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Public Sector Reports

*Michigan* **COMMENTARY**

# Global Economic Trends and the Michigan Economy

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The U.S. and Michigan economies are entering some of the roughest waters they have navigated since the 1930s. Many of the problems we face are related to the changing world economy, but most are of our own making. The federal government, as well as many consumers and businesses, has been fiscally irresponsible for the last decade, and the economy is paying the price.

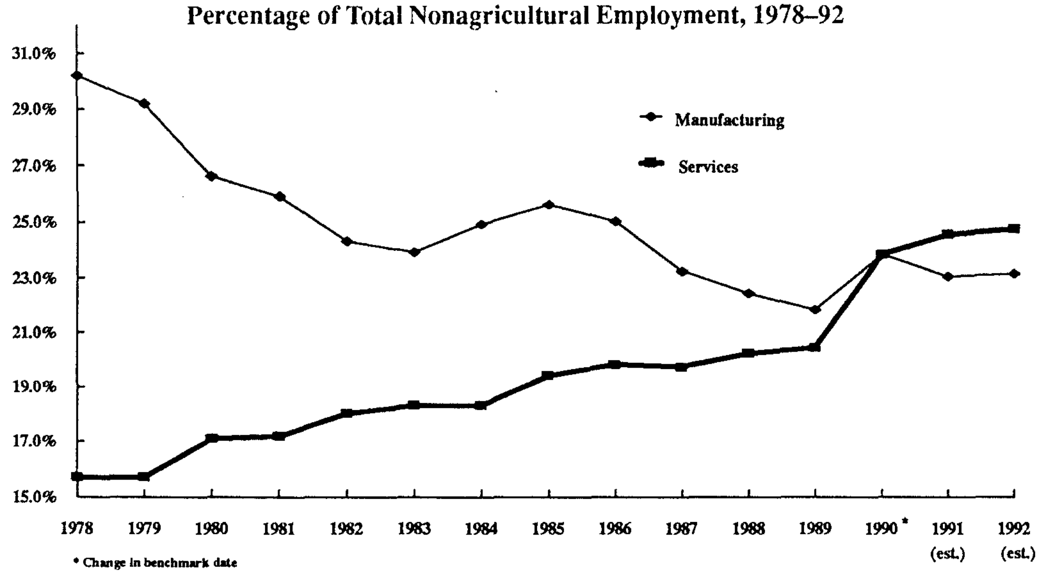
## THE ECONOMIC RECORD

Let's look at Michigan's record:

- Median family income in Michigan fell 10.3 percent from 1979 to 1989.
- Employment in Michigan was up only 3.7 percent from 1979 to 1991 compared with a national increase of 18.2 percent.
- Manufacturing jobs fell 261,000 from 1979 to 1991; 126,000 of these were in the motor vehicle sector.
- Manufacturing now accounts for only 23 percent of wage and salary employment, down from about 32 percent in 1979; during that period the services sector has increased its share of employment from about 17 percent to 24 percent. (See Exhibit 1.)

**EXHIBIT 1**

**Michigan Manufacturing and Services Employment, as a Percentage of Total Nonagricultural Employment, 1978–92**

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- Michigan per capita income, which was about 7 percent above the national average in the late 1970s (and as much as 19 percent above in mid-1950s), was 2 percent below the national average in 1991. (See Exhibit 2.)
- Motor vehicle sales are down about 23 percent from 1986 and 9 percent from 1979. Michigan currently produces only 6.2 percent of all motor vehicles worldwide, down from 8.5 percent in 1979 and about 26 percent in the early 1950s. (As recently as 1973 the figure was 11 percent.) (See Exhibit 3.)
- The last year Michigan's economic growth was above the national average was 1986. From 1986 to 1991 real Michigan income increased at an annual rate of 0.9 percent, compared to 1.9 percent nationally. (See Exhibit 4.)

## FUTURE PROSPECTS

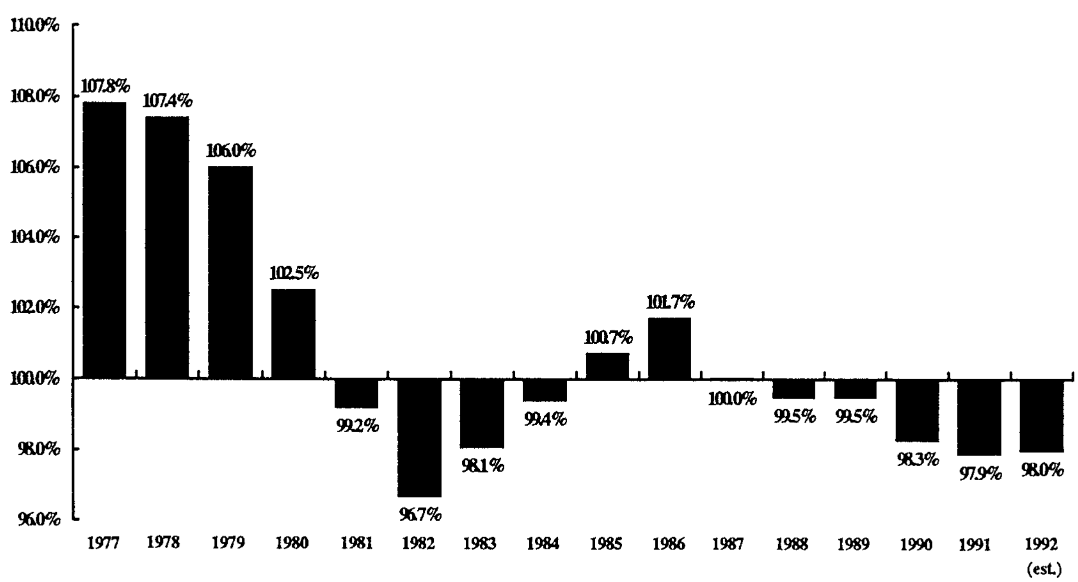
The outlook for the 1990s is not promising. I expect national economic growth in this decade to be slower than in any decade since the 1930s, gross domestic product (GDP) to average 2–2.5 percent, and growth in Michigan to be even slower. The reason for this is that we have been hit by more negative developments than at any time since the Great Depression. These events fall into four categories: the excesses of the 1980s, the end of the cold war, changing demographics, and global competition.

### The Excesses of the 1980s

In the 1980s we consumed at a record rate, invested little, and worried little about the future. These chickens have now come home to roost. Employment increased by about 19 million or 2.1 percent annually from 1982 to 1990. If growth is one percent annually during the 1990s (and we are well below that pace so far), there will be 16.6 million fewer jobs than if employment increased by 2.1 percent annually.

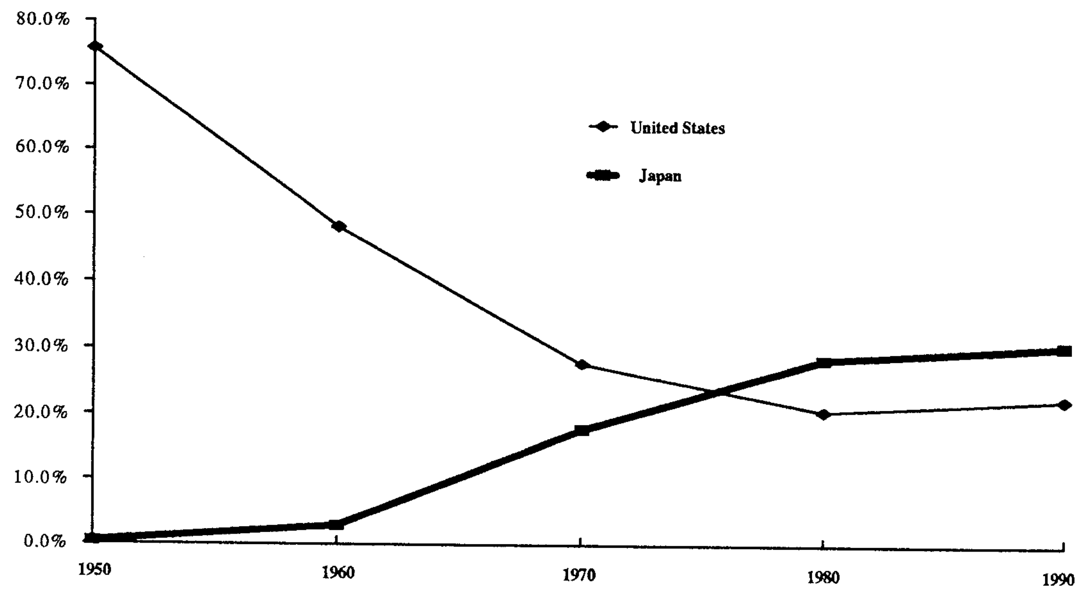
**EXHIBIT 2**

**Michigan Per Capita Income as a Percentage of U.S. Per Capita Income, 1977–92**



## EXHIBIT 3

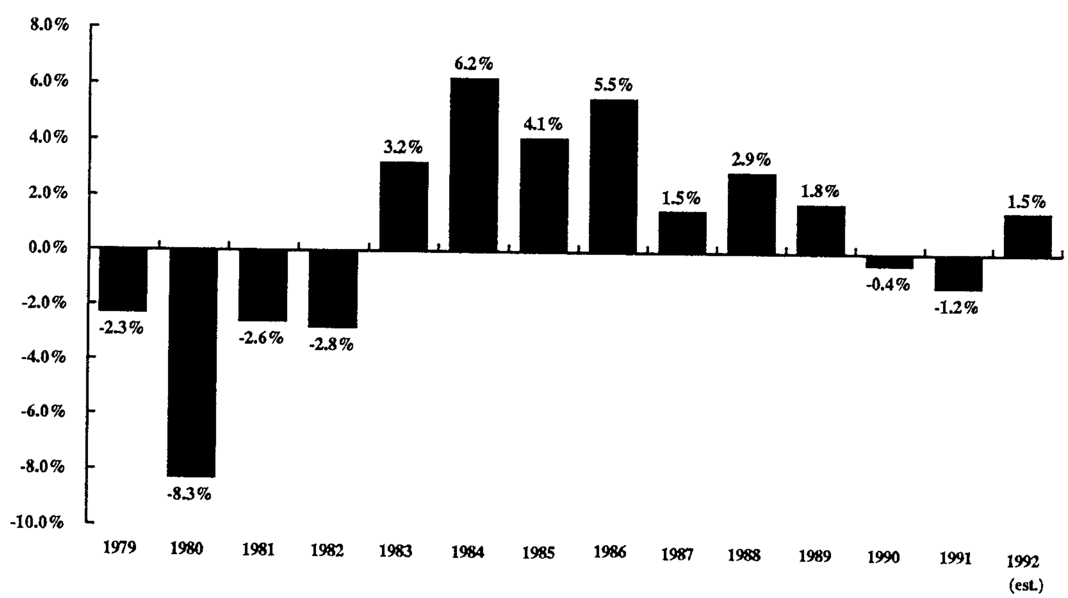
### U.S. and Japanese Share of World Vehicle Production




SOURCE: Automotive News, *1991 Market Data Book.*

## EXHIBIT 4

### Percentage Change in Real Michigan Personal Income, 1979–92



**Federal Budget Deficit** In my view this is the major problem facing the nation. The national debt was $908 billion in 1980; it now exceeds $4 trillion. (See Exhibit 5.) The interest on the debt is $200 billion, larger than the entire federal budget in 1970. The Congressional Budget Office estimates that after a brief decline in the next few years from about $375 billion in FY 1993, the annual deficit will increase to $500 billion in 2002 (Exhibit 6). The longer term outlook is even bleaker. A recent GAO study estimates that without a change in policy the deficit will reach 20 percent of GDP in 2020 (it is currently about 6 percent) and interest on the debt will be $1 trillion in 1992 dollars, 31 percent of the budget. (See Exhibit 7.)

**EXHIBIT 5**

**Total National Debt, Selected Years Between 1976 and 2002**
**(dollars in billions)**

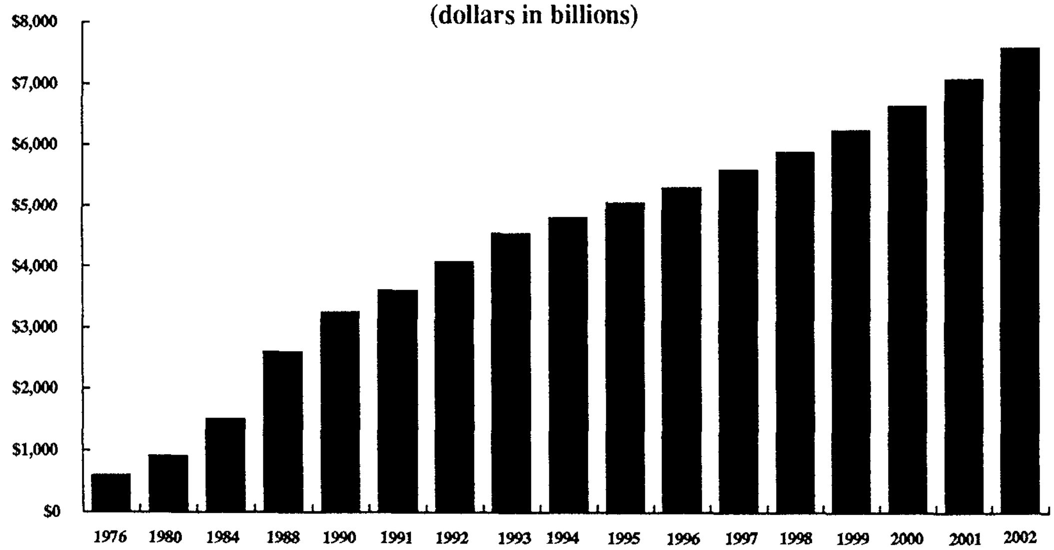



**EXHIBIT 6**

**Federal Budget Deficit, 1979–93**
**(dollars in billions)**

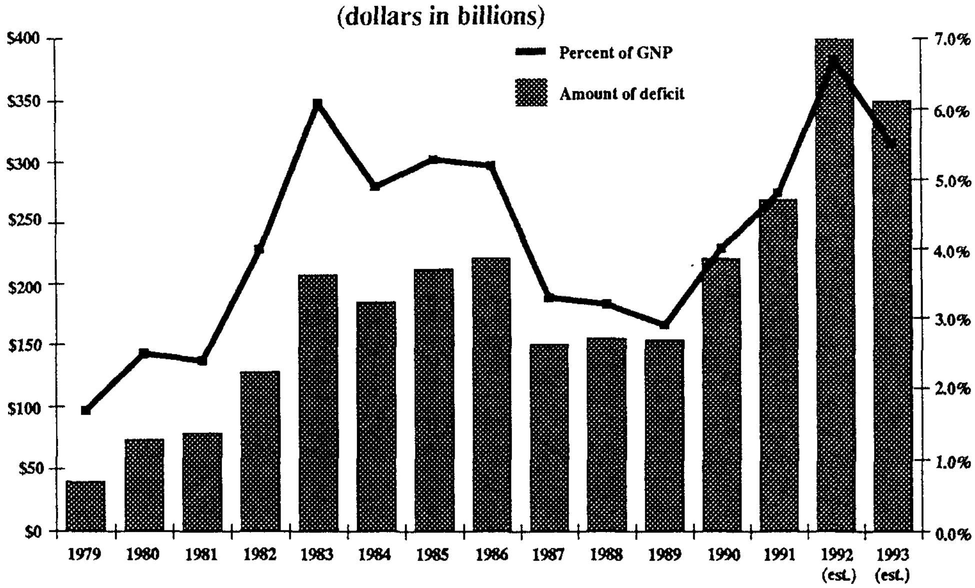


**EXHIBIT 7**

**No Action Scenario Budget Deficits, 1992–2020**

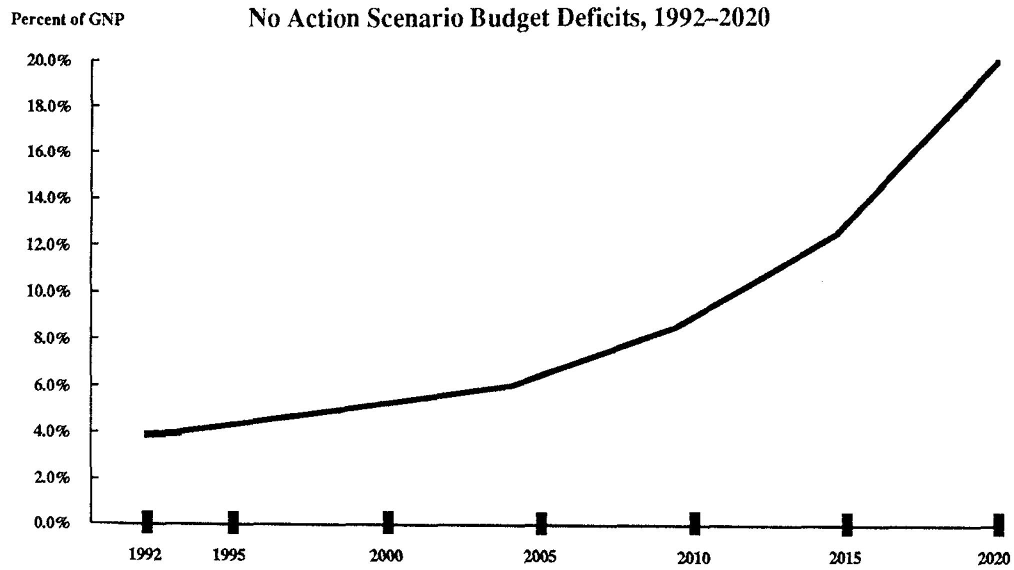



**EXHIBIT 8**

**Distribution of Federal Expenditures**

| | 1970 | 1992 | 2002 |
|---|---|---|---|
| Social Security | 14.2% | 19.5% | 19.6% |
| Medicare | 3.3 | 8.9 | 15.2 |
| Medicaid | 1.3 | 4.7 | 9.1 |
| Retirement | 3.2 | 4.0 | 3.8 |
| Net Interest | 6.9 | 13.7 | 16.5 |
| Other Entitlements | 10.2 | 12.1 | 8.5 |
| Discretionary | 60.9 | 37.1 | 27.3 |

As shown in Exhibit 8, reducing the budget is going to get more difficult, as discretionary spending will comprise only 27.3 percent of the budget in 2002, down from 60.9 percent in 1970 and 37.1 percent in 1992.

Why does this matter? In 1984 gross domestic investment was 19 percent of GDP. It is now below 14 percent. And national saving has not been sufficient to finance even this level of investment. The gap has been filled by foreign capital, which is declining due to low U.S. interest rates, weak growth worldwide, and the need for investment in other parts of the world, such as Eastern Europe. (See Exhibit 9.) The budget deficit and low savings have contributed to high real interest rates, which increase the cost of investment, decrease the accumulation of capital, inhibit economic growth, and ultimately reduce the standard of living. (See Exhibit 10.)

It is worth noting that global economics contributed to the running up of the federal debt. According to the September 19 issue of the *Economist*:

> International capital played a big part in supplying the needs of the American government. The measure of that, just as for Latin American debtors, was the worsening of America's current-account balance from a surplus of $1 billion in 1980 to a deficit of $160 billion in 1987—the mirror image of the country's inflows of capital. If capital controls had been in place, America would have had to finance its fiscal debt domestically. That would have required interest rates to climb even further, or else, if the deficit had been financed by the domestic creation of money, rising inflation would have resulted. Without cross-border flows of capital, the choice facing the third-world debtors would have been the same. The choice is so unattractive that governments would in all likelihood, have tried harder to spend and borrow less.

**EXHIBIT 9**

**Gross Saving and Gross Private Domestic Investment as a Percentage of GNP, 1970–91**

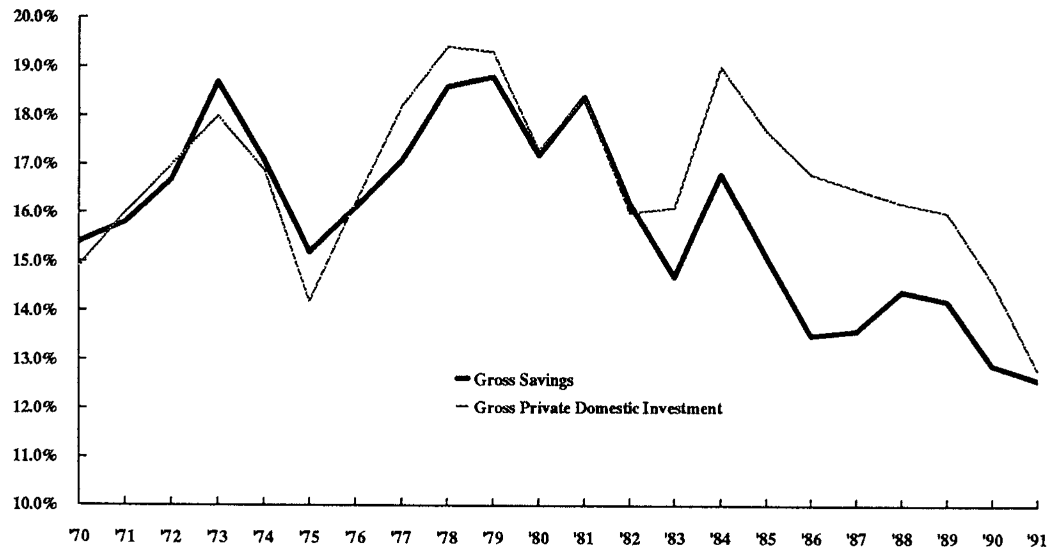



**EXHIBIT 10**

**Real Interest Rates, 1962–92 (Corp. Aaa Bond Rate - U.S. CPI)**

In other words, the ability to borrow abroad gave governments the chance to be irresponsible. That is a useful reminder: economic changes that broaden the choices of policy makers are often a mixed blessing.

**Real Estate Crash** Construction activity will be relatively weak because of the overbuilding in the 1980s, and declining home prices have reduced the net worth of many homeowners. Housing starts are down to 1.1 million from the 1986 peak of 1.8 million.

**Excess Consumer Debt** Consumer debt reached a record 19 percent of disposable personal income in the 1990s, and paying down this debt will continue to depress consumer spending. (See Exhibit 11.)

**Collapse of Banking System** This has cost thousands of jobs, run up the federal deficit, and made financial institutions reluctant to lend money. And there is still more bad news to come.

### The End of the Cold War

**Defense Cutbacks** Reductions in defense expenditures are hurting the economy in the short run. About 800,000 defense jobs will be lost by 1995. Fortunately, Michigan is not as affected as many states, such as California.

### Changing Demographics

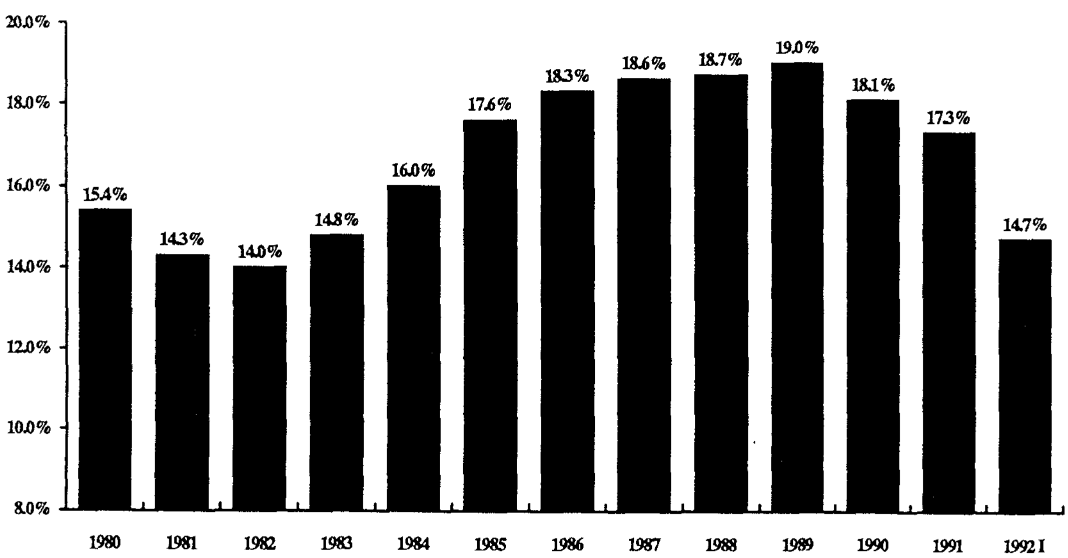
**Aging of Baby Boomers** Many in this age group have already bought their first homes. This, combined with the related decline in household formations, will dampen housing activity as well as demand for other big ticket items. The aging of this group will also put pressure on government budgets due to increasing health care and retirement costs.

### The Global Economy

**Corporate Cutbacks** To compete worldwide and remain profitable, businesses have eliminated millions of jobs (many of them in middle management for first time), and the end is not in sight. According to a U.S.

**EXHIBIT 11**

**Consumer Installment Credit as a Percentage of U.S. Disposable Income**



Department of Commerce study, in the 1960s only 7 percent of our economy was exposed to foreign competition; today that figure exceeds 70 percent.

**Falling Real Wages** The decline in real wages in the last two decades is related to increased global competition putting downward pressure on wages and slow gains in productivity caused by our failure to save and invest. (See Exhibit 12.) The federal budget deficit is the main culprit here.

**Worldwide Recession** Most industrial nations are in an economic slump and this has slowed U.S. exports, which have been one of the few robust sectors of our economy in the past five years. Exports have increased from 7.5 percent of GDP in 1985 to 10.5 percent in 1991. (See Exhibit 13.)

**EXHIBIT 12**

**Growth in U.S. Productivity, 1960–91 (annual rate of change)**

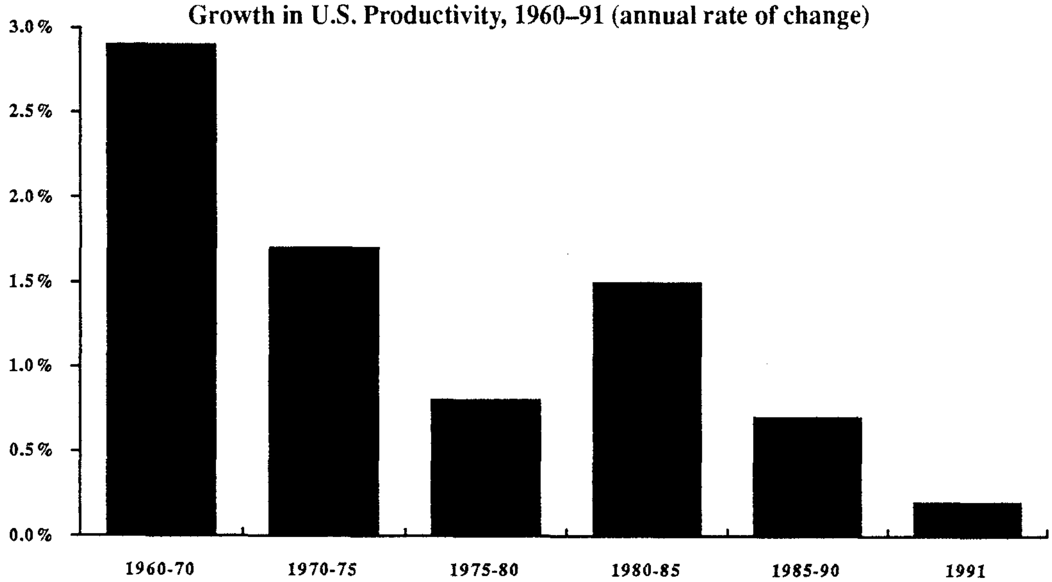
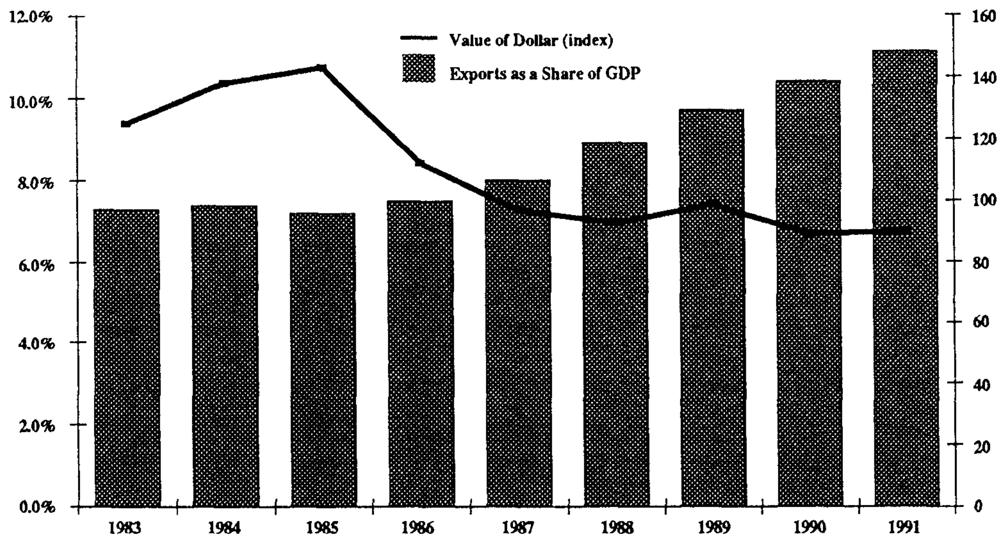



**EXHIBIT 13**

**Exports as a Share of GDP and Value of U.S. Dollar, 1981–91**
**(constant dollars)**



## ECONOMIC ADVANTAGES

Although the near term looks bleak, Michigan and the Great Lakes region have many strengths that will provide economic vitality in the next century.

- A skilled labor force
- A diversified economic base, making Michigan less vulnerable to downturns.
- An excellent transportation system
- Access to raw materials
- Abundant water resources
- Declining relative costs for land, labor, and taxes. In 1986 state and local taxes as a percentage of personal income were 10 percent above the national average, in 1991 they were one percent below the national average.
- A strong infrastructure although it is beginning to crumble
- Strong multijurisdictional and binational cooperation
- Well positioned to exploit new export markets. Michigan ranks 7th among the 50 states in export-related jobs per 1,000 population, 29 jobs per 1,000 population compared to the U.S. average of 23 (1987 data).
- Below-average reliance on defense industries—a disadvantage becomes an advantage
- Well positioned to benefit from increased investment in capital equipment

### What Must Be Done?

Most of the solutions are outside of Michigan's control. We can help improve the situation at home by trying to create a hospitable business climate, improving our education system, and rebuilding our infrastructure. Beyond this we have little control, even less than in the past.

Long-term solutions must include the following:

**Reduce the Federal Budget Deficit** This is key. Unless this is done, the long-term prospects are bleak. We must free money for investment and unshackle fiscal policy. According to a June 1992 study by the U.S. General Accounting Office:

> Long-term economic growth is central to almost all our major concerns as a society. Investment is critical to economic growth. The surest way to increase the resources available for investment is to increase national savings, and the surest way to increase national savings is to reduce the federal deficit.

**Invest in Infrastructure** This is, of course, related to reducing the deficit. Because of the deficit, public infrastructure has been allowed to crumble, and several studies have shown that infrastructure investment contributes to increased productivity.

**Improve Education and Job Training** We all know we have to be better educated to compete worldwide, and this is becoming even more important as about 75 percent of the new workers in the next decade will be immigrants and minorities. Many workers are being displaced by our changing economy, and they must be retrained for other jobs.

**Control Health Care Costs** This is central to reducing the federal budget deficit and allowing us to compete globally. Our health care costs are $2,500 per person, more than twice the level of most of the world's industrialized economies. These costs add 15 percent to the price of every motor vehicle, an amount that by itself eliminates almost all the cost reductions achieved by Ford and Chrysler.

**Change the Tax System** I believe that we should enact a national value-added tax (VAT), used by almost every other industrial nation, to replace the corporate income tax and the business portion of social security tax and to reduce the federal deficit. This would reduce consumption and promote investment. I also would like to see this serve as the basis for a common state tax system, as proposed by Alice Rivlin of the Brookings Institution, by allowing states to eliminate some or all of their taxes and piggyback on the VAT. I believe we need to reduce competition among states and devote all our efforts to competing with other nations.

**Promote Free Trade** I believe that the North American Free Trade Agreement (NAFTA) will be good for the country and, in the long term, good for Michigan. Mexico is our fastest growing trading partner, and a strong Mexican economy means more business for American firms. (See Exhibit 14.) Michigan is in a unique position to benefit. Currently, nationwide, 6.1 percent of all our chemicals, 8 percent of machinery, 12.4 percent of manufactured goods, and 6.4 percent of transport equipment exports are to Mexico, and this can only increase.

**EXHIBIT 14**

**Major U.S. Trading Partners (dollars in billions)**

| | 1986 | 1991 | % change |
|---|---|---|---|
| Canada | $55.0 | $85.1 | 55% |
| Japan | 26.6 | 48.1 | 80 |
| Mexico | 12.4 | 33.3 | 168 |
| Germany | 10.4 | 21.3 | 105 |
| Britain | 11.3 | 22.1 | 95 |
| Korea | 5.9 | 15.1 | 155 |
| France | 7.2 | 15.4 | 114 |
| Taiwan | 5.2 | 13.2 | 154 |

I believe fears about continued job losses to Mexico are exaggerated. Most of these low skill jobs have already been lost, and this would have happened with or without NAFTA. We will lose jobs in some industries but gain jobs in others. It is likely that southern states will be hurt much more than Michigan. To soften the blow, we need to levy a type of excess profits tax to create a fund to help retrain and temporarily support displaced workers.

For the long term, companies may move plants from Asia to Mexico, increasing the ability of Mexico to buy our exports. Elsewhere, the opportunities for trade with Eastern Europe, the former Soviet Republics, and China are enormous.

## CONCLUSION

There is no question that we have the ability to compete worldwide. But we must first put our own house in order. This will mean sacrifices on the part of every American for the next decade. We must give up some consumption for more investment. We must ask ourselves how much is enough. We must give up our need for instant gratification, and our belief that there is a free lunch. Can we do these things? I am not sure. But if we don't our children's future will be bleak. And while the 20th century has been called the American Century by historians, the 21st century may see the sun set on our power just as it did on that of many empires before us.