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WEEKLY ECONOMIC BRIEFING
OF THE PRESIDENT OF THE UNITED STATES

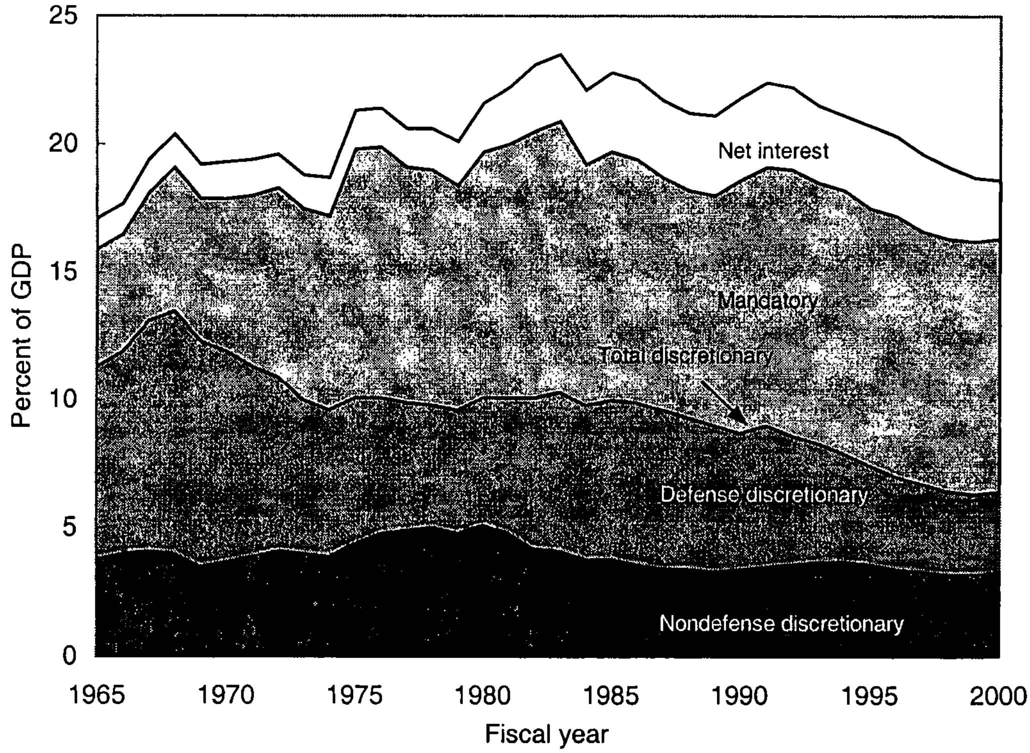
Prepared by the Council of Economic Advisers
with the assistance of the Office of the Vice President

August 4, 2000

Copied
Bailey
Podesta

CHART OF THE WEEK

Federal Budget Outlays as Share of GDP



All budget enforcement act categories of Federal outlays fell as a share of GDP between 1992 and 2000, led by a drop of 1.9 percentage points in discretionary spending for national defense. Net interest fell 0.9 percentage points; mandatory spending fell 0.5 percentage points; and nondefense discretionary spending fell 0.3 percentage points. The total decline in Federal outlays as a share of GDP was 3.5 percentage points (reflecting rounding).

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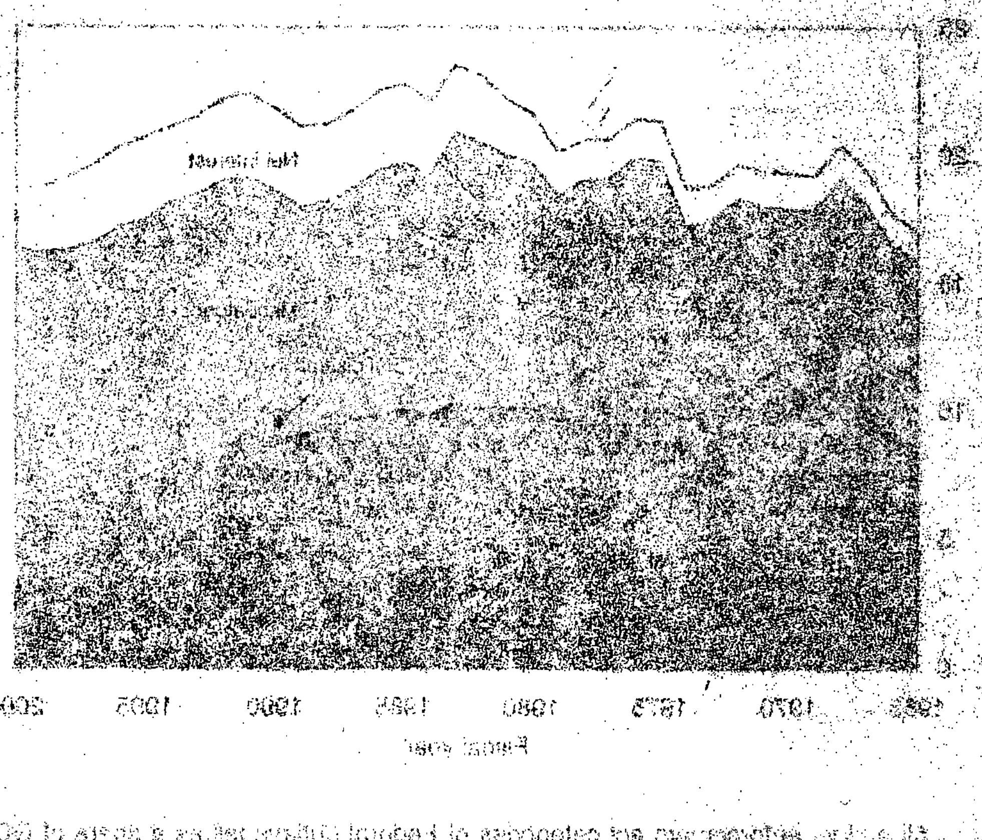

All major expenditure categories of Federal outlays fell as a share of GDP between 1992 and 2000, led by a drop of 1.6 percentage points in discretionary spending for national defense. Net interest fell 0.7 percentage points, mandatory spending fell 0.5 percentage points, and nondefense discretionary spending fell 0.3 percentage points. The total decline in Federal outlays as a share of GDP was [illegible] percentage points (reflecting rounding).

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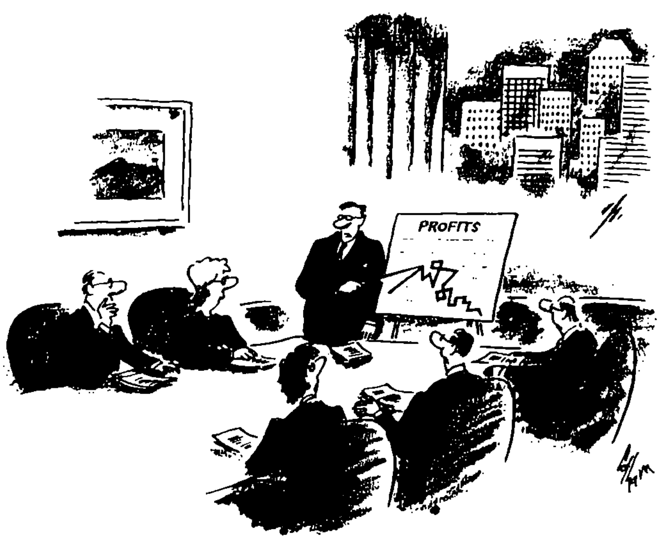


"This is where things started getting really weird."

THE PRESIDENT HAS SEEN
8 · 8 · 00

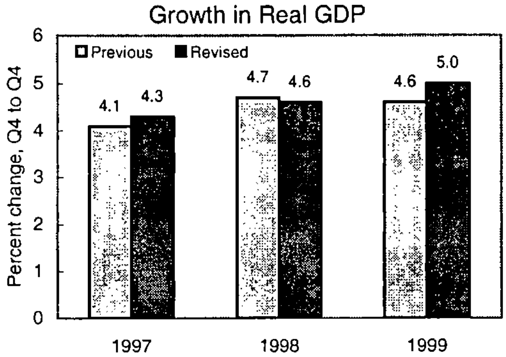
CURRENT DEVELOPMENT

GDP Revisions Raise Output, Implying More Productivity

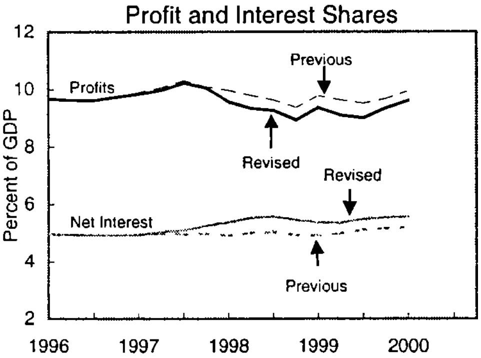
Last week the Commerce Department issued revised national income accounts for 1997 and beyond which showed slightly stronger growth in GDP. Official measures of productivity growth are likely to be revised upward as a result.

Growth in GDP. Revisions to real GDP growth for 1997 and 1998 were small and partially offsetting (see upper chart). But the 0.4 percentage point upward revision in 1999 (due to upward revisions to software investment and farm inventories) was substantial. Over the 1997-2000 period of the revisions, the average annual growth rate of GDP was revised up a little over 0.1 percentage point.

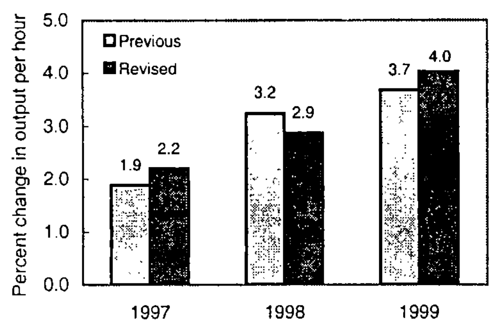
Growth in Real GDP



Profit and Interest Shares



Growth in Nonfarm Productivity



Income. Because real GDP measured on the income side of the accounts (gross domestic income) was not revised much, the increase in GDP reduced but did not eliminate the statistical discrepancy. Labor's share of income was reduced slightly reflecting a downward revision to employers' contributions to pensions and health insurance. The capital share was revised up slightly reflecting more depreciation. Estimates of capital income were reallocated as new IRS tabulations resulted in an upward revision to interest payments and an offsetting downward revision to profits (see middle chart). The profit share of GDP peaked in mid-1997.

Productivity. This upward revision to real GDP growth in 1999, together with changes in hours, is likely to result in a 0.3 percent upward revision to 1999 productivity growth (see lower chart).

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SPECIAL ANALYSIS

Coastal Erosion and National Flood Insurance

A significant and expanding number of Americans live in coastal areas at risk from both storm-related flooding and coastal erosion. The National Flood Insurance program (NFIP) was not designed to address coastal erosion, yet *de facto* it covers many kinds of erosion damage without incorporating erosion risk into its premium structure. As a result, it provides incentives to build or buy in areas subject to such erosion.

Down at the shore. Coastal areas are inherently dynamic and unstable, and most U.S. coastlines have historically contracted landward as a result of storms, currents, and geological processes. About 338,000 structures are located within 500 feet of an ocean or Great Lakes shoreline. An estimated 87,000 of these are located in areas that will be damaged by erosion in the next 60 years if current erosion rates continue. Estimated annual property losses from coastal erosion are about $500 million per year.

Risk and insurance. The National Flood Insurance Program administered by the Federal Emergency Management Agency (FEMA) was instituted in 1968 as a policy response to flood risk throughout the United States. While NFIP premiums are based on flood risk and do not take into account the risk of loss from erosion, a recent evaluation found that claims for erosion losses were almost always paid. As a result, the insurance premium tends to be too low for houses at high erosion risk—and therefore cross-subsidized by houses with lower erosion risk. Because individuals do not bear the full risk of building in erosion hazard areas, more building takes place and more houses are lost to erosion. A recent study found that development density in high-risk areas rose to a level closer to that in low-risk areas after the enactment of the NFIP. This suggests that the program has indeed increased the incentives to develop in risky areas.

Why does it matter? The current system effectively subsidizes a group of coastal property owners who build in risky areas. In addition, greater development in erosion hazard areas increases the pressure on all levels of government to provide protection through costly public works projects that attempt to prevent erosion. These include the construction and maintenance of shoreline engineering (seawalls, groins, and jetties) and the execution of beach nourishment projects (pumping or trucking sand onto the beach from other locations). Shoreline engineering detracts from the recreational and aesthetic experiences of visitors and can negatively affect coastal ecosystems; nourishment projects can increase erosion or siltation in areas used as the source of sand.

Policy challenges. Changes in the structure of NFIP premiums could provide better incentives for efficient coastal development. FEMA has the ability to develop and disseminate maps displaying the best available information on erosion risk by specific location at a cost of about $44 million over 10 years.

These maps can provide information to make NFIP premiums better reflect the risks they insure. This information can also help individuals to make more informed decisions about building or buying in erosion hazard areas. But these changes could make some homeowners worse off.

Impact on property owners. Recent research indicates that flood insurance rates in designated high-hazard coastal areas would have to roughly double to fully cover erosion risks, rising by about $0.90 per $100 of coverage. A survey of homeowners in erosion zones indicates that roughly half would voluntarily buy insurance against erosion losses at a cost of $1-2 per $100. This suggests that the necessary rate increase, while unlikely to be popular, would be tolerated. In addition to any impact on insurance premiums, developing better information could affect coastal property values. The market value of existing homes found to be at high erosion risk may decrease, while homes near the coast found to be at relatively low risk could see their value increase.

Implications. The interests of property owners in the coastal zone do not always coincide with the interests of the wider group of Americans who value beaches as recreational and environmental assets. Government policies that affect the density of coastal development and the direct management of coastal resources need to balance carefully the sometimes-competing needs of both groups. Providing accurate information on erosion hazards and using this information to set NFIP premiums to reflect both erosion and flood risks can help establish this balance.

8 - 8 - 00

ARTICLE

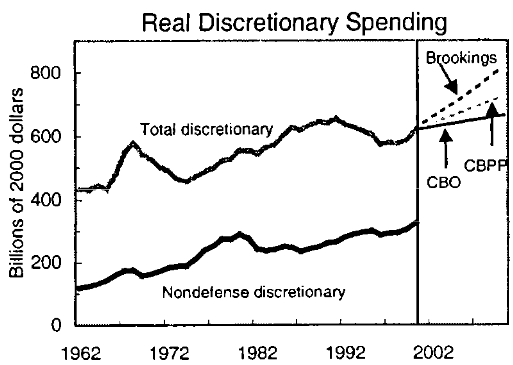
Carving up the Pie: How Big Is the Available Surplus?

CBO's latest estimate of cumulative non-Social Security baseline budget surpluses is $2.2 trillion over the next 10 years. Two recent studies from the Brookings Institution and the Center on Budget and Policy Priorities (CBPP) suggest, however, that only a fraction of these surpluses are realistically available for new initiatives, such as tax cuts or new spending programs. In part, these analyses make alternative assumptions about how policies should be measured in the baseline, but they also make judgments about policy priorities.

Assumptions about current policy. Both studies start with the CBO's $2.2 trillion baseline and then adjust it for certain spending and tax changes that they believe are already "built in" to the policy process.

- Discretionary spending. CBO's "inflated baseline" projection assumes that total discretionary spending increases with inflation but not with population growth. According to CBPP, the 10-year surplus would fall by about $350 billion if real per capita spending were maintained. The Brookings analysis observes that the cumulative surplus would be over $850 billion smaller if discretionary spending were kept constant as a share of GDP.

  How the Congress and the President will treat discretionary spending in the future is, of course, unknown. Discretionary spending has reached an historically low level as a share of GDP recently, due largely to a falling share for defense (see the Chart of the Week). However, its real level has grown at a 3.8 percent annual rate in the 1998-2000 period, compared with about 1 percent per year over the 1962-2000 period (see chart). This has led some to question whether CBO's baseline assumption of low real spending growth over the next 10 years is realistic.



- Expiring provisions. The official budget projections assume certain farm and tax provisions will decline or expire as scheduled. But farmers have received substantial emergency payments in recent years, and expiring tax credits have been regularly extended. Both studies use CBO's estimate that continuing tax provisions which would otherwise expire would cost more than $50 billion over the next 10 years. The CBPP study also adds $60 billion for farm aid.

- Alternative minimum tax. Under current law, more and more households, including middle-class families, will become subject to the alternative minimum tax (AMT), due to the effects of inflation. The CBPP and

Brookings studies argue that policymakers will not allow that to happen. Likely changes to the AMT would cost about $80-90 billion over 10 years.

In sum, these two forecasts of how current policy is likely to evolve would reduce the available non-Social Security budget surplus by about $600 billion in the CBPP analysis and by over $1 trillion in the Brookings analysis (these figures include increases in interest on the debt).

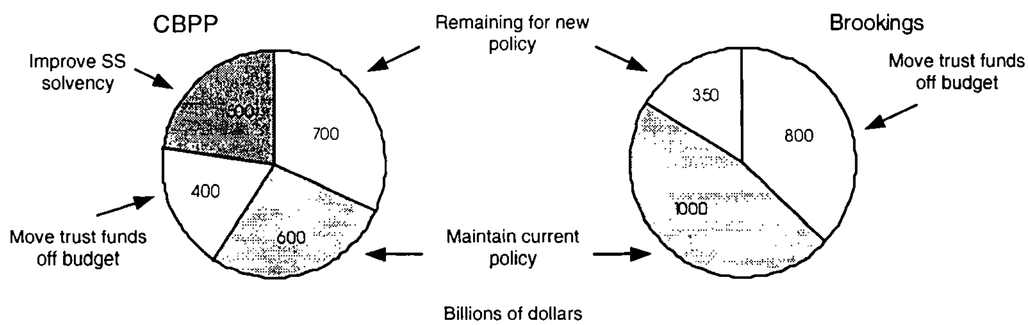
Accounting for longer-term policy needs. Echoing the Mid-Session Review, both studies also urge policy changes to help save Social Security and Medicare.

- Setting aside the trust funds. The CBO surplus projections account for Social Security's off-budget status but do not subtract the surpluses of other trust funds that remain on budget. The CBPP study estimates that excluding projected Medicare HI trust fund surpluses in line with the Administration's proposal would reduce the available surplus by about $400 billion over 10 years. Brookings additionally puts aside government military and civilian employee pension funds, reducing the surplus by another $400 billion.

- Strengthening Social Security and Medicare. The studies stress the importance of saving some general revenues now to prepare for future rainy days. Both observe that achieving longer-term Social Security and Medicare solvency will require substantial tax increases or general fund transfers. CBPP reduces the 10-year surplus by another $500 billion in recognition of this claim.

The bottom line. The CBPP analysis concludes that only $700 billion of CBO's 10-year, $2.2 trillion non-Social Security surplus is really available to fund changes in tax and program policies. The Brookings analysis concludes that even before addressing the long-term solvency problem, the 10-year surplus is reduced to $350 billion (see chart). These studies support the Administration's view that the latest surplus projections do not support large tax cuts. The argument is even stronger using OMB projections that the cumulative 10-year surpluses are a smaller $1.9 trillion.

Dividing Up CBO's 10-Year $2.2 Trillion Surplus



BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Individual Investors Who Trade More Earn Less. Individual investors who trade shares of stocks more often than the average investor earn similar gross returns, but they pay more each year in transaction costs, according to a new study based on 1991-96 data from a large discount brokerage house. The fifth of investors who traded most often (with an average monthly portfolio turnover of 21.5 percent) earned net annual returns in the stock market of 11.4 percent, after subtracting transaction costs. In contrast, the fifth of investors who traded least often (with an average monthly turnover of 0.2 percent) earned net annual returns of 18.5 percent per year. The average household buying and selling stocks through this discount broker earned a gross annual return of 18.7 percent and a net return of 16.4 percent, after paying transaction fees. Over this same period, the S&P 500 rose by about 17.9 percent annually. Related research found that men traded 45 percent more frequently than women, with the result that transactions costs subtracted 0.6 percentage point more from men's annual returns than from women's. These differences by sex were even larger among single people.

Tobacco Settlement Provides Health Benefits. The tobacco settlement between the states and the tobacco companies requires payments of about $87 billion (in present value) through 2025 to compensate for Medicaid spending arising from smoking-related illness. Most of these payments will be financed by higher cigarette prices. A recent study estimates that these higher prices will reduce smoking, benefiting society in two ways. First, Medicaid payments for smoking-related illnesses will be reduced. Second, and quantitatively far more important, reduced smoking will allow people to live longer and healthier lives. The study argues that smokers significantly undervalue the health risks of their actions, and thus benefit when higher cigarette prices discourage them from smoking (though continuing smokers bear the cost of higher prices). The study estimates that for each dollar of payments transferred from tobacco companies to the states there are $6 of benefits, mainly due to the longer and healthier lives enjoyed by those who are discouraged from smoking.

Are CEOs Rewarded for Luck? Economics suggests that the way to encourage CEOs to act in the shareholders' best interest is to tie CEO compensation to changes in the value of the firm that seem to have arisen from the CEO's actions. In this view, good firm performance that can be attributed to events outside the CEO's control (luck) should not affect pay. A recent study found, however, that among the 51 largest U.S. oil firms, CEO pay increased 0.8 percent for every 1 percent increase in general firm performance between 1977 and 1994, while it increased 2 percent for every 1 percent increase in performance attributable to worldwide oil prices (luck, presumably). The study also found that CEO pay in a broader set of industries responded more to good luck than to bad. Structuring CEO pay to provide the right incentives is difficult, but the study did find that firms with more effective and independent monitoring by shareholders rewarded CEOs less for firm performance that was attributable to luck than did other firms.

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INTERNATIONAL ROUNDUP

Agreement May Lead to Higher Drug Prices in Developing World. The WTO agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) provides valuable incentives to innovate and protection for inventors. However, it could cause a price increase of 200-300 percent in patented medicines for developing countries, according to a recent analysis. Such an increase could have a drastic impact on nations where up to 66 percent of total health spending is on medicine and 50-90 percent of expenditures are out-of-pocket. Before TRIPS, many countries did not allow patents for medication; now most are members of the WTO, where TRIPS requires a patent term of 20 years. While the agreement only affects applications for new medicines made from 1995 onwards, drugs for diseases like AIDS fall within the jurisdiction of TRIPS. Developing countries have several options to reverse a price increase, including compulsory licenses, in which the patent holder licenses the invention to a third party in return for "adequate remuneration;" price controls; and generic drug approvals.

If You Think U.S. Stock Prices Are High... Broad indexes of U.S. stocks continue to trade near historically high price-to-earnings (P/E) ratios, and the P/Es of technology stock indexes are substantially higher than those of the broader indexes. But U.S. markets are not unique: major European stock markets are trading at P/Es similar to those in the United States, and European technology markets are experiencing substantially higher P/Es than those of comparable U.S. markets. For example, the Bloomberg European 500 Index, an index of the 500 most highly capitalized European companies, is trading at 27 times earnings, which is roughly comparable to the P/E of 29 for the S&P 500 and the P/E of 32 for the Wilshire 5000, one of the broadest indices of U.S. stocks. By contrast, the New Market, a pan-European grouping of regulated markets dedicated to high-growth stocks, is trading at 1,630 times earnings, substantially higher than the P/E of 126 for the NASDAQ Composite Index. Substantial national variation exists within the New Market however. While the Netherlands New Market is trading at 64 times earnings, the German is at 604, and the French has negative aggregate earnings. The EASDAQ, a unified European market dedicated mainly to technology companies and designed to be a European NASDAQ, also has negative aggregate earnings.

RELEASES THIS WEEK

Employment and Unemployment
****Embargoed until 8:30 a.m., Friday, August 4, 2000****

In July, the unemployment rate was unchanged from June at 4.0 percent. Nonfarm payroll employment decreased by 108,000.

Leading Indicators

The composite index of leading indicators was unchanged in June.

NAPM Report on Business

The Purchasing Managers' Index was unchanged in July at 51.8 percent. (A reading above 50 percent indicates that the manufacturing economy is generally expanding.)

MAJOR RELEASES NEXT WEEK

Productivity (Tuesday)
Retail Sales (Friday)
Producer Prices (Friday)

U.S. ECONOMIC STATISTICS

	1970-1993	1999	1999:4	2000:1	2000:2
Percent growth (annual rate)					
Real GDP (chain-type)	2.9	5.0	8.3	4.8	5.2
GDP chain-type price index	5.2	1.6	1.6	3.3	2.5
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.7	3.7	6.9	2.4	N.A.
Real compensation per hour:					
Using CPI	1.0	1.7	0.9	0.2	N.A.
Using NFB deflator	1.5	2.9	1.8	1.8	N.A.
Shares of Nominal GDP (percent)					
Business fixed investment	11.4	12.9	13.0	13.4	13.8
Residential investment	4.5	4.3	4.3	4.3	4.3
Exports	8.2	10.6	10.8	10.8	10.8
Imports	9.2	13.4	13.9	14.2	14.5
Personal saving	6.6	1.6	1.1	0.1	0.2
Federal surplus	-2.8	1.3	1.5	2.4	N.A.

	1970-1993	1999	May 2000	June 2000	July 2000
Unemployment Rate (percent)	6.7**	4.2**	4.1	4.0	**4.0**
Payroll employment (thousands)					
increase per month			**171**	**30**	**-108**
increase since Jan. 1993					**22010**
Inflation (percent per period)					
CPI	5.8	2.7	0.1	0.6	N.A.
PPI-Finished goods	5.0	2.9	0.0	0.6	N.A.

**Figures beginning 1994 are not comparable with earlier data.

New or revised data in **boldface**.
Employment and unemployment data **embargoed until 8:30 a.m., Friday, August 4, 2000.**

FINANCIAL STATISTICS

	1998	1999	June 2000	July 2000	Aug. 3, 2000
Dow-Jones Industrial Average	8626	10465	10583	10663	10707
Interest Rates (percent per annum)					
3-month T-bill	4.78	4.64	5.69	5.96	6.05
10-year T-bond	5.26	5.65	6.10	6.05	5.95
Mortgage rate, 30-year fixed	6.94	7.43	8.29	8.15	8.12
Prime rate	8.35	8.00	9.50	9.50	9.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level August 3, 2000**	**Percent Change from**	
		Week ago	**Year ago**
Euro (in U.S. dollars)	0.904	-3.1	-15.3
Yen (per U.S. dollar)	108.4	-0.7	-5.9
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	99.22	1.3	5.1

International Comparisons [1]	**Real GDP growth** (percent change last 4 quarters)	**Unemployment rate** (percent)	**CPI inflation** (percent change in index last 12 months)
United States	6.0 (Q2)	**4.0** (Jul)	3.7 (Jun)
Canada	4.9 (Q1)	6.6 (May)	2.9 (Jun)
Japan	0.7 (Q1)	4.6 (May) [2]	-0.7 (Jun)
France	3.4 (Q1)	9.8 (May) [2]	1.7 (Jun)
Germany	2.3 (Q1)	8.3 (May)	1.9 (Jun)
Italy	3.0 (Q1)	10.8 (Apr)	2.7 (Jun)
United Kingdom	3.0 (Q1)	5.7 (Mar)	3.3 (Jun)

U.S. unemployment data **embargoed until 8:30 a.m., Friday, August 4, 2000.**

1/ For unemployment data, rates approximating U.S. concepts as calculated by the U.S. Department of Labor, Bureau of Labor Statistics, except as noted in footnote 2.

2/ Data from OECD standardized unemployment rates.