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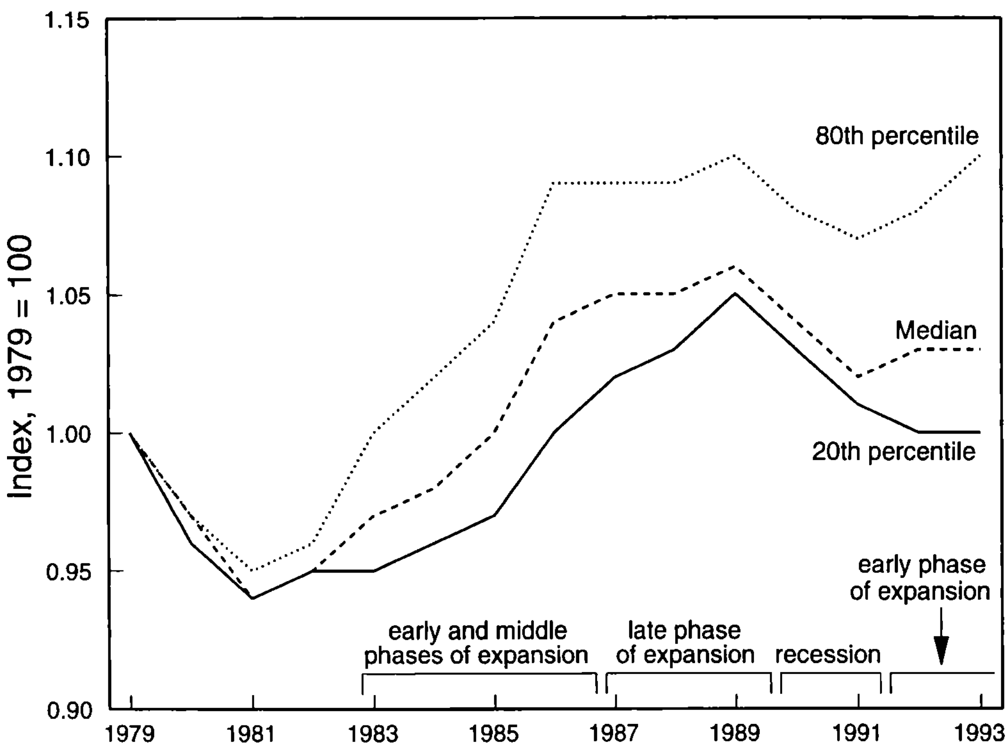
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

October 24, 1994

CHART OF THE WEEK

Real Household Income After Taxes and Transfers



Since 1979, the real after-tax-and-transfer income of households at the 80th percentile of the income distribution has increased about 10 percent. In contrast, the real after-tax-and-transfer income of households at the 20th percentile has been virtually unchanged on net. These data suggest that the distribution of income has become more unequal not only at the very top and bottom, but nearer the middle as well. Inequality appears to have increased during the early and middle phases of the previous expansion, but to have subsided a bit during the late phase. During the most recent recession and the early phase of the current recovery, inequality appears to have increased again.

EYES ONLY

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"Next, let's hear from Horton Delahe[illegible] . . who will g[illegible] over in detail your company's cu[illegible] excuses."

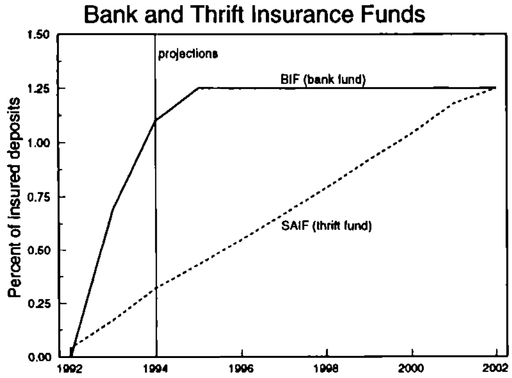
EYES ONLY

CURRENT DEVELOPMENT

Bank Insurance Fund Thrives, but Thrift Fund Still Ails

BIF. Deposits held at most commercial banks are insured by the Bank Insurance Fund (BIF). At the end of 1992, BIF was slightly in the red. But conditions in the banking industry have improved since then, and BIF payouts have been well below projected levels. As a result, the health of the fund has improved markedly. According to the latest FDIC forecast, the fund will reach its designated reserve ratio of 1.25 percent of insured deposits by the end of 1995 (see chart).

Bank and Thrift Insurance Funds



SAIF. Deposits held at most thrift institutions are insured by the Savings Association Insurance Fund (SAIF). Costs of thrift "resolutions" have also come in below projections, but the windfall (roughly \$8 billion) has remained on the books of the Resolution Trust Corporation and cannot be used to help recapitalize SAIF without new legislation. While the FDIC predicts gradual improvement in the funding status of SAIF, it does not expect SAIF to reach 1.25 percent of insured deposits until 2002 (see chart).

The problem. Current law may be interpreted as requiring the FDIC to cut premia on BIF-insured deposits once BIF reaches 1.25 percent of insured deposits. Given the competitiveness of the banking industry, a reduction in BIF premia without a corresponding reduction in SAIF premia might place thrifts at a considerable competitive disadvantage relative to banks. But current law gives the FDIC only limited latitude to cut premia on SAIF-insured deposits until SAIF reaches 1.25 percent.

Another oft-mentioned possible solution, merging the two funds, is very unpopular with banks because they would end up sharing the cost of cleaning up the S&L mess. Devising a course of action will be one of the first tasks facing FDIC Chair Tigert.

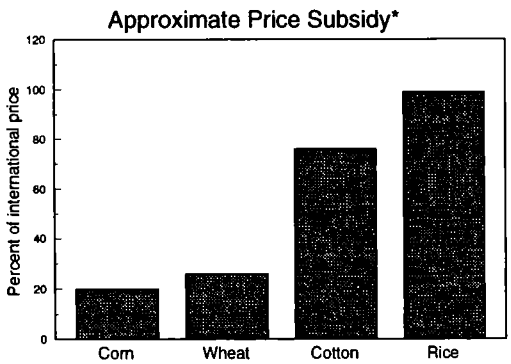
EYES ONLY

SPECIAL ANALYSIS

The Economic and Environmental Costs of Farm Commodity Programs

Farm commodity programs are currently designed in two main formats:

Deficiency payment programs make payments based on statutory target prices for each commodity and on the number of acres a farmer has accredited to each program. Farmers can maximize their payments from each program by planting the same crops year after year and, to a lesser extent, by increasing the number of acres planted in program crops.



* averages for 1991/2 through 1993/4

Price support programs make payments based on the difference between a commodity's support price and its international price, as well as on the volume of the program crops produced.

Historically, these programs have provided large subsidies (see chart). Subsidies are also provided through other channels; for example, cotton and rice growers in the West receive additional support through water subsidies.

Adverse effects. As currently designed, these farm commodity programs inhibit the achievement of important economic and environmental objectives.

- The programs represent a significant drain on the Federal budget—$8 billion per year on average between 1991 and 1993.
- By encouraging over-investment in agriculture, the programs distort the allocation of resources in the economy and thus reduce overall productivity.
- The programs also reduce productivity in the agricultural sector itself, because they subsidize different kinds of agricultural output to varying extents. (Almost half of agricultural production is not covered either by price support or by deficiency payment programs and hence is at a relative disadvantage compared to subsidized agricultural production. High-value crops, such as vegetables, are not subsidized, while basic crops, like wheat and corn, are.)
- The programs encourage environmentally harmful practices. They discourage crop rotations that would break pest cycles and confer soil conservation benefits; they encourage farming of marginal lands, which tend to be environmentally sensitive; and they encourage excessive use of pesticides, herbicides, and fertilizers that increase yields but contribute to offsite environmental damage.

EYES ONLY

ARTICLE

What Has Happened to Earnings Inequality, and Why?

The distribution of earnings has become more unequal during the last twenty years. At the same time, the structure of rewards in the labor market has shifted dramatically against less-educated and less-skilled workers. These developments are particularly disturbing because they have been associated with an absolute decline in the real earnings of those at the bottom of the earnings and skill distributions. For example, real hourly wages for those at the 20th percentile of the wage distribution declined 10.9 percent between 1979 and 1993. During the same time period, real hourly wages for high school graduates declined 11.7 percent.

The forces behind increasing earnings inequality are not well understood, but the facts are stark.

> Overall wage inequality has increased. In 1979, the hourly wage of workers in the top fifth of the wage distribution was 145 percent more than the hourly wage of those in the bottom fifth. By 1993, the difference had increased to 174 percent.
>
> Returns to education have increased. For example, college graduates earned 38 percent more than high school graduates in 1979; in 1993, they earned 58 percent more. This increase was even larger for new entrants into the labor market.
>
> Inequality between races has increased. In 1979, young black workers earned 10.9 percent less than young whites (controlling for education and region of residency). In 1989, the gap was 16.4 percent.
>
> Even within observably similar groups, inequality has increased. Controlling for age, education, and experience, male workers at the 90th percentile of the earnings distribution earned 99 percent more than workers at the 10th percentile in 1973; by 1989, this difference had risen to 111 percent.
>
> Pay at the top has increased. While real median pay was up less than 10 percent between 1979 and 1992, CEO pay packages in large companies increased about 60 percent.

About the only important dimension in which inequality has declined is with respect to gender. The median hourly wage of women rose from 62.8 percent of the median hourly wage of men in 1979 to 78.2 percent in 1993.

Explanations for Increasing Inequality. A complete explanation of the timing and magnitude of the growth in inequality does not exist, but most researchers believe that the major factor behind this trend is a shift in labor demand. Employers have become more interested in hiring high-skill workers and less

EYES ONLY

interested in hiring low-skill workers. This explanation is consistent with the fact that both the earnings and employment of high-skill workers have increased.

In part, the shift in demand toward high-skill workers reflects a change in the sectoral composition of the U.S. economy. Employment has declined in goods-producing sectors that historically have been the source of high-wage opportunities for blue-collar workers. At the same time, employment has expanded in service sectors (such as health care) that employ many college graduates.

The internationalization of the American economy has contributed to these inter-industry shifts, but so far the empirical evidence suggests that increased trade explains less than 15 percent of the total increase in earnings inequality. An increase in immigration of low-skill workers to the United States during the 1980s also appears to have contributed to downward pressure on the earnings of high-school drop-outs and other low-income workers. But because immigration is small relative to the size of the overall labor force, immigration's effect on overall earnings inequality has been modest.

The shift in the sectoral composition of the U.S. economy does not explain all of the increase in demand for high-skill workers: A similar increase in demand is observable within individual sectors.

While the source of the overall shift in demand is unclear, a substantial portion of the increased returns to education appears to be due to increased use of computers. For example, workers who use computers receive a wage premium of more than 15 percent, and more-educated workers are more likely to use computers. Between 1984 and 1993, the share of the labor force using computers on the job increased from 25 percent to 47 percent.

Finally, the decline in unionization and the erosion in the real value of the minimum wage also appear to explain some of the increase in earnings inequality. According to some recent studies, the precipitious decline in unionization explains as much as one-fifth of the increase in wage inequality in the last 15 years. And the large decline in the real value of the minimum wage between 1981 and 1990 also contributed to rising wage inequality, especially among women.

Future Trends. We cannot confidently predict future trends in earnings inequality. Presumably, globalization of trade and increased computer use will continue to exercise some downward pressure on the low end of the earnings distribution. In addition, the Bureau of Labor Statistics anticipates continued demand shifts to higher-skilled occupations, although future shifts are expected to be smaller than those during the 1970s and 1980s. At the same time, if the current trend continues, the share of college graduates in the labor force should increase. This should reduce the earnings premium for education.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Mega-Steel and Mini-Mill Unite to Cut Costs, Pollution. U.S. Steel, the giant of the traditional steel industry, has agreed to join with the Nucor Corporation, a leading mini-mill steelmaker, in exploring the feasibility of a cheaper, environmentally friendlier way to produce steel. By allowing the manufacture of steel within a closed environment without the use of coke, the new process could substantially reduce plant emissions into the air and water. In addition, it could result in considerable savings in capital costs because it does not involve use of expensive blast furnaces and coke batteries. If the results of the feasiblity study are favorable, a demonstration plant will be built in Hickman, Arkansas.

"Warning: Vehicle Closing in at 5 O'Clock—Take Evasive Action." Delco Electronics, the automotive electronics division of General Motors, has unveiled a new radar-based system designed to warn drivers of impending collisions. Front- and rear-mounted radar sensors will scan the area around the vehicle. When the system detects a hazard, it will give a visual warning, activate an audio alarm, and—if the driver still hasn't reacted—apply the brakes. The visual warning system, named the Head-Up Display, will use technology developed by Hughes Aircraft to flash an image on the windshield, which should allow the driver to react more promptly than would be possible with a conventional instrument-panel warning light.

Mexico Throws Open Banking Sector. Mexico's finance ministry announced that it is issuing licenses to virtually all of the foreign financial institutions that have applied to enter the Mexican market. This move represents an important step in Mexican implementation of NAFTA requirements. For most of this century, Citibank has been the only foreign bank operating in Mexico. But Monday night's announcement opens the doors to 18 commercial banks (including Chemical Bank and Bank of America), 16 securities firms, 12 insurance companies, 5 financial groups, and a leasing company. Most of the new entrants are expected to concentrate on investment banking, trade financing, and corporate advisory services.

Defying Forecasts, Oregon Adds Jobs. Oregon's economy is creating jobs at a buzzsaw pace, contrary to the dire predictions of those who opposed the recent moves to protect the spotted owl and old-growth forests. In August, the state's unemployment rate was just 4.8 percent—the lowest in two decades. Since 1990, Oregon has lost about 9,000 jobs in forest products, but has gained more than 120,000 jobs overall. At least some of the former loggers and millworkers are finding new employment. Lane Community College in Springfield has retrained about 1,500 displaced timber workers in the past three years; nearly 9 out of every 10 of the program's graduates have found new jobs, at an average wage of $9 per hour—about $1.50 per hour less than their average pre-dislocation wage.

EYES ONLY

RELEASES LAST WEEK

U.S. International Trade in Goods and Services

The goods and services trade deficit decreased to $9.7 billion in August from $11.2 billion in July.

Housing Starts

Housing starts were up 4 percent in September to a seasonally adjusted annual rate of 1.5 million units. During the first 9 months of this year, starts were up 16 percent over the same period in 1993.

MAJOR RELEASES THIS WEEK

Employment Cost Index (Tuesday)
Consumer Confidence–Conference Board (Tuesday)
Advance Durable Orders (Wednesday)
Gross Domestic Product (Friday)

EYES ONLY

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	4.1
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	3.0
Federal surplus	–2.8	–3.8	–3.4	–2.7	–2.2

	1970–1993	1993	July 1994	Aug. 1994	Sept. 1994
Unemployment Rate	6.7*	6.8*	6.1	6.1	5.9

*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.

	1970–1993	1993	July 1994	Aug. 1994	Sept. 1994
Payroll employment (thousands)					
increase per month			290	246	239
increase since Jan. 1993					4619
Inflation (percent per period)					
CPI	5.8	2.7	0.3	0.3	0.2
PPI-Finished goods	5.0	0.2	0.5	0.6	–0.5

EYES ONLY

FINANCIAL STATISTICS

	1992	1993	Aug. 1994	Sept. 1994	Oct. 20, 1994
Dow-Jones Industrial Average	3284	3522	3797	3881	3911
Interest Rates					
3-month T-bill	3.43	3.00	4.48	4.62	5.00
10-year T-bond	7.01	5.87	7.24	7.46	7.80
Mortgage rate, 30-year fixed	8.40	7.33	8.51	8.68	8.85
Prime rate	6.25	6.00	7.51	7.75	7.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level Oct. 20, 1994**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.493	−2.8	−9.2
Yen-Dollar	97.00	−2.6	−9.8
Multilateral (Mar. 1973=100)	85.41	−2.4	−8.7

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	4.1 (Q2)	5.9 (Sep)	3.0 (Sep)
Canada	3.9 (Q2)	10.3 (Aug)	0.1 (Aug)
Japan	0.1 (Q2)	3.1 (Aug)	−0.2 (Jul)
France	2.0 (Q2)	12.3 (Jul)	1.7 (Aug)
Germany	2.3 (Q2)	6.5 (Aug)	2.9 (Aug)
Italy	2.3 (Q2)	11.9 (Apr)	3.7 (Aug)
United Kingdom	3.8 (Q2)	9.4 (Aug)	2.4 (Aug)

EYES ONLY

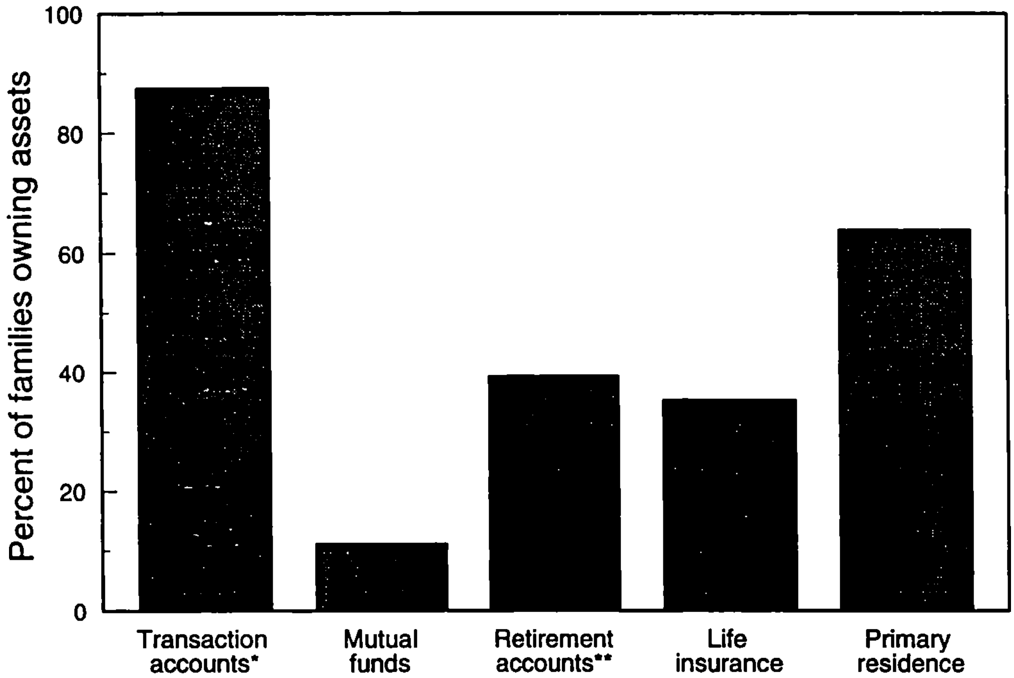
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

October 17, 1994

CHART OF THE WEEK

Ownership of Assets by U.S. Families



* includes checking, savings, and money market accounts
** excludes defined-benefit plans

In 1992 (latest available data), 87.5 percent of American families had a checking, savings, or money market account. The remaining 12.5 percent of families were predominantly low-income families, the majority of whom reported that they either did not write enough checks or did not have enough money to warrant acquisition of a checking account. Nearly 40 percent of families owned a retirement account, up from 24 percent in 1983. The home ownership rate was estimated at 64 percent, essentially unchanged from 1983.

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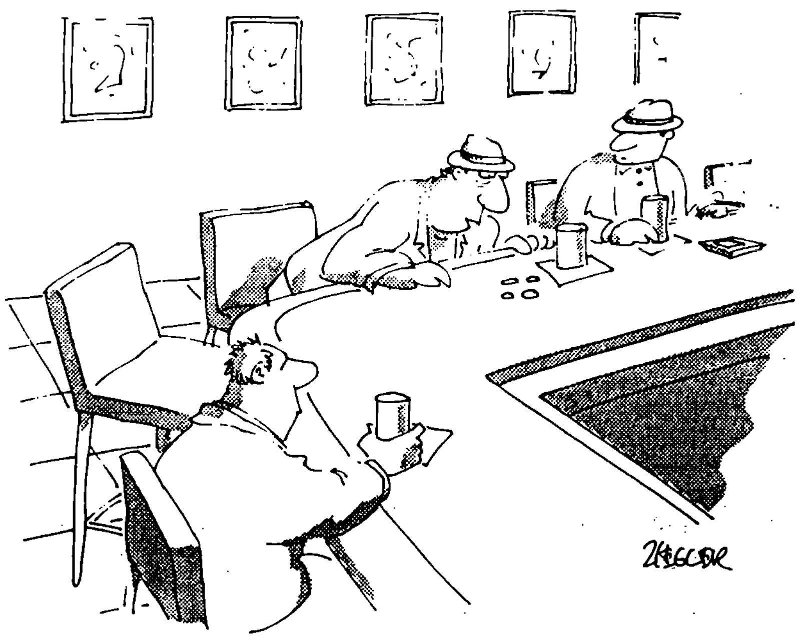

"The index of leading economic indicators currently being at only 32 cents, gentlemen, I believe I'll say goodnight."

EYES ONLY

CURRENT DEVELOPMENT

The Uneven Funding Status of State and Local Pension Plans

Unfunded liabilities of state and local pension plans totalled at least $117 billion in 1992—more than twice as much as total underfunding of plans in the private sector (estimated at $53 billion at the end of 1992).

Funding status differed widely across 451 state and local pension plans responding to a recent survey. While half of the plans were well funded (with assets equal to 90 percent or more of pension benefit obligations), one-fifth of the plans were less than 70 percent funded. And 25 plans accounted for 76 percent of the aggregate unfunded liabilities of the plans included in the survey (see box on next page).

State and local pension plans generally are not bound by the provisions of the Employee Retirement Income Security Act (ERISA). As a result,

- Benefit payments from these plans are not guaranteed by the Pension Benefit Guaranty Corporation.
- Plan sponsors face no Federal minimum contribution requirements. In 1992, 23 percent of plan sponsors in the survey contributed less than 90 percent of the actuarially determined contribution.

Although the underfunding of some state and local pension plans is severe, it is dwarfed by the underfunding of the Federal civil service and military retirement systems.

EYES ONLY

25 State and Local Pension Plans With Large Unfunded Liabilities

Plan	Unfunded Liabilities (billions of $)	Funding Ratio* (percent)
DC Police	3.3	26.8
IN Teachers	5.1	31.9
DC Teachers	1.7	35.7
ME State	2.6	38.9
OK Teachers	3.3	39.9
LA Teachers	4.2	53.8
LA State	1.9	53.9
CT State	2.6	56.2
OH School	2.5	58.3
Chicago Police	1.4	58.7
WA Teachers Plan I	2.6	60.7
IL Teachers	6.2	63.0
IL State Universities	2.7	63.0
IL State	2.0	65.0
MI School	8.2	65.9
WA Police Plan I	1.1	70.8
WA State Plan I	2.0	72.3
SC Retirement	3.1	73.3
CT Teachers	1.8	73.4
NJ Teachers	4.7	75.1
FL Retirement	9.1	75.9
CA Teachers	11.1	76.4
VA Retirement	3.7	78.2
KY Teachers	1.3	78.9
MS General	1.5	79.4

* Ratio of assets to projected benefit obligations.

EYES ONLY

CURRENT DEVELOPMENT

Brazil's Reform: Is It For Real?

Brazil has been identified by the Department of Commerce as one of 10 key emerging economies. While the potential of the Brazilian economy is enormous, during the last decade it has experienced slow growth and periodic bouts of explosive inflation. Between 1968 and 1980, real output grew at an average rate of more than 8 percent per year. But Brazil was hit hard by the debt crisis of the early 1980s and has never recovered. Since 1981, real growth has averaged about 1-1/2 percent per year, government deficits have been large, and inflation has been very high—at times exceeding 50 percent per month.

Since 1986, Brazil has made a number of abortive attempts at economic reform. In large part, these attempts have aimed to break the inflationary spiral directly by fixing the exchange rate and imposing wage and price controls. But they have not resolved the fiscal crisis that is considered to be the underlying cause of inflation.

The most recent reform program—the so-called Real Plan instituted earlier this year—was formulated by newly-elected president Fernando Cardoso when he was serving as finance minister. Thus far, this program appears to be similar to previous reform attempts. Inflation dropped from 50 percent in June to 1-1/2 percent in September (monthly rates). However, there are fears that the budget has not yet been put on a sustainable long-run path. Unless credible fiscal consolidation is implemented, inflation likely will soar again and the Real Plan, like its predecessors, will fail.

EYES ONLY

SPECIAL ANALYSIS

Farm Conditions Change, Yet New Deal Programs Persist

In FY1993, Federal outlays for farm commodity programs totalled $11 billion (more than $2,000 per person living on a farm). These programs are rooted in legislation enacted as part of the New Deal. However, the agricultural economy has evolved in many important ways during the past 60 years.

Farming Has Declined in Macroeconomic Importance. In the 1930s, farm households accounted for 25 percent of the U.S. population and generated more than 10 percent of GDP. Today, farm households comprise about 2 percent of the population and generate less than 2 percent of the nation's GDP. Moreover, farming now generates only 9 percent of rural employment.

Farm Payment Recipients Are No Longer Poor. In the 1930s, per capita farm income was only one-third the non-farm national average. Today, farm households have slightly more income than the average U.S. household, and about four times as much wealth. Two-thirds of program payments go to the 18 percent of farms with the largest gross revenues, even though the average income of recipients ($133,000) is more than triple that of the average U.S. household.

Farmers Now Can Insure in Private Markets Against Price Risk. In the 1930s, farmers were at the mercy of year-to-year fluctuations in commodity prices. Commodity programs established price floors, and thus insured farmers against adverse price swings. Today, futures and options markets allow farmers an efficient private means of insuring themselves against price declines.

Agricultural Production is Increasingly Concentrated. The number of farms has fallen more than 60 percent since 1950, while the average farm size has doubled. Moreover, 92 percent of the households classified as farm households by the Census are not primarily in the farming business today. These households operate small farms, but receive almost all their income from off-farm sources, and have about the same income as non-farm households.

The Environmental Costs of Farming Are Increasing. Modern agricultural practices increasingly lead to hazardous nutrient and chemical runoff. Both pesticide and fertilizer use have doubled since the 1960s. Agriculture is now considered a contributor to water quality problems in about 60 percent of "environmentally impaired" rivers and lakes.

Conclusion. Existing farm support programs have adverse distributional and efficiency effects that call for their redesign. The re-negotiation of the Farm Bill, currently set to expire in 1995, offers an opportunity to undertake such a redesign. Next week's Weekly Economic Briefing will discuss some specific efficiency costs of current policies.

EYES ONLY

ARTICLE

Is There a Consumption Tax in Your Future?

Some tax analysts have proposed that the basis for taxation of households be shifted from income to consumption. In large part, these analysts are motivated by two key concerns:

Encouragement of saving. Shifting to a consumption tax may encourage individuals to accumulate greater wealth, and thus foster greater investment and higher living standards.

Fairness. Shifting the basis for personal taxation from annual income to annual consumption would bring the tax system more into line with the belief of some observers that people should be taxed according to what they remove from society (consumption) rather than what they contribute to society (income).

A typology of consumption taxes. Three main types of consumption taxes have been proposed:

Value-added tax (VAT). A VAT imposes a tax at each stage of the production process on the value added at that stage. For example, during the production of a car, coal producers, steel producers, and final assemblers each would pay a tax on the difference between their sales revenues and the cost of their purchases (that is, value added at that stage of production). Most European countries use some form of a VAT.

Retail sales tax. In contrast with a VAT, a retail sales tax is levied on a good or service only when it is sold to the final consumer (for example, when a car is sold to an individual). Provided markets function reasonably well and the tax base is broad, a retail sales tax should have about the same economic effects as a VAT imposed at the same rate. Most states currently use some form of retail sales tax.

Savings-exempt income tax. This approach taxes consumption indirectly, by allowing taxpayers to subtract their saving from their income to compute their tax base. (This approach is equivalent to a consumption tax because consumption equals income less saving.) Senators Nunn and Domenici have proposed a plan along these lines.

Issues in the implementation of a consumption tax. Although consumption taxes may have some attractive attributes, several difficult issues would need to be settled before a consumption tax could be implemented as even a partial replacement for the income tax.

Practicalities. In principle, a consumption tax should tax all consumption, including items like the imputed rental value of owner-occupied housing and the flow of services from consumer durables. In practice, it is extremely difficult to ensure that all elements of consumption are included in the tax base. For example, in many countries, existing consumption taxes exempt housing.

Progressivity. From an administrative point of view, it is difficult to make VATs and retail sales taxes progressive. Many countries attempt to make their VATs less regressive by having low or zero rates on necessities. Under the savings-exempt form of a consumption tax, it is straightforward to adopt progressive tax rates.

Other distributional considerations. To the extent that a consumption tax succeeds in generating greater accumulations of capital assets, ownership of wealth might become even more concentrated than it is currently. This may be of particular concern because gifts and bequests can pass these accumulations on to future generations. This potential problem could be addressed by strengthening the estate, gift, and inheritance taxes.

Transition issues. A switch from the current income tax system to one based on some measure of consumption would inevitably affect different individuals differently. For example, the exemption of savings from taxation implies that younger households would be treated more favorably than older households, who have already paid taxes on (the taxable portion of) the income from their saving. In addition, changing the tax treatment of different types of assets would cause unintended windfall gains and losses to the holders of such assets.

Special interest politics. Proponents of a consumption tax often compare an ideal version to the admittedly flawed current income tax. However, if Congress were to enact a consumption tax, some sectors of the economy would almost certainly be treated more favorably than others.

Would it all be worth it? Unfortunately, the answer is not clear. Proponents of consumption taxes point out that saving rates in European countries are much higher on average than in the United States. But this evidence is not conclusive because there are many differences between the economic environments in the United States and Europe in addition to differences in tax systems. Other analysts (more skeptical of the benefits of a shift to a consumption tax) note that most evidence suggests that the responsiveness of saving to changes in the rate of return in the United States is small, and hence that a shift to a consumption-based tax system would not elicit much additional saving. However, this evidence (based on incremental changes in the rate of return within a *given* tax structure) might not be a reliable guide to the effects of changing the entire foundation of the tax system. The only certainty about a wholesale change from our current system to a consumption-based system is that it would involve a difficult and costly transition.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Small Business Takes to the Information Superhighway. Small manufacturers now have a new place to look for low-cost, high-quality parts and components: IndustryNet, an on-line service that serves as a virtual marketplace linking buyers and sellers. For between $1,500 and $40,000 a year, suppliers are allowed to advertise products and services over the Net. Customers pay nothing for network time, but gain access to 3000 potential suppliers. For the smaller manufacturers that are IndustryNet's major target consumers, this access can be a boon. Unlike Chrysler or General Motors, they typically lack the resources to scour the country by conventional means. Automated News Network, which operates IndustryNet, estimates that well over 20,000 firms now are using the network.

Greenspan Calls for Risk-Based Pricing of Loans. In a speech last week before the American Bankers Association, Federal Reserve Board Chairman Alan Greenspan urged bankers to revise their approach to pricing loans. Historically, industry practice has been to set a uniform interest rate for all borrowers, regardless of creditworthiness. Greenspan noted that this practice invites non-bank lenders to engage in "cherry-picking" (lending at lower rates to the best credit risks), leaving banks to serve only poorer-quality borrowers. To preserve the market share of the banking sector, banks should "grade" their commercial loans, according to Greenspan, much in the same way as rating agencies assign ratings to corporate bonds.

State Funding Restrictions Prevent Some Abortions, But Not Most. State restrictions on public funding for abortions substantially reduce the number of abortions obtained by state residents, according to a new study published by the National Bureau of Economic Research. Using state-level data for the period 1974-1988, the authors estimate that, on average, a state ban or restriction on the use of Medicaid funds for abortions reduced the number of abortions obtained by state residents by 5 percent. These results suggest that the impact on poor women may have been quite large. If all of the 5 percent reduction were concentrated on poor women, their likelihood of obtaining an abortion may have been reduced by as much as 20 percent. What of the other 80 percent? They apparently went through with abortions, despite the personal cost and their already strained financial circumstances.

U.S. Economists Share This Year's Nobel. The 1994 Nobel Prize for Economic Science, announced Tuesday, was awarded to three researchers, two of whom are Americans. The U.S. recipients were John Harsanyi of the University of California at Berkeley and John Nash of Princeton University; the other recipient was the German economist Reinhard Selten. The three were honored for their theoretical contributions to the analysis of strategic interaction between economic agents—for example, competition among firms in concentrated industries (like automobiles or cereal) or conflict between governments over subsidies to aircraft manufacturers.

EYES ONLY

RELEASES LAST WEEK

Consumer Price Index

****FOR RELEASE FRIDAY at 8:30 a.m.****

The consumer price index rose 0.2 percent in September. Excluding food and energy, the consumer price index also rose 0.2 percent.

Retail Sales

****FOR RELEASE FRIDAY at 8:30 a.m.****

According to advance estimates, retail sales rose 0.6 percent in September. Retail sales excluding autos were also up 0.6 percent.

Industrial Production and Capacity Utilization

****FOR RELEASE FRIDAY at 9:15 a.m.****

The Federal Reserve's index of industrial production was unchanged in September after rising 0.7 percent in August. Capacity utilization fell 0.2 percentage point to 84.6 percent.

Producer Price Index

The producer price index for finished goods declined 0.5 percent in September. Excluding food and energy, producer prices were up 0.1 percent.

MAJOR RELEASES THIS WEEK

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

EYES ONLY

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	4.1
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	3.0
Federal surplus	–2.8	–3.8	–3.4	–2.7	–2.2

	1970–1993	1993	July 1994	Aug. 1994	Sept. 1994
Unemployment Rate	6.7*	6.8*	6.1	6.1	5.9

*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.

	1970–1993	1993	July 1994	Aug. 1994	Sept. 1994
Payroll employment (thousands)					
increase per month			290	246	239
increase since Jan. 1993					4619
Inflation (percent per period)					
CPI	5.8	2.7	0.3	0.3	**0.2**
PPI-Finished goods	5.0	0.2	0.5	0.6	**–0.5**

CPI data **embargoed until 8:30 a.m., Oct. 14 (Friday).**
New or revised data in **boldface**.

EYES ONLY

FINANCIAL STATISTICS

	1992	1993	Aug. 1994	Sept. 1994	Oct. 13, 1994
Dow-Jones Industrial Average	3284	3522	3797	3881	3890
Interest Rates					
3-month T-bill	3.43	3.00	4.48	4.62	4.91
10-year T-bond	7.01	5.87	7.24	7.46	7.64
Mortgage rate, 30-year fixed	8.40	7.33	8.51	8.68	8.93
Prime rate	6.25	6.00	7.51	7.75	7.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level Oct. 13, 1994**	**Percent Change from Week ago**	**Year ago**
Deutschemark-Dollar	1.535	–0.4	–4.2
Yen-Dollar	99.55	–0.2	–5.9
Multilateral (Mar. 1973=100)	87.50	–0.2	–4.7

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	4.1 (Q2)	5.9 (Sep)	**3.0** (Sep)
Canada	3.9 (Q2)	10.3 (Aug)	0.1 (Aug)
Japan	0.1 (Q2)	3.1 (Aug)	–0.2 (Jul)
France	2.0 (Q2)	12.3 (Jul)	1.7 (Aug)
Germany	2.3 (Q2)	6.5 (Aug)	2.9 (Aug)
Italy	0.6 (Q1)	11.9 (Apr)	3.7 (Aug)
United Kingdom	3.8 (Q2)	9.4 (Aug)	2.4 (Aug)

U.S. CPI data **embargoed until 8:30 a.m., Oct. 14 (Friday).**

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001. report	re: Weekly Economic Report (12 pages)	10/11/1994	P1/b(1)

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[Weekly Economic Report October 1 1993 - October 24 1994] [1]

2018-0275-F
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Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
P3 Release would violate a Federal statute [(a)(3) of the PRA]
P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
P5 Release would disclose confidential advice between the President and his advisors, or between such advisors [a)(5) of the PRA]
P6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

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b(3) Release would violate a Federal statute [(b)(3) of the FOIA]
b(4) Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
b(6) Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
b(7) Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
b(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

EYES ONLY

BN|05M|30

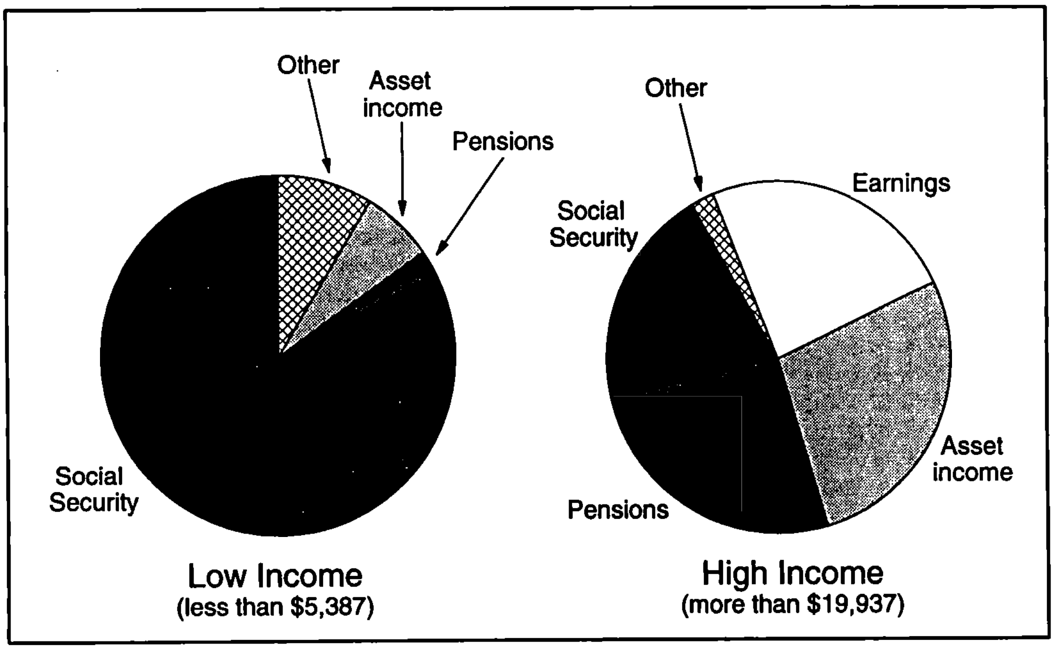
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

October 3, 1994

CHART OF THE WEEK

Sources of Cash Income for Americans Aged 65 and Over
for low-income and high-income households



Social Security benefits represent 83 percent of the total cash income of older households at the bottom end of the income distribution. By contrast, Social Security benefits constitute only 20 percent of the total cash income of older households at the top end of the distribution. For these high-income households, pension benefits, asset income, and earnings are more important than Social Security as sources of cash income.

EYES ONLY

CONTENTS

CURRENT DEVELOPMENT

TRENDS

ARTICLE

DEPARTMENTS

"On the negative side, we could lose millions. On the positive side, none of it's ours."

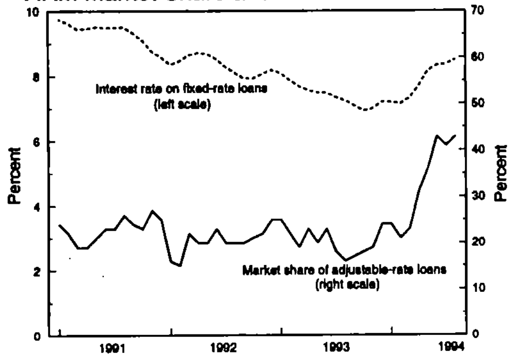
EYES ONLY

CURRENT DEVELOPMENT

Adjustable Rate Mortgages Gobble Market Share

Since last year, the share of mortgage borrowers opting for adjustable-rate contracts has roughly doubled, from about 20 percent to about 40 percent (see solid line in chart).

ARM Market Share and FRM Interest Rates



Analysis. The increased popularity of adjustable-rate mortgages (ARMs) probably reflects two factors. First, interest rates on fixed-rate mortgages (FRMs) have increased, from 6.9 percent last October to 8.4 percent in August (see dotted line in chart). As a result, some borrowers probably have been forced out of the FRM market because they no longer meet cash-flow standards for loan qualification. Some of these borrowers may have resorted to the ARM market where they could qualify because contract rates there are considerably lower than in the FRM market.

Second, the spread between FRM rates and ARM rates has widened, from about 1-1/2 percentage points late last year to about 2 percentage points currently.

Entering the ARM market no doubt has enabled some borrowers to close on homes that they otherwise would not have been able to purchase. But it also exposes them to the risk of a squeeze on their cash flow if and when the rates on this year's ARMs adjust upward.

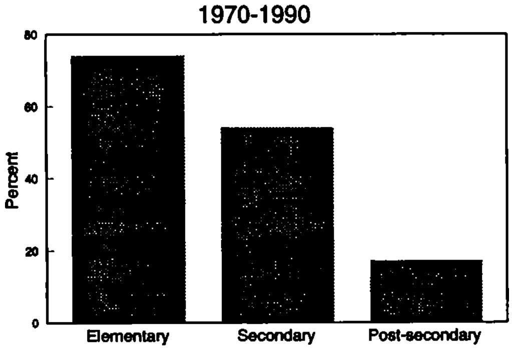
EYES ONLY

TREND

The Rising Cost of Teaching Dick and Jane to Read

Since 1970, real expenditures per student have increased more than 50 percent at both the elementary and secondary levels (see chart). By contrast, outlays per student at the post-secondary level have increased only 17 percent.

Increase in Real Education Cost per Student
1970-1990



Most of the increase in cost at the elementary and secondary levels reflects a 50 percent increase in the average number of staff per student (see table). About two-thirds of the increase in the staff ratio is accounted for by an increase in the number of classroom teachers and other instructional staff per student. The remainder reflects additional administrative and other support staff (including clerical, food service, transportation, health, and maintenance staff).

Analysis. In terms of the number of teachers per student at the K-12 level, the United States ranks ahead of the United Kingdom, Japan, and Korea, but trails Canada, France, and Germany. A good teacher-student ratio, however, is not a prerequisite for first-rate academic achievement by students. For example, Korea (which has nearly half as many teachers per student as our schools have) perennially outperforms the United States and most other countries on international math achievement tests.

Staff per 100 Students
in Public Elementary and Secondary Schools

Year	Total	Classroom Teachers	Other Instructional	Other
1970	7.4	4.4	0.4	2.5
1980	10.2	5.3	1.4	3.5
1990	10.9	5.8	1.2	3.9

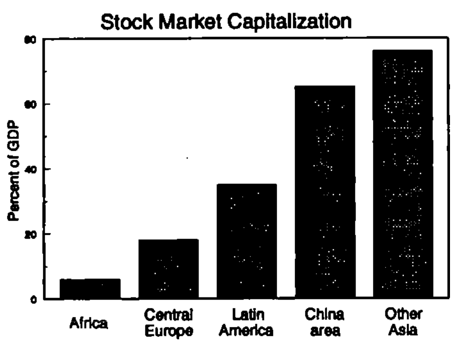
EYES ONLY

TREND

Emerging Markets: An Opening Financial Door

A host of new stock markets have gained prominence in world capital markets. Since 1988, the total capitalization of about 30 "emerging" markets in Asia, Latin America, Central Europe, and Africa has increased from almost $500 billion to about $2 trillion. Emerging markets now account for 14 percent of world stock market capitalization, up from 4-1/2 percent in 1988.

The most formidable emerging markets are in Asia. In the China area (consisting of mainland China, Hong Kong, and Taiwan), the ratio of total capitalization to combined GDP at the end of 1993 was about 65 percent (see chart). In the rest of Asia, the capitalization ratio was about 75 percent. (By way of comparison, the capitalization ratio in the United States was roughly 80 percent.)



Analysis. Solid macroeconomic performance, structural reforms, and privatization have paved the way for the recent growth in emerging stock markets. Some countries limit the ability of foreigners to invest in equities. Nonetheless, about half of total capitalization in emerging markets appears to be available to foreign investors; as a result, these markets represent a significant conduit for foreign capital into the host countries.

Because prices in emerging stock markets do not move in lock-step with prices in U.S. markets, emerging markets offer American investors a valuable opportunity to reduce risk through international diversification.

EYES ONLY

ARTICLE

Are Baby Boomers Saving Enough?

A spirited debate has erupted recently over the question of whether Baby Boomers (those born between 1946 and 1964) are saving adequately for their retirement. Some analysts have attacked this issue by investigating whether Boomers will be able to sustain their pre-retirement standard of living into their retirement years. These analysts tend to come to very pessimistic conclusions. For example, one study commissioned by Merrill Lynch concludes that Boomers would need to *triple* their rate of saving for retirement in order to maintain their pre-retirement standard of living. Other analysts have investigated whether Boomers will be better off in retirement than their parents were. These analysts (including the Congressional Budget Office) tend to arrive at more optimistic conclusions.

What factors have fueled concern? A number of developments suggest that Boomers may have to undertake a more aggressive saving program than their parents did:

- Earlier retirement. Between 1960 and 1991, the average age at which men began receiving Social Security retirement benefits declined from 66.8 years to 63.7 years. For women, the decline was from 65.2 to 63.5.
- Longer lifetimes. In 1960, a woman aged 65 could expect to live another 16 years. Today, a 65-year-old woman can expect to live another 19 years. For men, life expectancy at age 65 has risen from 13 years in 1960 to 15-1/4 years today.
- Guarded prospects for Social Security. According to the latest "intermediate" estimate of the Social Security Trustees, the OASDI Trust Fund will be insolvent in 2029, just as the youngest of the Boomers begin reaching retirement age. Analysts have suggested several steps that could be taken to improve the solvency of the system, including means-testing benefits, reducing cost-of-living allowances, and further boosting the normal retirement age. All of these steps would adversely affect the payout from the Social Security system to Boomers as a group. In addition, payroll taxes might be increased, and this might further reduce the net value of the system to Boomers (especially the younger members of the cohort) if the increase were enacted prior to their retirement.
- Slower growth in real wages. Benefits from Social Security and from many other retirement plans are tied to pre-retirement earnings. The slowdown in real wage growth since the early 1970s means that such benefits will be calculated from a lower base than would have been the case if the earlier growth of real wages had been maintained.
- Possible fiscal retrenchment outside Social Security. Long-run projections show the Federal deficit deteriorating sharply beginning around the turn of the century. Putting the Federal budget on a sustainable track may require

taking other steps in addition to reining in Social Security. These steps might include reductions in other transfers to the elderly (like Medicare).

- Cohort effects. Some analysts have worried that prices of key assets such as real estate may fall when Boomers sell their holdings. If so, then savings plans predicated on current asset prices may prove insufficient.

- Widening inequality of economic circumstances. Income inequality during working life will probably be transmitted into retirement. Low-skill workers are less likely than others to have access to an employment-based retirement plan; for workers without such access, resources in retirement may be especially scarce.

Any cause for hope? Not every indicator points in a discouraging direction.

- Boomers are better off currently than their parents were at the same age. Median real household income of Boomer households aged 25-34 in 1989 was 35 percent higher than the median real income of similarly aged households in 1959. And the income gain of Boomer households aged 35-44 over the previous generation was even greater.

- Female workforce participation is up. A higher fraction of Boomer women will be eligible for Social Security and other pension benefits in their own right, rather than relying on their spouses' benefits.

- Boomers may inherit the riches of their parents. Some analysts explain the apparent low rate of saving by Boomers as evidence that inheritances will help provide for the retirement income security of Boomers.

One trend with ambiguous implications.

- Defined-contribution retirement plans are becoming more important. An increasing fraction of workers derive their primary retirement coverage from defined-contribution plans (see Chart of the Week, September 19, 1994). These plans provide greater portability of benefits to job-changers. But they also shift investment risk from employers to employees, and saddle participants with greater responsibility for portfolio management. Many workers seem to be taking a low-risk approach to investing their retirement assets, and may therefore be earning low returns. And some may be succumbing to the temptation to use their pensions assets for non-retirement purposes, despite tax penalties for doing so.

What could be done? Available options fall into two categories: voluntary and mandatory. On the voluntary front, the Federal government could introduce new incentives for personal saving. Although the evidence on the effectiveness of IRAs in boosting national saving during the 1980s is mixed, a more effective program probably could be designed. On the mandatory front, the Social Security system could be supplemented by a compulsory saving program. A future issue of the Weekly Economic Briefing will examine the pros and cons of such programs.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Global Prospects Continue to Brighten. The International Monetary Fund's semiannual World Economic Outlook is out, and its tone is sunnier than in the recent past. World output is expected to increase 3.1 percent this year and 3.6 percent in 1995, up from only 2.3 percent in 1993. Even so, the Fund sees "little immediate risk of a generalized pick-up in inflation." U.S. growth is projected to ease to 2.5 percent next year, from 3.7 percent in 1994. (The Fund assumes that the Federal Reserve will increase short-term interest rates further, in light of its judgment that "little or no slack" remains in the U.S. economy.) Growth in both Germany and Japan will continue to pick up according to the Fund, from 2.3 percent and 0.9 percent respectively this year to 2.8 percent and 2.5 percent in 1995. Among the world's regions, Asia will remain the growth leader, although its rate of expansion is expected to moderate slightly to 7.3 percent in 1995 (from 8.0 percent this year). The former socialists economies, while showing improvement, still are not expected to register positive growth on average.

Choosing to Downsize. An annual membership survey by the American Management Association, whose 7000 members employ one-fourth of the U.S. workforce, reveals that 47.3 percent reported job eliminations in the 12 months ending in June, no better than in the preceding two years. The good news? First, the downsizing firms are eliminating fewer jobs than they did last year—9.2 percent of their workforces, on average, compared with 10.4 percent last year. Second, two-thirds of the downsizers were creating jobs (in other divisions or localities) at the same time, so that the net labor-force reductions for downsizers averaged only 5.2 percent, an improvement from last year's 8.4 percent. Finally, more firms are now <u>choosing</u> to downsize: When asked why they were eliminating jobs, fewer than half of the firms cited business downturns (versus almost two-thirds last year), and an increasing number cited productivity improvements or strategic moves.

"Supertomato" Market Ripens. Despite the criticisms that preceded it to the market, the genetically engineered "FlavorSaver" tomato appears headed for the nation's kitchens. Produced by Calgene of Davis, California, the tomato sold like hot cakes in 25 stores in Chicago, Sacramento, and San Diego over the summer. Recent sales have been held back by a lack of supply, but with a large crop now ready for harvest in California and Florida, Calgene expects the tomato to be available in 1,000 stores by year's end.

EYES ONLY

RELEASES LAST WEEK

Personal Income ****FOR RELEASE FRIDAY at 8:30 a.m.****

Personal income rose 0.4 percent in August (monthly rate), while disposable personal income rose 0.5 percent. Personal consumption expenditures rose 0.9 percent.

Gross Domestic Product

According to revised estimates for the second quarter, real GDP grew at a 4.1 percent annual rate.

Durable New Orders

Advance estimates show that new orders for durable goods increased 6.0 percent in August.

Consumer Confidence

Consumer confidence, as measured by the Conference Board, decreased 2.0 index points in September, to 88.4 (1985=100).

MAJOR RELEASES THIS WEEK

Leading Indicators (Tuesday)
Employment (Friday)

EYES ONLY

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	**4.1**
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	**3.0**
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.

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.**

EYES ONLY

FINANCIAL STATISTICS

	1992	1993	July 1994	August 1994	Sept. 29, 1994
Dow-Jones Industrial Average	3284	3522	3718	3797	3855
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	7.64
Mortgage rate, 30-year fixed	8.40	7.33	8.62	8.51	8.82
Prime rate	6.25	6.00	7.25	7.51	7.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level Sept. 29, 1994**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.546	−0.0	−4.0
Yen-Dollar	98.52	0.5	−6.3
Multilateral (Mar. 1973=100)	87.67	−0.1	−4.6

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	4.1 (Q2)	6.1 (Aug)	2.9 (Aug)
Canada	3.9 (Q2)	10.2 (Jul)	0.1 (Aug)
Japan	0.1 (Q2)	2.9 (Jun)	−0.2 (Jul)
France	2.0 (Q2)	12.4 (Jun)	1.7 (Aug)
Germany	2.3 (Q2)	6.6 (Jun)	2.9 (Aug)
Italy	0.6 (Q1)	11.9 (Apr)	3.7 (Aug)
United Kingdom	3.8 (Q2)	9.6 (Jul)	2.4 (Aug)

BR/Bo/GS/SM

EYES ONLY

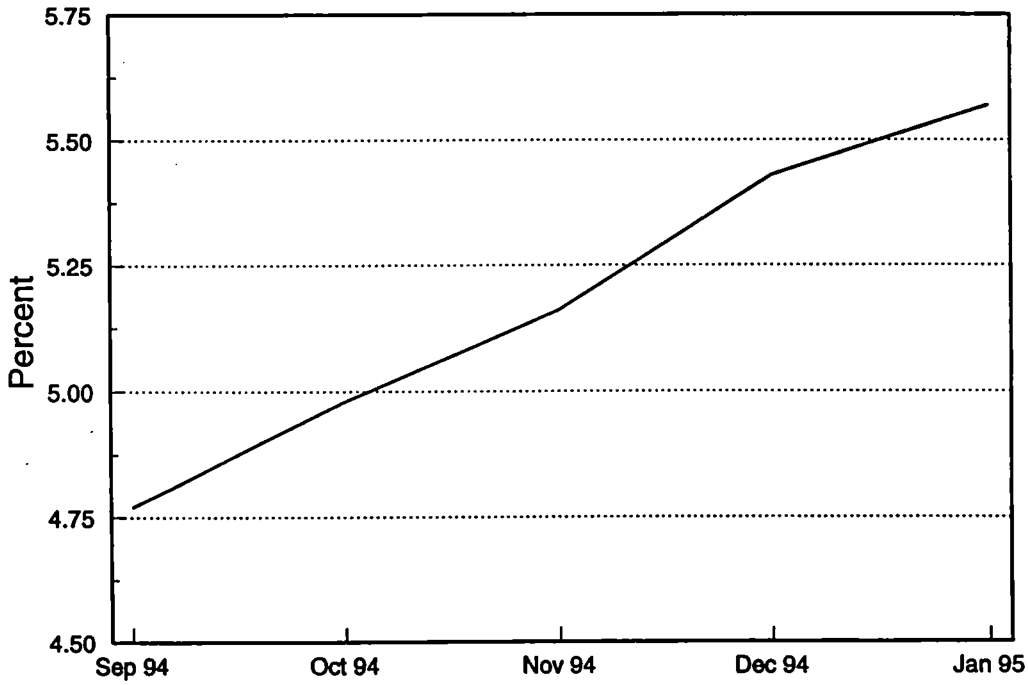
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

September 26, 1994

CHART OF THE WEEK

Investor Expectations of Future Short-term Interest Rates

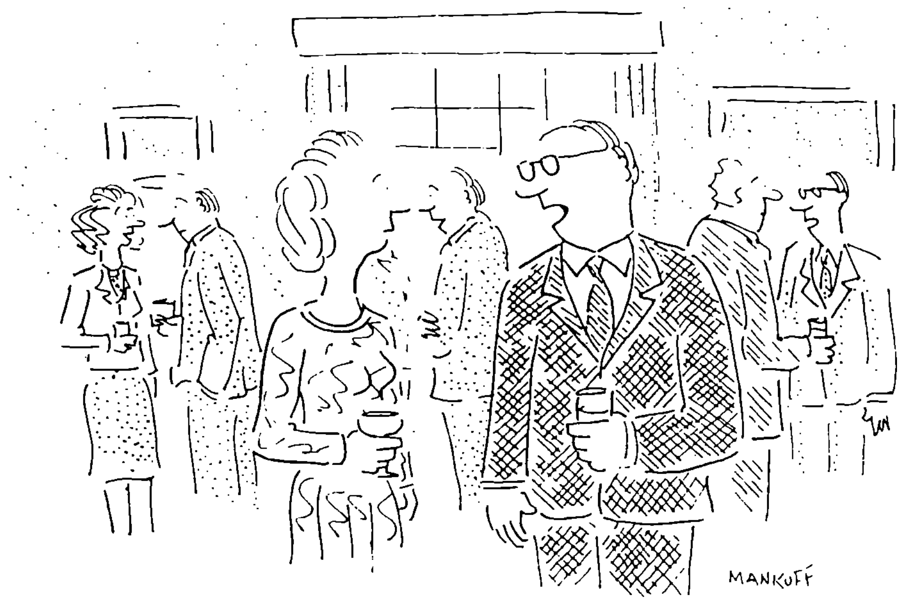


Note: Observations are closing prices for futures contracts quoted on September 22, 1994.

Investors in the market for futures on federal funds are betting that the Federal Open Market Committee will raise the federal funds rate when it reconvenes on Tuesday, September 27. They also expect further rate increases in coming months.

EYES ONLY

CONTENTS



"You can't fool the American people—that's why I'm in exports."

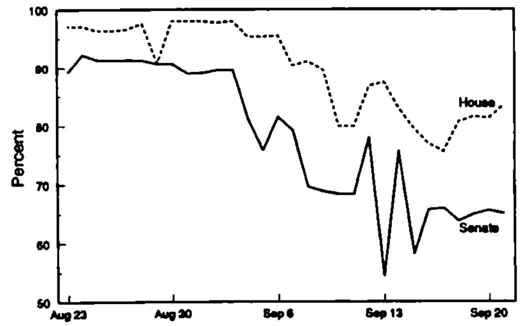
EYES ONLY

CURRENT DEVELOPMENT

Market Says Democrats Will Retain Control of Congress

Senate races. Democrats have a 65 percent chance of retaining control of the Senate in the upcoming elections, according to the latest data available from the Iowa Political Market (see chart for data and box below for description of the market). In separate results (not shown in the chart), the market is predicting that Democrats will emerge from the mid-term elections holding 56 seats, unchanged from the current total.

Probability that Control of the Senate and House Will Remain in Democratic Hands



House races. Meanwhile, Democrats in the House of Representatives are given an 83 percent chance of retaining control, with a separate market projecting a post-election total of 237 seats, down 19 from the current number of 256 seats.

The Iowa Political Market

Since 1988, the College of Business at the University of Iowa has sponsored trading in futures contracts with payoffs tied to the outcome of various political events. The market was sanctioned by the Commodity Futures Trading Commission in 1992, and traders from around the country participate via the Internet. Trading accounts are limited to an initial investment of no more than $500.

The accuracy of the market's predictions has yet to be tested in the United States on any issue as complicated as party control of the two Houses of Congress. However, in both the 1988 and 1992 Presidential elections, the market proved to be far more accurate than contemporaneous opinion polls in predicting the vote share of each candidate.

EYES ONLY

CURRENT DEVELOPMENT

Lethargy in California Masks Strength Elsewhere

National statistics that include California substantially understate the strength of the economy in the rest of the nation. For example, personal income grew a meager 1.3 percent in California over the four quarters ending in 1994:Q1 (latest data available). By contrast, personal income in the rest of the country increased 4.5 percent. Other major indicators tell a similar story (see box).

Analysis. If the California economy were to strengthen significantly, the national economic picture would brighten considerably. However, fears of macroeconomic overheating no doubt would also be exacerbated.

U.S. Economic Performance With and Without California
(percent change except for the unemployment rate)

	1981-90 annual average	1992	1993	1994
Personal Income (Q4/Q4)				
United States	7.2	6.5	4.4	4.1[1]
California	7.9	5.3	3.2	1.3[1]
U.S. excluding Calif	7.1	6.7	4.5	4.5[1]
Retail Sales (Dec/Dec)				
United States	6.2	10.2	7.0	8.2[2]
California	6.8	3.4	3.1	5.2[2]
U.S. excluding Calif	6.1	11.1	7.5	8.6[2]
Unemployment Rate (annual average)				
United States	7.1	7.4	6.8	6.3[3]
California	7.1	9.1	9.2	9.0[3]
U.S. excluding Calif	7.1	7.2	6.5	6.0[3]
Payroll Employment (Dec/Dec)				
United States	1.8	1.1	2.1	2.7[4]
California	2.3	-1.6	-1.2	-0.4[4]

[1] 1st Qtr/1st Qtr, adjusted for bonus payments in 1992:Q4
[2] June/June
[3] January through August (new CPS basis)
[4] July/July

EYES ONLY

ARTICLE

Why a Reduction in the Capital Gains Tax Is Not a Panacea

As part of their "contract with the American people," Congressional Republicans may propose reductions in the tax rates on capital gains income.

Current treatment. Under current law, capital gains income is taxed like other forms of income, with four major exceptions. First, capital gains income is never taxed at a higher rate than 28 percent, while other income (e.g., wages and salaries) may be taxed at rates as high as 39.6 percent. Second, half of all gains generated by equity investments in certain "small" businesses held for at least five years may be excluded from taxable income. Third, capital gains income is taxed only when assets are sold; unrealized gains are not taxed. Fourth, the income tax liability of an appreciated asset is forgiven when its owner dies. In combination, these aspects of current law ensure that capital gains income is taxed more lightly—often significantly so—than other forms of income.

Should current treatment be changed? There are six major rationales offered by proponents of additional tax relief for capital gains income. All six are questionable in important ways.

- *"A lower rate would be a revenue raiser."* Over the long haul, capital gains realizations appear to be fairly insensitive to changes in the tax rate. As a result, a reduction in the capital gains tax rate is almost surely a revenue loser in the long run—and probably within the 5-year and 10-year budget windows as well. Nonetheless, a reduction in the capital gains tax rate may be a revenue gainer in the short run, especially if the reduction is viewed as temporary, which would encourage asset sales to take advantage of a short-term opportunity.
- *"A lower rate would boost national saving."* National saving is the sum of private saving and public saving. Most evidence suggests that private saving is not very responsive to changes in after-tax rates of return, and thus would not increase much in the wake of a cut in the capital gains tax rate. Thus a reduction in the tax rate would probably <u>reduce</u> national saving because it would not elicit a sufficient increase in private saving to compensate for the decrease in public saving resulting from lower revenues. (The CEA in the previous Administration took the opposite view, but they assumed that personal saving is much more responsive to capital gains tax rates than most estimates suggest.)
- *"A lower rate would reduce the inequity of taxing gains resulting from inflation."* In an ideal income tax system, <u>all</u> capital-related items (including interest receipts and outlays as well as asset prices) would be adjusted for inflation. Unfortunately, such adjustments would be difficult to implement in practice. Although a lower rate on capital gains is one way to adjust for the effect of inflation, it is a crude way at best.

- *"A lower rate would encourage investors to reallocate investment toward more dynamic sectors of the economy."* Capital gains taxes may increase the reluctance of some investors to sell assets and reinvest in possibly more profitable activities. However, the small-company capital gains rate reduction enacted in OBRA93 was an attempt to address this concern, and it is not obvious that more is needed. Moreover, unlike the OBRA93 adjustment, most proposals for additional tax relief make no attempt to target dynamic sectors.
- *"A lower rate would reduce the 'lock-in' effect caused by the tax-free accumulation of capital gains until realization and the step-up in basis at death."* The step-up of basis at death may indeed inhibit the turnover of some assets, because the financial reward for dying in possession of an asset with accumulated gains can be large (up to 28 percent of the value of the asset). But certainly the most straightforward way to eliminate this effect is to eliminate its cause—the step-up in basis.
- *"A lower rate would reduce the alleged double taxation of business investments held in corporate form."* Double taxation probably is not a very serious problem in itself. The real issue is the overall burden the tax system places on business investments. The most direct way to calibrate (and possibly reduce) this burden would involve integrating the corporate and individual income taxes; however, this would be particularly controversial.

There are at least two additional arguments against a further reduction in capital gains tax rates.

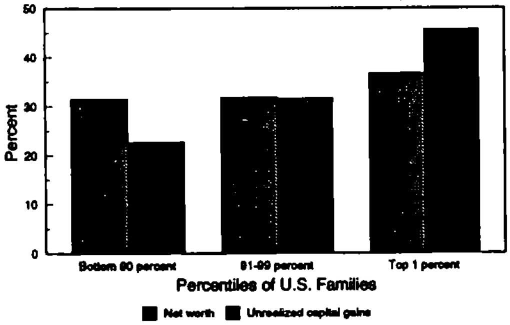
- <u>Distributional considerations</u>. A reduction in capital gains tax rates would benefit the owners of assets, especially those with unrealized capital gains. Ownership of both wealth and unrealized capital gains is quite concentrated (see Special Analysis)—so the benefits of a reduction in capital gains tax rates would accrue disproportionately to the wealthiest Americans. A 1992 analysis by the Joint Committee on Taxation of a Bush Administration proposal estimated that about half of the reduction in tax burden resulting from that proposal would have gone to the 1 percent of the population with the highest incomes.
- <u>Tax avoidance</u>. Increasing the differential between the tax rate on capital gains income and that on ordinary income would increase the payoff to engaging in some forms of tax avoidance. Taxpayers would have a greater incentive to transform ordinary income into tax-preferred capital gains income (e.g., closely held corporations might retain earnings rather than pay dividends to shareholders).

For all these reasons, the economic merits of a reduction in capital gains tax rates are questionable at best, although some adjustments may have limited beneficial effects.

SPECIAL ANALYSIS

The Distribution of Unrealized Capital Gains

Distribution of Ownership of
Household Net Worth and Unrealized Capital Gains



Holdings of unrealized capital gains are even more concentrated than wealth. For example, in 1989 (latest data available), the top 1 percent of capital gains owners held 46 percent of all unrealized capital gains, whereas the wealthiest 1 percent of families owned "only" 37 percent of household net worth (see chart).

Overall, 44 percent of total household net worth in 1989 was held in the form of unrealized capital gains. In combination, the skewed distribution of unrealized gains, and their magnitude, indicate that a reduction in capital gains tax rates would increase the inequality of the distribution of wealth.

How are the Gains Held? More than 40 percent of all unrealized capital gains are embedded in the value of primary residences. Capital gains on primary residences generally escape taxation because: (1) taxpayers may roll over the gains from the sale of one residence into the purchase within two years of another, and (2) taxpayers over the age of 55 may exclude $125,000 of such gains from taxable income.

Another 20 percent of unrealized gains is held in other real estate. About 33 percent is embedded in directly-held business. Surprisingly, only 5 percent of total gains are held in equities (either individual stocks or mutual funds).

Who Owns the Gains? In 1989, 61 percent of all families held assets with unrealized capital gains. Families with a head between the ages of 45 and 64 were the most likely to hold assets with gains; 74 percent of all such families held unrealized gains.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Trash Turns to Green for Cities. Prices of baled cardboard, used newsprint, and other types of waste paper are on the rise this year, giving a boost to recycling efforts. For example, West Coast prices for old newspapers have shot up, from $45 per ton to over $100 per ton. The upturn in prices is benefitting municipalities across the country. Philadelphia previously paid $5 per ton to have its newspapers recycled; recyclers are now paying the city $16 for each ton it collects. At the city's current annual volume, this price increase would translate into nearly $700,000 in unanticipated budgetary savings.

U.S. Increases Competitiveness in High-Tech Areas. The United States has made broad gains in its global technological standing according to a new report by the private-sector Council on Competitiveness. An earlier Council report in 1991 examined a list of 94 critical technologies, and concluded that U.S. industry was "weak" or "losing badly" in 33 of them. Since then, the United States has substantially improved its competitive standing in 22 of those areas, including printed circuit board technology, gallium arsenide and silicon technologies (used in making semiconductors), robotics, and integrated-circuit fabrication and testing equipment. In addition, U.S. industry remains the world leader in all but one of the categories in which it led in 1991, including biotechnology, software, environmental technologies, and database systems. The main poor grade on the nation's recent report card: liquid crystal and other displays, an area in which U.S. industry has made no progress since being classified as "losing badly" three years ago.

Detecting Troubled Bridges (In Some Cases, Over Water). A University of Pennsylvania scientist has devised a new method for detection of metal fatigue and corrosion in bridges and airplanes. The method operates by measuring the tiny electrical charges that are released when metal cracks—long before the fractures are visible to the human eye. Early detection may save lives, and should help city planners and airline fixit chiefs to allocate maintenance budgets more efficiently. Los Angeles' Tensiodyne Scientific Corporation owns the rights to the procedure and hopes to produce a commercial measuring device.

EYES ONLY

RELEASES LAST WEEK

U.S. International Trade in Goods and Services

The goods and services trade deficit rose to $11.0 billion in July from $9.0 billion in June.

Housing Starts

Housing starts were up 2.1 percent in August to 1.44 million units at an annual rate. Starts during the first 8 months of this year were 16 percent above their level during the same period in 1993.

MAJOR RELEASES THIS WEEK

Consumer Confidence—Conference Board (Tuesday)
Advance Durable Shipments and Orders (Wednesday)
Gross Domestic Product (Thursday)
Personal Income (Friday)

EYES ONLY

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.

		1993	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

EYES ONLY

FINANCIAL STATISTICS

	1992	1993	July 1994	August 1994	Sept. 22, 1994
Dow-Jones Industrial Average	3284	3522	3718	3797	3837
Interest Rates					
3-month T-bill	3.43	3.00	4.33	4.48	4.79
10-year T-bond	7.01	5.87	7.30	7.24	7.56
Mortgage rate, 30-year fixed	8.40	7.33	8.62	8.51	8.73
Prime rate	6.25	6.00	7.25	7.51	7.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level Sept. 22, 1994**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.547	–0.1	–5.1
Yen-Dollar	98.0	–1.4	–7.8
Multilateral (Mar. 1973=100)	87.73	–0.4	–5.1

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 (Aug)
Japan	–0.0 (Q1)	2.9 (Jun)	–0.2 (Jul)
France	2.0 (Q2)	12.4 (Jun)	1.7 (Aug)
Germany	2.3 (Q2)	6.6 (Jun)	2.9 (Aug)
Italy	0.6 (Q1)	11.9 (Apr)	3.7 (Aug)
United Kingdom	3.7 (Q2)	9.6 (Jul)	2.4 (Aug)

EYES ONLY

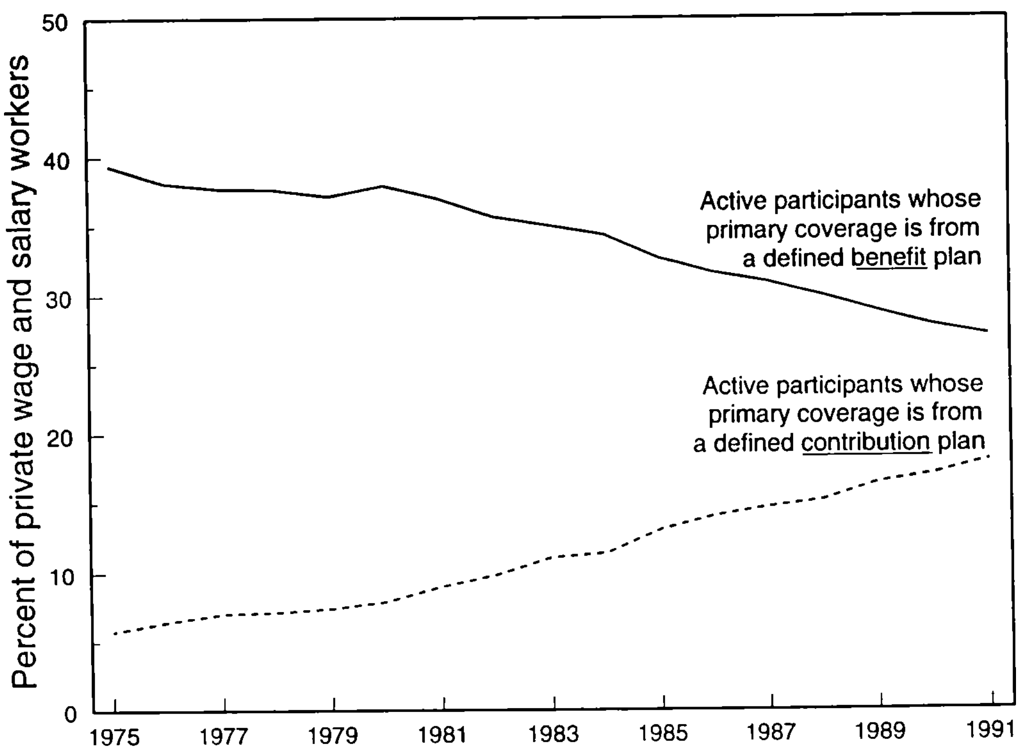
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

September 19, 1994

CHART OF THE WEEK

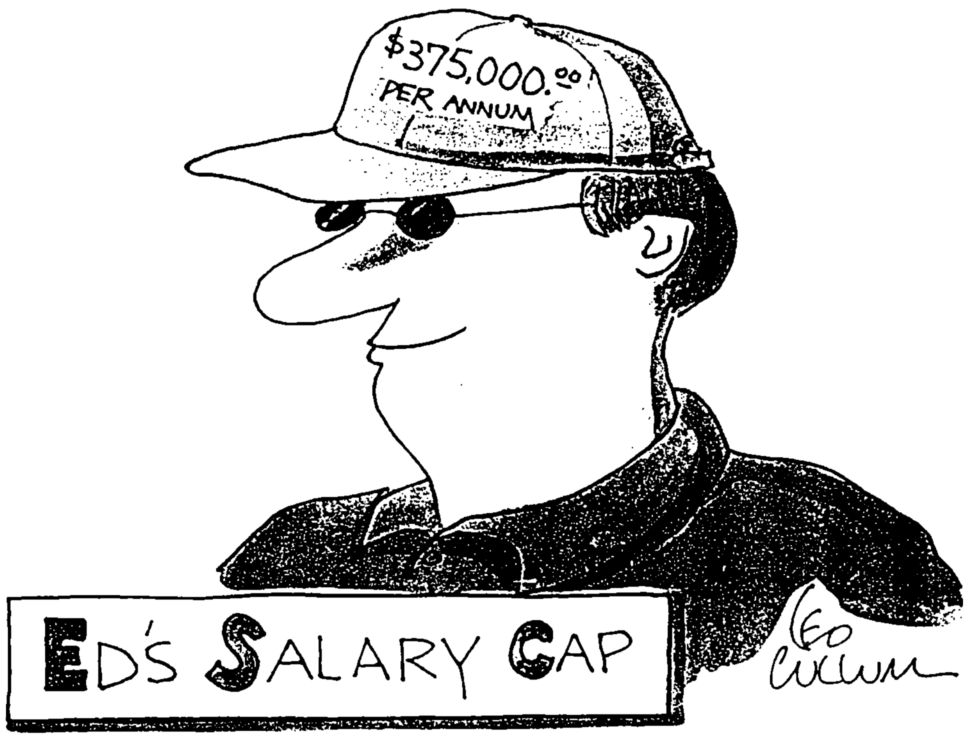
The Changing Composition of Pension Coverage



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.

EYES ONLY

CONTENTS

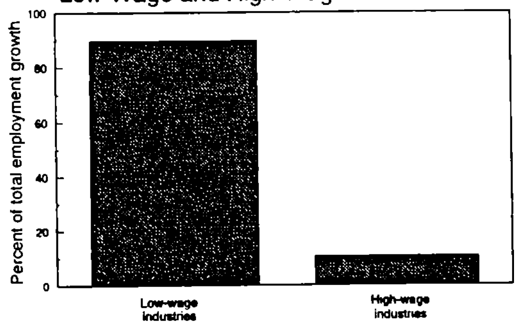


EYES ONLY

TREND

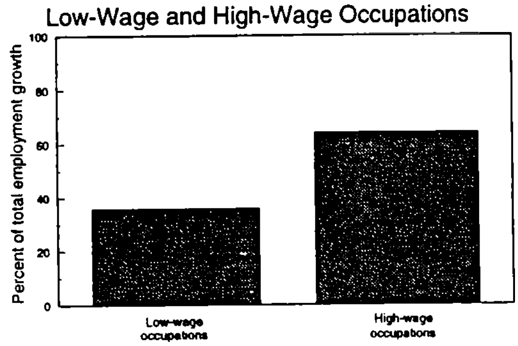
Update on the Quality of Jobs

Employment Growth in
Low-Wage and High-Wage Industries



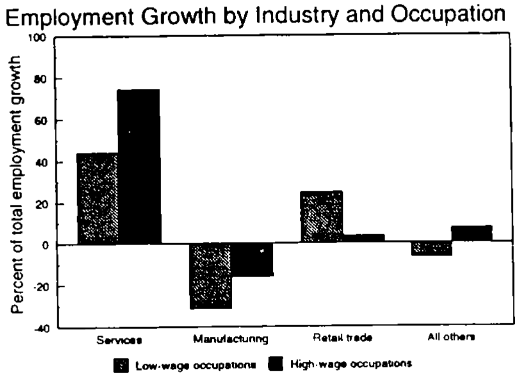
Job growth by industry. Job growth in recent years has been concentrated in low-wage industries, especially services. Jobs have been shed in many high-wage industries such as manufacturing. Overall, an estimated 89 percent of net new jobs created between 1988 and 1993 were in industries with below-average 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 most of the net new jobs created over the last five years were in *high-wage occupations* located in *low-wage industries*. 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.

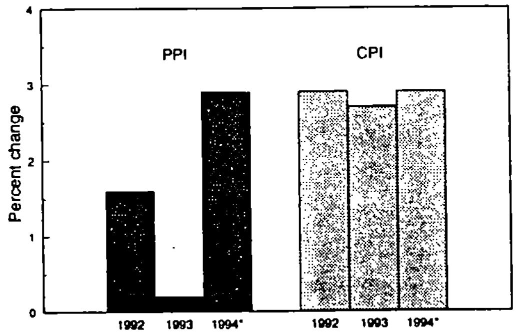
EYES ONLY

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.

EYES ONLY

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.

EYES ONLY

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.

EYES ONLY

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)

EYES ONLY

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.

		1993	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**.

EYES ONLY

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**	**Percent Change from 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)

EYES ONLY

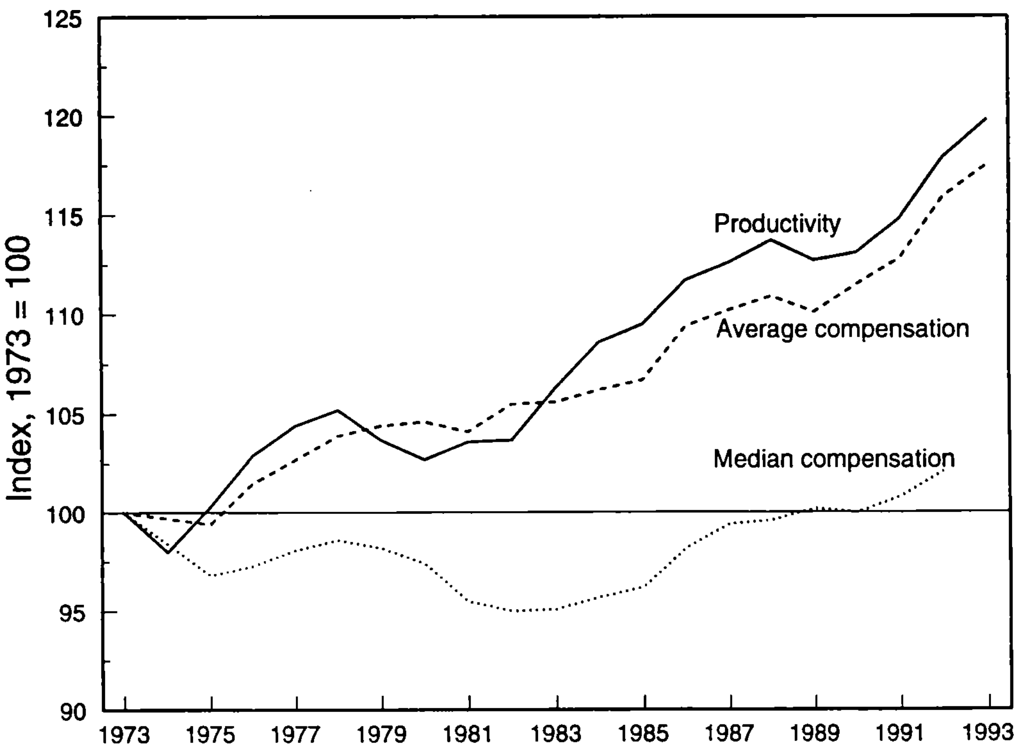
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

September 12, 1994

CHART OF THE WEEK

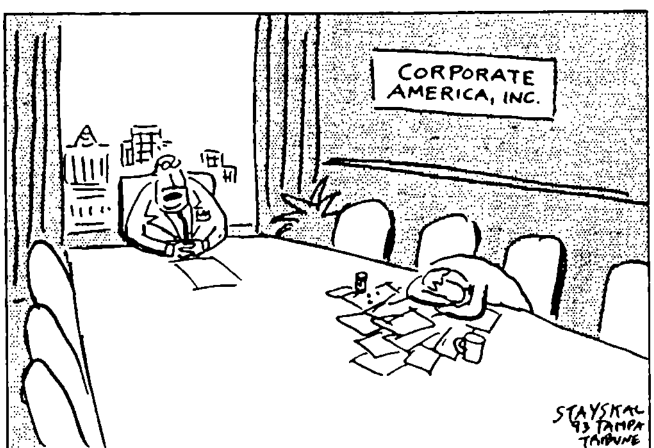
Productivity and Real Compensation



Over the past 20 years, average compensation (defined in terms of product prices) has tracked average productivity reasonably closely. However, median compensation has lagged behind. The gap between average and median compensation probably reflects the increase in the inequality of the distribution of income.

EYES ONLY

CONTENTS



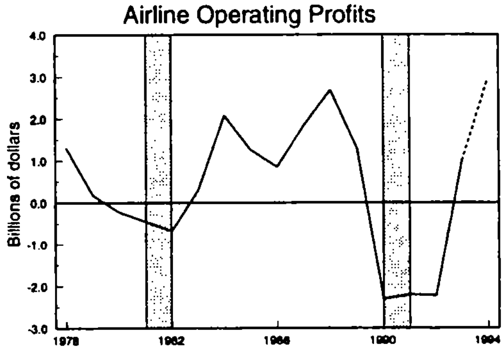
"AND NOW, GEORGE, LET'S HAVE YOUR REPORT ON HOW TRIMMING THE PAYROLL HAS BOOSTED OUR EFFICIENCY AND PRODUCTIVITY!"

CURRENT DEVELOPMENT

Airline Profits Rebound

In the year since the publication of the Airline Commission's report, the profitability of the airline industry has improved markedly (see chart).

Airline Operating Profits



Note: Observation for 1994 is a projection.
Shaded areas indicate recessions.

Analysis. Airline profits are extremely sensitive to the business cycle. Between 1987 and 1989—the last three years of the previous economic expansion—the major carriers earned large operating profits. Between 1990 and 1992—the three years surrounding the most recent recession—the industry suffered comparably large operating losses. In line with past experience, most major carriers are again showing operating profits now that the economy has strengthened.

Despite the improved financial condition of the industry as a whole, some carriers are still struggling. Although USAir earned an operating profit in the second quarter (traditionally its best quarter), its long-term prospects remain bleak unless it can reduce labor costs (see box). Delta has been taking losses in its foreign operations. TWA's financial condition is shaky, and Continental has yet to prove that it can profitably sell no-frills fares on routes in lower-density markets. However, these carrier-specific problems do not reflect a structural problem facing the industry as a whole.

USAir, Unions Talk; Little Progress Reported

To stave off insolvency, USAir probably needs to negotiate major wage and work rule concessions from its unions, perhaps in exchange for a substantial ownership interest (see Weekly Economic Briefing, May 6, 1994). In August, a contract proposal by the pilots' union was rejected by unions representing other USAir employees and by management.

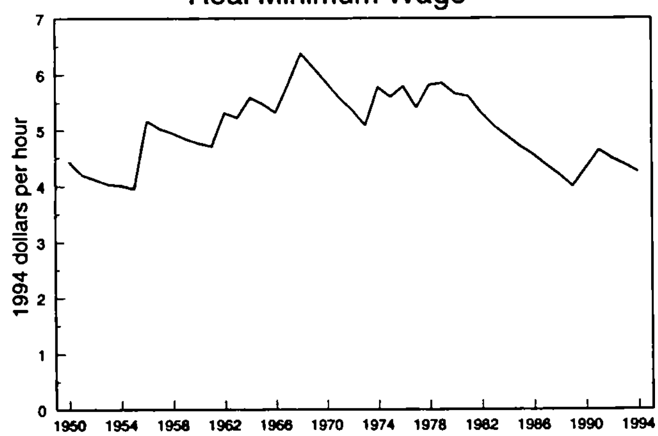
EYES ONLY

TREND

Minimum Wage Near Postwar Low in Real Terms

Since April 1991, the minimum wage has been fixed at $4.25 per hour. In real terms, its current level is near the postwar low. During the 1970s, the real minimum wage was about 25 percent higher than it is today (see chart). Between 1981 and 1989, however, the minimum wage was fixed in nominal terms at $3.35 per hour, leading to a significant erosion in real terms.

Real Minimum Wage



Note: Observation for 1994 is a projection.

Non-wage compensation of minimum-wage workers has probably declined since the 1970s as well. In 1979, 40 percent of workers in the bottom quintile of wage earners were covered by employer-provided health insurance; by 1989, this fraction had declined to 26 percent. Similarly, the fraction of low-wage workers participating in employer-sponsored pension plans declined from 18 percent to 13 percent.

In 1993, 4.2 million workers were at or below the minimum wage of $4.25 per hour. Another 1.1 million workers earned between $4.25 and $4.50 per hour.

EYES ONLY

ARTICLE

Causes and Consequences of the Decline of Unionization

In the mid-1950s, more than one-third of American workers employed in the private non-agricultural sector belonged to unions. Today, the figure is only 11 percent. The celebration of Labor Day is an appropriate time to summarize recent evidence on the causes and consequences of this decline.

Causes of Declining Unionization. About one-fifth of the decline in private-sector unionization can be attributed to three structural changes in the economy: a shift out of the more unionized manufacturing sector toward the less unionized service sector; an increase in the share of women (who are less unionized than men) in the labor force; and a shift in production from the more unionized North and Midwest to the less unionized South.

Another fraction of the decline in unionization can be attributed to a reduced enthusiasm of workers themselves for unions. For example, in 1977, about 39 percent of American workers said they would vote for union representation. Over the next 11 years, this share declined to 33 percent.

Perhaps the most important explanation, however, for the union decline is intensified management opposition. Despite a legal guarantee of collective representation, some employers take actions to discourage the unionization of their workforces. For example, an illegal employee termination occurs during roughly one-fourth of all union campaigns for representation. And workers seem to understand the hazards of engaging in pro-union activities. In a 1991 poll, 79 percent of workers agreed that it was "very" or "somewhat" likely "that nonunion workers will get fired if they try to organize a union." (The Dunlop Commission is looking into possible changes in labor law, with a focus on both union organizing and on changes to promote employee involvement.)

Together, these factors have led to a dramatic decline in the rate of organization of new workers. In the peak years of the 1950s, unions organized new workers at a rate of 2 percent of the workforce per year; more recently, this rate has declined to 0.1 percent per year. This latter rate is below the natural "death" rate of existing union jobs due to downsizing, plant closings, and occasional union decertifications. Furthermore, the fraction of newly elected unions successfully negotiating a first contract has declined from about 85 percent in the 1950s to roughly 70 percent today.

Consequences of Declining Unionization. Economists have attempted to define and quantify several economic consequences of the decline in unionization.

Effects on wages and benefits. Unions boost the wages of unionized workers by an estimated 15 percent, on average. The decline in unionization in recent decades may account for as much as a third of the reduction in the average blue-collar wage between 1979 and 1988. Unions also secure pension and health benefits for a larger fraction of their members, and these benefits tend to be more generous than the benefits of nonunion workers.

The effect of higher compensation for union members on the compensation of nonunion workers is unclear. On the one hand, union wage gains will tend to reduce employment at unionized firms. The resulting migration of workers into nonunionized activities may put downward pressure on nonunion compensation. On the other hand, nonunion firms may choose to pay union wages simply to reduce the possibility of becoming unionized.

Effects on productivity. Unions are associated with higher productivity both because they tend to reduce employee turnover and because they encourage improvements in the quality of management.

Effects on profits. Since unions increase wages more than they boost productivity, on average, they tend to reduce profits. Conversely, the decline in unionization over the past several decades probably has been good for profits.

Effects on inequality. Unions mainly raise low-end wages relative to those of managers and other high-wage workers. According to recent evidence, the decline in unions may be responsible for as much as 20 percent of the increase in wage inequality in the last 15 years.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Hirers to Outnumber Firers in Fourth Quarter. According to Manpower Inc.'s latest quarterly survey of employment plans, hiring should remain strong for the remainder of the year: 26 percent of surveyed firms expect to expand their payrolls over the next three months, while only 10 percent expect to contract. Hiring plans are especially robust in the durable-goods manufacturing sector, where 30 percent of firms intend to add personnel and only 9 percent anticipate shedding workers—the strongest reading for this time of the year since 1978.

Coals to Yokohama? The Ford Motor Company has announced that it will invest $40 million in a new technology center in Yokohama, Japan. The facility's scientists and engineers will develop parts and components for Japanese car manufacturers, focusing on fuel injection, onboard computers, visual displays, voice communications, safety, and climate control. Ford now sells about $300 million worth of parts annually to Japanese firms, mostly to plants located in the United States.

Gunning for Mickey and Donald. Sega Enterprises, the Japanese video-game giant, has announced plans to open as many as 50 high-tech miniature theme parks in North America by the end of the decade. Described by a company official as "somewhere between Disneyland and an arcade," these parks will feature both traditional video games and larger virtual-reality and interactive rides. Yokohama's Joypolis Park, one of two such parks that Sega has already opened in Japan, draws up to 10,000 customers on weekend days, each of whom spends an average of $35 to $40. According to press reports, one of the parks will be built in Los Angeles, at a cost of about $25 million, and with the participation of MCA Inc., a U.S. subsidiary of Matsushita Electric of Japan.

Man Bites Dog, Large Firm Adds Workers. United Airlines, recently purchased by its employees (see Weekly Economic Briefing July 15, 1994), announced recently that it has lifted a hiring freeze and plans to add more than 1,700 workers. The firm currently has 75,500 employees, down from a high of 85,000 in 1993. The new employees will include 140 pilots, 240 flight attendants, and 1200 reservations agents.

EYES ONLY

RELEASES THIS WEEK

Producer Price Index ****Embargoed until 8:30 a.m., Friday****

The producer price index for finished goods rose 0.6 percent in August. Excluding food and energy, producer prices were up 0.4 percent.

Productivity

Nonfarm business productivity declined 2.5 percent at an annual rate in the second quarter. Manufacturing productivity increased 4.5 percent.

MAJOR RELEASES NEXT WEEK

Consumer Prices (Tuesday)
Retail Sales (Wednesday)
Industrial Production (Friday)

EYES ONLY

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**

	1970–1993	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.

	1970–1993	1993	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	N.A.
PPI-Finished goods	5.0	0.2	0	0.5	**0.6**

New or revised data in **boldface**.
PPI data **embargoed until 8:30 a.m., September 9, 1994 (Friday)**.

EYES ONLY

FINANCIAL STATISTICS

	1992	1993	July 1994	August 1994	Sept. 8, 1994
Dow-Jones Industrial Average	3284	3522	3718	3797	3908
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INTERNATIONAL STATISTICS

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Yen-Dollar	99.4	–0.2	–5.8
Multilateral (Mar. 1973=100)	88.72	–0.6	–3.4

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
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