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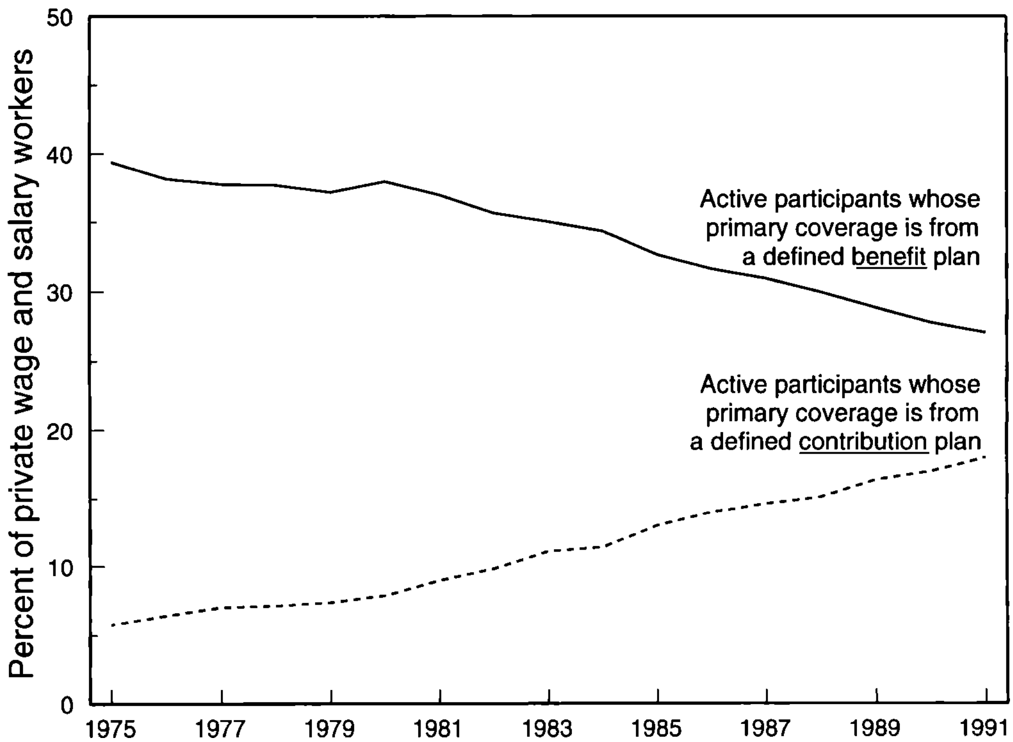
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

Prepared by the Council of Economic Advisers
with the assistance of the Office of the Vice President

September 19, 1994

CHART OF THE WEEK

The Changing Composition of Pension Coverage



Over the past two decades, there has been a marked evolution in the pension coverage of American workers away from "defined benefit" plans and toward "defined contribution" plans. Defined benefit plans offer a more predictable payout to the employee upon retirement. On the other hand, defined contribution plans offer greater portability between jobs, and place no burden of insurance on the Pension Benefit Guarantee Corporation.

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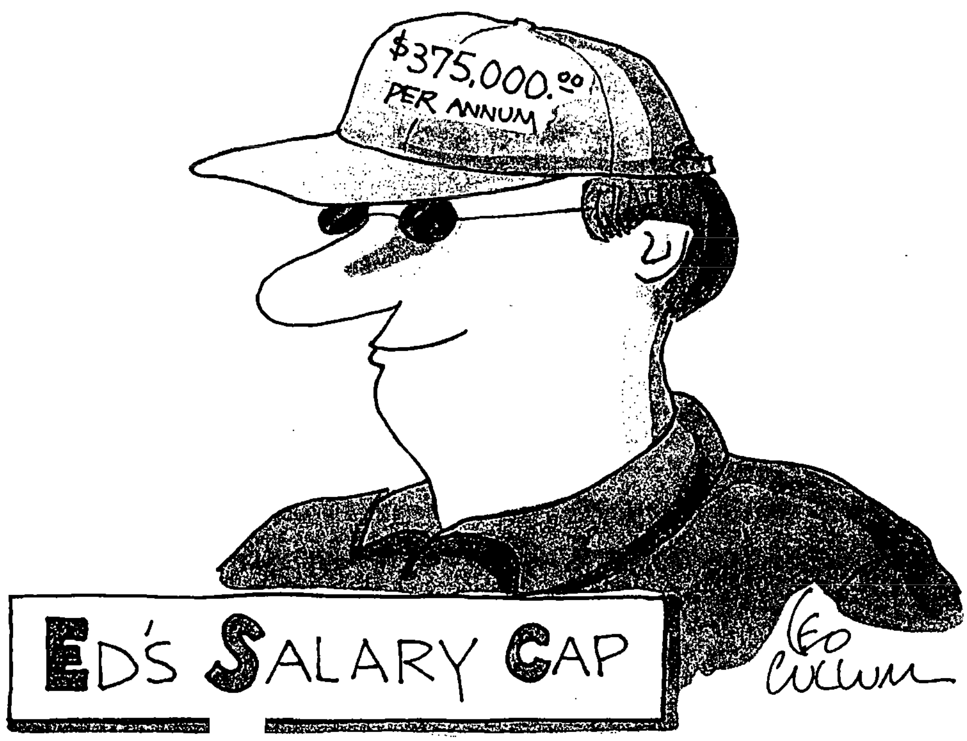
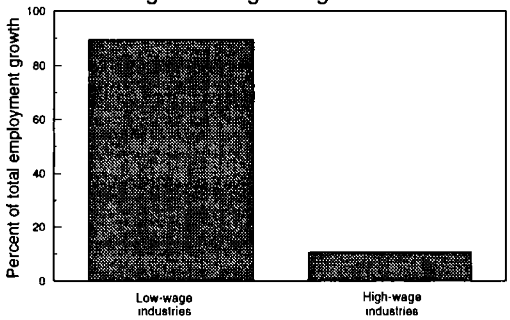
CONTENTS



TREND

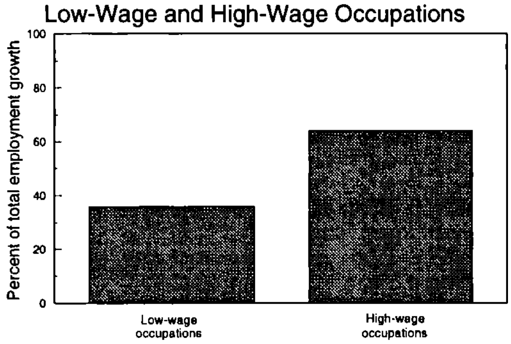
Update on the Quality of Jobs

Employment Growth in
Low-Wage and High-Wage Industries



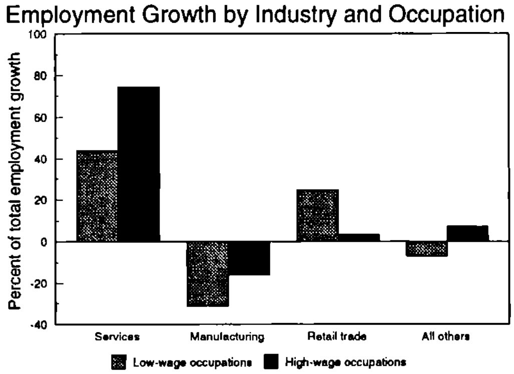
Job growth by industry. Job growth in recent years has been concentrated in low-wage industries, especially services. Jobs have been shed in many high-wage industries such as manufacturing. Overall, an estimated 89 percent of net new jobs created between 1988 and 1993 were in industries with below-average wages while only 11 percent were in industries with above-average wages (see chart). Many observers have inferred that the jobs created during those years were "bad" jobs.

Employment Growth in
Low-Wage and High-Wage Occupations



Job growth by occupation. Others have countered that 64 percent of the job growth between 1988 and 1993 was in high-wage occupations (see chart), especially managerial, professional, and technical occupations. Far fewer jobs were created in low-wage occupations. Thus an apparent puzzle: The data by occupation indicate that the recently created jobs were "good" jobs, which seems to contradict the industry data.

Employment Growth by Industry and Occupation



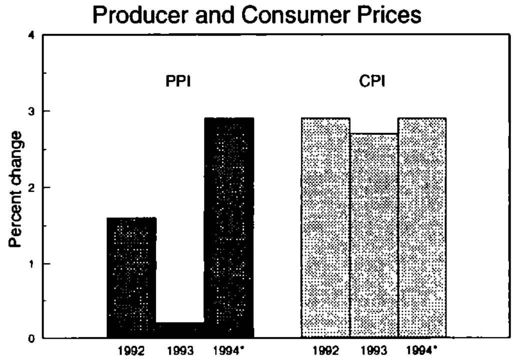
The puzzle solved. Calculations performed recently by the Bureau of Labor Statistics indicate that <u>most of the net new jobs created over the last five years were in *high-wage occupations* located in *low-wage industries*</u>. For example, fully three-fourths of net new jobs created between 1988 and 1993 were high-wage jobs in the "low-wage" services industry (see chart). In manufacturing, too, there was a compositional shift from low-wage jobs to high-wage jobs, though only because the job losses were greater at the low end of the wage spectrum than at the high end. Managerial jobs in the services sector—although high-wage—do not pay as much, on average, as managerial jobs in the manufacturing sector. The median weekly earnings of a manager in manufacturing in 1993 was $804, compared with $598 in services.

CURRENT DEVELOPMENT

Inflation Clouds on the Horizon?

Producer prices for finished goods jumped 0.6 percent in August, pushing the increase thus far this year to 2.9 percent at an annual rate (see chart). Last year, producer prices were essentially unchanged.

Producer and Consumer Prices



* Year-to-date at an annual rate

Consumer prices increased a more moderate 0.3 percent in August. Thus far in 1994, these prices have increased 2.9 percent at an annual rate, about the same as in 1992 and 1993 (see chart). Consumer prices for food and energy have moved higher this year, and the CPI excluding those two categories has increased a bit more slowly this year than last.

Analysis. In the last few weeks, the price of crude oil has retreated a bit from its recent peak, and prices at the gasoline pump may have edged down in September. Consumer coffee prices, which have increased more than 20 percent in each of the last two months, have leveled out at the wholesale level. As a result, the next reading or two on the CPI for food and energy may be more favorable.

Nonetheless, there are some signs that inflationary pressures may be intensifying. The prices of imported goods other than oil have increased 3 percent at an annual rate thus far this year, up from 1-1/2 percent last year. Unit labor costs in the nonfarm business sector increased 3.2 percent at an annual rate in the first half of this year, compared with 0.6 percent last year. Commodity prices have shot up this year—12 percent according to one measure, 20 percent according to another. And capacity utilization in manufacturing reached 84.3 percent in August, the highest level since April 1989, indicating that manufacturers may have greater latitude to pass these cost increases on in the form of higher finished goods prices.

CURRENT DEVELOPMENT

Financial Chaos Strikes Venezuela

The economic and financial situation in Venezuela has deteriorated sharply this year. In January, the country's second largest bank was closed by the government at a cost of more than 4 percent of Venezuelan annual GDP. Since then, nine more banks have received financial assistance, bringing the total cost thus far to about 10 percent of GDP. (For comparison, resolution of the savings and loan debacle in the United States cost less than 3 percent of U.S. annual GDP to resolve.) Inflation has increased, the value of the currency has fallen by half, and real GDP is projected to decline significantly this year.

Government response. In response to the unfolding crisis, the government has: introduced price controls on basic consumer goods and services; required importers and exporters to transact all foreign currency business with the central bank; established an emergency board to take control of the nation's commercial banks; and placed the central bank under government control once again. On September 12, the government announced its intention to take further steps toward the resolution of the situation.

Analysis. The United States has a stake in the outcome of this crisis. Venezuela is our third largest export market in Latin America and our 19th largest overall. The controls on foreign exchange and the economic contraction are reducing imports into Venezuela. Eight large American banks have a total of about $4 billion outstanding in loans to Venezuelan borrowers (about 2-1/2 percent of their combined foreign exposure). And prospects for Venezuelan inclusion in an expanded NAFTA now seem remote.

ARTICLE

Flat-Earth Society Proposes Flat Tax

As part of their "compact with the American people" to be unveiled later this month, Republicans may propose that the existing individual income tax system be scrapped in favor of a "flat tax." (They may also propose a companion overhaul of business taxation.)

Major elements of the plan. While details of the proposal are still being fine-tuned by its architects, currently available information suggests that:

- Only labor income (e.g., wages, salaries, and pension benefits) would be subject to taxation. Capital income (e.g., dividends, interest, rent, and royalties) would be exempt from taxation.
- The only allowable deductions would be $12,350 each for the taxpayer and (for a joint return) spouse, and $5,000 for each dependent. No deductions would be allowed for mortgage interest, state or local taxes, charitable contributions, or any other currently allowable purpose.
- A single tax rate of 17 percent would be applied to taxable income (labor income net of deductions).

The plan would abolish income-tax withholding and require taxpayers to write a monthly check to the Internal Revenue Service (IRS).

Arguments for the plan. Proponents will argue that the plan has the following desirable effects. According to them,

- A family of four with less than $34,700 in labor income would pay no income tax. In 1992, median total family income (including capital income) was about $36,800. Therefore, many families would pay no income tax.
- The exclusion of capital income from taxation would encourage saving. (Many analysts are skeptical of the magnitude of this effect.)
- The abolition of income-tax withholding would increase taxpayer scrutiny of government outlays because taxpayers would be regularly reminded of the full cost of their Federal income taxation.
- Relative to the current system, the proposed flat tax would be more neutral toward marriage.
- The simplicity of the new system would reduce the amount of time that taxpayers spend filling out their tax returns each year. Currently, taxpayer compliance with Federal and state personal income taxes is estimated to consume 3 billion hours per year (or about 1-1/2 percent of hours worked).

Problems with the plan. There are other effects of the plan that its proponents no doubt will fail to highlight. In particular,

- CEA estimates that the proposal would raise only about $300 billion, or roughly half as much revenue as the current income-tax system raises, even assuming that taxpayers make no effort to "game" the new system.
- Tax avoidance under the new system could be relatively easy and richly rewarded. Taxpayers would seek to transform as much of their "labor" income into "capital" income as possible. For example, owners of small businesses could pay themselves a meager salary and take the rest of their compensation in the form of "dividends." It is difficult to estimate the revenue loss from this source, but it could well be substantial.
- Although it would be somewhat progressive, the new system would probably be less progressive than the current income tax. The average tax rate on upper-income Americans would fall from well over 25 percent currently to considerably less than 17 percent under the new system.
- The shift to the new system would produce large gains for some taxpayers and considerable losses for others. Owners of assets with unrealized capital gains would enjoy a windfall gain, of up to 28 percent of the unrealized gain. In 1989, unrealized capital gains totaled an estimated $6.3 trillion. Municipal bond prices would probably decline about 20 percent; house prices would also drop sharply.
- For many taxpayers, the new tax system would be less simple than the current one because they would be forced to pay taxes twelve times per year. (There would be genuine simplification for those who itemize their deductions and those who have complicated transactions to report.) The new system would also create significant new burdens for the IRS, both in processing the monthly payments and in attempting to monitor the division between labor and capital income.

Solutions to the problems? Some of the shortcomings of the proposed plan would be relatively easy to fix. For example,

- The flat tax could be made to raise the same amount of revenue as the current system by increasing the tax rate or reducing the deductions.
- At the cost of "flat"-ness (a characteristic with more popular than substantive appeal), additional progressivity could be achieved by subjecting higher levels of income to higher marginal tax rates.

But some of the defects plaguing the "flat tax," including the fungibility of labor and capital incomes, would be difficult to address.

The flat tax with capital income exclusion can be viewed as one version of a consumption tax (albeit, one with many flaws). Several other proposals for such a tax (e.g., Nunn-Domenici, Boren-Danforth, and the Bush Administration's "Comprehensive Business Income Tax") avoid at least some of these flaws.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Technological Triage Cuts Costs. Fewer than 30 percent of those admitted to high-tech coronary care rooms as possible heart-attack victims are subsequently found to have suffered heart attacks. The costs of monitoring the other 70 percent add up quickly—to perhaps $4 billion per year. But relief may have arrived: The New England Journal of Medicine reports that by measuring changes in a blood enzyme, a new test can greatly speed the identification of heart-attack victims. In clinical trials, currently available tests correctly identified only 48 percent of all victims within 6 hours of the suspected event, while the new test had a success rate of 96 percent. Faster identification of non-victims should give rise to substantial savings by allowing doctors to provide them with lower-cost care.

A House Divided in Japan. Pressure on Japan's government for further liberalization of financial markets is now coming from the most unlikely of sources: from within. The Ministry of Health and Welfare, which manages $200 billion in pension reserves, has formally asked the Ministry of Finance for permission to hire investment advisers, including foreign fund managers. Under Japan's strict pension regulations, its $1-1/2 trillion pension market has been the province of a handful of Japanese trust banks and life-insurance companies. But recently, the return on the health ministry's portfolio has lagged, prompting the ministry to look abroad for help.

We're Number One—But at What, Exactly? According to the 1994 World Competitiveness Report, the United States has displaced Japan as the most competitive economy in the world for the first time since 1985. In compiling their ranking, the authors looked well beyond the usual indicators of a country's competitiveness. For example, the United States was boosted in the standings because it ranks number one in terms of exports of goods and services, computer power per capita, and Nobel prizes. But there are plenty of areas for further improvement: For example, U.S. managers indicated the greatest level of dissatisfaction over alcohol and drug abuse by their employees. In addition, the United States ranked first on serious crime, with the highest number of murders, other violent crimes, and armed robberies reported per inhabitant.

Fed Roundup: The Economy's Bubbling, But Not Boiling Over. Economic activity continued to expand moderately through the summer, according to the Federal Reserve's most recent "beige book" roundup. Regions that had lagged during the expansion are now growing more strongly, while those that recovered rapidly are seeing growth level off. Nationally, consumer spending and commercial demand for bank loans continue to grow, although more slowly than in the recent past. Summer tourism was up strongly over last year. Despite the strength of the expansion, the survey turned up few signs of an imminent pickup in inflation. Although labor markets have continued to tighten and industrial materials prices have further edged up recently, price pressures from both sources are still described as modest.

RELEASES THIS WEEK

Industrial Production   **Embargoed until 9:15 a.m., Friday**

The index of industrial production rose 0.7 percent in August. Total capacity utilization rose 0.4 percentage point to 84.7 percent.

Consumer Prices

The consumer price index rose 0.3 percent in August. Excluding food and energy, consumer prices also rose 0.3 percent.

Retail Sales

Retail sales increased 0.8 percent in August. Excluding sales in the automotive group, retail sales were up 0.7 percent.

MAJOR RELEASES NEXT WEEK

U.S. International Trade in Goods and Services (Tuesday)
Housing Starts (Wednesday)

U.S. ECONOMIC STATISTICS

	1970-1993	**1993**	**1993:4**	**1994:1**	**1994:2**
Percent growth (annual rate)					
Real GDP	2.5	3.1	6.3	3.3	3.8
GDP deflator	5.5	1.8	1.3	2.9	2.9
Productivity					
Nonfarm business	1.2	1.9	4.9	2.9	–2.5
Manufacturing (1978-93)	2.3	4.8	7.9	6.8	4.5
Real compensation per hour	0.6	–0.2	–0.6	3.9	–1.9
Shares of Real GDP (percent)					
Business fixed investment	11.0	11.5	12.0	12.2	12.4
Residential investment	4.7	4.1	4.3	4.4	4.4
Exports	8.0	11.7	12.0	11.8	12.1
Imports	9.2	13.2	13.6	13.8	14.2
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	2.9	2.7	2.9
Federal surplus	–2.8	–3.8	–3.4	–2.7	–2.2

		1993	**June 1994**	**July 1994**	**August 1994**
Unemployment Rate	6.7*	6.8*	6.0	6.1	6.1

*Figures beginning 1994 are not comparable with earlier data. The 1993 unemployment rate is estimated to have been 7.4 percent on a basis comparable to the 1994 data.

			June 1994	**July 1994**	**August 1994**
Payroll employment (thousands)					
increase per month			383	251	179
increase since Jan. 1993					4274
Inflation (percent per period)					
CPI	5.8	2.7	0.3	0.3	**0.3**
PPI-Finished goods	5.0	0.2	0	0.5	0.6

New or revised data in **boldface**.

FINANCIAL STATISTICS

	1992	1993	July 1994	August 1994	Sept. 15, 1994
Dow-Jones Industrial Average	3284	3522	3718	3797	3954
Interest Rates					
3-month T-bill	3.43	3.00	4.33	4.48	4.58
10-year T-bond	7.01	5.87	7.30	7.24	7.35
Mortgage rate, 30-year fixed	8.40	7.33	8.62	8.51	8.66
Prime rate	6.25	6.00	7.25	7.51	7.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level Sept. 15, 1994**	**Percent Change from Week ago**	**Year ago**
Deutschemark-Dollar	1.548	−0.5	−3.0
Yen-Dollar	99.4	0	−6.4
Multilateral (Mar. 1973=100)	88.07	−0.7	−3.0

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	4.0 (Q2)	6.1 (Aug)	2.9 (Aug)
Canada	3.9 (Q2)	10.2 (Jul)	0.1 (Jul)
Japan	−0.0 (Q1)	2.9 (Jun)	0.6 (Jun)
France	2.0 (Q2)	12.4 (Jun)	1.6 (Jul)
Germany	2.3 (Q2)	6.6 (Jun)	2.9 (Jul)
Italy	0.6 (Q1)	11.9 (Apr)	3.5 (Jul)
United Kingdom	3.7 (Q2)	9.6 (Jul)	2.4 (Jul)