Tennessee's BUSINESS

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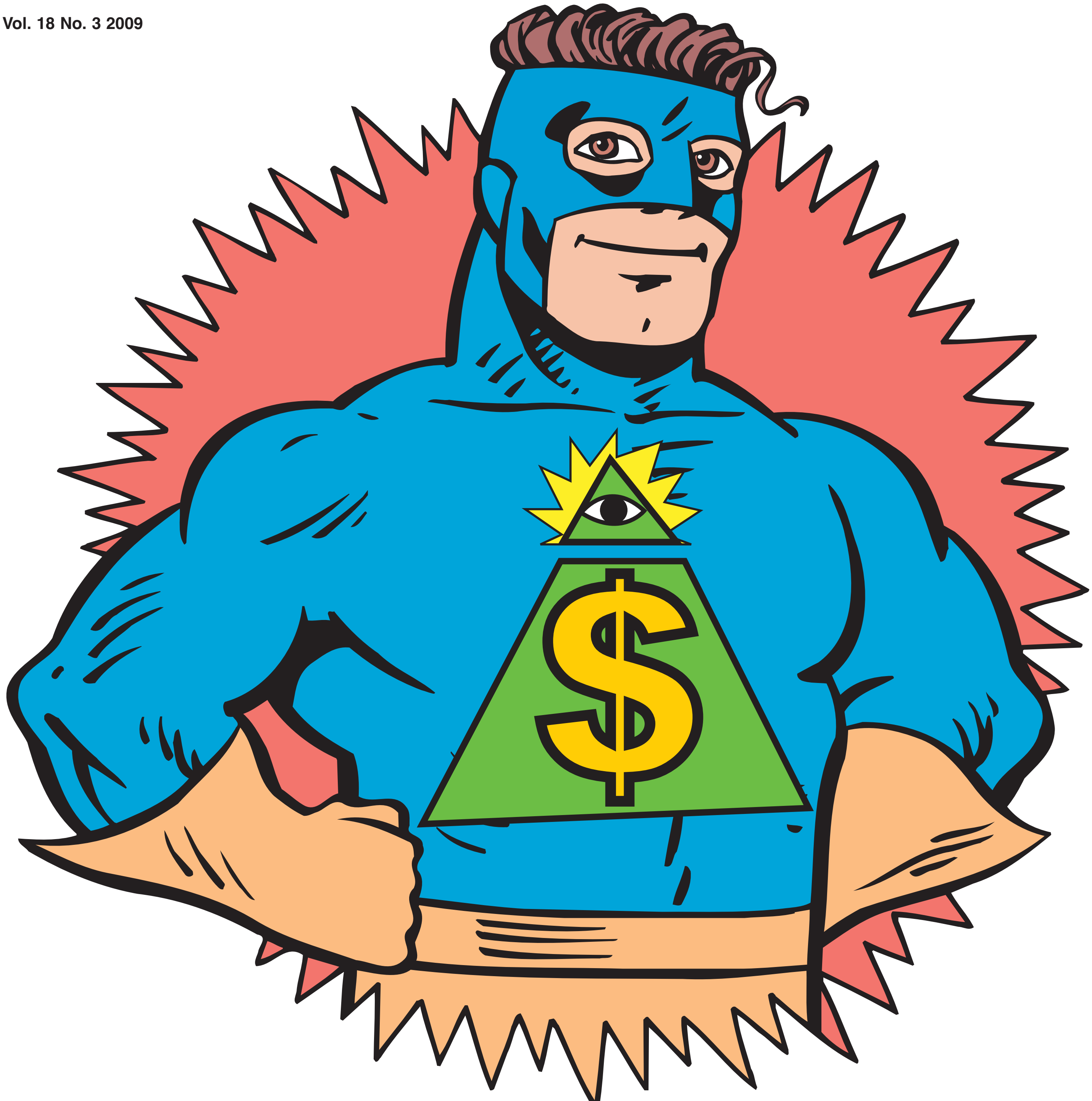

STIMULUS

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MIDDLE TENNESSEE STATE UNIVERSITY

EDITOR'S NOTE

Not only is the recession hurting the national economy, but it is also slamming the Tennessee economy.

Before knowing that Tennessee would receive federal stimulus money, Governor Bredesen anticipated cutting 2,300 jobs from the current roll of 48,000 state employees. However, Tennesseans breathed a sigh of relief when the state became entitled to receive $4.5 billion from the federal stimulus package. Briefly, it appeared that the state could avoid painful job cuts, thereby relying on only attrition (not filling new job vacancies) to help balance the budget.

However, the deteriorating Tennessee economy has only worsened, causing Bredesen to put job cuts back on the table. Next year's state budget, originally set by Bredesen at $29 billion back in March and based on receipt of federal stimulus money, appears in jeopardy. That budget would take effect July 1 and run through June 30, 2010.

In April, overall state revenue fell for the ninth straight month, and state sales taxes (which account for about 60 percent of all revenue) fell for the 11th straight month. April 2009 sales tax revenues fell more than 10 percent compared to April 2008.

Tax revenues for Tennessee have fallen about $1.2 billion below December estimates. This is a historic drop: we could come up between $80 million and $180 million short before the end of this fiscal year on June 30.

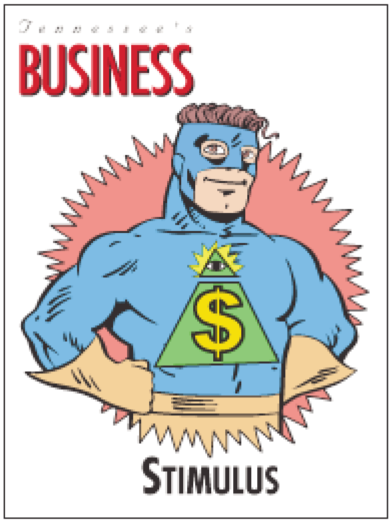
Some economists fear next year could be worse. Noted UT economist Bill Fox, who frequently consults with the governor and state lawmakers over budgetary matters, expects state revenues to fall an additional $108 million and unemployment to reach at least 10.5 percent during the upcoming budget year, running from July 1, 2009, through June 30, 2010.

Bredesen had hoped the federal stimulus money would tide the state over during the next two years, making cuts in state jobs and departments easier in the face of a shrinking state government. But the worsening revenue collections and projections have thrown cold water on that scenario. In short, federal money will help, but it will not save a sinking ship.

So how are we to deal with the additional shortfall? First, money will have to be taken from the state's $750 million rainy day fund. Second, laying off some state workers, as well as cutting work hours of others, is being considered. Both K-12 and higher education, however, are to be spared from cuts this year—higher education only because receipt of federal stimulus money required state funding to be at its pre-recession level.

The dramatic decrease in sales tax revenues has wreaked havoc on Tennessee's budget this year, and it is highly likely that it will do the same next year and beyond. Tennessee's sales taxes, which constitute the bulk of the state's revenues, have been historically unable to adequately fund state government, and this situation is made even worse during a recession. Despite having one of the highest rates in the nation, Tennessee's sales taxes have been and are unable to maintain existing levels of state services. Therefore, if and when the recession ends, don't expect dramatic improvement for Tennessee.

—Horace Johns, executive editor, professor of business law, MTSU



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THE ABCs OF ECONOMIC RECOVERY

The employment effects of every dollar increase in the deficit depend on whether it is spent on goods and services (infrastructure) or is the result of tax reduction or increases in government transfer outlays such as unemployment compensation.

by Thomas F. Dernburg

President Obama called his $787 billion recovery program a "stimulus" program designed to "jump start" the economy. It sounded very much as if "stimulus" is a cousin of what used to be called "pump priming." The theory is an optimistic one. The idea is that the Federal government should prime the pump by increasing federal spending and cutting taxes, and the private economy will spring to life and do the rest.

Unfortunately we can't be too confident that spending in the private economy will recover fully in response to the stimulus. In the current severe recession, there is likely to be a persistent deficiency of private spending that will necessitate continuing federal deficit spending for years to come. To get private spending up and keep it up, consumers must overcome their current pessimism. But at present consumers seem more intent on rebuilding their financial assets after severe stock market losses. Investment by business in plants, equipment, and inventory must recover. But with substantial amounts of excess capacity at most stages of production and distribution, private investment spending is not likely to provide a boost very soon. The same is true for residential construction in the face of foreclosures, rising vacancies, and falling home prices. Until the banking freeze thaws, lack of credit will continue to be a huge obstacle to the revival of spending on automobiles and other durable goods.

Most members of Congress are lawyers who seem to lack training in economics, especially macroeconomics. Conservatives seem to believe the way to prosperity is through ideology rather than sound economic analysis. Confusion about the number of jobs that an increase in the federal budget deficit would create has been a prime example of muddled thinking. There has been little recognition that the employment effects of every dollar increase in the deficit will depend on whether it is spent on goods and services such as infrastructure or is the result of tax reduction or increases in government transfer outlays such as unemployment compensation. The first job here is to clarify the difference.

Many congressional conservatives insist that tax reduction for the rich is more effective in creating jobs than government expenditures on goods and services. That trickle-down claim is demonstrably wrong, but that doesn't seem to be well understood. A simple example will nail down an essential difference. Let government spend $1 billion on road-repair projects. Contractors respond by hiring workers and purchasing equipment and materials. Employment increases, and Gross Domestic Product (GDP) rises by $1 billion. But that is only the first round of spending. The $1 billion becomes income to the workers and others who provide input for the projects. Hopefully, they will spend most of the additional income on consumer goods. That second round of spending then becomes income to other people. All the subsequent rounds of income and consumer spending added up yield a "multiplier" effect on GDP. For

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To keep GDP at its new level, there will have to be a continuing stream of new projects. . . . We should not therefore be surprised if there have to be repetitions of the current recovery program in the near future.

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illustrative purposes, assume that the multiplier value is 2.5. GDP increases by $2.5 billion in response to a $1 billion investment in roads.

It is important to note that the spending effects will peter out over time. Therefore, to keep GDP at its new level, there will have to be a continuing stream of new projects. A one-shot expenditure won't do the trick. We should not therefore be surprised if there have to be repetitions of the current recovery program in the near future.

Tax cuts and transfer outlays provide the same $1 billion increase in income. They have the same employment effects as the second round of the road projects. The $1 billion in road projects are, however, by-passed. The multiplier will therefore be 1.5, so GDP will rise by $1.5 billion. That increase could be much lower if pessimistic recipients use their tax cuts as savings with which to rebuild their assets rather than spending the additional income on consumer goods. It also seems obvious that there will be very little spending effect if the tax cuts go to the rich.

Is the $787 billion stimulus legislation sufficient? Many distinguished economists don't seem to think so. There is a yawning gap between the GDP level that would restore full employment and the actual level of GDP. The Congressional Budget Office (CBO) estimated that, over the next three years beginning in 2009, there will be a $2.9 trillion gap between what the economy could produce and what it is actually likely to produce in the absence of a federal recovery program. That estimate was made some time ago, so some supplementary back-of-the-envelope calculations may be helpful.

Here is what such calculations disclose: the growth of current dollar GDP over the period 1999 to 2007, two prosperous years, was at a 5 percent annual rate. If this rate is projected, its hypothetical continuation provides rough estimates of "potential GDP." For the third quarter of 2008, this procedure projects potential GDP at an annual rate as $15.232 trillion. But actual third-quarter GDP was $14.413 trillion. The difference between the two implied a gap of $819 billion, a level consistent with CBO. However, the gap became much larger in the fourth quarter when the economy virtually fell out of bed, with GDP declining 6.2 percent at an annual rate. Our estimated gap increases to $1,908 billion, placing the economy about 13 percent below capacity.

These estimates suggest that the enacted recovery program is well below the level the economy needs for a satisfactory recovery. On the negative side, the outlays contemplated by the program will be spread out over a two-year period. In fact, by mid May only 6 percent of the $787 billion had been spent by the Treasury. Also, a substantial fraction of the total consists of tax cuts and increased transfer outlays, which have a lower multiplier effect than expenditures on goods and services. On the plus side, the president's plan is to begin immediately to reform the healthcare system. That will add a lot of additional spending. It is possible as well that the government funds given to the banking system will unfreeze lending activity, thereby financing increases in consumer and business spending.

State and local governments are suffering severe deficits, due largely to revenue losses caused by the recession. They will certainly benefit from federal grants provided by the stimulus package. The effect on GDP will depend on the fraction of the grants that are used as public investment in roads, bridges, school construction, and the like. They could also be used to hire back laid-off teachers and government workers and prevent others from losing their jobs. It is unfortunate that some conservative governors have been balking at using the federal funds allocated for their unemployment compensation systems. They claim that an expanded system will cost more once the federal money runs out. That may be true. If it is, it calls attention to the inadequacy of their state systems. And in the meantime the governors are denying their unemployed citizens badly needed income support.

Increased spending and tax cuts give rise to concerns over the growth of the federal deficit. We can ease the pain by noting that when GDP rises the deficit declines, thanks to income-tax feedback and automatically reduced transfer outlays. A larger increase in GDP will yield larger feedback. Conservatives won't like the conclusion, but infrastructure outlays will give the economy more of a boost and therefore also produce greater revenue feedback. This means the net increase in the deficit, from both the initial and feedback effects, will be smaller than the effects of equal tax cuts and increases in transfer outlays. ■

Thomas Dernburg is a professor of economics emeritus at the American University and a former holder of the Chair of Excellence in Free Enterprise at Austin Peay State University.

REMEMBERING MOM'S WISDOM

I remember how I got from where we were to where I am. I remember capitalism and free enterprise.

by Jim Burton

Prologue: my mother is deceased, but sometimes it helps me to have a little "talk" with her anyway. Her wisdom still comes through and puts me back on track.

Yes, Mom, I remember. You had so many "sayings" that taught great lessons. The one in the title comes to mind right now. If you were alive I know you would be very distressed with what's going on. We certainly seem to have forgotten how we got to be the country we are. And it looks like we may have decided to dance with a new partner.

But, Mom, I did not forget. I remember how I got from where we were to where I am. I remember capitalism and free enterprise. They were a lemonade stand on the road in front of our house. They were a lawn mower tied to the back of a bicycle going down the road looking for a house with tall grass. They were the windfall from the trees in Uncle Putt's yard that needed to be picked up before the mowers went over it. They were pigs that needed to be fed so they would grow and be sold. They were hard work and reasonable reward.

Capitalism was when two friends and I put in the money to create a small business based on a patented product the two friends had invented. It was raising additional equity investment. It was signing personal notes at the bank to raise even more money. And it was the great pain of paying off those notes when the business did not live up to expectations. Yes, there was a bailout but not from the government. One of the two friends could not pay his share of the obligations, so the remaining two, one friend and I, bailed him out by paying off all the debt in prorated portions, even at interest rates in excess of 18% during those days.

Free enterprise was when I borrowed money to finance the purchase of some land that I later sold for a profit. It was when I worked three jobs at one time to provide the capital to get a business off the ground. It was when I employed 10 people in jobs that had not existed before I created the business from sweat and long hours.

I remember capitalism and free enterprise. They ruled the land. They were the engines of commerce. They made America great. They distinguished us from other nations. Maybe we did not invent them, but we sure knew how to use them. I remember them. I liked them. They motivated me. They made my life better.

How could they be forgotten so quickly? How could they evaporate like a mist? How could we let that happen? Why would we let that happen? I don't have those answers, Mom.

Now we have socialism. How did we get it? Maybe it was because no one else wanted it. Many have tried it and found that it did not

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- If you take money from those who have risked and worked hard to earn and save and give it to those who have not, fewer people will take risks and work hard.
- If government borrows all the available funds in the market, businesses will be unable to expand, job creation will be reduced, and credit will dry up for those who need it most.
- Risk capital, and therefore job creation, comes from those who have "more than average." If you penalize these people by raising their taxes, risk capital, job creation, and the average well-being for all will decline.

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work. So it was just lying around waiting for someone to try again.

Some smart and well-known people have had bad things to say about socialism. Winston Churchill reportedly said, "The inherent vice of capitalism is the unequal sharing of blessings; the inherent virtue of socialism is the equal sharing of misery." He also reportedly said, "Socialism is a philosophy of failure, the creed of ignorance, and the gospel of envy…."

Thomas Sowell, a senior fellow at the Hoover Institution at Stanford University, said, "The assumption that spending more of the taxpayer's money will make things better has survived all kinds of evidence that it has made things worse," and "Socialism in general has a record of failure so blatant that only an intellectual could ignore or evade it."

Somewhat further back in history, Alexis de Tocqueville commented, "Democracy and socialism have nothing in common but one word, equality. But notice the difference: while democracy seeks equality in liberty, socialism seeks equality in restraint and servitude."

There is another I really like, but it may be an urban legend. Baroness Margaret Thatcher, former Prime Minister of the United Kingdom, is often quoted as saying, "The problem with socialism is that you eventually run out of other people's money."

These and many other folks wiser than I have scorned socialism. Certainly it was not the intent of our founding fathers. They believed in hard work, reward for risk, and individual responsibility—virtues socialism minimizes.

What exactly is socialism? The Encarta encyclopedia says it is an economic and social system under which essential industries and social services are publicly and cooperatively owned and democratically controlled with a view to equal opportunity and equal benefit for all. Wikipedia says it refers to a broad set of economic theories of social organization advocating public or state ownership and administration of the means of production and distribution of goods, and a society characterized by equality for all individuals, with an egalitarian method of compensation.

Note there is nothing in these definitions of socialism about risk and reward. Note there is nothing about any differentiation based on contributions from the individual. Note there is nothing about hard work.

Where was "equality for all" when I had to pay off those bank notes out of personal assets? Where was "equalitarian compensation" when all of my employees were drawing paychecks and I got nothing? I took the risk; I got the result, good or bad. I think that is the way it is supposed to be.

Have we really come to socialism? Well, let's look at the auto industry. Is it an essential industry? Yes! Is it cooperatively owned? Yes, it is now! Is it democratically controlled (no pun intended)? Yes! Is there a view toward equal opportunity and benefit for all? Looks like that's the objective. If we have not yet quite arrived at socialism, we are moving in that direction at warp speed. And the leaders of both political parties are pushing the pedal.

Now, Mom, I don't pretend to know all the right answers, but of some things I am sure:

- If you take money from those who have risked and worked hard to earn and save and give it to those who have not, fewer people will take risks and work hard.
- If government borrows all the available funds in the market, businesses will be unable to expand, job creation will be reduced, and credit will dry up for those who need it most.
- Risk capital, and therefore job creation, comes from those who have "more than average." If you penalize these people by raising their taxes, risk capital, job creation, and the average well-being for all will decline.

None of these results are good for the country. But that is what's happening in America today.

Just in case you missed it, Mom, I am still a capitalist. I still believe in free enterprise. I am convinced together they form the best system anyone has found so far. The problem isn't that they don't work. The problem is we are not letting them work.

So, Mom, I do remember that capitalism and free enterprise brought me here, and I sure hope I get the chance to have another dance. And, by the way, I still miss you every hour of every day. ■

Jim Burton is the dean of the Jennings A. Jones College of Business at MTSU.

CLOSING THE EDUCATION GAP

IT'S TIME TO INVEST IN HUMAN CAPITAL

How can southern middle Tennessee, experiencing significant economic decline, emerge as a globally competitive manufacturing region?

by Murat Arik

Rural America has experienced dramatic changes in its economic landscape. The obvious manifestation of this change is the steady decline of manufacturing sector employment through downsizing, plant closings, relocation of companies overseas, and consolidation of branch operations. Rural regions where traditional manufacturing sectors dominated the economy have been affected by these shifts disproportionally. Although increasing overseas competition and globalization have been seen as the primary triggers in shifting economic dynamics, technological changes further exacerbated the situation in rural areas where basic infrastructure (i.e., information technology, physical infrastructure, human resources) are not up to the challenge of making the transition from traditional manufacturing to a technology-intensive knowledge economy.

For many rural regions, the critical issue is to manage this multifaceted transition in a way that (1) strengthens existing businesses, (2) upgrades workforce skills, (3) addresses small business concerns, and (4) upgrades the aging infrastructure. The ultimate goal is to create employment and wealth. What should these communities do to ensure success? One answer is to understand, evaluate, and address workforce-related issues. Based on my previous study,[1] this article highlights some critical issues regarding workforce education in the 14 counties of southern middle Tennessee.

Southern Middle Tennessee at a Glance

Strategically located between Nashville and Huntsville, this region includes the following 14 counties: Bedford, Coffee, Franklin, Giles, Hickman, Lawrence, Lewis, Lincoln, Marshall, Maury, Moore, Perry, Warren and Wayne. Nearly 22 states are within one day's drive from the center of the region, located in Marshall County.

Three major interstates dissect the region: I-65 connecting Nashville and Huntsville, I-24 connecting Nashville and Chattanooga, and I-40 to the north. The region has significant market potential, as nearly 2.5 million people live within a 70-mile radius or one-hour drive from its center.

Once the hub of traditional manufacturing, the southern middle Tennessee counties have experienced major economic setbacks: first, through the flight of manufacturing companies overseas, and second, due to the recent prolonged economic crisis. The manufacturing sector is still the major source of employment, accounting for more than one-third of jobs in Bedford, Giles, Lincoln, Marshall, Perry, and Warren counties as of the third quarter of 2008. In the rest of the counties, employment makes up about 20 percent of the manufacturing sector. Compared to the third quarter of 2005, the manufacturing

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These counties should develop policies to upgrade the skill and education levels of the existing workforce.

Table I: Southern Middle Tennessee Counties: Unemployment Rates

County Name	Current Unemp. Rate (02/09)	% Difference from U.S. Avg. (02/09)
Bedford	10.8	+1.9
Coffee	10.3	+1.4
Franklin	10.2	+1.3
Giles	13.8	+4.9
Hickman	12.0	+3.1
Lawrence	14.6	+5.7
Lewis	15.1	+6.2
Lincoln	7.0	-1.90
Marshall	14.7	+5.8
Maury	11.6	+2.7
Moore	9.0	+0.1
Perry	24.1	+15.2
Warren	15.9	+7.0
Wayne	13.0	+4.1

Source: BLS and BERC

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sector shed nearly 9,000 jobs (a 24 percent decline) in the 14-county region.

These job losses have led to a spike in unemployment in these counties since November 2008. Seven of the 14 counties had an unemployment rate (not seasonally adjusted) 4% higher than that of the U.S. as of February 2009 (Table 1). Only one of the 14 counties registered a rate slightly lower rate than that of the U.S.

Given the extent of job losses and unemployment as well as underemployment, building a globally competitive economy requires a careful look at the region's most important asset: human capital.

Workforce Education in Southern Middle Tennessee

At the heart of any regional economic initiative is the availability and quality of the workforce.

Figure I (a). Educational Attainment Levels, 2000

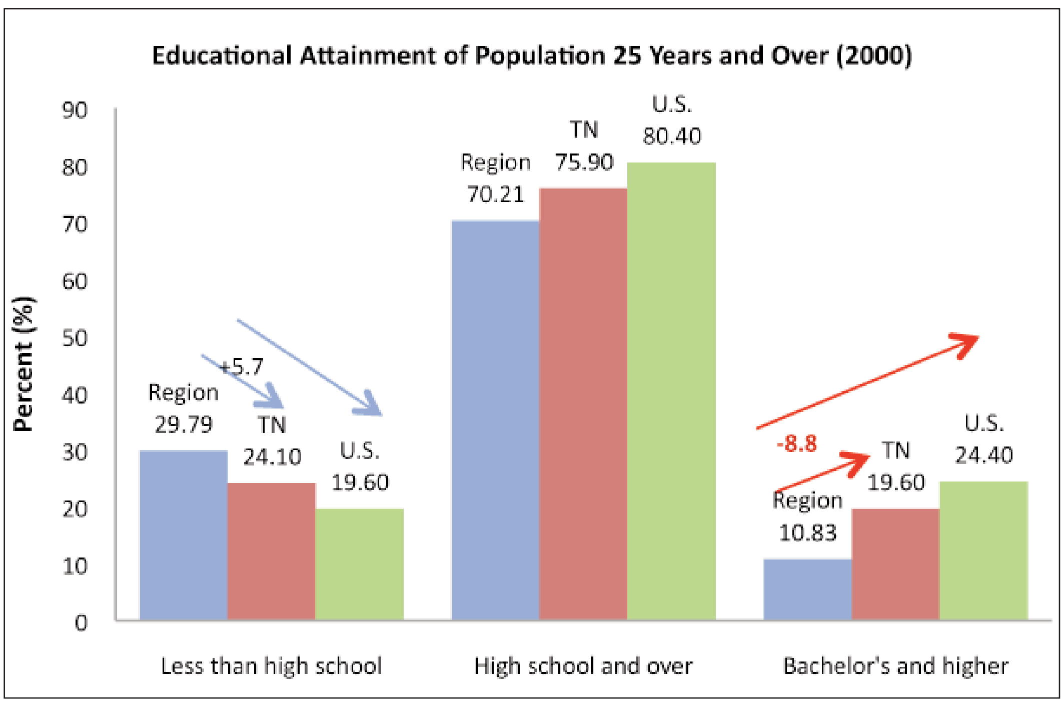

Table II. Educational Attainment: Then and Now (25 years and over)

Educational Attainment	2000 Region	2000 TN	2000 U.S.	2006 Region	2006 TN	2006 U.S.
Less than high school	29.79	24.10	19.60	24.05	19.10	15.90
High school graduate (includes equivalency)	38.21	31.60	28.63	40.68	34.40	30.20
Some college, no degree	16.94	20.00	21.05	16.31	19.20	19.50
Associate's degree	4.23	4.70	6.32	5.56	5.70	7.40
Bachelor's degree	6.78	12.80	15.54	8.62	14.10	17.10
Graduate or professional degree	4.04	6.80	8.86	4.78	7.50	9.90
Summary View						
Less than high school	29.79	24.10	19.60	24.05	19.10	15.90
High school and over	70.21	75.90	80.40	75.95	80.90	84.10
Bachelor's and higher	10.83	19.60	24.40	13.40	21.70	27.00

Source: Tabulated from Census 2000 and American Community Survey

This is especially true now due to major economic shifts in rural areas. In the course of this study, the following statement resonated across counties: "We would like to bring high-paying, high-tech jobs to the region." Although this is an extremely desirable goal for rural communities where income and wages are falling behind the national average while the cost of living is increasing, the reality is that many of these communities are significantly lagging behind national averages in workforce education.

This dilemma is very visible in the region, as the desire to have high-paying, high-tech jobs is countered by the educational realities of the workforce. Of course, a less desirable option is to recruit workers with these qualities from other regions.

How is the region performing in terms of workforce education? Table II clearly illustrates the large gap between the study region and Tennessee on one hand and between the study region and the U.S. on the other, in terms of postsecondary education.

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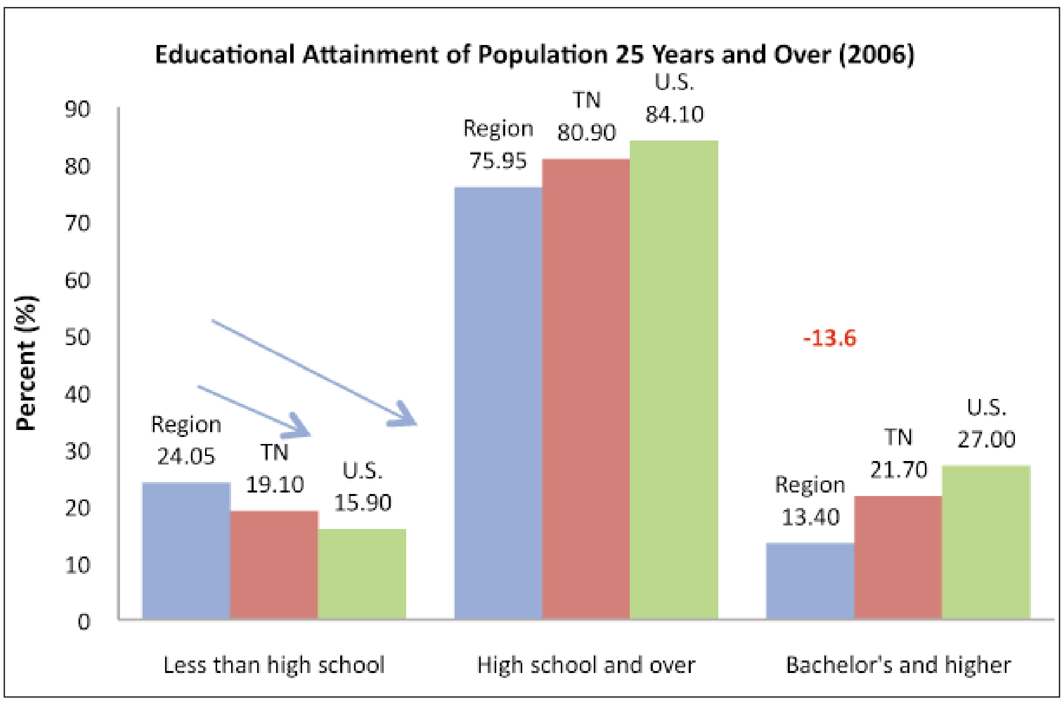
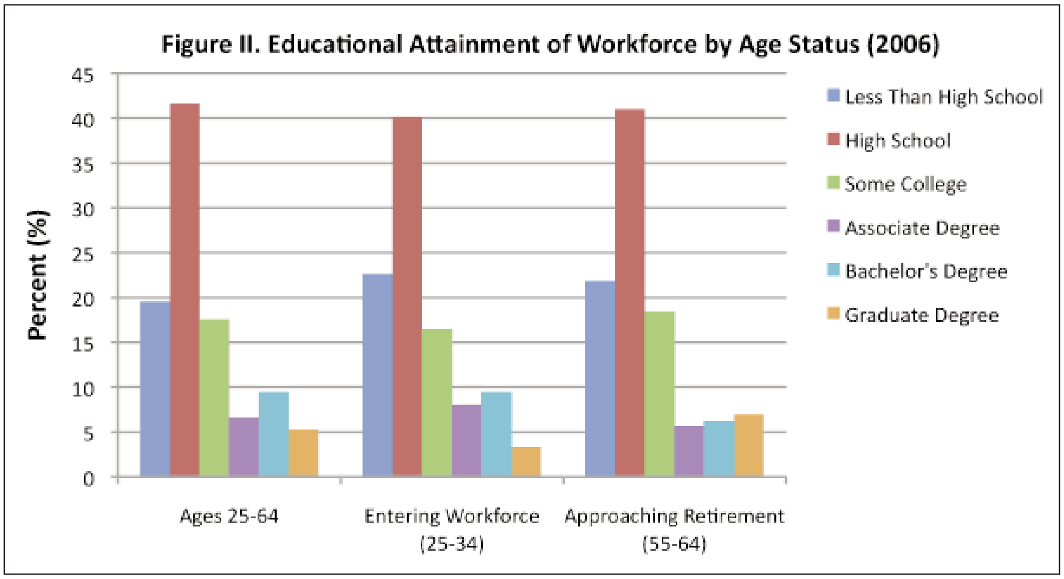
Figure I (b). Educational Attainment Levels, 2006





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Although the 14-county region showed some improvement between 2000 and 2006 in the bachelor's degree and higher educational categories, it is still significantly behind the U.S. average and Tennessee. For example, the number of those over age 25 with a bachelor's degree or higher increased 2.75% in that period. However, the region lagged behind the U.S. 13.6% in 2006 for the same educational attainment level. Figure I illustrates these differences across time and educational attainment levels. One observation is that, compared to the U.S., the region has a significant surplus in less than high school educational attainment and a substantial and stable deficit in bachelor's and higher educational attainment.

Intergenerational Difference in Educational Attainment

While the gap in postsecondary educational attainment is significant compared to both the Tennessee and U.S. average, is there an intergenerational difference in educational attainment levels in the region as well? Figure II looks at educational attainment level by age cohort.

According to Figure II, there is not much change between the entering workforce (ages 25-34) and those approaching retirement (ages 55-64) in the less than high school educational attainment category. The workforce approaching retirement is relatively better off in the high school, some college, and graduate degree categories. The entering workforce is slightly better in the associate's and bachelor's degree categories.

A critical observation is that there is no significant change in the "less than high school" category. An analysis of occupational employment by educational attainment shows that "less than high school" as an educational requirement is no longer part of the official job description for nearly all occupations in the U.S. (www.bls.gov). In order to address employment and wage issues effectively, policies should aim at eliminating the education gap in the region.

Extent of Educational Gap by Occupation

What is the extent of the educational gap in the region? Table III provides a detailed look at the region's employment by occupation and educational attainment. The table also compares the percent of the region's workforce with a college degree or above in each occupational category to that of the U.S. workforce. The large gap indicates that the region has the potential to make significant gains in wages and income by eliminating existing educational gaps in occupational employment.

For example, only 33% of scientists and technicians in the region have a college degree or above as opposed to 79 percent in the U.S. This translates into a gap of 46%, indicating significant room for educational improvement in this occupation. Similarly, the college and above degree gap in legal services occupations is more than 25%, in medical occupations 24%, in sales

Table III. Educational Attainment by Occupation (%) (2006)

	Southern Middle Tennessee Region					U.S. Avg.	Region-U.S
Occupations	< High School	High School	Some College	Assoc. Degree	College+	College+	Gap in College+
Managerial Positions	6.07	34.48	19.99	2.89	36.58	60.00	-23.42
Business Services Positions	0.00	29.48	19.04	16.84	34.64	51.00	-16.36
Financial Services Positions	2.27	15.20	24.76	12.46	45.32	63.00	-17.68
Computer Programmers & Database Administrators	0.00	22.21	15.26	15.08	47.45	66.00	-18.55
Engineering	1.12	14.45	29.52	8.02	46.89	60.00	-13.11
Scientists and Technicians	0.00	41.76	17.49	7.51	33.24	79.00	-45.76
Community Services	12.42	5.64	6.41	7.86	67.67	69.00	-1.33
Legal Services Occupations	0.00	27.63	16.33	16.33	39.71	65.00	-25.29
Education	4.72	18.64	10.19	5.94	60.52	77.00	-16.48
Entertainment	3.64	25.44	13.93	13.98	43.01	54.00	-10.99
Medical	0.00	10.52	14.74	40.77	33.97	58.00	-24.03
Health Services	20.32	35.34	36.14	4.26	3.94	15.00	-11.06
Protective Service Workers	7.02	53.69	22.84	3.49	12.95	23.00	-10.05
Eating and Drinking	39.33	42.69	14.24	2.68	1.06	9.00	-7.94
Cleaning Services	37.90	46.02	10.10	0.00	5.98	8.00	-2.02
Personal Services	20.05	42.31	26.55	7.06	4.03	21.00	-16.97
Sales	16.77	42.43	24.02	4.52	12.26	37.00	-24.74
Office Workers	6.87	39.78	31.75	12.43	9.18	18.00	-8.82
Farming, Fishing & Forestry	59.00	22.62	18.38	0.00	0.00	7.00	-7.00
Construction	31.33	56.82	9.03	0.99	1.82	4.00	-2.18
Extraction (Drilling)	51.21	48.79	0.00	0.00	0.00	3.00	-3.00
Maintenance and Repair	16.57	50.80	23.10	6.77	2.76	9.00	-6.24
Production Workers	23.68	54.98	15.21	2.50	3.63	7.00	-3.37
Transportation	30.88	55.16	11.55	1.18	1.22	12.00	-10.78

Source: American Community Survey and BERC Estimates

25%, and in computer programming and database administration 19%.

Eliminating higher education attainment gaps even in these selected occupations is likely to boost economic dynamics in the region. A synchronized approach to workforce education and cluster strategy is necessary for a successful regional economic development initiative.

Conclusion

The workforce in the southern middle Tennessee counties has a deficit in educational attainment compared to the U.S. In order for these counties, already experiencing significant economic decline, to emerge as a globally competitive manufacturing region, they should develop policies to upgrade skill and education levels of the existing workforce. In doing so, these counties are likely to increase employment opportunities as well as income level for the unemployed and underemployed labor force. Now is the right time to invest in human capital to create a globally competitive regional workforce. ■

Murat Arik is the associate director of MTSU's Business and Economic Research Center.

Note

1. Murat Arik and David A. Penn (2008), "Increasing Competitiveness through Strengthening Regional Industrial Clusters: Middle Tennessee Marketing Region," Business and Economic Research Center, MTSU.

AMERICAN HABITS LED TO DILEMMA

THE CHINESE PIPER?

The U.S. should not be in hock to another country, but we cannot entirely blame China, and in the short run there is no way out.*

by Steven G. Livingston

China purchased some $500 billion of U.S. bonds and assets last year alone. Is it the piper that will soon call the tune? China's recent warning to the U.S. Treasury was a wake-up call as well as a demonstration of some new realities.

The United States has racked up an eye-popping amount of debt. The government is the problem, yes. The federal budget deficit in 2008 alone was $455 billion. But average Americans are the problem, too. Our national savings rate has hit historic lows. The inability of Americans to save shows up in the balance of payments. This balance measures how much we buy (imports) versus how much we sell (exports). In 2008, our trade deficit—imports over exports—approached $600 billion. The order of the day seems to be not "buy American" but "buy everything!"

Who finances all this debt? Who is America's banker? Try China, among others. In effect, they loan us the money to keep spending. Of course they do want this money back—and with interest, please.

Now, we can blame the Chinese for this. They manipulate their currency, aid their exports, and are too tolerant of pirated American goods. But, quite frankly, that is too easy. America runs a trade deficit with just about everybody. If China didn't exist, we would only be buying, and borrowing, from someone else. Remember the Japan-bashing of 20 years ago? The Chinese don't force our government to run budget deficits.

The Chinese don't force us to buy flat-screen TVs on credit, either. And they certainly didn't make anyone buy toxic securities. These are our problems. We made them.

Of course, the U.S. should not be in hock to another country, and certainly not to one with as many differences as we have with China. We don't want to tremble every time China—or anybody else—makes noises about our economic policies or about the value of the dollar.

The dilemma is that, in the short run, there is no way out. The eventual solution is to bring federal spending under control, place American entitlement programs on a sound footing, and return Americans to their earlier savings habits. Unfortunately, if we did this right now, our weakened economy might collapse altogether. Ending spending when the economy is in the midst of a rapid decline is madness. Hence, the stimulus plan, among other policies.

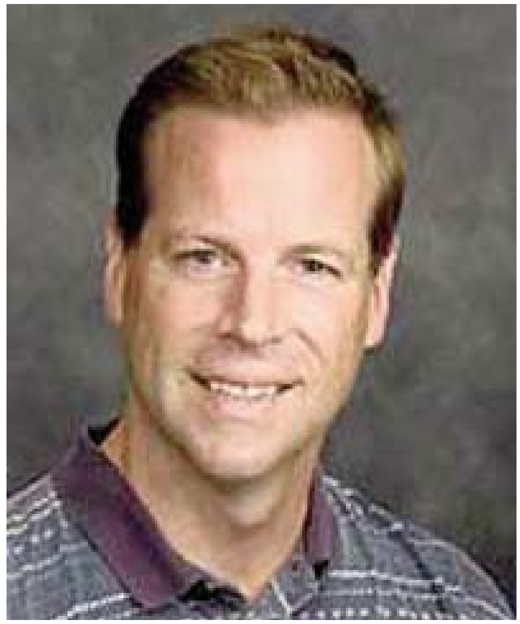
Yes, this will pack more debt on top of the mountain we already have. And yes, China will be buying a lot of it. But what's the alternative? All we can say is that China and other creditors are at least in the same boat we are in. If we collapse, they lose their investments.

In the longer run, this cannot go on. Once through this crisis, we must make the reforms necessary to wean ourselves off our addiction to debt. If we cannot do this, the Chinese piper will indeed call the tune. And it will not be a pretty melody. ■

**This article first appeared in the* Tennessean. *Steven G. Livingston, editor of Global Commerce, is a professor of political science and a senior associate of the Business and Economic Research Center at MTSU.*

ARE WE KEYNESIANS?

There is plenty of room for empirical debate with respect to the efficacy of fiscal policy in general, whether monetary policy is a better tool, or what constitutes spending that will make us more productive in the future.



by Martin Kennedy

It is unclear whether we are all Keynesians, or even mostly Keynesians, now as some have suggested. Keynesianism is a somewhat elastic concept. It is safe to say that most economists believe the economy can be stimulated in the short run via deficit spending. It is also safe to say that the recently passed federal stimulus, the American Recovery and Reinvestment Act (ARRA), has enabled states, otherwise constrained, to engage in Keynes-inspired fiscal stimulus. States, unlike the federal government, must balance their budgets annually and so don't have as powerful a fiscal policy lever to pull in an attempt to counter a downturn. The recently passed federal stimulus, $787 billion in spending, includes $144 billion that has gone directly to state and local governments for "fiscal relief." This relief means that states will be able to engage in a sort of deficit spending, using expansionary fiscal policy, via the federal government.

In Tennessee, for example, the budget deficit in the current fiscal year that runs through June 2009, before the ARRA money, is projected to be just north of $1 billion out of a budget that is just over $29 billion. The roughly $4.5 billion in relief coming to Tennessee from Washington will enable the state to balance the budget without dramatic cuts in spending this year and for the next two fiscal years. So for the next 30 months, the state should be able to maintain spending levels and thereby help stabilize aggregate demand and mitigate the rising rate of unemployment. In short, the federal government is borrowing on behalf of state governments.

Theoretically, at least according to classical theory, the economy is self-correcting: markets are efficient; prices, wages, and interest rates adjust downward in response to a demand shock, and full employment returns.

Markets adjust sluggishly, countered Keynes.

> *The long run is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is past the ocean is flat again.*

So wrote John Maynard Keynes in 1923. His influence has been dramatic—for the five decades following that statement and again today. Beyond asserting that markets don't

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One wonders what Keynes would have thought about running deficits, in good times and in bad, in peace and in war, which we began practicing in the early '80s.

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adjust in the real world quite as quickly as they do on a classroom chalkboard, Keynes thought that below full-employment equilibrium was possible. Firms might not engage in investment projects or begin hiring even as interest rates and wage rates drop if aggregate demand is weak. Unwilling lenders could "trap liquidity" in a time of low interest rates and great uncertainty. Falling prices lead people to hoard money and reduce consumption. Reducing consumption is rational in a period of deflation, but ultimately, and paradoxically, savings could actually begin to fall as an economy deteriorates and incomes fall: the so-called paradox of thrift.

Active fiscal policy, engaging in deficit spending, could insure sufficient aggregate demand and serve to counter a downturn, according to Keynes. Government spending would compensate for reduced consumption and investment spending. Such action would "prime the pump" of economic activity. Fiscal policy, according to Keynes, should be countercyclical in nature, running deficits to counter a downturn but paying down the debt when growth resumed. Keynesian fiscal policy, properly understood, is focused on the short run. It should be viewed as a mechanism to smooth the business cycle rather than a long-run strategy to enhance growth. A recent survey of Ph.D. economists found that 85% agreed that the federal budget should be balanced over the course of the business cycle.

The recently proposed Tennessee budget, actually a plan for the next several annual budgets, seems to have embraced the smoothing concept. The Bredesen administration is using the federal money as a means to mitigate, not eliminate, spending cuts. There would be nothing smooth about having to cut $1.1 billion this year, and there would be nothing countercyclical if projected spending were not adjusted. In short, the governor's multiyear plan recognizes that the stimulus, as the concept should imply, is temporary. The proposed budget for the 2009-2010 fiscal year is about 1.5% lower than last year's budget. Without the ARRA funds, it would have been about 8.5% lower, reflecting the reality that state tax revenue is down by roughly that amount. Another way of looking at it is that state agencies planned for cuts of about 15% before the ARRA funds and now will cut by just 3.5%.

State spending in Tennessee grew faster than personal income between 2003 and 2007, but it would be hard to suggest that the current budget proposal is imprudent or that it relies on unrealistic expectations of revenue growth. Wisconsin, which has a slightly lower population than Tennessee, is looking at a $5 billion deficit this year and higher taxes in the near future as are residents in California, Illinois, New Jersey, and New York. Tax hikes are contractionary and would mitigate the stimulatory impact of the ARRA funds. The administration in Nashville is anxious to close what it sees as tax loopholes and might tinker around the edges with fees in the next couple of years, but we shouldn't expect any tax increases.

There is plenty of room for empirical debate with respect to the efficacy of fiscal policy in general, whether monetary policy is a better tool, or what constitutes spending that will make us more productive in the future. There is ample room for ideological differences with respect to the role and size of government at the federal level. Most of the ARRA money is not going to the states. At the federal level, the deficit is projected to be a whopping 12% of GDP this year. The Obama administration's projections show a deficit of 5% of GDP and falling five years out, when growth will be robust and unemployment low. The Congressional Budget Office projections show a growing deficit five years out. Their GDP growth estimates are not as optimistic as the administration's. One wonders what Keynes would have thought about running deficits, in good times and in bad, in peace and in war, which we began practicing in the early '80s.

As for Tennessee, the budget response is a problem of constrained optimization. It is not a question of what Tennessee should do in some theoretical sense but rather what the budget should look like given the sharp and now extended recession as well as how the state should respond to the ARRA funding out of Washington. There seems to be bipartisan support for the Bredesen administration plan to use the money to mitigate the impact of the recession, to prevent drastic cuts at the state level, and to adjust spending over the next two fiscal years. There will be no initiatives, like universal pre-K education, that require a substantial and permanent commitment of funds. Neither will there be any tax increase. ■

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ARE CEOs OVERPAID?

(AS PERCENT OF CORPORATE PROFITS)

A team of MTSU's economics and finance faculty members is researching the trend in executive compensation measured as a percent of corporate profits.

by William Ford and Kevin Zhao

During the current very serious economic recession, the financial media have focused a lot of attention on the compensation paid to top business executives. Numerous examples of multimillion-dollar payments to executives of failing companies that have received huge injections of taxpayer dollars have generated a firestorm of public protests. The U.S. Congress and President Obama's Cabinet members have also responded by initiating a series of actions designed to curtail excessive compensation payments to the executives of such companies. That, in turn, has rekindled interest among academic researchers in "agency theory."

Agency theory focuses on the question of how best to align the interests of shareholders of public companies with the inherently conflicting interests of non-owner managers. When a company is managed directly by its owners, economists assume there is no inherent economic conflict between the two roles of owner-managers. However, when the managers own little or none of the stock in a company, they may attempt to maximize their own compensation rather than their company's profits and dividends accruing to shareholders. And, in today's financial crisis environment, when taxpayer monies are used to rescue or nationalize failing companies such as Fannie Mae, Freddie Mac, General Motors, and AIG, media-driven public resentment rises when the top executives of such firms are seen flying around in corporate jets and drawing multimillion dollar salaries, bonuses and other benefits.

In response to this re-aroused interest in executive compensation and related agency-theory issues, a team of MTSU's economics and finance faculty members has initiated a project drawing on a number of databases to shed some new light on the question of whether or not non-owner business executives are, over time, capturing a growing share of the earnings of major publicly owned companies they manage. To address this issue, the MTSU team has developed a new metric, the executives' total compensation measured as a share of company earnings. Or, in plainer English, what is the trend in executive compensation measured as a percent of corporate profits?

In the first phase of work on this project, recently completed and published in the April 2009 issue of *Business Economics*, the MTSU team measured the "CEO Share of Earnings" (CEOSE) of S&P 500 companies over a 15-year period, from 1993 through 2007, the latest year for which data on those companies is available. During 2007, the CEOs of the S&P 500 companies in our sample varied in age from 38 to 83 with a median (mid-point) age of 56. Their companies, on average, had roughly 55,000 employees and $65 billion in assets. At the end of that year, the market value of the average company was about $30 billion, and the average CEO received total compensation of $10.8 million, of which only 10%, or about $1 million, was salary. The other 90% of the CEO's total compensation was received in bonus payments, option awards, restricted stock grants, and various other forms of compensation including private use of company planes, club memberships, professional tax advice, etc. Measured as a share of corporate earnings (after-tax profits) the S&P 500 CEO's share of earnings (CEOSE) averaged about 2.4% over the entire 15 years from 1993 to 2007. As shown in Figure 1, the CEO share of earnings generally rose from

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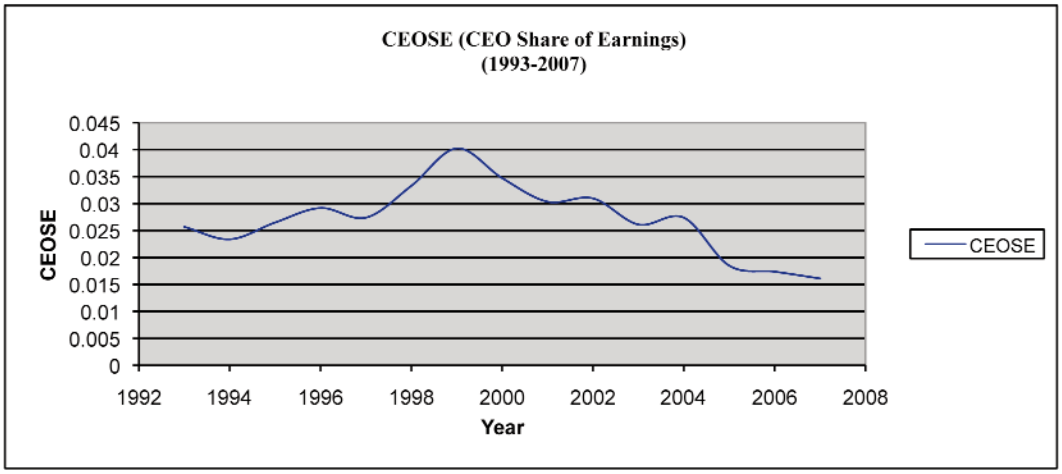
Figure 1. CEO Share of Earnings (1993-2007)



Source: *Business Economics*, April 2009, Vol. 44, No. 2, p. 122

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around 2.5% in the mid-1990s to a peak level of 4.0% in 1999 and, surprisingly, has trended downward since then, ending at a historically low level of about 1.6% of earnings in 2007.

Moreover, during that entire period, CEOs' average salary, in inflation-adjusted dollars, rose by only about one-third of 1% annually, and their bonuses actually declined by over 1% per year. However, their total compensation rose by roughly 6.1% annually, driven mainly by restricted stock grants. Because almost all corporate stocks have declined sharply in value since the end of 2007, a majority of those restricted stock grants are undoubtedly now much less valuable than they were in 2007. The same is true of the stock option awards received in recent years by S&P 500 CEOs.

Readers of this article may, by now, be as intrigued as the authors were to find that this preliminary study of long-term trends in S&P 500 CEO total compensation is not consistent with the public's media-driven perception that top executives of U.S. companies are increasingly overpaid, at least not when their compensation is measured as a share of their companies' after-tax profits, CEOSE. And, as noted above, it is now virtually certain that CEOSE fell sharply in 2008. According to an Associated Press analysis of regulatory filings from 309 companies in the S&P 500, average CEO compensation fell 7% in 2008. Unfortunately, our preliminary work does not directly address the current financial crisis and the current economic recession because the sample of companies we studied omitted S&P 500 firms that were merged out or failed and firms that were unprofitable during the period we analyzed. Also, our initial findings covered only the total compensation trends of the CEOs of S&P 500 companies.

Looking ahead, we plan to delve more deeply into trends in total executive compensation in a number of ways. For example, we will examine the total compensation of the top executive teams of S&P 500 companies rather than just trends in the CEOs' share of earnings. We also plan to refine the sample of companies we study by adjusting it for mergers that occurred over time and other factors that bias the sample of companies we used in this first pass at the databases we are using. Because most of the recent media and public concern about executive compensation has been focused mainly on financial companies, we also plan to conduct a separate study of the S&P 500 companies in that industry.

In conclusion, our preliminary answer to the question of whether business executives are overpaid is: *perhaps not*. If we assume that CEOs of major U.S. firms should be compensated based on the earnings they manage to produce for the shareholder owners of their companies, this first pass at long-term trends in their total compensation does not indicate that S&P 500 CEOs are receiving a growing share of their companies' profits over time. Whether or not that finding holds for major financial firms, or for top executives of failing firms supported by the taxpayers, remains to be seen. ■

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ARTHUR LAFFER

WE'RE ALL KEYNESIANS NOW

The government can redistribute income but cannot create it out of thin air.

by Arthur Laffer

At times of great economic disturbances such as we are currently experiencing, rather than trying to micromanage the economy, it is beneficial to step back and evaluate where we stand in relation to the ideal economic policies. We do this by looking at what I like to call the four grand kingdoms of macroeconomics: fiscal policy, monetary policy, trade policy, and incomes policies.

Ideal fiscal policy would include fiscal restraint, spending controls, and low-rate flat taxes. That is the perfect world. The ideal monetary policy would be stable-valued money: stable currency now and forevermore. Markets need to know with a fair degree of certainty that a dollar bill 40, 30, 20, 10, and 5 years from now will be worth approximately what it is worth today, which allows us to lend and borrow in the capital markets.

The ideal trade policy would be to have minimal impediments to the free flow of goods, services, and people across national boundaries. With total free trade, each country can avail itself of the maximal gains from global trade and specialization. Impediments to the free flow of goods and services, such as tariffs, quotas, restrictions on trade, or restrictions on people, lead to a deviation from the ideal trade policies.

Incomes policies include all of the indirect effects government can have on business—regulations, restrictions, requirements, minimum wage, wage and price controls, universal healthcare, security measures at airports, environmental policy, union activities, and everything of that ilk. We do need regulations. No one would suggest that you wake up in the morning and decide whether you are going to drive on the left or the right side of the road. But the ideal incomes policies are those that don't go beyond their specific regulatory purpose and thus cause collateral damage to the economy. The minimal amount of regulation necessary to achieve order and structure in society, but not go beyond that, is the ideal.

Unfortunately, over the past few years, we have begun to stray farther and farther from these ideal policies, particularly in fiscal policy. To illustrate this, I want to go through the logic of the stimulus and how it works to better explain the theory behind the current administration's fiscal policy. Its leaders describe it this way: if you give a guy $600 that he otherwise would not have had, he is going to spend more than he otherwise would have spent. And that's true; he is going to go out and buy stuff. That in turn is going to create jobs for people who are now supplying him with the goods and services that he otherwise would not have bought. Those people in turn will have higher incomes and spend more money, and there will be this cascading effect through the economy. And that will lift the economy up by the bootstraps.

As far as that description goes, it is correct. But that's not the whole truth; it's only the first chap-

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Whenever you transfer resources, you drive a wedge between wages paid and wages received, and you provide less incentive to the workers and producers.

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ter of the story. The second chapter is that unfortunately, in this world we live in, the government does not have a tooth fairy. To give command over real resources to someone based upon any characteristic other than work effort, it must take those resources from someone else. It is a zero sum game. The government can redistribute income but cannot create it out of thin air. When resources are given to one group and taken from another, the taxpayers who lose the resources in turn will spend less. That will disemploy people who had heretofore been employed through supplying the goods and services people are no longer buying. The incomes of the newly disemployed will be down, they will in turn spend less, and there will be a cascading effect through the system on the other side that exactly offsets the multiplier effect on the stimulus recipients. For every dollar received there is a dollar lost; whenever you bail someone out of trouble, you put someone else into trouble. That's double-entry accounting.

But that isn't the end of the story; there is still one more chapter. Yes, the income effects net to zero—the transfer recipients spend more, the taxpayers or transfer losers spend less, and those effects exactly offset. But something else happens: the substitution effects accumulate across the whole process. Let me describe it this way. If you transfer real resources to people based upon some characteristic other than work effort, those real resources that are transferred can only come from workers and producers. Whenever you transfer resources, you drive a wedge between wages paid and wages received, and you provide less incentive to the workers and producers. They will withdraw their services from the labor force, and the substitution effects will accumulate. You find that, in fact, the stimulus package not only doesn't stimulate but actually hurts the economy.

If instead we could move fiscal policy back toward low, flat-rate taxes accompanied by fiscal restraint, you would see the economy and stock market respond much more positively. ■

Arthur Laffer served as a member of President Reagan's Economic Policy Advisory Board and is co-author of The End of Prosperity: How Higher Taxes Will Doom the Economy—If We Let It Happen.