Northwood University's
# Monthly Economic Outlook

May 25, 2011

## Introduction

While the U.S. economy continues to move in a positive direction, April and early May data shows it is doing so at a less-than desirable pace. The advance estimate for 1st quarter U.S. GDP for 2011 was a lowly 1.8%, down from a solid 3.1% growth rate for the 4th quarter of 2010. We remain deeply concerned over oil prices, the Japanese economy (especially automobile parts production) and the current unrest in the Middle East and Northern Africa. The negative impact that a shortage of Japanese automobile parts coupled with gasoline prices just south of $4 a gallon nationally will have on automobile sales, travel and tourism harkens back to the conditions we faced in the summer of 2008. Gold and oil prices have been heralding the arrival of higher inflation and in April real U.S. inflation reached 3.16%, which is the first time the inflation rate has exceeded 3% since January 2008. We grow more and more uneasy over the increasing size and scope of the U.S. national debt which surpassed the U.S. debt ceiling of $14.3 trillion and will soon exceed $14.4 trillion. The White House and Congress do not seem capable of bi-partisan cooperation and true debt reform. Recent quantitative easing by the U.S. Federal Reserve Bank (FED) coupled with record deficits have triggered ever-growing inflation rates in the U.S. and a loss of confidence in the dollar as the world's reserve currency, as witnessed by the U.S. dollar index which fell roughly 3.9% in April. While gold continues to soar as it tops $1,525 an ounce, oil and silver prices have receded slightly. Oil is still trading just north of $100 on the NYMEX in late May and silver remains just below $40 an ounce. The threat of a global inflationary cycle still weighs heavy on the global economy.

## Key April/May Data

### Positive Signs

According to the latest manufacturing ISM Report on Business, the Manufacturing sector of the U.S. economy was still strong at 60.4% even though it realized a slight decline of .8% in April relative to March 2011. This is the 4th consecutive month that the PMI has settled above 60%. U.S. productivity remains among the highest in the world while U.S. non-financial corporations' cash reserves remain at nearly $2 trillion dollars. The Dow Jones Industrial Average rose 434 points in April, or an increase of a healthy 3.5%. The April Conference Board Global Leading Economic Indicators Report shows U.S. and China as positive at .4% and .3% respectively, while Europe was down .5%. The U.S. savings rate continued at a notable 5.5% in April. Automobile, SUV and light truck sales remained strong in April as they increased 17.9% relative to April 2010. Cumulative light vehicle sales for March and April reached the highest consecutive two month cumulative level since the end of the Cash for Clunkers program in 2008. The U.S. Pending Homes Sales Index increased 5.1% in April which is the highest increase since November 2010.

### Negative Signs

The national unemployment rate discontinued its four month downward trend, as it increased in April to 9.0%. March and April inflation rates are on the rise with wholesale prices signaling increased inflation for the future as do gold, silver and oil prices. These trends are feeding our concern over global economic stability. Unemployment benefits remain at record highs and will continue at these levels for the next 11 months. The dollar continues to weaken against other major world currencies such as the Euro and the Yen. The U.S. remains one of the highest corporate tax rate countries in the world at an average rate of 39.25% with U.S. companies holding more than $1.2 trillion overseas as a result. Housing starts and construction spending remain at near rock bottom levels, with each decreasing in April 2011 relative to April 2010 by 10.1% and 7.4% respectively.

## Current Issues

You may be familiar with the popular economic phrase, "There is no such thing as a free lunch." This saying

should be revised to say, "There is no such thing as free, period." Everything comes with a cost, and that includes profits. The federal corporate income tax is the price tag government puts on corporate profits, and in 2007 [most current IRS data] that price tag rang up at $370 billion dollars. Without a perspective this is a meaningless number so consider this: A one week stay at Disney World will run a family of four $3,000. With $370 billion 125 million of these vacations could be purchased accommodating 500 million people, or more than the populations of the United States, Canada, and Mexico combined. Putting it another way, $370 billion could purchase roughly 25 million base level Ford Focus automobiles.

The U.S. operates under a worldwide system of taxation. This type of system, which is becoming increasingly rare amongst OECD countries, taxes all revenue earned by American companies regardless of where in the world the revenue is earned. Contrastingly, a country with a territorial tax system, such as Japan, only taxes income earned within its borders. The implications of this difference are evident when considering the scenario in which Ford competes with Toyota in a foreign market such as Italy. As an American company Ford will not only pay Italian corporate income taxes, but American corporate income taxes as well when they repatriate their profits. Toyota, a Japanese company, will be subject to the Italian corporate tax rate but is not liable for any Japanese corporate income taxes. From a competitive viewpoint, Ford is left at a clear disadvantage.

Today over 80% of OECD nations have adopted a territorial tax regime. The United States is just one of five OECD countries to operate with a worldwide system, and of these five nations the U.S. is the only country to have a corporate income tax rate over 30%. In fact, the U.S. combined average corporate income tax rate is the second highest in the OECD (behind Japan at 40%) and the third highest in the world. With a combined corporate income tax rate of 39.25% the U.S. dwarfs the tax rates of some its largest global competitors such as China (25%), India (30%), Russia (16%), and Germany (29.44%). This disparity between rates is largely due to a global tax reform trend centered around cutting corporate income tax rates. According to KPGM, an international tax and auditing firm, the global average tax rate fell from 32.69% in 1999 to 24.91% in 2010. All the while the U.S. rate has remained relatively untouched producing the incentive for companies to move production abroad in order to escape the higher U.S. tax rate.

## Conclusions

Tax rates are becoming increasingly important in investment decisions as capital becomes ever more mobile in the global market place. Japan delayed its scheduled April 2011 corporate income tax cut to 35% due to their current economic crisis caused by recent natural disasters. Whether the U.S. moves to a territorial system or keeps our current system, a cut in the corporate income tax rate must be included in any tax reform if we are to make any real progress in enhancing U.S. global competitiveness.

## Contact Us

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