THE ECONOMIC SITUATION

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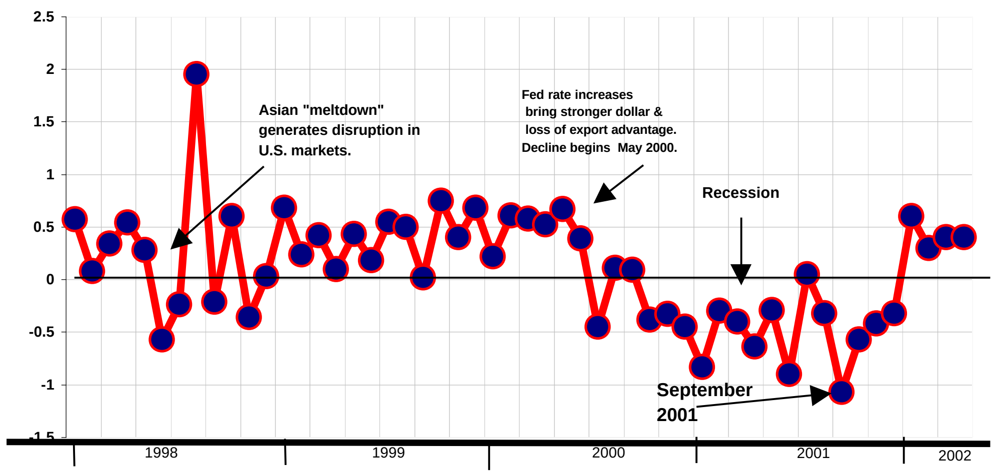
Growth resumes in the manufacturing economy.
The Fed opens the money valves.
GDP growth responds.
What about state revenues?
Do the poor get poorer, and the rich, richer in South Carolina?

Evidence of a strong recovery continues to be seen.

With the 11-month recession now behind us, questions still remain as to when the nation's factory economy will show meaningful growth. Part of the answer relates to excess inventories that must be sold. Another part relates to the strong dollar that makes foreign-produced goods such a bargain for American consumers. Fortunately, there is some good news.

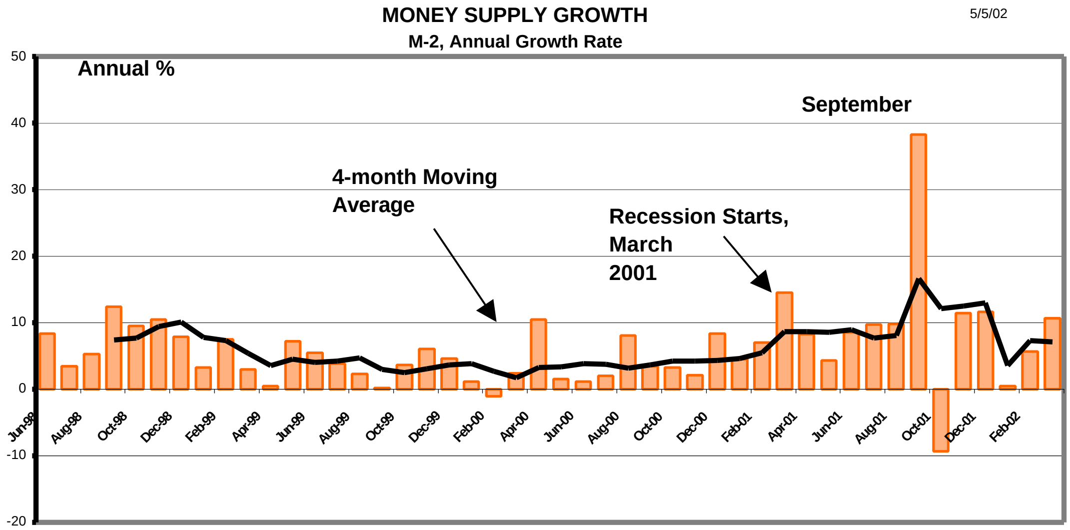
Strong evidence of the recession's end is seen in the Industrial Production data shown in the accompanying chart. The January, February, March, and now April 2002 data points reveal the signal. We have a trend of positive growth in factory output. And that is good news for South Carolina.

Growth in U.S. Industrial Production: 1998-2002



The Fed and the money machine.

The fortunes of the U.S. economy are determined largely by action taken by the central bank. The next chart shows the growth of money in the economy, as determined by Mr. Greenspan and his Fed colleagues. Inspection of this data tells us when the Fed is tightening or loosening the reins. The data show the period in 1999 when the Fed was slowing the economy. We then see the Fed's recognition of the recession and expansion of the money supply. The huge September expansion of credit that cushioned the horrors of 911 is seen in the chart. This is followed by some tightening, when the Fed adjusts for its expansion. The Fed is currently accommodating a recovering economy.



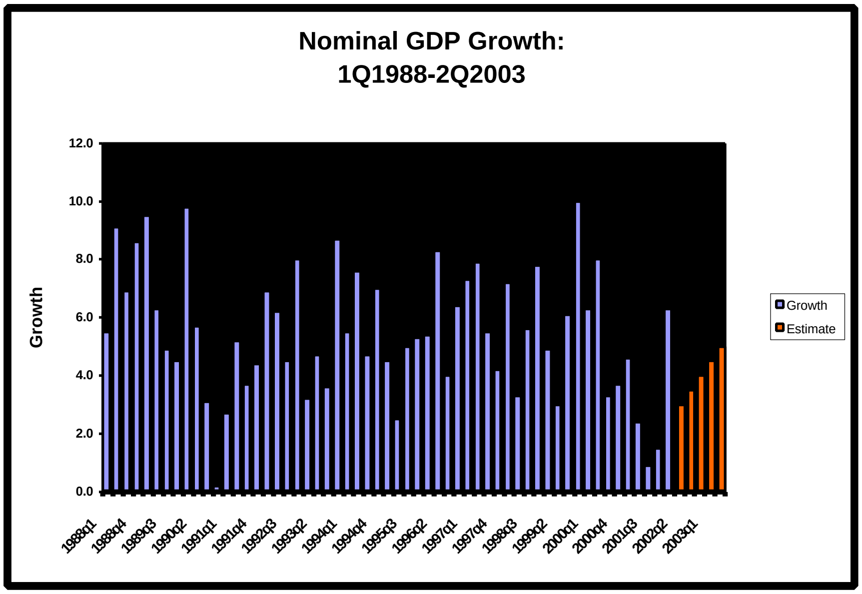
Money supply data provided by Freelunch.com.

With the economy picking up and a wee bit of inflation in the air, all bets on the table are calling for a tighter stance to be taken by the Fed by late fall.

The good news: GDP growth.

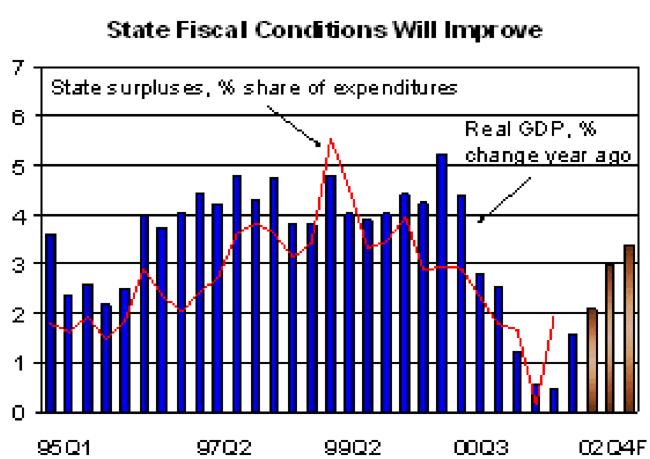
The national economy has responded to the Fed's action, continued consumer spending and a huge increase in post-911 government spending. Real GDP growth for 2001Q4 came in at 1.7%. This was almost nothing compared to 1Q2002, which was spurred by the huge response to zero interest loans on new car sales. The initial number came in at 5.8%, with expectations of a positive revision. Bear in mind that part of this high growth comes at the expense of later quarters. Even so, national forecasters are calling for 3.7% to 4.0% real growth rates over the next 12 months.

The GDP growth picture and forecast are shown below.



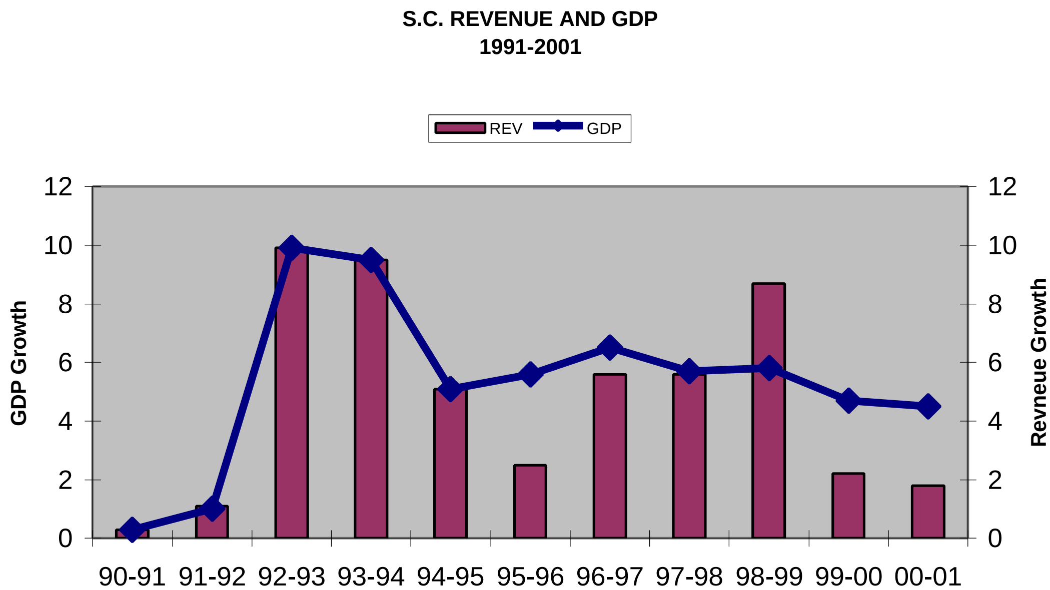
Moving from the nation to the states

There is an understandable strong link between the nation's economic growth and state fiscal conditions. The chart below, developed by Economy.com, shows a mapping of GDP growth to the composite budgets of the 50 states. Notice how the surplus position responds to changes in GDP growth. The forecast shown indicates movement to a stronger surplus position will occur in this calendar year.



S.C. general fund revenues

So what does all this mean for South Carolina state revenues? First, a brief assessment of the situation. The next chart shows the relationship between growth in nominal GDP and growth in State General Fund Revenues. As indicated here, the linkage between GDP and revenue growth does not connect well during the last few years. The S.C. revenue engine suffers from short-term and structural problems. The manufacturing recession, which hits the state harder than the nation, the related loss of capital gains tax revenues, and higher gasoline prices that do not produce sales tax revenue are elements in the short-term problem. These problems will eventually pass. Then, there are the structural problems that relate to a large list of tax exemptions and the unpredictable timing of employment incentives provided as part of economic development incentives. Eliminating some exemptions and establishing a timetable for corporations to follow in exercising development incentives would help to deal with the structural problem.



The 2001-02 revenue difficulties

The General Assembly's financial plan for the current 2001-02 fiscal year was based on an appropriations budget of $5.918 billion. In November 2001, a plague of revenue shortfalls brought a reduction of $310 million in the State Board of Economic Advisors (BEA) official revenue estimate, and corresponding cuts in spending. The plague continued. The BEA took another $92 million cut on March 21. Now, with the estimate set at $5.517 billion there is still a shortfall, which sharply affects the 2002-03 fiscal plan. By way of comparison, the state general fund produced $5.481 billion in the 2000-01 fiscal year. We are close to a standstill in revenue growth. When inflation is factored in, we see declining real revenues.

A year ago, before all the adjustments, the BEA's 2002-03 plan called for revenues of $5.840 billion. In May, the Governor submitted a $5.3 billion budget for 2002-03, which is some $200 million below the current BEA estimate for this year but close to the General Assembly's reduced spending rate. According to newspaper reports, Mr. Hodges' budget calls for agency cuts of about 3%. This makes room for new spending he proposes. Now, the question, of course, is what might be a realistic estimate for next fiscal year.

Estimating revenue for fiscal year 2002-03

If we go back to the four years before the 2001-2002 slowdown, we find that state total personal income grew at an annual rate of 4.7% to 6.6%, in nominal terms. During those years, inflation was running 2% to 3%. At present, growth in nominal total personal income is estimated to be approximately 2%. The estimate for the 2002-03 fiscal year is roughly 3%. The inflation rate is currently about 1.5%. Part of the loss in state revenue is accounted for by reductions in inflation

I provide here, a comparison of growth in total personal income and growth in total general fund revenues, all in nominal terms along with my estimate for the 2002-03 year. The last item in the last line shows my projection of 3.8% for next year's general fund revenue growth. Based on a current revenue estimates of $5.300 billion for fiscal year 2001-02, revenue for next year will be $5.501 billion, an amount that exceeds the Governor's budget request. Again, my estimate calls for 3.8% revenue growth. To achieve the 2002-03 estimate of $5.840 used by the General Assembly for 2002-03, revenue growth would have to achieve 5.9%.

		GROWTH		
	Employment	**Income**	**Inflation**	**Revenue**
1995-96	0.9	4.7	3.0	2.7
1996-97	5.4	6.6	2.3	5.6
1997-98	0.0	6.1	1.6	5.6
1998-99	0.6	6.6	2.2	8.7
1999-00	- 0.1	5.4	3.4	2.3
2000-01	- 3.9	5.1	1.6	1.8
2001-02	0.0	2.0	1.5	0.0
2002-03	**1.0**	**3.2**	**2.0**	**3.8**

Note: Income growth is for calendar years. Data for 2001-02 and 2002-03 are estimates. Employment Growth is based on re-benchmarked BLS data. Income data provided by U.S. Department of Commerce. Inflation is based on the all-items CPI and estimates for the near term.

Misery loves company

The last two fiscal years have been unusually challenging for South Carolina. But while it has been tough for us, things have generally been even worse for some of our neighbors. The data here show shortfalls relative to initial appropriations.

FY2002 Projected Budget Shortfalls

Florida	**6.1%**
Georgia	**3.9**
North Carolina	**8.3**
South Carolina	**5.5**
Tennessee	**4.6**
Virginia	**12.0**

Source: State Board of Economic Advisors

Do the poor get poorer and the rich, richer in South Carolina?

In April, the Economic Policy Institute released an in-depth study and comparison of income data taken from various Census reports. The Institute focused on what happened to richer and poorer population segments across the 50 states. A comparison was made for two periods, the years 1978-80 and 1988-00. Incomes were calculated in 1999 dollars.

There were six states in America where those with incomes in the lowest 20% of the population gained on those in the highest 20%. South Carolina is one of the states. The others are Alaska, Indiana, Georgia, Louisiana, and Mississippi. Connecticut and Massachusetts were the two states where the bottom fifth grew poorer and the top fifth grew richer. Of course, there are a multitude of forces that contribute to these outcomes. But it is just possible that South Carolina has provided improved opportunities for income growth at the lower end.

The Economic Policy Institute report confirms generally what has been found for economic development around the world. The general rule says that where capitalism is strong, which is to say where economic opportunity is based on open markets and enforcement of property rights, income growth spreads evenly across all income groups. Of course, there are always exceptions to the general rule. But instead of speaking about an unequal distribution of income across countries, perhaps we should join Swedish economist Johan Nordberg and call it an unequal distribution of capitalism.