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WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

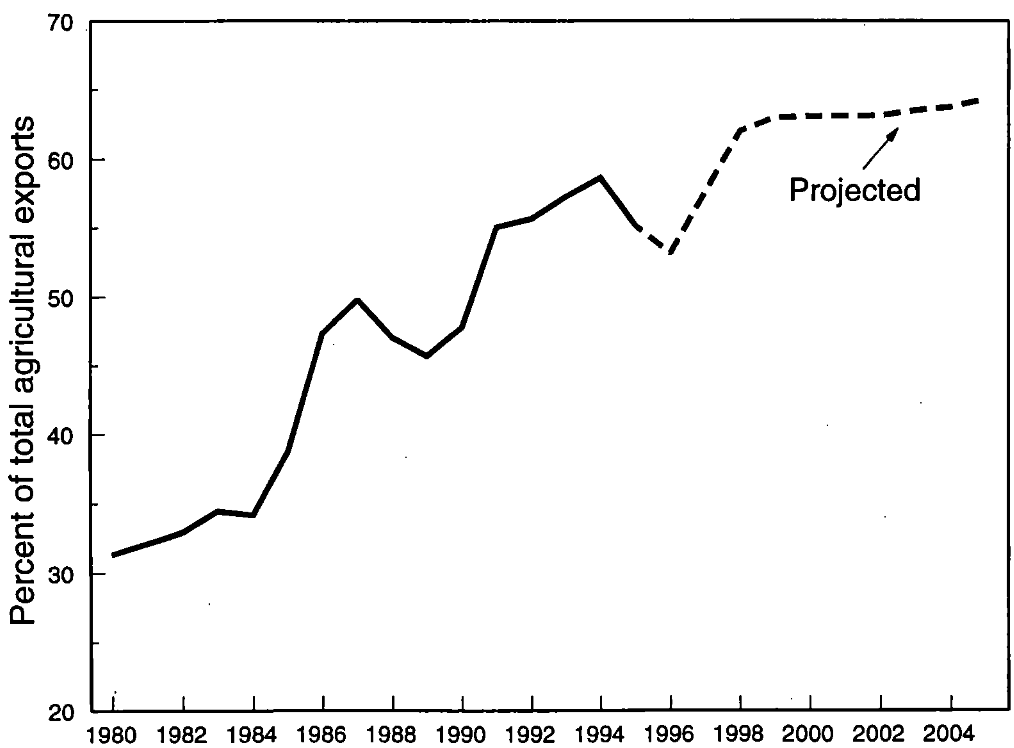
Prepared by the Council of Economic Advisers
with the assistance of the Office of the Vice President

October 11, 1996

Copied to
Joseph Stiglitz

CHART OF THE WEEK

Processed Farm Exports Grow in Importance



American agricultural exports are, increasingly, processed and "ready-to-eat" goods like meat, poultry, vegetables, fruit, and snack foods, as opposed to bulk goods like corn, wheat, soybeans, and cotton. U.S. meat and poultry exports are growing rapidly and account for much of the increase in the share of processed agricultural exports.

WEEKLY ECONOMIC BRIEFING
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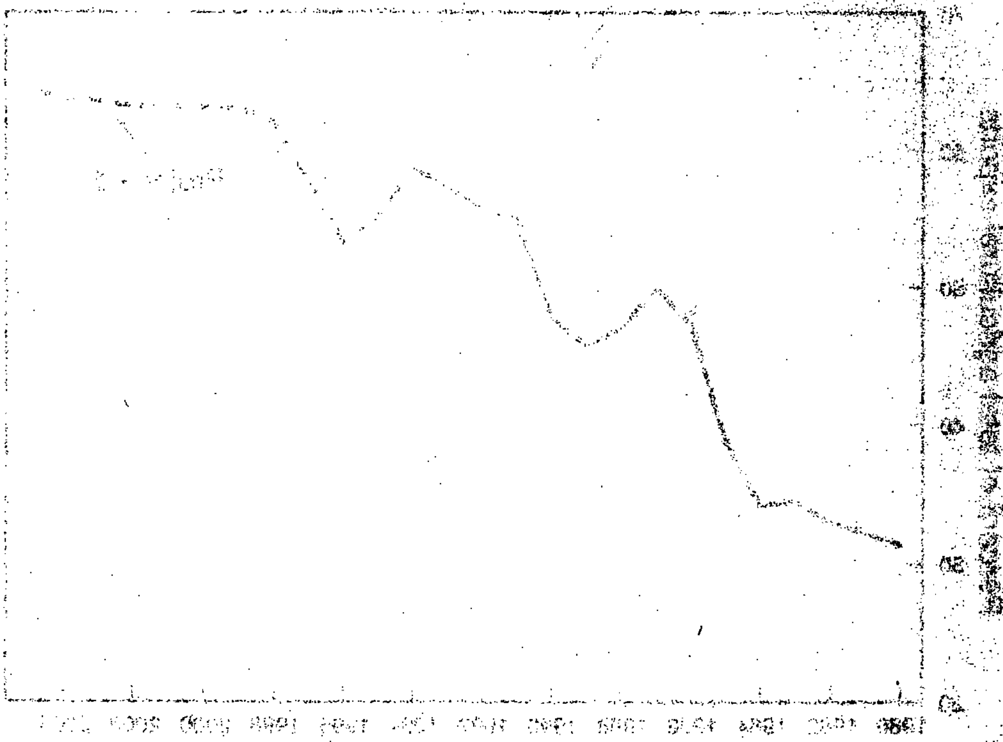
Processed Farm Exports Grow in Importance



American agricultural exports are increasingly [illegible] meat, poultry, vegetables, fruit and snack foods as opposed to bulk goods like corn, wheat, soybeans, and cotton. U.S. meat and poultry exports are growing rapidly and account for much of the increase in the share of processed agricultural exports.

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CURRENT DEVELOPMENT

Prize-Winning Economic Insights

This year's Nobel Prize in economics was awarded to William Vickrey of Columbia University and James A. Mirrlees, long at Oxford but now at Cambridge University. The award cites "fundamental contributions to the theory of incentives under asymmetric information." But the laureates are perhaps best known for their wide-ranging contributions to public economics.

Auctions. How can the government get bidders on Treasury bills, offshore oil leases, or radio spectrum to reveal their true willingness to pay? Vickrey analyzed the properties of different auction mechanisms under asymmetric information (when buyers and sellers do not share the same information). His analysis shows that well-designed auctions can garner substantial revenue without discouraging efficiency. A specific mechanism he proposed (in which, paradoxically, the highest bidder ends up paying less than his or her bid) is reflected in some current Treasury auctions.

Congestion pricing. Vickrey has made important contributions to the analysis of efficient pricing of public services, including visionary proposals to relieve traffic congestion that today are becoming increasingly technologically feasible. More generally, proposals to use "peak-load pricing" at airports and other facilities with scarce capacity offer the opportunity for substantial efficiency gains (one estimate suggests that passenger delays at major congested airports could be reduced by up to 50 percent, for example).

Income taxation. Economists have long recognized that more progressive taxation (higher rates for higher-income individuals) could have adverse incentive effects. Although strong supporters of progressive taxation, both Vickrey and Mirrlees have made fundamental contributions to the analysis of the trade-off between equity and efficiency, showing that a highly progressive tax system might also be highly inefficient.

Other Applications. The basic mathematical framework Mirrlees used to analyze income taxation has been extended to a number of other incentive problems, including a broad category of problems emphasizing moral hazard. For example, more complete insurance coverage, while it reduces risk, often creates adverse incentives that reduce efficiency (too little care taken by the insured party to avoid insured losses). Mirrlees showed how adverse incentive effects can be balanced against risk. This research shows that well-designed insurance schemes may require the insured to bear a considerable part of the risk, especially for relatively small losses, if large efficiency costs are to be avoided.

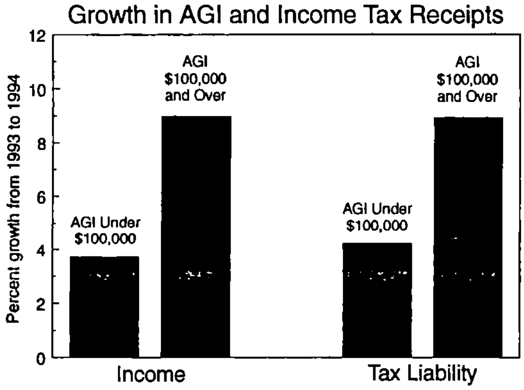
CURRENT DEVELOPMENT

Dire Predictions Gone Awry

Dire predictions by some economists that the 1993 increase in top marginal income tax rates would produce little new revenue and would discourage economic activity appear wrong. Recent data show that both incomes and tax liabilities grew faster for high-income taxpayers than for everyone else between 1993 and 1994 (see chart).

Analysis. Claims that the Administration was too optimistic in its revenue estimates were based on the belief that high-income taxpayers would substantially rearrange their economic affairs to minimize the amount of income subject to the new rates. Indeed, some evidence exists that many high-income taxpayers with flexible compensation packages shifted taxable wage payments from the early months of 1993 to late 1992 in anticipation of tax increases in 1993 (see Weekly Economic Briefing, July 12, 1996).

Growth in AGI and Income Tax Receipts



But recently published data from individual tax returns filed for 1994 show faster income growth for taxpayers with Adjusted Gross Income (AGI) of $100,000 and over (9.0 percent) than for those with AGI under $100,000 (3.7 percent). Differences in tax liability growth mirror these differences in income growth.

Part of the growth in the $100,000-and-over category reflects the fact that the threshold is not adjusted for inflation. Hence, the amount of income in that category would be expected to increase just as a result of normal growth and inflation. However, the observed growth for those with AGI over $100,000 is much too large to attribute to these factors alone. Instead, people in the top income classes appear not to have reduced their work effort, or hours, or shifted compensation toward fringe benefits very much, in contrast to the pessimistic predictions made in 1993.

SPECIAL ANALYSIS

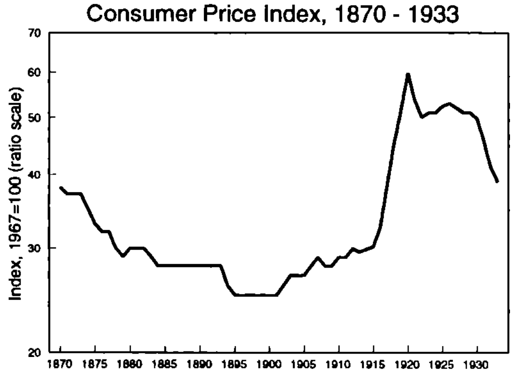
The Gold Standard: We're Not in Kansas Anymore

Advocates of returning to the gold standard, including Jack Kemp, believe it would reduce inflation and improve economic performance. But both theory and historical experience suggest a gold standard could, in fact, exacerbate instability in the economy and make events like chance gold discoveries in South Africa more important than domestic economic conditions in determining Federal Reserve policy.

How would a gold standard work? Under a gold standard, the central bank would fix the price of gold in terms of dollars and then stand ready to buy or sell gold in order to maintain the price at that level. With the price fixed at $400 per ounce, for example, the Fed would step in and buy gold whenever market forces threatened to push the price below $400. By exchanging dollars for gold, the Fed would be running an expansionary monetary policy. Similarly, in the face of upward pressure on the price of gold, the Fed would sell gold for dollars, thus running a contractionary monetary policy.

The gold standard has played a prominent role in American history: William Jennings Bryan's 1896 "Cross of Gold" speech was an attack on the gold standard, which he wanted to replace with a bimetallic (silver and gold) standard. "The Wizard of Oz" is an allegory of the gold standard debate (see box on next page). Supporters argue that a government operating under a pure gold standard could not pursue an inflationary policy because the price level would be tied to the stock of gold. But the gold standard has serious disadvantages as well, principally:

- It would prevent the Fed from responding to fluctuations in the economy.
- It would make monetary policy dependent on fluctuations in the gold market.
- It could stunt long-term growth. If, over time, the stock of gold does not grow fast enough to accommodate increases in the demand for money from a growing economy, interest rates would be higher and long-run growth lower than they otherwise would be.



The U.S. experience. Economic performance during the time when the United States was on a de facto gold standard (between the late 1870s and 1933) belies the benefits promised by gold advocates. Prices varied sharply, with periods of both deflation and inflation (see chart), unlike the consistently positive inflation of the postwar period. Price changes were influenced by variations in the gold stock. Little gold was discovered between the mid-century California gold rush and the 1890s, leading to falling consumer prices. Following discoveries in South Africa, Alaska, and Colorado, and improvements in mining and refining technologies, the global gold stock more than doubled between 1890 and 1914. After other economies left the gold standard at the beginning of World War I, large quantities of gold flowed into the United States. Consumer prices jumped 98 percent between 1915 and 1920.

A gold standard today? Most economists view the gold standard as a straitjacket—making monetary policy hostage to the gold market. In response to the entreaties of Jack Kemp and his fellow supply-siders, Treasury Secretary Donald Regan formed a blue-ribbon commission in 1981. The commission concluded that the gold standard "does not appear to be a fruitful method for dealing with the continuing problem of inflation."

The Wizard of Oz and the Gold Standard

Frank Baum's *The Wonderful Wizard of Oz* is an allegory of the gold standard debate. It was written shortly after the 1896 election, in which the conflict between gold and bimetallism played a central role. The central characters represent different factions in the debate. The tin woodman represents the industrial worker, who has been alienated (lost his heart) by industrialization; the scarecrow is the Western farmer, who appears to have no brains because his head is stuffed with straw, but who turns out to be quite shrewd; the Wicked Witch of the East represents the Eastern business and financial interests; the Wicked Witch of the West is the drought that plagued farmers in the 1890s (she was killed by water); and the lion is William Jennings Bryan, whose roar exceeds his might.

Dorothy, the Kansan paragon of American values, travels with her friends along the yellow brick road (the gold standard) to the Emerald City (Washington), in which everyone wears green-colored glasses (money). After being disappointed by the broken promises of the Wizard (William McKinley or Marcus Alonzo Hanna, one of McKinley's power brokers), Dorothy solves her problem when she unleashes the magical power of her silver slippers. (Heedless of the allegory, Hollywood decided ruby slippers looked better on the silver screen.)

ARTICLE

"Wait and See:" Often a Sensible Option

A new approach to evaluating investments under uncertainty is becoming increasingly prevalent in the private sector. It attempts to account for the "option" value of obtaining more information before making an irreversible decision. This approach has wide applicability in the public sector as well. Examples where it could be useful include analyses of purchasing a new fighter plane, protecting an environmentally-sensitive piece of land, setting a new technological standard, building a dam, changing a workplace safety rule, or privatizing a government corporation.

An example. Suppose the government owns some land that a private developer would be willing to buy for $1 million but that might be environmentally sensitive. In particular, suppose the value of preserving the land from development is contingent upon its role in the migration pattern of an endangered species. If the land is unimportant, the value of preserving it from development would be $10,000 per year. But if the land turned out to be critical to the species, the value of preserving it from development that would cause irreversible harm would be $90,000 per year. If scientific evidence regarding migration patterns is not yet known, but the odds of the land being important are 50-50, the current expected value of preserving the land from development is $50,000 per year, or about $700,000 in net present value at the government's borrowing rate (see box). The gain from the sale is thus about $300,000 in expected net present value terms.

A Potentially Misleading Approach:
An Expected Net Present Value Analysis of Selling Land Today

Benefit:	$1 million today
Cost:	½ probability: $90,000 per year ($1.3 million present value)
	½ probability: $10,000 per year ($0.1 million present value)

Expected net present value from selling today:
$1.0 million - (½ x $1.3 million + ½ x $0.1 million) = $300,000.

Note: present value calculated using a 7 percent discount rate.

The wrong calculation. The simple expected net present value rule gives a misleading answer, however, because it ignores a third option—waiting until more is known about migration patterns before deciding whether or not to sell. For simplicity, suppose a scientific study resolving the issue will be available next year. If it turns out the environmental value of the land is $10,000 per year, the government can sell. But if the land's environmental value turns out to be $90,000 per year, the government should preserve the land. The expected net present value from this strategy of "waiting and seeing" is $550,000—almost twice the expected gain from selling immediately (see box). In this case, the government should wait until next year, in order to avoid selling the land when its environmental value turns out to be high. In other words, the problem with the simple "sell now" approach is that the government won't know the true value of the land until after development has begun— too late to save the species if the land turns out to be environmentally important.

A Better Approach:
An Expected Net Present Value Analysis of "Waiting and Seeing"

If environmental benefit is low: sell next year	If environmental benefit is high: don't sell
Benefit: $1 million next year	Benefit: $90,000 per year
Cost: $10,000 per year	Cost: $1 million next year in forgone revenue
Net present value: $0.8 million	Net present value: $0.3 million

Expected net present value from waiting until next year before deciding:
½ x $0.8 million + ½ x $0.3 million = $550,000.

Notes: present value calculated using a 7 percent discount rate; present value of $1 million next year is $935,000.

Analysis. Actions that are irreversible and involve uncertainty implicitly have an "option value" attached to them. In the example above, the government's decision was irreversible (since the development would change the land), and its ability to delay selling the land was valuable. If the government decided to sell today, it would extinguish its option to wait, but without counting the cost of losing that option. In a wide variety of applications in which the government can "wait and see," simple net present value calculations could be misleading. But the option to wait is only valuable in certain conditions; it may not be sufficient to change the government's decision in many others. In the case examined here, for example, the option to wait would not have been valuable enough to change the government's decision if the government could easily "undo" the development, or if there were less uncertainty over the environmental value of the land.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Macroeconomists Reach Consensus Forecast. *The Economist* magazine recently made its own foray into political polling, asking half the macroeconomists at the top 15 U.S. universities whether the economy would benefit more under Clinton or Dole. By a margin of almost 3-to-1, the economists think the economy will benefit more under Clinton. Nearly half disagree with the notion that higher growth should be the top economic priority; many instead put issues like income distribution and poverty higher on the agenda. Most are wary of the assertion that we can dramatically boost our growth rate: only 5 percent think we can realistically achieve sustained long-term growth greater than 3 percent per year, while a majority (60 percent) think 2.5 percent or less is the most reasonable target. When asked to rate different policy proposals on their long-term growth potential, most economists think a cut in marginal tax rates with corresponding spending cuts would have little or no impact on growth. Over half, however, think education reform would raise the long-term growth rate.

Policies Could Help Extinguish Youth Smoking. After declining sharply during the 1970s, youth smoking rates have remained flat during the 1980s and 1990s, and they have increased for some cohorts such as teenage girls. Since almost all adult smokers acquire the habit by the time they finish high school, tobacco control policies discouraging youth from smoking may contribute most to long-term reduction. A new study examining middle- and high-school students finds that several tobacco control policies are particularly effective with youth. Youth demand for cigarettes is very sensitive to price—much more so than adult demand. Therefore, significant increases in cigarette excise taxes will likely lead to sharp reductions in youth smoking. The study estimates that if smokers had to pay an additional 75-cent-per-pack tax beginning in 1992, overall youth cigarette consumption would have been cut in half by 1994 and the number of youth smokers would have decreased by about a quarter. Stronger restrictions on smoking in public places would also reduce the incidence of smoking among youths, and more limits on smoking in schools would reduce young smokers' average cigarette consumption.

California and Oregon Ballot Initiatives Seek Managed Care Reform. When they go to the polls next month, Californians may determine the future of managed care in their state, which has more HMO enrollees than any other state. Proposition 216 would outlaw bonuses and other financial incentives for doctors to withhold treatment, prohibit HMOs from limiting what doctors tell patients, and require HMOs to disclose all written criteria for denial of care. HMOs would not be allowed to deny payment for services without a second opinion. The measure would also establish four new taxes: on the elimination of hospital beds, on mergers and acquisitions in the health care industry, on the sale or conversion of a nonprofit health care business to a profit-making enterprise, and on "excessive compensation." The new revenue would be used for regulation of the health industry and public health measures. Provisions in an Oregon initiative would go even further, disallowing capitation, the payment system often used by HMOs, in which insurers pay doctors a fixed amount per patient regardless of the amount or type of care provided.

INTERNATIONAL ROUNDUP

Economic Progress May Be Returning to Africa. After the "lost decade" of the 1980s and average growth of only 1.4 percent during 1991-94, Sub-Saharan Africa's economic performance is improving. The region's GDP is estimated to have grown 4 percent in 1995, with even higher growth expected this year. But aggregate numbers mask the fact that economic performance has varied dramatically across the continent. Although at least 15 countries grew by 5 percent or more last year (with Angola, Lesotho, Malawi and Uganda growing in excess of 10 percent), 8 countries registered declines. And growth has not yet been sufficient to reduce poverty in most of the continent. Indications exist that economic performance has responded to policy reforms, which are spreading. For example, the French-speaking countries that use the CFA franc adjusted their exchange rates in early 1994 and registered the sharpest increase in exports.

Canada's Finance Minister Announces Tough Deficit Targets. In the annual fall update given to the Canadian Parliament, Finance Minister Paul Martin announced that, for the second year in a row, the federal government bettered its deficit target. The deficit fell to 3.7 percent of GDP in the 1995-96 fiscal year, and the goal is to reduce the deficit to 1 percent by the 1998-99 fiscal year. Contractionary effects of deficit reduction may be eased by lower interest rates, which in the past year have fallen by more than 4.5 percentage points for shorter maturities. But the Canadian economy does not yet appear to have responded to these lower rates. As recently as June, unemployment was 10 percent, although it has fallen somewhat since then. And no growth in youth employment has occurred since the beginning of the year. With economic activity still weak, prices rose at an annual rate of only 1.4 percent in August, and unit labor costs have grown by less than 0.5 percent per year since the beginning of 1991.

Kuwait's Lawmakers Approve 1996-97 Budget. The Kuwait National Assembly recently unanimously approved next year's budget. The budget package entails deficit reductions until 2000, the target year for a zero deficit. With successful completion of the post-Gulf-War reconstruction and rehabilitation program, government attention is now directed at reducing fiscal imbalances and strengthening the structure of the economy. In 1995, Kuwait recorded strong GDP growth and a reduction in the deficit to 12 percent of GDP. This improvement was primarily due to higher oil prices, as the hydrocarbon sector accounts for close to 40 percent of GDP and oil revenues represent 75 percent of total government income. Looking forward, the Kuwait economy faces the challenge of finding enough employment opportunities for the growing number of Kuwaitis who will be entering the labor force. Currently, 40 percent are below the age of 14. Furthermore, an increasing number of women are entering the labor force. Kuwait is heavily dependent on imported labor, with surveys suggesting that nearly 80 percent of the labor force is expatriate.

RELEASES THIS WEEK

Producer Price Index

****Embargoed until 8:30 a.m., Friday, October 11, 1996****

The producer price index for finished goods increased 0.2 percent in September. Excluding food and energy, producer prices increased 0.3 percent.

Retail Sales

****Embargoed until 8:30 a.m., Friday, October 11, 1996****

Advance estimates show that retail sales increased 0.7 percent in September following a decrease of 0.2 percent in August. Excluding sales in the automotive group, retail sales increased 0.4 percent in September after a decrease of 0.5 percent in August.

MAJOR RELEASES NEXT WEEK

Consumer Prices (Wednesday)
Industrial Production and Capacity Utilization (Thursday)
Housing Starts (Thursday)
U.S. International Trade in Goods and Services (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	241	-40
increase since Jan. 1993					10466
Inflation (percent per period)					
CPI	5.8	2.5	0.3	0.1	N.A.
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**.
PPI data **embargoed until 8:30 a.m., Friday, October 11, 1996.**

FINANCIAL STATISTICS

	1994	1995	Aug. 1996	Sept. 1996	Oct. 10, 1996
Dow-Jones Industrial Average	3794	4494	5686	5804	5922
Interest Rates					
3-month T-bill	4.25	5.49	5.05	5.09	5.01
10-year T-bond	7.09	6.57	6.64	6.83	6.61
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. 10, 1996**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.530	0.1	7.8
Yen-Dollar	111.3	−0.2	10.6
Multilateral $ (Mar. 1973=100)	88.05	−0.0	4.5

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	2.7 (Q2)	5.2 (Sept)	2.9 (Aug)
Canada	1.2 (Q2)	9.4 (Aug)	1.4 (Aug)
Japan	3.9 (Q2)	3.4 (Aug)	0.2 (Aug)
France	0.4 (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)