicators of Business-Cycle Changes

Change in Base Data					*Cyclical Status*		
Jun.	*Jul.*	*Aug.*	*Sept.*	***Primary Leading Indicators***	*Aug.*	*Sept.*	*Oct.*
+	+	–		M1 money supply	+	+	+?
–	–r	–		M2 money supply	–	–	–
+	+	–		Change in sensitive materials prices	+	+	+
–	–	+		New orders for consumer goods	+	+?	+
+	–	+		Contracts and orders for plant and equipment	+	+	+
–	+	+		Index of new housing permits	?	?	?
+	–			Ratio of manufacturing and trade sales to inventories	+?	+?	?
–	–	+	+	Vendor performance	+	+	+
+	–	+		Index of common stock prices (constant purchasing power)	?	?	?
–	nc r	nc r	nc	Average workweek in manufacturing	+	+	+?
+	+	+		Initial claims for unemployment insurance (inverted)	+?	+?	+?
–	–	–		Change in consumer installment debt	+	+	+
				Percentage expanding cyclically	*90*	*90*	*89*
				Primary Roughly Coincident Indicators			
+	+	+	+	Nonagricultural employment	+	+	+
+	+	+		Index of industrial production	+	+	+
–	–	–		Personal income in manufacturing	+?	+?	?
+	–			Manufacturing and trade sales	+	+	+
–	–	+	+	Civilian employment to population ratio	+	+	+
+				Gross domestic product (quarterly)	+	+	+
				Percentage expanding cyclically	*100*	*100*	*100*
				Primary Lagging Indicators			
+	–	nc	nc	Average duration of unemployment (inverted)	–?	–?	?
+	+			Manufacturing and trade inventories	+	+	+
+	+	+		Commercial and industrial loans	+	+	+
+	+	+		Ratio of consumer installment debt to personal income	+	+	+
+r	–	–		Change in labor cost per unit of output, manufacturing	–	–	–
+	+	+	+	Composite of short-term interest rates	+	+	+
				Percentage expanding cyclically	*67*	*67*	*80*

nc No change. r Revised.

Under "Change in Base Data," plus and minus signs indicate increases and decreases from the previous month or quarter and blank spaces indicate data not yet available. Under "Cyclical Status," plus and minus signs indicate expansions or contractions of each series as currently appraised; question marks indicate doubtful status when shown with another sign and indeterminate status when standing alone.

PRICE OF GOLD

	1992	*1993*	*—— 1994 ——*	
	Oct. 15	*Oct. 14*	*Oct. 6*	*Oct. 13*
Final fixing in London	$341.85	$367.25	$392.00	$387.25

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