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Washington Behind Closed Minds

In the debate over taxing and spending, there are many very sharp pencils in Washington, but they are always calculating who will gain and who will lose in the short term. The important issues of what is right or the best to do and the long-term consequences of short-term changes seem to be beyond them.

One of the most persistent myths regarding the 1980s (the so-called "Decade of Greed") is the notion that large and chronic Federal budget deficits are the result of Ronald Reagan's "tax cuts for the rich."

This is wrong-headed in two respects.

First, as we have often noted, "the rich" paid more in taxes after the top income tax bracket was reduced from 70 percent to 50 percent by the 1981 Act. They paid even more in taxes after the top bracket was reduced to 28 percent by the 1986 Act. This is so whether the taxes are measured in current dollars, in constant dollars, or as a percentage of all income taxes paid to the Treasury and no matter how "the rich" are defined (as the top 0.1 percent of taxpayers, as the top 50 percent, or as any percentage in between).

Low-Income Taxpayers Benefited

The major beneficiaries of the "Reagan tax cuts" were, in fact, the millions of low-income taxpayers who were removed from the income tax rolls entirely and the millions of middle-income taxpayers who saw their average rates decrease. Such taxpayers benefited from increases in personal exemptions and standard deductions, and were little affected by more stringent rules for itemized deductions and tax shelters. Both tax acts were designed to be "revenue neutral," but the 1981 Act phased in lower brackets during the years 1982-1984. When price inflation abated more rapidly than projected during those years, most taxpayers faced lower rates than were contemplated when the reform was enacted. The effect of this 1982-84 windfall was relatively small (it was negligible for taxpayers with a lot of income in the top bracket where 50 percent was still 50 percent), however; and for most low- and middle-income *workers*, the income tax cuts were offset by subsequent increases in Social Security and Medicare taxes.

Revenues Changed Little

This leads us to our second point: the Reagan tax cuts did not gut Federal receipts. Chart 1 shows Federal receipts as a percent of GDP. During the 10 years 1982-1991, this averaged 19.8 percent, which was exactly the same proportion that it averaged during the preceding 10 years, 1972-1981. The Federal Government was not starved for revenue, but it was put on a "maintenance diet."

The principal reason for the recent relative stability of Federal receipts as a percent of GDP has been the indexing of personal income tax brackets, exemptions, and standard deductions for 1985 and later years — which appears to be the most durable feature of the 1981 Tax Act. Indexing has eliminated the "bracket creep" that sharply boosted Federal receipts during the years 1975-81 and similar periods when accelerating price inflation resulted in effective tax increases not voted upon by Congress.

Indexing thus also has denied Congress opportunities to vote for "tax cuts," which, prior to 1981, it did whenever unlegislated bracket creep boosted taxes significantly. There is little reason to mourn, however. With only one major exception — the 1964 measure that was originally proposed by President Kennedy — tax acts prior to 1981 mainly involved the creation and enlargement of "normative" measures (*i.e.,* loopholes) that served to reduce the taxes of special interests. The marked decrease in Federal receipts as a percent of GDP during the years 1982-85 was comparable to decreases during prior recessionary periods, which were also made larger by "tax relief," as in 1954, 1969-70, or 1975.

In short, the notion that Federal tax policy retrogressed during the 1980s would seem to be based on envy and/or "inside the Beltway" thinking. "The rich," however defined, paid more in taxes because they earned and reported markedly more income. Presumably, they spent or invested their higher incomes in ways of their own choosing. It is quite perverse to believe that this is less desirable than having "the rich" hide or forego income and invest for tax advantages (often unintended by the politicians that created them) instead of economic fundamentals.

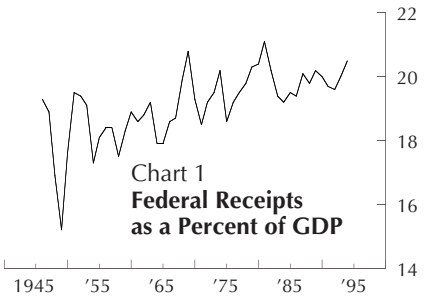
Similarly, the notion that the Federal Government is somehow due an ever-increasing share of the Nation's output would seem to be embraced mainly by those who have a Washington address.

It's the Spending, Stupid

If Federal receipts have changed little in relation to GDP, on average, then it is clear that the cause of chronically higher budget deficits is substantially higher spending.

Chart 2 shows Federal outlays, again as a percent of GDP. Such outlays averaged 23.6 percent of GDP during the 10 years ended 1991, which was fully 2 percentage points higher than they averaged during the preceding 10 years. With revenues at an average of 19.8 percent of GDP during both periods, all of the increased spending was borrowed (*i.e.,* added to the national debt). These percentages probably are understated. The Treasury has reported an increasing amount of "offsetting receipts" as reductions of spending rather than as revenue. If all receipts were counted as receipts, then Federal revenues would be seen to have increased in relation to GDP, and outlays to have increased even more than indicated above.

As Chart 2 also indicates, the sustained large deficits of the 1980s themselves have added to Federal outlays. The greatly en-



Source for Charts 1 and 2: *National Income and Product Accounts*.

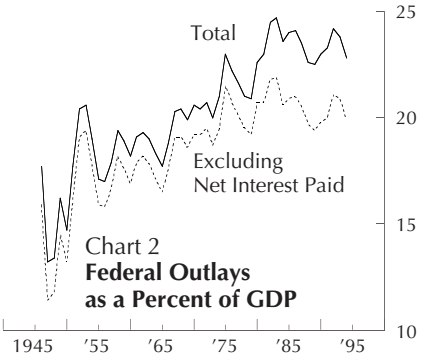


Chart 2
Federal Outlays as a Percent of GDP

larged national debt has meant a huge increase in interest payments by the Treasury. However, even this situation — which some seem to believe was Ronald Reagan's devious way of putting the squeeze on Federal spending all along — only accounted for about 1.4 percentage points of the increase in spending in relation to GDP. Federal outlays excluding interest averaged 20.6 percent of GDP during the years 1982-91 vs. 20.0 percent during the preceding 10 years. No squeeze there.*

With "the rich" paying more in taxes and with more of the Nation's output controlled by the Federal Government, the incessant whining about "tax cuts for the rich" and limited revenues are quite absurd. The genuine concern, that debt service cannot continue to absorb an increasing share of outlays forever, has long been evident. The remedy favored inside the Beltway — higher taxes — consistently has been rejected by the voters. Walter Mondale said he would raise taxes, Michael Dukakis had raised taxes as Governor of Massachusetts, and George Bush promised "no new taxes," only to impose them 2 years later. They all lost. We should also note that the remedy favored outside the Beltway — lower spending — was proposed again and again by Presidents Reagan and Bush, but their budgets were proclaimed "dead on arrival" by the Congressional leadership. That leadership was replaced last November.

Baseline Budgeting

The Republican-controlled Congress does seem to be attempting to curtail spending. It is now President Clinton's business-as-usual budget that is dead on arrival. In taking up this task, one of the Republicans' most consistent complaints has been against baseline budgeting in which a change that reduces an outlay from its "current service" level is described as a cut, even when the dollar amounts to be spent are projected to increase. This complaint was recently ridiculed by Michael Kinsley:

> "… the most tiresome conceit of the current budget debate [is] the insistence of the Republicans that they're not cutting federal programs — they're merely slowing the rate of growth."†

Kinsley, who arguably is the brightest and most articulate of the Washington pundits and "talking heads," describes the obvious: that reducing the projected rate of growth of a program means not spending funds in the same way. He writes that:

> … the Defense budget today is the same in dollar terms as it was in 1987, yet troop strength has dropped from 2.2 million to 1.6 million, there are fewer ships and planes, and so on. Who would maintain that Defense has not been "cut"?
>
> But let us accept, for the moment, the metaphysical conceit that the essential nature of a "cut" requires that it be a reduction in an actual dollar amount. This raises a mysterious question. How do the Republicans propose to balance the budget in seven years? After all, the Senate and House leaderships have agreed on $245 billion in tax cuts. If spending is actually going up, albeit at a slower pace, while taxes are going down, how will these two lines ever cross?
>
> To solve this mystery, we must look at the revenue side of the equation the same way the Republicans wish us to look at the spending side. What we discover is that under the Republicans' own strange accounting rules their promised tax cut melts away even faster than their proposed spending cuts. Indeed the Republican budget, which is billed as offering a $245 billion tax "cut" actually amounts to a gigantic tax *increase.*
>
> Tax revenues for fiscal 1995 are projected to be $998 billion. In the Republican budget, these rise to $1.3 trillion by the year 2002 …

They Just Don't Get It

Whether the size of next year's appropriation or (in this context) the change in outlays is measured in dollars, against current services, or as a percent of some larger total, such as GDP, would seem to be mainly a matter of one's rhetorical goals. The Republicans have a valid point when they cry "foul" when the Democrats decry cuts in, say, school lunches, when the relevant committee has approved an increase in spending on school lunches. But the Democrats are certainly entitled to point out that the approved levels of spending will require changes that may adversely affect some school children.

Government spending is very different from private spending. Government spending is rigidly categorical: so much for this and so much for that. Bureaucrats are adept at spending whatever they are authorized to spend. Success is a larger appropriation for the next year. This categorical decision-making process accounts for the relative lack of innovation and unimaginable waste in Government spending. The way the Government spends our money also stands in marked contrast to the incremental decisions we make as producers and consumers every day. Those who are spending their own money are continually seeking ways to do something better for less, and they must live within their means.

Thus the important question, say, on national defense, is not how much it has been cut, or not cut, since 1987, but whether our security has increased or deteriorated since then and/or if what we have now is appropriate to current conditions. In this regard, the politicians' preoccupation with which contracts and which bases are in what districts with what votes are, from the ordinary citizen's point of view, not only irrelevant, but obscene.

With respect to revenue, the first consideration on any tax change should not be how much the Treasury will gain or lose (such static calculations almost invariably are wrong, sometimes disastrously so — remember the "luxury tax" on yachts that was part of President Bush's 1990 budget compromise with Congress), but how the change will affect what taxpayers pay *at the margin*, where all decisions are made. This seems to be too elementary a notion for our politicians to grasp. The Republican's current tax proposals leave much to be desired (see *Research Reports*, June 5, 1995). Nevertheless, as Kinsley states, "they are not planning a tax increase in any reasonable meaning of the word." In contrast to appropriations and outlays, estimating what revenues will be under a given set of rules and rates, *i.e.,* baseline budgeting, would always seem to be more appropriate than looking at dollars, but such estimates are little more than guesses. It is the taxpayer who ultimately decides how much the government gets and if the taxes are too onerous the government will get nothing.

In any event, no amount of smoke and mirrors can alter the fact that our politicians now spend much more than we give them, that something needs to be done about it, and that the electorate vastly prefers less spending to more taxes.

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* The Federal Government's direction and control of the Nation's output is much larger than its outlays for goods and services and for transfer payments. The amounts directed via regulations and various reporting requirements (*e.g.,* simply *preparing* tax returns takes up vast resources over and above the taxes due) are not only significant in relation to the budget totals, but also have been growing much more rapidly.

† "The G.O.P. Tax Increase: Frankly, my dear, there's some phony accounting going on," *The New Yorker*, July 10, 1995, p. 4.

Business-Cycle Conditions: The Amber Light is Still Flashing

The situation has changed little from last month. Downtrends continue to dominate the leaders, several of the coinciders have unclear trends, and the laggers continue to suggest that bottlenecks have developed. However, our cyclical score remains above 50 and it remains premature to conclude that the next recession is imminent.

Among the 12 primary leading indicators of business-cycle changes, only two series continue to expand. These are *contracts and orders for plant and equipment* and the *index of common stock prices* (these and all other dollar-denominated series are reported in constant dollars), which reached new historical and cyclical highs in May and June, respectively. The strength of the contracts and orders series seems to be across the board and the stock market continues to astonish analysts. Recent negative economic news does not seem to have disturbed the optimism of businessmen and investors. It remains to be seen whether this will be confirmed by second quarter profit reports, which will be announced during the next few weeks.

The moving averages of all 10 other leading series remain below their highs for this cycle. The *average workweek in manufacturing* was up slightly in June to 41.5 hours per week from May's revised figure of 41.4 hours, but the moving average of the series continues to decrease from its peak 4 months earlier. The workweek remains at a historically high level, and it is not clear that the recent decrease represents a new downward trend. Its cyclical status remains indeterminate. The latest drop in both the base data and the moving average for *initial claims for unemployment insurance* (inverted) also was insufficient to warrant a change in that series' indeterminate status. *New orders for consumer goods* increased slightly during May, but the series' moving average decreased for the fourth consecutive month. Its cyclical status also remains indeterminate.

Both the base data and the moving average for the *change in consumer installment credit* increased in June. The increase was deemed sufficiently large to change the series' status from probably contracting to indeterminate.

Among the six leaders appraised as contracting, only the *M2 money supply* and the *change in sensitive materials prices* increased since our last report. The 1-month increase in M2 was sufficient to raise doubts concerning its continued contraction, but the moving average of the erratic price series continued to decrease and it remains appraised as probably contracting. The narrower money measure, *M1 money supply*, decreased in May, for the tenth consecutive month and it remains appraised as clearly contracting. The base data and moving average for *vendor performance*, the percentage of purchasing managers reporting slower deliveries from their suppliers, continued to decrease in June from a peak last November. This decrease was sufficient to remove doubt concerning the contraction of the series. The *index of new housing permits* was unchanged in May and it remains appraised as probably contracting. This series reached its high for this cycle 16 months ago.

Due to declining sales and rising inventories, the *ratio of manufacturing and trade sales to inventories* decreased for the third month in a row. The most recent decline was judged sufficient to downgrade the status of this series from indeterminate to probably contracting. This change offset the upgraded status of the consumer debt series from probably contracting to indeterminate, and the percentage expanding of the leaders for which a trend is evident remains at 25 (2 out of 8).

However, our cyclical score, which is a purely statistical calculation based on the 12 primary leaders, remains well above 50, indicating that continued economic expansion is probable. This month it stands at 66 vs. 67 last month.

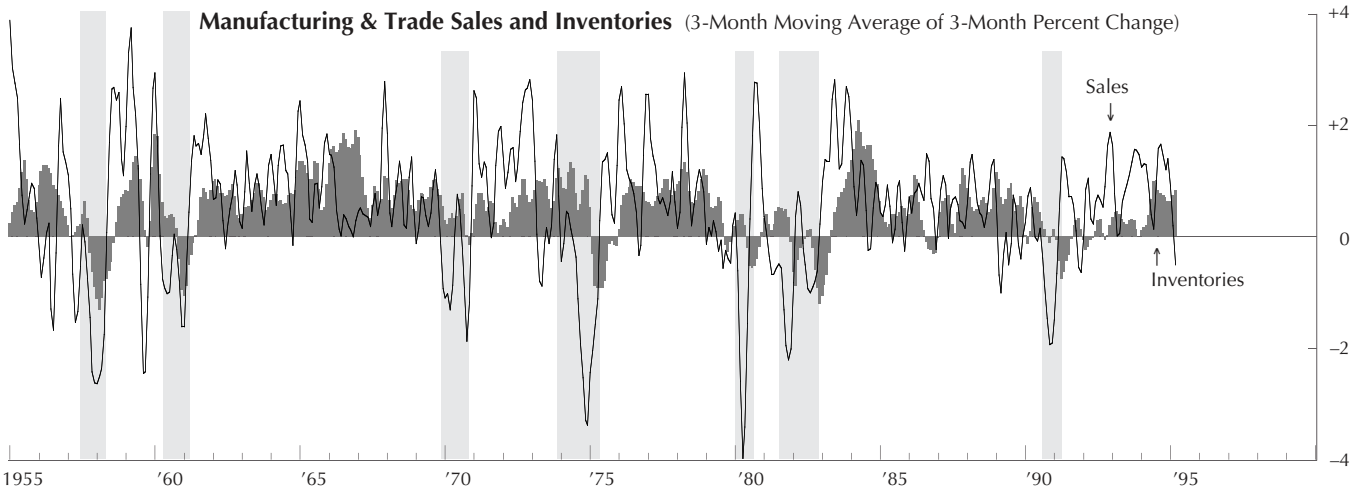
Among the primary roughly coincident indicators, *nonagricultural employment* reached a new historical high. The 215,000 increase in payroll employment in June more than offset the decrease in May. The series is now appraised as clearly expanding. The *index of industrial production* decreased for the third consecutive month, raising doubt concerning its continued cyclical expansion. The advance estimate for second quarter gross *domestic product* will be released next month and should provide further indication of the extent to which the economy has slowed.

The moving average of *personal income in manufacturing* decreased markedly in May and its status is now indeterminate. The *civilian employment to population ratio* increased slightly during June, but its moving average decreased for the third consecutive month, which was sufficient to downgrade its status to indeterminate.

Statistical Indicators of Business-Cycle Changes

Change in Base Data					Cyclical Status		
Mar.	*Apr.*	*May*	*Jun.*	***Primary Leading Indicators***	*May*	*Jun.*	*Jul.*
–	–	–		M1 money supply	–	–	–
–	–	+		M2 money supply	–	–	?–?
–	–	+		Change in sensitive materials prices	?–?	?–?	?–?
–	–	+		New orders for consumer goods	?+?	?	?
+	–	+		Contracts and orders for plant and equipment	+	+	+
–	+	nc		Index of new housing permits	?–?	?–?	?–?
–	–			Ratio of manufacturing and trade sales to inventories	?+?	?	?–?
–	–	–	–	Vendor performance	?	?–?	–
+	+	+	+	Index of common stock prices (constant purchasing power)	+	+	+
–	–	r–r	+	Average workweek in manufacturing	?+?	?	?
nc	–	–		Initial claims for unemployment insurance (inverted)	?+?	?	?
+	+	+		Change in consumer installment debt	?–?	?–?	?
				Percentage expanding cyclically	*55*	*25*	*25*
				Primary Roughly Coincident Indicators			
+	r+r	–	+	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			
–	–	+	+	Average duration of unemployment (inverted)	?+?	?+?	+
+	+			Manufacturing and trade inventories	+	+	+
+	+	–		Commercial and industrial loans	+	+	+
+	+	+		Ratio of consumer installment debt to personal income	+	+	+
+	–	–		Change in labor cost per unit of output, manufacturing	?	?+?	?+?
+	–	–	–	Composite of short-term interest rates	?+?	?	?
nc No change.		r Revised.		*Percentage expanding cyclically*	*100*	*100*	*100*

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.



Source: U.S. Department of Commerce.

Manufacturing and trade sales decreased sharply in May. The downturn in this series over the past 3 months was sufficient to downgrade its status from clearly expanding to indeterminate.

Overall, 100 percent (3 out of 3) of the roughly coincident indicators with apparent cyclical trends are expanding. Although this percentage is unchanged from last month, it could decrease sharply in the next few months if upticks remain as scarce (see the accompanying table) as they have been during recent months.

Among the six primary lagging indicators, the *average duration of unemployment* (inverted), *manufacturing and trade inventories*, and the *ratio of consumer installment debt to personal income* all reached new cyclical highs. All three series are appraised as clearly expanding. A slight decrease in *commercial and industrial loans* in May was not sufficient to change the status of the series, which remains clearly expanding.

The base data for the *change in labor cost per unit of manufacturing output* decreased during the past 2 months, and its moving average decreased slightly this month after increasing sharply during the previous 3 months. The series remains appraised as probably expanding. The *composite of short-term interest rates* fell again this month, from 5.98 percent to 5.93 percent. The Federal Reserve's recent move toward looser monetary policy, which is not reflected in the current statistics, suggests that this series will continue to decline. For now, however, the status of the series remains indeterminate.

Overall, 100 percent (5 out of 5) of the lagging series with evident cyclical trends are expanding. The further strengthening of the laggers continues to suggest developing bottlenecks in the economy. As mentioned in last month's business-cycle review, one measure of bottlenecks is the Department of Commerce's ratio of coincident to lagging indexes. The DOC's ratio fell again this month. The decrease in this series since December indicates that imbalances are developing. The question is whether these imbalances are severe enough to precipitate a recession.

Inventory Accumulation

Excessive inventory accumulation often is a key indicator of a growing imbalance between the supply and demand for goods. However, the inventory can accumulate for both positive and negative reasons. If businesses expect sales to rise over the next several months, they may want to increase their inventories to ready themselves for increased demand. Such planned inventory accumulation can be a sign of strength in the economy. On the other hand, inventories can also pile up if sales fall short of expectations, which in turn can prompt cutbacks in production. Thus, an important distinction is whether a buildup in inventories is planned or unplanned — something that, unfortunately, often is not clear until "after the fact."

Although not all inventory buildups have been followed by recessions, all postwar recessions have involved an inventory cycle of accelerating inventory accumulation due to faltering sales, followed by inventory liquidation. Indeed, the resulting fluctuation of output in goods-producing industries typically accounts for well over half of the fluctuation of employment, earnings, GDP, etc., from the peak to the trough of a typical recession.

Although it is hard to tell whether inventory accumulation is planned or unexpected, the ratio of sales to inventories often is a useful indicator (which is why we include it among our leaders). When sales grow faster than inventories, the ratio increases. If sales falter and inventories grow faster than sales, the ratio declines. A decline in the ratio often indicates an unplanned buildup of inventory.

The smoothed percent changes in manufacturing sales and inventories are plotted in the accompanying chart. As this chart shows, inventory accumulation was relatively low during most of the current expansion. Inventories did not begin to increase strongly until January 1994. Shortly after this surge, sales growth accelerated, but sales peaked late last year. It seems clear that the recent levels of inventory accumulation (the latest available data are for April) were not warranted by sales.

It appears plausible that, as some analysts assert, the sudden economic swoon reflected in the leading and roughly coincident indicators during the past 2 months reflects a scramble by managers (aided by computers and the latest methods of inventory control) to keep their stocks lean. If they are successful, the incipient recession could be "nipped in the bud."

We are inclined to be skeptical of tales of why "this time is different," but only time will tell.

PRICE OF GOLD

	1993	*1994*	*—— 1995 ——*	
	Jul. 15	*Jul. 14*	*Jul. 6*	*Jul. 13*
Final fixing in London	$392.70	$384.20	$384.15	$389.20

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