TaxAction Analysis™

Second Quarter 1999

Economic Scorecard

A Quarterly Publication of the Institute for Policy Innovation

Robbing Peter to Pay…Uncle Sam?

Budget Surpluses Have Come Almost Entirely Out of Personal Savings

The U.S. economy again surprised analysts, this time by posting weaker-than-expected growth. While forecasters thought second quarter, real gross domestic product would exceed that of the first quarter by 3.5 percent, the Commerce Dept. reported only a 2.3 percent increase. This lag marks the slowest rise in GDP since the 1.8 percent turned in during the second quarter of last year. Yet, for the first half of the year, the economy is still advancing at a 4 percent pace. [See **Scorecard** Table.]

More importantly, a look at the two components of GDP that have been driving the recovery — consumer spending and investment — shows a fundamentally sound economy. Fixed investment, increasing by 9.1 percent over the first quarter, gave the biggest boost to GDP. [Table 1 shows the growth in the major components of real GDP.]

Personal consumption expenditures, which make up over two-thirds of GDP, rose at a respectable 4 percent, after inflation, and 5 percent in comparison to the same time last year. Together with fixed investment, these key parts of GDP grew at an annual rate of 5 percent in the second quarter.

Inventories, however, increased by only half of what they had in the previous two quarters. When added to consumption and fixed investment, slower inventory accumulation lowered the growth rate to 3.9 percent. But while detracting from growth in the second quarter, reductions in inventory accumulation could be a positive force if businesses seek to replenish their shelves in the next quarter.

Weak performance in the other two major parts of GDP — government and trade — further dropped the growth rate. The 1.2 percent decline in government purchases, mainly at the federal level, cut the growth rate to 3 percent.

The $23.4 billion increase in the current account deficit brought the growth rate down to the 2.3 percent reported by Commerce. While exports showed some signs of life, almost reversing their first quarter drop, the rise was not enough to overcome the continuing flood of imports. But if recent weakness in the dollar bolsters foreign demand for U.S. goods while curbing domestic demand for foreign goods, the trade sector could be a positive for the growth rate later in the year.

Prices remain in check. The GDP price deflator increased by 1.6 percent in the second quarter and by 1.3 percent year-over-year. Even the Consumer Price Index (CPI), thought to overstate inflation, is running only 2 percent ahead of last year. [See Table 1 and the **Scorecard** table.]

The Scorecard This Quarter

Item	FY 2000 Budget Forecast		Actual	Comments
	OMB	CBO		
Federal Government Performance (Amounts are in $billions)				
Surplus(+)/Deficit(-)	79.0	70 .0	94.3	Forecast is for FY1999: actual is Oct 1998 to June 1999
Spending	1,295.2	1,238.1	1,284.0	Forecast is pro-rated for Oct 1998 to June 1999 based on average patterns of receipts & outgo over last 5 yrs. Actual is Oct 1998 to June 1999
Revenue	1,361.7	1,368.2	1,378.2	
Individual	653.1	648.6	669.1	
Corporate	138.4	146.6	137.3	
Social Security/Medicare	461.6	462.5	460.6	
Current Economic Conditions				
Nominal GDP ($bil)	8,833	8,846	8,851	Forecast is CY 1999; actual is 1st half of year
Economic Growth	2.4%	2.3%	4.0%	Forecast is CY 1999; actual is 1st half of year
New Jobs	n.a.	n.a	244,750	Average number created monthly since Jul 1998.
Federal Employment - Non defense	n.a.	n.a	2,022,900	As of May 1999.
			15,900	Change from May 1998.
Federal Employment - Defense	n.a.	n.a	643,100	As of May 1999.
			-25,900	Change from May 1998.
Total Employment	n.a.	n.a	128.7 mil	Nonfarm, self-employed, military.
Consumer Confidence	n.a.	n.a	-1.2%	July 1999 over July 1998.
Long-term Economic Growth				
Rates on 10-year Treasury notes	4.9%	5.3%	5.5%	Forecast is CY 1999; actual is average for Jan. thru Jul. 1999
Inflation (CPI)	2.1%	n.a.	2.0%	Actual is June 1999 over June 1998.
Net Investment as a % of GDP	n.a.	n.a.	5.1%	Actual is 1st half of 1999
Standard & Poor 500 Stock Index	n.a.	n.a.	8.87%	Total return (price + reinvested dividends) for Jan. thru Jul. 1999.
			20.20%	Total return Jul. 1999 over Jul. 1998.

Table 1a

CHANGE IN REAL GDP COMPONENTS, 2nd QUARTER 1999

Basic data come from the Commerce Department's National Income and Product Accounts, Tables 1.02 and 7.01 released on 7/29/99.

Annualized rates of change

* Not applicable.

CHANGE IN REAL GDP COMPONENTS, 2nd QUARTER 1999	(billions of chained (1992) dollars)			Percent Change from:	
	1998:2	1999:1	1999:2	1999:1 to 1999:2	1998:2 to 1999:2
Gross domestic product	7,498.6	7,759.6	7,803.6	2.3%	4.1%
Personal consumption expenditures	5,130.2	5,331.9	5,384.7	4.0%	5.0%
Gross private domestic investment	1,306.5	1,388.5	1,399.5	3.2%	7.1%
Fixed investment	1,264.1	1,344.0	1,373.6	9.1%	8.7%
Change in business inventories	38.2	38.7	19.4	*	*
Net exports of goods and services	-245.2	-303.6	-323.0	28.1%	31.7%
Exports	972.1	996.5	1,007.6	4.5%	3.7%
Imports	1,217.3	1,300.1	1,330.6	9.7%	9.3%
Government purchases	1,294.8	1,323.9	1,320.0	-1.2%	1.9%
Federal	454.1	458.4	454.7	-3.2%	0.1%
National defense	300.3	299.4	296.9	-3.3%	-1.1%
Nondefense	152.9	158.0	156.8	-3.0%	2.6%
State and local	840.9	865.8	865.5	-0.1%	2.9%
Implicit price deflator	112.56	113.52	113.97	1.6%	1.3%

Table 1b

Contribution of GDP Components to Growth, 2nd Quarter 1999

Contribution of GDP Components to Growth, 2nd Quarter 1999 (Annualized rate of change from 1st quarter)	
Consumption + Fixed Investment	5.0%
Plus	
Inventory	3.9%
Government Purchases	3.0%
Net Exports + Residual = GDP	2.3%

Companies Continue to Invest, Particularly in Computers

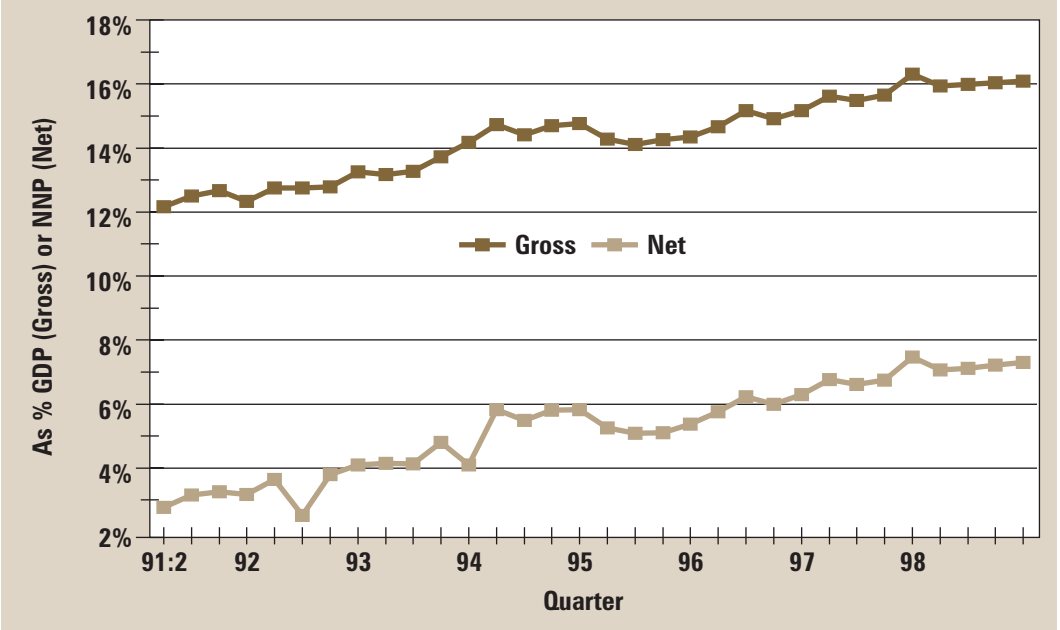
As throughout this expansion, private investment continues to be very strong. Gross private domestic investment has steadily climbed from 12.2 percent of GDP at the start of the recovery in March 1991 to 16.1 percent in the first quarter of 1999. [See Figure 1.]

Of course, gross investment includes replacement of assets that have worn out or become obsolete. Historically, investment needed just to cover depreciation has amounted to about 11.5 percent of GDP. But to keep the economy expanding requires net new additions to the stock of capital.

Even after depreciation, investment has done very well. Net private investment has risen from 3.6 percent of net national product (GDP less capital consumption allowance) at the

Figure 1

Private Investment Has Been Climbing since the End of 1990–91 Recession



start of the recovery to 7.3 percent last quarter. Currently, the private sector is adding almost $650 billion a year to the capital stock.

Much of that increase is coming in producer's durable equipment (PDE), particularly computers and other devices related to the new information technology. Since 1991, real investment in nonresidential PDE has increased an average 11.2 percent a year. Computers have been growing at an annual rate of 41.5 percent. [See Table 2 for investment by type.]

On the other hand, longer-lived structures like industrial buildings and residential housing have been growing much more slowly at around 8 percent. Going forward, this shift toward shorter-lived assets means that replacement of the capital stock will require larger amounts of investment.

But Can Saving Keep Up?

Saving provides the means to invest. For our economy to continue to generate enough investment, there must be sufficient saving. But the personal saving rate has been of growing concern. Last year individuals saved only 0.3 percent of GDP in contrast to the 3.6 percent averaged since 1982. In the first quarter of this year personal saving fell by 0.5 percent.

Considering that most U.S. saving comes from businesses and not individuals, how worrisome is this trend? A look at the total saving rate since the start of the recovery shows it rising from 15.2 to 17.2 percent of GDP. The same is true for net saving (total saving minus depreciation), which has increased from 4.8 to 7.4 percent over the same period. Of course,

Recent Growth in Real Investment by Type

Type of Investment	Distribution of Components[1]	% Change at Annual Rate	
		99:1 to 99:2	91:2 to 99:2
Private fixed investment (bil $1992)	**1,378.6**	**9.1%**	**8.0%**
Nonresidential	**75.3%**	**10.8%**	**8.2%**
Structures	15.0%	-1.1%	1.3%
Nonresidential buildings, including farm	11.3%	-5.2%	2.1%
Utilities	2.3%	12.5%	-0.2%
Mining exploration, shafts, and wells	1.0%	-11.2%	-3.0%
Other structures	0.5%	121.8%	1.1%
Producers' durable equipment	61.6%	15.4%	11.2%
Information processing and related equipment	35.0%	34.2%	19.5%
Computers and peripheral equipment	35.8%	41.5%	41.5%
Other	11.7%	29.2%	8.1%
Industrial equipment	9.6%	2.2%	5.1%
Transportation and related equipment	12.6%	19.3%	10.2%
Other	9.2%	-4.6%	6.1%
Residential	**24.7%**	**5.1%**	**7.7%**
Structures	24.0%	5.0%	7.8%
Single family	12.0%	-2.8%	7.8%
Multifamily	1.7%	-5.0%	5.1%
Other structures	10.4%	17.7%	8.2%
Producers' durable equipment	0.6%	9.6%	4.9%

Table 2

Recent Growth in Real Investment by Type

[1] Components may not add to totals because different price deflators are used to convert from nominal to real dollars.

TaxAction Analysis™
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Editor & Publisher . . . . Tom Giovanetti

Economic Scorecard is a quarterly publication of TaxAction Analysis, the tax policy arm of the Institute for Policy Innovation. Nothing written here should be construed as an attempt to aid or hinder the passage of any bill before Congress.

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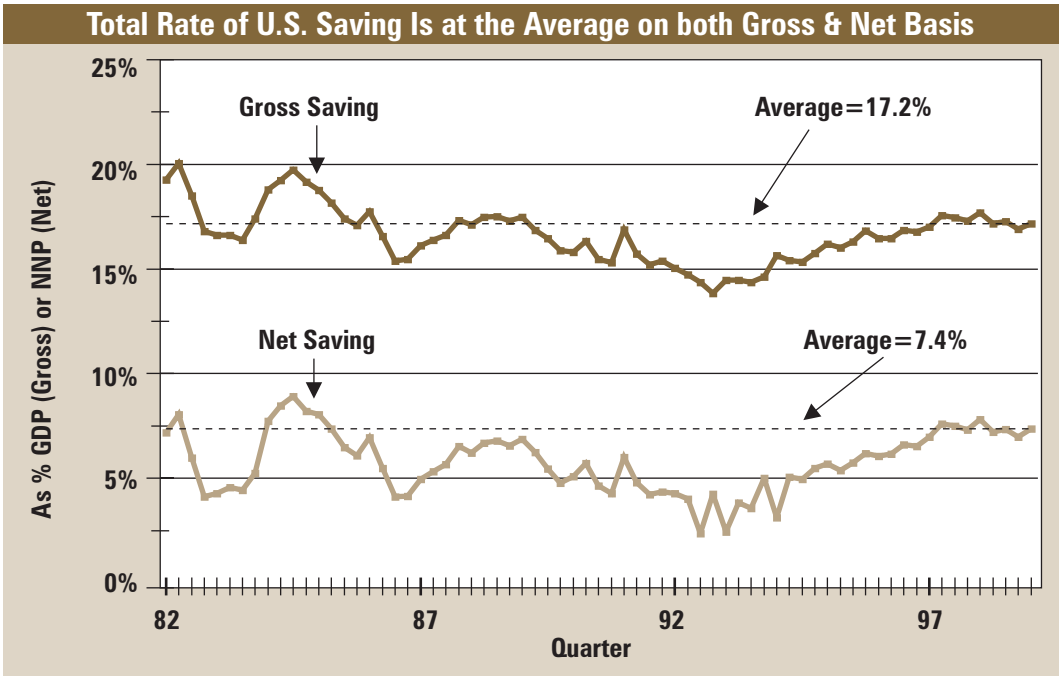
Figure 2

Total Rate of U.S. Saving Is at the Average on both Gross & Net Basis



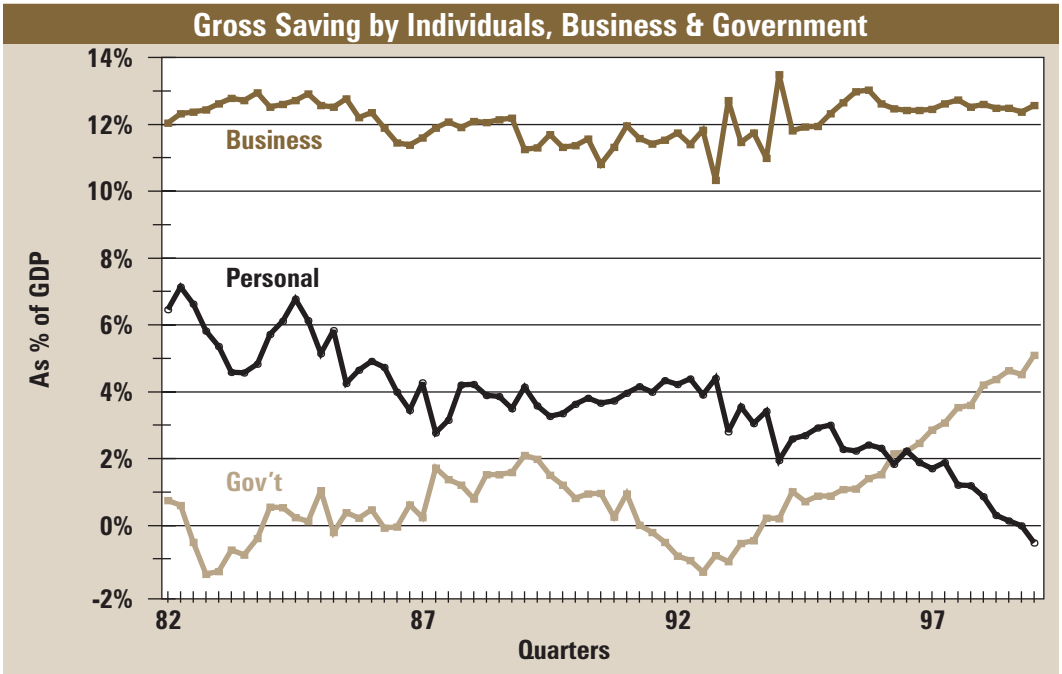
"…the transformation of federal deficits into surpluses seems to have come almost directly out of personal saving."

these rises have merely served to return both measures to their long-run trends. [See Figure 2 for the rate of total and net saving since 1982.]

Several interesting observations emerge when total saving is split into its three main parts — business, personal and government. First, business saving, which consists of depreciation and retained earnings, remains pretty constant at around 12 percent of GDP. Second, personal saving has been falling as a share of GDP since 1993 — around the same time that government saving started to turn up. Similar patterns hold for net saving rates as well. [See Figure 3 for the components of gross saving.]

Figure 3

Gross Saving by Individuals, Business & Government



Moreover, personal and government saving appear to be mirror images of each other. In other words, the increase in public sector saving resulting from the transformation of federal deficits into surpluses seems to have come almost directly out of personal saving. For example, in the first quarter of this year the gross saving rate for individuals was 4.1 percentage points below its average, while government saving was 4.2 percentage points above its average. [See Figure 4.]

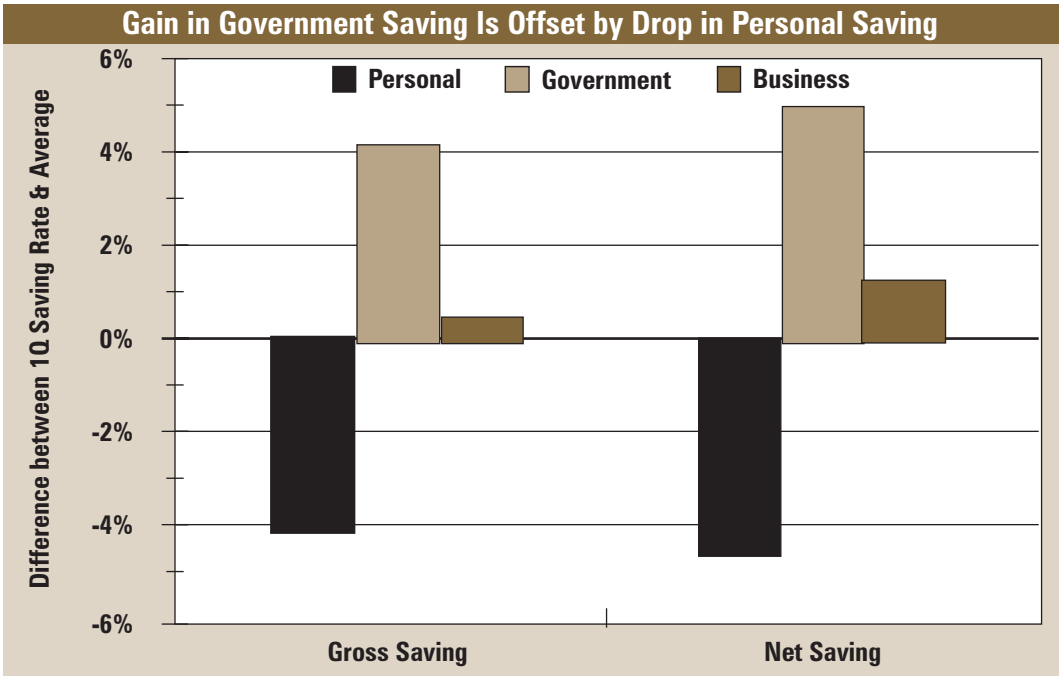


Figure 4

Gain in Government Saving Is Offset by Drop in Personal Saving

Recent evidence at least would appear to support the theory of economist Robert Barro who posits that government and personal saving are interchangeable because the public perceives the government's balance sheet as part of its own. If so, the goal of running large surpluses to reduce federal debt will not produce any net increase in saving for the economy as whole.

Moreover, federal surpluses are mainly the result of higher taxes. Because the increased federal tax burden (running at 20.8 percent of GDP for the current fiscal year) imposes high marginal rates which discourage saving and investment, the current policy of running surpluses will result in less — not more — U.S. saving.

Latest Government Budget Forecast
(in $billions)

Fiscal Year	Receipts	Outlays	Surplus	
			Total	On-budget
1999	1,821	1,701	120	-4
2000	1,905	1,744	161	14
2001	1,970	1,777	193	38
2002	2,045	1,798	246	82
2003	2,116	1,869	247	75
2004	2,198	1,932	266	85
2005	2,296	2,009	286	92
2006	2,396	2,062	334	129
2007	2,501	2,137	364	146
2008	2,609	2,224	385	157
2009	2,725	2,312	413	178
1999-2009	**22,761**	**22,609**	**3,015**	**992**

Table 3

Latest Government Budget Forecast

Source: Congressional Budget Office, *The Economic and Budget Outlook: An Update,* July 1999, Tables 5 & 7.

Congress Wants To Use Some of the Surplus for Pro-growth Tax Cuts

In its latest forecast the Congressional Budget Office (CBO) projects that federal budget surpluses will amount to $3 trillion over the next ten years, up from $2.7 trillion in its January projection. One-third of that will be "on-budget" — meaning outside Social Security. [See Table 3.]

Congress has voted to return $792 billion of the almost $1 trillion in non-Social Security surpluses to taxpayers. Drawing elements from House and Senate tax bills, the "Taxpayer Refund and Relief Act of 1999," passed by both houses in August, would:

1. reduce each income tax rate by one percentage point;
2. lower the capital gains rate from 20% to 18%, with indexed gains for inflation going forward;
3. repeal the individual and corporate alternative minimum tax (AMT);
4. repeal the estate tax;
5. expand IRAs and pensions; and
6. provide marriage penalty relief.

According to an IPI study released in July, the House tax bill would have raised productivity and thereby increased the growth rate from the 2.5 percent that the Congressional Budget Office expects under current law to 2.9 percent. By 2009, accumulated gross domestic product would have been $1.2 trillion higher, and the economy would have created an extra 1.5 million jobs, generating almost $1.5 trillion more in capital formation than otherwise. Extra revenue from higher growth would have offset about 30 percent of the static loss from the tax cuts over the next ten years.

Because the Conference bill contains many of the pro-growth provisions in the House bill — repeal of estate and AMT taxes and capital gains reduction — along with IRA and pension expansion from the Senate bill, it should produce similar, positive growth effects for the U.S. economy. [A table from the forthcoming IPI Issue Brief on the Conference Bill is reproduced below.]

Conclusions

Strong investment has been a major reason behind this second-longest economic recovery. By reducing inflation from about 5 percent to less than 2 percent, vigilant monetary policy has helped lower the tax take on capital gains and deprecation. But with inflation unlikely to go much lower, investment will need another shot in the arm.

Saving provides the means for investment. But because decreases in personal savings match increases in government savings almost dollar for dollar, simply running surpluses won't necessarily lead to more total saving and a larger capital stock. A better way to keep the investment boom and therefore the expansion going is to increase incentives to save and invest by lowering taxes on capital. The bill just passed by Congress, which awaits action by the President, would do just that. Let's hope that the White House and Capitol Hill will reach a compromise that preserves most, if not all, of the pro-growth tax cuts.

Which H.R. 2488 Tax Cuts Provide the Most "Bang for the Buck?"

[1] The share of each provision in the total static revenue loss from 2000 through 2009.

[2] Estimates from the Fiscal Associates Model. Assumes that sunset provisions slated for 2009 do not take effect.

[3] The total increase in GDP between 2000 and 2009 that would result from the provision divided by its static revenue loss.

[4] The total dynamic revenue increase between 2000 and 2009 from the provision divided by its static revenue loss.

Which H.R. 2488 Tax Cuts Provide the Most "Bang for the Buck?"
(Evaluated at the end of 10 years)

Provision	Static Revenue Loss[1]	Economic Growth[2]	Bang For the Buck[3]	Revenue Returned by Tax Cut[4]
Income Tax Rate Cut	41.9%	21.7%	$1.30	$0.29
Marriage Penalty Relief	13.0%	4.9%	$0.87	$0.23
Repeal the Individual Minimum Tax	11.9%	5.6%	$1.03	$0.28
IRA's and Pension Reform	4.6%	6.7%	$4.05	$0.70
Reduce Individual Capital Gains Rates	4.8%	39.8%	$21.67	$3.77
Repeal the Corporate Minimum Tax	0.9%	0.8%	$2.04	$0.52
Death Tax Relief	7.4%	8.0%	$2.66	$0.51
Other Individual Changes	7.5%	4.5%	$1.34	$0.32
Other Business Changes	8.0%	8.1%	$2.56	$0.56
Entire Package	100.0%	100.0%	$1.36	$0.31