

## Big Government

*During the past 50 years, Federal, state, and local government spending and taxes have grown steadily by any measure, so that they are now near or at postwar highs. Most of this growth has reflected increased transfer payments that have been financed with increased payroll taxes.*

A driving force in the 1994 "Republican revolution" was the desire of voters for a smaller and less-intrusive government. At all levels of government, policy-makers are under pressure to cut spending and taxes. In Washington, Republicans gained control of the House and Senate by promising to limit government, and they now are working on a budget plan that presumably will satisfy, at least on paper, their goal of eliminating the Federal deficit in 7 years by reducing the rate of growth of spending. They may also vote to cut taxes. Similarly, the trend among policymakers in state and local governments is to pledge to balance budgets by restraining spending growth. How successful they will be remains to be seen.

One source of voter discontent no doubt has been the perception that government spending is relentlessly rising and that it is substantially larger today than it was even a few years ago. In simple nominal terms, this assuredly is so. According to National Income and Product Accounts (NIPAs) estimates, the combined expenditures of Federal, state, and local governments increased from \$1,848 billion in 1990 to \$2,258 billion in 1994. Add to these figures the additional tens of billions paid each year by state and local governments into government-employee pension reserves (contributions that are not counted as government expenditures in the NIPA data), and total outlays increased from \$1,918 billion to \$2,331 billion during these years, or more than 20 percent.

Going further back, the increase in nominal outlays is staggering. Total government spending now is 7 times higher than it was in 1970, 17 times higher than in 1960, and 233 times higher than in 1929, when the NIPAs begin and when total government spending was just \$10 billion. In simple dollar terms, government spending has exploded during this century.

Of course, these huge dollar increases overstate the growth of spending in rela-

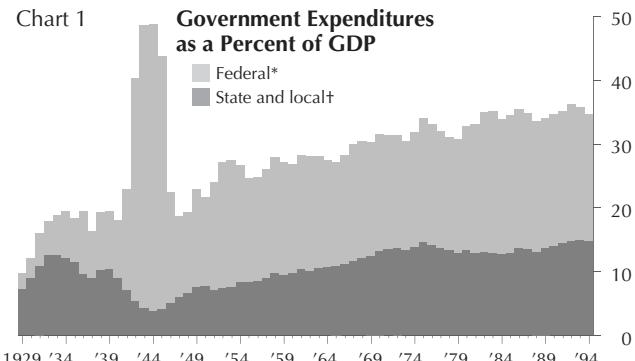
tion to the economy, because price inflation has greatly eroded the buying power of the dollar. Today's dollar has roughly the same buying power as did 30 cents in 1970 and 13 cents in 1929. In addition, the real economy has grown substantially, due to increases in population and productivity. (The population alone has doubled in the past 50 years, to 260 million.) A more useful measure that takes these factors into account is government spending as a percentage of Gross Domestic Product (GDP). Chart 1 shows the historical trend of this percentage. The upper shaded area shows Federal expenditures less grants-in-aid to state and local governments; the lower shaded area shows state and local expenditures (including Federal grants-in-aid) as measured in the NIPA data.

However, state and local government employee pension funds are included in the state and local government sector in the NIPAs, with the investment income on the pension fund assets and the benefits paid to retirees included in that sector's accounts. This distorts the data. Ideally, state and local government expenditures should include what their treasuries pay into their employees' pension plans rather than the benefits paid out, and the investment income on the pension funds' assets should not be in-

cluded in receipts (or used as an offset to interest paid — see below).

In an attempt to overcome this distortion, we have added the net change reported in the assets of state and local government pension funds (as reported in the Flow of Funds Accounts) to the government outlays plotted in Charts 1 and 2. This is equivalent to assuming that the benefits paid out by these pension plans equal their investment income, which probably is not so, but it provides a better indication of state and local outlays than the unadjusted NIPA estimates.

We did not make a similar adjustment for accumulations in Federal trust funds. Unlike state and local pension funds, which are invested in financial assets — corporate stocks, bonds, and mortgages — that are claims to things with tangible value, the Federal trust funds are "invested" in Federal IOUs — promises by the Treasury to pay itself out of future taxes.



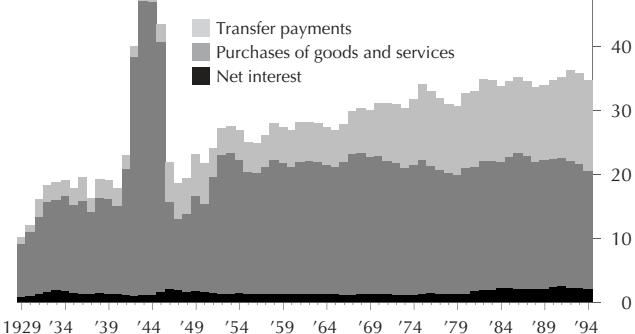
**Government Expenditures  
as a Percent of GDP**

Federal\*  
State and local†

\* Less grants-in-aid to state and local governments.  
† NIPA estimates plus contributions to pension fund reserves.

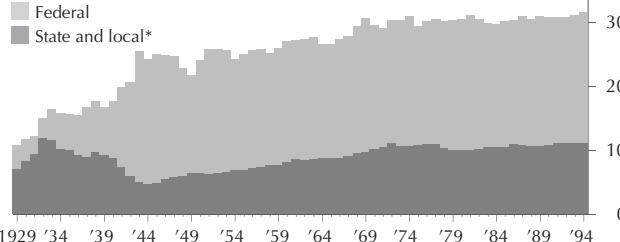
Sources for charts : Flow of Funds and National Income and Product Accounts.

**Chart 2 Federal, State, and Local Government Expenditures  
by Type\* as a Percent of GDP**



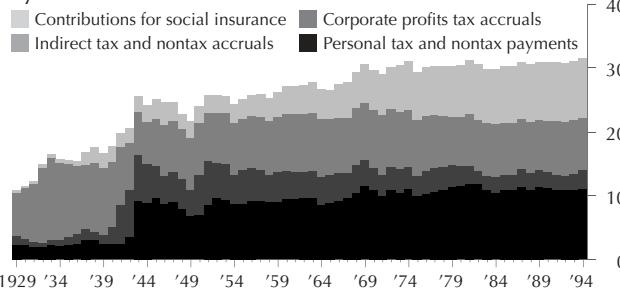
\* Excludes subsidies less current surplus of government enterprises, and wage accruals less disbursements. Together these average less than 0.15% of GDP.

**Chart 3**  
**Government Receipts as a Percent of GDP**



\* Less grants from Federal Government.

**Chart 4 Federal, State, and Local Government Receipts by Source as a Percent of GDP**



In any event, after soaring to nearly 50 percent of GDP during World War II, due to enormous war-related spending by the Federal Government, total government expenditures retreated briefly, then began to climb inexorably after 1946. Spending at all levels of government increased fastest in the 1960s. By 1994, combined spending equaled 34.6 percent of GDP, more than 3 times its share in 1929. This is slightly lower than it was 2 years ago when expenditures reached a postwar peak in relation to GDP. The decrease since then reflects a reduction in Federal spending as a proportion of GDP, due to sharp cuts in defense outlays and slower growth in nondefense spending.

As shown in Chart 2, transfer payments account for nearly all of the long-term upward trend in government spending as a percentage of GDP. These outlays include benefits paid under the following Federal, state, and local programs: old age, survivors, and disability insurance (Social Security); hospital and supplementary insurance (Medicare); unemployment insurance; government employee retirement; railroad retirement; pension benefit guaranty; veterans' benefits and life insurance; workers' compensation; military medical insurance; temporary disability insurance; food stamps; black lung; supplemental security income; and public assistance (including Medicaid). Such payments increased from 8.3 percent of GDP in 1970 to 14.2 percent in 1994.

Net interest payments also have increased as a share of GDP, but by much less. After trending downward from the end of World War II until the mid-1970s, they began to edge upward after 1975. They

remain small compared with other outlays, however, equaling \$137 billion, or 2 percent of GDP, in 1994. This aggregate figure masks very different experiences at different levels of government, however. The Federal Government paid out \$192 billion in net interest last year, while (according to the NIPAs) state and local governments, on the whole, were *recipients* of net interest, to the tune of \$55 billion. Since the mid-1960s, state and local governments are reported to have collected more in interest than they have paid out.\* In other words, all of the interest outlays shown in the chart represent interest paid by the Federal Government, after netting out the interest income received by other governments.

Government spending for purchases of goods and services as a percentage of GDP, which includes compensation of government employees, has fluctuated with the business cycle — increasing during recessionary years, and decreasing during expansions — but otherwise has shown little trend for the past 30 years. In 1994 these outlays decreased to 18.5 percent of GDP, which was, by a small margin, the lowest percentage since 1952. Although this category still accounts for the largest share of government outlays, it is likely to be overtaken by transfer payments within a decade or two if Congress fails to curb the growth of the latter.

The burden of financing all this government spending is estimated by the ratio of government receipts to GDP, shown in Chart 3. Receipts here include tax payments plus a relatively small amount of other payments to government, such as fees and fines. As a percentage of GDP, total receipts of all levels of government sharply

\* Again, this is a reflection of the inclusion of state and local government employee pension funds in the state and local government sector. State and municipal treasuries do receive some interest on cash balances, but the bulk of the interest receipts included in the net interest for the state and local sector accrues to its pension plans. This really should not be an offset against interest outlays, but it is an indeterminate portion of the net change in the assets of state and local government pension plans, which we have added to our estimate of the purchases of goods and services of state and local governments.

decreased following the war, but from the late 1940s to the mid-1970s they subsequently increased by about 50 percent.

In light of the apparently widespread belief that the burden of taxes has increased substantially in recent years, it may come as a surprise that receipts have increased very little, in relation to GDP, over the past 2 decades. Receipts were \$2,125 billion in 1994, more than 4 times higher in nominal terms than they were 20 years ago, but after taking into account the debasement of the dollar and the increase in productivity and population during this period, the level of receipts relative to the Nation's output increased less than 1 percentage point during this period. This creeping upward trend was sufficient, nonetheless, to push receipts up to 31.5 percent of GDP last year, the highest ratio ever recorded. Given the measurement limitations of the NIPA data, however, the marginal increase in this ratio from its earlier peaks in 1969, 1974, and 1981 is less notable than the absence of a clear upward trend since 1969.

A more striking trend in the past quarter century is the shift in the sources of government receipts, which is evident in Chart 4. Personal tax and nontax receipts, which primarily are personal income taxes plus a much smaller amount of estate and gift taxes and nontax payments, have increased very slowly as a proportion of GDP over the past 50 years, and not at all since 1980. This long-term increase has been offset by a decrease in corporate profits tax accruals (accruals include tax liabilities that have been incurred but not yet paid). Despite many changes in income tax laws, the combined total of these two sources of receipts has changed little relative to GDP since 1950, aside from fluctuations related to the business cycle.

Indirect taxes and nontax accruals have not trended upward either. Three-fourths of these are sales and property taxes paid to local governments. The rest is mostly excise taxes (on alcohol, gasoline, cigarettes, and such) and customs duties paid to the Federal Government, which have declined steadily in importance as a source of revenue (from 3 percent of GDP in 1950 to 1 percent last year). The ratio of these indirect taxes to GDP is slightly lower now than it was 25 years ago.

The major source of higher taxes since the mid-1960s is what the Government calls "contributions" for social insurance. These are the payroll taxes paid by employees, employers, and the self-employed for Social Security, Medicare, government employee retirement plans, unemployment insurance, and so on. These taxes have *doubled*, relative to GDP, over the past 30 years, as a result of higher tax rates and









increases in the amount of earnings subject to tax. Payroll taxes now are the second largest source of government receipts, and in 1994 they equaled 85 percent of total personal income tax payments.

The other major source of government financing, not shown in the charts, is borrowing. Since 1950, total government receipts have been sufficient to cover expenditures in only 6 years, the last in 1969. In 1994, governments collectively ran a deficit of \$206 billion, which they financed by issuing debt. The Federal Government borrowed \$159 billion, while state and local governments together borrowed \$47 billion. Although the ratio of the total government deficit to GDP has decreased for the past 2 years, at 3.1 percent it remains much higher than it was in the 1950s and 1960s.

## BUSINESS-CYCLE CONDITIONS

*The primary leading indicators improved slightly this month, mainly on the strength of consumers' willingness to borrow. Although the economy is not yet out of the woods, a recession now appears less likely to occur soon.*

Among the 12 primary leading indicators, only two are at their highs for this cycle. The *index of common stock prices* (this series and all other dollar-denominated series are reported in constant dollars) reached another all-time high in August, and is clearly expanding. The 4-month moving average of the *change in consumer installment debt*, which had decreased earlier this year, has returned to a new high for the cycle, despite slight decreases in the monthly data for June and July. The status of this series, which had been indeterminate, now is clearly expanding.

*Contracts and orders for plant and equipment* decreased in July, but that 1-month decrease (after 15 consecutive months of increases) was not sufficient to alter its clearly expanding appraisal. The *M2 money supply* has increased for 3 months in a row. This increase was sufficient to bring its status from indeterminate to probably expanding.

All of the other leading indicators are below their highs for the cycle. These eight series have, on average, remained below their highs for 9 months, but only three, the *M1 money supply*, *vendor performance* (the percent of purchasing managers reporting slower deliveries from their suppliers), and the *change in sensitive materials prices*, have established downtrends sufficient to warrant an appraisal of clearly contracting. A continued decrease in the last series in July removed doubt that it is contracting. Last month the status of the sensitive prices series was probably contracting.

Both spending and taxes probably are higher, or at least more significant in relation to the economy as a whole than the data we have discussed indicate. As the foregoing discussion of state and local pension funds suggests, the budgetary and NIPA accountants play astonishing "shell games" for programs that generate receipts as well as outlays. What the public perceives as a tax may be reported as a reduction in spending.

Moreover, estimates of spending, taxes, and borrowing provide only a partial measure of the activities and costs of Federal, state, and local government. A comparable statistical estimate of bureaucratic meddling and mind-bending rules and regulations almost surely would show that these have increased even more during the past 50 years than outlays and re-

ceipts. Whether Republicans will achieve a lasting reversal of this trend toward bigger government remains to be seen.

One imminent test will be the battle over the Federal budget for fiscal 1996, which is supposed to be in place by October 1. It appears likely that Federal spending will be cut, but where and how much will give a clearer indication of how far the politicians are prepared to go. A cut in the Federal payroll tax, which currently brings in billions more dollars than are needed to pay current benefits, is not even being discussed. Whether the Republicans' efforts will do anything more than "hold the line" on total government spending, taxation, and borrowing, rather than simply reduce it temporarily or shift Federal spending to the state and local level, will not be apparent for several years.

June, and its status remains probably contracting. The recent increases were small, but they suggest that the inventory adjustment that began suddenly last spring could be ending. The *average workweek in manufacturing* also remains appraised as probably contracting. The most recent data show the average workweek in August was 41.5 hours per week, up slightly from last month's figure of 41.3. Although this is a very high level by historic standards,

## Statistical Indicators of Business-Cycle Changes

Change in Base Data				Primary Leading Indicators			Cyclical Status		
May	Jun.	Jul.	Aug.				Jul.	Aug.	Sept.
-	-	-		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)			+	+	+
-	+	-	+	Average workweek in manufacturing			?	?-	?-
-	+	+		Initial claims for unemployment insurance (inverted)			?	?	?
+	-	+		Change in consumer installment debt			?	?	+
Percentage expanding cyclically							25	25	44
Primary Roughly Coincident Indicators									
-	+	+	+	Nonagricultural employment			+	+	+
rnc <sup>r</sup>	r <sup>r</sup>	+	+	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			+	+	+
-	r <sup>r</sup>	+		Change in labor cost per unit of output, manufacturing			?+?	?	?+?
-	-	-	nc	Composite of short-term interest rates			?	?-	?-
nc No change. <sup>r</sup> Revised.				Percentage expanding cyclically			100	80	83

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.

the increase was not considered large enough to change the status of the series.

There still is no apparent trend in the 3-month moving average of *new orders for consumer goods*. New orders increased slightly, but not enough to warrant changing its status, which remains appraised as indeterminate. *Initial claims for state unemployment insurance* (inverted), now 9 months from its latest peak, also remains appraised as indeterminate. The base data increased slightly during June and July, but the moving average of the claims series has continued to contract.

The status of the *index of new housing permits* was upgraded from probably contracting to indeterminate. As discussed in the September 4 *Research Reports*, lower mortgage rates seem to be boosting home-building, but, even after recent increases, the level of this series remains well below the peak for this cycle reached in December 1993.

Overall, 44 percent (4 out of 9) of the leaders with an apparent cyclical trend are expanding. This is an improvement over last month's percentage of 25, but this is the fourth month that the percentage has been less than 50. AIER's cyclical score, however, which is designed to reduce the incidence of false signals of recession, has remained above the 50 percent level. It now stands at 62 percent, down from last month's reported level of 64. As in recent months, we will wait to see if the cyclical score falls below 50, or if the leaders continue to improve from their recent lows.

All six primary roughly coincident series increased this month as did all of the base data. *Nonagricultural employment* and *Gross Domestic Product* (quarterly) both reached new highs again, and are clearly expanding.

The *index of industrial production* increased during July, but it remains below its peak last February. It remains appraised as probably expanding.

The moving averages of the other three coinciders, *personal income in manufacturing, manufacturing and trade sales*, and the *civilian employment to population ratio*, remain sufficiently below their highs for the cycle to render their cyclical statuses indeterminate.

Overall, 100 percent (3 out of 3) of the coinciders with an apparent cyclical trend are expanding. In the table, the dominance of pluses in the base data columns for the coinciders suggests that the economy has continued to expand.

There were three new highs among the six primary lagging indicators. *Manufacturing and trade inventories* continues to grow, but at a slower rate than last year. *Commercial and industrial loans* and the *ratio of consumer installment debt to personal income* also reached new highs. All three are clearly expanding. The *average duration of unemployment* (inverted) decreased slightly during August, to 16.3 weeks. However, that series also remains appraised as clearly expanding.

The *change in labor cost per unit of output in manufacturing* increased this month. The increase was deemed sufficient to upgrade the series' status to probably expanding from indeterminate. The *composite of short-term interest rates*, now 8 months from its most recent peak, did not change. The interest rate series remains appraised as probably contracting.

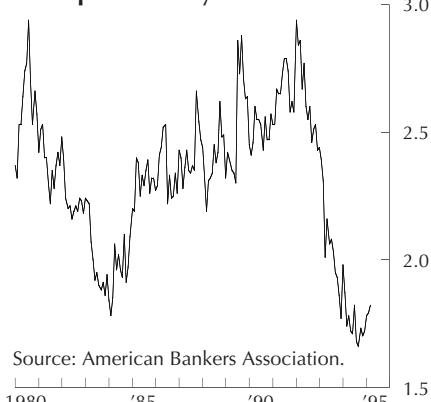
Overall, the laggards improved slightly — 83 percent of laggards with an apparent cyclical trend are expanding. This is up from last month's 80 percent expanding. Of all the potential bottlenecks (which is what the lagging series are designed to measure) that could choke off the expansion, perhaps the most widely dreaded is the high level of borrowing by consumers — sales growth financed with excessive debt accumulation cannot be sustained.

### **Consumer Borrowing — How Much is Too Much?**

The sudden collapse of the indicators last spring largely was a reflection of flagging consumer demand, evidenced in decreases in manufacturing and trade sales (which precipitated a quick inventory adjustment), homebuilding, and consumer credit. The recent improvement of the indicators appears to reflect a "second wind" on the part of consumers and a renewed willingness to borrow to purchase things.

In July, consumer installment debt rose \$8.8 billion dollars (seasonally adjusted), and this followed an \$11.1 billion dollar increase in June. Consumer installment debt is comprised of automobile debt, revolving debt, and an "other" category that includes such loans as mobile home loans, educational loans, boat loans, trailer loans, and vacation loans. The fastest growing portion of consumer installment debt has been revolving debt, which is credit card and department store card debt. Early in the current expansion it surpassed automobile debt as the largest component of consumer installment credit. If consum-

**Percent of Consumer Installment Loans Delinquent 30 Days and Over**



Source: American Bankers Association.

ers eventually become worried about their high credit card bills, and refrain from using their credit cards, economic activity could slow significantly.

How much more debt can consumers take on? The ratio of consumer installment credit to personal income, a primary lagging series, decreased during and after the last recession, but since early 1993 it has expanded markedly to a new all-time high that is slightly in excess of the peak reached in 1989. This suggests that consumers could henceforth become more restrained in their use of credit.

However, the ratio of consumer installment debt to personal income does not reflect the fact that the use of such credit varies greatly among households. Some consumers never borrow at all, while others purchase nearly everything on credit. Such behavior is closely related to demographics; younger consumers generally are more willing to borrow rather than postpone purchases. The important question may well be how the consumers who borrow are managing their debts, rather than the level of their debts in an absolute or relative sense.

The accompanying chart shows the percentage of consumer installment loans delinquent more than 30 days. During the current expansion this series has decreased markedly and, despite a relatively small increase during recent months, it remains close to a 15-year low. This suggests that the borrowing excesses that preceded the last two recessions have not yet reappeared during this expansion.

### **PRICE OF GOLD**

	1993 Sept. 16	1994 Sept. 15	— 1995 —	
Final fixing in London	\$352.75	\$388.00	Sept. 7	Sept. 14
			\$381.45	\$385.10

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