THE ECONOMIC SITUATION
A Quarterly Commentary

Bruce Yandle
Distinguished Adjunct Professor of Economics, Mercatus Center at
George Mason University,
Dean Emeritus, College of Business & Behavioral Science, Clemson University
yandle@bellsouth.net

We encourage distribution of the report to others. The reports, current and past, are posted at http://sti.clemson.edu/esr. To add your name to the report email list or to have it removed, please contact economic_situation-l-subscribe@strom.clemson.edu.

Note: Cartoonist Robert Arial generously allows his cartoons to be used in the Economic Situation report.

June 2013

- **The Mid-year economy**
- **What about manufacturing? Reshoring?**
- **Measure twice, cut once, and the continuing tax rate debate.**
- **Does the IRS target based on politics? Some evidence.**
- **South Carolina Digest**

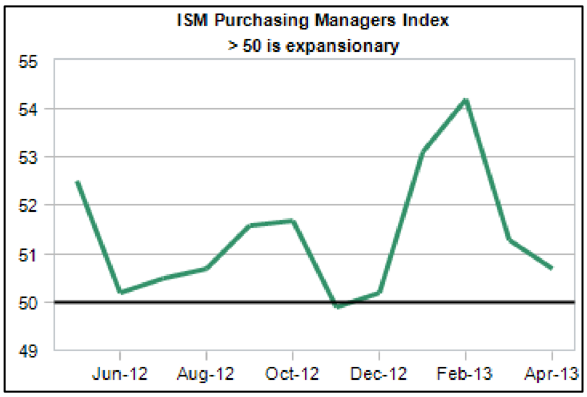
The Mid-year Economy

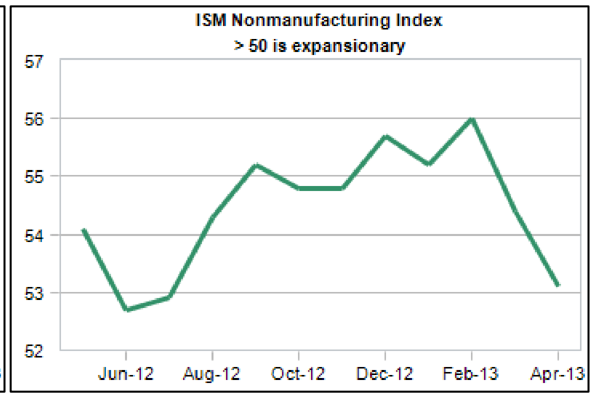
The U.S. economy is creating new wealth and growing employment, albeit at a slow pace, but uncertainty is the key word that describes the situation at mid-2013. Advanced estimates for 1Q2013 growth came in at 2.5%, but more current data, discussed below, show much slower growth. There are major unknowns with respect to Fed policy, taxing and spending, the effects of Obamacare on employment, the implementation of Dodd-Frank financial reform, regulatory policy affecting the production of electricity, and the prospects for Europe's recovery from an extended recession. Added to this pallid picture, reductions in growth in China, India, and the developing world are taking some of the edge off the global boom, which in spite of that growth haircut is still tugging away on America's export growth.

With the closing of the books on the 2012 economy, real GDP growth registered 2.2%. The 2012 overall picture now suggests we will be lucky to break 2.0% in 2013 and a bit more in 2014. This compares with the results of the Federal Reserve Bank of Philadelphia's Livingston Survey in December 2012, which predicted 2.1% growth in 2013's first half and 2.3% in the second half of the year. It will be a while before Livingston speaks again, but right now, Economy.com's dynamic GDP growth meter indicates the economy is expanding at 1.8%.

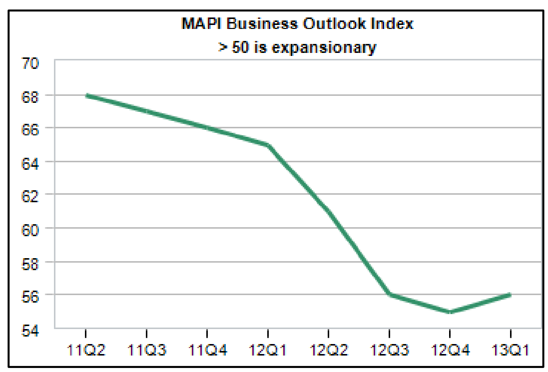
As Goldilocks might put it. "It's not just right." Not by a long shot.

We can see images of the slowdown in the Institute of Supply Management's indexes for the manufacturing and nonmanufacturing (services) economies shown in the next panel. Both indexes are headed south of the border. Recall 50 is the magic number that coincides with zero growth.





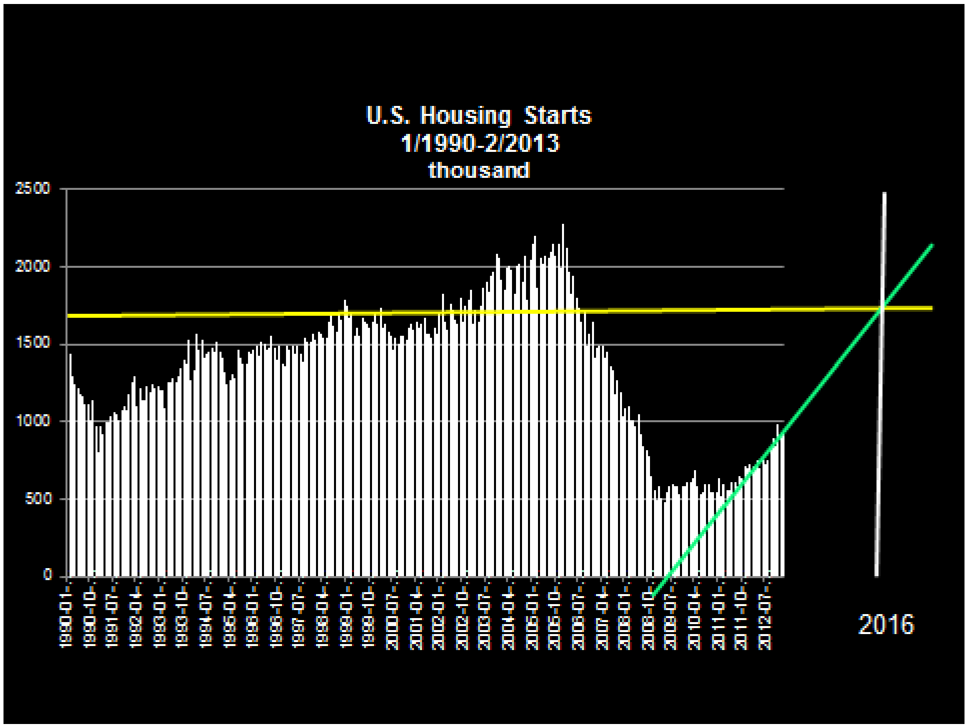
But there is a bit of hope seen in the MAPI business outlook index. As shown here, it took a swoon in late 2012 but is now pointed north, barely. This reflects the expected output effects associated with new capital investments and improvements. Again, 50 is the neutral point for the MAPI index. Right now, the index rests in positive territory.



So we are on a bumpy slow growth highway, but there is growth. As a result, several major economic sectors have fully recovered from the Great Recession demise. These include manufacturing, retail sales, machinery wholesalers, and Federal revenues.

Housing in recovery

Housing is the key sector still in recovery, but out of intensive care.
I show housing start data in the next chart. The yellow horizontal line marks 1.6 million annual starts, the longer term norm. As shown, if the current trend continues apace, and I believe it will, housing will recover to the norm by around 2016.

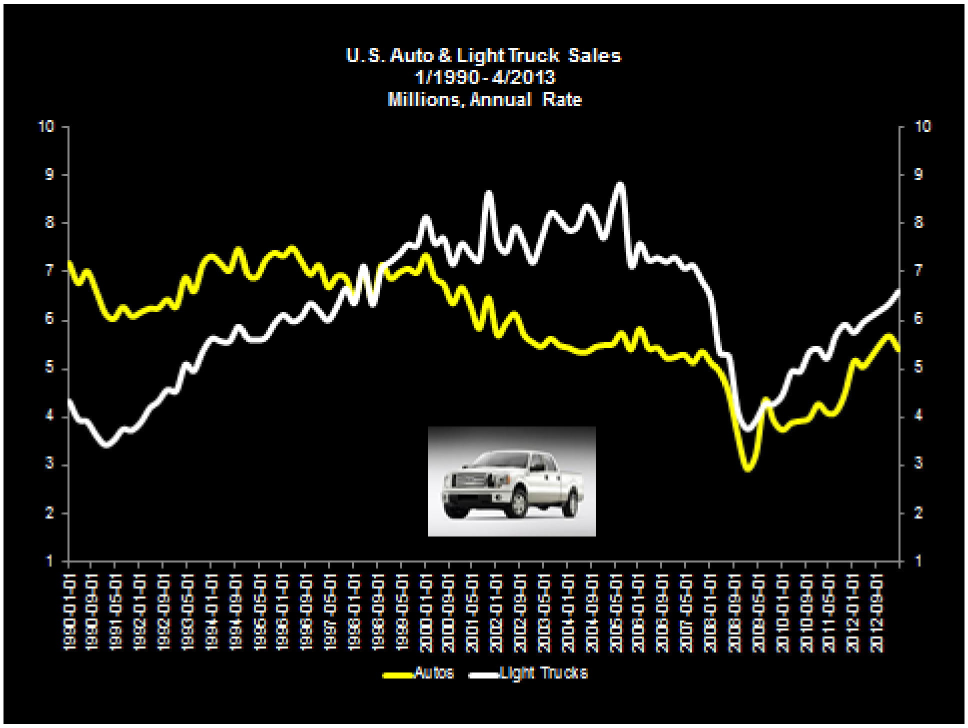


Pick-ups are picking up

Always looking for real indicators of progress, I love to pull into one of those mega filling stations early in the morning when lots of vehicles, especially pick-up trucks are filling up for the day. Powered by the housing recovery, these are real people, doing real work, for other real people. Carpenters. Painters. Dry wall installers. Heating and air conditioning folk. But here's the good news. The number of trucks seen on site is growing. And the trucks are getting newer.

Inspired by this, I created a pick-up truck economic indicator. Here you see a time series for autos mapped with a series for light trucks. Look at the most recent observations: pick-ups are outpacing autos. Yes, there is lot going on behind these numbers, but there's also a lot going on in the numbers themselves.

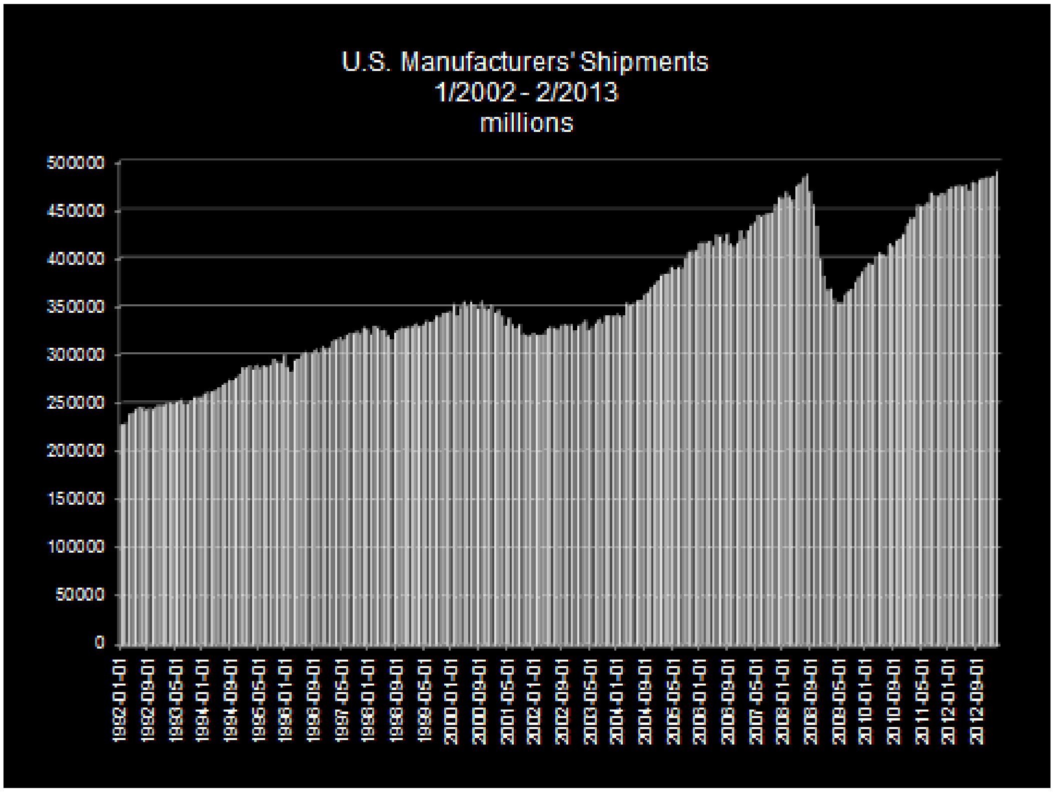
America is building again. Things are getting better.



What’s Happening in Manufacturing?

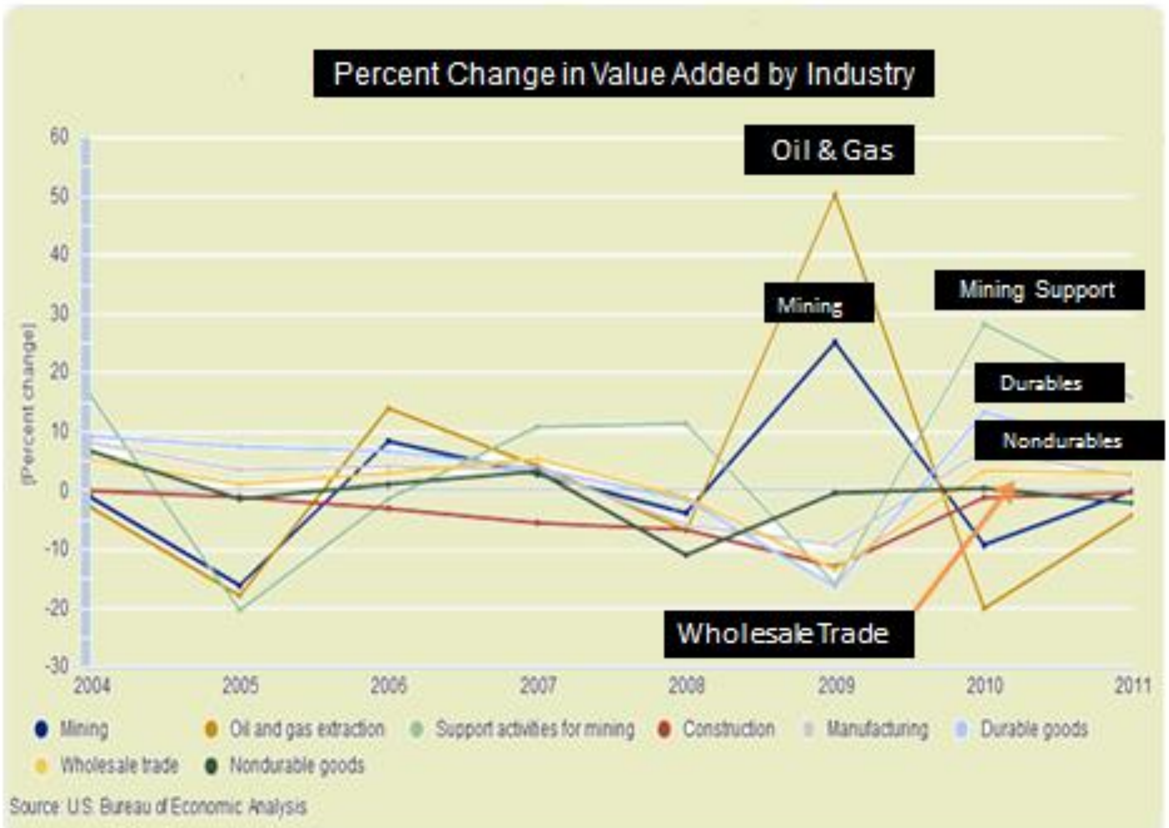
U.S. manufacturing was the locomotive that pulled the country out of the Great Recession. And within manufacturing, auto production was the lead engine. With the recession still visible in the rearview mirror, what can say has happened? Is manufacturing still hot? Is there enough “reshoring” of production from abroad to see the return in data?

Consider some data. The next chart shows the nominal value of all manufacturers’ shipments for 1990 through February 2013. Here we see a fully recovered sector. The current level of shipments just barely exceeds the 2008 peak. And while the growth pace has slowed since 2011, the slope of the earlier part of the 2009-2012 recovery is steeper than its 2004-2007 counterpart. Put another way, manufacturing was really hot in 2010-11, but cooled more than a bit with Europe’s slowdown in 2012.



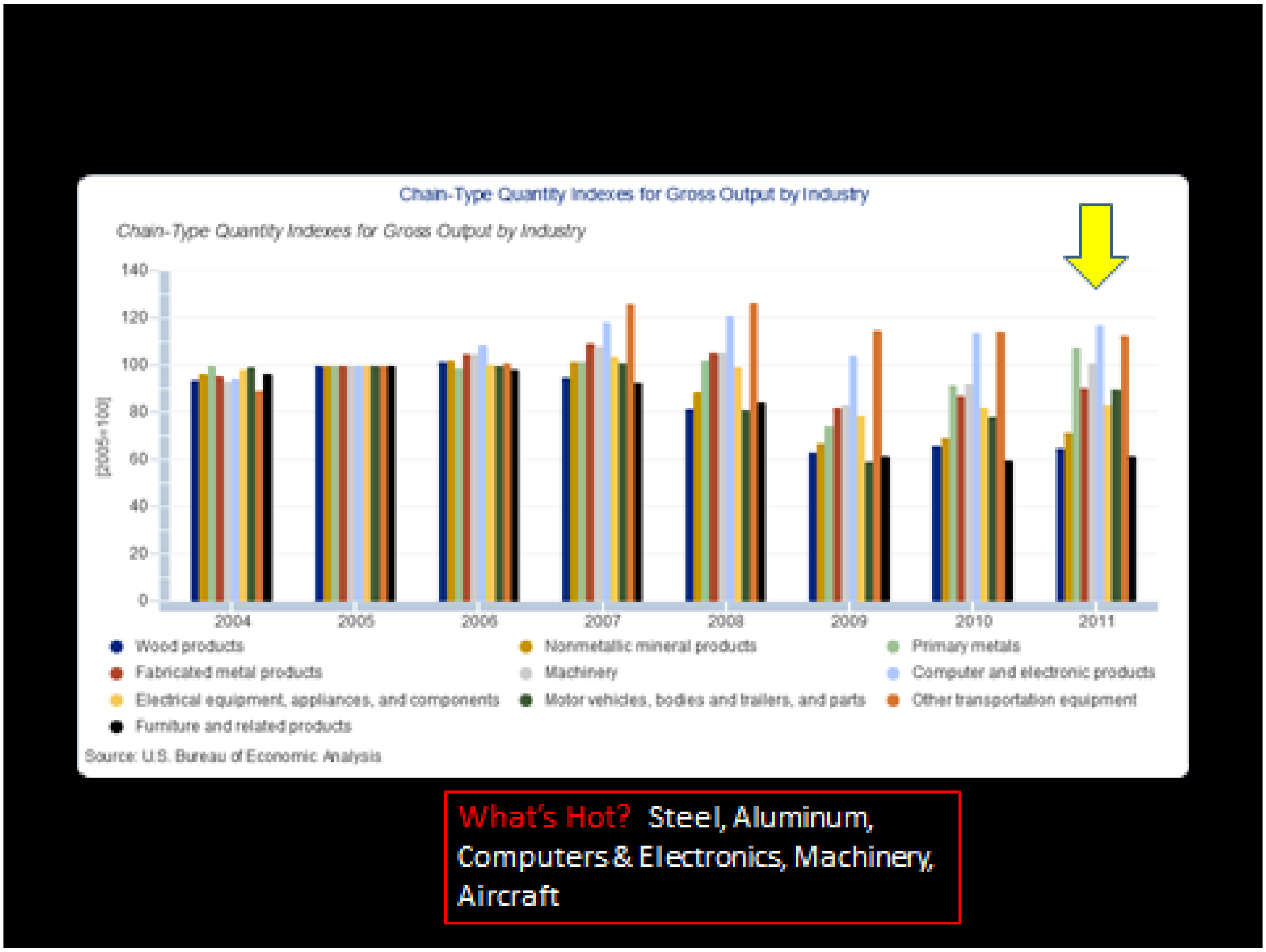
Looking inside the box

When we open the manufacturing box and examine the contents, we can begin to identify which sectors seemed to have the most wind in their sails. I do this in the next chart, which reports growth in value added for some sectors from 2004 through 2011.



The boom in oil and gas and related industries is clearly seen here. We also see a mini-boom in durable goods production. Wholesale trade growth follows the manufacturing pattern.

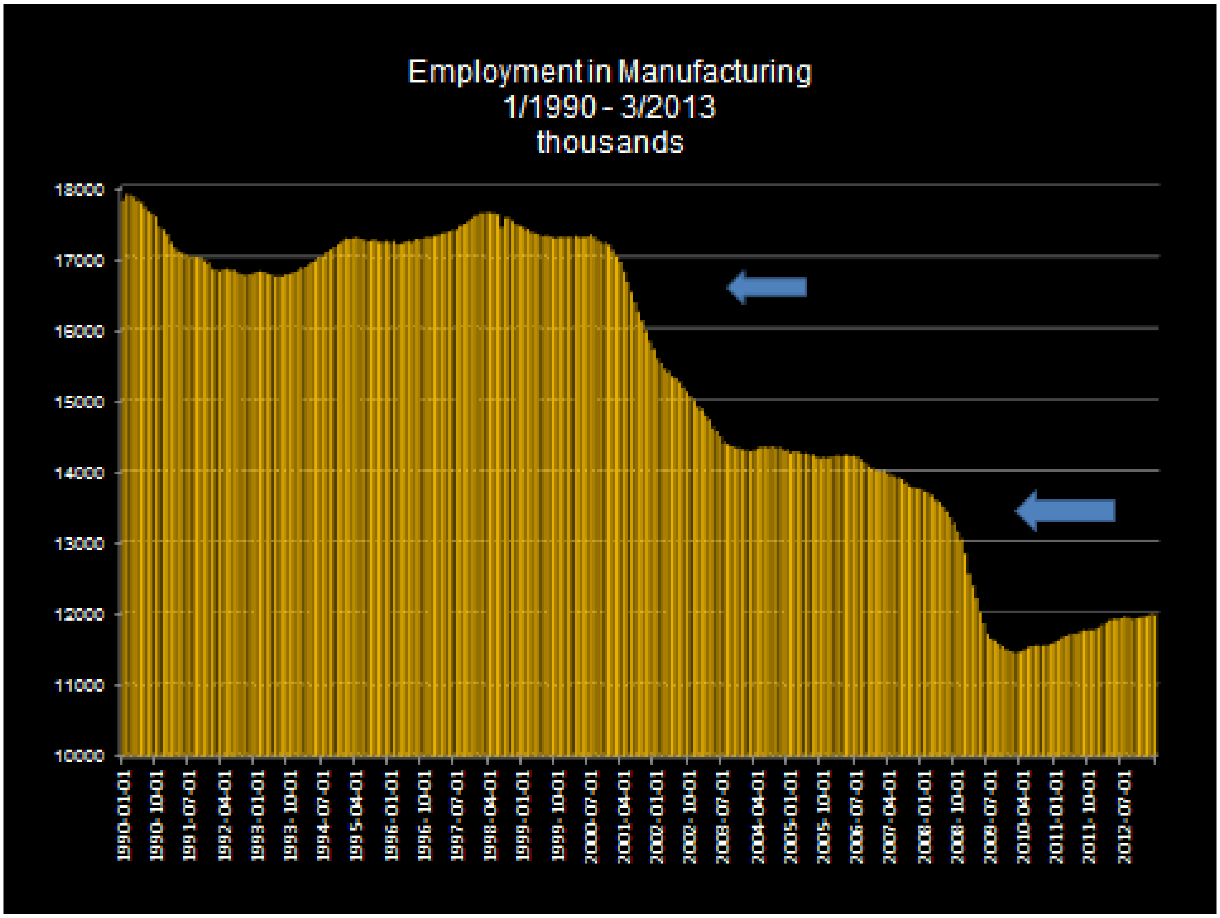
I take a deeper cut by looking inside the durable goods category. The next chart reports a series of indexes where 2005 is equal to 100. With this in mind, the 2011 data suggest that if reshoring is occurring in a meaningful way, we should expect to find it in steel, computers and electronics, machinery, and aircraft. These are the leading growth categories.



But what about employment?

Economic recovery is important, but most people want to know about jobs. If manufacturing has recovered, they say, why don't we see more cars in the parking lots? Generally speaking, when the economy slows down, it is only natural that people in every organization and industry look for ways to become more effective and productive in their work. After all, the name of the game is keeping employed. Within manufacturing, becoming more productive means shuttering obsolete plants, contracting out activities to lower-cost providers, discovering new supply sources, and investing in new automation tools. Taking these actions can lead to a slimmer workforce, higher output, and lower costs.

The next chart on manufacturing employment tells the tale.



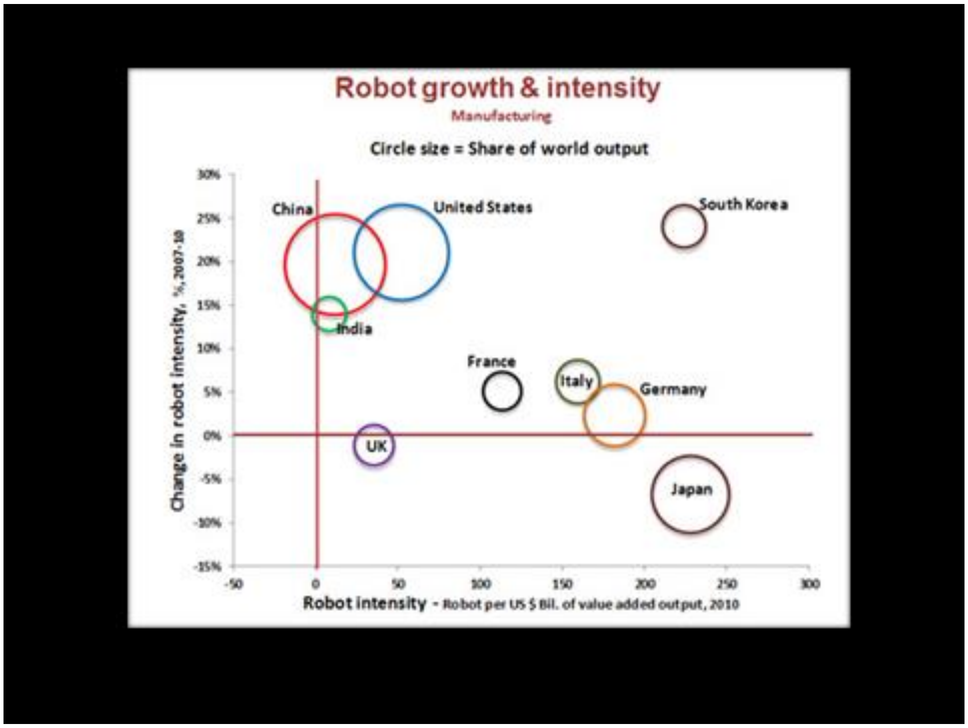
The chart vividly reports the imprint of two recessions, 2001-2002 and 2008-2009. In both cases, there were sharp employment reductions. As can be seen, the level of employment has fallen from around 17 million in 1992 to 12 million in 2013. And, as shown in the earlier chart, manufacturing shipments have risen from $25 billion to $50 billion. Employment has fallen about 30% and production has doubled. That is a huge increase in productivity.

Is there evidence of “reshoring”?

We have only indirect evidence that U.S. manufacturing is getting a new shot in the arm and that production from across the water is coming this way. One last point can be made. Consider the employment chart and the data for the 2010-2012. Employment is increasing. Now look for similar data across the full series. We can see something close in 1995-1998, but not quite as hot. Conclusion? We may be experiencing a bit of manufacturing employment renaissance.

But why is so hard to generate employment growth?

The next and final chart on robot employment provides some insight. In recent years, robots have become cheaper and labor has become more costly; wages are flat, but healthcare and other fringe benefit costs are rising. The chart shows which of several countries are experiencing robot growth. The horizontal axis measures robots per billion of value added in manufacturing. The vertical axis shows change in intensity. As indicated, the U.S. is a high growth robot country, but not as fast paced as South Korea.



Measure Twice, Cut Once and the Continuing Tax Rate Debate

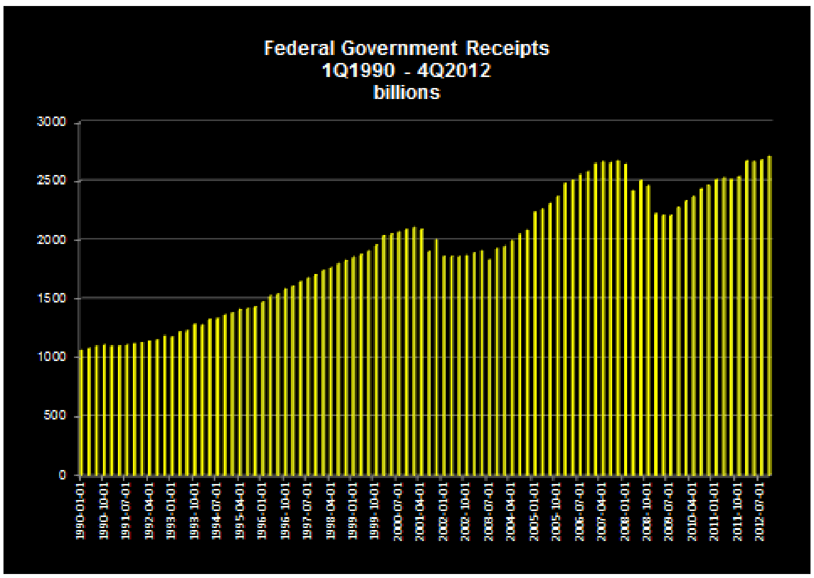
There on the executive's office wall was a framed motto: Measure Twice. Cut Once. He was CEO of a stainless steel fabricating company. Material costs are high. Errors are costly in that business. As I looked at the motto, I couldn't help but think of the many times I had redone a piece of carpentry work for lack of measuring twice. It occurred to me that my motto must be "measure once, cut twice," or even worse, "don't measure at all, and keep on cutting."

So it is with deficits, budgets, sequestration and collective decision making. Some refer to the congressionally imposed sequestration as mindless budget cutting. There was no measuring, just cutting. But now—as when I do carpentry--adjustments are being made. Air flight controllers? Oh yes, we will adjust for that. (Irate business travelers matter to politicians.) White House visits for middle school students? No. Show them the door. (Middle school students apparently don't matter much.) Auctions for off-shore drilling in California waters? No. We can't afford that. (Environmentalists matter a lot.)

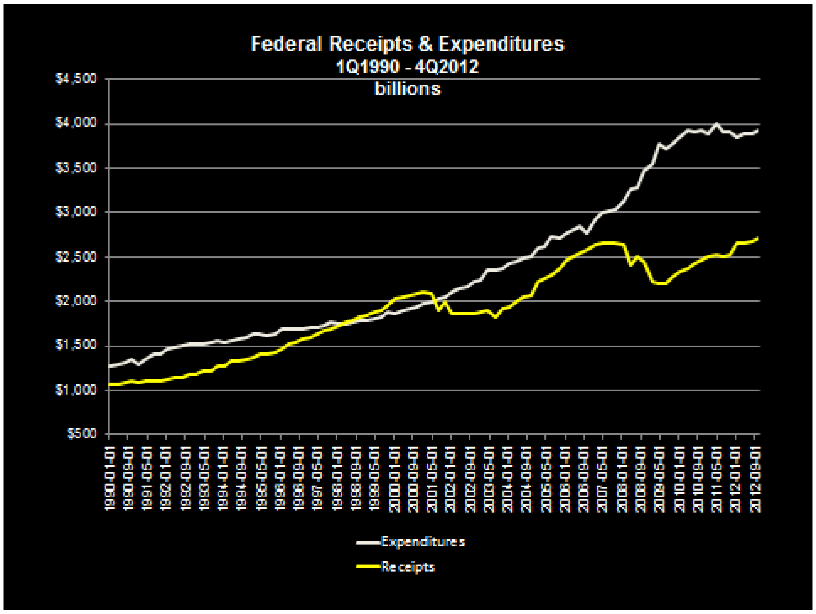
Politics enters at every margin, of course, but adjustments will take place as the people's representatives nip and tuck to provide politically acceptable outcomes.

But let's face it. This is how a democracy does business. We cut and then measure. Even so, for the first time since 2007, the Treasury is actually reducing the size of the federal debt. But before shouting hooray, consider this: The revenue surge comes partly from capital gains taken by taxpayers at the end of 2012 to avoid higher 2013 taxes. But, still, let's not look a gift horse in the mouth.

The good news about reducing the federal debt is supported by evidence that, as shown in the next chart, federal revenues have fully recovered to pre-recession levels.



Now the bad news. Consider the next chart. It shows in nominal terms the level of federal receipts and expenditures for 1Q1990 through 4Q2012. Even with progress being made, there is a yawning gap waiting to be closed.



The Continuing Tax Rate Debate

If the gap is to be closed, there is no doubt but that it will take more revenue and less spending. But when it comes to getting revenue, there is a never ending political debate regarding tax rate fairness and which taxpayer income group, if any, should pay the higher or lower tax rate. (After all, there could be a flat tax.) There is hardly any discussion of revenues, which seems odd to say the least.

But of course, there is reason to be concerned about fairness. People understandably rebel when they perceive they are being treated unfairly by government. (Consider the current IRS controversy.) But if revenues are the chief concern, then how total revenue is collected may be an equally important consideration when politicians talk about taxes.

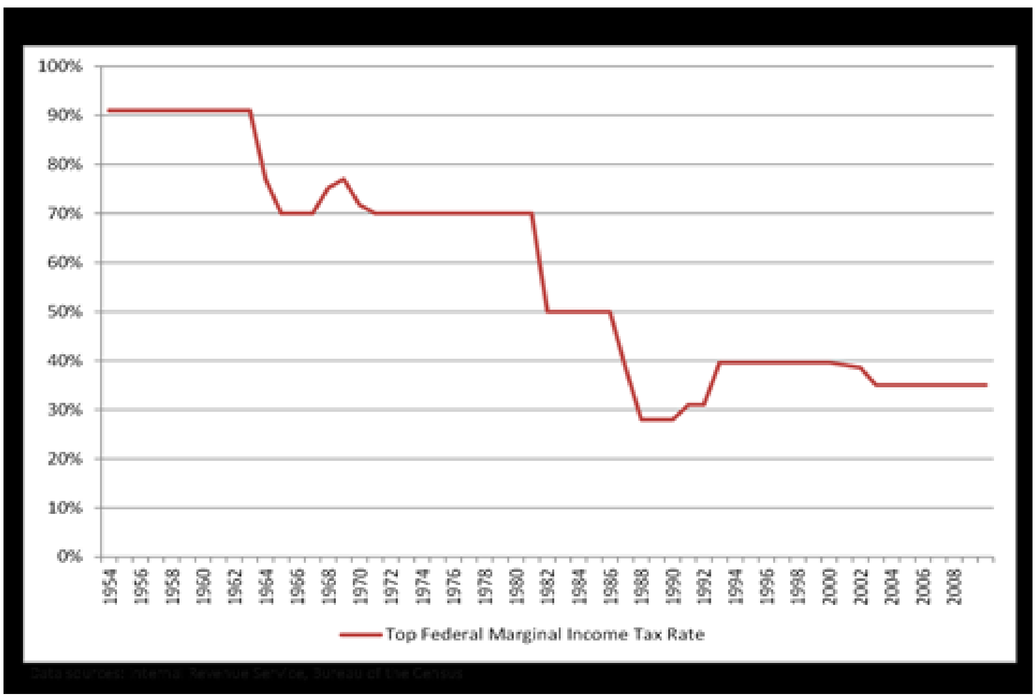
Writing in 1924, treasury secretary Andrew W. Mellon said this about the political manipulation of tax rates:[1]

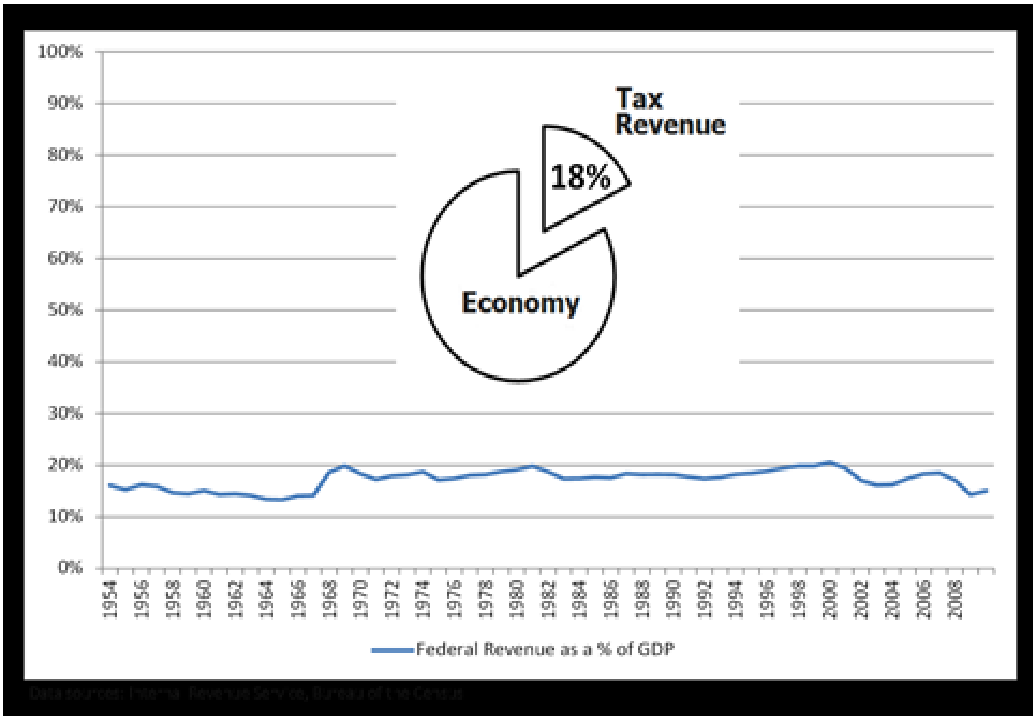
I have never viewed taxation as a means of rewarding one class of taxpayers or punishing another. If such a point of view ever controls our public policy, the traditions of freedom, justice and equality of opportunity, which are the distinguishing characteristics of our American civilization, will have disappeared and in their place we shall have class legislation with all its attendant evils. The man who seeks to perpetuate prejudice and class hatred is doing America an ill service.

[1] Andrew W. Mellon. *Taxation: The Peoples' Business*. New York: The Macmillan Company, 1924: 11.

But why pay attention to the thoughts expressed by Andrew Mellon. Does he have credentials that command attention? Yes, indeed. As Secretary of Treasury during the Harding and Coolidge administrations, Mellon led a successful effort to reduce the size and debt of the federal government. The nation was adjusting to a post-World War I environment, with lots of debt overhang. Sound familiar? His arguments about the relative merits of lower tax rates to produce higher revenues won the day. He literally discovered the basis of what later is celebrated as the Laffer Curve. In all fairness, we should call it the Mellon-Laffer Curve.

For those who may think that higher tax rates bring in more revenue, consider some data provided by Mercatus economist Antony Davies. The next chart reports the highest marginal income tax rate from 1954 through 2010. The chart that follows shows tax revenues as a share of GDP for the same years. There's only so much wool the sheep will give.





The IRS and Political Influence

Recent revelations about the IRS targeting Tea Party affiliated organizations for investigation and slow treatment reminds me of what Public Choice scholars learned long ago. All of government is political. Special interest influence seeps through in unusual but systematic ways. On the IRS specifically, Jim Couch and colleagues at the University of North Alabama published research in 1999 that focused on statistical treatment of IRS audit activities as conditioned by political variables. The 1995 audit data were part of annual summaries for IRS districts reported in the Transactional Records Access Clearinghouse (TRAC) at Syracuse University.

The Couch et al. statistical model explained the frequency of those audits across states. Their explanatory variable included whether or not a state senator sat on the IRS senate oversight committee or a representative sat on the house oversight group, the share of votes cast for President Clinton in 1992, and other variables that are thought to be positively associated with audit activity, such as higher levels of earned income tax credits as proxied by the state poverty rate and gambling income.

A direct quote from and summary of the work and findings are shown below. As indicated by the plus and minus signs over variables, audit rates fall when senators or congressmen sit on IRS oversight committees. They fall when a larger share of a state population voted for Bill Clinton, or rose for those states with a poor Clinton record. More agents in a state and more gambling mean more audits as does a higher share of poverty.

In short, politics seems to matter in explaining IRS audit behavior.

Poitical Influence and the Internal Revenue Service

Jim F. Couch, Keith Atkinson, TommieSingleton, and Pete M. Williams
CATO Journal, 19(Fall 1999): 313-322.

The Mendoza family was both surprised and alarmed when they received notice from the Internal Revenue Service (IRS) that their home would be confiscated if $200 in back taxes were not paid, especially in light of the fact that the family had never experienced an previous tax problems. However, it was Patricia Mendoza who was seen on television shouting insults at President Clinton about the deaths of 19 soldiers in Saudi Arabia; "You stink, and those boys died" (Richmond Times Dispatch 1997). Critics of the Clinton Administration are convinced, and perhaps for good reason, that the Mendoza's tax problems are not coincidental.

$$\text{AUDIT RATE} = f(\overset{+}{\text{POVERTY}},\ \overset{+}{\text{AGENTS}},\ \overset{+}{\text{GAMBLING}},\ \overset{-}{\text{SENATE}},\ \overset{-}{\text{HOUSE}},\ \overset{-}{\text{CLINTON}}).$$

SENATE=ONE if a state's senator is a member of the Senate Taxation and IRS Oversight Committee, zero otherwise.

HOUSE=ONE if a representative within one of the 63 IRS districts is a member of the House Ways & Means Committee.

CLINTON=% of Total Vote in a state cast for Clinton in 1992.

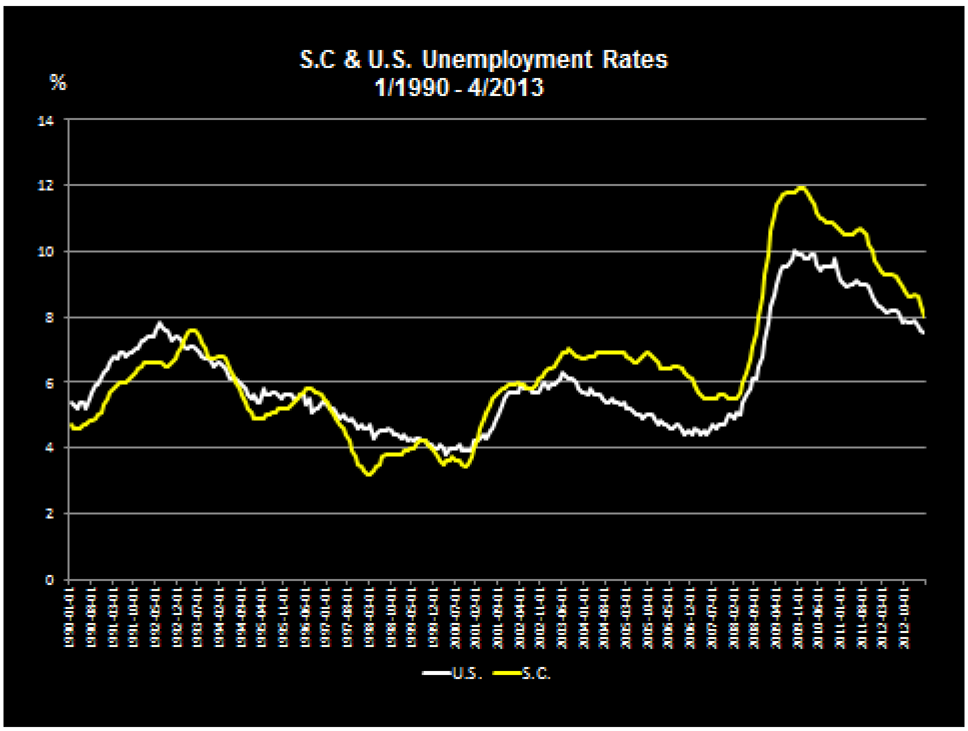
These statistical results parallel others that focused on federal antitrust activity and presidential declarations of national disasters, an action which triggers a flood of federal support.[2] The antitrust study shows that actions are taken less frequently against firms headquartered in the states and districts of congressmen who sit on antitrust agency oversight committees. The national disaster study examined FEMA activity, adjusted for severity of disasters, state population and other variables. The researchers found greater frequency of disaster declarations for politically important states than for others. The authors reported that some 45% of FEMA actions were motivated by politics instead of disaster severity.

These Public Choice findings suggest two things. First, human beings respond to incentives, whether they are supplying houses, food, or politically determined actions. Second, since this is common knowledge, we must take action to reduce occurrences that corrupt the political process. But how? By requiring transparency, regular agency reports that demonstrate choice neutrality, publicity, competition from the loyal opposition and constant vigilance.

[2] See Roger L. Faith, Donald R. Leavens and Robert D. Tollison, Antitrust Pork Barrel, *Journal of Law & Economics* 25(1982): 329-342 and Molly D. Caselao and Thomas A. Garrett. In the Rubble of Disasters, Politicians Find Economic Incentives *The Regional Economist*, Federal Reserve Bank of St. Louis, July 2003: 10-13.

South Carolina Digest

April unemployment numbers brought some good news to South Carolina. The state unemployment rate fell to 8.0%. This was driven by an increase in employment of about 3,000 workers and a labor force decline of about 5,000; there is evidence of encouraged workers—the new hires—and discouraged workers, those who dropped out of the labor force. Putting the two numbers together yields the largest drop in the unemployment rate since 1987. When compared with the national unemployment rate, we can see that the gap between the two rates is closing.

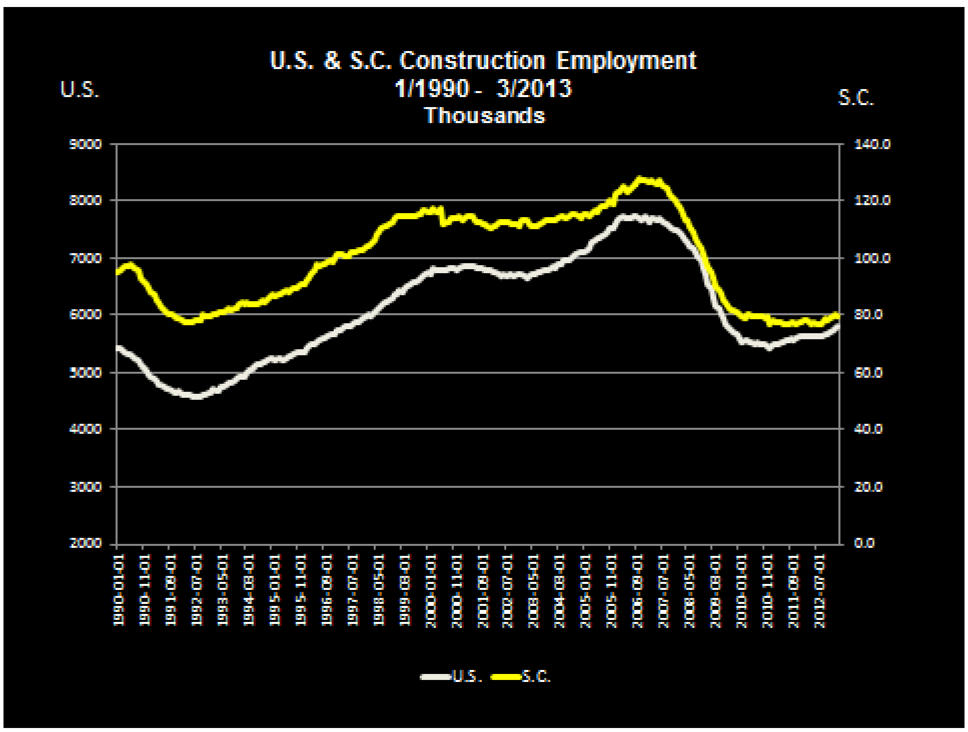


The gap closing suggests that South Carolina's economy is once again performing more like the nation's. As can be seen, the two rates marched together rather closely from 1992 until 2002. At that point, the 1994 North American Free Trade Agreement, which phased out tariffs and quotas on textile products shipped to the United States, and the effects of the collapse of Asian currency values in dollars sent a double whammy to S.C. textile and apparel producers. Unemployment rates jumped in S.C. textile communities as plants were closed permanently. Manufacturing expansions in other industries could not take up the slack, and in many cases, the rapidly growing services economy was unable to absorb highly skilled textile workers who lacked service economy skills.

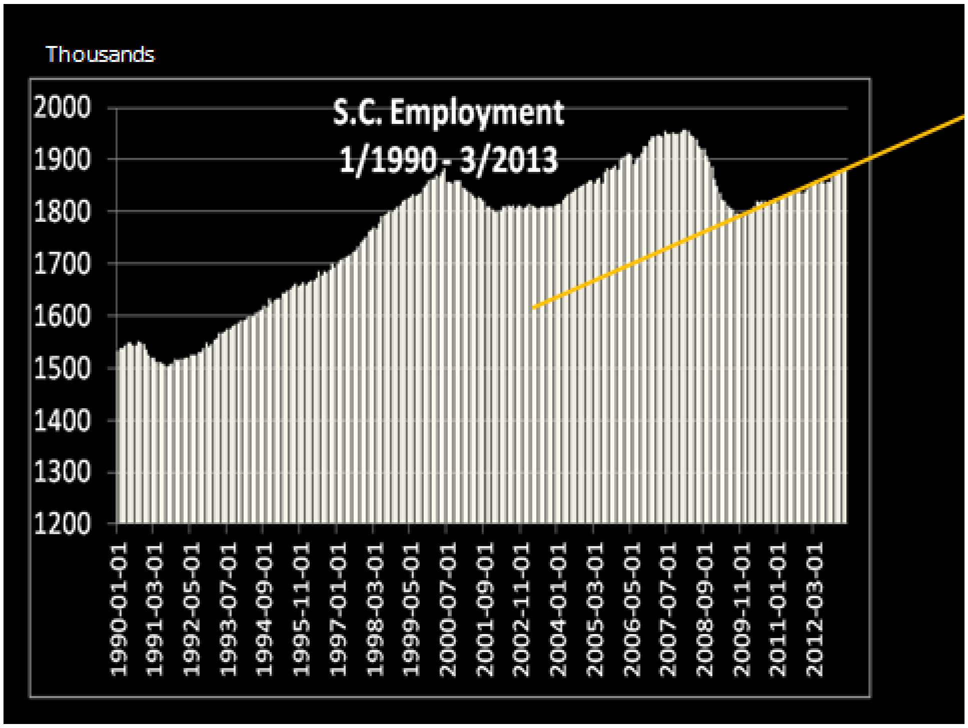
The transition has lasted a bit more than a decade. Meanwhile the Great Recession took wind from the sails of the U.S. and the S.C. economy. The result is seen in a higher unemployment economy.

A glimpse at the construction sector and total employment

The April employment report contained other good news items. S.C. construction employment is increasing again. This sector, hard hit by the recession, is slow getting on its feet, and that slowness forms a drag for the entire economy. The next chart compares S.C. construction employment with that of the United States. Mapping the two series together enables us to see S.C.'s larger construction surge, the resulting deep decline, and now the recovery.

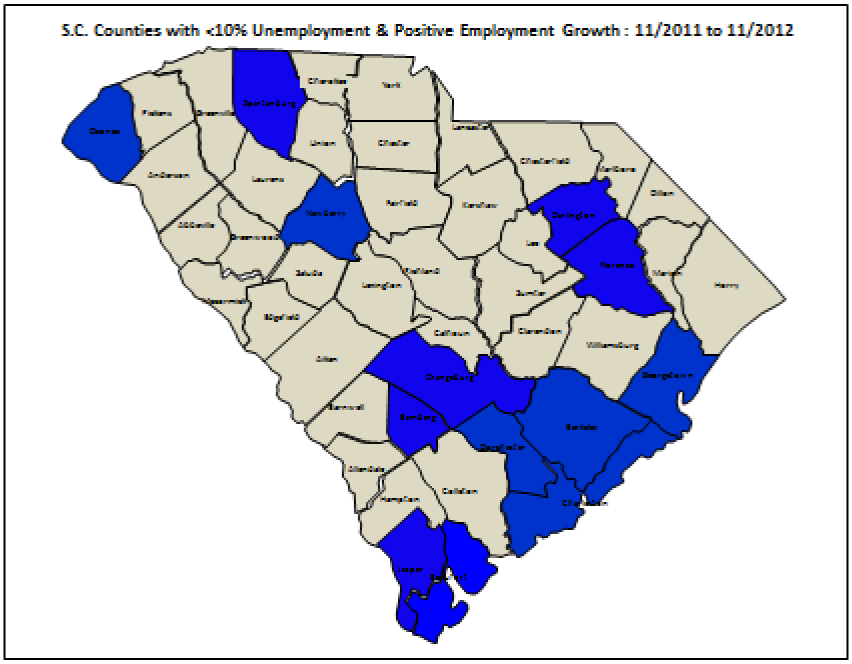


S.C. total employment is shown in the next chart. Notice that if the current growth trend continues, the state will attain pre-recession levels of employment around 2016.

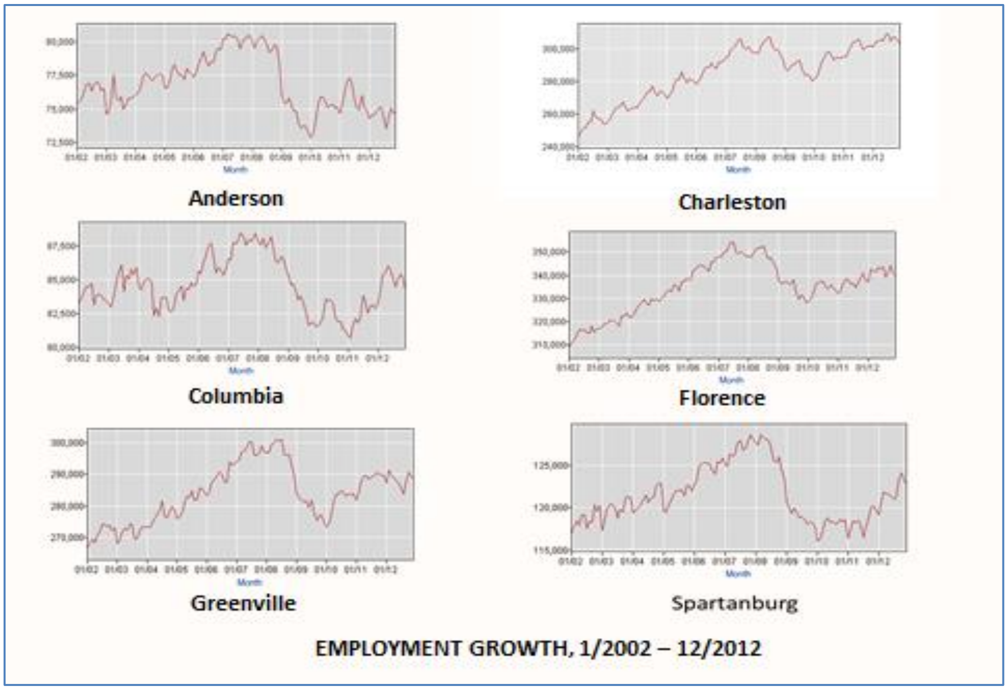


Performing an acid test for regional employment prosperity

The employment picture varies significantly across the state. The accompanying county outline map identifies those counties that had less than 10% unemployment in November 2012 and also experienced employment growth in the previous 12-month period. This acid test reveals six employment prosperity pockets in the state. The largest concentration is seen in the Charleston/Georgetown region.

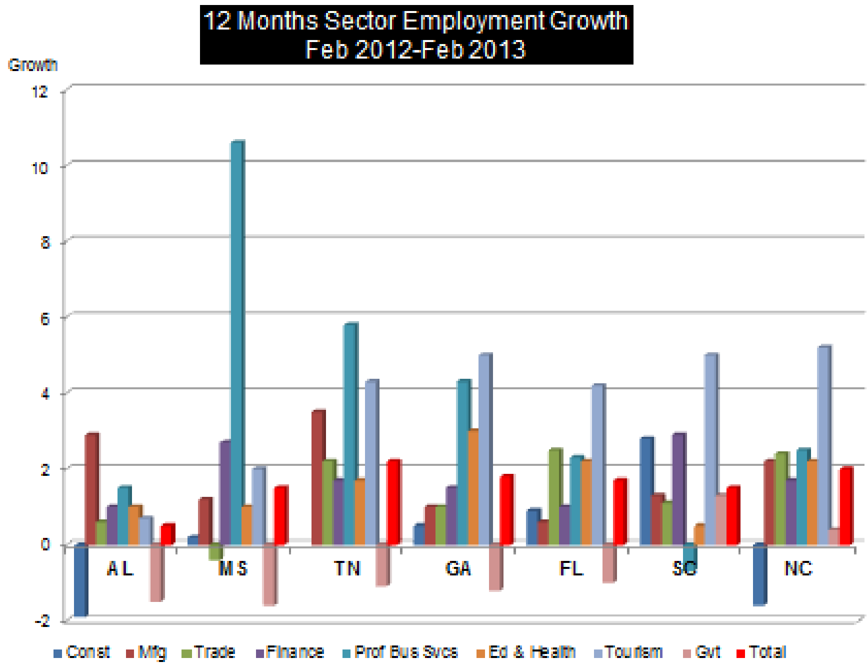


We get another glimpse of employment prosperity by examining total employment for S.C. metro areas. As seen in the next composite chart, the Charleston metro is the only one where total employment exceeds the pre-recession 2008 level. There are gains taking place across the other metros with noteworthy progress shown in Columbia and Spartanburg. Where manufacturing drives an economy, employment gains are slow. Productivity gains in manufacturing continue to reduce the demand for labor in that sector.

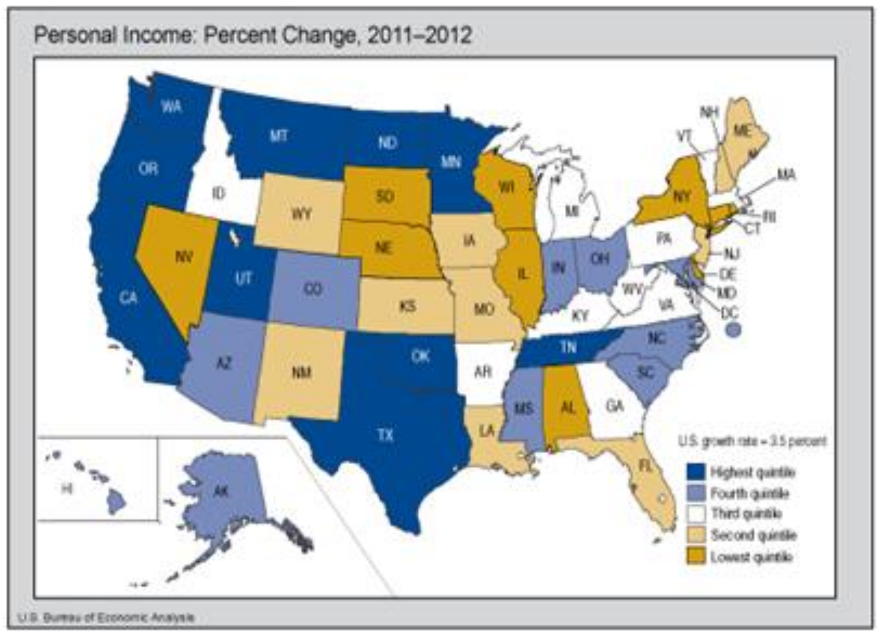


Southeast employment and personal income growth

Another glimpse of the South Carolina's relative prosperity is seen in the next two charts. The first of these shows employment growth for major sectors and total growth for southeastern states. Close examination suggests Tennessee if the strongest in the neighborhood. Mississippi's unusual surge in Professional Business Services is probably driven by manufacturing hiring of temporary workers, which is a prelude to making more permanent hires.



The next chart finally takes us away from employment data to an overall prosperity measure, total personal income growth. Here we see South Carolina and North Carolina are in the blue, which is the desirable color for growth. Tennessee is dark blue. Notice that other states in the region are not doing nearly as well as South Carolina.

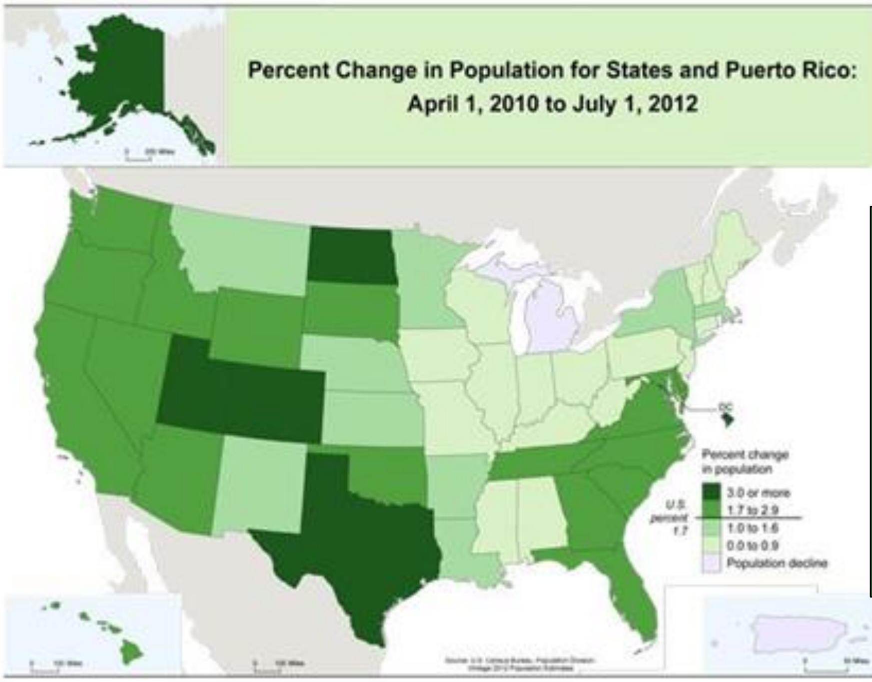


With the S.C. Department of Commerce leading indicators pointing north, future prospects continue to be positive for the state. (See Commerce report at http://sccommerce.com/sites/default/files/document_directory/economicoutlookmonthly-may2013.pdf)

Voting with their feet

The ultimate test of how well a state or region is doing can be observed when people vote with their feet. Are more people coming and staying in South Carolina than leaving? And how do the people votes compare with similar ones for other states?

The final chart in the Digest answers these two questions. In a nutshell, South Carolina's and the region's population growth exceeds that of the nation (1.7%) and compares favorably with other regions east of the Mississippi. Three southeastern states are growing at a lower rate than the nation: Alabama, Louisiana, and Mississippi.



SC 2.13%

FL 2.75%
VA 2.51%
GA 2.40%
TN 2.31%
NC 2.27%
LA 1.51%
AL 0.88%
MS 0.51%