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Jun 28, 96 - Weekly Economic Breifing

THE PRESIDENT HAS SEEN
7-2-96

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

June 28, 1996

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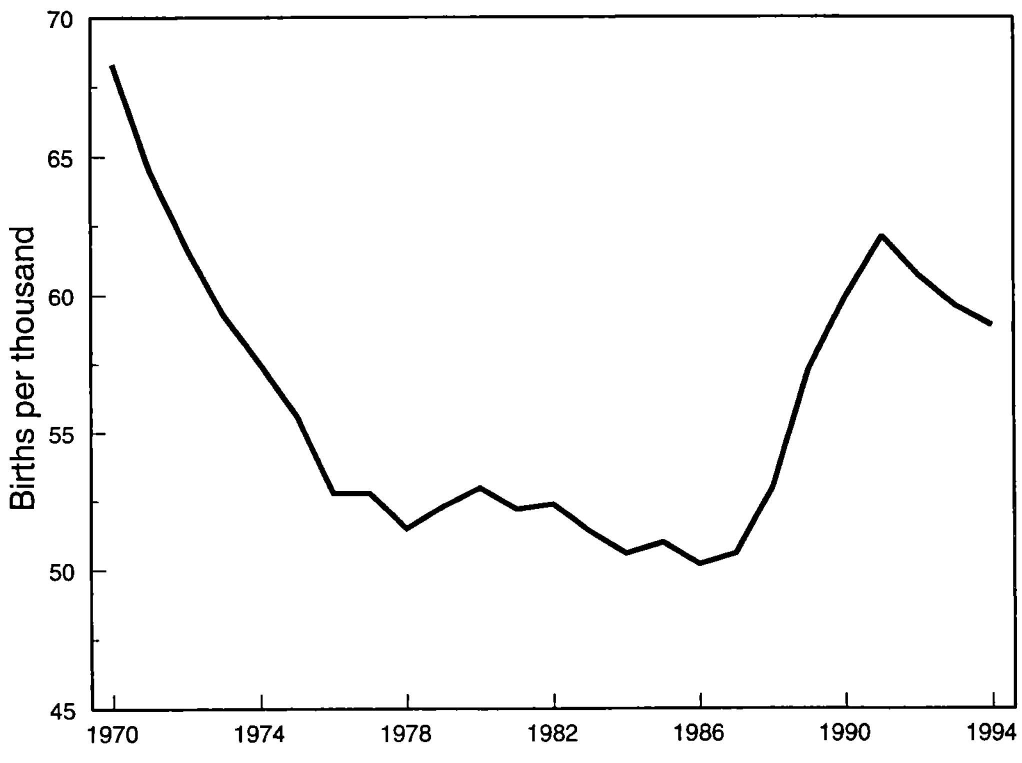
CHART OF THE WEEK

Teenage Birth Rates



The latest data on teenage birth rates, just released by the Department of Health and Human Services, show three straight years of decline. The teen birth rate nevertheless remains well above the low rates seen between 1976 and 1988. A Business, Consumer, and Regional Roundup in this Weekly Economic Briefing discusses a study of the economic costs of teenage births.

PHOTOCOPY
WJC HANDWRITING

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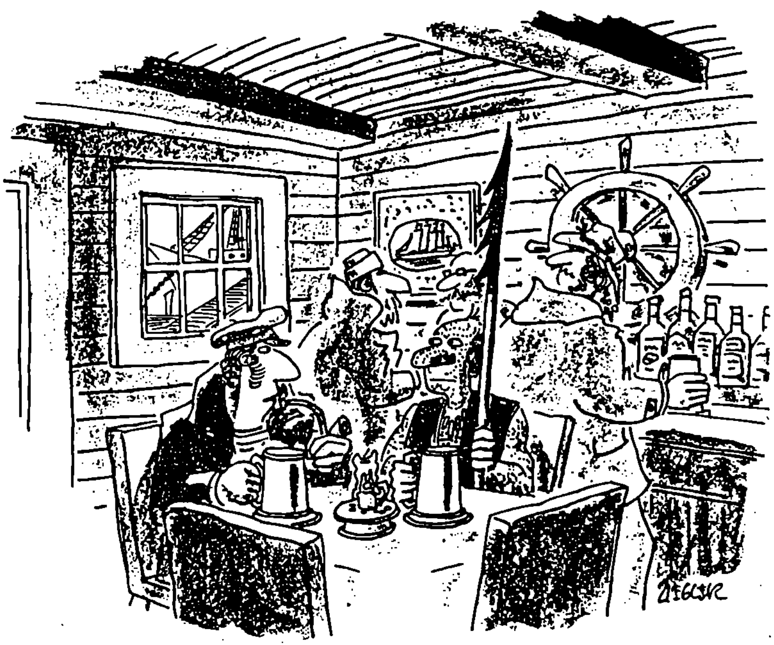


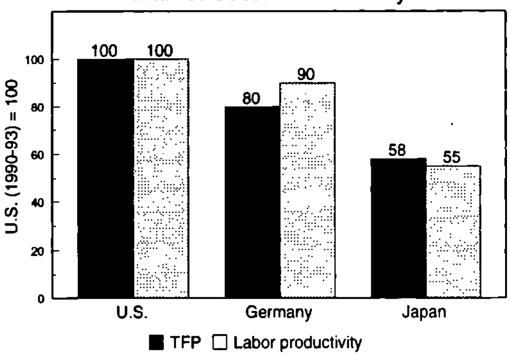
"No health or dental, no stock options, and no severance package. We do, however, provide free burial at sea."

SPECIAL ANALYSIS

Higher Capital Productivity Found in U.S. Firms

U.S. saving and investment rates are much lower than those of Germany and Japan. These lower rates may have been partly offset, however, by more efficient use of capital by U.S. firms, according to a new study from an international consulting firm.

Analysis. Previous studies have shown that labor productivity (output per hour) in the market sectors (that is, excluding government, education, and health care) is higher in the United States than in Germany or Japan. The new study finds that total factor productivity (TFP) is also higher in the United States (see chart). TFP is output divided by a measure of inputs that includes both capital and labor.



The TFP gap between the United States and Germany is larger than the labor productivity gap. Germany has almost 40 percent more equipment and structures per hour of labor input than the United States, yet achieves only 90 percent of the output per hour. Although Japan has some industries (including autos) where productivity is above U.S. levels, it also has large industries with very low productivity (including food processing) that pull average productivity in Japan well below that of the United States.

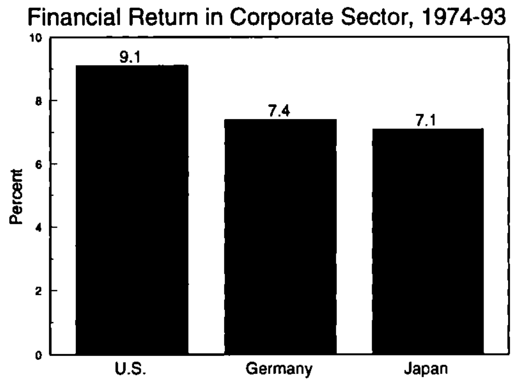
Lessons from case studies. A variety of factors contribute to the productivity gap between the United States and the other countries, but the new study highlights more efficient use of capital. Case studies of the automotive, retailing, food processing, telecommunications and electric power industries provide insight into why U.S. companies are able to operate with capital utilization rates estimated to be 25 to 30 percent higher than their German and Japanese counterparts. For example:

- In autos, German employees work fewer hours per year, and high union premiums discourage multiple shift operations. This forces companies to maintain a very large stock of capital relative to output.

- In electric power, pricing strategies that discourage usage during peak periods, together with efficient management of the power grid, allow U.S. companies to hold down capacity. Japan, by contrast, has over twice as much capital per kilowatt hour in the electric power sector as the United States.

- Germany also uses capital inefficiently by "goldplating" its capital equipment. The specifications for capital goods in Germany are often above those needed for efficient operation, adding roughly 5 to 15 percent to capital costs.

Implications for Saving. The consulting firm's analysis becomes a little more speculative when it moves from the specific to the general. The case studies suggest that higher TFP and better use of capital allow U.S. corporations to earn higher rates of return on their assets. The study extends the case results to a national number by calculating that the average annual rate of return on corporate stocks and bonds between 1974 and 1993 was about 2 percentage points higher in the United States (see chart). This rate of return, however, is driven heavily by the increase in stock market valuation and hence is sensitive to the period chosen.



Still, the study makes an important point: if savers can earn higher returns on their funds they will end up with substantially more wealth for a given level of saving or can save less to achieve a given stock of wealth. (An article in this issue of the Weekly Economic Briefing discusses the relationship between rates of return and saving.) Over the period 1974-93, for example, investing in U.S. corporations at the higher U.S. rate would have yielded a final wealth 37 percent higher than investing in Japanese corporations at their lower rate.

Conclusion. The implications for policy are not straightforward. The ability to earn higher rates of return in the United States may account in part for why U.S. saving rates are lower than those of the other countries and might imply less need to raise the U.S. saving rate. The opposing argument is that maybe we should be saving more to take advantage of the higher rate of return. The real bottom line of this study is that capital investment is not an automatic virtue. Using capital efficiently is at least as important as saving and investing more.

SPECIAL ANALYSIS

Testing the Farm Safety Net

This year farmers must contend with bad weather and concerns about how they will fare under the new farm bill. Drought in the Southern Plains has severely damaged the winter wheat crop, while heavy rains elsewhere in the Midwest threaten corn and other crops. Concern has been expressed that the fixed payments introduced in the Federal Agricultural Improvement and Reform (FAIR) Act of 1996 may not protect farmers as well as the farm price supports they have largely replaced. Recent research raises questions, however, about how effective price supports are at stabilizing income for many farmers.

Analysis. Farm revenues are subject to two types of risk: low yields and low prices. Previous legislation limited yield risk by requiring farm program participants to take out crop insurance. The insurance pays farmers for yield losses above 50 percent of their average yields at a rate of 60 percent of the crop price. Price risk was addressed by deficiency payments that paid farmers the difference between the market price and a pre-set target price for a portion of their production. In addition, price floors limited how far market prices could fall. The FAIR Act replaced deficiency payments with fixed annual payments based on historic production rather than current production or prices.

Preliminary USDA analysis suggests that a fixed payment system, combined with crop insurance, can actually provide more stable farm incomes than a price support system. This is because the price support system pays very little when yields are low and can result in very high payments when yields are high.

An example. Fixed payments can increase income stability relative to price supports for a significant number of producers. We have conducted simulations comparing how a hypothetical 500-acre Southern Plains wheat farm would fare under different market conditions, both under a deficiency payment system and under a fixed payment system. While the results would not apply to all producers, one would expect them to be representative of farms in major production areas.

Three cases were compared:

Normal crop year. Farm yields and market prices approximate USDA's baseline projection, which assumes normal weather conditions.

Severe drought. The farm suffers yield losses of 65 percent with a wheat price of $5.00 per bushel.

Bumper crop. Yields and prices approximate those of 1990, a year characterized by high production and low prices.

Returns to a hypothetical Southern Plains wheat farm

Market Scenario	Market Returns	Support Payments	Crop Insurance	Gross Income
Deficiency payments				
Normal year	$60,375	$7,331	$0	$67,706
Severe drought	$30,000	$0	$7,875	$37,875
Bumper crop	$49,400	$22,610	$0	$72,010
Average	$46,592	$9,980	$2,625	$59,197
Fixed payments				
Normal year	$60,375	$9,980	$0	$70,355
Severe drought	$30,000	$9,980	$7,875	$47,855
Bumper crop	$49,400	$9,980	$0	$59,380
Average	$46,592	$9,980	$2,625	$59,197

This example illustrates how:

- Farm income varies more under the deficiency payment system. The deficiency payment system does less well at maintaining farm income in the drought case where prices are high, but yields are low.

- With a bumper crop, prices are low, so deficiency payments can be large. Fixed payments do less well at maintaining income when prices are low.

- The FAIR Act no longer requires program participants to purchase crop insurance. Producers who forego this insurance could be exposing themselves to significant income risk.

- Neither deficiency nor fixed payments does a perfect job at stabilizing farm income. The Administration has already initiated a pilot program to provide producers with revenue insurance. This insurance would provide farmers with payments for revenue shortfalls below a guaranteed amount regardless of whether the cause was a low price or a low yield.

Conclusion. Price support programs aim to control price instability but do not directly target the income instability farmers really care about. As a result, price supports do not always stabilize farm incomes more effectively than fixed payments do.

ARTICLE

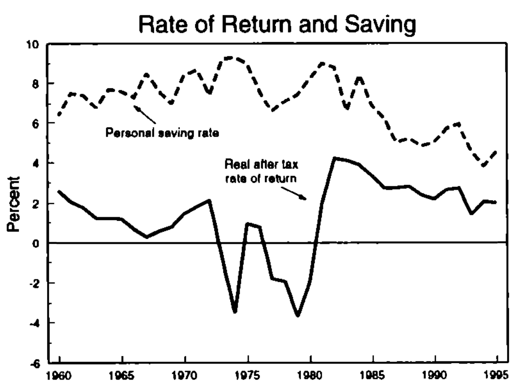
Supply Side Economics Scorecard, Part 1: Saving

Across-the-board cuts in income tax rates may become an issue as the campaign progresses. They will likely be justified by supply-side arguments asserting, first, that people's economic behavior is highly responsive to changes in the after-tax return to work, saving and investment and, second, that such tax cuts will "pay for" themselves through increased economic activity. This article on saving and a subsequent article on labor supply will examine whether the supply-siders' claims are grounded in economic analysis and evidence.

The theory. Theory suggests that a tax cut raising the after-tax rate of return on saving has two effects that work in opposite directions. On the one hand, it increases the reward to saving. On the other, it reduces the need to save. The first effect encourages saving because each dollar saved now generates more future income and hence permits more future consumption. The attractiveness of future consumption rises relative to current consumption. The second effect discourages saving because a higher after-tax return allows people to spend more on current consumption and more on future consumption with less current saving. Economic theory cannot say which effect will be larger.

A review of the statistical evidence. Since World War II, many economists have tried to estimate the responsiveness of overall saving to changes in interest rates. The results have been inconclusive: some studies have found that saving is completely unresponsive to changes in interest rates, while others have found moderate or even large saving responses (the larger estimates claim that saving increases by 4-6 percent when after-tax interest rates increase by 10 percent). Data limitations and reasonable differences over appropriate methodology preclude a definitive sorting out of this evidence. Statistically, it is difficult to disentangle the effects of economic shocks like recessions and oil shocks that can affect both saving and interest rates simultaneously. Also, different studies make different adjustments for inflation, taxes, business cycle effects, and income growth.

The CEA, after reviewing the evidence, concludes that the expected response of saving to changes in after-tax interest rates is quite small, though not zero. A plausible estimate is that a 10 percent increase in the after-tax interest rate (say, from 5 percent to 5.5 percent) would yield about a 1 percent increase in saving (from about $240 billion to $242 billion).



The historical record. The chart shows movements in the U.S. saving rate and real after-tax interest rates for the period

1960-95. It is noteworthy that when the real after-tax rate of return fell and became negative during the late 1970s, the personal saving rate stayed relatively high; and when the after-tax rate of return climbed substantially during the early 1980s, the saving rate fell. To be sure, there were other changes occurring in the economy that might have accounted for these movements, but this simple evidence makes it hard to discern a strong relationship between after-tax returns and aggregate saving.

Tax cuts, deficits, and growth. The essential supply-side justification for tax cuts is that they will raise the economy's long-term growth rate. With respect to saving, these incentives must increase the share of GDP devoted to national saving (private saving plus public saving) and ultimately, investment. The box presents illustrative calculations indicating that such an outcome is unlikely. For reasonable estimates of saving responsiveness, the revenue loss from the tax cut produces a decline in public saving (an increase in the federal budget deficit) that will be larger than the increase in private saving. The net effect is to lower national saving and investment, not raise them.

The responses of aggregate saving to tax incentives are even less likely to be large enough to spawn enough extra economic activity to "pay for" themselves. And the evidence of the United States during the supply-side experiment of the 1980s should stand as warning against these claims.

Will a Tax Cut Pay for Itself?

Consider a tax cut proposal (e.g., a tax credit) intended to raise after tax rates of return on all savings (both new and existing) by 10 percent. Given that about $400 billion of capital income was reported by individuals on 1994 tax returns, this tax credit would lose around $30 billion a year of revenue, based on an average tax rate on capital income of 25 percent (the tax credit in this example would offset about 30 percent of the income tax due on capital income for the average taxpayer). For savings to increase from $240 to $270 billion in response to the tax cut, the saving response would have to be more than 10 times bigger than what the CEA considers reasonable. It would have to be more than twice the upper bound of plausible empirical estimates. And a response this large would just keep total national saving from falling. A much larger response would be needed to generate enough additional saving, investment, and income to offset the revenue loss and keep the Federal budget deficit from growing.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Teen Birth Rates Down but Teenage Motherhood Costly. New data from the Department of Health and Human Services show the teen birth rate declining for the third year in a row (see Chart of the Week). This good news is tempered, however, by evidence that teenage childbearing continues to carry a heavy economic cost. A new study released by the Robin Hood Foundation indicates that, after controlling for other factors correlated with early child-bearing, children of teenage mothers carry additional disadvantages. Children of teenage mothers are more likely to repeat a grade in school, drop out, be unemployed as young adults, and become teenage parents themselves. The study estimates these problems associated with teenage childbearing will cost taxpayers about $7 billion this year, one-third from higher welfare payments and the rest from higher outlays for foster care, medical treatment and criminal justice, plus lost tax revenues.

To VP
any national
possibilities here? —
BC

Higher Education Goes Online. This week the governors of ten Western states appro~~ved plans for a new "virtu~~al university" that will allow students to take courses and earn a degree via computer. They anticipate that the first students will be working in electronic classrooms next year. Many students already learn at a remote distance from teachers through correspondence courses. And the Western Governors' University will likely expand these nontraditional options and help meet an expected enrollment boom without the huge expense of expanding traditional colleges and universities. The full start-up costs are estimated to be between $6 and $10 million. The governors do not see this virtual university as a replacement for the existing system of higher education, but as a supplement that will spread opportunities across the region's vast space and expand opportunities for non-traditional students, such as those whose jobs, family obligations, or physical disabilities make it difficult to be on campus.

THE PRESIDENT HAS SEEN
7-2-96

INTERNATIONAL ROUNDUP

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World Bank Finds Successes and Challenges in Fight Against Poverty. Living standards in the developing world have improved substantially over the past 25 years, according to a recent World Bank report. Per capita income has doubled, the infant mortality rate has been cut in half, and average life expectancy has been raised by nearly ten years. At the same time, more than 1.3 billion people must make ends meet on less than one dollar a day, and this number is growing. Childhood morbidity and mortality from malnutrition, contaminated water, and air pollution remain high. About 130 million children, 80 percent of them girls–lack educational opportunities. The World Bank emphasizes the importance of investing in the health and education of the poor in order to increase their chances of participating fully in the growth of the global economy. Expansion of education for girls, which has been found to lower fertility rates and raise productivity, is considered particularly important.

Chile Signs Association Agreement with Mercosur. This week Chile and the countries of the Mercosur Free-Trade Area (Argentina, Brazil, Paraguay, and Uruguay) agreed to eliminate tariffs on most goods traded between them by 2004. Tariffs on most goods will be cut 40 percent when the agreement goes into effect on October 1, lowering average Mercosur tariffs on Chilean products to an estimated 6 percent. For a few sensitive agricultural products, Chilean import tariffs will not be fully dismantled until 2014. Chile's ports are of special interest to the Mercosur countries as they look to strengthen their trade with the Pacific Rim. According to embassy reports, the issue of most-favored-nation status was settled in a way that should reduce complications for any future Chilean NAFTA accession negotiations. The Mercosur deal follows on the heels of a new framework cooperation agreement between Chile and the European Union, signed last week in Florence, that provides for gradual trade liberalization and expanded cooperation in several areas including investment, services, intellectual property, and science and technology.

Business Coalition Sees Foreign Aid as Good Investment for United States. The Business Alliance for International Economic Development, a coalition representing over one thousand U.S. businesses, published a study this week urging a 50 percent increase in U.S. foreign aid to match the levels of the 1960s. The Alliance points out the important role played by assistance programs in helping developing countries build the physical, human, and institutional infrastructure necessary to bolster economic growth, foster trade, and attract private investment. It advances a view of foreign assistance as an investment in future markets for U.S. goods and services, observing that U.S. exports to developing countries increased by nearly $100 billion between 1990 and 1995, with future growth prospects favorable as well. The Alliance notes the extent of Americans' misinformation about foreign aid, citing a poll showing that nearly six out of ten believe the United States spends more on foreign aid than on Medicare. Many Americans also do not realize that 80 percent of the total U.S. foreign assistance budget is spent on American goods and services.

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RELEASES THIS WEEK

Gross Domestic Product

****Embargoed until 8:30 a.m., Friday, June 28, 1996****

According to revised estimates, real gross domestic product grew at an annual rate of 2.2 percent in the first quarter.

Advance Durable Orders

According to advance data, manufacturers' new orders for durable goods increased 3.3 percent in May, following a decrease of 1.8 percent in April.

Consumer Confidence

Consumer confidence, as measured by the Conference Board, declined 5.9 index points in June, to 97.6 (1985=100).

MAJOR RELEASES NEXT WEEK

National Association of Purchasing Managers' Report (Monday)
Leading Indicators (Tuesday)
Employment (Friday)

U.S. ECONOMIC STATISTICS

	1970–1993	1995	1995:3	1995:4	1996:1
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	1.3	3.6	0.5	**2.2**
GDP chain-type price index	5.3	2.6	2.2	2.2	2.4
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	0.3	1.7	−0.8	2.1
Real compensation per hour:					
Using CPI	0.6	1.0	2.1	0.5	0.1
Using NFB deflator	1.3	1.7	2.0	2.0	2.4
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.2	10.2	10.2	10.4
Residential investment	4.5	4.0	4.0	4.0	4.1
Exports	8.2	11.1	11.1	11.3	**11.2**
Imports	9.2	12.5	12.5	12.4	**12.5**
Personal saving	5.1	3.3	3.2	3.6	3.4
Federal surplus	−2.7	−2.2	−2.2	−2.1	−2.1

	1970–1993	1995	March 1996	April 1996	May 1996
Unemployment Rate	6.7**	5.6**	5.6	5.4	5.6
Payroll employment (thousands)					
increase per month			158	163	348
increase since Jan. 1993					9724
Inflation (percent per period)					
CPI	5.8	2.5	0.4	0.4	0.3
PPI-Finished goods	5.0	2.3	0.5	0.4	−0.1

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

New or revised data in **boldface**.
First quarter 1996 GDP data **embargoed until 8:30 a.m., Friday, June 28, 1996**.

FINANCIAL STATISTICS

	1994	1995	April 1996	May 1996	June 27, 1996
Dow-Jones Industrial Average	3794	4494	5580	5617	5678
Interest Rates					
3-month T-bill	4.25	5.49	4.95	5.02	5.06
10-year T-bond	7.09	6.57	6.51	6.74	6.83
Mortgage rate, 30-year fixed	8.35	7.95	7.93	8.07	8.29
Prime rate	7.15	8.83	8.25	8.25	8.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level**	**Percent Change from**	
	June 27, 1996	**Week ago**	**Year ago**
Deutschemark-Dollar	1.522	0.0	+10.0
Yen-Dollar	109.5	+1.2	+30.2
Multilateral $ (Mar. 1973=100)	87.90	0.0	+7.6

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	**1.7** (Q1)	5.6 (May)	2.9 (May)
Canada	0.6 (Q1)	9.4 (Apr)	1.5 (Apr)
Japan	5.5 (Q1)	3.5 (Apr)	0.1 (Mar)
France	1.0 (Q1)	12.6 (Mar)	2.4 (Apr)
Germany	0.8 (Q4)	7.1 (Mar)	1.5 (Apr)
Italy	1.1 (Q1)	12.0 (Jan)	4.5 (Apr)
United Kingdom	1.9 (Q1)	8.5 (Apr)	2.4 (Apr)

U.S. GDP data **embargoed until 8:30 a.m., Friday, June 28, 1996.**