

A BRIEF REVIEW OF THE RECESSION OF 1990-1991

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ABSTRACT

This is a brief essay concerning the 1990-1991 recession. The events that led to a slowdown in economic growth with the subsequent slip into recession will be reviewed. While recessions are a natural part of the business cycle, this paper includes a discussion of the differences between the 1990-1991 recession and previous declines, the people and firms who were hit the hardest, reasons for the snag in the recovery, as well as a presentation of some suggestions for recovery.

INTRODUCTION

A recession is defined as "a period during which real GNP, the value of GNP in constant prices, falls for two consecutive quarters. Its start is the peak of the preceding expansion, and it lasts until the economy reaches its trough, the lowest point reached by GNP in each business cycle" (Gordon, 1987, p. 600).

A recession is a natural part of the U.S. business cycle, which consists of peak, trough, recovery, and expansion. From the end of World War II through 1989, seven recessions occurred. The business cycle usually lasts three to four years with the expansion phase longer than the period of recession. On average, a recession lasts about a year. A recession is not an unexpected occurrence; it is a natural response to periods of expansion (Dunnan & Pack, 1991).

During expansion, consumers and corporations borrow money. During this period, the demand for credit causes interest rates to rise. Rising demand can lead to higher prices for goods and services. Real estate prices escalate, and inflation may result. All of this leads to too much debt--consumers no longer want to borrow. This causes a reduction in spending that leads to business cutbacks, and a reversal of the expansion begins. When both consumer and business spending and borrowing decline, production and income fall. If a contraction of the economy begins, the economy recedes (Dunnan & Pack, 1991). If the contraction lasts long enough (falling GNP for two consecutive quarters), it is labeled a recession.

The good news about recessions is that they eventually end. When consumer confidence returns, the economy begins the cycle all over again.

DESCRIPTION OF EVENTS LEADING TO THE 1990-1991 RECESSION

The 1990-1991 recession followed a particularly long period of recovery and expansion, from 1983 through 1988. According to some analysts, Iraq's invasion of Kuwait in August 1990 tipped the scales--the resulting jump in oil prices combined with the drop in consumer confidence forced the U.S. into a recession. Statistics show, however, that the economy had lacked vigor since the first quarter of 1989, when output measured 3.6 percent. From April 1989, GNP growth in any

quarter was not higher than an annual rate of two percent. When compared to the four percent average annual rate from 1983 to 1988, it is obvious the economy had been slowing for a fairly long period (Thompson, 1992). There were two reasons for the growth of the 1980s and the later downturn--demographics and tax policy.

Beginning in the mid-1970s, there was a surge in population growth. This generation, known as the baby boomers (1946-1964), was the post-World War II generation; they comprised one-third of the population in the mid-1970s. In 1980, the oldest baby boomer was only 34, and this group matured over the decade. They helped drive forward the demand for housing and commercial construction. The recession of 1981-82 slowed construction long enough to cause pent-up demand to build. When this demand exploded, it provided a boost in housing and throughout the economy. Baby boomers bought not only houses, but also everything to furnish them. During this time, consumers more than doubled their debt, and the spending spree of the 1980s was great enough to revive the economy throughout the decade.

Federal tax policy also fueled this period. The 1981 Economic Recovery Tax Act cut federal taxes by 25 percent over three years. Personal income taxes were again cut by the Tax Reform Act of 1986 that mandated just two tax brackets, 15 and 25 percent.

A significant aspect of the 1990-1991 recession dealt with the housing sector. The housing boom reached its peak in the late 1980s. According to Thompson (1992), this peak was not reached due to high interest rates or a slowdown of the economy. The pent-up demand from the 1981-82 recession disguised the slowing growth in the population, down from approximately three million in 1980 to only 1.5 million per year in 1991 (Liscio, 1991). Demand was satisfied due to this slowing growth rate.

While the 1986 Tax Reform Act spurred consumer spending, it hurt business. This Act repealed the investment tax credit, cut the value of depreciation allowances, and began the treatment of capital gains as ordinary income. The resulting increase in business taxes curtailed investment and the creation of new jobs. Entin (1991) estimated a \$300 billion loss in investment from 1986-1991. This translates to approximately a one-percentage point drop annually in GNP, resulting in a reduction in the growth of employment and wages. The 1986 Act also imposed passive loss rules, effectively limiting tax deductions on real estate. The resulting collapse in commercial real estate and home values triggered the savings-and-loan crisis and the dramatic tightening of bank lending. This breakdown in bank lending is probably what caused the change from feeble growth to recession (Entin, 1991).

The 1990-1991 recession was not a typical inventory recession. Hyman (1991) stated that the source of this recession was the amount of leverage in the system (Wait until next year, 1991). The 1980s was a decade of enormous speculative surge in the price of real estate and other assets. A large part of this was made possible by the tremendous growth in debt financed by the country's financial institutions. The decline in the value of commercial real estate has affected not only commercial construction--it has weakened financial institutions.

The hardest hit areas have been financial firms, banks, thrifts, and insurance companies (Liscio, 1991). This produced tight money without a tight monetary policy by the Federal Reserve. The top of the credit cycle was not that of a typical business cycle. The trigger for this recession was what may be called a "stand alone" risk crunch--reduced availability of credit without the classic Fed tightening (Liscio, 1991).

WHO WAS HIT THE HARDEST?

Who took the brunt of the 1990-1991 recession? The service sector--financial firms, banks, thrifts, and insurance companies, and the white-collar workers employed by these companies. The weakness in manufacturing was not as bad as the 1974 and 1982 recessions, while the weakness of the service sector was close to what it was at its worst point in the three recessions prior to 1990-1991 (Wait until next year, 1991). Restructuring of corporations caused the loss of an average of 2,200 white-collar jobs per day in the third quarter of 1991, followed by an average of 2,500 jobs per day in the fourth quarter (Thompson, 1992). Typically, this was the type of job that was well paying and guaranteed success for the American white-collar worker. This sector may have been harder hit for a longer period because this type of cut-back is atypical from that of inventory recessions, when production workers are the ones being laid off. When demand returns at even moderate levels, the production worker is rehired. This did not happen with white-collar workers (Wait until next year, 1991). Corporations eliminated anyone "... not involved in selling, marketing, or delivering to the core customer" (O'Reilly, 1992, p. 46).

WHAT SLOWED THE RECOVERY?

The 1990-1991 recession lasted the usual length, but there were two significant areas hobbling the start of a recovery. One area was the public's gloomy outlook. Many believed that there was no hope for a speedy recovery. A University of Michigan index indicated that consumer confidence fell 1.1 points in January of 1992 to 67.1 percent, continuing a four-month slide (Somerville, 1992). This reflected consumers' continued reluctance to spend. This mood cannot be pinpointed to one particular cause, but to a combination of factors. A Wall Street Journal/NBC News poll indicated that 53 percent of the people who responded felt that the U.S. was in a state of general decline. Other polls showed a lack of confidence by Americans that their children would live better than they did (Murray, 1991).

Part of the reason for this attitude can be traced to the drop in home values. Often this is the largest single asset for an individual, and serious declines in value cause a significant drop in net worth. While the perceived change in wealth may be greater than the actual drop, for a public accustomed over the past 10 to 20 years to ever-appreciating home values, any drop comes as a shock, and it has forced many to reconsider their financial planning. The cost of their children's college educations and their own retirement may not be coming from the equity in their home, and the only way to replace this lost equity is to reduce spending.

Consumers were also burdened with the heavy debt-load incurred from the 1980s spending spree. The combination of debt and the pessimistic outlook of most mean there is little incentive to borrow. Cornerstones of past recoveries were construction and auto sales, but new-home starts in the early 1990s were at their lowest level since 1946 and auto sales fell to the lowest level since 1982. The Fed's effective policy of lowering interest rates did not induce consumers to borrow and spend, which ordinarily would jump-start these cornerstones of past recoveries (Thompson, 1992).

A second area of prime concern was the level of capital spending. Higher profits made capital investment possible. This led to higher employment levels, reduced costs, and improved products--all of which boost economic growth. Following past recessions, corporate profits came

back strongly, strengthening the recovery. However, most analysts did not notice this happening. With low inflation and moderate sales growth in the early 1990s, most predictions were for only modest profit increases in 1992 and 1993 (Clark, 1991). This limited the dollars that could have been invested in capital.

Borrowing to cover the costs of investment may not be an option for businesses. Banks, caught in a Recession described as financial rather than inventory, were slow to cut long-term rates, and they lent money to only the most credit worthy customers. Funds were not available to some businesses at any rate of interest (Clark, 1991).

The tax changes of 1986 could also be blamed. As discussed earlier, this change sharply curtailed the incentives for business to finance investment.

HOW TO END A RECESSION--A PRIMER

What can be done to stimulate an economy whose average GDP was estimated to rise only 1.6 percent in 1992 and whose estimates for corporate pre-tax profits were only eight percent for the year? (Meyers, 1992). When comparing these percentages to 4.8 percent and 23 percent, respectively, for the first full year [1992], it may seem an insurmountable task. However, solutions were proposed.

Entin (1991) proposed changes in tax and regulatory barriers. He stated that the increase in the minimum wage, the 1988 and 1990 payroll tax increases from 14.3 percent to 15.3 percent, the increase in the Social Security wage base, and the rise in the top income tax rate all resulted in an increase in the cost of labor. To absorb the costs, employment fell. Entin (1991) estimated that the payroll tax change caused the economy to lose 500,000 jobs.

One way to lower labor costs and raise work incentives is to reduce the marginal tax rate on labor. In the past, this was effectively accomplished with marginal tax cuts on individual income. Entin (1991) states, however, that a more potent change would be a reduction in payroll tax rates, which exceed the income tax rate for many Americans. This was also advocated by the U.S. Chamber of Commerce. Economists for the Chamber suggested cutting the Social Security tax by two percentage points, one each for the employer and the employee, from the 1991 rate of 15.3 percent (Thompson, 1991).

A second area of concern was the cost of capital. Entin (1991) estimated the damage caused by the 1986 Tax Reform Act to be \$300 billion in investment from 1986-1991. Another cost was the collapse in real estate prices and the ensuing savings-and-loan crisis (Entin, 1991).

The most powerful method to cut the cost of capital was to lower the tax rate on capital gains and improve depreciation allowances. Entin (1991) and the U.S. Chamber of Commerce suggested a top capital gains rate of 15 percent for assets held one year or longer. Both recommended indexing capital gains in order to adjust for inflation. This protected gains caused by inflation from taxation.

Another recommendation was a modification of depreciation schedules. Investment decisions hinged on whether or not the present value of the returns on the investment exceeded the cost of the investment. Entin (1991) estimated a firm would be lucky if its write-offs for equipment spending averaged 85 percent of its costs--the end result being costs to business due to over-taxation. To eliminate this, he suggested increasing capital consumption allowances until their present value was equal to writing off (expensing) the entire investment in the first year. Entin (1991) placed the

value on such a change as equivalent to a five percent investment tax credit. Entin (1991) estimated that enhanced depreciation schedules, distributed over the lifetime of the capital assets so as to cost nothing over the five-year federal budget period, could still boost incentive and add billions of dollars in investment.

CONCLUSION

While there were varying proposals to end the 1990-1991 recession, most pointed to a concern for the long run. Many of the proposals included incentives for growth in investment. Many people felt that the first step was to set a goal of four percent annual growth for the 1990s in contrast to the 2.5 percent forecasted. Any changes to the tax system should be permanent features and not instruments used to fine-tune an ailing economy.

Incentives boosting overall economic growth led to fewer lay-offs, new jobs, and increased income. This provided the public with encouragement that steps were taken in order to end the recession.

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