An Economic Report to the Governor of the State of Tennessee

On the State’s Economic Outlook

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AN ECONOMIC REPORT TO THE GOVERNOR OF THE STATE OF TENNESSEE

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Preface

This 2007 volume of An Economic Report to the Governor of the State of Tennessee is the thirty-first in a series of annual reports compiled in response to requests by state government officials for assistance in achieving greater interdepartmental consistency in planning and budgeting efforts sensitive to the overall economic environment. Both short-term, or business cycle-sensitive forecasts, and longer-term, or trend forecasts, are provided in this report.

The quarterly state forecast through the first quarter of 2009 and annual forecast through 2016 represent the collective judgment of the staff of the University of Tennessee’s Center for Business and Economic Research in conjunction with the Quarterly and Annual Tennessee Econometric Models. The national forecasts were prepared by Global Insight, Inc. Tennessee forecasts, current as of January 2007, are based on an array of assumptions, particularly at the national level, which are described in Chapter One. Chapter Two details evaluations for major sectors of the Tennessee economy, with an agriculture section provided by the University of Tennessee Agricultural Policy Analysis Center. Chapter Three presents the long-run outlook and forecast for the state. Chapter Four discusses the environmental challenges confronting Tennessee today, including issues relating to air pollution, water pollution, and preservation of the Great Smoky Mountains National Park.

The primary purpose of this annual volume—published, distributed, and financed through the Tennessee Department of Finance and Administration, Tennessee Department of Economic and Community Development, the Tennessee Department of Revenue, the Tennessee Department of Labor and Workforce Development, and the Appalachian Regional Commission—is to provide wide public dissemination of the most-current possible economic analysis to planners and decision-makers in the public and private sectors.

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Executive Summary

The U.S. Economy

For much of 2006, the headline stories focused on the housing sector contraction. This sector certainly saw turbulence over the year. However, if we look at evidence from the broader economy, we saw solid growth for the overall economy in 2006. Inflation-adjusted Gross Domestic Product (GDP) grew 3.3 percent in 2006, slightly above the 3 percent benchmark for growth. While the housing sector contracted, other sectors have advanced. Business construction grew 9 percent over the year. This offset some, but not all, of the housing sector slowdown. In the overall economy, labor markets are tight, following several years of steady economic expansion, and this raises some concerns about inflation pressures. The unemployment rate dropped over 2006, to a 4.5 percent rate by December. Especially early in the year, wage pressure became evident, with increases in wages and non-farm unit labor costs. Consumer inflation picked up in the first half of the year. Overall inflation, measured by CPI growth, was over 4 percent at mid-year, but slowed later in the year. “Core” inflation was still above 2 percent at the end of the year, which is above the Federal Reserve’s (Fed) 1 to 2 percent comfort zone for inflation. The Fed has been increasing the Federal Funds rates since 2005, aiming to achieve a “soft landing” for the economy: slower economic growth and a cooling of inflation and labor market cost pressures. In mid-2006, it appears the economy did throttle down to a slower pace.

In 2007, we expect the economy to grow, but below the 3 percent benchmark pace. Inflation-adjusted GDP will grow at an annual rate of 2.3 percent. The nation’s labor market will feel the pinch of the slowdown. The unemployment rate will drift up to 5.0 percent by the last quarter of 2007. Exports were an important driver for the 2006 economy. Improving economic growth around the world and a declining dollar have been key factors. Exports will be an important source of strength going forward. Export gains should average in the high single digits in 2007, and this pace will continue into 2008 and 2009. Overall consumption spending will slow, but still grow 2.8 percent in 2007. Durable goods will bear the brunt of spillover effects from the housing contraction, and decline in the first half of 2007 before rebounding. Inflation will move lower, with CPI inflation below 2 percent.

The housing sector correction will continue in 2007. The decline in residential investment could run 15 percent (annualized), particularly in the first half of the year, as builders continue reduce their inventories. There is some evidence that the housing market is has begun to stabilize. The economy may achieve a soft landing in 2007, though some turbulence will continue for the housing sector.

The Tennessee Economy

Current Economic Environment. The Tennessee economy showed sustained strength in 2006 despite rising interest rates, high energy prices and continued setbacks in manufacturing employment. Nonfarm jobs enjoyed a 1.3 percent gain, personal income was up 6.0 percent and the state unemployment fell to 4.8 percent in the fourth quarter of the year. Despite this decent showing, the state nonetheless trailed the nation in the performance of these three measures of economic activity.

The service sector continues to be the driver for nonfarm job growth, especially jobs in leisure and hospitality services (up 3.3 percent in 2006) and education and health services (up 2.3 percent for the year). At the same time, the manufacturing sector saw jobs fall at a 1.2 percent pace as both the nondurable and durable goods sectors contracted. While
Executive Summary, continued

Tennessee’s annual unemployment rate for 2006 of 5.2 percent was well above the national average of 4.6 percent, it was also the lowest annual average recorded since 2001. It is especially encouraging that the number of unemployed people fell by 4.4 percent in 2006.

Personal income had a strong showing in 2006, registering a 6.0 percent gain. Rent, interest and dividend income, along with wage and salary income, helped carry personal income forward. Tennessee per capita personal income had somewhat slower growth of 5.1 percent for the year. Per capita income in the state stood at $32,474 compared to $36,367 for the U.S. in 2006. Based on data for the second quarter of 2006, per capita income in Tennessee placed it fourth among all southeastern states, behind Virginia, Florida and Georgia.

Taxable sales were up 6.8 percent in 2005 following growth of 5.1 percent in the previous year. Automobile dealer sales actually contracted in 2005.

Short-Term Economic Outlook. A slight slowdown in economic activity is projected for Tennessee in 2007, though there is little chance of a serious economic downturn. Growth will then show some improvement in 2008. Personal income in Tennessee is expected to grow more strongly than the nation in 2007 and 2008; state job growth will surpass the nation in 2007 and the match the nation in 2008.

Slightly lower job growth, coupled with slower growth in the average wage, will translate into slower wage and salary income for 2007. Rent, interest and dividend income should continue to show healthy growth. Together, expect Tennessee personal income to advance 5.5 percent in 2007 and 5.7 percent in 2008. Per capita income is expected to grow 4.5 percent and 4.8 percent this year and next year. Taxable sales will show only 4.2 percent growth in 2007 and rebound with stronger growth the following year. On a fiscal year basis, taxable sales should be up only 3.6 percent in 2006/07, with growth improving to 5.0 percent in 2007/08.

The state unemployment rate will likely rest above its national counterpart through 2008. With slower job growth expected this year, the unemployment rate is expected to inch forward from its 4.8 percent to 4.9 percent by the fourth quarter of 2007. Overall nonfarm job growth should come in at 1.2 percent in 2007, just shy of the 1.3 percent gain registered in 2006. Nonfarm job growth will reach 1.4 percent in 2008 as economic activity accelerates. The manufacturing sector is expected to continue to see job erosion, though the value of output in manufacturing will continue to expand due to productivity gains. The durable goods sector is projected to see job growth, but this will be more than offset by further contractions in the nondurable goods sector.

Situation and Outlook for Tennessee Agriculture. Higher crop prices during the last four months of 2006 should have a positive effect on calendar cash farm receipts for Tennessee crop farmers. To the extent that those prices continue into the new year, cash farm receipts for 2007 could be strong as well. Because of the counter-cyclical nature of the commodity programs, some of the gains in cash receipts for both years will be offset by lower government payments. The exceptionally strong corn prices will likely result in a shift in the allocation of crop acres to the various crop alternatives.
Executive Summary, continued

While crop farmers enjoy the benefits of higher crop prices, livestock producers end up facing higher feed prices. This is particularly true for poultry producers who cannot keep their animals on pasture or feed them distiller dry grains—a byproduct of ethanol production. Beef, poultry, and pork producers may see tighter margins in 2007 when compared to 2004 and 2005.

Despite the declining numbers and small size of farms, agriculture remains an important component of Tennessee’s economy, especially when businesses that process agricultural products—or service, distribute, or manufacture farm equipment and inputs—are taken into consideration. This is even true in urban areas like Shelby County (Memphis) where over 10 percent of its economic activity is agriculturally related. In Moore County, nearly 80 percent of the economic activity of the county is agriculturally related. Moore County is home to a distillery that uses grain in the production of its product. For the state as a whole, three-quarters of one percent of all economic activity is generated by farming activities while over 12 percent of the state’s total economic activity is agriculturally-dependent with a significant portion of that coming from those who provide goods and services to those engaged in primary and secondary agriculture.

Every Federal farm bill is influenced disproportionately by the current economic and political conditions in the farm sector and the larger economy at the time the bill is written and certainly that will be true for the 2007 Farm Bill. The current farm bill (set in place in 2002) is scheduled to expire in 2007 and Congressional leaders have said that they hope to have the new legislation in place by late summer or early fall 2007. Based on history, the most likely outcome for the 2007 Farm Bill is only modest changes from the 2002 Farm Bill. However, several forces are coalescing that could put enough pressure on the delicate farm policy balance to trigger more significant changes to the nation’s farm policy. These include the large and growing federal budget deficit, negotiations and obligations under the World Trade Organization (WTO), interest and emphasis on renewable energy, and the public perception that farm programs are not achieving their objectives (or rather, widespread misperception about the real objectives and expectations of current farm policy).

Long-Term Economic Trends. The state’s long-term economic forecast includes trend projections extending to 2016. Long-term forecasts generally do not try to predict when the next business cycle will take place, and the forecast presented in the body of this report is no exception. While a recession is a distinct if not likely occurrence sometime over the course of the next ten years, it is an event that cannot be predicted with any degree of accuracy.

Long-term growth is affected by a variety of factors, ranging from population and labor force growth, to improvements in productivity that arise from investments in new plant and equipment, infrastructure and human capital, i.e., education and training. These are among the areas of focus for public policy if the state is to enjoy economic prosperity in the years ahead.

The state economy continues to endure a process of transformation as the manufacturing job base declines in importance and the service sector rises in importance. But while manufacturing jobs are shrinking—both as a share of overall jobs and in absolute number—the value of output in the state’s manufacturing sector continues to grow. This is a sign of improved productivity in the state’s industrial base.
Executive Summary, continued

Tennessee’s inflation-adjusted per capita income stood at $22,819 in 1994, which was 92.4 percent of the national average. State per capita income reached $28,338 in 2006, but the U.S. also saw decent income growth between 1994 and 2006. State per capita income in Tennessee slipped to 89.3 percent of the national average in 2006. Improvement in the state’s standing relative to the nation hinges on making sound education investments in people and in the infrastructure that supports economic development.

Nonfarm job growth is projected to advance at an average 1.4 percent pace per year between 2006 and 2016. Manufacturing jobs, which represented 14.5 percent of nonfarm jobs in 2006, will account for 12.3 percent of jobs in 2016. Growth in the durable goods sector will not be sufficient to overwhelm losses in nondurable goods. On a positive note, the share of state output attributable to manufacturing will rise in the years ahead, despite job losses. By 2016 manufacturing will account for 22.9 percent of state gross domestic product versus 20.9 percent in 2006. The service sector will continue to rise in importance, both in terms of the number of jobs and as a share of the overall state job base. Professional and business services will see especially strong growth.

Distribution of Income. As a special supplement to the long-term outlook, this year’s Report provides a discussion of changes that have taken place in the distribution of income for the state and nation. This is timely in light of the popular media’s attention to the rise of a new class called the ultra-rich and stagnating earnings for lower skilled workers. The rich appear to be getting richer, especially at the very top of the income distribution. We hope that readers find this topical discussion to be interesting.

Assessing the State of Tennessee’s Environment

Due in part to significant geographic diversity across Tennessee, local environmental conditions and natural resource endowments vary significantly across the state. Protecting Tennessee’s diverse environment to ensure continued increases in standards of living, including improved health and recreational opportunities, and preserved biodiversity presents constant challenges for residents of the state policymakers. Environmental quality is also important to the job creation process and economic development. People want to work and live in areas with strong environmental amenities. Problems like non-attainment of federal air quality standards in our metropolitan areas can hamper the state’s ability to attract new employers. Because of the nature of environmental resources and the services flowing from those resources, the government, at the federal, state, and local levels, is charged with enacting policies consistent with these goals. The sometimes overlapping control of environmental policymaking at different levels of government presents unique challenges for residents and policymakers within the state.

Chapter 4 focuses on environmental issues confronting Tennessee today. These problems require ongoing attention so that the state’s environmental assets are not squandered. The chapter considers air pollution, water pollution, and preservation of the Great Smoky Mountains National Park, one of the state’s premier environmental assets. This certainly does not exhaust the environmental issues confronting the state, but provides a foray into some of the more important issues at hand.