The State’s Economic Outlook

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Preface

This 2008 volume of *An Economic Report to the Governor of the State of Tennessee* is the thirty-second 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 2010 and annual forecast through 2017 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 2008, 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 welfare policy changes and the extent to which graduates from Tennessee’s institutions of higher education contribute to the state’s economy.

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

The U.S. economy continued its slowdown in 2007 as the housing market slumped further and banks tightened credit availability. Inflation-adjusted gross domestic product (GDP), perhaps the most widely used indicator of overall economic health, grew 2.2 percent over the course of the year. Most sectors of the economy, with the exception of residential investment (housing), experienced modest growth. Consumption, which accounts for roughly two-thirds of GDP, grew at a 2.9 percent clip in 2007 while business investment displayed 4.8 percent annual growth. A weakening dollar boosted GDP, contributing to a 7.9 percent growth in exports and only 2 percent growth in imports. The housing market continued to make headlines for its poor performance, declining by an alarming 17 percent in 2007. For the year, the job market showed resiliency with unemployment rates averaging 4.6 and an overall increase in employment while inflation was in check at a manageable 2.9 percent.

Yearly growth figures mask the recent discouraging developments in the macroeconomy. Despite higher yearly figures, consumption and export growth slowed in the fourth quarter, generating annualized growth of 2 and 3.9 percent, respectively. Residential investment fell more swiftly in the fourth quarter than for the year, registering a 24 percent annual drop. These numbers contributed to overall annual GDP growth of only 0.6 percent for the quarter. To make matters worse, inflation and unemployment rose to 4 percent and 4.8 percent, respectively, in the fourth quarter of 2007. These disturbing trends are expected to carry over into 2008, prompting anticipation of further interest rate cuts by the Federal Reserve and the proposal of a substantial federal fiscal stimulus program.

Economic growth is projected to fall, but remain positive, in 2008. We expect the economy to avoid recession and produce inflation-adjusted GDP growth of 1.9 percent for the year. With the exception of residential investment, all sectors are expected to display positive growth. Consumption spending, government outlays, and business investment will experience modest growth of between 2–3 percent. Export growth will continue to bolster the economy with an expected increase of 9.6 percent for 2008. Despite lower interest rates, the housing market will continue to fall: residential investment is estimated to fall by 21.3 percent. Contributing to these projections is the expected weakening of labor markets. Total nonfarm employment should rise in 2008, but only slightly, while unemployment is projected to rise to 5.1 percent. Slow demand growth and a decline in oil prices should keep inflation under control at 2.2 percent for the year.

The Tennessee Economy

Current Economic Conditions

The weight of the national economy has tempered economic growth in Tennessee. Most broad measures of economic activity—including job growth, income growth and the unemployment rate—weakened as 2007 progressed. The good news is that growth continues to take place. Weaker growth, yes, but growth nonetheless. An important exception is the state’s housing sector. Evidence from the state’s metropolitan areas points to a significant slowdown in
residential construction activity that will affect the economy well into 2009.

Tennessee’s job growth in 2007 was only 0.8 percent, the poorest showing since 2003 when the nation was in the midst of the jobless recovery. Many counties in the state, especially those in rural areas, have struggled mightily to maintain a viable job base; metropolitan Tennessee has fared much better. As job growth has weakened, the unemployment rate has ticked upward. The state unemployment rate bottomed out at 4.0 percent in August. However, by December the unemployment rate had climbed to 5.3 percent.

The slowdown has hurt income growth and has dampened taxable sales growth, in turn putting pressures on the state budget and the budgets of local governments across the state. Nominal personal income in Tennessee grew 5.1 percent last year, which is a respectable achievement. But year-over-year taxable sales growth was below 4 percent in the last three quarters of the year, and year-over-year sales tax revenue contracted in January.

**Short-Term Economic Outlook**

Tennessee’s fate hinges on the path taken by the national economy in the quarters ahead. As we go to print, the economic news for the nation has deteriorated further. This suggests that the short-term forecast for Tennessee presented here is an upper bound on the state’s likely growth path through 2009.

Nonfarm job growth is projected to be 0.6 percent in 2008, improving to 1.0 percent growth in 2009. Despite the strong showing in 2007, the state’s construction sector is expected to see jobs fall by 0.4 percent for the year. The outlook for construction could weaken further if the economy’s weaknesses spill into non-residential construction. The state unemployment rate will average 5.1 percent in 2008, a one-half percentage point increase over 2007.

Nominal personal income should advance 4.6 percent for the year and inflation-adjusted personal income should remain in the black. Wage and salary income will also show positive but slower growth than last year due to slower job growth and slower growth in the average wage. Taxable sales will see growth of only 3.5 percent for the year.

**Long-Term Historical Trends**

The ten year historical window for Tennessee includes the slowdown in the late 1990s that culminated in a brief recession in 2001. The years immediately following the recession of 2001 were characterized by decent economic growth, though job growth was relatively slow compared to other post-recession expansions. The economy finally gained momentum and produced stronger growth from 2004 and through much of 2007.

Between 1997 and 2007, Tennessee experienced 8.6 percent job growth compared to 12.4 percent job growth for the nation as a whole. The state’s job growth performance placed it in 7th place compared to other southeastern states. On the other hand, Tennessee’s population grew 14.7 percent compared to 12.7 percent for the nation over the same time period.

The state’s pattern of job and overall economic growth continues to undergo transformation. Manufacturing job and plant losses have continued, as has been the case for the nation. Because rural Tennessee has relied disproportionately on manufacturing, many rural communities have suffered significant job losses. The weak job situation has spilled beyond the labor market: a total of 17 counties saw population contract between 2000 and 2006.

Metropolitan areas of the state continue to benefit from growth in the service sector. Job growth, per capita income levels and unemployment rates are generally more attractive in metropolitan areas of the state.

**Long-Term Economic Outlook**

The long-term trend performance of the state economy is driven by growth in the ingredients to economic growth. Paramount among these is population growth which affects labor force participation rates and the size of the labor market. Population
Executive Summary

growth rates are expected to slow in the years ahead, while large numbers of the Baby Boom generation will retire. Tennessee will record a 10.1 percent change in population between 1997 and 2020, which is noticeably slower than the 14.7 percent change in population between the shorter historical window 1997–2007. (Tennessee is expected to place 5th among the southeastern states in population growth by 2020, trailing Florida, North Carolina, Virginia and Georgia.) Growth in the civilian labor force in 2017 will be about one-half the rate of growth expected in 2010 and 2011. An important consequence will be slower rates of growth in state gross domestic product and personal income. Per capita personal income, on the other hand, should continue to grow at a healthy pace.

A second important ingredient to economic growth is the skill level of the workforce. Lower-skilled jobs are evaporating rapidly, while jobs requiring more advanced academic training and skill levels are growing at faster rates. If Tennessee cannot produce the skilled workforce required by businesses that compete in the global marketplace, these jobs will go elsewhere, to the detriment of the state and its residents. A survey of business leaders in Tennessee reinforces the seriousness of the current worker skills’ gap and heightens concerns regarding the outlook in 10 years. To put the situation in perspective, about two-thirds (66.2 percent) of surveyed businesses responded that it will be “much harder” or “harder” to find qualified workers in Tennessee’s workforce over the next decade.

Tennessee Policy Watch

Welfare Assistance in Tennessee: A Policy Update

Tennessee made a number of significant changes to its Families First welfare program in the past year to both policies for participants as well as the program’s administration. Families First must now align with federal rules following the mid-2007 expiration of a waiver that enabled the state Department of Human Services (DHS) to diverge from federal rules. Although Families First had many of the same features of the federal welfare program created in 1996, Tennessee must now adapt to subsequent changes to federal requirements. For example, Tennessee must now conform to federal legislation passed in 2005 that caused virtually all states to face higher work activity participation rate requirements. Previously, Families First emphasized the importance of education and training in moving recipients from welfare to work and included post-secondary education, adult basic education and job skills training as qualifying activities. New federal rules tighten the requirements on including such activities in calculating the work activity participation rate, and training and education now must be more directly related to employment.

To meet new federal rules since the expiration of its waiver, Tennessee has made a number of important changes to both its policies and its approach to delivering welfare services to participants. These changes will warrant attention and evaluation from policymakers as they begin to make an impact both on Families First participants and the state’s economy. DHS instituted a new performance-based contracting model that divides the state into five zones, each served by a different contractor primarily responsible for matching program participants with work activities. This model provides new variation across the state in how contractors place participants in work, and the outcomes will need to be tracked across contractor zones within Tennessee in order to see if certain methods prove to be
more effective. Tennessee also eliminated the 18-month interim time limit so that families can now receive assistance for a continuous 60-month period, which may impact not only recipients’ behaviors, but also future state budgets. The creation of a one-time assistance program intended to divert families from ongoing monthly cash assistance under the traditional Families First program may help Tennessee meet higher participation rate requirements, but will require continued attention from program administrators to ensure that these payment recipients fare as well as traditional Families First participants.

School-to-Work: Do Tennessee’s Higher Education Graduates Work in Tennessee?

Tennessee’s institutions of higher education provide an important service to students and the Tennessee economy at large. A better-educated workforce enhances the state’s prospects for economic development, and students enhance the quality of life for themselves and their families by earning higher incomes. Graduates from Tennessee’s public institutions of higher education make a substantial direct contribution to the state’s economy: in 2005, nearly 120,000 Tennessee higher-education graduates within the 1997 to 2005 study period were working in Tennessee and earned over $4.4 billion. Within two years of graduation, about two-thirds of graduates are working in the state. This percentage declines over time, but the leaving workers are replaced by new graduates, effectively re-stocking Tennessee’s labor force with educated and trained workers. The labor force participation rates and wages vary considerably by type of degree and field of study, and there are also differences among Tennessee institutions (Tennessee Board of Regents and the University of Tennessee). Wages progressively increase for higher level degrees, and in-state participation rates get progressively lower. Tennessee Board of Regents institution graduates are more likely to remain in the workforce over time, but generally have lower wages and slower wage growth than their University of Tennessee counterparts.

The state’s institutions of higher education graduate productive workers, a large number of whom remain in Tennessee after graduation. These graduates contribute to the workforce, replace any labor force losses from educated workers leaving Tennessee, and enhance the state’s competitiveness. The health of these institutions is vital to the workforce and ultimately to the Tennessee economy.