GEORGIA ECONOMIC REPORT

The economic news facing the State of Georgia for Fiscal Year 2006 should be viewed with cautious optimism. There are a number of economic indicators that suggest the economy is in good shape and able to generate increases in revenue to support the state budget. Output as measured by Gross Domestic Product (GDP) has increased substantially over the last three years. Inflation has, until recently, not been a worry. State revenues rebounded in Fiscal Year 2004 after two years of declining receipts. Major construction projects in Georgia (Hartsfield-Jackson International Airport, the Aquarium, Atlantic Station, facilities construction at Georgia Southern University and others) bolster economic activity in the state. Most macroeconomic forecasts suggest future increases in output and employment that will add to the strength of Georgia's fiscal situation.

With the good news also come some warnings that act as detractors to the health of the state budget. The employment situation, while improving, has not been as strong as forecasts projected. The state lost high paying jobs during the recession, and was hit relatively hard in important sectors. Nationally, consumer confidence (measured by two national surveys) has not been strong, likely due, in part, to the employment situation. Until recently, oil prices have been on the rise, and the uncertainty of future oil prices creates an uncertainty regarding inflation. The combination of these factors adds the "caution" to the optimism regarding the economy for the coming year. This economic report presents a summary of these major economic influences on the state budget.

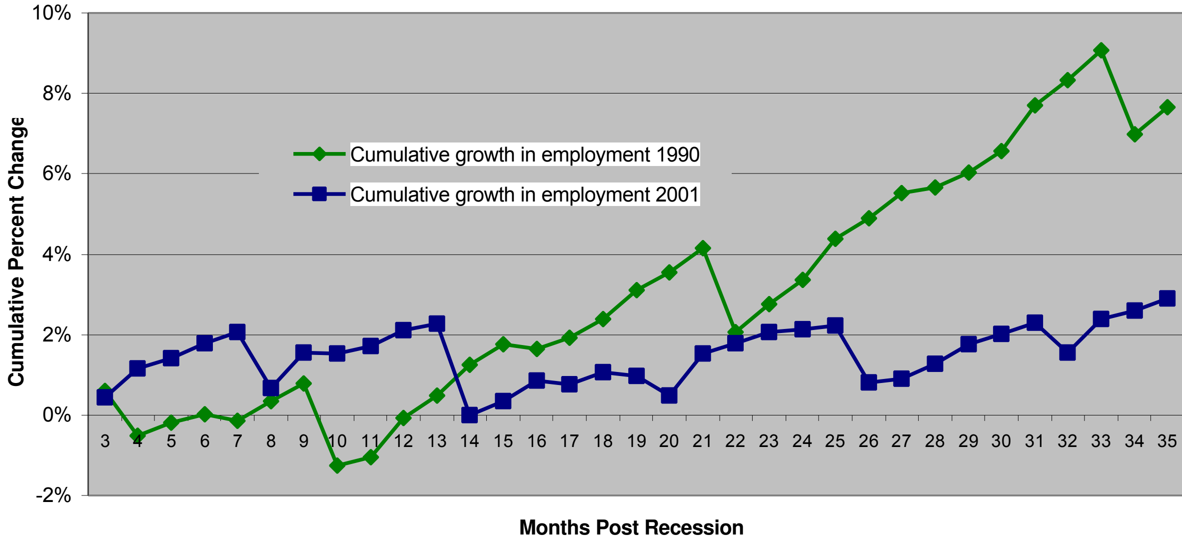
Recession, Employment and Income

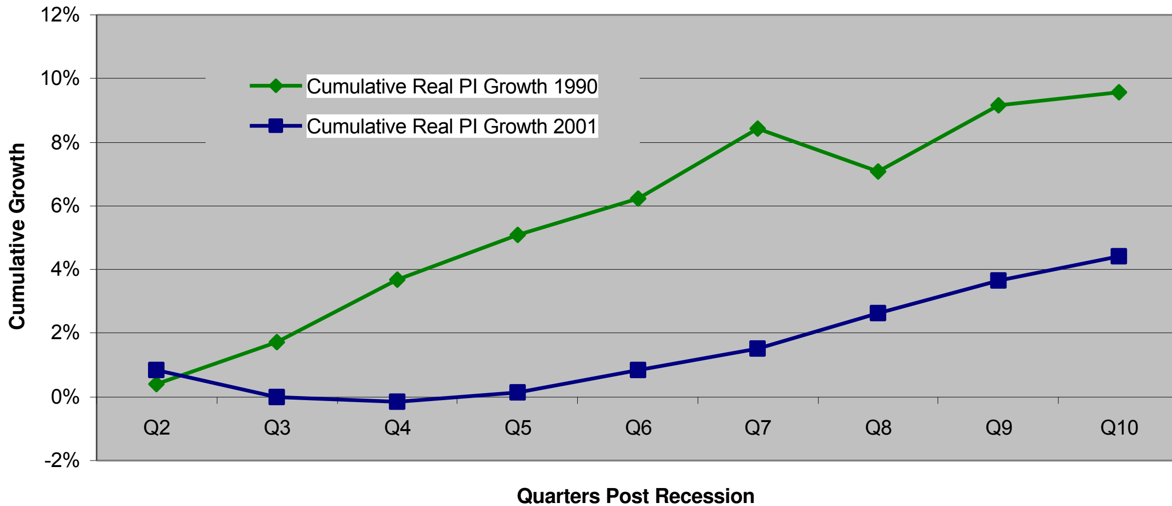
Officially, the economic recession of 2001 has been over for three years. The recession ran from the first quarter of 2001 (March) to the fourth quarter of 2001 (November). Its eight-month duration was equal in length to that of the 1990-91 recession. The growth in real domestic product in 2001 was 0.8%, and has since rebounded to an annual growth rate of 1.9% in 2002, 3.0 % in 2003, and 2004 has shown average real growth of 3.83% over three quarters. Productivity, the measure of the output of our economy per unit of labor input, has been increasing. These statistics suggest that the U.S. economy is continuing to increase its efficiency in production, which in turn may help to keep inflation at bay. However, increases in productivity also mean that the economy can produce more with fewer workers—everything else equal. Recent statistics (November 2004, Bureau of Economic Analysis) indicate that productivity growth is slowing which may translate into increases in employment in order to fulfill the demand for goods and services.

The 2001 recession hit Georgia hard. The state's economic emphasis on air transportation and telecommunications made it vulnerable to recession and hit these industries particularly hard. With the contraction in these industries, Georgia lost a substantial number of relatively high-paying jobs and the tax revenue associated with wages and consumption from those previously employed individuals. Forecasts call for increased growth in employment, but particularly in employment of the relatively higher paying sectors beginning in 2006.

The impacts of the job losses during the recession and sluggish job growth since the recession are very apparent in the employment growth statistics for Georgia. The unemployment rate statistics mask the underlying issue with respect to employment due to the reduced growth rate in the overall population of Georgia. In 2000, Georgia's unemployment rate was 3.7%, while that of the nation was 4.0%; in 2003, the rates were 4.7% and 6.0%, respectively. A comparison of the impact of the recession of 1990-91 and that of the recession of 2001 demonstrate the long, drawn-out impact that the recent recession has had on Georgia. Figure 1, on the following page, presents the cumulative increase in non-agricultural employment in Georgia for a period of 35 months post recession for the 1990-91 and 2001 recessions. The growth in employment is calculated beginning in the second month after the end of the recession. The graph demonstrates why it has been so hard to shake off discussion of the recession—the growth in employment has been much lower than in previous periods. Gains in employment in one month have consistently been offset with losses in employment in subsequent months, while employment after the earlier recession grew at a more constant rate as the economy expanded. At the end of this 35-month period, the cumulative growth in employment post 2001 recession is less than half that of an equivalent time period following the 1990-91 recession.

A comparable story can be told with respect to personal income recovery. Personal income is a measure of economic activity that relates very closely to tax revenues for the state—as personal income expands, so too do revenues from most tax sources. Figure 2 presents an analysis of the cumulative growth in real personal income in the 10 quarters post recession for the last two recessions. The graph again demonstrates that recovery out of the most recent recession was much more anemic than recovery in the early 1990s. By the end of a 3-year post recession period, real personal income growth in the most recent period was about half of what it had been following the earlier recession.





Both output growth and employment growth are important to the strength of the state's fiscal position. While the state draws revenue from many sources, the workhorses of the tax system in Georgia are the individual income tax and sales tax. Table 1 demonstrates the importance of income and sales taxes to Georgia's revenue base. Over 70% of the individual income tax is generated from wage and salary income, and wage and salary growth is obviously tied to employment growth. Sales tax revenues are driven by consumption, which in turn is driven by the level of income held by Georgians and visitors to Georgia. Sales and income tax revenues are closely correlated with personal income.

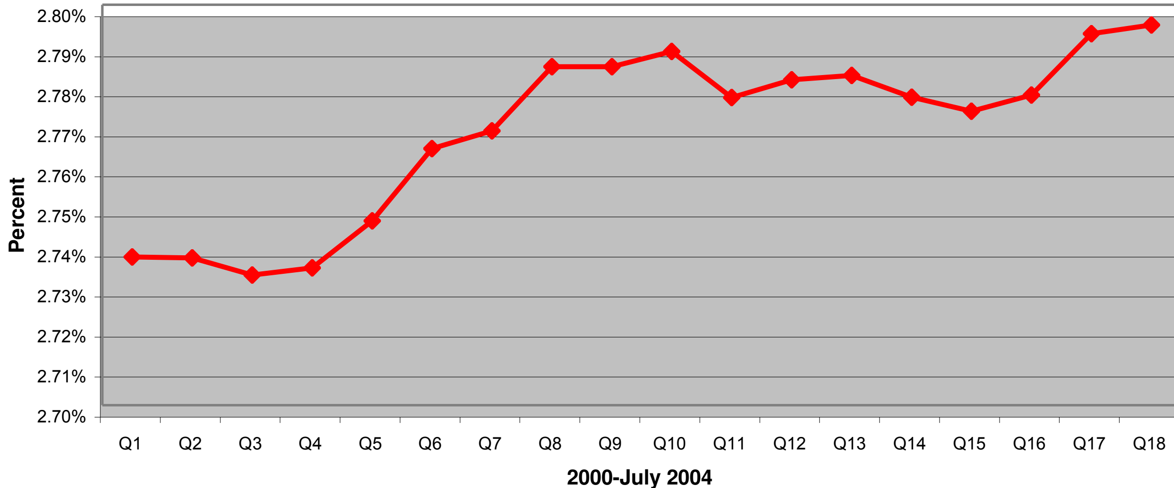
Table 1: Income and Sales Taxes

Fiscal Year	Personal Income Tax as a % of Total Taxes	Corporate Income Tax as a % of Total Taxes	Sales Tax as a % of Total Taxes
1996	42.2	6.9	39.4
1997	44.2	6.6	38.1
1998	47.4	6.7	35.6
1999	46.7	6.6	36.7
2000	48.1	5.0	36.4
2001	49.3	4.9	36.6
2002	50.1	4.2	34.5
2003	47.3	3.6	36.3
2004	47.9	4.0	36.4

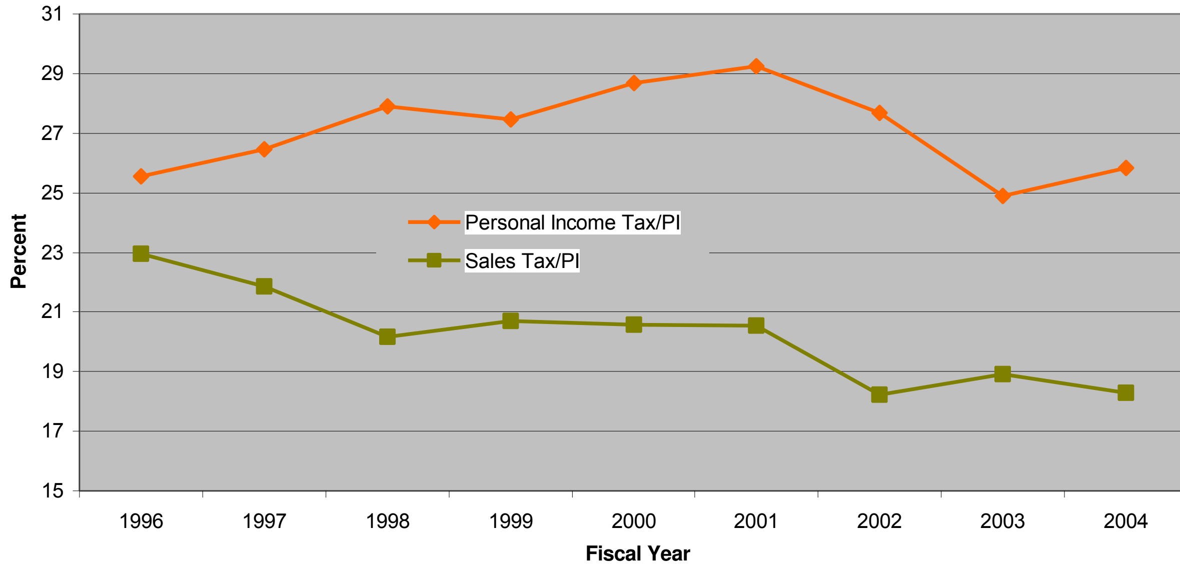
Source: *The Governor's Budget Report* (selected years) and Department of Revenue, *Annual Report* (selected years)

Personal income growth in Georgia has exceeded that of the nation for the last two decades. This growth has helped fuel increases in state revenue. During the recession, Georgia's relative strength in personal income growth took a hit relative to that of the nation, reflecting the strong impact of the recession in Georgia (Figure 3). Since 2003, growth of personal income in the state has gained momentum relative to the U.S., and expectations are for continued growth in the personal income of Georgians at a slightly higher rate than that of the nation.

Figure 3: State Personal Income as a Percent of National Personal Income



The reduced growth in personal income had a direct impact on state tax revenues, especially for the income and sales tax. However, the tax productivity of a dollar of personal income (the revenue per dollar of personal income) also fell during the recession and has yet to return to pre-recession levels. This impact is demonstrated in Figure 4. A decline in the tax productivity of personal income may be due to the relative level of income per employed worker (if more people have lower-paying jobs, they will pay less income tax as a group due to the progressive tax structure) or to reduced consumption, especially on items with high price tags, or to tax policy changes that influence the tax base. While there have been some tax policy changes in recent years, there is evidence that more of the decline in the level of revenue produced by a dollar of personal income is due more to the first two economic reasons—loss of high-paying jobs and reduced consumption of taxable goods. These trends have started to show a reversal more recently and the tax revenue to personal income ratio is expected to increase in Fiscal Year 2006, although not expected to reach the pre-2002 levels.



Prices, Dollars, Economy and the Budget

There are many aspects of the economy that are outside of the control of Georgia's constituents and policy makers that have important implications for the budget. Inflation can have a short-term effect of increasing revenue, but can also increase the cost of providing services and may affect the cost of borrowing money.

The exchange rate of the U.S. dollar for other currencies around the world can also impact Georgia's fiscal situation. When a foreigner wants to purchase something using U.S. dollars, they must sell their local currency and buy U.S. dollars. This occurs when a foreigner purchases U.S. goods (intermediate and final goods), invests in the U.S. (by purchasing real estate or bonds), or tours the U.S. (and spends U.S. dollars). When the demand for U.S. goods, services, and investments is low, there is less demand for the dollar, and it becomes cheaper in the world market. When U.S. consumers, investors, and governments purchase foreign goods, we sell our dollars to exchange them for foreign currency. The more dollars we "sell" the cheaper they become on the world market. The reduction in the value of the dollar (devaluation) is the result of reduced demand for that currency (or increased supply), but in turn, the devaluation will have additional impacts on the economy. Throughout calendar year 2004, the value of the dollar has fallen. To gauge the importance of this macroeconomic change, we might ask: Why has the demand for our dollar decreased? What are the implications of this weakening? What might we expect to happen in the future?

Why has the demand for the dollar decreased? Two reasons are typically cited for the decline in the dollar. First, the U.S. economy consumes large amounts of imported goods and we have to sell dollars to purchase these goods in the world market. If we sell more dollars to purchase imports than other countries wish to buy (by purchasing U.S. exports), the value of the dollar is weakened. Secondly, investors will purchase U.S. dollars if they obtain a good rate of return on their investment. As interest rates in the U.S. have remained low, the attractiveness of U.S. based investments may be waning, and if so, this reduces the demand for the dollar. Since U.S. government bonds are paid back in U.S. dollars, if the dollar continues to weaken, there may be reduced demand by foreigners to hold U.S. government bonds, which are used to finance the U.S. federal deficit. Higher rates of return might be needed to attract foreign investors, and this in turn would increase the cost of financing in the U.S.

What are the impacts of a falling dollar for Georgia? There are good and bad impacts of a falling dollar and the net effect is very difficult to predict. If the U.S. government were forced to increase the yield on bonds to attract foreign investment when the dollar falls, this action could increase the cost of financing in the U.S. The cost of borrowing—home mortgages, business start-up loans, financing for equipment purchases, cost of state debt, and the like would increase. This could reduce economic activity in the state, and thereby reduce growth in revenue. The devaluation of the dollar will also increase the price of the imports that we purchase (including raw materials and other inputs), driving up the general price index and reducing the competitiveness of the U.S. economy. While this could increase sales tax revenues in the short run (due to the imposition of the tax on higher prices), in the long-run, inflation could reduce demand for goods and reduce employment. On the upside, U.S. produced exports become cheaper on the world market; as the dollar falls in value, goods produced and consumed within the U.S. become cheaper relative to imported goods. For example, a car manufactured in the U.S. could look much more attractive in terms of price than an imported car. Tourists from abroad would find the U.S. a cheaper destination as the dollar weakens—another positive aspect of devaluation. The net effect of these impacts of a weaker dollar is difficult to determine and are influenced by the world's reaction to the fall in the dollar. In the long run, the expectation is that the increased competitiveness afforded U.S. goods by the devaluation will increase the demand for U.S. produced goods—if the U.S. can provide those goods.

There has also been some concern regarding the level of inflation. Oil prices have risen over the last several quarters and, while there is some consensus that prices may fall, there is a great deal of uncertainty surrounding projections of crude oil prices. Increases in oil prices, given the relatively high level of U.S. consumption of energy, translates into higher prices for many products, while a substantial portion of the increase in oil revenue goes off-shore. In some ways, the increases in oil prices are a tax that is not funneled directly into the U.S. economy. If industry and consumers in the U.S. respond to higher oil prices with increased efficiency (either through innovation or conservation), the price increases are mitigated. There is no guarantee, however, regarding the timeliness of such changes in producer or consumer behavior.

What Comes Next?

The expectations for Georgia's economic situation are that personal income and employment growth will increase, although not at pre-recession levels. Employment growth is expected in most sectors, with services leading the pack. Some specific components of the service sector, namely financial services and health and education services are expected to grow strongly in the coming two years. These sectors do include relatively high-paying jobs and thus their expansion should increase the growth in state tax revenue.

The detractors to economic and budget stability remain. The impact of oil prices and the devaluation of the U.S. dollar could mitigate some of the expected growth in the economy. Two years of revenue declines have created a pent-up demand for public expenditures (salaries and goods and services) that the state must deal without the benefit of a decidedly upbeat economic landscape. A major player on the state economy and revenue scene, Delta Airlines and its employees have negotiated concessions to stave off bankruptcy of the company. The $1 billion in pilot concessions comes in the form of wage and benefits reductions. While the impact of these concessions is not large in terms of the state budget (less than 0.2% of income taxes or 0.01% of sales tax revenues), Delta's situation is a reminder of the fragility of the economic recovery and its potential impacts on the state's fiscal health.