

The Battle Over the Surplus

It is unlikely that the huge projected budget surpluses will materialize. Keeping this in mind, the goal should be to balance the budget at a level of expenditure that does not require a crushing tax burden.

The Federal government is awash with money. Last year it collected \$69 billion more in taxes than it spent, resulting in the first annual budget surplus since 1969. When the current fiscal year ends on September 30, there will be an even larger surplus of \$120 billion, according to the latest projections from the Congressional Budget Office (CBO). The surplus is projected to be still larger next year, and between now and 2009, annual surpluses are projected to total a remarkable \$2.9 trillion. Of this, \$1.9 trillion will be generated by payroll taxes that are used to finance Social Security. The remaining \$1 trillion will be generated by general tax revenues.

President Clinton and Congress now face a choice that was unthinkable a few years ago: what do to with all this money? There are three options: cut taxes, increase expenditures, or reduce the national debt. Both Republicans and Democrats want to do some of each, but in varying degrees. President Clinton favors using most of the projected surplus to pay down the debt. Republicans want to cut taxes. Both parties appear to have agreed to use the Social Security surplus to reduce the portion of the federal debt held by the public. The debate is over what to do with the remaining surplus of \$1 trillion.

Although the projections fueling this debate are cited with great precision, they must be regarded as highly uncertain. They are highly sensitive to assumptions about how the economy will perform. Even small errors can have a large impact on budget projections, and it is not uncommon for a one-year budget forecast to be off by \$100 billion. Only a few years ago, budget analysts predicted there would be huge deficits for the foreseeable future. Having been wrong by hundreds of billions, they now predict huge surpluses. The assumption is that the latest long-term forecasts will prove more accurate. This belief would appear to be based more on

hope than experience.

One assumption of the budget forecasts is especially dubious. Namely, that the U.S. economy will not experience a recession during the next 10 years. For this to happen, the economy would have to grow continuously from 1991 (when the current expansion began) to 2009, providing 18 years of uninterrupted expansion. This is possible but unlikely. The longest expansion in U.S. history lasted less than 9 years (1961-1969).

Another doubtful assumption is that Congress will continue to adhere to "spending caps" that since 1990 have limited the growth of discretionary spending. Congress is already using budget gimmicks to get around next year's caps. For example, it classified outlays for the Federal census as "emergency spending," which is exempt from the caps. By using such tricks Congress reportedly has already spent *all* of next year's projected non-Social Security surplus of \$14 billion.

Proponents for spending the surplus (or, as they like to say, "investing" it) argue that increased outlays are needed to restore cuts in social spending made in the 1980s and early 1990s. However, a closer look at outlays broken down by function reveals that outlays for health care, welfare, and other social programs

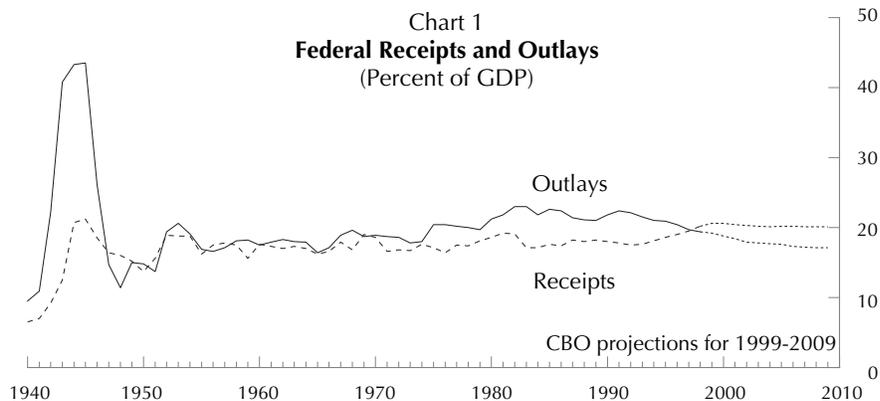
have not substantially decreased. These and other transfer payments (i.e., payments that transfer income, in cash or in kind, to individuals) increased to 12.2 percent of GDP in 1995, a record high, and since then have declined less than a percentage point. Rather, federal spending as a share of GDP has fallen mainly because of defense cuts. At 3.2 percent of GDP, defense spending is now lower than at any time since before World War II.

Moreover, Federal spending remains high by historical standards. The surprising disappearance of the deficit is due not to a sharp drop in spending, but largely to a remarkable increase in revenues.

Federal receipts rose to a postwar high of 20.2 percent of GDP in 1998. The last time tax receipts topped 20 percent of GDP was more than half a century ago, during World War II. Far from being a onetime upswing, this is the third consecutive year that receipts have reached levels previously seen only during wartime. If the laws remain the same and the economy performs as the CBO assumes, taxes will remain exceptionally high, above 20 percent of GDP, for the next ten years. (See Chart 1 below.)

This surge in revenues is a result of the strong economy, including the remarkable stock market boom. In this regard, the income generated by large capital gains may have created a "revenue bubble" in the past few years—which could burst if future market gains are less robust. If this happens, government receipts could quickly fall short of projections.

Nevertheless, the tax burden is exceptionally heavy right now. This is one of



the strongest arguments for a tax cut. Unfortunately, both parties are focussing more on targeted tax cuts than genuine tax reform. In August, Congress approved a plan that would return an estimated \$792 billion of the projected \$1 trillion on-budget surplus to taxpayers over the next 10 years. It does cut income tax rates, which would reduce the incentive for people to arrange their income in inefficient but tax-saving ways. A 10 percent cut in marginal rates would be phased in over 10 years. (For example, the 28 percent rate would gradually fall to 25.2 percent in 2009.) The bill also cuts the capital gains tax, repeals the estate tax and the alternative minimum tax, eliminates the step-up in basis on property included in some estates, allows individuals to deduct health insurance premiums, and strengthens incentives to save for education and retirement. Some of these are good ideas and would correct inequities in the current tax code. But many of the bill's provisions are simply special breaks for special interests, or attempts to use the tax code for social engineering.

Nothing in the bill addresses another goal of genuine tax reform, simplification. Nor is there any mention of the payroll tax. Many people pay more in payroll taxes than income taxes. Billions of dollars in payroll taxes are now used to pay for government spending other than Social Security and Medicare. If Social Security reform is off the table, as it seems to be, a reduction in payroll taxes should be considered.

The Debt Issue

President Clinton has promised to veto the Congressional bill and says he will support tax cuts of no more than \$300 billion. The Clinton administration argues that it would be irresponsible to use the budget surplus for large tax cuts instead of paying down the debt.

The federal debt currently stands at \$5.6 trillion. About two-thirds of this is held by the public, including the Federal

Reserve, and the rest is held by various government trust funds, the largest of which is the Social Security Trust Fund. Over the next 10 years, Social Security is projected to collect \$1.9 trillion more in payroll taxes than it spends on benefits. Republicans and Democrats apparently plan to use these funds to reduce the federal debt held by the public. The \$1 trillion surplus outside of Social Security, if it is not used to cut taxes or increase spending, also would be used to retire debt held by the public.

Many people think paying off the debt is obviously a good idea. Five trillion dollars is an awful lot of money to owe. But a better yardstick of the burden of federal debt is to compare it to GDP. When GDP is used as an approximate measure of the ability to borrow, the level of the debt is not as alarming as the nominal-dollar debt suggests.

This is evident in the top curve of the Chart 2, which plots the ratio of total federal debt to GDP. This ratio recently peaked at 68 percent of GDP in 1995. However, this was far from a record high. In 1946, after the government borrowed enormous amounts to finance World War II, the federal debt was twice as high as it is now.

This debt ratio has been falling for the past 4 years. It will continue to fall *even if the surplus is not used to pay down the debt*. It is sufficient for the debt to grow less rapidly than the economy. This is how the federal debt declined as a share of GDP from 1946 to 1974. The government rarely ran budget surpluses during this period. The debt ratio fell because budget deficits, while chronic, were relatively small.

Paying off the federal debt held by the public, as the Clinton administration proposes, will reduce the debt ratio faster. But the benefits of doing so are not clear. There is no direct link between the level (or trend) of the federal debt and the growth of the U.S. economy. The debt was higher as a share of GDP in the 1950s than it is now, but the economy grew and

living standards improved. The debt ratio trended upward from the mid-1970s to the mid-1990s but, aside from cyclical downturns, the economy prospered.

Moreover, reducing the portion of the federal debt that is held by the public will not reduce the future cost of Social Security. When the baby boomers retire, their benefits will have to be paid out of tax revenues collected during their retirement. Investing the current Trust Fund surpluses in Treasury securities does not prefund this obligation. Eventually the Treasury will have to repay the money it borrowed from Social Security, and to do so it will have to collect more revenue (or borrow more) from future generations.

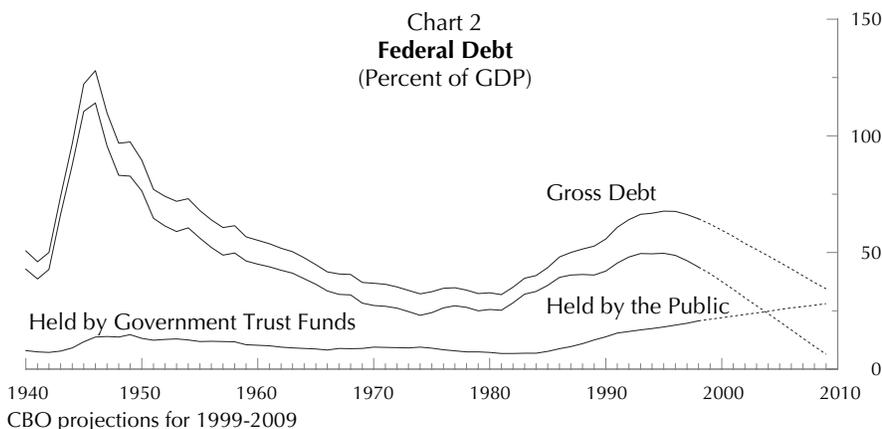
One benefit of paying down the federal debt is that interest payments on the debt would be lower. But here, too, the nominal amount of these payments is less important than their burden on the economy, which is best measured by their level relative to GDP. This ratio can be reduced if the debt grows more slowly than the economy. The dollar amount of debt does not actually have to be reduced.

Reducing the ratio of federal debt to GDP, whether by slowing its growth or paying it down, would also weaken the government's incentive to inflate. Economists have long recognized that debtors benefit from price inflation, because they repay their debts with dollars that have less purchasing power than the dollars they borrowed. The U.S. Government, as the world's biggest debtor, benefits enormously from price inflation. During the past 60 years of chronic price inflation, the real value of its obligations to lenders has been reduced by trillions of dollars. The smaller the government debt is, the lower the pressure on policymakers to inflate away the real burden of that debt.

A Lesson from the 1950s

This is not the first time that the United States has faced the question of what to do with a budget surplus—and whether to use it to pay down a large federal debt. In 1956, the budget finally was balanced, following a long string of budget deficits during the Depression, World War II, and the Korean war. The budget surplus in 1956 equaled 0.9 percent of GDP, almost the same as last year. The federal debt equaled 64 percent of GDP, roughly the same as now. Then as now, the economy was growing, price inflation was moderate, and unemployment was low. President Eisenhower had the same three budget choices as President Clinton: spend the surplus, cut taxes, or reduce the national debt.

Eisenhower chose to reduce the debt. In his 1957 budget message, he said, "It



is essential, in the sound management of the Government's finances, that we be mindful of our enormous national debt and of the obligation we have toward future Americans to reduce that debt whenever we can appropriately do so. Under conditions of high peacetime prosperity, such as now exist, we can never justify going further into debt to give ourselves a tax cut at the expense of our children. So, in the present state of our financial affairs, I earnestly believe that a tax cut can be deemed justifiable only when it will not unbalance the budget, a budget which makes provision for some reduction, even though modest, in our national debt."

Eisenhower was not opposed to tax cuts, however. He objected only to additional cuts beyond those he had successfully proposed earlier in his administration. In his first budget message, for fiscal 1955, Eisenhower said, "It is the determined purpose of this administration to make further reductions in taxes as rapidly as justified by prospective revenues and reductions in expenditures. The objective will be to return to the people, to spend for themselves and in their own way, the largest possible share of the money that the Government has been spending for them."

A REVIEW OF BUSINESS-CYCLE FORECASTING

AIER's record of predicting peaks and troughs in business-cycle activity is respectable, but there is always room for improvement. By creating composite indexes from our 24 statistical indicators we hope to improve that record.

For over half a century the AIER research staff has used statistical indicators of economic activity to monitor the business cycle, with the objective of forecasting peaks and troughs in general business activity. In the earliest years of this endeavor, AIER published a weekly article entitled "Coming Effects of Current Events," in which several statistical series were charted and analyzed. In 1950, the Institute broadened this list to cover 18 economic indicators (8 leading, 6 coincident, and 4 lagging) and developed a method of analyzing them that was adapted from a study published by the National Bureau of Economic Research (NBER). This list has changed and expanded over the years to the 24 series we use today, and our methods of analysis have advanced, but the NBER report was the catalyst.

Over the years, the NBER, together with the Commerce Department's Bureau of Economic Analysis (BEA), revised their own list of statistical indicators and

After his tax cuts became law, Eisenhower claimed credit for having eased the "crushing load of taxation." He was referring to federal taxes that claimed 18.8 percent of GDP. They are now substantially higher.

The prudent policy now, as in Ike's time, is to balance the budget at a level of expenditures that does not require a crushing tax burden. Given that the tax burden is now at a postwar high, a tax cut is warranted. One that strengthens the incentives to produce and to create wealth is preferable. But a large cut will set the stage for a return to budget deficits if Congress and the administration spend more than currently projected, as they seem likely to do.

The 1950s battle over the surplus ended when the economy went into recession in 1957. Revenues fell short of expectations and budget deficits returned. The economy soon rebounded, but higher revenues were more than matched by higher spending. With the exception of two years, the government would run budget deficits for the next 38 years, until 1998. The present economic and budget outlook could change just as abruptly. Perhaps the best we can hope for is that the politicians do nothing to trigger such a reversal or make it worse. □

used these to develop composite indexes of leading, coincident, and lagging indicators. Each composite index measures the aggregate movement of a group of series that show similar timing at business-cycle peaks and troughs, but differ in the aspects of economic activity that they represent. Many readers may be familiar with the most widely cited of these, the BEA's "leading economic index." In 1995, the BEA handed over its stewardship of these composite indexes and their components to the Conference Board, a private research group, which has since made changes of its own.

AIER's list of indicators is similar to that of the Conference Board, but our method of analysis is different. Our first step is to appraise the trends in the individual indicators. These appraisals are based partly on a probability analysis that compares each series' current trend with trends in previous business cycles dating as far back as 1947. Each series is appraised as either clearly expand-

ing, probably expanding, cyclically indeterminate, probably contracting, or clearly contracting.

Then we calculate the percentage of leading indicators expanding. This is done by dividing the number of leading indicators appraised as expanding or probably expanding by the number of indicators for which a cyclical trend is apparent. Series for which the cyclical trend is indeterminate are disregarded. For example, suppose nine of the 12 leading indicators are clearly expanding cyclically, one is clearly or probably contracting, and the cyclical statuses of two series are indeterminate. We would report that 90 percent (nine out of ten) of the primary leading indicators with an apparent cyclical trend are expanding. The same procedure is used to calculate the percentage of coinciders and laggards expanding.

Only when less than 50 percent of the leaders are expanding do we suggest that a recession is probable. The percentage fell below this threshold before every postwar recession. However, it also gave several false signals of recession.

The Cyclical Score

Although the procedure for calculating the percentage of leaders expanding is straightforward, it does not allow for any "shades of gray." Each series must be accorded a specific cyclical status each month and a series reaching a new high for the cycle has the same "weight" as one that has decreased for several months and is on the verge of an indeterminate status.

As a result, AIER developed an alternative measure of the primary leading indicators called the cyclical score. Although it too theoretically can fluctuate between 0 and 100, it differs from the percent expanding series in several respects. The cyclical score is a purely arithmetical calculation that does not reflect the judgments of AIER's staff in any way. Also, it is based on the current list of primary leaders each month. Consequently, the historical record of the cyclical score may itself be revised whenever a series is revised or one series is dropped and another substituted.

We rely on the cyclical score primarily to supplement the percentage expanding series. For example, if the percentage of leaders appraised as expanding indicates that a recession is probable, but the cyclical score of the leaders does not, we would be somewhat hesitant in asserting that a recession is imminent. On the other hand, if both series were to decrease to a level where a recession becomes statistically more probable, we would be some-

what more confident in offering such an appraisal.

Our New Composite Indexes

In an effort to further improve the accuracy of our forecasts, we recently developed three composite indexes based on AIER's leading, coincident, and lagging indicators. The methodology for creating these three composite indexes is similar to the Conference Board's. Unlike the Conference Board, however, we use moving averages of each series to calculate the composites. Presumably this reduces irregular fluctuations and the incidence of "false signals." In addition, the calculation of each composite gives a smaller weight to its more volatile components. For example, the 3-month percentage change in sensitive materials prices is our most volatile leading indicator, thus it has a smaller weight than the less volatile M2 money supply. We recalculate these weights each month, whereas the Conference Board recalculates the weights used in their composites only periodically.

The results of these calculations are plotted in the accompanying chart. This chart also shows the ratio of the composite of coinciders to the composite of lagging indicators. In the final stages of a business expansion, the lagging indicators often increase faster than the coinciders, indicating the development of bottlenecks that can choke off expansion. Thus we would expect this ratio to turn downward before a recession.

There are a few important caveats about analyzing these charts. First, the latest values plotted are based on incomplete data, because monthly data for some component series are not yet available. Second, movements in the composites might reflect large movements in only a few component series. For example, a sharp drop in the S&P 500 could drag down the composite of leading indicators, of which it is a component, even if the other 11 leading indicators increased. In this respect, it is helpful to look at yet another series, the percent of leading indicators that are higher than they were six months prior. If, say, the AIER composite of leaders were to fall for several months, but most of its components are higher than they were six months ago, a recession would be less likely than if most of the series were declining. Similar analysis can be done with the coincident and lagging indicators

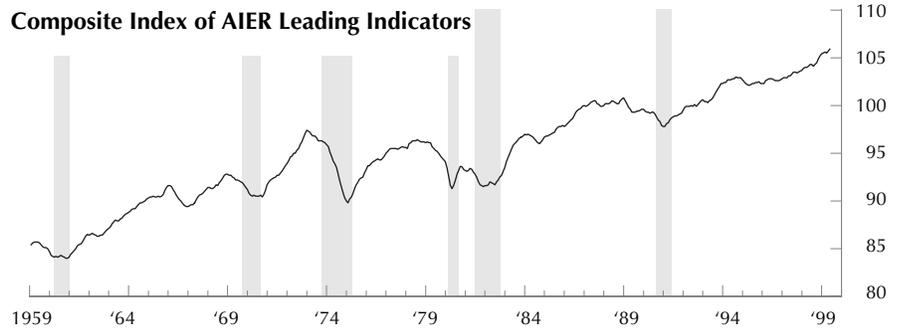
These indexes are intended to supplement our current tools for identifying peaks and troughs in the business cycle, not replace them. They provide one more way to study our 24 statistical indicators and ascertain the current trend of busi-

ness activity and its probable future direction. We still believe that a careful analysis of each series individually is the most useful way to develop an overall picture of the economy.

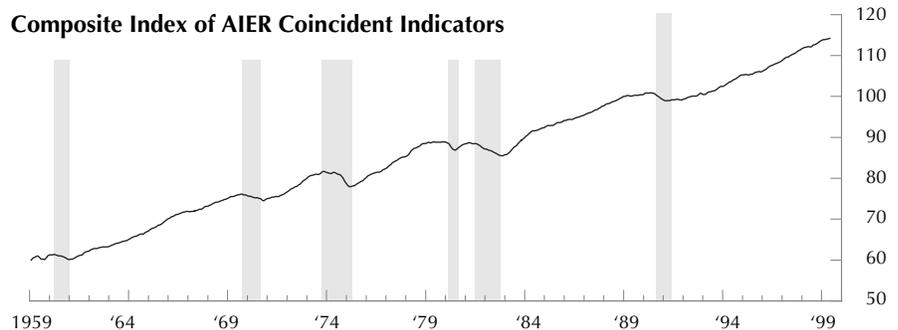
Currently, 100 percent of AIER's leading indicators are expanding. The cycli-

cal score stands at 78. Both series are above 50, the threshold below which a recession becomes statistically probable. Our new composite index of AIER leading indicators is trending upward, providing further evidence that the economic expansion is likely to continue. □

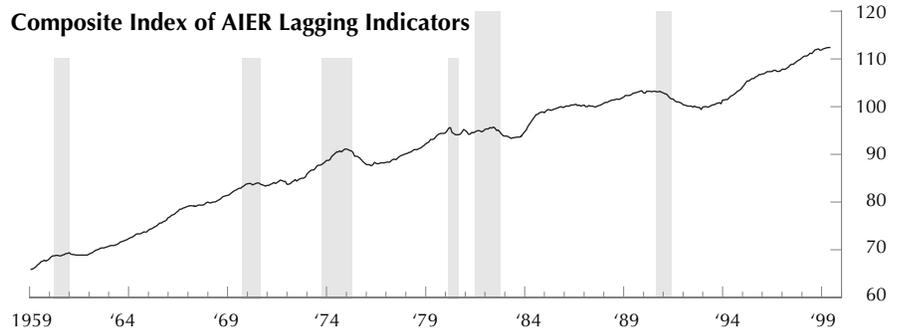
Composite Index of AIER Leading Indicators



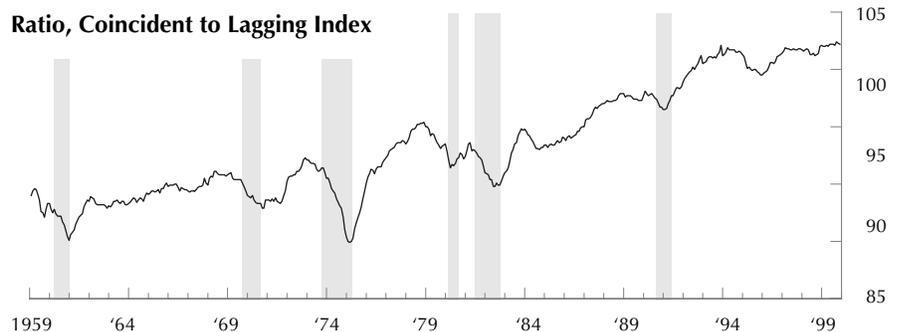
Composite Index of AIER Coincident Indicators



Composite Index of AIER Lagging Indicators



Ratio, Coincident to Lagging Index



PRICE OF GOLD

	1997 Sept. 11	1998 Sept. 10	— 1999 —	
			Sept. 2	Sept. 9
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