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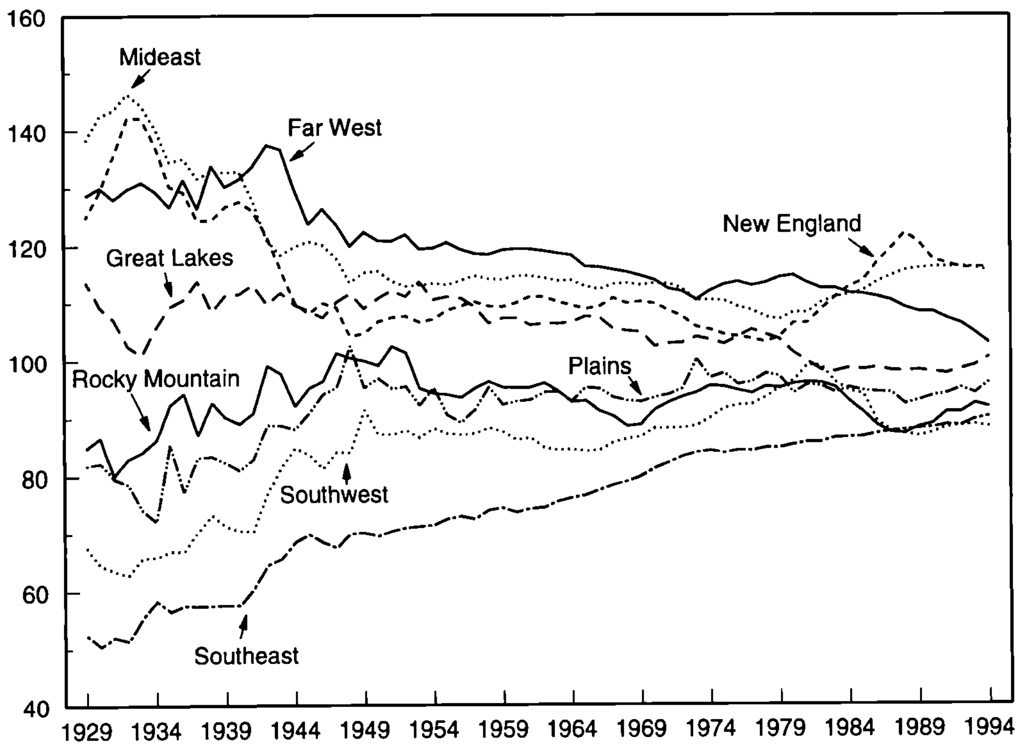
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

September 15, 1995

CHART OF THE WEEK

Per Capita Personal Income as a Percentage of U.S. Average by Region



Regional differences in per capita personal income have narrowed considerably since the Great Depression. The trend toward regional convergence, however, stalled in the 1980s, as per capita income across regions began to diverge. Since the early 1990s, regional differences have begun to stabilize, and in some cases regional incomes have resumed their trend toward convergence. California has driven the pattern of convergence for the Far West region. Over the years, its per capita income has fallen from a level 150 percent of the national average to a level in 1994 only slightly above the national average.

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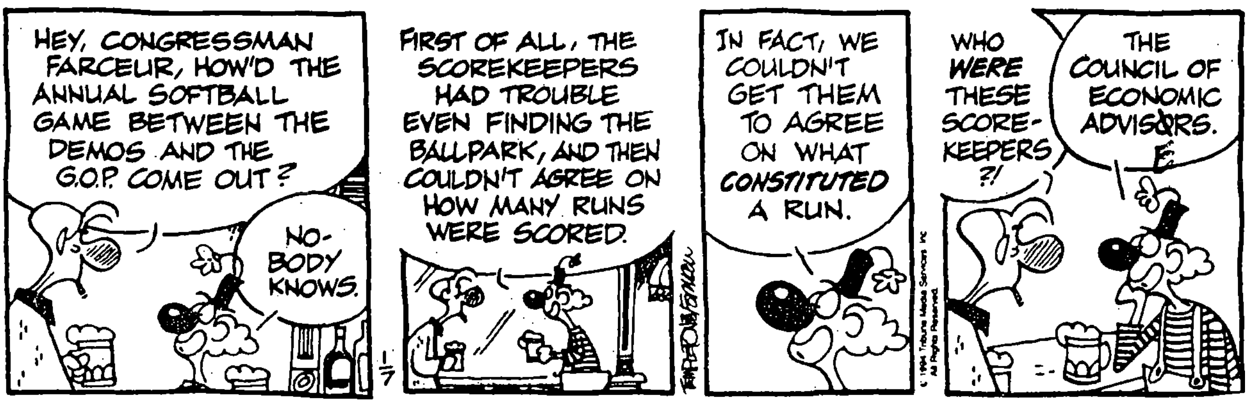
MOTLEY'S CREW



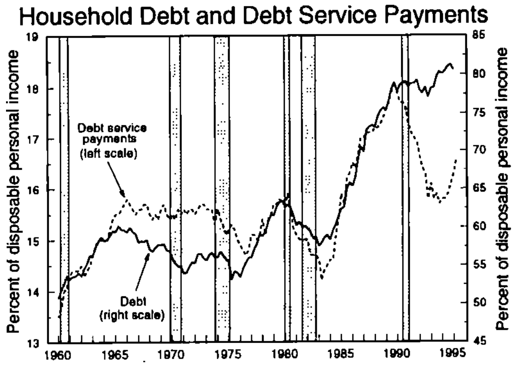
CURRENT DEVELOPMENT

Household Debt Rising, But Still Manageable

American households continue to take on debt, though the pace has eased somewhat in recent months. Rising debt has sparked some concern that consumers may soon cut back their spending, contributing to an economic slowdown.

Analysis. Debt recently has been growing roughly twice as fast as wages and salaries. Although the ratio of debt to income remains near its all-time high, the share of income devoted to servicing that debt is still well below the levels of the late 1980s (see top chart). Likewise, delinquency rates on mortgage and consumer installment loans are still far below the levels reached in the 1980s, and remain close to 20-year lows (see bottom chart). These indicators suggest that Americans are managing their debt effectively and that the increase in debt would not be expected to restrain spending.

Household Debt and Debt Service Payments



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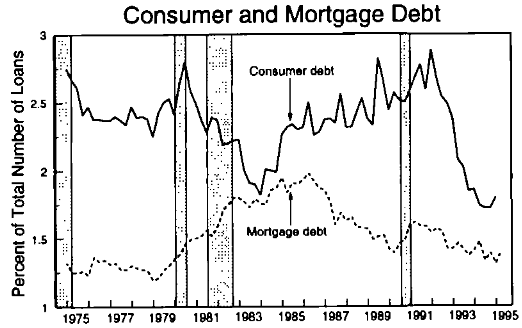
Delinquency Rates on
Consumer and Mortgage Debt



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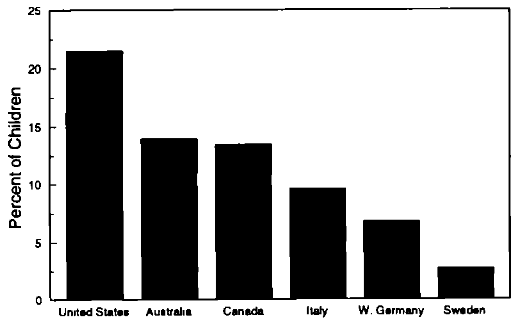
Debt service as a share of income has risen slightly over the past year, primarily as a result of increases in interest rates on home mortgages and consumer loans during 1994. The drop since January of about 1.5 percentage points in interest rates on fixed-rate mortgages, along with similar declines for adjustable-rate mortgages, should help moderate the recent uptick, keeping future debt burdens manageable. Because debt as a share of income remains close to its historical high, though, an unexpected move back up in interest rates could raise the debt burden quickly.

TREND

The State of Our Poorest Children

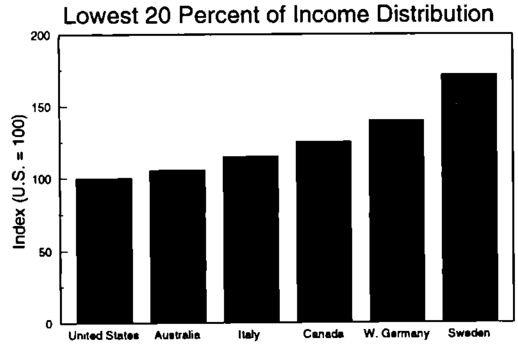
The recently released Luxembourg Income Study of children in 18 nations finds that poor children in the United States fare far worse than their counterparts in other countries. Using a relative measure of poverty—defined as the percent of children in families with incomes less than 50 percent of the country's median income—the United States has the highest child poverty rate, at 21.5 percent (see top chart). Australia comes in a distant second, with a child poverty rate of 14.0 percent.

Child Poverty Rates of Selected Countries in Recent Years



The reported high U.S. poverty rate would be less of a concern if our poorest children were still better off in absolute terms than the children of other countries. However, when comparing real spendable incomes of families with children, the study finds that, while children in our high- and middle-income families do extraordinarily well relative to those in other countries, children in our low-income families fare far worse (see bottom chart). Children in families in the poorest 20 percent of households in the United States are worse off than those in all other countries studied except for Israel and Ireland.

Income of Families With Children in the Lowest 20 Percent of Income Distribution



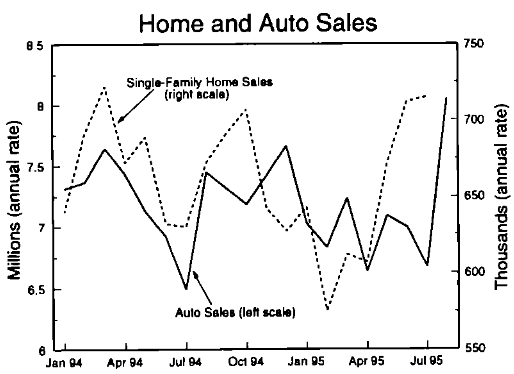
Analysis. The Luxembourg study's definition of income differs from official U.S. poverty statistics in that the study uses after-tax income, which includes the Earned Income Tax Credit and food stamps, whereas the official U.S. rate is based on before-tax income. As such, the Luxembourg poverty rate is closer in definition to that recommended by the National Research Council (see Weekly Economic Briefing, May 15, 1995). Accordingly, cuts proposed by the Republicans in the EITC and in welfare programs likely would raise U.S. poverty as measured in the Luxembourg study, worsening our already dismal international ranking. Moreover, the study's calculations do not include government-provided health care or other in-kind benefits; the inclusion of these benefits would likely exacerbate the relative standing of the poorest U.S. children.

MACROECONOMIC UPDATE

Expansion Regaining Momentum

The Department of Commerce recently revised upward its estimate of second-quarter growth in real GDP to 1.1 percent, so that growth over the first half of the year is now about one-half of a percentage point below potential. Sales of motor vehicles in August were sufficiently strong that the auto sector should no longer be a drag on GDP growth. Thus, GDP is likely to expand at a 2 to 2.5 percent rate over the second half of this year. An added bonus is that inflation has been quite low, in fact surprisingly so compared to most analysts' forecasts of inflation.

Analysis. Many factors have contributed to the slowdown in the economy during the first half of the year, including repercussions from the crisis in Mexico. But the slowdown in autos and housing was especially pronounced, due in large part to the interest rate hikes in 1994 through February of this year. Sharp declines in sales of autos and houses led to a build up in inventories and then to significant cutbacks in auto production and housing construction, depressing second-quarter growth. The declines in interest rates in recent months, which have boosted demand for autos and homes (see chart), as well as the production cutbacks, have allowed both sectors to work off their excess inventories. As a result, housing starts have been increasing of late, rising close to 7 percent in July, and residential construction is now poised to add to GDP growth for the first time this year. Similarly, recently announced auto production schedules suggest that this sector will no longer significantly restrain growth.



Risks to the forecast. Upside and downside risks to the forecast are fairly well balanced. On the upside, recent data show the manufacturing sector is finally rebounding at an impressive rate. This should boost incomes and generate additional spending throughout the economy. The major concern on the downside is the possibility of an impasse with respect to the appropriations bills or the failure to raise the debt ceiling. Although their direct impacts on growth are likely to be marginal, their repercussions in financial markets could be substantial (see Weekly Economic Briefing, August 4, 1995). Extreme reactions in debt or equity markets—markets where valuations have been known to deviate from economic fundamentals for sustained periods—could seriously impair consumer and business willingness and ability to spend.

ARTICLE

Tax Reform and the Tax Treatment of Housing

Recent proposals to reform the U.S. income tax system could have effects on many sectors of the economy. An important aspect of these effects are the costs associated with the transition to a new tax system. Transition costs must be carefully weighed against any benefits of proposed reforms. As an example of these transition costs, this article focuses on the impact of proposed changes in the tax treatment of housing. In particular, we consider the effects of eliminating the tax preference for housing, a change that is implicit in Representative Armey's proposed flat tax and other consumption tax proposals.

Current Tax System. Many people believe that the tax subsidy provided to owner-occupied housing derives solely from the deductibility of mortgage interest. More accurately, the subsidy also stems from the fact that the implicit rental income homeowners receive from their investment in housing is untaxed. Even taxpayers who have paid off their mortgages receive a substantial subsidy.

> Example. Consider an investor who buys a house for $100,000 that could be rented for $8,000 per year. Excluding tax considerations, that investor would be equally well off purchasing a $100,000 bond that paid $8,000 per year in interest, and renting a similar house for $8,000. However, the investor who purchases the house pays no tax on the return to the investment (the $8,000 in implicit rent), whereas the investor who rents and purchases a bond pays tax on the $8,000 of interest.
>
> Deductibility of mortgage interest. If the investor borrowed the $100,000, interest on that borrowing would be deductible regardless of whether the investor purchased a bond or purchased a house. Eliminating the deductibility of mortgage interest would, of course, wipe out the tax subsidy provided to homeowners with a mortgage, but would still leave a subsidy for homeowners without a mortgage.

The current tax system provides additional subsidies to housing by its preferential treatment of capital gains on housing and the deductibility of property taxes.

What is to be gained from reform? Proponents of changing the tax treatment of housing point to two benefits:

- **Efficiency effects.** The current tax system encourages people to become homeowners, but also encourages people to buy more costly houses. This biases investment toward housing at the expense of other potentially more productive investments, like plant and equipment investment. Eliminating this bias could, in the long run, increase the nation's productive capacity.

- **Distributional Effects.** The subsidy to housing primarily benefits middle- and upper-income households. For example, while less than 10 percent of all taxpayers have incomes of $100,000 or more, these taxpayers receive almost 50 percent of the total tax benefits associated with the deductibility of mortgage interest.

What is the cost of reform? Even if eliminating the tax subsidy to housing would have long-term beneficial effects, it could create significant transition costs:

- **Value of housing.** Eliminating the preferential tax treatment of housing most likely would cause the value of residential real estate to fall. Assessing the magnitude of the fall is difficult, and could vary substantially across different types of houses and across regions of the country. Nevertheless, a recent study concluded that replacing the current tax system with a flat tax (which would eliminate the tax preference to housing) would result in a 15 percent decline in home values.

- **Banking spillovers.** It is possible that the elimination of the mortgage interest deduction would make servicing mortgages more difficult for many homeowners, and could result in some increase in mortgage defaults. If the removal of the tax preference to housing were done in the context of a tax reform that generally lowered income taxes, the additional costs of mortgage payments might be offset by lower taxes on other income, and defaults might not pose a significant problem.

- **Macroeconomic effects.** Reducing the tax subsidy provided to owner-occupied housing would reduce the amount of wealth people devote to housing. This reduction in demand could result in a severe short-term contraction in the housing industry, which could spill over to other sectors of the economy. Again, the exact effects would depend on the other provisions of the tax reform.

Summary. Many people believe that the current tax system subsidizes investment in housing at the expense of investment in other forms of capital, such as factories and equipment. As a consequence, capital may be misallocated and economic growth may be lower than otherwise. Removing this subsidy, however, would generate significant transition costs. Incremental reductions in the subsidy provided to housing, however, might improve efficiency without causing severe disruptions in the housing market. Balancing long-term benefits against transition costs should be central to any consideration of tax reform.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

World Bank Report Focuses on Inequality within Families. A recently released World Bank policy paper finds that, while the past two decades have seen progress in the treatment of women worldwide, inequalities nonetheless persist between men and women. According to the report, unequal treatment of the sexes can result in a vicious circle in which households invest less in girls' education than in boys', perpetuating inequality. For example, if educated females earn less than similarly educated males, households will have an incentive to provide boys with more education than girls. This decision, however, can affect social outcomes for future generations because there is a strong correlation between women's education and the number of children they have, as well as the education and health of their children. Therefore, the report stresses that the government must play an important role by encouraging investment in women's education and health.

Fed Survey Suggests Stable Economy. The Federal Reserve's latest district-based Current Economic Conditions survey cites further expansion in economic activity with no clear change in underlying price pressures. After the last report suggested a slowdown in manufacturing, this one finds that industrial activity has stabilized and in some areas may now be strengthening. Many districts also report a pickup in construction. While business conditions appear soft in some sectors, like retailing and agriculture, the hot, dry summer weather commonly is blamed. Increases in consumer prices are somewhat restrained and suggest little acceleration in retail price pressures over the near term. Reinforcing this fact, the demand for labor is seen as growing moderately, with little unusual pressure on wage gains. Tourism and construction each appear to have performed favorably throughout the country.

$14,000 A Vote?!? A recent National Bureau of Economic Research working paper takes a novel approach to computing the effects of Federal spending in Congressional elections. While it is widely believed that bringing Federal expenditures to their districts helps incumbent Representatives get reelected, empirical evidence has been extremely weak. One explanation is that incumbents who anticipate a tough campaign may exert greater effort to obtain spending for their districts. Hence statistical analyses will be clouded by the fact that we observe greater Federal spending in districts whose incumbents are likely (for other reasons) to get a smaller share of the vote. Controlling for this problem, the paper shows that the effect of non-transfer spending (e.g., construction projects) is five times that measured with less adequate statistical techniques. An additional $100 per capita in non-transfer spending is worth as much as 2 percent of the popular vote—which can work out to as much as $14,000 a vote!

RELEASES THIS WEEK

Industrial Production and Capacity Utilization

****Embargoed until 9:15 a.m., Friday, September 15, 1995****

The Federal Reserve's index of industrial production rose 1.1 percent in August. Capacity utilization rose 0.6 percentage point to 84.3 percent.

Retail Sales

Advance estimates show that retail sales rose 0.6 percent in August following a 0.4 percent decline in July. Excluding sales in the automotive group, retail sales were basically unchanged in July and August.

Consumer Price Index

The consumer price index increased 0.1 percent in August. Excluding food and energy, consumer prices rose 0.2 percent.

Producer Price Index

The producer price index for all finished goods decreased 0.1 percent in August. Excluding food and energy, producer prices increased 0.1 percent.

MAJOR RELEASES NEXT WEEK

Housing Starts (Tuesday)
U.S. International Trade in Goods and Services (Wednesday)

U.S. ECONOMIC STATISTICS

	1970–1993	1994	1994:4	1995:1	1995:2
Percent growth (annual rate)					
Real GDP:					
Fixed weights	2.5	4.1	5.1	2.7	1.1
Chain weights	2.7	3.7	4.0	1.7	0.5
GDP implicit price deflator:					
Fixed weights	5.5	2.3	1.3	2.2	1.6
Chain weights*	5.4	2.7	2.5	2.8	2.2
Productivity, nonfarm business (NFB):					
Fixed weights	1.2	1.8	4.3	2.5	4.8
Chain weights	1.4	0.9	1.4	0.2	2.9
Real compensation per hour (NFB):					
Using CPI	0.6	0.6	1.5	1.0	0.1
Using NFB deflator:					
Fixed weights*	1.1	1.1	2.9	2.9	2.1
Chain weights*	1.2	0.7	2.2	1.8	1.4

* CEA estimates.

	1970–1993	1994	1994:4	1995:1	1995:2
Shares of Real GDP (percent)					
Business fixed investment	11.0	12.6	13.0	13.6	13.9
Residential investment	4.7	4.3	4.3	4.2	4.0
Exports	8.0	12.3	12.8	12.9	13.1
Imports	9.2	14.4	14.8	15.1	15.4
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	3.4	3.8	2.9
Federal surplus	−2.8	−2.4	−2.3	−2.1	−1.8

	1970–1993	1994	**June 1995**	**July 1995**	**August 1995**
Unemployment Rate	6.7**	6.1**	5.6	5.7	5.6

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

	1970–1993	1994	June 1995	July 1995	August 1995
Payroll employment (thousands)					
increase per month			299	6	249
increase since Jan. 1993					7325
Inflation (percent per period)					
CPI	5.8	2.7	0.1	0.2	**0.1**
PPI-Finished goods	5.0	1.7	−0.1	0.0	**−0.1**

New or revised data in **boldface**.

FINANCIAL STATISTICS

	1993	1994	July 1995	Aug. 1995	Sept. 14, 1995
Dow-Jones Industrial Average	3522	3794	4685	4639	4802
Interest Rates					
3-month T-bill	3.00	4.25	5.42	5.40	5.28
10-year T-bond	5.87	7.09	6.28	6.49	6.08
Mortgage rate, 30-year fixed	7.33	8.36	7.61	7.84	7.60
Prime rate	6.00	7.15	8.80	8.75	8.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level Sept. 14, 1995**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.485	+0.6	−3.5
Yen-Dollar	102.6	+4.0	+3.5
Multilateral $ (Mar. 1973=100)	86.88	+0.9	−1.1

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.2 (Q2)	5.6 (Aug)	2.6 (Aug)
Canada	2.5 (Q2)	9.8 (Jul)	2.5 (Jul)
Japan	0.1 (Q1)	3.2 (Jun)	0.3 (Jun)
France	2.9 (Q2)	12.4 (Apr)	1.4 (Jul)
Germany	2.1 (Q2)	6.5 (May)	2.3 (Jul)
Italy	4.0 (Q1)	12.2 (Apr)	5.7 (Jul)
United Kingdom	2.8 (Q2)	8.8 (Jul)	3.5 (Jul)

EYES ONLY

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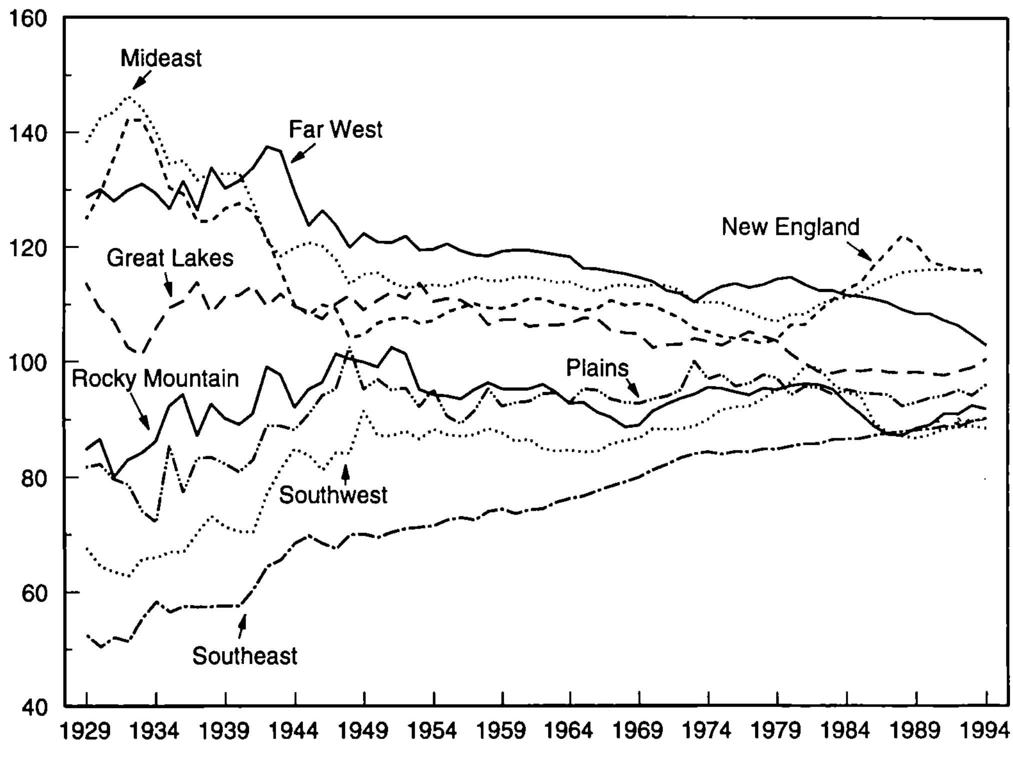

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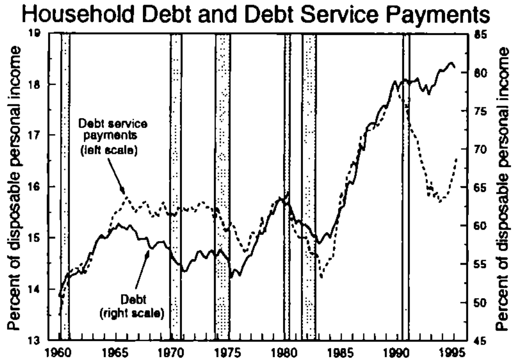

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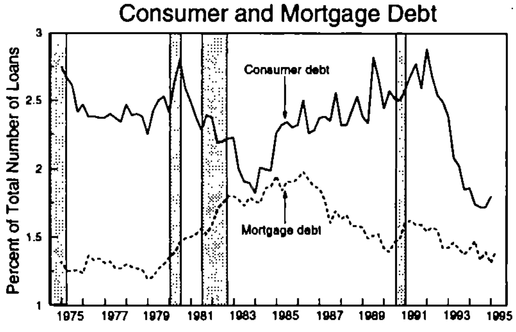

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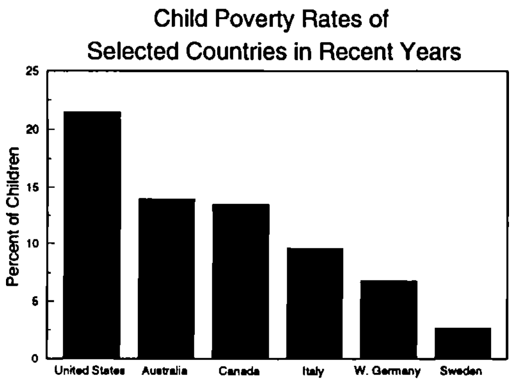

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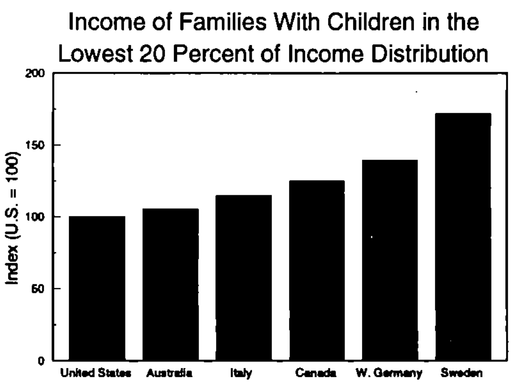

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