TaxAction Analysis™

Third Quarter 1999

Economic Scorecard

A Quarterly Publication of the Institute for Policy Innovation

Same Song, Second Verse

Surplus Again Much Larger Than Expected — And Still No Tax Cuts

The pace of U.S. economic growth behaved much as expected during the third quarter. Real gross domestic product increased by 4.8 percent, rebounding from 1.8 percent in the second quarter – the slowest advance in four years. Year-over-year, the economy is growing at 4 percent.

Consumer spending and investment continue to propel the economy. Personal consumption expenditures, which make up two-thirds of GDP, increased by 4.3 percent, after inflation, over the second quarter and by 5.1 percent over the same time last year. Fixed investment, thanks to continued strong growth in computers, was up 9 percent over the second quarter and 9.6 percent over last year. Together these key parts of GDP grew at an annual rate of 5.3 percent in the second quarter. [Table 1 shows the growth in the major components of real GDP.]

Unlike last quarter, inventories – another major investment category – also added to growth. Inventories along with fixed investment and consumer spending grew at 6.2 percent. While companies doubled their stockpiles in the third quarter, perhaps in anticipation of Y2K problems, inventories are still only at roughly half their average level of the last four years.

The slower rate of increase in government purchases – 3.3 percent – compared to consumption and investment shaved a half point off GDP growth. Reversing a recent pattern, federal defense spending jumped by 9.9 percent while nondefense fell 8 percent in the third quarter. However, year-over-year, nondefense purchases are up 6.3 percent while defense is down 0.1 percent.

Once again the trade sector dragged down GDP, at least in the short run. U.S. exports continued to recover, increasing by 12.4 percent over the second quarter. But, a 17.2 percent jump in imports increased the trade deficit by $44 billion, bringing the growth rate down to the 4.8 percent reported by Commerce. Of course, a deficit in the current account means an offsetting surplus in the capital account. Foreigners continue to invest more in the U.S. than Americans invest abroad, boosting U.S. capital formation and future economic growth.

THE SCORECARD THIS QUARTER

Federal Government Performance
(Amounts are in $billions)

Item	FY 2000 Budget Forecast OMB	FY 2000 Budget Forecast CBO	Actual	Difference ($bil and %) OMB		Difference ($bil and %) CBO	
Surplus(+)/Deficit(-)	79.0	70 .0	122.7	43.5	(54.9%)	52.7	(75.3%)
Spending	1,727.1	1,707.0	1,704.5	-22.5	(-1.3%)	-2.5	(-0.1%)
Revenue	1,806.3	1,815.0	1,827.3	21.0	(1.2%)	12.3	(0.7%)
Individual	868.9	863.0	879.5	10.5	(1.2%)	16.5	(1.9%)
Corporate	182.2	193.0	184.7	2.5	(1.4%)	-8.3	(-4.3%)
Social Security/ Medicare	608.8	610.0	611.8	3.0	(0.5%)	1.8	(0.3%)

Current Economic Conditions

Item	OMB	CBO	Actual	
Nominal GDP ($bil)	8,833	8,846	9,165.1	Forecast is CY 1999; actual is January - September 1999
Economic Growth	2.4%	2.3%	3.9%	
New Jobs	n.a.	n.a	227,420	Average number created monthly since October 1998.
Federal Employment - Non defense	n.a.	n.a	2,016,200	As of August 1999.
			-12,300	Change from August 1998.
Federal Employment - Defense	n.a.	n.a	640,800	As of August 1999.
			-25,700	Change from October 1998.
Total Employment	n.a.	n.a	129.3 mil	Nonfarm, self-employed, military.
Consumer Confidence	n.a.	n.a	10.9%	October 1999 over October 1998.

Long-term Economic Growth

Item	OMB	CBO	Actual	
Rates on 10-year Treasury notes	4.9 %	5.3%	5.6%	Forecast is CY 1999; actual is average for January thru October 1999
Inflation (CPI)	2.1 %	n.a.	2.6%	Actual is September 1999 over September 1998.
Net Investment as a % of GDP	n.a.	n.a.	4.8%	Actual is January – September 1999
Standard & Poor 500 Stock Index	n.a.	n.a.	12.03%	Total return (price + reinvested dividends) for January thru October 1999.
			25.67%	Total return October 1999 over October 1998.

If there was a surprise in the Commerce report, it was prices. Higher-than-expected increases in the Producer Price Index and Consumer Price Index (CPI) earlier in the year had raised concerns that inflation might be heating up. But, the mere 0.9 percent rise in the third-quarter GDP price deflator along with tame reports on wage increases from the Labor Department seem to have quelled inflationary fears, at least for the moment.

Table 1

CHANGE IN REAL GDP COMPONENTS, 3rd QUARTER 1999

Basic data come from the Commerce Department's National Income and Product Accounts, Tables 1.02 and 7.01 released on 10/29/99.

[1] Annualized rates.

CHANGE IN REAL GDP COMPONENTS, 3rd QUARTER 1999	(billions of chained (1996) dollars)			Percent Change from:	
	1998:3	1999:2	1999:3	1999:2 to 1999:3[1]	1998:3 to 1999:3
Gross domestic product	**8,536.0**	**8,778.6**	**8,882.6**	**4.8%**	**4.1%**
Personal consumption expenditures	5,730.7	5,961.8	6,025.1	4.3%	5.1%
Gross private domestic investment	1,551.1	1,599.8	1,650.5	13.3%	6.4%
Fixed investment	1,474.0	1,581.0	1,615.4	9.0%	9.6%
Change in business inventories	76.1	14.0	28.1	*	*
Net exports of goods and services	-237.9	-319.0	-343.0	33.7%	44.2%
Exports	993.0	1,026.4	1,056.9	12.4%	6.4%
Imports	1,231.0	1,345.4	1,399.9	17.2%	13.7%
Government purchases	1,485.3	1,519.5	1,532.0	3.3%	3.1%
Federal	527.0	534.2	538.3	3.1%	2.1%
National defense	347.5	339.2	347.3	9.9%	-0.1%
Nondefense	179.6	194.9	190.9	-8.0%	6.3%
State and local	958.1	985.1	993.4	3.4%	3.7%
Residual	2.9	8.1	6.7		
Implicit price deflator	**103.07**	**104.19**	**104.43**	**0.9%**	**1.3%**

Table 1b

Contribution of GDP Components to Growth, 3rd Quarter 1999

Contribution of GDP Components to Growth, 3rd Quarter 1999 (Annualized rate of change from 2nd quarter)	
Consumption + Fixed Investment	5.3%
Plus	
Inventory	6.2%
Government Purchases	5.7%
Net Exports + Residual = GDP	4.8%

Economy Grows Faster under Commerce Revisions

Along with third-quarter GDP, the Commerce department also released revised data for the national income and product accounts (NIPA) going back to1959. Revisions included some definition changes and a rebasing of the price deflator from 1992 to 1996.

Two definition changes of note affected the saving and investment series. One reclassified business purchases of computer software from an expense to an investment. In 1998, the change added about $125 billion to the category "information processing equipment" which already included computer hardware. [See Table 2.]

Table 2

Information Technology Has Been Becoming a Bigger Part of Investment

[1] National Income and Product Accounts, Tables 5.4 and 5.5, September 1999.

[2] National Income and Product Accounts, Tables 5.4 and 5.5, October 28, 1999.

[3] Information processing equipment which includes computer hardware. Column labeled "New NIPA" also contains computer software.

Information Technology Has Been Becoming a Bigger Part of Investment
NIPA Revisions Released in October Now Include Software
(Amounts in $billions)

	Private Fixed Investment		Information Technology[3]		As % of Investment	
	Old NIPA[1]	New NIPA[2]	Old NIPA	New NIPA	Old NIPA	New NIPA
1987	722.9	754.3	109.8	141.9	15.2%	18.8%
1988	763.1	802.7	118.2	155.9	15.5%	19.4%
1989	797.5	845.2	127.1	173.0	15.9%	20.5%
1990	791.6	847.2	124.2	176.1	15.7%	20.8%
1991	738.5	800.4	122.6	181.4	16.6%	22.7%
1992	783.4	851.6	134.2	197.5	17.1%	23.2%
1993	855.7	934.0	141.6	215.0	16.5%	23.0%
1994	946.6	1,034.6	152.1	233.7	16.1%	22.6%
1995	1,012.5	1,110.7	173.0	262.0	17.1%	23.6%
1996	1,099.8	1,212.7	189.4	287.3	17.2%	23.7%
1997	1,188.6	1,315.4	206.6	315.4	17.4%	24.0%
1998	1,307.8	1,460.0	233.3	356.9	17.8%	24.4%
	Avg Annual Growth Rate					
Nominal	5.5%	6.2%	7.1%	8.7%		
Real	4.3%	5.1%	13.4%	13.4%		

This switch further underscores the importance of new technology to the economy. Since 1987, real investment in computers has been growing at an annual rate of 13.4 percent, compared to 5.1 percent for investment in general. As a result, almost one-fourth of investment today involves either computer hardware, software or peripheral equipment.

Commerce also reclassified federal employee retirement plans which it had previously treated like Social Security. Contributions along with interest and dividends earned counted as government receipts. Benefits paid out were considered transfer payments to individuals. As long as the federal retirement program was solely pay-as-you-go, this treatment made some sense, though it did ignore the saving aspect of federal employee retirement.

But, federal employees hired after 1984 have a new retirement program that operates just like a 401(k) or Individual Retirement Account (IRA). It doesn't make sense to count contributions and earnings from dividends and capital gains on stocks and mutual funds as government receipts. Doing so artificially inflates the amount of national savings credited to government.

After the revision NIPA will treat the old and new federal retirement programs the same as private pension plans. Contributions, interest, dividends and benefits paid will be deleted from the government accounts and added to labor compensation. Doing so, reduces government savings and increases personal income. With more income and less taxes, personal savings goes up. [See Table 3 for difference in saving as a percent of GDP between the old and new NIPA measures.]

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Economic Scorecard

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Difference in Saving Measures between Old & New NIPA[1]
(as a percent of GDP)

Year	Type of Saving			
	Total	Business	Personal	Government
1982	0.6%	0.6%	1.5%	-1.6%
1983	0.4%	0.4%	1.6%	-1.6%
1984	0.3%	0.5%	1.6%	-1.8%
1985	0.5%	0.6%	1.7%	-1.8%
1986	0.2%	0.3%	1.7%	-1.8%
1987	0.5%	0.5%	1.7%	-1.7%
1988	1.0%	0.6%	1.9%	-1.5%
1989	1.0%	0.5%	1.9%	-1.5%
1990	1.1%	0.5%	2.0%	-1.4%
1991	1.2%	0.5%	2.1%	-1.4%
1992	1.5%	0.6%	2.3%	-1.4%
1993	1.2%	0.4%	2.1%	-1.4%
1994	0.9%	0.2%	1.9%	-1.3%
1995	0.7%	0.3%	1.6%	-1.2%
1996	0.6%	0.6%	1.4%	-1.3%
1997	1.0%	0.6%	1.8%	-1.3%
1998	1.5%	0.5%	2.3%	-1.3%
1999*	1.7%	0.5%	2.7%	-1.4%
Average	**0.9%**	**0.5%**	**1.9%**	**-1.5%**

Table 3

Difference in Saving Measures between Old & New NIPA[1]

* Average of first two quarters of 1999.

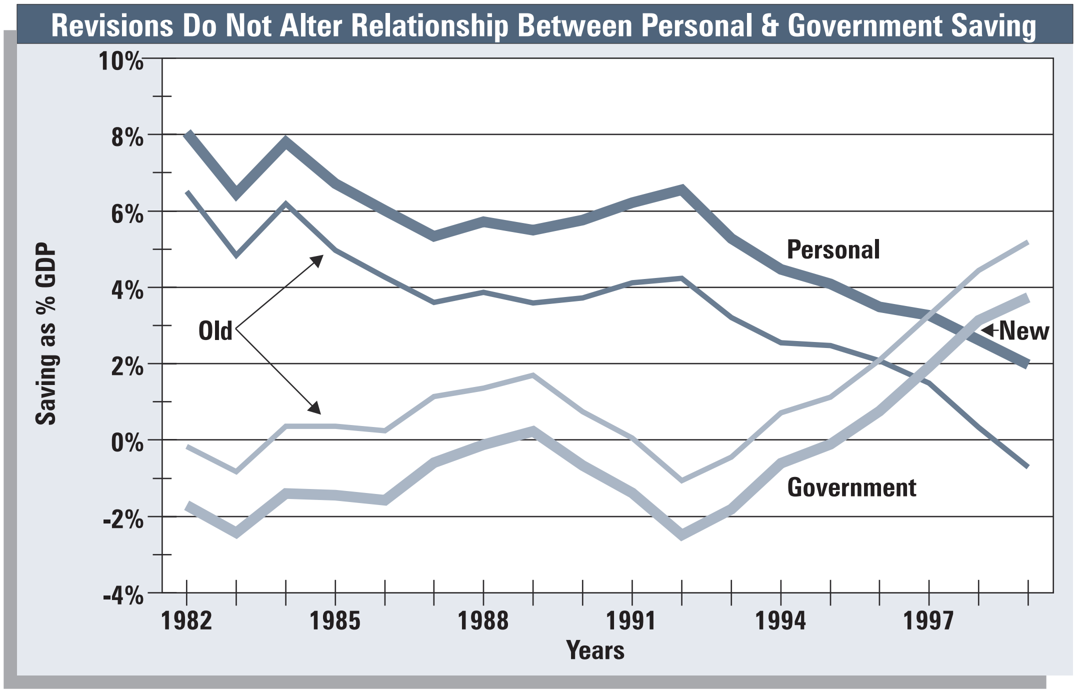
[1] New NIPA saving measure (from Table 5.1 released October 28, 1999) minus Old NIPA saving measure (released September 1999).

Based on data before the NIPA revisions, the last **Economic Scorecard** showed how personal and government savings move in opposite directions. Faced with higher tax bills, which have helped bring about recent federal surpluses, people forego saving rather than cut back on consumption. While the revision shifts money out of government savings and into personal savings, the relationship between the two stays the same. [See Figure 1 for personal and government savings as a percent of GDP.]

Because of all the changes undertaken by Commerce, the economy has done better than previously thought. Whereas the annual rate of growth between 1987 and 1998 averaged 2.7 percent under the old measures, the new revisions have boosted that

Figure 1

Revisions Do Not Alter Relationship Between Personal & Government Saving



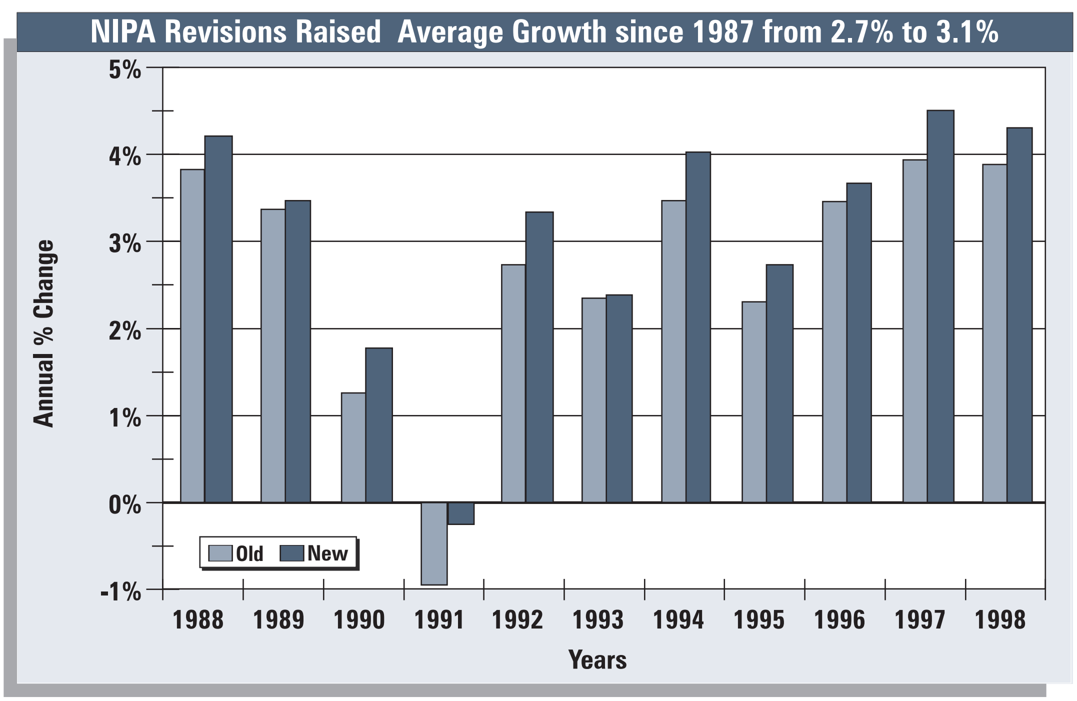
growth rate to 3.1 percent. [See Figure 2 for a comparison of real GDP growth under the old and new NIPA measures.]

Will this Recovery Break the Record?

If the economy continues to register positive growth for another 5 months, the recovery, which began in March 1991, will become the longest expansion, surpassing that of the 1960s. Now that dire warnings of Y2K havoc are subsiding, it is highly unlikely that an economy surging at 4.8 percent will plunge into negative territory during the last quarter of this year or the first of next.However, some recent developments have been raising concerns about how much longer the economy can continue to grow and maintain price stability. Unexpected jumps in the CPI and Employment Cost Index last spring cast the specter of inflation over financial markets. The 30-year Treasury bond, which had dipped below 5 percent in October 1998, steadily rose during this year to a level of 6.4 percent. But, thanks to recent reports showing restrained growth in both prices and wages, inflation concerns are easing once again and the bond has dropped closer to 6 percent.

Figure 2

NIPA Revisions Raised Average Growth Since 1987 From 2.7% to 3.1%



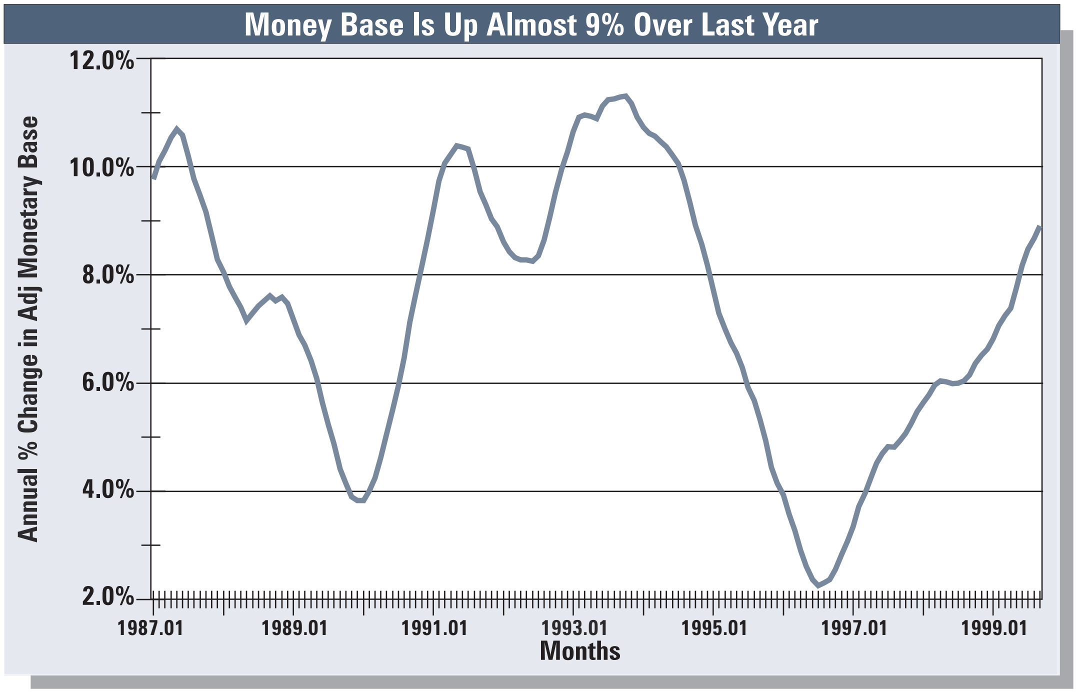


Figure 3

Money Base Is Up Almost 9% Over Last Year

Because inflation is a monetary phenomenon, eyes should be directed at the central bank. Following several years of increases under 6 percent, the monetary base (currency plus reserves of member banks) is up almost 9 percent over last year. Although criticized as too stingy during 1996-97, when growth in the money supply dipped below 3 percent, the Federal Reserve may have been too generous of late. [See Figure 3 for the annual growth in money base since 1987.]

A related concern has been the strength of the U.S. dollar. After registering a 33 percent rise between July 1995 and August 1998, the trade-weighted dollar has been falling. While less than 4 percent off its high, continued weakness could pose an inflation threat if dollars being held by foreigners make their way back into the U.S. money supply. [See Figure 4 for the dollar's strength since 1995.]

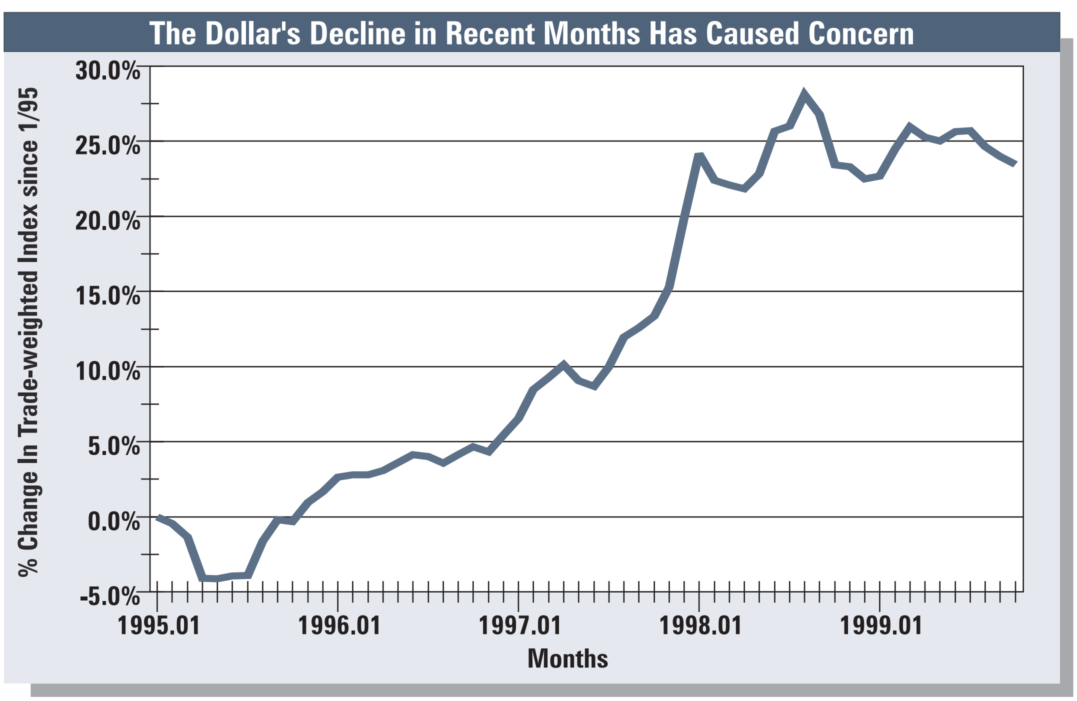
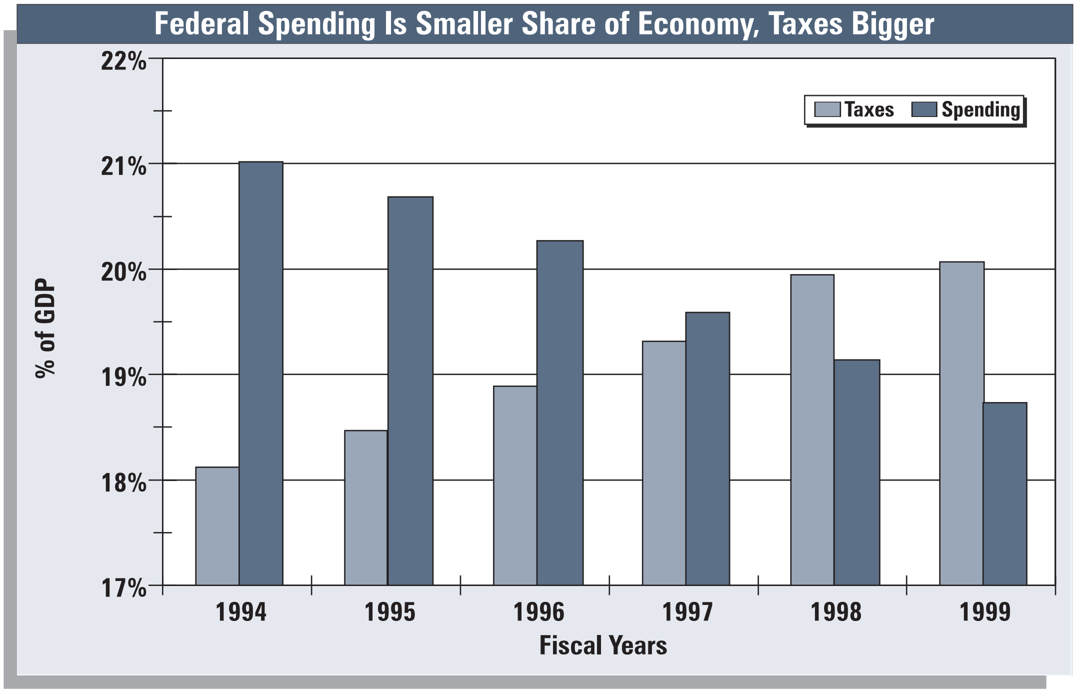


Figure 4

The Dollar's Decline in Recent Months Has Caused Concern

Figure 5
Federal Spending Is Smaller Share of Economy, Taxes Bigger.



Federal Government Records a $122 Billion Surplus

The federal government recorded a $122 billion surplus for fiscal year 1999, which ended September 30. That was over 55 percent higher than the $79 billion expected by the President's Office of Management and Budget (OMB) and 75 percent higher than the $70 billion forecast by the Congressional Budget Office (CBO). [See **Scorecard** table.]

However, government forecasts of taxes and spending – the two components that determine the surplus/deficit – were much closer. Income, payroll and excise tax revenues amounted to over $1.8 trillion dollars, only 1 percent higher than CBO and OMB expected. The $1.7 trillion in outlays came even closer to forecasts.

The surplus is a combination of federal spending growing more slowly than the general economy while federal revenues have grown more rapidly. Between fiscal years1994 and 1999, the annual increase in nominal GDP averaged 5.6 percent. Revenues, however, grew more than a third faster (7.8%) while outlays rose roughly half as fast (3.1%). As a result, spending declined from 21 percent of GDP to 18.7 percent, and taxes climbed from 18.1 percent to 20.1 percent. [See Figure 5.]

Conclusions

The Goldilocks economy continues with 4 percent growth and little inflation. Given its current momentum, the current expansion will most likely break the 1960s record for length.

Inflation danger signals earlier in the year have prompted the Federal Reserve to raise the federal funds rate by 50 basis points. A more effective course for monetary policy going forward may be to drain off excess reserves, particularly if the dollar continues to weaken and foreigners starting sending their holdings back to the U.S.

Fiscal policy should look to reduce the federal tax burden which now takes a fifth of the economy. Because capital income is the most heavily taxed and because of progressive rates, these higher taxes come at the expense of saving and investment. Using surpluses to pay down debt doesn't help because the increases in government savings are almost exactly offset by reductions in personal saving.

The best way to prolong the current expansion is with a pro-growth tax cut. Washington was two-thirds of the way there this year with the tax bill passed by the House and Senate but vetoed by President Clinton. Let's hope the Congress tries again next year and the President signs on.