

April 12, 2005

The Liscio Report

On the Economy

For John Liscio 1949-2000

Leveraged, squeezed and still shopping

Our survey of March sales tax receipts rose to 73% of states at their expected collections, up from just 45% in February, and the number of states reporting positive growth year over year fell to 78% from February's 90%. (There are some non-economic reasons for this fall, however.) The three-month moving averages, graphed on p. 2, both fell, as December's strong showings dropped off and were replaced by March's relatively weaker ones.

Strongest collections were reported on the West Coast and in the Midatlantic region, where our contacts report solid growth year over year. "It makes you think they are immune to the rise in gas prices around here." All but one of the states that did not make their estimated collections were in the Midwest, where there is growing concern at several states about weakness in work weeks and wages, and the unemployment rate's stickiness.

But even at the strongest states our contacts are wondering how immune consumers will be to rising interest rates and

high fuel prices in the coming months. At one large state, currently doing well in all collections, our contact has noted that 70% of new home sales in the last year employ ARMs. This is a small percentage of total home-ownership, but a lot of people who could see their monthly mortgage payments rise \$300 a month by summer

"without changing anything." Our contact at one state wonders if the many couples making around \$50,000 to \$60,000 who have used various mortgage options (like adding a seven-year-note to a thirty year mortgage thereby putting

only 10% down) realize that rising rates on the note would likely require a \$10,000 increase in annual income. And one was shocked to see an ad for 40-year mortgages.

Withholding boom?

In winter 2004 withheld federal tax receipts as reported by the Treasury caused a number of analyst to assert that payrolls would finally be making the 250,000 to 300,000 monthly gains one would expect in a recovery. We warned that the

- **Midwest weakens**
- **bracket creep**
- **is rising net worth comforting?**

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earsplitting noise in the federal tax receipts make them a very poor gauge of labor market activity, and the payrolls did disappoint. This year that same noise is raising hopes that there is hidden strength in wage and salary growth that will be revealed when the official data are revised.

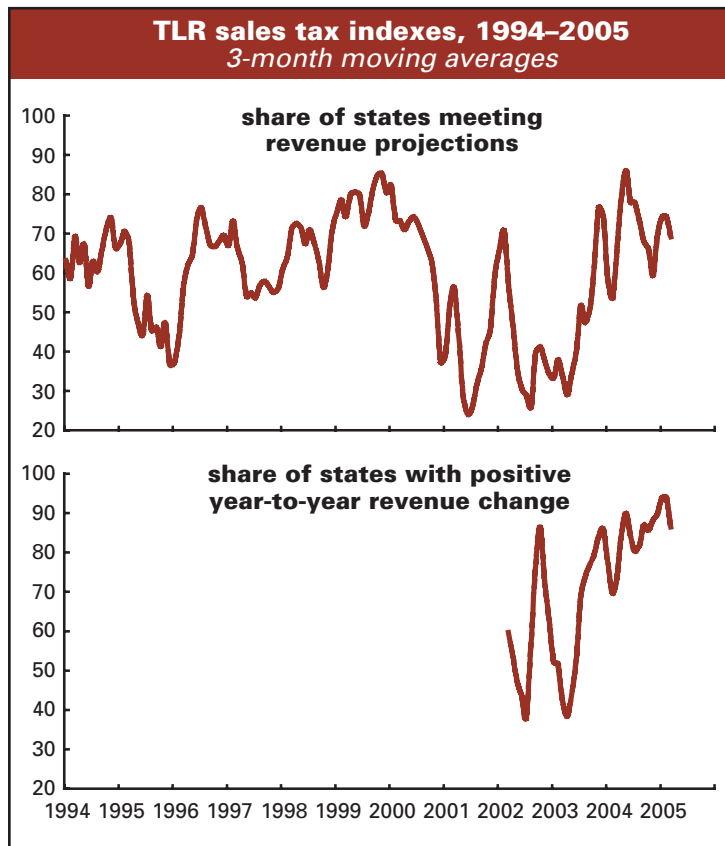
We looked at the federal withholding numbers again, and took some measures to neutralize the level of noise. First, we adjusted for the number of workdays per month (just one extra day can add 3-4% to collections). That reduced the din somewhat, but it took a six-month moving average to bring the noise down to relatively comfortable levels. The results are shown in the bottom graph on p. 6. Note that withholding has frequently spiked well above wages (and even stayed there, as it did for much of the 1990s). We wouldn't make too much of the latest surge, then.

Several of our state contacts are indeed expecting modest upward revisions to their wage data, but in line with historic turns. (Many of these same contacts correctly anticipated that their wage data would be revised down in spring of 2002.) They also pointed out that it is common

for withholding taxes to run well ahead of both employment and wage growth. One reason is elasticity of the rate structure, meaning that for every 1% increase in wages, withholding rises by 1.2 to 1.3%. A Midwestern contact tells us that from January 1991 through February 2005 the change in withholding averaged 9.8 times the change in employment figured one

way, and 6.9 times another. For some brackets, there can be steep increases as taxpayers move from one bracket to the next. One contact points out that when singles break about \$29,000 their marginal rate increases from 15% to 25%, and noted that 2002 statistics by filing status show that nearly a quarter of single filers were in brackets where the average taxable income could easily move into the next

bracket over a two to three year period. For a pal of a contact, bracket creep on a 7.5% wage increase (from \$27,500 to \$30,000) incurred a 9% increase in *taxable* income and a 12.5% increase in tax liability. And with the return of bonuses equaling a full year's income, hefty real-estate commissions and the like, several contacts wondered how much withholding is coming from the upper brackets where it has a better chance of being invested than spent.



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One contact suggests over-withholding can be a real problem. At his state, from 1998 through 2004 gross individual income tax revenues rose 14.02%, while individual income tax refunds increased by a whopping 62.18%, almost all attributed to over-withholding. And several pointed out the unknown effect of the alternative minimum tax, and the possibility that people have chosen to up their withholding to avoid penalties come spring 2006.

A better comparison with employment is what the national income accountants call personal contributions for social insurance, which is dominated by social security taxes. Its course is shown in the top chart on p. 6, and it's quite in line with earlier behavior.

If American workers were faring much better than official data suggest, the confidence measures would not be falling, the ranks of those without health insurance would likely not be growing, household balance sheets would

surely be in better shape and the savings rate would be improving.

Net worths

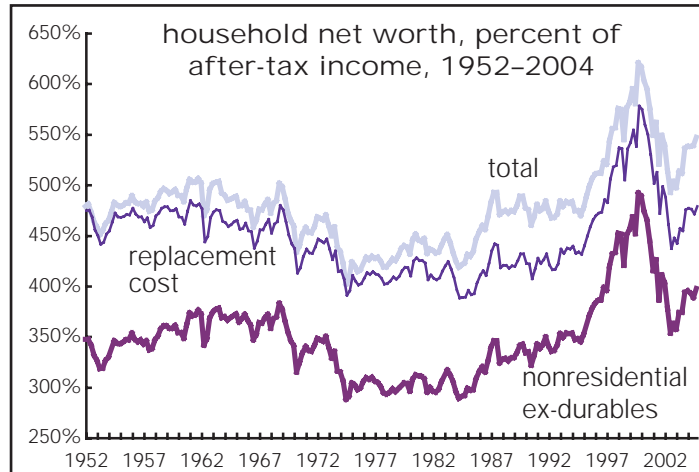
We frequently see claims that U.S. household indebtedness isn't something to worry about because assets are growing strongly as well, and so net worth measures are comfortably strong. There are several reasons why this argument fails to reassure.

First, it's a simple accounting identity

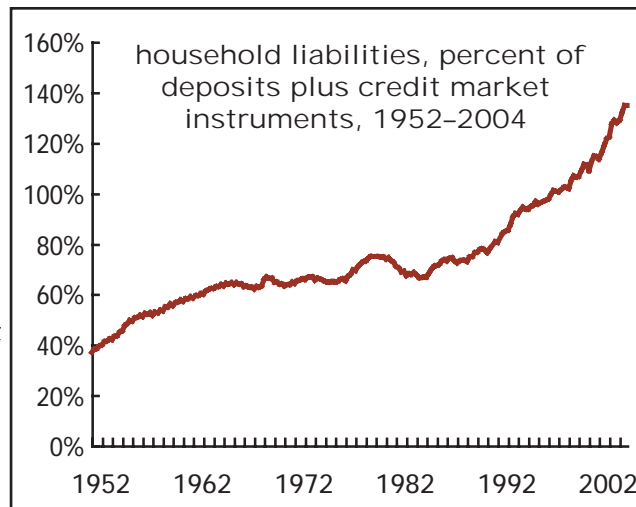
that one person's debt is another's asset,

so it's not surprising that assets and liabilities should grow more or less in tandem. Second, it's very misleading just to look at aggregate balance sheet measures, as in the flow of funds accounts, because rich households own most of the assets, and middle-income ones owe most of the debts.

If you take the aggregate numbers and divide them by the number of households, you won't get anything like a picture of the "average" household—you'll get something more like a household at the 95th percentile of



Household net worth by several measures. The line marked "total" includes all assets and liabilities. The line marked "replacement cost" values residential real estate at replacement cost rather than market value. And the line marked "nonresidential ex-durables" excludes household real estate and mortgages, and also excludes consumer durables, which the flow of funds accountants at the Fed normally include in assets. Source: Federal Reserve, flow of funds accounts.



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the wealth distribution. And third, even the flow of funds aggregates can be disturbing if you look at them from the right angle.

A couple of charts can make this point. If the net worth figures include residential real estate, you're counting something that could be in the midst of a bubble as an asset. As the top chart on p. 3

shows, if you value residential real estate at replacement cost (what it would take to rebuild an existing house), the net worth measures look less impressive. Market values were 154% of replacement cost at the end of last year, a hair below the all-time highs of the late 1980s and early 1990s. And if you strip out residential real estate and associated mortgages from the household balance sheet as well as durable goods, net worth looks even less impressive.

And if you compare debts to the most solid financial assets (bank deposits, money market funds, and credit market assets) and leave out those that are unstable (stocks), illiquid (equity in privately held businesses), or almost untouchable (pension fund assets), then you see a pattern of steadily rising leverage. That's graphed on the bottom of p. 3.

And, though we hate to keep harping on this, given our near-zero level of domestic savings, most of this borrowing has been financed by foreigners: 29% of funds

borrowed in the credit markets came from abroad in the fourth quarter of 2004. In cumulative cross-border borrowing, the U.S. simply has no peer. In the winter issue of its *Quarterly Bulletin*,

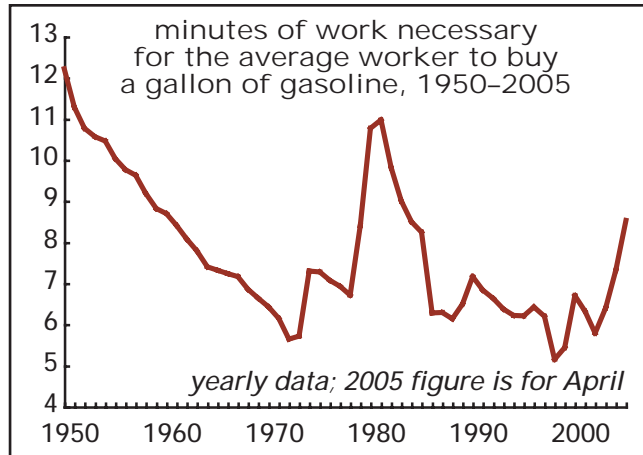
the Bank of England regularly compares the international investment position of the G-5 economies (defined as assets of all kinds less liabilities of all kinds). As of 2003, the latest year available, Japan had a net external position of almost +40% of GDP. France and Germany were around +10%. Britain, the only other big economy running

a chronic current account deficit, was in the red about 5% of GDP. But that's nothing next to the U.S., whose net investment position was almost -25% of GDP. And it's only gotten worse since then.

We're not partisans of the sky-is-falling school. But our national balance sheet isn't a very pretty thing right now, and we shouldn't be looking for excuses to deny that.

Energy squeeze

Gas prices are getting serious. The conventional way of comparing prices over time is to deflate them by a price index, like the CPI, but there are some serious practical and conceptual problems with doing that over the long term. (For example, there were no VCRs in 1955, and almost no home milk deliveries in 2005. Such radical changes in the market basket are hard to capture in a price index.) Another approach is comparing a price with the time it takes a worker paid the average hourly wage to earn enough to buy



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the commodity. That's what we've done with a gallon of gas in the nearby graph. Based on an early April national average price of \$2.26 a gallon, and an estimated average hourly wage of \$15.98, it would take the mythical average worker 8.5 minutes to earn enough to pay the bill at the pump. That's the highest number we've seen for this measure since 1985, just before the collapse in oil prices—and higher than what prevailed after the first oil shock of 1973.

The issue is rising in political salience. Last week, Gallup editor-in-chief Frank Newport wrote that "energy prices have zoomed up to tie with unemployment as the most frequently mentioned issue when Americans are asked to name the most important economic problem facing the nation. Americans have also become much more negative about the direction of the economy in general, and I believe the high price of energy is one of the reasons why President Bush's job approval rating has fallen." In Gallup's latest poll, 58% of respondents said that gas prices were causing them financial hardship, the highest share since they started asking the question in 2000. To cope with the response, people are comparison-shopping more intensely and thinking about switching to a more fuel-efficient vehicle when they buy their next car. But 4 in 10 are cutting back on other household spending.

Wednesday's retail numbers

We see the rise in gasoline prices adding less to March retail sales than appears to be in the consensus model, and are looking for an overall increase of +0.6%, with ex-autos at +0.5%. Most private surveys found March to be a disappointing

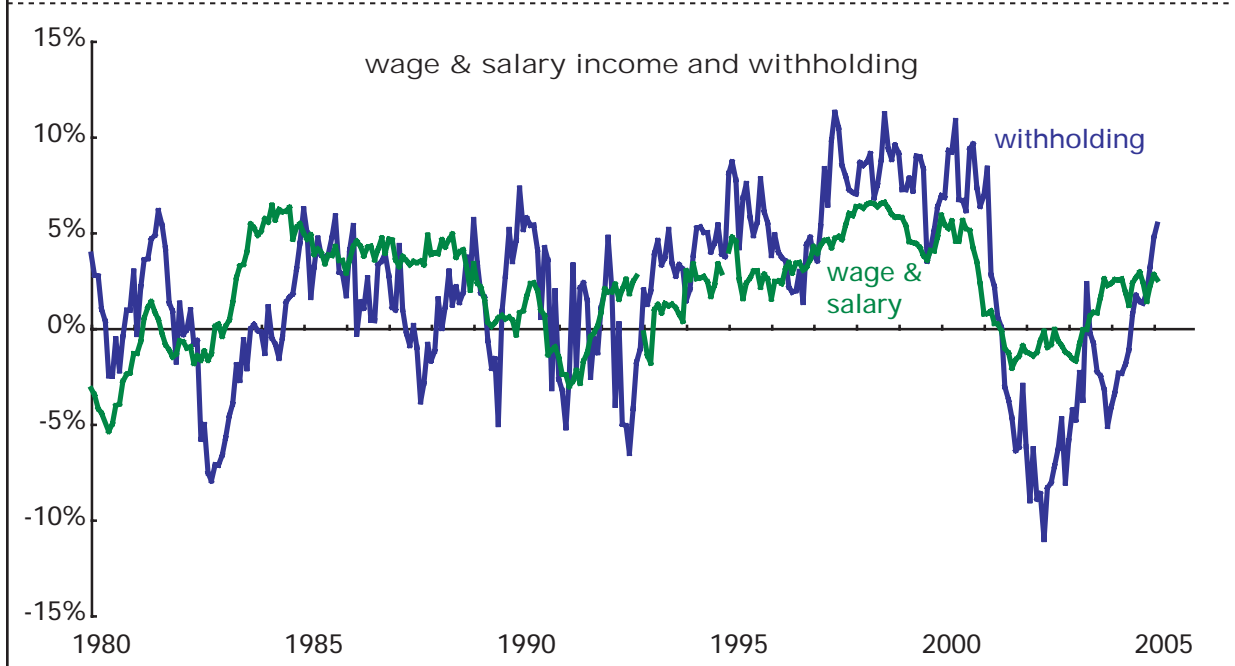
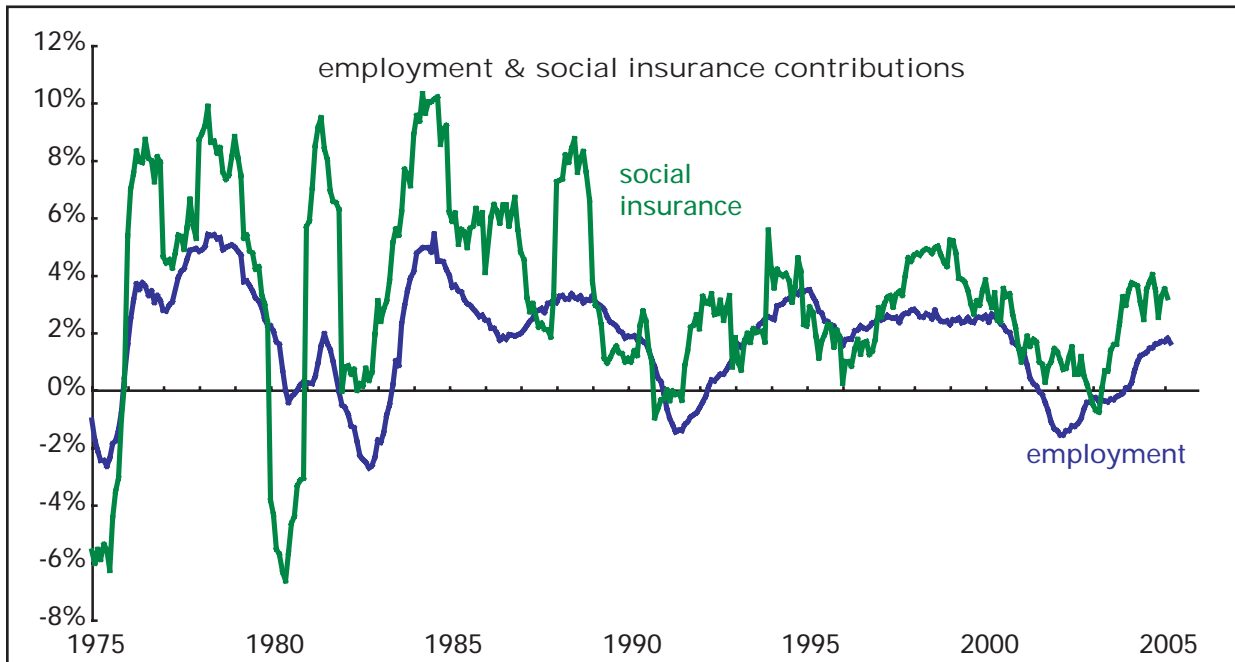
month, even with an early Easter.

One caveat: the March Retail Sales print has come in substantially over consensus and above trend for the last few years, and we are concerned that there may be a bit of a seasonal adjustment problem causing that. We generally think it's pretty cheap to be below consensus and then add that the danger is to the upside, but we are aware there could be an upside surprise that may have little to do with the underlying trend. So, our forecast is in line with what we think is real.

by Philippa Dunne and Doug Henwood

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Top chart shows year-to-year changes in personal contributions for social insurance (mostly social security) and payroll employment; bottom chart, yearly changes in wage & salary income and federal withholding receipts. Withholding is a six-month moving average adjusted for the number of workdays per month. Monetary values are deflated by CPI.