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# WEEKLY ECONOMIC BRIEFING *BE* OF THE PRESIDENT OF THE UNITED STATES

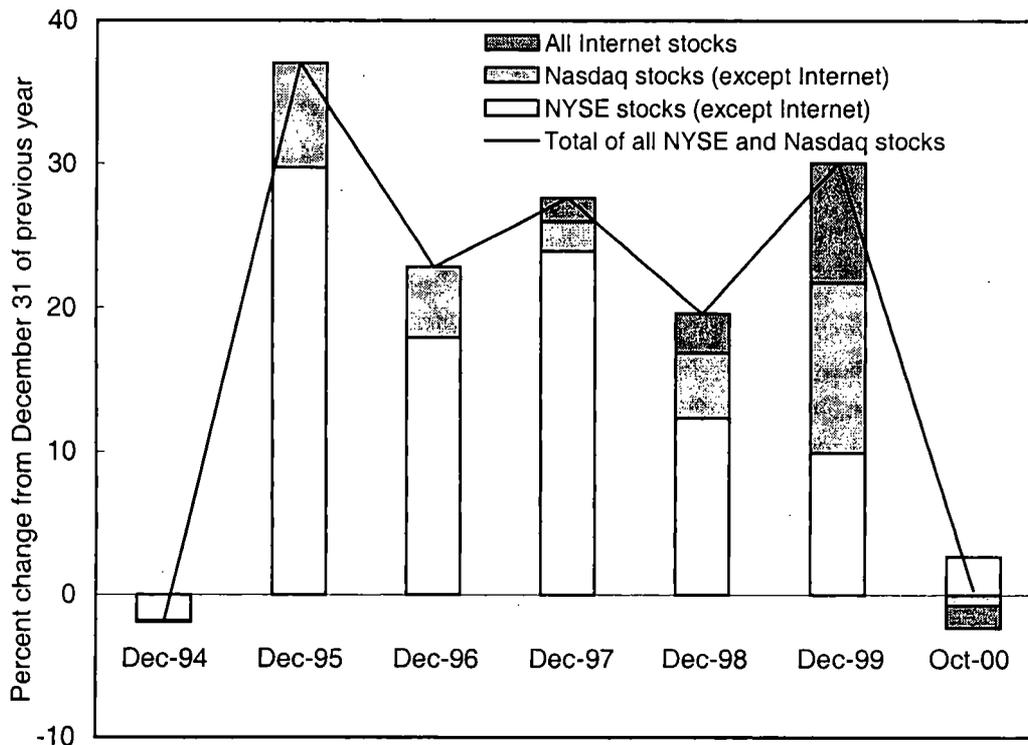
Prepared by the Council of Economic Advisers  
with the assistance of the Office of the Vice President

December 1, 2000

*Copied  
Bailey  
Podesta*

## CHART OF THE WEEK

### Changes in Stock Market Capitalization



At the end of October the total market capitalization of stocks traded on the New York Stock Exchange (NYSE) and the Nasdaq Stock Market was largely unchanged from its level at the end of 1999. Increases in the market value of non-Internet NYSE stocks offset declines in Internet and other Nasdaq stocks—in contrast to 1998 and 1999 when Internet and other Nasdaq stocks were important sources of growth in stock market capitalization.



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*"If you would like to press one, press one now. If you would like to press two, press two now. If you would like to press no numbers, you may press no numbers and hang up if you wish and have a nice day."*

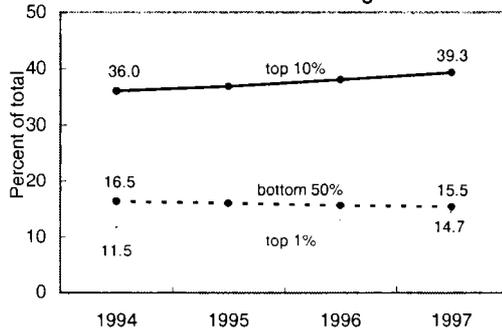
## SPECIAL ANALYSIS

### Real Incomes Growing Strongly, Even After Taxes

As the economy has boomed, household incomes have grown substantially, even in real terms. But tax revenues have surged as well, leading to questions of whether gains in *after-tax* incomes can be large, especially for highest-income households who pay a large fraction of individual income taxes. Recent Federal tax return data provide some evidence about what has happened to real, after-tax incomes through tax year 1997. In contrast to Census data that measure a wide range of income concepts but lack complete information on the very highest-income households, tax return data contain detail on the reported incomes (including capital gains) of all tax filers and are thus particularly useful for examining trends at the top end of the income distribution.

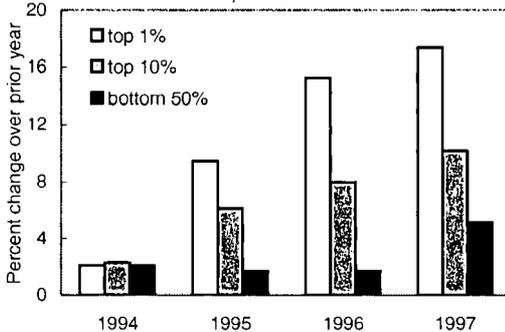
**Tax shares have risen at the top, but so have after-tax income shares.** Tax return data show that higher-income households do indeed pay a large share of Federal income taxes and that over the 1990s, their share of taxes has grown. The fraction of total individual income taxes paid by the top 1 percent of tax filers (those with adjusted gross incomes (AGI) of at least \$250,736 in 1997) increased from one-fourth in 1990 to one-third in 1997. The tax shares paid by the top 5 percent (AGI over \$108,048) and the top 10 percent (AGI over \$79,212) grew as well, almost entirely because of the top 1 percent's contribution. In contrast, the share of individual income taxes paid by the bottom 50 percent of filers (AGI below \$24,393 in 1997) was 5.8 percent in 1990, and fell to 4.3 percent in 1997.

After-Tax Income Shares Among Tax Filers



Despite the higher shares of taxes paid by the rich, their shares of after-tax, real incomes have increased as well. After-tax income shares have grown significantly at the top, such that the top 1 percent of tax filers now receive nearly as much after-tax income as the bottom 50 percent (see upper chart).

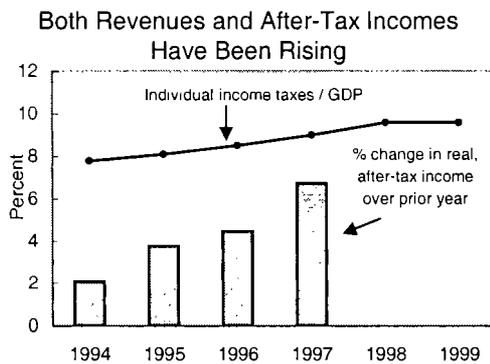
Growth in Real, After-Tax Incomes



**But real, after-tax incomes have grown for all tax filers.** Although the after-tax income share of highest-income households has increased, this has not come at the cost of reductions in incomes for other people. Between 1993 and 1997, all tax filing groups—including the bottom 50 percent—experienced real, after-tax income growth (see lower chart). In contrast to an average annual growth rate in real, after-tax income of only 0.4 percent for

this group over 1986-93, the annual growth rate averaged 2.6 percent over 1993-97. The increased skewness of after-tax income shares is due to even faster growth in real, after-tax incomes for the highest-income households; from 1996 to 1997 alone, real, after-tax income rose over 17 percent for the top 1 percent of tax filers.

**Even as revenues have surged.** Because the income tax system is progressive, overall increases in before-tax real incomes—and the particularly high growth at the top—have contributed to a rise in individual income tax revenues as a share of GDP. This has occurred without any increase in statutory tax rates. It is



noteworthy that both revenues as a share of GDP and *after-tax* incomes rose over the 1993-97 period (see chart). The last time real, after-tax incomes grew by more than 5 percent in 1 year (1987-88), the gains across households were much more skewed, and individual income taxes as a share of GDP *fell*. In the early 1990s, real, after-tax incomes and revenues relative to GDP *both* fell.

**Conclusion.** When incomes grow, so do taxes paid. The income gains of the highest-income households have far more than offset their increased tax liabilities. Their real incomes, *even after taxes*, have been growing at an accelerating pace. The rest of tax filers have seen growth in real, after-tax incomes as well, albeit more modest. In fact, the unique experience of the 1993-97 period is that we have seen strong growth in revenues relative to GDP, while real, after-tax income growth appears to be quite widespread.

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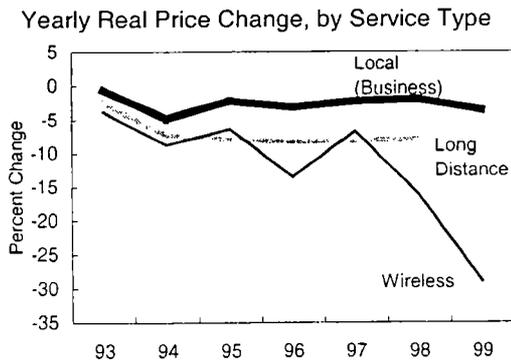
SPECIAL ANALYSIS

**Local Telephone Markets: Whither Competition?**

Local telephone markets are starting to become open to competition. In 1993 there were 20 “competitive local exchange carriers” (CLECs) challenging the incumbent carriers; in 1999 there were 298. However, introducing competition into local wireline markets is among the most difficult challenges facing telecommunications policymakers. CLEC share prices have fallen sharply this year, leading to fears that local-market competition will never be viable. While these fears are unwarranted, significant challenges remain.

**The challenges.** Competition has not emerged as quickly as many had hoped, but this should not be entirely surprising. Of all telecommunications markets, local wireline markets are probably the most difficult to open. For many years, a single monopoly carrier had served each local market. Building a brand-new network from scratch is expensive and inefficient, so entrants must arrange to share existing facilities. The regulatory structure is complex, with authority shared between the FCC and the states. Given these constraints, no piece of legislation could make strong competition emerge overnight. However, progress is being made. Despite the recent drop, the market capitalization of the CLEC sector remains large, suggesting that investors still perceive them to be viable alternatives to the incumbent local carriers.

**The 1996 Telecommunications Act.** The Telecommunications Act encouraged incumbents to open their networks to competitors by prohibiting them from entering the long-distance market until the FCC deemed their local markets to be sufficiently open. The Act provided three specific channels for CLECs to access local customers by using parts of the existing network infrastructure. First, incumbents were required to separate, or “unbundle,” their components (lines, switches, etc.) and make any or all available for leasing to CLECs at cost-based wholesale prices. Second, CLECs were allowed to buy and resell the incumbents’ existing retail services. Third, CLECs that constructed or purchased their own lines or other equipment were allowed to connect to the incumbents’ existing networks at “reasonable” prices.



**Consequences for local competition.** Evidence on local-market competition is mixed. While prices for highly competitive long-distance and wireless devices have fallen sharply, prices for local wireline service have declined only slightly (see chart). Many new CLECs have emerged, but they serve relatively few customers. At the end of 1999, CLECs claimed only about 4 percent of local telephone lines. Still,

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this represents considerable progress. Local service revenue of CLECs nearly doubled from \$2.4 billion in 1998 to \$4.5 billion in 1999. Moreover, given the increasing availability and affordability of wireless service, along with the potential for competition from cable TV providers (who already have their own rival networks), these figures understate the actual degree of competition in local markets.

**Why isn't local-market competition emerging faster?** Companies seeking to enter local wireline markets face several challenges. One is incumbent compliance. So far, incumbents in only 8 states have sought to demonstrate compliance with Section 271 of the 1996 Act. More generally, the Telecommunications Act left in place a complex layer of regulation involving 50 state authorities, the FCC, and the Federal courts. Universal-service requirements keep residential prices artificially low, giving CLECs the incentive to focus instead on more lucrative business customers. The use of cost-based wholesale prices (as opposed to price caps) for unbundled incumbent services may also have discouraged incumbents from investing in cost-reducing innovations. Finally, the rapid pace of technological change in the telecommunications industry and the emergence of strong competitors such as wireless communications have made CLECs reluctant to invest in the necessary equipment.

**Future prospects.** Over the past 3 years, the strong financial market performance of CLECs suggests that investors expect these competitors to make additional inroads into local markets. However, the market for CLEC shares has been extremely volatile. In 1998 and 1999 the CLEC sector rose roughly 295 percent, handsomely outperforming the broader market. But since the beginning of this year, CLEC shares have declined roughly 65 percent. By comparison, the telecom sector as a whole has fallen nearly 55 percent for the year. Some industry analysts suggest that the CLEC sector is entering a "shakeout" period, with some consolidations and bankruptcies, as is typical in emerging industries.

ARTICLE

## The New Economy Helps the Old Economy

While much has been written about the IT sector and the dot.coms of the New Economy, little has focused on how the “old economy” has benefited from the IT revolution. The machine tool industry is one of the most basic and long-lived of our manufacturing industries. Using IT embedded in its capital equipment, this industry has consistently reduced production costs over the 1990s, thus retaining its levels of employment. However, the increasing use of IT has resulted in a need for more highly trained machinists.

**Performance gains in the machine tool industry.** This industry makes the machines used in manufacturing production, and thus improvements in the quality and capability of its products can result in productivity gains for all of manufacturing. Annual productivity growth for the industry averaged -0.2 percent from 1979 through 1990, and rose to about 2.5 percent from 1990 through 1998. But these figures underestimate the performance gains from improvements in factors such as reduced inventories and higher quality products.

One small component of the industry is valve production. Used to control the flow of liquids or gases in pipelines, valves are used extensively throughout industry. Manufacturing data described below from a typical valve-making firm document pronounced productivity gains in three primary areas of the firm: new product design, production, and inspection.

**New product design.** Product design is a primary element of production, because valve producers often make very specialized products. In the 1990s, valve-producing firms switched from two-dimensional CAD/CAM software programs to three-dimensional CAD/CAM software that shows a solid model of the valve rather than a 2-D representation, thus enormously facilitating rapid design. The 3-D software also allows all properties of the valve—such as stress loads and the center of gravity—to be calculated automatically, eliminating the need to produce extensive manual calculations. It also eliminates the need to produce demonstration prototypes and significantly improves design quality. A typical firm can reduce the design period by more than 50 percent and cut the number of required engineers and draftsmen on each new product design by 30 percent—or achieve more work with the same staffing levels.

**New production methods.** Numerically controlled (NC) machines were introduced about 30 years ago, but the latest models of Computer Numerical Control (CNC) machines are much more efficient. They are run by sophisticated software with a simple graphical user interface that enables operators to produce typical complicated parts in a day, compared to the 4 days it would take prior to adopting these new machines.

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**High-tech inspection.** Each dimension of a complicated valve often must be produced to an accuracy rate of 1/1000 of an inch, so inspection is a critical part of the production process. For many years, inspection was done with time-consuming manual measuring devices. In the past few years, probe technology has been incorporated into inspection machines. Using these machines the operators touch each surface (interior, exterior, holes, etc.) of the valves with probe, producing a 3-D image that allows precise measurement of all dimensions. Using this technology, the inspection time for a typical, complicated valve part fell from 20 hours to 4 hours.

**The importance of IT.** The new machines used in valve production are run by sophisticated software programs requiring high-speed computing and extensive data storage. These machines are now available and affordable because the costs of computing have plummeted, and because capital goods makers have developed software to harness this inexpensive computing power. Thus, the performance improvement in valve production is partly the result of high levels of specific new investments, but is also due to broader improvements in IT.

**Conclusion.** The machine tool firms most likely to flourish in the United States are those that produce customized products using sophisticated IT-based production techniques and skilled labor. Firms producing commodities have an incentive to move abroad seeking lower costs. Employment in machine tools pays well and has grown modestly in the 1990s. However, the industry now requires more skilled machinists with problem-solving skills and some computer knowledge, which are taught at community colleges and technical institutes. Individuals usually pay for this training themselves, because many firms are unwilling to make such investments given the possibility that employees could leave before returns are fully realized. Skills of machine operators or draftsmen are in less demand.

## BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

**Student Loan Debt Not a Big Burden for College Grads.** When surveyed in 1997, 39 percent of students who had received bachelor's degrees in 1992-93 were still paying off their college loans. Another 16 percent had finished paying back their loans, and 46 percent never had such loans. Of debtors who had not pursued further education by 1997, 90 percent were employed full-time, and their loan payments amounted to an average of 5 percent of income each month. Those who had borrowed at least \$5,000 for their undergraduate education were less likely to undertake further education within a year of graduating, even after controlling for age, sex, race, GPA, major, and type of undergraduate school. By 1997, however, there were no significant differences in graduate enrollment, marriage rates, car ownership, or homeownership between undergraduate borrowers and non-borrowers, although those still enrolled in graduate school and not repaying debts were less likely to own a home. While debt burdens associated with obtaining bachelor's degrees appear low, they are substantially higher for students who borrow in pursuit of graduate or professional degrees.

**House Prices Rise When Schools Get Good Grades.** A recent analysis examines the effect of school ratings on housing values, focusing on the experience in Florida with their new report-card grading system. Based on a detailed data set on house prices from the Gainesville metropolitan area, the authors find that the letter grade received by a school is capitalized into neighborhood housing prices, even after controlling for other publicized measures of school quality (such as students' test scores) and other factors affecting housing value. The analysis reveals that in the Gainesville area, the distinction between a grade of "A" and a grade of "B" translates into a house price differential of over \$9,000 on average (or roughly 8 percent of the average house price in Gainesville). The effects are stronger for larger houses and houses in higher-valued neighborhoods.

**Labor Markets Are Absorbing Former Welfare Recipients Without Displacing Other Less-Educated Workers.** Despite the increasing number of former welfare recipients looking for work, labor demand has been strong enough that unemployment rates for single mothers have actually fallen sharply. A new study finds this trend has held even in large metropolitan areas, and that in these areas the increased labor-force participation of single mothers did not reduce employment or wages of other less-educated workers. The authors speculate that along with the boom of the economy, demographic factors have played an important role in providing jobs for former welfare recipients. Young entrants into the labor market are more highly educated (and thus unlikely to be competing for low-skill jobs), while relatively less-educated, older workers are retiring.

## INTERNATIONAL ROUNDUP

**OECD Predicts Slowing World Economy.** A preliminary edition of the OECD Economic Outlook projects that output growth for OECD countries will slow to about 3.3 percent in 2001, down from approximately 4.3 percent this year. The U.S. economy is expected to weaken considerably, from a GDP growth rate of 5.2 percent in 2000 to 3.5 percent in 2001. Next year, output growth in the European Union is projected to drop by 0.4 percent to 3.0 percent, while Japan's nascent recovery picks up, boosting growth to 2.3 percent. Inflation is predicted to remain moderate across the OECD. Unemployment rates are expected to fall in most regions, but the rate in the United States is projected to rise 0.2 percent to 4.2 percent in 2001. The United States will also likely keep its large current account deficit, while world trade is expected to grow 9.7 percent next year (compared to a 13.3 percent increase this year). The OECD cautions that its predictions rely on oil prices moderating somewhat and continuing stability in financial markets.

**Economic Conditions Affect Filings for Trade Relief.** New research finds that macroeconomic factors—specifically the growth rate of GDP and the real exchange rate—have significant impacts on antidumping filings. The analysis looked at Australia, Canada, the European Union, and the United States (all substantial users of antidumping relief) over the period 1980-98. A one-standard-deviation real appreciation of the domestic currency was associated with a 33 percent increase in filings. A two-standard-deviation appreciation was correlated with a 77 percent rise. This suggests that firms believe they are injured by relatively cheap imports and thus seek antidumping action. In addition, the paper found that a one-standard-deviation decrease in real GDP growth led to a 23 percent increase in filings. A slowing economy clearly damages firm profits, potentially leading to more antidumping complaints. Moreover, a weaker importing economy might cause foreign firms to reduce prices on shipments to that economy.

**New Economy Is Starting to Lift EU Growth.** A European Commission report finds that the New Economy is having an increasingly positive effect on growth in the European Union. Information and communications technology (ICT) added less than 0.3 percentage points to output growth over the 1992-94 period, but 0.5 percentage points over 1995-99. The contribution to growth in the later period exceeds that of the United States in the earlier period, suggesting that the European lag in ICT diffusion may be less than 5 years. However, the growth effects of ICT in the EU still remain substantially below those in the United States where ICT accounted for nearly 0.9 percentage points of output growth over 1995-99. There remains substantial variation across EU countries. The New Economy added an astounding 1.9 percentage points to growth in Ireland over 1995-99, making it the only European country in which ICT contributed more than in the United States. However, Ireland is truly an exception, as its ICT contribution is about three times greater than in Sweden, which ranked second in this measure. At the other extreme, ICT added just 0.2 and 0.4 percentage points to growth in Greece and Denmark, respectively.

## RELEASES THIS WEEK

### **NAPM Report on Business**

**\*\*Embargoed until 10:00 a.m., Friday, December 1, 2000\*\***

The Purchasing Managers' Index fell 0.6 percentage point to 47.7 percent in November, the fourth consecutive month below 50 percent. (A reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent that it is generally declining.)

### **Gross Domestic Product**

According to revised estimates, real gross domestic product grew at an annual rate of 2.4 percent in the third quarter.

### **Advance Durable Orders**

Advance estimates show that new orders for durable goods fell 5.5 percent in October, following an increase of 2.4 percent in September.

### **Consumer Confidence**

Consumer confidence, as measured by The Conference Board, fell 2.3 index points in November, to 133.5 (1985=100).

## MAJOR RELEASES NEXT WEEK

Leading Indicators (Monday)  
Productivity (Wednesday)  
Employment (Friday)

## U.S. ECONOMIC STATISTICS

	1970- 1993	1999	2000:1	2000:2	2000:3
<b>Percent growth</b> (annual rate)					
Real GDP (chain-type)	2.9	5.0	4.8	5.6	<b>2.4</b>
GDP chain-type price index	5.2	1.6	3.3	2.4	<b>1.9</b>
<u>Nonfarm business (NFB) sector:</u>					
Productivity (chain-type)	1.7	4.1	1.9	6.1	3.8
Real compensation per hour:					
Using CPI	1.0	2.2	-0.2	2.2	3.2
Using NFB deflator	1.5	3.3	1.1	4.0	4.3
<b>Shares of Nominal GDP</b> (percent)					
Business fixed investment	11.4	12.9	13.4	13.7	<b>13.9</b>
Residential investment	4.5	4.3	4.3	4.2	4.1
Exports	8.2	10.6	10.8	11.0	11.3
Imports	9.2	13.4	14.2	14.6	<b>15.1</b>
Personal saving	6.6	1.6	0.1	0.2	-0.2
Federal surplus	-2.8	1.3	2.4	2.4	<b>2.5</b>

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	1970- 1993	1999	August 2000	September 2000	October 2000
<b>Unemployment Rate</b> (percent)	6.7**	4.2**	4.1	3.9	3.9
<b>Payroll employment</b> (thousands)					
increase per month			-79	195	137
increase since Jan. 1993					22358
<b>Inflation</b> (percent per period)					
CPI	5.8	2.7	-0.1	0.5	0.2
PPI-Finished goods	5.0	2.9	-0.2	0.9	0.4

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

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New or revised data in **boldface**.

## FINANCIAL STATISTICS

	1998	1999	October 2000	November 2000	Nov. 30, 2000
<b>Dow-Jones Industrial Average</b>	8626	10465	10441	10666	10414
<b>Interest Rates</b> (percent per annum)					
3-month T-bill	4.78	4.64	6.11	6.17	6.03
10-year T-bond	5.26	5.65	5.74	5.72	5.48
Mortgage rate, 30-year fixed	6.94	7.43	7.80	7.73	7.65
Prime rate	8.35	8.00	9.50	9.50	9.50

## INTERNATIONAL STATISTICS

Exchange Rates	Current level	Percent Change from	
	November 30, 2000	Week ago	Year ago
Euro (in U.S. dollars)	0.869	3.7	-13.7
Yen (per U.S. dollar)	110.9	-0.4	9.0
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. \$)	102.9	-1.6	10.3

International Comparisons <sup>1/</sup>	Real GDP growth	Unemployment rate	CPI inflation
	(percent change last 4 quarters)	(percent)	(percent change in index last 12 months)
United States	5.3 (Q3)	3.9 (Oct)	3.4 (Oct)
Canada	5.0 (Q3)	6.8 (Sep)	2.8 (Oct)
Japan	0.8 (Q2)	4.7 (Sep) <sup>2/</sup>	-0.8 (Sep)
France	3.1 (Q3)	9.5 (Sep) <sup>2/</sup>	1.9 (Oct)
Germany	3.4 (Q3)	8.2 (Sep)	2.4 (Oct)
Italy	2.4 (Q3)	10.6 (Jul)	2.6 (Oct)
United Kingdom	2.9 (Q3)	5.3 (Jul)	3.1 (Oct)

1/ For unemployment data, rates approximating U.S. concepts as calculated by the U.S. Department of Labor, Bureau of Labor Statistics, except as noted in footnote 2.

2/ Data from OECD standardized unemployment rates.