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# Maine's Economy: Peering into the Crystal Ball


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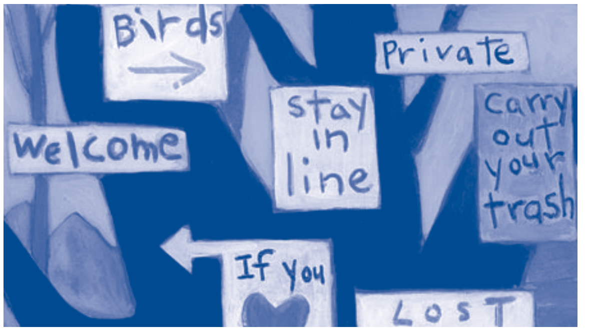


# Maine's Economy: *Peering into the Crystal Ball*

by Catherine Reilly

*The five economists and financial professionals who comprise Maine's Consensus Economic Forecasting Commission (CEFC) meet twice a year to forecast the state's economy. By statute, this forecast then is used to project state revenues and develop the state's budget. In this article, State Economist Catherine Reilly presents the CEFC's fall 2006 forecast for employment, income, and inflation. Although never a guarantee, this year's forecast suggests Maine's economic future will be one of slow and steady growth, with moderating energy prices, lower inflation, and a continued expansion of the state's service sector.*

Twice a year, five Maine citizens meet in Augusta and set the course of future state government budgets. They are not politicians or lobbyists, they hold no public office, and they don't even work for a government agency. Yet policymakers and state officials anticipate their arrival, monitor their deliberations, and feel the impact of their decisions months after they leave. They are the members of the Consensus Economic Forecasting Commission (CEFC)—five economists and financial professionals who make the economic forecast from which projections of state revenues are calculated.[1] They serve as somewhat of a crystal ball of the Maine economy, forged in statute and polished by reputation.

The CEFC held its most recent meeting on October 3, 2006.[2] They pored over data, listened to reports from state agencies, and consulted economic models. Ultimately, they agreed on a forecast that shows Maine's economy growing slowly and steadily over the next five years. This article illuminates the artful process of forming a consensus forecast and highlights some of the key issues that will shape Maine's economic future.

Governor John McKernan established the CEFC in an executive order issued May 14, 1992. The stated purpose of the CEFC, and the accompanying Revenue Forecasting Committee, was "to serve as a more comprehensive approach to consensus forecasting for the state economic assumptions and state revenues in the mutual best interest of the Executive and Legislative branches of State Government."

The CEFC's forecast feeds into state revenue projections. Its income forecast influences estimates of sales and income tax revenue. Its inflation projection affects estimates of income tax brackets and fuel tax rates. The state is bound by law to use the CEFC's forecast as the basis for its revenue projections. In turn, budget writers are bound to stay within revenue projections. Therefore, the CEFC's forecast affects the amount of money over which lawmakers deliberate and negotiate, the amount of money they can spend and invest.

Each CEFC meeting begins with the Maine Department of Labor, Maine Revenue Services, and the State Planning Office reporting the latest economic data. Then state agency staff fade into the background as the commissioners begin their discussions.

The commissioners use a large-screen projection of a spreadsheet that displays growth projections from various economic models. There is space for the commission to record its forecast for employment, income, the components of income (wages, interest, etc.), and inflation. The commissioners can make real-time changes to their forecast and often try out different scenarios. For example, "Oil prices have fallen lately and the Federal Reserve has raised interest rates since we last met. Therefore, I see inflation dropping to 2.5 percent in 2007 and 2.2 percent thereafter." The proposal is entered into the spreadsheet and is then accepted, rejected, or modified as necessary in order to reach consensus.

…the [Consensus Economic Forecasting] commission's work is integral to operating Maine's state government and is perhaps the most well-informed prediction of what lies ahead for the Maine economy.

Forecasting is an art, not a science. In this case, the five artists involved spend considerable time gazing at the spreadsheet, deciding whether the picture it paints matches their gut knowledge of Maine's economy. They're a respectful group. Consensus is never rushed and always amiable.

The following sections present the three primary areas of the CEFC's forecast: employment, income, and inflation. The forecast focuses on these state-level economic factors to accomplish its legal purpose: projecting state revenues. Because of its focus, the forecast has some limitations. State-level indicators do not show how growth will vary across Maine's regions or how Mainers of different income levels will fare. The forecast does not articulate the effect or importance of some implicit determinants of economic growth, such as demographics. Knowing this could help policymakers understand how those factors affect

Maine's economy and how to respond accordingly. Nonetheless, the commission's work is integral to operating Maine's state government and is perhaps the most well-informed prediction of what lies ahead for the Maine economy.

## EMPLOYMENT

Employment is one of the key indicators the commission forecasts, and it is the first they tackle. The Maine Department of Labor (DOL) reported that Maine's labor market has improved in 2006. Unemployment remained at or below the national average for the first three quarters. The state has seen job gains in professional and business services, construction, health and social services, wholesale trade, and transportation, warehousing, and utilities. This is an improvement over 2005, when the number of workers on Maine payrolls was unchanged. At their January 2006 meeting, the CEFC predicted that job growth would resume in 2006. DOL's data proved them right.

> …over the next five years, the commission projects strong growth in education and health services, professional and business services, and leisure and hospitality.

A monthly survey of about 2,000 Maine employers showed that payroll employment increased by 0.2 percent, or 1,200 jobs, in the first eight months of 2006. The Quarterly Census of Employment and Wages (QCEW), which collects data from all Maine employers and therefore takes longer to compile, showed 0.5 percent job growth for the first three months of 2006. Resident employment, a third measure, showed even stronger growth. Resident employment captures people who are employed, but not on the payroll of a Maine business. They may be self-employed, work on a farm, or work for an out-of-state company. Resident employment increased 1.2 percent through the first eight months of 2006, well above the other two measures.

The variation of employment growth measures has become familiar in recent years. In 2005, Maine payroll employment was flat, but resident employment grew by 1.5 percent, or 10,000 jobs. One reason for this is the growing influx of southern Maine residents who work out-of-state. Surveys of Maine employers miss those people. Interestingly, Massachusetts saw a reverse trend in 2005; job counts there rose by 10,000 more than the number of employed residents.

The variation also reflects historical post-expansion employment trends. During an economic expansion, such as the one preceding the 2001 recession, wages rise as employers compete for workers. That attracts people away from potentially less lucrative or stable options such as self-employment and contract work. After a boom, wage growth cools and more people find work off company payrolls. There also is evidence that some companies are using more independent contractors and consultants, rather than full-time wage-and-salary employees.

Regardless of magnitude, all three data sources showed employment in Maine expanding. Therefore, the commission left its 2006 job growth forecast unchanged at 0.5 percent, or 3,000 jobs.[3] Job gains are expected in health services, professional and business services, and government (which is comprised of federal, state, and local government employees, including public school employees). Manufacturing will continue to lose jobs.

After verifying their 2006 estimate, the commissioners began the more speculative task of predicting job growth for 2007 to 2011. For this they consulted economic models from Moody's Economy.com and Global Insight, as well as their own calculations. They were mindful of two forces that could bump the state off its usual growth path over the next few years: a weak housing market and the closure of Brunswick Naval Air Station.

For 2007, the CEFC predicts a slight slowdown in job growth (to 0.4 percent, or 2,500 jobs) based on signs that the national housing slowdown is reaching Maine. The State Planning Office reported that August sales of existing homes in Maine were 17.8

percent lower than the same month one year ago. Issuances of new housing permits also have fallen. Through August, permits were down 13 percent statewide. This decline is mirrored in other states. New England as a whole saw a 12 percent drop in housing permits over the same time. State impacts varied from a 3 percent increase in Rhode Island to a 23 percent decrease in New Hampshire. Maine Revenue Services noted that growth of building supply sales, which had been strong, slowed during the summer. July 2006 sales were 1 percent lower than July 2005 sales. This corroborated the picture shown by existing home sales and permit data.

The CEFC's decision to revise 2007 job growth based on this news reflects the role of housing markets as economic drivers. Residential development supports construction jobs and increases demand for complementary services and goods such as real estate services, landscaping, washers, dryers, bedding, rugs, and other furnishings. Furthermore, home values influence how wealthy homeowners feel. High sale prices make homeowners feel wealthier, even if they don't sell their home to liquidate its value. That feeling may encourage them to spend more and/or take out a home equity loan. Conversely, low home values make homeowners feel less wealthy and may result in more conservative spending. Through this "wealth effect," events in the housing market can spread throughout the economy.

Most analysts expect the national housing market to stabilize in 2007.[4] The CEFC's forecast reflects a similar recovery; annual employment growth in Maine should increase to 0.8 percent or 4,900 jobs by 2009.

Job growth will strengthen just in time to absorb the closure of Brunswick Naval Air Station, according to the CEFC's forecast. From its peak in 2009, annual job growth will recede slightly to 0.6 percent or 3,800 jobs in 2011. The impact of losing roughly 3,400 federal military and civilian jobs during those years will ripple through mid-coast Maine and slightly dampen economic growth. However, the base closure is not expected to cause a net loss of jobs at the statewide level. The mid-coast economy is diverse and growing, which bodes well for economic recovery. Local communities will undoubtedly feel the loss of federal jobs in the short-term, but the long-term outlook is favorable. Converting the base to civilian use should generate diverse new job opportunities.

TABLE 1: **Projections of Annual Employment and Population Growth, Maine and the United States**

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| Annual Employment Growth | | | | | | |
| Maine | 0.5% | 0.4% | 0.6% | 0.8% | 0.7% | 0.6% |
| United States[a] | 1.2% | 1.2% | 1.2% | 1.2% | 1.2% | 1.2% |
| Annual Population Growth[b] | | | | | | |
| Maine | 0.6% | 0.6% | 0.6% | 0.6% | 0.5% | 0.5% |
| United States | 0.9% | 0.9% | 0.9% | 0.9% | 0.9% | 0.9% |

(a) U.S. Department of Labor, Bureau of Labor Statistics, 2004-2014 Employment Projections, Average Annual Employment Growth. Release Date: December 7, 2005.

(b) U.S. Census Bureau, Population Division, Interim State Population Projections, 2005. Internet Release Date: April 21, 2005.

Table 1 displays annual employment and population growth projections for Maine and the nation. Maine's employment projections are from the CEFC. The nation's projections are the annual average growth estimates for 2004 to 2014 from the U.S. Bureau of Labor Statistics. Both population projections are from the U.S. Census Bureau.

The CEFC projects annual employment growth of 0.4 percent to 0.8 percent in Maine over the next five years. National employment is expected to grow faster, 1.2 percent on average. This difference is not entirely surprising considering the population growth expected in each region. Maine's population will grow about one-third slower than the nation's over the next five years. Job growth is in part constrained by the number of working-age residents seeking employment.

The CEFC's final report separates employment growth by sector. Over the next five years, the commission projects strong growth in education and health services, professional and business services, and leisure and hospitality. Professional and business services will experience the highest percentage growth (about 2.0 percent annually), but health services will add the greatest number of jobs (about 9,000 over the next five years). The commission projects moderate growth in trade, transportation and utilities, information, and financial activities (each gaining 500-2,000 jobs over

TABLE 2: **Projections in Personal Income Growth in Maine, by Income Category**

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| Personal Income (Total) | 5.2% | 4.3% | 4.5% | 4.5% | 4.3% | 4.2% |
| Net Earnings* | 4.7% | 4.2% | 4.3% | 4.3% | 4.1% | 4.0% |
| Dividends, Interest, & Rent | 5.5% | 5.0% | 5.0% | 5.0% | 5.0% | 5.0% |
| Transfer Payments | 5.5% | 4.7% | 4.5% | 4.4% | 4.4% | 4.4% |

* Author's calculation based on components of net earnings forecasted by the CEFC.

the time period); and flat or declining employment in natural resources, construction, manufacturing, and government. In the latter group, government employment will decline by about 3,000 while employment in the other sectors will remain essentially flat.

These projections reflect the continual evolution of Maine's economy from one based on natural resources and manufacturing to one based on services and information. For years, the overall number of jobs in Maine has grown steadily. Job losses in declining sectors, such as manufacturing, have been surpassed by gains in growing sectors, such as business and professional services. The challenge is helping workers with specialized skills honed for work in declining industries transition to growing industries that may require very different capabilities. This challenge will persist over the next five years, even as overall economic growth continues.

## INCOME

Employment is a closely watched indicator by the commissioners, but it's not necessarily the most important for projecting state revenue. The income levels of Maine residents directly determine their income tax payments and greatly influence how much sales tax they will pay. Since income and sales taxes are the state's main revenue sources (accounting for about three-fourths of General Fund revenue), predicting incomes is essential for sound revenue projections.

Throughout the year, Maine Revenue Services (MRS) monitors the amount of income tax withheld from employee paychecks and other sources of personal income. In each of the first three quarters of 2006, withholdings were higher than the same quarter one year ago. Thus far, withholdings are up 4.2 percent for the year, about equal to last year's growth.

The U.S. Bureau of Economic Analysis (BEA) tracks income from sources in addition to employment, such as investment income, social insurance income, and income earned from out-of-state employment. It indicated that total income rose 5.2 percent in the first half of 2006. So, both the MRS data and the BEA data show positive income growth.

These results were slightly more favorable than the growth projected by the CEFC in January 2006. Therefore, they raised their 2006 income growth projection from 5.0 percent to 5.2 percent. However, they lowered their projection for 2007 from 4.5 percent to 4.3 percent in response to the news of a weakening housing market. As with employment, the commission projected income growth to strengthen after 2007 until the closure of Brunswick Naval Air Station again moderates growth in 2010 and 2011.

The CEFC goes a step further than these total income estimates and projects growth for income's various components, such as interest earnings, wages, and transfer payments.[5] This is necessary to accurately predict state revenues. Some forms of income are taxed differently than others (e.g., employee wages versus employee benefits). Some forms are more likely to accrue to people in higher tax brackets (e.g., income from dividends, interest, and rent). Other forms are more likely to go to people in lower tax brackets (e.g., transfer payments).

To inform these projections, the State Planning Office presented information on the growth of income's three main components (earnings; transfer payments; and dividends, interest, and rent) since 1970. The share of income from "net earnings" has gradually declined in both Maine and the United States.[6] For Maine, earnings in 1970 represented 75.6 percent of income; by 2004 that share had dropped to 65.8 percent. For the United States, the share of income from earnings declined from 77.2 percent to 69.5 percent over the same time. Meanwhile, the share of income from "current transfer receipts" (e.g., social security income, food stamps, government medical benefits) and from dividends, interest, and rent has risen steadily in both Maine and the United States.

In 2005, transfer payments composed 20.0 percent of Maine's total personal income, up from 10.9 percent in 1970. Nationally, they have increased from 9.0 percent to 14.9 percent. A large portion of that increase is from the expansion of government medical benefits, which accounted for less than one-fifth of transfer payments in 1970 and now account for almost half, both in Maine and the United States. Income from dividends, interest, and rent has increased from 13.5 percent to 15.4 percent in Maine, and from 13.8 percent to 15.6 percent in the United States. Demographic factors, such as population aging, the in-migration of retirees, and the presence of veterans, likely influence the growth of income from each of these sources.

The CEFC projects a continuation of this trend over the next five years. As shown in Table 2, total personal income is projected to grow 4.2 percent to 5.2 percent annually from 2006 to 2011. Each year, earnings are expected to grow slightly slower, while income from dividends, interest, rent, and transfer payments, are expected to grow faster.

These trends will be important to monitor as Maine considers tax policy changes in the coming years. For instance, some people have suggested eliminating taxes on retirement income to attract more retirees to Maine. However, population forecasts already show that over one in four Maine residents will be age 65 or older by 2030.[7] Significantly reducing that age group's income tax liability would shift a large burden onto other taxpayers, namely businesses and younger residents.

## INFLATION

Inflation is the final economic factor forecasted by the CEFC. As mentioned earlier, inflation estimates are necessary for revenue projections because some taxes increase annually based on the rate of inflation (such as fuel taxes), and individual income tax brackets are adjusted annually for inflation. Furthermore, inflation is a standard factor for predicting overall economic growth.

TABLE 3: **Inflation Projections: Annual Rates**

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| Consumer Price Index for all Urban Consumers-(CPI-U) | 3.5% | 2.5% | 2.2% | 2.2% | 2.2% | 2.2% |

The CEFC forecasts the most common measure of inflation: the Consumer Price Index for All Urban Consumers (CPI-U). This index, maintained by the U.S. Bureau of Labor Statistics, tracks the prices of goods and services commonly purchased by U.S. households. These items range from food and clothing to medical care, transportation, and recreation. Recently, energy has been one of several factors pushing the index to its highest level in years. In 2005, the CPI-U rose 3.4 percent, more than double the rate of 1.6 percent just three years earlier.

Many analysts expected inflation to ease in 2006. In January, the CEFC estimated that inflation would fall to 2.8 percent. This projection proved to be too optimistic. In the first eight months of 2006, inflation neared 3.9 percent (although setting aside the costs of energy and food, inflation was just 2.4 percent). Fortunately, energy prices receded somewhat this fall. On the day of the CEFC's October meeting, gasoline was about 18 percent cheaper than one year ago and heating oil was 12 percent cheaper.[8] Anticipating that lower prices would hold for the remainder of 2006, the commission increased its inflation estimate, but only to 3.5 percent.

The commission foresees inflation returning to recent historical levels in 2007-2011. This outlook is emblematic of widespread faith in the Federal Reserve to keep inflation low. That was not always the case. At one time the Federal Reserve sought to keep interest rates low even as inflation rose. They wanted to encourage businesses and individuals to borrow money, make investments, and create jobs. However, when inflation is high, prices may rise faster than incomes causing economic activity to slow. In the 1970s, it became apparent that chasing high employment at the cost of inflation was hurting the U.S. economy and actually resulting in fewer jobs. Since then, the Federal Reserve has maintained a consistent policy of targeting inflation. It seeks low, predictable inflation to create a stable investment environment, which in turn sustains

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jobs. The CEFC's long-run forecast reflects that policy.

## CONCLUSION

After the commission's meeting, the State Planning Office drafts a written report that summarizes the background data presented by the state agencies, the commissioners' deliberations, and their consensus forecast. The commissioners review and edit the draft and then send the final report to the Revenue Forecasting Committee (RFC). RFC staff and members combine the CEFC's forecast with other information to update projections of state revenues. The full impact of the CEFC's forecast adjustments become apparent when the RFC releases its report one month later.

This fall, the RFC increased its General Fund revenue projection by $80 to $90 million for each of fiscal years 2007 to 2009 (equivalent to about 3 percent of total revenues). The increase stemmed in part from high income growth among upper-income earners and strong corporate profits, trends that the CEFC's forecast hints at but does not explicitly quantify. The RFC decreased its forecast of Highway Fund revenue by $5 to $10 million (about 2 percent of revenues) for the same years. That adjustment came primarily from lower than expected fuel tax revenues. Higher energy prices and increased demand for more fuel-efficient vehicles has cooled the growth of fuel consumption. Again, these factors are alluded to in the CEFC's forecast (within the inflation forecast, for example) but not explicitly stated. As this article went to press, policymakers were just beginning to deliberate what those re-projections will mean for state spending.

The CEFC's fall 2006 forecast shows slow and steady growth in Maine's economic future. Moderating energy prices, lower inflation, and the continued expansion of Maine's service industries should increase economic activity. The weakened housing market and the closure of Brunswick Naval Air Station will moderate growth in some years, but not enough to create net job losses.

For the average Mainer looking at the CEFC's forecast, the message is that Maine's economic future currently looks very similar to its recent past. Employment and income growth will be positive and steady, but moderate. There is currently nothing in the crystal ball suggesting that Maine's economy will jump to a higher growth path. Only a change of a fundamental economic factor could trigger such a jump. The fundamental elements include the skills and size of our workforce; the age and racial composition of our population; the structure and cost of our government; the technology and resources available to our businesses; the expenses faced by our businesses and households; and our natural resources.

To alter the course of Maine's $44 billion economy, at least one, and likely several, of those fundamentals would have to change. For example, access to higher education would have to increase dramatically; new, diverse populations would have to move to Maine in greater numbers; the most expensive aspects of government would have to be meaningfully restructured; we would make large, targeted investments in research and development; our natural resources would be firmly protected against sprawl and incremental development.

The CEFC's current economic forecast for Maine is both comforting (it calls for slow and steady growth) and aggravating (it calls for slow and steady growth). Either way, it reflects the fundamental characteristics of our economy and points to where they lead. Whether we follow or point in a new direction is up to us.

## ENDNOTES

1. Four CEFC members are appointed by the governor (one based on recommendation by the president of the Senate and one recommended by the speaker of the House of Representatives). The fifth member is appointed by the other four members. Current members are Charles Colgan (Chair), Professor of Public Policy and Management, Edmund S. Muskie School of Public Service, University of Southern Maine; Eleanor Baker, Managing Principal, Baker Newman Noyes, LLC; John Davulis, Chief Economist, Central Maine Power Company; Michael Donihue, Associate Professor of Economics, Colby College; and Charles Lawton, Senior Economist, Planning Decisions, Inc.
2. The Consensus Economic Forecast Commission reviews its forecast in January and October each year. For meeting dates and locations, please contact the State Planning Office at (207) 287-6077 or visit its Web site at www.state.me.us/spo. Meetings held in State House Room 288 are broadcast on the State Legislature's live, online audio broadcast system: http://janus.state.me.us/legis/audio/approps_cmte.html.
3. DOL and the CEFC agreed to monitor new QCEW data scheduled for release several days before the CEFC's final report deadline. The new data showed that growth seen in the first three months of 2006 continued during the next three months. This information supported the CEFC's decision to keep its 2006 job growth estimate at 0.5 percent despite preliminary surveys showing slower growth. As part of its regular revision process, DOL will update the preliminary survey estimates based on the more complete data gathered by the QCEW.
4. See, for example, Mark Jewell, "Housing market recovery expected in '07," A.P. Wire Service, November 12, 2006. Zoltan Pozsar, "U.S. Chartbook 11/10/2006," Moody's Economy.com, November 10, 2006.
5. Transfer payments are defined as payments by federal, state and local governments and by businesses, for which no current services are performed; they include government retirement benefits, health benefits such as Medicare and Medicaid, unemployment insurance compensation, income maintenance benefits, and similar payments.
6. Net earnings equal wage and salary earnings *plus* employer-paid benefits and contributions to government social insurance *plus* proprietors' income *minus* employee contributions to government social insurance *plus* any necessary adjustment for income earned out-of-state.
7. U.S. Census Bureau, Population Division, Interim State Projections, 2005. Internet Release Date: April 21, 2005.
8. The statewide average price of a gallon of regular gasoline was $2.86 on October 2, 2005 and $2.35 on October 2, 2006. The statewide average price of a gallon of heating oil was $2.56 on October 3, 2005 and $2.25 on October 2, 2006.