The Florida Senate

Interim Project Summary 2000-48 *August 1999*

Committee on Fiscal Resource Senator Jim Horne, Chairman

FAIL SAFE: IMPACTS OF ECONOMIC DOWNTURN ON FLORIDA REVENUES

SUMMARY

Many of us think that the present economic growth and stability will continue into the future with only mild periodic adjustments. Others believe that the economy is staged for a downturn or even a recession within the next few years. The economic indicators, with few exceptions, support continued growth. Even Chairman Greenspan, in his testimony to the U.S. Senate stated that the economic stability could continue, but we need to be cautious, aware of indicators and be ready to make any needed adjustments in rates.

Florida's economy is also strong and has a 60% probability of remaining strong without major downturns. Not withstanding our optimism, what would be wrong with exploring the consequences of a downturn on Florida. What will happen to Florida's revenue collections in the event of a downturn? What has happened in the past? What components of Florida's sales tax collections were most affected by the downturn of the first part of this decade? What was the legislative reaction to the downturns of the past? The purpose of this project is to enhance awareness of possible impacts of economic downturns on the Florida's General Revenue stream.

While all component of sales tax were reduced, sales tax from building, business investment, and automobiles were hit hardest and also recovered very nicely after the downturn. An analysis of the downturn of the early 90's revealed that budget cuts, tax increases and transfers of $2.88 billion were made to balance the budget and continue services. Budget cuts were $1.5 billion; tax increases were $1.0 billion; the remainder was from transfers from the Working Capital Trust Fund and other funds. In addition, the legislature began installments into the Budget Stabilization Fund to deter the effects of future downturns.

Three economic models were used to simulate the effects of a future downturn on Florida's General Revenue collections. The three models simulate a mild recession, a deep recession, and the third model mirrors the percentage reductions of the early 90"s on General Revenue of the future. Next, the budget stabilization fund is overlaid on the three models to evaluate the degree of remedy offered by the BSF.

The three simulated models created revenue reductions beyond the anticipated balances of the Budget Stabilization fund. The mirror scenario produced a General Revenue reduction of $3.38 billion compared to the $2.88 billion of early nineties. The Budget Stabilization Fund will not be adequate to shield the budget from cuts. The Legislature will again have to make tough choices to balance the budget in each of the simulated scenarios. The Budget Stabilization Fund as it exist today is a band-aid that stops the bleeding until the following session. Florida should be proud that policy makers and citizens created the budget stabilization fund, but should not assume that it cures the problems of a deep recession. In fact, the requirement to replenish the fund each year during the downturn digs the hole deeper.

Hopefully, this is only an exercise in awareness. But if a downturn exists in the near future, Florida policy makers can know which parts of the economy were affected in the most recent downturn and have at least one model of possible responses to assure that Florida has a balanced budget and can continue providing services to the Citizens of Florida. Consideration might be given to accelerating the contributions to the Budget Stabilization Fund and/or maintaining a higher balance in the Working Capital Trust Fund.

BACKGROUND

The United States' economy continues to perform better than expected. On nearly all fronts economic conditions are remarkably buoyant in the middle of the ninth year of one of the longest economic booms on record.

- Gross Domestic Product grew at an annualized 2.3 percent in the second quarter of 1999, down from 4.3 percent in the first quarter but exceeding the January forecast rate of 1.6 percent.

- Fear of inflation continues to dictate Federal Reserve policy, but actual evidence of inflation is non-existent. The CPI rose 0.7 % in April, but was flat in May and June.

- Unemployment remained at a low 4.3 percent in June and July. This low jobless rate has raised concerns about the inflationary threat of rising wages, and in late July a report on rising labor compensation rates created concern on the stock market. Average hourly earnings are up 3.8 percent over a year ago.

- New job creation was higher than expected in July, with 310,000 additional jobs. Manufacturing employment rose for only the second time in 16 months, and overall manufacturing employment has lost almost one-half million jobs since early 1998.

- Consumption is the engine powering the economy. Household spending has exceeded income since January. Households have, in effect, let the stock market do their saving for them, relying on the higher value of their assets to support their spending. (The savings rate looks only at household income and spending and does not allow for the effect of additional wealth.) A lot of consumption is related to home purchases -- new furnishings and appliances are often bought for newly purchased homes. July retail sales figures were higher than expected, and most major retailers are sharing in the good times.

- Interest rates have begun to creep up, after remaining low for most of 1998-99. The Federal Reserve raised the federal funds rate on June 30, and Chairman Greenspan has threatened additional rate increases if wages continue to rise. The 30-year mortgage rate rose past 8 percent in early August, which will probably slow the construction industry. Auto sales may also be affected by higher interest rates.

- Residential construction has been at an historically high level in recent months. Sales of new single family homes grew in June by 3.1 percent over the previous year, after declining slightly in May. Commercial construction is soft because of excess capacity in retail and manufacturing, but state and local construction spending is growing, mostly because of highway construction.

- International trade remains the dark cloud on the economic horizon. Asia has begun to recover from recession, but only slowly, and Japan remains in the economic doldrums. South America is moving into recession, and the U.S. trade deficit continues to deteriorate.

- Corporate profits have been healthy, and second quarter earnings were higher than anticipated.

With all this good news, why do we need awareness of recession impacts? The answer is “just in case”.
What will happen to Florida’s General Revenue Fund if the economic climate changes and the Nation and Florida are forced to deal with a recession? Not having a crystal ball to look into the future, what would be wrong with looking at Florida’s response to downturns of the past? More specifically, one might assume that the downturn of the early 90's will give us clues about the impacts of downturn in the future. The purpose of this interim project is to offer research data that creates awareness of the impacts of a downturn, awareness of Florida’s response in the past, and awareness of the extent of remedy offered by the Budget Stabilization Fund (BSF).

METHODOLOGY

Quantitative research and analysis of historical data is used to provide three economic models of what impacts a recession might have on the General Revenue Fund.

The state of the economy was garnered from the DRI information provided to the Florida Legislature. Research of the general revenue volatility in Florida since 1970 is provided to illustrate the fluctuation of revenue collections particularly in the 70's and 80's.

Historical data was provided by the Office of Economic and Demographic Research. Similarly, the Office of Economic and Demographic Research provided two possible scenarios of future recessions in Florida.

The two scenarios and the mirror image of the downturn in the early 90’s were overlaid on the projections of General Revenue collections in the near future. The result is a graphic representation of the possible revenue and budget impacts of three models; a mild recession, a deep recession, and a recession mirrored after the last downturn in the early 90's.

In addition to the recession models, a detailed analysis of the effects of the 90's downturn on individual component of sales tax is provided to show what parts of Florida's economic structure were affected and to what extent.

Finally the budget stabilization fund is overlaid on the three models to illustrate the extent to which this fund will mitigate the effects of a recession.

FINDINGS

General Revenue sales tax increases from 1971 to the present have ranged from a high of 22.46% in 1971 to a low of -1.23% in 1991. The volatility mirrored the nations economic trend both in inflationary growth periods and, more recently, stable continuous growth of the economy.

- The peaks following the downturn years are a result of recovery and tax increases . The penny increase in sales tax in 1982 and 1988 (following the repeal of the services tax) indicate both the increase in rate and recovery from each downturn.

- In 1990/91 the rate of change was actually negative at -1.23%. Sales tax collections during the years of the last downturn and recovery may give us a model to predict what might happen in the event of another downturn in the future. Unfortunately, neither the past downturns, the best economic model or Chairman Greenspan can tell us WHEN it will occur if ever. Now let us dissect the component of sales tax.

- Sales tax collections from the Business classification dropped from a increase of 16% to an increase of 7% in 1989/90, dropped to 2% in 1990/91 and bottomed out at 0.5% in 91/92 and recovered very well in 1992/93.

- The Building Industry booming at a 21.5% increase in 1988/89 dropped to a -3.3% change in 1989/90 and even lower the next year with a -6.7% change. The previous decreases were recovered with a 18.6% increase in a 1992/93 and appear to be stable at 6% in the following years.

- Other Durables took a similar path dropping from a high of 16.3% change in 1988/89 to 5.8% in 1989/90, followed by a -2.5% decrease in 1990/91, 0.8% in 1991/92 and recovering in 1992/93 to a 15% increase.

- Automobile sales tax collections fell rapidly from a 16% increase in 1988/89 to 0.2% in 1989/90, to -6.17% in 1990/91, beginning recovery to 3.18% in 1991/92 and recovering to an increase of 18.6% in 1992/93.

- Tourism decreased from an increase of 21% in 1988/89 to an increase of 8.7% followed by stable increases of 4% for two years and then increasing two-fold in 1992/93 to over 10%.

- Consumer Non-Durables generally followed the same path, dropping from a high of 19.4% to an increase of 6.9% in 1989/90, 3.36% in 190/91, 3.8% in 1991/92 and recovering to 10.8% in 1992/93.

Consumer Non-Durables, Automobiles, the Building Industry and Business took hits in percentage change and dollars, with automobiles, other durables and building showing losses in collections from previous years. These losses were followed by a nice recovery in 1992/93, particularly Consumer Non-Durables, Automobiles, Building and Business. Now that we see what happened to General Revenue and more specifically Sales Tax, the next question is: What did we do about it? What was the Legislature's reaction?

Legislatures Reaction to the Shortfall, Downturn, General Revenue Gap of the early 1990's.

December 1989	$271.6 million in Budget Cuts
Session 1990	$186 million in Tax Increases
Post Session 1990	$500 million in Tax Increases
November 1990	$479.9 million in Budget Cuts
January 1991	$270 million in Budget Cuts
March 1991	$170 million used from WCTF (Working Capital Trust Fund)
Post Session 1991	$30 million in Tax Increases
June 1990	$42 million in Budget Cuts
December 1991	$514.2 million in Budget Cuts
December 1991	$15.8 million in Trust Fund Transfers
February 1992	$46 million in unappropriated FEFP
Spec. Sess. 1992	$350 million in Tax Increases
Total Cuts, Transfers or Tax Increases	$2.8 8 Billion

Reserve Funds

Florida has two reserve funds designated for use if revenue collections in the General Revenue Fund are insufficient to meet appropriations. These are the Working Capital Fund, created in 1959, and the Budget

Stabilization Fund, created by Constitutional amendment in 1992.

Working Capital Fund

The Working Capital Fund is established pursuant to s. 215.32, F.S. It is statutorily created and not required by the Constitution. The Working Capital Fund (WCF) accrues from moneys in the General Revenue Fund in excess of the amount needed to meet General Revenue Fund appropriations. The WCF cannot exceed 10% of the preceding fiscal year's net General Revenue Fund collections. The Governor is required to transfer to the WCF by September 15 each year moneys in the General Revenue Fund in excess of the amount needed to meet appropriations for that year. No minimum is required for the WCF. In the event of a shortfall in the General Revenue Fund, the Governor is directed to transfer funds from the WCF in accordance with the procedures in s. 216.221, F.S.

Budget Stabilization Fund

The Budget Stabilization Fund (BSF) was created upon approval of a constitutional amendment placed on the November 1992 ballot by the Taxation and Budget Reform Commission. The relevant portion of that amendment states:

> (g) BUDGET STABILIZATION FUND. Beginning with the 1994-1995 fiscal year, at least 1% of an amount equal to the last completed fiscal year's net revenue collections for the general revenue fund shall be retained in a budget stabilization fund. The budget stabilization fund shall be increased to at least 2% of said amount for the 1995-1996 fiscal year, at least 3% of said amount for the 1996-1997 fiscal year, at least 4% of said amount for the 1997-1998 fiscal year, and at least 5% of said amount for the 1998-1999 fiscal year. Subject to the provisions of this subsection, the budget stabilization fund's principal balance shall be maintained at an amount equal to at least 5% of the last completed fiscal year's net revenue collections for the general revenue fund. The budget stabilization fund's principal balance shall not exceed an amount equal to 10% of the last completed fiscal year's net revenue collections for the general revenue fund. The Legislature shall provide criteria for withdrawing funds from the budget stabilization fund in a separate bill for the purpose only of covering revenue shortfalls of the general revenue fund or for the purpose of providing funding for an emergency, as defined by general law. General law shall provide for the restoration of this fund. The budget stabilization fund shall be comprised of funds not otherwise obligated or committed for any purpose.

While the Legislature has not yet enacted procedures for withdrawing funds from the BSF, s. 216.222, FS, was enacted establishing criteria for transferring money from the Budget Stabilization Fund. These purposes are: offsetting a deficit in the General Revenue Fund, and providing funding for an emergency as defined in s. 252.34, FS. Section 252.34, FS, is part of the State Emergency Management Act and defines emergency as "any occurrence, or threat thereof, whether natural, technological, or manmade, in war or in peace, which results or may result in substantial injury or harm to the population or substantial damage to or loss of property." All required transfers to the BSF have been made. No funds have been transferred from the fund. Interest on moneys in the BSF accrues to the General Revenue Fund.

WORKING CAPITAL FUND

Fiscal Year	July 1 Balance	Transfers into Fund	Interest Credited	Disburse-ments	June 30 Balance
1997-98	$193,670,000	$150,700,000	$16,914,019	$5,808,858	$355,475,171
1996-97	150,396,891	40,125,817	9,751,430	6,604,128	193,670,010
1995-96	161,576,695	0	8,753,289	19,933,093	150,396,891
1994-95	296,203,418	0	15,737,169	150,363,892	161,576,695
1993-94	162,384,316	122,600,000	11,219,102	0	296,203,418

BUDGET STABILIZATION FUND

Fiscal Year	July 1 Balance	Transfers into Fund	Interest Credited	Disburse-ments	June 30 Balance
1999-00	$786,890,000	61,110,000	$0	$0	$847,000,000
1998-99e	686,000,000	100,900,000	0	0	786,900,000
1997-98e*	409,390,000	276,610,000	0	0	686,000,000
1996-97	260,790,000	148,600,000	0	0	409,390,000
1995-96	120,590,000	140,200,000	0	0	260,790,000
1994-95	0	120,590,000	0	0	120,590,000

Both Funds together create a reserve of $1.2 billion.

We have provided a "state of the economy", provided historical data of percentage changes in General Revenue sales tax since 1971, provided detailed information of the components of sales tax and their response to an economic downturn, communicated the Legislative response to the most recent downturn.

Now, what about the future? Will we have another downturn? If we do, what are some possible scenarios? How will the Florida Legislature respond to a downturn "now simulated" that mirrors the most recent downturn? What are some other scenarios? "What are the probabilities of each simulated scenario? Will the budget stabilization fund be adequate or will the Legislature have to cut services and/or increase taxes?

Models of Recession

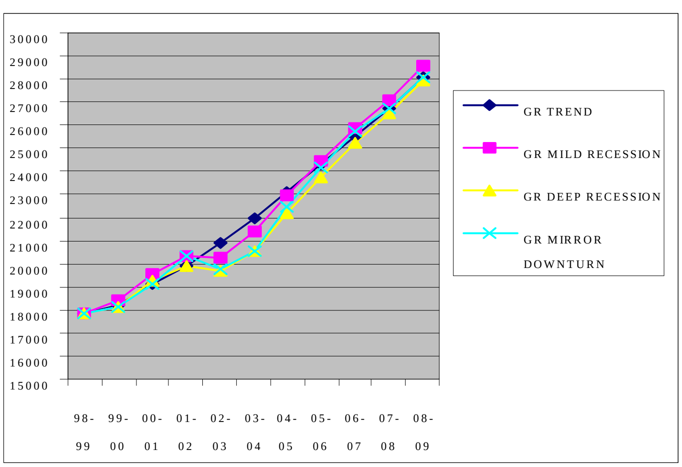
The following approach is to first identify the Estimating Economic Conference Trend projections for General Revenue. Next, Frank Williams, Economist with Demographic and Research, created two scenarios using DRI data adjusted for Florida: a mild recession, and a deep recession. For a third scenario we simply mirror the percentage changes of the early 90's downturn on the trend projections of the future, adjusting the percentage change by adding back the budget cuts and tax increases . According to DRI the stable trend has a 60% probability, the mild recession has a 25% probability and the deep recession has 15% probability. The probability of the mirrored scenario, more similar to the deep recession, is also estimated at 25%.

In the ***mild recession scenario***, inflation remains low as oil and commodity prices fail to recover in 1999. Consumers continue to spend as their confidence remains high, wealth rises, jobs remain plentiful, and wages increase. The economy continues to soar and is boosted further by spending on the year-2000 problem.

In 1999, businesses boost inventories to guard against millennium bug-related production problems. Businesses also create additional spending as they pour money into computer hardware and software to ensure a smooth transition to four-digit year dates. Given the extra inventory buildup and the surge in computer spending, real GDP grows 3.3% in 1999.

As the labor market tightens, the Federal Reserve, fearing a surge in inflation led by a tight labor market, begins to apply the brakes in early 2000. By the beginning of 2001, the economy is still strong and the Fed's action has failed to slow the economy. The Fed raises rates again in the spring of 2001 and continues raising rates until the federal funds rate reaches 6.0% at the end of the year.

With the Fed tightening, the stock market begins to correct. The S&P 500 index peaks in 2001:3 at 1543.0. It then tumbles almost 43% to a low of 865.8 in 2002:3 (63% of the trend forecast in that quarter), leaving the index at its lowest level since 1997:2 (it doesn't surpass its peak until 2005:4). The slide drags down consumer confidence and spending. The economy falls into a four-quarter recession during 2001-02. Real GDP peaks in 2001:3 at $8202.9 billions (saar), and it reaches its trough of $8023.6 billion in 2002:3, tumbling 2.2%, peak to trough.



In the midst of the recession, consumer sentiment sinks to 64, its lowest level since the 1981/82 recession. Weak profits and declining output force layoffs, and the unemployment rate climbs to 7.0% by the beginning of 2003. The Fed reacts to the economic downturn by cutting the federal funds rate to 5.25% by mid-2002 and 4.84% by late-2003.

In the ***deep recession scenario***, the swing in investment in inventories is magnified, as is consumer confidence (reaching a low of 61) and consumer spending. However, the stock market does not increase as much as under the mild recession scenario, but the slide is deeper.

Under the deep recession real GDP peaks at $8200.2 billion (saar) in 2001:3. It then declines for 5 consecutive quarters, with a trough in 2002:4 at $7948.1 billion. This is a fall of 3.1% (peak-to-trough). It isn't until 2004:1 (the 5th quarter of the recovery) that real GDP surpasses its pre-recession peak.

The S&P 500 index peaks in 2001:2 at 1455.5. It then falls for 5 quarters to a low of 838.9 in 2002:361% of the trend forecast in that quarter. This represents a decline of 42.4% in the value of stocks its lowest level since 1997:2. It doesn't surpass its peak until 2004:3.

While the Fed's reaction in staving off inflation is similar to the mild recession scenario, weaker consumer confidence, greater job losses (the unemployment rate peaks at 7.8% in 2003:2), and larger inventory correction requires bigger cuts in the federal funds rate to generate a recovery. The rate reaches a low of 3.75% in 2004:1.

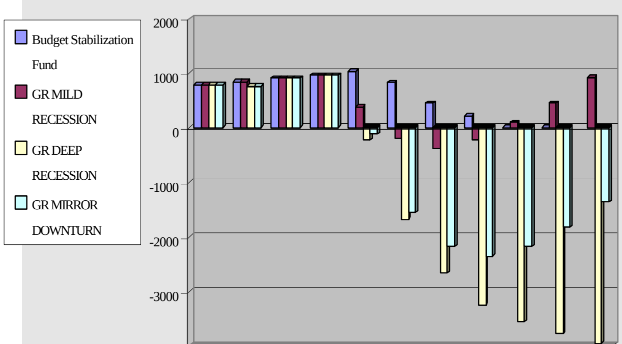
The ***mirror image scenario*** applies the downturns of the 90's to the revenue forecast of tomorrow: Like the downturn of the early 90's tourism ironically drops some, but is not reduced as much as automobiles or the building industry. The cummulative reduction in sales tax as a result of the mirror scenarios is $2.24 billion. All general revenue sources, however are reduced by $3.38 billion compared to $2.8 billion in the early 90's. This is not surprising since the mirror image scenarios applies the percentage reductions of the early 90's to a larger trend base of the future.

The mild recession depleted the fund in three years. The deep recession depleted the fund in one year. The mirror scenario depleted the Budget Stabilization Fund in the first year as well.

Budget Stabilization Fund will not be adequate to shield the budget from cuts. The Legislature will again have to make tough choices to balance the budget in each of the simulated scenarios. The Budget Stabilization Fund as it exist today is a band-aid that stops the bleeding until the following session. Florida should be proud that policy makers and citizens created the budget stabilization fund, but should not assume that it cures the problems of a recession. In fact, the requirement to replenish the fund each year during the downturn digs the hole deeper.

RECOMMENDATIONS

Like thirty-two other states, Florida, has created a budget stabilization or “rainy day” fund to ease the pain of a future downturn in the revenue collections. During the most recent downturn, the Florida Legislature cut budgets by more than$1.5 billion. Yet, what is generally perceived is that the Florida legislature raised taxes; tax increases during the downturn were only $1.0 billion compared to $1.8 billion in cuts and transfers. The downturns of the 80's however, each resulted in penny increases in sales tax.



	98-99	99-00	00-01	01-02	02-03	03-04	04-05	05-06	06-07	07-08	08-09
Budget Stabilization Fund	786	847	908.5	970	1031.5	825.09	448.81	216.79	0	0	
GR MILD RECESSION	786.00	847	908.5	970	387.23	-206.41	-376.28	-232.01	95.55	456.44	921.70
GR DEEP RECESSION	786.00	763.99	908.5	970	-223.86	-1681.6	-2665.4	-3243.9	-3554.5	-3782.9	-3949.3
GR MIRROR DOWNTURN	786.00	763.99	908.5	970	-116.68	-1550.8	-2183.9	-2351.2	-2185.8	-1824.9	-1359.7

We have a 60% probability of not having a severe downturn during the forecast period, but the possibility also exists that by the time this interim study is published and presented to the Fiscal Resource Committee, we could be discussing budget cuts to balance the 2000/01 fiscal year. Chairman Greenspan, economic models, our Revenue Estimating Conference, or our Office of Economic and Demographic Research will not be able to predict when, if ever, a downturn will occur. In fact, there is almost a 100% probability that all of us will miss the next downturn in our forecasts. We can take comfort in the recent stable economic growth with less volatility than in inflationary years, and in the prudent policy of the Florida Legislature of continuing the contributions to the Budget Stabilization Fund. While the fund is not adequate to shelter the State from budget cuts in the event of a downturn similar to any of the scenarios presented in this interim project, the fund will allow policy makers time to make decisions about the best response. The budget stabilization fund has already helped Florida keep good bond ratings and will likely prevent a emergency decision mode. Additionally, an opportunity may exists, because of the BSF, to fund expenditures that enhance economic recovery, such as construction of schools or roads.

The purpose of this project is to aid in the awareness of the economic downturns of the 70's, 80's and early 90"s. Similarly, we want to report the responses of the Florida Legislature in the past; to present scenarios of possible effects of economic downturns on Florida’s revenue stream and to demonstrate the extent of remedy offered by the Budget Stabilization Fund.

Hopefully, this is only an exercise in awareness. But if a downturn exists in the near future, Florida Policy makers can know which parts of the economy were affected in the most recent downturn and have at least one model of possible responses to assure that Florida has a balanced budget and can continue providing services to the Citizens of Florida.

After reading this report, legislators might consider the need to accelerate the contributions to the budget stabilization fund and perhaps even increase the cap beyond the maximum of 10% of previous year Net General Revenue.

COMMITTEE(S) INVOLVED IN REPORT ***(Contact first committee for more information.)***
Committee on Fiscal Resource, 404 South Monroe Street, Tallahassee, FL 32399-1100, (850) 487-5140 SunCom 277-5140

MEMBER OVERSIGHT
Senators Grant and Sebesta