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The Liscio Report

On the Economy

For John Liscio 1949-2000

State Tax Officials "Still Waiting"

The percentage of states that made their withholding tax projections in March slipped marginally to 41%, down from February's level of 48%. The three-month moving average, graphed on p. 2, rose to 39% as December's weak reading dropped off. The number of states enjoying positive growth year-over-year rose to 54% from February's 44%.

That improvement is better read as avoidance of disaster than real strength; officials' attitude can be summed up as "It's positive, that's all I care about." In March 2002 our survey was in the low thirties, with the majority of states missing their projections of flat to minimal growth. And all the way back then our contacts were suggesting that the country was "getting ahead of itself" with hopes of what then looked like a burgeoning recovery, and that we probably needed more time for any strength to take hold. We're still waiting.

- ***avoiding disaster***
- ***downard revisions to employment?***
- ***debts up, profitability too***

An increase in refunds is a big topic at the states and in the markets these days. But experienced tax officials are waiting to draw their conclusions until they have more complete numbers. Some were shocked by a major run-up in February and are seeing a leveling in March, perhaps indicating that electronic filing is getting the refunds out the door more quickly. (One commented that his own refund was in the bank within 5 days of e-filing.) But, it is clear that refunds are higher this year than last—an experience duplicated at the federal level (though February's numbers are the latest we have). The majority of states report an increase of 3-7% fiscal year-to-date, and that can't be written off as speedier processing.

Some of our contacts are also reporting downward revisions to their prior employment levels, which brings them more in line with what their withholding collections indicated. Others report they are now bracketing the BEA income projections, building their own ES-202 numbers and withholding trends into their projection models instead. That's causing more downward revisions to budget projections. And estimated payments are looking pretty weak.

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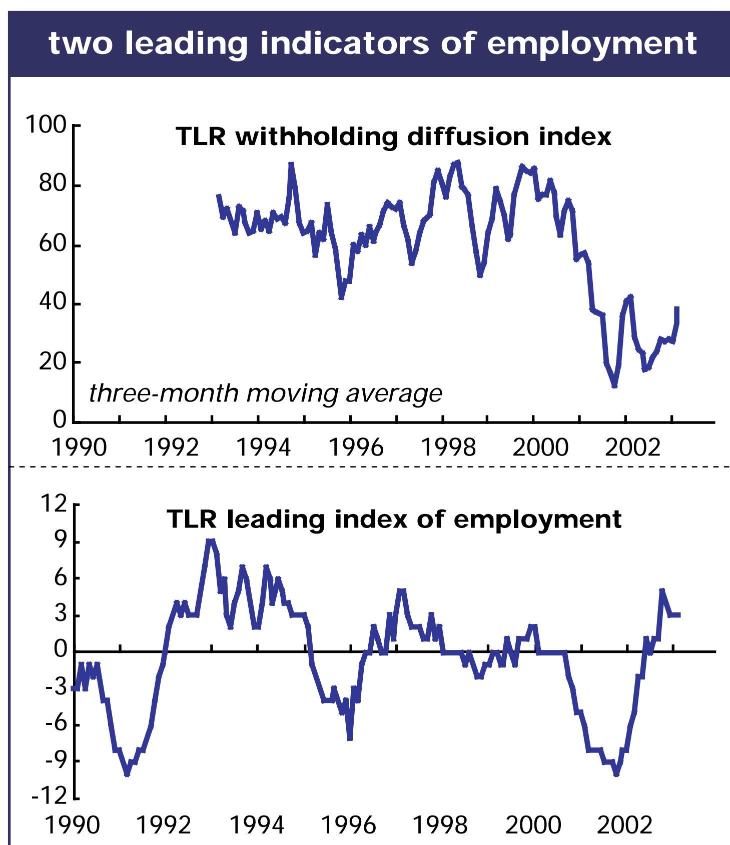
Some bad news, some good news

Turning to some longer-term concerns, there's some mixed news. On the bad news side, newly released flow of funds data from the Fed show that U.S. sank deeper into hock to the outside world last year. As the chart on p. 3 shows, net foreign debt—what Americans owe the outside world less what the outside world owes Americans—reached 25% of GDP at the end of 2002, an increase of 6 percentage points in just two years. Recessions are supposed to be times when countries get their international accounts in order, but not this time—one of the many unusual features of this downturn.



How much does that matter? As long as foreigners keep lending, it doesn't; the inflow has helped keep consumption above water. But if they ever change their minds, the U.S. faces a rude adjustment—at the very least, slower growth rates than we'd like and lower levels of consumption as well. The Fed could be forced to raise interest rates higher than it would prefer if it were making policy according to strictly domestic concerns.

And how indulgent do foreign investors seem? The weakness of the dollar in recent months suggests their ardor for U.S. assets may be cooling—and it probably doesn't help that much of the rest of the world is rather upset with the U.S. at the very moment federal deficit projections are rising. One rather alarming portent was a report in Monday's *NRC Handelsblad,* a Dutch financial daily, that Indonesia is seriously considering switching its foreign reserve assets from dollars to euros because the government considers the dollar "unstable."

And now for the good news. Data from the same flow of funds release shows the profitability of U.S. nonfinancial corporations rose in the fourth quarter after declining in the third (see graph, p. 4). Corporate America could finally be reversing the profits slide that began in 1997—well ahead of the bursting of the stock bubble and the subsequent recession. A sustained profit recovery is essential if corporations are ever going to invest and hire vigorously again. There's no evidence of a capital spending revival yet; nondefense capital goods outlays fell in February, and have declined in five of the last seven months. But if the profit upturn continues, capital spending is almost certain to follow. (Unfortunately, a few states

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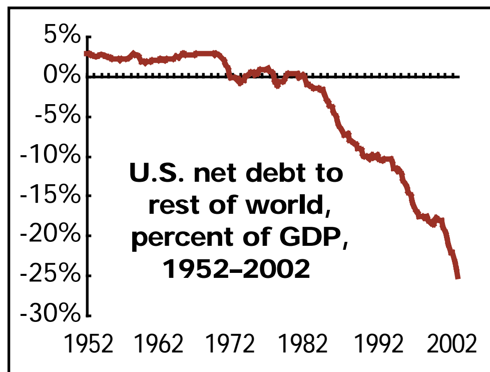
worry that their corporate collections are stumbling in March after months of solid improvement. We'll cover this highly volatile series in next week's issue.)

Friday's numbers

Expectations are already pretty low for Friday's headline number—from a decline of –25,000 to –75,000. Some analysts are expecting a bounceback from February's dismal performance, but it's not going to be easy. Our leading index of employment hit a wall late last year and has been flat for three months, suggesting no acceleration is in the cards anytime soon.



And the difficulty of mounting that bounceback is confirmed by a close examination of the seasonal adjustment factors. The overall seasonal number is the sum of the sectors; in most months, some sectors are expected to add and some to shed, often in widely divergent numbers. For example, February's aggregate factor was anticipating job gains of approximately 600,000, but was the sum of almost 300,000 layoffs expected in some sectors and 900,000 new hires in others. For March, the overall seasonal expectation is for 600,000 hires—but buried within the aggregate is a slim 57,000 layoffs, meaning that most sectors are expected to hire strongly. This skew is quite stunningly unusual. (January is the mirror image with the seasonals expecting across the board layoffs.) If you look closely at the sectors, it seems unlikely the March expectations will be met: Were 85,000 help supply services jobs created in March? Did struggling hotels hire 24,000 and recreation services 47,000 employees? Did this year's roller coaster, the eating and drinking establishments, hire 115,000 new workers? At least in New York City, restaurants are looking pretty empty, and we're hearing that from contacts in other cities as well. Was air transportation flat as expected, a sector flirting with disaster? State and local governments are expected to hire 119,000 new workers. But we're reading about four-day school weeks and our contacts are grumbling about irresponsible legislators finding ways to ramp up gambling and funnel state "vice control" into revenue departments: "Drinkin', gamblin', we'll have them all." Employment in building materials and garden supplies grew last month when it was expected to shrink so, there again, it's unlikely the 26,000 bar will be met. If seasonal expectations aren't met, the result could be sharply negative numbers after adjustment.

Private employment surveys are looking rather weak. Almost a third of respondents to the Conference Board's confidence survey reported jobs "hard to get," the highest of the current cycle, and a level not seen since 1994. The employment component of the ISM manufacturing survey fell in March, to a level consistent with a decline of 54,000 jobs in that hard-hit sector. And the evidence reviewed in the last paragraph suggests that services are going to have a hard time offsetting that southward pull. So although the consensus estimate of a decline of about 50,000 is in-line with our survey, we wouldn't be surprised by a steeper drop.

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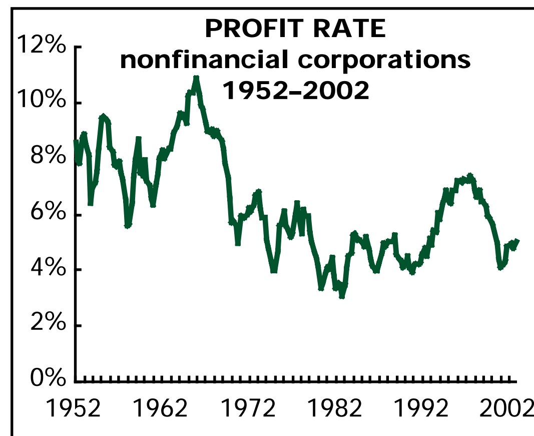
Hourly earnings should come back to earth after February's sharp 0.7% rise. In our survey, the majority of states that made their numbers are in the Midwest, reversing that region's very weak performance in February. This runs contrary to the downtrend in manufacturing, so our contacts suspect we may see a replay of February's strength in hourly earnings coupled with falling employment. It's doubtful we'll see another big jump in earnings, but we may well see stability. Look for a gain of about 0.2%. Our unemployment model is calling for a rise from 5.8% to 6.0% (compared to the 5.9% consensus).



The importance of the employment report may be fleeting, unless it's a real shocker. War news is in the driver's seat right now, and there's no way to predict that at all.

by Philippa Dunne and Doug Henwood

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