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WEB Aug. 1995

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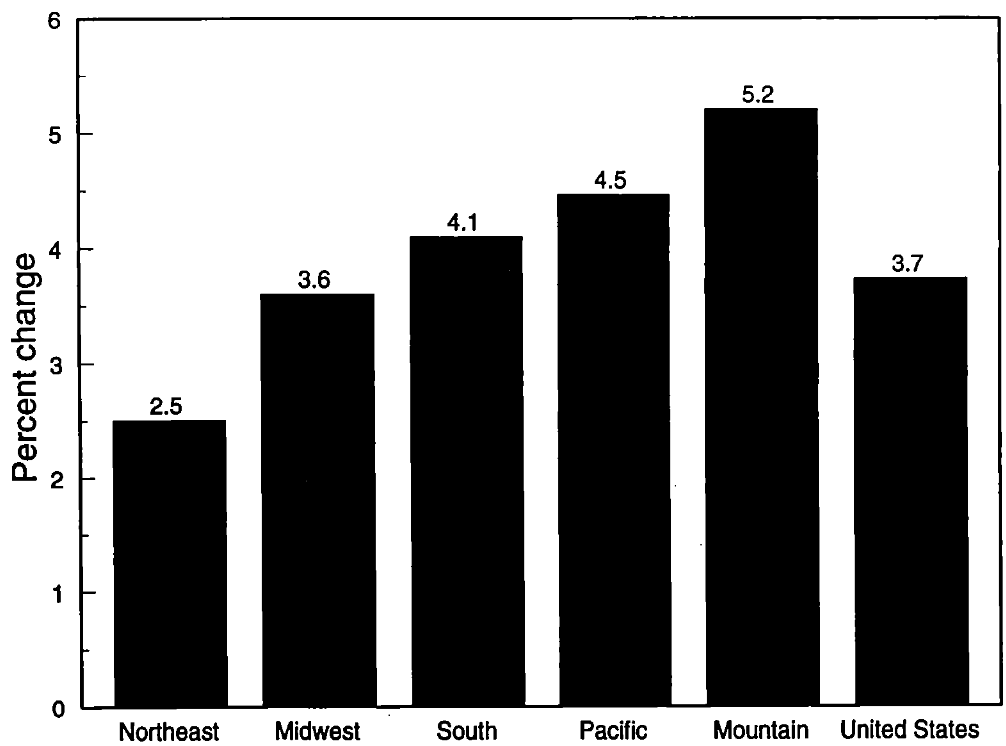
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

August 11, 1995

CHART OF THE WEEK

National and Regional Growth in Real Personal Income
First Quarter 1994 to First Quarter 1995



Personal income, adjusted for inflation, grew by a healthy 3.7 percent nationally from the first quarter of 1994 through the first quarter of this year (latest data). Gains in income varied sharply across the country, with the Mountain states posting the largest increase and the Northeastern states lagging behind the national average. Overall, the regional pattern of income growth was similar to that for recently reported employment growth (see Chart of the Week, <u>Briefing</u>, July 28, 1995), except for the Pacific states, which had relatively weak growth in employment but strong growth in income.

EYES ONLY

CONTENTS

"I think you may be getting them mixed up—Perot is the one with charts, and Perdue is the one with chickens."

EYES ONLY

MACROECONOMIC UPDATE

Resuming Cruise Control

Economic growth in the current quarter should bounce back from its sluggish pace of last quarter, with real GDP rising at an annual rate of 1.5 to 2.5 percent. Neither the sharp cut in auto production nor the double-digit decline in housing construction, which together were responsible for weakness in the second quarter, should repeat this quarter. Price increases have been restrained in recent months, and inflation could easily be below 3 percent for the year. Job creation during coming months is likely to match the expansion of the labor force, so that the unemployment rate, currently at 5.7 percent, should vary little over the quarter.

Because data for the third quarter are very incomplete at this date, estimates of economic growth are necessarily imprecise. Favorable indicators for near-term growth include:

- Hours worked grew strongly in July, following impressive gains in June. This should boost income growth.
- Industrial production in June posted its first gain since January and probably also rose in July due to a big jump in electricity production, which resulted from unusually warm weather in parts of the country.
- Orders for and shipments of non-defense capital goods (excluding aircraft) continue to show growth well above trend.
- Sales of new single-family homes continued to rebound in June, returning the inventory of unsold new homes relative to sales to more comfortable levels.
- Production schedules for motor vehicles indicate an increase relative to the second quarter.

Unfavorable indicators for near-term growth include:

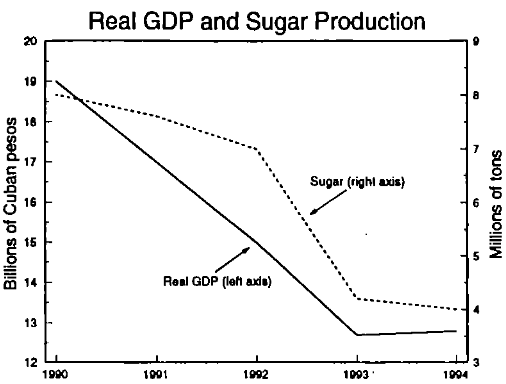
- July sales of motor vehicles were lower than expected, and could lead to cuts in planned production. Retail sales other than motor vehicles were also lackluster.
- Real disposable income fell during the last quarter.
- A widely used survey of consumers indicates that more people expect the unemployment rate to rise.
- Payroll employment growth was weak in July.

EYES ONLY

TREND

The Cuban Economy: Struggling to Recover

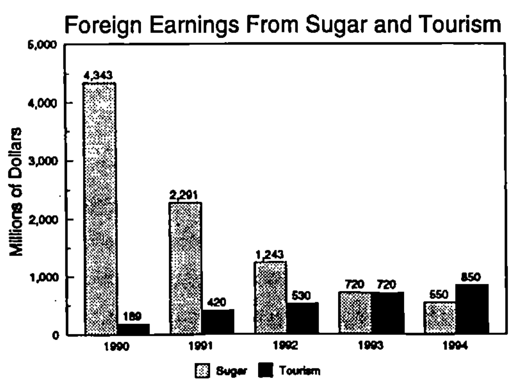
With the collapse of the Soviet Union, Cuba lost both its primary trading partner and main source of external financial support. This event, coupled with a sharp decline in sugar production (see top chart), drove the Cuban economy into severe recession, as gross domestic product plunged by a staggering 33 percent from 1990 through 1993. Economic growth was stagnant in 1994, and forecasts predict a modest 2 percent growth rate for 1995. With per capita GDP of about $1700 (roughly comparable to that of Bulgaria), living standards remain poor for most Cubans, many of whom continue to face daily power outages, deteriorating housing, and rationing of consumer products and food.



Government Initiatives. Although the Cuban economy still is directed heavily by the state, the government recently has made some limited moves to shift the economy away from its socialist foundations and towards further integration with the global economy.

- Domestic Market Reform: In recent years, the government has scaled back central planning, cut government employment, and reduced subsidies. It expects that another 10 percent of the labor force will lose their jobs in coming years as part of efforts to restructure inefficient industries. Cuban officials hope that many of the newly jobless will enter the swelling ranks of the self-employed (an option legalized for certain sectors in 1994) or join workers' cooperatives that now manage some former government operations in agriculture.

- Integration with the World Economy: Joint ventures with foreign corporations have increased recently, with investment inflows coming from Canada, Western Europe, and Mexico. Much of this investment has been in tourism which last year surpassed sugar as the largest source of foreign earnings for Cuba (see bottom chart). A new investment law, which soon may be implemented, might allow full foreign ownership of businesses and property, thus providing further incentives for foreign investment. In another move



to encourage foreign investment, the government in July 1993 legalized the use of the U.S. dollar within Cuba. It is unclear how successful such efforts to attract investment will be since foreign investors remain wary of the myriad state controls and continue to be uncertain about the government's commitment to economic reform.

EYES ONLY

SPECIAL ANALYSIS

Weighing the Costs: The ITC Report on Unfair Trade Laws

When foreign companies sell products in the United States at excessively low prices, U.S. companies may be injured or forced out of business. In theory, anti-dumping and countervailing duty laws are intended to prevent foreign companies from competing unfairly by setting such cut-throat prices (see box). But in practice, the laws may also prevent foreign companies from offering low prices even when they are competing fairly. A recent report requested by the U.S. Trade Representative and conducted by the International Trade Commission concludes that the costs to consumers and other producers of anti-dumping and countervailing duties exceed the benefits to the affected industry.

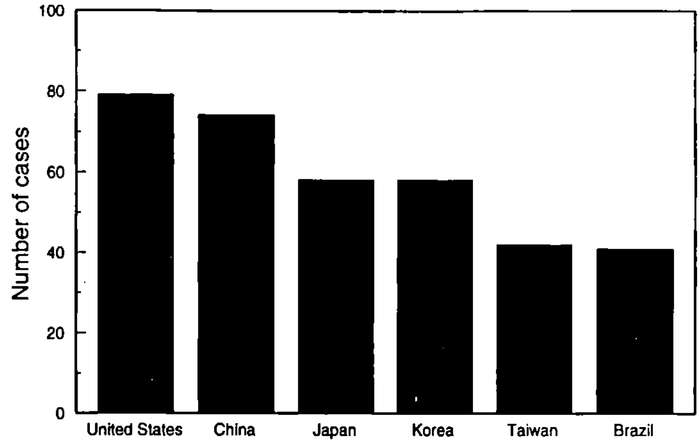
An Example. The I.T.C. report estimates that anti-dumping and countervailing duties on ball bearings led both U.S. and foreign producers to raise their prices significantly after anti-dumping and countervailing duty cases were filed in 1988 (duties were imposed beginning in 1989). These price increases generated benefits of $70 million per year for U.S. producers and boosted employment in the industry by 8.4 percent. But because consumers and industrial purchasers had to pay higher prices for both domestic and foreign bearings, the duties cost them $136 million. So the net impact on the economy was a loss of over $65 million per year, which amounts to an annual cost of about $70,000 per job saved in the ball bearing industry (relative to average annual compensation of about $35,000).

The story is similar for other industries. The I.T.C. estimates that the 163 anti-dumping and 76 countervailing duty orders applied to imported goods during 1991 reduced U.S. economic welfare by $1.6 billion. One I.T.C. commissioner believes that since then the cost may have doubled because of an expansion after 1991 in imports subject to duties.

Analysis. In general, lower prices for the goods we consume make us better off. One exception is when lower prices drive U.S. producers out of the market, subsequently allowing foreign firms to raise their prices. In this case, trade laws designed to prevent such practices should be swiftly applied before U.S. producers suffer irreparable harm. But when such predatory pricing is absent, the anti-dumping and countervailing duty laws often prevent consumers from enjoying lower prices. Instead, these laws often force consumers and downstream producers to pay higher prices, which serve to protect inefficient domestic industries.

Costs to U.S. Exporters. U.S. companies exporting abroad may bear additional, indirect costs when foreign governments use laws similar to our anti-dumping and countervailing duty statutes to limit U.S. exports to foreign markets. In recent years, our exporters have been subject to more anti-dumping cases than firms from any other country (see chart). As foreign governments continue to mimic our unfair-trade statutes, any biases or problems in those statutes may redound to the detriment of our exporters.

Anti-Dumping Cases Filed Against Exporters
From the U.S. and Other Countries, 1989-1993



Conclusion. U.S. industries often use anti-dumping and countervailing duty laws in efforts to limit competition, rather than reserve their use for situations of unfair dumping. But any benefits to these industries usually are more than offset by the costs to consumers and other producers. Furthermore, U.S. exporters continue to bear the risk that foreign governments will use similar laws to limit U.S. access to markets abroad.

Anti-dumping and countervailing duty laws

"Dumping" occurs when foreign firms sell their products in the United States at prices below some "fair value" (usually either the foreign price or the foreign cost of producing the good). The anti-dumping laws address such behavior and, if U.S. firms are injured, impose import duties equal to the margin of dumping. The countervailing duty statutes are intended to offset foreign government subsidies that distort international trade. Using the standards applied under these laws, analysts have estimated that in the U.S. market, prices set by a large number of U.S. companies would be considered prima-facie evidence of dumping.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Economic Expansion Uneven Across Nation. The economy continues to expand in most regions of the country, though in some areas growth has moderated, according to the Federal Reserve's latest survey of business conditions. The upper Midwest, Southeast, and West continue to expand, while other regions are experiencing little or no growth. Activity in manufacturing remains weak across much of the country, but orders for future delivery are up in some areas and inventories generally are at acceptable levels. The pace of economic growth in the West has quickened a bit, with residential real estate and construction experiencing recent gains. Although most regions report continued moderation in wage and price pressures, there are some exceptions: wages of temporary workers have been rising quickly in the Dallas and Richmond areas, and wages of entry-level workers in the Midwest continue to experience upward pressures.

Atlanta Going For the Gold. Amidst an economic upturn in the Southeast, Georgia's economy is gaining extra steam from preparations for the 1996 Olympics in Atlanta. According to a recent University of Georgia report, the Olympics will generate $5.1 billion in spending and add over 70,000 jobs to the state's economy—an impact equivalent to the hosting of 31 Super Bowls. Because much of the money pumped into Atlanta will generate additional spending elsewhere within Georgia, economic benefits will spread throughout the state. Although some of the newly created jobs will be lost after 1996, the Olympic legacy will boost the Georgia economy for years to come through increases in tourism and global business, which already are evident a full year before the opening ceremonies.

IBM & Toshiba Chip In For Virginia's Economy. IBM and Toshiba Corporation have announced plans to establish a joint venture to manufacture dynamic random access memory (DRAM) chips used in computers. The project calls for an initial investment of more than $1.2 billion over three years, including construction and joint operation of a plant in Manassas, Va., on property currently owned by IBM. Construction is expected to be completed by January of 1997, and the companies estimate that production will begin by the end of that year. The companies expect that more than 1,200 jobs will be created by the new venture, and two future facilities provided for in the companies' agreement could boost total direct employment to 4,000 people. Business interests and government officials hope that the deal will help spark a wave of new high-technology investment in Virginia, particularly in light of Motorola's announcement this past spring that it would open a similar plant in the area. This optimism notwithstanding, the companies' site choice carries a hefty price tag: Manassas alone is to provide more than $100 million in tax and other incentives, and additional provisions offered by the Commonwealth of Virginia may push the total cost to taxpayers well over $150 million.

EYES ONLY

RELEASES THIS WEEK

Consumer Price Index

****Embargoed until 8:30 a.m., Friday, August 11, 1995****

The consumer price index increased 0.2 percent in July. Excluding food and energy, consumer prices also increased 0.2 percent.

Retail Sales

****Embargoed until 8:30 a.m., Friday, August 11, 1995****

Advance estimates show that retail sales decreased 0.1 percent in July following increases of 0.8 percent in June and 1.1 percent in May. Excluding sales in the automotive group, retail sales increased 0.4 percent.

Producer Price Index

The producer price index for all finished goods was unchanged in July. Excluding food and energy, producer prices increased 0.2 percent.

Productivity

Nonfarm business productivity increased 3.0 percent at an annual rate in the second quarter. Manufacturing productivity increased 2.1 percent.

MAJOR RELEASES NEXT WEEK

Industrial Production and Capacity Utilization (Tuesday)
Housing Starts (Wednesday)
U.S. International Trade in Goods and Services (Thursday)

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970–1993	1994	1994:4	1995:1	1995:2
Percent growth (annual rate)					
Real GDP	2.5	4.1	5.1	2.7	0.5
GDP deflator	5.5	2.3	1.3	2.2	1.3
Productivity					
Nonfarm business	1.2	1.8	4.3	**2.5**	**3.0**
Manufacturing (1978-93)	2.1	4.2	3.7	**3.5**	**2.1**
Real compensation per hour	0.6	0.6	1.5	**1.0**	**0.2**
Shares of Real GDP (percent)					
Business fixed investment	11.0	12.6	13.0	13.6	14.0
Residential investment	4.7	4.3	4.3	4.2	4.0
Exports	8.0	12.3	12.8	12.9	13.1
Imports	9.2	14.4	14.8	15.1	15.4
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	3.4	3.8	3.1
Federal surplus	–2.8	–2.4	–2.3	–2.1	N.A.

	1970–1993	1994	May 1995	June 1995	July 1995
Unemployment Rate	6.7*	6.1*	5.7	5.6	5.7

*Figures beginning 1994 are not comparable with earlier data.

	1970–1993	1994	May 1995	June 1995	July 1995
Payroll employment (thousands)					
increase per month			–62	250	55
increase since Jan. 1993					7076
Inflation (percent per period)					
CPI	5.8	2.7	0.3	0.1	**0.2**
PPI-Finished goods	5.0	1.7	0.0	–0.1	**0.0**

New or revised data in **boldface**.
CPI data **embargoed until 8:30 a.m., Friday, August 11, 1995.**

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FINANCIAL STATISTICS

	1993	1994	June 1995	July 1995	August 10, 1995
Dow-Jones Industrial Average	3522	3794	4511	4685	4644
Interest Rates					
3-month T-bill	3.00	4.25	5.47	5.42	5.40
10-year T-bond	5.87	7.09	6.17	6.28	6.51
Mortgage rate, 30-year fixed	7.33	8.36	7.53	7.61	7.80
Prime rate	6.00	7.15	9.00	8.80	8.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level August 10, 1995**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.419	+2.1	−10.3
Yen-Dollar	92.72	+2.5	−8.3
Multilateral (Mar. 1973=100)	83.29	+1.7	−7.5

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.1 (Q2)	5.7 (Jul)	**2.8 (Jul)**
Canada	4.2 (Q1)	9.6 (Jun)	2.7 (Jun)
Japan	0.1 (Q1)	3.2 (Jun)	0.0 (May)
France	3.8 (Q1)	12.4 (Apr)	1.6 (Jun)
Germany	3.3 (Q4)	6.5 (May)	2.5 (Jun)
Italy	4.0 (Q1)	12.2 (Apr)	5.8 (Jun)
United Kingdom	2.9 (Q2)	8.6 (May)	3.5 (Jun)

U.S. CPI data **embargoed until 8:30 a.m., Friday, August 11, 1995.**

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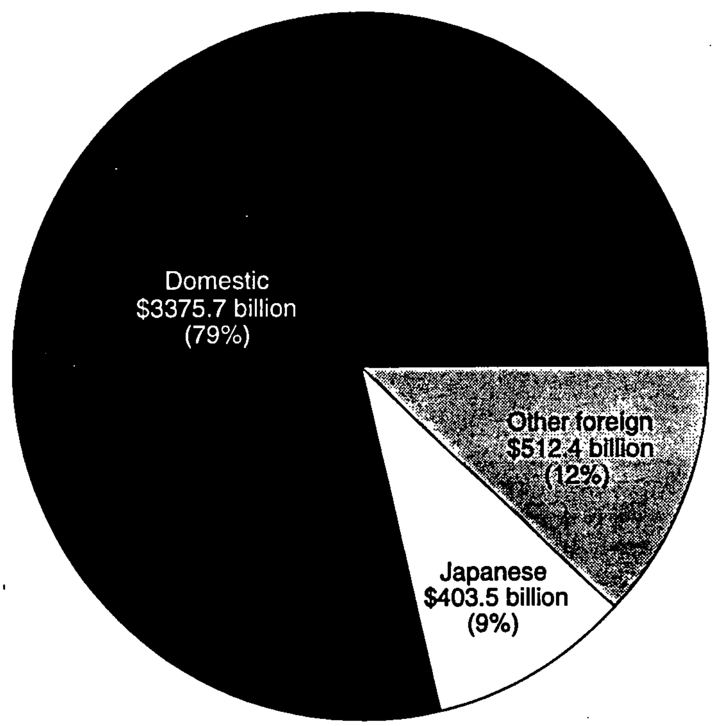
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

August 4, 1995

CHART OF THE WEEK

Ownership of Banking Assets Held in the United States
December 1994



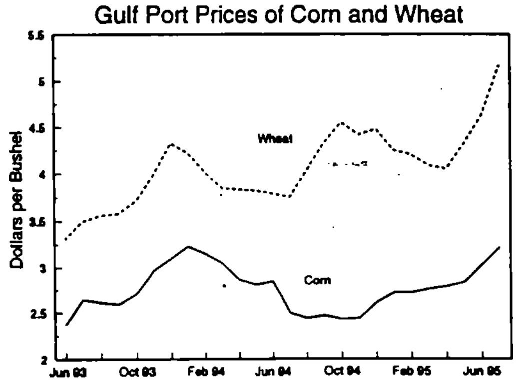
Twenty-one percent of bank assets in the United States are held by foreign banks, with Japanese banks holding the largest single country share. Over one-third of these foreign bank assets are in International Banking Facilities, the U.S. form of offshore banks. A Special Analysis in this issue of the Briefing considers how a possible Japanese banking crisis might affect the U.S. economy.

EYES ONLY

CURRENT DEVELOPMENT

Crop Prices Rise Sharply

U.S. wheat and corn prices have risen sharply recently (see chart), in part due to forecasts that domestic and world production of these commodities in 1995 will be lower than last year.



Stocks of wheat in the United States are projected to end the growing season at their lowest levels since 1973-74, while stocks of corn are estimated to fall to less than half of last year's level, because rainy weather in the Midwest delayed plantings and reduced yields. Global stocks of these commodities are expected to hit 20-year lows. Due to these tight supply conditions, the prices corn and wheat farmers receive now are expected to approach target prices set under U.S. commodity support programs, possibly reducing Federal outlays on farm support payments (see Weekly Economic Briefing, July 28, 1995).

Analysis. The last time grain stocks were this low (in the 1973-74 crop year), increases in agricultural prices contributed significantly to overall inflationary pressures. Yet a comparison of this year with that notorious crop year would be premature. First, the 1970s were marked by sharp price increases in other basic commodities, most notably oil. Such price pressures are not apparent today. Second, since 1974, farm value as a share of the retail cost of food has fallen from 40 to 24 percent; for cereals, this share has fallen from 24 percent to 7 percent. Hence, an increase in crop prices should have a smaller effect on retail food prices today than twenty years ago.

Some factors contributing to price increases—like the weather—are beyond our control. But one lesson of the 1970s was that government policies restricting farm acreage and production can contribute substantially to rising prices.

EYES ONLY

SPECIAL ANALYSIS

How the British Make Withholding PAYE

Under the Pay-As-You-Earn (PAYE) system used in the United Kingdom (and run by the U.K. Inland Revenue), most taxpayers have the correct amount of taxes withheld at the time income is paid. As a result, these taxpayers neither owe anything nor receive a refund at the end of the year. Under this system, almost two-thirds of Britain's 25.7 million income tax payers need not file annual returns. In 1984, the U.S. Department of Treasury proposed developing a tax system that would increase substantially the accuracy of withholding and thus eliminate the need for many taxpayers to file annual income tax returns. This proposal was never adopted.

How do they do it? The relatively simple structure of the UK's personal income tax enables the PAYE system to work by having:

Fewer tax brackets. The British income tax rate structure has only two tax rates. No income tax is due on income below a stated amount (analogous to the standard deduction plus personal exemptions in the U.S. tax system). A basic rate of 25 percent is applied to income above the exemption amount, and a higher rate of 40 percent applies to gross income above £27,825 (about $44,500).

Fewer deductions. The U.K. system permits few deductions for taxpayers who are not self-employed. However, British homeowners do get a break through the tax system. Mortgage borrowers subtract a subsidy amount directly from their payment to lenders (so they pay only 75 percent of the interest owed). Lenders then claim a tax credit from Inland Revenue.

Coordinated capital income provisions. Tax on interest income is withheld by the payer at the basic 25 percent rate (dividends are treated similarly since the corporate and individual income tax systems are partly integrated). An annual exemption of £6,000 (about $9,600) is provided for capital gains adjusted for inflation.

Tax allowances incorporated into wage withholding. Taxpayers inform Inland Revenue of their personal characteristics (e.g., marital status or whether they are the primary earner in a family) and Inland Revenue provides the appropriate tax code to the employer. The employer then withholds income tax on wages according to published tables.

Who still has to file? Of the 9 million taxpayers who do have to file an annual return, about half are self employed. The rest tend to be those paying at the higher tax rate and those with complex tax affairs, such as those receiving income from several sources.

EYES ONLY

SPECIAL ANALYSIS

How Would a Japanese Banking Crisis Affect the U.S. Economy?

Concerns about a financial crisis in Japan heightened recently when Japan's Ministry of Finance acknowledged publicly that the bad loan problem facing Japanese banks is far worse than it had previously believed. The Ministry now estimates total nonperforming loans at almost ¥50 trillion (about $550 billion at current exchange rates), while some private estimates are as much as twice as high. This problem is much larger relative to the size of Japan's economy than the savings and loan crisis was in the United States and thus represents a serious problem for Japan. This special analysis considers how and to what extent a financial crisis in Japan might affect the U.S. economy.

Possible Impact on the U.S. Economy. A spillover to the U.S. economy could come through the following channels:

Reduced demand for U.S. exports. While Japan's bad loan problem has contributed little so far to the recession in Japan, a more serious financial crisis could lead to a deeper recession, reducing Japanese demand for U.S. exports. The overall effect on the U.S. economy likely would be small, however, because U.S. exports to Japan account for only about one percent of our GDP. Estimates show that a 5 percent fall in Japan's GDP (a recession deeper than any Japan has experienced since 1951) would reduce U.S. output by only 0.1 percent.

A financial crisis in Japan might also cause a sharp decline in the value of the yen, if investors were to seek safety outside the country. While shifts in exchange rates would have some effect over time on U.S. exports, their short-term effect is likely to be even smaller than the direct effect from lower Japanese growth.

Curtailed lending in the United States. Japanese banks are major players in the U.S. market, accounting for 9.4 percent of bank assets and 17 percent of business loans. Over the past four years, Japanese banks have cut their U.S. business lending by $13 billion, which amounts to 2 percent of total business loans. But this reduction has been more than matched by increased lending from other foreign banks. Even if a financial crisis caused Japanese banks to further curtail their U.S. lending, the market for bank loans is competitive, so U.S. or other foreign banks would likely step in to fill the gap.

Financial contagion. Potentially more serious, but less probable, is that a severe financial crisis in Japan would spread overseas through:

Depositor Withdrawals. A bank run in Japan is unlikely to affect non-Japanese banks, since the underlying causes of bank weakness are specific to Japan. A bank run could, however, affect Japanese banks operating abroad. In the United States, Japanese banks have $236 billion in deposits. Most of these deposits are in wholesale and off-shore accounts held by other banks, who would be less likely to withdraw them quickly. The retail deposits of Japanese banks in the United States are much smaller, and those held by U.S. residents are covered by FDIC insurance.

Market Linkages. A large and sudden collapse in Japanese markets could affect U.S. markets adversely, but this is unlikely: investors in the U.S. market are likely to understand that the downturn in Japan was caused by factors specific to Japan. Overall, correlations between U.S. and Japanese stock price indexes are small, with changes in the U.S. market having a larger effect on the Japanese market than vice-versa. So far this year, the Nikkei index has fallen by 14 percent, while the Dow has risen by 23 percent.

Default on a Foreign Payment. The most likely way a financial crisis in Japan would spread overseas is if a Japanese bank were unable to meet a large payment obligation to an overseas creditor, who then was unable to meet obligations to others. For this to occur, the crisis in Japan would have to bring down a Japanese bank with large international operations.

Could a large bank fail? So far, the Japanese financial institutions most seriously affected have been housing finance companies, credit co-operatives, and specialized lending institutions. Few of these have significant international operations. None of the twenty-one large Japanese banks appears close to insolvency, although this might change if the prices of real estate or other assets used to secure bank loans decline further. Japanese authorities have stated that none of the large banks would be allowed to fail, and Japan would take steps to meet their international obligations. Even Mexico, a country with far fewer resources and a much smaller stake in world financial markets, took pains to assure creditors that the international obligations of Mexican banks would be met.

A greater concern than insolvency is an illiquidity crisis, in which banks are unable to meet short-term demands for payments. In this instance, the actions of the Bank of Japan to provide liquidity would be crucial. The importance of this lender-of-last-resort function is well understood in Japan, and the Bank of Japan can act quickly, as it did during the run on a Tokyo credit co-operative this week.

Conclusion. Although the Japanese bad loan problem is serious and should be monitored closely, it is unlikely to affect significantly the U.S. economy or U.S. financial markets. This does not mean that there is no danger to world financial markets: these markets are fragile in ways that are sometimes surprising, and all countries have an interest in Japan solving its banking problems quickly and effectively. But in the end, an international financial crisis originating in Japan would be likely only if the Japanese government were unwilling to protect a financial system it has nurtured so carefully over the last 50 years.

EYES ONLY

ARTICLE

Social Security: A Multi-Faceted Program

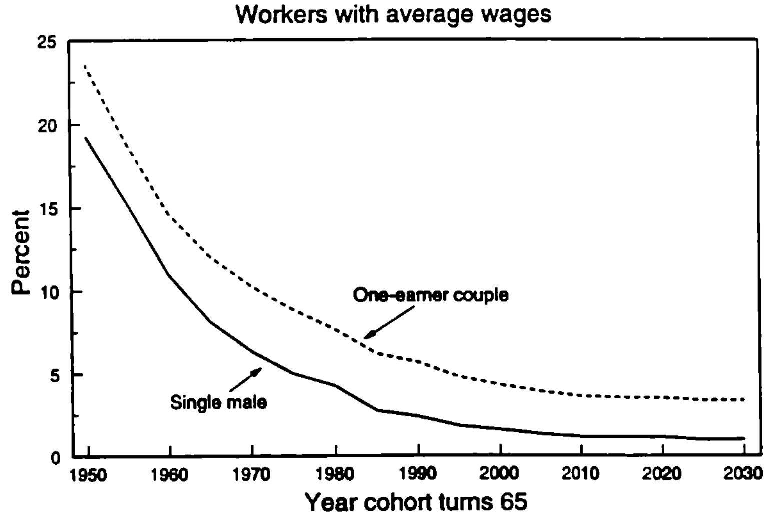
The Social Security program, which celebrates its 60th anniversary on August 14, has been tremendously successful in reducing poverty among our nation's elderly. The poverty rate for those aged 65 and over has fallen from roughly 35 percent in 1959 (when Social Security was still a small program) to just over 12 percent this year. Impending demographic changes, which likely will exhaust the Social Security trust fund over the next 35 years, mean that the system will have to be reformed if it is to continue meeting the needs of our seniors. As a prelude to discussing possible reforms, it is important to examine several of the different functions served by Social Security. Three important functions are:

(1) Mandatory savings program. Social Security requires all workers to "save" a fraction of their wages, in the form of a payroll tax. Such a system is desirable if workers do not save for themselves, either because they are short-sighted or because they believe that government will protect them if they are destitute.

(2) Transfer program. Social Security transfers wealth both <u>between</u> members of the same generation and <u>across</u> generations. This occurs because Social Security does not simply provide beneficiaries with their contributions plus interest. Instead, benefits depend on a multitude of factors (including average wage, marital status, and number of years worked).

Real Rates of Return on Social Security Contributions

Workers with average wages



The chart illustrates past and projected future (under current law) real rates of return on social security contributions. While real rates of return have been quite high in the past—exceeding those available in private markets—returns are expected to decline significantly in the future. For high-wage workers, future returns are expected to be particularly low, and will even be negative for high-wage single males.

Actual rates of return in the future likely will be even lower than those projected in the chart, since the retirement of the baby-boom generation means that under current law benefits will not be sustainable without major changes in payroll taxes on current and future workers. The broad-based support historically given to the Social Security program may soften as contributions change from being good investments to bad investments.

(3) Efficient real annuity. Social Security provides beneficiaries with a constant real benefit from the time they begin to collect benefits until they die. The government may be in a unique position to provide this type of benefit because it can:

Solve the problem of adverse selection. The private annuity market has been shown to attract those who expect to live longer than average. Companies take this into account when pricing their annuities. As a result, these annuities are not attractive investments for people in poor health who do not anticipate living a long time. This market may also be characterized by high transaction costs. By requiring everybody to participate, the Social Security system solves the adverse selection problem, and because of its large size, also may have lower transaction costs.

Index Benefits to Inflation. Social Security benefits are indexed to the Consumer Price Index, so recipients are protected against the vagaries of inflation. There are no assets that provide real security against inflation. Historically, other assets (stock market, bonds, real estate) have yielded significantly lower real returns when inflation is high. Other countries have addressed this problem by issuing indexed bonds (bonds whose yields are tied to measures of inflation).

Summary: Examining each of Social Security's functions helps provide a useful framework for thinking about Social Security reform. In particular, policymakers should determine which of these functions the government is uniquely suited to carry out, which of these could be accomplished through other government programs (the income tax system, for example), and which of these might be more efficiently performed by the private sector.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Report Shows Gaping Wealth Divide. A study released last month by the RAND Corporation found "enormous" wealth inequality in the United States. The report found that among white households with a member over 70 years old, the top five percent have at least $655,000 in household wealth (defined as real estate and financial assets excluding the value of Social Security and pension benefits), which is more than seven times the median of $90,000, while households in the bottom ten percent of this group had less than $800 in wealth. Moreover, the median holdings of financial assets by black and Hispanic households in this age bracket is zero. For lower-income households, Social Security and pension benefits represent the bulk of their total wealth.

Further Evidence that College Pays Off. Is there a glut of college graduates on labor markets? Proponents of this view often point to the high proportion of graduates who are either unemployed or are employed in "high school jobs" (those requiring only a high school education). While this proportion nearly doubled between 1970 and 1990 (from 11 to 20 percent), almost all of the growth occurred in the 1970s. And a recent National Bureau of Economic Research study suggests that although labor-market conditions for college grads may have worsened in the 1970s, going to college paid off in the 1980s. The study shows that the proportion of men and women aged 25 to 34 holding high school jobs actually declined between 1979 and 1989; the slight overall increase in the 1980s occurred at the expense of older workers. Moreover, median earnings rose for college grads of both sexes, and the proportion earning less than the median high-school graduate dropped sharply. Things were less sanguine for middle-aged men in the 1980s: the proportion holding high school jobs increased from 15 percent to 18 percent, and their median earnings actually declined by 4 percent.

Need A Vacation? Bank On It! According to an employee benefits survey done last year, letting employees buy and sell extra days off has become increasingly common. More than one-sixth of respondents had Paid Time Off (PTO) banks. Nearly all include both vacation and sick days in their program, and two out of three also include personal or holiday time. While companies that implemented PTO banks found their employees taking about the same number of vacation days and holidays as before, more than half of these firms reported fewer sick days taken. In fact, the median number of sick days dropped by six among PTO firms, suggesting that employees in such firms are willing to pay for extra time off that they otherwise would have claimed as sick leave. Besides reducing unscheduled absenteeism, PTO banks also seem to be a hit among employees.

EYES ONLY

RELEASES THIS WEEK

Employment and Unemployment

****Embargoed until 8:30 a.m., Friday, August 4, 1995****

In July, the unemployment rate rose to 5.7 percent from 5.6 percent in June. Nonfarm payroll employment increased by 55,000 in July following an increase of 250,000 in June.

Personal Income and Expenditures

Personal income increased 0.4 percent in June (monthly rate). Disposable personal income increased 0.3 percent. Personal consumption expenditures increased 0.2 percent.

Leading Indicators

The index of leading economic indicators rose 0.2 percent in June—the first monthly increase this year.

Domestic Auto Sales

Domestic autos were sold at an annual rate of 6.7 million units in July.

MAJOR RELEASES NEXT WEEK

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

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970–1993	1994	1994:4	1995:1	1995:2
Percent growth (annual rate)					
Real GDP	2.5	4.1	5.1	2.7	0.5
GDP deflator	5.5	2.3	1.3	2.2	1.3
Productivity					
Nonfarm business	1.2	1.8	4.3	2.7	N.A.
Manufacturing (1978-93)	2.1	4.2	3.7	3.4	N.A.
Real compensation per hour	0.6	0.6	1.5	1.2	N.A.
Shares of Real GDP (percent)					
Business fixed investment	11.0	12.6	13.0	13.6	14.0
Residential investment	4.7	4.3	4.3	4.2	4.0
Exports	8.0	12.3	12.8	12.9	13.1
Imports	9.2	14.4	14.8	15.1	15.4
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	3.4	3.8	3.1
Federal surplus	–2.8	–2.4	–2.3	–2.1	N.A.
			May 1995	**June 1995**	**July 1995**
Unemployment Rate	6.7*	6.1*	5.7	5.6	**5.7**

*Figures beginning 1994 are not comparable with earlier data.

	1970–1993	1994	May 1995	June 1995	July 1995
Payroll employment (thousands)					
increase per month			**–62**	**250**	**55**
increase since Jan. 1993					**7076**
Inflation (percent per period)					
CPI	5.8	2.7	0.3	0.1	N.A.
PPI-Finished goods	5.0	1.7	0.0	–0.1	N.A.

New or revised data in **boldface**.
Employment and unemployment data **embargoed until 8:30 a.m., Friday, August 4, 1995.**

EYES ONLY

FINANCIAL STATISTICS

	1993	1994	June 1995	July 1995	August 3, 1995
Dow-Jones Industrial Average	3522	3794	4511	4685	4701
Interest Rates					
3-month T-bill	3.00	4.25	5.47	5.42	5.42
10-year T-bond	5.87	7.09	6.17	6.28	6.53
Mortgage rate, 30-year fixed	7.33	8.36	7.53	7.61	7.82
Prime rate	6.00	7.15	9.00	8.80	8.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level August 3, 1995**	**Percent Change from Week ago**	**Year ago**
Deutschemark-Dollar	1.390	+0.7	−12.1
Yen-Dollar	90.45	+2.9	−9.9
Multilateral (Mar. 1973=100)	81.86	+0.5	−8.8

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.1 (Q2)	**5.7** (Jul)	3.0 (Jun)
Canada	4.2 (Q1)	9.5 (May)	2.7 (Jun)
Japan	0.1 (Q1)	3.2 (Apr)	0.0 (May)
France	3.8 (Q1)	12.0 (Apr)	1.6 (Jun)
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U.S. unemployment data **embargoed until 8:30 a.m., Friday, August 4, 1995.**

WEB July 1995

EYES ONLY

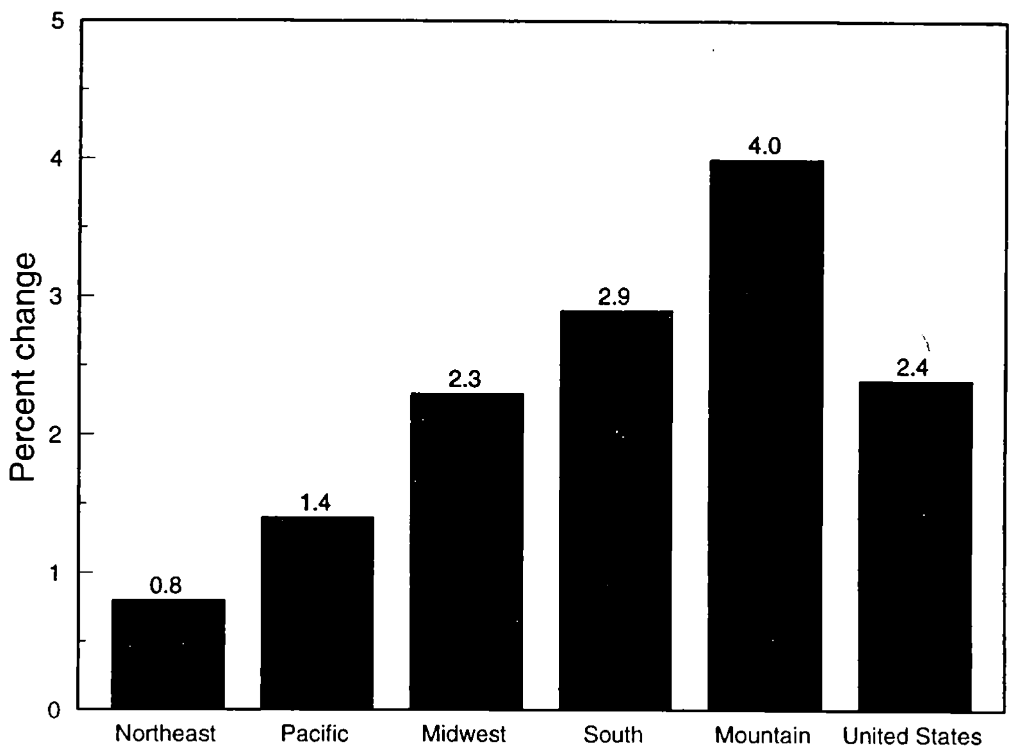
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

July 28, 1995

CHART OF THE WEEK

National and Regional Growth in U.S. Employment
May 1994 to May 1995



Employment increased nationally by a moderate 2.4 percent from May 1994 to May 1995, representing the creation of 2.7 million new jobs over the year. Job growth varied by region, with the Northeast and Pacific states lagging well behind other parts of the country. Employment in California grew by just under one percent, reflecting the effects of defense realignment. New York and Pennsylvania posted growth rates below one-half of one percent for this period as a result of sluggish recoveries in their manufacturing sectors.

EYES ONLY

CONTENTS

EYES ONLY

CURRENT DEVELOPMENT

GDP Scorecard: Second Quarter 1995

Real GDP increased at an annual rate of 0.5 percent in the second quarter of 1995, according to advance estimates made by the Commerce Department. Although the growth rate is the weakest since the fourth quarter of 1991, the report of modest but positive growth is actually good news: production indicators (such as hours worked, auto production, and industrial production) had pointed to a likely decline in output over the second quarter. The following scorecard gives the growth of major GDP components during the second quarter and indicates factors affecting the recent performance or outlook.

Component	Growth*	Comments
Consumer expenditures on motor vehicles	–5.6%	Motor vehicle purchases continued to decline. But auto production was scaled back sharply, so that little problem of inventory overhang remains in this sector.
Total consumer expenditures	2.5%	Spending on goods was weak, but spending on services rose strongly. Unseasonably cold weather boosted energy consumption.
Producers' durable equipment	12.7%	Impressive growth in this sector likely reflected declines in long-term interest rates and spectacular gains in equity prices.
Housing	–14.2%	Housing starts have apparently bottomed out and housing expenditures should rebound significantly by year's end.
Nonresidential structures	8.5%	Investment in nonresidential structures has been growing strongly since the second quarter of 1994, albeit from very low levels.
Inventories (change, billions of 1987$)	$30.4	Inventory accumulation slowed this quarter, largely reflecting the reduction in auto inventories, which had reached undesirably high levels over the past 2 quarters.
Government purchases	–0.3%	Federal purchases fell at a 3.1 percent annual rate; state and local purchases rose at a 1.4 percent annual rate.
Exports	7.2%	Export growth picked up from its first quarter pace, in part reflecting the effect of the dollar's decline on U.S. price competitiveness.
Imports	9.4%	Import growth remained strong but should ultimately slow to reflect the dollar's decline.

*Percent real growth in the second quarter at annual rates (except inventories). The advance estimate is subject to substantial revision.

SPECIAL ANALYSIS

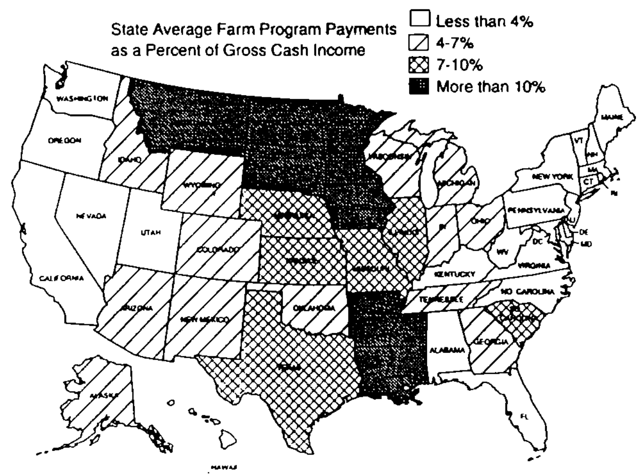
Reducing Farm Program Payments: Need It Be Painful?

Federal spending on farm programs is likely to be reduced in coming years. The budget resolution passed by Republicans calls for spending cuts in farm programs over the next seven years of more than $13 billion. The Clinton Administration's plan to balance the budget seeks more modest reductions of $4.2 billion over that same period. This article identifies those farmers who currently receive farm payments and discusses a way to achieve some budgetary savings without causing undue hardship for American farm families.

Reliance on payments varies by commodity and region. Federal spending on direct payments to farmers has averaged $10 billion annually in recent years. These payments, however, are distributed unevenly: in 1992, about two-thirds of farmers received no direct payments. Whether a farmer receives payments depends mainly on the types of commodities produced:

- Farmers receive no direct payments for producing meats, fruits, and vegetables;
- Farmers receive some direct payments for producing commodities such as sugar, tobacco, and milk, but these farmers rely more on supply controls to support their income;
- Farmers receive direct payments for producing field crops (such as cotton and grains) which account for 26 percent of all farm sales.

Since the level of support varies by commodity, the mix of commodities produced in particular regions determines the geographical distribution of farm payments. Payments as a share of gross farm income are greatest in rice and cotton producing states of the Mississippi delta, wheat producing states of the Great Plains, and corn producing states of the Midwest (see map). Farmers on either coast primarily produce commodities that are not covered by farm payments.



Reliance on payments varies by farm size. Farms of different sizes rely to varying degrees on farm program payments as a source of total income (see table). Medium and large farms receive almost all program payments, while small farms receive relatively little. For medium-sized farms, program payments are a larger share of household income than for either large or small farms. Although some small farmers are poor, many are not: small farms with incomes above $15,000 actually have higher average incomes than medium-sized farms.

	Small Farms (Poor)		Small Farms (Not Poor)	Medium Farms	Large Farms
Percent of Farms	22.0		51.5	24.7	1.8
Percent of Sales	5		11	49	35
Average Household Income	below $15,000		$50,000	$40,000	above $140,000
Percent of Farm Program Payments	-----	12.1	-----	73.5	14.4
Average Program Payment	-----	$796	-----	$10,215	$27,957

Note: Small Farms (Poor) are defined as those with annual sales less than $50,000 and with household incomes less than $15,000. Small Farms (Not Poor) are those with annual sales less than $50,000 and with household incomes greater than $15,000. Medium Farms are those with sales above $50,000 but below $500,000. Large Farms are those with annual sales above $500,000. Figures for program payments to Small Farms are an average for both subgroups, and the cutoff between Small Farms and Medium Farms is $40,000 of sales.

Targeting cuts in program payments. Policies to limit payments for certain "well-off" farmers were considered during debates over the 1990 Farm Bill and were part of the Administration's guidance on this year's Farm Bill. Such policies have included proposals to limit the maximum program payment any individual may receive and to exclude payments to individuals who earn more than $100,000 per year in off-farm income.

Targeting cuts toward farmers with high off-farm incomes will, however, yield only small savings. For example, individuals receiving more than $100,000 in off-farm income received just 2.3 percent of total farm payments in 1991. Policies that apply more aggressive means-testing to total farm incomes could generate much larger savings. One attraction of such policies is that they could be designed to spare small and medium scale farmers from cuts in payments. An important challenge of policies placing limits on payments, however, is that it may be difficult to prevent farmers from reorganizing their business activities to avoid those limits.

EYES ONLY

ARTICLE

Controlling Medicare Costs with Managed Care Innovations

For the past thirty years, Medicare has provided our nation's elderly with affordable access to the best health care. This access, though, has come at a high price: spending on Medicare has jumped from roughly 3 percent of the Federal budget in 1970 to about 10 percent today, and estimates are that spending on the program will continue to grow at over 9 percent per year over the next decade. A pace of growth this rapid is difficult to finance over the short term, but it is particularly daunting over the longer term, when the retirement of baby boomers will sharply lower the number of tax-paying workers supporting each Medicare recipient. This article discusses several ways in which elements of managed care might help restrain Medicare costs.

Controlling costs by improving incentives. Traditional fee-for-service insurance is widely believed to lead to overconsumption of medical care because the cost faced by consumers and their doctors for an additional medical procedure is much lower than its full cost. This problem is particularly acute for Medicare, since most beneficiaries are covered by supplemental insurance that eliminates most or all coinsurance and deductibles. Changes that decrease the use of supplemental insurance would likely lead to lower Medicare costs and lower total beneficiary costs (out-of-pocket plus Medigap insurance premiums), but would also impose somewhat greater risk on Medicare beneficiaries.

An alternative is to improve incentives for health care providers to control costs. One approach is to pay providers fixed fees for given sets of services. Since fees are fixed, providers have an incentive to hold down costs of treatment. Unless the fee fully reflects the severity of the patient's medical condition, however, this type of payment system might induce providers to try to limit costs by choosing relatively healthy patients, thereby restricting access for sicker patients (the adverse selection problem), or by cutting corners through reduced quality of care.

Reforming Medicare: A Continuum of Managed Care Options. There are several ways Medicare may be structured to provide incentives to limit costs while ensuring access for all beneficiaries.

- **Medicare's Prospective Payment System.** Medicare currently pays hospitals a fixed fee for each inpatient episode, regardless of how long the patient stays or how many resources are used. The fee is based on the patient's medical condition, as measured by the Diagnosis Related Group (DRG). This payment system encourages hospitals to control costs of treatment, and has been credited with reducing Medicare inpatient costs. However, the DRG system is also believed to encourage hospitals to substitute outpatient for inpatient treatment and to reduce length-of-stay by discharging patients earlier. (Under the DRG system, providers could conceivably profit by refusing care to the sickest patients, but this has not been viewed as a significant problem.)

- **Extensions of DRG Coverage.** Expanding the services covered within a DRG could increase the cost-effectiveness of the current payment system.

  Post-Acute-Care Bundling. Some analysts advocate incorporating services for care following hospitalization into the DRG payment. Hospitals would be paid a fixed fee for both the hospital stay and all medical services within a period of time following the hospitalization (4-weeks, for example). This could actually lower total costs by eliminating early discharges not warranted by the patient's condition. Although there is some concern about whether hospitals have competency in managing "post-care" services, it is likely they could acquire this ability, in part by contracting with outpatient providers.

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  Consolidated DRGs. Because some DRGs classify patients according to type of treatment rather than medical condition, the current system can lead to the overuse of intensive (and more highly compensated) procedures. For example, a recent study traced the sharp increase in inflation-adjusted Medicare payments for heart attacks entirely to a rise in intensive procedures, rather than increases in DRG fees. Consolidating DRGs, so that in this case providers receive the same payment for all heart attacks, could increase the cost-effectiveness of care.

- **Comprehensive Managed Care.** Health providers could be paid a fixed fee per patient to cover all medical care, eliminating some of the problems with more modest approaches. Providers would not be able to "game" the system by reclassifying patients into more highly compensated DRGs, nor would they gain from shifting procedures from hospital to outpatient clinic or nursing home. However, in order to prevent providers from choosing only healthy patients, fees would have to vary substantially with the medical conditions of patients. If adjusting fees for differences in medical conditions is too difficult or costly, regulatory oversight would be necessary to ensure access to care for all beneficiaries.

Summary: Medicare payment policies that pay a fixed fee for a bundle of services can help control costs. In general, the broader the set of services included in the bundle, the more effective the payment policy. Without sophisticated adjustments for differences in medical conditions, however, adverse selection is likely to be a greater problem for comprehensive managed care than for post-acute-care bundling or consolidated DRGs. Whether risk-adjustment mechanisms can be developed to offset this problem remains an open question.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Commerce Study Points to Disparities in Information Access. The Commerce Department has released survey results showing very low rates of computer ownership and home access to on-line information among residents of rural areas and low-income residents of central cities. Just 4.5 percent of poor rural residents own a computer, and only 23.6 percent of those with computers own modems. Similarly, only 7.6 percent of poor central city residents have computers, although 43.9 percent of these computer owners have modems. The potential importance of computers for the poor is underscored by the fact that low-income users in all areas (rural, central city, and urban) were found to be among the most likely users of on-line educational classes. The report concludes that until groups in need of service can be identified and targeted effectively, "community access centers"—including schools and public libraries—should assume a pivotal role in providing access to on-line information.

World Development Report Focuses on Labor. This year's World Development Report, released last month by the World Bank, draws the broad conclusion that economic development requires both open markets and active governments. While stating that rising exports are a pivotal factor for generating real wage growth, the Report asserts that most setbacks suffered by unskilled workers in advanced nations are not caused by foreign competition. The Report stresses the importance of investing in people and infrastructure and says that the key to helping the unskilled in industrial countries lies in domestic policy. Emphasizing the role of labor policy and unions, the Report states that governments should set basic labor standards and argues that collective bargaining is a good solution for determining wages and working conditions. However, the Report criticizes past government and union practices that helped only those few workers holding good jobs.

Zenith No Longer Pinnacle of Domestic TVs. The last American-owned television maker, Zenith Electronics Corporation of Glenview, Ill., has agreed to sell a controlling interest to LG Electronics Inc., of South Korea. LGE makes the Goldstar line of consumer electronic products, and the company says it intends to preserve and promote the Zenith brand name. Agreements like this one underscore the multinational character of our economy: while Zenith has moved production to Mexico in the last decade, foreign-owned TV makers have maintained production operations in the United States. Moreover, the buyout includes a large infusion of cash for Zenith to expand and improve its last major domestic manufacturing plant. As such, aside from the symbolic loss to the United States, deals like this one may entail real economic gains.

on sale for 5 yrs - no Am buyer fear of losing [illegible].

EYES ONLY

RELEASES THIS WEEK

Gross Domestic Product

****Embargoed until 8:30 a.m., Friday, July 28, 1995****

According to advance estimates, real gross domestic product grew at an annual rate of 0.5 percent in the second quarter.

Consumer Confidence

Consumer confidence, as measured by the Conference Board, rose 5.3 index points in July, to 99.9 (1985=100).

Employment Cost Index

The employment cost index for private industry workers rose 2.8 percent for the 12-month period ending in June.

Advance Durable Orders

Advance estimates show that new orders for durable goods decreased 0.1 percent in June. New orders for durable goods in the second quarter were 3.3 percent below the first quarter.

MAJOR RELEASES NEXT WEEK

Personal Income (Monday)
Leading Indicators (Wednesday)
Employment (Friday)

EYES ONLY

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	1970–1993	1994	1994:4	1995:1	1995:2
Percent growth (annual rate)					
Real GDP	2.5	4.1	5.1	2.7	**0.5**
GDP deflator	5.5	2.3	1.3	2.2	**1.3**
Productivity					
Nonfarm business	1.2	1.8	4.3	2.7	N.A.
Manufacturing (1978-93)	2.1	4.2	3.7	3.4	N.A.
Real compensation per hour	0.6	0.6	1.5	1.2	N.A.
Shares of Real GDP (percent)					
Business fixed investment	11.0	12.6	13.0	13.6	**14.0**
Residential investment	4.7	4.3	4.3	4.2	**4.0**
Exports	8.0	12.3	12.8	12.9	**13.1**
Imports	9.2	14.4	14.8	15.1	**15.4**
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	3.4	3.8	**3.1**
Federal surplus	–2.8	–2.4	–2.3	**–2.1**	N.A.

			April 1995	May 1995	June 1995
Unemployment Rate	6.7*	6.1*	5.8	5.7	5.6

*Figures beginning 1994 are not comparable with earlier data.

Payroll employment (thousands)					
increase per month			8	–46	215
increase since Jan. 1993					7002
Inflation (percent per period)					
CPI	5.8	2.7	0.4	0.3	0.1
PPI-Finished goods	5.0	1.7	0.5	0.0	–0.1

New or revised data in **boldface**.
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3-month T-bill	3.00	4.25	5.67	5.47	5.41
10-year T-bond	5.87	7.09	6.63	6.17	6.43
Mortgage rate, 30-year fixed	7.33	8.36	7.91	7.53	7.79
Prime rate	6.00	7.15	9.00	9.00	8.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level July 27, 1995**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.380	–0.1	–12.3
Yen-Dollar	87.88	0.0	–10.8
Multilateral (Mar. 1973=100)	81.44	–0.4	–8.9

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	**3.1** (Q2)	5.6 (Jun)	3.0 (Jun)
Canada	4.2 (Q1)	9.5 (May)	2.9 (May)
Japan	0.1 (Q1)	3.2 (Apr)	–0.2 (Apr)
France	3.8 (Q1)	12.0 (Apr)	1.6 (May)
Germany	3.3 (Q4)	6.5 (Apr)	2.1 (May)
Italy	4.0 (Q1)	12.2 (Apr)	5.5 (May)
United Kingdom	2.9 (Q2)	8.6 (May)	3.4 (May)

U.S. GDP data **embargoed until 8:30 a.m., Friday, July 28, 1995.**

EYES ONLY

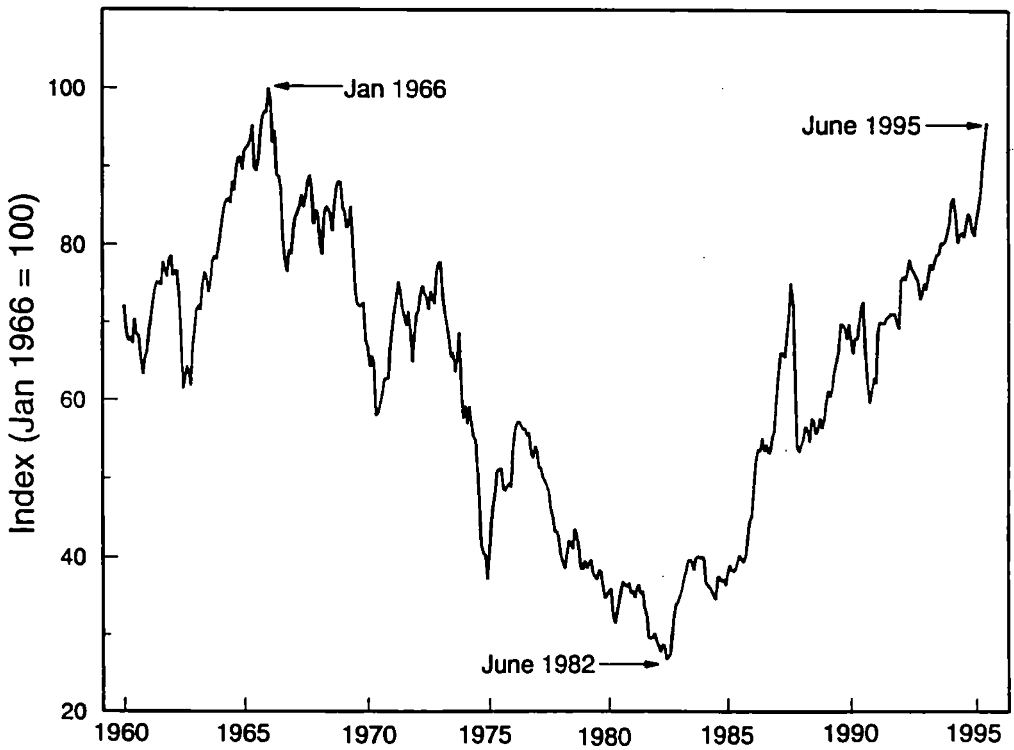
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

July 21, 1995

CHART OF THE WEEK

The Dow Jones Average Adjusted for Inflation



The Dow Jones Industrial Average, adjusted for inflation, is approaching its previous high, reached during January 1966. From its low point in June 1982, the purchasing power of the shares included in the index has almost quadrupled. Since the beginning of this year, most stocks have increased in value, raising wealth and helping to offset the uptick in consumer debt over the past few months. Provided this week's setback for the stock market proves temporary, the gains earlier this year should help spur consumer spending over the rest of the year and into next.

EYES ONLY

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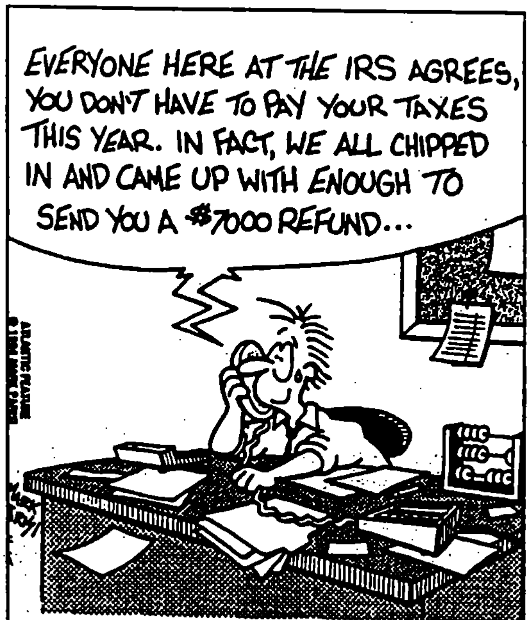

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CURRENT DEVELOPMENT

When Greenspan Talks, E.F. Hutton Listens

Fed Chairman Greenspan delivered his semiannual Humphrey-Hawkins testimony before the House Banking Committee on July 19. Given the usual parlance of Fed governors, the statement was atypically clear.

Analysis. Chairman Greenspan's assessment of second quarter growth and his forecasts of real growth and inflation over the next year and a half were in line with those of private sector analysts. He testified that economic growth would rebound over the rest of the year, the economy would be operating near its potential next year, and inflation would moderate in 1996. He also painted an upbeat picture about the ability of the Fed and financial markets to accommodate a program of deficit reduction.

Stock and bond prices fell sharply following the Chairman's testimony. Investors may have interpreted his reaffirmation of the goal of price stability as a signal that further interest rate cuts were not in the offing in the near future. One analyst quipped, "the market looked at his remarks and extracted the worries it wanted from them."

EYES ONLY

SPECIAL ANALYSIS

Trainwreck or Minor Derailment?

By the start of the next fiscal year, lack of agreement on appropriations bills or failure to raise the debt ceiling could lead to a government shutdown. In the past, shutdowns have lasted at most a few days. If a shutdown occurs, the effects on economic growth are likely to be small but measurable.

Without a Continuing Resolution, failure to enact appropriations bills by the beginning of the fiscal year halts discretionary spending on virtually everything but public safety and national security. Failure to raise the debt ceiling means that outlays for both discretionary and nondiscretionary purposes could take place only as revenues were received by the government.

Analysis. A delay in the enactment of appropriations bills would likely affect mainly non-essential payroll. Government purchases of goods and supplies probably would be postponed rather than permanently cut, especially if the impasse is short-lived.

If the Federal government were to shut down for one week in the fourth quarter and no Federal employees (except for the military) were to be paid, real GDP growth for the quarter would fall by about 0.4 percentage points at an annual rate. Growth would then rebound by a nearly equal amount in the first quarter of 1996. On average, real GDP would be about 0.03 percent lower through the end of 1996. But if the impasse were longer, the effects on real GDP would be greater, especially because financial markets could react adversely.

We are doing full fledged close down scenario

SPECIAL ANALYSIS

Economic Report Card

Economic performance during the first two and one-half years of your Administration has, according to standard indicators, been outstanding: The economy has grown fast enough to reduce unemployment sharply; interest rates have declined and remain relatively low; and inflation is no longer a major factor in economic decisions. Compared to the economic record at the same juncture during previous administrations, the past 30 months have witnessed gains across the board in traditional gauges of macroeconomic health (see table).

Comparative Economic Performance

	Ford	Carter	Reagan	Bush	Clinton
GDP Growth	-1.4	5.1	-1.0	0.2	3.2
Unemployment	8.8	5.7	10.1	6.8	5.6
Job Growth	0.9	9.4	-1.1	1.1	7.0
Inflation	9.8	8.9	5.6	4.8	2.8
Federal Deficit	3.1	0.4	5.5	2.6	2.1
10-Yr. Bond Yield	7.9	8.9	10.9	8.3	6.2

Note: GDP Growth is average annual percent change in chain-weighted real GDP from first quarter of presidential term through ninth quarter. Unemployment rate and government bond yield are for June of third year of term. Job growth is increase in nonfarm employment (in millions) from January of first year of term through June of third year. Inflation is annual percent change in consumer prices from January of first year of term through June of third year. Federal deficit is on a national income accounts basis expressed as a percent of GDP and is for the first quarter of third year of term. Data for President Reagan are for his first term.

After 30 months in office, Presidents Ford, Reagan, and Bush faced an economy in the early stages of recovery from recession, with unemployment lingering at relatively high levels. President Carter was watching an accelerating rate of inflation, intensified by the crisis in Iran, and the economy was moving toward recession.

Why the sour mood? Despite the upbeat numbers describing current economic performance, the mood across the country has been restrained. This may be due, in part, to a downward drift in the median wage, a widening disparity in earnings, and greater uncertainty felt by workers who believe their jobs are no longer secure—all of which have been on-going trends for the past two decades. The Administration, through its support for education and training programs, is seeking to raise the earnings of families and equip workers to compete in a rapidly changing economic environment.

Forecasting elections using macroeconomic indicators. Economists have developed models to forecast the outcome of presidential elections using indicators of economic performance. Although these models have had some success, they failed miserably in 1992 by predicting a Bush landslide. An important reason for this failure was that, in line with conventional wisdom, these models emphasized economic performance during the year preceding a presidential election. But during 1992, voters apparently placed more weight on the economy's performance over the entire four-year record. Thus, despite solid growth and low inflation during 1992, memories of the weak economy from 1989 through 1991 seem to have lingered in voter's minds. If voters focus on the entire four-year record under President Clinton, the strong economic performance of the past two and one-half years should bode well for this Administration as the 1996 election approaches.

EYES ONLY

SPECIAL ANALYSIS

How Taxing are Taxes?

Proposals to replace the U.S. income tax with a flat tax have drawn interest because of their apparent simplicity. Besides the direct cost of paying taxes, households and businesses also expend time and money understanding the tax code, keeping records, and filing their tax returns—as well as planning their financial affairs to take advantage of special tax provisions. In addition to these "compliance" costs, the government incurs administrative costs for operating and enforcing the system.

How large are compliance costs? The total implicit costs to taxpayers and governments could easily be $75 billion annually, or about eight percent of Federal and state income tax ~~revenue~~.

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- Individuals spent an average of 27 hours of their own time in 1989 complying with income taxes. In addition, nearly half of all filers pay a professional tax preparer (see box). The self-employed bear particularly high compliance costs. Surveys indicate that the total value of time and money spent on these activities amounts to about 6 percent of Federal and state personal income tax revenue. (Because Federal and state taxes require much of the same record keeping, separating compliance costs is nearly impossible.)
- According to a 1988 report, businesses spent twice as many hours as did individuals complying with the tax code. However, these costs can be even harder to measure, because tax compliance overlaps regular accounting and planning functions.

How does the tax system affect compliance costs? Compliance costs are greatly affected by the design of the tax system, especially the following features:

Who has to file. Taxes, such as value-added and sales taxes, that are collected at the source and those, such as the employee portion of payroll taxes, that are collected by withholding generally have lower compliance costs because they don't require individuals to file returns. Higher minimum income thresholds will also lower the number of people who need to file. Raising the standard deduction, for example, not only lowers compliance costs by reducing the number of people who itemize, but also lowers costs by reducing the number of people who need to file at all. On the other hand, excess withholding requires individuals to file returns when they otherwise wouldn't, thereby reducing the simplifying effect of higher filing thresholds (see Weekly Economic Briefing, 10/11/94).

England
example
from
Martin

What is taxed. Part of the complexity of the income tax system results from difficulties in defining income. Capital income is generally harder to handle than labor income, and definitions that are convenient in some ways may be costly in others. For instance, capital gains are taxed when assets are sold rather than as the gains accrue on paper. Thus, gains need not be calculated every year for each asset held, but records of purchase must be kept longer, and time will be spent to determine the best time to sell for tax purposes.

Differences in tax rates. Differences in treatment by type of income can lead to differences in effective tax rates as well. This creates incentives to shift income toward types with relatively low tax rates, such as shifting labor compensation from wages toward stock options or untaxed fringe benefits. Unequal treatment of income may also arise within a progressive tax structure. The more differentiated are tax rates, the greater is the incentive to shift income to more lightly-taxed entities, such as other family members or businesses. Rules to offset these incentives and to prevent abuse inevitably add to the complexity of the tax code.

Personalized deductions and credits. Attempts to use the tax system to promote certain behavior (such as charitable giving or home ownership) or to account for individual circumstances (such as burdensome medical expenses) tend to increase compliance costs. Itemized deductions, for instance, add record-keeping and planning costs.

Summary. Tax changes themselves raise compliance costs in the short term, since a new law must be learned and plans must be adjusted. Frequent tinkering with the tax system can frustrate planning efforts. But if simplification can be achieved—and maintained—the long-term gains may be substantial.

	Form Filed		
	1040EZ	1040A	1040
Percentage of all returns filed	16.7%	25.3%	58.0%
Returns with paid preparer's signature as a percentage of returns	4.1%	19.2%	75.5%
IRS estimated average time to prepare a return (hours)			
Return only	2.9	6.7	11.6
All schedules	2.9	11.2	46.7

The 1040EZ is filed by people with no dependents and only wage and interest income (below caps). The 1040A is filed by people with income (below a cap) taking the standard deduction. The 1040 is filed by people with business income, capital gains, and itemized deductions. Time to prepare a return includes time for record keeping, learning, preparing, copying and sending.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Does Welfare Affect Family Structure? A recent academic study questions the popular perception that larger welfare benefits increase the likelihood households will be headed by single mothers. Arguing that previous work on the issue has not controlled adequately for welfare-induced migration, the study finds that there is no statistical evidence that welfare contributes to increasing propensities to form female-headed households, either for whites or blacks. Unlike most previous research on the topic, the paper uses a dataset that allows repeated observations of particular individuals, allowing it to control for personal characteristics that can't be measured directly. If such characteristics are related to the decision to take welfare benefits, welfare may not be important to family structure. While this study will not be the last word on the topic, its findings may be an important contribution to our understanding of welfare's effects on households.

State of the States Looking Up. According to a report by the National Conference of State Legislatures, state fiscal conditions continue to improve. Revenues for fiscal year 1995 met budgets, increased reserves, and permitted tax cuts. Only three out of forty-four reporting states increased taxes by as much as one percent of the previous year's collections, while nine cut taxes by at least that much and eleven cut taxes by lesser amounts. Although fiscal year 1996 revenues are projected to increase by 2.9 percent, they will be outpaced by growth in expenditures, expected to be 4 percent. For affected states, this gap will be covered partly by reserves built up in the past fiscal year.

Not the Write Type. Underscoring the American economy's technological transformation, Smith Corona Corp. has filed for bankruptcy protection. The New Canaan, Conn. maker of portable electronic typewriters and word processors has fallen mightily in recent years, largely because ever-cheaper, ever-better personal computers have eroded its market, but also because stiff price competition from makers of similar products has cut into its profit margins. Totaling $1.4 billion as recently as 1988, U.S. shipments of electronic typewriters had plummeted to $591 million by 1993, prompting one analyst recently to refer to electronic typewriters as "road kill on the information superhighway." Nonetheless, one could hardly find better evidence of type's eclipse by byte.

EYES ONLY

RELEASES THIS WEEK

U.S. International Trade in Goods and Services

The goods and services trade deficit was $11.43 billion in May; it was $11.42 billion in April.

Housing Starts

Housing starts in June were about unchanged from May at 1.26 million units at an annual rate. For the first six months of 1995, starts were 11 percent below the same period a year ago.

MAJOR RELEASES NEXT WEEK

Employment Cost Index (Tuesday)
Consumer Confidence—Conference Board (Tuesday)
Advance Durable Shipments and Orders (Thursday)
Gross Domestic Product (Friday)

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970–1993	1994	1994:3	1994:4	1995:1
Percent growth (annual rate)					
Real GDP	2.5	4.1	4.0	5.1	2.7
GDP deflator	5.5	2.3	1.9	1.3	2.2
Productivity					
Nonfarm business	1.2	1.8	2.7	4.3	2.7
Manufacturing (1978-93)	2.1	4.2	3.4	3.7	3.4
Real compensation per hour	0.6	0.6	–0.8	1.5	1.2
Shares of Real GDP (percent)					
Business fixed investment	11.0	12.6	12.7	13.0	13.6
Residential investment	4.7	4.3	4.3	4.3	4.2
Exports	8.0	12.3	12.4	12.8	12.9
Imports	9.2	14.4	14.6	14.8	15.1
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	3.0	3.4	3.8
Federal surplus	–2.8	–2.4	–2.3	–2.3	–2.2

	1970–1993	1994	April 1995	May 1995	June 1995
Unemployment Rate	6.7*	6.1*	5.8	5.7	5.6

*Figures beginning 1994 are not comparable with earlier data.

	1970–1993	1994	April 1995	May 1995	June 1995
Payroll employment (thousands)					
increase per month			8	–46	215
increase since Jan. 1993					7002
Inflation (percent per period)					
CPI	5.8	2.7	0.4	0.3	0.1
PPI-Finished goods	5.0	1.7	0.5	0.0	–0.1

EYES ONLY

FINANCIAL STATISTICS

	1993	1994	May 1995	June 1995	July 20, 1995
Dow-Jones Industrial Average	3522	3794	4392	4511	4642
Interest Rates					
3-month T-bill	3.00	4.25	5.67	5.47	5.43
10-year T-bond	5.87	7.09	6.63	6.17	6.43
Mortgage rate, 30-year fixed	7.33	8.36	7.91	7.53	7.60
Prime rate	6.00	7.15	9.00	9.00	8.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level July 20, 1995**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.381	−0.7	−11.8
Yen-Dollar	87.85	+0.5	−11.0
Multilateral (Mar. 1973=100)	81.73	−0.3	−8.1

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	4.0 (Q1)	5.6 (Jun)	3.0 (Jun)
Canada	4.2 (Q1)	9.5 (May)	2.9 (May)
Japan	0.1 (Q1)	3.2 (Apr)	−0.2 (Apr)
France	3.8 (Q1)	12.0 (Apr)	1.6 (May)
Germany	3.3 (Q4)	6.5 (Apr)	2.1 (May)
Italy	4.0 (Q1)	12.2 (Apr)	5.5 (May)
United Kingdom	3.8 (Q1)	8.6 (May)	3.4 (May)

EYES ONLY

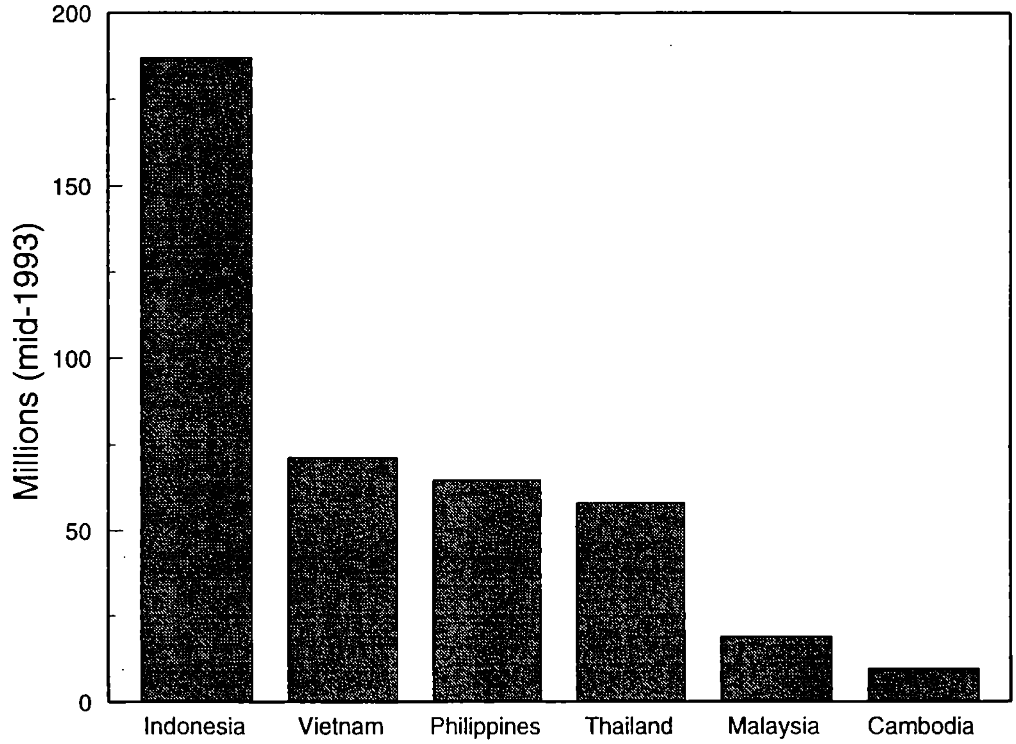
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

July 14, 1995

CHART OF THE WEEK

Population in Vietnam and Selected Asian Countries



At over 71 million, the population of Vietnam outranks all other Southeast Asian nations except Indonesia, making it an important potential future market for U.S. investment and exports. During the past several years, Vietnam has moved to encourage private enterprise, and it is now estimated that about 10 percent of the workforce is employed in the private sector. Although it is too soon to assess the final outcome of these policies, they have helped generate annual GDP growth above 8 percent for the past three years, a sharp contrast to the declines in GDP during this period for the economies of Central and Eastern Europe and the former Soviet Union.

EYES ONLY

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"Rough day. The guy I pass the buck to was out."

EYES ONLY

TREND

Can Korea Keep Up the Pace?

President Kim Young Sam of the Republic of Korea, who will make a state visit to Washington in late July, heads a country that has experienced a remarkable economic transformation over the past three decades. Income in South Korea, adjusted for inflation, has grown from about $100 per person in the mid-1960s to nearly $8500 per person today, a level more than double that of Mexico and just below that of Portugal. To achieve this gain in living standards, South Korea's economic growth over this period has averaged close to 10 percent per year (see chart). Growth during 1994 continued strong at 8.4 percent and inflation was moderate at around 6 percent.

In its drive to develop, Korea has pursued a strategy of industrializing through the export of manufactured goods. Combined with state-directed and subsidized investment in heavy industry, this strategy has spawned world-class competitors in ship building, steel, and electronics. These government industrial policies have also led to an extreme concentration of economic power: the top four industrial conglomerates accounted for 57 percent of Korean exports and 32 percent of sales in 1994. The top two alone, Hyundai and Samsung, garnered almost a quarter of all sales.

This year, South Korea applied for membership in the Organization for Economic Cooperation and Development (OECD). Membership in the OECD requires countries to meet certain standards of financial market liberalization. Although Korea recently has made some progress in opening its financial markets to international competition, it has not yet met the OECD standards. Thus, accession to the organization for Korea awaits further reform.

MACROECONOMIC UPDATE

Expansion Returning to Course

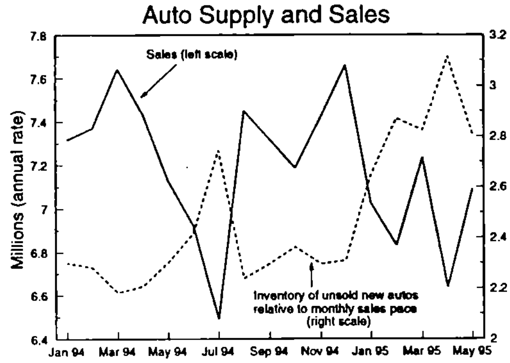
After stagnating for two months, employment rose strongly in June. This increases the likelihood that second quarter numbers for real GDP growth, to be released on July 28, will be marginally positive, though there remains a significant chance that the economy will have contracted a bit over the past three months.

The good news, however, is that the second quarter will likely represent a brief and relatively mild interruption of the long expansion that began in the second quarter of 1991. Financial markets continue to surge forward, consumer confidence—though falling in recent months—remains high, and inflation—though accelerating earlier this year—has moderated over the past two months.

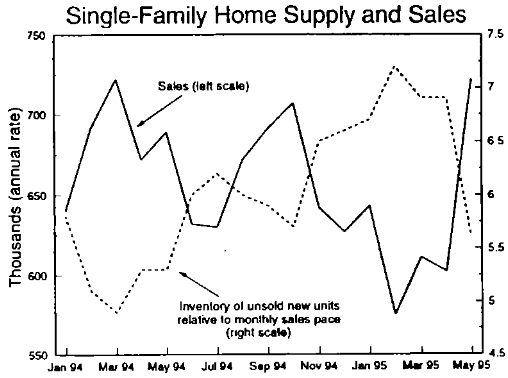
Reasons for optimism. The outlook for the two sectors where weakness has been most pronounced this year—autos and housing—has improved in recent weeks (see charts):

- Cuts in auto production and a recent pickup in car sales have reduced auto inventories, clearing the way for a step-up in auto production this quarter.
- Sales of new and existing homes were up sharply in May, making it more likely home construction will rebound.
- The recent cut in the Federal funds rate, along with declines in long-term rates over the past few months, should reinforce the on-going recovery in these sectors.

Auto Supply and Sales



Single-Family Home Supply and Sales



Net exports should strengthen later this year and into next, as foreign economic activity regains momentum (except in Japan) and improved competitiveness from last winter's decline in the dollar begins to be felt. This, in conjunction with the elimination of excess inventories, should push U.S. growth close to its potential by early 1996.

EYES ONLY

ARTICLE

Who Really Pays the Corporate Income Tax?

Recent congressional proposals to reform the Federal tax code, and the tax bill recently passed by the House as part of the "Contract with America", would make important changes in the way corporate income is taxed. These changes range from modification and repeal of certain corporate tax subsidies to elimination of the corporate income tax altogether.

Many people strongly believe that corporations should pay their fair share of taxes, just as households do. Economists, however, note that a corporation is solely a legal entity, so that the corporate income tax is actually "paid" by overlapping groups of people: investors (through lower rates of return), workers (through lower wages), and consumers (through higher prices). Understanding which groups of people ultimately "pay" the corporate income tax is important for determining the effects of proposed tax changes on the overall distribution of tax burdens and after-tax income.

Burden of the corporate income tax. There is no firm consensus about who ultimately bears the burden of the corporate income tax, though it is generally acknowledged that the burden rests most heavily on those least able to escape it (see box for varying approaches to measuring the burden). This lack of consensus stems from different views about how effectively and quickly various groups of people are able to avoid the tax. A particularly important distinction is between those groups affected in the near term and those affected in the long term. In the near term, the burden of the corporate income tax falls mainly on investors. In the longer term, workers may bear a noticeable fraction of the corporate tax burden.

Investors: A common perception is that an increase in the corporate tax lowers after-tax returns to investors in corporate stocks, so, under this view, these investors must bear the tax burden. Although the tax itself only applies to corporations, the burden may well fall on investors in all types of businesses. The reason is that investors will hold corporate stocks only if the after-tax rate of return on stocks, adjusted for risk, is approximately equal to returns on other competing investments. A tax change that initially reduced the after-tax return on corporate stocks would shift investors toward other investments, driving down returns on these alternative investments. Therefore, returns to all capital investments will be lower because of the corporate income tax, not just returns on investments in corporate stocks.

Workers: In the longer term, investments can move relatively freely across international boundaries; so an increase in the corporate income tax in one country makes investment less attractive in that country. The resulting lower level of investment reduces the productivity of workers and likely leads to lower wages.

Thus, in the long term, workers may bear a substantial portion of the corporate tax.

Consumers: Consumers also may bear the burden of the corporate income tax if corporations raise prices to maintain their after-tax profits in response to an increase in the tax. Vigorous competition from foreign and non-corporate producers, though, could limit price increases and block the ability of firms to pass the burden on to consumers.

Summary. Who ultimately pays the corporate income tax is unclear. Although persuasive arguments can be made that its burden rests on investors in the short term, arguments can also be made that workers (or even consumers) pay at least some of the tax in the long term.

Current Approaches to Assessing the Burden

Different views about the burden of the corporate income tax are reflected in different approaches to measuring its effect on after-tax incomes. The Treasury Department presently assigns the burden of the corporate tax entirely to investors. Other analysts, though, disagree. The Congressional Budget Office historically has assumed that 1/2 of the corporate income tax is borne by investors and the rest by workers. The Joint Committee on Taxation in the past has assigned the corporate income tax burden to investors, but in the new Congress the Committee staff has decided that there is too much uncertainty about the ultimate burden to assign it at all.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

(Flu) Bug Off! A new flu vaccine developed by MicroGeneSys, Inc., of Meriden, Conn., recently passed preliminary clinical trials with flying colors. The new vaccine proved as effective as existing ones and caused fewer side-effects. Flu vaccines currently available to the public—which are manufactured from chicken eggs—can take up to nine months to produce and cannot be adapted to season-specific flu strains. The new vaccine's reliance on genetic engineering will allow production in as little as three months and speedy updating to current strains. This improvement is important because epidemic outbreaks of the flu often cannot be halted if the strain emerges after the year's vaccine supply has been manufactured. According to the Centers for Disease Control, the flu infects 25 to 50 million Americans annually, about 20,000 of whom die from influenza itself or its complications. Current vaccines are 70-90 percent effective in young adults but less so in the elderly, who account for 85 percent of flu-related deaths. In addition to its public health benefits, a more effective vaccine would help reduce the economic cost of the flu, which a conservative estimate places at over $1 billion yearly.

Sharp Demand for Mexican Bonds. An initial plan by the Mexican government to issue $500 million in sovereign debt received offers from investing banks totaling $1.8 billion, a response so strong that the debt sale was doubled to $1 billion. The interest rate on the two-year notes is high relative to pre-crisis Mexican rates but significantly lower than rates at the peak of the crisis. Though the bonds carry no external guarantee of repayment, they will be collateralized. While the deal's size pales by comparison to the nearly $40 billion pledged in late December by the United States and the IMF, it may be an indicator of renewed faith by financial markets in Mexico. Such a successful offering is a hopeful sign that, unlike the debt crisis of the early 1980s, Mexico's recent problems will not drag on for years. If all goes well, Mexico may see its borrowing costs fall in the future, possibly spurring much-needed economic growth.

Regulating Research. A recent change in regulations governing the hiring of foreign workers has caused a good deal of controversy among university officials. The change, which was the Labor Department's response to an administrative court's interpretation of labor law, requires universities to pay foreign workers on a wage scale comparable to the private sector's. As a result, required salaries for foreigners can significantly exceed—sometimes nearly double—those typically offered to U.S. citizens in the same job. The regulation originally was designed to prevent wage undercutting by foreigners. But educators say that just the opposite may happen—universities may be priced out of some important research if no qualified American is available, since the regulation makes foreigners too expensive.

EYES ONLY

RELEASES THIS WEEK

Industrial Production and Capacity Utilization
****Embargoed until 9:15 a.m., Friday, July 14, 1995****

The Federal Reserve's index of industrial production was little changed for the second month—up 0.1 percent in June, following a decrease of 0.1 percent in May. Capacity utilization fell 0.2 percentage point to 83.5 percent.

Retail Sales
****Embargoed until 8:30 a.m., Friday, July 14, 1995****

Advance estimates show that retail sales increased 0.7 percent in June following an increase of 0.9 percent in May. Excluding sales in the automotive group, retail sales increased 0.3 percent.

Consumer Price Index
****Embargoed until 8:30 a.m., Friday, July 14, 1995****

The consumer price index increased 0.1 percent in June. Excluding food and energy, consumer prices rose 0.2 percent.

Producer Price Index

The producer price index for all finished goods declined 0.1 percent in June. Excluding food and energy, producer prices increased 0.2 percent.

Domestic Auto Sales

Domestic autos were sold at an annual rate of 7.0 million units in June.

MAJOR RELEASES NEXT WEEK

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

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970–1993	1994	1994:3	1994:4	1995:1
Percent growth (annual rate)					
Real GDP	2.5	4.1	4.0	5.1	2.7
GDP deflator	5.5	2.3	1.9	1.3	2.2
Productivity					
Nonfarm business	1.2	1.8	2.7	4.3	2.7
Manufacturing (1978-93)	2.1	4.2	3.4	3.7	3.4
Real compensation per hour	0.6	0.6	–0.8	1.5	1.2
Shares of Real GDP (percent)					
Business fixed investment	11.0	12.6	12.7	13.0	13.6
Residential investment	4.7	4.3	4.3	4.3	4.2
Exports	8.0	12.3	12.4	12.8	12.9
Imports	9.2	14.4	14.6	14.8	15.1
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	3.0	3.4	3.8
Federal surplus	–2.8	–2.4	–2.3	–2.3	–2.2

			April 1995	May 1995	June 1995
Unemployment Rate	6.7*	6.1*	5.8	5.7	5.6

*Figures beginning 1994 are not comparable with earlier data.

			April 1995	May 1995	June 1995
Payroll employment (thousands)					
increase per month			8	–46	215
increase since Jan. 1993					7002
Inflation (percent per period)					
CPI	5.8	2.7	0.4	0.3	**0.1**
PPI-Finished goods	5.0	1.7	0.5	0.0	**–0.1**

New or revised data in **boldface**.
CPI data **embargoed until 8:30 a.m., Friday, July 14, 1995**.

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FINANCIAL STATISTICS

	1993	1994	May 1995	June 1995	July 13, 1995
Dow-Jones Industrial Average	3522	3794	4392	4511	4727
Interest Rates					
3-month T-bill	3.00	4.25	5.67	5.47	5.39
10-year T-bond	5.87	7.09	6.63	6.17	6.09
Mortgage rate, 30-year fixed	7.33	8.36	7.91	7.53	7.41
Prime rate	6.00	7.15	9.00	9.00	8.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level July 13, 1995**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.391	0.6	–9.5
Yen-Dollar	87.45	2.7	–10.8
Multilateral (Mar. 1973=100)	81.98	0.5	–6.4

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	4.0 (Q1)	5.6 (Jun)	**3.0** (Jun)
Canada	4.2 (Q1)	9.5 (May)	2.9 (May)
Japan	0.1 (Q1)	3.2 (Apr)	–0.2 (Apr)
France	3.8 (Q1)	12.0 (Apr)	1.6 (May)
Germany	3.3 (Q4)	6.5 (Apr)	2.1 (May)
Italy	4.0 (Q1)	12.2 (Apr)	5.5 (May)
United Kingdom	3.8 (Q1)	8.6 (May)	3.4 (May)

U.S. CPI data **embargoed until 8:30 a.m., Friday, July 14, 1995**.

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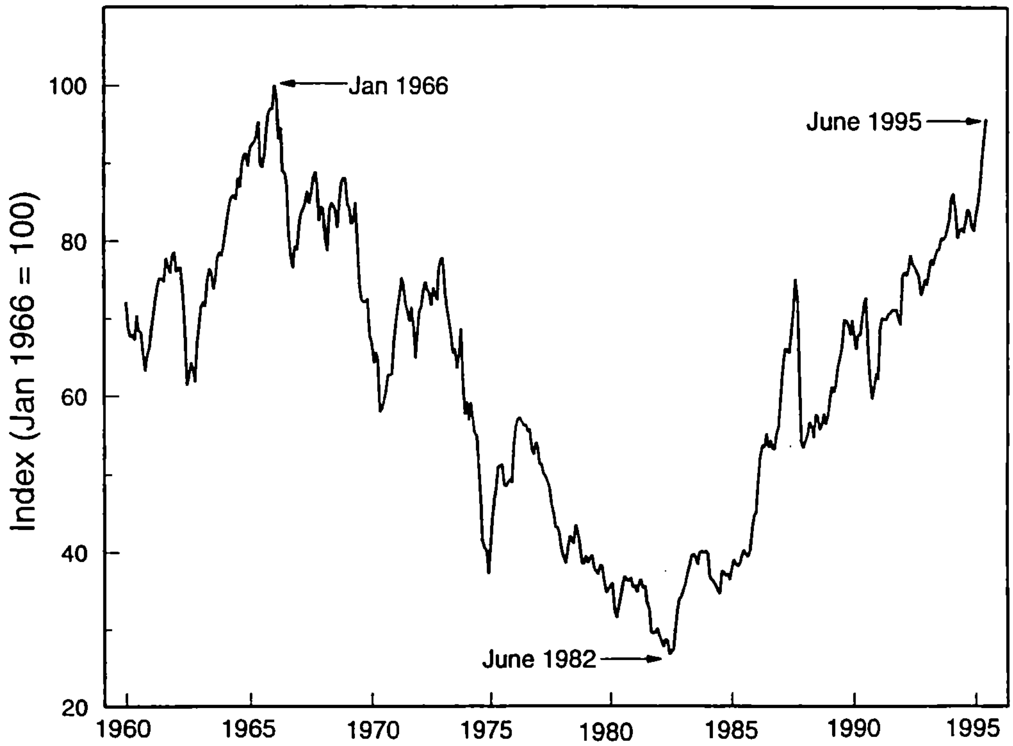
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

July 21, 1995

CHART OF THE WEEK

The Dow Jones Average Adjusted for Inflation



The Dow Jones Industrial Average, adjusted for inflation, is approaching its previous high, reached during January 1966. From its low point in June 1982, the purchasing power of the shares included in the index has almost quadrupled. Since the beginning of this year, most stocks have increased in value, raising wealth and helping to offset the uptick in consumer debt over the past few months. Provided this week's setback for the stock market proves temporary, the gains earlier this year should help spur consumer spending over the rest of the year and into next.

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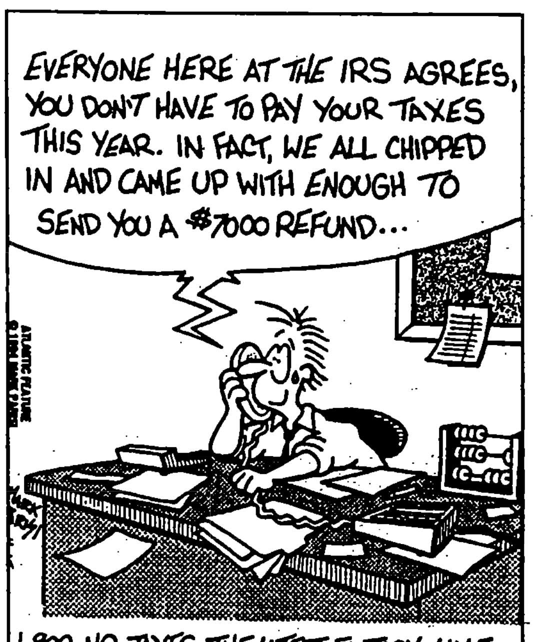

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CURRENT DEVELOPMENT

When Greenspan Talks, E.F. Hutton Listens

Fed Chairman Greenspan delivered his semiannual Humphrey-Hawkins testimony before the House Banking Committee on July 19. Given the usual parlance of Fed governors, the statement was atypically clear.

Analysis. Chairman Greenspan's assessment of second quarter growth and his forecasts of real growth and inflation over the next year and a half were in line with those of private sector analysts. He testified that economic growth would rebound over the rest of the year, the economy would be operating near its potential next year, and inflation would moderate in 1996. He also painted an upbeat picture about the ability of the Fed and financial markets to accommodate a program of deficit reduction.

Stock and bond prices fell sharply following the Chairman's testimony. Investors may have interpreted his reaffirmation of the goal of price stability as a signal that further interest rate cuts were not in the offing in the near future. One analyst quipped, "the market looked at his remarks and extracted the worries it wanted from them."

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SPECIAL ANALYSIS

Trainwreck or Minor Derailment?

By the start of the next fiscal year, lack of agreement on appropriations bills or failure to raise the debt ceiling could lead to a government shutdown. In the past, shutdowns have lasted at most a few days. If a shutdown occurs, the effects on economic growth are likely to be small but measurable.

Without a Continuing Resolution, failure to enact appropriations bills by the beginning of the fiscal year halts discretionary spending on virtually everything but public safety and national security. Failure to raise the debt ceiling means that outlays for both discretionary and nondiscretionary purposes could take place only as revenues were received by the government.

Analysis. A delay in the enactment of appropriations bills would likely affect mainly non-essential payroll. Government purchases of goods and supplies probably would be postponed rather than permanently cut, especially if the impasse is short-lived.

If the Federal government were to shut down for one week in the fourth quarter and no Federal employees (except for the military) were to be paid, real GDP growth for the quarter would fall by about 0.4 percentage points at an annual rate. Growth would then rebound by a nearly equal amount in the first quarter of 1996. On average, real GDP would be about 0.03 percent lower through the end of 1996. But if the impasse were longer, the effects on real GDP would be greater, especially because financial markets could react adversely.

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SPECIAL ANALYSIS

Economic Report Card

Economic performance during the first two and one-half years of your Administration has, according to standard indicators, been outstanding: The economy has grown fast enough to reduce unemployment sharply; interest rates have declined and remain relatively low; and inflation is no longer a major factor in economic decisions. Compared to the economic record at the same juncture during previous administrations, the past 30 months have witnessed gains across the board in traditional gauges of macroeconomic health (see table).

Comparative Economic Performance

	Ford	Carter	Reagan	Bush	Clinton
GDP Growth	-1.4	5.1	-1.0	0.2	3.2
Unemployment	8.8	5.7	10.1	6.8	5.6
Job Growth	0.9	9.4	-1.1	1.1	7.0
Inflation	9.8	8.9	5.6	4.8	2.8
Federal Deficit	3.1	0.4	5.5	2.6	2.1
10-Yr. Bond Yield	7.9	8.9	10.9	8.3	6.2

Note: GDP Growth is average annual percent change in chain-weighted real GDP from first quarter of presidential term through ninth quarter. Unemployment rate and government bond yield are for June of third year of term. Job growth is increase in nonfarm employment (in millions) from January of first year of term through June of third year. Inflation is annual percent change in consumer prices from January of first year of term through June of third year. Federal deficit is on a national income accounts basis expressed as a percent of GDP and is for the first quarter of third year of term. Data for President Reagan are for his first term.

After 30 months in office, Presidents Ford, Reagan, and Bush faced an economy in the early stages of recovery from recession, with unemployment lingering at relatively high levels. President Carter was watching an accelerating rate of inflation, intensified by the crisis in Iran, and the economy was moving toward recession.

Why the sour mood? Despite the upbeat numbers describing current economic performance, the mood across the country has been restrained. This may be due, in part, to a downward drift in the median wage, a widening disparity in earnings,

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and greater uncertainty felt by workers who believe their jobs are no longer secure—all of which have been on-going trends for the past two decades. The Administration, through its support for education and training programs, is seeking to raise the earnings of families and equip workers to compete in a rapidly changing economic environment.

Forecasting elections using macroeconomic indicators. Economists have developed models to forecast the outcome of presidential elections using indicators of economic performance. Although these models have had some success, they failed miserably in 1992 by predicting a Bush landslide. An important reason for this failure was that, in line with conventional wisdom, these models emphasized economic performance during the year preceding a presidential election. But during 1992, voters apparently placed more weight on the economy's performance over the entire four-year record. Thus, despite solid growth and low inflation during 1992, memories of the weak economy from 1989 through 1991 seem to have lingered in voter's minds. If voters focus on the entire four-year record under President Clinton, the strong economic performance of the past two and one-half years should bode well for this Administration as the 1996 election approaches.

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SPECIAL ANALYSIS

How Taxing are Taxes?

Proposals to replace the U.S. income tax with a flat tax have drawn interest because of their apparent simplicity. Besides the direct cost of paying taxes, households and businesses also expend time and money understanding the tax code, keeping records, and filing their tax returns—as well as planning their financial affairs to take advantage of special tax provisions. In addition to these "compliance" costs, the government incurs administrative costs for operating and enforcing the system.

How large are compliance costs? The total implicit costs to taxpayers and governments could easily be $75 billion annually, or about eight percent of Federal and state income tax revenue.

- Individuals spent an average of 27 hours of their own time in 1989 complying with income taxes. In addition, nearly half of all filers pay a professional tax preparer (see box). The self-employed bear particularly high compliance costs. Surveys indicate that the total value of time and money spent on these activities amounts to about 6 percent of Federal and state personal income tax revenue. (Because Federal and state taxes require much of the same record keeping, separating compliance costs is nearly impossible.)
- According to a 1988 report, businesses spent twice as many hours as did individuals complying with the tax code. However, these costs can be even harder to measure, because tax compliance overlaps regular accounting and planning functions.

How does the tax system affect compliance costs? Compliance costs are greatly affected by the design of the tax system, especially the following features:

Who has to file. Taxes, such as value-added and sales taxes, that are collected at the source and those, such as the employee portion of payroll taxes, that are collected by withholding generally have lower compliance costs because they don't require individuals to file returns. Higher minimum income thresholds will also lower the number of people who need to file. Raising the standard deduction, for example, not only lowers compliance costs by reducing the number of people who itemize, but also lowers costs by reducing the number of people who need to file at all. On the other hand, excess withholding requires individuals to file returns when they otherwise wouldn't, thereby reducing the simplifying effect of higher filing thresholds (see Weekly Economic Briefing, 10/11/94).

What is taxed. Part of the complexity of the income tax system results from difficulties in defining income. Capital income is generally harder to handle than labor income, and definitions that are convenient in some ways may be costly in others. For instance, capital gains are taxed when assets are sold rather than as the gains accrue on paper. Thus, gains need not be calculated every year for each asset held, but records of purchase must be kept longer, and time will be spent to determine the best time to sell for tax purposes.

Differences in tax rates. Differences in treatment by type of income can lead to differences in effective tax rates as well. This creates incentives to shift income toward types with relatively low tax rates, such as shifting labor compensation from wages toward stock options or untaxed fringe benefits. Unequal treatment of income may also arise within a progressive tax structure. The more differentiated are tax rates, the greater is the incentive to shift income to more lightly-taxed entities, such as other family members or businesses. Rules to offset these incentives and to prevent abuse inevitably add to the complexity of the tax code.

Personalized deductions and credits. Attempts to use the tax system to promote certain behavior (such as charitable giving or home ownership) or to account for individual circumstances (such as burdensome medical expenses) tend to increase compliance costs. Itemized deductions, for instance, add record-keeping and planning costs.

Summary. Tax changes themselves raise compliance costs in the short term, since a new law must be learned and plans must be adjusted. Frequent tinkering with the tax system can frustrate planning efforts. But if simplification can be achieved—and maintained—the long-term gains may be substantial.

	Form Filed		
	1040EZ	1040A	1040
Percentage of all returns filed	16.7%	25.3%	58.0%
Returns with paid preparer's signature as a percentage of returns	4.1%	19.2%	75.5%
IRS estimated average time to prepare a return (hours)			
Return only	2.9	6.7	11.6
All schedules	2.9	11.2	46.7

The 1040EZ is filed by people with no dependents and only wage and interest income (below caps). The 1040A is filed by people with income (below a cap) taking the standard deduction. The 1040 is filed by people with business income, capital gains, and itemized deductions. Time to prepare a return includes time for record keeping, learning, preparing, copying and sending.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Does Welfare Affect Family Structure? A recent academic study questions the popular perception that larger welfare benefits increase the likelihood households will be headed by single mothers. Arguing that previous work on the issue has not controlled adequately for welfare-induced migration, the study finds that there is no statistical evidence that welfare contributes to increasing propensities to form female-headed households, either for whites or blacks. Unlike most previous research on the topic, the paper uses a dataset that allows repeated observations of particular individuals, allowing it to control for personal characteristics that can't be measured directly. If such characteristics are related to the decision to take welfare benefits, welfare may not be important to family structure. While this study will not be the last word on the topic, its findings may be an important contribution to our understanding of welfare's effects on households.

State of the States Looking Up. According to a report by the National Conference of State Legislatures, state fiscal conditions continue to improve. Revenues for fiscal year 1995 met budgets, increased reserves, and permitted tax cuts. Only three out of forty-four reporting states increased taxes by as much as one percent of the previous year's collections, while nine cut taxes by at least that much and eleven cut taxes by lesser amounts. Although fiscal year 1996 revenues are projected to increase by 2.9 percent, they will be outpaced by growth in expenditures, expected to be 4 percent. For affected states, this gap will be covered partly by reserves built up in the past fiscal year.

Not the Write Type. Underscoring the American economy's technological transformation, Smith Corona Corp. has filed for bankruptcy protection. The New Canaan, Conn. maker of portable electronic typewriters and word processors has fallen mightily in recent years, largely because ever-cheaper, ever-better personal computers have eroded its market, but also because stiff price competition from makers of similar products has cut into its profit margins. Totaling $1.4 billion as recently as 1988, U.S. shipments of electronic typewriters had plummeted to $591 million by 1993, prompting one analyst recently to refer to electronic typewriters as "road kill on the information superhighway." Nonetheless, one could hardly find better evidence of type's eclipse by byte.

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RELEASES THIS WEEK

U.S. International Trade in Goods and Services

The goods and services trade deficit was $11.43 billion in May; it was $11.42 billion in April.

Housing Starts

Housing starts in June were about unchanged from May at 1.26 million units at an annual rate. For the first six months of 1995, starts were 11 percent below the same period a year ago.

MAJOR RELEASES NEXT WEEK

Employment Cost Index (Tuesday)
Consumer Confidence—Conference Board (Tuesday)
Advance Durable Shipments and Orders (Thursday)
Gross Domestic Product (Friday)

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U.S. ECONOMIC STATISTICS

	1970–1993	1994	1994:3	1994:4	1995:1
Percent growth (annual rate)					
Real GDP	2.5	4.1	4.0	5.1	2.7
GDP deflator	5.5	2.3	1.9	1.3	2.2
Productivity					
Nonfarm business	1.2	1.8	2.7	4.3	2.7
Manufacturing (1978-93)	2.1	4.2	3.4	3.7	3.4
Real compensation per hour	0.6	0.6	–0.8	1.5	1.2
Shares of Real GDP (percent)					
Business fixed investment	11.0	12.6	12.7	13.0	13.6
Residential investment	4.7	4.3	4.3	4.3	4.2
Exports	8.0	12.3	12.4	12.8	12.9
Imports	9.2	14.4	14.6	14.8	15.1
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	3.0	3.4	3.8
Federal surplus	–2.8	–2.4	–2.3	–2.3	–2.2

	1970–1993	1994	April 1995	May 1995	June 1995
Unemployment Rate	6.7*	6.1*	5.8	5.7	5.6

*Figures beginning 1994 are not comparable with earlier data.

	1970–1993	1994	April 1995	May 1995	June 1995
Payroll employment (thousands)					
increase per month			8	–46	215
increase since Jan. 1993					7002
Inflation (percent per period)					
CPI	5.8	2.7	0.4	0.3	0.1
PPI-Finished goods	5.0	1.7	0.5	0.0	–0.1

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FINANCIAL STATISTICS

	1993	1994	May 1995	June 1995	July 20, 1995
Dow-Jones Industrial Average	3522	3794	4392	4511	4642
Interest Rates					
3-month T-bill	3.00	4.25	5.67	5.47	5.43
10-year T-bond	5.87	7.09	6.63	6.17	6.43
Mortgage rate, 30-year fixed	7.33	8.36	7.91	7.53	7.60
Prime rate	6.00	7.15	9.00	9.00	8.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level July 20, 1995**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.381	−0.7	−11.8
Yen-Dollar	87.85	+0.5	−11.0
Multilateral (Mar. 1973=100)	81.73	−0.3	−8.1

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	4.0 (Q1)	5.6 (Jun)	3.0 (Jun)
Canada	4.2 (Q1)	9.5 (May)	2.9 (May)
Japan	0.1 (Q1)	3.2 (Apr)	−0.2 (Apr)
France	3.8 (Q1)	12.0 (Apr)	1.6 (May)
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Italy	4.0 (Q1)	12.2 (Apr)	5.5 (May)
United Kingdom	3.8 (Q1)	8.6 (May)	3.4 (May)