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Entitled to Big Government

Spending on programs that redistribute income from taxpayers to beneficiaries ("transfer payments") has become the largest component of Federal outlays, exceeding the next two largest (defense and interest on the national debt) combined. Low-income persons receive a relatively small portion of these payments, which are dominated by programs that make payments without regard to the recipients' incomes. Unless the growth of these "entitlements" is curtailed, the "era of big government" is not likely to end.

A fundamental issue in every presidential election is how much of its citizens' income the Government should take in taxes and how it should spend the revenue, yet, surprisingly few voters accurately understand how the Government currently spends their dollars.

For example, many people reportedly believe that outlays for foreign aid are so large that eliminating them would substantially reduce outlays and the deficit. In fact, in 1995, outlays for "international affairs" (which includes the operations of the State Department as well as foreign aid) totalled $16.5 billion, about 1 percent of total Federal spending, or a tenth of the $164 billion deficit.

Similarly, many voters continue to believe that defense spending dominates budget outlays. Even those who acknowledge the cutbacks since the end of the cold war complain that the "peace dividend" has been minuscule. However, defense spending is now smaller, relative to total outlays and to Gross Domestic Product (GDP), than at any time since 1940.

But perhaps the most widely-held and emotionally-charged notions about federal spending concerns programs designed to help low-income individuals. "Welfare" is flawed: virtually no one is content with the current system as it is now constituted. It may be legitimately argued that "needy" persons do not receive enough, that welfare benefits often enable recipients to continue deplorable "life styles," that "handouts" foster dependency while doing little to address the causes of poverty, and so on and so forth. But even those with the strongest views on the subject usually have an exaggerated view of its significance to overall Federal spending.

How Much Entitlement Spending is Welfare?

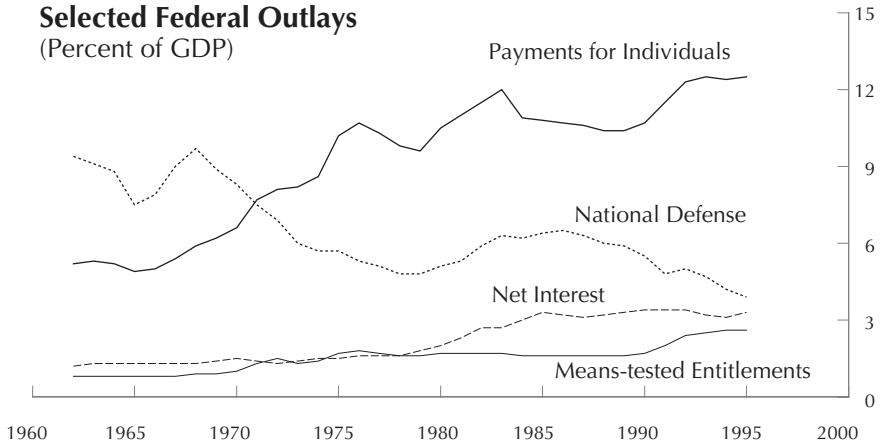
Nearly all Federal "welfare" spending falls into a broad category that the Office of Management and Budget calls Federal "payments for individuals." In addition to cash payments to individuals and families, these include the payment of bills on their behalf (for example, for medical care), the value of services and goods provided by the Government (such as food stamps and medical care in a Government hospital), and other forms of assistance, such as housing subsidies and food stamps.

None of these payments is intended to be a reimbursement for a good or service currently provided by the individual; rather, they are designed to redistribute income from one group (taxpayers) to another group (beneficiaries).

The accompanying chart shows Federal payments for individuals as a percent of Gross Domestic Product (GDP). This percentage has trended upward since the 1960s, and in 1995 it equalled 12.5 percent, compared with 5 percent in 1965. Total Federal spending is not plotted, but it equalled nearly 22 percent of GDP last year, compared with 18 percent in 1965. Payments for individuals have thus increased more rapidly than other outlays, and they now dominate the budget. Last year, they accounted for 57 cents of every dollar the Government spent, up from 28 cents in 1965.

As shown in the chart, most of this increase is due to higher outlays for programs that are not means-tested. Payments not based on income (but on some other criterion such as age, years of service in the military, years of Government employment, disability, or unemployment) account for four out of every five dollars spent on payments for individuals. Stated differently, 46 cents of every dollar the Government spends is an income transfer from taxpayers to beneficiaries that is made without regard to the recipients' income.

In contrast, the portion of payments for individuals spent on programs directed at low-income people has increased only slightly during the past 3 decades. As shown in the chart, spending on means-tested entitlements — programs that use income as a test for benefit eligibility — increased in the late 1960s but remained steady, in relation to GDP, during the 1970s and 1980s. Although this percentage has increased since 1990, payments for means-tested programs were still less than 3 percent of GDP in 1995.



Welfare Reform

In 1531, Britain required local officials to identify "all aged and impotent persons which... of necessity be compelled to live by means of alms..." and to grant such persons licenses to beg. Historians have identified this measure as the beginning (in Anglo-Saxon countries) of the welfare state, because the statute (22 Henry VIII, c. 12) was based on the notion that some people were incapable of supporting themselves and that the state had a role in providing for their support. Previously, begging had been viewed as shirking the labor force and was usually subject to harsh penalties.

Over the centuries, "welfare" has been changed many times and no generally satisfactory way of supporting indigents has been found to date. Yet, despite the wide variety of policies that have been tried (poorhouses, workhouses, grants in cash or in kind, etc.), the issues have consistently involved the same three questions. The first is what level of support will indigents receive? The second is how much will that level of support cost? The third and most complex question concerns the effects of handouts on recipients, specifically, the often perverse incentives that public assistance can create. Some of these involve failures to adhere to social norms (such as postponing childbearing, or not abusing alcohol or drugs). In a purely financial sense, however, this third question involves the barriers welfare recipients face when they attempt to enter or return to productive lives. If welfare recipients earn money, their benefits will at some point be withdrawn, which means that their effective marginal tax rates can be very high (even more than 100 percent in certain instances in the United States under current laws). Any attempt to flatten these barriers (such as Milton Friedman's proposal for a "guaranteed annual income" of a quarter century or so ago) will greatly increase the cost of supporting "the poor" — benefits must be withdrawn very gradually as income increases so that they will be paid to many who are not really "poor" — or greatly decrease the basic subsistence paid to the totally destitute, or both.

In other words, the three questions are interrelated. Attempts to improve one aspect of welfare will perforce make the others worse. Reducing costs will cut benefits and/or raise the barriers, raising benefits will raise costs and/or raise the barriers, and, as noted above, lowering the barriers means raising costs and/or cutting benefits.

Sadly, Aid to Families with Dependent Children, which is the largest single means-tested welfare program and what most people think of as welfare, is probably cheaper than alternatives involving more direction and supervision of the recipients' lives (education, training, day-care, etc.). That cutting benefits (time limits seem to be the most widely-favored proposal) seems to be gaining in popularity as the next major "reform" suggests how frustrated the public has become. But curtailing benefits is the only reform now on the table that could facilitate a lowering of the barriers to getting off welfare without adding to its costs.

Anyone for licenses to beg?

Where the Money Goes

The table below shows a breakdown of the $875 billion spent last year on payments for individuals (in billions of dollars):

Social security and railroad retirement	$337.0
Medicare	177.1
Medicaid	89.1
Federal employees retirement and insurance	82.2
Public assistance and related programs	61.8
Food and nutrition assistance	37.5
Housing assistance	25.5
Other medical care	23.6
Unemployment assistance	21.9
Assistance to students	14.8
All other	4.2
	$874.7

"Need" is not the primary criterion for the largest programs. Of course, not all of the recipients of Social Security, Medicare, and other payments that are not means-tested are middle or upper income. If eligibility for these programs were based on income rather than age, many of the people now collecting benefits would still qualify. In this respect, spending for means-tested entitlements, which is plotted in the chart, understates the percentage of Federal outlays going to low-income people.

By the same token, however, not everyone who collects a means-tested benefit is genuinely needy. For example, Medicaid, the health plan for the poor, increasingly is used to pay for long-term nursing care for elderly beneficiaries who are not poor but have managed to shield enough assets and income to qualify as such. There are no data on how much is spent on Medicaid payments for the "middle class" aged, but judging from the proliferation of consultants offering tips on how to qualify for Medicaid while retaining substantial income and assets — and the growing efforts of the Federal and state Governments to thwart such efforts — the amount could be substantial. It also may help account for the doubling of Medicaid outlays in the past 5 years.

Payments for individuals also include civil service and military pensions, which might be considered reimbursement for services provided in prior years. However, they still are an income transfer, because they are financed not with savings set aside years ago but with dollars collected from current taxpayers. (The Government does not fully prefund its future pension obligations, as it requires private employers to do. This is one reason why government pensions tend to be more generous than private-sector plans.) In addition, the so-called reserves of Government pension plans are invested in Treasury securities whose interest and principal eventually will have to be paid out of revenue raised from future taxpayers.

Outlook

Whatever the rationale or justification, payments to persons (means-tested or not) that are financed with revenues and borrowing involve taking money from some people to give to others. As the foregoing discussion indicates, this has now become the major financial function of the Federal government.

Despite widespread calls for reforms and balancing the budget, middle class entitlements continue to have overwhelming support. Proposals to change (*i.e.,* curtail) income-transfer programs have been unable to overcome the protests of beneficiaries and others who have a vested interest in protecting these programs. However, with income-transfer payments now accounting for more than half of the Federal budget, defense spending at a 55-year low, and interest payments on the national debt not a discretionary outlay, it is hard to see how the "era of big government" can end unless the growth of transfer payments is restricted. ❑

BUSINESS-CYCLE CONDITIONS

The latest data provide further evidence that the current business expansion is likely to continue. Although there still is uncertainty about the cyclical status of several leaders, the percentage appraised as expanding increased this month. Earlier indications that an economic downturn might be imminent seem to be behind us for the time being.

Of the 12 primary leading indicators, only the *index of common stock prices* reached a new high in this month's assessment of business conditions (this series and all dollar-denominated series are reported in constant dollars). The series remains appraised as clearly expanding. The *M2 money supply,* a broad measure of money, turned down this month, but the decrease was not enough to downgrade its cyclical status of clearly expanding. The only other leading indicator that is clearly expanding this month is *contracts and orders for plant and equipment*. A decrease in the base data for April ended this series' 9-month streak of new highs. Although the latest figure was down, the overall trend remains positive.

The data used to calculate the *ratio of manufacturing and trade sales to inventories* have been revised. The constant-dollar figures for both sales and inventories now are based in "chained 1992 dollars" instead of fixed 1987 dollars. The method for determining the chained 1992 dollar figures is the same approach now used to calculate constant-dollar Gross Domestic Product. Also, the rebased data now begin in 1959 instead of 1948. The ratio increased in March, the latest month for which data are available, and this increase was judged sufficient to upgrade the series' cyclical status to probably expanding

The *average workweek in manufacturing* also was upgraded this month to probably expanding. Its cyclical status had been indeterminate, but at 41.5 hours, the workweek in May was slightly longer than it was prior to the sharp (apparently weather-related) decrease earlier this year.

There are no discernable trends in six of the leading indicators. Although the 3-month percent *change in sensitive materials prices* remains negative in absolute terms (indicating that prices continue to decrease), in relative terms the series has increased during the past 2 months (indicating that the rate of price decrease has slowed). The recent uptick is not yet sufficient to warrant an upgrade in the status of this volatile series. *Manufacturers' new orders for consumer goods and materials* rose this month due to an increase in the base data. However, the series still is drifting sideways between $119 and $125 billion. The *index of new housing permits* rose 2 percent, but has yet not recovered from the decreases of the previous 3 months.

Vendor performance (the percent of purchasing managers reporting slower deliveries from their suppliers) remains close to 50 percent. It is unclear whether the series is cyclically expanding or contracting. *Initial claims for state unemployment insurance* (inverted) fell by 2,000 claims (plotted as an increase on the chart). This series had been appraised as probably contracting, but this month's change renders its cyclical status questionable.

The cyclical status of the 3-month percent *change in consumer installment debt* also is indeterminate. With the release of the latest data, the Commerce Department announced a redefinition of the debt series. Consumer debt previously included only installment debt, but it now also includes noninstallment debt, which currently accounts for about $65 billion, or 5.7 percent, of the $1.14 trillion total consumer debt. Currently there are revised data back to 1990, but data for earlier years should be available in time for our next business-cycle update. The revision appears to have had little impact on the longer-term trend in the data. The chart on page 64 plots both the historical data for the older series and the available revised data for the 3-month change in consumer installment debt. As the chart shows, until mid-1995 the revised data closely track the old data and, if anything, the revised series appears smoother. The differences between the two data sets are most evident in the latest observations. The old data indicated that consumer debt recently increased at a faster pace whereas the new data indicate that since mid-1995 the rate of increase has steadily slowed. Given the opposite recent directions of these two data sets, and until the historical data are further revised, the series must be viewed as indeterminate.

The *M1 money supply* decreased this month, reversing last month's increase. M1, which already had an established downward trend, remains appraised as clearly contracting.

Overall, 83 percent (6 out of 7) of the leading indicators are expanding — a 23-point improvement from last month's 60

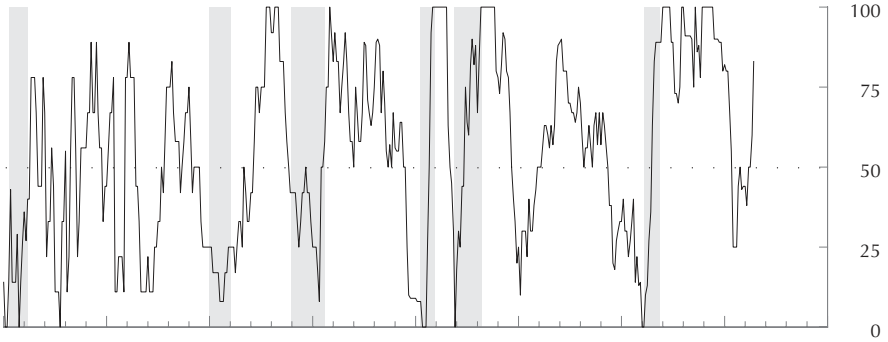
Statistical Indicators of Business-Cycle Changes

Change in Base Data					*Cyclical Status*		
Feb.	*Mar.*	*Apr.*	*May*	***Primary Leading Indicators***	*Apr.*	*May*	*Jun.*
-	+	-		M1 money supply	-	-?	-
+	+	-		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]	+	+	Average workweek in manufacturing	?	?	+?
-	-	+		Initial claims for unemployment insurance (inverted)	?	-?	?
+	-			Change in consumer installment debt	?	?	?
				Percentage expanding cyclically	50	60	83
				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	83	83	83
				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	?	-?	-?
-	+	+	nc	Composite of short-term interest rates	-	?	?
				Percentage expanding cyclically	80	75	75

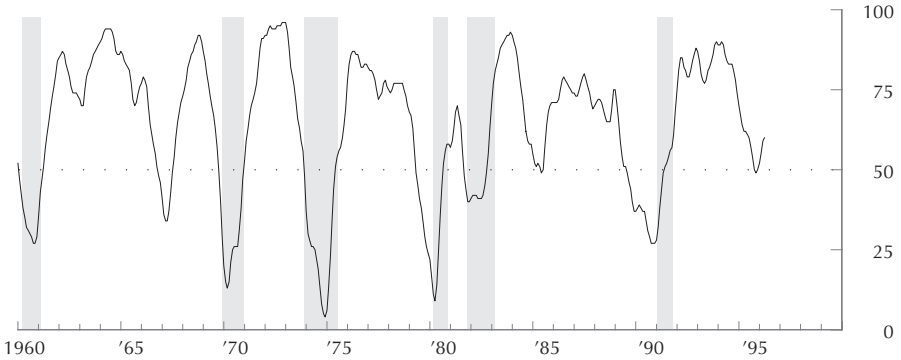
nc No change. [r] Revised.

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.

Percentage of AIER Leaders Expanding



Cyclical Score of AIER Leaders



percent expanding. However, because fully half of the leading indicators have no discernable trends, the percent of leaders expanding could change markedly in the coming months.

The cyclical score, AIER's other measure of the aggregate behavior of the leading indicators, also increased this month to 60 from a revised score of 59. The improvement in both of these diffusion indexes provides further statistical warrant for the view that a recession is unlikely to occur in the near term. It also tends to confirm the usefulness of our relatively new cyclical score series in assessing possible turning points in the business cycle.

A Blunder Avoided

The record of business-cycle prognostication — including to some extent our own — is justly notorious for forecasting "twelve of the past eight recessions." In this respect, and as the charts of AIER's two diffusion indexes on this page show, early this year the percent of leaders expanding had dropped to a level that, in the absence of other measures, might have indicated imminent recession. The cyclical score, on the other hand, fluctuated more narrowly — only briefly reaching the 50 percent level at which recession is statistically as likely as continued expansion. In this instance the latter series prevented us from calling a phantom recession, and so adding another page to the chronicle of business-cycle misforecasts.

There were no changes this month in the cyclical status of the six primary roughly coincident indicators. The four coinciders that had established upward trends in previous months remain appraised as clearly expanding. Among these, *nonagricultural payroll employment* increased in May by 348,000 jobs. The employment data were revised back to 1988, and the revisions indicate that more jobs were created in the past 8 years than previously reported. The cumulative effect of these revisions is that there are 878,000 more jobs in the U.S. economy than previously indicated. This series is at another new high.

The *index of industrial production* increased from 124.4 to 125.3, a new high. *Gross Domestic Product* also is at a new high and revised *manufacturing and trade sales* data indicate that sales are at a new high as well. As mentioned, the sales data are now in chained 1992 dollars.

Currently 14 months from its most recent peak, the *ratio of civilian employment to population* rose to 63.08 percent and remains appraised as probably expanding. However, the series remains below the peak of 63.15 reached in February 1995.

Personal income in manufacturing still is the only coincider with an established downward trend. Despite an uptick in the base data, the series continues its broad decline. Overall, 83 percent (5 out of 6) of the coinciders with apparent cyclical trends are expanding — unchanged from last month.

Among the primary lagging indicators, *commercial and industrial loans* reached a new high this month as did the *ratio of consumer installment debt to personal income*. Although we have revised consumer debt data only back to 1990, this is sufficient to indicate that the debt ratio is at a new high for the cycle. As the historical chart on page 66 indicates, the revised ratio is higher than previously reported data, reflecting the broadened definition of consumer debt. Both laggers are appraised as clearly expanding.

Manufacturing and trade inventories was appraised as clearly expanding last month, but the new revisions to the data cast some doubt on this judgment. Based on the decrease in March, the series was downgraded to probably expanding.

There are still no identifiable trends in either the *average duration of unemployment* (inverted) or the *composite of short-term interest rates*. The average duration of unemployment fell to 17.1 weeks from 17.35 weeks, and short-term interest rates averaged 5.34 percent in May, unchanged from April.

Despite an increase this month, the *change in labor cost per unit of manufacturing output* remains appraised as probably contracting. Overall, 75 percent (3 out of 4) of the lagging indicators with apparent cyclical trends are expanding. This is unchanged from last month.

On the whole, there is only slight doubt that the economy will continue to expand in the near term. However, the longer-term outlook for this expansion, now over 5 years old, remains highly uncertain. On July 3rd, the Federal Reserve will meet to set monetary policy. Any decision to raise interest rates at that meeting could have a significant impact on the amount of time left in this expansion. ❑

PRICE OF GOLD

	1994	*1995*	*—— 1996 ——*	
	June 23	*June 22*	*June 13*	*June 20*
Final fixing in London	$389.00	$389.65	$384.70	$384.40

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