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THE PRESIDENT HAS SEEN
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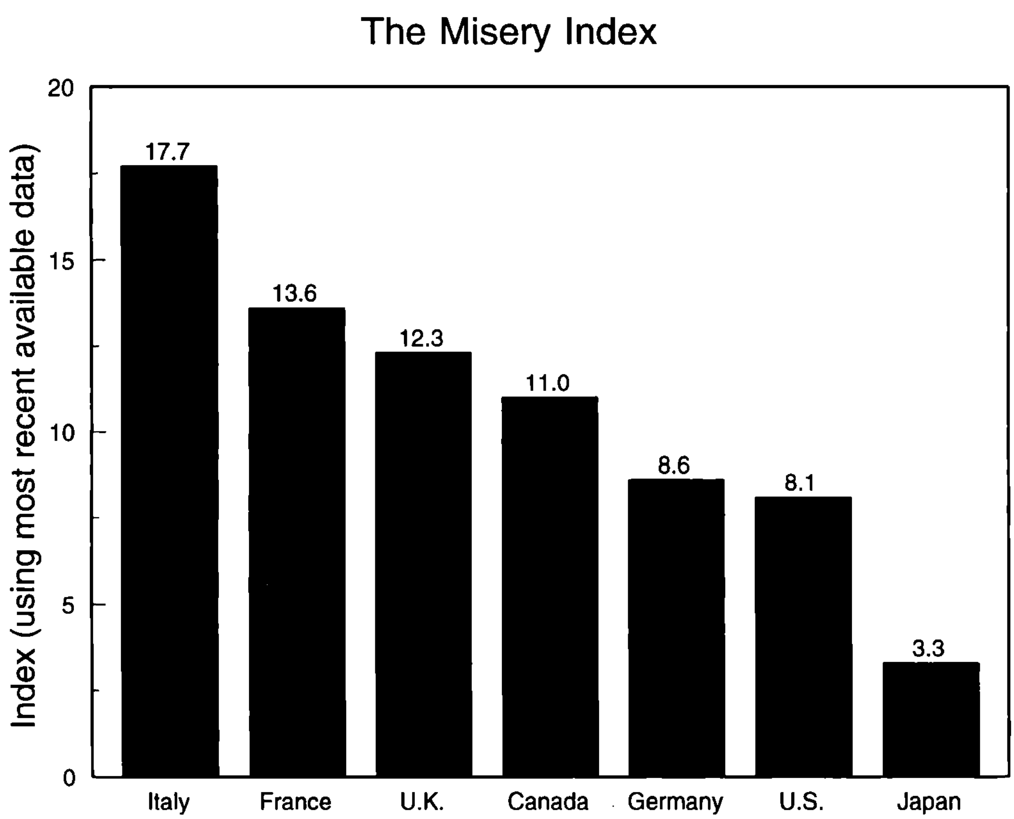
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

November 3, 1995

CHART OF THE WEEK



The Misery Index—the sum of the unemployment and inflation rates—currently is lower in the United States than in any other G-7 country, except in Japan where economic recession has brought inflation to a standstill and unemployment has historically been extremely low. On a 12-month basis, the index for the United States is currently at its lowest level since 1969.

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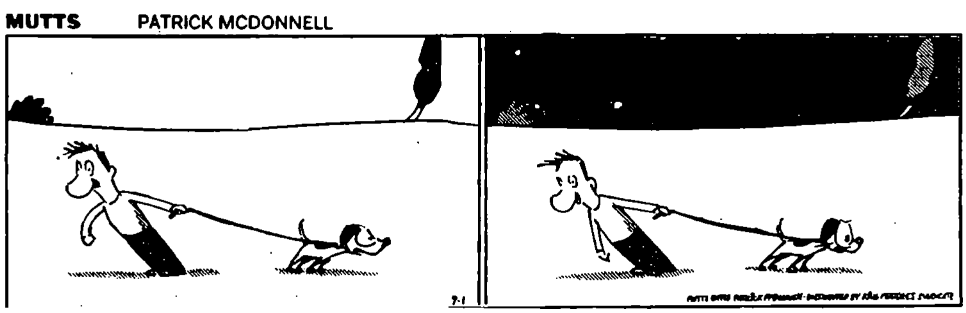
TREND

ARTICLE

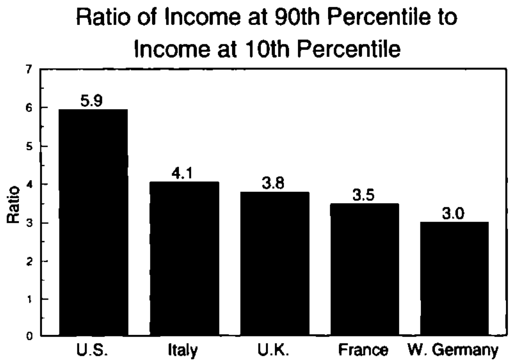
DEPARTMENTS



TREND

U.S. Income Inequality Highest in OECD Survey of Countries

A recent study commissioned by the OECD finds that during the mid-1980s, income inequality in the United States was greater than in any other industrialized country surveyed.

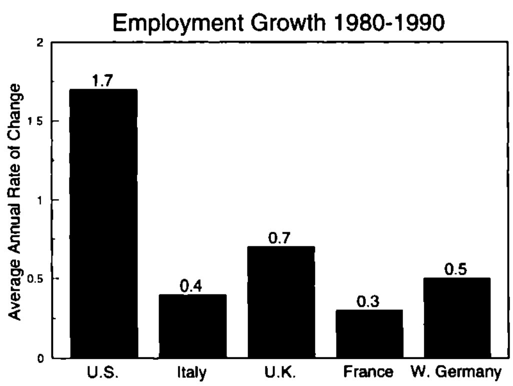


Note: U.S., Italy, and U.K. in 1986; France and W. Germany in 1984

The study compares disposable incomes of individuals (excluding in-kind benefits) and finds that individuals near the top of the income distribution in the United States received 5.9 times as much as individuals at the bottom of the income distribution (see chart). In West Germany, by comparison, individuals at the top received 3 times as much as individuals at the bottom.

Analysis. Three main factors explain the cross-country differences in income inequality:

- **Institutional differences.** Countries differ in institutional features such as collective bargaining arrangements, minimum wage laws, and education and training programs. As a result, economies respond differently to worldwide economic forces—such as technological change and increased international competition. For example, the greater flexibility of labor markets in the United States often has been credited as the driving force behind strong job creation and low unemployment relative to Europe (see chart). At the same time, this flexibility also has been cited as a cause of the decline in real wages for the less-skilled.



- **Social differences.** Differences in family structure across countries can probably also explain some of the difference in income inequality. For example, changes in family composition, declining male labor-force participation, and the increased number of single-parent families in the United States each appear to have played a large role in increasing income inequality over time. Another important difference is the fact that the United States has a less homogeneous population and a larger number of immigrants compared with other countries.

- **Policy differences.** Differences in income redistribution through government transfer and tax policies are an important determinant of differences in income inequality. Relative to many other countries, the United States has only modest income redistribution through government tax and transfer programs. Accordingly, when income before taxes and transfers is measured, the difference between inequality in the United States and in other countries generally is much smaller, with inequality in some countries actually exceeding that in the United States. Furthermore, the exclusion of health benefits from the OECD's estimates of income likely paints an even bleaker picture of U.S. inequality than if health benefits had been included. This is because government-provided health benefits are targeted toward the very poor in the United States, while health benefits in other countries usually cover the entire population.

ARTICLE

Inflation and the Capital Gains Tax

The Budget Reconciliation bills recently passed by both the House and the Senate include legislation to reduce the tax on income from capital gains. The House version would allow a deduction of 50 percent of capital gains in calculating taxable income, and would index the basis of capital assets for inflation. The Senate version allows the 50 percent deduction, but would not index for inflation. One frequently cited—but not the only—reason for cutting the capital gains tax is that much of the increase in the value of stocks and other assets is due to inflation and does not reflect an increase in real wealth. As a consequence, some observers argue that reducing the tax on income from capital gains would improve the fairness of our tax system.

Inflation and the real return from investment. The current system for taxing capital income—rents, dividends, royalties, and capital gains—does not adjust investment returns for inflation. As a result, the higher the inflation rate, the higher the effective tax rate on the real return. Two aspects of our tax system, however, actually reduce the effective tax rate on capital income, thereby offsetting some of the effects from inflation:

- **Deferral of capital gains offsets the effects of inflation.** Income earned on corporate stock can be in the form of capital gains or dividends. Investors do not have to pay any tax on capital gains until an asset is sold. This deferral of tax reduces the effective tax rate on capital income and partially offsets the effects of inflation. The higher the fraction of earnings in the form of capital gains (and the lower the fraction in the form of dividends), the lower the effective tax rate.

- **Borrowing offsets the effects of inflation.** Investors can borrow funds to invest and deduct nominal interest payments each year (which reflect compensation for inflation), but only pay tax on the capital gain when the asset is sold. The more borrowing that is used to finance investments, the smaller the impact of inflation.

How much of an exclusion do investors currently get? Under current law, the maximum capital gains tax rate of 28 percent provides investors significant advantages that are equivalent to an exemption of part of their gain. This exemption amounts to 30 percent of capital gains for investors in the 39.6-percent tax bracket, 22 percent for those in the 36-percent bracket, and 10 percent for those in the 31-percent bracket. Investors with marginal tax rates of 28 percent or below, who in 1993 earned about 44 percent of total capital gains, do not benefit from this provision.

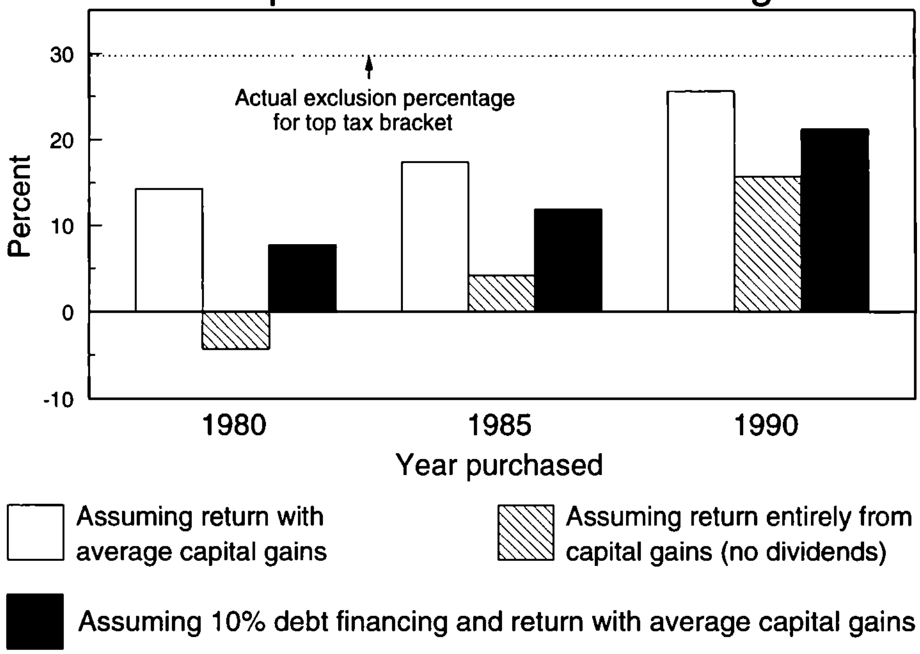
What is the bottom line? To assess the extent to which deferral and borrowing offset the effects of inflation, we have calculated the fraction of the capital gain on a stock portfolio that would have to be excluded from tax so that the after-tax return equals the return under a hypothetical system with indexing and no deferral of capital gains (see chart on next page). While the exact results depend on the years the investment is held, the fraction of the total return due to capital gains, and the fraction of the investment financed by borrowing, some conclusions can be drawn:

- In most cases, the exclusion presently received by investors with marginal tax rates of 36 percent or higher (a 22-percent exclusion) was more than enough to offset the effects of inflation.
- Investors with marginal tax rates of 31 percent or below may have been overtaxed on their capital gains, unless they had a significant amount of debt financing or held stocks that had most of their return paid in the form of capital gains.

Of course, these results depend on actual historical experience. Looking forward, the exact exclusions could be quite different.

Policy implications. Because the present tax system already compensates many investors generously for the effects of inflation, the case for further reducing taxes on income from capital gains cannot be based primarily on fairness. Instead, changes in the way capital gains are taxed should be based on considerations of economic efficiency, such as whether the current tax system helps allocate capital resources into their best possible use. In this regard, the Administration-sponsored 1993 reduction in capital gains tax for long-term investments in small businesses was designed to improve economic efficiency by encouraging investments that credit markets on their own often fail to finance.

Required Exclusion Percentage



Calculations of Exclusion Percentages

We first calculated the total after-tax return under a hypothetical system that imposed tax each year (no deferral) on the annual real return to a portfolio of the S&P 500 stocks purchased in a given year and sold in 1994. The chart reports the percentages of the capital gain on the same portfolio that would have to be excluded from tax in order for the total after-tax return to equal the return under the hypothetical tax system (assuming a real discount rate of 4 percent). We assumed that the tax rate was the same in each year; the same qualitative pattern would emerge if actual tax rates were used. A negative exclusion percentage means that the current tax system is more favorable than the hypothetical tax system.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Fed District Survey Shows Slowing Economy. Economic growth probably slowed somewhat in early fall, according to the Federal Reserve's regular survey of business conditions. The dropoff, driven in part by slower consumer spending, reflects an inevitable decline in economic growth after last quarter's unsustainable 4.2 percent real GDP growth. While the Fed survey found that manufacturing activity remained stable or increased in most districts, the National Association of Purchasing Management reported that the manufacturing sector continued to contract in October. As for other sectors of the economy, loan demand reportedly increased in most districts, while residential building activity varied widely by geographic area but changed little overall. Wage increases generally remained moderate, despite reports from some districts that labor demand had tightened relative to supply. At the same time, many districts emphasized that skilled workers have been commanding larger-than-average wage gains, suggesting that unskilled workers may be seeing further erosion in their wages.

Economic Performance Brightens in the Golden State. Employment in California grew 2.3 percent from September 1994 to September 1995, compared to 1.2 percent for the nation as a whole, according to the Labor Department. Over that period, the unemployment rate in the Golden State fell to 7.2 percent from 8.3 percent. As recently as January 1994, California's unemployment rate exceeded 10 percent. The good news on the employment front is reflected in several recent private-sector reports that suggest the California economy is picking up steam and will do better in 1996 than it has done in 1995.

The Distribution of Income and Wealth in the United States. As we move into budget discussions, it may be useful to examine the distribution of income in the United States.

Quintile	Family Income Range (1994)	Share of Aggregate Family Income (1994)	Share of Total Household Wealth (1989)
Highest fifth	$70,000+	47%	65%
4th	$47,000 - $70,000	23%	14%
3rd	$31,000 - $47,000	16%	11%
2nd	$18,000 - $31,000	10%	7%
Lowest fifth	$0 - $18,000	4%	2%
Top 5 Percent	$120,000+	20%	45%

INTERNATIONAL ROUNDUP

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Middle East Development Bank. International leaders met for a Middle East economic summit in Amman, Jordan early this week. They announced plans to create the Bank for Economic Cooperation and Development in the Middle East and North Africa, capitalized at about $5 billion, to promote private sector growth, support regional development projects (especially transborder infrastructure), and enhance regional dialogue on economic policy. Officials from the State and Treasury Departments played an instrumental role in championing the development bank, and over 125 U.S. companies were represented at the conference.

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Personal Income and Expenditures

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

Employment Cost Index

The employment cost index for private industry workers rose 2.6 percent for the 12-month period ending in September.

Consumer Confidence

Consumer confidence, as measured by the Conference Board, decreased slightly (0.3 index point) in October, to 97.0 (1985=100).

Leading Indicators

The index of leading economic indicators decreased 0.1 percent in September.

MAJOR RELEASES NEXT WEEK

Productivity (Tuesday)
Producer Prices (Thursday)

U.S. ECONOMIC STATISTICS

	1970–1993	1994	1995:1	1995:2	1995:3
Percent growth (annual rate)					
Real GDP:					
Fixed weights	2.5	4.1	2.7	1.3	4.2
Chain weights	2.7	3.7	1.7	0.7	3.0
GDP implicit price deflator:					
Fixed weights	5.5	2.3	2.2	1.6	0.6
Chain weights*	5.4	2.7	2.8	2.2	1.9
Productivity, nonfarm business (NFB):					
Fixed weights	1.2	1.8	2.5	4.8	N.A.
Chain weights	1.4	0.9	0.2	2.9	N.A.
Real compensation per hour (NFB):					
Using CPI	0.6	0.6	1.0	0.1	N.A.
Using NFB deflator:					
Fixed weights*	1.1	1.1	2.9	2.1	N.A.
Chain weights*	1.2	0.7	1.8	1.4	N.A.

* CEA estimates.

	1970–1993	1994	1995:1	1995:2	1995:3
Shares of Real GDP (percent)					
Business fixed investment	11.0	12.6	13.6	13.9	14.1
Residential investment	4.7	4.3	4.2	4.0	4.1
Exports	8.0	12.3	12.9	13.1	13.3
Imports	9.2	14.4	15.1	15.4	15.5
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	3.8	2.9	3.1
Federal surplus	−2.8	−2.4	−2.1	−1.8	N.A.

			MONTHLY DATA		
			Aug. 1995	**Sept. 1995**	**Oct. 1995**
Unemployment Rate	6.7**	6.1**	5.6	5.6	**5.5**
Payroll employment (thousands)					
increase per month			**263**	**50**	**116**
increase since Jan. 1993					**7527**
Inflation (percent per period)					
CPI	5.8	2.7	0.1	0.1	N.A.
PPI-Finished goods	5.0	1.7	−0.1	0.3	N.A.

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

New or revised data in **boldface**.

Employment and unemployment data **embargoed until 8:30 a.m., Friday, November 3, 1995**.

FINANCIAL STATISTICS

	1993	1994	Sept. 1995	Oct. 1995	Nov. 2, 1995
Dow-Jones Industrial Average	3522	3794	4747	4760	4809
Interest Rates					
3-month T-bill	3.00	4.25	5.28	5.28	5.31
10-year T-bond	5.87	7.09	6.20	6.04	5.92
Mortgage rate, 30-year fixed	7.33	8.35	7.64	7.48	7.44
Prime rate	6.00	7.15	8.75	8.75	8.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level November 2, 1995**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.418	+1.1	–5.7
Yen-Dollar	103.6	+1.8	+6.8
Multilateral $ (Mar. 1973=100)	84.23	+0.3	–1.9

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.3 (Q3)	**5.5 (Oct)**	2.5 (Sept)
Canada	2.5 (Q2)	9.6 (Aug)	2.3 (Sept)
Japan	0.6 (Q2)	3.2 (Jul)	–0.3 (Aug)
France	2.9 (Q2)	12.2 (Jul)	2.0 (Sept)
Germany	2.1 (Q2)	6.6 (Aug)	2.0 (Aug)
Italy	2.9 (Q2)	12.0 (Jul)	5.8 (Sept)
United Kingdom	2.8 (Q2)	8.7 (Aug)	3.8 (Sept)

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CHART OF THE WEEK

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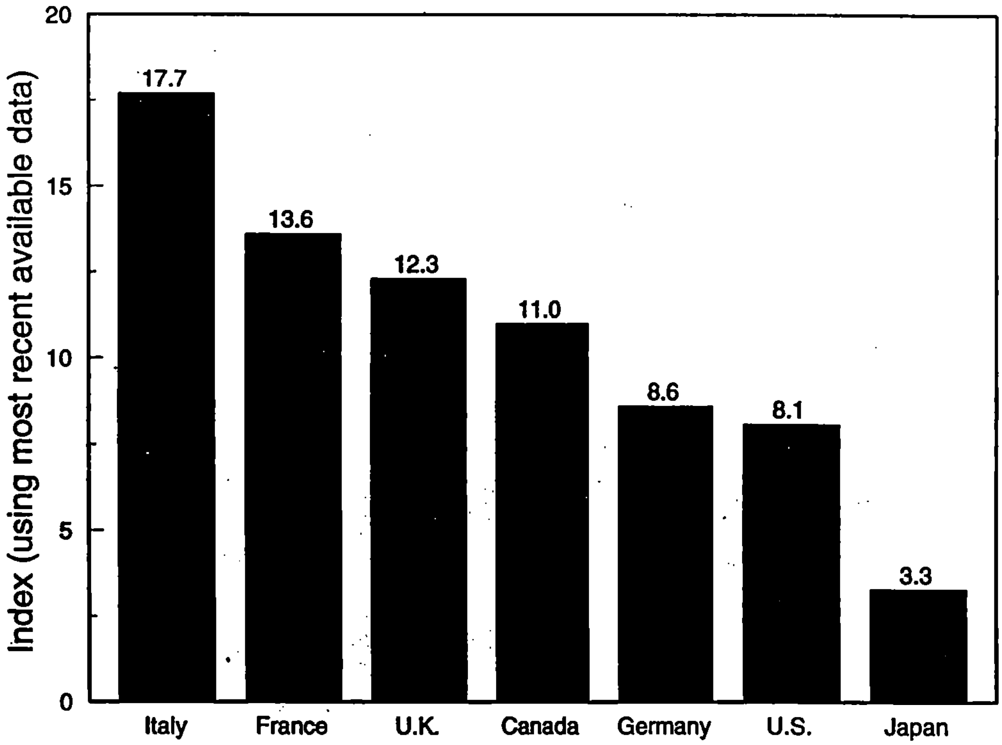

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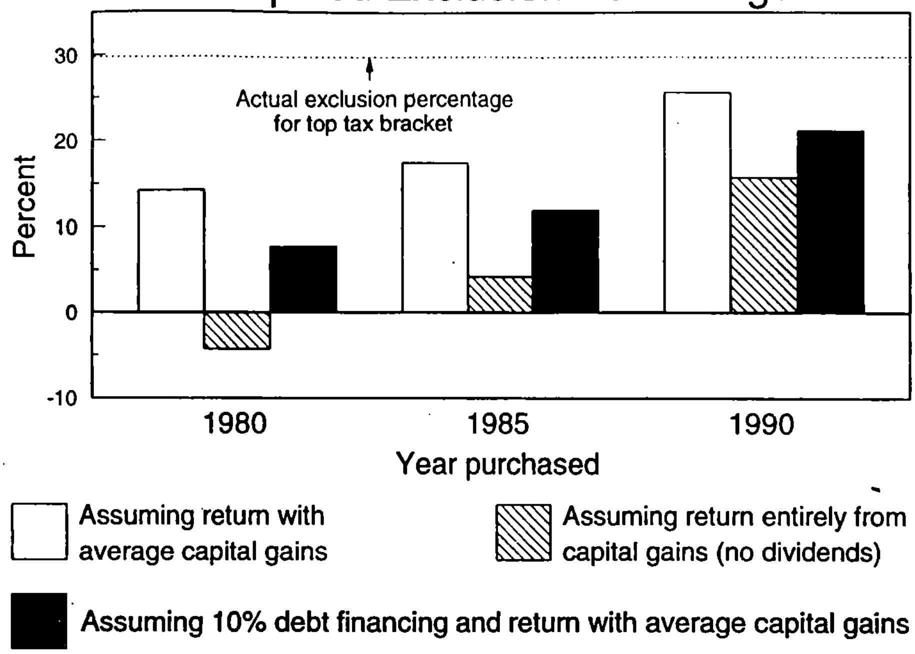

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Shares of Real GDP (percent)					
Business fixed investment	11.0	12.6	13.6	13.9	14.1
Residential investment	4.7	4.3	4.2	4.0	4.1
Exports	8.0	12.3	12.9	13.1	13.3
Imports	9.2	14.4	15.1	15.4	15.5
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	3.8	2.9	3.1
Federal surplus	–2.8	–2.4	–2.1	–1.8	N.A.

	1970–1993	1994	MONTHLY DATA Aug. 1995	Sept. 1995	Oct. 1995
Unemployment Rate	6.7**	6.1**	5.6	5.6	**5.5**
Payroll employment (thousands)					
increase per month			**263**	**50**	**116**
increase since Jan. 1993					**7527**
Inflation (percent per period)					
CPI	5.8	2.7	0.1	0.1	N.A.
PPI-Finished goods	5.0	1.7	–0.1	0.3	N.A.

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

New or revised data in **boldface**.

EYES ONLY

Employment and unemployment data **embargoed until 8:30 a.m., Friday, November 3, 1995.**

FINANCIAL STATISTICS

	1993	1994	Sept. 1995	Oct. 1995	Nov. 2, 1995
Dow-Jones Industrial Average	3522	3794	4747	4760	4809
Interest Rates					
3-month T-bill	3.00	4.25	5.28	5.28	5.31
10-year T-bond	5.87	7.09	6.20	6.04	5.92
Mortgage rate, 30-year fixed	7.33	8.35	7.64	7.48	7.44
Prime rate	6.00	7.15	8.75	8.75	8.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level November 2, 1995**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.418	+1.1	–5.7
Yen-Dollar	103.6	+1.8	+6.8
Multilateral $ (Mar. 1973=100)	84.23	+0.3	–1.9

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.3 (Q3)	**5.5 (Oct)**	2.5 (Sept)
Canada	2.5 (Q2)	9.6 (Aug)	2.3 (Sept)
Japan	0.6 (Q2)	3.2 (Jul)	–0.3 (Aug)
France	2.9 (Q2)	12.2 (Jul)	2.0 (Sept)
Germany	2.1 (Q2)	6.6 (Aug)	2.0 (Aug)
Italy	2.9 (Q2)	12.0 (Jul)	5.8 (Sept)
United Kingdom	2.8 (Q2)	8.7 (Aug)	3.8 (Sept)

U.S. unemployment data **embargoed until 8:30 a.m., Friday, November 3, 1995.**