AN ECONOMIC REPORT TO THE GOVERNOR OF THE STATE OF TENNESSEE

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PREFACE

This 2015 volume of An Economic Report to the Governor of the State of Tennessee is the thirty-ninth 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 2017 and annual forecast through 2024 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 IHS Global Insight, Inc. Tennessee forecasts, current as of January 2015, 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 discusses Tennessee’s role in the international economy and presents the long-run outlook and forecast for the state. Chapter Four presents Tennessee’s labor market before and after the Great Recession.

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 is situated to have sustained growth through 2015 and 2016. Early estimates are that GDP grew 2.4 percent in 2014, compared to 2.2 percent in 2013 and 2.3 percent in 2012. Last year started off slow, with GDP falling 2.1 percent in the first quarter of 2014 but rebounding in the subsequent quarters. In fact, in the third quarter of 2014 GDP increased by 5.0 percent (on a seasonally-adjusted basis), the highest growth since the recession began. This makes 2014 the fifth year of consecutive economic growth, and economic indicators point to that growth continuing. This strong recovery makes the U.S. an outlier globally; many other nations are experiencing much slower recoveries.

One of the most important milestones of 2014 was U.S. total nonfarm payrolls finally reaching and surpassing their prerecession level. It is estimated that 2.5 million jobs were created in 2014 for a total of 138.9 million jobs in the economy. As the job market improved, unemployment continued dropping, down to 5.8 percent in the fourth quarter of 2014. This is the lowest that the unemployment has been since the third quarter of 2008. Along with the positive news from the labor market, consumer confidence was up. Falling gas prices in the third and fourth quarter led to increases in consumers’ real disposable income. Consumption and nonresidential fixed investment both experienced strong growth, up 2.5 percent and 6.3 percent respectively. This makes 2014 the year with the highest consumption growth rate postrecession. In addition, while the U.S. federal debt continued to rise, the government deficit was $483.3 billion, small when compared to the deficits run during the Great Recession. One negative indicator in 2014 was that the housing market did not experience the double-digit growth that was experienced in 2013 and 2012. Residential fixed investment grew by a disappointing 1.6 percent, and housing starts increased by only 994 thousand units.

Despite the sluggish housing market, the Federal Reserve views the overall state of the economy as positive. The Fed ended its large asset-purchasing program (“quantitative easing”) in October 2014. Expectations are that the Fed will begin raising interest rates in mid-2015. By the end of 2014, the federal funds rate had been kept very low (below 0.25 percent) for twenty-four consecutive quarters. There is some worry that rising interest rates combined with lower gasoline prices will cause inflation to be lower than its targeted 2 percent.

While there are reasons to be cautious about the next year in the U.S. recovery, there are more reasons to be optimistic. The economy did well overall last year and is expected to continue to grow in 2015. GDP is expected to increase by 3.1 percent, and the unemployment rate is predicted to fall to 5.5 percent. The year is expected to have solid gains each quarter, with GDP increases of 3.1 percent, 2.5 percent, 2.6 percent, and 2.3 percent in the first, second, third, and fourth quarters respectively. Expectations are that 2016 and 2017 will both register solid economic growth, 2.7 percent in both 2016 and 2017.

While there is reason to be cautious about the global recovery, most indicators point to the U.S. expansion continuing in earnest. The economy sustained solid growth in 2014, and expectations are that this growth will only continue.
The Tennessee Economy

The Short-Term Economic Outlook
Tennessee’s economy continued to grow in 2014 as the economic recovery persists. Nonfarm employment increased by 1.9 percent in 2014, representing job gains of more than 51,000. The state unemployment rate saw a huge drop between 2013 and 2014, falling from 8.2 percent to 6.9 percent. However, Tennessee’s unemployment rate still rests above the national rate.

Nominal personal income grew by 3.7 percent in 2014. This was slightly slower than national income growth of 3.9 percent but much faster than the 2.1 percent growth rate that the state registered in 2013. Nominal taxable sales increased by 4.3 percent in 2014, outpacing the previous year’s growth rate of 3.0 percent.

Tennessee’s short-term forecast is a mixed bag, as employment, taxable sales, and inflation-adjusted GDP are all expected to grow at a slightly slower rate in 2015 and 2016 as compared to 2014. Personal income growth will accelerate over the next two years and the unemployment rate will continue to trend downwards.

Nonfarm employment will grow by 1.8 percent in 2015 and 1.5 percent in 2016. Professional and business services, natural resources, mining, and construction, and leisure and hospitality services will enjoy the largest employment gains in 2015 and 2016. Conversely, the government sector will continue to see job losses over the next two years. Manufacturing employment will continue to grow, but at a slower rate of 1.3 percent in 2015 and 0.9 percent in 2016. Much of this slowdown can be attributed to job losses in nondurable goods manufacturing, which will largely offset job gains in the durable goods manufacturing sector.

The state unemployment rate will fall to 6.5 percent in 2015 and 6.2 percent in 2016. The number of unemployed people is projected to decline by 5.1 percent in 2015 and 3.9 percent in 2016. The number of employed people will see small gains of 0.4 percent in 2015 and 1.4 percent in 2016.

Nominal personal income is projected to increase by 4.4 percent this year, followed by a 5.0 percent increase in 2016. On a fiscal year basis, nominal personal income will grow by 4.0 percent in FY 2015 and 4.4 percent in FY 2016. Nominal taxable sales are projected to increases by 3.9 percent this year and 3.4 percent the following year. On a fiscal year basis, nominal taxable sales will expand by 5.3 percent in FY 2015 and 3.0 percent in FY 2016.

The Long-Term Economic Outlook
Tennessee’s long-term outlook is a trend forecast, which focuses on the influence of factors such as population and labor force growth. The forecast pays particular attention to Tennessee’s growth from 2004 to the present, as well as the state’s outlook extending out to 2024.

Between 2004 and 2014, nonfarm employment in Tennessee grew by less than 0.4 percent (compound annual growth rate, CAGR), compared to 0.5 percent (CAGR) growth for the nation as a whole. Employment growth during this ten year historical window was greatly influenced by the Great Recession which began in the fourth quarter of 2007 and lasted until the second quarter of 2009. In Tennessee, nonfarm employment contracted in three consecutive years: 2008, 2009, and 2010. Following these years of employment contraction, the state economy has seen slow but steady gains in employment. Overall nonfarm employment in Tennessee is forecasted to grow by 1.2 percent (CAGR) from 2014 to 2024. By comparison, the U.S. will see nonfarm job growth of 1.1 percent (CAGR).

The state’s employment mix is subject to ongoing transformation as the manufacturing sector continues to become a smaller portion of the Tennessee economy. In 2004 manufacturing accounted for 15.2 percent of all nonfarm jobs in Tennessee, but by 2024 the manufacturing share will fall below 10 percent. In the near-term, the manufacturing sector will enjoy some job growth as the economy continues its rebound from the recession. However, these gains will not erase the job losses felt during the Great Recession, and manufacturing employment will return to trend contraction in 2018. Despite shrinking employment levels, manufacturing output is still expected to grow by 2.4 percent (CAGR) over the next 10 years. Conversely, professional and business
services, education and health services, and leisure and hospitality services have all become a bigger part of the Tennessee economy since 2004, and will continue to enjoy employment growth in the next decade.

The state unemployment rate will continue to trend downwards and should reach 5.5 percent in 2020. This can be attributed to modest employment growth, population growth, and a decrease in the number of unemployed persons. Over the next 10 years, population growth for the state will stand at 1.0 percent (CAGR), which is slightly faster than the 0.8 percent (CAGR) growth for the nation. Despite the declining unemployment rate, the labor force participation rate, which is already at its lowest in recent years, will continue to drift down.

An important ingredient to long-term economic growth is the quality of the labor force (i.e. education, skill level, and health). In some respects economic growth in Tennessee has lagged behind national growth, and consistent with this story, education and health data show that Tennessean’s are below the national average. In 2013, the percentage of Tennessean’s with a high school degree or higher was 85.6 percent, but 86.6 percent for the nation. More importantly, the percentage of Tennessean’s with a Bachelor’s degree or higher was only 24.8 percent, compared to a national average of 29.6 percent. Furthermore, according to the 2014 edition of America’s Health Rankings, Tennessee currently ranks 45th out of all U.S. states in overall health status, largely because of a high prevalence of obesity, diabetes, physical inactivity, smoking, and a high violent crime rate. If Tennessee cannot produce a high quality workforce, businesses that need to compete in a global economy will seek other opportunities.

Tennessee’s Labor Market – Before and After the Great Recession

This chapter challenges the notion that Tennessee’s labor market has fully “recovered” from the Great Recession. Inflation-adjusted incomes have fallen for the vast majority of the state, the rate of labor force participation is still three percentage points lower than 2004, and the recovery in the unemployment rate is incomplete. The post-recession period (2009-2013) can better be described as a continuation of ongoing structural change rather than recovery. The industrial and occupational sectors that were most affected during the recession (production, construction, metal fabrication and plastics & rubber manufacturing) have not rebounded. Manufacturing has contracted from the 2nd largest sector of employment in Tennessee to the 4th. Not only has manufacturing contracted, but so have all industries where manufacturing human capital is transferrable. The health care and education sector, which saw growth in jobs and inflation-adjusted incomes during the recession, still exhibits growth in jobs but sharp decreases in incomes. Seven of Tennessee’s ten largest occupational sectors of employment in Tennessee are service-driven occupations. From a policy perspective, it is important to remember that these trends are not unique to Tennessee.

Three particularly troubling trends result from these structural changes. First, post-recession job growth has been concentrated in low-paying industries and occupations. Second, income disparity by industry and occupation is getting increasingly pronounced. Inflation-adjusted incomes in the low-paying sectors that employ large numbers of Tennesseans are falling, while inflation-adjusted incomes in high paying jobs that employ relatively few people are rising. The majority of the jobs near the median in 2004 were in construction, manufacturing, and production. Those jobs are vanishing. Third, the income and post-recession period was hardest on young workers (aged 18-35). The median inflation-adjusted income fell by 19 percent for young workers from 2004-2013, and the jobless rate is still 15% (4 percentage points) higher than in 2004. When young workers exhibit greater joblessness and declining wages, there is a strong compounding effect: not only are adverse effects felt today, but a young worker’s trajectory of income growth over their working life may be
stunted. Many young workers today may bear these costs over their entire lifetime and never fully recoup the opportunities that were lost over the Great Recession.

Faced with the reality of the changing industrial composition of the U.S., layered with at least some Skill Biased Technical Change, the state of Tennessee has some alternatives to address falling average incomes and declining labor force participation. Tennessee could take aggressive steps to bring jobs to the state that fit the skills of its workers. As many other states may be competing for a shrinking set of jobs, this may prove very costly in terms of targeted economic development incentives. Alternatively, Tennessee could put measures in place to develop the skills of its workers to match the demands of the changing economy. This is not to suggest that blue-collar jobs and manufacturing should be abandoned, but to emphasize that the skills and quantities of workers in production are different than in years past. In practice, a combination of these strategies will be needed that can both attract jobs to the state and make Tennesseans more productive in the workplace. Programs like TN Promise and the “Drive to 55” can help transition workers in Tennessee into high-skilled occupations in sectors that are growing, rather than contracting. There is still considerable work to be done to determine what majors/fields of study students might be best steered towards, let alone how to incentivize students to focus in these targeted areas. However, policies like TN Promise are a crucial step in preparing Tennessee to attract high-paying jobs in high-growth sectors rather than competing for jobs in sectors that will inevitably continue to contract.