TaxAction Analysis™

Fourth Quarter 1999

Economic Scorecard

A Quarterly Publication of the Institute for Policy Innovation

Different This Time?

High Tax Burden Could End the Boom, as it Did in the 1960s

The twentieth century came to a close with the U.S. economy firing on all cylinders. Real gross domestic product increased by 5.8 percent during the last three months of 1999, bettering the 5.7 percent advance of the third quarter. For the year as a whole, the economy grew by 4 percent. This strong finish virtually assures that the current recovery, which began in March 1991, is now the longest in history.

Record levels of consumer confidence boosted Christmas sales. Personal consumption expenditures, which account for two-thirds of the economy, increased by 5.3 percent, after inflation, for both the fourth quarter and 1999 as a whole. [Table 1a shows the growth in the major components of real GDP.]

Business investment was up 8.4 percent over the third quarter, thanks to a 72 percent increase in inventories. A potential trouble spot was fixed investment which increased by only 1.6 percent in the fourth quarter compared to 6.8 percent in the third. Two-thirds of the slowdown occurred in transportation equipment, a likely result of higher oil prices, and the rest in computers and communication equipment probably related to Y2K.

The federal government went on a spending spree in the fourth quarter. Defense purchases increased by 18.9 percent and nondefense by 11.1 percent. Combined with the more restrained 4.4 percent rise in states and localities, government purchases increased by 8.4 percent over the third quarter. For 1999 as a whole, government purchases almost kept pace with economic growth.

The gap between exports and imports widened in the fourth quarter. While American goods sold overseas increased by 6.8 percent, foreign goods purchased at home jumped by 10.6 percent. For all of 1999, the current account deficit stood at $324.5 billion compared to $215.1 billion in 1998.

Based just on the two stalwarts of growth—consumption and fixed private investment—the economy advanced by 4.5 percent in the fourth quarter. The build up in inventories and the jump in government spending raised the growth rate to 6.3 percent while the trade deficit knocked it back down to 5.8 percent. [See Table 1b.]

Putting somewhat of a damper on this strong performance was a 2 percent increase in the GDP price deflator. That, along with rises in the closely-watched Employment Cost Index and the prices-paid component of the Purchasing Manager's Index re-ignited concerns over inflation, prompting the Federal Reserve to raise interest rates by 25 basis points at its February meeting.

THE SCORECARD THIS QUARTER

	FY 2001 Budget Forecast		Actual	Comments
	OMB	CBO		
Federal Government Performance (Amounts are in $billions)				
Surplus(+)/Deficit(-)	167.0	176.0	-20.6	Forecast is for FY2000: actual is Oct to Dec 1999
Spending	468.4	462.9	464.2	Forecast is pro-rated for Oct to Dec 1999 based on average patterns of receipts & outgo over last 3 yrs.
Revenue	436.4	449.8	443.6	
Individual	203.7	202.3	215.5	
Corporate	48.8	47.9	48.8	
Social Security/Medicare	142.9	143.5	141.3	Actual is Oct to Dec 1999
Current Economic Conditions				
Nominal GDP ($bil)	8,833	8,846	9,248	Forecast and actual are CY 1999
Economic Growth	2.4%	2.3%	4.0%	
New Jobs	n.a.	n.a	242,833	Average number created monthly since Jan 1999.
Federal Employment - Non defense	n.a.	n.a	2,012,300	As of Nov 1999.
			-51,000	Change from Nov 1998.
Federal Employment - Defense	n.a.	n.a	629,700	As of Nov 1999.
			-24,000	Change from Nov 1998.
Total Employment	n.a.	n.a	130.3 mil	Nonfarm, self-employed, military.
Consumer Confidence	n.a.	n.a	14.5%	Jan 2000 over Jan 1999.
Long-term Economic Growth				
Rates on 10-year Treasury notes	4.9%	5.3%	5.7%	Forecast and actual are CY 1999
Inflation (CPI)	2.1%	n.a.	2.7%	Actual is Dec 1999 over Dec 1998.
Net Investment as a % of GDP	n.a.	n.a.	4.7%	Actual is CY 1999
Standard & Poor 500 Stock Index	n.a.	n.a.	-5.02%	Total return (price + reinvested dividends) for Jan 2000.
			10.35%	Total return Jan 1999 over Jan 2000.

Table 1a

CHANGE IN REAL GDP COMPONENTS, 4th QUARTER 1999

Basic data come from the Commerce Departments National Income and Product Accounts, Tables 1.02 and 7.04 released on 1/28/00.

[1] Annualized rates of change

* Not applicable.

CHANGE IN REAL GDP COMPONENTS, 4th QUARTER 1999

	(billions of chained (1996) dollars)					Percent Change from:		
	1998:4	1999:3	1999:4	1998	1999	1999:3 to 1999:4	1998:4 to 1999:4	1999 over 1998
Gross domestic product	**8,659.2**	**8,900.6**	**9,026.9**	**8,516.3**	**8,861.0**	**5.8%**	**4.2%**	**4.0%**
Personal consumption expenditures	**5,795.8**	**6,033.3**	**6,111.2**	**5,698.6**	**5,998.7**	**5.3%**	**5.4%**	**5.3%**
Gross private domestic investment	**1,593.9**	**1,651.6**	**1,685.4**	**1,547.4**	**1,636.2**	**8.4%**	**5.7%**	**5.7%**
Fixed investment	1,522.5	1,607.3	1,613.5	1,471.8	1,589.4	1.6%	6.0%	8.0%
Change in business inventories	70.7	38.0	65.4	74.3	41.9	*	*	*
Net exports of goods and services	**(232.3)**	**(338.2)**	**(356.1)**	**(215.1)**	**(324.5)**	**22.9%**	**53.3%**	**50.9%**
Exports	1,030.8	1,054.8	1,072.4	1,007.1	1,042.5	6.8%	4.0%	3.5%
Imports	1,263.1	1,393.0	1,428.6	1,222.2	1,367.0	10.6%	13.1%	11.8%
Government purchases	**1,495.9**	**1,536.5**	**1,567.7**	**1,480.3**	**1,534.6**	**8.4%**	**4.8%**	**3.7%**
Federal	532.0	539.7	560.1	526.1	541.3	16.0%	5.3%	2.9%
National defense	344.9	348.3	363.7	341.7	348.1	18.9%	5.5%	1.9%
Nondefense	187.1	191.3	196.4	184.4	193.1	11.1%	5.0%	4.7%
State and local	963.6	996.6	1,007.5	953.9	993.0	4.4%	4.6%	4.1%
Implicit price deflator	**103.3**	**104.5**	**105.0**	**102.9**	**104.4**	**2.0%**	**1.6%**	**1.5%**

Table 1b

Contribution of GDP Components to Growth, 1999

*Annualized rate of change from 3rd quarter

Contribution of GDP Components to Growth, 1999

	4th Q*	1999
Consumption + Fixed Investment	4.5%	5.8%
Plus		
Inventory	5.9%	5.4%
Government Purchases	6.3%	5.1%
Net Exports + Residual = GDP	5.8%	4.0%

Economic Recovery Now Longest in History

Lingering worries over inflation and whether the Federal Reserve has more interest-rate hikes in store aside, the economic recovery which began in March 1991 is now the longest in history. Although official confirmation won't come until the Commerce Department reports on first-quarter GDP at the end of April, the sheer momentum with which the economy finished 1999, along with the 387,000 jobs added in January, assures at least one more quarter of positive growth. That means February marks the 107th month of economic expansion, surpassing the 1960s boom which lasted from February 1961 through December 1969.

But can the current expansion last much longer? Are there parallels between the late 1960s and today? To help answer these questions, this issue of the **Economic Scorecard** compares the performance of a number of economic indicators during the two recoveries.

Real GDP

As pointed out in previous **Scorecards**, the current recovery has been less robust than earlier ones. Typically expansions start out with a bang and then taper off. In the 1960s, the economy powered ahead by 7.5 percent in the first year and then slowed to 2 percent after eight years. Reversing this pattern, the 1990s started off slowly at 2.7 percent and gradually built up a head of steam, growing at a 4 percent clip the last several years.

Because the strongest growth has come later rather than sooner, the current recovery has not been able to take full advantage of compounding. As a result, real GDP today is 36.4 percent higher than in March 1991 where the advance during the 1960s reached over 50 percent. [See Figure 1 and Table 2.]

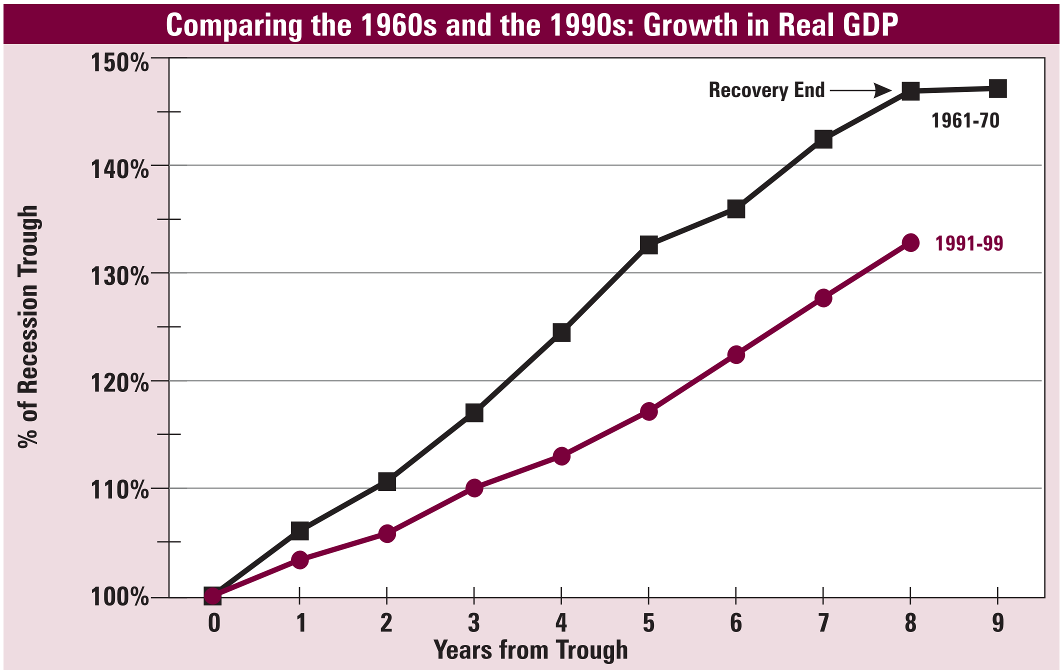


Figure 1

Comparing the 1960s and the 1990s: Growth in Real GDP

Inflation

Inflation exhibits a similar pattern reversal. At the start of the 1960s, prices, as measured by the implicit GDP deflator, were rising by only 1 to 1.5 percent a year. By the end of the decade, the annual rate of inflation had ratcheted up to almost 5 percent. In contrast, during the 1990s, inflation which began around 3.5 percent has decelerated to 1.5 percent. [See Figure 2 and Table 2.]

Comparing Recoveries of 1960s and 1990s: Summary of Various Economic Indicators

	1960s	1990s
Real GDP growth		
1st year of expansion[1]	7.5%	2.7%
8th year of expansion[1]	2.0%	4.2%
Increase from start[2]	52.6%	36.4%
Inflation		
1st year of expansion[3]	1.1%	3.4%
8th year of expansion[3]	4.8%	1.5%
Increase from start[2]	22.9%	16.3%
Investment		
1st year of expansion[3]	3.0%	0.9%
8th year of expansion[3]	4.8%	4.7%
Stock Market		
Increase from start[2]	46.5%	291.6%
8th year of expansion[4]	-14.4%	19.5%
Employment		
Increase from start[2]	29.9%	17.6%
Average annual new jobs (thous)	2,050	2,544
Average Tax Rates[5]		
Start of expansion	30.7%	34.8%
8th year of expansion	34.4%	37.1%
%Change in tax rate	12.2%	6.5%
Marginal Tax Rates[6]		
Start of expansion	55.8%	48.3%
8th year of expansion[7]	59.6%	56.4%
%Change in tax rate	6.8%	16.8%

Table 2

Comparing Recoveries of 1960s and 1990s: Summary of Various Economic Indicators

1 4th quarter over 4th quarter.

2 Cumulative percent change from start of recovery

3 Annual rate of change.

4 December over December

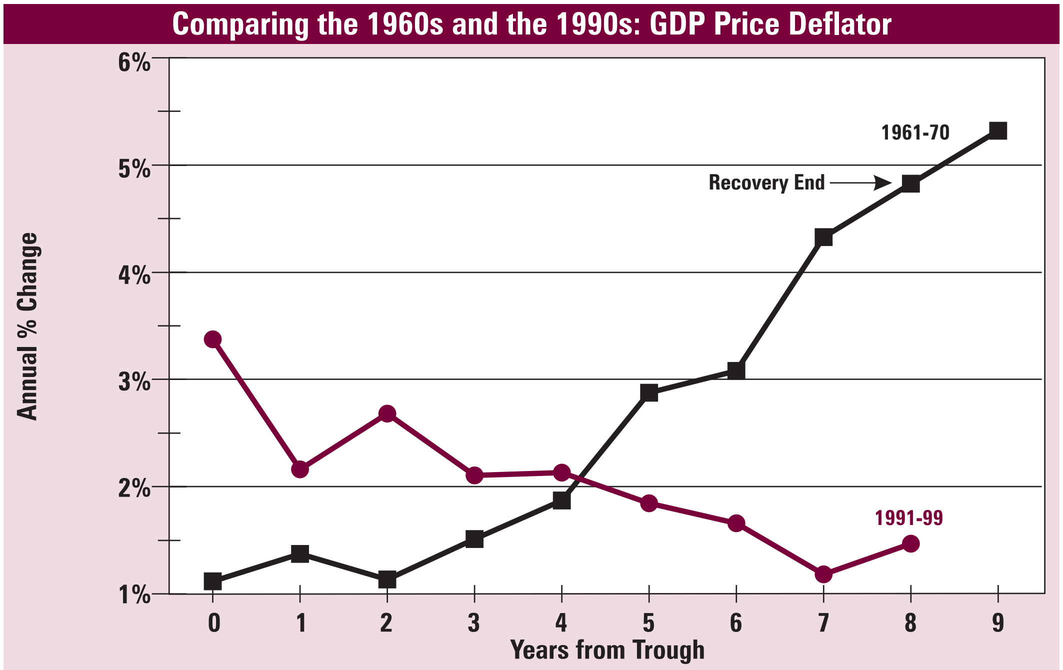
5 Federal, state and local taxes as a percent of national income

6 Federal, state and local taxes on the next dollar of private business output. Preliminary results from a forthcoming IPI study.

7 Data available only through 1997.

Figure 2

Comparing the 1960s and the 1990s: GDP Price Deflator



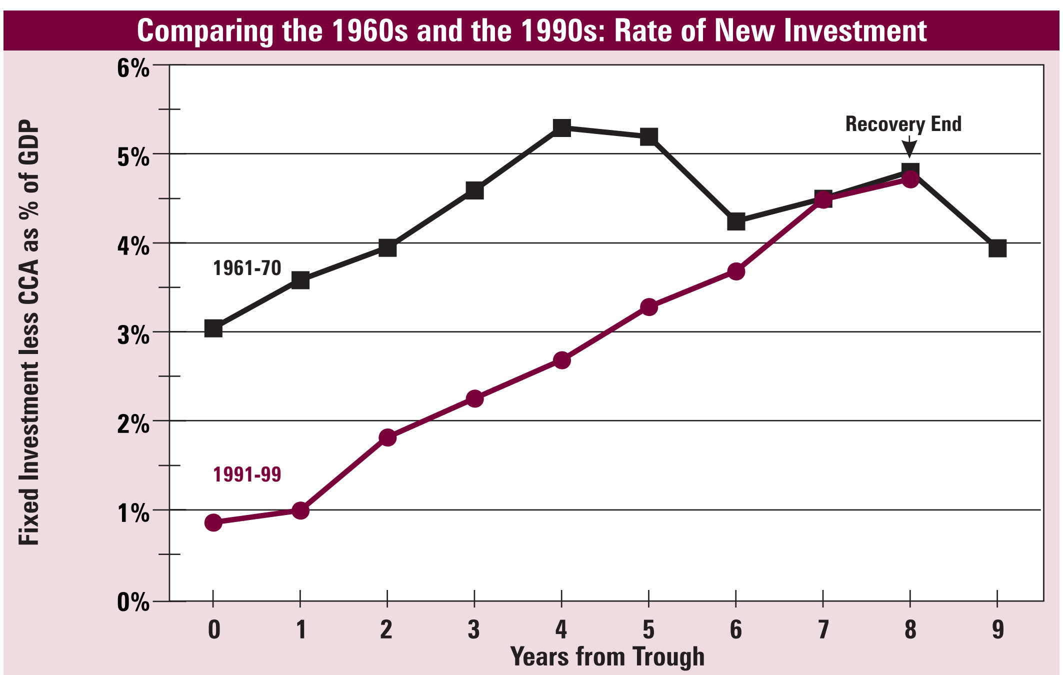
These results fly in the face of conventional wisdom which holds that strong growth inevitably leads to higher inflation. In both cases, periods of strongest growth were associated with lower inflation and periods of weakest growth were associated with higher inflation.

Investment

For an economy to continue expanding, it must keep adding to the stock of machines, buildings, equipment and other capital. Slowdowns in investment generally precede economic downturns. During the 1960s the rate of new investment (fixed investment less depreciation as a percent of GDP) peaked at 5.3 percent in 1965 and dropped to 4.2 percent in 1967. After a temporary rise, it fell back to 3.9 percent as the economy went into recession. [See Figure 3 and Table 2.]

Figure 3

Comparing the 1960s and the 1990s: Rate of New Investment



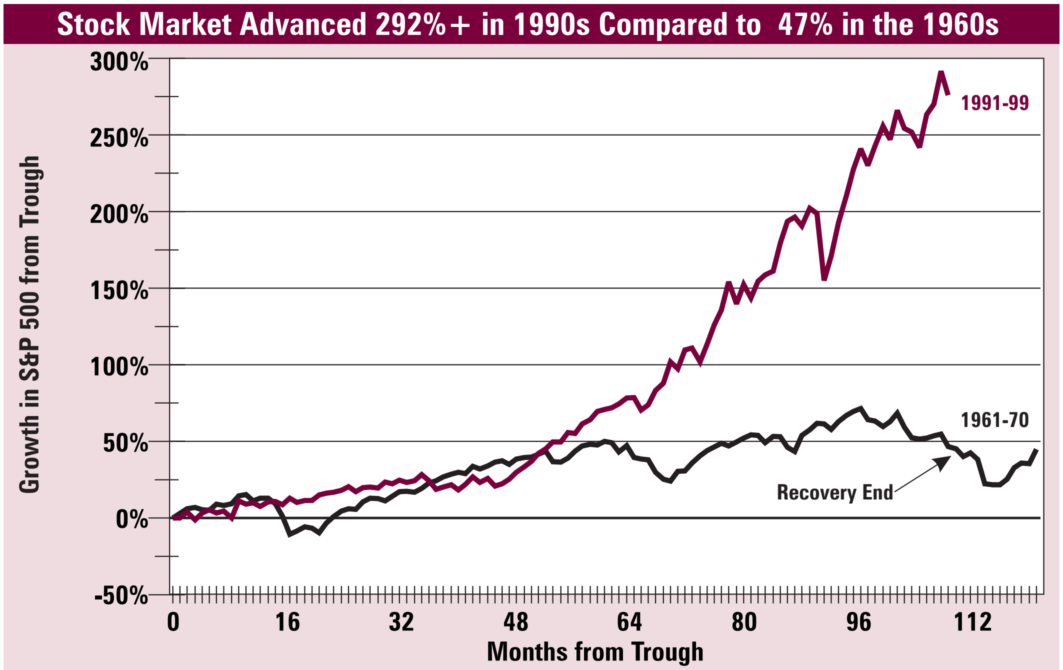


Figure 4

Stock Market Advanced 292%+ in 1990s Compared to 47% in the 1960s

While starting out considerably below the 1960s, the rate of new investment during the current expansion continues to accelerate, rising from 0.9 percent in 1991 to 4.7 percent last year. This strength in investment means that this expansion most likely is not yet ready to end.

Stock Market

Wall Street's heady performance of late has prompted talk about "speculative bubbles," particularly in the technology sector, and some have warned of parallels with the late 1960s. After reaching its peak during December 1968, the stock market began correcting. A year later, when the recovery came to an end, the S&P 500 was 15 percent lower and was not able to take out the previous high until February 1972. [See Figures 4 and 5 and Table 2.]

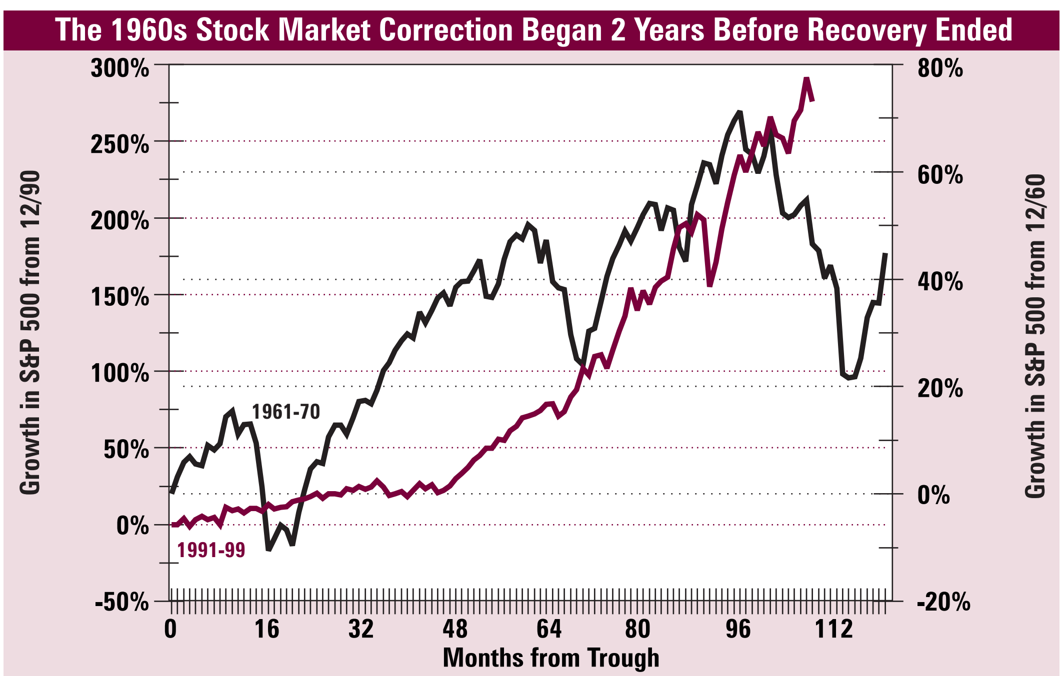


Figure 5

The 1960s Stock Market Correction Began 2 Years Before Recovery Ended

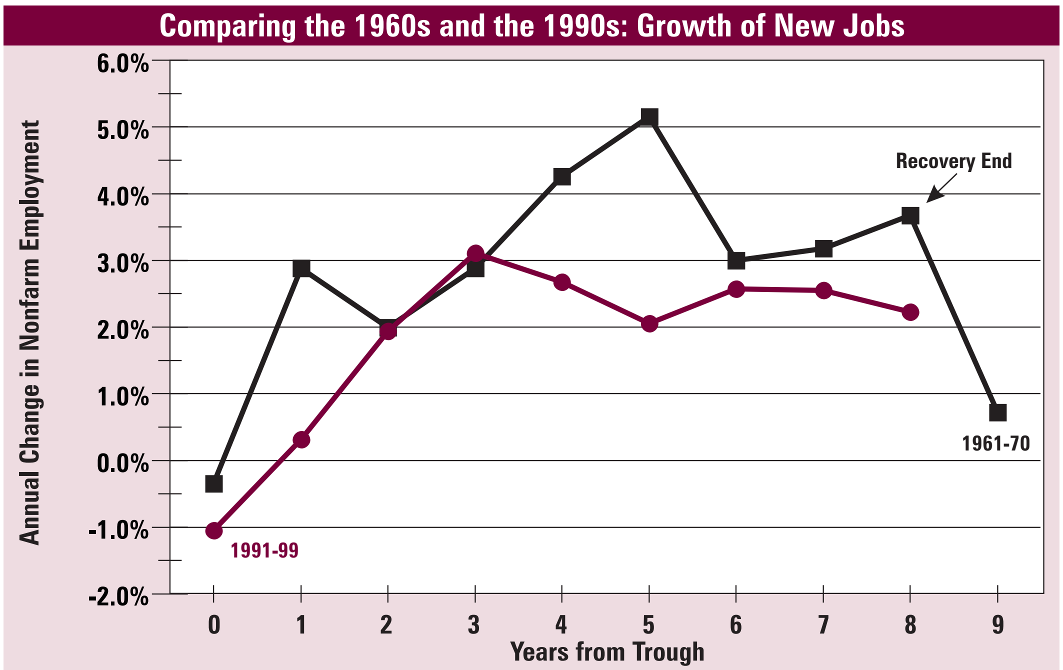
Concerns over excess speculation may be valid, especially in view of the market's spectacular growth the past few years. The 345 percent increase in the S&P 500 during the 1990s beats the 60 percent advance of the 1960s five times over. But what is not yet in evidence is a prolonged market correction like the one that started a year before the 1960s expansion came to an end. Like investment, the stock market is a leading economic indicator. Asset prices usually head south well before the economy shows other visible signs of slowing. As long as the stock market continues to move higher, the current expansion should continue.

Jobs

The economy of the 1960s added over two million new jobs a year. By 1969, employment had increased by 30 percent. Job creation in the current expansion has not been quite as strong. Although creating an average 2.5 million new jobs each year, the economy is larger than it was thirty years ago. As a result, employment increased by only 17.6 percent between 1991 and 1999. Job creation during this expansion has been far steadier, however, with annual employment expanding between 2 and 3 percentage points for the last six years. [See Figure 6 and Table 2.]

Figure 6

Comparing the 1960s and the 1990s: Growth of New Jobs



Tax Rates

The final comparison looks at tax burdens between the 1960s and 1990s. Thanks in large part to bigger state and local governments and the expansion of entitlements like social security and medicare, taxes at all levels of government take a larger bite out of national income today (37.1%) than they did during the 1960s.

While marginal tax rates were lower at the start of the recovery, they too are trending higher. In 1997, federal, state and local taxes claimed 56.4 cents out of the next dollar of output produced by private businesses, up from 48.3 cents in 1991.

One of the factors that led to the demise of the 1960s recovery was the surtax put on in 1968 to help fight two wars—Vietnam and poverty. The resulting increases in average and marginal tax rates coupled with loose monetary policy helped end the boom of the 1960s and laid the groundwork for stagflation. Likewise, ever-higher tax rates could just as easily squeeze off the current expansion. [See Figures 7 and 8 and Table 2.]

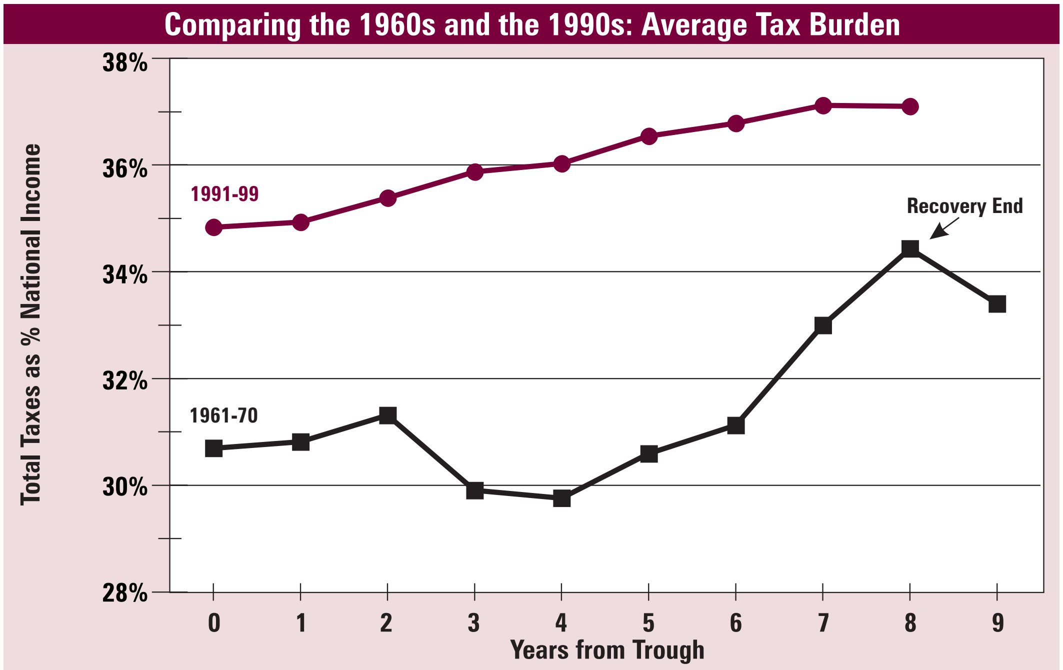


Figure 7

Comparing the 1960s and the 1990s: Average Tax Burden

In sum, from the evidence presented here, the longest expansion in history still seems to be going strong. Productivity gains from robust investment, particularly in computers and other information-age technology, have kept corporate profits growing and made non-inflationary wage gains possible, even in supposedly tight labor markets. All of these factors have helped fuel the stock market.

But, the weak performance of fixed investment in the fourth quarter noted earlier and the choppy start of the year for the stock market (the S&P 500 finished January down 5 percent) bear close watching. Persistent weakness in these leading economic indicators would mean that businesses no longer wish to expand in the U.S. Rising marginal tax rates is the one factor reducing U.S. attractiveness as a place to invest. The best way to avert a premature end to the recovery would be to cut taxes on saving and investment.

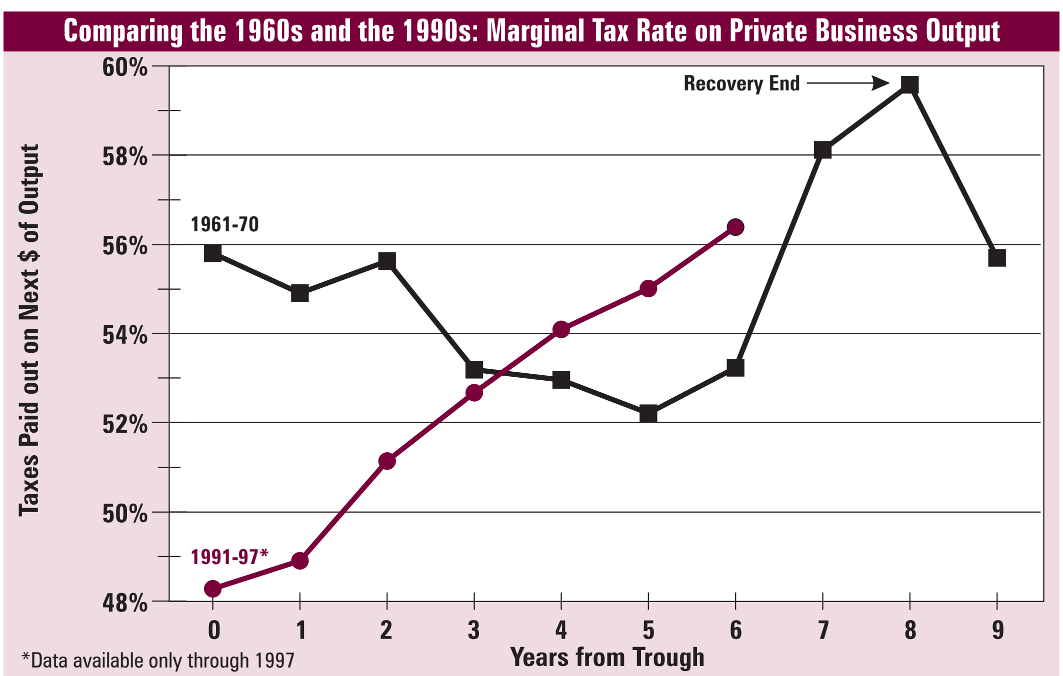


Figure 8

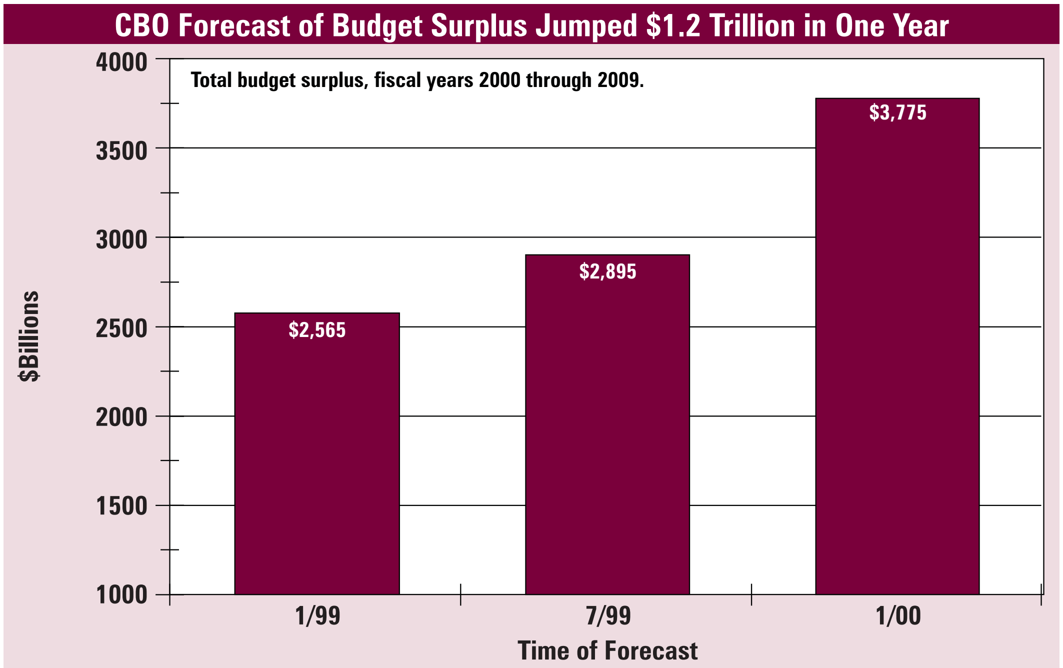
Comparing the 1960s and the 1990s: Marginal Tax Rate on Private Business Output

CBO Ups Its Forecast of Federal Surpluses

Thanks largely to a booming economy, the federal government's black ink keeps mounting. In its January *Budget and Economic Outlook,* the Congressional Budget Office (CBO) forecasts budget surpluses mounting to almost $3.8 trillion between 2000 and 2009. That is 30 percent higher than July's forecast of $2.9 trillion and 47 percent higher than last January's. Three-fourths of the difference is due to an upward revision in forecasts of federal tax revenues. [See Figure 9.]

Figure 9

CBO Forecast of Budget Surplus Jumped $1.2 Trillion in One Year



Conclusions

In February, the expansion that began in March 1991 entered its 107th month, surpassing that of the 1960s to become the longest in history. A healthy rate of investment, particularly in technology, low inflation and high productivity have been the driving forces behind a recovery whose persistence and strength has repeatedly surprised forecasters and analysts. But the economic good times should not lull the public and policy makers into complacency. What must be remembered is that, just as in the 1960s, higher inflation from wrong-headed monetary policy or ever-increasing marginal tax rates that lower returns to workers and investors could again bring the now-longest expansion abruptly to an end.

TaxAction Analysis™

Economic Scorecard

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