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Economy Continues Restrained Recovery

F. Kathleen Vinlove, BERC associate director

With the U.S. economy growing through each quarter of 2002, recovery technically has begun, but pessimistic profit expectations coupled with the threat of war have made a quick and complete rebound less likely in 2003. Still, the fundamentals of low inflation, low interest rates, and high U.S. productivity appear to be sound, and most economists are forecasting GDP growth between 2.5 and 3 percent in the coming year.

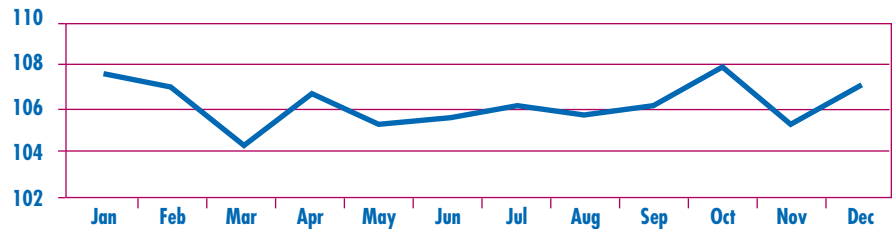
As the U.S. unemployment rate hovered above 5.5 percent in 2002, Tennessee's unemployment declined for the first three quarters before turning upward in the fourth quarter, ending at a seasonally adjusted 4.7 percent. Service sector employment growth in the state remained strong, creating nearly 14,000 jobs between December 2001 and December 2002, but declines in manufacturing put a drag on growth in the fourth quarter.

Although it, too, continues to experience clouds over its manufacturing production, Nashville's economic climate remains sunnier than that of the state, southeast region, and nation. Of 19 cities with average total non-farm employment between 500 and 750 thousand, Nashville ranked third in employment growth at the midpoint of the fourth quarter.

Growth in services and most other key Nashville industries has counterbalanced declines in the goods producing and wholesale trade sectors (Figure 2), leading to a year-over-year increase in total non-farm payroll employment of 0.3 percent but a 0.2 percent decline for the quarter. The city's overall unemployment (3.1 percent in December, preliminary estimate) remains well below Tennessee's rate.

The area's tourist industry also has fared better than most. Because Nashville is a drive-to tourist location, it has revived more quickly than fly-to destinations. This quarter's hotel payroll employment for the metropolitan area showed an increase compared to last quarter and last year, and hotel revenue rose by 3.1

Figure 1. BERC Midstate Leading Index, 2002



percent from last quarter. Air travel remained relatively flat over the period, possibly reflecting reduced business travel.

While service industries stay strong, employment in the area's industrial machinery and equipment industry, as well as in the transportation equipment industry, will continue to slacken until business investment picks up. Manufacturing employment (seasonally adjusted) in the MSA fell by 1.7 percent from last quarter, the largest decline of the year, attributable in part to a downswing in the truck manufacturing industry. The recent closing of Eaton Corporation's truck transmission production plant in Shelbyville is one example of hits received by the recession-prone industry.

Holiday retail spending remained relatively flat for the region, and this trend may continue as reflected in the significant drop in February's Middle Tennessee Consumer Confidence Index compiled by Dr. Timothy Graeff of MTSU's Office of Consumer Research. All three

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The Business and Economic Research Center is pleased to announce that, beginning with this issue, the *Midstate Economic Indicators* is sponsored in part by the

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Figure 2. Percent Change in Non-farm Payroll Employment, Nashville MSA, Fourth Quarter 2002 seasonally adjusted

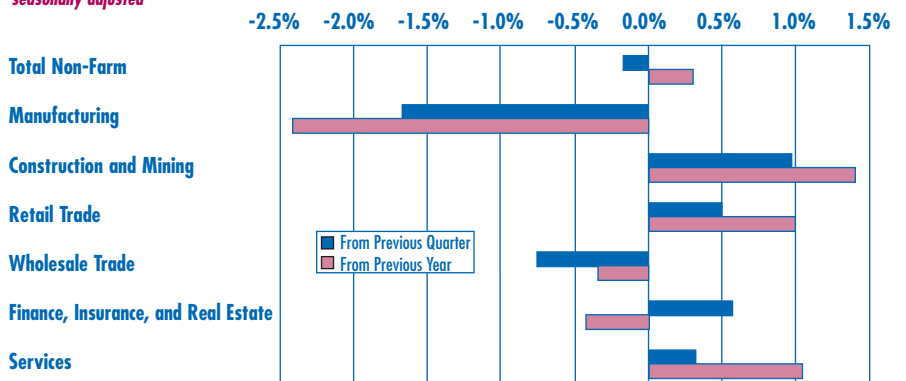


Table 1. Economic Indicators for Middle Tennessee

Series (seasonally adjusted)	Geographical Area	2001Q4	2002Q1	2002Q2	2002Q3	2002Q4	Percentage Change 2002Q3-2002Q4
Midstate Leading Index	Midstate (41 Counties)	105.0	106.9	105.3	105.8	105.3	-0.4%
EMPLOYMENT							
Midstate Number of Employed Persons	Midstate (41 Counties)	1,035,467	1,053,384	1,058,311	1,058,344	1,059,943	0.2%
Midstate Unemployment Rate	Midstate (41 Counties)	4.6%	5.0%	4.6%	4.3%	4.0%	-7.0%
Average Hours Worked per Week in Manufacturing	Nashville MSA (8 Counties)	38.20	38.92	38.81	39.45	39.04	-1.0%
Average Pay per Hour in Manufacturing	Nashville MSA (8 Counties)	\$14.82	\$15.26	\$15.10	\$14.79	\$14.80	0.0%
INITIAL CLAIMS AND BANKRUPTCY							
Initial Claims for Unemployment Compensation	Midstate (41 Counties)	47,393	37,141	43,710	37,580	38,023	1.2%
Bankruptcy Case Filings	Midstate (41 Counties)	3,883	3,839	3,681	3,941	4,009	1.7%
HOUSING CONSTRUCTION							
New Residential Units (permits)	Midstate (41 Counties)	3,219	3,783	3,838	3,866	4,035	4.4%
Value of New Residential Units (million \$)	Midstate (41 Counties)	381.2	425.2	444.8	450.1	450.7	0.1%
AUTOMOBILE PRODUCTION							
Autos Assembled in Midstate	Midstate (41 Counties)	159,187	188,714	198,609	187,613	161,370	-14.0%
Units Sold: Autos Assembled in Midstate	United States	178,290	155,881	160,013	148,049	139,096	-6.0%
TOURISM							
Hotel Revenue	Davidson County	\$93,380,264	\$92,293,353	\$93,112,353	\$94,538,704	\$97,507,867	3.1%
Total Air Passengers, Nashville International Airport	Davidson County	1,948,080	1,972,329	1,992,908	2,035,129	2,036,274	0.1%

Notes: Seasonal adjustment with X11-ARIMA.

Sources: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Bureau of the Census; U.S. Bureau of Economic Analysis; Tennessee Department of Labor and Workforce Development; Davidson County Clerk's office; Metropolitan Nashville Airport Authority; Nashville Electric Service; *Automotive Weekly*; *economagic.com*; U.S. Bankruptcy Court, Middle Tennessee District

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indicators—present and future situation indices and purchasing situation index—shrank from November levels, with 49 percent of those surveyed believing war will have a negative impact on the local economy.

Local consumers are continuing to spend on interest-rate sensitive items such as housing and

automobiles, however. As Nashville residential construction remained robust, final quarter employment in the construction sector increased 1.4 percent from 2001 to 2002, but overall nonbuilding and nonresidential construction contracts fell during the period.

Other potentially dampening impacts for the Nashville area include further area retail closings by K-Mart and Food Lion, declines in government employment as state budget cuts are enacted, and a sluggish market for electronic equipment. Dell officials believe that corporate spending on technology will remain soft this year, and even after the economy recuperates fully, spending on information technology is not expected to increase greatly except in the wireless computing arena.

All these disparate forces may add up to flat overall performance in the midstate for the year ahead or, at best, incremental improvement. The first half of the year may be especially problematic, as the BERC Midstate Leading Index, down by half a percentage point, predicts a slightly more negative situation for the first quarter of 2003. Initial unemployment claims are up in the midstate region by 1.2 percent as well. Add to this yet another danger: when the economy does gather momentum, the unemployment rate may actually increase as discouraged workers re-enter the work force, producing more job-seekers than jobs.

Although the Bush administration's proposed fiscal stimulus may lead to budget deficits, it may also have a beneficial impact on consumer expectations, an important factor in the current climate of uncertainty. This, plus a resolution to the world's geopolitical suspense, may help to restore confidence in the region and nation. Without such boosts to economic morale, the year ahead could bring more waiting for a true upswing to begin. ■

For more information on the Middle Tennessee Consumer Confidence Index:

www.mtsu.edu/~mgmtmkt.CMRC.htm

Table 2. Nashville MSA Quarterly Payroll Employment (thousands, seasonally adjusted)

Sector	2002Q3	2002Q4	% Change
Total Non-Farm	687.6	686.4	-0.2%
Construction and Mining	33.4	33.7	1.0%
Manufacturing	90.7	89.2	-1.7%
Durable Goods	55.9	54.7	-2.1%
Nondurable Goods	34.7	34.5	-0.6%
Finance, Insurance, and Real Estate	41.6	41.8	0.6%
Transportation, Communications, and Utilities	39.0	38.0	-2.6%
Wholesale Trade	38.1	37.8	-0.8%
Retail Trade	128.4	128.8	0.4%
Services	228.0	228.7	0.3%
Government	88.5	88.0	-0.5%

Table 3. Nashville MSA Monthly Payroll Employment (thousands, seasonally adjusted)

Sector	2002			% Change Nov.-Dec.
	October	November	December	
Total Non-Farm	686.6	685.9	686.8	0.1%
Construction and Mining	33.7	33.7	33.8	0.2%
Manufacturing	89.6	89.2	88.7	-0.6%
Durable Goods	55.1	54.8	54.2	-0.9%
Nondurable Goods	34.5	34.5	34.5	-0.1%
Finance, Insurance, and Real Estate	41.9	41.8	41.7	-0.3%
Transportation, Communications, and Utilities	37.9	38.0	38.0	0.1%
Wholesale Trade	38.0	37.8	37.7	-0.4%
Retail Trade	128.5	128.8	129.3	0.4%
Services	228.6	228.7	228.8	0.1%
Government	87.8	87.7	88.6	1.0%

State Government Finances

David A. Penn, BERC associate director

The financial situation faced by state governments is bleak: states are scrambling to reduce a total budget gap of \$26 billion for fiscal 2003 (the *current* fiscal year), if current revenue estimates are correct. Previous revenue estimates have been overly optimistic: just last November, for example, the budget gap for fiscal year 2003 was estimated at a much lower \$17.5 billion. Preliminary estimates show a much larger budget gap, on the order of \$68.5 billion, for fiscal 2004.¹

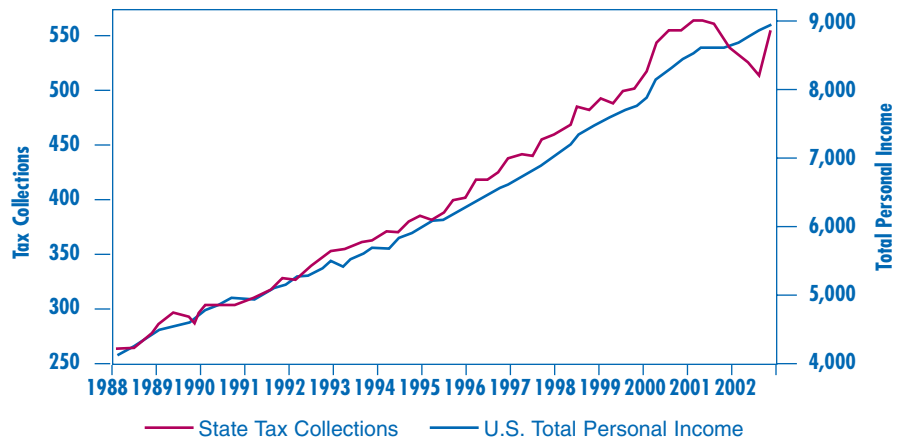
While revenues have been falling, costs have been rising. Growing health care costs have created great strains on state Medicaid systems. Some states have cut Medicaid spending, while others have cut spending for higher education and common education. Potential increases in taxes are under consideration in at least 24 states.² This article briefly examines the origins of the current state government revenue crisis and the revenue outlook for fiscal year 2004.

The figure shows the trend of total state government tax collections for the 50 states from the first quarter 1988 through the third quarter 2002, adjusted for seasonal fluctuations. The recent revenue crisis began when tax revenue growth stalled early in 2001, peaking at \$564.1 billion (annualized) in the first quarter. After a small increase in the second quarter, year-to-year tax collections fell 1.8 percent in the third quarter and 4.8 percent in the fourth quarter. The revenue crisis heightened dramatically in 2002: year-to-year collections fell 6.8 percent in the first quarter and 8.8 percent in the second quarter. The rapid drop in collections halted and reversed itself in the third quarter of 2002 owing to tax hikes in several states.

The unraveling of state government tax collections was dramatic in 2001-02. States were forced to make hard decisions regarding support for education, Medicaid, and other government services, but was the dramatic fall in revenue entirely unexpected?

In hindsight, the time path of state government tax collections from 1999 through 2002 can best be described as a roller coaster ride. The dramatic decline in collections in 2001 and 2002 represents the roller coaster as it plunges down the hill, but to reach the top of the hill the roller coaster had to climb dramatically first. As the figure shows, tax collections in fact zoomed up in 2000. In the first quarter of 2000, state government tax collections were up 11.1 percent from the same quarter of 1999. Collections were up 10.5 percent in the second quarter, 10.6 percent in the third quarter, and 8.5 percent in the fourth quarter compared with the same quarters of 1999. To put these increases in

Figure 3. Total State Government Tax Collections and U.S. Total Personal Income (seasonally adjusted annual rate, billion \$)



perspective, compare them with the long-term state government tax collection growth rate of 5.8 percent from 1998 through 1999. Tax revenue growth in 2000 clearly was much greater than trend revenue growth. Growth of this magnitude, greatly above trend, is unlikely to be sustained. States would have been wise to limit spending to the long-term rate of revenue growth, saving revenue in rainy-day accounts when revenue growth occurred above the long-term trend.

A comparison of state government tax collections with total personal income of the U.S. also shows how much tax revenue strayed from the long-term trend. As shown in the figure, total personal income and state tax collections grew in tandem from 1990 to 1999. The close relationship between income and tax collections is to be expected since the bulk of revenue collected by most states is derived from household income, either directly through individual income taxes or indirectly through sales tax and *ad valorem* taxes collected on items that households purchase. The relationship clearly became out of sync in 2000 when tax collections grew much faster than personal income, and when tax collections were falling dramatically in 2001 and 2002, total personal income slowed but did not fall.

Why the huge drop in tax collections compared with total personal income? The evidence suggests that the dramatic fall in stock market values caused large declines in capital

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The unraveling of state government tax collections was dramatic in 2001-02.

Table 4. State Government Tax Collections (Million \$)

	FY2001	FY2002	\$ Change	% Change
Total	560,661	528,714	-31,947	-5.7%
Individual Income Tax	209,477	186,521	-22,956	-11.0%
General Sales Tax	182,897	179,468	-3,429	-1.9%
Corporation Net Income	32,319	26,547	-5,772	-17.9%
Motor Fuel Sales	30,046	30,514	468	1.6%
Motor Vehicle and Operators' Licenses	16,205	16,566	361	2.2%
Property	9,501	8,385	-1,116	-11.7%
Tobacco Product Sales	8,062	8,214	152	1.9%
Alcoholic Beverage Sales	4,258	4,364	106	2.5%
All Other	67,896	68,135	239	0.4%

Source: U.S. Census Bureau

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Jones College of Business,
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BERC Director: David Penn
Associate BERC Director:
F. Kathleen Vinlove
Dean, Jennings A. Jones
College of Business:
E. James Burton
Publications Editor/Designer:
Sally Ham Govan
Graduate Research Assistant:
Xiaojuan Wang
Phone: 615-898-2610
e-mail: kkulp@mtsu.edu
<http://www.mtsu.edu/~berc>

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¹ National Conference of State Legislatures, *NCSL News*, online version, February 4, 2003, <http://www.ncsl.org/programs/press/2003/pr030204.htm>.

² *NCSL News*.

³ "Behind California Budget Mess Is Pattern of Political Paralysis," *Wall Street Journal*, January 10, 2003, p. 1.

⁴ *Report of the Maryland Board of Revenue Estimates on Estimated Maryland Revenues*, Fiscal Years Ending June 30, 2003, and June 30, 2004, December 16, 2002.

State continued from inside

gains and stock option income. The importance of taxable income created by stock market gains is difficult to exaggerate for some states. In California, for example, realized stock market gains produced huge increases in state government tax collections: just 0.3 percent of tax filers collectively paid \$15 billion in taxes to the California treasury, or 24 percent of state government general-fund revenues for 2000.³

Declines in capital gains and stock option income impact state governments by reducing

collections from individual income taxes. From fiscal year 2001 to 2002, individual income tax collections by states fell 11.0 percent, accounting for 72 percent of the net decline in total state tax collections (Table 4).

States that depend on income tax revenue for a large portion of total state government tax collections were hammered hard. Revenue declines of 10 percent or more occurred in these states (Table 5). In Oregon, individual income tax accounted for 88 percent of general revenue in 2001, and Oregon general revenue suffered a drop of 24.1 percent. Other states highly dependent on individual income tax include California, Connecticut, Massachusetts, New York, and Colorado, all of which experienced large revenue declines.

It is unlikely that revenue losses attributable to declining capital gains income will continue to loom large in fiscal year 2004 if for no other reason than tax revenue from capital gain income has shrunk so much already that further declines would not have much impact. Realized capital gains (net proceeds from sales of stocks) fell by 50 percent in 2001, dropped an additional 20 percent in 2002, and are expected to fall another 10 percent in 2003. According to an analysis by the State of Maryland, realized capital gains are expected to return to long-term trend annual rate of growth of 10 percent beginning with 2004.⁴ ■

Table 5. Change in General Revenue for State Governments April-June 2001-02

State	General Revenue		% Change In Individual Income Tax Revenue	Individual Income Tax as % of General Tax Revenue
	\$ Change (Million)	% Change		
California	-6,315	-24.7%	-39.4%	66.4%
Oregon	-382	-24.1%	-23.2%	88.3%
Massachusetts	-594	-19.7%	-30.9%	72.2%
New York	-2,312	-19.4%	-26.8%	66.0%
Connecticut	-536	-19.0%	-29.7%	52.0%
Colorado	-261	-13.8%	-15.3%	65.0%
North Carolina	-320	-12.6%	-17.4%	66.5%
Tennessee	-98	-4.3%	—	—
Arkansas	-37	-3.1%	-6.3%	49.2%
Alabama	-44	-2.5%	-1.6%	43.5%
Georgia	-87	-2.3%	-10.2%	51.2%
Kentucky	-40	-2.1%	-6.6%	45.6%
Mississippi	-1	-0.1%	-12.6%	26.1%
United States	-14,226	-10.4%	-22.3%	48.3%

Source: "State Tax Revenue Decline Accelerates," *State Revenue Report*, The Nelson A. Rockefeller Institute of Government, September 2002, No. 49