Economic Bulletin

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GOOD news

Interest rates continued to fall in December, with the federal funds rate—the rate at which banks lend to each other—dropping to 5.75 from 5.76 in November and 5.80 in October. During the first week of January, the rate dropped further to 5.35. This will translate into lower interest rates for consumers and businesses, giving the economy a needed stimulus.

BAD news

The Conference Board announced that the **help-wanted index**, which reflects the volume of help-wanted ads in U.S. newspapers, fell to 127 in November, down from 131 in October and 134 one year ago. The slight decline in the index indicates that employers are cautious about adding to their payrolls, likely due to many economists' predictions that the economy is in for a slowdown.

◆ **Motor vehicle sales** continued to weaken in December, declining 1.4 percent from the year-ago level. Passenger car sales dropped 5.4 percent, while light truck sales rose 4.2 percent. Sales by the Big 3 were down 4 percent compared with a 5 percent gain for Japanese models. For the 1995 year, motor vehicle sales were down 2.1 percent.

◆ The nation's largest retailers reported that **retail sales** this Christmas season were the worst in five years. A recent survey of large retail companies found that December sales were up only 1.8 percent from last year, compared to a 4.6 percent rise in December 1994. The slowdown is being blamed on conservative consumers who are facing high consumer debt levels and are skittish about losing their jobs.

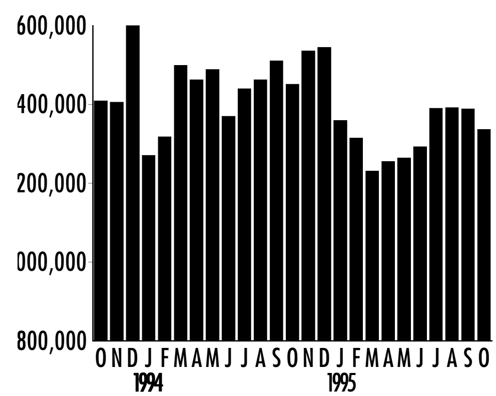
◆ Despite low mortgage rates, **home resales** fell 1.7 percent in November from the previous month. November's annualized rate of 4 million existing home sales represents a 3.7 percent decline from the November 1994 rate. The slowdown likely is due to news of an economic slowdown and high consumer credit levels, making consumers wary of big-ticket purchases.

◆ The **index of manufacturing activity**, reported by the National Association of Purchasing Managers, fell to 47.3 in December. The drop in the index indicates a weakening in the manufacturing sector in coming months.

◆ Recently released statistics show that U.S. **consumer installment credit** rose 10.4 percent in November, supporting economists' claims that indebtedness is contributing to an economic slowdown. The November rise in consumer installment credit, which includes auto loans, credit card debt, home equity loans, and miscellaneous consumer loans, followed a 13.7 percent rise in October and brings consumer indebtedness to just over $1 trillion.

***NOTE**: Due to the federal government shutdown, we are unable to report the Michigan and U.S. unemployment rates, the inflation rate, and other statistics that we normally include in GOOD NEWS and BAD NEWS. Many of the above statistics are drawn from nongovernment sources.*

U.S. Housing Starts



SOURCE: *Wall Street Journal.*

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January 1996

MONTHLY FOCUS

BUDGET CUTTERS EYE THE CPI

What if the federal deficit could be drastically reduced without tax increases or spending cuts? Some say that changing the way the government calculates the Consumer Price Index (CPI), as described in an October 2 *Wall Street Journal* article, could do just that.[1]

Is the Inflation Rate Inflated?

Many economists have long contended that the CPI (or inflation rate), which measures increases in the prices of consumer goods, overstates the cost of living. While there are many plausible arguments for an overinflated CPI, some of them quite complex, one of the primary arguments is very simple—the CPI does not reflect the price of goods that people actually buy. The rate is calculated from price changes in a set of goods and services that a typical consumer buys. However, this "market basket" of goods is based on consumption patterns of the early 1980s, and spending patterns have changed markedly since then. As economic theory would predict, consumers have substituted cheaper goods for goods with rising prices, shopping more at discount stores, and buying more generic and store-brand products than in the early 1980s. The CPI, however, does not reflect these changing patterns and assumes that higher-priced goods are bought in the same proportion they were over a decade ago.

While there *is* growing consensus that the CPI is too high, little agreement exists on the matter of *how much* too high. The U.S. Bureau of Labor Statistics, which compiles the CPI, estimates that it may be as little as one-tenth of a percentage point over the actual inflation rate, while Alan Greenspan, chairman of the Federal Reserve Board, calculates it is 0.5 to 1.5 percent too high. Others have estimated it to be up to 2 points over the actual level.

Inflation and the Budget Debate

With Social Security (SS) payment increases, federal employee compensation, and standard income tax deductions and tax brackets tied to the CPI, big federal dollars could be gained by lowering it.

As the exhibit shows, the largest savings would stem from reduced SS payments, which are tied to the cost of living. Savings in SS payments, lower cost-of-living adjustments for federal employees, and other savings would reduce both spending and interest payments on the federal debt. In tandem with higher income tax collections resulting from a lower CPI, the government would come out $282 billion ahead over the course of seven years—all without formally taking the politically unpopular actions of raising taxes or cutting SS benefits.

On the flip side, a lower CPI means that SS recipients would receive smaller annual increases in benefits. Also, since public and private sector pay increases are commonly tied to the CPI, many people would see slower growth in their wages. Lower federal income tax deductions, exemptions, and tax brackets would translate into more taxes for almost everyone. Therefore, while benefits and wages technically would not be cut and taxes would not be increased, deflating the CPI would, in effect, have similar results.

Conclusion

While adjusting inflation figures may seem like an unlikely way to balance the budget, the fact is that it would save billions of federal dollars. Like other deficit-cutting options before Congress, however, it has its costs—lowering the CPI is, in effect, a roundabout way of increasing taxes and cutting projected spending. However, it may be more politically palatable than other options, and given the impasse in Washington on a budget-cutting plan, political viability is no small consideration.

Effect of a One-Percentage-Point CPI Reduction on the Federal Budget, 1996–2002 (billions)

Social Security savings	$102
Increase in tax revenues	98
Savings on other spending	43
Savings on debt service	39
TOTAL	$282

SOURCE: Congressional Budget Office.

[1] *Wall Street Journal*, "Outlook: Money Inflated Debate About Altering the CPI," October 2, 1995, p. A1.

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NEWS FROM THE STATE CAPITOL

TAX CUTS SIGNED

Governor Engler has signed into law a series of bills, which take effect immediately, that give business tax and income tax relief to Michigan taxpayers. One law gives a tax cut to Michigan businesses that sell most of their goods out of state. Another provides relief to small businesses by raising the amount their owners may earn without paying the full single business tax and rewarding businesses for in-state capital investments.

Another law grants a 2 percent refund on 1995 income taxes, which was part of an effort to avoid exceeding a constitutional limit on state tax revenues of no more than 9.49 percent of personal income. The refund is included on the 1995 tax forms. A related law gives state colleges and universities a share of any excess revenues collected by the state in FY 1994–95. It is designed to give higher education institutions, which have not fared well in the past several budget allocations, a badly needed boost in revenues.

GOP PUTS BRAKES ON TAX CUTS

After passing a flurry of tax cuts in 1994 and 1995, the legislature will likely hold off on additional cuts in the coming months. Engler administration officials and GOP leaders have agreed to postpone additional tax cuts until the effects of previous cuts are better understood.

There are many reasons for lawmakers' concerns over revenues—tax cuts have been helped along in the past year or two by a booming state economy, one-time spending cuts, and other favorable conditions. However, the coming year may not be so amenable to cuts—the Michigan and U.S. economies are expected to grow more slowly, the state has two pending court cases that could cost the state hundreds of millions of dollars, prisons are expected to reach capacity next year, federal aid may decline, and K–12 enrollments may be higher than anticipated.

DEMOCRATS PROPOSE TAX CUTS

Despite the GOP agreement to hold off on further tax cuts until spring, a group of House Democrats is calling for major changes in the state's income tax. The plan's supporters reiterated arguments made throughout 1995—the first year the Michigan legislature had a Republican majority in almost 30 years—that GOP tax cuts had benefited primarily business rather than individuals. Nevertheless, the plan does have some Republican support.

The plan would reduce the state's income tax rate from 4.4 to 3.9 percent and raise the personal exemption from $2,400 to $2,600. It also would create credits for child care, pre-school, and elder care, increase credits for college tuition, and eliminate income taxes for persons living below the poverty line. Supporters said the tax cuts could be phased in over several years, and perhaps not take full effect until 2000.

The governor, who has repeatedly expressed concern about state revenues, has said he would endorse further cuts only if their supporters detail offsetting state budget reductions. Given the current revenue situation, backers of the plan may find it hard to show that the state is in a position for another major cut.

PUBLICATIONS OF INTEREST

Steven D. Gold, et al., *The Fiscal Crisis of the States: Lessons for the Future* (Washington, D.C.: Georgetown University Press, 1995).

This book looks at tax and spending policies implemented in the states of California, Connecticut, Florida, Massachusetts, Michigan, and Minnesota during recent fiscal crises. It lays out the problems each state faced, explains what measures the governments took, and evaluates their effectiveness. Gold then attempts to draw beneficial lessons for governments from the experiences.

Congressional Budget Office, *Who Pays and When? An Assessment of Generational Accounting* (Washington, D.C.: CBO 1995).

This 66-page report discusses the practice of generational accounting, or estimating how much people in different age groups will pay the government for various governmental expenditures. Generational accounting has received more attention as debate has intensified over the effect that entitlements such as Social Security and Medicare will have on deficit reduction efforts. The report analyzes the generational accounting methodology, including how it is done, how the results can be interpreted, and the strengths and weaknesses of its results. The CBO, which does not use generational accounting, concludes that it is a useful tool for analyzing broad policy options but contains too many unknown variables to be used as a governmental accounting system.

MICHIGAN REVENUE REPORT

State revenue collections slowed sharply in the first two months (November and December) of FY 1995–96. Sales, use, and withholding (S-U-W) collections increased only 2.2 percent, falling a good deal short of the consensus estimate (reached by a group of state fiscal officials) of 7.6 percent for the fiscal year. Some of the difference can be attributed to the weakness in automobile sales and also to very weak Christmas sales. December collections were much weaker than November's. November S-U-W collections were up 4.3 percent above the year-ago level, while December collections rose only 0.5 percent. It is unlikely, however, that revenues will continue to be this weak.

Breaking down the S-U-W figures, sales tax collections increased 2.8 percent. November sales were up 1.7 percent over a year ago, and December sales were up 3.8 percent. The latter may be overstated, however, as the figure for motor vehicle sales is only an estimate (at the same level as last year). Such sales were down 6.6 percent in November. Use tax collections were up 3.3 percent.

Personal income tax withholding collections rose only 1.5 percent for the two-month period; December collections dropped 3.3 percent, which may be due in part to smaller corporate bonuses this year.

The bright spot is single business tax (SBT) collections, which continue to be strong. During November and December, they grew 8.1 percent, a pace well above the consensus estimate for the year. Because of the SBT's strong performance, *total* collections for the taxes covered in this report were up 5.7 percent, which also is above the consensus estimate.

Lottery sales increased 4 percent for the two-month period, an improvement over recent months.

November and December 1995 Revenue Collections (preliminary, millions)

Source	Nov./Dec. Collections	% Change Year-ago	% Change Year-to-date	Nov./Dec. 1994 Actual	Consesus 1995–96 Estimate (% change)
Income tax					
Withholding	$877.6	1.5%	1.5%	$864.7	4.7%
Quarterly	58.3	136.0	136.0	24.7	5.5
Annual	10.3	43.1	43.1	7.2	5.3
Subtotal: gross income tax	946.2	5.5	5.5	896.6	4.8
Sales tax	874.0	2.8	2.8	850.2	4.3
Use tax	163.2	3.3	3.3	158.0	6.0
Cigarette tax	91.1	−12.2	−12.2	103.7	−2.3
SBT	318.0	8.1	8.1	294.1	0.3
Insurance	22.7	152.2	152.2	9.0	3.0
State education property tax	80.3	24.7	24.7	64.4	4.5
Real estate transfer tax	11.6			0.0	4.0
Estate/inheritance tax	6.7	−27.2	−27.2	9.2	3.5
Intangibles ax	4.4	−13.7	−13.7	5.1	3.9
Severance Tax	4.5	2.3	2.3	4.4	1.5
TOTAL	$2,522.7	5.7%	5.7%	$2,387.5	3.8%
Sales, use, and withholding	$1,914.8	2.2%	2.2%	$1,872.9	7.6%
Sales tax: Secretary of State	$113.0	−3.4%	−3.4%	$117.0	
Sales tax: other	761.0	3.8	3.8	733.2	
Gross lottery sales	$246,188.0	4.0%	−0.5%	$236,764.0	

SOURCE: Senate Fiscal Agency.