L. R. Levin Consulting, L.L.C.

Newsletter

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Will The Jobs Creation Bill Help The Economy?

The news has been filled with discussion of the proposed $450 billion jobs creation bill (the "American Jobs Act") being sent to Congress. The news media has largely focused on the political aspect of the proposal. ***What is the potential economic impact of key elements of the proposal?***

Without question, two primary drivers necessary to return the economy to growth are creating the right climate for business expansion and reduction of unemployment. Both small and large businesses invest and expand (creating jobs) when there is sustained demand for their products and services. ***Judged by these criteria, how do the key elements of the jobs bill do?***

One key element is that for 2012, with certain caps, the social security payroll tax on both individuals and employers be cut in half on the first $5 million in payroll or eliminated entirely for firms that hire new workers or increase wages. It is estimated that this could infuse as much as $250 billion into the economy in 2012.

Increasing private sector spending power by long term tax reduction is clearly the most effective means to create the climate for a meaningful recovery from a recession. ***But is this proposal the right type of tax reduction?***

That this element would increase private sector spending power by $250 billion is a real plus. However, this is a short term infusion of liquidity. Individuals and employers would know that this

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increase would not be repeated in the following year, 2013.

Under that circumstance they must choose between spending it or saving it. A business may not use it to finance or invest in new plant and equipment because if taxes go up they may need it to pay for inventories, future taxes, or other costs. The need is for long term tax cuts that allow planned spending which give a return on investment over a longer period.

Individuals face the same question. Since they cannot count on the cash next year, they may save it to pay their mortgage or other future expenses.

But there is an even more compelling reason why this is the wrong form of tax cut. This particular cut reduces the funding of the social security program at a time when that is particularly destructive.

Beginning with last year, there are not enough workers paying social security tax to fund the current costs of the social security program. With baby boomers retiring, that is an increasing problem that will not change for the foreseeable future.

Social security does not have any actual reserves. All of its reserves have been invested in federal bonds. The Federal government has already spent that money.

When the social security administration cashes in bonds to generate the funds to pay its costs, the government has no current revenues to pay back those bonds. The federal government already borrows 46 cents of every dollar it spends.

If the social security administration receives $250 billion less revenues next year, the Federal government will have to borrow $250 billion more to pay for the short fall. Even before this suggested tax holiday, it was clear that the social security program needed to be reformed, just to keep it solvent in the long run.

By taking another $250 billion away, it will only make the problem worse. By increasing the minimum amount the Federal government must borrow to fund entitlements, it only adds complexity to the deficit reduction problem.

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There is a further problem with the deduction for hiring people who have been unemployed for 4 months.

This was tried over the past two years, and it did not work. Employers don't hire just because they get a deduction.

Businesses hire people when demand for their products and services create a return on that investment. With the prior hiring deduction, it was businesses that would have hired anyway that got the deduction, so government revenues were reduced without any meaningful impact on employment.

Another element of the jobs program is a series of short term tax reductions for specific activities that employers might take. One element is allowing businesses to deduct immediately any investment in new plant and equipment. This is an excellent suggestion and would provide for private sector spending that would have a multiplier effect in the economy providing growth and employment. It is estimated that this would cost $5 billion, but return much more to the economy.

Another element is providing tax credits of up to $9,600 for hiring unemployed veterans. Given the service that veterans have rendered, while this may not increase the total number of people hired, it is a preference for veterans that should be acted upon.

Another element is a possible elimination of the U.S. tax on foreign profits. It is not clear yet how this will be structured. If it is unrestricted, it will encourage investment abroad, not at home. If it is on profits brought back to the U.S. it may help encourage investment here.

Such tax incentives only help companies that do business abroad, not most smaller U.S. businesses. Currently, larger U.S. businesses with overseas operations have been profitable and domestic hiring depends on other factors. The question is one of domestic demand and the return on investing in domestic production.

To work, such approaches need to be long term and coupled with much broader across the board tax relief for both individuals and

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businesses, and government policies that both strengthen the dollar and create domestic demand.

Perhaps the biggest problem with these incentives is that they are all short term. That may help the economy in 2011 and 2012, during this election cycle, but not in 2013-2014 as the economy slows.

Another element is further increases in unemployment benefits. This approach subsidizes continued unemployment. Certainly, in extreme cases continued assistance may be needed, but the current system is far too broad.

The cure for unemployment is steps that create a real recovery, growth and jobs. What is needed is ***long term tax reform*** and across the board tax cuts putting demand and liquidity back in the economy and a business oriented approach to economic regulation. This coupled with immediate deficit reduction would be a real "game changer."

The jobs creation bill seems to be short on this element. The remaining portions of the jobs bill focus on aid to state and local governments. There is little in the details, explained so far, that suggest that these initiatives will work any better than in the past two years. Most will only go to pay for government employees that do not provide self-sustaining goods or services that have a multiplier effect.

To improve the economy we need to concentrate on much more important fundamental changes that will have a meaningful effect on growth.

Will The Economy Pick Up In 2012?

In the military, they talk about the "fog of war." That is the confusion that sets in when the first shots of battle occur. With poor communication, unable to separate fact from fiction, the commanders lose focus, not knowing to what to respond.

Consensus economists are experiencing that phenomenon right now with the current economic data seeming to point in all directions.

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What does this mean for business? It means that there will be real opportunities for businesses with the foresight to identify what the opportunities are and how they can take advantage of them.

When we sort through all the conflicting data, a picture of where the general economy is going begins to emerge. It is multidirectional over the next 4 years. Our strategic partner, The Institute For Trend Research ("ITR") believes that in 2013-2014 we are headed for a recession. ITR cannot tell from the current data, if it will be a soft or a hard landing?

It is the economic data that points in the direction of recession that is confusing how the economy will behave during 2011 and 2012. How the government acts as we go through the next year and a half will impact both the short and the long run results.

The stock market is never a good predictor of the long run economic outcome, but it is currently a case in point of the "fog of war." The market during the spring was rising at a steady pace. Now it has been erratic, but has fallen 15%.

Based on the data, it appears the market was rising primarily as a result of the short term impact of the Fed policy of buying debt and pumping money into the economy. The stock market is looking to see if the government will resume this approach.

If the Fed resumed this approach, there would be little real use for this type of liquidity other than to invest in the market. The market is down, because this particular prop is currently uncertain.

What does the economic data tell us about the business climate in 2011 and 2012. The data still points to a slightly increasing rise for the general economy through this period. However, the factors that drive that rise may be the very factors that cause the recession in 2013-2014.

One major uncertainty is whether in inflation adjusted dollars our GDP is growing. While economists are concerned about our slipping into recession, the data used by the Commerce Department's

Bureau of Economic Analysis has shown that the GDP continues to grow.

Businesses that have adjusted to the level of reduced demand in the recovery are doing well. But other businesses “feel” like we are still in a recession. In inflation adjusted dollars, the Commerce Departments data may be misleading.

In preparing its GDP calculations, Commerce uses the 10 year trailing inflation rate, currently 2.5%. By contrast the Labor Department reported a prior month inflation figure of 3.6%. If Commerce had used 3.6% or a higher average inflation figure, our GDP would not be growing.

Economists compute that we would need to hit a 4.8% inflation rate for GDP to go negative. Currently, by over weighting items people really don’t buy extensively and under weighting items like food, clothes and gasoline, the Labor Department materially understates inflation. Commerce’s use of the 10 year average inflation figure overstates the GDP growth. This is why our strategic partner ITR uses industrial production as a proxy for GDP in ITR’s forecasting.

It is not unusual for inflation data or other elements of the GDP calculation to be adjusted or corrected over time by the government. The inflation disparity in which figure is used to calculate GDP demonstrates how weak the current recovery is.

The economic cycle is in one of those periods where the public perception of how the economy is performing, and what the government is or isn’t doing, can impact how the economy does. Credit expansion, individual and business spending are all impacted by perception. In an election year, perception can be driven by politics as much as by hard data.

For business, this means it is much harder to predict what will happen over the near term. ITR and we believe that the economy will continue to improve slowly. The improvement should accelerate into 2012.

Having said this, it is important to recognize that the level of

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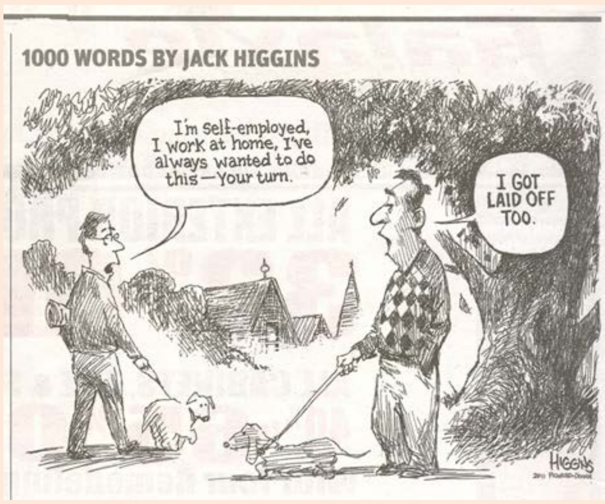
uncertainty about where government policy is headed could impact the next 6 months. With our national debt having already exceeded $123 trillion dollars, for the 3rd year in a row, how the government handles reducing the debt going forward is increasingly important.

Talk of paying for the proposed jobs bill over 10 years with increased taxes is a very real negative. We have in the past discussed how government policy is driving the U.S. toward the perfect storm where all the monetary policy choices could be unpleasant!

Even without the Tax increases suggested to pay for the jobs bill, there are $1.5 trillion in new federal taxes scheduled to go into effect in 2013. As focus on the impact of withdrawing that level of liquidity from the economy occurs, it may negatively impact the recovery in 2012.

Recent Cartoon



With the economy experiencing structural issues, the direction of manufacturing, retail sales, finance, and exports is uncertain. Energy and raw material costs have not yet fallen sufficiently to help take up the slack. Business needs to look for new revenue streams and brand penetration in traditional markets to drive increased revenues.

Action steps need to anticipate sudden changes that may result from structural shifts. For the next 6 months there may be a lot of talk with little actual change in the economy's slow recovery. We can help you be prepared for what the government's failure to change direction means to your business.

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