Along for the **Ride?**

A look at the economy and consumer spending

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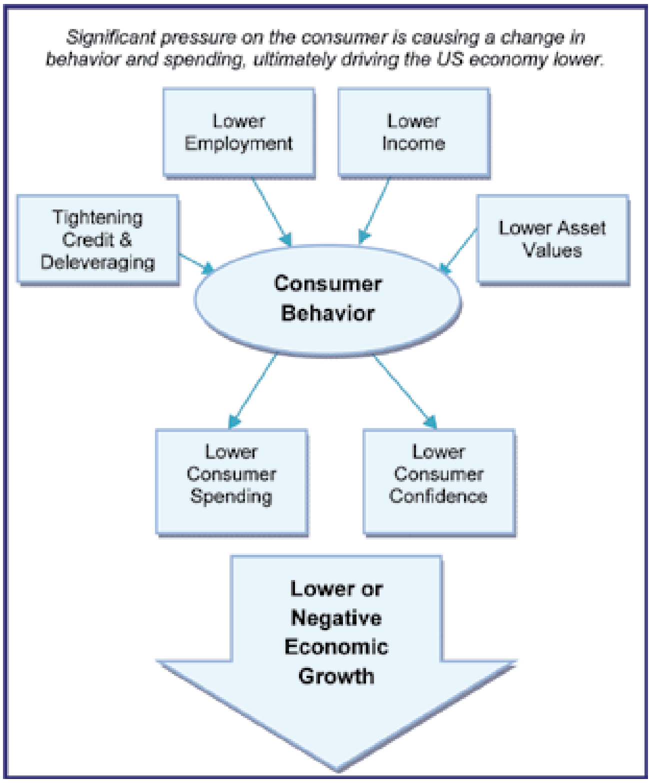

The past year brought a dramatic shift in the way consumers spend – and save. While this phenomenon affects the retail economy, it also has the potential to create changes in our overall economic environment that affect boroughs and other local government entities.

Over the past year, consumer spending has declined rapidly, resulting in an interesting "chicken-or-egg" conundrum: Are current economic conditions causing the dramatic drop in consumer confidence? Or is the belt-tightening behavior of the consumer driving our economy further into recession?

In fact, parts of both are true.

Fifty years ago, consumer consumption accounted for 60 percent of the Gross Domestic Product (GDP) in the US. Today, it stands at 71 percent. For the past several years, the U.S consumer has been the engine that has driven much of the growth in the global economy. This growth resulted in part from a rising income – we earned more, so we spent more – but much of it stemmed from borrowing and a reduced savings rate.

In recent years, however, a collection of economic events have created the perfect storm for consumer concern: dropping employment levels, sinking home equity values and the tightening of credit all made the American consumer more fearful, and they are protecting their wealth by spending less.

Spending and Saving: Shifting Consumer Priorities

Recent data indicate that consumers have developed new spending patterns. For example, personal savings levels as a percentage of personal income nearly tripled from 0.55 percent in 2007 to 1.45 percent during 2008. After months of layoffs, rising jobless claims and other dire economic news, it seems that consumers are opting to hold some cash in reserve in case of emergencies.

But in today's economy, even the act of saving has given consumers cause for concern. In recent months, inflation-adjusted incomes have fallen – that is, what we earn now buys less than it used to. The year-to-year change in average hourly earnings has remained below the Consumer Price Index for more than a year, and consumers have been forced to reevaluate their necessities and luxuries as their real wages decline.

Add to that the steep decline in the stock market, as consumers watch their 401(k) accounts and other investments decline and their homes lose value, and it is no surprise that consumer confidence recently reached a 28-year low.

As an expression of this lack of confidence, consumers are steering clear of most discretionary spending. Advance retail sales show flat or negative growth in every sector of the economy except for necessities like groceries and healthcare.

The lack of consumer confidence and a slowdown in overall consumption have created a ripple effect on American business. With a drop in consumer demand, businesses are forced to cut back on their workforces and secondary business with vendors. Job loss affects consumer confidence and spending practices – and the cycle continues. (See diagram.)

An index of consumer expectations for six months from now, which more closely projects the direction of consumer spending, dropped below projections, suggesting that consumers may remain cautious of their spending well into 2009.

The Effect on Boroughs

What do all these changes mean for local governments and municipalities? First and foremost, the rapid decline in consumer spending (remember, consumer spending accounts for about 71 percent of GDP) weakens our economy as a whole. That has resulted in job loss, foreclosures and a host of related challenges that have had real consequences for boroughs.

For example, local governments are suffering multiple blows to their tax revenues: lower employment hurts income tax revenue, decreased consumer spending affects sales tax revenues and the drop in housing values lowers property and transfer tax receipts.

Lower tax income will affect the number of infrastructure repairs and other improvement projects that can be undertaken by municipalities and may even have an impact on increasing or even maintaining current workforce levels.

Some variables exist that may change the consumers' view of the economy. New policies and priorities may spur consumers to take the first few tentative steps toward looser discretionary spending. But if the consumer's perception of the economy continues to deteriorate, it is possible that the US economy may experience a prolonged and deep recession. **(B)**

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