Northwood University's
Monthly Economic Outlook

September 2012

Introduction

At the close of the third quarter for 2012, the U.S. economy is trying desperately to rid itself of the effects of the Great Recession of 2008-09. Revised second quarter GDP growth increased just 1.3% which was initially reported to be a disappointing 1.7%, according to the third and final revision by the U.S. Commerce Department. The third quarter came to a close on September 30th with the 3 major stock indexes up: the Dow Jones up 3.4%, S&P up 5.8%, and the NASDAQ up 6.2% for the month.

Key August/September Data

Positive and Negative Signs

Even more impressive is the year to date gains for these indexes with the Dow Jones increasing 10%, the S&P up 14.6%, and the NASDAQ up 19.6%. However, third quarter growth was greatly influenced by aggressive measures taken by the Federal Reserve, known as QE3, the Feds will buy $40 billion worth of mortgage-backed securities per month into the foreseeable future and has stated it will keep interest rates at or near zero until early to middle 2015 to stimulate the economy and bring unemployment to below 7%. In addition, QE1-3 could be having a negative inflationary impact as the Consumer Price Index rose by 0.6 points in August. Gold on Sept 28 closed at $1,772.20 up from a month ago at $1,669.52.

The U.S. national debt surpassed a new mark of $16 trillion, which is only $400 billion away from the debt limit of $16.4 trillion and will require the congress to approve more debt or massive spending cuts…or both in early 2013. This continues to be a burden that inhibits growth and stability in our financial markets and around the world. Orders for durable goods fell by a astonishing 13.2% in August as manufacturing firms cut back on expectations and their inventories for the quarter as they become wary of future demand.

The August Conference Board's Global Leading Economic Indicators Report states that the U.S. declined .1 percent in August, the EU was up .6 percent, while China increased 1.7 percent which was the seventh consecutive month of growth for the country. However, the U.S. Consumer Confidence index rose greatly to 70.3, up from 61.3 in August, which signals that consumers are feeling more optimistic of the economy, leading to them purchasing more goods and services.

The unemployment rate fell from 8.3% to 8.1% in August. The purchasing managers' index decreased by .2% to 49.6 for August. This is the lowest level since May 2009 with a number under 50 signaling a recession for this sector. U.S. consumers spent more in August rising by 0.5%, which is the fastest rate since February and marks its second straight sharp gain. But with the sharp increase in spending, consumers' wages grew more slowly with lower wages and increased spending, the U.S. savings rate dropped to 3.7% from 4.1%, which is the biggest one-month decline in the year.

As of September 24, 2012, national gasoline prices were at $3.82, not changing much from the end of August. Yet new vehicle sales were up 20 percent in August and likely up 8 percent in September relative to a year ago.

Current Issues

Last month we focused our analysis on the need for tax reform in the United States with special emphasis on the "fair tax". This month we continue our focus on tax reform with our emphasis being placed on the idea of a "flat tax" or "proportional tax" as a way to improve U.S. competitiveness and provide simplified tax reform. A flat rate tax system is one with a constant marginal tax rate and is usually applied to individual and or corporate income at the local, state and or national level. A flat tax is often called a proportional tax with the same rate applied across all income levels. Most flat tax proposals would allow for a limited number of deductions (such as the home mortgage deduction) and usually are not applied on the first $10,000 or $15,000 of income. The problem in starting a flat rate tax system with limited deductions is that you open the door for more "well intended deductions" and quickly the need arises for a higher rate and the tendency to adopt a progressive tax system where wealthier income earners are taxed at even higher rates.

We propose that the U.S. consider a flat rate tax that begins taxing income at anything greater than $25,000 for an individual or $30,000 for a family at a 15% rate with no exemptions or deductions allowed. We believe that Americans would continue to be charitable and continue to purchase homes if in fact their take home pay from the federal government was no less than 85% of the income that they earn. Such a tax would also put pressure on state and local governments to keep income taxes more reasonable to compete on a state by state basis.

Interestingly enough, many former communist countries have recently introduced or reintroduced flat tax rates in the hope of boosting economic growth. Countries like Estonia, Latvia, and Lithuania have adopted flat tax rates of 24%, 25%, and 33% respectively since the 1990's. Each country has a different initial tax exempt amount but all three have had impressive rates of economic growth since adoption of the flat rate tax. On January 1, 2001, a 13% flat tax on personal income took effect in Russia and the Ukraine which was later increased to 15% in 2007. Romania introduced a 16% flat tax on personal income and corporate profits in January 2005 while Macedonia adopted a 12% flat tax on personal income and corporate profits in January 2007. Albania and Bulgaria both adopted flat rate taxes on personal income and corporate profits in 2008. Economic growth in the "flat rate" Eastern European countries was more than double the rate of the EU on average from 2009-2011. Countries like Russia, Ukraine and the Baltic countries are expected to grow at percentage rates triple that of the European Union in 2012 and 2013. Along with the "fair tax", a "flat tax" system deserves strong consideration by the occupant of The White House and the new U.S. Congress in 2013.

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