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Tax Planning

Make It Part of Your Business Plan, Personal Financial Plan, and Estate Plan

Each of you should have a business plan, personal financial plan, and estate plan. The purpose of each plan will differ. Reasons may include expanding your business, sending your children to college, providing retirement income, or preserving your business for your family in the event of your death. But even though your plans seek to accomplish diverse purposes, they share a common goal—a goal of capital accumulation. Without capital accumulation, you will be unable to accomplish your purposes.

Because good tax planning will enhance your ability to accumulate capital, include tax planning when you develop your business plan, personal financial plan, or estate plan. Accumulate capital by reducing your tax liability through permanent reductions of taxable income; temporary reductions in taxable income; and use of credits to pay tax liability.

If you use tax planning to achieve capital accumulation, review your plans at least annually. Because the tax law continually is changing, your plans will be effective only if it is based on current tax law. You and your adviser must determine if current tax law still is helping you to reach your goals.

Examples of tax law changes in the past year are numerous. The Internal Revenue Service (IRS) has issued regulations on interest deductions and a revenue ruling on deferred payments to independent contractors. The United States Supreme Court has made a landmark ruling in which the principle of the historic *Corn Products*[1] case was limited. In 1986 and 1987, Congress made radical changes in the tax law. There has been yet another such change in 1988.

The paragraphs that follow briefly discuss several tax planning techniques that were affected in the past year—either by Congress, the IRS, or the courts. The purpose of this discussion is not to do your tax planning, for only a few of many tax changes can be reviewed here. Rather, the purpose is to remind you that things have been happening ... things that may affect your goal of capital accumulation. The author hopes this reminder will be all the prodding you need to have your adviser review your plans with you and determine how tax laws have affected them.

Business and Personal Financial Plans

Permanent Reduction in Taxable Income

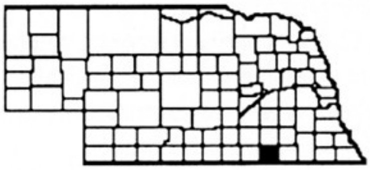
You have made a permanent reduction in your taxable income when you receive part of your compensation in the form of **income excluded from the tax base**. For instance, you may have incorporated your business and, consequently, you may have been receiving a nontaxable benefit in the form of group term life or health insurance. Although your corporation was able to claim a tax deduction for the cost of these benefits, you, as the insured employee, did not include the benefit in your taxable compensation. By structuring a part of your compensation to be received as a nontaxable benefit, you permanently reduced your taxable income. But things have changed. You need to reevaluate the real cost of these benefits.

First, the real cost of providing group term life insurance coverage has increased because of the Revenue Act of 1987. Beginning in 1988, group term life insurance coverage in excess of $50,000 is subject to FICA tax. If the coverage is discriminatory, the value of the discriminatory insurance coverage is subject to FICA tax. Second, new tests must be applied, beginning in 1989, to determine if insurance and similar benefits are discriminatory.[2] If they are, a portion, if not all of the value of the benefit, will be included in the employee's taxable income. To avoid

In This Issue . . .

County of the Month

Thayer



Size of county: 577 square miles, ranks 49th in the state
Population: 7,000 (estimated) in 1987, a change of -7.9 percent from 1980
Per capita personal income: $14,354 in 1986, ranks 22nd in the state
Unemployment rate: 3.7 percent in Thayer County, 4.9 percent in Nebraska for 1987
Net taxable retail sales ($000, unadjusted for inflation): $31,662 in 1987, a change of +12.3 percent from 1986; $19,938 during January-July, 1988, a change of +11.7 percent from the same period one year ago
Nonfarm employment (1987):

	State	Thayer County
Wage & salary workers	659,223	1,792
	(percent of total)	
Manufacturing	13.3%	13.2%
Construction and Mining	3.9	3.3
TCU	6.5	5.6
Retail Trade	18.7	15.2
Wholesale Trade	7.1	9.7
FIRE	7.3	5.6
Services	22.7	18.1
Government	20.5	29.3
Total	100.0%	100.0%

Agriculture:
Number of farms: 707 in 1982, 759 in 1978
Average farm size: 513 acres in 1982
Market value of farm products sold: $80.1 million in 1982 ($113,283 average per farm)

Sources:
Bureau of the Census: *Area Measurement Reports*, 1970; *Census of Agriculture*, 1982; *Census of Population*, 1980; *Provisional Estimates of the Population of Counties*, 1986
Bureau of Economic Analysis: *Survey of Current Business*, April 1988
Nebraska Department of Labor: *Labor Market Summary Report*, 1987
Nebraska Department of Revenue: *Net Taxable Sales* M.W.E.

Taxes (continued)

being discriminatory, you may need to extend insurance coverage to a greater number of employees. You must decide if the tax savings that remain are worth the additional cost. You face a business decision.

Income shifting is another technique often used to permanently reduce taxable income.

EXAMPLE: You've been making cash gifts to your child for a number of years. You are investing these funds for your child, hoping that he or she will use them for a college education.

By making gifts to your child, you have shifted the income that will be earned by investing these gifts to your child. This shift permanently has reduced your taxable income because you will not be taxed on the investment return. It is advantageous, however, only if your child is at a lower tax bracket then you are.

With the 1986 Tax Reform Act, children under the age of 14 must use the marginal tax rate of their higher-earning parent to compute the tax on their investment income. But this rule only applies if the child's investment income exceeds $1,000 annually. If the child's investment income is less than $1,000, the income shift should result in a tax savings. If your child's investment income will exceed $1,000, you should consider alternate investments. Rather than making investments that are interest-bearing, consider making investments that do not generate currently taxable income. Examples include growth stocks, municipal bonds, and E bonds.

When children become 14 years of age during a tax year, they no longer will have their investment income taxed at their parents' marginal tax rate. Their marginal rate generally will be 15 percent. If you are making investments for your child, you now may find that municipal bonds no longer provide a greater after-tax return than taxable interest-bearing investments. You should revise your investment strategy.

Regardless of the age of your children, money that they earn will be taxed at their own tax rate and not at your marginal tax rate. In addition, the first $3,000 of income they earn is not subject to income tax. But realistically, a child of 7 does not have the skills necessary to earn $3,000 annually. On the other hand, children at age 12 are able to take responsibility and often do in rural Nebraska. It is not unreasonable to expect them to begin earning money for their college education.

Example: A child, age 12, works in her parents' business for 450 hours during a year. The child earns $1,500.[3] *The parents are able to deduct these wages as a business expense. The parents reduce their taxable income to $35,000. Yet the child pays no income tax. Neither the child nor parent pays FICA or self-employment tax. The following tax reduction has been accomplished:*

	Tax Reduction	
	Without Wage to Child	With Wage to Child
Income Tax:		
($1,500 x 28 percent)	$420	N/A
($1,500 x 15 percent)	N/A	N/A
Self-Employment Tax:		
($1,500 x 13.02 percent)	195	N/A
FICA Tax:		
($1,500 x 7.51 percent)	N/A	N/A
TOTAL TAX	$ 615	$ -0-

While the child is paid $1,500, taxes are reduced $615. Forty percent of her wages are paid with tax savings.

A portion of the tax reduction in the preceding example resulted from a reduction in FICA or self-employment taxes. This occurred because the parents received a deduction when they paid their child—reducing their income subject to the self-employment tax. The child, however, as an employee of her parents was not subject to either FICA or self-employment tax. The Revenue Act of 1987, however, has limited this exclusion.

Prior to the Revenue Act of 1987, you did not pay payroll taxes if you employed your spouse or your child who was under the age of 21. Beginning in 1988, you were required to pay payroll taxes when you employed either a spouse or your child who was at least 18 years old. Consequently, the tax reduction achieved by income shifting to a spouse or older child has been reduced.

Rather than shifting income from yourself to a family member who is in a lower tax bracket, you may shift income to a corporation that you own and in which you are the primary employee. Perhaps this is necessary because you transferred business debt to the corporation at the time it was formed. Because the corporation now must generate cash flow to repay that debt, income must be retained in the corporation rather than being used to increase your salary as an employee. The advantage you gained by having the corporation pay the business debt is that the corporation, due to its lower tax rates, will have more after-tax income available.

A corporation generally is taxed at 15 percent on its first $50,000 of taxable income, whereas the stockholder-employee may be paying tax at a marginal rate of 28 or 33 percent. These tax savings may be used by the corporation to pay the debt. But today you need to rethink this plan. If your corporation is a personal service corporation, it is no longer a lower bracket taxpayer. Beginning with 1988, personal service corporations have a single tax rate—34 percent. Even for nonpersonal service corporations, the high tax cost of liquidation has made incorporation less advantageous.

Deferral of Taxable Income

Income may be deferred by **accelerating deductions**. But if deductions are being accelerated, the income reduction is temporary—lasting only as long as the deduction.

When an accrual method of accounting is elected, deductions are taken when performance occurs rather than when payment is made. In certain instances, however, accrual deductions are denied until payment is made. For instance, if you owe an amount to a cash basis taxpayer who is related to you, you are unable to claim a deduction until payment is made.[4] A similar rule has been enacted for independent contractors.[5] This rule, however, applies regardless of whether or not the independent contractor is related to you.

EXAMPLE: An independent contractor conducts public opinion polls for an accrual basis taxpayer. An agreement executed prior to the performance of the contract required payment of 25 percent of a fixed fee in 1988 and 25 percent in each of the next three years. Total performance, however, was completed in 1988. The accrual basis taxpayer may deduct only the fee that actually was paid in 1988 or within 2 1/2 months after his tax year end.

Another method of accelerating deductions is to recognize losses. The character of the recognized loss, however, determines the tax benefit of the deduction. If an ordinary loss is recognized, offset taxable income and, to the extent the loss exceeds taxable income, carry it back three years and forward 15 years. You receive the maximum income deferral and tax benefit. But if a capital loss is recognized, you only may use it to reduce capital gains and, to the extent the loss exceeds capital gains, $3,000 of ordinary income. Although a capital loss carries forward indefinitely for an individual taxpayer, such a carryforward does not provide the immediate temporary income deferral you gain from an ordinary loss.

A recent United States Supreme Court case, *Arkansas Best and Subsidiaries v. Commissioner*,[6] has changed loss characterization planning. Prior to *Arkansas Best*, you may have relied on *Corn Products Refining Co. v. Commissioner*[7] to obtain ordinary loss treatment when you purchased stock or securities in a company for business reasons rather than investment reasons.

EXAMPLE: A group of ranchers purchase a cattle feeding corporation located in their area. The corporation has been a primary purchaser of their cattle, but it has been having financial difficulties. The ranchers are unable to save the cattle feeding business. Can they claim an ordinary loss?

Prior to *Arkansas Best*, these ranchers may have relied on *Corn Products* and claimed an ordinary loss because their purchases were motivated solely by business reasons. After *Arkansas Best*, the ranchers will have a capital loss if they purchased either stock or securities from the prior owners. Their motivation in acquiring the corporation is not relevant.

An ordinary loss still may be obtained in the above situation, but planning is required. And you should do that planning before you make your investment, particularly if high risk is involved.

In your business plan, you may have been using **accounting methods** to defer income. For instance, if you sell assets on an installment basis, you often can defer gain recognition. But that gain deferral has a cost. In an installment sale, you give up your right to immediate cash payment from the purchaser. Congress, however, perceived that taxpayers were using installment sales without incurring any loss in their liquidity. The taxpayer merely used the installment sales contract as collateral for a loan.

In 1986, Congress enacted legislation to treat a portion of a taxpayer's borrowings as a payment on certain installment sale obligations. In 1987, Congress modified this rule substantially. One change it made was to treat only debt that is directly secured by an installment sale obligation as a payment on that obligation. Several other changes were made. Consequently, if you had considered and rejected using an installment sale when selling your business or rental properties, you may want to reconsider your decision.

Although the Revenue Act of 1987 provided a beneficial change in the treatment of installment sales for nondealers, it provided harsher treatment for dealers. In 1986, Congress had eliminated installment sale treatment for revolving credit plans. The Revenue Act of 1987 eliminates all use of installment sales by dealers in either real or personal property.

Uniform capitalization rules are another accounting method change made by the Tax Reform Act of 1986. Under these rules, farmers were required to capitalize the cost of raising a heifer until she dropped her first calf. The 1988 Technical Corrections Bill enacted by Congress on October 21 has eliminated this capitalization rule for farmers. Farmers once again may accelerate expenses in order to defer taxable income.

Estate Plan

If your business has experienced substantial growth, your estate plan may include an estate freeze to minimize estate and gift taxes. To accomplish this freeze, you may have incorporated your family business, and a senior family member may have exchanged his or her common stock for preferred stock. The common stock, which had little or no value, was gifted or sold to younger family members. At the senior family member's death, only the preferred stock, which did not participate in the equity appreciation, would be included in the taxable estate. The goal of minimizing estate and gift taxes would be accomplished. The Revenue Act of 1987 may have destroyed your plan.

Prior to the Revenue Act of 1987, property was included in your gross estate if you retained a life estate or an income interest in property. In 1987, Congress extended this rule to include in your gross estate property transferred under the typical estate freeze. For this rule to apply, you must hold a substantial interest in the business; transfer, after December 17, 1987, property having a disproportionately large share in the appreciation in the business; and retain a disproportionately large share in the income of, or rights in, the business.[8] If your estate plan is using an estate freeze, you need to discuss this change with your adviser.

Conclusion

Tax laws are evolving and changing continually. Yet, they should be an important element in reaching the goals of your business plan, personal financial plan, or estate plan. Make them an important, viable component by reviewing your plans annually. Include new tax incentives in your plans that will help achieve your goal. And, to the extent possible, mitigate the effect of adverse tax laws.

Footnotes

**All statutory references are to the Internal Revenue Code of 1986, as amended to the date of publication, unless otherwise indicated.

1. 76 S.Ct. 20 (1955).
2. I.R.C. Section 89.
3. Earnings are based on wage of $3.30 per hour for 450 hours.
4. I.R.C. Section 267.
5. Rev. Rul. 88-68, I.R.B. 1988-35,20.
6. 108 S.Ct. 971 (1988).
7. 76 S.Ct. 20 (1955).
8. I.R.C. Section 2036(c)

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Restoring the U.S. Competitive Edge--Part I

Management has been a popular topic during the past five years. Recent New York Times bestseller lists include such management volumes as *In Search of Excellence*, *A Passion for Excellence*, *Thriving on Chaos*, *One Minute Manager*, *Theory 2*, *The Art of Japanese Management*, *Iaccoca*, etc. Even some way-out books have become popular, including *A Book of Five Rings*, written by a famous 17th century Japanese samurai (Miyamoto Musasbi). Heralded as Japan's answer to the Harvard MBA, this book has nothing to do with management; however, American executives thought this book about samurai strategies could help them fight Japanese corporations.

The reason for the popularity of management books is that we have serious economic problems at the national level and various productivity problems at the individual organization level. Until the mid 1960s, the United States was number one in almost every category—productivity, product quality, research and development, international trade, per capita income, etc. I believe we achieved economic leadership for three primary reasons. First, we were able to make important innovations in product/service development and in production/delivery processes. Second, we used innovative marketing strategies to sell those products/services. Third, we had the entrepreneurship to bridge those innovations with human talents in organizations. Organizational innovations for products/services and delivery systems can be labeled contestable advantages. Such innovations can be copied or imitated easily by competitors in most cases. Entrepreneurship represents the true comparative advantage of U.S. corporations.

In the 1960s, U.S. corporations began to pursue short-term financial goals rather than long-term growth, with predictable consequences. Perhaps the most distressing measurement of our nation's economic woes is our annual productivity rate increase, one of the lowest among industrialized nations. Our manufacturing productivity rate increase during the past twenty years has been approximately 2.7 percent per year, ninth among the nine leading industrialized nations of the world. Japan leads other nations with a 9.3 percent average annual rate. The productivity rate of the U.S. service sector lags behind that of the manufacturing sector.

Our international trade deficit has been accumulating year after year. Even with the cheaper dollar and a protective government posture, our trade deficit reached $165 billion in 1987. As the late U.S. Senator Everett Dirksen once said, "One billion here and one billion there; it will soon add to real money." The estimated trade deficit for 1988 is $150-155 billion.

Today the U.S. is the largest debtor nation in the world. Our national debt is over $2 trillion. Much of that money is what we owe ourselves. We also owe more than $270 billion to foreigners, however. In 1987 we paid more than $26 billion in interest to foreigners. That amount is 50 percent more than what the federal government spent for higher education in 1987. Today about 30 percent of new U.S. treasury notes are being sold to foreigners. We would be hard pressed to keep our federal government in operation without borrowing heavily overseas.

We hear much about the importance of the service sector in the U.S. economy. When we examine the employment figures, the service sector dominates. In 1950, the manufacturing sector represented 35 percent of total U.S. employment, while agriculture and public organizations had 6 percent and the service sector 59 percent. In 1987, the respective employment figures for the above three categories were 19 percent, 5 percent, and 76 percent. In addition, 90 percent of all new jobs being created in the U.S. are in the service sector.

A sound and prosperous service sector cannot exist without a healthy manufacturing sector. There is no guarantee that we would be more successful in the service sector than in the manufacturing sector. The service sector currently is plagued by the same factors that brought many problems to manufacturing, such as emphasis on short-term financial goals over long-term growth. U.S. leadership in several important service industries has eroded significantly. For example, among the ten largest banks in the world (total assets), Citicorp is the only U.S. bank, eighth in size. The remaining nine largest banks are Japanese. The Japanese own 10 percent of U.S. bank assets. Among the ten largest insurance firms, only six are U.S. companies. The world's largest advertising agency is Japanese. Even high fashion centers around Tokyo today.

Another alarming fact is the increasing Japanese acquisition of U.S. corporations. Since 1987, major Japanese acquisitions of U.S. firms include:

*Bridgestone acquired Firestone for $2.6 billion
*Sony acquired CBS Records for $2 billion
*Aoki Corp. acquired Westin Resorts for $1.53 billion
*Nippon Life acquired Shearson Lehman for $538 million
*Several Japanese banks acquired Bank America Corp. stocks for $350 million
*Yasuda Mutual acquired Paine Webber for $300 million

These are some of the distressing facts about the U.S. economic situation. We must pause and closely examine what has happened to the U.S. since the 1960s. Today "Made in the USA" often means that the quality must be bad, but the service surely is worse. Let us review some of the causes behind these problems.

The Success Syndrome

When things were great, we took success for granted. Consequently, we became complacent and neglected the details that made U.S. corporations successful, such as product quality, service, and constant innovation to meet the customer's needs.

Antiquated Human Resource Management

In the 1910s, about 90 percent of all employed persons could be labeled laborers whose primary work responsibility called for physical labor. Today this number is less than 20 percent. Commensurately, labor costs amount to less than 15-20 percent of total cost for most products. The primary concern of most firms remains cutting labor costs by trimming manpower. We must concentrate instead on how best to utilize skilled human resources in such a way that the remaining 80-85 percent of total product cost can be reduced.

Many U.S. corporations still have the general notion that management's primary functions are command and control. Such a notion promotes the idea that only managers can think and make decisions and low-level employees simply perform the work given to them. This is not only a false idea about management, but such thinking is destructive. Management is a collaborative process where every member of the organization fully is exercising his or her creativity on the job for a common purpose.

Neutron Bomb Mentality

Many organizations measure their success based on their quarterly profit figures. Thus, even the slightest decline in the quarterly financial report requires prompt management action (such as zapping all human resources in sight) to preserve the plant, machinery, and inventories. That is what a neutron bomb does: it kills only persons without destroying anything else. Such a neutron bomb mentality on the part of management destroys the fabric of employees' loyalty and dedication to the organization.

Technology Syndrome

We have seen some remarkable advances on many technological fronts—computers, communication systems, new materials, fiber optics, etc. Such technological developments have profound impacts on the way organizations are managed. Technology, however is not like merchandise that we can just buy and then use. Technology is embedded in human brains. The interface of technology and human resources is the key for a successful application of technologies.

In 1978, the U.S. automobile industry was stunned to find that the Japanese cost advantage per automobile amounted to $1,500. To reduce this gap, the auto industry invested $40 billion in robotics for automated factories. After five years of American effort and investment, the Japanese advantage increased to $2,500.

Obviously, technology per se was not the problem. Many U.S. managers think technology is a panacea. The technology that Japanese firms use is typically inferior to the sophisticated technologies that comparable U.S. firms use. The big difference is that the Japanese choose the technology that is most appropriate for their products, personnel, environment, and strategies instead of always looking for the most advanced technology. Also, the Japanese are meticulous when it comes to the interface of technology and human resources. New technologies are not introduced to the workplace until a thorough training program is completed by all affected personnel.

Goliath Syndrome

The general notion among U.S. corporations is that organizations must become big to be powerful, dominant, and profitable.

Of course, there exists a critical mass in order to take advantage of the economies of scale and survive in certain industries. Big organizations, however, suffer from increased bureaucratic management, heavy corporate structure, and lost resilience. Small is beautiful when it comes to corporate size. Small firms are much more flexible in today's volatile environment.

Based on empirical studies, small firms obtain much better return from investment in research and development than larger firms. Their return is five times more than that of medium-size firms and 21 times more than that of large corporations. Many innovative U.S. corporations have begun to downsize or further decentralize their organizations. IBM, Exxon, GE, and Sears come to mind.

Lack of Knowledge about Competitors

Many U.S. firms and the American public in general still do not know or have an interest in our overseas competitors. We like to think that the U.S. is so powerful that we can crush any foreign competitor. We must realize that U.S. preeminence or domination in the global market is an illusion. Today the U.S. is a member in the network of industrialized and newly industrializing nations. We no longer can control other nations' trade or industrial policies through our economic muscle.

Our overseas competitors are not only tough, but they are determined to succeed in the global market. I go to Japan, Korea, Hong Kong, or Singapore at least once a year to examine their management innovations. Our competitors not only have the determination to excel, but they also have vitality through constructive corporate cultures. Their corporate mottos are not merely slogans, but the emotional backbone of the common destiny for their employees. "We build people," "Harmony and dedication," "Don't walk, run, run, run," "Today Japan, tomorrow the world," and "The customer is not our king, he is our god," reflect their corporate values.

Our technological innovations rewarded our corporations handsomely in the past because it took a long time for our competitors to diffuse our technological edge. Today, however, Sony, Matsushita, Samsung, and Toshiba can copy our ideas in weeks or days. Our competitive disadvantage comes not from our competitors' ability to copy our ideas, but from our inability to copy theirs.

A good lesson can be learned from a recent development in the field of superconductivity. An important breakthrough was made in this area by scientists at IBM's Zurich Laboratories. The finding was published by Dr. Alex Mueller in a German journal. Scientists in Germany, Japan, and other nations carefully studied this article. American scientists, however, did not know about this article until about six months after its publication. Consequently, we are about six months behind other nations in this particular area.

Our competitors also have shown astoundingly short development periods for new products. For example, Xerox Corporation recently discovered that their Japanese competitors can develop new copiers in 60 percent less time and at half the cost. Honeywell used to develop new thermostats in about two years using its own scientists and engineers, while the Japanese do it in one year. Now Honeywell's Tiger Team, composed of scientists/engineers and key manufacturing and marketing personnel can develop new thermostats in ten to twelve months. The parallel development process and the right to break any company rules have made competition possible for Honeywell.

In addition to the above factors, there are many others that are critical, including federal industrial policies and regulations, state government economic policies, management-labor relations, and the like. Excluding exogenous factors, the above items listed represent important indigenous factors that have plagued U.S. corporations.

Recommendations for restoring U.S. competitive edge will be presented in Part II in next month's issue of *Business in Nebraska.*

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Metropolitan Nebraskans....

The Omaha-Council Bluffs area now ranks as the 60th largest metropolitan statistical area (MSA), down from 57th in 1980. That population is estimated at 616,400 as of July 1, 1987. The Lincoln MSA now is ranked as the 152nd largest, with an estimated population of 207,700.

...An An Even More Metropolitan Nation

According to the Census Bureau, three of four Americans now live in metropolitan areas. That figure is up from 25 years ago, when 64 percent of Americans lived in metropolitan areas.

Are We Meeting Your Needs...

Putting out a newsletter is like fishing. We throw out the bait and hope that something strikes. It is time to check the line. We would like to hear from you. Do you find items of interest in *Business in Nebraska?* What do you like best? Do you have suggestions for future issues? Send us your ideas and suggestions.

Review and Outlook

National Economy

It is hard for a reader of the business press to believe that the current business expansion is continuing, yet that is what is happening. The newly named advanced report, formerly the preliminary report, on real Gross National Product (GNP) shows that the third quarter advance was 2.2 percent at annual rates. The third quarter increase followed a second quarter revised jump of 3.0 percent. The advanced third quarter number was lower than expected. Imports were stronger than anticipated, causing net exports to shrink.

Weakness was also attributable to drought effects. The drought is estimated to have decreased GNP by 0.6 percentage points in the third quarter and 0.9 percentage points in the second quarter. The Bureau of Economic Analysis (BEA) currently estimates the total drought effect for the year at $13.0 billion in real (1982) dollars or 0.8 percent of GNP. So far this year, they have allocated $6.0 billion to the second and third quarters. This leaves $7.0 billion or 1.75 percentage points at annual rates for the fourth quarter. Unless methods are changed, BEA should show a low rate of growth in the fourth quarter, barring any offsetting effects from some other sector.

Nevertheless, growth in the third quarter was positive. The game of outguessing the direction and magnitude of forthcoming revisions is reserved for a small group of experts. The only certainty is that there will be revisions. Data from the BEA suggest that revisions tend to be positive, but have a broad range. BEA states that the third quarter estimate of 2.2 percent will not be revised below 1.0 percent or above 5.0 percent.

The largest component of GNP is consumption. Real co sumption rose 3.5 percent in the third quarter, after a 3.0 perc gain in the second quarter. The consumer durables portion consumption barely advanced in the third quarter, but n durables increased 3.7 percent. That pattern was nearly reverse of the second quarter. Consumption of services, the m stable sector, increased 4.4 percent in the third quarter versus percent in the second. Underlying these gains, personal inco grew 0.5 percent in September following an increase of percent in August.

Let's take a few minutes to review the pluses and minuses the current (late October) evidence. On the plus side, consum prices rose only 0.3 percent in September versus 0.4 percent each of the preceding two months. Once again, the bigg elements have been food prices (up) and energy prices (dow The Consumer Price Index advanced 0.4 percent in Septemb Producer prices matched the 0.4 percent growth from August September. Table III presents the price data in year ago compa sons. The picture is mixed, with intermediate producer pri matching the 0.4 percent gain, but raw material prices sliding h a percent. On a year ago basis, they are up only 1.0 percent.

The good news on prices is especially surprising in view of current capacity utilization rate. Capacity utilization edged do marginally to 83.6 percent, within a range where inflation usua becomes a problem. Part of the explanation comes from signs restraint in the labor compensation area. First year major la contracts have increased only 1.2 percent through September t year versus a moderate 1.0 percent gain for the same peri

Table I
Income and Earnings In Nebraska*
(millions of dollars)

	First Quarter 1987	Second Quarter 1987	Third Quarter 1987	Fourth Quarter 1987	First Quarter 1988	Second Quarter 1988	% Change 1988:II vs. Year Ag
Income							
Total Personal Income	22,622	22,206	21,944	24,610	23,452	24,381	9.8
Nonfarm	20,327	20,494	20,830	21,262	21,542	21,872	6.7
Farm	2,295	1,711	1,113	3,348	1,910	2,509	46.6
Earnings by Industry**							
Ag. Services, Forestry, & Fisheries	73	72	75	82	85	86	19.4
Mining	40	46	50	51	46	49	6.5
Construction	928	864	851	885	968	938	8.6
Manufacturing	2,121	2,134	2,206	2,255	2,345	2,399	12.4
Nondurable	1,041	1,067	1,093	1,121	1,144	1,160	8.7
Durable	1,080	1,068	1,113	1,133	1,201	1,240	16.1
Transportation & Public Utilities	1,571	1,574	1,612	1,629	1,661	1,713	8.8
Wholesale Trade	1,105	1,116	1,142	1,160	1,198	1,223	9.6
Retail Trade	1,528	1,543	1,556	1,574	1,614	1,627	5.4
FIRE	1,161	1,149	1,177	1,197	1,192	1,213	5.6
Services	3,154	3,207	3,279	3,387	3,358	3,465	8.0
Government	2,886	2,917	2,936	2,999	3,029	3,064	5.0
Federal, Civilian	453	451	462	467	470	466	3.3
Military	396	397	400	400	407	405	2.0
State & Local	2,037	2,069	2,075	2,132	2,152	2,194	6.0

*All data are seasonally adjusted at annual rates
**Earnings is the sum of wages and salaries, other labor income, and income earned by sole proprietors

last year. Total compensation in private industry rose 1.0 percent in the third quarter versus 1.2 percent in the second. There is little pressure from the cost side at this time. If OPEC raises oil prices, the low rate of growth in consumer and producer prices may end. The latest news available shows no such indication.

Continuing on the plus side, housing starts rose in September 1.5 percent. That increase was due to multifamily starts, a sector that has been weak since tax reforms at the end of 1986. Single family starts decreased 2.3 percent. Housing starts peaked long ago, reaching a total of 1.84 million starts at annual rates in December 1986.

The unemployment rate fell 0.2 percent, and industrial production showed no increase. Have we been lucky or is something else happening? We'll return to this theme after reviewing some of the negatives.

On the minus side, in October the National Association of Purchasing Managers reported a decrease in their index of -1.4 percent. This index reports a percentage of members experiencing higher levels of activity than in the previous month. NAPM members tend to be associated with manufacturing firms. Consumer confidence as reported by the Conference Board plummeted 8.9 percent in September, the largest fall since the decrease following the stock market crisis last year. This series, however, has fallen twice so far this year and then rebounded. Consumer confidence levels are where they were in January and well above November 1987 levels. We should be concerned if the consumer confidence index continues to slide the next two or three months.

Reflecting the drop in consumer confidence, retail sales decreased in September 0.4 percent. Auto sales accounted for a large part of the drop, falling 1.9 percent. This has been blamed on the elimination of dealer incentives. Early October domestic auto sales (auto sales are reported every ten days) are somewhat below the year-to-date average, but well above year ago levels. Automakers may have pulled sales from September and October into the summer, or they may have conditioned consumers so that consumers won't buy without dealer incentives. Auto list prices have increased dramatically in the last five years, especially on some luxury models. Cash incentives are a tool used by manufacturers to increase traffic to dealerships and to offset sticker shock.

As a balance to the consumer-oriented minuses, there is good news on the income side. Third quarter disposable personal income rose 9.4 percent at annual rates before adjustment for inflation or 4.7 percent in real terms. Seasonally unadjusted average weekly earnings of factory workers leaped 2.7 percent over August levels. That figure is not an annualized rate, but a single month's gain. Later reports toned down this dramatic increase. Average weekly earnings or production and nonsupervisory workers (another series) rose 0.5 percent in September from August after adjusting for seasonal variation and inflation. There is even good news in the agricultural sector. Despite the drought, one forecaster expects net cash farm income to peak this year at $60 billion. That sharply contrasts to the $30 to $40 billion levels of the early 1980s.

What are all these conflicting data telling us? The story remains unchanged from previous issues. We appear to be expanding at moderate but positive growth rates. We should expect to see pluses and minuses in individual data series as the economy continues to adjust to the ongoing expansion. With the possible exception of the housing sector, there is no major economic data series displaying a long-term downward trend. Mixed signals are evident, but we continue to move forward.

The other major issue we face is harder to address—where are we going? If the BEA sticks to its guns on the allocation of drought effects, the first quarter of 1989 likely will show strong growth. According to the Undersecretary of Commerce, Robert

Table II
Employment in Nebraska

	Revised Aug. 1988	Preliminary Sept. 1988	Aug. % Change vs. Year Ago
Place of Work			
Nonfarm	666,199	673,133	1.0
Manufacturing	93,314	93,172	3.5
Durables	46,375	46,270	5.4
Nondurables	46,939	46,902	1.7
Mining	1,878	1,783	-2.3
Construction	25,831	25,199	-2.2
TCU*	44,304	44,281	1.6
Trade	171,498	171,645	0.0
Wholesale	48,189	47,990	1.3
Retail	123,309	123,655	-0.5
FIRE**	48,326	48,260	0.8
Services	150,358	150,589	0.1
Government	130,690	138,204	2.0
Place of Residence			
Civilian Labor Force	818,125	818,466	0.1
Unemployment Rate	3.2%	3.2%	

*Transportation, Communication, and Utilities
**Finance, Insurance, and Real Estate

Source: Nebraska Department of Labor

Table III
Price Indices

	Sept. 1988	% Change vs. Year Ago	YTD % Change vs. Year Ago
Consumer Price Index - U* (1982-84 = 100)			
All Items	119.8	4.2	4.0
Commodities	113.0	3.8	3.4
Services	127.3	4.6	4.5
Producer Price Index (1982 = 100)			
Finished Goods	108.6	2.7	2.2
Intermediate Materials	108.7	5.8	5.4
Crude Materials	96.6	1.0	2.9
Ag Prices Received (1977 = 100)			
Nebraska	151	12.7	10.7
Crops	138	62.4	33.6
Livestock	160	-3.0	2.8
United States	145	12.4	8.0
Crops	139	32.4	17.5
Livestock	151	-0.7	1.3

U* = All urban consumers
Source: U.S. Bureau of Labor Statistics

Ortner, the end of the drought will add 2.75 percentage points to GNP in that year. For the remainder of the year, the preponderance of testimony from those brave enough to make forecasts is that next year will show lower growth than this year. In general, economic forecasters call for growth in the 2 percent area for 1989.

What evidence do we have to support such a conclusion? Some cite impending inflation, but so far there is no evidence. The main risk is energy prices. OPEC has been having difficulties coordinating producing nations and raising prices. Others rely on the Federal Reserve System to tighten the monetary screws too hard. That possibility cannot be dismissed by anyone after the 1981-1982 downturn. Even here, a necessary condition appears to be an acceleration of inflation. It is the Fed's overreaction to inflation that causes concern. Still others expect a reversal of the devaluation of the dollar to lead us downward.

In reality, I suspect that the real cause of the forecasts of decreased growth next year by many economists is that they don't believe that such a long expansion can continue.

Perhaps our lack of understanding of how the expansion can continue is caused by a lack of understanding of what is maintaining our growth. I see two major factors. Our exports have helped in recent quarters. Net export numbers in the GNP accounts are not as negative as those to which we have been accustomed. Perhaps we have been able to export some of our inflation as well. That point is difficult to prove, but makes interesting speculation. Second, an economy as service-oriented as ours behaves differently than a manufacturing-oriented economy. In particular, business cycle effects are not as strong. I don't think that mainstream forecasting economists have given that factor enough thought yet. It will be interesting to watch this area of analysis develop.

Is another recession looming? One may be likely, but without the ability to pinpoint the timing of a recession, I think it would be a disservice to tell persons to run for cover when there is plenty of opportunity to harvest economic gains before the impending storm.

Table IV
City Business Indicators
July 1988 Percent Change from Year Ago

The State and Its Trading Centers	Employment (1)	Building Activity (2)
NEBRASKA	2.3	8.1
Alliance	2.4	75.6
Beatrice	2.1	219.9
Bellevue	2.6	61.9
Blair	2.6	-63.3
Broken Bow	3.6	88.8
Chadron	2.9	-85.2
Columbus	4.5	98.3
Fairbury	2.9	1,861.2
Falls City	1.9	36.2
Fremont	1.4	2.4
Grand Island	1.0	45.8
Hastings	0.8	95.9
Holdrege	2.8	-22.6
Kearney	1.3	92.4
Lexington	1.8	307.4
Lincoln	1.0	9.1
McCook	0.2	219.4
Nebraska City	2.2	-7.5
Norfolk	1.4	-17.8
North Platte	1.5	21.3
Omaha	2.6	-11.1
Scottsbluff/Gering	1.4	-11.0
Seward	1.2	-24.8
Sidney	2.3	-21.7
South Sioux City	6.4	89.9
York	1.7	-63.0

(1)As a proxy for city employment, total employment (labor force basis) for the county in which a city is located is used.

(2)Building activity is the value of building permits issued as a spread over an appropriate time period of construction. The U.S. Department of Commerce Composite Cost Index is used to adjust construction activity for price changes.

Sources: Nebraska Department of Labor and reports from private and public agencies.

Figure I
City Business Index
July 1988 Percent Change from Year Ago

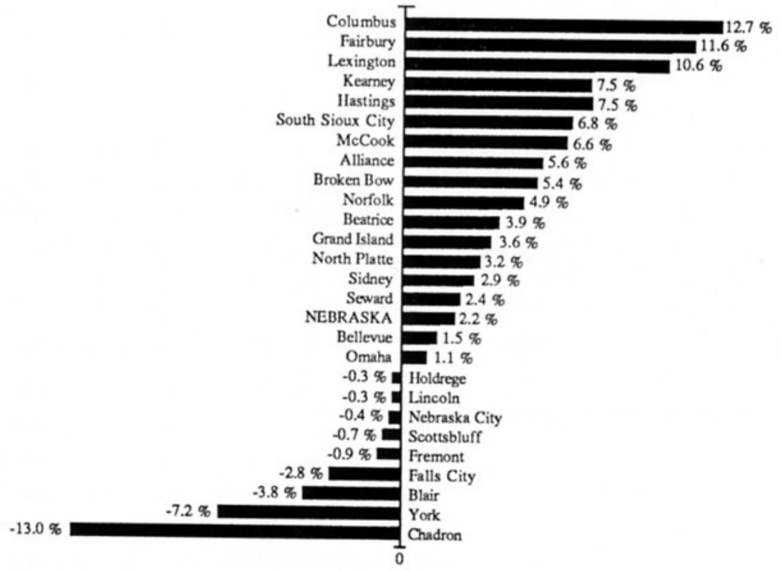
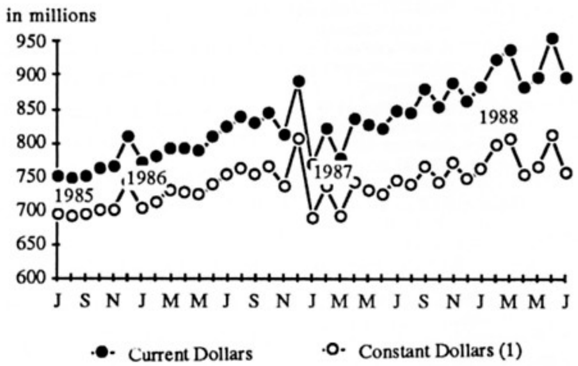


Table V
Net Taxable Retail Sales of Nebraska Regions and Cities

Region Number and City (1)	City Sales (2) July 1988 (000s)	City Sales (2) % Change vs. Year Ago	Region Sales (2) July 1988 (000s)	Region Sales (2) % Change vs. Year Ago	YTD % Change vs. Year Ago
NEBRASKA	$782,584	5.6	907,337	5.8	11.8
1 Omaha	269,098	4.9	338,936	3.8	8.6
Bellevue	11,291	-1.0	*	*	*
Blair	4,151	3.4	*	*	*
2 Lincoln	106,678	0.9	125,734	3.5	13.0
3 South Sioux City	4,323	5.7	6,268	5.8	22.5
4 Nebraska City	3,559	1.4	16,704	1.5	8.8
6 Fremont	14,228	-0.1	26,418	1.4	14.2
West Point	2,022	0.9	*	*	*
7 Falls City	1,927	-8.3	8,074	0.2	7.2
8 Seward	3,779	11.0	13,471	6.5	12.3
York	5,796	-3.9	14,418	8.7	12.6
10 Columbus	14,789	20.8	24,901	12.5	16.1
11 Norfolk	17,282	15.8	30,930	13.1	18.0
Wayne	2,274	3.6	*	*	*
12 Grand Island	29,695	6.7	42,686	6.3	15.6
13 Hastings	14,378	12.7	23,723	9.3	11.2
14 Beatrice	6,687	-2.5	15,930	-0.3	10.1
Fairbury	2,379	-5.9	*	*	*
15 Kearney	17,612	12.4	25,407	12.3	19.4
16 Lexington	5,158	10.6	15,099	12.9	20.8
17 Holdrege	4,042	3.0	7,966	0.6	12.5
18 North Platte	15,127	7.3	18,958	6.6	16.7
19 Ogallala	6,067	5.9	11,579	8.5	13.5
20 McCook	7,053	5.7	10,276	7.8	18.6
21 Sidney	3,915	10.7	7,904	0.8	9.4
Kimball	1,979	-0.5	*	*	*
22 Scottsbluff/Gering	16,076	1.8	22,665	2.6	6.8
23 Alliance	5,084	7.8	13,529	5.5	12.3
Chadron	2,684	-8.2	*	*	*
24 O'Neill	3,698	4.5	12,552	11.2	16.7
Valentine	2,418	8.2	*	*	*
25 Hartington	1,345	13.3	7,561	4.2	9.8
26 Broken Bow	2,970	5.4	10,378	10.0	20.8

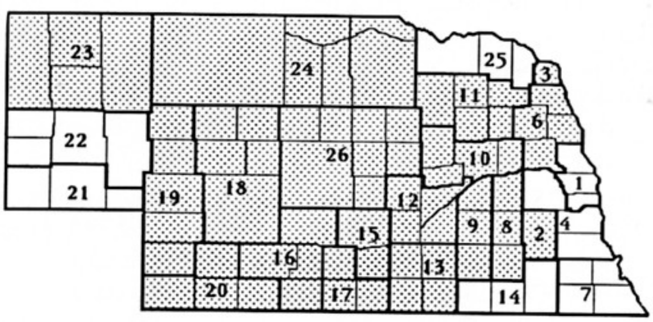
(1) See region map.
(2) Sales on which sales taxes are collected by retailers located in the state. Region totals include motor vehicle sales.
* Within an already designated region.
Compiled from data provided by the Nebraska Department of Revenue

Figure II
Nebraska Net Taxable Retail Sales
(Seasonally Adjusted)



(1) The Consumer Price Index (1982-84 = 100) is used to deflate current dollars into constant dollars

Figure III
Region Sales Pattern
YTD as Percent Change from Year Ago



Shaded areas are those with sales gains above the state average.

Nebraska Economy

The personal income data shown in Table I tell us what we already know. Yes, we're "doin' fine." Total personal income advanced 9.8 percent in the second quarter versus year ago levels. (The attentive reader may have noticed that the most recent Nebraska personal income is for the second quarter, whereas the national personal income was through the third quarter. The lag from first receipt of national personal income to corresponding receipt of Nebraska personal income is about two and one-half months.)

Most of the gain came from the farm sector. Total farm personal income increased 46.6 percent from a year ago and 31.4 percent from the previous quarter. The gain in nonfarm personal income was a more moderate 6.7 percent from a year ago or 1.5 percent from the first quarter. Nebraska's manufacturing sector increased 12.4 percent from a year ago or 2.3 percent from the previous quarter. Thus, the strength in retail sales of the first half of this year is not surprising. The income base was there to support it. The most recent data show that seasonally adjusted net retail sales have continued their sawtooth pattern, dropping to $895,675 million in July (see Figure II). Total region sales in Nebraska (see Table V) remained well above year ago levels in July and are nearly 12 percent above year ago levels on a year-to-date basis.

It is much more difficult to say how the year will finish. Preliminary employment data for September indicate that the nonfarm sector continues its expansion, with employment 1.0 percent ahead of a year ago. The unemployment rate remains 3.2 percent, the same as August. We have to make substantial assumptions to draw a picture for the balance of the year. The first assumption is the relatively easy one that nonfarm employment and earnings will have no major downfalls between now and Christmas. The second one is the hard one. What will happen to the agricultural sector? Although many Nebraska farmers will be affected adversely by the drought, many others will do well. According to mid-October reports, Nebraska corn production will be down 4.1 percent versus -35.6 percent for the nation. Nebraska wheat production will be down 16.1 percent versus -14.0 percent for the nation. But prices are ahead of last year. Wheat prices were up 46 percent, corn up 70 percent. In both cases, prices are well above the loan price. As a result, 1988 Nebraska farm income may rise above last year.

Turning to within state comparisons, we find it hard to discern any pattern. We can see how easy it is to get distortions in data. A large hospital project in Fairbury skyrockets its building activity number (and has for several months). Without another large project, next year's data for Fairbury will show large decreases in building activity. Drawing relationships between employment and sales almost works for Omaha and South Sioux City, but in nonmetropolitan Nebraska, the pattern breaks down. In general, regional sales tend to outstrip employment changes. Perhaps all this is saying is that the agricultural sector is especially important to nonmetro Nebraska.

J.S.A.

Terms to Know

Place of Work vs. Place of Residence

Nebraska employment data routinely are reported in two formats: place of work and place of residence. Table II in this publication is organized according to these classifications. Data on the place of work basis are counts of the number of wage and salary jobs in nonfarm industries. The data are collected from firms on a monthly basis and are alternatively referred to as work force data. In contrast, data on the place of residence basis are counts of the number of Nebraska residents who are participating in the labor force, are employed (including the self-employed), or are unemployed. These data are collected from a survey of Nebraska residents and are alternatively referred to as labor force data.

J.R.S.

Nebraska Per Capita Personal Income

One important measure of how well a state is doing is its per capita personal income. Using this measure provided by the Bureau of Economic Analysis, Nebraska is slightly behind either the nation or the plains region. In 1987, Nebraska per capita personal income was $14,328. That level compared to a U.S. average of $15,481 and a plains average of $14,792. Nebraska is 26th of the 50 states plus the District of Columbia. The District is number two, just behind Connecticut. Further, if Minnesota were removed from the plains data, Nebraska would be well above the regional average. When Minnesota is included, Nebraska ranks fourth in the region.

There's some concern, however, that Nebraska's growth rate has slipped relative to either the plains or the U.S. From 1982 to 1987, Nebraska per capita personal income grew by 5.3 percent. That was slightly behind the plains (5.9 percent) and behind the U.S. (6.2 percent). In the past, Nebraska has both exceeded and lagged the national and plains growth rates. With some efforts in the right direction, our growth rates can exceed those of the region and nation.

Furthermore, we have to ask the question of whether per capita personal income is the only measure of economic health on which to focus. Aren't cost of living and quality of life important considerations? For example, Nebraskans do not pay the national average $127,200 for new homes, much less the $170,900 average paid in the northeast. Nebraskans may desire the income levels of Connecticut, but are they willing to assume the density of living conditions and high housing prices that accompany it?

One last note. Please don't get carried away with the exact numbers you see reported here. The Bureau of Economic Analysis periodically revises them. We hope that the relative position of the numbers remains fairly constant with the various revisions.

J.S.A.

Scoreboard

Percent of same month one year ago

	State	Metro+	Nonmetro
Motor Vehicle Sales (July) Constant $	3.3%	1.7%	4.9%
Nonmotor Vehicle Sales (July) Constant $	1.4%	-0.7%	3.7%
Building Activity (July) Constant $	5.5%	-3.3%	20.3%
Employment (Sept)	1.0%	2.6%	-0.6%
Unemployment Rate* (Sept)	3.2%	3.2%	3.2%

+Omaha and Lincoln

*Unemployment is this month's rate, not a percent change from year ago

Bureau Personnel Notes:

David DeFruiter

The Bureau of Business Research is proud to introduce David DeFruiter, statistical technician. David joined the Bureau staff in January 1987. He is a native Nebraskan, raised in Gothenburg. David graduated from Kearney State College with a degree in human factors and a minor in statistics. David completed a number of research projects and an independent study for the Boeing Military Airplane Company in Wichita, Kansas during his four years at Kearney State College.

David's contributions to the *Business in Nebraska* newsletter are the economic and demographic statistics that help readers make more informed business decisions. He is also a State Data Center contact person and the information management specialist at the Bureau of Business Research.

David is the resource person for the Bureau's statistical software package, the Site Evaluation and Location System (SELS). The SELS package accesses 1980 information from the Bureau of the Census by block level for any county in the United States.

David currently is working on developing an electronic bulletin board system. This new service will permit data users to access information electronically by computer modem.

Mark Your Calendars....

A state of the state conference is being planned for January 26, 1989 at the Nebraska Center for Continuing Education. The conference will focus on the outlook for Nebraska and on future choices. Further details and agenda will be forthcoming in the December issue.

Business in Nebraska

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