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96 OCT 25 A9:00

WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

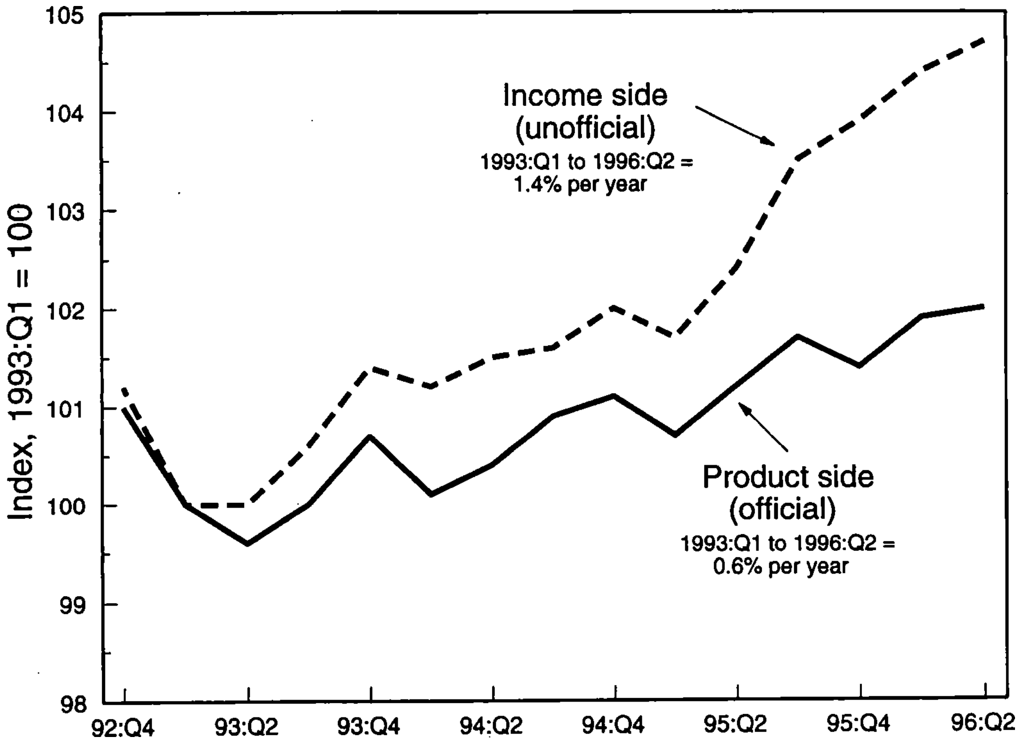
Prepared by the Council of Economic Advisers
with the assistance of the Office of the Vice President

October 25, 1996

cc: Joe Stiglitz
copied 10-28-96

CHART OF THE WEEK

Recent Productivity Growth



Based on official data, productivity growth appears quite sluggish over the past 4 years. But as noted elsewhere in this *Weekly Economic Briefing*, productivity growth may well be stronger than the official measure. Conceptually, product-side GDP, which is used to compute productivity, should equal income earned (see *Weekly Economic Briefing*, May 17, 1996). But the two measures currently differ by a large and as-yet-unresolved "statistical discrepancy," with income apparently growing faster than product. Until recently, productivity was estimated using the income side rather than the product side.

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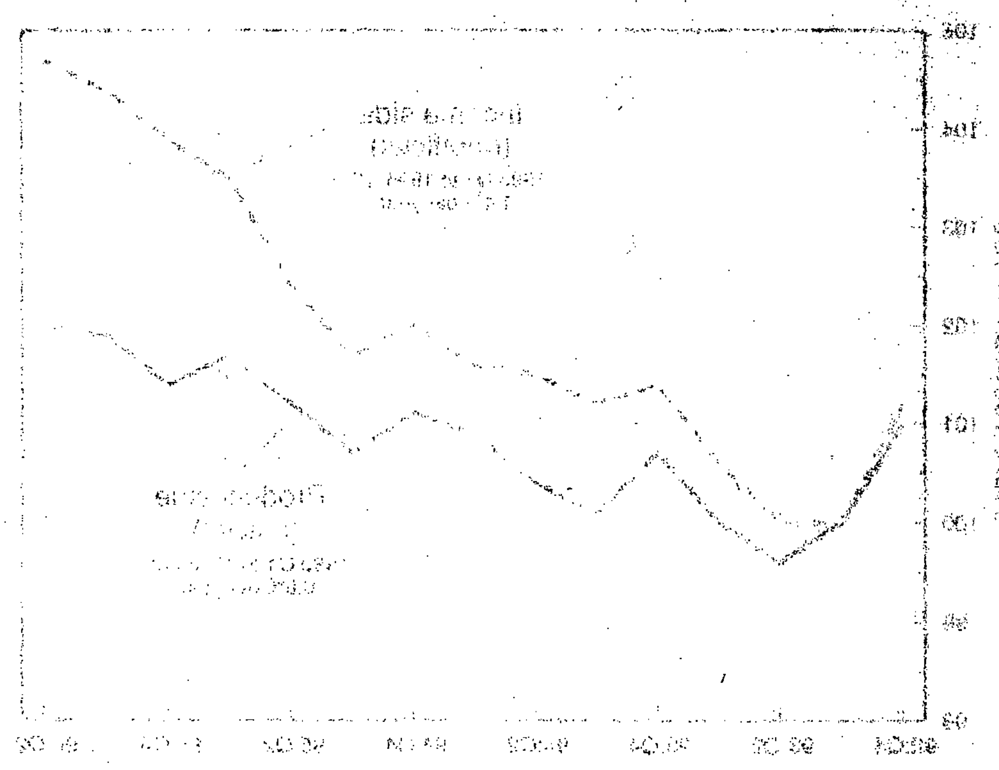

[illegible] data, productivity [illegible] over the past [illegible] years. But as noted elsewhere in this Weekly, [illegible] productivity growth may well be stronger than the official measures. Conceptually, [illegible] which is used to compute productivity, should equal income-side [illegible] (see the Weekly Economic Briefing, May 17, 1996). But the two measures currently differ by a large and as-yet-unresolved "statistical discrepancy," with income apparently growing faster than product. [illegible] productivity was calculated using the income side rather than the product side.

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CONTENTS

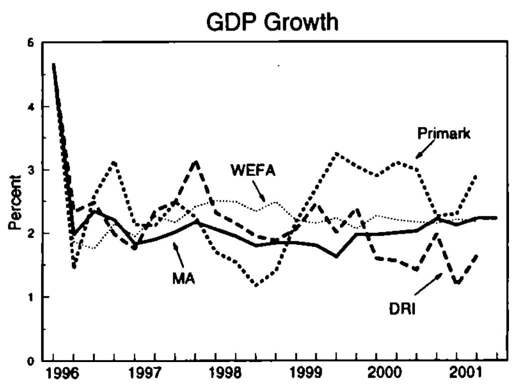
"I've decided to outsource my emotional needs."

CURRENT DEVELOPMENT

Forecasts Show Bright Economic Outlook

The cyclical outlook for the U.S. economy is better than it was in the 1960s, according to one prominent participant at a conference of forecasters held at the CEA last week. Other participants agreed that the U.S. economic outlook is very good.

Continuing expansion. Most of the forecasters reported no cyclical excesses of the sort that might lead to significant weakness, and none expected a recession between now and 2001 (see chart). The forecasters' outlook on inflation was also sanguine, with annualized growth in the chain-type GDP price index expected to rise a bit to between 2.5 and 3 percent by early next year, and then remain between about 2 and 3 percent thereafter.



Trend productivity. The forecasters generally saw trend productivity growing a bit faster than 1 percent per year, about twice the official rate recently. They noted that current data may understate actual gains in productivity to the extent that GDP growth is understated (see Chart of the Week).

Risks? Forecasters emphasize the most likely outcome. The unanticipated shocks that typically cause recessions cannot be incorporated into their forecasts. Other analysis, however, points to about a 2 percent chance that a recession will start in any given month of an expansion. Thus, as a purely statistical matter, the odds of a recession next year are about 1-in-4, and the odds of one at some point in the next 4 years are better than even. Given the current strength of the economy, however, and the lack of rising inflation or inventory imbalances, the probability of recession may be lower than this statistical average would suggest.

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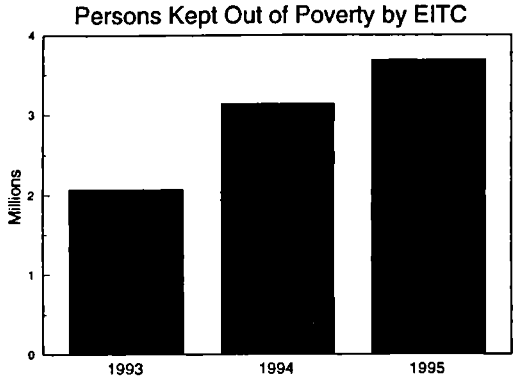
CURRENT DEVELOPMENT

Earned Income Tax Credit Effective in Reducing Poverty

The Earned Income Tax Credit (EITC) has a well-deserved reputation for reducing poverty among working families. The recently released income and poverty statistics provide further evidence to support this view.

Background. The EITC was first enacted in 1975 and has been gradually expanded since then. Changes enacted in 1993 were particularly large. Low-income working families with two children could claim a maximum tax credit of 19.5 percent in 1993, 30 percent in 1994, 36 percent in 1995, and 40 percent this year. The maximum credit expanded from about $1,500 in 1993 to about $3,500 in 1996. Tax credits paid out increased from $16 billion to $25 billion between 1993 and 1995.

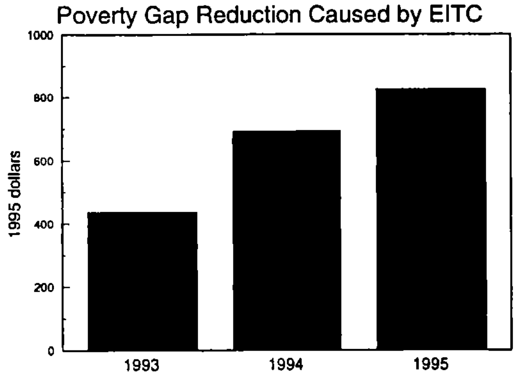
Persons Kept Out of Poverty by EITC



Analysis. The expansion of the EITC has had a striking impact on poverty. The number of individuals kept out of poverty almost doubled between 1993 and 1995 (see upper chart). EITC payments are not included in income for purposes of calculating the official poverty rate. But with the EITC included, 2 million people in 1993 and almost 4 million people in 1995 would have been moved above the poverty threshold. The poverty rate would have been reduced by 0.8 percentage point in 1993 and 1.4 percentage points in 1995 if EITC payments were included in income.

cc: Baer
M. Penn
copied 10-28-96

Poverty Gap Reduction Caused by EITC



An alternative measure of the benefits of the EITC is its impact on the "poverty gap," which is the difference between the actual income of families in poverty and the poverty threshold level of income. Again, the EITC has become increasingly effective, reducing the poverty gap by $437 per family in 1993 and $826 per family in 1995 (see lower chart).

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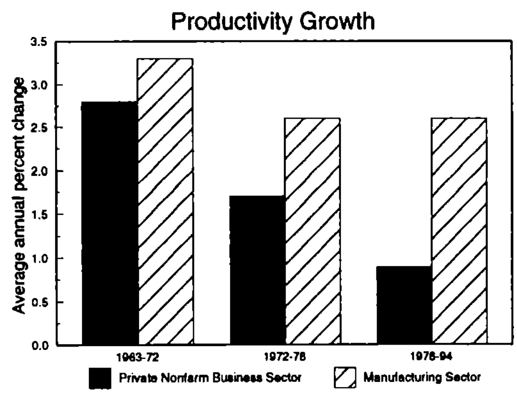
SPECIAL ANALYSIS

Are Services a Drag on Productivity?

Problems with measurement may produce a misleading picture of productivity growth in the different sectors of the economy.



Trends. The slowdown in productivity growth that began in the early 1970s appears to be concentrated outside manufacturing. Although growth in output per hour in the nonfarm business sector as a whole has fallen, growth in manufacturing has remained relatively strong (see chart). Services are widely viewed as a drag on productivity growth. But it is hard to determine whether growth in service sector productivity is truly low or merely poorly measured.

Measurement issues. Productivity is calculated by dividing a measure of output by a measure of labor input for the sector in question. But it is often hard to measure output in many service industries. As a result, important innovations in the service sector—including the introduction of ATMs in banking, the spread of 24-hour convenience stores in retailing, and the development of new surgical procedures in medicine—are only imperfectly reflected in the aggregate productivity statistics. Yet detailed studies of selected individual service industries often support the popular perception of substantial innovation.

Banking provides an example. Bureau of Labor Statistics estimates show more than 2 percent per year growth in productivity, based on detailed efforts to quantify output. But banking industry output is estimated differently in aggregate estimates of output and productivity. Indeed, growth in real output in banking and other financial services is assumed roughly equal to the increase in hours worked in the industry, so that growth in labor productivity is roughly zero by assumption.

Impact on aggregate productivity. Some of the mismeasurement of productivity in services merely creates offsetting biases elsewhere, with little net impact on the estimate of aggregate productivity. For example, any underestimate of productivity in services that are intermediate inputs into manufacturing would result in an offsetting overestimate of manufacturing productivity. The issue of biased output and productivity measurement remains important, however, because services represent over half the output used to calculate aggregate productivity.

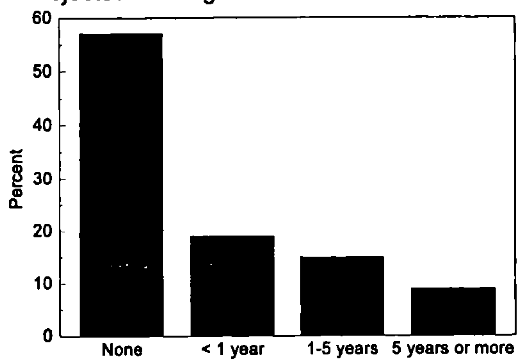
ARTICLE

Insurance for Long-Term Nursing Home Care

Insurance is particularly desirable for events that are rare but expensive. The need for long-term nursing home care is such an event. Yet the market for private nursing home insurance is underdeveloped. (Private care policies also cover home care but the focus of this article is nursing home care.)

Rare but expensive events. A majority of persons reaching age 65 can expect never to receive care in a nursing home. Of the rest, most are likely to stay a relatively short time. Just 24 percent of those reaching age 65 can expect to spend more than a year in a nursing home and only 9 percent will spend more than 5 years (see chart).

Projected Nursing Home Use of 65 Year-Olds



With the cost of skilled nursing home care averaging $36,000 per year and rising over time, a lengthy stay can be extremely expensive. Some of this cost covers normal living expenses that would be incurred anyway. But, even so, the incremental costs of nursing home care are high.

A limited private insurance market. In 1994, just 3 percent of nursing home expenditures were paid by private insurance. By contrast, 39 percent were paid out-of-pocket or from other private funds and 58 percent were paid by government, the vast majority through Medicaid. Several factors account for the limited importance of private long-term care insurance.

- Medicaid. Medicaid pays the expenses of persons who have no financial assets or who spend down their assets after entering a nursing home. To the extent that people think government will pick up the tab, they have less incentive either to engage in precautionary saving or to purchase insurance for long-term care.

- Expense. Premiums for private insurance are relatively high. One reason is that the vast majority of long-term care policies are individual rather than group policies, and individual policies have higher administrative costs. Another is that those purchasing long-term care insurance, especially when they are older, may be less healthy than others their age, and this will be reflected in premiums. Finally, premiums will be higher to the extent that people with insurance use nursing home care in situations when it is not appropriate.

- Desire to live with family members. Many disabled elderly persons are currently cared for by family members. Elderly persons who consider nursing homes less desirable than living with family might not be interested in purchasing insurance that reduces out-of-pocket nursing home expenses if this makes their families less willing to care for them (as evidence suggests).

Analysis. A limited private insurance market means most people reaching age 65 remain vulnerable to catastrophic nursing home costs that could substantially erode their assets. It also means Medicaid outlays are larger than they would be if the private insurance market were more extensive. Medicaid outlays are also higher to the extent that seniors needing long-term care have an incentive to find ways to transfer assets to family members rather than spend them down before becoming eligible for the program.

Policy implications. If government wanted more people to purchase long-term care insurance, it could require universal coverage, either directly through Medicare or indirectly by mandating that individuals purchase private insurance (ideally at a young age and possibly through their employers). Alternatively, government could create greater incentives for people to buy insurance within the current voluntary system.

Tax provisions in the Kennedy-Kassebaum law provide some incentives to purchase insurance. But more might be needed, including some protection for insurance companies against risks related to general increases in costs due to technology or government policy. Allowing more asset protection—perhaps by exempting individuals covered by private insurance plans from having to spend down their assets before qualifying for Medicaid—might further encourage individuals to buy insurance. Provisions in the Omnibus Budget and Reconciliation of Act of 1993, however, limited most states' ability to do this. The cost of providing sufficient incentives to achieve desirable levels of voluntary purchases could be high. But a universal coverage approach might also be expensive, especially if the resulting increase in nursing home use was large.

Conclusion. Unless people can be encouraged to put aside more money for nursing home expenses, the aging of the baby boom is likely to put an increasing burden on the Medicaid system—and thus on the finances of the Federal Government and the states—for the foreseeable future. And to the extent that more Medicaid funds are needed to support the elderly, less will be available to provide health care for children and the disabled.

cc: Chris Jennings

copied 10-28-96

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Council on Competitiveness Finds U.S. Economy to Be Strong. Indicators of strength in the U.S. economy rose sharply over the past decade, according to a new report by the Council on Competitiveness. Key gains include strong U.S. net job creation, which has exceeded that of all other G-7 countries combined. Budget deficit reduction has lowered real interest rates and stimulated growth, and the U.S. deficit is now lower as a percentage of GDP than in any other G-7 economy. The United States has increased its global market share and continues to lead the world in per capita GDP. The study cautions that long-term vulnerabilities remain. Although the United States currently leads in absolute R&D spending, longer-horizon R&D investment is falling as a percentage of GDP. Further improvements in education will be necessary to enhance the skills and abilities of the future U.S. workforce in order to improve productivity and continue to raise living standards. Additionally, increased wage inequality and a low saving rate threaten future competitiveness.

Bigger Gifts by Fewer Givers. Charitable giving by households increased nearly 4 percent in real (inflation-adjusted) terms between 1993 and 1995, according to a recent study. But the increase did not result from an increase in the number of donors. Only 69 percent of households—the lowest percentage since the survey began nearly a decade ago—chose to give. The average contribution among giving households increased 10 percent in real terms over the 2-year period, as many middle-class and affluent households boosted their giving levels. Almost 90 percent of households with incomes above $100,000 made charitable contributions in 1995, averaging 3.4 percent of their incomes. The survey indicates that the charitable deduction is a major factor in giving. Among givers, those who itemize deductions on their income tax returns contribute a substantially higher percentage of their income to charity than those who do not, and the gap in giving between itemizers and non-itemizers has been growing over the survey years.

Many Uninsured Lack Adequate Health Care. According to a recent survey, over half of the 37 million adults who lack health insurance have trouble obtaining or paying for medical care. Most of those who reported they had trouble getting care also said they suffered "serious" physical or mental health problems, or severe damage to household finances as a result. Many did not obtain health care at all. Although it is widely thought that the uninsured have ready access to charity care, only 37 percent of the uninsured who reported having trouble paying medical bills received free or reduced-price care. Indeed, more people were referred to collection agencies than received such care. The authors report the problem was not necessarily doctors' turning people away. Rather, individuals often felt they should pay for their care and simply did not seek medical attention when they could not afford it.

INTERNATIONAL ROUNDUP

Western Businesses Rank World's Riskiest Markets. A recent survey of more than 2,500 American and British multinationals found Russia to be the world's riskiest market. Venezuela, Mexico, Pakistan, and Brazil occupied the next 4 places, while China, Indonesia, the Philippines, Turkey, and India garnered places 6 through 10. The study combined traditional country risk assessments like credit agency ratings and macroeconomic and political risk studies, with a host of other factors that affect risk. These factors include levels of local and national corruption, bureaucratic delays, problems caused by the absence of legal frameworks, and extremist activity and threats to assets and executives. According to the authors of the study, many surveyed companies entered emerging markets where they had no experience, no contacts, and little understanding of the risks they faced.

Mexico Launches Project to Increase Financial Flows to the Rural Poor. With the help of a $30 million loan from the World Bank, the Mexican government has set up a $103 million rural finance project that will provide rural farmers, merchants, traders, and artisans access to credit from the formal financial sector. Access to credit plays a fundamental role in combating poverty and promoting private sector development. One of the main barriers faced by the poor when they try to get credit from established financial institutions is lack of assets to offer as collateral. But even when they do have small plots of land that could be used to guarantee a loan, the poor often live in localities too small to support a formal financial institution. The project's central idea—establishing very small branches of private banks in rural communities—has been relatively successful in Indonesia and Thailand. The project also aims to assist the development of financial institutions, mechanisms, and skills in rural areas, in order to foster the growth of the private sector.

South American Trade Pact Found to Protect Regional Inefficiencies. The Mercosur trade area of Argentina, Brazil, Paraguay, and Uruguay—set up to stimulate trade among its members—may, in fact, be an artificial world of economic growth, where inefficient industries are protected behind trade barriers, according to a recent study by a World Bank economist. Although intra-Mercosur trade has grown rapidly—from $4.2 billion in 1990 to $12.3 billion in 1994, the fastest-growing exports have been transportation equipment and other capital-intensive goods, which members have not been able to export competitively to outside markets. Mercosur's protective trade barriers are also hurting countries with more efficient producers. The automobile industry is cited as a prime example, with foreign automakers facing high import tariffs and quotas. The study is unusually frank in its public criticism of member countries, but its results accord with the World Bank's general opinion that global free trade is generally more beneficial than regional trading pacts.

RELEASES THIS WEEK

Advance Durable Orders

****Embargoed until 8:30 a.m., Friday, October 25, 1996****

Advance estimates show that new orders for durable goods rose 4.6 percent in September, following a decrease of 3.5 percent in August.

MAJOR RELEASES NEXT WEEK

Employment Cost Index (Tuesday)
Consumer Confidence—Conference Board (Tuesday)
Gross Domestic Product (Wednesday)
NAPM Report on Business (Friday)
Leading Indicators (Friday)
Employment (Friday)

U.S. ECONOMIC STATISTICS

	1970–1993	1995	1995:4	1996:1	1996:2
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	1.3	0.3	2.0	4.7
GDP chain-type price index	5.3	2.5	2.1	2.3	2.2
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	0.3	–1.1	1.8	0.5
Real compensation per hour:					
Using CPI	0.6	1.4	1.6	0.0	-0.1
Using NFB deflator	1.3	2.1	2.8	2.0	1.6
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.2	10.2	10.4	10.3
Residential investment	4.5	4.0	4.0	4.1	4.2
Exports	8.2	11.1	11.4	11.3	11.3
Imports	9.2	12.4	12.3	12.5	12.6
Personal saving	5.1	3.4	3.8	3.6	3.2
Federal surplus	–2.7	–2.2	–2.1	–2.1	–1.7

	1970–1993	1995	July 1996	Aug. 1996	Sept. 1996
Unemployment Rate	6.7**	5.6**	5.4	5.1	5.2
Payroll employment (thousands)					
increase per month			235	**257**	-40
increase since Jan. 1993					**10465**
Inflation (percent per period)					
CPI	5.8	2.5	0.3	0.1	0.3
PPI-Finished goods	5.0	2.3	0.0	0.3	0.2

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

New or revised data in **boldface**.

FINANCIAL STATISTICS

	1994	1995	Aug. 1996	Sept. 1996	Oct. 24, 1996
Dow-Jones Industrial Average	3794	4494	5686	5804	5992
Interest Rates					
3-month T-bill	4.25	5.49	5.05	5.09	5.00
10-year T-bond	7.09	6.57	6.64	6.83	6.57
Mortgage rate, 30-year fixed	8.35	7.95	8.00	8.23	7.86
Prime rate	7.15	8.83	8.25	8.25	8.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level Oct. 24, 1996**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.522	-1.4	9.7
Yen-Dollar	112.8	.6	12.7
Multilateral $ (Mar. 1973=100)	87.78	–.9	5.3

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	2.7 (Q2)	5.2 (Sept)	3.0 (Sept)
Canada	1.2 (Q2)	9.4 (Aug)	1.4 (Aug)
Japan	3.9 (Q2)	3.4 (Aug)	0.2 (Aug)
France	0.5 (Q2)	12.2 (Jul)	1.6 (Aug)
Germany	1.1 (Q2)	7.2 (Aug)	1.4 (Aug)
Italy	0.7 (Q2)	11.9 (Jul)	3.4 (Aug)
United Kingdom	2.2 (Q2)	8.1 (Aug)	2.2 (Aug)