TaxAction Analysis™

First Quarter 1999

Economic Scorecard

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Day of Reckoning Delayed

Economic Growth Postpones Social Security Losses—by One Year

Once again, the U.S. economy has turned in an unexpectedly strong performance. Gross domestic product, after inflation, grew at annual rate of 4.5 percent in the fourth quarter, well ahead of the consensus 3.5 percent forecast. Real GDP has advanced by 4 percent since the first quarter of 1998. [Table 1 shows the change in the major components of real GDP.]

Consumers led the way, increasing their spending a robust 6.7 percent over the fourth quarter. Year over year, personal consumption expenditures were up 5.5 percent.

Investment kept up its rally from the end of last year. Fixed investment — equipment, machinery and structures — increased by a healthy 10 percent, following the 14.8 percent of the previous quarter. Inventories which had been slashed in the fourth quarter increased by only $1 billion.

Rumors that the global economy is finally beginning to recover did not find support in the trade sector, however. U.S. exports fell by 7.7 percent from the fourth quarter and remain below year-ago levels. Imports, on the other hand, continued to flood American markets, increasing by 16.7 percent over the fourth quarter. If exports and imports had behaved more in line with 1998, first-quarter growth would have been an even stronger 5 percent.

Government, which accounts for almost one-sixth of GDP, grew by 4.4 percent during the quarter thanks to a 7.2 percent jump in state and local purchases. Federal purchases fell by 0.7 percent, mainly due a 4.3 percent drop in defense.

After several quarters of increases below one percent, the GDP price deflator advanced by 1.4 percent in the first quarter, prompting some to wonder if inflation is heating up again. But this unexpected increase was mainly due to a one-time pay raise for federal workers. Year over year, the deflator is up by only 1.0 percent while the Consumer Price Index (CPI) increased by only 1.6 percent. [See Table 1 and the **Scorecard**]

The Scorecard This Quarter

Item	FY 2000 Budget Forecast		Actual	Comments
	OMB	CBO		
Federal Government Performance (Amounts are in $billions)				
Surplus(+)/Deficit(-)	79.0	70 .0	- 49.9	Forecast is for FY1999: Actual is Oct 1998 to Mar 1999
Spending	865.2	827.1	864.0	Forecast is pro-rated for Oct 1998 to Mar 1999 based on average patterns of receipts & outgo over last 5 yrs. Actual is Oct 1998 to Mar 1999
Revenue	808.8	812.7	814.0	
Individual	389.6	386.9	380.7	
Corporate	69.0	73.1	72.4	
Social Security/Medicare	281.8	282.3	286.6	
Current Economic Conditions				
Nominal GDP ($bil)	8,833	8,846	8,807.9	Forecast is CY 1999; actual is 1st quarter
Economic Growth	2.4%	2.3%	4.5%	Forecast is CY 1999; actual is 1st quarter
New Jobs	n.a.	n.a	223,000	Average number created monthly since Apr 1998.
Federal Employment-Non defense	n.a.	n.a	2,051,700	As of Feb 1999.
			63,000	Change from Feb 1998.
Federal Employment-Defense	n.a.	n.a	645,300	As of Feb 1999.
			-27,100	Change from Feb 1998.
Total Employment	n.a.	n.a	127.9	Nonfarm, self-employed, military.
Consumer Confidence	n.a.	n.a	-1.3%	Apr 1999 over Apr 1998.
Long-term Economic Growth				
Rates on 10-year Treasury notes	4.9 %	5.3%	5.2%	Forecast is CY 1999; actual is average for Jan thru Apr 1999
Inflation (CPI)	2.1 %	n.a.	1.6%	Actual is Mar 1999 over Mar 1998.
Net Investment as a % of GDP	n.a.	n.a.	4.7%	Actual is 1st quarter of 1999
Standard & Poor 500 Stock Index	n.a.	n.a.	4.18 %	Total return (price + reinvested dividends) for Jan thru Mar 1999.
			32.49%	Total return Mar 1999 over Mar 1998.

Table 1

Change In Real GDP Components, 1st Quarter 1999

Basic data come from the Commerce Department's National Income and Product Accounts, Tables 1.2 and 7.1 released on 4/30/99.

[1] Annualized rates of change

* Not applicable

Change In Real GDP Components, 1st Quarter 1999

Components	(billions of chained (1992) dollars)			Percent Change from:	
	1998:1	1998:4	1999:1	1998:4 to 1999:1	1997:1 to 1999:1
Gross domestic product	**7,464.7**	**7,677.7**	**7,762.5**	**4.5%**	**4.0%**
Personal consumption expenditures	5,055.1	5,246.0	5,331.9	6.7%	5.5%
Gross private domestic investment	1,321.8	1,360.6	1,393.3	10.0%	5.4%
Fixed investment	1,224.9	1,311.0	1,342.4	9.9%	9.6%
Change in business inventories	91.4	44.2	45.2	*	*
Net exports of goods and services	-198.5	-250.0	-305.6	123.3%	54.0%
Exports	991.9	1,009.6	989.5	-7.7%	-0.2%
Imports	1,190.4	1,224.3	1,270.6	16.0%	6.7%
Government purchases	1,283.0	1,310.3	1,324.6	4.4%	3.2%
Federal	446.1	460.6	459.8	-0.7%	3.1%
National defense	293.3	304.6	301.3	-4.3%	2.7%
Nondefense	151.9	155.2	157.6	6.3%	3.8%
State and local	837.1	850.0	865.0	7.2%	3.3%
Implicit price deflator	112.32	113.07	113.47	1.4%	1.0%

Rising Interest Rates — Prelude to Inflation?

After declining for most of 1998, interest rates have begun to rise again. The 30-year Treasury bond, which dropped below 5 percent in October and again in December, almost hit 6 percent in late January. While it's come down from there, the long bond still finished April close to 5.7 percent. [See Figure 1 for recent changes in the Treasury yield curve.]

But these are nominal yields. What about the interest rate adjusted for inflation? The real rate on 10-year Treasury bonds — a reasonable summary of the yield curve — has fluctuated between 3 and 5.3 percent since 1991. Over most of the past few years, the real interest rate has been well above average. Right now it is almost at its average, 4.2 percent. [See Figure 2 for the real yield on a 10-year Treasury since 1991.]

Figure 1

After Falling During 1998, Interest Rates Are on the Rise Again

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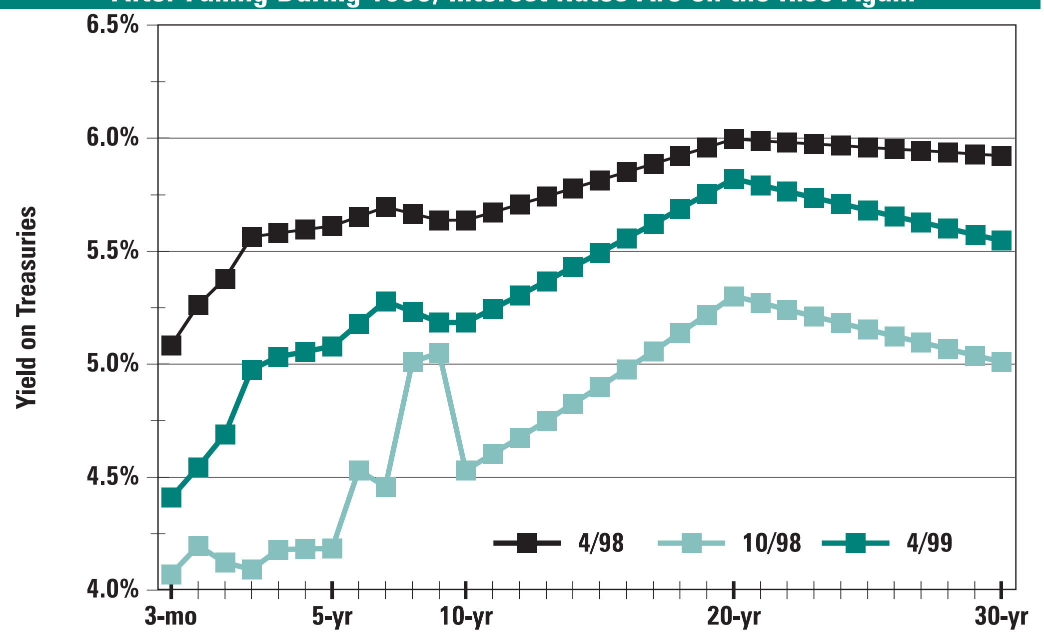
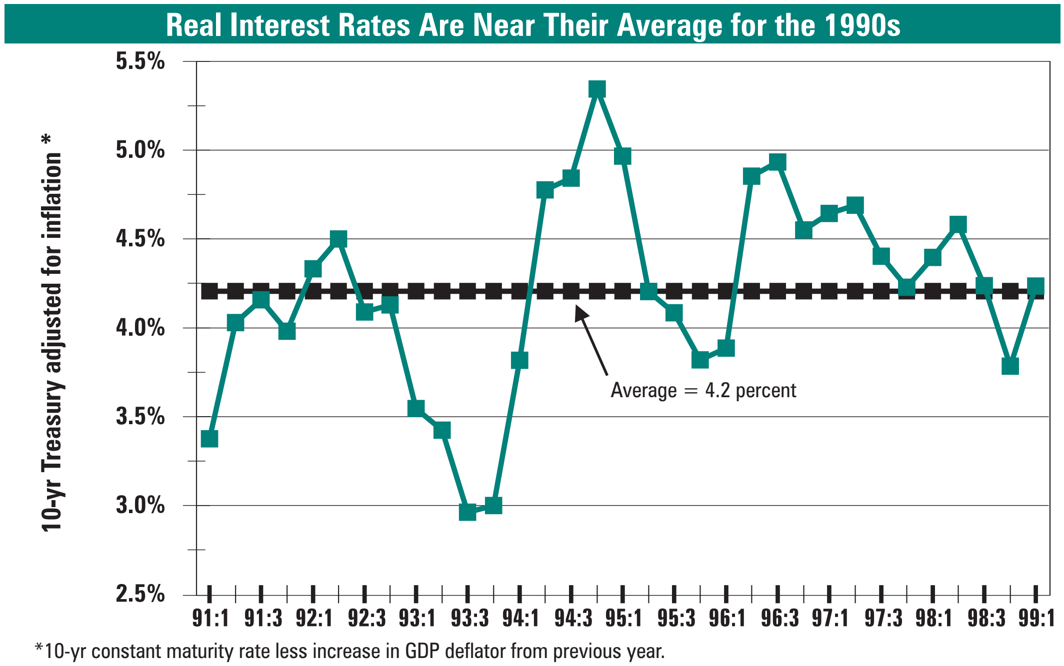


Figure 2

Real Interest Rates Are Near Their Average for the 1990s



*10-yr constant maturity rate less increase in GDP deflator from previous year.

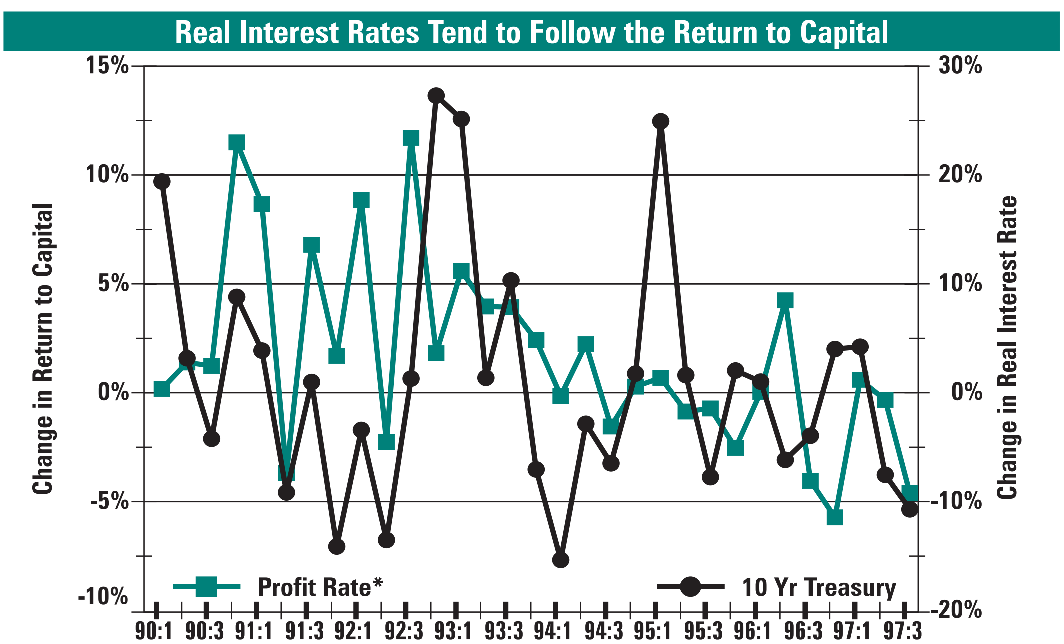
Or Higher Returns to Capital?

Inflation plays a key role in what happens to interest rates. As prices come down, so do rates. Conversely, as inflation heats up, interest rates will too. At present, there is little evidence to suggest that prices are increasing. Both the GDP deflator and CPI remain tame. Gold is still well under year-ago prices of $300 an ounce. Despite the recent uptick in oil prices, commodity prices are about 20 percent below where they were last April. And while economists keep talking about tight labor markets, wage growth remains modest. Two closely-watched measures — the employment cost index and the hourly wage rate — just surprised to the low side.

Yet, why the recent rise in interest rates? The reason may have more to do with the returns to capital than inflation. Investors can buy stocks or bonds. Higher returns to stocks require higher bond returns to keep investors happy. As investment becomes more profitable, stock prices rise, making it easier for companies to fund expansions through issuing more stock. Because they compete for funds in the same financial markets, interest rates also must neces-

Figure 3

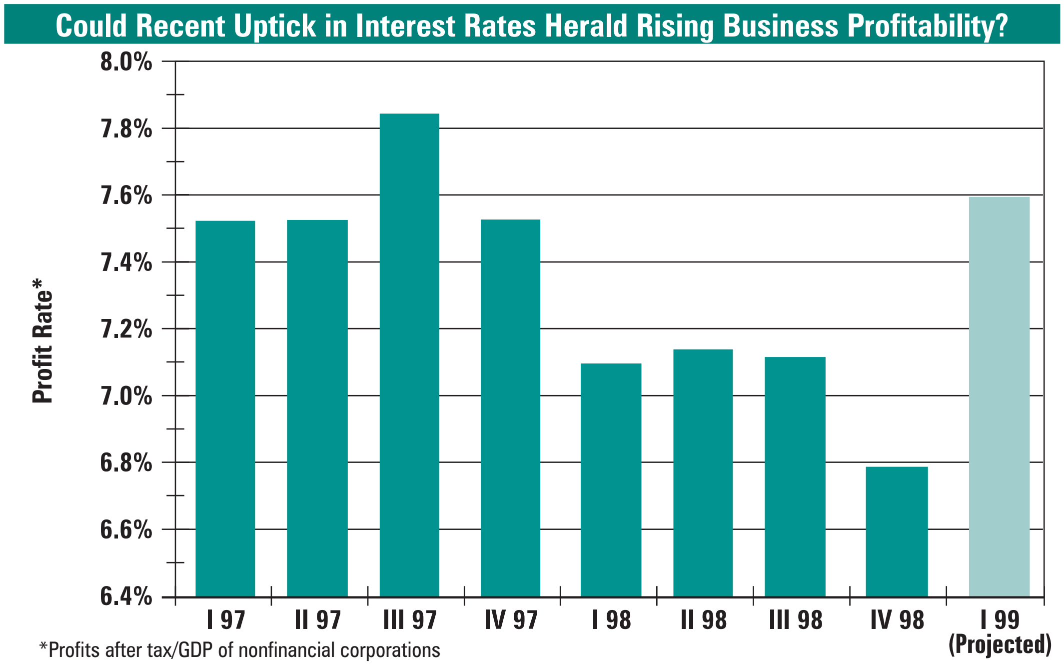
Real Interest Rates Tend to Follow the Return to Capital



*Profits after tax/GDP of nonfinancial corporations

Figure 4

Could Recent Uptick in Interest Rates Herald Rising Business Profitability?



*Profits after tax/GDP of nonfinancial corporations

sarily rise. That's why higher interest rates can coexist with a strong economy, particularly in a low-inflation environment like the one we've been in.

A simple chart illustrates this relationship. Since 1991, changes in the real interest have moved with changes in the return to capital — as measured by the profit rate on private business output. [See Figure 3 for changes in the real 10-year Treasury bond and changes in profit after tax per unit of output since 1991.]

Corporate profitability has slipped of late. Profits after tax for nonfinancial corporations declined from 7.8 percent of output in the third quarter of 1997 to 6.8 percent in the fourth quarter of 1998. For much of that time, interest rates also were coming down. The 30-year Treasury bond dropped from an average 6.3 percent during October 1997 to 5.1 percent for December 1998. The 10-year Treasury after inflation declined from 4.4 percent in the third quarter of 1997 to 3.8 percent in the fourth quarter of 1998.

Could the recent rise in interest rates herald improving business profits? The recent strength in the stock market, particularly in cyclical industries and smaller-cap companies, shows that investors believe profits are expanding again. If they are correct, interest rates will rise so that bonds can stay competitive. [See Figure 4 for recent trend in corporate profits.]

The Budget Outlook: Revenue Forecasts on Track despite Low Growth Assumptions

Unlike the last two years, it doesn't appear there will be any August budget "surprises." Halfway through fiscal 1999, revenues and spending are on track with forecasts the administration's Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) released in January. OMB and CBO also forecast that federal revenues would claim a larger share of the U.S. economy than last year's 20.5 percent.

Yet, GDP is coming in much stronger than either expected. In fact, nominal GDP for the first quarter of 1999 is almost where OMB and CBO thought it would be for the year. [See **Scorecard** table.] If revenues continue to come in as expected and nominal GDP increases by a more restrained 5 percent in the next two quarters, taxes will take a smaller bite out the economy than they did last year. [See Table 2 for forecast and actual revenues and outlays as a percent of GDP.]

Table 2

Federal Government as a Share of GDP

Forecast versus Actual, Fiscal Year 1999

Federal Government as a Share of GDP Forecast versus Actual, Fiscal Year 1999			
	OMB[1]	CBO[2]	Actual[3]
Receipts	**20.6%**	**20.7%**	**20.0%**
Individual	9.9%	9.8%	9.3%
Corporate	2.1%	2.2%	2.1%
Payroll	7.0%	7.0%	6.8%
Outlays	**19.7%**	**18.8%**	**18.9%**

[1] Executive Office of the President, *Budget of the United States Government, Fiscal Year 2000*, February 1999.

[2] Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 2000-2009*, January 1999.

[3] Actual is federal revenues or outlays for the first six months of fiscal 1999 pro-rated to full year on the basis of historical monthly patterns. Nominal GDP, which grew by 6.9% in the fourth quarter of 1998 and and 6% quarter of 1999, is assumed to grow at 5% for the last two quarters of fiscal 1999.

Strong Economy Helps Social Security and Medicare

Because the economy is performing so well, the Social Security Trustees (the Secretaries of Treasury, Health and Human Services and Labor along with two private sector individuals) are more optimistic than last year. Raising their "best guess" forecast of taxable payroll after inflation has improved the outlook for Social Security somewhat over last year's report.

In the short run, the 5.8 percent increase in real taxable payroll pushes back by one year — from 2013 to 2014 — the date at which operating losses begin. At that point, Social Security spending will impinge on other government programs as the trust fund must start cashing in some of its IOUs. Longer run, the improved economic outlook moved back the date at which the trust fund depletes — that is, when the IOUs are gone — by two years from 2032 to 2034.

Higher wages also helped out the Medicare Hospital Insurance trust fund which has been running operating deficits since 1992. Last year, the Trustees forecast the trust fund would run out in 2008. Their latest report extends that deadline by seven years to 2015.

While faster economic growth certainly eases the financial burden of these entitlements, it is not the total cure. Fundamental reform to bring promised benefits in line with the ability of future workers to pay the bill remains an absolute necessity.

Figure 5

Stronger Economy Means Faster Wage Growth and More Payroll Tax Revenue

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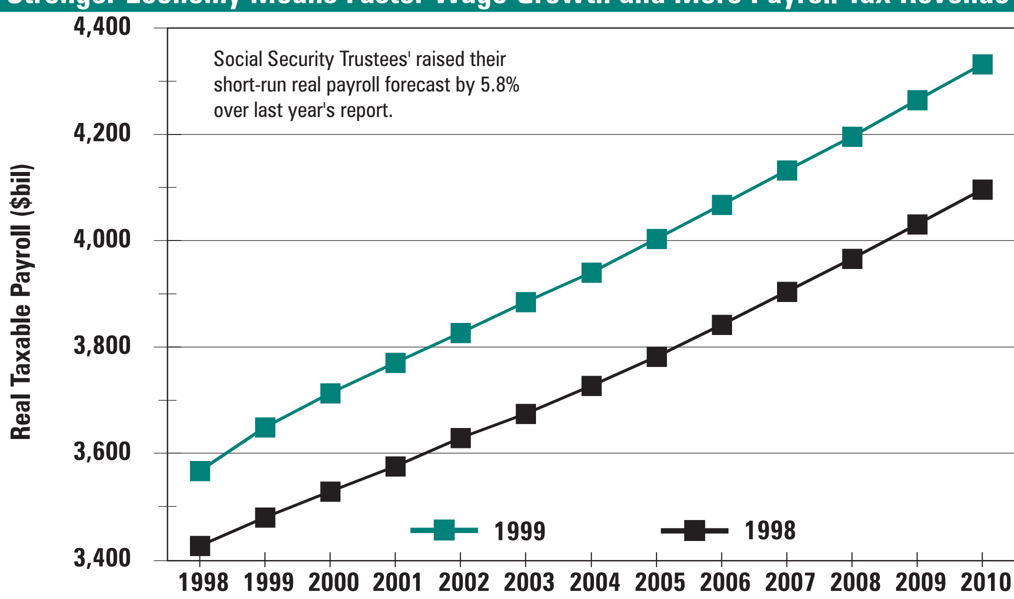


Source: Social Security Trustees' Reports, 1998 and 1999

Conclusions

Signs that the economy may cool are few and far between. The first quarter saw the economy keep up its recent, torrid pace. While the GDP deflator showed some upward inflection, prices still appear to remain in check. Modest increases in labor costs coupled with healthy productivity gains are leaving inflation well below 2 percent.

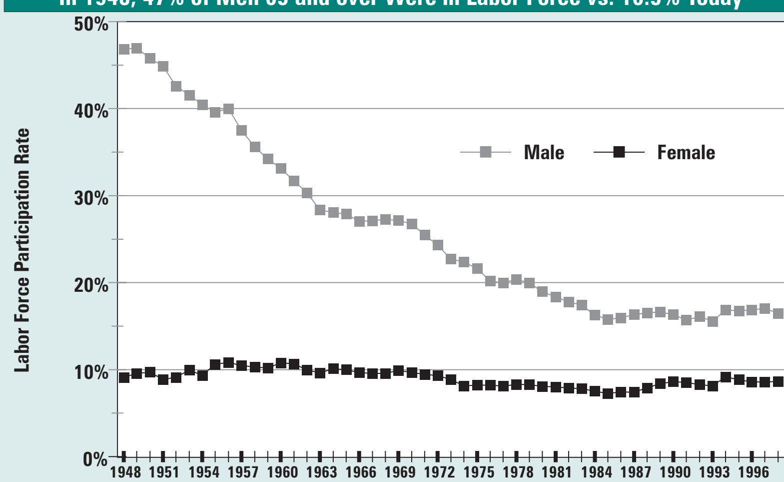
But unlike last year, it does not appear that a fiscal surprise in the form of higher surpluses will accompany the unexpected economic strength. Except possibly in the area of defense, it is unlikely we will see spending increases or big tax cuts this year. And it looks like better-than-expected economic conditions have taken the pressure off Washington to come up with real reform of the Social Security and Medicare entitlements.

Retiring the Social Security Earnings Test

Spawned by the Great Depression, the Social Security earnings test was supposed to keep older workers who had retired out of the labor force to free up jobs for younger workers. But with today's premium on labor, America can no longer afford to lose the productive talents of its most experienced workers.

The retirement earnings test penalizes people receiving Social Security benefits who work. The earnings test puts a huge tax on wage income. Someone between ages 65 and 69, paying no income tax but earning over the limit, would lose 33 cents out of the next dollar in wages. Add to that the 7.65 percent Social Security and Medicare payroll tax and that person faces a marginal tax rate of 41 percent. The tax rate is even higher—57.65 percent—for someone under age 65. For people who also pay federal income tax, the marginal tax rate on wages can reach well over 80 percent.

In 1948, 47% of Men 65 and over Were in Labor Force vs. 16.5% Today



Such high punitive tax rates on working may help explain why, despite improved health among retirees, only 16.5 percent of men age 65 and over are in the labor force today compared to 47 percent fifty years ago.

Eliminating the earnings limit in 1999 would reduce the marginal tax rate on working for people ages 65 to 69. If they respond the same way other workers do to higher take-home pay, they would supply more of their labor services. By 2008, we estimate that, economy-wide, there would be 63 million more hours worked than otherwise. That translates into almost 31,500 more full-time equivalent jobs.

The increase in hours worked would also stimulate more total output for the economy. By 2008, we estimate GDP would increase by $19.5 billion and the stock of U.S. capital would be $6.8 billion higher than otherwise.

This extra growth would generate new federal payroll, income and excise taxes that would offset some of the cost. By 2010, the added revenue would be enough to offset higher benefit payments from removing the limit on earnings.

A relic from a time when jobs were scarce, the Social Security earnings test has no place in today's economy. In fact, quite the opposite. Companies already have trouble filling positions, particularly for skilled labor. With labor shortages like these, government policy should not prevent retired workers from entering the labor market or cause them to restrict the number of hours they work.

TaxAction Analysis™
Economic Scorecard

Editor & Publisher . . . . Tom Giovanetti

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