



Research Seminar in Quantitative Economics
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The Michigan Economic Outlook for 2004-2005

June 2004 Forecast Update

Introduction

The recovery in the national economy has finally discarded its "jobless" characterization. Since last August the nation has added about 1.1 million jobs, and over half (625,000) have come in March and April. The Michigan economy has lagged behind the nation; the state's job count continued to slide through the fall and into the early part of this year. There is some evidence, however, that the job market in Michigan has turned the corner as well. The state's job count rose in both March and April by a combined total of 25,600 jobs—the best two-month performance since employment peaked in mid-2000.

All of the job gains in the past two months have occurred in private nonmanufacturing. The largest contributor by far was the professional and business service sector, which added 18,600 jobs. The gains included jobs in the higher-wage professional and scientific component as well as temporary-help workers. Other major contributors were health services and construction. The improvement in construction was in part a rebound from adverse winter weather but also reflected strong building activity, spurred by low mortgage rates. The manufacturing sector, on the other hand, has continued to lose jobs, but the recent losses have been relatively small.

The unemployment rate registered 6.6 percent in January and February. It surged to 6.9 percent in March before plummeting to 6.1 percent in April, but the two months averaged 6.5 percent, little different from the prior two readings. We judge the two-month average to be more representative of current labor market conditions in the state.

We believe this spring marks a solid turnaround for job prospects in the state economy, but before we examine the scope of the recovery, we first highlight the national and state-related input assumptions that are most essential to the local outlook.

Inputs to the Forecast

Major elements from our national forecast dated May 14, 2004 include the following:

- After expanding by about 5 percent during the year ending in 2004q1, real GDP grows at a 4.2 percent pace during the next two quarters before easing back to a 3.9 percent rate from late 2004 through late 2005. Healthy growth in consumer demand and rapid increases in business capital spending continue through 2005, and an accelerating pace of inventory building gives a boost to output growth in the spring and summer of 2004.
- We expect the Federal Reserve will begin to nudge up short term interest rates with a 25-basis-point increase in the federal funds rate at the late-June Federal Open Market Committee meeting. We have assumed a series of gradual rate increases that will put the fed funds rate at 2 percent by the end of 2004 and 3.75 percent a year later. The 3-month Treasury bill rate moves with the federal funds rate, rising from 0.9 percent in 2004q1 to 1.6 percent by the closing quarter of the year and 3.3 percent in 2005q4. Long term interest rates, which have jumped sharply since March, move up more slowly over the forecast. The 30-year conventional mortgage rate, which poked below 5½ percent in March, reaches 6.5 percent in late 2004 and 6.8 percent a year later.
- Fiscal policy, which has been highly stimulative during the past three years, becomes less expansionary, but by no means restrictive, in fiscal 2005. Paced by strong growth in the defense budget, federal spending increases by about 5 percent per year this fiscal year and next. With no new tax cuts after this year and the sunset of some business tax breaks at year's end, growth in federal receipts picks up from 3.7 percent this year to 11 percent in fiscal 2005. The federal deficit spikes to \$426 billion this year, but recedes to \$338 billion in fiscal '05.
- The unemployment rate peaked at 6.3 percent in June 2003 and has hovered around 5.6 percent since the beginning of this year. The reentry of workers into the labor market postpones further decline in the unemployment rate until late this year, but with solid output growth the unemployment rate retreats to 5.1 percent by late 2005.
- Consumer prices, measured by the U.S. CPI, are forecast to increase by 2.5 percent in 2004 and 2.2 percent in 2005 following a 2.3 percent rise in 2003. The recent rapid runup in oil prices propels the increase in consumer prices well ahead of the 1.7 percent rate projected for core consumer inflation this year.
- Light vehicle sales backed off from the very strong 17.1-million-unit pace of the second half of 2003 to a pace averaging just 16.3 million units during the first four months of this year. With

interest rates moving up only gradually and employment growing steadily, light vehicle sales improve to total 16.6 million cars and light trucks for 2004 and 16.9 million units in 2005.

- With the slowdown in sales in the early part of this year, vehicle output, as measured in the National Income and Product Accounts, slips by 1.9 percent during the first half of 2004. As sales pick up again, output reverses, rising by 2.7 percent from mid-2004 to mid-2005.

The outlook for Michigan is affected by some additional assumptions involving the automotive industry, a key component of the local economy. The economic provisions of the current auto contract call for a bonus this September equal to 3 percent of earnings, or about \$2,000 per eligible worker. This bonus will not be included in the workers' base pay. The next two years of the agreement do include increases in base pay, 2 percent in the final quarter of 2005 and 3 percent at the end of 2006.

Auto industry profit-sharing payments were distributed in the opening quarter of 2004 by General Motors and Ford, based on domestic profits for 2003. General Motors paid out \$170 per eligible worker and Ford distributed \$195 per worker. Among the Big Three automakers collectively, the total payout was down considerably from the one made in early 2003. We are assuming a modest increase in the total payment disbursed at the beginning of 2005.

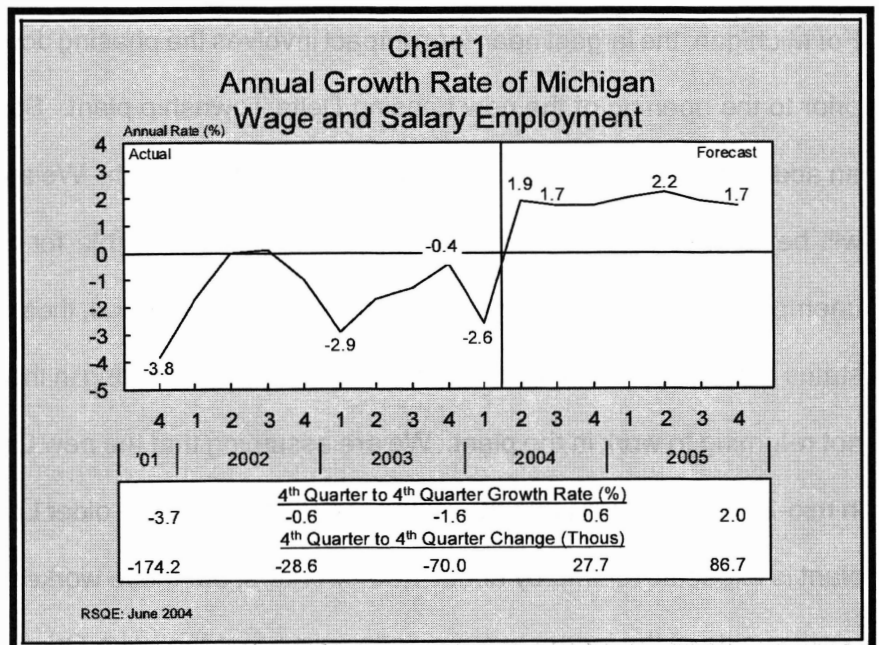
As part of the current agreement, a plant-closing moratorium was signed subject to listed exclusions. For Michigan, the largest near-term impact involves the phasing down of the older Lansing assembly plants prior to the opening of the new Lansing Delta Township plant. Some workers are already on layoff, and an additional 1,500 workers are scheduled to go this month. We are expecting that most of these workers will be on layoff for 48 weeks and that they will be eligible for SUB pay and, for 26 of those weeks, unemployment insurance benefits. Subsequent to this period, these workers would be eligible for protected status programs, receiving full straight-time pay and counting in the payroll employment statistics, despite not returning to work in the plant. We are assuming that the new Lansing plant will be open for production in mid-2006, coinciding with the remaining phase-out of the older Lansing plants. The new Delta Township plant is expected to employ about 1,800 workers, but these workers are not likely to be new hires. On the positive side of the ledger, we are anticipating that the Lake Orion assembly plant will add a second shift

at the beginning of 2005.

The Forecast of the State Economy

It appears that the long-awaited turn in Michigan's job market has arrived. Establishment employment continued to retrench in January and February of this year, with a loss of 26,000 jobs over the two-month period. This loss was recovered in the following two months, in tandem with a strengthening U.S. job market, representing the largest two-month job gain in the state in almost four years. The majority of the local job additions occurred in April, contributing to the annual rate of employment growth of 1.9 percent that we anticipate for the second quarter, which would be the strongest quarterly performance for Michigan since the spring of 2000. Our projected growth path for wage and salary employment for this year and next is shown in Chart 1. The box at the bottom of the chart translates the growth path into employment changes during each year—that is, the change from the end of one year to the end of the next year—shown both as a percentage and as the number of jobs.

As shown in the chart, we are forecasting that the job gains will be sustained through 2005, the end of our forecast period, and that this growth will be solid. The pace of job creation throughout the period is expected to exceed the trend rate of 1.4 percent established over the past twenty-five years. Job growth backs off slightly from its second quarter pace in the second half of 2004, expanding at a rate of 1.7 percent. The pace picks up in the first half of 2005 to average 2.1 percent, aided by the move into protected status programs of Lansing autoworkers laid off in



mid-2004. Since these workers will appear again on the payroll records, even though they will not have returned to the plant, they will be counted as employed in the establishment survey. In the second half of 2005, job growth moderates slightly, to average 1.8 percent.

The pattern of job growth over the forecast horizon translates into job gains totaling 27,700 during 2004 and accelerating to 86,700 during 2005, the best performance during a year since 1996.

The job count turned positive earlier for the nation (September 2003) than for the state, and U.S. job growth is projected to run about a half of a percentage point ahead of the Michigan rate on average over the last three quarters of 2004. By the beginning of 2005, though, the forecast path of job growth in Michigan and the nation is virtually synchronized, with job growth in the state running only a tenth of a percentage point behind the national rate on average throughout the year.

The manufacturing sector has been hit much more severely than the Michigan economy overall since mid-2000, and has yet to return to positive job growth. The recent losses have been smaller, though, and after continued retrenchment in the current quarter, we are forecasting a reversal to modest but positive job growth during the second half of the year and through the summer of 2005. Our national forecast of rising vehicle output over the next year, a recovery in equipment investment, and an improving export market supports a return to job growth in manufacturing. During 2004, the improvement in Michigan is tempered by layoffs of autoworkers in Lansing and stamping workers in Grand Blanc, and by reductions-in-force at Delphi. Some of the gains in 2005 reflect the addition of a shift at the Lake Orion assembly plant and the increase in the payroll employment count attributable to the laid-off autoworkers in Lansing who shift into protected status programs.

The manufacturing sector adds 1,700 jobs during 2004 and 5,200 jobs during 2005, a substantial improvement over job losses averaging 36,000 per year in 2002 and 2003.

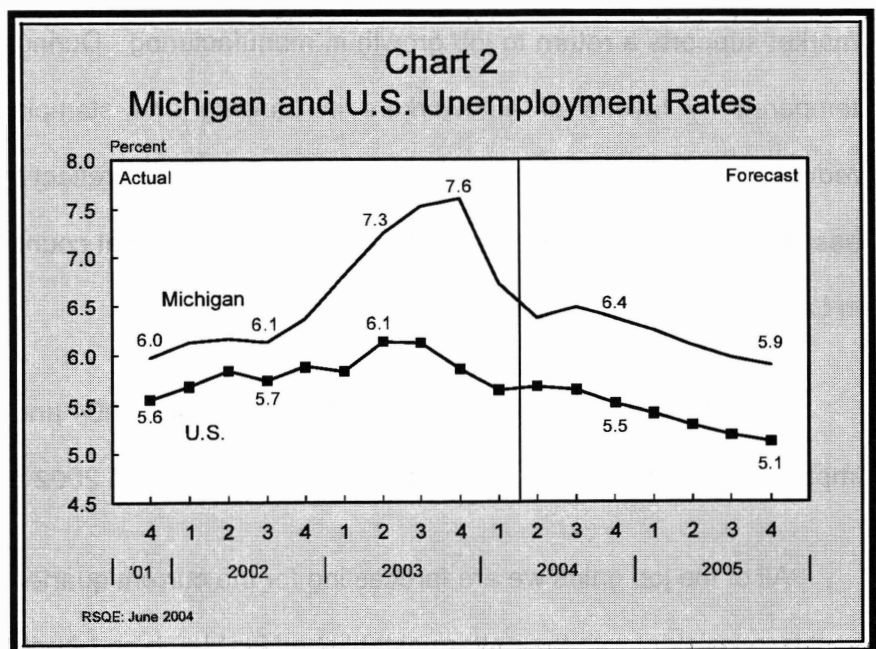
All of the job gains we are forecasting for the current quarter occur in the private nonmanufacturing sector, consistent with the pattern established for March and April. We are forecasting that the sector will

add 24,200 jobs in the second quarter, counterbalancing the loss of 23,000 jobs in the prior quarter. By the closing quarter of 2004, the sector settles in to average a healthy 20,000 job additions per quarter through 2005. The rebound is consistent with an improving local manufacturing sector and strengthening purchasing power among the state's residents. The service industries contribute five out of eight net job additions to the sector over the forecast period. Almost half of the job creation in services is in the professional and business component, and another quarter is in leisure and hospitality. Every major industry component in private nonmanufacturing except information and mining shows positive employment growth over the forecast horizon.

Private nonmanufacturing in total adds 37,500 jobs during 2004 and 80,600 jobs during 2005.

The ongoing state budget crisis will constrain public sector hiring in the near term. The government sector is forecast to cut 11,500 jobs during 2004 before contributing a modest 1,000 job additions during 2005.

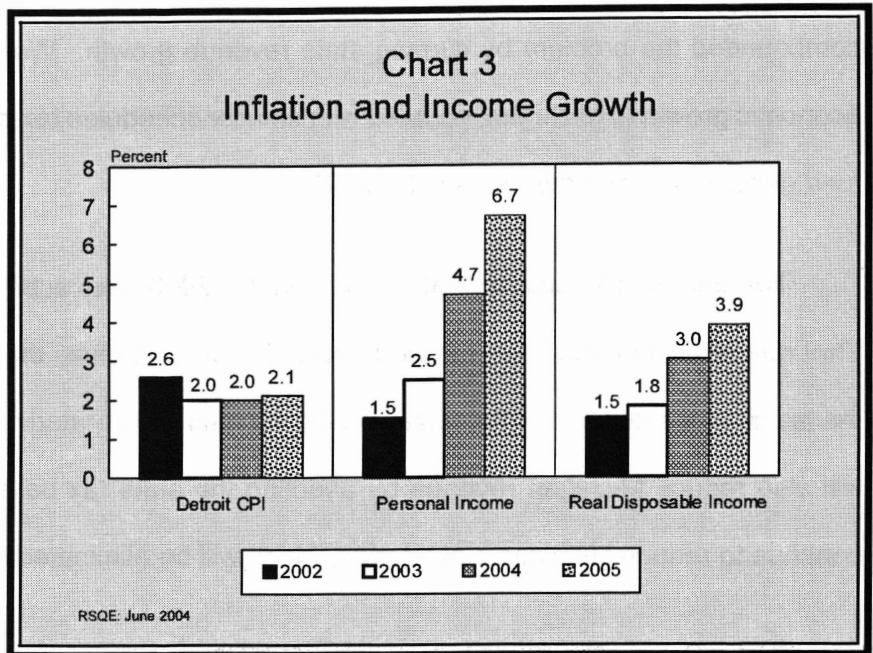
Our forecast of the Michigan unemployment rate is shown in Chart 2, with the national rate included for comparison. The Michigan jobless rate has taken large swings in the past two months, but has averaged 6.5 percent for the first four months of 2004; we judge this average to better reflect current conditions than do the individual monthly readings. We project the rate to edge down from there by the final quarter of 2004, closing the year at 6.4 percent, and to continue falling during 2005 to 5.9 percent by yearend. We expect the differential between the state and



national unemployment rates to be fairly stable during the second half of 2004 and through 2005, with the state rate holding about 8/10 of a percentage point above the national rate over the period.

Our forecast of inflation and income growth is summarized in Chart 3. Local consumer price inflation, as measured by the growth rate of the Detroit CPI, registered 2 percent in 2003, somewhat lower than the 2.3 percent increase in the U.S. CPI. Local consumer inflation continues to run behind the U.S. rate over the next two years, holding steady at about 2 percent. Upward pressure on prices from the strengthening economy in 2005 is counterbalanced by the assumed decline in energy prices from recent highs.

The income side of the forecast is summarized in the other panels of the chart. The state income data have recently been



revised to be consistent with the rebenchmarked National Income and Product Account data. Based on the revised data, personal income growth picked up from 1.5 percent in 2002 to 2.5 percent in 2003. Income growth strengthens to 4.7 percent in 2004 as hiring improves and the manufacturing workweek lengthens by nearly an hour. Robust job gains, including renewed growth in manufacturing, and a more rapid increase in interest income propel income growth to 6.7 percent in 2005.

As shown in the third panel of the chart, the growth in real disposable income, or purchasing power, climbs from 1.8 percent in 2003 to 3 percent in 2004 and 3.9 percent in 2005. Although taxes are again on the rise with the winding down of federal and state tax cuts, the acceleration in income growth dominates the increase in taxes. The rate of increase projected for purchasing power for calendar 2005

would be the highest since 1994.

Our income forecast has implications for the state revenue outlook, to which we now turn.

The State Revenue Outlook

The prolonged weakness in the state economy has contributed to a persistent imbalance in the state budget. Tax cuts at the federal level that impact state revenues and reductions in the state tax rates have compounded the problem by curbing state revenue growth. We expect the projected return to robust economic growth in Michigan, coupled with smaller scheduled tax cuts, will finally halt the slide in general fund general purpose revenues in fiscal 2005.

The personal income tax rate, 4 percent for 2003, was scheduled to drop to 3.9 percent for 2004. That rate reduction has been delayed until July 1 to help close the budget gap this fiscal year. Some of the tax changes enacted at the federal level, such as accelerated depreciation and expensing provisions, will also reduce Michigan revenue by affecting the state tax base. Changes in the federal estate tax continue to reduce Michigan's estate tax, which will be eliminated in calendar 2005.

Reductions in the single business tax (SBT) rate have been temporarily suspended. The SBT rate was scheduled to drop by one-tenth of a percentage point per year, but a halt in the rate reduction was triggered by the depletion of the Budget Stabilization Fund (BSF). The rate reductions will resume when the BSF balance returns to \$250 million, but we have assumed this will occur after 2005.

When the cigarette and tobacco taxes were raised in 2002, the distribution of these revenues was altered so that about one-eighth goes to health-related programs, one-third to the general fund, and the balance to the school aid fund (SAF). For three years beginning with fiscal 2005, about 55 percent of the general fund portion of the cigarette/tobacco tax will be redirected to the Budget Stabilization Fund. We estimate that this provision will add \$155 million to the BSF in fiscal 2005, reducing general fund revenue by the same amount. To help balance the budget, the governor has recommended another hike in tobacco tax rates. A number of proposals regarding the cigarette tax are under discussion in the legislature, but

the final resolution is unclear. At this time we have not incorporated a cigarette tax increase into our forecast.

Changes to the state education property tax were designed to provide a one-time boost to school aid fund revenues in fiscal 2003 and involved a permanent shift in the timing of collections. Previously, payments were split between summer and winter. Beginning in 2003, all state education property tax revenue is due in the summer. To ease the transition for taxpayers, the tax rate was reduced from 6 mills to 5 mills for last year only. It is estimated that the tax change generated an additional \$470 million in fiscal 2003. This year, revenues will again reflect a single year's tax liability at the 6 mill rate.

Lottery revenue, which goes to the school aid fund, has been augmented by the addition of two new games this fiscal year. They are expected to generate about \$50 million in SAF revenue.

Our forecast of state revenues is summarized in Table 1. The upper portion details general fund general purpose (GFGP) revenues, and the lower portion presents school aid fund revenues. The current practice among budget planners in Lansing is to report GFGP revenues reflecting full payment of revenue sharing from sales tax revenues. Reductions in revenue-sharing payments are shown elsewhere in the budget. For comparability, most of Table 1 also reflects full funding of revenue sharing, but two lines have been added to incorporate the impact of projected revenue-sharing cuts on GFGP revenue and its growth.

GFGP income tax revenues declined by 6.4 percent in fiscal 2003 and are forecast to drop by another one percent this year. Through April, combined estimated payments and final settlements are running about 6½ percent above a year ago and withholding is about flat, but income tax refunds are projected to be 5.8 percent higher than last year. In addition, the scheduled tax rate reduction to 3.9 percent will impact the final quarter of the fiscal year. With solid job growth projected through 2005, we expect GFGP income tax revenue to rise by 2.9 percent next year, the first increase since fiscal 2000.

Sales and use tax collections posted increases of less than one percent in fiscal 2001 and '02 and actually declined by one percent in fiscal 2003. Revenue growth from these taxes is forecast to turn

Table 1
RSQE Forecast:
State Revenues by Fiscal Year
(Millions of dollars, except as noted)

	Actual	RSQE Forecast	
	2003	2004	2005
<u>General Fund General Purpose</u>			
Income Tax	3961	3922	4035
(% Change)	(-6.4)	(-1.0)	(2.9)
Consumption Taxes	1255	1323	1214
(% Change)	(1.9)	(5.5)	(-8.2)
Sales*	64	100	109
Use	820	854	894
Other Consumption	371	369	212
Business Taxes	2122	2178	2243
(% Change)	(-5.3)	(2.6)	(3.0)
Single Business	1843	1877	1937
Other Business	279	301	305
Other GFGP Taxes	274	211	178
(% Change)	(-30.1)	(-22.9)	(-15.5)
GFGP Tax Revenue	7612	7634	7671
(% Change)	(-6.0)	(0.3)	(0.5)
Nontax Revenue	347	246	199
GFGP Revenue*	7959	7880	7869
(% Change)	(-5.6)	(-1.0)	(-0.1)
Adjusted GFGP Revenue**	8091	8161	8404
(% Change)	(-4.5)	(0.9)	(3.0)
<u>School Aid Fund</u>			
SAF Taxes	10038	9848	10251
(% Change)	(6.5)	(-1.9)	(4.1)
Lottery and Casino	677	736	736
(% Change)	(-4.0)	(8.7)	(0.1)
Earmarked State SAF Revenue	10715	10583	10988
(% Change)	(5.7)	(-1.2)	(3.8)

* With full funding for revenue sharing

** Includes adjustment for revenue sharing reduction

positive again this year, but it runs well behind income growth as the saving rate increases. Revenue gains are more in line with disposable income growth in fiscal 2005. Sales and use tax revenues are projected to rise by 2¼ percent this year and by 4¾ percent in fiscal 2005.

GFGP consumption tax revenues typically follow the pattern of gross sales and use tax collections, but the increase in the tobacco tax in summer 2002 helped boost consumption tax revenue growth by 1.9 percent in fiscal 2003 despite the drop in sales and use tax revenues. Consumption tax revenues rise by 5.5 percent in fiscal 2004, but the shift of a portion of the tobacco tax revenues to the BSF beginning in fiscal 2005 generates an 8.2 percent drop in GFGP consumption tax revenues for that year.

A sharp drop in SBT revenues, exacerbated by unusually large refunds and the full effect of the latest rate reduction, led to a 5.3 percent decline in business tax revenues in fiscal 2003. After three years of declines, business tax collections are forecast to turn around, rising by 2½ to 3 percent this year and next. With a constant tax rate and a more normal refund pattern, SBT revenues improve, rising by 1.8 percent this year and 3.2 percent in fiscal '05. In addition, high energy prices provide a temporary surge in oil and gas severance tax revenues this year.

Our forecast of other GFGP taxes incorporates the phase-out of the estate tax by calendar 2005. Revenues for this category plummet by 23 percent this year and by 15½ percent in fiscal 2005.

GFGP revenues (assuming full revenue sharing) are forecast to continue to slide this fiscal year, falling by one percent to \$7.88 billion. With little further deterioration, GFGP revenues bottom out next year at \$7.87 billion. When the reductions in revenue sharing are taken into account, GFGP revenues rise by 0.9 percent to \$8.16 billion in fiscal 2004. If the governor's revenue-sharing proposal for fiscal '05 is adopted, GFGP revenues are forecast to increase to \$8.40 billion—a 3 percent gain.

Our forecast of school aid fund revenues is presented in the bottom portion of Table 1. With the hike in the tobacco tax and the one-year supplement to the state education property tax, SAF revenues rose by 5.7 percent in fiscal 2003. In fiscal 2004, a projected 17 percent drop in state education tax revenues

overwhelms the gains from other revenue sources—including the new lottery games—and SAF revenues dip by 1.2 percent to \$10.58 billion. The improving economy supports a 3.8 percent increase in SAF revenues to \$10.99 billion in fiscal 2005.

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