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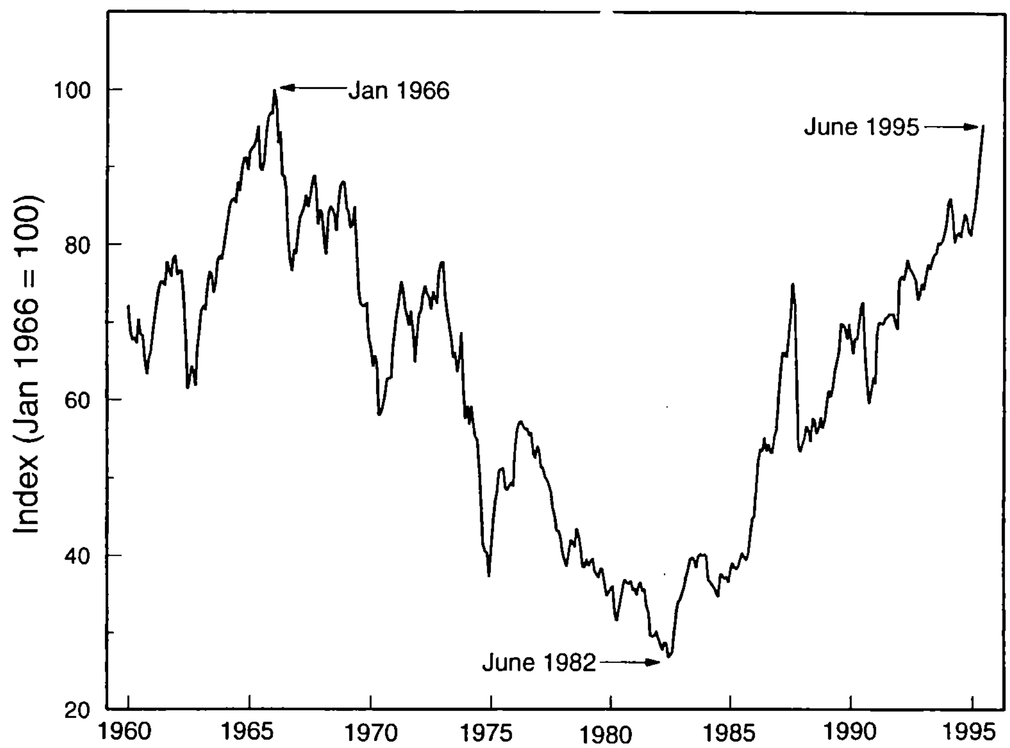
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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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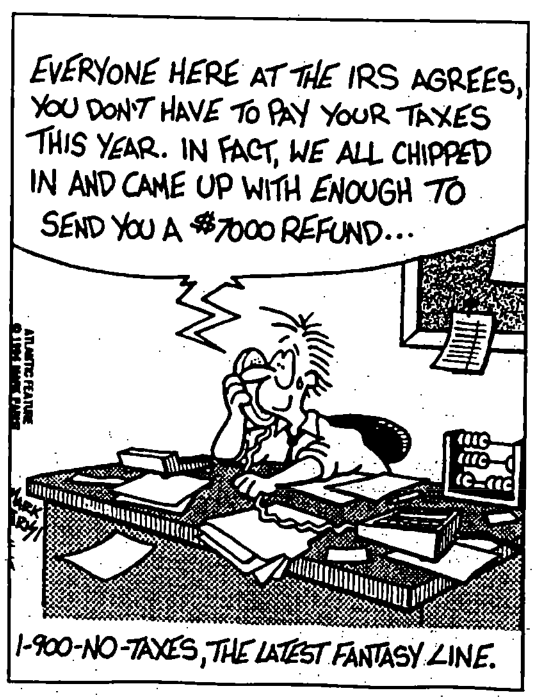

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CURRENT DEVELOPMENT

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.

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.

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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
			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**	**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)

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