

August 5, 2004

The Liscio Report

On the Economy

For John Liscio 1949-2000

State withholding receipts decelerate

Our index of states that made their withholding tax projections climbed to 57% in July, just two points above June's level. The number of states reporting positive growth year over year was up to 88% from June's 82%, a improvement somewhat undermined by only 54% of the states in our survey reporting positive year-on-year growth in July 2003. The three-month moving average of both measures, graphed on p. 2, declined modestly.

The most important thread repeated by the majority of states is that withholding collections were accelerating nicely in the period between February through March or May (depending on the state), slowed in early summer, and are now clearing last year's low hurdles by smaller margins and currently not accelerating.

There were more calendar quirks than usual for this June/July period, and several large states were over or under in the June by almost exactly the same amount that they were under and over in July. They suggested taking the two months to-

gether and that put them at expectation. It would make a grabbing headline to report that a major Midwestern state missed its July estimate by \$30 million, but it would leave out the crucial fact that it was just about that much over in June owing to a large payment that hit the bank on June 30th.

• **"Withholding not robust, and no longer accelerating," say some**

- **NIPA revisions**
- **bounceback due?**

Often, the most difficult decision in reckoning current conditions is setting the correct starting point for the prior month. Was June's weakness an anomaly, payback for an overly strong spring, or truly the beginning of a

weaker stretch? That our index fell 14 points in June, and some states once again dropped into negative territory year over year, corroborates the softening in payrolls reported by the BLS. That it went nowhere in July undermines the hoped for bounceback (about which more in a moment). As we have reported before, we are now in the stretch that was of greatest concern to the majority of our contacts, as fiscal stimuli are wearing off and employment and business investment expected to take the lead. Construction spending and

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wage growth are not encouraging currently, and many states report they will need a serious re-acceleration to meet budgetary goals.

Yet another word on birth/death modeling...

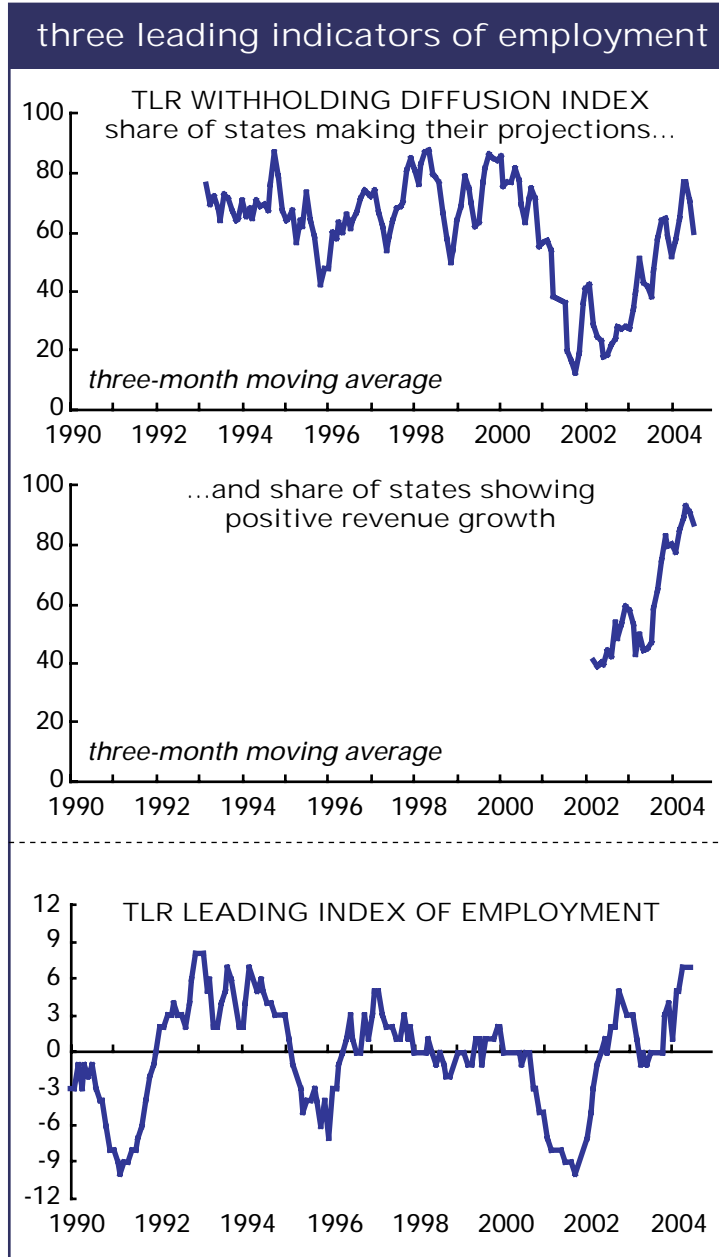
During the period of 2002 to 2003 for which we now have benchmarked numbers, the BLS added in close to 500,000 jobs in their birth/death model, and during that stretch of economic weakness far many more jobs were still reported lost. Had the BLS not made the corrections they did, the monthly drops would have been steeper, but the benchmark revision would have been sharply upward. The benchmark was, in fact, only modestly downward. That the BLS is adding in more jobs during the current period of greater economic strength sounds pretty reasonable. Several state contacts lend support to this by reporting that small businesses, who generally pay toward the end of the month, are quite consistently giving a late month boost to withholding collections.

...and data revisions

Data revisions often inspire suspicions in the press. In the most recent instance, on Tuesday, *New York Post* columnist John Crudele implied that the BEA's routine revisions of the 2001-2003 national income accounts were a political favor to the Bush campaign. "With a little snip here and a tuck there, the department [*sic*] made the recession—at least as it is traditionally defined—disappear with the skill of a plastic surgeon getting rid of a patient's annoying worry lines." The "traditional definition" Crudele was alluding to was the one citing two consecutive quarters of decline in GDP as the defining

characteristic of a recession, one the National Bureau of Economic Research, the official arbiter of business cycles in the U.S., explicitly rejects as inadequate and misleading.

It is true that the growth rate for 2001's



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second quarter was revised from -0.6% to $+1.2\%$, meaning that only the first and third quarters showed declines. But growth estimates for the last two quarters of 2001, three quarters of 2002, and two quarters of 2003 were revised down, making the cumulative effect of the revisions roughly flat. Much the same was true of the components, with consumption over the full period revised down slightly, and investment and government spending revised up slightly. (Crudele attributed much of the upward GDP revision to a "fortunate" change in seasonal adjustment technique; while it is true that durable goods consumption was revised upward over the full period, that increase was more than offset by cumulative downward revisions to nondurable and service spending.)

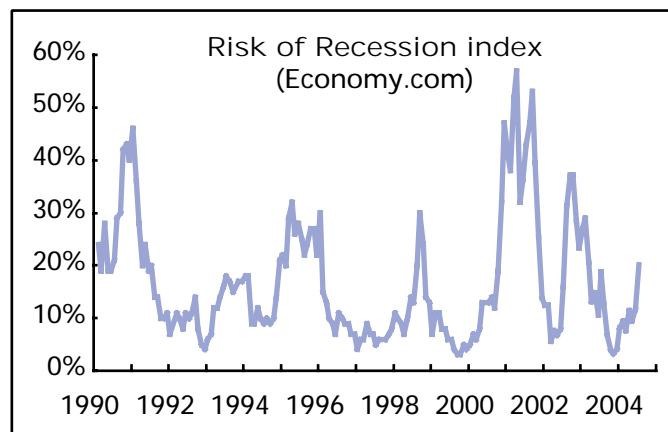
In other NIPA revision news, long-standing expectations of an upward revision to wage and salary income in the second half of 2003 were confirmed. Yearly nominal growth in wages and salaries for the fourth quarter of 2003, initially reported at 3.6% , was revised to 4.0% . It's not clear, though, whether the source of the revision was stronger payroll growth, or higher salaries at the upper end; arguing for the latter were strong upward revisions to employer contributions to pension funds and insurance benefits (2.6 percentage points in 03Q4), and modest upward revisions to social insurance contributions (0.2 percentage points in 03Q4). But investment income, proprietors' income, and government transfer payments were

mostly revised downwards, leading to lower annual growth rates in disposable personal income for every quarter between the fourth of 2001 and the third of 2003 (inclusive). The savings rate was also marked down for every quarter during that same period, and the first of 2004 as well. If households ever decide to cut back on borrowing and restock their savings, the U.S. economy could face a rough adjustment.

And, extending a pattern seen throughout the 1990s, corporate profits were revised downward for all three years. Taken as a whole, it's hard to see the revisions as a gift to anyone.

We have indeed come a long way.

With discussions of economic data highly politicized, and conspiracy theories



running high, we want to mention a description of an incident between President Nixon and the BLS Alan Krueger included in his recent piece, "How to Measure Terrorism Data."

Krueger reports that in 1971 the Nixon Administration halted the BLS's monthly unemployment briefings because a staff member described a drop in the unemployment rate the administration had called "very significant" as "marginally significant," and added it could have been caused by a seasonal adjustment mishap. The melee that ensued (which included an attempt to give the poor fellow a lie detector test and get administrative "control of releases") prompted action to protect our economic releases from

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politicization. For example, in the first hour after a release, agency staff may comment on technical issues, but political appointees may not comment publicly during that time.

Also, spending time speculating about political abuse of the data focuses attention away from areas of real weakness in wages and questions about the quality of jobs we are creating that could conspire to slow the recovery. Insurance CEOs have been in the press recently reporting that the rolls of the insured are not growing as fast as the recent employment gains would lead them to believe, so the newly employed may be paying more medical bills out of their own pockets. Wages have yet to show acceptable growth. With problems such as these in place, any welcome improvements in the labor market may not prove to be enough, and are not likely to be inflationary.

Crystal ball dept.

Speaking of weakness, at least until yesterday, the consensus seems to have been that the softness in many indicators during June was an anomaly, and the U.S. economy will soon return to stronger growth. Is this too complacent?

In our July 13 issue, we noted the slippage in the Economic Cycles Research Institute's (ECRI) weekly leading index, an indicator with a very good track record. That slippage has continued further, to the point that the six-month rate of change went negative last week. According to the index's compiler, Lakshman Achuthan, its behavior suggests slower growth for the rest of this year, but no outright recession unless it slips deeper into the red. Another warning flag is

Economy.com's risk of recession index, graphed on p. 3, which has now risen to 20%. That's not a high reading—the firm suggests 40% is the real danger level—but it's further evidence that the "soft patch" could be a bit more unpleasant than most people expect. The rise to the 20% level in December 1994, which was sustained into 1995, did signal a significant slowdown; GDP growth fell from around 4% in 1994 to the 2% neighborhood in 1995. But the spike in 1998 was a false alarm. So we'll continue to watch the ECRI and Economy.com indexes carefully. The sideways performance of the stock market for much of the year is also a bit discouraging.

And our own leading index of employment is now stuck at 7 (on a -12 to +12 scale) for the third month in a row. This suggests no acceleration in job growth in the next several months—though, it must be emphasized, no contraction either. A survey of recruiters and temp firms by Market News Service reports a moderation in labor demand in July, as well as in expectations for the rest of the year, with sources citing political uncertainties around the election and a lack of focus in the economic outlook.

Friday's numbers

There is some excitement about the historical likelihood of a big bounce back in July payrolls. It's generally true that if one month falls quite far below trend, as June did, the next month will rebound. (That's actually true of all months, not just June/July.) Based on the experience of the last 30 years—and working with initial prints, not final data—we come up with a far more modest bounceback than the ones

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we're reading, on the order of 150,000. That, when added to June's initial print of 112,000, would suggest a gain of 262,000 for July, slightly higher than consensus.

But bouncebacks don't always happen; about a third of the time, the subsequent month is disappointing as well. And, most importantly, the BLS is using a relatively new methodology for seasonal adjustment. If you look at revisions to prior months since the new methods were in place, you will see that the not seasonally adjusted first and second revisions sometimes actually move in the opposite direction of the seasonally adjusted revisions. This is because the BLS is attempting to smooth out monthly noise by distributing gains across current and last two months. A disappointing gain in July and two months of upward revisions could have a similar effect on the market as a big July stand alone, but likely more muted.

Given the evidence of our survey, our unemployment claims model, and the softening in the ISM employment components in both manufacturing and (especially) services, we're looking for a headline payroll number around 215,000. We expect the unemployment rate to decline to 5.5% (unless more newly confident people join the labor force than can be accommodated), the work week to rise by +0.1, and wages to remain muted at +0.2%. There's enough slack in the labor markets that the last thing we need to worry about is wage inflation (which, after all, is a very different beast from commodity inflation).

by Philippa Dunne and Doug Henwood

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