# Economic Bulletin

**GOOD news** Vehicle sales rebounded in August to an annualized rate of 15.3 million units. The sales rate, the strongest since April, was 10.1 percent higher than in August 1993. General Motors led the surge, posting an 18 percent rise in car sales and a 14.8 percent rise in truck sales. Among Japanese auto makers, Toyota led the way with a 23.4 percent increase in total vehicle sales. Through August, the Japanese share of the U.S. market for 1994 stood at 23.4 percent, compared to 22.9 percent for the same period in 1993.

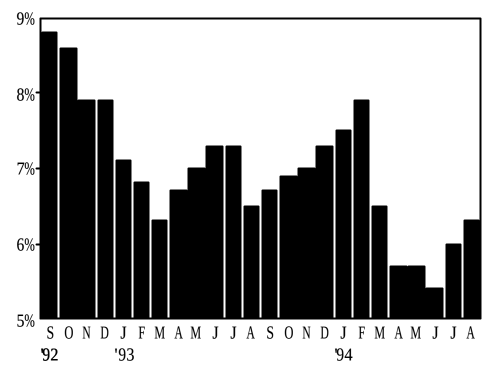
◆ The U.S. unemployment rate remained at 6.1 percent in August. Employment grew by 179,000 jobs; the number includes 32,000 factory and 123,000 service sector jobs. Despite hovering for the last four months around 6 percent—a rate that economists expect to lead to labor shortages and higher labor costs—the unemployment rate does not seem to be driving up wages or inflationary pressure. Historically, at this point in a recovery, labor costs are rising at a 5 percent annual rate, but currently the rate is only about 0.4 percent.

◆ New construction contracts increased 2 percent in July, following a three-month slide. Strength was seen in commercial and industrial building and also in the nonbuilding sector, which includes highway and bridge construction and public works.

**BAD news** The Michigan unemployment rate rose for the second consecutive month in August, registering 6.3 percent. The rate was up 0.3 percent from July but down 0.4 percent from the August 1993 level of 6.7 percent. Although the number of jobless workers rose slightly, to 297,000, the number of new jobless claims filed dropped to a 21-year low of 71,000. The summer's upward trend in interest rates translated into August job losses in construction and finance, insurance, and real estate.

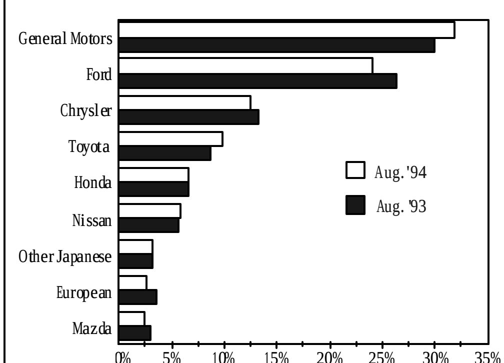
◆ The U.S. Commerce Department reports that factory orders declined 2.3 percent from June to July, the largest one-month drop in nearly three years. Orders for durable goods were down 4.3 percent, and orders for nondefense capital goods fell 4.7 percent. The slowdown in orders combined with weakening consumer confidence to keep the index of leading economic indicators unchanged in July.

## Michigan Monthly Unemployment Rates (seasonally adjusted)




SOURCE: Michigan Employment Security Commission.

## Market Share, by Manufacturer, August 1993 and August 1994




SOURCE: *Wall Street Journal.*

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September 1994

MONTHLY FOCUS

## SLOWING THE GROWTH OF BUSINESS ATTRACTION INCENTIVES

*State Tax Notes* recently excerpted a report cautioning local governments about tax abatements and other business incentives.[1] The report's author warns that such subsidies can, and often do, cause a community more harm than good.

The use of development incentives has grown tremendously. The author states that "many incentives that were not very common 15 years ago are now offered by 40 or more states" and that packages have offered up to $350,000 per job.

### *Getting What We Pay For*

The report claims that the costs of many incentive programs exceed the benefits. Many times the jobs produced by an incoming business fall short of expectations in number, pay, or both. The local cost-benefit analyses conducted on subsidies rarely are meaningful, because assumptions of job growth are unrealistically high or hidden costs (e.g., higher demand for public services) are not counted.

Even if a community invests heavily in attracting and retaining a business, jobs rarely are guaranteed. The author suggests that local development officials get explicit job guarantees before giving abatements and other incentives. Such guarantees often take the form of "clawbacks," usually binding contracts in which a company agrees to pay back subsidies it has received if it fails to provide a certain number of jobs for a given time.

### *A Michigan Example*

The former employees of GM's Willow Run plant likely would applaud the use of clawbacks. In this all-too-typical case of incentives gone wrong, Ypsilanti Township, to keep jobs in the area, gave GM $1.3 billion in tax abatements. Yet GM, after successfully fighting off the township's legal efforts to make the operation stay in the area, moved it—and the 4,500 jobs with it—to Arlington, Texas. To add insult to local injury, GM signed a clawback with Arlington, guaranteeing to repay all abated taxes if at least 2,000 jobs are not provided for five years.

### *Alternatives to Subsidies*

"No More Candy Store" asserts that local development incentives have less influence on business location decisions than other factors. In making site decisions, businesses weigh heavily the quality of roads, bridges, communication systems, and the skill level of the local work force. To attract and keep businesses, the author urges communities to use fewer company-specific incentives and instead make broad investments in infrastructure and education.

Competition among communities or states frequently drives them to offer costly incentives to companies. The author points out that the United States is the only developed nation without a federal policy to encourage economic cooperation and discourage competition among government units. He asserts that cooperation would ease the pressure on individual communities and states to compete with their neighbors and, overall, create more jobs in larger areas.

### *Conclusion*

Increased global competition, structural changes in the economy, and other factors causing a "soft" job market are partially to blame for the growth in subsidies. Yet these very continuing economic pressures heighten the need for awareness of the limitations of subsidies. The article emphasizes that states and localities need to carefully weigh all costs of job retention and expansion incentives against alternative investments—many may find that an improved overall busines climate brings a bigger pay-off.

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[1] Greg LeRoy, "No More Candy Store: How States and Cities Can End Civil Wars Over Jobs," *State Tax Notes* (Arlington, Va.: Tax Analysts, August 22, 1994). The excerpt is from *No More Candy Store: State and Cities Making Job Subsidies Accountable*, Federation for Industrial Retention and Renewal (Chicago, Ill.) and Grassroots Policy Project (Washington, D.C.).

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## NEWS FROM THE STATE CAPITOL

### CIGARETTE TAX LOOPHOLE COSTS STATE $43 MILLION

When a 50-cent per pack cigarette tax increase went into effect on May 1, 1994, Michigan Treasury officials were expecting it to raise an additional $141 million in FY 1993–94 for the state. However, a loophole has resulted in $42.6 million of it being foregone, $38.8 million of which would have gone to schools and $3.8 million to health care.

The cigarette tax legislation, which passed in the wee hours of last Christmas Eve, exempted from the increase cigarettes already in inventory on the effective date of the increase, May 1, and on which the old 25-cent-per-pack tax already had been paid. To temporarily skirt the higher tax, vendors bought huge quantities of cigarettes before the increase went into effect.

The problem stems in part from a state ruling on the legislation that interpreted it to mean that cigarette wholesalers, in addition to retailers, were entitled to the exemption. Although the Treasury Department was aware of the loophole, it did not anticipate that as many as 85 million packs of cigarettes would be stockpiled.

Michigan Treasurer Doug Roberts is asking legislators to close the loophole and to discuss ways to recover the lost funds, including applying the tax retroactively. Cigarette wholesalers and retailers say they will contest any attempt to recover the funds, maintaining that it would be unfair and that the money they saved already has been reinvested.

### PUBLIC FUNDING OF CHARTER SCHOOL CHALLENGED

Michigan courts are trying to sort through some legal issues to determine what is and is not allowed under the state's *charter school* (or "academy") legislation. Last year legislation was enacted providing for public academy schools—schools with a special curriculum or approach, such as an emphasis on math or helping troubled students.

The operation of one of the six schools that have received charters to date, Noah Webster, in Ionia county, is being challenged in court. Noah Webster provides on-line and correspondence services and coordinates curricula for students who are educated at home. One point of contention is the new law's requirement that charter schools operate on a single site. Plaintiffs say that Noah Webster is required to operate within the boundaries of the school district that granted the charter (Berlin Township), and in serving students statewide the school violates this provision. Another argument is that Noah Webster violates the constitutional ban on using public funds for private schools, because Michigan law defines home schools as private schools. Critics also contend that there is not enough public oversight of charter schools, since the state school board is not part of the charter-granting process.

The current case is the second challenge to Noah Webster. Although the first was thrown out of court on the basis that the plaintiffs did not have standing to sue, the presiding judge said the academy school law has "serious problems" that need to be addressed. The second case, filed late last month, makes the same arguments as the first but has been filed by the Michigan Department of Education alone. The outcome of the case could have a long-term effect on how Michigan charter schools are managed.

PUBLICATION OF INTEREST

The Chronicle of Higher Education, Inc., *The Chronicle of Higher Education: Almanac Issue* (Washington, D.C.: The Chronicle, September 1994).

The *Almanac Issue* of this weekly publication provides more than 100 pages of data and information on national and state higher education. The national section includes several measures of student characteristics and achievement, faculty characteristics, and finances. It also lists all selected institutions by type. The state section includes an overview of major higher education development for each, along with demographic data, information on political leadership, the number of institutions by type, and data on finance, faculty, and students.

# MICHIGAN REVENUE REPORT

August revenue collections were fairly strong, after two relatively weak months. Personal income tax withholding increased 13 percent, adjusted for the lower tax rate and an extra state payday last year. Because monthly collections fluctuate, a more accurate reading is provided by three-month collections, which are up an adjusted 6.2 percent—about in line with the current strength of the economy.

August sales and use tax collections were weak, increasing only 1.5 percent (adjusted for the now-higher rate). Motor vehicle collections were unchanged, while all other sales tax collections increased 3.3 percent. Use tax collections declined 12.7 percent, partially offsetting last month's 27 percent gain.

Single business tax collections continued to surge, up 23.3 percent above the year-ago level. Collections for the last three months were up 13.2 percent, due in part to record earnings by automobile companies.

Cigarette tax collections declined 26.2 percent (adjusted for the higher rate), but collections continue to improve as the effect of advance buying prior to May 1 wears off. Collections per penny of tax were $650,000 in August, up from $503,000 in July and only $290,000 in June. When the effect of advance buying has played out, we expect collections to run about 12–15 percent below the pre–tax-increase level.

Lottery sales continue strong despite having fallen 1.5 percent (preliminary) in August after four straight monthly increases; August was the second-best month of 1993. Year-to-date collections are up 7.7 percent, and, as reported last month, the profit, which goes to the School Aid Fund, may exceed $500 million for the first time in history. The FY 1992–93 profit figure was $427.6 million.

## MONTHLY TAX COLLECTIONS *(dollars in thousands)*

| TYPE OF REVENUE | Preliminary August 1994 | % Change from Last Year | Past 3 Months' Collections | % Change from Last Year | FY 1993–94 Year-to-Date | % Change from Last Year |
|---|---|---|---|---|---|---|
| Personal Income Tax | | | | | | |
| Withholding | $404,967 | 3.2% | $1,184,838 | 1.6% | $4,208,350 | 7.8% |
| Quarterly & Annual Payments | 11,722 | 4.7 | 122,959 | 3.8 | 654,679 | 3.8 |
| Gross Personal Income Tax | 416,689 | 3.2 | 1,307,797 | 1.8 | 4,863,029 | 7.2 |
| Less: Refunds | –34,087 | –6.1 | –146,556 | 17.0 | –1,358,019 | 10.0 |
| Net Personal Income Tax | 382,602 | 4.2 | 1,161,241 | 0.2 | 3,505,010 | 6.2 |
| Sales & Use Taxes | 463,091 | 52.2 | 1,455,144 | 45.8 | 3,561,422 | 23.0 |
| Motor Vehicles | 76,388 | 50.4 | 227,574 | 44.1 | 550,346 | 30.7 |
| Single Business Tax | 265,973 | 23.3 | 481,520 | 13.2 | 1,785,132 | 14.5 |
| Cigarette Tax | 48,366 | 121.4 | 107,887 | 69.5 | 268,602 | 32.9 |
| Public Utility Taxes | 47,250 | –17.0 | 62,832 | –17.2 | 80,899 | –45.7 |
| Oil & Gas Severance | 2,839 | –18.1 | 8,266 | –18.8 | 26,911 | –18.9 |
| Lottery [a] | 44,514 | –1.3 | 137,951 | 15.1 | 470,927 | 7.7 |
| Penalties & Interest | 517 | 30.6 | 15,821 | –1.1 | 83,207 | 3.6 |
| SUW—Annuals & Undistributed [b] | 7,318 | 432.6 | –5,379 | –263.0 | 4,173 | –84.5 |
| State Education Taxes | 28,917 | 0.0 | 29,124 | 0.0 | 29,124 | 0.0 |
| Other Taxes [c] | 58,940 | 141.2 | 103,323 | 12.8` | 399,551 | –4.6 |
| TOTAL TAXES (GF & SAF) [d] | $1,321,410 | 27.0% | $3,861,582 | 17.7% | $10,185,834 | 11.9% |
| TOTAL LESS NEW [e] | $1,137,929 | 9.3% | $3,357,220 | 2.4% | $9,681,472 | 6.4% |
| Motor Fuel Tax [f] | $63,277 | –11.6% | $192,720 | 1.1% | $623,539 | 2.4% |

SOURCE: Data supplied by Michigan Department of Treasury.

[a]The state share of lottery sales is 35 percent (FY 1993). The previous years's figures are adjusted to the current year's profit margin; the percent change reflects the change in ticket sales.

[b]These revenues are distributed to the sales, use, and withholding (SUW) accounts when final numbers for the month are reconciled.

[c]Includes intangibles, inheritance, foreign insurance premium, corporate organization, and industrial and commercial facilities taxes.

[d]Excluded are beer and wine, liquor, and horse racing taxes.

[e]Does not reflect changes in cigarette and income tax rates.

[f]The motor fuel tax is restricted to the Transportation Fund.

# Special Insert
# September 1994

MICHIGAN ECONOMIC FORECAST

## INTRODUCTION

The economy continues to grow at a moderate pace, and there are many indications that it will continue to do so. Consumer confidence remains fairly strong, the manufacturing sector has picked up in the past few months, and inflation is still well under control. National employment growth has been very impressive in recent months, and Michigan factory workers are finally enjoying a relatively healthy job market. Personal income growth is strong both nationally and in Michigan.

In light of so many positive economic indicators, second-quarter growth in the nation's economy was somewhat disappointing. The economy's recent bright spots, housing and automobile manufacturing, are beginning to weaken, and higher interest rates could take their toll on both sectors in coming months.

## GROSS DOMESTIC PRODUCT (GDP)

GDP, the value of all goods and services produced in the economy, grew at a revised 3.8 percent pace in the second quarter of 1994, up slightly from an initial estimate of 3.7 percent. Although this moderate pace is lower than many economists had expected, it is higher than the lackluster 2.6 percent first-quarter rate.

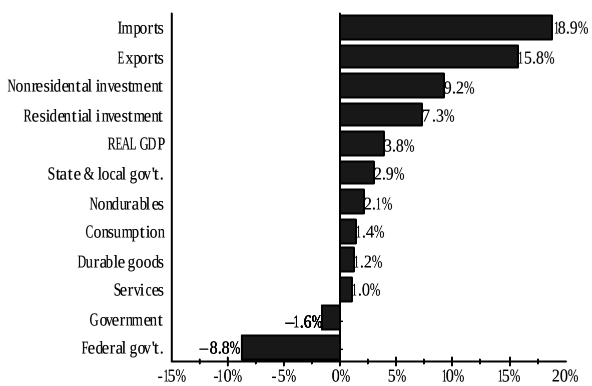
Much of the second quarter's economic growth was due to a buildup in inventories, which more than doubled from the first quarter. The buildup has the potential to slow growth, because many employers will hold off on new hiring until what they have already produced begins to sell faster.

Exhibit 1 shows growth in major components of GDP. Declines in government spending, particularly federal spending, and meager growth in services helped to keep GDP growth moderate. Import growth once again outpaced that of exports, which also dampened GDP growth. After robust 10 percent growth in the first quarter, manufacturing of durable goods (such as cars and furniture) grew only 1.2 percent in the second quarter. Consumer spending, which was expected to contribute to strong second-quarter GDP growth, was sluggish, growing a disappointing 1.4 percent.

Fortunately, the second quarter contained some bright spots. Business investment in new equipment (nonresidential investment) continued to grow at a strong pace, expanding 9.2 percent from the first quarter. Housing (residential investment) grew at a steady 7.3 percent, which is faster than its 5.5 percent growth in the first quarter.

EXHIBIT 1

*Percentage Change in Selected Components of GDP, 1994 I–1994 II*




SOURCE: Bureau of Economic Analysis.

### *Outlook*

The economy should continue to grow at a moderate pace in the third quarter and through the end of the year. Third-quarter growth should range between 3.2 percent and 3.4 percent. GDP should average 3.2 percent growth in 1994 and slow slightly to 2.8 percent in 1995.

Such moderate growth is predicted because of several factors. Although a higher than usual number of overtime hours indicates increased hiring, higher inventories could cause some companies to keep hiring on hold. The spectacular performance of the automotive industry is beginning to wane, as pent-up demand falls off. Finally, higher interest rates and higher taxes will drag on GDP.

## EMPLOYMENT AND INCOME

U.S. nonfarm payroll employment jumped by 1,017,000 jobs in the second quarter of 1994, the best quarterly gain of the 1990s. Services and retail trade led the way with increases of 459,000 and 219,000 jobs, respectively; business services were particularly strong. The largest percentage gain was in construction, which added 142,000 jobs. Manufacturing employment increased by 43,000, and government added 88,000 jobs—mostly in local government. The job market continued strong in July, as employment rose by

259,000, with 82 percent of the new jobs in services and retail trade.

The **U.S. unemployment rate** averaged 6.2 percent in the second quarter, down from 6.6 percent in the first quarter.

The **Michigan** labor market continued to improve in the second quarter as **wage and salary employment** increased 2.8 percent above the year-ago quarter compared with a 2.1 percent gain in the first quarter. The growth rate strengthened in all major categories except transportation, communication, and utilities and government. (See Exhibit 2.)

The largest gains were 5.3 percent in construction and 4.1 percent in manufacturing employment; motor vehicle employment jumped 6.1 percent. Employment in the trade sector was up 2.9 percent compared with a 1.6 percent increase in the first quarter. Services employment continued strong, increasing 3.9 percent, about the same growth rate as in the first quarter. The business services sector remained strong, with employment increasing 8.4 percent. The best performing industry in this category was personnel supply services, which increased 13.2 percent to about 90,000 jobs. The weakest sector was government, as employment fell 0.8 percent below the year-ago quarter. Employment remained strong in July, increasing 3 percent above July 1993. Motor vehicle employment was up 6.9 percent, as the industry continues to drive the recovery.

The **Michigan unemployment rate** averaged 5.6 percent in the second quarter, down sharply from 7.3 percent in the first quarter—only North Carolina and Illinois among the largest states had a lower rate. In July the rate jumped to 6 percent, third lowest among 11 large states, and 6.3 percent in August.

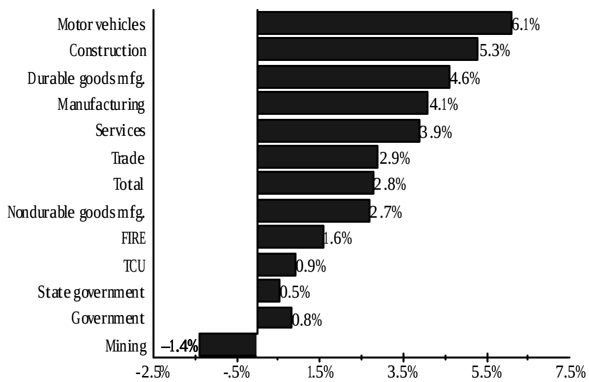
**U.S. personal income** increased at an annual rate of 5.2 percent in the first quarter and 7 percent in the second. The annual rate of increase for the first half of 1994 was 6 percent. This compares with a 1993 increase of only 4.3 percent.

**Michigan personal income** turned in a strong performance in the first quarter of 1994 (latest data available), increasing at an annual rate of 9.2 percent. (See Exhibit 3.) Wages and salaries increased at an annual rate of 11.8 percent, led by a 22.3 percent gain in manufacturing income. The strength in the manufacturing sector is due mainly to the boom in the motor vehicle industry. The increase in personal income was held back by a modest 3 percent increase in transfer payments (social security, welfare, and unemployment).

The final 1993 state personal income figures were released in August, and Michigan recorded a 4.9 per-

EXHIBIT 2

*Michigan Wage and Salary Employment by Sector, Percentage Change 1994 I–1994 II*




FIRE: Finance, insurance, and real estate
TCU: Transportation, communications, and utilities
SOURCES: Michigan Employment Security Commission (special release) and Public Sector Consultants' estimates.

EXHIBIT 3

*Michigan Personal Income, Selected Components, 1989 to 1994 I (dollars in millions)*

| Year | Total Personal Income | Wages and Salaries | Manufacturing Wages | Services Wages | Transfer Payments | Dividends, Interest, and Rent |
|---|---|---|---|---|---|---|
| 1989 | $162,358 | $98,939 | $34,581 | $19,511 | $23,27 | $27,837 |
| 1990 | 169,808 | 102,804 | 34,193 | 21,254 | 25,250 | 29,603 |
| 1991 | 175,244 | 103,703 | 33,406 | 21,950 | 29,890 | 29,690 |
| 1992 | 185,665 | 110,141 | 35,175 | 24,058 | 31,763 | 29,209 |
| 1993 | 194,687 | 115,332 | 37,073 | 25,518 | 34,172 | 29,681 |
| 1994 I | 203,643 | 122,440 | 40,526 | 26,685 | 33,528 | 31,520 |
| % change 1993 I to 1994 I | 8.0% | 10.2% | 14.4% | 7.3% | 3.8% | 2.9% |
| % change 1993 IV to 1994 I (annual rate) | 9.2% | 11.8% | 22.3% | 8.1% | 3.0% | 6.4% |

SOURCE: Bureau of Economic Analysis, U.S. Department of Commerce. Calculations by Public Sector Consultants, Inc.

cent increase. Wages and salaries increased 4.7 percent, led by a 9.3 percent gain in the manufacturing sector. Growth was restrained by a weak 1.6 percent increase in income from dividends, interest, and rent. Michigan per capita income increased 4.4 percent to $20,542, the 11th highest gain among the 50 states; nationally, per capita income rose 3.2 percent. Michigan per capita income is still 1.1 percent below the national average of $20,781.

### *Outlook*

We expect economic growth to slow in the second half of 1994 and in 1995, both nationally and in Michigan, due to higher interest rates, the effect of increased federal taxes, and a slowdown in motor vehicle sales as pent up demand no longer drives sales. One positive sign for continued employment growth is that overtime hours in manufacturing remain very high, 4.7 hours per week in the second quarter, the highest level since World War II.

We project a 2.5 to 2.75 percent increase in U.S. payroll employment in 1994 and 1.5 to 2 percent in 1995. The U.S. unemployment rate is forecast at about 6.25 percent in 1994, with a modest drop to 6 percent in 1995. For Michigan we are projecting a 2.3 percent increase in wage and salary employment in 1994, but only a 1.5 percent gain in 1995. The Michigan unemployment rate is expected to be the same as the national rate in 1994, about 6.25 percent, and remain between 6 and 6.5 percent in 1995.

Our forecast for U.S. personal income is 6 percent growth in 1994 and 5 percent in 1995. In our last quarterly forecast we projected 5.5 percent growth in Michigan personal income for 1994. We are revising that estimate up to 6.5 percent, due in large part to increased overtime hours in the motor vehicle industry. We expect personal income growth to slow to about 5 percent in 1995.

## AUTOMOBILE SALES

Following the strong 18.3 percent first-quarter gain (year-to-year growth), motor vehicle sales increased 5.3 percent in the second quarter. Car sales edged up only 2.2 percent, while truck sales jumped 10.2 percent. The annualized sales rate for the first half averaged 15.5 million units.

July sales bucked the first-half trend of six consecutive increases by falling 0.1 percent from the year-earlier levels, as General Motors labored to get more new models to showrooms following second-quarter production delays and early July plant shutdowns. August sales increased a robust 10.1 percent as GM finally worked out its production/delivery kinks. Sales should register healthy increases through the remainder of 1994, as auto makers fulfill pent-up demand for various new introductions and buyers continue to lease cars and trucks at record rates.

### *Outlook*

Continuing employment and income gains along with attractive leasing options will combine to push sales to about 15.2 million units in 1994 and 15.5 million units in 1995. The 1994 total translates into a 14.9-million-unit annualized rate for the second half, and a 9.3 percent increase over 1993 sales. The 1995 forecast represents a 2 percent increase over the 1994 estimate. Light trucks will account for approximately 40 percent of all 1994 and 1995 sales.

## HOUSING

The housing market continues strong nationally, although it is beginning be affected by higher interest rates. In the first quarter and in the first part of the second, low interest rates, pent-up demand, and bolstered consumer confidence continued to keep home sales strong. However, seasonally adjusted July sales of existing homes fell slightly (0.3 percent) from June's level. Despite the July drop in sales, some industry analysts are predicting that this year's sales will approach the 1978 record of 4.1 million units.

Mirroring the nation, Michigan's housing market is strong, but not as strong as in the first quarter. Michigan housing starts were up 12.1 percent in the second quarter from the second quarter of 1993. Although this is a healthy growth rate, it is lower than the impressive 17.7 percent growth in the first quarter. As with the national rate, seasonally adjusted housing starts did not grow as fast in July as in previous months.

### *Outlook*

The housing market should continue strong in the third and fourth quarters, although higher interest rates will continue to take some of the vigor out of the market. Much of the housing market's fate in the coming months depends on the actions of the Federal Reserve Bank (Fed), which may again opt to raise rates. Next year should be another strong one for housing sales, although it will not match 1994's performance.

In Michigan strong growth in employment and income should contribute to a continued healthy housing market. Third-quarter housing starts should grow between 9 and 11 percent over last year's levels, and the fourth quarter should bring similar growth. Growth in 1995 should remain strong and exceed national growth, although it will not be quite as strong as in 1994.

## MONETARY AND FISCAL POLICY

Early in the year, the Fed began to push up the federal funds (short-term) rate in an effort to cut off the inflationary fears being generated by the strong economy. Although the Fed raised the rate 0.75 percent to 3.75 percent through April, inflation anxiety persisted in the stock and bond markets. The Fed has moved twice since then, raising both the federal funds and the discount rates half a percentage point in May and mid-August. The rates currently stand at 4.75 percent and 4 percent, respectively. While the markets have calmed down for now, many analysts believe that the Fed has not made its last move for 1994; the consensus is that the next move will come late in the year, after third-quarter growth figures come out.

The budget deficit for the first nine months of FY 1994 totaled $150 billion, down 25 percent from the $201-billion nine-month total in FY 1993. Receipts were up $81 billion, and outlays rose $30 billion. The government is projecting that the deficit will decrease from the FY 1993 level of $255 billion to $202 billion in FY 1994 and $162 billion in FY 1995.

While health care legislation dominated the fiscal policy agenda the past six months, it does not appear that any substantive changes will take place this year. Nevertheless, health care will begin to push up the deficit again in FY 1996 as Medicare and Medicaid expenditures increase.

### *Outlook*

The federal funds rate will move as high as 5.25 percent before year's end as the Fed reacts to increases in consumer and producer prices and upward wage pressures brought about by high employment rates. In 1995, however, the Fed is not likely to act as aggressively as economic growth slacks off somewhat from this year's pace. Long-term rates will remain around their current level of 7.5 percent through 1994 and rise somewhat more in 1995 as inflation picks up slightly.

The November elections will have a major effect on the fiscal policy agenda for 1995 and beyond. If Republicans add a significant number of seats to their minority position, we will likely hear renewed calls for tax cuts and decreased government spending. Unless Democrats gain seats, we will see little support for a major overhaul in the health care system. The outlook is for government intervention in the economy to remain neutral through 1995.

## PRICES

The U.S. consumer price index (CPI-U) rose at an unadjusted annualized rate of 2.2 percent in the second quarter, following a 3.8 percent increase in the first. Prices, however, increased at a brisk 4.1 percent annualized rate between June and August. Excluding the more volatile food and energy segments, prices rose only one percent in the second quarter, reflecting a steady increase in gasoline prices. Between June 1993 and June 1994 medical prices rose 4.6 percent compared to a general price increase of 2.5 percent.

Michigan consumer prices (as measured by the Detroit-Ann Arbor CPI, released every two months) jumped sharply at an annualized rate of 9.3 percent between April and June, followed by a 2.1 percent increase between June and August. Rising transportation, commodity, and food prices were the force behind the June increase. Medical care prices rose slower than average, and apparel prices fell sharply. Between August 1993 and 1994 Michigan prices rose 3.9 percent compared to a 2.9 percent increase in the U.S. CPI.

The producer price index for finished goods, a measure of wholesale prices that generally foreshadows consumer prices, increased 1.9 percent (unadjusted annualized rate) in the second quarter but jumped sharply—5.25 percent—between June and August. The two-month surge reflects a 55 percent rise in coffee prices, higher oil prices (which have dropped again since the August index was compiled), and rising prices for new vehicles. Recently, prices for raw materials excluding food and energy also posted large increases.

### *Outlook*

The rate of inflation is rising but remains under control. Wages are rising at a 2.5 percent rate, and recent price increases have been driven by temporary surges in oil and coffee prices. Consumer prices are likely to rise at the rates posted in recent months, putting the December 1993 to December 1994 increase at 3.2 percent. The rise in producer prices signals that the inflation rate will be up a little in 1995, perhaps to 3.5 percent. Local inflation, which has trailed the national rate during most of the recovery, will surpass national inflation on the strength of wage increases being led by the strong manufacturing sector. Michigan's inflation rate will register about 3.5 percent in 1994 and about the same in 1995.