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The Tax Bill

The political maneuvering over the tax bill has yet to play itself out. Some aspects of the legislation move in the direction of fairness — but in arbitrary and inefficient ways that mainly reflect political posturing over relatively petty amounts (about 1 percent of Federal receipts, overall). In contrast to the tax reforms of the 1980s, the entire exercise would seem to be a return to business as usual in Washington — rewarding specific constituencies — rather than getting down to the task of removing the government from economic decision-making.

Both the House and Senate passed tax bills at the end of last month. A House-Senate Conference Committee is re-working this legislation for another vote before the final result is sent to the White House to be signed into law. As this is written it appears that, in the belief that it will somehow be to the Republican's political advantage, Congress may first pass a bill that President Clinton will veto. Whatever finally becomes law, however, will probably be agreeable to the President as the Republicans do not have the votes to override a veto.

Meanwhile lobbyists are no doubt working furiously to have obscure and arcane provisions retained (or even to have entirely new ones included) in the final result. Although of intense interest to the affected taxpayers, many of these are essentially unrelated to the major provisions. The latter include:

1) gains tax relief,
2) estate tax relief,
3) tax breaks for college tuition,
5) expansion of Individual Retirement Accounts, and
4) a credit for dependent children.

On these items, the White House is the major lobbyist. Without a "veto-proof" majority, the Congressional leadership must reach agreement with the President. Perhaps as a result, the most striking feature of the current tax bill (the first major piece of tax legislation since the Republicans took control of Congress) is how unambitious it is.

For one, over the next 5 fiscal years the amount of money involved in these "tax cuts" is estimated to total only about 1 percent of total Federal revenues. Not only is this 1 percent likely to prove substantially less than the error in the current forecast of such revenues, but it is largely in the form of "targeted" tax cuts (exemptions and credits) with little in the way of lower rates.

The Republicans had long championed getting the government out of the way of the economy. During most of the 1980s lowering rates was the main weapon in that fight. In other words, instead of providing for broad "tax relief" as a means of generally promoting economic growth, the backers and designers of the current legislation would seem to be mainly concerned with favoring particular constituencies.

Gains Taxes

Reform of the gains tax is long overdue and badly needed. The problem is that much of what is taxed as a capital gain reflects chronic price inflation over the years rather than genuine economic income. The Republicans are calling for a lower rate than the top 28 percent rate that now applies to nominal gains. However, as we stated in *Research Reports* for March 10, "A lower rate on capital gains would be a singularly ineffective and ham-handed way of adjusting the taxpayers liability to reflect genuine economic income."

A lower rate on capital gains than on ordinary income would serve to make the tax somewhat less confiscatory for those whose holdings have appreciated less than or only slightly more than the dollar has lost its purchasing power. On the other hand, a lower rate is a windfall for those who investments have appreciated at above-average rates. Moreover, the alchemy of the accounting and legal professions can transform ordinary income into a capital gain if the incentive to do so is great enough.

Indexing the cost basis used to calculate a taxable gain is the reform that this situation cries out for. The House Republicans have called for indexing, but only for investments acquired in the future. The Clinton White House, asserting that it would eventually cost the government too much revenue, has vowed to oppose even this modest step in the right direction. The administration instead favors a lower rate as long as the taxpayer's income and gain isn't too large. (Technically the President favors an exclusion of a portion of the gain, thereby effectively decreasing the rate on the total reported gain. But this exclusion would vanish, along with other exemptions and exclusions, for higher-income taxpayers.) The administration also favors excluding gains on the sales of residences (up to $500,000). The attitude seems to be that "we don't care if the tax isn't fair because the government needs the money, but we are willing to give a break to some taxpayers who then might be encouraged to vote for us."

Estate Taxes

The estate tax is a curious tax. Its major rationale (the breaking up of concentrations of wealth) is belied by the fact that is levied on estates rather than on inheritances (the tax is the same whether a taxable estate is left to a single or to multiple heirs). Moreover, even more than the capital gains tax (which taxpayers can defer by simply holding on to their investments), the estate tax has become an essentially voluntary tax. It applies to less than 2 percent of estates. It accounts for relatively little revenue — less than 1 percent of Federal receipts — because it can be and is largely avoided with careful estate planning. Some analysts believe that the overall effect of the estate tax is a *net loss* of revenue to the Federal government, because the steps taken to avoid estate taxes also reduce the amount subject to income taxes.

Relief on estate taxes is also likely to

be enacted this year. This will be in the form of an increase in the amount that can pass through to heirs tax-free, currently $600,000, an amount that is not indexed and therefore has lagged price inflation. As a result, many more estates have become subject to the tax. Again, this form of tax "relief" would seem to reflect the politicians' desire to offend fewer voters (especially the owners of farms and closely-held businesses that can be forced to liquidate to pay estate taxes).

A preferable solution would be to abolish the estate tax completely while at the same time eliminating the "stepped up basis" on assets acquired by heirs. This would mean that a family farm or business would not be burdened as long as the next generation wanted to continue running it, but that a tax would be due when and if they sold out. It would also mean that heirs in general would not pay taxes on inherited assets unless they sold them, *i.e.,* at such time as the funds became available for consumption.

This reform would, of course make indexing an even more pressing concern so that the taxable gains of heirs would only reflect genuine economic income instead of price inflation over many decades. Eliminating the "angel of death" loophole probably would more than offset any revenue losses due to indexing. Regrettably, such a useful step is nowhere near the table — perhaps because it would greatly reduce the need for lawyers, accountants, life insurance salesman, *et al.*, to plan for and to avoid taxes.

College Tuition

Tax breaks for college tuition were President Clinton's idea. As we noted in *Research Reports* for October 28, 1996, such tax credits would be a wildly inefficient means of achieving the stated goal of encouraging college enrollments, especially in comparison to direct outlays. Most of the benefits will go to those who would be enrolled without the benefit.

The Republicans seem to have signed on to this proposal 1) in an attempt to gain the administration's support for the entire package and 2) because the benefits would largely accrue to much sought-after middle class voters.

Expanded IRA's

The House and Senate bills and the administration proposals include a variety of measures to enlarge the deductibility of contributions to Individual Retirement Accounts and/or to reduce the taxes on withdrawals. Some of these proposals will probably make it into law. By and large, these reflect the politicians' attempts to micro-manage consumers' saving and spending choices — especially toward home buying or college education.

The Child Credit

The House, the Senate, and the Administration all call for a tax credit of $500 per dependent child. These plans differ in the timing of the phasing in of the credit, the levels of income at which it would phase out, and in other details. Nevertheless, some form of credit seems assured of passage into law. This move is well justified from the standpoint of fairness, or "horizontal equity" — the principle that those in similar circumstances should pay similar taxes.

Taxpayers with dependents manifestly have many more demands on their resources than those with no dependents, and the tax collector's adjustment for such differences have been insultingly small — for 1996 a taxpayer in the 15 percent bracket received $337.50 per dependent and one in the 28 percent bracket received $630. The provision of a $500 credit would make these adjustments more commensurate with the burdens of child rearing and it would reduce the disparity of the adjustment between lower and upper-income taxpayers.

One of the greatest areas of contention between Congress and the Administration

Back to the Future?

Roughly a quarter century ago, Treasury officials in the Nixon administration and analysts of libertarian bent, notably Milton Friedman, gave serious consideration to a "negative income tax."

This would have substituted a universal tax credit, payable in cash, for the various programs of the "Great Society," which were placing an increasing share of the Nation's output under bureaucratic control. The negative income tax proposal foundered because, for tax credits to approach what was then defined as "the poverty line" and for net income tax receipts to be sufficient to pay for the rest of government, the tax rate on the first dollars of income had to be very high (more than those then applied to the highest incomes).

We mention this history because it stands in marked contrast to the Congressional Republicans' opposition to making the Child Tax Credit payable in cash. They now assert that "tax cuts should only go to people paying taxes," while ignoring the distinct advantages of letting families act on their own instead of turning to government bureaucrats for help.

Democrats favoring cash payments of the child tax credit have similarly flip-flopped. Within recent memory, Democratically-controlled Congresses summarily rejected Sen. Moynihan's suggested reduction in the Social Security tax (the largest tax paid by low-income workers) or Jack Kemp's suggested income tax credit for Social Security taxes paid. Democrats apparently only favor attempts to help the "working poor" via the tax code that result in government checks rather than smaller deductions from their paychecks.

In any event, we believe that the notion of a negative income tax as an alternative to welfare bureaucracies remains worthy of consideration: refundable credits for dependent children could mark a start in that direction. Similarly, expansion of IRA's could represent a move toward making the income tax more of a consumption tax (it is quite perverse that the major personal tax is largely levied on what one puts into the economy rather than what one takes out).

For anyone hoping for significant and useful changes in the tax code, however, the 1997 tax bill is a very thin gruel indeed.

has been whether the child credit should be payable in cash to those whose income tax liabilities are wiped out by the credit or other exemptions or credits. This debate is in some ways the most interesting aspect of the entire tax bill (see box).

Simplicity? Nah...

On the other hand, the most discouraging aspect of the debate has been that it has mainly concerned who gets how large a tax cut. In particular, the gains tax reduction has been criticized because it will mainly "go to high-income taxpayers," yet most of these criticisms ignore the fact that realizing a gain is often what makes a taxpayer "high income" for the year that the tax is due. Estate tax cuts have been similarly attacked as a giveaway to the "rich," even though the proposed increases in the exemption would not even bring it to the same level of purchasing power as when it was first set at $600,000. Fundamental principles, such as the "fairness" of taxing nominal gains or the "deadweight loss" of taxes and avoidance schemes, have scarcely been mentioned in the current debate.

Finally, our politicians seem to have totally abandoned the goal of simplifying the tax code. Nearly all of the items discussed above will require more forms and more lines on existing forms, with each of these representing a particular benefit to a particular group.

At the time of the 1986 tax reform, which drastically lowered rates and abolished many special provisions of the tax code, cynics concluded that it was passed by Congress only because the existing code was so overloaded with special features that it was difficult to add any more. In this view, that "housecleaning" was needed so that the politicians could again pass special provisions to reward specific constituencies. Events since 1986, and the current tax bill suggest that the cynics were right. ❑

BUSINESS-CYCLE CONDITIONS

Business conditions remain favorable and the outlook for the next few months is positive. Our leading indicators are not quite as strong as they were a few months ago, but overall they are signaling further expansion through the third quarter of 1997.

Although half of our leading indicators declined this month, the business outlook remains favorable. Four of the 12 leading indicators reached new highs for the cycle. They are the *M2 money supply*, *new orders for consumer goods and materials*, the *ratio of manufacturing and trade sales to inventories*, and the *index of common stock prices* (to adjust for price inflation, the stock series and all dollar-denominated series in this review are reported in constant dollars). Two factors in the economy have helped our stock market index to rocket upwards. One is the rapid rise in share prices over the past several months, and the other is the benign growth in the Consumer Price Index (CPI), which we use to deflate the S&P 500 index. The year-to-date (YTD) annual rate of increase in the CPI is a paltry 1.4 percent. This is the lowest rate for the first six months of a year since 1986, when the YTD change in the CPI was -0.2 percent. This time last year, the YTD increase in the CPI was closer to its historical average of 3.3 percent. If one considers that the CPI may overstate price inflation by as much as 1.5 percentage points, it appears that we could currently be in a near zero inflation environment.

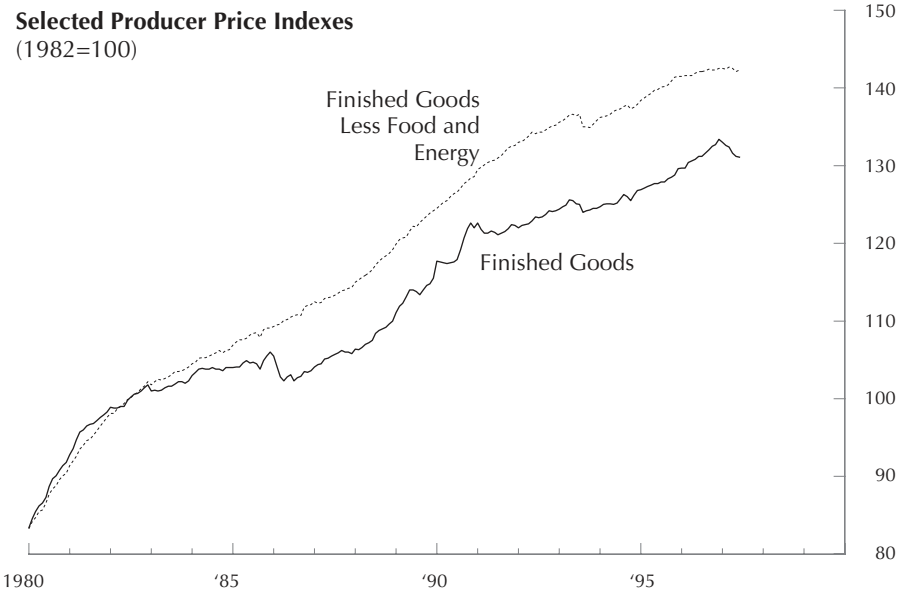
While the rate of increase in the prices of consumer goods and services has slowed significantly, what is more striking is the six month decline in the Producer Price Index for finished goods (PPI). The producer price index for finished goods measures the selling prices that domestic producers receive for their completed products that are ready to be sold to either consumers or businesses. The chart below is a plot of the PPI for finished goods along with the PPI for finished goods less food and energy — the "core" PPI. As the chart indicates, the core PPI has decreased slightly in recent months, but the PPI for finished goods has decreased markedly. The diverging trends in the two series reflect a substantial drop in energy prices, which decreased at annual rate of 16 percent during the first 6 months of the year. Still, even the core PPI is trending down, which suggests that productivity gains in crude materials production earlier this year are now helping to limit increases in the prices of finished goods.

Vendor performance, the percentage of purchasing managers reporting slower deliveries from their suppliers, continues to expand. The cyclical peak in this series occurred 31 months ago. Decreases from peaks that occur so long ago are not as useful in appraising the series' trend as its more recent fluctuations. Ignoring this initial peak, vendor performance is at a new high for the cycle.

The *average workweek in manufacturing* shortened a bit in June to 41.9 hours. This decline was not large enough to warrant downgrading the appraisal of the series. It remains appraised as clearly expanding.

Following last month's revisions to *contracts and orders for plant and equipment* there was another decrease in the series this month. This raised sufficient doubt about the series' trend to downgrade it to probably expanding. We also downgraded *initial claims for state unemployment insurance* (inverted). This too had been appraised as clearly expanding but is now only probably expanding.

There still is no identifiable trend in the highly volatile *3-month percentage change in sensitive materials prices*. The chart on page 79 shows how wide the swings in this series can be, which makes the narrow fluctuations of the past few



months more difficult to interpret. Its cyclical status remains indeterminate.

The *new housing permits* series does not have an identifiable trend either. It has rebounded recently but remains below its cylical peak. Until the series surpasses the peak reached 12 months ago it probably will remain cyclically indeterminate.

The *3-month percentage change in consumer debt* dipped slightly after increasing for 3 months. This decrease was not sufficient to indicate a clearly negative trend, and the series remains appraised as probably contracting. The only series that is clearly contracting is the *M1 money supply*.

Overall, 80 percent (8 out of 10) of the primary leading indicators with apparent cyclical trends are expanding. This is unchanged from last month. Our cyclical score, however, fell one point to 72 from a revised score of 73. This is the second month that the cyclical score has decreased, but it still is well within the range that signals further expansion.

Of the six primary roughly coincident indicators, only the *ratio of civilian employment to population* failed to reach a new high this month. The other five coincident indicators are all at their highest levels for the cycle. *Nonagricultural employment* increased by 217,000 new jobs. The *index of industrial production* increased 0.3 percent — about the same increase as in the previous 3 months. *Personal income in manufacturing*, *manufacturing and trade sales*, and *gross domestic product* all continue to expand as well. All six of the coincident indicators are appraised as clearly expanding.

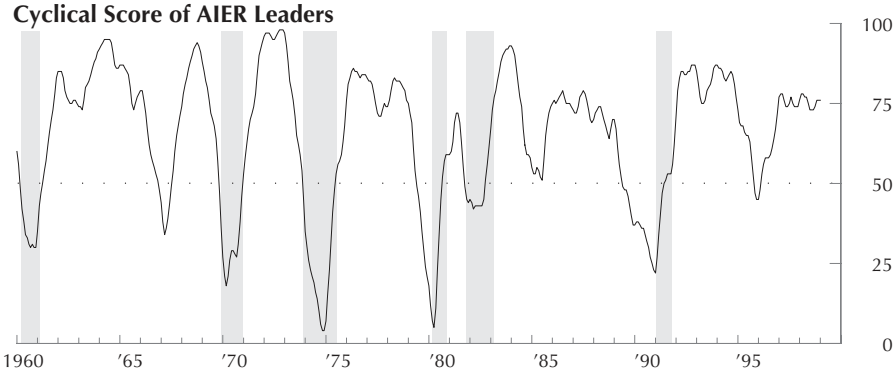
There were three new highs among the primary lagging indicators. The *average duration of unemployment* (inverted) reached a new high, as did *manufacturing and trade inventories* and *commercial and industrial loans*. All three are appraised as clearly expanding.

The *composite of short-term interest rates* decreased slightly to 5.59 percent. This series remains appraised as probably expanding.

The other two lagging indicators show no apparent trend. The *ratio of consumer debt to personal income* has leveled off and the *percent change from a year earlier in manufacturing labor cost per unit of output* continues to fluctuate in a narrow range. Both series are appraised as cyclically indeterminate.

Overall, 100 percent of the primary lagging indicators with apparent cyclical trends are expanding. Yet the bottlenecks that could choke off this expansion do not seem to be evident. For example, manufacturers' unit labor costs usually increase at an accelerating rate at this stage of an expansion, but our series shows that for the past 6 years they have changed little, and this stable trend has continued in recent months. Increased costs for labor input apparently have been accompanied by roughly equal increases in the value of labor output, *i.e.*, an increase in productivity. In the next few weeks the Commerce Department is expected to release revised data that will show that productivity has increased even more than previously reported. If so, unit labor costs may actually be lower than current data indicate and possibly trending downward. This would be yet another indication that the outlook for at least the next few months is favorable. ❑

Cyclical Score of AIER Leaders



Statistical Indicators of Business-Cycle Changes

Change in Base Data Mar.	Apr.	May	Jun.		*Cyclical Status* May	Jun.	Jul.
				Primary Leading Indicators			
-	-	-		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	-	-	Average workweek in manufacturing	+	+	+
-	-	+	-	Initial claims for unemployment insurance (inverted)	+	+	+?
+	-	-		Change in consumer debt	-	-?	-?
				Percentage expanding cyclically	82	80	80
				Primary Roughly Coincident Indicators			
+	+	+	+	Nonagricultural employment	+	+	+
+	+[r]	+	+	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	Average duration of unemployment (inverted)	+	+	+
+	+			Manufacturing and trade inventories	+	+	+
+	+[r]	+		Commercial and industrial loans	?	+	+
-	+	-		Ratio of consumer debt to personal income	?	?	?
+	-	-		Change in labor cost per unit of output, manufacturing	?	?	?
+	+	nc	-	Composite of short-term interest rates	+?	+?	+?
				Percentage expanding cyclically	100	100	100

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

	1995	*1996*	*—— 1997 ——*	
	July 27	*July 25*	*July 17*	*July 24*
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